



Improving SMEs' Access to Finance Through Capital Markets and Innovative Financing Instruments: Some Evidence from Developing Countries

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Question

What evidence is there about the impact of capital markets on improving access to finance for businesses in developing countries?

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1. Overview

In developing economies, where the financial sector is typically characterized by marked weaknesses that constrain the access to finance, private equity and other alternative sources of financing can be a valuable source of stable, longer-term financing for some firms (IFC, 2011). While bank financing will continue to be crucial for small and medium-sized enterprises (SMEs), there is a fear that credit constraints around traditional bank lending are limiting SME growth.¹ It is, therefore, necessary to broaden the range of financing instruments available to SMEs and entrepreneurs, in order to enable them to continue to play their role in investment, growth, innovation and employment (OECD, 2015).

Traditional debt financing from banks also appears to be less suited particularly to newer, innovative and fast-growing companies, i.e. those with a higher risk-return profile.

Significant amounts of funds might be needed to finance projects with high growth prospects, while the associated profit patterns are often difficult to predict. The financing constraints can be especially acute in the case of start-ups or small businesses that depend on intangibles in their business model, as these are highly firm-specific and not easy to use as collateral in traditional debt instruments (OECD, 2010a). However, for most enterprises, there are few options than traditional debt. This signifies an important task for policy makers aiming at long-term growth (OECD, 2015; Adb and oecd, 2014).

This report maps some of the key and alternative types of financing instruments supporting SMEs' access to finance and access to financial services. It also provides some evidence on the implications of firm size (i.e. SMEs versus large firms). In addition, it provides examples from different countries to offer lessons. As such, it aims to highlight the financing options available to SMEs in different circumstances. Unfortunately, the evidence about the use of these various financing tools by SMEs, and how they respond to their needs, remains sparse (especially in developing countries) – despite their increasing significance both for SMEs and investors.

This rapid evidence review looks at reports issued by different international financial institutions, development agencies and some academic publications – regarding different types of financing instruments (especially those linked to capital markets) that help to improve access to finance by businesses in developing countries. The report particularly focuses on the evidence from lower middle-income countries (LMICs) and low-income countries (LICs). However, the very limited evidence on those countries has been a major constraint. The literature on the topic mainly details the experiences of advanced economies and emerging economies (i.e. upper middle-income countries (UMICs)). This is because most of the financing instruments under discussion (i.e. those linked to capital markets) are better suited to advanced/emerging economies – which have a reasonably developed financial sector – unlike most LICs and LMICs. Some of the key findings gathered from different financing instruments adopted by various countries have been summarized below:

¹ Financial stability, financial inclusion and financial deepening must be considered as mutually strengthening objectives in the quest for long-term SME growth. While bank financing will continue to be vital for the SME sector, a more diversified alternative for SME financing may support long-term investments and lessen the vulnerability of the sector to changes in the credit market (OECD, 2010b, 2012).

- Kenya has an informal (largely unregulated) capital market catering to SME financing. The performance of most of these respective SME stock exchanges is, however, weak.
- In Vietnam and Indonesia, there is no dedicated and independent SME stock exchange. However, SMEs can take part in the national stock market through special arrangements. In India and the Philippines there are stock exchanges devoted to SMEs – where the platforms are hosted by their main stock markets.
- In Lebanon, the Innovative Small and Medium Enterprises project (supported by the World Bank) offers equity co-investments in innovative SMEs. There are possibilities for the programme's expansion to Venture Capital directed at SMEs.
- Through a partnership between the Government of Jordan, the European Investment Bank, and Abraaj Capital, the 'Jordan Enterprise Development Corporation' and its innovation fund support high-potential and innovative growth SMEs.
- In Brazil, the Inovar Programme employs a venture capital that funds the development of new technology-based SME companies.
- In Malaysia, agriculture funds support early stage SMEs through a local Venture Capital association.
- In India, the Growth, Innovation and Inclusive Finance Project (supported by the World Bank) has successfully worked on access to finance for start-ups, services, and manufacturing businesses.
- In China, different types of SME bond instruments (e.g. SME Collective Note, SME Joint Bond, and SME Private Placement Bond) have been utilized to enhance access to finance by SMEs. The market is also rapidly growing.
- In Mexico, the Production Chains Programme has enabled SMEs to improve their access to capital through factoring schemes.
- In Ethiopia and Guinea, leasing programmes (supported by the World Bank) have improved access to finance by SMEs. The Advisory Services initiative by the International Finance Corporation has also supported the mobilization of investment capital to fund leasing operations in various African countries.
- In Nigeria, the World Bank has supported the formation of the Development Bank of Nigeria – which offers long-term financing and partial credit guarantees to financial intermediaries so that they can provide lending to small and medium businesses.
- In Morocco, credit guarantees provided by the Micro, Small and Medium Enterprises (MSME) Development project have notably enhanced access to finance by businesses.
- In Palestine (West Bank/Gaza), the European-Palestinian Credit Guarantee Fund (supported by the German Government, the European Commission, and the European Investment Bank) has strengthened access to finance to SMEs. In Afghanistan, USAID and the German Government have helped to introduce a similar SME Credit Guarantee Facility for SMEs.
- In Afghanistan, Bangladesh, and Pakistan, Apex Funds have supported microfinance institutions – which in turn funded SMEs. Further, bigger regional Apex Funds (e.g. the South Asian Regional Apex Fund that was supported by the International Financial Corporation, Japan Bank for International Corporation, Asian Development Bank, Industrial Development Bank of India, etc.) have provided growth investments for SMEs.

- In Ethiopia, the Women Entrepreneurship Development Project has supported local microfinance institutions to upscale their operation and broaden loan coverage to women entrepreneurs/SMEs.

The report is structured as follows. Section 2 briefly discusses the financing challenges faced by SMEs, especially those in developing countries (i.e. those with weak capital markets). Section 3 discusses major types of capital market instruments to finance businesses, primarily those in LMICs and LICs. Section 4 deals with other creative financing instruments targeting SMEs' access to finance and access to financial services.

