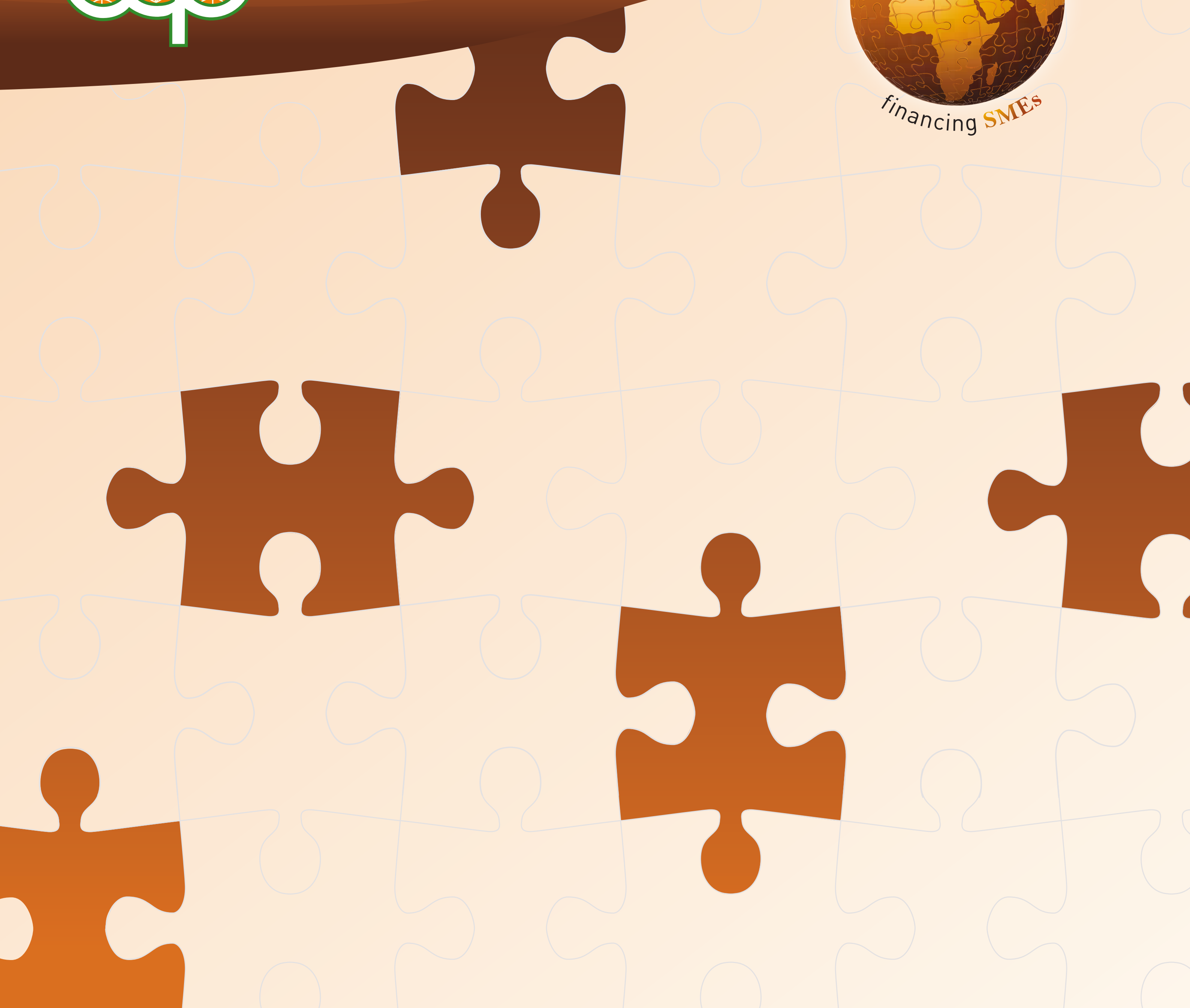

Enhancing SME financing in ACP countries

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SME FINANCING


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While the importance of the SME sector is widely recognized, SMEs in ACP countries face major obstacles for their creation and development, notably in obtaining finance.

