SME FINANCE – INSIGHTS FROM THE RECENT LITERATURE

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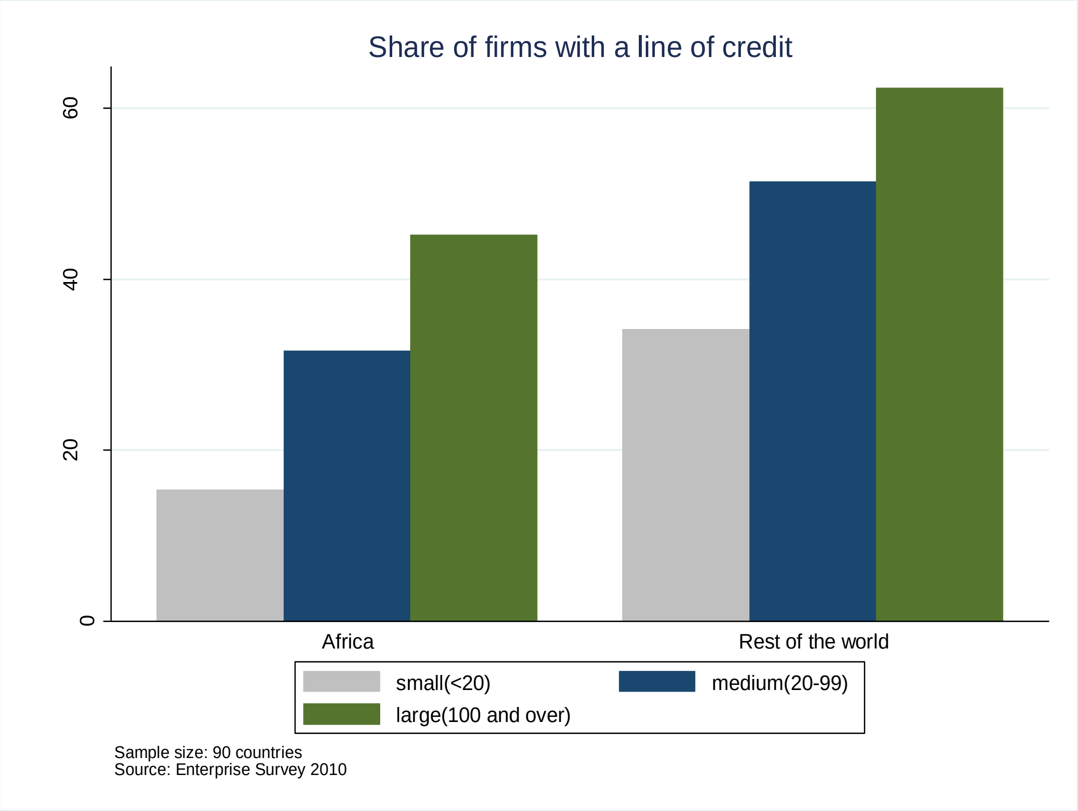
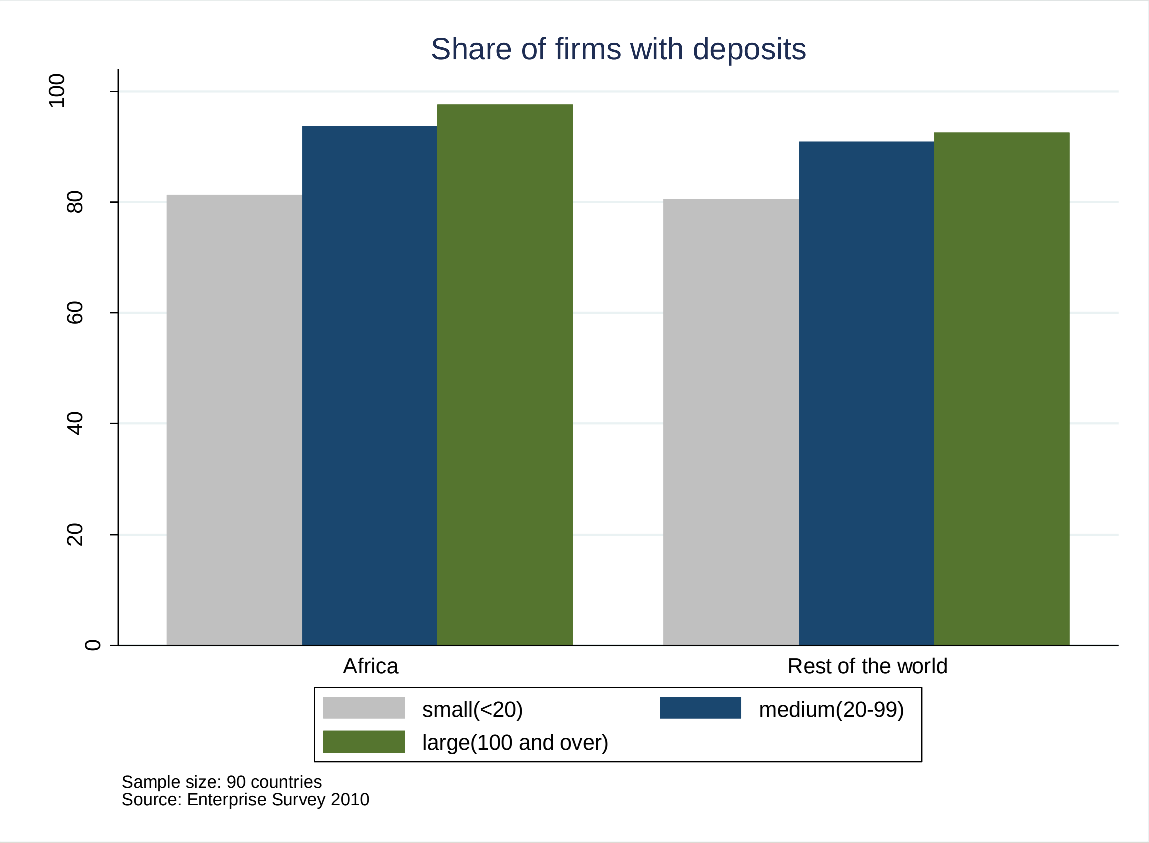
WHY DO WE CARE ABOUT SMES?