2. SMEs and Gaps in Access to Finance

SMEs receive limited external funding compared to large firms and face a financing gap – even if they deliver employment to a large share of the workforce in developing countries.

Further, SMEs are less likely to have a formal bank loan or other lines of credit compared to large firms, according to the World Bank Enterprise Survey (Abraham and Schmukler, 2017). Instead, they depend on internal funds, or cash from friends and family, to start and initially operate their businesses. About 65 million firms, or 40% of formal micro, small and medium enterprises (MSMEs) in developing countries, have an unmet financing need of US\$5.2 trillion every year – according to estimates by the International Finance Corporation (IFC). This is equivalent to 1.4 times the current level of the global lending to Micro, Small and Medium Enterprises (MSMEs). East Asia and Pacific region accounts for the biggest share (46%) of the total global finance gap and is followed by Latin America and the Caribbean (23%) and Europe and Central Asia (15%). The gap volume differs significantly region to region. Compared to potential demand, Latin America and the Caribbean and the Middle East and North Africa regions have the greatest proportion of the finance gap – measured at 87% and 88%, respectively. About half of all formal SMEs do not have access to formal credit (World Bank, 2019).

The financing gap is even bigger when micro and informal enterprises are considered.

Informal SMEs may especially be unserved or underserved by financial institutions. Moreover, financial sources are inclined to dry up more quickly for small firms than for larger firms during recessions. The scarcity of finance faced by SMEs makes the economic and social impacts of economic crises more difficult and long-lasting. While many SMEs face difficulties in acquiring bank finance, access to non-bank financing is even more limited (Koreen et al., 2018).

Unlike large firms that may take advantage of different types of finance, SMEs have difficulty securing sources of financing beyond straight bank debt. These challenges are more pronounced for SMEs in economies where private capital markets are immature and SMEs lack the scale, knowledge and skills to move towards alternative sources of finance (e.g. in LICs and LMICs). Since bank financing will remain vital for the SME sector across all economies, there is a persistent need to develop a more diversified set of choices for SME financing, so as to decrease their susceptibility to changes in credit market conditions, reinforce their capital structure, grab growth opportunities and increase long-term investment. This will also add to the buoyancy of the financial sector and the real economy and to promoting new sources of growth (Koreen et al., 2018).

Studies have shown that having access to finance is correlated with higher job growth rates at the firm level (Dinh et al., 2010, World Bank, 2019; Abraham and Schmukler, 2017;

IFC, 2013). Governments, development finance institutions, financial intermediaries and other private sector actors should all intervene to close the financing gap and to lessen the financing constraints. Improved financial infrastructure, regulatory reforms, higher competition in the financial sector, and support measures to financial intermediaries (including to unserved and underserved groups) are some of the measures that can enhance access to finance, and in turn help to create jobs. For instance, programmes targeted at reducing costs of financial services for underserved and unserved SMEs can promote job creation. Financing SMEs by pursuing underserved groups such as women, youth, or the poor can deliver help where it is needed the most (IFC, 2013).

Maintaining the proper balance between bank debt and capital market (equity) financing is crucial for businesses. Debt and equity financing play a complementary role in a firm's growth. Just piling more debt onto SMEs without a balanced capital structure may prevent them from securing or repaying the bank debt and make them vulnerable to business downturns and changes in interest rates. Carrying little or no debt may be an indicator of risk aversion. Too much equity, on the other hand, dilutes firms' ownership interest. The IFC experience suggests that lack of equity finance is a binding constraint for many SMEs, in particular for larger SMEs, in developing countries, while extending additional debt financing for undercapitalized SMEs may be counterproductive. Unlike the large-buy-out funds in developed markets, typical SME funds in emerging markets rarely try to use leverage to increase their returns, focusing instead on making money by assisting with operational, management, and marketing improvements (IFC, 2010).

3. Financing SMEs Through Capital Markets

Equity finance can be a good financing instrument for SMEs in their early lifecycle stages, i.e. when their cash flow is not yet regular. For these businesses, bank debt is usually not accessible in adequate amounts for a range of regulatory reasons – making equity their key source of finance. Nevertheless, even well-established and successful SMEs face several difficulties when trying to access local or international capital markets. The cost of raising capital is often significantly higher for SMEs, not just because of the apparent greater risk linked to investing in such businesses, but also due to the smaller relative amounts of financing that SMEs need. Since most of the compliance costs associated with accessing capital markets are fixed (e.g., listing and rating agency charges, legal fees, prospectus preparation costs, etc.), SMEs often find that the cost of using the capital markets is expensive (IFC, 2010).

SME stock exchanges have been created by some countries to facilitate access to public funds, even if the performance of these exchanges has been mixed. Many countries have tried to address the issues faced by SMEs by launching dedicated stock exchanges, junior market segments, or distinct trading platforms solely for the SME sector, with the goal of easing access to capital markets more quickly, with less strict eligibility criteria and at a lower all-in cost. Nevertheless, the performance of many of these junior exchanges, especially those in lower-income countries, has been poor. At times, only a handful of SMEs choose to list in certain markets and with little or no new capital actually being raised on these platforms (IFC, 2010).

3.1 SME stock exchanges

Type (Description) of Financial Instrument

SME-focused stock exchanges have surfaced as an important option for SME fundraising.

They have been set up with the objective of allowing SMEs to obtain public equity capital. The main feature of such venues is that listing conditions have been relaxed. This may bring lower issuance costs for SMEs. But in contrast to large enterprises, SMEs often face certain difficulties in raising funds via stock exchange. Largely, this involves high transaction costs, listing requirements and often very complex legal and regulatory frameworks. SMEs face greater obstacles and costs to raise capital from equity markets than larger issuers due to the lack of visibility of SME markets, the lack of market liquidity for SME shares and the high costs of an initial public offering (Šestanović 2016; Baker and McKenzie 2012).

Implication of Firm Size

The performance of many (junior) SME stock exchanges, particularly those in lower-income countries, has been unimpressive, with only a few SMEs choosing to list on certain markets and with little or no new capital being raised (IFC, 2011).