The economic and social importance of the small and medium enterprise (SME) sector is well recognized in academic, policy literature and governments. The contribution of formal SMEs in developing countries is estimated to be up to 45 percent of employment and up to 33 percent of GDP. These numbers are significantly higher when taking into account the estimated contributions of SMEs operating in the informal sector.

Today, governments worldwide recognize the importance of SMEs and their contribution to economic growth, social cohesion, employment and local development, especially in those economies belonging to developing countries and, within that broad category, especially to those with major employment and income distribution challenges.
Asian and Latin America experiences have provided the laboratory to illustrate that a growing economy can be built on a dynamic SME sector and, in addition, that inequality can fall significantly when the weight of the SME sector rises quickly.

Nevertheless, entrepreneurs and small companies find it very difficult to set up and grow their businesses. SMEs face a host of non-financial and financial constraints, especially in low-income countries. According to IFC research, the five nonfinancial components of the business environment that SMEs most frequently rate to be major obstacles are lack of electricity, heavy regulation, high tax rates, practices of competitors in the informal sector, and corruption.

Regarding the financial constraints, about 45-55 percent of formal SMEs in emerging markets do not have access to formal institutional loans or overdrafts, despite a need for them. Banks do not find it easy to lend to small and medium sized companies with little collateral and uncertain prospects. Across the ACP countries, entrepreneurs, no matter how smart or driven, often fail for lack of access to capital.

THE PROJECT


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The ACP Council of Ministers highlighted the need for flexible and innovative measures and mandated the Committee of Ambassadors to reflect on ways and means to ensure greater effectiveness in the delivery of funds to the ACP regions in line with the Paris Declaration.

Cognizant of the importance of SME access to finance and the potential role of the European Investment Bank (EIB) in this regard, the ACP Secretariat, through BizClim, launched a project aiming at enhancing SME financing in ACP countries and improving the impact of the Investment Facility on SMEs. In this context, a first high level meeting took place on Friday, 15th of July 2011 at the ACP House in Brussels that saw the launch of a study on the subject. A Second high-level meeting, which took place on October 13-14, 2011 discussed the findings of the study and drew key recommendations.

This is a follow-up to the mandate given by the ACP Council of Ministers at its 92nd Session in November 2010 where Ministers adopted a Resolution on the IF underscoring the limited role of the EIB in the development of ACP States. In particular, the need for flexible and innovative measures was highlighted. Ministers also called on the need to address the problem of small ACP States not always able to propose projects with budgets above € 5 M. Ministers also mandated the Committee of Ambassadors to reflect on ways and means to ensure greater effectiveness in the delivery of funds to the ACP regions in line with the Paris Declaration.

Aware of the importance of private sector and SMEs, the European Investment Bank under the Cotonou Agreement, has been managing for the past seven years the ACP Investment Facility. A recently completed mid-term evaluation of the Facility concluded that its impact on countries' growth and competitiveness has been limited.

The ultimate objective of this reflection is to assist in enhancing access to finance by SMEs. Access to finance is the biggest stumbling block in the growth of SMEs.
SMEs are the backbone of our economies, and the promotion of their development is crucial in the growth of ACP economies. Not only in ACP Countries is this catalytic role of SMEs preponderant; only the previous day at a major event on industrialisation in Africa the role of SMEs in Europe was emphasised: in the EU there are 23 million SMEs; imagine the impact on employment if each of them would only hire one more person! Well, this is true also in ACP Countries.

The Investment Facility is endowed with €3,185.5 million risk-bearing revolving fund geared to fostering private sector investment in ACP countries; as well as of grants for the financing of interest rate subsidies worth 400 million, of which up to EUR 40 million can be used to fund project-related technical assistance. The projects are financed in the ACP regions with a broad range of flexible risk-bearing instruments to support projects that deliver sustainable economic, social and environmental benefits.


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The Study was prompted by concerns of ACP States in respect of a perceived low level of access to finance by SMEs in the ACP States, small projects, and projects in small Countries to the ACP Investment Facility (IF) created under the Cotonou Agreement and managed by the European Investment Bank (EIB). These concerns were embodied in a Resolution of the ACP Council of Ministers of November 2010.

