

SME Financing – How To Topic Guide

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Abbreviations

ADB	Asian Development Bank
CGS	Credit guarantee scheme
CIB	Credit information bureau
DCA	Development Credit Authority
DFI	Development finance institution
DFID	UK Department for International Development
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EIB	European Investment Bank
EIF	European Investment Fund
FI	Financial institution
GDP	Gross domestic product
GPFI	Global Partnership for Financial Inclusion
IADB	Inter-American Development Bank
IFC	International Finance Corporation
IMF	International Monetary Fund
ISA	Individual Savings Accounts
MENA	Middle East and North Africa
MFI	Microfinance institution
MSME	Micro, small and medium-sized enterprises
NBFI	Non-bank financial institution
OECD	Organisation for Economic Co-operation and Development
PCG	Partial credit guarantee
PFI	Partner financial institution
SCF	Supply chain finance
SMEs	Small and medium-sized enterprises
TA	Technical assistance
VC	Venture Capital
WB	World Bank
WEF	World Economic Forum

Key Points

1. SMEs can play a major role in job creation and economic development. They constitute a large share of private sectors across the globe. More important than their share in the overall economy, however, is their potential for transformation and growth.
2. SMEs face severe financing constraints, with the credit gap estimated to be over \$2 trillion globally. SME access to finance in developing countries is particularly significant due to the risk management challenges of financial institutions and the high transaction costs involved in lending to SMEs.
3. Development partners have used a wide variety of tools (both financial and through broader market enabling initiatives) to bridge the SME finance gap.
4. There is much we can learn from the experiences of developed countries.
 - South Korea has shown us the benefits of a comprehensive SME policy approach as well as the importance of market compatibility.
 - The UK has taught us that not only supply but also demand-side constraints matter and that innovation is critical.
5. Credit Guarantee Schemes can help manage risk by guaranteeing repayment of part of the loan in the event of default. They help overcome lack of collateral faced by SMEs and compensate for banks' low profit margins when lending to SMEs.
6. Credit and equity lines to financial institutions can support the funding of a bank's loan portfolio and allow donors to channel money through a market focused decision-making entity.
7. Lease finance allows SMEs to obtain equipment without collateral and is particularly well tailored to smaller and agri-based SMEs with no collateral.
8. General equity funds can help support mid-size enterprises in their growth process and development partner involvement in this field is growing.
9. Financial benefits for SMEs are a widely used part of government fiscal policies. These benefits, including tax holidays or deductions, require a careful cost-benefit analysis and should be transparent.
10. Challenge funds can have an important role in fostering innovation in the market place encouraging product development and new delivery channels.
11. Blended finance is a key mechanism through which private sector funding can be leveraged to achieve both developmental and commercial objectives, as long as it does not crowd out market funding.
12. Innovative and technology based solutions (FinTech) bring a lot of promise, but also new challenges and their impact is too early to assess.
13. For SME support programmes to work properly, an appropriate enabling environment is necessary, including conducive informational, contractual, macroeconomic and regulatory frameworks.

1 Introduction

Purpose of this Guide

This topic guide focuses on the financial instruments available to help bridge the financing gap for SMEs, reviewing existing financing programmes and their impacts and drawing out lessons learnt. It will:

- Explore how governments and development partners have stepped in to address market failures through financial instruments, complementary market infrastructure, and regulatory initiatives.
- Provide an in-depth review of specific financial sector instruments (ranging from the traditional to the innovative) and will consider what works and why, with whom and under what conditions; and
- Make recommendations as to how SME financing programmes could be structured including sequencing and preconditions for success.

Role of SMEs¹

SMEs can play a major role in job creation and economic development. Private sectors in most developing countries are dominated by SMEs, often disadvantaged by uneven playing fields in terms of the institutional infrastructure and business environment. The vast majority of people are either employed by SMEs or run small enterprises themselves. There are approximately 365 to 445 million formal and informal MSMEs in the developing world, 80 to 100 million of which are formal.² The prominence of SMEs in developing countries' private sectors and the growth obstacles they face justify the focus by policy makers and donors.

In this context, it is important to distinguish between two different types of enterprises and entrepreneurs.

1. **Subsistence entrepreneurs** have tiny businesses, based on self-employment and informality and are almost exclusively micro-entrepreneurs. A large share of MSME owners are running their business to make a living while they are looking for a wage job, and may not have plans for expanding their business. There is evidence that the majority of microenterprises are managed by this type of subsistence entrepreneur.³
2. **Transformational entrepreneurs** who are leading enterprises that create jobs and have growth ambitions.

