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Expanding Access to Finance

Good Practices and Policies for
Micro, Small, and Medium Enterprises

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by

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WBI Learning Resource Series

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Foreword

This book provides policy recommendations to governments on how to deepen and broaden financial systems so that enterprises ranging from the most micro to small and medium enterprises can access financing and contribute to overall economic development and growth. This work is unique in that its policy recommendations are based on World Bank Group research and analysis and on the practical experiences of innovative financial institutions around the world.

Micro, small, and medium enterprises rightly assert that lack of access to finance is an important factor that constrains their growth. Financial institutions view this market segment as high risk and expensive to reach—the transaction costs of making a small loan are as high as those involved in making a large loan—and typically lack the know-how and risk management techniques required to serve small clients who lack financial track records or collateral. In addition, well-intentioned financial sector policies often hurt rather than help. For example, interest rate ceilings limit the viability of serving this market segment, and capital adequacy requirements penalize lending without traditional collateral requirements.

This book lays out a market-based policy framework that governments can use to address these constraints, pointing to the empirical evidence of how countries as diverse as Armenia, Brazil, Indonesia, and Mongolia have built solid financial institutions and increased poor people's access to finance by following elements of the proposed policy framework. The 13 case studies are in their own right a guide for financial institutions wishing to emulate and learn from others' successes.

I hope *Expanding Access to Finance* will help inform the financial innovations taking place across the world. The World Bank Institute has already drawn on this book to guide discussions on how to build inclusive financial systems

with the aim of increasing the poor's participation in, contributions to, and benefits from the broader economy.

FRANNIE LÉAUTIER
Vice President and Head
World Bank Institute

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This book draws extensively on substantial research by the World Bank Group, mainly the Development Economics Vice Presidency; the Small and Medium Enterprise Department of the International Finance Corporation; and case studies prepared by the Consultative Group to Assist the Poor. It has been guided by a peer group consisting of Thorsten Beck, Vajanti Desai, Laurie Efron, Heywood Fleisig, Kris Hallberg, Anjali Kumar, Bikki Randhawa, Ravi Ruparel, William Steel, Peer Stein, Luc Vaillancourt, and Leila Webster. The authors would like to give special thanks to William Steel for providing additional guidance. The cases were compiled from existing materials, with additional information from the organizations concerned. The authors would like to thank all the financial institutions involved for sharing their experience so generously toward the common cause of building inclusive financial systems to increase access. Last but not least, many thanks to Alice Faintich for her meticulous editing and to Benjamin Chan for his great help throughout the preparation of this book.

Abbreviations

ACBA	Agricultural Cooperative Bank of Armenia
AG BANK	Agricultural Bank of Mongolia
BRI	Bank Rakyat Indonesia
CGS	credit guarantee scheme
CSFP	Caucasus Small and Medium Enterprise Finance Program
DELP	developing enterprise loan product
EU	European Union
FNG	<i>Fondo Nacional de Garantías</i>
GDP	gross domestic product
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IFI	intermediary financial institution
KSBP	Kazakhstan Small Business Program
MSMEs	micro, small, and medium enterprises
NAFIN	<i>Nacional Financiera</i>
PAR	portfolio-at-risk
SBI	ShoreBank International, Ltd.
SEAF	Small Enterprise Assistance Funds
SEED	Southeast Europe Enterprise Development Facility
SMEs	small and medium enterprises
SOA	ShoreBank Overseas Azerbaijan
TA	technical assistance
TACIS	Technical Aid to the Commonwealth of Independent States Program
TBC	Tbilisi Business Center
USAID	U.S. Agency for International Development

I. Introduction

This book on micro, small, and medium enterprise (MSME) finance is intended primarily for government policy makers.¹ It presents a policy framework whereby governments can support increased access by MSMEs to financial services based on empirical evidence and practices.² MSMEs complain that lack of access to finance constrains their growth and competitiveness. Indeed, financial sector policies often work against the ability of commercial financial institutions to serve MSMEs, albeit often unintentionally. In many countries, lack of competition in the banking sector limits pressure on banks to reach out to MSME client segments. High risk and high transaction costs—real or perceived—associated with bank lending to MSMEs likewise constrain access. Often, supervisory and capital adequacy requirements penalize banks for lending to enterprises that lack traditional collateral. Would-be MSME borrowers often have no financial track record and are unable to provide reliable information, while banks lack the appropriate instruments for managing risk and face difficulties in enforcing contracts because of inadequate legal frameworks and inefficient court systems. Most important, banks typically lack the know-how to reach the MSME market segment.

Attempts by governments to address these constraints and offset the inequalities in financial sector policy generally have not achieved the desired results. This book lays out a market-based policy framework for governments that focuses on delivery of financial services to MSMEs on commercial terms.

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1. This publication is part of a larger compendium of materials on MSME development prepared by the World Bank Institute's Investment Climate Program. The three other companion papers are Criscuolo (2004a, 2004b) and Jacobs (2005).
 2. The abbreviation MSMEs will be used when referring to the full range of micro, small, and medium enterprises and SMEs will be used when the focus is on enterprises with between 11 and 300 employees.

The framework guides governments in focusing scarce resources on developing an inclusive financial sector policy; building sound financial institutions; and investing in a supportive information infrastructure, such as credit bureaus and accounting standards. Examples from around the world illustrate how such a strategy has helped build more inclusive financial systems for all.

II. The Mismatch between MSMEs' Demand for and Financial Institutions' Supply of Quality Financial Services

Over the past two decades, MSMEs have become targets of policies aimed at promoting economic growth and employment in developing countries. Governments and donor agencies have advocated paying special attention to MSMEs given their particular contribution to poverty reduction, employment generation, and private sector development. Despite this growing interest, the debate on MSMEs remains controversial within the development community, especially in light of the poor results of traditional pro-MSME policies. In particular, the conceptualization of MSME assistance in terms of welfare and social protection rather than firm efficiency and sustainability has led to overly protectionist policies that have actually hindered development of the private sector. Dissatisfaction on the part of both governments and the private sector with these MSME policies and the lack of clear evidence about the contribution of MSMEs to economic growth and development (Beck, Demirgüç-Kunt, and Levine 2004) may lead policy makers to dismiss the entire MSME agenda.

MSME advocates increasingly point to the contribution of MSMEs to private sector-led economic development and poverty reduction in terms of job creation, innovation, higher productivity, and greater social equality. They argue that this is the case because MSMEs represent a large segment of the private sector; contribute significantly to employment and gross domestic product (GDP); and provide the only employment and income source for many poor households, disproportionately so for women.³ Others argue that insufficient

3. "Recent empirical studies show that SMEs contribute to over 55 percent of GDP and over 65 percent of total employment in high-income countries, SMEs and informal enterprises account for over 60 percent of GDP and over 70 percent of total employment in low-income countries, while they contribute over 95 percent of total employment and about 70 percent of GDP in middle-income countries" (OECD 2004a, p. 11).

attention has been paid to conducting impact assessments to verify these claims (Batra and Mahmood 2003).

This book goes further in arguing for support for MSME finance on the grounds of deepening and broadening financial sector development to build inclusive financial systems that work for the majority of the population and thereby facilitate pro-poor, private sector-led growth. It identifies the key constraints to access to finance by MSMEs and indicates how to correct financial policies that often inadvertently restrict MSME financial institutions. It does not argue for a pro-MSME finance policy, but rather for a neutral and level playing field for all financial institutions and products.

SME Definitions

This book takes a broad view and defines MSMEs as independent businesses that are managed mainly by their owners and that have limited access to finance from formal financial markets. It focuses on SMEs, which are generally likely to be registered entities, and on microenterprises, which are typically informal and are defined as having fewer than 10 employees. Inclusion of the latter is important, because microfinance methodologies as adopted by some commercial financial institutions can provide useful lessons for SME finance, such as repeated small, unsecured loans; lending based on cash flow analysis; intense loan monitoring; and client follow-up. Furthermore, the underlying reasons for credit rationing by formal financial institutions to both microenterprises and SMEs are similar, including lack of reliable information, lack of traditional collateral, and weak property rights and contract enforcement (Holtmann, Rühle, and Winkler 2000).

MSME definitions are context specific, and thus vary by country.⁴ They are typically based on the number of employees, the value of sales, and/or the value of assets (OECD 2004b). Table 2.1 presents the definitions used by the World

Table 2.1. World Bank Group Definitions of Types of Enterprises

<i>Type of enterprise</i>	<i>Number of employees^a</i>	<i>Extent of total assets^a</i>	<i>Annual turnover^a</i>
Microenterprise	1–10	Less than US\$100,000	Less than US\$100,000
Small enterprise	11–50	Between US\$100,000 and US\$3 million	Between US\$100,000 and US\$3 million
Medium enterprise	51–300	Between US\$3 million and US\$15 million	Between US\$3 million and US\$15 million

Source: World Bank Group data.

a. Two of the three characteristics must be met for an enterprise to be classified in a particular category.

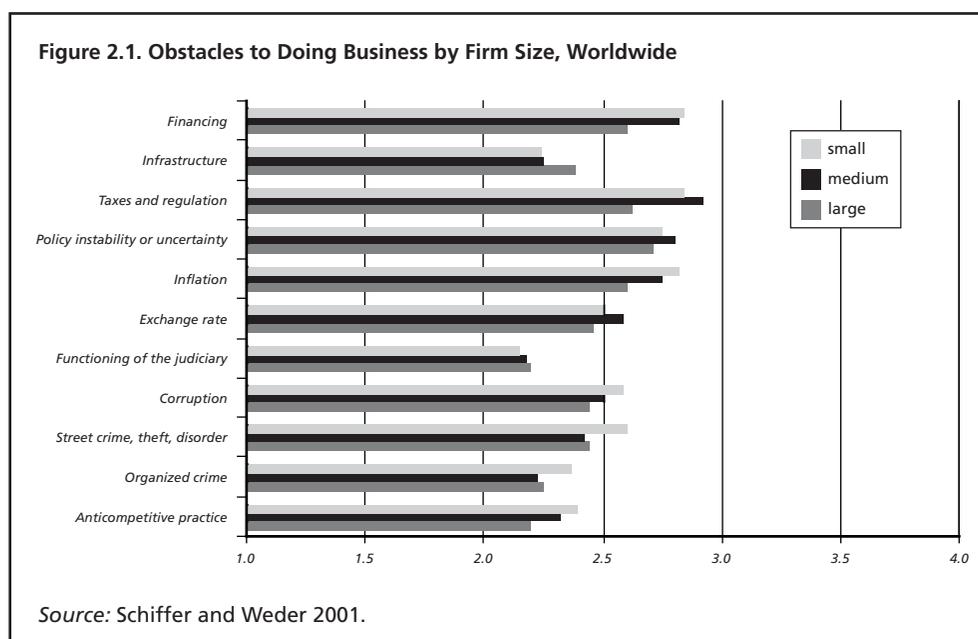
4. For a complete overview of official definitions of SMEs by country, see Ayyagari, Beck, and Demirgüç-Kunt (2003, p. 31–33) and OECD (2002).

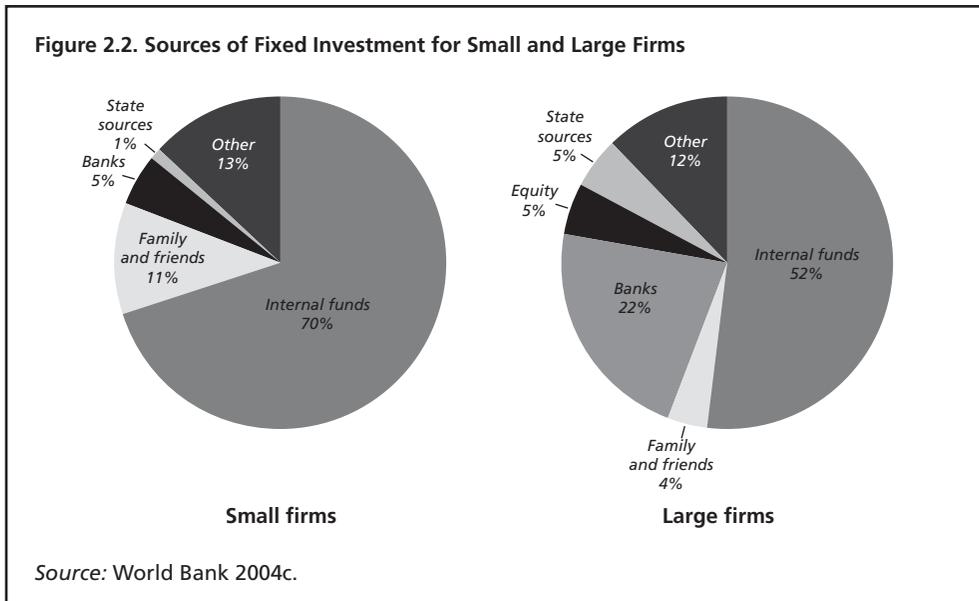
Bank Group. The most commonly used variable is the number of employees because of the comparative ease of collecting this information.

Thus the MSMEs covered in this book are a heterogeneous group, ranging from the lone artisan producing agricultural implements for the village market; to a coffee shop or Internet café; to a small, sophisticated engineering or software firm selling in overseas markets; to an automotive parts manufacturer selling to multinational automakers in the domestic and foreign markets (OECD 2004a). The owners are typically poor at the microenterprise end of this spectrum, though not necessarily so at the upper end. The firms operate in different markets (urban, rural, local, national, regional, and international); embody different levels of skills, capital, and sophistication; and vary in relation to their growth orientation.

Access to Finance as a Constraint on SMEs

The literature on economic development and corporate finance consistently demonstrates that inadequacies in relation to finance are key barriers to firm growth. Schiffer and Weder (2001) show that SMEs find accessing financing more difficult than larger firms. They rank all the obstacles firms face in doing business and find that financing is a top problem for SMEs, which rate it higher than larger firms (figure 2.1).





Beck, Demirgüç-Kunt, and Maksimovic (2002b) further clarify how financial constraints affect firms of different sizes. Their study of 4,000 firms in 54 countries offers evidence that large firms internalize many of the capital allocation functions carried out by financial markets and financial intermediaries. They conclude that financial constraints affect the smallest firms most adversely and that an incremental improvement of the financial system that helps relax these constraints will be most beneficial for SMEs. The 2005 *World Development Report* (World Bank 2004c) indicates that small firms obtain only 30 percent of their financing from external sources, whereas large firms meet up to 48 percent of their financing needs through external financing (figure 2.2).

Small firms identify lack of access to financial services as one of the key constraints to growth and investment. SMEs are usually more credit constrained than other segments of the economy because of the following: (a) financial sector policy distortions; (b) lack of know-how on the part of banks; (c) information asymmetries, for example, lack of audited financial statements; and (d) high risks inherent in lending to SMEs.

Financial Sector Policy Distortions

Firms' ability to access finance is directly related to the presence of well-functioning financial markets that connect firms to lenders and investors willing to fund their ventures. In their efforts to respond to market failures, governments

have often intervened heavily in financial markets in the following ways, with overall poor results.

INTEREST RATE CEILINGS DISCOURAGE BANKS FROM LENDING TO HIGHER-RISK BORROWERS

Government-mandated, below-market interest rate caps usually cause more problems than they solve and discourage banks from lending to higher-risk borrowers such as SMEs. In Indonesia, lifting interest rate controls in 1983 allowed Bank Rakyat Indonesia (BRI), a large agricultural development bank in Indonesia, to experiment with new financial products serving micro and small entrepreneurs, most notably with market-priced working capital and investment capital loans. Demand for these products proved strong and contributed to BRI's transformation from a chronic loss maker to a profitable institution.

STATE-OWNED ENTERPRISES CROWD OUT SMEs

In many countries, large state-owned enterprises and government infrastructure projects enjoy preferential access to bank credit, crowding out nonstate enterprises, especially SMEs. In China, for example, the share of bank loans to nonstate enterprises, many of which are SMEs, is significantly lower than SMEs' share of industrial output (table 2.2). A survey of Sichuan firms found that large firms were able to finance 18 percent of their working capital needs, compared with 7 percent among SME survey respondents. The main constraints SME respondents identified were lack of access to long-term loans (40 percent of respondents), collateral requirements (37 percent of respondents), lack of access to foreign banks (32 percent of respondents), and need for personal connections to facilitate loan approval. Chinese SMEs also report that they typically receive lower credit ratings than large state-owned enterprises from the state-owned commercial banks. Large state-owned enterprises are typically seen as less of

Table 2.2. Shares of Nonstate Enterprises in Industrial Output and Short-Term Bank Credits, China, 2001

<i>Location</i>	<i>Share of industrial output</i>	<i>Share of short-term bank credit</i>
China	56	24
Yunnan	20	20
Cuizhou	23	15
Guangxi	39	25

Source: National Bureau of Statistics of China 2002; provincial yearbooks for 2002.

a credit risk and as more likely to receive support from local governments and party officials (World Bank 2004a).

PUBLIC SECTOR BORROWING CROWDS OUT FINANCE FOR THE PRIVATE SECTOR

Public sector borrowing likewise crowds out credit from financial institutions to the private sector: investing in government securities is a safer bet than investing in unknown SMEs.

DIRECTED PUBLIC SECTOR CREDIT AND GUARANTEES OFTEN HURT INSTEAD OF HELP SME DEVELOPMENT

In their efforts to help the development of certain sectors or regions, governments often direct banks to channel their credit to certain activities or geographical areas. Such intervention distorts market forces and also provides opportunities for corruption. Lenders can reclassify loans to meet government requirements, while borrowers may obtain credit for unintended purposes. In addition, many directed loans go to unprofitable projects and are often not repaid. Consequently, banks end up incurring losses, which retards development of the financial market (World Bank 2004c).

Development finance institutions are typically state-run banks that provide subsidized credit to beneficiaries who are unable to borrow from commercial banks. Although this arrangement may seem appealing, the experience of such approaches has generally been unsatisfactory. Few development finance institutions have been able to operate profitably, and their outreach has been limited. They have often supported political projects with little economic value or have benefited favored constituencies, while crowding out private initiatives trying to compete on market terms.

Credit guarantees offered by governments are typically meant to encourage lending to riskier SME clients by sharing the default risk with banks. This can lead to moral hazard on the part of both borrowers and lenders by making borrowers less willing to repay and banks less attentive to credit risk and to monitoring borrowers. The resulting high default rates raise issues of the sustainability of such schemes. Chapter III describes conditions under which credit guarantees can work.

LEGAL AND REGULATORY FRAMEWORKS DO NOT SUPPORT DIFFERENT FORMS OF FINANCING

Although various promising forms of financing such as leasing, factoring, and venture capital have been introduced in most financial markets, the lack of supportive legislation, regulations, and tax treatment has often restrained their growth.

WEAK JUDICIAL AND LEGAL FRAMEWORKS AND LACK OF PROPERTY RIGHTS INCREASE RISKS AND DISCOURAGE INVESTMENT

Governments can increase financial institutions' willingness to provide finance to MSMEs by ensuring that both lenders and borrowers have clearly defined property rights. Stronger creditor rights—stemming, for example, from laws guaranteeing secured creditors' priority in the case of default—allow lenders to reduce the risk of future losses. Studies in the United States show that small firms are 25 percent more likely to be denied credit if they are in states that provide creditors with less protection when the borrower is bankrupt (World Bank 2004c).

Securing borrowers' property rights to assets they can pledge as collateral can help borrowers both in accessing finance and in obtaining cheaper and longer-term loans. A study of 37 countries found that countries in the 25th percentile for property rights protection had loan spreads 87 basis points lower than those in the 75th percentile (World Bank 2004c). However, having legal provisions that ensure debtors' and creditors' rights is not sufficient. Their effectiveness depends on strong enforcement of the law. The lack of an effective legal system to enforce laws in the Russian Federation, for instance, impedes the development of a deeper credit market.

Some laws exclude movable assets, such as machinery, vehicles, and livestock. As movable assets often account for a greater share of the assets of smaller firms than of larger ones, the impact on access to credit is relatively negative for SMEs. Laws and registries permitting the collateralization of movable assets can offer great benefits to small firms.

Title to land and real estate is often crucial for providing access to finance for business development. The lack of enforceable property rights limits the ability of physical assets to generate capital. If property cannot be bought and sold with the confidence that the authorities will uphold the transaction, financial institutions will be reluctant to take on the risk of lending against physical collateral. Poorly defined property rights not only reduce firms' ability to access finance, but also lead to the overall failure of markets to generate dynamic growth.

Banks' Lack of Know-How

Two main problems are associated with banks' lack of know-how.

SMALL LOAN SIZE RELATIVE TO TRANSACTION COSTS

SMEs typically require relatively small loans compared with large firms. The transaction costs associated with processing and administering loans are, however, fixed, and banks often find that processing small SME loans is inefficient. They lack the techniques, such as credit scoring, to increase volume and lower costs.

DIFFICULTY IN ADOPTING NEW LENDING TECHNOLOGIES

Experience from the microfinance industry shows that one way to successfully bridge the gap between the demand for and supply of credit is through innovative lending methodologies. Such methodologies include the following: (a) undertaking loan analysis that focuses on prospective clients' ability to pay (cash flow), with less emphasis on collateral; (b) giving loan officers incentives for maintaining high-quality portfolios; (c) introducing appropriate decision-making and control mechanisms supported by management information systems and information technology to help manage and administer the loan portfolio; and (d) providing larger loan amounts and longer terms for well-performing borrowers (Holtman, Rühle, and Winkler 2000).

Information Asymmetries

The main information asymmetries that constrain SMEs access to finance are as follows:

HIGH COST OF OBTAINING CREDIT INFORMATION ON SMEs

For markets to allocate resources efficiently, all market participants must have the same relevant information. This is seldom the case, however, in developing countries, and the resulting market failures can create biases against small firms. Under these circumstances, for banks to obtain information on the creditworthiness of potential SME clients is difficult or costly. If, as a result, lenders perceive the risks of lending to SMEs to be greater than they actually are, they

will charge higher interest rates or refrain from lending to them altogether. If lenders do charge high interest rates, this increases the risk they are exposed to by discouraging low-risk, low-return borrowers from seeking loans, ultimately discouraging lenders from lending to SMEs altogether (Hallberg 2000; World Bank 2004c). At the same time, higher interest rates are associated with mainly high-risk projects, a circumstance referred to as adverse selection.

INCONSISTENT SME FINANCIAL STATEMENTS AND AUDITS

As SMEs are often not required to adopt international accounting standards when preparing their financial statements, large discrepancies arise in the ways firms report their financial positions. An assessment of the investment climate in China (Dollar and others 2003), for example, points out that Chinese firms may have two or three sets of books for different audiences. Auditing such statements can be labor- and time-intensive, which raises the cost of loan processing for SMEs. In addition, even audited financial statements can be unreliable. In China, audit report findings often reflect negotiations between enterprises and outside auditors, who face sharp competition and are eager to retain clients and obtain fees.