The study sought to map out available financing instruments and needs and to explore ways for improving access to finance by Small States and SMEs. It also aimed at discussing the best product packages and delivery channels for meeting the unsatisfied needs of SMEs in ACP countries, finding innovative solutions for addressing challenges and constraints. In particular, it was expected that the discussion will evolve around how to ensure that financial partners contribute to mobilizing a critical mass of additional private finance, commercial resources and/or domestic savings, notably through the use of financial instruments (guarantees, innovative credit lines and syndications) with high catalytic potential and, at a more general level, impact on growth and competitiveness at country level.

The study was to capitalize on the evaluation of the Investment Facility and to suggest ways to enhance financing of smaller projects. It also sought to integrate recent developments on the financial markets, notably the growing and deepening regional markets. In practice, the study was organized with the following concrete aims:

- To identify constraints faced by SMEs in the ACP in accessing finance, and remedies and options for improved access to finance;
- To focus on the level of SME access to finance in general, and in particular from the IF; and
- To review the subsidiary question of access to the IF by small projects and smaller States. This review is expected to lead to practical recommendations for enhancing access to IF finance. The EIB provides financing in the ACP not only out of the IF, but also out of its own resources, and thus the Study would often consider the whole of EIB's current and potential interventions in the ACP Countries targeting SMEs and the financial sector.


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Two successful High-level meetings

On Friday 15 July 2011, the ACP Secretariat held a one-day high-level meeting to discuss ways and means of enhancing SME financing and improving the impact of the Investment Facility on SMEs. The meeting brought together more than 100 leaders of some of the ACP regions biggest financial and multilateral institutions and some of the region's largest banking institutions with the main objective of providing guidance and inputs to a team of experts who had to undertake a study on improving access to finance by SMEs and Small States.

This high-level meeting assessed available cooperation options, as well as envisaged new possibilities and discussed practical recommendations. Mainly, the meeting called for a stronger collaboration between the Development Financial Institutions and the Commercial Banks as well as for a better coordination between key stakeholders in SME development.

The regionalization of the Investment Facility was also pointed out as a key issue for improving access to finance by the SMEs. The meeting ended with the establishment of an Advisory Committee in charge of following up on the recommendations made during the meeting, continuing the reflection on SME financing and advising the ACP Secretariat on related issues.

Following the successful first High-level Meeting, the ACP Secretariat held a second meeting on October 13-14 aiming more specifically at discussing the preliminary findings of the study and focusing on key conclusions and recommendations of significant relevance to enhancing SME financing and improving the outreach of the Investment Facility to SMEs and Small States. Also, there were presentations and discussions about the social entrepreneurship and SME financing as well as best practice and success stories. Key recommendations have been agreed and the Advisory Committee has been mandated to finalize and operationalize these recommendations.


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SUCCESS STORIES

Success stories are there providing flexible and innovative measures in addressing the problem of limited SME access to finance

There are good examples that illustrate the strong desire at all levels to find new ways of addressing the SME financing gap. In the search for innovative approaches, it must be recognized that the financial system as a whole should be the focus more than individual financial institutions. The Basel Committee has watered down some prudential ratios to free up SME lending.

For effective financing of SMEs, the financial system needs to develop loans, credit guarantees and capital markets. The latter requires exit possibilities and a securities market that is backed by a solid legal framework. Effective delivery of innovative SME financing instruments could be leveraged by the creation of partnerships between various players.

- At the national level, the SME Finance Innovation Challenge fund seeks to encourage financial innovation, supporting testing by financial service providers (banks and non-banks) and developing of innovative business models that will deliver new products and better services to underserved SME clients. The fund is a risk-sharing mechanism that finances up to half of the cost of developing new services, involving new technologies, better credit scoring, creating links with service providers in order to reach previously unserved businesses, opening up new service channels and devising creative marketing and customer service strategies.

- The G-20 has committed more than one-half billion dollars to support the winners of the G-20 SME Finance Challenge. The winners of the G-20 SME Finance Challenge were present at the G-20 Seoul Summit. The G-20 SME Finance Challenge, the first ever competition launched by the G-20, is a unique financial inclusion effort aimed at giving small entrepreneurs a chance to grow their businesses. The goal of the Challenge is to identify catalytic and well-targeted interventions to unlock finance for SMEs. Maximizing leverage of scarce resources is at the core of the Challenge. Multilateral Institutions (e.g. IFC and the World Bank, the Asian Development Bank, the Inter-American Development Bank Group, the African Development Bank, and the European Bank for Reconstruction and Development) have all expressed their support for implementing scalable and sustainable SME financing proposals, including those from the Challenge, in partnership with the private sector.

