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Beyond Microfinance:
Getting Capital to Small and Medium Enterprises to Fuel Faster Development

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ABSTRACT

Small and medium-sized enterprises (SMEs), typically employing between 10 and 250 workers, form the backbone of modern economies and can be crucial engines of development through their role as seedbeds of innovation. In much of the developing world, though, SMEs are under-represented, stifled by perverse regulatory climates and poor access to inputs. A critical missing ingredient is often capital.

Tinier firms—micro-enterprises—frequently get more attention, as donors seek to help the very poor: the recent Nobel Peace Prize awarded to Muhammad Yunus of the Grameen Bank visibly demonstrates the emphasis given to this approach. But the type of support inherent to microfinance lending is generally ill-adapted to serving their slightly larger, and arguably more dynamic, cousins, the SMEs.

New options are emerging for meeting SMEs' financial needs, including commercial banks moving "down-market," micro-credit institutions moving "up," and creative application of venture capital investing ideas.

Governments can help by removing artificial policy and regulatory obstacles to SME lending—importantly, policies that promote greater competition within the financial sector as a whole are generally likely to be especially good news for smaller borrowers like SMEs. External actors can help too—for example by promoting development of credit information systems and reform of collateral regulations. They can also usefully play a selective pump-priming role; for example, they can partially guarantee commercial lenders' moves into SME lending.

Private investors—sometimes with collaboration from and in partnership with the public sector—have a key role, too. For example, in the case of firms facing high-risk, high-return scenarios, home-grown "angel investors" can step in.

Donor support for traditional microfinance models has helped provide basic financial services to millions of poor people. But in order to help build dynamic competitive economies in developing countries, the time has come to pay greater attention to the potential of small and medium-sized commercial firms to promote economic growth.

Why Care about Small and Medium Firms?

Small and medium-sized firms matter—everywhere.

Advanced economies are paying new attention to small and medium enterprises (SMEs). One reason is their sheer quantitative importance. The OECD reports that SMEs account for more than 95 percent of manufacturing enterprises and an even higher share of many service industries in OECD countries; in most OECD countries, SMEs generate two-thirds of private sector employment and are the principal creator of new jobs. Additional interest in SMEs has been sparked by dynamic firms like Microsoft, which developed from tiny start-ups.

What are SMEs? Analysts use varying definitions of SMEs. Many advanced countries define SMEs as firms employing between 10 and 250 workers (or, in some countries, 500). SMEs are generally viewed as occupying the middle of the firm size distribution -- larger (and typically more formalized) than "micro-enterprises," which are usually informal units employing at most a handful of people. In many small and less-developed countries, it should be noted, firms employing 250 or 500 people could well be among the larger firms in the country.

Not every SME is a budding Microsoft. A three-way typology is useful:

> (i) A large proportion of SMEs are relatively stable in their technology, market, and scale. Many are in retail or service sectors. A significant number are at best static and at worst heading for failure;
>
> (ii) Other SMEs are technically advanced specialists filling crucial product or service niches within complex modern economies. Examples come from the German *mittelstand* and technically savvy sub-contractors in Japan and northern Italy;
>
> (iii) U.S.-style "start-ups" are potentially the most dynamic but often the riskiest SMEs. Many seek to commercialize new technology coming straight from the research sector.

The "start-up" phenomenon has highlighted the contribution of flexible equity financing to innovation. Professional venture capitalists, who manage pools of risk capital, famously helped build Silicon Valley. More recently, many have ratcheted up the minimum size of their deals. The resulting gap for early-stage funding is increasingly being filled by angel investors, affluent individuals who back nascent entrepreneurs with their own money and intensive mentoring, in return for equity stakes.

SMEs in developing countries face a harder time.

The SME picture in developing countries varies greatly. Some more dynamic emerging market economies, notably in East Asia, present thriving SME sectors, including significant numbers of skill-intensive subcontractors. Many more developing countries, though, suffer from a "missing middle". They typically have very large numbers of informal micro-enterprises. They may also have a handful of larger firms—possibly ventures created by foreign investment (in large-scale activities like mining, for example), or family-controlled conglomerates built up over generations. But there are typically few SMEs in-between.