Examples and Lessons

- In Kenya, where there is an informal and mostly unregulated capital market that serves SMEs, several small firms have been able to raise capital from local investors such as private equity firms. The securities market regulator in Kenya does not regulate the activity in this market. On the other hand, the regulator is hesitant to see the market closed (IFC, 2011).
- In Vietnam, the Hanoi Stock Exchange has a trading venue for unlisted public businesses named UPCoM (Unlisted Public Company Market), which was established in 2009. This market is not a dedicated SME market but an equity finance venue that SMEs can access. The UPCoM has no listing fees (Adb and oecd, 2014).
- Indonesia has no SME capital market but some enterprises that are regarded as SMEs (under the capital market rule) have conducted initial public offerings in the Indonesia Stock Exchange. SMEs are given special treatment to tap the Indonesia Stock Exchange, such as simplified disclosure documents as opposed to other (non-SME) businesses (Adb and oecd, 2014).
- In India, two devoted SME exchanges have been launched since 2012: i.e. the SME Platform under the Bombay Stock Exchange and the National Stock Exchange (Adb and oecd, 2014).
- The Philippines launched the SME Board under the Philippine Stock Exchange in 2001. However, only a handful of firms have been listed. No preferential treatment is available for firms applying for listing in this board (Adb and oecd, 2014).

3.2 Equity funds and Venture Capital

Type (Description) of Financial Instrument

Equity funds:

Equity funds are pooled investment instruments that invest in unlisted equity, quasi-equity and, sometimes, debt securities. There has been a rise in the involvement of SME equity funds in emerging markets in recent years. Over the last decade, Development Finance Institutions (DFIs) have expanded their participation in SME equity funds, and evidence suggests that there are hundreds of investment funds supporting small and growing businesses (SGB) in emerging markets (IFC, 2011).

In general, market opportunities (deal flow and exit) in most of the smaller emerging countries are too limited to support dedicated single-country funds. Consequently, successful SME fund models typically cover more than one country, with a small central team and local management teams in each country. This structure permits the local teams to focus on investments while spreading overhead costs over as broad a base as possible. The central platform reduces the learning curve for the local teams and offers necessary services and support in an efficient and cost-effective way (IFC, 2011).

Venture Capital:

A 'venture capital' (VC) usually comprises of private equity investments usually in young firms that exhibit potential for high growth (see also section 3.2 above about equity funds, which are similar instruments to VC but not restricted to new/start-up businesses). Such firms are in need of funds to pursue their initial growth targets (Berger and Schaeck, 2011).²

Implication of Firm Size

The size of firms (or industries) supported with private equity investments grow faster in terms of production, value added, and employment, while at the same time exhibiting more resilience to industry shocks. Employment and sales growth rates reported for random samples of exited deals in South Africa, Tunisia, and Morocco confirm that private equity fund-backed businesses grow faster and create more jobs than those without private equity fund support. South African businesses that were backed by private equity funds grew their sales by 20%, outperforming Johannesburg Stock Exchange (JSE) listed companies and companies included in the All Share Index ALSI by 2 and 6%, respectively. Likewise, these private equity fund-backed companies reported employment growth rates significantly superior to regional rates estimated at 2.88% for North Africa and 2.98% for sub-Saharan Africa. The involvement of private equity funds in African businesses seems to foster innovation as well. For instance, 69% of private equity fund-backed companies introduced new products and/or services. The annual growth rate of Research and development (RandD) in private equity fund-backed businesses

² VC funds are relatively focused toward advanced sectors that have been growing in recent years. At the same time, these funds commit part of their portfolios to goals unrelated to the mission of genuine VC; i.e., non-technologically advanced sectors absorb about half of total investments, and some investments target large or mature firms. In other words, the portfolios of VC funds are only partially devoted to innovative, young and small firms (Rossi, 2015).

was 7%, seven times the rate reported for JSE listed companies over the same period (IFC, 2011:42; Beck et al., 2011a).

Berger and Schaeck (2011:20) note that **using venture capital has a positive effect on performance of small firms**. SMEs that have had venture capital observe significantly higher employee growth than they would if they had not received funds from venture capital providers. Specifically, Berger and Schaeck (2011) argue that using venture capital is associated with a more than 21% increase in the probability of a growth in the number of employees.

Examples and Lessons

- In Lebanon, the World Bank supported Innovative Small and Medium Enterprises (iSME) project is a US\$30 million investment lending operation providing equity co-investments in innovative young firms in addition to a grant funding window for seed stage firms. As of August 2019, iSME's co-investment fund has invested US\$10.23 million across 22 investments and has been able to leverage US\$25.47 million in co-financing, demonstrating its ability to crowd in private sector financing and expand the market for early stage equity finance in Lebanon. To date, 60 out of 174 grantees had leveraged the iSME funding to raise a total of US\$13.1 million from various funding sources, a leverage ratio of 5.3 times. The iSME project could play an even larger role in the future financing of the Venture Capital (VC) sector by supporting existing VCs and emerging players, including increasing attention on a fund of funds approach, which could also cover growth funds (later stage and private equity) (World Bank, 2019).
- The Jordan Enterprise Development Corporation is financing an innovation fund with the Government of Jordan, the European Investment Bank, and Abraaj Capital. The Oasis 500 early stage and seed investment network offers small amounts of start-up capital linked to intensive mentoring and business incubator support, while the US\$500 million (target size) RED Growth Capital Fund set-up by Abraaj Capital is complemented by mentoring, networking, and informational support to high-potential and innovative growth SMEs. Further source of funding can be from Diaspora (IFC, 2011).
- The Inovar Programme in Brazil was designed in 2001 by Financiadora de Estudos e Projetos (FINEP), which provides funding to strengthen technological and scientific development in Brazil, in coordination with the InterAmerican Development Bank. The objective of the programme is to support the development of new, technology-based SME companies through the establishment of a venture capital (VC) market and to enhance private investment in technology businesses. Inovar created a research/knowledge and information dissemination platform and develops managerial capacity for channelling and accelerating VC investments in small company funds in Brazil. The programme successfully achieved the creation of a VC portal with information on how to register for different programme components, with thousands of registered entrepreneurs, and hundreds of investors. It also established a Technology Investment Facility where investors can perform joint analyses and due diligence on VC finds, which resulted in over 50 joint due diligences with approximately US\$165 million committed/approved in 15 VC funds. The programme has also established 20 venture forums for SMEs to interact with potential investors and present business plans, resulting in 45 SMEs receiving over US\$1 billion in VC/ PE investments (IFC, 2011).
- In Malaysia, non-bank financial institutions (NBFIs) such as venture capital, factoring, and leasing companies also cater to SME financing needs. At present, the Malaysian

Venture Capital Association serves a small number of SMEs or early stage firms through agriculture funds (Adb and oecd, 2014).