- In 2008, Ghana embarked upon a reform of its movable collateral framework to encourage SME financing against valuable movable assets. Before the reform, use of movable collateral under Ghana law was a key constraint for SME financing, as bank lending was largely based on real estate collateral, while SMEs typically do not possess real estate assets. After creating a new law «Borrowers and Lenders Act, 2008», Ghana set up a collateral registry at the Bank of Ghana. This registry was set up as a temporary solution, and it›s currently being upgraded into a web based electronic registry. However, this transition period of operation has been extremely fruitful as illustrated by some of the early results of this reform process.

Some of the highlights of the success of the Ghana movable collateral reform include:

- Increased volume of financing for SMEs: more than 20,000 loans have been registered by Banks and NBFIs in the collateral registry since its creation in March 2010. These loans account for more than US$800 million in financing secured with movable property.
- Wider use of movable assets as collateral by businesses. These types of collateral include: inventory and accounts receivable (in 32% of the loans); investment instruments such as shares, cash, bonds, deposit accounts (19%); household assets (13%); motor vehicles (10%); real estate property (10%); and machinery, equipment, all enterprise assets (16%)
- Increased financing by banks and non-bank Financial Institutions taking movable property as collateral: out of 52 financial institutions, 33 institutions (17 banks, 13 non-bank financial institutions, 4 foreign-based banks and 2 rural banks) have registered with the collateral registry and granted loans secured with movable property.

RECOMMANDATIONS

On the basis of the study and the two High-level Meetings held in the context of this project, a set of recommendations have been discussed and made. The key recommendations are summarized in table A (see page 10).

General nature

The Study recommends that the European Commission (EC) funds well-managed Technical Assistance (TA) to worthwhile SMEs lacking access to financing from IF intermediaries. Depending on the country, the TA management unit should thus report to the SME association, the banking association, the EIB, or ideally some combination of these. Financiers and SME representatives are unanimous in advising against involvement of the Government, referring to past experiences in inefficient or biased allocation of the assistance. Moreover, Government involvement would not generally add to the desired ownership and financing focus. In this respect, it is noteworthy that EIB has recently signed an agreement with the St. Kitts Development Bank where funding is coupled with technical assistance. A discussion on a similar deal with the Caribbean Development Bank is ongoing. COMESA highlighted the need for strengthening the capacities of intermediaries – Capacity Building Trust Fund – and improving the infrastructure (e.g. credit scoring).

The project addressed the dearth of information, insufficient communication and the lack of coordination between key stakeholders in SME development. It was felt important to strengthen coordination of actions in favour of SMEs. the European Investment Bank will present for approval of its Board a communication strategy that would enhance the dissemination of information about the Bank's interventions.

Bank financing remains by and large the most important source of finance to SMEs. Bank credit is the common source of external finance to SMEs in ACP countries. Factoring clearly appears as an important complement of working capital finance for SMEs. Likewise, leasing appears as an important complementary source of investment finance, especially in countries where the collateral regime and the information infrastructure are weak. However, the meeting concluded that equity financing is necessary to address the high cost of borrowing and to enable firms to invest and support increased needs for debt. It was also recommended to develop factoring and procurement of receivables.

The development of local and regional capital markets were seen as critical to enhancing access of SMEs to capital. Afreximbank reported it guarantees the issue of a diaspora bond by a commercial bank to raise capital from the diaspora to fund projects under the Zimbabwe's Revival Fund. Zimbabweans are in the diaspora in South Africa, UK and the US. The Jamaica Stock Exchange Junior Market is a success story where listing of SMEs making an Initial Public Offering (IPO) is done on the basis of simplified procedure, with listing fees almost 50% lower than for listing on the Main Board. Listed SMEs enjoy waiver from profit tax for 5 years and a reduction by half in the next 5 years.

The importance of the role governments in enhancing SME financing was highlighted, notably during the High-level Meetings. Whenever, governments create the right conditions and enter with the private sector into a genuine partnership, positive results can be observed. It is indeed incumbent to governments to create a favourable environment for SME financing. This includes access to electricity, regulation, taxes, competition from the informal sector, and combating corruption.

