SMALL AND MEDIUM ENTERPRISE FINANCE: NEW FINDINGS, TRENDS AND G-20/GLOBAL PARTNERSHIP FOR FINANCIAL INCLUSION PROGRESS

GPFI Global Partnership for Financial Inclusion

IFC International Finance Corporation
World Bank Group

Cover photo: Woman entrepreneur in Nepal, April 2013. Photographer: Anka Zaremba.

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List of Abbreviations

DFI	Development Financial Institutions
DFID	Department for International Development (U.K.)
GPFI	Global Partnership for Financial Inclusion
IFI	International Financial Institutions
ILO	International Labor Organization
MDGs	Millennium Development Goals
MSME	Micro, Small and Medium Enterprise
OECD	Organisation for Economic Co-operation and Development

Acknowledgments

The SME Finance Forum, managed by the International Finance Corporation (IFC), is an implementing partner to the SME Sub-group of the Global Partnership for Financial Inclusion (GPFI) of the G-20. The GPFI is the main platform for implementation of the G-20 Financial Inclusion Action Plan. The Group engages partners from G-20 and non-G-20 countries, the private sector, civil society and others. It is chaired by the G-20 *troika* countries, currently Mexico, Russia and Australia. The GPFI is supported by five other implementing partners: the Alliance for Financial Inclusion (AFI), the Consultative Group to Assist the Poor (CGAP), World Bank, IFC, and the OECD.

The report was produced by the SME Finance Forum on behalf of the GPFI.

This update on developments in SME Finance was produced under the overall guidance of Peer Stein, Director, IFC Access to Finance Advisory Services, and the co-chairs of the SME Sub-Group: Susanne Dorasil (Germany), Aysen Kulakoglu (Turkey) and Garam Kim and Hyo-jin Kim (Korea). Matthew Gamser, Head, SME Finance Forum, authored the paper, based on important work since the 2010 SME Finance stocktaking exercise undertaken by all the implementing partners. Thorsten Beck, Cass Business School and Tilburg University, currently undertaking work evaluating the World Bank Group's SME development experience, provided data and ideas.

FOREWORD

Early in the G-20's work, the stocktaking it commissioned on SME finance helped identify current gaps and challenges. Since that stocktaking, further work on SME finance policy, agricultural SME finance and finance for women-owned enterprises has refined our understanding of the issues, while providing many promising models of successful practice by governments and the private sector. New work by the World Bank Group expands on the key role the private sector, and SMEs in particular, must play in new job creation. These studies cite access to finance as a key determinant in SMEs' ability to expand employment. At the same time, new collaborative efforts through the Global Partnership for Financial Inclusion, including the SME Finance Forum, the SME Finance Initiative, the SME Finance Compact, the G-20 Peer Learning Program and the AFI SME Finance Working Group continue expanding knowledge and resources in this field. The SME Finance Challenge's 14 winners provide models of innovation. This latest publication in the GPFI's SME Finance series summarizes this learning and its implications for the way forward.

The SME Finance gap remains large, particularly in emerging markets. The gap affects both formal and informal SMEs, with access to credit the biggest problem. As this paper notes, the financial crisis has made banks world-wide more cautious in lending, and regulators understandably concerned about risk management and sound credit underwriting processes. There is much the G-20 can do to close this gap, and the paper makes useful recommendations in a number of areas, including financial markets infrastructure strengthening, reduction of administrative and regulatory barriers to increasing SME clients in financial institutions, and promoting "big data"- based innovation to lower costs and improve quality in SME finance. The SME sub-group of the Global Partnership for Financial Inclusion will be supporting work in all these areas.

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Executive Summary

This update considers new findings since the initial Stocktaking report, substantiating the contribution of the private sector, and of small and medium enterprises (SMEs) in particular, for new jobs and investment. These findings further illustrate the key role access to finance plays in SMEs' abilities and willingness to add jobs—including the special circumstances of fast-growing SMEs, or "gazelles."

The new findings further detail availability and gaps in SME financing, including for specific subsectors such as women-owned firms and agri-enterprises. New trends include progress made in recent years to improve financial markets infrastructure, and expanded lending in countries such as China, which have made progress in this area. The findings also include key private sector innovations pioneered by the SME Finance Challenge winners and other private sector institutions, focusing on key sector opportunities (such as agribusiness and energy), product innovation (such as expanded local currency options), and risk management alternatives.

The new findings and trends highlight the potential of collaborative platforms that have emerged from the G-20/GPFI process to combine resources to improve SME access to finance, and some of the major outstanding issues and obstacles these platforms might address. The conclusion provides recommendations for priority issues and work areas for G-20/GPFI attention.

1. SMEs, Jobs, and Investment

SMEs will be critical for job growth. But all SMEs are not equal in job creation.

Recent research expands on the key links between SMEs, jobs and SME access to finance/investment. More than 200 million people are unemployed in the world today. Young people are more than 2.5 times more likely to be unemployed than older people, and more than 620 million young people worldwide are neither working nor in training.[1] Emerging market countries must create another 600 million jobs by 2020, mainly in Asia and Africa, just to keep employment rates constant.

The private sector is the main engine of job creation and the source of 9 out of every 10 jobs in the world. Within the private sector, SMEs account for more than half of all jobs worldwide, though as countries become richer the share of larger firms in employment increases. They provide two-thirds of the formal private sector jobs in emerging markets. Informal enterprises provide 48 percent of all jobs in emerging market countries, and 25 percent of all jobs in developed countries, but only 37 percent and 16 percent of GDP in these two markets, respectively.[2]

As countries do better, informal sector employment declines. This seems to be less due to formalization than to employees moving to formal firms when the opportunity arises. Formal firms pay higher wages and offer better working conditions than informal firms.[3] Also, as economies grow, smaller firms' share of total employment declines. Small firms have the largest share of employment only in lower income countries. In middle-income and high-income countries, large firms have the biggest share, but SMEs together have the largest share of employment in all countries.[4]

In developed economies, a relatively small number of fast-growing SMEs, often dubbed "gazelles," account for the majority of new job creation. Firms comprising less than 10 percent of the total SME population create 70 percent or more of all net new jobs.[5] Emerging market gazelles also create a disproportionate number of new jobs, but with significantly smaller multipliers, with some country exceptions. World Bank Enterprise Surveys found that these high growth firms make up 16.4 percent of all SMEs, and create almost 38 percent of new jobs. In Brazil, 8 percent of SMEs account for 57 percent of new jobs.[6] SME clients of "mid cap" private equity funds supported by IFC from 2000 to 2010 grew jobs at an average rate of 18 percent per year.[7]

Women make up 49.6 percent of the world's population, but only 40.8 percent of the formal labor market. The overall figures mask much variation between countries—77 percent participation by women in the formal labor force in Vietnam, versus 28 percent participation by women in Pakistan, for example. They also hide the dynamic differences in women's work development between countries—as in the increase in female participation rate in Latin America from 36 to 43 percent since the 1980s (and from 47 to 65 percent from 1984 to 2006 in Colombia), versus only a 0.17 percentage point increase in the Middle East and North Africa over the last three decades.[8]

Growing formal jobs for women also may be constrained by the relatively limited role of women in the ownership and control of SMEs. Women entrepreneurs control less than 40 percent of formal microenterprises, less than 36 percent of small firms, and less than 21 percent of medium-sized firms.[9] Women operate more in the informal sector and lower value-added service sectors, and more in home-based businesses—all of which are less likely to grow and add jobs.