Distinguishing between these two groups is critical for purposes of job creation and for tailoring support, especially financing mechanisms for them. This guide will focus on the latter group.

It is, however, important to note that the role of SMEs in modern market economies and economic development has been controversial. While there is a positive correlation between the share of SMEs in manufacturing and GDP per capita growth, there is no evidence that this relationship is causal, i.e. that having a high share of SMEs helps countries grow faster or reduces poverty at faster rates.⁴ Successful economies thus have

¹ For further insights on the evidence around the contribution we can expect SMEs to make in terms of jobs and transformational economic development, DFID's RED2 note on Finance for SMEs serves as a useful guide.

² Stein, Goland and Schiff (2010). "Two Trillion and Counting, Assessing the credit gap for micro, small, and medium-size enterprises in the developing world" McKinsey & Company and IFC

³ For example, Hsie and Klenow (2009) show that 90% of all enterprises in India never grow. De Mel, McKenzie, and Woodruff (2009) show that only 30% of microenterprise owners in Sri Lanka have characteristics like large firm owners, whereas 70% are similar to wage workers. Bruhn (2013) finds that about 50% of a sample of Mexican micro- entrepreneurs are similar to wage workers.

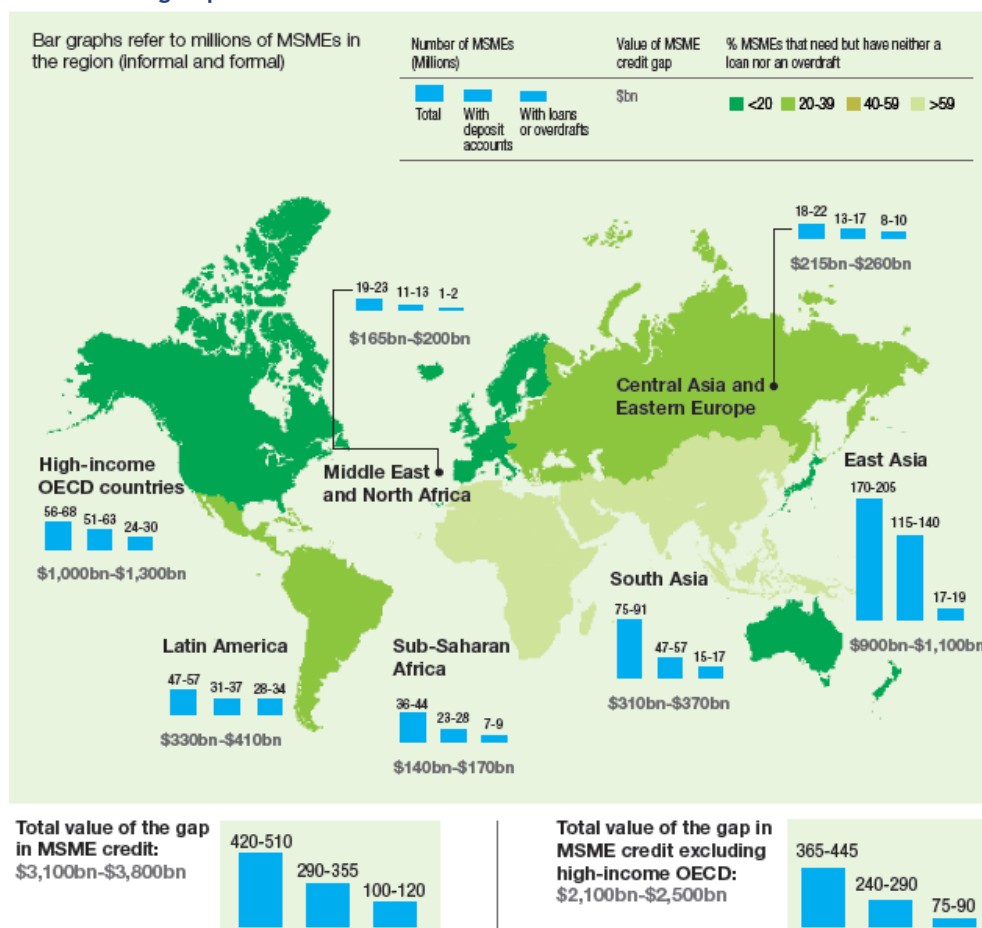
⁴ Beck, Demircuc-Kunt and Levine (2005). "SMEs, Growth, and Poverty," Journal of Economic Growth

more SMEs, but their success is not explained by having many SMEs. More important is the potential for growth and transformation of the SMEs within the sector.