The World Bank estimates that SMEs contribute an average 51.5 percent of GDP in high income countries—but only 15.6 percent in low income countries. By contrast, the "informal" micro-enterprise sector accounts for an average 47.2 percent of GDP in low income countries, but just 13 percent in high income countries.

Does it matter whether SMEs in developing countries thrive? Yes. In contrast to healthy SMEs, most micro-enterprises show very low productivity, with little capacity to master improved technology or grow beyond the smallest scale. In developing countries with a "missing middle," competition is often squelched by dominant conglomerates.

The organic growth of small firms in developing countries may be held back by numerous obstacles, including government red tape and corruption, as well as infrastructure deficiencies, and difficulties in accessing technology, skills, or markets (surveys like the World Bank's annual Doing Business series have helped to highlight inter-country differences in the regulatory climate for aspiring entrepreneurs, and the hurdles that perverse government regulations can create for enterprise development). Regulatory reform may be a critical priority at national level, and technical assistance a crucial need for aspiring entrepreneurs. But *finance* also ranks high among their concerns.

In the World Bank's "World Business Environment Survey" (WBES) of more than 10,000 firms in 80 countries, SMEs worldwide on average named financing constraints as the second most severe obstacle to their growth, while large firms on average placed finance only fourth. Firms in Central and Eastern Europe, the former Soviet Union, and Africa were most likely to cite finance as their most severe constraint, followed by those in South Asia and Latin America. World Bank researchers Beck, Demirguc-Kunt, and Maksimovic concur that SMEs are far more likely than larger firms to be held back by financial constraints.

Empirically, World Bank researchers find a positive correlation between the size of a country's SME sector and the rate of economic growth. This does not necessarily prove causation runs from SMEs to growth. More plausibly, policies that are good for SMEs are generally good for growth, too. Among these policies, the promotion of vibrant, competitive financial systems has proven to be especially important.

Challenges to Financial Systems

How well countries' financial systems provide SMEs with access to finance depends on a range of factors, from the overall financial sector framework to the ingenuity of individual intermediaries.

Policymakers need to get financial sector incentives right—competition is fundamental.

Rajan and Zingales argue convincingly that, when misguided government policies stifle financial sector competition, banks feel little pressure to seek new customers and broaden financial access. By contrast, financial intermediaries exposed to vigorous competition are motivated to pursue non-traditional customers, including SMEs. Empirical studies confirm, for example, that when foreign banks are allowed to enter previously closed national markets, financial access improves for smaller clients. Eliminating barriers to competition in the provision of financial services in general may be the single most important task for governments and regulators in helping small firms.

Financial intermediaries face particularly challenging environments.

Every financial intermediary must overcome certain basic challenges to remain viable. First and foremost remains managing the risks raised by asymmetric information:

- *Adverse selection*: How can lenders screen out high risk borrowers in advance?

- *Moral hazard*: How can lenders protect their repayment prospects once borrowers have the money in their hands?

Lenders in many developing countries must handle these challenges in the face of special obstacles: weak accounting standards, limited third-party credit information services, and restrictions on the use of physical collateral.

Very likely the most important longer-term contribution that development partners can make will be to address the underlying weaknesses in *financial infrastructure*—e.g., by helping countries establish credit bureaus and reform collateral laws.

The second major challenge for intermediaries is to keep costs low (and revenues sufficiently high). Cost management is especially challenging when average loan size is small, since transaction costs do not automatically fall as loan size declines. Successful micro-finance institutions (MFIs) employ creative procedures to hold down their costs, while setting interest rates at cost-covering levels.

Finally, each intermediary must mobilize a continuing supply of funds. Banks can pursue increased deposits; they may also sell securities. Some non-bank MFIs are licensed to take deposits, others are not. Many MFIs have relied at least in part on external funding—often from non-commercial sources such as public sector aid or philanthropies.