2. Current State of SMEs in the Global Economy

Credit is a major constraint for SME and job growth.

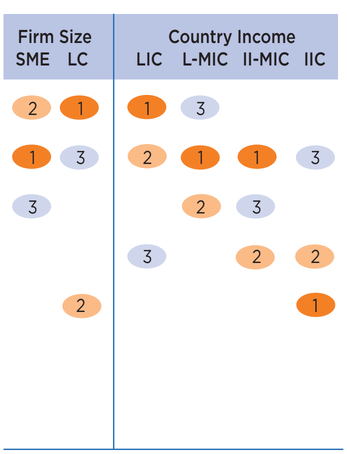
Restoring global economic growth has been a key priority of the G-20 from its inception. Jobs and investment are the cornerstones of that growth. Over 90 percent of all jobs are created by the private sector. In emerging economies, SMEs provide the vast majority of those jobs. Yet every second business remains credit constrained in emerging markets, and struggles to raise the financing necessary to invest and create new jobs. New research by McKinsey and IFC found that 70 percent of the micro, small and medium enterprises (MSMEs) in these countries do not use any external financing from formal financial institutions, and another 15 percent are underfinanced from formal sources.

This explains why SME finance has been a key part of the agenda of the G-20 since the Pittsburgh Summit. While some progress has been made, it will require further commitment from governments, development financial institutions (DFIs) and international financial institutions (IFIs), financial institutions, and the private sector to unleash the growth potential of

SMEs consider access to finance and power as the leading constraints

- Access to finance is cited as the leading constraint for SMEs, more so than large firms
- Large firms and SMEs in low-income countries cite power as the most important constraint
- Informal sector competition, taxes and workforce skills are also key constraints

Key Constraints According to MSMEs in Emerging Markets
(Share of respondents per region, percent)



Most serious obstacle to growth of SMEs	Sub-Saharan Africa	South Asia	East Asia	Latin America	Central Asia and Eastern Europe
Electricity	27	38	7	5	3
Crime, theft and disorder	17	2	3	7	2
Access to finance (availability) and cost	14	29	39	12	17
Corruption	7	4	2	7	7
Practices of competitors in the informal sector	6	1	17	13	10
Access to land	4	4	4	1	3
Tax rates	4	1	4	19	19
Transportation of goods, supplies and inputs	4	1	5	2	1
Inadequately educated workforce	4	1	5	9	13
Courts	3	18	6	6	11
Number of countries	38	4	9	17	31

*For this analysis: Small = <20 employees, medium-sized = 21-99, large >= 100 employees.
The results are the same for SMEs considering Small 10-49 employees and medium-sized = 50-249.

small- and medium-sized businesses in G-20 and non-G-20 countries. The world has moved beyond the crisis situation that marked the G-20's formation, but international and domestic financial flows to small firms continue to suffer.

SMEs worldwide consider access to finance their greatest obstacle to growth.[10] Access to electricity ranks second overall, though it tops the list in the lowest income countries. Competition from informal firms ranks third. There is some significant regional variation, with Latin American firms (of all sizes) citing informality as the top constraint, and firms in South Asia (of all sizes) citing political instability.

These entrepreneur perception-based findings strongly correlate with business results. Studies by the International Labor Organization (ILO) and others conclude that the absence of finance is among the greatest constraints to firm growth and job creation. Firms in Enterprise Surveys that perceived access to finance as their greatest problem were more likely to experience sluggish growth in subsequent years.[11] Conversely, firms that have access to finance have higher job growth rates. Higher proportions of enterprises receiving external finance correlates with higher start-up rates and with higher indirect job-creation when firms receiving finance are part of larger supply/value chains.[12] Detailed case study work in Sri Lanka, for example, showed bank clients receiving loans grew jobs at more than twice the country's jobs growth rate between 2009 and 2012.[13]

2.1 Financial Crisis and SME Access to Finance

While some parts of the world are recovering faster from the financial crisis than others, the overall picture for SME finance remains cloudy. The crisis has made banks world-wide more cautious in lending, and regulators understandably more concerned about risk management and sound credit underwriting processes. World Bank Enterprise Surveys continue to show that SMEs are more likely to be credit constrained than large firms.[14] OECD's *SME Finance Scoreboard* reports mixed or deteriorating conditions overall for SME finance in 24 of its 25 participating countries.[15] Even in countries where SME shares of total credit increased, this was more due to decreased credit to larger firms, which found alternative sources of financing in difficult markets. The European Small Business Finance Outlook also reports further decline in the overall business environment for SMEs, and disproportionately greater tightening of credit standards for SMEs by euro area banks.[16]

That said, many central banks world-wide are increasing their activities in SME credit markets, through both direct capital injections into the banking system and indirectly through guarantee funds and other risk-sharing instruments. The financial crisis has increased resources for such initiatives. The Central Bank of Korea, which has channeled low-cost funds to banks for SME lending through its "aggregate credit ceiling" policy since March 1994, has substantially raised its ceiling level since the financial crisis. There is an active debate going on in Europe on this topic as, despite significant new capital invested in similar measures, SMEs still report deteriorating credit conditions.[17] In the United States there seemed little positive impact of government capital injections into banks on SME finance for a long period after the crisis, but overall small business lending has rebounded in the first half of 2013 in both large and small banks, albeit at much higher interest rates than the previous year.[18]

The crisis has led to an active debate, particularly in Europe but relevant to all financial markets, about broadening the range of financing instruments available for long-term credit, including credit for SMEs. Alternatives may enable better responses to the diverse needs of the SME sector, and reduce vulnerability to credit shocks. This discussion also has focused new attention on credit guarantee programs and on the role of public financial institutions in supporting SME finance.[19]

2.2 BASEL II/III IMPLEMENTATION—MORE OF A CONSTRAINT TO SME FINANCE THAN PREVIOUSLY THOUGHT?

In the Stocktaking report and subsequent SME Finance Policy Guide caution was advised in implementing Basel II and III standards in a way that would not cause unintended negative impacts on access to finance for creditworthy enterprises. While in principle the 2019 timetable should give banks plenty of time to adjust to the new rules, and minimize negative impact on willingness to lend to SMEs, more recent work by OECD suggests that European banks already are adjusting their capital positions, shedding higher risk-weighted assets in favor of government bonds, mortgages and inter-bank lending.[20] Similar movements in emerging markets, where SMEs have virtually no alternatives to banks for formal debt financing, could reverse what small gains are being made to fill the SME credit gap. In addition, the Basel Committee's inclusion in Basel III of open lines of credit and trade credit under off-balance sheet items requiring 100 percent risk-weighting could discourage even such receivables-supported short-term SME transactions, disrupting trade finance flows.[21] This raises costs for emerging market banks executing trade transactions with correspondents in countries implementing Basel III, even though Basel II and III implementation remains far off in their countries.

None of this argues for a reassessment of the fundamental aims of Basel III to mitigate and possibly avoid future financial crises. Implementation experience to date suggests that more attention should be given to supervisory capacity-building in this process, to avoid unintended consequences for SME financial inclusion.[22] There are some hopeful signs in this area. The new European Union Capital Requirements Directive IV (CRD IV/CRR) provides an explicit definition of trade finance instruments that can receive more appropriate credit conversion factors (CCFs), and specifies how maturity, liquidity inflows, and outflows from such instruments should be treated by regulators. This guidance may alleviate some of the additional regulatory burden that has fallen on trade finance as a consequence of Basel III implementation.[23]

3. The SME Finance Gap

New research shows a credit gap of well over $2 trillion for SMEs in emerging markets. The gap for formal SMEs alone is close to $1 trillion.