- In India, the World Bank's MSME Growth, Innovation and Inclusive Finance Project improved access to finance for MSMEs in three vital but underserved segments: early stage/startups, services, and manufacturing. A credit line of US\$500 million, provided to the Small Industry Development Bank of India (SIDBI), was designed to provide an affordable longer-term source of funding for underserved MSMEs. Technical assistance of about US\$3.7 million complemented the lending component and focused on capacity building of SIDBI and the participating financial institutions (PFIs). In addition to directly financing MSMEs, disbursing a total of US\$265 million in loans, the project pushed the frontiers of MSME financing through the development of innovative lending techniques that lowered turnaround time, reached more underserved MSMEs, and crowded in more private sector financing. It also reached new clients, women owned MSMEs, and MSMEs in low-income states. The project supported SIDBI to scale-up of the Fund of Funds for Startups, which aims to indirectly disburse US\$1.5 billion to startups by 2025. SIDBI's "contactless lending" platform, a digital MSME lending aggregator and matchmaking platform, has crowded in US\$1.9 billion of private sector financing for MSMEs, making it the largest online lender in India (World Bank, 2019).

3.3 SME Bonds (Covered bonds)

Type (Description) of Financial Instrument

SME-backed covered bonds are "simple" fixed-income securities backed by high-quality SME loan pools acting as collateral. They have dynamic cover pools, and non-performing SME loans (depending on contract and legislation) are substituted to ensure continuous payments. To achieve the highest possible rating and in some cases to satisfy regulatory requirements, they are overcollateralized. In other words, the SME loan pool is larger than the face value of the bonds issued. In contrast to other asset-backed securities, covered bonds remain on the balance sheet of the issuer (usually banks) and are backed not only by the cover pool, but also by the issuer's balance sheet – the "dual recourse". There are advantages for issuing institutions as well: in addition to the general features mentioned above, SME-covered bonds provide banks with greater flexibility with respect to the collateral spectrum, i.e. they allow using an asset class other than the typical mortgage or public-sector loan to back these securities. Taken together, SME-backed covered bonds offer favourable features for investors and issuers alike. Yet in practice, legal issues and market dynamics have so far limited their impact as a potential quick fix to revitalise bank credit for SMEs (Kaya, 2015).

Implication of Firm Size

The corporate bond market has traditionally been dominated by large firms – which (unlike SMEs) usually have a robust operational history, stable earnings and relatively low volatility stocks. Understandably, only a very minor share of SMEs has approached the bond market (Ashcroft, 2011; OECD, 2015).

Examples and Lessons

SME financing through issuance of bonds is less likely to be a potent instrument in LICs and LMICs due to underdevelopment of their capital markets. Even in advanced markets such as those in Europe, most of the SME securitization originates from a few countries (e.g. Germany, Italy, Benelux, and United Kingdom) (OECD, 2015).

There is a new movement for creating an SME bond market in countries such as China. The country has developed three types of SME bond instruments: the SME Collective Note, SME Joint Bond, and SME Private Placement Bond. The SME Collective Note market is an interbank market regulated by the People's Bank of China and the National Association of Financial Market Institutional Investors. It is growing quickly, with annual issuance of CNY10.6 billion in 2012. An SME Collective Note is issued on behalf of 2–10 SMEs and generally guaranteed by a government guarantee institution. SME Joint Bonds are traded in the interbank and exchange markets, which are regulated by the National Development and Reform Commission, but the issuance volume is quite limited at CNY0.98 billion in 2012. SME Private Placement Bonds are regulated by the China Securities Regulatory Commission (ADB and OECD, 2014).

4. Other Innovative Instruments for SMEs' Access to Finance and Access to Financial Services

Both access to finance and access to financial services, particularly by SMEs, has become important in many developing countries. SMEs constitute a big part of the emerging private sector in many LICs and LMICs. Nevertheless, they are also more limited in their access to financial services than large firms. While micro-finance has aided the access to finance by the poor (e.g. by implementing specific lending techniques such as group lending), it appears less helpful to easing financing constraints of formal businesses. Lately, specific financing forms such as leasing or factoring have been endorsed as advantageous to easing financing constraints of SMEs, since they are based on the underlying assets and cash flows instead of borrowers' financial history (Beck et al., 2013). Conversely, banks, particularly large banks³, have also shown growing interest in SME financing, exploiting scale economies and technology (Beck, Demircu-Kunt and Martinez Peria, 2011b).

Just like equity instruments (see Section 3), alternative financing instruments (discussed in this section) may involve both local and international investors/funds. However, unlike typical equity instruments, alternative/hybrid instruments can – for instance – supply growth capital to businesses by incorporating elements of debt (e.g. bank lending instruments) and equity (e.g. venture capital instruments) in a single investment vehicle. This allows alternative financing techniques to provide a different risk–reward structure that enables an investor to accept higher/lower risk in exchange for a higher/lower return. Therefore, hybrid techniques have the capacity to produce a better alignment of the interests of both the firms and investors (e.g. capital market actors) (Cusmano and Thompson, 2018). The interest in alternative instruments is expanding particularly in the post-2007 global financial environment where there is a relatively tight access to bank credit by firms in many countries. Further (as

³ Entry barriers and minimum capital requirements imposed by policy makers in developing countries to foster a specific market structure affect the size of financial institutions (World Bank, 2011; Beck et al., 2011a).

discussed in Section 3), market failures limit the effectiveness of equity instruments in many LICs and LMICs. For this reason, alternative financing instruments are being used (or show great potential for use) in countries where market failures are common (ADB and OECD, 2014).