Specific to the EIB

In relation to the Investment Facility (IF), the European Investment Bank (EIB) was encouraged to diversify the financial intermediaries it works with, to be flexible in the direct financing of projects and to be less risk-averse at the individual project level. The EIB is already supporting the strengthening of the financial sector, but calls were made at the meeting for more efforts towards promoting venture capital and capital markets. The launch of schemes targeted exclusively at SMEs was also recommended.

A higher share (e.g. a third) of the IF should be used to finance SMEs of a relevant size, including through regular credit lines. Credit is the largest type of SME financing and banks are the largest providers of credit. IF's standard SME "package" in a country should thus always include a credit line to banks in order to have a broad impact. And only enterprises of a size consistent with the country's SME definitions would be eligible for financing under this SME credit line. Other indirect IF instruments like equity funds could also be earmarked for ACP SMEs.

The Study has recommended that IF's SME credit lines provide for bank portfolio risk-sharing, with EC risk capital and possible collaboration with local guarantee funds. These SME guarantees should thus be dovetailed to IF's credit lines, as part of the standard IF "package" aimed at the real ACP SMEs in a country. If possible at the same time, the IF guarantees would be channelled or monitored by local guarantee funds when these are reliable. Procedures should be streamlined to prevent multiple ex-ante approvals (i.e. by the EIB, the bank and the fund).

Devolvement of the Investment Facility

There is an opportunity for relative devolvement that would expand the scope of SME financing by the EIB. At present the IF has reached real ACP SMEs only in some 12 countries, according to the sizes of credit line allocations. Up to one third of this financing further concentrates on a single country, the Dominican Republic. The EIB would extend a credit line directly to one retailing bank, for on-lending to enterprises in one country. Regional banks are not used as wholesalers for distributing a credit line to banks in several countries at one go.

The Study therefore recommends that the distribution of some IF credit lines be delegated to regional banks in order to reach SMEs in more countries, including the smaller ACP States. For that purpose, the EIB could simply call on the existing regional networks of interested commercial banks. Alternatively, it could partner up with the regional development banks of good standing. Else it has all the expertise needed to help promote reliable regional relays where they are lacking (e.g., the Pacific).

Generally, when preparing new projects the EIB could consider any secure opportunity for increased delegation to regional institutions. This may reduce costs and the need for ex-ante approvals, and contribute to institutional development. This applies to guarantees, leasing and other instruments as well as credit.

The project called for Development Finance Institutions to join hands with commercial banks in serving SMEs. Commercial banks know better their clients and are interested in providing long term finance, provided they have long term resources. There are things commercial banks do better than development banks and vice-versa. It is not the raison d'être of development banks to provide working capital to SMEs. Sometimes they assume a substantial exposure to the SME sector. There is an opportunity for development banks and commercial banks to start working together. Partnerships between DFIs and commercial banks, as partners of a syndicate, are therefore highly recommended. Commercial banks are scaling up their offerings of financial and non-financial products. Since 3 years, Standard Bank is in a PPP with a development bank, supporting small-farmers in Africa.

Table A: Key recommendations

	Title	Comments	Type
1	Reaching Missing Middle	Higher share of the IF to be used to finance SMEs of a relevant size.	IF
2	Balancing the credit risk	IF's SME credit lines provide for bank portfolio risk-sharing, with EC risk capital and possible collaboration with local guarantee funds	IF
3	Building up SME capacity	The EC funds well-managed TA (Technical Assistance) to worthwhile SMEs lacking access to financing from IF intermediaries	IF
4	Spanning more countries	The distribution of some IF credit lines be delegated to regional banks in order to reach SMEs in more countries, including the smaller ACP States	IF
5	Blending Grant Money	Increase blending grant money with DFI's money (European Union and EIB) in SME financing	IF
6	Capacity building support	Support capacity building focused on SME financing, which is paramount to their growth, requires grant funding that is private sector driven	General
7	Partnerships with the private sector	Enhance partnering with private sector organizations when providing SME financing	General
8	Partnerships with Governments	Engage governments in partnerships with the private sector in SME financing and the creation of an enabling business climate	General
9	Enhancement of new mechanisms	Broaden the scope of grant money for project-related TA and other enhancement mechanisms and develop new blending instruments	General

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