Who Will Finance SMEs?

Four main financing channels may potentially help meet SMEs' needs.

(a) MFIs.

MFIs, like the Nobel-winning Grameen Bank, won fame for "banking on the poor." A recent study by Rodman and Qureshi demonstrates that many well-known MFI policies represent pragmatic solutions to the business challenges outlined above.

Many analysts present the common MFI *group responsibility* model, with group members accountable for each others' repayments, as a crucial break-through in handling asymmetric information. Rodman and Qureshi accept that group responsibility may help screen out those viewed by their neighbors as bad risks. But they argue that other forms of moral pressure—including MFIs' use of large meetings to make loans and repayments openly—are often more important than formal group responsibility in keeping repayment rates high. (The meetings have the additional benefit of holding down MFIs' costs.)

More controversially, perhaps, Rodman and Qureshi argue that some traditional MFI practices, including an emphasis on very short-term loans with repayments commencing immediately, may be beneficial for repayment discipline but seriously limit the usefulness of traditional MFI loans for financing medium-term capital investments.

This is not to deny that many traditional MFIs provide poor families with valued help in managing their finances. But the incompatibility between traditional MFI loan terms and the needs of growing enterprises may help explain why researchers have found it hard to establish a correlation between the extent of countries' MFI sectors and statistical measures of economic progress.

So can MFIs transform themselves into practical sources of finance for growing SMEs? Some MFIs are clearly trying:

- The Grameen Bank recently dropped its group responsibility model and introduced more flexible loans—although it still retained regular group meetings, likely to prove burdensome for busy entrepreneurs.

- Some other MFIs have long made individual loans. Nicaragua's FINDESA studies a potential borrower's reputation in the local community before lending. Bank Rakyat Indonesia seeks physical collateral to encourage repayment.

- Practically speaking, introducing individual lending may require significant changes in an MFI's institutional culture—including, experts suggest, hiring better-educated staff.

Many MFIs undertaking individual lending, though, offer only modest loans. A 2004 survey by the MicroBanking Bulletin reports that the average balance on individual loans made by MFIs was only $1,084. Lending on this scale might help a very small SME, but it would do little for a potentially dynamic firm seeking to upgrade its technology.

Beyond the loan size issue, another challenge for MFIs moving up-market is raising additional funds. Some undertake creative deposit mobilization; for example, Ecuador's Banco Solidario seeks clients among Ecuadorian migrants in Europe. On the external side, progressing beyond philanthropic or public sector resources to

truly commercial funds raises questions about MFIs' institutional strength, including the ability of their accounting standards to meet investors' expectations.

The Grameen Foundation estimates that only about 2 percent of MFIs demonstrate high levels of institutional capacity. This top tier has reportedly been the main focus of external investors to date (to the point that some observers worry about the extent of uncovered foreign exchange risk in some institutions). Encouragingly, some external partners are starting to reach beyond the "usual suspects." Citigroup recently announced a new initiative for smaller MFIs that have not previously received financing, including help to strengthen their institutional capacity.

In sum, time will tell how many MFIs will be willing and able to move up-market in ways that make them relevant to the needs of growing commercial SMEs—and how far up-market they will go. Experience to date suggests that at least some MFIs will adapt sufficiently to be able to help firms at least at the smaller end of the SME size distribution. However, above this level, larger SMEs, especially, will in most cases continue to need to look elsewhere for financing support. Even in the best circumstances, therefore, MFIs moving up-market need to be complemented by banks moving down.

(b) Banks.

Even in financially sophisticated economies, banks constitute the main financing channel for businesses. In the U.S., commercial banks directly supply about 56 percent of business finance (as well as providing additional funds *indirectly* through purchases of securities); in Germany and Japan, the figure is over 80 percent.

Banks in developing countries span the spectrum from publicly-owned to commercial. Institutions all along the spectrum play important roles in supplying *savings* products to small clients. Many studies, however, have found that, in their *lending*, publicly-owned banks frequently experience political pressure to favor influential borrowers who may feel little incentive to repay—undermining the banks' viability.