IFC and McKinsey conducted a study in 2010 to estimate the number of MSMEs worldwide, and the degree of access to formal financial services of this market segment. This led to the much cited figure of a credit gap of over $2 trillion.[24] IFC revisited this data in 2011 to 2012 as new Enterprise Surveys became available, enabling a more refined understanding of the financing gap. The revised figures estimate a total MSME population worldwide of 420 to 510 million, of which 360 to 440 million are in emerging markets. Of these, there are 36 to 44 million formal SMEs globally (about 9 percent of the total MSME population), of which 25 to 30 million are in emerging markets.

The estimated credit gap for formal and informal MSMEs worldwide has been revised upwards to $3.2 to 3.9 trillion globally, of which $2.1 to 2.6 trillion is in emerging markets.[25] Lumping formal microenterprises with the formal SME population, the credit gap for the 100 million-plus formal MSME sector alone may be as high as $1.7 trillion. For formal SMEs, the new analysis estimates a total value gap for credit of $1.5 to 1.8 trillion, of which $0.9 to 1.1 trillion is from emerging markets. Another $0.5 to 0.6 trillion represents the credit gap for the estimated 60 to 70 million formal microenterprises in emerging economies.[26] While dubbed "microenterprises," more than 90 percent of the credit for these companies appears to come from banks (private and state-owned), implying that the nature of their credit demand (and potential supply) may be closer to that of small firms than to informal self-employed and other microenterprises.

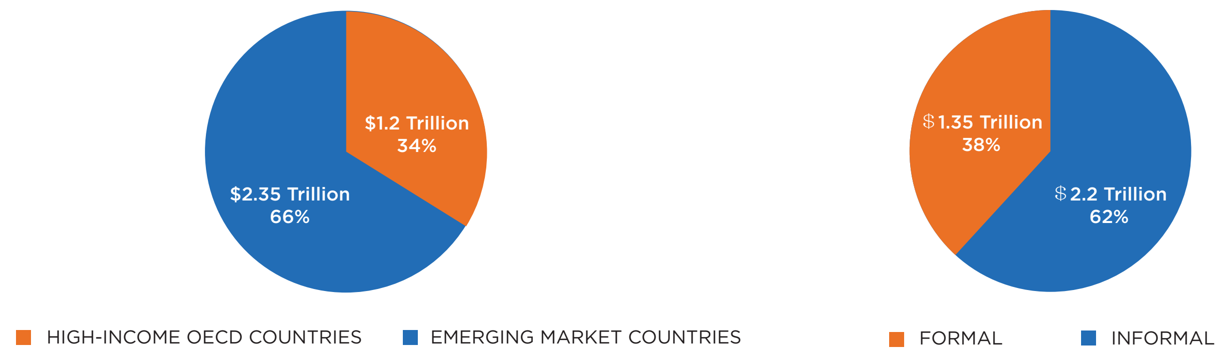
The updated survey information confirmed that the vast majority of formal SMEs in emerging markets, unlike informal SMEs and microenterprises, have bank accounts with formal financial institutions. Fewer than 30 percent of formal SMEs reported that they did not have a deposit account.[27] The access gap for SMEs is qualitatively quite different than that for the informal sector and for poor households in general. Banks already have these customers inside their doors, but the sector is substantially under-served, particularly on the credit side of their business in emerging markets.

3.1 Women-owned SMEs Face Higher Barriers in Access to Finance

Women face disproportionately higher barriers relative to their male counterparts in operating their businesses, including laws that discriminate by gender, customary practices, resource access, and access to education, training, and apprenticeship. Data from the World Bank's Global Financial Inclusion database highlights the existence of significant gender gaps in ownership of accounts and usage of savings and credit products.[28] Women are 15 percent less likely than men to have a bank account, and significantly lag behind men in saving and borrowing through formal financial institutions, even after controlling for individual characteristics, such as income, education, age, and other characteristics.

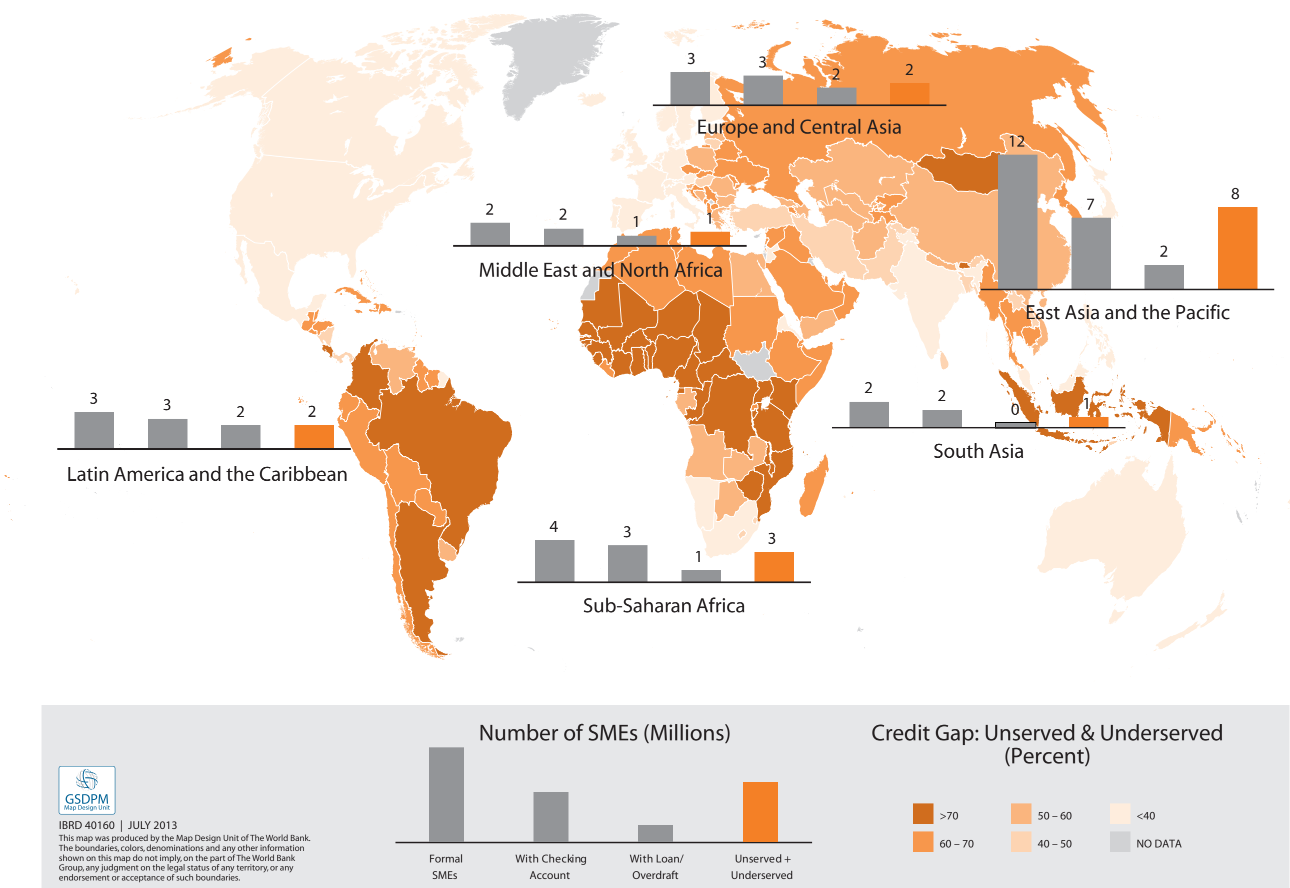
Women entrepreneurs in emerging markets are even more likely than their male counterparts to cite access