Access to Finance for SMEs

Expansive research has shown that SMEs face higher operational and growth constraints than large enterprises, which can undermine resource allocation within the economy and, ultimately, the growth process. Among these constraints, access to and cost of external finance loom large. The significance of financing constraints for firm growth is inversely related to firm size and such constraints are stronger in countries with less developed financial systems. This can also explain the diverging firm size distribution in many developing countries, resulting in a ‘missing middle’. Trying to quantify the global financing gap of SMEs and using enterprise surveys, the total credit gap has been estimated at \$2 trillion⁵ as illustrated in the figure below. While SMEs, especially smaller enterprises, rely extensively on informal sources of finance, including friends and family, limited information is available to quantify the importance of these sources. It can also be argued that these sources are typically not as efficient as formal finance, given that they are not market-priced⁶.

Figure 1: The Financing Gap.



Source: Stein et al (2010)

⁵ While such efforts are to be applauded for putting the issue of SME finance on policy makers’ agenda and can serve as input for quantitative indicators, they have several inherent shortcomings. First, credit demand by enterprises is not the same as commercially viable demand. Second, firm size distribution and the firm population itself arise as a result of financial development. Identifying a credit gap based on current firm size distribution and use of financial services is therefore necessarily a static rather than a dynamic exercise.

⁶ Ayyagari, Demirgüç-Kunt and Maksimovic (2010), find that for the average SME formal finance is associated with higher firm growth while informal finance is not. Degryse, Lu and Ongena (2013) find that informal finance is associated with a higher sales growth rate for small SME firms but not large SME firms.

1.1 Definitions

For the purpose of this guide, SMEs are defined as small and medium businesses with an annual turnover of up to \$5 million and/or less than 100 employees. We focus only on formal sector companies recognising that in some countries the distinction is somewhat blurred and that there are many different shades of formality (for example, firm registration, tax registration, land registration etc.).

Given that the literature available on SME financing is vast, it is also important to highlight what the topic guide will not cover in considering instruments to promote SME development. This includes microenterprises, household- or family-based enterprises; microfinance institutions; capacity building / skills development of SMEs; formalisation of SMEs; mentoring; cluster creation; policies to address information failures (e.g. establishment of Credit Information Bureaus); capital market development; or an evaluation of the institutions delivering these instruments.

The study will, however, consider at a high-level how SME financing best sits within the broader policy agenda.

1.2 Research methods

This review was undertaken as a desk review by Nathan Associates London Ltd. The guide largely depends on secondary data sourced from donors, practitioners, development partners and academic papers as well as DFID strategy documents.

Where possible the authors have considered the extent to which credible data is available and lessons have been drawn from programmes with robust evaluations of their results and impacts. The authors have not attempted to review all literature on this topic but have chosen selected programmes to review on a case study basis. Cross-comparison studies of specific financial instruments are limited, however, we will highlight where broader data sets can be found and draw out relevant data from these to support our analysis.

In addition, the team has gathered information through telephone interviews with selected programme managers and practitioners. These interviews have focused on individuals with hands-on experience in implementing the financial tools reviewed in order to draw out real life lessons on what works and does not work. Specific attention has been paid to what contributes to the success or failure of a particular instrument.

2 Conceptual Framework

Why are SMEs more constrained? Transaction costs and different levels of information available on potential borrowers are the main reasons for the variation in access to finance across firms of different sizes. **Fixed transaction costs** in credit assessment, processing, and monitoring mean that unit costs decrease as the size of the loan increases, which makes lending to SMEs costlier. In addition, SME lending, more than other lending products, is affected by **challenges in managing risks**. Compared with large firms, SMEs are generally more opaque, less likely to be able to post collateral, and often do not have audited financial statements that can provide a better picture of the enterprise and its projected profits. Compared to retail clients, financial institutions are also less able to rely on the law of large numbers to exploit scale economies and diversification benefits.