How far commercial banks reach out to smaller borrowers may largely depend, as argued earlier, on the competitive pressures they feel. The practical management issues confronting banks who try to move down-market remain a challenge; many banks find they need to rethink procedures, staffing, and technologies in order to service SMEs. Cost management is one area where commercial banks have to make important changes.

Some banks are starting in this direction:

- In developed economies, statistically-based "credit scoring" models have radically cut the costs of processing SME loan applications. However, the minimum information needs of such models may pose challenges in some less-developed countries.

- New forms of technology, such as smart cards and cell-phone banking, can help expand service to small clients at affordable cost.

Other creative financing solutions for SMEs may include equipment leasing and factoring (the purchase of a firm's accounts receivables).

Development agencies can encourage bank lending to SMEs. USAID's Development Credit Authority (DCA) recently began to offer partial guarantees to commercial banks committing to lend to SMEs. Limiting DCA's guarantees to about 50 percent ensures the banks maintain a financial interest in the success of their loans.

With a conducive external policy environment, and internal management commitment, commercial banks should indeed be able to find additional innovative—and successful—ways to serve SMEs on a growing scale.

(c) Capital markets.

Direct access to markets for bonds or equities is not typically a relevant financing channel for most SMEs, even in advanced economies. But promoting local capital market development may help improve SMEs' financial access *indirectly.* Banks and a growing number of MFIs have been seeking credit ratings and issuing bonds on domestic markets. This can expand the pool of capital for lending, including to SMEs.

A more complex approach, commonplace in developed economies, takes pools of loans off intermediaries' balance sheets by converting them into securities to be sold to institutional or individual investors. Many SME loans in the U.S. are "securitized" in this way; cumulative issues during the 1992-2002 period totaled $6.4 billion. With a primary lender still needed to originate and service individual loans, securitization represents a *complement* to lending by banks (or MFIs), rather than a substitute.

Any securitization creates at least two "tranches" of securities, targeted at investors with differing risk tolerance. The major tranche, with priority in the receipt of interest and capital payments, is typically designed to achieve "investment grade". (Various forms of credit enhancement can help boost the rating, including over-collateralization or third party guarantees.) Heavier risks are carried by investors who purchase junior/equity tranches, typically in the hope of higher returns. Sometimes public-spirited investors may buy these tranches in order to promote social goals, including development results.

Securitization will not fly everywhere. A robust legal basis is needed for executing "true sales" of assets. Credible accounting standards are essential, as is the ability to maintain a homogeneous class of eligible assets for the pool, in order for ratings agencies to assess risks and assign the securities a rating.

Korea and Singapore are among the advanced emerging markets that have securitized SME loans. Some development agencies are also helping promote securitization; in mid-2006, a major Bangladeshi MFI (BRAC) made a $180 million equivalent, local currency-denominated securitization of micro-credit receivables, with the participation of Citibank and of the German and Dutch development agencies.

Unlike the now-routine securitizations in advanced economies, each developing country securitization is at this stage still "unique." Further experience will be needed to clarify the potential of securitization to mobilize incremental capital that is strictly return-driven, as distinct from capital that is at least partly oriented to "social" returns.

Is there a role for multilaterals? Some market participants argue that wider use should be made of guarantees from development agencies, possibly including multilateral development banks (MDBs), to enhance the credit ratings of securitized loans from developing countries. Other voices caution that such guarantees cannot fully substitute for the proven fundamentals that normally guide investors in lending and borrowing.

The MDBs themselves stress the importance of not merely channeling external funds, but of building sustainability by strengthening local financial institutions and improving the regulatory environment for SMEs. For example, MDB work on regulatory difficulties—like the World Bank's *Doing Business* series—is gaining influence. MDBs have also stepped up work on credit information systems and collateral reform.