- More growth, more jobs? Not necessarily
- More innovation, more competition? Possibly
- **SMEs are the private sector of most emerging/developing markets!**

- Critical interaction between financial deepening and SME development
  - Sound and effective financial systems benefit small firms more than large firms
  - Financial deepening allows more entrepreneurship, firm dynamism and innovation
  - Financial deepening allows better exploitation of growth and investment opportunities and achieving optimal size
  - Financial deepening allows better resource allocation, more efficient corporate organization and more formality

ACCESS TO FINANCE – THE SIZE GAP





WHY ARE SMES LEFT OUT?

- Transaction costs
  - Fixed cost component of credit provision effectively impedes outreach to "smaller" and costlier clients
  - Inability of financial institutions to exploit scale economies (as in household credit!)
- Risk
  - Related to information asymmetries between borrower and lender
  - Heavier reliance on collateral
- These challenges arise both on the country- and bank-level
- SMEs therefore often squeezed between household (large number!) and large enterprise finance (more manageable risk, scale)

UNPACKING THE UNIVERSE OF SMES

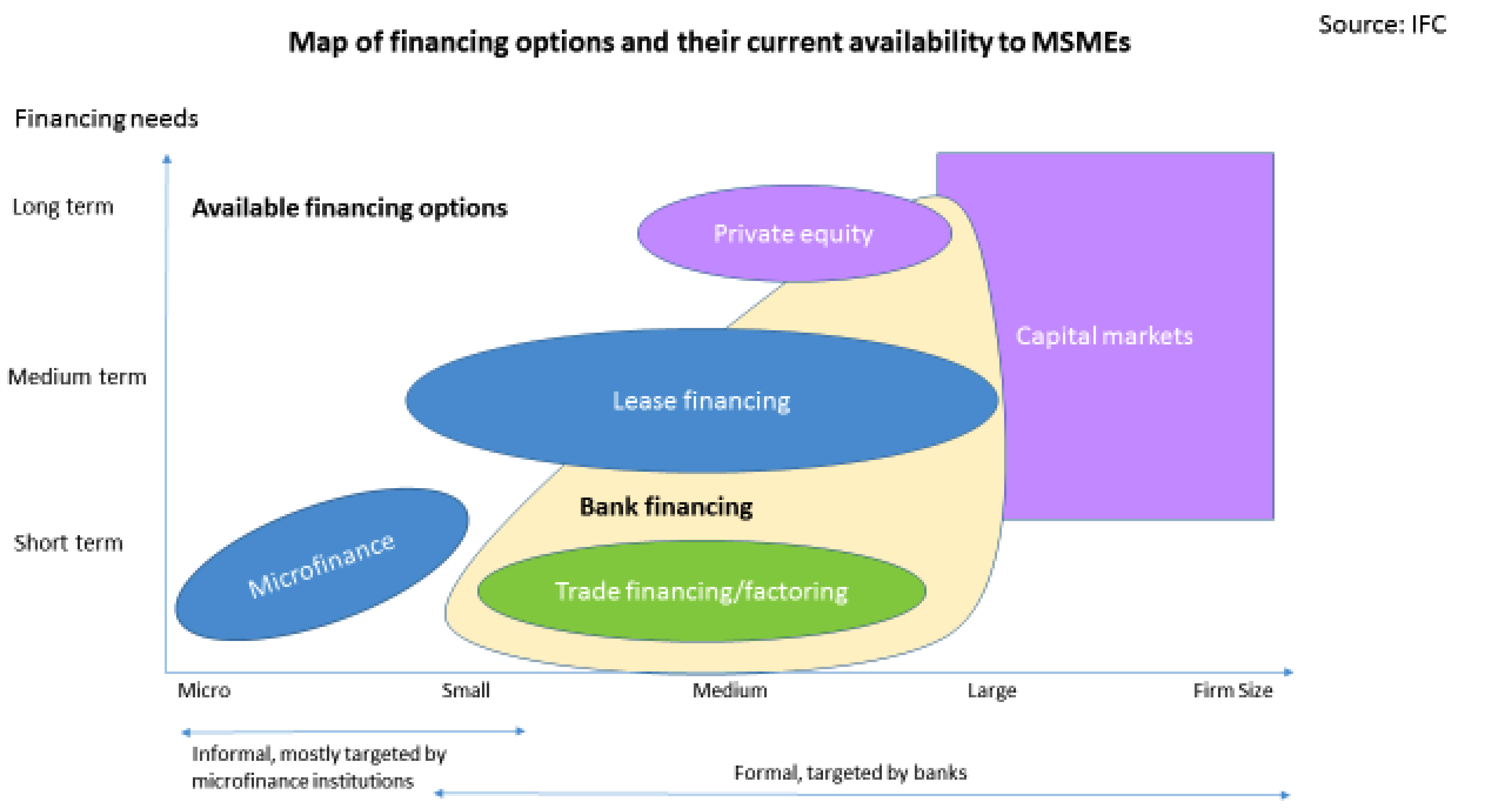
Different segments to be distinguished

- Microenterprises: informal, household- or family based
- Small enterprises – formal; often "missing middle"
- Medium-size enterprises: aspiring, export-oriented etc.

Differentiation between subsistence and transformational enterprises is critical for

- Discussion on job creation
- Interventions and policies for easing financing constraints

We need different policies and approaches for these different groups!


Source: IFC
Map of financing options and their current availability to MSMEs
Financing needs
Long term
Medium term
Short term
Available financing options
Private equity
Capital markets
Lease financing
Bank financing
Microfinance
Trade financing/factoring
Micro
Small
Medium
Large
Firm Size
Informal, mostly targeted by microfinance institutions
Formal, targeted by banks

WHO FINANCES SMES AND HOW?

- Limited financing sources – mostly banks, limited if any access to capital market
  - Demand-side constraints: resistance again sharing control
- Supplier credit, internal finance
- **Bank lending: relationship vs. transaction based lending**
  - ✓ ***Relationship***: bank repeatedly interacts with clients in order to obtain and exploit proprietary borrower information ("soft" information)
  - ✓ ***Transaction***: typical one-off loans where bank bases its lending decisions on verifiable information and assets ("hard" information, hard assets)

➢ Relationship lending traditionally seen as appropriate tool for lending to SMEs as they tend to be more opaque and less able to post collateral

➢ But: transaction lending proposed as alternative lending technique, especially useful for larger and non-local banks