Government and donor interventions are frequently designed to overcome these two constraints. It is important to realise, however, that there are **not only supply, but also demand-side constraints**. Such demand-side constraints can refer to firm characteristics that exacerbate supply-side constraints, such as the lack of proper financial

management and the refusal to register the company or assets even where reasonably feasible. Such demand-side constraints can also refer to the lack of financial literacy and necessary business development skills. On a broader and more aggregate level, this can also relate to the absence of profitable investment projects.

Finally, it is important to keep in mind that finance – although often considered as a major constraint to firm growth – might not always be the binding constraint.

Disadvantaged Groups: There is additional evidence that some entrepreneur groups are more affected than others. **Female entrepreneurs often face higher growth obstacles** than male entrepreneurs which in many countries link to legal and cultural issues (see box 1). However, there is also evidence that access to finance might not always be the binding constraint⁷. On the other hand, there is some evidence that **minority groups might suffer from discrimination** and lower access to external funding⁸, which might result in lower access to credit and thus negative effects on overall resource allocation in an economy.

SMEs are constrained by both limited *levels* of funding available and limited *sources* of external funding. One important group of providers of external funds are non-bank, non-regulated entities, which can range from suppliers providing trade credit to friends and family to moneylenders. These informal providers often face lower costs and lower information asymmetries than formal financial service providers, and thus lower risks. Conversely, informal finance has the disadvantage of not benefitting from geographic and sectoral diversification and is often unreliable, costly and violates the privacy of customers.

Overcoming Constraints: To overcome the main constraints to SME financing, governments and donors have designed and implemented interventions at different levels. At the broadest levels are programmes that support institution building, such as the establishment of credit or collateral registries or court reforms. These also include regulatory reform programmes, such as, for example, introducing leasing legislation. We will not discuss these here but would emphasise that often there are important complementary reforms necessary within the institutional framework to increase SME finance provision and make financing programmes as efficient as possible. In this note, we will instead focus specifically on financing instruments, be they contingent (such as providing guarantees) or involving direct funding.

Delivery Mechanisms: Another important distinguishing factor has been the channel for implementing programmes – central bank, development finance institutions or commercial banks directly. There has been quite some empirical evidence on the limited efficiency with which first-tier government-owned and -managed banks support funding needs in developing countries. There is much less evidence on the efficiency of second-tier development finance institutions that serve as facilitators or conduits for donor funding,

Box 1: Can the gender gap in entrepreneurship be explained by a lack of access to finance?

Women entrepreneurs outnumber men in many parts of the world. Despite this, women-led SMEs tend to lag behind men in terms of the turnover, profitability and growth performance of their businesses. The barriers for women regarding access to finance and the supporting business environment (e.g. legal system, property rights) result in women receiving a lower share of available external funding than men. The evidence suggests that this might be less attributable to explicit discrimination but results from higher credit risk (perceived or actual) from lack of collateral.

More than this, the authors find that the concentration of women in low capital intensive industries—which require less funding and at the same time have a lower potential for growth and development—might also be driven by barriers against women regarding access to finance.

Source: Klapper and Parker. 2011.

⁷ Aterido, R., Beck, T., & Iacovone, L. (2013). "Access to Finance in Sub-Saharan Africa: Is There a Gender Gap?" World Development, 47, 102–120.

⁸ For example Fisman, Paravisini and Vig, 2015, for India.

although anecdotal evidence from Latin America suggests that they can play an important role in jump-starting markets⁹.

In the developed world, governments and financial institutions have made significant steps in providing services to SME clients, particularly in response to the recent crisis. In addition, an emerging and fast-growing technology sector is promoting new innovations in financing (such as peer to peer lending) which have circumvented traditional finance providers by leveraging low-cost platforms and using innovative credit scoring and psychometric techniques to assess potential borrowers. Much of this progress is yet to make its way to the developing world, but it provides a unique opportunity for governments and donors to consider the role these can play going forward.

3 Bridging the Gap. A review of current approaches

Governments, non-governmental and international organisations have long promoted initiatives to support access to finance by SMEs. Early European guarantee funds began in the early 20th century with origins in Belgium (1929), France (1917) and Germany (1930). Other nations such as the UK (1981) and much of the developing world introduced schemes in the latter part of the century.¹⁰

The recent financial crisis has prompted a renewed interest in SME financing¹¹ as there is evidence that SMEs are disproportionately more affected by recessions and financial crises than large firms. The international community as a whole responded in 2010 as the leaders of the G20 recognised financial inclusion as one of the main pillars of the global development agenda, endorsing a concrete Financial Inclusion Action Plan. As a result of this, the G20 established the Global Partnership for Financial Inclusion (GPFI), to serve as a means for implementation as well as the SME Finance Challenge (in August 2010) aimed at identifying new ideas for financing small businesses and helping them grow. The GPFI later established the SME Finance Forum (in 2012) as a knowledge centre for data, research and best practice in promoting SME finance.