TOTAL MSME CREDIT GAP ($ TRILLION), BY MARKET SEGMENT



Source: IFC. 2011/2012 update

TOTAL CREDIT GAP, FORMAL SECTOR SMEs



Source: IFC Enterprise Finance Gap Database (2011) to finance as a severe or major constraint.[29] Women-owned formal SMEs have $260 to 320 billion in unmet financing needs world-wide.[30] Total firms with at least one female owner collectively face a $1 trillion credit gap.[31] As women entrepreneurs in emerging markets are concentrated in the smallest firm segment, they are more likely to be negatively affected by financial constraints.[32]

Recent work produced by IFC for GPFI on access to finance for women entrepreneurs notes that these impediments persist despite the demonstrated capabilities of women business owners. Recent research by MasterCard in Indonesia, Malaysia, Thailand, and Vietnam showed average growth rates of women-run firms significantly higher than for male-owned firms.[33] This suggests that, when women owners take the leap into formality, they can perform at least as well as their male counterparts. Women owners of formal firms have fewer differences in accessing finance, including overdraft facilities.[34] Microfinance partly compensates for women's access to formal finance in many emerging market countries. However, as women's enterprises grow, they need financial products and services beyond simple micro-credit from microfinance institutions.

An increasing number of institutions today support going beyond microfinance for women entrepreneurs, including a number of DFIs and IFIs, and some innovative commercial banks. Successful business models generally include building a separate brand identity for women entrepreneurs' banking services. While these do not always entail fundamental changes to specific financial products, they do involve detailed analysis of differences in women customer behavior, and adaptations to service offerings to reflect these patterns. Virtually all of the models include some forms of training/financial education, as well as networking opportunities with other women business owners.[35]

Impediments in regulations and financial infrastructure can act as barriers to women's access to financial services. For example, regulatory restrictions on opening a bank account linked to anti-money laundering guidelines can restrict women's access to accounts. Documentation requirements—such as a birth certificate, utility bill in the woman's name, a professional guarantor, or signature of a male family member—can in practice exclude women.

Credit bureaus and registries can have restricted or limited information on potential women borrowers that lenders need. For example, credit bureaus may not be required to include information from a range of sources, such as microfinance institutions, utility providers, cell phone companies, or retail stores that provide credit, all widely used by women. Collateral frameworks may not enable women to use assets as guarantees for loans. If collateral frameworks do not include registries that cover movable assets (such as inventory), as well as immovable assets (such as land), then women who do not own land or housing can be excluded from accessing credit.

In addition, lack of financial education, literacy, and capability can limit women, as well as men, from accessing financial services. OECD research suggests that women entrepreneurs have comparatively less access to mentoring and other important non-financial services.[36]

Studies show that women are less likely to save for retirement, to understand a range of financial topics (even young college-educated women), and less likely to predict their future earnings.[37]

Corresponding public initiatives can further encourage banks to promote new women entrepreneurs' services. These include programs that promote and increase joint property registration, collateral or secured transactions reforms, and risk shares or partial credit guarantees. The latter are more effective when combined with capacity-building services for both women owners and their bankers.

3.2 Agri-SMEs Face Special Challenges and Opportunities

Agricultural production needs to increase by 70 percent by 2050 to keep feeding the world. Three quarters of the world's poor live in rural areas, where most depend on agriculture for their livelihoods. Small farmer agriculture tends to be low productivity and high volatility. Finance for Agri-SMEs faces special challenges, but some promising solutions are emerging.

Farmers are risky borrowers, and small farmers are riskier than large farmers. All agriculture has seasonal ebbs and flows, with irregular cash flows. Small farmers tend to be very concentrated in one activity, or have a portfolio of activities all exposed to similar risks (drought, disease, etc). They have more limited collateral than larger farmers, often only land, which may not be properly registered nor easily foreclosed upon and resold.

Agricultural finance in general involves higher transaction costs due to the greater distances, lower population densities and lower quality infrastructure encountered in serving rural areas, which discourages smaller transactions. Sub-optimal policy and regulatory environments can confuse the picture of value chain structure, pricing, profitability, and overall competitiveness. As with women entrepreneurs' finance, limitations in laws and regulations governing movable assets financing raise the costs and risks of some possible solutions.[38] All this leads to a big gap in credit from $5000 to $500,000 to upgrade the small farmers that must form a part of key value chains for the foreseeable future. These clients are too large for microfinance institutions, and too small, risky, and remote for most commercial banks.

Innovations at the farmer, movable collateral, and buyer levels hold promise for closing this gap.[39] At the farmer level, improved market segmentation knowledge enables banks to locate specific growth opportunities for distinct farmer groups, both by crop and by location. Coupled with improved cash flow understanding of these farming systems, risks and costs to serve can be reduced through more focused marketing. Leasing key equipment or taking security against commodities in warehouses reduces risks further. Buyers can assist in both selecting farmers and in managing repayments, particularly in regions with longstanding business relationships.

Farmer organization or aggregation reduces risks and costs-to-serve across all three types of innovations. The looser the organization of the value chain, the more important producer organizations become for developing viable, scalable financing models. As with women entrepreneurs' finance, credit must come as a part of a broader package of services, in particular services that improve productivity, traceability and sustainability. Risk mitigation through collective support (farmers associations), guarantees/risk shares and insurance (personal and production) can play an important role. Equally important is setting up the right mix and sequencing of products (lending and savings), leading with short-term finance and savings to build quality portfolios and relationships. Technological innovation, in electronic payments and other areas, can reduce distribution costs and improve profitability.[40]

Public interventions will be critical in scaling up promising agri-finance innovations. As in a number of other SME finance areas, ensuring that the legal system can quickly and reliably resolve issues of contract and property rights strengthens value chain financing options, providing alternative collateral possibilities (through receivables financing, warehousing, leases, etc). Public-private partnerships to improve the physical infrastructure for agriculture can leverage private sector funding for warehouses, cold storage facilities, irrigation, and improved roads and ports. Supporting first loss/guarantee funds, particularly those focused on smallholder farmers and agri-SMEs, can complement improved risk management in banks and other financial institutions.[41]

4. G-20/GPFI SME Finance Progress Since Seoul Summit 2010

Early in the G-20's work, the stocktaking it commissioned on SME finance helped identify current gaps and challenges. The stocktaking noted that closing the credit gap for formal SMEs may be easier than for the informal sector, considering that more than 70 percent of these already have checking or deposit accounts. The spread of better practices in customer service for SMEs in financial institutions worldwide, using new business models that reduce costs through technology, and more cost-effective client relationship management is demonstrating the potential profitability of what had heretofore been considered a high-risk, low-reward market segment. However, limited financial information sources and problems recognizing and enforcing collateral (particularly movable assets securities) prevent greater outreach.[42]

The stocktaking encouraged further work in key areas of SME finance, and made four key recommendations for G-20 action to scale up these financial services globally. This update considers its main findings and recommendations in light of subsequent research and actions by the G-20 and others. It concludes with a new action plan and recommendations for accelerating progress.