LACK OF ACCESS TO THIRD-PARTY INFORMATION BY PROVIDERS IN THE MARKETPLACE

Lenders' lack of knowledge of their clients and of information on clients' credit profiles and histories reinforce their perception of the high risk involved in lending to SMEs. One way to overcome the high cost to lenders of directly screening and monitoring clients is through the establishment and use of credit bureaus as third-party information providers. Credit bureaus are standard practice in most developed countries and are gradually becoming more common in developing countries. Credit bureaus are proven to decrease the cost of lending to SMEs by providing reports on firms' loan repayment histories. This allows lenders to use information on how borrowers have met their past loan obligations, which is a better predictor of future loan performance than client behavior in relation to their payment of water, electricity, and other utility bills. They also provide an incentive for borrowers to repay loans promptly, as late payment to one lender can result in an inability to obtain future loans from other lenders.

In a World Bank survey on doing business (World Bank 2004a), more than half the credit bureaus surveyed indicated that the availability of credit history information reduced processing time, processing costs, and default rates in their countries by more than 25 percent. On average, countries without credit registries have a private credit-to-GDP ratio of 16 percent, in those with publicly

owned registries the ratio is around 40 percent, and in those with private registries it is about 67 percent (World Bank 2004c).

High Risks of MSME Operations

MSME operations are subject to two major risks.

VULNERABILITY AND TURNOVER

SMEs are intrinsically riskier borrowers than large firms. Schiffer and Weder (2001) use a worldwide sample of firms and demonstrate a negative relationship between firm size and level of risk. This is the case because SMEs are more vulnerable to market changes and often have inadequate management capabilities because of their smaller size. Liedholm's (2001) study based on data from Africa and Latin America found that MSME closure rates exceeded 20 percent per year in the early 1990s, demonstrating the intrinsically high risk associated with them. Lack of demand and shortages of working capital were the two most frequently mentioned underlying causes of these business failures. The same study also reveals a substantial rate of MSME start-ups, averaging more than 20 percent of all start-ups. These findings, which are probably not atypical on a global scale, highlight the extreme volatility of MSME activities, with a large number of them starting up while many others are closing down.

MANAGEMENT WEAKNESSES

Despite evidence that lack of access to finance constrains many MSMEs, actual effective (or bankable) demand may itself be constrained by weaknesses in firm management and the dossiers their management can present when applying for credit. Programs to increase financing for SMEs often begin with training and business development services to strengthen firms' management and productivity. However, sole proprietorships, such as many SMEs, have few incentives to obtain external audits of their financial statements to improve management and productivity, and such audits are also expensive relative to the size of loans that SMEs may be seeking. Thus banks often complain that loan applications from SMEs do not meet their standards.

III. Good Practices for Addressing MSMEs' Financing Constraints

This chapter focuses on how financial institutions have resolved or worked around three of the four constraints highlighted in chapter II: lack of know-how on the part of banks, information asymmetries, and high risks inherent in lending to MSMEs. Chapter IV focuses on the fourth risk: financial sector policy distortions. This chapter draws lessons from the 13 cases described in the appendix (listed in box 3.1), which profile how financial institutions are serving MSMEs profitably around the world through commercial banking ser-

Box 3.1. Studies on Improving MSME Access to Finance

Commercial Banks Involved in MSME Finance

- The Kazakhstan Small Business Program
- The Agricultural Bank of Mongolia: Restructuring and Expanding through Downscaling
- Innovation from the CrediAmigo Program of Banco do Nordeste
- ShoreBank International, Ltd. in the Caucasus
- Wells Fargo Credit Scoring Model
- The Agricultural Cooperative Bank of Armenia
- Inter-American Development Bank Microenterprise Global Credit Program in Paraguay
- BRI

Other Financial Instruments for MSMEs

- Nacional Financiera and Factoring in Mexico
- Venture Capital and Small Enterprise Assistance Funds
- Financial Leasing in Serbia
- Credit Guarantee Schemes
- Credit Information and SME Access to Finance

vices as well as with other instruments such as leasing, guarantee funds, and factoring. The lessons are discussed in terms of commercial bank innovations in applying microfinance technologies, other credit analysis and risk management techniques, and other finance instruments.

Commercial Bank Innovations in Applying Microfinance Technologies

A number of banks around the globe have learned the lending and pricing strategies that allow them to compensate for the high transaction costs of making many small loans and have adopted risk management techniques commensurate with the higher risk profiles of their MSME clients. Many of the innovations originated in serving clients at the lower end of the private sector spectrum using microfinance technologies. These innovations consisted of providing small, uncollateralized working capital loans; promising access to larger amounts for longer terms based on repayment performance; and permitting small savings accounts that were safe, convenient, and flexible in terms of withdrawal. In the 1980s, BRI was one of the early leaders in adopting microfinance techniques and achieved phenomenal success in terms of scale and lowered costs (box 3.2). Driven by competition pressures, private commercial banks are increasingly moving toward reaching previously unserved, poorer clients.

Box 3.2. Bank Rakyat Indonesia (Appendix Case 8)

BRI is a state bank run on commercial principles. It has received worldwide fame for its success, via its Unit Desa division, for developing a nationwide microfinance portfolio, which in 2004 was serving 31.3 million savers with average saving accounts of US\$108 and 3.2 million borrowers with average outstanding balances of US\$540. BRI is particularly notable for having turned itself around from a large, subsidized, state-owned bank to a profitable bank within three years by providing products that were in demand: small nontargeted loans, simple pass-book savings accounts, and time and demand deposits. It turned each of the 3,600 branches in its nationwide network into profit centers with their own financial statements and performance standards. By 2004, the microbanking system had made US\$233 million in pretax profits and its return on assets was 6.8 percent.

BRI's risk management techniques rely on sticks and carrots: cutting off nonperforming clients from future access to finance, making site visits to clients that coincide with repayment schedules, and providing incentives for timely repayment in the form of a refund of 25 percent of the interest payment on the loan. Loan officers are also given incentives, which can account for a significant component of their earnings, for initiating and maintaining quality portfolios. The Unit Desa system has clear efficiency benchmarks: a loan officer handles 400 borrowers; a teller handles 6,000 deposit accounts; and administrative costs are 8 percent of the average loan portfolio, which compares favorably with the industry standard of 10 to 20 percent. The Unit Desa division, one of four business divisions in BRI, accounts for 25 percent of total BRI assets, 15 percent of the loan portfolio, and 70 percent of total savings accounts and accounted for all of BRI's profits in 1996, including coverage of losses incurred by other parts of BRI.

Approach Is Relationship Based

The key characteristic cutting across developing-country commercial banks applying microfinance principles to MSME finance is that they have focused on relationship-intensive banking rather than more traditional transactions banking, to use Berger and Udell's (2005) terminology. The relationship-lending model is based on qualitative information with an emphasis on the character and reliability of MSME owners gathered from informal sources such as suppliers and community leaders. The transactions lending approach is based primarily on hard quantitative data that can be observed and verified at the time of credit origination: financial ratios calculated from audited financial statements, credit scores assembled from data provided by credit bureaus, or valuation of hard collateral.

Initial Small, Short-Term Loans Are Ratcheted Up Based on Repayment Performance

Loans are initially small and short term, and clients gain access to larger amounts and longer terms based on their repayment performance as they build a credit history with the financial institution. All successful microfinance banks apply this basic model, and this is one of the key lending innovations that can be applied to SME finance.

Loan Monitoring and Credit Risk Control Methods Are Intensive

Banks monitor loans through site visits timed to coincide with clients' repayment schedules and provide clients with incentives for timely repayment. Close relationships with its clients enabled BRI to weather the 1997 East Asian financial crisis relatively well. Its loan repayments suffered only marginally, in contrast to the massive defaults by large and corporate customers of other banks. This is attributed to strong client relationships and monitoring and to BRI continuing to provide loans to its existing clients during the crisis. As many private banks closed, state banks merged, and the banking system was on the verge of collapse, BRI experienced an enormous influx of deposits: 3 million new accounts in 1998 alone. Kazakhstani banks have similarly been successful in controlling credit risk. Even in 1999, in the aftermath of the Russian financial crisis, the portfolio-at-risk of loans at least 30 days overdue never exceeded 4 percent of portfolio volume. From 2002 to 2004—a period characterized by financial stability—the portfolio-at-risk stayed well under 1 percent, compared with almost 20 percent of all bank loans in Kazakhstan being considered doubtful.

Loan Officers' Incentives Are Tied to Loan Portfolio Performance

Incentive structures hold loan officers accountable for their institution's relationship with a client throughout the life of the loan, including analysis, disbursement, monitoring, and repayment. Loan officers are paid performance-based salaries, with their compensation being a function of productivity and portfolio quality.

Transaction Costs Are Lowered in Several Ways

Banco do Nordeste in Brazil contracted its loan officers through employment agencies on a temporary basis for the microfinance business in order to keep fixed costs low while it experimented with a new product line. In Armenia, the first stage of credit screening was devolved to village associations. BRI followed a rigorous approach that emphasized standardization and efficiency benchmarks by branch.

Full-Cost Pricing Is Adopted to Achieve Sustainability

The profiled banks charged clients the full cost of service provision via the interest rate and sometimes via fees. The interest rates were set to cover the cost of funds for onlending; the cost of loan loss risk; and the cost of administration, that is, identifying and screening clients, processing loan applications, disbursing loans, collecting repayments, and managing nonpayment. Many of the innovations come from keeping administrative costs down.

Pricing, while context specific, was set by the banks in such a way as to permit continuation of this line of business on profitable terms. In doing so, the banks were able to achieve sustainability and remarkable degree of success:

- BRI's microfinance portfolio has been profitable since 1986. Pretax profits in 2004 were US\$233 million, and the return on assets was 6.8 percent.
- Within three years of its launch in 1998, CrediAmigo in Brazil was fully financially sustainable; had 55,000 active clients; and had a portfolio whose quality was on a par with international best practices, with only 3.5 percent of the portfolio being late using a strict 30-day portfolio-at-risk measure.
- Between late 2000 and February 2004, the Agricultural Bank of Mongolia disbursed 878,000 loans while maintaining an arrears rate consistently below 2 percent. It became the most profitable bank in Mongolia, with a return on assets of 2.96 percent and a return on equity of 44.19 percent in 2003. As of February 2004, 128,227 loans were outstanding for a port-

folio of almost US\$50 million, with US\$75.5 million in 377,424 deposit accounts. The 15,433 domestic transfers totaled US\$260,000 for the month. The average outstanding loan balance is US\$382, deposit accounts average US\$200, transfers average US\$17, and half of Mongolia's households do business with the bank.

Other Credit Analysis and Risk Management Techniques

Several other credit analysis and risk management techniques that were successfully implemented to diminish the risks of lending to MSMEs are described below.

Emphasis on Cash Flow Analysis to Determine Clients' Ability to Pay

Credit analysis focuses on clients' ability to pay, which is assessed primarily through cash flow analysis. The profiled banks focused loan officer training on this aspect of credit analysis. For example, ShoreBank invested considerably in training bank officers on cash flow lending and credit analysis when starting up SME banking operations in Azerbaijan and Georgia.

In-Depth Knowledge of Clients and Their Businesses

The MSME banking business model places a premium on realistic assessments and in-depth knowledge of clients and their businesses through site visits by loan officers throughout the loan period. This doorstep banking approach also reduces the travel and other transaction costs of MSME clients, which is particularly important for women clients, who typically juggle household and enterprise tasks. Loan officers are also typically hired from client communities. As an example, the Agricultural Bank of Mongolia hires its loan officers from the communities it serves, which means that they understand communities' risk profiles and have communities' trust. Assets pledged as loan security are a secondary consideration compared with loan officers' recommendations in terms of credit approval. Even when collateral is required, these banks use more flexible definitions of what constitutes collateral. For instance, individual loans by the Banco do Nordeste of Brazil are backed by guarantees from peer group members.

Many of the banks have benefited their bottom lines by providing services to women. Many discovered, initially by accident and then by conscious design, that women tend to be more responsible clients than men in terms of loan repayment and that targeting women clients was simply good business.

Credit Scoring

Wells Fargo in the United States uses a sophisticated credit scoring methodology based on hard data (see box 3.3).

Timely Technical Assistance to Address the Lack of Bank Know-How in SME Finance

Quality technical assistance (TA) can address the most critical binding constraint: lack of bank know-how. Most of the banks profiled received high-quality TA from expert practitioners that allowed them to build their successful SME finance businesses. The banks in Kazakhstan and Paraguay received this expertise from Internationale Projekt Consult, an international company based in Germany with equity stakes in SME banks worldwide; Banco do Nordeste received TA from ACCION International, one of the leading networks of microfinance banks in the world; the banks in Azerbaijan and Georgia received assistance from ShoreBank International, Ltd., the consulting arm of the pioneer community bank ShoreBank in the United States; the Agricultural Bank of Mongolia received support from Development Alternatives, Inc., a specialized international consulting practice; the European Union provided significant TA to the Agricultural Cooperative Bank of Armenia during 1997–2000; and in Serbia, the International Finance Corporation (IFC) provided significant training programs for local banks, leasing companies, SMEs, and business service providers, complemented by building the capacity of Serbia's Association of Leasing Companies. This TA included assessing market demand, designing and

Box 3.3. Credit Scoring by Wells Fargo (Appendix Case 5)

Wells Fargo in the United States is an exception to the relationship-banking model pursued by the other banks profiled in this book and the majority of successful microfinance banks in the developing world. It also illustrates how a sophisticated information infrastructure can increase SMEs' access to finance. Through the use of a robust credit scoring model that routinely collects data on every customer on elements such as open commitments, number of accounts, and financial assets for loan origination, it has grown to be the largest SME bank in the United States in terms of total dollar volume. By 2004, via its Business Direct division dedicated to SMEs, it had a US\$6.3 billion outstanding SME loan portfolio, of which 94 percent was unsecured. The average loan balance is US\$15,000 and median deposits are US\$7,000. Total bank assets were US\$253 billion at the end of 2003. Use of the credit scoring model means that Wells Fargo accepts loan applications by mail or telephone. No collateral, financial statements, or tax returns are required. Two-thirds of all decisions are made automatically based on the scorecard and the remaining one-third through 15-minute reviews. As a result, Wells Fargo's costs for processing small business loans of US\$30 per loan are among the lowest in the industry.

launching products, examining lending methodologies, and reviewing risk management techniques, with the emphasis on portfolio monitoring and management information systems that keep the finger on the pulse of portfolio quality. The TA provided to the banks in Paraguay through two projects funded by the Inter-American Development Bank illustrates the cost and terms of TA. The first project had a TA component of US\$2.7 million to complement a US\$12 million credit component, and the second project had a US\$3 million TA component with a US\$22 million credit component. The TA had a duration of three years and included one resident adviser. The TA to the Agricultural Bank of Mongolia was paid for by the U.S. Agency for International Development (USAID) through a management contract with Development Alternatives and cost US\$2.7 million over 1998–2003. However, given how much has been learned, TA can and does now take much more modest forms, and the Consultative Group to Assist the Poor is experimenting with highly tailored TA support to banks on the order of US\$50,000 to US\$250,000 per project.

Other MSME Finance Instruments

This section describes other finance instruments, such as guarantee funds, factoring, leasing, and investor equity or venture capital, which were successfully applied by different entities to make financing available for SMEs

Guarantee Funds

Guarantee funds shift some risk from banks to guarantors to induce banks to work with clients perceived to be higher risk, such as MSMEs. Government-run guarantee schemes have had poor to mixed results stemming from design issues (see case 12 in the appendix). A number of reasons account for this, namely: banks becoming lax in monitoring the MSME portfolio because of the overly comfortable safety cushion of the guarantee, lack of assurance of the financial sustainability of guarantee funds, and difficulties in measuring the additionality of MSME finance stemming from these schemes. Private guarantee schemes appear to be more successful. One of the more successful portfolio guarantee schemes is run by ACCION, a network of regulated microfinance banks in Africa and Latin America (box 3.4). Key features that account for ACCION's success are the declining risk coverage, a portfolio guarantee approach that reduces time and costs as opposed to an individual-retail selective model, the high quality of the retail financial institutions that obtain access to the guarantee fund, and the sound financial management of the fund itself.

Box 3.4. ACCION's Global Bridge Fund (Appendix Case 12)

ACCION's Global Bridge Fund acts as collateral for irrevocable standby letters of credit issued in U.S. dollars by a U.S. bank (currently Citibank), which guarantees a declining percentage of the credit local commercial banks provide to ACCION's partner institutions: banks, nonbank financial intermediaries, and so on. The percentage is initially up to 90 percent of the credit provided and declines rapidly to 10 percent. As of early 2005, the fund had collateralized more than US\$70 million in letters of credit for 23 financial institutions in 12 Latin American countries. Since its creation in 1984, the fund has incurred losses on three letters of credit, which were covered by the loan loss reserve. No investor in the fund has lost principal or interest. ACCION is extending this model to other parts of the world.

Factoring

Factoring is a form of supplier finance whereby firms sell their creditworthy accounts receivable at a discount (interest plus service fees) and receive immediate cash (see box 3.5). Underwriting is based on the risk of the accounts receivable and, therefore, on an assessment of the creditworthiness of the buyer in relation to that of the SME supplier. This makes it an important financing instrument for SMEs that lack collateral or credit histories. In 2003, the volume of factoring worldwide was more than US\$750 billion, as a result of a 135 percent growth between 1996 and 2003.

Leasing

Leasing is a contract between two parties whereby the lessor provides an asset for use by the lessee for a specified period of time in return for specified payments. It is a medium-term financial instrument for procuring machinery, equipment, and other fixed assets. Leasing focuses on the lessee's ability to generate enough cash flow from business operations to service the lease payment, rather than on the balance sheet or credit history. This makes it advantageous for SMEs, which typically lack collateral or credit histories. Leasing can take several forms, for example, operational leases are similar to a rental contract, whereas financial leases are more similar to installment plan financing whereby the lessee acquires or retains the assets.

While much of the literature on leasing is not specific to leasing experiences with SMEs, IFC is involved with a promising intervention to build the leasing industry in Serbia. IFC's assistance consisted of five parts: undertaking a market research study on the demand for leasing products, working with stakeholders to draft a leasing law, providing training programs for staff of financial and leasing institutions and of SMEs, initiating national awareness campaigns on

Box 3.5. Nacional Financiera's Factoring Program (Appendix Case 9)

Nacional Financiera (NAFIN), a state-owned development bank in Mexico with 32 branch offices nationwide, developed a so-called productive chains program to link large, creditworthy buyer firms with small, risky firms unable to access formal finance. Participating in the factoring program are 190 big buyers (45 percent of the private sector) and more than 70,000 SME suppliers. Twenty domestic banks and finance companies act as the factors. Since the program's inception in September 2001, NAFIN has extended more than US\$9 billion in financing to SMEs. The program also contributed to a dramatic turnaround in NAFIN's own finances from a deficit of US\$429 million in 2000 to a surplus of US\$13 million in December 2003. With the efficiency of its Internet platform, NAFIN's market share of factoring grew from 2 percent in 2001 to 60 percent in 2004. It is able to provide the cheapest form of financing available for small suppliers in Mexico.

The NAFIN factoring program operates an electronic platform that provides factoring services online. The Web site has a dedicated page for each big buyer, while small suppliers are grouped into chains with those big buyers with whom they have business relationships. The suppliers and NAFIN sign an agreement allowing the electronic sale and transfer of receivables. Once a supplier delivers goods and its invoice to the buyer, the buyer posts a negotiable document equal to the amount that will be factored on its NAFIN Web page. In general, this is equal to 100 percent of the value of the receivable. The supplier can then access NAFIN's Web page to see which participating banks and finance companies are willing to factor its receivables, and at what interest rate offer. Picking the one it deems has the most favorable terms, the supplier clicks on the name of the factor, and the amount of the negotiable document less interest is transferred to the supplier's bank account. When the invoice is due, the buyer pays the factor directly. The efficiency of the electronic platform means that small suppliers typically receive money within one business day. NAFIN is spreading this model into Venezuela, and possibly into other Latin American countries as well, in the near future.

leasing, and helping to set up the National Association of Leasing Companies. IFC's support led to the passage of a leasing law that included provisions to provide security to lessors (repossession within six days). The law can in part be credited with the subsequent formation of 11 leasing companies in Serbia. The experience is too recent to draw conclusions about the impact on SMEs, but the early results look promising.

Investor Equity (Venture Capital)

Investor equity is another source of potential funding available to SMEs, but equity markets in many developing countries are insufficiently developed to make this a reality for most SMEs. One business model is the Small Enterprise Assistance Funds (SEAF), a nongovernmental organization headquartered in the United States. SEAF provides equity funds and postinvestment TA to SMEs through affiliated commercial investment companies in 14 countries (box 3.6). SEAF invests primarily in locally registered, private, early-stage companies in

Box 3.6. The SEAF Fund in Macedonia (Appendix Case 10)

With the establishment of a US\$13 million investment fund in 1998, the SEAF Fund in Macedonia was the first private equity fund to enter Macedonia during its volatile political and economic transition. At that time, Macedonia's banking system was in disarray, and its fledgling private sector was in need of capital injections and TA for the transition to a market economy. When ethnic violence escalated in the spring of 2001, SEAF was forced on two occasions to temporarily close its offices, evacuate staff, and suspend investment activity. However, SEAF continued its work by focusing on strategies to help its portfolio companies endure the civil unrest. Today, the SEAF Fund in Macedonia is among SEAF's top performing funds, with 14 portfolio companies now successfully exited and an overall multiple of 1.6 times the capital invested.

which local residents are majority owners. SEAF usually seeks an initial minority position of no less than 20 percent. Investments are made primarily through minority equity positions in combination with quasi-equity financial instruments and subordinated debt. SEAF also provides TA and business development assistance to the companies it invests in and considers this to be the cornerstone of its approach. SEAF reported that as of June 2004, its total invested capital exceeded US\$85 million in 213 investments. SEAF has achieved full and partial exits from 81 investments, generating a gross internal rate of return of 24 percent in U.S. dollars with a multiple of 2.1 times invested capital.

Business Partners Limited has used a similar approach to provide debt and equity financing, mentoring, and property management services to more than 27,000 SMEs in South Africa since its inception in 1981. Business Partners has developed an effective process for evaluating, structuring, and monitoring investments in SMEs that minimizes the cost of processing small investments and aligns the interests of investment staff with maximizing the value of the investments. The process also provides critical support and mentoring to investees and is easily adapted to incorporate a formal TA program.