4.1 Factoring, Leasing and Purchase Order Finance

Type (Description) of Financial Instrument

Advances in access to finance for SMEs do not depend on banks alone, since they can be achieved through a range of non-bank financial institutions (NBFIs). NBFIs of diverse types offer a wide range of services, such as: hire purchase transactions like leasing of machinery or equipment; the factoring or discount purchasing of accounts receivable and other forms of supply chain finance; and new equity to invest in businesses. Provision through NBFIs can be improved by reforming tax, legal, and regulatory environments, and by supporting the creation of technological platforms that support a wider variety of financial products and services to be developed, drive down the costs of financial access, and reach previously unexploited markets. Factoring is an important source of working capital finance for SMEs, particularly in those jurisdictions where the financial infrastructure is deficient (IFC, 2011).

Factoring:

Factoring implies purchase by the lender of a firm's accounts receivables at a discount and, in the case of non-recourse provisions, the collection of invoices directly from the parties that owe money. Factoring addresses the issue of SME opacity by focusing on the quality of the obligor; in effect, a risky supplier can transfer its credit risk to that of a higher quality buyer. In recent years, 'reverse factoring' or 'supply-chain financing', has become a fashionable financial instrument. With reverse factoring, the financial institution purchases receivables only from high credit quality buyers rather than a portfolio of all buyers of particular sellers, which leads to the delivery of low-risk loans to high-risk suppliers (e.g. SMEs). Reverse factoring is especially useful for SMEs in LICs and LMICs with underdeveloped contract administration capacity and weak credit information systems (IFC, 2011).

Factoring can be a powerful tool in delivering financing to high-risk, informationally opaque sellers, which are often SMEs. Factoring's key benefit is that underwriting is based on the risk of the receivables (i.e., the buyer) instead of the risk of the seller. Therefore, factoring may be especially well suited for financing receivables from large or foreign firms when those receivables are obligations of buyers who are more creditworthy than the sellers themselves. Factoring may offer useful export services to SMEs in developing countries. Like traditional forms of commercial lending, factoring offers SMEs with working capital financing (IFC, 2011).

Leasing:

Leasing (just like factoring) is a complementary but essential source of investment finance, especially in those countries (e.g. LICs and LMICs) where the information infrastructure is weak. A key benefit of leasing lies in the fact that it is focused on the firm's ability to create cash flows from business operations to service the leasing payment, instead of on its credit history or capability to guarantee a collateral (IFC, 2011).

While regulating leasing, country-specific factors should be considered by regulators (e.g. central banks). Setting minimum capital requirements for leasing institutions might help eliminate inadequately capitalized leasing companies. However, this limit may also inhibit the development of the leasing industry, especially in developing economies (e.g. LICs and LMICs) where leasing may be slow to grow. Therefore, the establishment of obligatory capital requirements for leasing requires careful evaluation in the context of the existing legal and regulatory framework, as well as other factors (IFC, 2011).

Purchase Order Finance:

Purchase Order Finance (POF) is a highly targeted version of asset-based finance, designed to enable a firm to fill a particular customer order. It, thus, enables firms to seize market opportunities that would be lost due lack of financial resources, e.g. to buy inputs and deliver the output. POF finances the production stage of an SME's activities, e.g. through a working capital advance to cover part of the production of goods or services demanded by one or more specified customers. Through POF, the SME obtains a verified purchase order from a customer and estimates the direct costs needed to produce and to deliver the product, which might include labour, raw materials, packaging, shipping, and insurance. The purchase order is presented to a financier, which bases the credit decision on (i) whether the order is from a creditworthy customer or (ii) is backed by an irrevocable letter of credit from a dependable bank and on (iii) whether the SME can produce and deliver the product according to the terms of the contract. If the loan has been approved, the financier advances a share of the total order value, usually paying the approved costs directly to the suppliers. Once production and delivery are completed, the accounts receivables from the customer are either assigned to the financier, as in the case of factoring, or the payment is directed into an account under the financier's control. When the financier collects payment, POF deducts the amount advanced and interest or fees, and remits the balance to the SMEs. (OECD, 2015).

Just like factoring, POF enables SMEs to transfer the credit risk to a more creditworthy customer, which is often a bigger company or a government agency. However, the advance rate is usually lower than in the case of factoring, as POF implies higher costs and risks for the financier. In fact, this system requires stricter monitoring of the firm's operation and the financier assumes the risk in the case that the firm will not be able to meet the order, plus the risk related to payment deficiencies by the customers. Consequently, interest rates and fees are generally higher than with other forms of asset-based finance. Furthermore, the financier can take guarantees and other collateral, such as inventory and bills of exchange, to mitigate risk (OECD, 2015).

Implication of Firm Size

Koreen et al. (2018) stress that **firm size (together with attributes like age and phase of development) has a significant implication on the type of financing needed by a firm** and its access to diverse financing sources. SMEs generally face higher interest rates, tighter borrowing terms and are more likely to be credit-rationed than large firms. They also note that **non-bank financial institutions (like leasing or factoring companies), play a less prominent role – compared to financing such as by banks.**

Navas-Alemán et al. (2015) note that **large firms (unlike SMEs) can afford to buy materials without credit, and they often obtain significant discounts.** They also note that **financing**

instruments such as standard factoring may present two problems for SMEs: (i) the factor must have confidence that invoices are authentic; and (ii) the factor must believe that outstanding invoices will be paid. Unless the SME has a strong track record that supports such confidence, use of this measure is limited.