DIFFERENT SME LENDING TECHNIQUES

Greater likelihood/level of collateral

Technology	Information source	Screening and underwriting policies	Contract structure	Monitoring mechanisms
Small business credit scoring	Hard information (data points) about the enterprise	Based on the SME's score in a statistical model	No collateral required, higher interest rates	Observation of timely repayments
Financial statement lending	Audited financial statements	Based on the strength (and credibility) of the SME's financial ratios	Contracts may vary but future cash flow is primary source of repayment	Ongoing review of financial statements
Relationship lending	Soft information on the SME, owner, and community, gathered over time	Based primarily on the decision or recommendation of the loan officer	Variety of structures	Continued observation of the enterprise's performance on all dimensions of its banking relationship
Factoring	Value of collateral: accounts receivable	Based on the quality of the enterprise's clients	Factor purchases the accounts receivable outright, thus taking over credit and collections	Lender owns the accounts receivable
Asset-based lending	Value of collateral: accounts receivable or inventory	Based on value of collateral	Primary method of repayment is asset collateral	Problematic, as value of the assets must be regularly updated
Leasing	Value of the asset leased	Based on value of the asset	Lessor purchases asset and rents to borrower, who may often purchase at end of lease	Observation of timely repayments
Fixed-asset lending	Value of collateral: real estate, equipment	Based on the assessed market value of the asset, and coverage ratios measuring the SME's ability to service debt	Collateral (asset) worth over 100 percent of loan, throughout amortization schedule; lien prevents borrower from selling asset	Observation of timely repayments

Source: Berger and Udell (2006) "A more complete conceptual framework for SME finance"

LENDING TECHNIQUES OVER THE CREDIT CYCLE

- ✓ Evidence on Central and Eastern Europe (Beck et al., 2018)
  - ✓ Combining firm-level and bank-level survey data
  - ✓ During 'good times', relationship and transaction lending act as substitutes
  - ✓ During 'bad times', relationship lending helps alleviate credit constraints
    - Especially for opaque firms
    - Especially in regions that suffer more during the crisis
  - ✓ Reduction in credit constraints has a *positive* impact on firm growth during the downturn (*not* an evergreening story), different from evidence in Japan

SME FINANCE AND COMPETITION

- Market efficiency view vs. dynamic relationship view
- Mixed empirical evidence
- Challenge: how to measure competition vs. market structure
- Competition vs. contestability
- Related to this: bank size and bank hierarchical structures

MARKET STRUCTURE – GOVERNMENT OWNERSHIP

- Bureaucrats as bankers have failed almost everywhere, but especially in developing countries
  - Less private credit lending and lower growth, BUT: can have important role on savings side
  - More concentrated lending (borrower-, sector-level) and related lending
  - Governance and regulatory challenges
  - More likely to suffer fragility and crises
- Worse than government ownership is …

  … failed privatization process
- Development Finance Institutions (DFIs): if direct lending, mostly dismal performance; if second-tier: can play important role (more below) if they have proper governance and structure

MARKET STRUCTURE- FOREIGN BANK ENTRY

- The arguments
  - Foreign banks can bring expertise, competition, liquidity
  - … but might lack market knowledge
  - Does foreign bank ownership reduce access?
    - Distinguish between different ways of foreign bank entry
    - Indirect effect on access by forcing domestic banks downscale
    - Differential effect across different foreign banks (multinational banks, regional banks, development-oriented banks
- The evidence
  - Positive impact on efficiency and competition
    - Less related lending
  - Positive impact on stability (unless shock comes from home country)
  - Not necessarily negative impact on access, BUT: depends on institutional framework
- New trends: regional banks

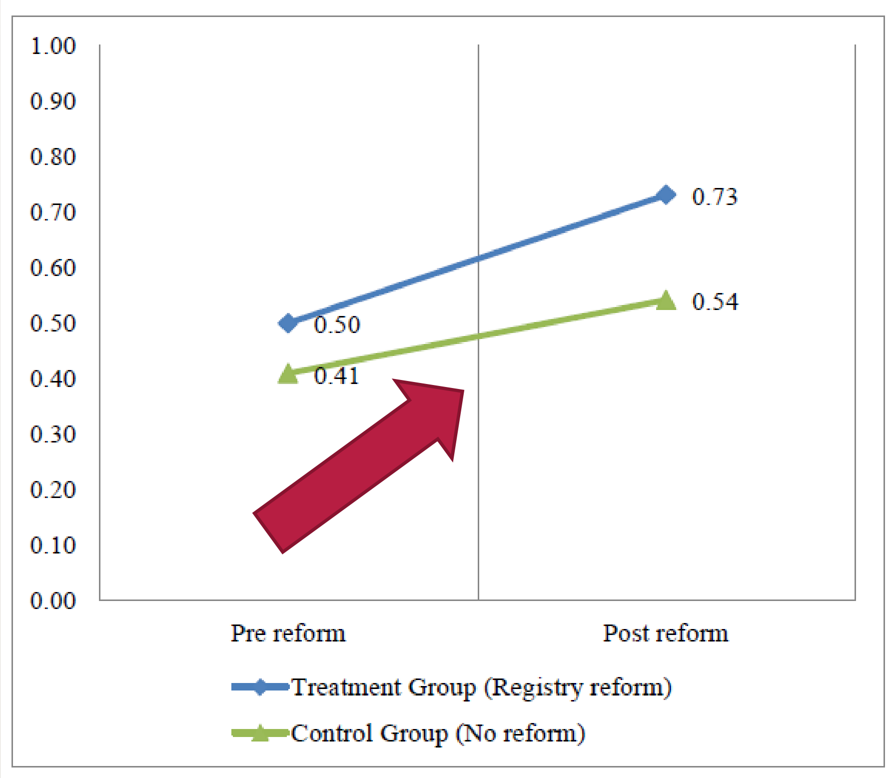
WHO FINANCES SMES?