Factors Underlying the Success of the Institutions Profiled

This section highlights a few of the most important factors that have contributed to the success of each of the institutions and experiences profiled. A more complete discussion is available in the case studies in the appendix.

Government Commitment and Political Economy for Reform

The commitment of the governments of Indonesia, Kazakhstan, Mongolia, and Paraguay to reform the countries' financial sectors and state-owned banks as

part of an overall reform program was critical to the success of the banks profiled in this book. The financial sector reforms provided an important backdrop underpinning the banks' success. The consolidation and increased competition in the banking sector made banks eager to find new client segments and invest in building SME portfolios. For their part, the governments were willing to make some difficult political choices such as liberalizing interest rates. In the case of state-owned banks, the governments permitted the banks' management teams to operate without political influence. In Mongolia's case, the bank was privatized via an international competitive tender. NAFIN in Mexico benefited from a mandate from the government elected in 2000 to use technology to increase the scale of SME finance, which underpinned its factoring program. Wells Fargo in the sophisticated U.S. financial market credits its success to stable and balanced legal and political environments with clear property rights and contract enforcement, sound banking and payments systems, interest rate flexibility for risk-based pricing, reliable communications systems, and good consumer bureaus for both positive and negative information about clients.

Commitment and Leadership within the Institutions

Banco do Nordeste's president, shortly after his appointment, told the World Bank he was interested in developing a world-class microfinance program. He launched a major reform in the bank with the objective of making it more modern, efficient, and responsive to the development needs of the northeastern region of Brazil, and started the microfinance program as part of this client-focused reform. BRI's president from 1983 to 1992 was the key driver of its cultural and operational transformation.

Learning and Experimentation

None of the institutions profiled started out with a blueprint. Each had to design and test products in its respective market and then roll them out or revise them based on the pilots. BRI focused on learning from others before implementation and learning by doing during implementation. The institutions also learned from mistakes along the way. Banco do Nordeste's desire to grow too fast resulted in loan losses, forcing it to pull back, consolidate its operating procedures, and retrain its loan officers in portfolio quality management.

The banks and other financial institutions profiled in this section and in the appendix were able to overcome the constraints to increasing MSME access to finance outlined in chapter II. They used creative approaches to address the inherent riskiness of their clients and relationship-building techniques that focused on getting to know their clients and their businesses to address the information

constraint. They addressed the lack of know-how constraint by investing in their staff and institutions to build their capacities to better serve their clients, to increase efficiency, and to become profitable. Most important, they were willing to innovate and to challenge traditional approaches to banking. They also benefited from enlightened government policies and support. Yet many financial institutions are unable to achieve the scale and sustainability of those profiled in this book, largely because of poor or inhibiting government policies and practices. The next chapter focuses on how governments can help populate their financial landscapes with a greater number of successful financial institutions.

IV. How Governments Can Help Increase Access to Finance

This chapter focuses on the important role of government in creating the right conditions for finance innovations aimed at MSMEs to take root and flourish. It suggests three complementary roles whereby governments can address some of the constraints discussed in chapter II and facilitate the innovations discussed in chapter III (table 4.1). The case evidence drawn from the appendix illustrates that having governments play at least one of these three roles was critical to the success of the institutions. An additional role for the government is to monitor and evaluate interventions and feed back lessons learned into improving the design of policies and programs.

Table 4.1. Proposed Government Interventions

<i>Set a sound policy framework for the financial sector</i>	<i>Strengthen the institutional infrastructure</i>	<i>Build the information infrastructure</i>
<ul style="list-style-type: none"> • Liberalize interest rates • Promote competition • Have supportive regulations regarding SME banking, leasing, factoring, and equity • Reduce and rationalize direct public sector intervention • Improve the legal and judicial frameworks 	<ul style="list-style-type: none"> • Support relevant training and TA for interested financial institutions • Provide or facilitate initial financial support (equity infusion, product development, risk mitigation methodologies) 	<ul style="list-style-type: none"> • Promote accounting standards • Invest in and promote credit bureaus and registries • Invest in technology
<i>Evaluate performance and incorporate lessons learned</i>		

Source: Authors.

Set the Stage for Innovation by Establishing a Sound Policy Framework for the Financial Sector

Macroeconomic stability is well accepted as a necessary precondition for a sound financial sector. A full discussion of what constitutes sound financial sector policy is covered elsewhere and is beyond the scope of this book. The main premise is not that pro-MSME financial sector policy is needed, but rather that a neutral and level playing field for all financial institutions is called for. Thus this book touches upon those elements of a financial sector policy environment that, often unintentionally, discriminate against financial institutions that serve MSMEs and thereby constrain their access to financial services. The financial sector reforms that Indonesia (box 4.1), Kazakhstan, and Paraguay undertook were all important for setting the stage for the financial innovations that followed.

Liberalize Interest Rates and Promote Competition

Evidence from the profiled banks and many others verifies that access to high-quality and efficient financial services is more important to microfinance clients than cost, and the only available alternative sources in the informal financial sector are far costlier than microfinance. Liberalized interest rates were critical in enabling the banks profiled in the appendix—including BRI, Banco do Nordeste, Kazakhstani banks, Paraguayan banks, and ShoreBank in the Caucasus—to provide financial services on commercial terms. Liberalization also led to increased entry of banks and to competition, which ultimately brought interest rates down (table 4.2).

Evidence shows that the single most effective way for governments to promote expanded access to financial services is to liberalize interest rates. The

Box 4.1. Bank Rakyat Indonesia (Appendix Case 8)

The government of Indonesia provided political support and commitment from BRI's inception to its transition from a subsidized, state-owned bank to that of a commercial financial institution. The economic and financial sector reforms laid the groundwork for BRI's own reforms. In 1983, a year before BRI's Unit Desa system was restructured, a financial sector deregulation package allowed banks to set their own interest rates, and BRI's senior management was protected from potential political interference. As a result, management had the operational autonomy to run the Unit Desa system on commercial terms and was able to instill a new institutional culture based on performance and accountability in order to develop a nationwide rural banking system. In November 2003, 41 percent of BRI's shares were sold in an initial public offering.

Table 4.2. Active Loans and Interest Rates, Paraguay, Selected Years

Category	Dec 1994	Dec 1996	Dec 1997	Dec 2000	Dec 2001
Number of active microfinance loans	567	7,667	19,779	37,183	44,584
Monthly interest rate charged by microfinance institutions (%)	7.8	5.5	4.5	5.7	4.7
Annual interest rate charged by commercial banks (%)	35.5	31.9	27.8	26.8	28.3
Annual interest rate charged by the central bank to intermediary financial institutions (%)	n.a.	n.a.	18 ^a	n.a.	20.1

Source: Berger, Yonas, and Lloreda 2003.

Note: n.a. = not applicable

a. June 1997.

converse is also true: the single most effective way for the government to destroy access to financial services is to impose interest rate ceilings. Yet an action typical of many governments eager to respond to SMEs' desire for affordable financing is to set interest rate caps. Interest rates need to cover three kinds of costs: the cost of funds for onlending; the risk of loan loss; and the costs of administration, for example, identifying and screening clients, processing loan applications, disbursing loans, collecting repayments, and managing the nonrepayment of loans. The proportion of administrative costs per dollar spent are higher for heavily relationship-dependent MSME finance techniques than for commercial lending. These costs must be recovered through interest rates higher than those other financial institutions charge, but they are still significantly lower than the only alternative often available in the informal credit markets as table 4.3 illustrates. Even extremely efficient microfinance institutions have been unable to reduce their administrative costs below 10 to 25 percent of their portfolios, depending

Table 4.3. Annual Interest Rates of Commercial Banks, Microfinance Institutions, and Informal Sources, Selected Countries, circa 2003 (percent)

Country	Commercial banks	Microfinance institutions	Informal sources (moneylenders)
Bangladesh	10–13	20–35	180–240
Cambodia	18	45	120–180
India	12–15	20–40	24–120 (varies by state)
Indonesia	18	28–63	120–170
Nepal	11.5–18.0	18–24	60–120
Philippines	24–29	60–80	120+

Source: Wright and Alamgir 2004.

on loan size, methodology, and location, compared with usual administrative costs of 5 percent or less for efficient traditional commercial banks.

Interest rate ceilings discourage the provision of small loans by making recovery of the high administrative costs of such lending impossible. At the same time, borrowers should not have to pay for inefficiency. Governments can help lower rates without compromising sustainability by promoting competition and innovation as strategies for improving efficiency and lowering prices. In Paraguay, interest rates charged to microfinance clients dropped from 7.8 percent per month in December 1994 to 4.7 percent in December 2001 while the number of outstanding loans increased and interest rates the central bank charged financial institutions also increased (table 4.2).

How do microenterprises pay such interest rates? The informal sector alternatives are much more expensive than the rates charged by commercial banks and microfinance institutions as shown in table 4.3, and the total amounts of loans are small, and are therefore affordable compared with MSMEs' income streams and business costs. In addition, returns per unit of capital are often higher for small firms, especially for commercial traders, than for large businesses. Research in India, Kenya, and the Philippines (CGAP 2004) found that the average annual return on investments by small firms ranged from 117 to 847 percent. It also found that microfinance institutions with sustainable interest rates reach six times as many borrowers as unsustainable peer institutions. While SMEs that are producing for highly competitive export and import substitution markets may be unable to afford to borrow large amounts at rates charged by microfinance institutions, rapidly accessible loans can serve many specific needs, such as obtaining raw materials to meet an order.

Have Supportive Regulations Regarding SME Banking, Leasing, Factoring, and Equity

This section highlights several examples of successful supportive regulations regarding SMEs banking, leasing, factoring, and equity designed in different countries.

BANK PRUDENTIAL REGULATION AND SUPERVISION

Some precautions are in order for institutions specializing in serving the lower end of the private sector spectrum, particularly if they provide unsecured lending, namely:

Box 4.2. Bolivia's Banking Regulation Reform

In Bolivia, banking regulations limited unsecured lending to 25 percent of capital, yet nearly 100 percent of the portfolio of the main bank lending to microenterprises at the time (BancoSol) was unsecured. Enforcing standard loan documentation requirements and standard reporting requirements would have made lending impossibly expensive. The banking supervisor waived these requirements given the bank's strong position as one of the country's best-performing banks based on its capital adequacy, asset quality, management, earnings, and liquidity ratings (Malhotra 2004a).

- Limiting unsecured lending to some percentage (often 100 percent) of a bank's equity base makes it impossible for the financial institution to leverage its equity with deposits or borrowed money.
- Regulations requiring 100 percent loan loss provisioning for all unsecured loans at the time they are made makes lending to microenterprises and small enterprises virtually impossible.
- Standardized reporting requirements on banks' financial positions are too onerous and expensive to comply with for portfolios consisting of many small transactions (box 4.2).

FACTORING

Two important steps taken by the Mexican government enabled NAFIN to undertake its successful factoring program (appendix case 9). First, in May 2000, the government implemented reforms to legislation pertaining to e-commerce that gave electronic messages the same legal validity as written documents. Passage of the Law of Conservation of Electronic Documents established requirements for conservation of the content of electronic messages regarding contracts, agreements, and accords. The Electronic Signature Law permits substituting electronic signatures for written signatures and allows the receiver of a digital document to verify the identity of the sender. Modifications to the Federation Fiscal Code included amendments necessary to complete electronic transactions, including factoring. Second, favorable taxation treatment helps keep factoring costs low for SMEs and gives them incentives to participate in the factoring program. All interest charges that small suppliers pay to their factors are tax deductible.

LEASING

The main recommendation to governments is to create an overall legal environment for leasing that is no worse than that for bank credit, once again to create

a level playing field. Governments can take the following specific actions to develop the leasing industry:

- Create an appropriate balance of rights and responsibilities of the parties to a lease.
- Create expedient, nonjudicial mechanisms for the repossession of leased assets.
- Remove discrepancies, if any, between the civil code and the leasing law in terms of definitions, lease classifications, and parties' rights and responsibilities.
- Maintain a light touch in industry supervision and licensing. IFC's position is that leasing should not be subject to licensing, supervision, or minimum capital requirements unless the lessors are also deposit-taking institutions or licensing is a common practice, as in Ethiopia. The Republic of Korea and Russia are two countries that have abolished licensing for lessors.
- Remove double taxation and registration fees for leasing when equipment is purchased by the lessor and again when it is transferred to the lessee at the end of the lease (Sultanov 2004).

EQUITY

Many countries lack a favorable environment for exiting from investments because of small and illiquid stock exchanges that rule out the initial public offering option or impose listing expenses and compliance requirements that are too costly and arduous for smaller companies. The SEAF example (appendix case 10) suggests the following actions for governments:

- Allow the equity fund to be registered offshore if necessary. In many cases, governments require the equity fund to be registered onshore, which makes raising funds from international investors difficult and complicates fund management. As a result, the fund is either too small to be profitable or the cost of compliance with local regulations may be so high that it eats up the profits from investments and deters fund managers.
- Allow a level playing field for onshore and offshore equity funds. For example, in some countries, offshore funds and investors cannot invest in certain sectors such as retail, financial services, or tourism. This discourages foreign investment through equity funds.
- Allow for favorable tax treatment for risk and venture capital to provide incentives for development of the industry and to increase access to finance for local firms.

Reduce and Rationalize Direct Public Sector Intervention

Empirical findings show the negative performance effects of state ownership: individual state-owned banks are relatively inefficient and large shares of state bank ownership are typically associated with unfavorable market consequences. Evidence also suggests that less MSME credit is available in nations where state-owned banks hold large market shares (Berger and Udell 2005). Nevertheless, Banco do Nordeste in Brazil and BRI's Unit Desa network in Indonesia show that state-owned banks can introduce programs to reach MSMEs under the right conditions of autonomy, leadership, and performance orientation. Both enjoy complete operational autonomy, run on private commercial banking principles, and are rare exceptions to the general state of politicized and poorly managed state-run financial institutions. The actions of the government of Kazakhstan provide another case in point (box 4.3).

Many governments around the world attempt to bring retail banks into SME finance by providing subsidized credit lines from second-tier development banks. Typically, a government-backed guarantee scheme is introduced to reduce retail banks' exposure to risk. This approach—typified by the first failed program in Kazakhstan (appendix case 1)—has rarely attained the intended objective. The false assumption is that lack of capital prevents banks from serving this market segment, when in most cases it is lack of know-how. In Paraguay, for example, the second-tier bank managing the lines of credit was technically good and completely free of political influence. It provided lines of credit at market rates, coupled with the provision of quality TA to the banks. In this case, as in the revised successful second program profiled in the Kazakhstani case, banks went far beyond the lines of credit and used their own resources to expand their MSME portfolios.

Government-operated guarantee schemes have been fraught with problems, the most typical being the increased moral hazard for banks, as well as for

Box 4.3. Financial Sector Reform in Kazakhstan (Appendix Case 1)

As in Indonesia, reform of the financial sector in Kazakhstan was at an advanced stage when the Small Business Program was launched in 1998, thereby laying the groundwork for the program's success. The government had privatized banks by 2001, had shut down poorly performing banks, and had reduced the number of banks from more than 200 in the early 1990s to 34 by 2003. This consolidation increased banking competition, inducing the largest and strongest banks to participate in the Small Business Program in search of new markets and clients. The government invested in the creation of an efficient banking supervisory authority, and interest rate ceilings were abandoned. In addition, direct TA, funded in part by the government, was provided to participating commercial banks to address the binding constraint of lack of know-how in providing MSME finance.

Box 4.4. Increasing Access to Credit in Romania: Early Results of Secured Transactions Reform

In 1999, Romania adopted a law governing security interests within the Romanian legal system. The older legal system had major impediments in relation to the protection of creditors' rights and the use of movable property as collateral, resulting in limited access to credit. First, the absence of a registry led to a lack of information about other claims on the collateralized property and higher risks for creditors, effectively limiting credit expansion through higher interest rates. Second, the lack of a clear and simple legal framework governing the enforcement of contracts and the repossession of collateralized goods gave rise to long and tedious legal processes that sometimes exceeded the economic life of the goods in question. Third, the old law limited collateral to mortgages, personal guarantees, and pledges.

The 1999 law governing secured transactions introduced a number of improvements by

- establishing an electronic registry for collateral that included all registered security interests,
- expanding the types of collateral that could be pledged to include a broad list of movable assets,
- simplifying and streamlining the legal procedures related to the enforcement of creditors' rights.

The reform resulted in credit expansion and increased access to finance. Early results show that after opening in late 2000, the number of filings in the collateral registry increased from 65,000 in 2001 to 171,000 in 2002 and 190,000 in 2003. The number of borrowers reported in the central bank's registry of debtors rose from 24,240 in 2001 to 37,562 in 2002 and 73,357 in 2003, while the total volume of private bank credit expanded by US\$4.8 billion between 2000 and 2003, rising from 11.4 percent of GDP in 2001 to 13.6 percent in 2002 and 15.8 percent in 2003. Credit expansion was not limited to urban areas: 42 of Romania's 43 counties had more filings in 2002 than in 2001 (Chaves, Fleisig, and de la Peña 2004; Stoica and Stoica 2002).

borrowers, as banks may be less motivated to supervise loans properly or to pursue collection if the bulk of loans is covered by a guarantee. Establishing criteria and verifying that additional lending under such programs goes to SMEs that would have otherwise been excluded is extremely difficult. Nevertheless, successful schemes have been operated by ACCION International and RAFAD (Recherches et Applications de Financements Alternatifs au Développement), two international nongovernmental organizations that have focused on an intermediary-wholesale model (appendix case 12). Successful private initiatives also include guarantees of bonds or securitized assets issued by financial institutions catering to MSMEs.

Improve the Legal and Judicial Frameworks

Governments should develop the laws and commercial codes that define property rights and the judicial institutions and processes that make them credible.

Markets need a clear definition of property rights that can be enjoyed and transferred to other parties. Disputes should be resolved rapidly and affordably. A country's commercial law on collateral liens is critical in determining the efficacy of collateral in a loan contract, that is, it must clearly define the implementation of laws governing contract enforcement, forfeiture and collection of collateral, and use of movable assets as collateral. Clear collateral laws and their implementation enable asset-based lending, another transactions-based lending technology whereby loans are based primarily on the value of specific borrower assets. Romania provides an interesting example of the use of movable assets as collateral, one that addresses one of the constraints that SMEs face in accessing capital (box 4.4).

Strengthen the Institutional Infrastructure

This section highlights the successful measures implemented by governments to strengthen the institutional infrastructure for the SMEs.

Support Relevant Training and TA for Interested Financial Institutions

The profiled banks demonstrate the benefits of strengthening the capacity of commercial financial intermediaries to undertake lending to MSMEs. The experience of the banks in Paraguay illustrates how addressing the binding constraint of bank know-how through TA was far more important than addressing the banks' perceived liquidity constraints in relation to developing strong SME portfolios (box 4.5). The Kazakhstani government used its own funds not to subsidize the interest rate, but to pay for TA to build private banks' capacity to serve this important market segment for the long haul.

Box 4.5. Financial Sector Reform and Effective TA in Paraguay (Appendix Case 7)

During the 1990s, the government of Paraguay implemented financial sector reforms, including liberalizing interest rates, eliminating subsidized interest rates, and improving banking regulation and supervision. The reforms and the resulting banking system consolidation created a highly competitive banking industry thirsting for new clients and markets. These broad reforms, coupled with the high-quality TA provided to the participating banks as part of the program, produced the positive results described in the appendix.

Provide or Facilitate Initial Financial Support

The experience of Armenia illustrates how governments can jump-start financial services for SMEs. Despite strong demand for rural loans in Armenia, banks were hesitant to risk extending credit to farmers and village associations. The government of Armenia borrowed funds from a multilateral agency and passed on half the money in the form of a grant to the Agricultural Cooperative Bank of Armenia, a private cooperative bank, to build its equity base and incubate an early demonstration of sustainable agricultural support services (see case 6 in the appendix).

Build the Information Infrastructure

An enabling legal framework should encourage information sharing among lenders and often requires reviewing bank secrecy laws, which have effectively prevented the establishment of private credit bureaus in almost every country of the former Soviet Union; provide incentives for sharing both positive and negative information; and eliminate restrictions on access to public records. The legal framework must balance the need for information sharing and the protection of privacy and of consumers' rights. Also important is the creation of public versus private credit bureaus. In Argentina, the Dominican Republic, and Peru, public and private registries complement each other and share data. In Sri Lanka, the credit bureau is a public-private venture, with the initial capital of 51 percent held by the central bank declining as more commercial financial institutions join the registry.

Promote Accounting Standards

Strong accounting standards and credible accounting firms are necessary for SMEs to have informative financial statements. Reducing SMEs' opacity by means of simplified, standardized charts of accounts would pave the way for additional forms of transactional lending technologies that depend on hard information, such as lending based on financial statements. At the same time, complementary support to SMEs to improve their financial accounting systems and obtain audits, for instance, through matching grants, is likely to result in more credible SME applications for financing.

Invest in and Promote Credit Bureaus and Registries

The availability of information about payment performance through credit bureaus has been empirically shown to increase the availability of credit. Surveys show that the time needed to process loans, the costs of making loans, and the extent of defaults are all higher without credit bureaus (Berger and Udell 2005). Such hard data would help pave the way for credit scoring—an additional lending technology for SMEs—whose use in the United States is exemplified by Wells Fargo (case 5 in the appendix).

Invest in Technology

One way to support technological efficiency is through such industry-level technology initiatives as building the capacity of information technology firms. This, in turn, can provide quality information technology services to financial institutions and/or programs that teach consumers how to use automatic teller machines, debit cards, and credit cards (CGAP 2005b).

Evaluate Performance and Incorporate Lessons Learned

This book argues for building strong, sustainable financial institutions that can serve MSMEs on commercial terms along with practical performance indicators that can help governments evaluate the impact of interventions as a basis for continued support or changes in approach. Such institutional performance indicators could include the following:

- *outreach (coverage)*: the number of individuals and enterprises reached (which should include qualitative indicators to ensure that the desired population has been reached);
- *cost-effectiveness*: administrative costs as a percentage of the outstanding portfolio, personnel costs as a percentage of the total portfolio, ratio of the number of loan officers to the number of loans, and so on;
- *portfolio quality*: portfolio-at-risk measures;
- *financial sustainability*: the extent to which revenues from clients equal or exceed the cost of service provision (including loan losses, cost of capital, and administrative costs).

For example, the World Bank loan of US\$50 million to Banco do Nordeste of Brazil is subject to a performance-based contract that requires Banco do Nordeste to meet two key performance indicators: portfolio-at-risk for longer

than 30 days is no greater than 8 percent and loan losses are no greater than 4 percent.