Examples and Lessons

Factoring:

The Production Chains Programme in Mexico allows small suppliers to use their receivables from large buyers to receive working capital financing. SMEs can access more and less costly financing by shifting credit risk to high quality customers – through a typical reverse factoring scheme. The programme was launched by NAFIN, the country's state-owned development bank, in 2001. NAFIN does not factor receivables directly, but rather coordinates factoring services through an electronic platform. It requires all the factoring services it brokers to be offered without further collateral and service fees. Two types of factoring are provided under the programme: (i) factoring without recourse, at a maximum interest rate of 4% above the interbank rate, and (ii) contract financing, which finances up to 50% of confirmed contract orders from large buyers, at a fixed rate. In addition to its role as a broker, NAFIN also offers financial training and assistance to SMEs. In addition, the platform mechanism, whereby suppliers are grouped in "chains" to big buyers, lets large firms to strengthen their relations with suppliers, and allows SMEs to build up a credit history, which may help them access bank lending. A special feature of the programme is that nearly all services are available electronically, which saves time and labour costs, and enhances security. Moreover, as the platform allows all commercial banks and SMEs to participate, it gives both national reach to regional banks and access to national financing networks to rural firms. Furthermore, it favours competition of multiple lenders for factoring suppliers' receivables. As of mid-2009, the programme included 455 large buyers, more than 80,000 SMEs and about 20 domestic lenders, including banks and independent finance companies, and had provided over US\$60 billion in financing (OECD, 2015:41).

Leasing:

In Ethiopia and Guinea, the World Bank Group is supporting local governments to launch and grow leasing operations, as well as enticing investors, to boost access to finance for SMEs. It is doing so by working at the macro, mezzo, and micro levels, assisting governments with legal and regulatory reforms, and working with industry players to build technical partnerships and to increase market awareness and capacity. In Ethiopia, the project has engendered a US\$200 million credit facility supporting seven leasing intuitions and introducing four new leasing products into the market: hire purchase, finance lease, micro-leasing and agri-leasing. 7,186 MSMEs have accessed finance valued at over US\$147 million (as of June 2019). The project in Guinea backed the implementation of the national leasing law and the accompanying prudential guidelines for leasing, which in turn, have helped three companies to introduce leasing operations. These institutions have assisted 31 SMEs through the disbursement of leases valued at US\$25 million (World Bank, 2019).

The Advisory Services of the International Finance Corporation (IFC) has established a leasing programme in African countries – to increase the volume of lease transactions in LICs in the region. It is designed around three core products that are rolled out individually or as

part of a package depending on country needs: i) entry-level advisory services tackling legislative and regulatory constraints for leasing, including tax issues at regional and country level; ii) value added advisory services by partnering with international skilled leasing technical partners to offer skill transfer, capacity building, and financing; and iii) mobilization of investment capital by addressing the availability of medium- to long-term capital to finance leasing operations in the region by facilitating partnerships among technical partners and potential local and international investors interested in the leasing market (IFC, 2011).

Purchase Order Finance:

The USAID-funded Rural Competitiveness Activity (ARCo) programme had initiated operations to enhance licit productive activities and access to financial services in coca-growing Yungas and Chapare regions of Bolivia in 2005. After leading supply- and demand-side analysis of the local financial sectors (i.e. to understand SME finance needs and available services), ARCo was able to identify Purchase Order Finance (POF) as a potentially valuable instrument to confront the main financial challenges for local producers. It picked FIE, a private financial fund and a major microfinance institution in Bolivia, to execute the POF pilot project. The agreement with FIE incorporated a small subsidy to start operations and technical assistance to train staff. FIE committed to use its own funds for the loan pool and issued US\$2.5 million in POF credits over two years. One of the first operations under the programme involved a transaction between Cooperativa Agropecuaria Integral Noreste, a 260-member association of small coffee producers, and A. Van Weely BV, a Dutch-trading company specialised in organic food in 2007. This latter had issued a purchase order for a full container of washed Arabic organic Bolivian coffee, but Integral Noreste required financing to process and ship the order. FIE issued a US\$30,000 POF loan to Integral Noreste for 90 days at 12% annual rate. This enabled Integral Noreste to buy coffee beans from producers and for post-harvest packaging. Integral Noreste shifted its accounts receivable to the buyer, which kept control of the funds and paid suppliers for bills incurred by the cooperative, without enforcing other fees or requesting collateral. The POF loan allowed Integral Noreste to pay its suppliers upon delivery of the coffee, which generated greater incentive for members to sell their coffee to the cooperative, as previously Integral Noreste could pay them only after it received payment from the buyer, often three to four months after delivery (OECD, 2015:41; USAID, 2009).

4.2 Partial Credit Guarantee Schemes

Type (Description) of Financial Instrument

The core objective of credit guarantee schemes (PCGs) is to ‘guarantee’ the loans provided by a financial institution to a borrower – subject to both the payment of a premium and a variety of other rules and conditions. When default happens, the lender is compensated by the guarantor as per the initial agreement. In some arrangements, the guarantor can benefit from the counter-guarantee from a higher-level guarantee institution that is also subject to the payment of a premium. Normally, the use of PCGs in LICs and LMICs is more recent, unlike advanced countries (IFC, 2011).

Credit guarantee schemes are one of the most market friendly kinds of interventions – due to the fact that private financial institutions usually retain a primary role in the screening of borrowers and final lending decisions. Contrary to other types of interventions, such as state banks or directed lending arrangements, they may create fewer distortions in the credit market

and may lead to better credit allocation outcomes). Guarantee schemes could prove to be an effective financing instrument for reaching underserved groups such as start-ups and small firms. They may also produce positive externalities by stimulating banks to get into the SME market and improving their lending and risk management systems. Guarantee schemes have also been used for countercyclical purposes and the 2008 global financial crisis highlighted the importance of this countercyclical role (IFC, 2011).

Implication of Firm Size

Arráiz et al. (2014), who study the relationship between Partial Credit Guarantees and firm performance in Colombia, note that 83.1% of small firms did not apply for a line of credit or loan because of unattainable collateral requirements. Comparatively, fewer medium sized firms (14.1%) and only 2.9% of large firms failed to apply for a line of credit for the same reason – according to data from the World Bank's Enterprise Survey standardized dataset. They also add that small and medium sized firms use less bank finance and fund a lower proportion of their investment externally – compared to large firms.