However, several MDBs' self-evaluations of their lending to SMEs—and a "peer review" of prior World Bank and UNDP small business programs, undertaken by the Consultative Group to Assist the Poor (CGAP)—suggest that, to date, only a minority of these operations has successfully helped build viable financial intermediaries.

Central among the problems identified by these reviews is the tendency for political pressures to compromise hard-nosed financial discipline—a lesson with potential relevance for all development partners.

(d) Venture capital (VC) and angel investors.

MFI, bank, and securitization approaches all focus on *debt* finance. The picture is generally more problematic when one turns to examine sources of *equity* capital for potentially dynamic SMEs in the developing world.

Even in developed countries, relatively few SMEs look to arm's length sources for equity financing. Most small business owners are reluctant to dilute their control, and prefer to rely on self-generated funds plus family and close friends. Markets are, in turn, ill-equipped to evaluate and monitor the risks of equity investments in small firms.

Venture capital remains the exception. Entrepreneurs in countries like the U.S. turn to VC when they see no alternative way forward. Venture capitalists and angel investors, for their part, handle asymmetric information challenges through very intensive monitoring. But this is costly and can only be justified for the rare investments that hold the promise of exceptional returns (which the investors hope to share in by virtue of their equity stakes).

Appreciable amounts of venture capital and private equity are now going into emerging markets. However, a recent Harvard Business School study by Josh Lerner reports that these investments largely shy away from small firms. Instead they concentrate on privatizations, corporate restructurings, strategic alliances between multinationals and local corporations, and infrastructure funds.

"True venture capital" and start-ups have been constrained, Lerner reports, by concerns about local investment climates (including intellectual property protection), and perceptions of limited deal flow potential. Venture capitalists also express concern about limited channels in developing countries for them to "exit" their

investments after a successful initial phase. Public equity markets on which Initial Public Offerings could be launched, for example, are generally poorly developed compared to the situation in many developed countries.

Lerner reports that true venture capital investments in developing countries are just starting to emerge, mostly in three categories: (i) the provision of business services that are well-established in developed countries but new to developing countries; (ii) services outsourcing, most notably in India; and (iii) a handful of deals to commercialize technology created within developing countries.

To bootstrap change, some countries have taken targeted actions to foster the development of indigenous VC. In Israel, the government played a catalytic role in launching a local VC sector in the early 1990s and subsequently exited successfully via privatization. A number of countries, both developed and developing, are pursuing variants on venture capital funds as sources of equity or quasi-equity for promising small firms. But if such funds are to operate within the *public* sector, they risk the politicization and abuse that have so often torpedoed the loan portfolios of public sector banks. Innovative efforts within the *private* sector are critically needed.

The angel investor model is one that may offer some potential for developing countries. A recent study by the Batten Institute (Darden Business School, UVA) found that variants of angel investing are emerging in parts of Latin America. Experts on angel investing emphasize the need for hands-on involvement by the "angels" and their physical proximity to the entrepreneur. This suggests that this niche may continue to be generally better suited to domestically-based investors than to outsiders.

The Way Forward

SME financing is no longer a totally unexplored frontier in the developing world. From basic investment climate reforms (including regulatory reform) and improved access to basic banking services in the poorest countries, to sophisticated options such as securitizations and domestic angel investors, new roads forward for SME finance are starting to open up.

Policymakers, financial institutions, development agencies, foundations and private sector financial players can all help foster the development of viable new financing channels for SMEs. Governments need above all to promote vigorous competition in the provision of financial services overall, and to challenge the rationale for any artificial constraints to such competition. Important priorities for development agencies include work on crucial financial infrastructure issues (such as credit information systems and collateral reform). In selected settings, there may also be scope for development agencies' pump-priming of commercial lending and securitization. Programs to fill gaps in the supply of finance will also need to be complemented by attention to the non-financial constraints to SME development in each country, including regulatory climate, infrastructure and technical services.

This brief has given a few examples of the potential for new SME financing mechanisms. With continued creativity, additional models are undoubtedly still waiting to be invented.

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