Evaluating the impact of interventions in developing a sustainable market for SME financing is a more difficult proposition. Market development indicators can include the following:

- number, distribution, and quality of service providers;
- types of MSME products available;
- degree of competition among providers and implications for interest rate pricing;
- awareness and willingness of MSMEs to pay for services at unsubsidized prices.

V. Conclusion

The premise of this book is that a sound MSME policy is synonymous with a sound financial sector policy. It advocates that governments should provide public goods that level the playing field for financial institutions to innovate services for all segments of the market. These public goods entail a sound financial sector policy framework; investing in building sound institutions; and investing in a supportive information infrastructure, such as credit bureaus and accounting standards. Examples from around the world illustrate how such a strategy has helped build more inclusive financial systems for all.

Appendix: Case Studies on Improving Small and Medium Enterprises' Access to Finance

Case 1. The Kazakhstan Small Business Program⁵

The Kazakhstan Small Business Program (KSBP) is a remarkable case of commercial banks successfully going down-market to provide finance for small and medium enterprises (SMEs). Following an urgent request from the government for a line of credit for SMEs, the KSBP arose as a partnership of seven private commercial banks. It was supported by the European Bank for Reconstruction and Development and received a sovereign, guaranteed credit line of US\$77.5 million as a refinancing facility and additional funding from the Kazakhstani government, the U.S. Agency for International Development (USAID), and the European Union (EU) for technical assistance (TA) and institution building.

Background

The impetus for creating the KSBP came from the need to replace an underperforming program consisting of an SME credit line provided by the European Bank for Reconstruction and Development and guaranteed by the government. This SME credit line, approved in 1993, offered partner banks a financing facility of up to US\$122.6 million. However, the quality of the portfolio was poor, and one bank failed completely, forcing the government to honor its guarantee for a lost portfolio of US\$9.5 million. The program's failure was not due to a lack of demand from the SME sector, which had been growing and had limited access to formal banking, but to a deficiency on the supply side, namely, the

5. Source: World Bank 2004b.

partner banks lacked the interest and know-how to issue and monitor SME loans. In contrast, the KSBP managed to avoid this structural fault in the design of the old program. The KSBP aimed not only to lend funds to SMEs, but even more important, to transfer know-how and create incentives to build the capacity of partner banks to pursue SME business.

Results

During April 1998 to February 2004, the KSBP's portfolio grew at an average annual rate of 100 percent, reaching more than US\$236 million and totaling more than 44,000 loans. KSBP partner banks opened 135 branches in all urban centers of Kazakhstan, employing 600 loan officers who provide an average of 4,000 loans per month.

Client Profile and Outreach

The KSBP's portfolio growth was complemented by significant client outreach: 90 percent of the clients never had access to formal bank credit prior to borrowing from the KSBP, and more than 65 percent of them were owners of an unregistered business. Indicative of the KSBP's successful outreach is that 85 percent of disbursed loans were microloans and that the average loan amount declined during the first two years of operation,⁶ with the median client having an outstanding loan of US\$2,000. Despite the large size of its portfolio, the KSBP has successfully controlled credit risk. After the 1998 financial crisis in the Russian Federation, only 4 percent of the portfolio was at risk, and portfolio-at-risk (PAR) has remained below 1 percent over 2001–3.

Products and Services

The aim of the KSBP is to provide small businesses with a reliable, long-term source of finance by giving them access to loans from Kazakhstani commercial banks. Loans can be granted either in U.S. dollars or in tenge. They must be repaid in equal installments, but flexible repayment schedules, and even rescheduling, are possible. To ensure that clients receive efficient service, the potential borrower market was divided into three groups, each with its own specifically targeted products, as follows:

6. Following the decline during the first two years, the average loan amount stayed at US\$5,000 per disbursed loan, US\$1,800 for microloans, and US\$20,000 for small business loans.

- *Express loans*: loans of US\$100 to US\$5,000 granted to private individuals and entrepreneurs needing uncollateralized working capital loans disbursed in one or two days with a term of 3 to 12 months.
- *Microloans*: loans up to a maximum of US\$10,000 granted to private individuals, entrepreneurs, and legal entities with a term of 3 to 24 months (up to 48 months for investment purposes).
- *Small loans*: loans up to a maximum of US\$200,000 granted to private individuals, entrepreneurs, and legal entities with a term of 3 to 36 months (up to 48 months for investment purposes).

Innovations to Increase Outreach to SME Clients

Two key innovations distinguish the KSBP's line of business from mainstream credit providers. First, the approach enabled private commercial banks to offer those SMEs not served by the formal financial sector with sustained access to loan financing. Second, the KSBP offered a simplified approach to lending. The borrower was required to submit minimum documentation and did not need to provide a business plan, permitting applications to be processed and loans to be granted in the shortest possible time. In the case of the express loan, loans can be granted within one or two days. Other types of loans (microloans and small loans) take less than a week on average. Such quick turnarounds for loan applications were not previously possible.

SME Finance Business Organization

The KSBP created a partnership of six private commercial banks and one state bank that was privatized in 2001. Each bank opened a specialized SME loan department designed to operate as a stable and independent entity within each bank. As the business became increasingly profitable, management started to integrate the SME departments into the banks' organizational structure. SME management positions were created for experienced SME staff, and a head office department, responsible for coordinating and monitoring SME business, was gradually established in all the partner banks.

Risk Management Techniques

The KSBP's success in controlling credit risk can be attributed to the use of a number of risk management lending technologies, namely:

- Credit analysis gives highest priority to prospective borrowers' ability to pay, primarily by undertaking realistic calculations of the cash flows of their businesses.
 - Loan officers are trained to insist on inspecting firms' parallel internal books and to use these accounts, together with their own calculations of sales figures, to arrive at a realistic assessment of capacity to repay the loan.
 - Loan officers give due consideration to the specific characteristics of an applicant's business. When relatively large-scale clients file applications, loan officers not only analyze the firms' balance sheets and profit and loss accounts, but also perform cash flow analyses and sensitivity analyses. In the case of very small businesses—most often informal—the analysis is less detailed, with greater emphasis on borrower households' social environment and financial situation when making the credit decision.
- While professional appraisers value assets pledged as loan security, this aspect of the analysis is secondary in relation to decision making.
- Initially, a credit committee makes all credit decisions. As the volume of small and micro lending increases, appropriate decision-making and control mechanisms are set up.
- Emphasis is placed on loan officers as the key to maintaining a low default rate, which is vitally important for the program's sustainability.
 - Each loan officer bears full responsibility for the institution's relationship with the client throughout the entire life of the loan, including analysis, disbursement, monitoring, and enforcement.
 - In addition to high-quality credit analysis, intensive monitoring by the responsible loan officers is a central factor in ensuring good repayment performance.
 - Loan officers are paid performance-based salaries, that is, their compensation is a function of their productivity and the quality of their work.
- A powerful software package is used to support credit decision making, manage the loan portfolio, and supply information to middle and senior management.

Success Factors

The unsuccessful guaranteed line of credit that preceded the KSBP demonstrated to the government of Kazakhstan that a line of credit alone was insufficient to

ensure successful SME lending and that the binding constraint in the banking sector was a lack of know-how. The KSBP successfully incorporated TA into the program, and the government worked with USAID, Internationale Projekt Consult, and the EU in providing training on SME lending to the partner banks. This boosted the capacity and know-how of the partner banks and enabled them to successfully build the SME lending segment of their business.

Other factors that contributed to the program's success include the lack of competition from nonprofit institutions in the SME loan market offering the same product on more attractive terms than for-profit players, which crowds out private institutions in some countries; the program's emphasis on institutional innovation and smooth institution building; and the establishment of an accounting sector that monitors profitability using profit center accounting.

Role of Government

The KSBP's success is also due to the government's strong commitment to developing the SME sector and financial markets in its pursuit of poverty reduction, liberalization, privatization, and structural reform of the economy. Sound macroeconomic policies have resulted in positive growth rates, a balanced budget, and low inflation. The government liberalized the financial sector by abandoning interest rate ceilings, establishing a banking supervisory authority at the National Bank of Kazakhstan, and adopting a legal framework in accordance with international standards. The government also liberalized the banking sector, which permitted strong competitive pressure among banks and provided an ideal environment for banks seeking down-market opportunities. Even though the government had asked for and strongly supported the program, it did not intervene directly in its operations.

Case 2. The Agricultural Bank of Mongolia: Restructuring and Expanding through Downscaling⁷

The Agricultural Bank of Mongolia (Ag Bank) provides an outstanding example of how an unprofitable state bank can be transformed into a prosperous private institution. Professional bank restructuring, new management, and strong government commitment—combined with support from donor organizations such as USAID and the World Bank—helped turn the bank around. Ag Bank now provides services to a variety of clients with a focus on microentrepreneurs and SMEs.

7. Sources: Boyer and Dyer 2003; World Bank 2004b.

Background

Ag Bank was founded in 1991 as a state-owned bank serving mainly agricultural cooperatives, farmers, and herders. Ag Bank assumed the activities of the former monopoly state bank, along with almost US\$2 million in mostly nonperforming loans and deposits. The central bank regulated interest rates. In 1992, deterioration of the bank's business and Mongolia's move toward a market economy forced the institution to reorganize. As a result of government interference, Ag Bank expanded its activities to larger loans, mainly to state administrative and budgetary organizations and the infrastructure sector. By 1996, the situation had worsened, and the central bank had to appoint a receiver. In 1999, existing shareholders' interests were eliminated, and the central bank put together a restructuring plan.

At that time, the World Bank made reforming Ag Bank a condition of its Financial Sector Adjustment Credit Program for Mongolia.⁸ To this end, USAID agreed to provide funds for an outside management contract. USAID provided US\$2.7 million for 60 months (1998–2003) for a management team with the objectives of restoring financial soundness and profitability to Ag Bank, providing financial products and services to an underserved market, and preparing the bank to operate independently. The government of Mongolia also agreed to provide this management with the full authority to manage the institution free from political and other interference.

In 2000, a U.S. company, Development Alternatives, Inc., won an international bid to manage Ag Bank. The new management team jump-started Ag Bank with a fresh lending program and converted payment services into deposits. It also created an extensive marketing program to increase deposits and a more effective management structure, implemented strong controls through new policies and procedures, and significantly increased training activities.

In 2003, Ag Bank was privatized through an international tender to H.S. Securities, a major Japanese company. The new owner retained Development Alternatives and awarded it a new three-year management contract in September 2004.

Results

The turnaround efforts have proved to be extremely successful. Between late 2000 and February 2004, Ag Bank disbursed 878,000 loans and maintained an arrears rate consistently below 2 percent. It became the most profitable bank

8. The Financial Sector Adjustment Credit Program for Mongolia included a US\$32 million credit line with a grace period of 10 years and a maturity of 40 years. It was designed to support the government's medium-term strategy for financial sector reform and the development needed to achieve macroeconomic stability, accelerate private sector-led growth, and reduce poverty.

in Mongolia, with a return on assets of 2.96 percent and a return on equity of 44.19 percent in 2003. As of February 2004, 128,227 loans were outstanding in a portfolio of almost US\$50 million, and the bank had US\$75.5 million in 377,424 deposit accounts. The 15,433 domestic transfers for that month alone totaled US\$260,000.

Today, the average outstanding loan balance is US\$382, deposit accounts average US\$200, transfers average US\$17, and half of Mongolia's households do business with Ag Bank. Moreover, the number of Ag Bank branches has increased from 269 to 379, making Ag Bank the largest branch network in the country and providing employment for an additional 1,000 people (the number of employees increased from 803 in 2000 to 1,833 in 2004). In addition, Ag Bank is one of the largest taxpayers in Mongolia, paying a total of US\$2.9 million (at current exchange rates) in income taxes for 2001, 2002, and 2003.

Client Profile and Outreach

Ninety-three percent of Ag Bank's branch locations are in rural areas, allowing Ag Bank to reach 98 percent of Mongolia's rural communities. Starting with loans for micro and small businesses, Ag Bank quickly expanded its outreach by offering loans for medium enterprises, pensioners, and herders. In addition, it offered payroll deduction loans and agricultural loans. The products are tailored to match clients' needs, therefore loans may vary from as little as US\$69 for pensioners to US\$5,000 for small businesses.

Products and Services

By design, Ag Bank was created to satisfy the needs of microentrepreneurs (farmers and herders) and farmers' cooperatives. After the turnaround, the bank diversified its clientele to include SMEs, which became mainstream clients along with farmers and herders.

Products were developed to meet the demand of a large segment of the market, thereby ensuring diversification of both products and geographical area. Ag Bank's strategy was to pilot products and then quickly expand them throughout the country via its large branch network. The three main types of products developed were loan products, deposits, and money transfer products. All deposit products are offered in local currency and U.S. dollars. The following loan products are mostly in local currency, but some of them can be offered in U.S. dollars:

- Micro and small business loans are mainstream products in all markets throughout the country. Launched in November 2000, they were designed for small service and production businesses. They are available both short term and long term for qualified borrowers. The average outstanding loan size is US\$1,419, with interest rates of 2.2 to 4.0 percent per month.
- SME loans, developed for small and medium production companies, are larger in size and term. Term loans are available on a limited basis while lending methodology and products are tested on the market. Given their higher risk, these loans require collateral in the form of personal residences and business assets. The average loan size is US\$5,000.
- Herder loans were designed specifically to bridge the gap between living and operating expenses for herders. The average loan size is US\$722.
- Agricultural production loans were introduced in May 2002 and were specifically designed to satisfy the needs of vegetable growers, small wheat farmers, and so on. The average outstanding agricultural production loan is US\$604.
- Payroll loans can be granted for an amount equal to up to seven months' salary for a term of one year. Employees make repayments through monthly salary deductions. This service is available for workers whose employers have Ag Bank handle their payrolls. This kind of cooperation can be mutually beneficial: employers save on administrative costs, Ag Bank receives payroll deposits, and employees can take advantage of payroll loans. The average size of a payroll loan is US\$218.
- Pensioner loans, developed in 2001, represent small loans averaging US\$69 that can be up to six times the size of borrowers' monthly pension. The loans are repaid through automatic deductions from future pension payments.

Deposit products include personal and business current accounts; savings accounts that permit savers to deposit or withdraw money at any time without payment of a fee; time deposits with higher interest rates than savings accounts, but with limitations on withdrawing funds; direct deposits of pension payments through a program with the Social Insurance Fund; and direct payroll deposits.

Money transfer products consist of the Quick Pay franchise, which guarantees cash transfers between offices in the capital and 77 online locations throughout the country within three hours; cash transfers between any Ag Bank location within one to three days; and Western Union transfers between Ag Bank and any other Mongolian bank or any Western Union office in more than 180 countries worldwide.

Risk Management Techniques

Ag Bank's success in controlling risk (its arrears rate is consistently less than 2 percent) can be attributed to a combination of the following factors:

- diversifying products based on clients' needs and geographical areas;
- piloting products and customizing them to local needs before launching them throughout the country;
- adopting a conservative lending approach for high-risk products by requiring collateral in the form of borrowers' private assets, such as personal residences, and business assets;
- having payroll and pension loans backed by automatic deductions from salaries and pensions;
- creating the right incentives for managers, who are completely accountable for all their decisions;
- having zero tolerance for politicians trying to influence lending decisions;
- providing every employee with incentive compensation on a quarterly basis based on his or her performance;
- ensuring connections with local communities by having staff and their families in rural areas embedded in those communities, thereby enabling loan officers to know whom to lend to, how much to lend, and who is likely to repay;
- monitoring loans carefully and regularly.

Success Factors

Foreign expertise, combined with local knowledge of economic peculiarities, contributed to the successful restructuring of Ag Bank. Other components included finding new clients, introducing innovative products, conducting banking activities in a professional manner, incorporating international experience into management strategy, and training local staff to international standards.

Role of Government

The government of Mongolia contributed to Ag Bank's success through strong commitment to providing the outside management with full authority to manage the institution free from political and other interference. Even after a complete change in the government from the Democratic Party back to the Communist Party, the government remained committed. The government also allowed fair and competitive privatization.

Case 3. Innovation by the CrediAmigo Program of Banco do Nordeste⁹

The CrediAmigo microfinance program managed by Brazil's Banco do Nordeste shows how an international financial institution like the World Bank can be a catalyst in the development of microfinance retail capacity. Contrary to conventional wisdom, the case of CrediAmigo shows that large state-owned banks can do microfinance well and that multilateral banks do not necessarily focus on short-term disbursement to the detriment of longer-term capacity building. The case of Banco do Nordeste also shows how donor-sponsored institutional innovations facilitate the adoption of an effective commercial bank approach to scaling up micro and SME lending.

Background

Created in 1954, Banco do Nordeste is a development, investment, and commercial bank that serves northeastern Brazil, one of the poorest regions of the country, with 46.5 million inhabitants or roughly 30 percent of the country's total population. Banco do Nordeste emerged from a major internal reform as a mixed capital company with majority ownership by the federal government, and in 1996, it had R\$6 billion (US\$3 billion) in assets and 176 branches throughout the northeast. To satisfy its regional development mandate, Banco do Nordeste looked for more effective ways to reach the poor than traditional credit operations when it approached the World Bank to seek its assistance in starting microenterprise lending on a sustainable commercial basis.

Brazil has long been considered one of the world's largest untapped microfinance markets, with the largest concentration of microenterprises in Latin America, estimated at more than 9 million, with at least 2 million in the northeastern region alone. Despite this large potential market and scant outreach by the banking sector, in 1998, no Brazilian microfinance program had more than 5,000 clients.

CrediAmigo has focused consistently on growth with quality since its initial pilot of a single loan product. This product consists of 90-day loans to individual clients organized in solidarity groups of about five borrowers who cross-guarantee each others' loans. They have repayment schedules of 15 days, free-market interest rates, and incentives for prompt repayment in the form of interest rebates. In 2003, five years after the launch of CrediAmigo, the program

9. *Source:* Bursky 2003; Christen, Schonberger, and Rosenberg 2001; World Bank 2004b.

was the largest microfinance program in Brazil and the second largest in Latin America, with 175 branches across the region. Currently, the bank's performance indicators are within international standards and growth remains strong, with increases in fiscal 2002 of 39 percent in total clients and 44 percent in total portfolio size.

Results and Sustainability

Between 1998 and 2003, the CrediAmigo program provided microcredit to more than 300,000 of Brazil's working poor and became financially sustainable. Most of these families lived on less than US\$2 per day and worked in the cities and towns of the northeastern region. After only three years of operation, CrediAmigo was already among the top microfinance institutions in Latin America in terms of geographic penetration, number of clients, and depth of outreach. By 2003, the program had more than 55,000 active clients in 358 municipalities throughout the northeastern region. The average outstanding loan balance was R\$541.47 (US\$270).

CrediAmigo's portfolio quality and staff productivity are at international best-practice levels. Using a strict 30-day PAR measure, only 3.5 percent of its loans are late. Its annualized loan loss rate is 2.5 percent, even after fully provisioning all loans with any payment overdue by 90 days or more. Loan officers with nine months or more of experience handle an average of 313 clients each. About 85 percent of CrediAmigo's 108 branches became operationally sustainable within three years, and the program as a whole reached full financial sustainability in mid-2001. Thus CrediAmigo is demonstrating that a down-market focus can be consistent with sustainable commercial banking in Brazil.

Success Factors

Several factors led to CrediAmigo's success. The single most important factor was the commitment of Banco do Nordeste's president to implementing best-practice microcredit principles, a significant departure from previous Banco do Nordeste policy and practice. The commitment to CrediAmigo has been evident from the following:

- Growth in the number of branches and loan officers was carefully controlled.

- Despite being a state-owned bank, Banco do Nordeste maintained a commitment to profitability in the design and management of CrediAmigo.¹⁰
- Sustainability required a high-productivity model with low costs. Banco do Nordeste created a bank within a bank, first by using loan officers outsourced by external agencies and then by replacing Banco do Nordeste branch managers with coordinators drawn from the loan officer pool.
- Branches were evaluated as individual profit centers, but to maintain the benefits of scale economies, Banco do Nordeste strengthened CrediAmigo's central technical units to permit better central monitoring of loan officers' and branches' performance.
- Banco do Nordeste's nontraditional management style has always involved many top managers in decisions relating to the program. While this takes a significant effort by CrediAmigo staff, it also has a catalytic effect on the rest of the bank in areas such as the use of staff incentives and the development of a culture with low loan delinquencies.

Other success factors include the following:

- charging above-market interest rates to clients to cover the relatively high cost of administering extremely small loans on a sustainable basis,
- compensating program staff based on the results they achieve,
- using management information systems that give microcredit staff immediate access to accurate transaction histories and current repayment status for all clients,
- making credit decisions on a decentralized basis that are backed up by ex post quality controls,
- maintaining a commitment to high levels of loan recovery,
- separating microcredit lending operations from Banco do Nordeste's government-directed lending programs.

Role of Public Policy

While not responsible for CrediAmigo's success, the World Bank played an important catalytic role in the program's evolution. It also made a number of key decisions that were critical to the program's long-term sustainability. The most important contribution of the World Bank was its patience in allowing development to proceed at its own pace as follows:

10. The program was initiated with a 5 percent flat monthly interest rate, translating to a 6.9 percent effective monthly rate after adjusting for inflation. Since then the interest rate has declined in proportion with the cost of funds in Brazil, but it has remained at levels consistent with achieving profitability.

- *Step 1: The World Bank facilitated external TA.* During the pilot stage, assistance from the World Bank and the Consultative Group to Assist the Poor was limited to helping Banco do Nordeste find high-quality international expertise and learn from similar experiences in other countries. From 1996 to 1999, the World Bank and the Consultative Group to Assist the Poor spent US\$150,000 and US\$50,000, respectively, on TA, while Banco do Nordeste invested US\$5 million of its own budget.
- *Step 2: The project started small.* The World Bank proposed a slow start based on a small pilot project that involved five branches providing a single product (90-day loans) to avoid the risk that Banco do Nordeste might have wanted to implement wide coverage in a short time before the management model had time to take shape.
- *Step 3: Donor staff received training in microfinance.* The effectiveness of the World Bank's engagement with Banco do Nordeste depended on the development of appropriate skills by World Bank staff and the involvement of successful microfinance practitioners.
- *Step 4: Donor involvement was initially limited.* During the pilot phase, the World Bank focused almost exclusively on the potential sustainability of CrediAmigo. Day-to-day management of CrediAmigo was left to Banco do Nordeste. The initial development process allowed Banco do Nordeste to develop its expertise and confidence in managing a large microfinance program.
- *Step 5: Confronted with initial missteps, the World Bank did not pull out, but instead got CrediAmigo back on track.* Positive results of the pilot project encouraged Banco do Nordeste to expand the microfinance program after only four months, expanding from 5 to 50 branches over the next year. However, overexpansion adversely affected loan repayment rates and portfolio quality dropped (the institution incurred approximately US\$2 million in loan losses and getting the portfolio back on track took six months of intensive retraining of managers and loan officers). While the World Bank had good reason to withdraw its support, it chose instead to maintain the relationship in light of Banco do Nordeste's strong commitment to the program.
- *Step 6: The loan to Banco do Nordeste was tied to portfolio quality, efficiency, and sustainability.* Approved in May 2000, the US\$50 million loan was subject to a performance-based contract that required Banco do Nordeste to meet two key performance indicators: PAR over 30 days no greater than 8 percent and loan losses no greater than 4 percent. As always, Banco do Nordeste remained responsible for day-to-day operations.