These are the main recommendations of the SME finance stocktaking report:

- Endorse a set of recommendations for policymakers in the developing world to establish a supportive enabling environment for SME access to financial services.
- Establish a global SME Finance Forum.
- Fund the winners of the SME Finance Challenge and set up a global funding platform to build capacity, mitigate risks, and create incentives for the delivery of sustainable and scalable financial services to SMEs.
- Lead the efforts to gather better SME finance data in a coordinated fashion and establish a platform to consistently collect cross-country data.

4.1 New Collaborative Platforms Central to G-20/GPFI SME Strategy

The GPFI has launched a number of collaborative platforms since the 2010 stocktaking and Seoul Summit that provide new ways to combine resources to promote SME finance and development. In the policy domain, the G-20 and the broader GPFI have launched several support initiatives. These include the **G-20 Peer Learning Program**, through which countries committed to create cross-sector coordination platforms, to prepare national strategies to achieve financial inclusion, and support each other in promoting greater SME access to finance.

Some 17 countries have committed to this program to date, including five G-20 countries and 12 from emerging and developing countries. The G-20 announced the SME Finance Compact at the Los Cabos summit in 2012. This feeds into the Peer Learning Program, providing coordinated support through the GPFI for countries making specific SME finance commitments.

The World Bank's new **Financial Inclusion Support Framework** will provide technical advice and capacity building support for governments seeking to improve SME finance policies and broader financial inclusion.

This builds upon the G-20/GPFI *SME Finance Policy Guide* and *SME Finance Impact Assessment Framework*. In a closely related effort, the **Alliance for Financial Inclusion's** more than 100 member institutions, from more than 85 emerging and developing countries, have formed a new working group to support peer learning amongst policymakers and regulators on SME finance challenges and solutions.

The **SME Finance Forum** was opened in April 2012. It operates a web platform containing links to key documentation from GPFI and other institutions, and sponsors knowledge sharing through a LinkedIn discussion group that has grown to more than 1,600 participants worldwide. In April 2013, Women's Finance hub was launched. The Forum has co-organized both global and regional meetings on SME finance topics with GPFI partners.

The **SME Finance Challenge** winners all received initial disbursements from their G-20/GPFI awards, which total more than $23 million. In part due to the publicity afforded to them by the Challenge program, they have received an additional investment of more than $119 million to date, with a further $90 million expected.

The **SME Finance Initiative** kicked off as a collaborative financing and capacity building platform for institution-level support, with some $450 million mobilized to date from the U.K. Department for International Development (DFID), IFC, and the European Investment Bank. The Initiative will support risk sharing and other blended finance instruments to encourage the growth of scalable, sustainable financial services to the sector.[43]

4.2 SME Finance Data Improvement and Harmonization — a Key Challenge

GPFI members and partners have taken small steps forward in this area. The GPFI's Data and Measurement Subgroup, having agreed an initial set of key financial inclusion indicators (the G-20 Basic Set), is currently working towards identifying an extended set that will include relevant SME-specific data points to guide national statistical measurement and reporting. Two of the five indicators in the Basic Set already are relevant to SME finance — "enterprises with outstanding loans or lines of credit by regulated institutions," and "points of service."

Meanwhile, the Organisation for Economic Co-operation and Development (OECD) started its SME Finance Scoreboard, which in its 2013 edition collected supply- and demand-side data for 25 countries. OECD is working with the Asian Development Bank (ADB) on harmonizing this data collection with the ADB's new Asia SME Finance Monitor (starting later in 2013).[44]

The IFI/DFI Working Group on SME Finance has begun work to harmonize SME finance data reporting from financial institution clients. Pilot research, commissioned by IFC and focused on the portfolios of eight fellow IFIs/DFIs, revealed strong overlap in clients and SME data interests.[45] However, as expected, it also revealed inconsistencies and inefficiencies in data capture and interpretation. The working group, assisted by the SME Finance Forum, is expanding this effort, with a goal of common, verified reporting on core indicators, as now seen in the MIX Market for microfinance.

5. The Way Forward — Potential for Concerted Action

While the overall picture remains gloomy, some points of promise are emerging. They show how a concerted effort by policymakers and key implementing partners could reverse the decline and start closing the SME finance gap. For example, IFC's SME and microfinance-oriented financial institution clients overall reported continuous growth in their volumes of SME lending portfoliosfrom 2008 to 2011.[46]

During the peak of the financial crisis, these emerging market financial institutions continued to expand their SME finance business. This still represents only a fraction of the potential market growth. Cooperative platforms for investment, such as the new SME Finance Initiative, currently supported by the UK Department for International Development (DFID), IFC and the European Investment Bank (EIB) with over $450 million in investment and capacity building funds, can bring in greater resources from fellow development finance institutions, donors, and even commercial investors to accelerate investment in emerging market institutions. The EIB recently launched a €4.6 billion project bond initiative (senior debt) to augment funding resources for its SMEs. Coupled with policymaker support to improve the infrastructure and enabling environment for SME finance, such actions could narrow the gap considerably in a short period of time.[47]

5.1 Private Sector Innovation through the SME Finance Challenge and Other Channels

Whether despite of, or in response to the recent financial crisis, the private sector continues to find new technologies and approaches to make SME finance more affordable and profitable. The G-20's SME Finance Challenge identified 14 promising private initiatives and provided grants and other financial support for their growth. Some of this innovation focuses on particular sectors, such as: the Bank of the Philippine Islands' and Barefoot Power's work on energy efficiency/resource efficiency/renewable energy finance; Grassroots Business Fund's, Equity for Africa's and Root Capital's initiatives in agrifinance; or Medical Credit Fund's work on small-scale health care and wellness services.[48]

Other Challenge winners innovate within financial products, such as the European Fund for Southeast Europe's (EFSE's) and MFX Solution's work on new options for local currency financing for microenterprise and SME-focused financial institutions, Equity for Africa's work on equipment leasing, ResponsAbility's initiatives on social venture capital, and Capital Tool Company's (TREFI's) on distributor financing and receivables factoring. Building Markets, BiD network and Aavishkaar build new platforms and networks, both on- and off-line, connecting SMEs to markets and investors. The Entrepreneurial Finance Lab (EFL) uses psychometric testing techniques for an alternative credit risk management approach, compensating for the absence of reliable credit information and history for most SME loan applicants.[49]

Beyond the Challenge winners, others are demonstrating how the more data- and transactions-driven approaches for SME finance, heretofore only a niche business in a few developed markets, can grow and thrive world-wide. "Big data"- based models are driving new SME lending initiatives by Amazon and eBay in the United States, Ratkusen in Japan, and Alibaba in China – all drawing on these firms' proprietary transactions information resources. Peer-to-peer crowd financing platforms for debt (Thin Cats, Funding Circle) and equity (Circle Up, Crowdcube) help mobilize the resources and intelligence of high net worth individuals to tackle the unique challenge of young, high-growth potential SMEs.