Small vs. large banks, domestic vs. foreign banks

- Small/domestic banks more likely to use relationship lending, large/foreign banks more likely to use transaction-based lending (example: Beck et al. (2018) on Bolivia)
- Also differences across foreign banks – higher proximity (geographic, cultural) implies that they are more similar to domestic banks (example: Mian (2005) on Pakistan; example: Bolivia: greenfield become more like domestic banks over time; acquired banks more like foreign banks over time)
- Central and Eastern Europe: foreign banks as likely as domestic banks to be relationship rather than transaction-based lender
  - Mostly from geographically close countries
  - Many of them SME focused in home markets

MARKET-DEVELOPING POLICIES

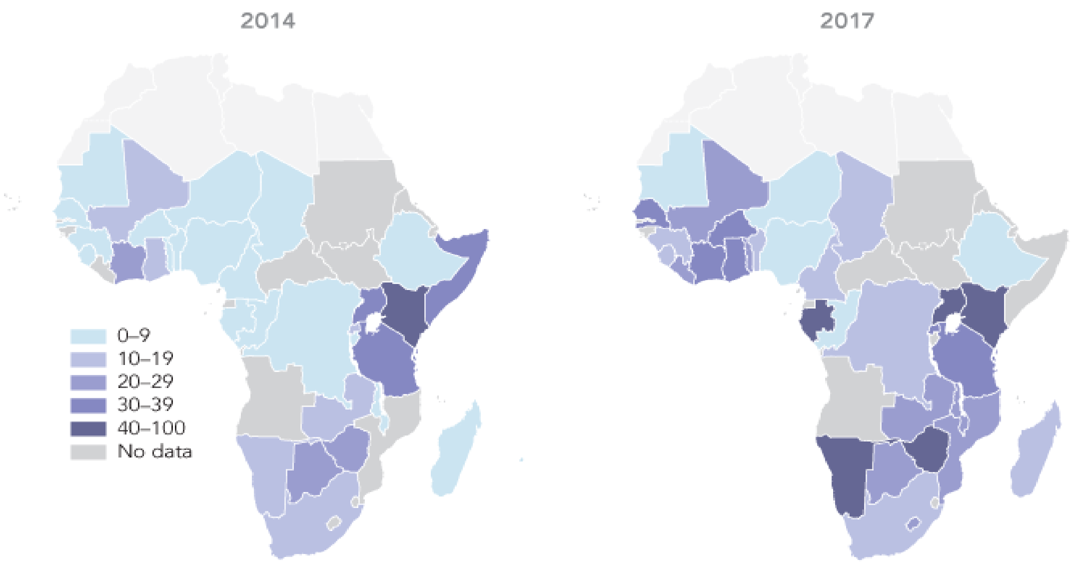
- **Institutional Framework**
  - Introduction of **credit registries or bureaus** → positive impact on lending to SMEs
  - Positive effect of introducing **movable collateral registries** on firms' access to finance, an effect stronger among smaller firms
  - Positive effect for SMEs of institution building often larger than for large enterprises