Lessons Learned

The CrediAmigo experience suggests the following lessons for multilateral donors in relation to microfinance:

- Large state-owned banks can do microfinance well with adequate autonomy, commitment to results, TA, and willingness to change culture.
- After proper pilot work, a bank with a large pre-existing branch network can roll out microfinance much more rapidly than a new institution focused only on microfinance.
- Outcomes may be better when a large volume of lending follows, rather than precedes, the development of proven retail capacity.
- Donors must help development finance institutions stay focused on best-practice finance principles, especially when the short-term interests of both donors and development finance institutions lie in disbursing large amounts of credit with little regard for loan recovery.
- Donors must counter the ultimate tendency of development finance institutions to grow too quickly and with too little financial discipline.
- Donors can be effective with a limited technical role of setting benchmarks consistent with international best practice and putting client institutions in contact with top microfinance practitioners.

Case 4. ShoreBank International, Ltd. in the Caucasus¹¹

The activities of ShoreBank International, Ltd. (SBI) in the Caucasus are an outstanding example of how TA combined with loan product innovation can help develop financial markets and open access to formal financing for SMEs and microentrepreneurs.

Background

SBI is a wholly owned affiliate of the ShoreBank Corporation, which provides a variety of consulting services to help other companies increase their services in underserved markets. In September 1997, SBI formed a five-year partnership with USAID to implement the Caucasus Small and Medium Enterprise Finance Program (CSFP). The CSFP was to use U.S. foreign assistance and other resources to build permanent, indigenous financial and nonfinancial institutions in the Caucasus that would underpin broadly based economic and employment growth and strengthen ties between the region's countries.

11. *Source:* ShoreBank International, Ltd 2001, 2003, 2004.

In 1999, SBI began a partnership with the Tbilisi Business Center (TBC) Bank in Georgia. In Azerbaijan, SBI had limited resources and no reliable partners. Consequently, SBI opened an independent, regulated financial institution, ShoreBank Overseas Azerbaijan (SOA). In February 2000, SOA was the first institution in the country to obtain a limited lending license issued by the Bank of Azerbaijan. A limited lending license required only US\$500,000 of capital, whereas a full license required US\$5 million. As a start-up institution, SOA relied solely on USAID funding for its operational and capital funding. As of March 2001, SOA had disbursed 56 loans with an average loan amount of US\$9,211 and an average term of 12 months.

Results

The partnership with the TBC Bank quickly yielded sound results. Between 1999 and 2002, the net portfolio amount of the TBC Bank increased from US\$9 million to US\$50 million, while overall PAR decreased from 15 to 3 percent. The net income of the TBC Bank quadrupled and the net operating margin increased from 6 to 31 percent, with an average of 32 percent. During this period, the TBC Bank also attracted 441 new clients. The annual number of developing enterprise loan product (DELP) loans increased from 30 in 1999 to 113 in 2002, with a total of 411, and the number of SME loans grew from 55 in 1999 to 77 in 2002, with a total of 254. SME loans and DELP loans were funded with US\$6 million in credit lines from IFC.

In addition to quantitative successes, SBI TA helped the TBC Bank to develop an SME lending department and a credit risk department. SBI also helped introduce two new lending products: SME loans and DELP loans. Moreover, SBI introduced the cash flow methodology of credit analysis to local staff and provided local officers with the necessary training on how to use cash flow analysis in day-to-day operations.

In Azerbaijan, SOA achieved operational self-sustainability of 199 percent in 2003 (local costs only). SOA earned positive operational profits during this period as well. During 2000–03, SOA managed to maintain PAR over 30 days of zero and had no unrecovered loan write-offs. The total portfolio increased from approximately US\$49,500 to US\$1.6 million. Return on assets rose from negative 5.0 percent to positive 10.1 percent. In September 2002, SOA received US\$2.375 million in grants from USAID to continue its activities in Azerbaijan until September 2005. As of 2005, SOA had disbursed approximately US\$6 million of loans funded with IFC credit lines.

Client Profile

Apart from the traditional individual microentrepreneurs and SME clients, SBI's clientele profile includes the "missing middle," that is, clients who have outgrown traditional microloans, but cannot yet access loans from commercial banks. In addition, Azerbaijani clients include individuals who want residential real estate loans.

Products and Services

As an advisory and consulting unit of the ShoreBank Corporation, SBI has accumulated extensive skills and experience in a number of areas, including SME lending and bank capacity development. Since 1990, SBI has undertaken microenterprise and SME and real estate finance projects with total disbursements of more than US\$250 million, working with 45 financial institution partners in nine different countries. SBI's main initiatives in the SME field include strategic planning for development finance institutions, small business lending and development loans, small business credit programs, and small business lending and commercial banks.

SME loans are in the range of US\$10,000 to US\$250,000 with terms up to three years, depending on the client's needs, and require collateral. Loans are provided in both U.S. dollars and local currencies. In Georgia, the average SME loan size increased from US\$15,843 to US\$39,943 between 1999 and 2002. In Azerbaijan, the average range was from US\$10,000 to US\$30,000.

DELP loans range from US\$1,000 to US\$15,000, with an average term of 12 months, and collateral is required for obtaining this kind of loan. As of 2001, the average DELP loan size in Georgia was US\$4,382 with an annual interest rate of 33.6 percent. Azerbaijan's average was US\$9,211 with an average annual interest rate of 36 percent.

Microlending is provided in the form of individual and group loans ranging from US\$100 to US\$2,000, but SBI does not focus on this type of loan.

In addition to introducing new products to the relatively unsophisticated Caucasian financial market, SBI contributed to capacity building in the financial market by providing training programs for local staff on implementing cash flow methodology in banking activities, carrying out credit risk assessments, and undertaking client monitoring.

Innovations to Increase Outreach to SME Clients

All SBI activities in the region were innovative and different from the bank's regular business in the relatively nascent Caucasian financial market. SBI was one of the pioneers to establish SME lending in the region. In Azerbaijan, banks did not lend less than \$30,000, and in Georgia, lending to SMEs was relatively rare. In both countries, SBI's activities opened formal access to financing for SMEs and microentrepreneurs by offering a reliable source of credit.

The most significant innovation is the DELP, a bridging product designed to meet the needs of businesses that had outgrown traditional microfinance products, but could not yet reliably access commercial banks as a source of financing. The DELP also helped create reliable and loyal clients. Many DELP borrowers are coming back for larger loans as their businesses grow.

SME Finance Business Organization

In Georgia, SBI helped the TBC Bank establish an SME lending department and credit risk analysis department. Two managers from SBI headquarters helped manage the first stages of the SME and DELP lending lines. They also trained local staff, introduced new credit analysis and monitoring methodology, and provided day-to-day mentoring and formal classroom training. In addition, during the course of the partnership, SBI helped launch DELP in five TBC Bank branches. In 2001, the TBC Bank opened a new branch in Tbilisi dedicated solely to lending to small businesses.

Even though Azerbaijan had a larger market than Georgia, SBI could not find a reliable partner to work with in Azerbaijan for several reasons. First, Azerbaijani banks were reluctant to lend less than US\$30,000, which meant that SMEs and microentrepreneurs did not have access to financing through commercial banks. Second, banks did not fully embrace SBI's approach to lending and did not wish to relinquish the informal payments that customarily accompanied any loan. Thus having no partner to work with and facing funding limitations (SBI had only around US\$730,000 from USAID for work in Azerbaijan), SBI undertook a pilot project to form an independent, regulated financial institution, SOA. As local laws did not allow for limited or nonbanking institutions, SBI initiated and helped pass a limited banking license through the Azerbaijani National Bank and parliament in late 1999. SOA now has two offices, one in the capital, Baku, and the other in Sumgait. Its small staff consists of nine local employees and one expatriate. Local staff members received extensive training in SME finance.

Risk Management Techniques

Facing an unstable macroeconomic environment in the Caucasus, SBI had to implement strict risk control practices to ensure loan repayment. The outstanding results—PAR over 30 days of 0 percent in Azerbaijan, and 1 percent in Georgia—show that it was quite successful in this exercise. The risk management techniques included the following:

- undertaking careful assessment of the needs of small businesses—the market, effective interest rates, competition, and potential partners—before entering the market in order to acquire pertinent information about the market and potential risks and difficulties;
- evaluating and assessing clients through reference checks and interviews with clients, other business owners, employees, suppliers, customers, neighbors, and relatives;
- making site visits to clients' businesses and homes;
- using cash flow statements as the main financial tool to determine repayment capacity;
- insisting on monthly monitoring of all the portfolios, whereas other players in the market did this exercise on a quarterly basis at best;
- making clients bear currency risks by linking loans in the local currency to the U.S. dollar;
- having strict collateral requirements whereby only the personal assets of the borrowers, such as real estate, shops, and equipment, were accepted, with collateral requirements even stronger in Azerbaijan, where real estate was accepted as a pledge;
- creating a risk-rating system for returning clients.

Success Factors

Having extensive expertise in the developing SME financial sector, SBI realized the need for conveying the necessary skills and training to local staff to ensure the program's effectiveness and the sustainability of the SME finance business after completion of the CSFP. To this end, SBI developed and conducted a comprehensive, week-long workshop in basic credit methods that covered everything from marketing to loan monitoring.

To guarantee the success of the DELP line, SBI began with a soft opening in one location with a few staff members in each country.¹² The methodology, poli-

12. A soft opening is used during the first month or two of a program to allow staff to learn how to apply procedures in the local environment, understand underwriting procedures, determine the proper legal documents and processes, and develop good habits without being overwhelmed with a high demand for loans.

cies, and procedures were tested in the culture and the environment with a small client pool. Then, before opening to the rest of the public, the basic procedures were modified and the legal procedures were adjusted to help clients obtain loans in the most effective, least costly, and quickest manner. The soft opening allowed the program to formally open to the public with solid procedures and policies in place and experienced staff who could handle large client flows.

Interviews with SBI staff showed that the greatest help from the government was in leaving the SBI team alone and not impeding its operations. In Azerbaijan, the success of SOA was indirectly determined by some of the government's macropolicies, such as steady economic growth and low inflation. This increased the number of clients and contributed to the growth of their businesses.

Case 5. Wells Fargo Credit Scoring Model¹³

Wells Fargo is a private financial services company headquartered in San Francisco. It provides banking, insurance, investment, and mortgage and consumer finance services.

Background

In late 1989, the Business Banking Group was set up in the retail bank part of Wells Fargo to focus on small business customers. In 1994, the Business Direct division was formed within the Business Banking Group to focus on making loans of up to US\$100,000, primarily to firms with sales of less than US\$2 million per year. The average loan size is US\$15,000. In addition to Business Direct, Wells Fargo's Community Banking Regions provide small business and small farm loans at local Wells Fargo offices and participate in special lending and referral programs.

Innovations to Increase Outreach to SME Clients

The newly formed Business Direct made dramatic changes to traditional business models to make small business lending highly profitable and to increase Wells Fargo's reach to SME clients. Loan applications are accepted by mail, telephone, or in branch offices and no tax returns or financial statements are required. Most decisions are made automatically based on a scorecard instead of review by the lender, there are no annual reviews, and collateral is not required.

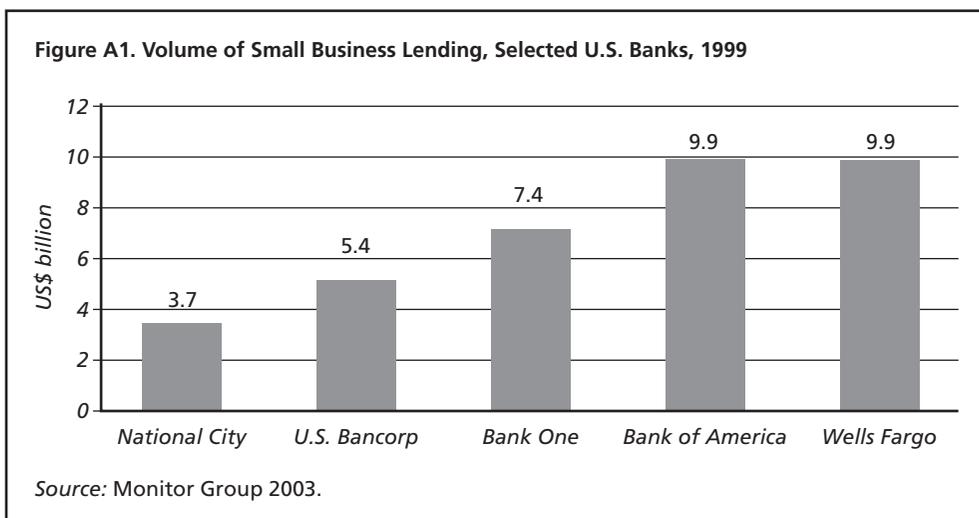
13. Sources: Monitor Company Group 2003; Wells Fargo & Company 2003; Xiao 2004; Wells Fargo Web site (<http://www.wellsfargo.com/>).

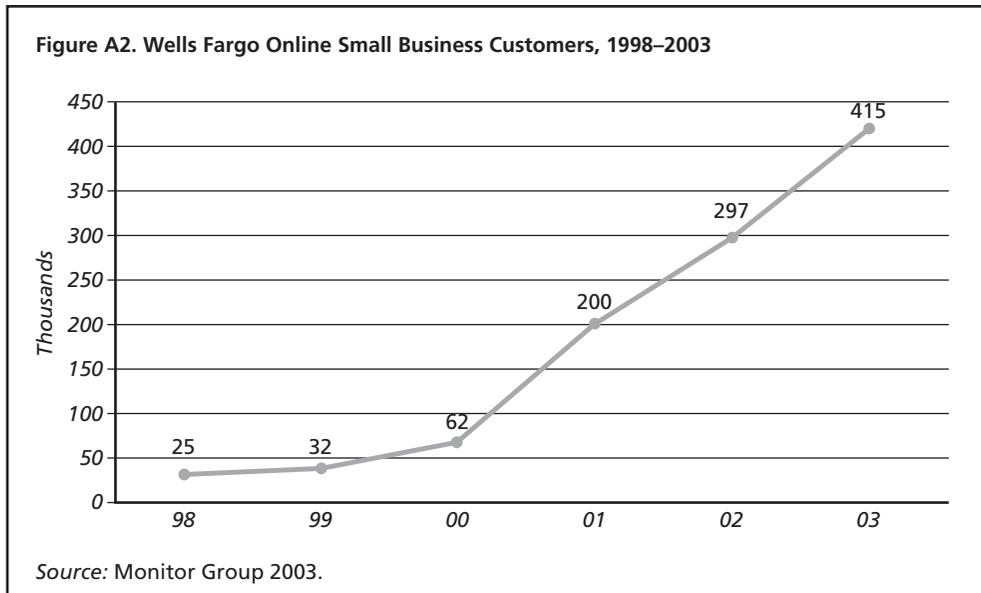
The bank's costs for processing small business loans rank among the lowest in the industry: US\$30 to underwrite and record a loan. Wells Fargo employees say that this new process not only cuts the bank's costs, but also helps reduce adverse selection. Time and simplicity are important criteria to small business owners when they are making financing decisions. By 2004, more than 1.5 million applications had been processed, with two-thirds of the decisions made automatically and the remaining one-third reviewed by the lender. Each review takes only about 15 minutes.

Results

Before 1990, Wells Fargo was not a significant small business lender. Following the establishment of Business Direct in 1994, by 1996, the bank had become the 2nd largest SME lending bank in the United States, with US\$3.5 billion in outstanding loans, up from the 11th largest the previous year, and equaling Bank of America's US\$9.9 billion in outstanding loans by 1999 (figure A1). By 2004, Business Direct had US\$15 billion in loan commitments. About 94 percent of the US\$6.3 billion in outstanding loans was unsecured as of 2004. Wells Fargo's total outstanding loans amounted to US\$253 billion at the end of 2003; profits increased steadily between 1995 and 2004.

In 2000, Gomez Advisors rated Wells Fargo as the friendliest bank to small business owners, and in 2002, the Community Reinvestment Act database rated Wells Fargo as the number one lender to small businesses in the United States in terms of total dollar volume.





Client Profile and Outreach

Business Direct's clientele grew rapidly from 2000 to 2004, when it had 410,000 customers in the United States and Canada (figure A2) with median sales of US\$325,000. About 70 percent of these customers employed five people or fewer. The average loan balance was US\$15,000, median business deposits were US\$7,000, clients' average time in business was 13 years, and average time as a Business Direct customer was 5.5 years.

Business Direct maintains a balanced and diversified small business lending portfolio without excessive concentration in particular industries or geographic areas. The types of businesses its customers are involved in mirror the overall distribution of small businesses in the United States.

Products and Services

In addition to deposit and loan services for small businesses, Wells Fargo also offers credit and debit card processing services to businesses that want to provide customers with additional ways to pay for products or services. Its online banking provides small business owners with free access to business accounts. Customers can also pay bills and transfer funds between their business and personal accounts online.

Business Direct applied techniques developed for unsecured lending, such as targeted marketing and credit scoring, to the traditional equipment leasing business. As a result, the complexity of leasing products was dramatically reduced and profitability increased. Business Direct then cross-sold these products to its existing small business customers.

Risk Management Techniques

The bank has developed a robust credit scoring system for its small business lending. It collects an extensive range of data and uses a scorecard for loan origination. Potential data elements for a small business origination scorecard include industry, years in business, years as a bank customer, credit history of the business owner or owners, average bank deposit balance, business location, financial assets, and liabilities of the owner or owners. Business Direct obtains approximately 100 pieces of information from consumer credit bureaus every month on every customer, including score, inquiries, number of accounts, and open commitments.

Business Direct also employs statistical models for targeted marketing to attract low-risk small business borrowers, for customer management, and for loan collection. Ongoing assessments of the risks of each account are conducted and necessary actions are taken at the first sign of trouble. Pricing is increased for risky behaviors such as frequent delinquency and over-limit. At the same time, automatic or conditional line increases are granted for good customers.

Success Factors

The following factors help explain Wells Fargo's success in SME lending:

- The adoption of innovative, low-cost distribution media, such as direct mailers, telephone banking, and the Internet, for its SME lending increased the bank's outreach to small business owners as well as its profit margins.
- The use of credit scoring models for loan origination, risk control, and evaluation lowered costs and improved efficiency, which in turn made small business lending highly profitable.
- The disciplined and ongoing assessment and monitoring of the risks of each account reduced the risk of losses and ensured profitability.
- The organizational support from top management and the bank's skilled and committed staff were important for effective implementation of the new techniques.

Role of Government

The bank also attributes its successful and profitable SME lending to the stable and balanced legal and political environments, for example, property rights and contract enforcement; a sound payment and banking system, including interest rate flexibility for risk-based pricing; the reliable communications and postal systems; and the availability of good consumer bureaus for both positive and negative information. Governments in developing countries can certainly play important roles in all these areas to create a healthy policy and regulatory infrastructure for SME lending.

Case 6. The Agricultural Cooperative Bank of Armenia¹⁴

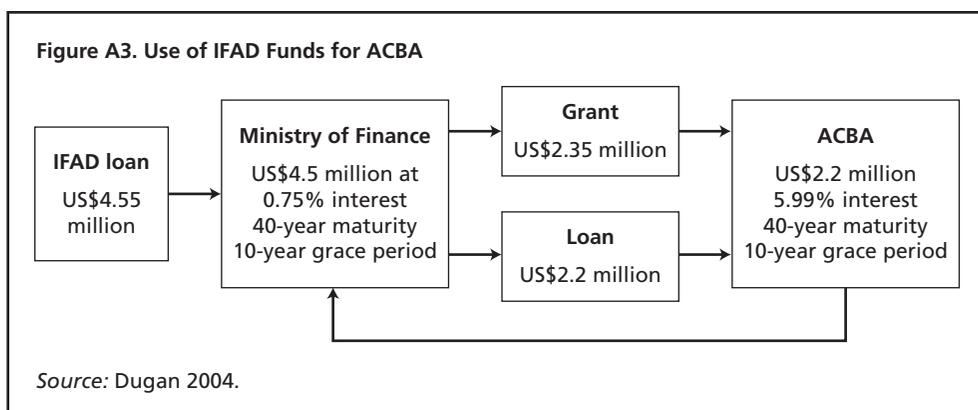
The Agricultural Cooperative Bank of Armenia (ACBA) provides an excellent example of how innovative use of a government loan helped a private bank expand in rural provinces, strengthen its capital base, and become the largest bank in Armenia.

Background

In 1991, the government of Armenia decided to implement a privatization program that resulted in the creation of more than 300,000 private farms. These farms faced numerous difficulties: small average area of cultivation (1.3 hectares), inadequate supplies of inputs and energy because of economic and trade issues (the collapse of the former Soviet Union and the conflict with Azerbaijan over Nagorno-Karabakh), and lack of credit. Existing banks were reluctant to take risks in the agriculture sector and were not interested in extending micro-credits to individuals.

ACBA was established in 1995 as a private cooperative bank to serve Armenia's rural communities. The bank's shareholders consist of 10,000 farmers from 243 village associations. A feasibility study carried out by Crédit Agricole in 1993–94 clearly indicated a significant demand for rural loans in Armenia. In late 1996, the International Fund for Agricultural Development (IFAD) launched the Northwest Agricultural Services Project in Armenia. The aim was to develop sustainable agricultural support services for 40,000 people living in three rural provinces in Armenia, and by this time, ACBA was ready for a strategic expansion after have been operating with a moderate level of success. IFAD and ACBA

14. *Source:* Dugan 2004; Agricultural Cooperative Bank of Armenia (<http://www.acba.am>); European Union (<http://tacisinfo.ru/en/fiches/acba>); International Fund for Agricultural Development (<http://www.ifad.org>); Microfinanza (<http://www.microfinanza.it>).



persuaded the Ministry of Finance to accept creative (in terms of the way it was structured) use of the IFAD loan, and the US\$4.5 million credit line was restructured into a grant and loan package for ACBA (figure A3), which used the grant resources to build its capacity.