One niche where data-driven approaches are showing great promise is in short-term finance, including trade, supply- and value-chain operations. IFC, the European Bank for Reconstruction and Development (EBRD), the Asian Development Bank and other development finance institutions have bolstered their trade and other short-term finance programs in recent years, breaking a long tradition in development finance of focusing only on longer term finance, because of strong demand for these services, particularly from SMEs. New offerings in supplier and distributor finance have grown upon initial trade finance platforms.

Strong back-office data management forms the key to success in these operations, coupled with partnerships with large buyer/seller firms who bring strong sectoral SME knowledge and information. Short-term finance now forms a significant part of these institutions' financial markets portfolios. Value-chain finance also forms a key part of women-owned SME development strategies, offering a way to encourage women entrepreneurs into higher growth potential markets, as in IFC's new global partnership with Coca Cola in distributor finance development, which has a specific women's enterprise component.

The faster that electronic payments increase in emerging markets, the more doors of opportunity will open for such data-driven innovations. As value chain, B2B, G2B and other payments move from cash to electronic form, the asymmetric information obstacles to assessing ability and willingness potentially get smaller and smaller, as long as credit information systems can be developed to tap into this valuable data resource responsibly. With payments histories available online, small firms become not much more expensive to research than larger firms, opening the door to banks and other financial institutions that can adapt their data management systems to mine this new resource.

5.2 Improved Financial Infrastructure Pays Dividends for SMEs in East Asia and the Pacific

The 2010 Stocktaking report urged governments to improve financial markets infrastructure to lower barriers to SME finance. Many East Asia and the Pacific countries have responded to this call by strengthening existing structures or launching new initiatives. New private credit information services have launched or are in development in Mongolia, Vietnam, Cambodia (including microfinance), the Lao People's Democratic Republic, the Philippines, Papua New Guinea, Vanuatu, Samoa, and Tonga. Legal reforms strengthening secured transactions and online movable assets registries have been undertaken in the Pacific, Vietnam, Cambodia, Lao PDR, Mongolia, and China. Electronic payments services are taking off as alternatives to expensive cash transactions across the region, through credit/debit cards, Internet platforms (such as Alibaba/AliPay) and mobile phone channels. These electronic payments options lower transaction costs, while creating valuable new sources of financial information on SMEs as well as on individuals.

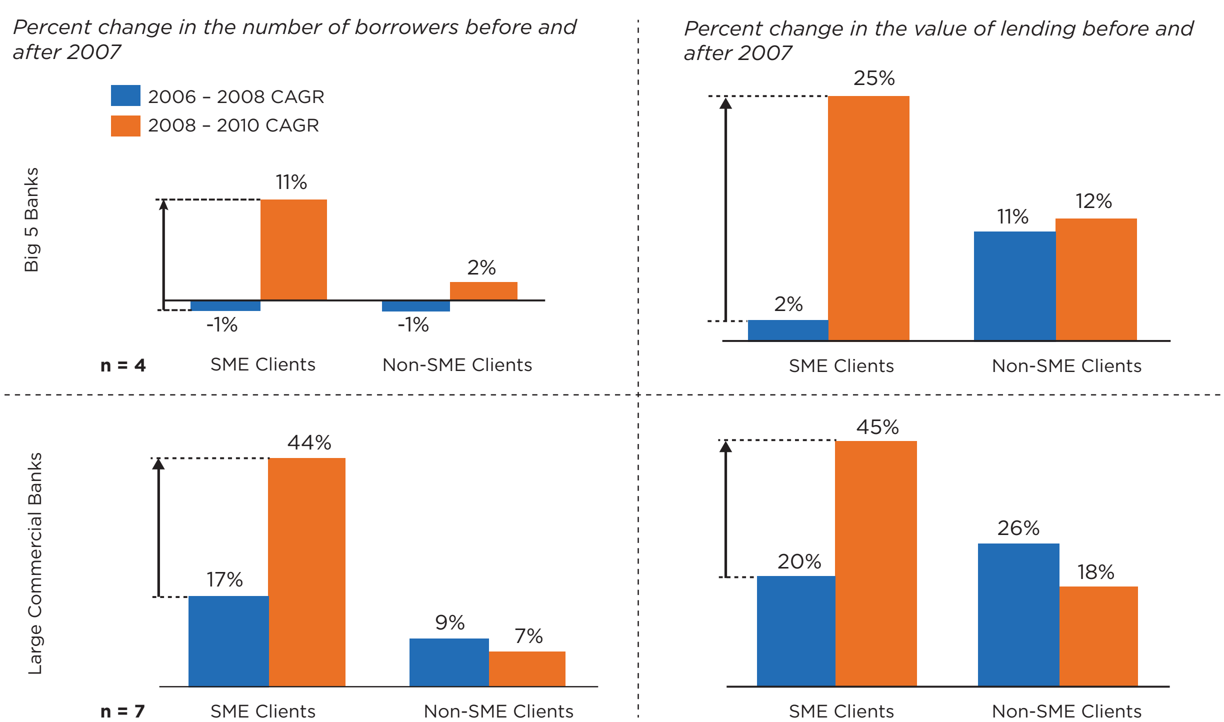
As an example, China's secured transactions reforms have had a striking impact, at least in terms of numbers rapidly achieved. Legal and regulatory changes, coupled with establishing an online registry in November 2007 for accounts receivable and leases, increased movable assets financing by 21 percent per year (by number), and 24 percent per year (by volume) from 2008 to 2010, compared to no growth from 2006 to 2008. The largest five banks increased their share of loans secured by movable financing from 27 percent to 33 percent during the period. From the registry launch in 2008 to June 2011, more than $3.5 trillion was financed using movable assets pledges, of which over $1 trillion for more than 68,000 new SME loans.[50] During calendar year 2012, another 61,000 SMEs received loans pledged against accounts receivable, out of more than 285,000 new loans and financial leases recorded in the registry.[51] By January 2013, just under $6 trillion (RMB 36 trillion) of accounts receivable and financial leases were registered.[52] This is without the registry including other potentially important movable assets, such as equipment and inventory.

These examples highlight the potential for financial markets infrastructure improvement to dramatically increase SME access to finance. However, they take time and require strong commitment from both the public and the private sector. China's successes are coming after over 10 years of hard work from policy-makers on reforms, and after significant, sustained public awareness campaigns (done as public-private partnerships) to educate financiers and entrepreneurs on the implications of reforms for new SME lending.

5.3 Gazelles — a Special Financing Challenge Requiring More Than Debt

As noted earlier, fast-growing SMEs, or gazelles, merit special consideration because of their disproportionate contribution to net job creation. Gazelles report the same constraints as emerging market SMEs in

IMPACT OF SECURED TRANSACTIONS REFORMS/REGISTRY ON SME LENDING IN CHINA



Source: Big 5 (Agricultural Bank of China, Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), Bank of Communications, and Bank of China), plus 50 FIs surveyed in Anhui, Guangdong, Shaanxi, Shandong, Shanghai, Zhejiang. Dahlberg 2011.

general, access to finance and power topping their priorities. However, they present different challenges for SME finance, needing more than straight credit, while their youth and small size discourage banks, conventional private equity firms, and capital markets from offering more.[53]

IFC's experience with gazelles confirms both their potential, and their challenges. SME investments by IFC's private equity fund partners grew jobs at almost twice the rate of larger firm investments (18 percent vs. 9.7 percent). There was a strong positive correlation between fund returns and job creation. At the same time, these smaller investments needed more innovative and long-term financing structures, utilizing quasi-equity instruments (such as royalties or other revenue-sharing). More complex structures bring higher management costs to the funds, yet investors rarely are willing to consider higher fund management fees.