Examples and Lessons

In Jordan, the World Bank Group's two lines of credit aim to increase access to finance for MSMEs and eventually contribute to job creation. The US\$70 million line of credit has encouraged growth and expansion of new and existing enterprises, increasing outreach to MSMEs, 58% of which were located outside of Amman and 73% were managed by women. The line of credit directed 22% of total funds to start-ups. The project funded 8,149 MSMEs, generating 7,682 jobs, of which 79% employed youth and 42% employed women. The additional funding of US\$50 million is well under way, towards achieving its desired objective. US\$45.2 million has been on-lent to 3,345 MSMEs through nine participating banks. The project is particularly benefiting women, who account for 77% of project beneficiaries, and youth (48% of project beneficiaries), and increasing geographical outreach, as 65% of MSMEs are in Governorates outside of Amman (World Bank, 2019).

In Nigeria, the World Bank supported Development Finance Project is helping to establish the Development Bank of Nigeria (DBN) – which is a wholesale development finance institution that will extend long-term financing and partial credit guarantees to eligible financial intermediaries for on-lending to MSMEs. Project also involves technical assistance to DBN and participating commercial banks – in support of downscaling their operations to the underserved MSME segment. The Development Bank of Nigeria credit line to PFIs for on-lending to MSMEs has disbursed US\$243.7 million through seven banks and ten microfinance banks – reaching nearly 50,000 end-borrowers (as of May 2019), of which 70% were women (World Bank, 2019).

In Morocco, the MSME Development Project aimed to improve access to finance for MSMEs. Particularly, it supports the supply of credit guarantees by backing/enabling the provider of 'partial credit guarantees' in the Moroccan financial system. The goal is to scale up existing MSME guarantee products and establish a new guarantee product targeting very small enterprises. As a result of the project, the number and volume of MSME loans are projected to have increased by 88% and 18%, respectively, since the end of 2011. Cumulative volume of loans backed by the guarantees during the life of the project is estimated at US\$3.28 billion. With substantially increased lending supported by guarantees, PFIs were able to continue

building their knowledge of MSME customers, refining their systems to serve them more effectively and efficiently. As a result of guarantees, many first-time borrowers were able to generate a credit history, which made it easier to obtain loans in the future (World Bank, 2019).

In the West Bank/Gaza, the European-Palestinian Credit Guarantee Fund (EPCGF) was designed to jumpstart SME lending in a very challenging environment that had resulted in very limited bank lending and practically no lending to SMEs. It was created in 2005 and financed by the German Government, the European Commission, and the European Investment Bank. EPCGF targets SMEs with less than 20 employees but avoids start-ups due to the perception of excessive risks in this segment. The scheme provides a coverage ratio of 60%, a maximum loan amount of US\$100,000, and a 1% up-front fee supplemented by a 1.5% annual commission on the outstanding guarantee. It offers guarantees on loans with maturities from one to five years and does not impose interest rate caps. It has streamlined procedures for approval of guarantees and payment of claims that improved its credibility among banks. The guarantees are not revealed to the borrowers in order to enhance discipline (IFC, 2011:57).

In Afghanistan, the SME Credit Guarantee Facility was created to jumpstart SME lending in a challenging environment and shares some of the characteristics of the Palestinian EPCGF scheme. It was established in 2005 and is funded by USAID and the German Government. It delivers coverage ratio of 72%, charges risk-related fees, does not impose interest rate caps, and does not disclose the guarantees to the borrowers to enhance discipline. Also like the Palestinian scheme, it introduced from the start a substantial capacity-building programme, including assistance to the establishment of dedicated SME units in the banks. It succeeded in boosting SME lending from negligible levels and has an NPL ratio of only 1.3% of the outstanding stock of guarantees. The programme has provided US\$37 million, reaching more than 1,200 SMEs (IFC, 2011).

4.3 Apex Funding Facilities

Type (Description) of Financial Instrument

An apex is a pool of funds formed domestically (e.g. in LICs or LMICs) to lend to microfinance institutions (MFIs) that, in turn, disburse loans to low-income people. Apexes are funded with public money, but they take various institutional forms, like development banks, nongovernmental organizations, donor programmes, private commercial banks, and special government or donor programmes. These “apex” facilities are appealing because they permit donors to pass the difficult and time-consuming task of SME selection to a local institution that is assumed to have the necessary skills. Nevertheless, they have a mixed track record in terms of effectiveness, results, and fund utilization. Their key funding instrument is local currency debt. They are mainly funded by governments, international donors, or a mix of both (Duflos and El-Zoghbi, 2010).

Implication of Firm Size

Apexes are an essential source of local funding for SMEs – indirectly through their support for microfinance institutions. Apex funds are disbursed to MFIs mostly as subsidized loans, but occasionally as grants. At times, the funding provided by apexes to MFIs is almost as much as the disbursements that donors and investors made to the entire microfinance sector.

These large sums demonstrate the importance of apexes as vehicles to channel public money into microfinance (Duflos and El-Zoghbi, 2010).

Examples and Lessons

Apexes have played a constructive role in delivering wholesale funding for microfinance in start-up and burgeoning financial sector environments in LICs and LMICs (e.g., Afghanistan, Bangladesh, and Pakistan), where commercial funding was scarce. They have also provided much needed liquidity when the 2008 global financial crisis squeezed commercial sources of funding. But apexes face several difficulties, including governance issues sometimes due to political interventions. In some instances, apexes have become less significant, as financial markets developed and commercial money became available to MFIs. Disbursement pressure has also made it difficult for apex managers to maintain quality standards, particularly in cases where there were inadequate numbers of viable MFIs in which apexes could invest. Lastly, some apexes have impeded the management of MFIs which they funded by imposing interest rate ceilings or lending methodologies on participating MFIs (e.g. as was the case in Sri Lanka and Cambodia) (Duflos and El-Zoghbi, 2010).