Results

By the end of 2003, ACBA had a portfolio of US\$21 million, of which US\$8.8 million was in agricultural loans with a repayment rate of almost 100 percent. The bank also established eight branches throughout the country. According to an investigation carried out in 1999 by the European Union's Technical Aid to the Commonwealth of Independent States (TACIS) Program, which provides technical assistance to Eastern European and Central Asian countries, ACBA's activities made the following significant contributions to agricultural development in Armenia between 1995 and 1999:

- Farmers financed by ACBA increased their cultivated areas by 27 percent.
- Farmers' yields increased by 22 percent.
- Cereal production doubled and animal production increased by 61 percent.
- New equipment purchases increased by 32 percent.

Products and Services

ACBA's client base of 32,640 customers consists primarily of owners of small farms organized in village associations. At the outset of its operations, ACBA

Table A1. ACBA's Development and Fostering of Agriculture, 1996–2004

Category	1996	1999	2002	2003	June 2004
Number of local associations	60	280	561	586	612
Number of association members	4,028	11,223	18,589	20,491	22,000
Agricultural credit portfolio (US\$ thousands)	557	4,386	7,386	8,870	11,064

Source: Microfinanza data (<http://www.microfinanza.it>).

provided only short-term loans. Today, ACBA offers a full range of financial services, including demand and time deposits, credit and debit card services, collateralized loans, installment lending, agricultural lending, lending to SMEs, and sale and purchase of promissory notes and securities. Savings products are in high demand: retail customer deposits grew 68 percent from December 2002 to December 2003. ACBA was the first bank in Armenia to provide financing for agriculture and has become the industry leader in lending to agricultural clients. During 1996 to 2004, ACBA's agricultural credit portfolio grew from US\$557,000 to more than US\$11 million and in 2004 accounted for over a third of ACBA's total portfolio (tables A1 and A2).

Innovations to Increase Outreach to SME Clients

The main innovation introduced by the IFAD-ACBA partnership that increased outreach was the creative use of the IFAD loan for sustainable microfinance. IFAD restructured a traditional credit line into a grant-loan package, thereby transforming credit into a capacity-building investment. While an ordinary credit line would have simply added to the liabilities of the balance sheet, grant resources were used to contribute to the capital and reserves of the bank, thus helping it build equity. The equity was leveraged through other bank loans and savings mobilization.

In 2002, ACBA became a principal member of Visa International and is now one of the leading banks in Armenia for issuing credit cards and providing

Table A2. Composition of ACBA's Portfolio, 2004

Type of loan	Total amount loaned (US\$)	Number of loans	Amount of average loan (US\$)
Agricultural	9,186,987	11,654	788
Commercial	13,328,561	1,669	7,986
Consumer	3,619,223	12,778	283
Total	26,134,772	26,101	1,001

Source: Microfinanza data (<http://www.microfinanza.it>).

automatic teller machines and point of service terminals. In 2003, ACBA, together with *Crédit Agricole*, IFC, and the Lebanese Leasing Company, established the first company in Armenia to offer leasing services to its customers. Finally, in 2003, ACBA was Armenia's first and only bank to introduce a quality management system and to receive an international quality management system certificate. These innovations not only enabled ACBA to expand the range of services it could offer its clients, but they also benefited the Armenian banking industry as a whole.

SME Finance Business Organization

ACBA based its institutional, financial, and management structures on the European cooperative bank model, adapting this model to take local economic and social conditions and the central bank's requirements into account. ACBA has a three-tier structure. The agricultural cooperative village associations are the foundation of the bank. Association members elect the administrative board, which undertakes preliminary assessments of loan applications. The agricultural cooperative regional unions are the second tier of the bank. As of November 1, 2002, 10 such regional unions were ACBA's sole stockholders. The third tier of the bank is the general meeting at which ACBA's strategic policy is worked out.

Risk Management Techniques

ACBA's success in controlling credit risk is largely due to the compatibility of its credit delivery system with the local social fabric. The village associations function as a screening mechanism by vetting potential borrowers before their appraisal by ACBA. This has proven to be an effective mechanism in the context of tight-knit Armenian communities, as applicants' approval by the community, and not just by the bank, is viewed seriously and helps make clients' commitments binding. In addition, the quantity of loans and their sectoral and regional diversification decreases the overall portfolio risk.

Success Factors

In addition to the effective mitigation of risk, ACBA's successful growth and sustainability can be attributed to the following key factors:

- ACBA managed to make the terms and conditions of IFAD's concessional loan appealing to the government, which made the credit restructuring pos-

sible. The government was receptive to the new way of using donor funds and did not interfere with loan decisions, thereby providing a good environment for ACBA to thrive.

- ACBA's and IFAD's priorities of wanting to serve clients in similar regions were in alignment, thereby creating the context for institutional collaboration.
- Significant TA was offered to ACBA by the EU's TACIS Program for more than three years. The TA focused on extending ACBA's services to more areas of the country; recruiting staff; and training the bank's workforce in credit risk management, financial management, management information systems, and marketing of rural products and services. In addition, consultants helped ACBA with the design and the implementation of current accounts and time deposits.
- ACBA's commercial practices and the absence of political interference ensured the transparent and effective flow of IFAD funds.
- ACBA's use of a cooperative structure for credit delivery ensured high portfolio quality.

Case 7. Inter-American Development Bank Microenterprise Global Credit Programs in Paraguay¹⁵

The Inter-American Development Bank's microenterprise global credit programs in Paraguay show that a wholesale, apex, or second-tier mechanism can be used successfully to reach large numbers of microenterprises with financial services without damaging the performance of the participating retail lenders if certain conditions are met. The microenterprise global programs provide financing to commercial banks and other intermediary financial institutions (IFIs) to facilitate their entry into the microenterprise market. The microenterprise global programs in Paraguay also show how donors can overcome the reluctance of traditional IFIs to reach down to small businesses by focusing TA on commercial banks' start-up costs in adopting microfinance technology.

Background

Between 1988 and 2003, the Inter-American Development Bank invested in 17 wholesale microfinance programs in 12 countries in Latin America.¹⁶ The micro-

15. *Source:* Berger, Yonas, Lloreda 2003.

16. During 1990–2001, the Inter-American Development Bank approved more than US\$534 million in loans and disbursed over US\$356 million through second-tier institutions. These institutions in turn lent to more than 100 first-tier financial intermediaries and to nearly 0.5 million microenterprises.

enterprise global programs are loans to national governments that channel the resources through their central banks to participating first-tier institutions. The executing agency is, in most cases, a department within the central bank itself or a state-owned development bank that serves as the apex, wholesale, or second-tier bank. The funds are lent through a variety of mechanisms, such as discounting, auction, or line of credit, at rates approximating the marginal costs of funds in the market. Participating first-tier IFIs lend directly to microenterprises and are permitted to freely set the interest rates they charge to borrowers.

Paraguay had two successful microenterprise global programs: the first was approved in 1992 (Microenterprise Global I) and the second in 1997 (Microenterprise Global II). Both programs focused on expanding microenterprises' access to the formal financial sector with a credit component channeled through an automatic rediscount mechanism to selected IFIs and a TA component to support participating IFIs and microenterprises. The success of the IFIs that participated in the first phase of the program produced a demonstration effect for others that later began to downscale their operations to serve microenterprises, a traditionally underserved market in Paraguay, but one that in 1990 accounted for 64 percent of employment. The microenterprise global programs also facilitated the introduction of microcredit technology to IFIs, which led to significant reductions in credit risk and administrative costs. In addition, an innovative voucher training program for microentrepreneurs associated with the microenterprise global programs in Paraguay helped create a market for SME training services by covering part of the cost of the training by means of the vouchers.

Results and Sustainability

Microenterprise Global I had a credit component of US\$12.0 million and a separate TA component of US\$2.7 million. The program achieved its objective of increasing the flow of funds to microenterprises through eight regulated IFIs located mainly in the capital, Asunción. By the end of the program in 1996, the participating IFIs had provided 11,295 subloans with an average loan size of US\$1,328 and an average term of 15 months. The average asset size of the microenterprises was US\$4,400, which indicates that the program had reached its target market (firms with less than US\$20,000 in assets), and 50 percent of the loans went to women entrepreneurs. Around 91 percent of the subloans financed retail and services and 9 percent financed manufacturing and agricultural activities. By June 1997, more than 15,000 loans were outstanding, the average interest rate for local currency loans was 4.3 percent per month, and PAR over 30 days averaged 6.6 percent for the program as a whole.

Microenterprise Global II had a credit component of US\$22 million and a separate TA component of US\$3 million for the 14 participating IFIs. By December 2001, an accumulated total of 115,000 subloans had been provided at an average monthly interest rate of 4.6 percent and an average term of 13 months. The total number of outstanding loans was 44,584 with an average loan size of US\$688. Credit reached mostly the retail trade sector (69 percent), followed by services (21 percent), manufacturing (10 percent), and the rural sector (1 percent). Almost 62 percent of the microenterprises that received credit had one employee and slightly over 21 percent had two employees. In 2001, the total outstanding microenterprise portfolio of participating institutions had reached US\$32 million, while only US\$10 million had been rediscounted from the central bank. This shows that the IFIs were already using their own funding sources (70 percent) and suggests that microcredit had become a sustainable product.

As of December 31, 2001—more than nine years after the beginning of Microenterprise Global I—the microenterprise portfolio represented a significant percentage of the participating IFIs' total portfolio. PAR over 30 days was no more than 7.7 percent and PAR over 90 days was no more than 3.0 percent. Compared with traditional IFIs in Paraguay, these were lower rates of loan delinquency. In addition, compared with traditional commercial banks, the average net income was only slightly lower: 10.2 percent for microfinance intermediaries compared with 10.5 percent for traditional IFIs.

Success Factors

The following key factors that contributed to the success of the microenterprise global programs relate to program design and execution components:

- *Effective executing agency.* The Unidad Técnica Ejecutora del Programa of the Central Bank of Paraguay was created as a special executing unit to administer the microenterprise global programs. The unit's location inside the central bank and its leadership by five experienced staff ensured efficient disbursement of loan funds and low transaction costs for participating IFIs. Reporting by IFIs was facilitated by the use of standard reporting templates.
- *Strict selection criteria, supervision, and monitoring.* The executing agency—with the support of the Superintendencia de Bancos—enforced strict selection criteria for participating IFIs and conducted rigorous audits.¹⁷ Strict monitoring of performance contributed significantly to success,

17. During Microenterprise Global I and II, the main selection and performance requirements were that IFIs should (a) be subject to supervision by the Superintendencia de Bancos, (b) show

but prevented many IFIs from participating because of their nonregulated status. However, several Cajas de Crédito were transformed into finance companies and participated in the microenterprise global programs. The Multilateral Investment Fund provided TA to the Superintendencia de Bancos to help strengthen the credit unions and enable them to join the program.

- *Technical assistance.* The microenterprise global programs helped cover start-up costs for investments in management information systems and training and provided TA to IFIs to set up appropriate technology for microlending. The German consulting firm Internationale Projekt Consult provided highly effective TA to the executing agency in the areas of finance and management information systems. Internationale Projekt Consult supported technology transfer to participating IFIs by training loan officers and providing TA on information systems for managing microloans. As part of the training, external consultants accompanied loan officers to visit clients who were in arrears. Finally, unlike other microenterprise global programs, the Paraguay programs included a demand-driven voucher system for microenterprise training, whereby 41 training institutions offered 1,303 courses averaging 17 hours per course to 8,000 microentrepreneurs.
- *Interest rate liberalization.* Both microenterprise global programs emphasized the importance of allowing the IFIs to set their own interest rates to cover their costs and earn profits.¹⁸ Interest rates on microloans were significantly reduced thanks to the economies of scale that the IFIs have achieved through an increase in the microenterprise portfolio and competition between IFIs.
- *Institution building.* The IFIs that participated in both microenterprise global programs were small and flexible financial intermediaries with an interest in expanding their financial services. After the microenterprise global programs, three IFIs were recognized as leaders in the Paraguayan microfinance market:
 - Financiera Familiar was previously a Caja de Crédito that benefited from liberalization and became a *financiera*. It initially experienced high operating costs and default rates in adapting consumer credit technology to microlending. However, in Microenterprise Global I, it adopted micro-

evidence of the capacity to administer microcredits, (c) maintain a capital adequacy ratio of at least 8 percent of risk-weighted assets, (d) have PAR over 30 days of no more than 10 percent, (e) have PAR over 60 days no greater than 10 percent, (f) have PAR over 90 days no greater than 3 percent, and (g) have profits greater than or equal to zero.

18. The interest rate the central bank charged IFIs was 18 percent in 1997 (Microenterprise Global I) and 20 percent in 2001 (Microenterprise Global II). The commercial lending rate was 28.1 percent in 1997 and 28.3 percent in 2001. Because of high operating costs, the subloan interest rates were usually high. Average monthly interest rates ranged from 7.8 percent in 1994 to 4.6 percent in 2001.

credit technology by eliminating its billing department and introducing an incentive scheme for loan officers that yielded positive results. As of September 31, 1986, Financiera Familiar had 6,476 active microenterprise clients and a loan portfolio of US\$6.3 million, representing 23 percent of the total loan portfolio. In 2003, with 70,000 clients, Financiera Familiar was the leading consumer credit institution in Paraguay with a focus on expanding through market niches, including 8,500 microenterprises.

- Financiera Visión became the most active IFI in Microenterprise Global II. As late as 2003, it was the market leader, with a portfolio of US\$14 million and 15,000 clients. Initially, it relied on consumer credit technology, but by 1997, high default rates led it to switch to microcredit technology.
- Interfisa Financiera, which originally focused on corporate banking, was being pushed aside by competition. In 1996, it began offering a limited number of microcredits through a centralized unit. After this pilot, it downscaled operations, with 15 percent of its loan portfolio aimed at the microenterprise market.

Role of Public Policy

During the 1990s, the Paraguayan government implemented several types of financial sector reforms, including liberalizing interest rates and insurance deposits, eliminating subsidized interest rates, and implementing improved prudential regulations and supervision for the banking sector. Stricter regulation and supervision of IFIs pressured the existing semiformal lenders, known as Cajas de Crédito, to transform themselves into regulated finance companies. Competitive pressures led these nonregulated institutions to look for new markets beyond the traditional consumer finance base. Finally, the major contribution of direct public intervention was the support for IFIs' entrance into a new market segment and the growth of a new client base. IFIs credited the microenterprise global programs with changing their perceptions of microenterprise clients and allowing them to develop a new microfinance technology in their loan operations.

Lessons Learned

The following lessons can be drawn from the success of the microenterprise global programs in Paraguay:

- The interest rates charged to the IFIs were set at market levels, but the availability of longer-term financing to IFIs provided an attractive incentive for their participation.
- The IFIs participating in the microenterprise global programs were able to set the interest rates on their loans to microenterprises at a level sufficient to cover their costs and generate profits.
- The competition among IFIs in traditional markets pushed them to explore new market segments.
- The government's financial reforms provided an incentive for certain semi-formal IFIs—the Cajas de Crédito—to become regulated finance companies that participated in the microenterprise global programs.
- The high-quality TA offered by Internationale Projekt Consult and financial incentives to defray start-up costs helped interested IFIs overcome barriers to entry into the microfinance market.
- The leadership of the executing agency and the efficiency of its operations facilitated active participation by interested IFIs.
- The strict eligibility criteria and performance standards for participating IFIs ensured that the IFIs' performance was not adversely affected as a result of their participation in the microenterprise global programs.

Case 8. Bank Rakyat Indonesia¹⁹

Bank Rakyat Indonesia (BRI) received worldwide fame for its success, via its Unit Desa division, for developing a nationwide microfinance portfolio. Its experience is a great example of large-scale, profitable, and sustainable microfinance practices, based on commercially-priced provision of credit and locally mobilized savings, which have had a powerful positive impact on the lives of millions of poor and low-income households.

Background

BRI was established in 1968 as a state-owned agricultural development bank, including 3,600 village units, to channel subsidized credit to farmers. The government fixed BRI's interest rates at below-market levels, which resulted in annual operational losses. In the early 1980s, default rates of the subsidized lending climbed to above 50 percent. The collapse of oil prices and the decline in revenues also strained the government's budget and prompted fundamental economic reforms, including financial sector deregulation in 1983. BRI faced the

19. Sources: Malhotra 2004b; Maurer 1999; Patten, Rosengard, and Johnston 2001; World Bank 2004b.

choice of either shutting down or transforming itself into a sustainable entity. The bank chose the latter and converted its unit system into a full-service rural banking network in 1984. The units were reorganized as independent profit centers with separate balance sheets and profit and loss statements. They function as highly decentralized and semiautonomous financial entities. Today BRI's Unit Desa system is the largest and one of the most successful microfinance institutions in the world.

Results

In 1984, only 14 percent of the units were profitable; two years later, 72 percent were. The entire unit system became profitable in 1986. Between 1987 and 1997, the BRI unit system added an average of 100,000 borrowers and 1.5 million depositors every year. In 1996, the units generated profits of US\$178 million, compared with a consolidated profit before tax of US\$145 million for BRI as a whole. Thus the units essentially accounted for all of BRI's profits and made up for the losses incurred by other parts of the bank. The unit system accounts for 25 percent of total BRI assets, 15 percent of its loan portfolio, and 70 percent of its total savings accounts. By 2003, BRI was providing services to about 3.1 million small borrowers with average outstanding loans of US\$540 and 30 million small savers with average accounts of US\$108.

In 1997, the East Asian financial crisis hit Indonesia. Within a few months, the rupiah devalued by 80 percent, and by 1998, inflation stood at 77 percent. The Indonesian banking system was on the brink of collapse, forcing the government to step in and provide a blanket guarantee for all bank deposits. Many private banks closed down and major state banks merged. In contrast, the BRI units weathered the crisis remarkably well. Between June 1997 and June 1998, more than 3 million new deposit accounts were opened and the volume of deposits in rupiah doubled. Loan repayments suffered only marginally. By 2001, units' borrowers continued to pay back more than 97 percent of loans due.

Client Profile and Outreach

BRI units primarily serve small savers and borrowers in rural areas. BRI's lending program does not specifically target those below the poverty line, but rather the working poor who have viable economic activities. The average outstanding loan amount of US\$540 is about half the per capita income in Indonesia. In 2001, 60 percent of the loans were below US\$300. Estimates indicate that 30 percent of all households in Indonesia have a savings account with the BRI unit system.

Products and Services

BRI's unit system provides one lending product, that is, microcredit to micro-business entrepreneurs, and a few deposit products, namely, simple passbook savings accounts, time deposits, and demand deposits. The lending part of the business is nontargeted and is available to any creditworthy customer for any kind of productive enterprise.

Innovations to Increase Outreach to SME Clients

One of the reasons the unit system was able to come out of the financial crisis unscathed was the way its microcredit was structured. The microenterprise loans the units offer are all installment loans adjusted to borrowers' cash flow. As borrowers pay back the installments, they normally reinvest their profits to maintain the level of business that they had reached with the loan proceeds. Another reason is that, in contrast to what banks would normally do during a crisis, BRI units kept their microcredit windows open so that those who paid on time were able to borrow again as long as their businesses justified the loan. Microenterprise borrowers valued their access to credit and savings services and were reluctant to sever their banking relationship with the units.

SME Finance Business Organization

BRI was reorganized into four strategic business units in 1997. The Microbanking Unit provides microloans in rural areas, the Retail Banking Unit is responsible for BRI branches providing full banking services and lending to SMEs, the Corporate Unit makes large corporate loans, and the Treasury and Investment Unit handles treasury functions.

Risk Management Techniques

Even though the unit system's microcredit is nontargeted, borrowers must provide sufficient collateral to cover the value of the loan, usually in the form of titles to land, but they can also pledge buildings, motorcycles, or other property. The system also has an on time repayment incentive equivalent to a refund of 25 percent of the interest paid on the loan. The lending portfolio is diversified in various sectors: 44 percent in small trade, 18 percent in agriculture, 2 percent in small industries, and 33 percent in services and consumption. The maximum loan ceiling of US\$10,500 effectively prohibits concentration of the

loan portfolio. Adequate reserve provisions are required: 3 percent for all loans, 50 percent for doubtful loans, and 100 percent for bad loans. On the liability side, the unit system is highly diversified in relation to its small savings deposits, and rural savings have proven to be much more stable than time deposits and other savings instruments provided for large businesses.

Success Factors

The BRI units have followed a profitable, sustainable approach to microfinance on a large scale, based on locally mobilized savings without subsidies and funds from the government or from donors. Key factors that led to the success of the unit system include the following:

- *Massive and decisive reform with support from the government.* The complete transformation of BRI's unit system in 1984 would not have been achieved without strong government support, especially that of the Ministry of Finance. The unit system has since been kept free from political intervention, and the government has maintained a hands-off position toward BRI units even though BRI is fully owned by the government.
- *Decentralized organizational structure.* The units are independent profit centers with separate balance sheets and profit and loss statements. The highly decentralized and semiautonomous organizational structure forms the basis for accountability and efficiency. In 2000, administrative costs as a percentage of the average loan portfolio were about 8 percent, which is extremely efficient by microfinance standards.
- *Introduction of new products, in particular, those meeting the demand for savings by rural communities.* As rural populations are more likely to be savers than borrowers, the introduction of savings products helped make the unit system viable and sustainable in the long term. The total amount of deposits in the unit system's savings service is about twice as large as the outstanding loan portfolio. The excess savings are transferred to BRI's branch system and earn an interest rate for the units that is slightly above the interest rate they pay on time deposits.

Role of Government

As a 100 percent government-owned bank, the success of BRI's unit system has everything to do with a conducive and enabling policy environment. Stable macroeconomic conditions and a series of financial sector reforms in the early 1980s laid the foundation for the new unit system to develop and prosper. Most

notably, in 1983, one year before the restructuring of the unit system, a major financial sector deregulation package was announced that allowed banks to set their own interest rates. This created opportunities and the enabling environment for a viable rural banking operation: the unit system was able to set its annual effective rate for microcredit at 33 percent in 1984. As the designated bank for the rural and agriculture sectors, BRI continued to implement subsidized credit programs for priority sectors and specific target groups; however, these programs were kept strictly separate from the operations of BRI's Unit Desa system.

In November 2003, 41 percent of BRI shares were sold to the public through a vastly oversubscribed initial public offering. The impact of this partial privatization on the microbanking business and the unit system has yet to be ascertained.