FINANCIAL INNOVATION

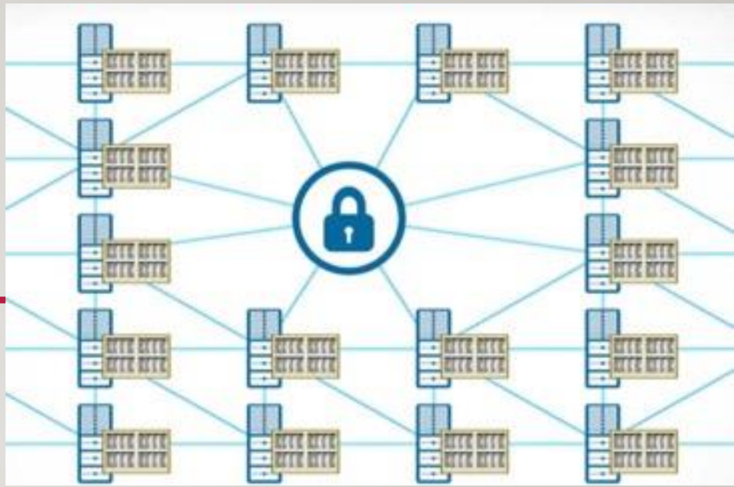
- Use of technology has enabled new products, processes, delivery channels and providers
- Mobile money; digital payment services (M-Pesa and beyond)
- Entrepreneurial finance lab – psychometric assessment
  - Can complement traditional credit scoring
- P2P and crowdfunding
- New forms of creating ID (digital, fingerprint)
- Digitalization of registries
- Use of blockchain to secure records

Mobile money accounts have spread more widely in Sub-Saharan Africa since 2014
Adults with a mobile money account (%)



Source: Global Findex database.
Note: Data are displayed only for economies in Sub-Saharan Africa.

BLOCKCHAIN



- The blockchain has perfect memory – and it never forgets
- There is no central authority, but rule by consensus
- You have to obey to play
- Blockchain is a ‘truth engine’

Examples:

- SME international payment settlement (Bitpesa) – can avoid USD
- Cross-border trading platforms
- Digital and portable KYC

Source: Tedd George, Ecobank

BENEFITS OF MOBILE MONEY NOT JUST FOR HOUSEHOLDS, BUT ALSO ENTERPRISES: EXAMPLE OF KENYA

Figure 1: Share of businesses using mobile money to pay to their suppliers according to credit relationship with suppliers

- Use of M-Pesa to pay suppliers allows entrepreneurs to avoid risk of theft, thus risk of non-payment, resulting in higher probability and amount of trade credit
- Availability of trade credit makes take-up of M-Pesa more attractive
- Beck, Pamuk, Ramrattan, and Uras (2018)

LOOKING BEYOND BANKS – NEED FOR COMPETITION

Secondary or alternative tiers of capital markets

- Works best in financial systems, which already have deep capital markets

Private equity, venture capital, angel financing

- Seems a good idea for mid-sized firms that do not have scale or track record to tap public equity or debt
- Large literature on (mostly positive) effect of equity funds on firm-level outcomes for the U.S., but limited evidence for other countries
- Mezzanine financing forms
- Often regulatory restrictions; scale problems

New financing arrangements:

- Crowd funding and peer-to-peer lending - Jury still out: enough scale, risk management?
- Entry of BigTech into financial intermediation?
- Regulatory implications (new forms of shadow banking?)

THE ROLE OF GOVERNMENT – LOOKING BEYOND INSTITUTION BUILDING

- **Focusing on contestability of financial markets**
  - Low entry barriers
  - Infrastructure open to all financial institutions
  - No regulatory barriers to innovation
- **Pro-market activism**
  - Do not replace markets, but help overcome market failures
  - Well-designed, limited (time, resources etc.) interventions might help
  - Providing infrastructure, overcoming scale problems
  - Example: Funding for lending (especially local currency resources)?
  - Example: Reverse factoring platforms
  - Example: Partial credit guarantee schemes
- **Tilting the playing field away from household debt?**

LOOK AT DEMAND-SIDE CONSTRAINTS

- Financial literacy
  - Financial awareness of products and options
  - Financial capability
  - Teachable moments, practical teaching
- Accounting and auditing standards
- Business development services – turn investment into bankable projects
- Don't ignore non-financial constraints

CONCLUSIONS

- SMEs are the private sector of developing and developed countries
- Critical to differentiate between different segments of the SME population
  - Different financial service providers: banks, MFIs, capital markets
  - Different lending techniques and complementary services: technical training, business development
- Policy levers on different levels:
  - Long-term institution building
  - Competition and innovation
  - Providing the market a helping hand
- Big data can only go so far – still need for soft information/relationships

THANK YOU

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