The South Asian Regional Apex Fund (SARA) was set up primarily to provide ‘growth investments’ for SMEs engaged in technology, manufacturing, media, and retailing. It is a US\$25 million fund launched in 1995. Its funders comprise multi-lateral institutions like IFC in Washington, Japan Bank for International Corporation, Asian Development Bank, and Indian institutions like ICICI, Industrial Development Bank of India, Small Industries Development Bank of India, and Punjab and Sindh Bank. While the Fund was initially conceived with a development orientation, and had a specific allocation for smaller developments in early stage companies, the portfolio was optimized, and since mid-1998, SARA has invested across technology, media, distribution, biotechnology, and telecommunications (IFC, 2011).

Another example is the National Bank for Agricultural and Rural Development (NABARD) – which was set up to promote sustainable and equitable agriculture and rural development in India. It was formed in 1982 and is funded by the Government of India and by the Reserve Bank of India. NABARD is one of the largest apex institutions in the world, disbursing tens of billions of US dollars every year (Duflos and El-Zoghbi, 2010).

4.4 Special Funds/Instruments Targeting Women run SMEs

Type (Description) of Financial Instrument

Tackling gender gaps in access to finance is an essential part of the development agenda. Across regions, women have lower access to finance than men. In addition to being less likely to have a loan, women often face less favourable borrowing terms. Many country studies show that women entrepreneurs are more likely to face higher interest rates, be required to collateralize a higher share of the loan and have shorter-term loans. Both non-financial and financial barriers can contribute to gender gaps in access to finance. Non-financial barriers can include characteristics of the entrepreneurs (e.g. differential access to education or management training); conditions in the broader business environment that may differentially affect women’s and men’s businesses (e.g., the legal and regulatory environment or the quality of available infrastructure); and constraints within financial institutions and a country’s financial infrastructure that limit incentives to reach out to more female clients (IFC, 2011).

Implication of Firm Size

Research has shown that i) firm size positively affects access to credit (Cenni et al., 2015; Rahman et al., 2017) and ii) access to finance may be negatively related to female ownership (Rahman et al., 2017; World Bank, 2019). **Women owned SMEs in developing countries face harsher barriers in access to finance owing to both factors – unlike larger firms that are also primarily male owned.** Financing SMEs by targeting underserved groups such as women (or SMEs owned by the youth and poor) can provide help where it is needed the most (IFC, 2013).

Examples and Lessons

In Ethiopia, the World Bank IDA is providing loans and business training for growth-oriented women entrepreneurs in Ethiopia – through the Women Entrepreneurship Development Project (WEDP). After spotting a persistent ‘missing middle’ financing gap for women entrepreneurs in Ethiopia, WEDP was started as an MFI upscaling operation, helping Ethiopia’s leading MFIs introduce larger, individual-liability loan products tailored to women entrepreneurs. WEDP loans are complemented through provision of innovative business training to women entrepreneurs. More than 14,000 women entrepreneurs took loans and over 20,000 participated in business training provided by WEDP (as of October 2019). 66% of WEDP clients were first-time borrowers. Due to the project, participating MFIs boosted the average loan size by 870% to US\$11,500, lowered the collateral requirements from an average of 200% of the value of the loan to 125%, and started distributing US\$30.2 million of their own funds as WEDP loans. The average WEDP loan has resulted in an upsurge of over 40% in annual profits and nearly 56% in net employment for Ethiopian women entrepreneurs (World Bank, 2019).

In Bangladesh, the Access to Finance for Women SMEs Project aims to create an enabling environment to expand access to finance to women SMEs by supporting the establishment of credit guarantee schemes⁴, issuance of an SME Finance Policy, and strengthening capacity of the regulator and sector. The project supported the issuance of Bangladesh’s initial SME Finance Policy: a steppingstone for boosting SME financing. The policy was introduced in September 2019 with an enhancement to the regulator’s capacity and a sharper gender lens. In Bangladesh, a US\$ 2.8 billion financing gap prevails in the MSME sector, where 60% of women SMEs financing needs are unfulfilled, and lack of access to collateral is one of the major impediments. Bangladesh lacked a single policy with a systematic plan to enhance SME finance. With nearly 10 million SMEs accounting for 23% of GDP, 80% of jobs in the industries sector and 25% of the total labour force, the SME Finance Policy will play a pivotal role in enhancing SME financing (World Bank, 2019).

USAID’s Development Credit Authority (DCA) is promoting lending to social groups and businesses in Kenya that are under-served due to the perception of high risks. The initiative operates in partnership with Kenyan financial institutions. Under this partnership, Kenya Commercial Bank (KCB) has introduced the Grace Loan, which is tailor-made for individual women entrepreneurs and women business groups to meet their working capital or business expansion needs. Through the Grace Loan, women can apply for a loan of up to US\$ 62,000, repayable in up to 36 months. The loan also has an important training component. To access

⁴ See section 4.2 for more on credit guarantee schemes.

value added services, women entrepreneurs get the opportunity to join KCB's Biashara Club, which, among other activities, offers workshops on entrepreneurship and capacity building, networking possibilities, and business advisory services. Since the launch, the Bank has on lent over US\$1.6 million to 350 women entrepreneurs (IFC, 2011:67).

The IFC is working on mainstreaming gender issues into its work through its Women in Business (WIN)⁵ programme – while helping to better leverage the untapped potential of both women and men in emerging markets. IFC provides financial products and advisory services to: Increase access to finance for women entrepreneurs; reduce gender-based barriers in the business environment; and improve the sustainability of IFC investment projects. So far, IFC has worked with more than 16 banks to enhance their ability to provide more targeted products and services to women entrepreneurs. Through this intervention, IFC has invested over US\$118 million, of which over US\$86 million have been on-lent to women entrepreneurs. Well over 2,200 women entrepreneurs have had the opportunity to increase their business and financial management skills (IFC, 2011).

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⁵ The Women in Business (WIN) programme was formerly known as Gender Entrepreneurship Markets.

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