Case 9. Nacional Financiera and Factoring in Mexico²⁰

A successful example of reverse factoring in a developing country, Nacional Financiera (NAFIN) offers online factoring services to SME suppliers through its productive chains program, which works to create chains between big buyers and small suppliers. The big buyers are large, creditworthy firms with low credit risk, and the suppliers are typically small, risky firms that cannot access financing from the formal banking sector. The NAFIN program allows these small suppliers to use their receivables from the big buyers to obtain working capital financing. With the Mexican economy improving and banks aggressively entering SME lending, factoring remains the cheapest form of financing for small suppliers in Mexico. An example for other countries as well, NAFIN has entered into an agreement with a development bank in República Bolivariana de Venezuela to develop a similar product. NAFIN's model is also being considered for replication in other Latin American countries, such as Argentina, Chile, Costa Rica, El Salvador, and Nicaragua.

Background

NAFIN is a state-owned development bank with 32 branch offices throughout the country that the Mexican government created in 1934 to provide commercial financing. When a new government was elected in 2000, NAFIN was given the mandate of using new technology to provide SME loans. The factoring program is part of the e-government initiative to provide quicker and cheaper government services by using the Internet. In December 2000, NAFIN reported US\$23.9 bil-

20. *Source:* Klapper 2004b; NAFIN Web site (<http://www.nafin.com/>).

lion of assets and a deficit of US\$429 million. In December 2003, it reported US\$26.75 billion of assets and a surplus of US\$13.23 million. Factoring helped contribute to this dramatic turnaround.

Factoring and SME Financing

Factoring is a type of supplier financing in which firms sell their creditworthy accounts receivable at a discount (equal to interest plus service fees) and receive immediate cash. Factoring is used in both developed and developing countries around the world. In 2004, the total volume of factoring worldwide was more than US\$860 billion. The advantage of factoring compared with traditional lending collateralized by fixed assets is that underwriting in factoring is based on the risk of the accounts receivable rather than the risk of the borrower. This makes factoring an important financing instrument for high-risk, informationally opaque borrowers. Factoring may also be important in financial systems with weak commercial laws and enforcement and inefficient bankruptcy systems, which are typical of many developing countries.

There are two types of factoring in SME financing: ordinary factoring and reverse factoring. In ordinary factoring, the small firm, which is the seller or supplier, sells its receivables from various buyers to a factor. In reverse factoring, the factor purchases accounts receivable owed by creditworthy buyers to any sellers or suppliers. The factor only needs to collect credit information and calculate the credit risk for the high-credit quality buyers, which are usually large, transparent, and internationally accredited firms.

NAFIN's Factoring Program

NAFIN established productive chains with 190 big buyers (about 45 percent of them in the private sector) and more than 70,000 SMEs (out of a total of about 150,000 participating suppliers). About 20 domestic factors—banks and independent finance companies—are currently participating in the factoring program. Since the program's inception in September 2001, NAFIN has extended more than US\$9 billion in financing to SMEs through factoring.

The NAFIN factoring program operates an electronic platform that provides online factoring services. The Web site has a dedicated page for each big buyer, and the small suppliers are grouped into chains to those big buyers with whom they have business relationships. The suppliers and NAFIN sign a pre-agreement allowing electronic sale and transfer of receivables. Once a supplier delivers its goods and the invoice to the buyer, the buyer then posts a negotiable document on its Web page that is equal to the amount that will be factored. In

general, this is equal to 100 percent of the value of the receivable. The supplier will then be able to access its buyer's NAFIN Web page to see all the factors that are willing to factor this particular receivable along with their quotes for interest rates. Picking the one it deems has the most favorable terms, the supplier clicks on the name of the factor, and the amount of the negotiable document, less interest, will be transferred to the supplier's bank account. When the invoice is due, the buyer pays the factor directly.

A few features make the NAFIN factoring program unique, namely:

- The use of the electronic platform and the Internet reduces costs and improves efficiency for all parties involved: sellers, buyers, and factors. More than 98 percent of all services related to the factoring are provided electronically, all transactions can be completed within three hours, and money is credited to the supplier's account by the close of business the same day. This provides immediate liquidity to suppliers. The use of the Internet has also allowed NAFIN to achieve significant economies of scale: NAFIN grew from having a 2 percent market share of factoring in 2001 to 60 percent of the market share in 2004.²¹
- The use of reverse factoring transfers the credit risk of the small suppliers to highly creditworthy buyers and enables NAFIN to offer factoring without recourse or any collateral to SMEs, which often lack a credit history or access to other forms of formal financing. In addition, there is no service fee, and the maximum interest rate charged is about eight percentage points below commercial banks' lending rates.
- The competitive, instant, online, multifactor structure nurtures competition among factors and allows small suppliers to pick the factor with the most favorable terms. Most factors refinance their factoring activities with NAFIN, earning the difference between the rate they charge the suppliers and the rate NAFIN pays.

Success Factors

The NAFIN factoring program has succeeded primarily because of supporting electronic security laws and taxation. In addition, use of the Internet for online transactions not only reduces costs, but also increases the program's ability to reach SMEs in remote and rural areas. Previously, the owners of many rural SMEs had to travel to the cities to present bills to their urban customers and collect payments. By factoring their receivables, the suppliers eliminated trips

21. The NAFIN factoring program is also less expensive than commercial factoring because NAFIN waives the service fee and pays the overhead and legal costs associated with maintaining the electronic platform and writing the contracts.

to customers and collection costs. In Mexico, the NAFIN factoring program is now used as a model for automating the services of other service providers and government agencies.

Role of Government

In May 2000, reforms in legislation pertaining to e-commerce gave data messages the same legal validity as written documents, thereby making electronic factoring possible. Passage of the Law of Conservation of Electronic Documents established the requirements for conserving the content of data messages regarding contracts, agreements, and accords. In April 2003, the Electronic Signature Law was enacted, which allows the substitution of electronic signatures for written signatures and permits the receiver of a digital document to verify the identity of the sender. In January 2004, modifications to the Federation Fiscal Code included amendments necessary to complete electronic transactions, including factoring. In addition, favorable taxation treatment helps keep factoring costs low for SMEs and provides incentives for them to participate in the factoring program. All interest charges that the small suppliers pay to their factors are tax deductible.

Case 10. Venture Capital and Small Enterprise Assistance Funds²²

Small Enterprise Assistance Funds (SEAF) is a not-for-profit organization headquartered in Washington, DC. SEAF provides equity funds and postinvestment assistance to SMEs through affiliated investment companies and representative offices that operate on a commercial basis. SEAF-sponsored funds are one of the most comprehensive portfolios of private equity investments in SMEs in the world. The private equity funds sponsored by SEAF total US\$224 million in capital commitments. Furthermore, SEAF invests in more than 20 countries in Asia, Central Asia, Central and Eastern Europe, and Latin America. As of December 31, 2004, SEAF's total invested capital exceeded US\$85 million through 224 completed small business investments.

Background

The international humanitarian organization CARE founded SEAF in 1989. Following the receipt of an initial US\$300,000 grant from USAID, SEAF devel-

22. *Source:* Small Enterprise Assistance Funds 2004; Small Enterprise Assistance Funds Web site (<http://www.seaf.com/>).

oped rapidly with the fall of socialism in Central and Eastern Europe. In 1995, SEAF separated from CARE to become an independent organization and now has 14 offices around the world. Current investors in SEAF-sponsored funds include multilateral institutions such as the World Bank Group and the European Bank for Reconstruction and Development; bilateral development agencies of Finland, Germany, Norway, Switzerland, and the United States; private foundations such as the Ford Foundation; and independent financial institutions, including the New York Life Insurance Company.

Business Model

SEAF invests primarily in locally registered, private, early-stage companies in which local residents hold the majority of ownership. SEAF usually seeks an initial minority position of no less than 20 percent. Investment proceeds are used to finance specific projects or investment programs for business modernization and expansion. SEAF makes investments primarily through minority equity positions in combination with quasi-equity financial instruments and subordinated debt. Businesses that have developed a product in a niche market with a sustainable competitive edge are particularly attractive to SEAF. It has invested in a wide variety of industries, including agribusiness, information and publishing, manufacturing, wholesale trade, and retail trade.

SEAF believes that partnering with SMEs following its investment is the most effective way to ensure the success of its investment. Therefore SEAF also provides TA and business development assistance to the companies it invests in to help increase their competitiveness and efficiency.

Exit Strategy

Successful exit from investments is critical to SEAF's long-term success and to any venture capital investment; however, in many developing countries the exit environment for venture capital investments is not as favorable as in mature markets. Most developing countries have small and illiquid stock exchanges that rule out the option of an initial public offering, the normal exit route in the United States. In many cases, listing expenses are too high and compliance requirements are too arduous for smaller companies, and investors perceive the analysis and monitoring required for SMEs as disproportionately high.

Despite these challenges, SEAF has shown an ability to exit investments in challenging economic and political environments. Through negotiated trade sales, management buyouts, and dividend and other cash payments, SEAF has achieved full and partial exits from 81 investments, generating a gross internal

rate of return of 24 percent in U.S. dollars with a multiple of 2.1 times invested capital. The company attributes its successful exit strategies to two factors: its focus on exit from the time of its initial investment and the targeted support and assistance it provides to its portfolio companies throughout the investment period.

Development Impact

SEAF recently finished an evaluation study of the economic impact of its investments in 10 firms in Central and Eastern Europe and Latin America, half of them urban firms and half of them rural firms. The study shows that, on average, every dollar SEAF invests generates at least 10 additional dollars for the local economy. Nearly all 10 firms have achieved significant economic rates of return, and even those investments with relatively low financial rates of return have had a significant economic impact. The 10 firms studied were selected on the basis of data availability and the agreement of the entrepreneurs and employees to be interviewed. The firms' annual sales ranged from US\$0.3 million to US\$17.0 million; the number of employees ranged from 4 to 308; and the types of businesses included hand-embroidered children's clothes, electronic components, media products, and food production and processing.

The study shows that of all the beneficiaries, employees and governments receive the greatest share of benefits from SEAF investments. Employees benefit in terms of real wage growth of up to 28 percent for low-skilled workers and 34 percent for high-skilled workers annually. They also benefit from training provided by employers, assets accumulated as a result of increased income and job stability, and health and social security benefits. Governments benefit from increased tax revenues when the SMEs expand: on average, the 10 companies studied paid 20 percent of their total revenues in taxes.

An Example: The SEAF-Macedonia Fund

SEAF was the first private equity fund to enter Macedonia during its volatile political and economic transition with the establishment of a US\$13 million investment fund in 1998. At that time, Macedonia's banking system was in disarray and the fledgling private sector was in need of capital injections and TA to help the transition to a market economy. When ethnic violence escalated in the spring of 2001, SEAF was forced on two occasions to temporarily close its offices, evacuate its staff, and suspend its investment activity. However, SEAF did not leave as many others did, but continued its work by focusing on strategies to help its portfolio companies endure the conflict. Today, the SEAF-Macedonia

fund is among SEAF's top-performing funds, with successful exit achieved from a number of its 14 portfolio companies and an overall multiple of 1.6 times the capital invested.

One of SEAF's portfolio companies during the ethnic conflict was Krug, a newspaper publisher and distributor. In March 1999, SEAF invested in Krug, providing about US\$350,000 in exchange for 36 percent ownership in the company. Working with the company's senior management, SEAF's equity investment in the business facilitated the purchase of capital equipment that improved Krug's profitability. SEAF also assisted the company with its business strategy and financial planning, including the decision to launch an evening newspaper. In 2003, SEAF sold its shares to a third party for more than US\$3 million, nine times its invested capital. By the time SEAF exited from the company, Krug had grown into a leading source for independent news and political commentary. During the four-year investment from 1999 to 2003, Krug increased its employment from 60 to 143 employees and increased its annual revenues from US\$1.8 million to US\$5.0 million.

Case 11. Financial Leasing in Serbia²³

In Serbia, classic forms of SME financing (loans) were insufficient because of an undeveloped financial sector and high transaction costs of lending. Thus the development of an all-encompassing leasing industry program was necessary as an alternative method of financing that would partly compensate for the unsatisfied external financing needs of SMEs.

Background

In accordance with its strategic objective to improve access to finance in south-eastern Europe, IFC's Southeast Europe Enterprise Development Facility (SEED) has been working to develop financial leasing in Serbia. The program consisted of two phases: legislation development and market development.

During the legislation development phase, SEED partnered with the government to introduce relevant leasing legislation. An assessment of all laws related to financial leasing activities was conducted in conjunction with government authorities, commercial banks, and SMEs to determine whether separate leasing legislation was required or whether amendments to various pieces of legislation would be sufficient. A market research study involving the commercial banking sector and SMEs indicated strong interest in leasing.

23. *Source:* Southeast Europe Enterprise Development Facility 2004; Vignjevic 2004.

During the market development phase, SEED focused on capacity-building activities that would promote financial leasing to all relevant parties. These consisted mostly of TA and training aimed at key local stakeholders, such as commercial banks and other financial institutions as potential lessors and local business service providers and SMEs as potential clients. Training was conducted in 10 cities nationwide over a period of seven months following the law's adoption and consisted of one-day programs for financial institutions, SMEs, and service providers.

Results

Within 16 months of the passage of the Financial Leasing Law in May 2003, €225 million was financed through leasing: 35 percent for equipment leasing and 65 percent for vehicle leasing. A leasing market assessment study carried out by SEED with full cooperation from the leasing industry showed rapid industry growth. The number of leasing companies grew from 2 in May 2003 to 11 in December 2004, and an association of leasing companies has been established. SEED's growth rate is projected to be 29 percent, reaching €460 million by 2008. SEED also estimates that 19 percent of all its investments in Serbia during 2004–08 will be financed through leasing.

Client Profile and Program Outreach

Statistics available to the Association of Leasing Companies in Serbia indicate that about 33 percent of the clients of leasing companies are manufacturing businesses, almost all of them privately owned. As of September 2004, approximately 8,000 leasing contracts had an average contract value of €20,000, pointing to strong SME participation.

Products and Services

The Financial Leasing Law defines leasing primarily as financial leasing. This law allows only the leasing of durable, movable goods and does not cover immovable goods. Nevertheless, one company offers real estate leasing services based on other laws and regulations. Only two companies provide operating leases, whereas sale and leaseback are widely available.

Innovations to Increase Outreach to SME Clients

The market for financial leases is currently in the initial stage of development. In general, clients for leasing services suffer from constrained cash flows. Stiff market competition—12 companies established in 18 months—is forcing leasing companies to use more competitive ways of attracting clients, for example, by having lower down payments relative to those in the EU and in neighboring countries, accepting government bonds as down payments, waiving required insurance payments in the first year of credit arrangements, and offering clients longer grace periods.

Leasing Business Organization

Nine leasing companies are currently members of the Association of Leasing Companies in Serbia, which represents the interests of all members to government officials. Each leasing company has two main subunits: sales and marketing and back-office support. Operations are handled in three phases as follows, with the sales and marketing unit responsible for the first two phases and the back office responsible for the third phase:

- Establish contact with the lessee by offering information, receiving documents, and undertaking analysis.
- Decide whether the client meets all the requirements of the leasing company.
- Ensure correct business arrangements by working with other stakeholders such as insurance companies and lawyers.

Leasing Intervention Sustainability

The SEED-initiated leasing program in Serbia started as a typical business-enabling environment intervention. The program supported the government with institutional strengthening and capacity-building activities to introduce leasing. Later, during the market development phase, the program was transformed into a private sector TA program with a cost-recovery component.

The cost-recovery activities were of two main types. The first type was charging for training activities delivered to financial institutions, business service providers, and SMEs with the help of international and local consultants (€100 per individual for financial institutions and service providers and €50 per SME). All local costs were recovered except for SEED's costs for international consultant fees and travel.

The second cost-recovery activity pertained to the funding of the second stage of a national awareness campaign by the leasing companies. From the start, the private sector saw financial leasing as a relevant instrument for the Serbian business community, therefore the private sector's willingness to bear the costs of training and other services was not a major issue. The second stage of the national awareness campaign, which arose from needs clearly identified by an analysis undertaken during the first stage of the campaign, focused on the advantages of leasing and leasing company promotion. SEED provided TA, and nine leasing companies contributed €3,500 each for implementing the campaign.

For the 2004 financial year, cost recovery was 55 percent of the program's budget. Of the US\$90,000 program budget for 2004, cost recovery and co-financing amounted to US\$50,000. This consisted of US\$11,000 in collected training fees and US\$39,000 in financial contributions from leasing companies for the second stage of the awareness campaign.

Success Factors

The success of SEED can be attributed to the following five main factors:

- *Private sector involvement.* Commercial banks and other financial institutions were invited to provide input and comments on the various drafts of the Financial Leasing Law, and comments by private sector entities were reviewed and incorporated into the draft law where appropriate. The financial institutions provided significant support for adoption of the law through a communication to the government that laid out the benefits of adopting the law, thereby accelerating the process of adopting the Financial Leasing Law, which had been stalled.
- *Extensive capacity-building program for all key stakeholders.* Following adoption of the law, training programs were implemented for local banks, leasing companies, SMEs, and business service providers. Feedback on the training indicated that it had contributed to decisions to establish new leasing companies. Furthermore, government staff attended a series of capacity-building activities and a leasing working group was provided with TA. This portion of the program built the government's capacity for supporting the newly developing leasing industry.
- *National awareness campaign on leasing.* SEED undertook a two-stage national awareness campaign on leasing and its advantages. The first stage, undertaken in parallel with the training program, consisted of a three-month, nationwide education program to introduce leasing to SMEs. The second stage, undertaken following SEED's initiative and facilitation of a

leasing company association, consisted of directly promoting the leasing association members through electronic and print media.

- *Establishment of a national association of leasing companies.* SEED initiated the formation of a national association of leasing companies consistent with European best practice. The association's objectives include acting as a repository for information about leasing, acting as an advocate for the leasing business community, promoting leasing, providing further capacity building, and preventing dishonest business practices by association members.
- *Exit strategy through transfer of knowledge and know-how.* SEED's exit strategy from the leasing program involves transferring know-how and training materials to the Association of Leasing Companies in Serbia and making the association self-sustainable and fully operational. This will enable the association to provide and facilitate such services such as statistical tracking, market monitoring, training for leasing companies and enterprises, and awareness campaigns.

Role of Government

SEED's experience in Serbia has shown that governments are willing to introduce leasing legislation and support implementation because they view leasing as a good initiative to support private sector development and attract foreign investment. The government's interest in supporting development of the leasing market was demonstrated by the passage of the Financial Leasing Law in 2003. The authorities' progressive leasing policies were also reflected in the adoption of provisions geared toward providing security to lessors, such as enabling them to start repossession procedures within six days. This commitment to reform by the government is one of the main reasons for the rapid growth of the leasing market.

Despite the government's efforts, Serbia faces an ongoing challenge in relation to the adoption of outstanding legal and regulatory reforms, including real estate leasing, which the government opted not to include in the Financial Leasing Law. The Financial Leasing Law does not allow leasing of immovables, although all the leasing companies in Serbia had expected that it would. The law gives a favorable impression upon initial reading, but court decisions based on the law are difficult to obtain and implementation of court decisions could take a long time. In addition, the government introduced a value added tax in 2005, which places leasing at a serious disadvantage compared with bank loans and insurance policies, which are tax exempt.

Another challenge is to get the various parts of the government to work in a coordinated fashion to pass complementary regulations and amendments to

other laws, for example, those pertaining to accounting, taxation, and registration of leased assets. The lesson to be learned, in particular for countries with a civil law system like Serbia and Montenegro, is that relevant laws must be amended in parallel with the drafting of a leasing law. Even now the registry of leasing assets, which was included in the law, has yet to be established, which is constraining the growth of equipment leasing.

Case 12. Credit Guarantee Schemes

Policy makers often use credit guarantee schemes (CGSs) in an attempt to augment lending to selected groups. They are typically part of a larger strategy to redirect lending toward groups and activities preferred by the policy makers (Orbeta, Lopez, and Adams 1998). In the case of SMEs, CGSs are designed to alleviate the constraints SMEs face in seeking access to credit by sharing the risk of default with banks.

Background

According to a study by Graham Bannock and Partners, Ltd. (1997), about 50 percent of all countries had CGSs, but whether operating CGSs existed was not clear in about 40 percent of the countries. Nevertheless, approximately 85 percent of countries of the Organisation for Economic Co-operation and Development had at least one CGS. The study showed that by 1995, the largest and best established guarantee schemes were almost all in developed countries, including Canada, Japan, the United Kingdom and some other EU countries, and the United States.

Debate on CGSs

CGSs have been a controversial and hotly debated topic. Table A3 summarizes some of the issues.

Vogel and Adams (1997) discuss three questions that they note should be asked about loan guarantee programs when assessing their effectiveness and efficiency in reaching small-scale borrowers, namely: (a) whether the programs significantly alter lenders' behavior in desired directions, (b) whether programs' benefits exceeds their costs, and (c) whether the resources would be more effective in assisting disadvantaged groups if used for other programs. These are the questions that governments should be asking when considering CGSs. Other important policy issues to consider include the following:

Table A3. Advantages and Disadvantages of CGSs

<i>Advantages</i>	<i>Disadvantages</i>
<ul style="list-style-type: none"> • CGSs serve as a substitute for collateral when the collateral market operates imperfectly. This is the most frequently cited justification for CGSs. • CGSs can be used as a financial instrument for stimulating business development by means of the financial leverage achieved. • CGSs can help increase borrowers' incomes, and ultimately their quality of life, if they result in net additional lending to targeted groups. • CGSs help develop institutional capacity in SME lending by inducing changes in the behavior and perceptions of bank and nonbank lenders. 	<ul style="list-style-type: none"> • Imperfections in the collateral market should be dealt with directly by means of reforms and strengthened regulations (although in many cases such reforms and changes can take a long time to take place). • CGSs increase the risk of moral hazard on the part of both banks and borrowers and contribute to weakening loan performance. Banks may not be motivated to supervise a loan properly or to vigorously pursue the collection of repayments when the bulk of the loan is covered by a guarantee. • Lenders and borrowers usually incur additional transaction costs when guarantees are initiated and claims are made.

Source: Authors.

- *Financial reforms.* CGSs cannot replace financial reforms. A guarantee shifts some risk from banks to guarantors, but expecting a guarantee scheme alone to be a panacea for all the problems of SME access to finance is naïve (Holden 1997; Levitsky 1997a).
- *Regulatory environment.* Efforts to establish and develop CGSs are not substitutes for improving the overall regulatory and institutional environments in which CGSs and other players in the field of SME financing operate.
- *Sustainability.* Graham Bannock and Partners, Ltd. (1997) assert that, in practice, not one credit guarantee organization involved in small business lending was able to cover its administrative costs and default claims with the fees its collected. In other words, none was financially sustainable without a subsidy or donor funding.
- *Moral hazard.* CGSs should be carefully designed and implemented with due regard for the danger of moral hazard on the part of both borrowers and lenders.