Also, the absence of longer-term mezzanine financing discourages the private equity industry from pursuing this segment, where returns often require more time, more aggressively.[54] IFIs and DFIs, through offering more patient capital for the industry, could remove some of these disincentives. These development finance institutions also may be able to prime the pump of angel investor support for these SMEs by supporting networking between local entrepreneurs and the high net worth individuals they have helped to create through their larger investments in these markets.

Governments, too, have intervened to support gazelle financing. One of the oldest programs is the US Small Business Investment Corporation (SBIC) program, famous for helping in early financing of Apple Computers. The Republic of Korea has been an aggressive innovator in this space of late. The Korean Trade Insurance Corporation manages an exchange rate volatility insurance program that has supported some 3,215 SMEs in trade contracts worth over $400 billion from 2000 to present. This insurance, with a structure similar to a forward contract, allows an exporter or importer to make settlement at a guaranteed rate regardless of foreign exchange fluctuations subsequent to the contract date. With higher growth potential SMEs found in disproportionate numbers in export-oriented subsectors, this provides these entrepreneurs a hedge against exchange rate volatility. Korea's Win-Win Fund targets another area where high-growth SMEs are well represented, supply and value chains for larger corporates. This Fund, managed by the Industrial Bank of Korea (IBK), raised $11.4 billion from the corporates and large banks for a total pool of over $31.6 billion, loaned to 3,456 SMEs to date. This Fund has helped ensure consistency and continuity in vital supply chains for 77 large corporations. The newest initiative from Korea is the "Measures to Develop a Venture-Startup Funding Ecosystem" program launched in May 2013. This program includes fiscal incentives for angel investors, a new public-private-financed co-investment fund (the "Future Creation Fund"), a new exchange focused exclusively on venture investments and SMEs (KONEX), and a "Growth Ladder Fund", another public-private partnership promoting intellectual property development and protection. The government will create a central start up platform to collect and review new ideas, accompanied by business environment reforms to reduce barriers to growth, investment and exit, and to strengthen intellectual property protection.[55]

6. Conclusions and Recommendations

Early in the G-20's work, the stocktaking it commissioned on SME finance helped identify current gaps and challenges. Since that stocktaking, further work on SME finance policy, agricultural SME finance and finance for women-owned enterprises has refined our understanding of the issues, while providing many promising models of successful practice by governments and the private sector. Responding to this promise, the G-20 launched the SME Finance Forum in April 2012 to serve as a focal point for knowledge and promotion of good practice, and the SME Compact at the Los Cabos meeting. Within the framework of the G-20 GPFI launched at the Seoul Summit, the following other concrete steps have been taken and endorsed:

- The SME Finance Challenge as a call to the private sector to put forward its best and innovative ideas to advance SME Finance, which have since received financing through G-20 and non-G-20 partners;
- The Global SME Finance Initiative, a collective investment and capacity-building vehicle for financial institutions and services, and financial markets infrastructure development, managed by IFC jointly with IFIs/DFIs and support from the U.K.
- The SME Finance Compact and Financial Inclusion Support Framework, providing technical advice and support for governments seeking to improve policies for SME finance and broader financial inclusion.
- The G-20 Peer Learning Program, and the AFI SME Finance Working Group on SME Finance, through which countries support each other in promoting greater SME access to finance.

  At the same time, while the world has moved beyond the crisis situation that marked the G-20's formation, international financial flows for long-term investment continue to suffer, as documented in the recent G-20 Umbrella Paper on Long Term Finance. This also has an impact on SMEs, which remain severely constrained. Trade and supply chain finance flows to smaller firms that were severely disrupted are being restructured, but much remains to be done. Adapting to the new Basel financial stability requirements while preserving support for viable small business ventures may strain the capacities of many regulators. This makes technical assistance in sound, risk-based regulation and supervision more important than ever.

Considering the experience and learning that has taken place since the 2010 Seoul Summit, G-20 leaders should focus further support on three areas:

- ***Collaborative Learning Platforms for SME Finance.*** Reaffirm their support through expanded contributions to the SME Finance Forum, the Global SME Finance Initiative, the SME Finance Compact/G-20 Financial Inclusion Peer Learning Program/AFI SME Finance Working Group, the World Bank Financial Inclusion Support Framework and other common platforms that permit accelerated, better coordinated support for SME finance growth and development.
- ***Harmonized Data Collection on SME Finance and its enabling environment.*** Support initiatives that increase knowledge of the main obstacles to SME finance, and of good practice benchmarks for SME finance. Issue areas meriting further investigation include:
  a. Excessive/inappropriate documentation requirements from regulators and financial institutions for opening SME accounts;
  b. Collateral restrictions and requirements for SME lending from regulators;
  c. Interest rate ceilings;
  d. Directed lending (SME quotas);

e. Payments systems and late payments constraints on SMEs; and
f. Restrictions on non-bank financial institution activities and financial products (such as leasing and factoring).

Major initiatives that can generate or improve this data through support from the G-20 include the SME Finance Scoreboard supported by OECD and other partners (such as the Asian Development Bank), the IFI/DFI client data harmonization initiative, the IMF/World Bank Financial Access Survey on SME finance, the World Bank and EBRD Enterprise Surveys, and the World Bank's annual Financial Sector Development Report. The SME Finance Forum can promote researcher collaboration in all these areas, and disseminate outcomes.

- ***Financial Markets Infrastructure, particularly credit information, movable collateral and secured transactions systems, and electronic payments.*** Improving this infrastructure greatly reduces costs for financial institutions to assess SME ability and willingness to repay, and broadens the range of assets SMEs can use to support their borrowing. Credit information needs to incorporate as wide a range as possible of financial transactions, as most SMEs lack a borrowing history with formal financial institutions. Collateral and secured transactions reform, in addition to creating the right balance between creditor and borrower rights over pledged assets, must focus on making the widest range of movable assets recognizable as security. SMEs have fewer fixed assets to offer, but they hold a range of movables such as accounts receivable, inventory, and equipment which, as the China example shows, provide ample asset cover when the enabling environment permits. Since SMEs' transactional history is one of the most reliable indicators of creditworthiness, the faster SMEs' business transactions can move from paper to electronic form, the cheaper they become to serve, provided financial institutions can innovate to exploit the new data resources. This infrastructure improvement will make SMEs less mysterious and more attractive to financiers, and makes financial markets more open and competitive for their businesses. It enables faster, more efficient credit underwriting processes in financial institutions of all sizes.
- ***Support "Big Data" Based Innovation in SME Finance.*** Building on key financial markets infrastructure improvement, continue efforts promoting innovation in the SME finance field through launching a new challenge fund focused on transferring developed country initiatives in brokering, crowd-financing and other "big data" mining innovations to mainstream financial institutions in emerging markets. Some of the most promising findings from the SME Finance Challenge experience suggest that data-driven solutions hold great promise for emerging markets SME finance. In particular, technologies and approaches that have made some headway in developed markets may now be more practical and relevant in emerging markets due to improvements in financial markets infrastructure in the latter. Areas of interest include: online services for brokering/facilitating SME finance; working capital finance systems building on trade, supply chain, merchant payments and other electronic payments platforms; and using social media combined with data mining to advance equity and quasi-equity financing for high growth-potential SMEs.