Evaluation Criteria for CGSs

The following criteria for evaluating CGSs can also serve as best-practice benchmarks for designing CGSs, although some of the criteria, such as additionality, are extremely difficult to measure and monitor:

- *Risk sharing among the CGS, borrowers, and banks.* Levitsky (1997a) emphasizes that guarantee schemes should obtain whatever collateral is available from borrowers and should pursue loan recovery vigorously, even after

the guarantee has been paid out. The lender should assume at least 30 to 40 percent of the risk, and never less than 20 percent.

- *Additionality of lending.* Financial additionality can be measured in terms of increases in bank loans to credible SME clients who previously did not have access to credit, increases in loan sizes, lower interest rates, and longer or better loan terms.
- *Sustainability.* Schemes should be designed so that fees and other income, such as the return on investments, cover all administrative costs and claims (Levitsky and Prasad 1989). This has not been the case in practice, although some indications suggest this is close to being achieved in some developed countries. The Canadian Small Business Loan Act scheme, the Loan Guarantee Scheme in the United Kingdom, and the Small Business Administration in the United States are able to operate on a break-even basis in some cases (Levitsky 1997b).
- *Leverage level.* Leverage levels of between 5 and 10 (that is, guarantee volumes of 5 to 10 times the fund amount) within 5 years of operation should be the target. A lower level would tend to increase moral hazard risks and would undermine the justification for the scheme.
- *Default rate.* A 5 percent default rate is the point at which action may be considered to remedy the situation. A rate of 2 to 3 percent would be more acceptable if a scheme had been operating for some years (Levitsky 1997a).

Types and Models of CGSs

There are three types, or models, of CGSs in terms of how guarantees are issued (Inter-American Development Bank 1998):²⁴

- *Individual-retail-selective model.* Under this model, guarantees are extended on a case-by-case basis and two possible methods of issuing guarantees can be distinguished. First, the borrower approaches a potential lender, who reviews the project and makes the loan dependent on a guarantee. Either the lender or the borrower will then apply for a guarantee from the scheme. Second, the guarantor can issue an advance guarantee approval to the borrower, who can use it to negotiate a loan contract with the lender. A direct relationship between the guarantor and the borrower exists, because the guarantor investigates every loan application and selects which ones to guarantee. This reduces the probability of moral hazard on the part of the

24. CGSs can also be categorized into four types according to who operates and controls them: government programs, donor or nongovernmental organization programs, mutual guarantee organizations set up by a group of SMEs, and independent CGSs with separate legal status funded by investors and/or donors.

lender, thereby lowering default costs and ensuring that guaranteed borrowers are indeed the targeted ones. Fundes International is an example of this model.

- *Portfolio model.* Under the portfolio model, the guarantor provides a guarantee that automatically covers all loans made by the lender within certain criteria (such as loan size and borrowers' assets) up to an overall portfolio amount. As there is no direct contact between the guarantor and the borrower, this approach enables a considerable expansion of activity by reducing time-consuming and cost-intensive screening procedures. However, the economies of scale are achieved at the cost of higher default rates and less additionality compared with the individual-retail-selective model (Green 2003). Examples of this model are the Fondo Nacional de Garantías (FNG) in Colombia and the Small Business Administration in the United States.
- *Intermediary-wholesale model.* Under the intermediary-wholesale model, the guarantor typically guarantees a loan or a line of credit from a local bank to a nonbank microfinance institution. What makes this model attractive to lending banks is that they do not need to employ resources and new lending methodologies to reach the unfamiliar microenterprise and SME sector. ACCION International's Global Bridge Fund and Women's World Banking have followed this model.

International Examples of CGSs

The Inter-American Development Bank (1998) points out that both the individual-retail-selective model and the portfolio model have proved to be ineffective in increasing lending to SMEs because of insufficient interest on the part of banks resulting from the high transaction costs involved. Furthermore, the perceived high risks and the inability of CGSs to cover costs under such arrangements also contribute to the ineffectiveness of these models. The intermediary-wholesale model is a potentially viable alternative. The following paragraphs present examples of the different models and their relative degrees of success.

THE INDIVIDUAL-RETAIL-SELECTIVE MODEL: FUNDES

FUNDES is a Swiss-based international fund that started offering credit guarantees in Latin America, in Panama in 1984 and subsequently in Bolivia, Chile, Colombia, Costa Rica, and Guatemala. The fund helped small business owners in those countries prepare their credit applications in a way that was acceptable to banks and offered a guarantee of 50 percent coverage. In the fund's experience, guaranteed credit was always 3 to 4 percent more expensive, as

the guarantee funds had to cover the additional costs related to administration, monitoring, and loan analysis. The banks continued to charge the usual high spread on loans to small businesses (Oehring 1997).

In early 1995, the fund undertook an evaluation of the impact of its guarantee programs. The evaluation identified several positive impacts, including longer loan terms, less collateral required and pledged, and increased employment and growth in companies that received loans and guarantees. Regarding sustainability, however, the review concluded that the fund had problems in achieving break-even in all its programs, and that 10 years of experience “confirmed that using selective, subsidiary guarantees is risky and makes it difficult to cover costs” (Oehring 1997, p. 61).

THE PORTFOLIO MODEL CASE 1: THE SMALL BUSINESS ADMINISTRATION

The 1968 Small Business Act empowered a U.S. federal government agency, the Small Business Administration, to guarantee loans that participating lending institutions made to eligible small businesses. Despite criticism of the subsidies required to support the administrative costs and loan losses from defaults and of the complex application procedures, the program has been considered a success in terms of additionality. Banks are required to certify that loans to be guaranteed would not be made in the absence of the guarantee and Small Business Administration regulations, and review procedures appear to be adequate to prevent the substitution of guaranteed loans for other modes of finance. Eighty percent of the guaranteed loans are term loans ranging from 5 to 10 years, which are not readily available to small businesses from other sources (Levitsky and Prasad 1989).

Levitsky and Prasad (1989) point out that the program has some fundamental advantages not often found in developing countries, namely:

- the availability of reliable, nationwide credit-rating services, which allow low-cost verification of applicants' credit standing;
- the relative ease and moderate degree of loss with which collateral may be liquidated, and the relatively low cost and expediency with which legal procedures can be used to protect the lender's legitimate interests or to recover defaulted loans;
- the great amount of low-cost information available on conducting all types of small businesses.

THE PORTFOLIO MODEL CASE 2: FNG, COLOMBIA

FNG was founded as a credit guarantee agency in 1982. During its first decade, it had low levels of operation, low leverage, and insufficient income to cover its costs. Initially, FNG was covering 100 percent of the amount of the loans in default with its guarantees. The intent was to entice banks into lending to non-traditional smaller clients by eliminating their risk. But the time-consuming claims procedure acted as a big disincentive for banks to use the guarantees.

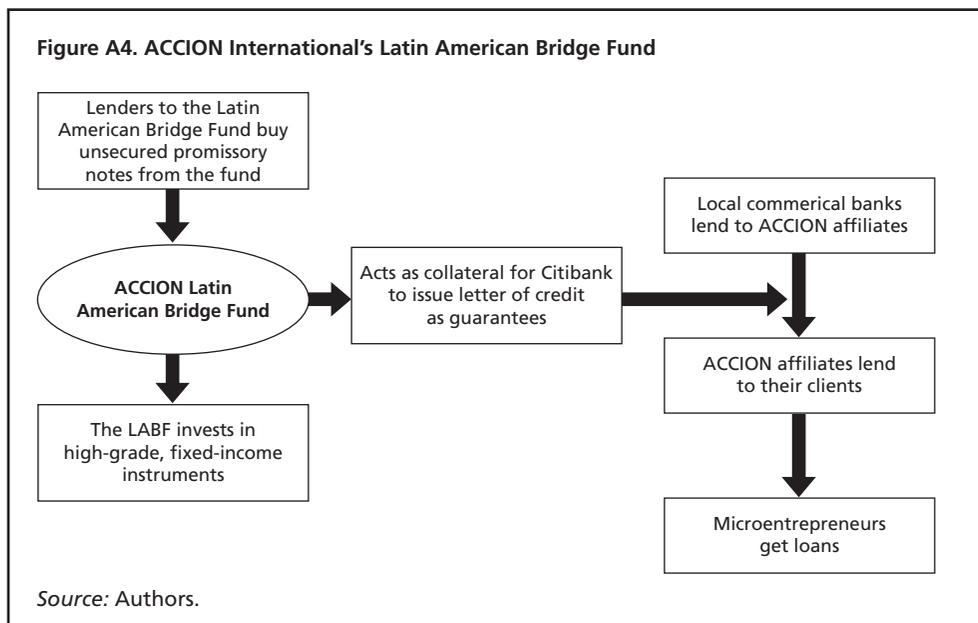
Until 1994, most of the guarantees were for loans from a single financial institution, Corporación Financiera de Desarrollo, the main publicly owned intermediary set up to provide financing for SMEs. In 1993, the outstanding amount of Corporación Financiera de Desarrollo guarantees accounted for 84 percent of FNG's total exposure (Marulanda de Garcia 1997). Marulanda de Garcia (1997) suggests that some of the risks that the Corporación Financiera de Desarrollo picked up in lending to some high-risk government programs were passed on to FNG. FNG's capital eroded over the years until it was rebuilt by a large capital increase in 1993. FNG's income from fees or guarantee recoveries was insufficient to cover its administrative expenses.

In 1995, new management introduced radical changes to FNG. The maximum coverage ratio was reduced to 70 percent. Agreements were signed with four major banks, three of which were state owned, and agreements with two other major private banks were being negotiated. These agreements were expected to allow the banks involved to approve guarantees to an agreed ceiling of up to 50 percent. FNG also helped create some regional guarantee funds and acted as a counterguarantor for 12 newly established regional funds, guaranteeing 66 percent of their operations. Because of this second level of guarantees, the regional funds expected to be able to extend guarantees up to 21 times the value of their underlying funds (Green 2003).

THE INTERMEDIARY-WHOLESALE MODEL CASE 1: ACCION INTERNATIONAL

This is one of the most respected nongovernmental organizations in microfinance. ACCION created the Latin America Bridge Fund in 1984. The fund acts as collateral for irrevocable standby letters of credit issued by a U.S. bank (currently Citibank) in U.S. dollars and guarantees 10 to 90 percent of credit provided by local commercial banks to ACCION's affiliate microfinance programs. Figure A4 illustrates how the fund works.

As of May 31, 2004, loans from investors to the fund totaled US\$6.7 million, with a weighted average maturity of 63 months and a weighted average interest rate of 2.53 percent. Outstanding Citibank standby letters of credit totaled US\$1.45 million. Since its inception, the fund has collateralized more than



US\$70 million of letters of credit for 23 ACCION microfinance institutions in 12 Latin American countries: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Mexico, Paraguay, and Peru. The fund has worked with 45 local commercial banks in these countries. The average loan term given to microentrepreneurs by ACCION affiliates is six months, with an average loan size of US\$500. An estimated 280,000 clients have been served according to information provided by ACCION.

Since its creation 20 years ago, the fund has suffered losses on only three letters of credit totaling US\$629,000, and in each case the fund's loan loss reserve fully covered the loss. No investor in the fund has experienced a loss of principal or interest (ACCION 2004b). In November 2004, ACCION launched its Global Bridge Fund to extend the model to other parts of the world (ACCION 2004a).

THE INTERMEDIARY-WHOLESALE MODEL CASE 2: RECHERCHES ET APPLICATIONS DE
FINANCEMENTS ALTERNATIFS AU DÉVELOPPEMENT

This is a Swiss-based nongovernmental organization that along with several of its partners in both developed and developing countries created the International Guarantee Fund in 1996. Similar to ACCION, the fund issues guarantees that allow its partners to gain access to loans from local banks in Africa and Latin America. The partners are independent of the fund's management and include organized groups of micro and small entrepreneurs, agricultural and craft product marketing organizations, and IFIs. Fund shareholders are various international donors and institutions, as well as local partners in developing countries.

As of 2003, the fund had issued US\$50 million of guarantees, against which US\$200 million in loans had been received by its cooperation partners—a leverage ratio of four. More than 250,000 microentrepreneurs in Africa (Benin, Burkina Faso, Burundi, Cameroon, Rwanda, Senegal, and Togo) and Latin America (Chile, Ecuador, El Salvador, Guatemala, Nicaragua, and Peru) have been served. The default rate during 1985–2003 averaged 5.2 percent (http://www.fig-igf.org/about_fig.htm). The International Guarantee Fund receives a counterguarantee for its operations from the Swiss Development Assistance Agency.

Examples of Guaranteeing Bonds or Securitized Assets

A more advanced version of the intermediary-wholesale model involves guaranteeing capital market instruments, such as bonds or securitized assets, issued by microfinance institutions. For example, in the 1990s, USAID provided a 50 percent guarantee for two two-year coupon bonds with face values of US\$1 million issued by BancoSol, a Bolivian bank specializing in microfinance (Inter-American Development Bank 1998). In 2003, USAID provided partial guarantees for a series of short-term corporate debt securities (commercial paper) totaling US\$12 million issued by a financial institution in Armenia to raise capital for loans to exporters (USAID 2003).

In 2004, IFC provided a 34 percent partial credit guarantee for a bond issuance of Mex\$500 million (US\$43.4 million) by Financiera Compartamos, a leading microfinance institution in Mexico. Financiera Compartamos is a financial institution that provides working capital microloans to small business entrepreneurs with an average size of US\$300. About 94 percent of its 250,000 clients are women (<http://www.ifc.org>). By August 2004, Financiera Compartamos had successfully issued the first tranche of Mex\$190 million (about US\$16.5 million). With IFC's credit enhancement of Mex\$64.6 million, the five-year bonds received an investment-grade local rating of AA by Standard & Poor's and Fitch Ratings.

Case 13. Credit Information and SME Access to Finance

Credit information registries support well-functioning and modern financial systems and are critical elements of the institutional framework (Miller 2003b). They provide rapid access to standardized information on potential borrowers. There are two main types of credit bureaus: public and private. Public credit bureaus usually only cover supervised institutions, require mandatory reporting of credit exposures, and typically have a high cut-off minimum loan amount. Private bureaus take five possible forms: private firms with bank ownership, private firms without bank ownership, bank associations, chambers of commerce, and commercial and credit insurance firms.

Background

World Bank surveys show that credit bureaus are fairly well established in high-income and middle-income countries, and even in some poor countries (Miller 2003b). However, the median age of private registries worldwide is only 10 years, and 30 percent of them were established after 1995. In the 1990s, Latin America led all other regions in the establishment of public credit bureaus (Miller 2003a).

Lower information asymmetries allow more efficient allocation of credit. Economic theory has long recognized the importance of asymmetric information in explaining behavior in credit markets. Collateral is commonly used as one of the tools to reduce asymmetric information. However, collateralization of loans is often problematic in developing countries, especially for new firms, microentrepreneurs, and SMEs, because they often lack significant fixed assets that they could use as collateral. In addition, the costs for lenders related to the seizure and liquidation of collateral can be significant, and the legal process can take a long time. One alternative is sharing credit information, which allows creditors to exchange information about individuals' and firms' past payment behavior.

Role of Credit Reporting and Credit Bureaus

Credit bureaus and registries collect and distribute factual data on payment performance, as well as other information used to assess the creditworthiness of a borrower. Using firm-level survey data on about 5,000 enterprises from 51 countries and a separate set of survey data of credit bureaus, both conducted by the World Bank, Love and Mylenko (2003) find that the existence of private credit bureaus is associated with lower financing constraints and a higher share

of bank financing. In addition, SMEs tend to have a higher share of bank financing in countries where private registries exist.

Credit bureaus and registries allow lenders to evaluate risks more accurately and improve the quality of their portfolios. Kallberg and Udell (2001) conclude that data from Dun & Bradstreet have substantially greater predictive power than firms' financial statements. Jappelli and Pagano (2001) find that the sharing of credit information is associated with higher lending, as measured by the ratio of private credit to gross national product and lower defaults. Barron and Staten (2001) also show that greater availability of information reduces default rates and improves access to credit. In a survey of banks in 34 countries conducted in 2001 and 2002, more than 50 percent of the respondent banks said that information sharing reduced loan processing time, costs, and default rates by 25 percent or more (World Bank 2004a).

A further advantage is reducing adverse selection problems and lowering the cost of credit for good borrowers. With credit information sharing, late payment or default with one lending institution can result in sanctions by others. This strengthens borrowers' discipline and reduces moral hazard. A good credit history also builds reputation collateral, which provides an incentive to meet commitments and is particularly important for SMEs.

Policy Issues Concerning Credit Bureaus

Despite little controversy about the importance of credit information sharing and its role in remedying credit constraints, the development of credit bureaus is not without debate. Policy conditions, including the legal and regulatory frameworks, can greatly affect whether credit reporting develops in a country, how it develops, and whether credit reports are useful for predicting risk (Miller 2003b). Critical policy issues that governments ought to consider in developing credit registries include the following:

- *Enabling legal and regulatory framework.* Such a framework is necessary to encourage information sharing among lenders and facilitate the flow of credit information. This often requires reviewing bank secrecy laws, permitting and providing incentives for the sharing of both positive and negative information, and eliminating restrictions on access to public records. Bank secrecy laws in many developing countries effectively prohibit or limit the operation of private credit bureaus (World Bank 2004a).
- *Balance between protecting privacy and consumers' rights and the need for information sharing.* Consumer protection concerns include issues such as fairness in the treatment of borrowers and lenders, accuracy in credit information, types of information collected, and noninvasion of privacy. Credit

bureaus must follow reasonable procedures to ensure that the information they obtain is accurate, relevant, and unbiased. In addition, laws and regulations should provide sufficient protection to consumers by ensuring that data are not misused, creating a balance between privacy protection and effective information sharing, allowing borrowers to access their own credit reports, and prescribing clear procedures for borrowers to challenge and correct incorrect information.

- *Balance between reasonable penalties for noncompliance and overly restrictive regulations.* An adequate legal and regulatory framework ensures the health and robustness of credit bureaus; however, legislation must be carefully crafted so that it is not overly restrictive, unnecessarily severe in relation to penalties or sanctions, or too complicated and so that procedures for information collection and exchange are not too extensive and expensive. The impact of overly restrictive rules can be severe. In Thailand, two credit bureaus that had operated for several years shut down when a new law was passed in 2003 that imposed large fines and criminal liabilities on participating financial institutions for minor violations in sharing information. The two bureaus did not reopen until five months later, when clarifying regulations were issued (World Bank 2004a).
- *Public versus private credit bureaus.* Public and private credit bureaus are not considered substitutes for, but rather complements to, each other. Governments in many countries have been prompted to establish public credit bureaus, typically through the central bank or the banking supervisor, to overcome the limitations of private bureaus or legal and regulatory restrictions on information sharing in the private sector (Miller 2003b). In some poor countries and those with highly concentrated lending markets, there may not be sufficient interest in the private sector to set up credit bureaus. Under such circumstances, the establishment of a public registry may offer the advantage of rapid setup, and direct enforcement by bank supervisors can counter lenders' unwillingness to comply.

Establishing public credit bureaus should not stifle private information sharing. As the credit market matures, or as private initiatives materialize, public credit bureaus can be restructured to complement the private initiatives by focusing on overall supervision and sharing data with the private registries. Public credit bureaus in Argentina, the Dominican Republic, and Peru share data with private bureaus. An example of more extensive private-public partnership is Sri Lanka's credit bureau, set up in 1990, with 51 percent of the capital held by the central bank and the rest shared among commercial financial institutions. The government's share declines as more institutions join the bureau (World Bank 2004a).

Entry of one of the major international credit reporting firms can accelerate the process of establishing private credit registries. In the Czech Republic,

Guatemala, India, and Mexico, private bureaus are being formed in joint ventures with foreign firms, which provide TA and expertise (World Bank 2004a). Countries need to ensure that legal obstacles do not stand in the way of such foreign investment.

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Useful Web Sites:

- Agricultural Cooperative Bank of Armenia: <http://www.acba.am>
- European Union: <http://tacininfo.ru/en/fiches/acba>
- International Finance Corporation: <http://www.ifc.org>
- International Fund for Agricultural Development: <http://www.ifad.org>
- International Guarantee Fund: http://www.fig-igf.org/about_fig.htm
- Microfinanza : <http://www.microfinanza.it>
- Nacional Financiera: <http://www.nafin.com>

- Recherches et Applications de Financements Alternatifs au Développement:
<http://www.fig-igf.org/rafad.htm>
- ShoreBank International, Ltd.: [http:// www.shorebankcorp.com](http://www.shorebankcorp.com)
- Small Enterprise Assistance Funds: <http://www.seaf.com>
- Wells Fargo: <http://www.wellsfargo.com/>

“There is growing and justified concern around the world regarding the importance of having formal financial institutions that reach the poor and of expanding them much more aggressively toward micro, small, and medium enterprises. The need exists for coordinated efforts between governments and financial institutions to reach and to open these vital markets. On the one hand, interest rate ceilings, directed public sector credit and guarantees, overregulation, weak judicial and legal frameworks, poor information networks, and weakness in property rights protection are often important components of the problem. On the other hand, financial institutions need to change the way they approach small and medium enterprises with innovative financial instruments and with new credit analysis and risk management techniques.

“*Expanding Access to Finance: Good Practices and Policies for Micro, Small, and Medium Enterprises* is a good guide for every policy maker and academic interested in promoting a deeper and more inclusive financial sector. International experiences presented in this book offer important insights for governments and for banks to change the way they think about this issue. The ample body of recommendations, based on solid theory and widespread practical experience, will help us move forward in an area where we can greatly influence our struggle against poverty and our commitment toward the MDGs.”

— *Alberto Carrasquilla, former Minister of Finance, Colombia*

“Microfinance, with its unprecedented success, could be the first of multiple streams of capital to reach talented entrepreneurs in developing countries, provided that we think clearly about how to differentiate among the ways of serving micro, small, and medium businesses. This book is one of the first to clarify how to segment types of small firms, and contains very interesting, concise descriptions of 12 successful and highly varied credit delivery systems. Access to capital is a fundamental constraint in building local economies. Some of the remarkable innovators in the microfinance sector are turning their attention to other entrepreneurial segments.”

— *Mary Houghton, President, ShoreBank Corporation*

“Access to finance is an important factor for investment growth and dynamism. Understanding what works in various settings by examining actual experience in various countries and settings is a contribution to the emerging literature on access to finance.”

— *Marilou Jane D. Uy, Director, Finance and Private Sector Development, Africa Region, World Bank*