Endnotes

1. World Bank, *World Development Report 2013: Jobs*, pp. 50ff.

2. *IFC Jobs Study: Assessing Private Sector Contributions to Job Creation and Poverty Reduction*, 2013 pp. 10-11.

3. World Bank Latin America and the Caribbean Enterprise Surveys.

4. Enterprise surveys, cited in IFC Jobs Study, p. 12. SMEs still account for over half of all employment in all but one reporting OECD country (Russia), and account for 2/3 of employment across the whole-membership. See OECD, *Entrepreneurship at a Glance 2013*, pp. 28ff for further details.

5. See, among others, OECD *High Growth Enterprises: What Governments Can Do to Make a Difference*, 2002. Acs, Z., W. Parsons & S. Tracy (2008). *High-impact firms: Gazelles revisited*, and Mitusch, K. & A. Schimke (2011). *Gazelles – high-growth companies. Europe Innova.*

6. World Bank Enterprise Surveys.

7. Parc and Shi 2012, cited in IFC Jobs Study p. 92.

8. World Development Report 2013 p. 4 and p. 30.

9. IFC, *Strengthening Access to Finance for Women-Owned SMEs in Developing Countries*, 2011, p 6.

10. Enterprise surveys, as cited in IFC Jobs study p. 38.

11. As cited in IFC Jobs Study, pp. 83ff.

12. IFC Jobs Study, p. 85.

13. IFC Jobs Study, p. 86.

14. See Kuntchev et al, p. 17.

15. Canada being the only exception. See OECD 2013, pp. 19-28.

16. See European Investment Fund, 2013, p. 3.

17. ECB semi-annual SME access to finance surveys, as cited in OECD, *Financing SMEs and Entrepreneurs 2012: An OECD Scoreboard*, 2012, p. 25

18. Biz2Credit, *Small Business Lending Index*, June 2013. There remains active discussion among economists whether the zero-interest rate policy of the Federal Reserve is hampering SME finance revival through discouraging the movement of surplus liquidity through the previously more vibrant inter-bank lending market.

19. See OECD, *Alternative Financing Instruments for SMEs and Entrepreneurs: The Case of Mezzanine Finance*, 2013. Credit guarantee schemes were covered extensively in the the GPFI 2010 Stocktaking report, and OECD produced *The Role of Credit Guarantee Schemes and Mutual Guarantee Societies in Supporting Finance for Small and Medium-Sized Enterprises* (2013). OECD has a forthcoming work on the role of public financial institutions in supporting SME finance. This topic was also covered in a broader financial markets sense in the World Bank's *Global Financial Development Report 2013: Rethinking the Role of the State in Finance.*

20. Ibid., p. 37.

21. Ibid pp. 37-39.

22. See IFC *SME Finance Policy Guide,* 2011, pp 19ff.

23. See Karen Fawcett, Standard Chartered Bank, *Basel III – Trade and Liquidity,* presentation to Bankers Association for Foreign Trade, 7 May 2012. While further work needs to be done on outstanding issues of interpretation, Tod Burwell, the President and CEO of BAFT has written to the G-20 recommending that the EU's approach be seen as a model for other regulators.

24. *Two Trillion and Counting,* p. 1.

25. Ibid, p. 3.

26. IFC Technical Note, *Closing the Credit Gap for Formal and Informal SMEs,* forthcoming, pp. 1-2.

27. Ibid p. 2.

28. Demirguc-Kunt, Klapper, Singer. "Financial Inclusion and Legal Discrimination against Women," April 2013. The research paper also draws on indicators from the World Bank's Women, Business, and the Law database.

29. IFC, *Strengthening Access to Finance for Women-Owned SMEs,* p. 16.

30. IFC Technical Note, p. 2.

31. IFC-McKinsey MSME database.

32. IFC, *Strengthening Access to Finance for Women-Owned SMEs,* p. 18, citing findings of Beck 2007.

33. Mastercard, 2010, cited in *Strengthening Access to Finance for Women-Owned SMEs* p. 13.

34. IFC, *Strengthening Access to Finance for Women-Owned SMEs,* p. 45. There are some differences in accessing other loans.

35. Ibid., pp. 48-56, for more detail. The Global Banking Alliance for Women, founded in 2000, was formed to promote peer learning in this field among commercial banks. The G-20-initiated Womens' Finance Hub was launched in April 2013 to expand this knowledge and good practice promotion effort.

36. See OECD, *Closing the Gender Gap. Act Now,* 2012, pp. 281ff.

37. ING Retirement Research Institute, 2012, pp. 4-7.

38. See IFC, *Scaling Up Access to Finance for Agricultural SMEs: Policy Review and Recommendations,* 2011, pp17-18 and IFC, *Innovative Agricultural SME Finance Models,* 2012 pp. 15-16.

39. For more detail, see IFC, *Innovative Agricultural SME Finance Models* pp. 25-40.

40. Ibid., pp. 52-53.

41. IFC, *Scaling Up Access to Finance for Agricultural SMEs: Policy Review and Recommendations* pp. 6-11 and *Innovative Agricultural SME Finance Models,* pp. 12-13.

42. IFC, *Scaling-Up SME Access to Financial Services in the Developing World,* 2010, pp. 6-7.

43. There is additional collaborative work going on outside the GPFI structure, such as the Business Development Bank of Canada's training and information sharing activities for other development finance institutions in SME and enterprise risk management. For more detail see BDC 2012, pp. 48-49.

44. The Scoreboard also monitors policy and program changes at country and international level. Its individual country profiles present data for a number of core indicators, measuring trends in SME debt and equity financing, solvency and policy measures by governments.

45. See MIX 2013, pp. 3-4.

46. Internal IFC portfolio data.

47. It is clear that public financial institutions (PFIs) can play an important role in addressing long-term market gaps for SME finance. However, there is significant debate about appropriate roles for PFIs and appropriate government policies for supporting these institutions. More on this debate can be found in OECD, The *Role of Public Financial Institutions in Supporting SME Finance, forthcoming, and the World Bank's Global Financial Development Report* 2013. A set of case studies on successful government interventions to strengthen SME finance will be produced during the Australian G-20 presidency.

48. Energy efficiency and other forms of green credit/ finance are taking a higher priority in many countries, and in G-20 activity, both for SMEs and for wider financial sector initiatives.

49. More on the work and progress of the SME Finance Challenge winners can be found through the SME Finance Forum, www.smefinanceforum.org.

50. As was noted earlier, alternatives to traditional debt finance may be relevant to the broader population of SMEs, particularly those with intangible assets or those experiencing transition. The global financial crisis has highlighted the need to strengthen capital market structures and decrease reliance on borrowing for longer term financing in general. This is an active discussion topic in the G-20 agenda.

51. IFC Jobs Study, pp. 80ff.

52. Ibid. It also should be noted that these total are despite the Registry being unable to take pledges against equipment and inventory, which still must be handled through different, off-line systems.

53. As was noted earlier, alternatives to traditional debt finance may be relevant to the broader population of SMEs, particularly those with intangible assets or those experiencing transition. The global financial crisis has highlighted the need to strengthen capital market structures and decrease reliance on borrowing for longer term financing in general. This is an active discussion topic in the G-20 agenda.

54. IFC Jobs Study, pp. 80ff.

55. The case summaries presented here will be expanded upon in a forthcoming publication on innovative policy measures and programs to promote SME Finance, currently under development by the GPFI SME Subgroup.

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