Support for SME development tends to be approached either directly or indirectly, or through a combination of the two. Direct investing in individual companies requires local knowledge and sector specific skills, and tends to be perceived as costly and involving higher risk. Indirect investing can, in some ways, be done more easily as it involves intermediaries such as commercial banks, designated SME finance institutions, SME focused funds and other types of financial institutions.

In recent years, national and international development finance institutions (DFIs)¹² have been very active in the provision of funding to SMEs, with the main instruments used including long term loans and guarantees to financial institutions to encourage on-lending to, and equity investments in, SME clients (all with or without a TA component). Most support by development partners is provided on the basis that it will be:

- 1) additional, i.e. only make investments that private investors are unwilling or unable to make;

⁹ De la Torre, Gozzi, and Schmukler. 2008. "Innovative Experiences in Access to Finance: Market Friendly Roles for the Visible Hand?" Stanford University Press and the World Bank.

¹⁰ Jonsson (2009). Performance of Credit Guarantee Schemes. Copenhagen Business School.

¹¹ Governments responded on an unprecedented level to promote job creation and retention, support employment and earnings in high-productivity sectors, and increase and create safety net programmes. Bangladesh, for example, allocated US\$14.6 million to provide credit to SMEs through commercial banks.

¹² This includes multilateral DFIs (such as IFC, ADB, IsDB, EBRD, and EIB) and bilateral DFIs (such as CDC, KfW, PROPARCO, FMO and Norfund).

- 2) catalytic - crowding in commercial investors by demonstrating the feasibility of such investment; and
- 3) sustainable - schemes should focus on investment in countries, regions and sectors that are considered to be too high risk by commercial investors and where there is the potential to ensure long-term sustainability.

These institutions can offer benefits in terms of cost effectiveness, economies of scale, consistency in approach and have the ability to attract both donor and private sector funding. Over half of the IFC's investments are in the financial sector and this sector is also the largest recipient of investments made by European DFIs.¹³ While extensive involvement can be positive, it also makes for a very crowded space and issues such as coordination, saturation and duplication are relevant. It is also important to consider that the motivation of DFIs is not always the same as bilateral donors and this is particularly significant when considering specific geographies or target segments.

Leveraging private sector investment is an important way of increasing the volume of development finance in the context of constrained resources and can enhance the effectiveness of aid. Blended finance (the use of public funds combined with private capital to make investments that deliver both financial returns and development impact) will be discussed later in this guide. The concept of **returnable capital** is also being embraced as a key instrument in delivering aid with DFID, Sida, USAID and other donors all active in this area. Returnable capital (also known as development capital or impact investing) refers to investments (not grants) with the expectation of repayment with modest returns, unlike DFIs' near-commercial returns. Returns are expected to be redeployed into development programmes by donors.

Perhaps the largest and most significant recent development in SME financing has stemmed from **technological innovation in finance**. These instruments will be discussed in more detail in section 4.7, and it is important to highlight the impact that some of these tools have had. Areas such as payments and cash management do not directly result in an increase in financing of SMEs but do address key constraints, leading to operational efficiencies and ultimately a reduction in the cost of doing business.

Technological development has also been key in **addressing the information constraints** that are so prevalent in developing countries. Innovative approaches to obtaining and sharing information have huge potential to open up markets beyond traditional lenders. The Entrepreneurial Finance Lab (EFL) estimates that 90% of the world's data has been created since 2013¹⁴, and data from online social networks, mobile phone records and psychometrics are helping to illuminate the potential of borrowers where traditional credit information is scarce.

Tools such as psychometric analysis (see box 2) have implications for how banks and other FIs assess risk, potentially leading to a bigger pool of 'bankable' SMEs. Conventional scoring is highly predictive but also relies on functioning credit information bureaus (CIBs) to gather, store, and share accurate repayment history. In many developing countries, CIBs do not work or are absent altogether so lenders are forced to look for alternative sources of data.

Box 2: EFL and Banco Pichincha, Ecuador

With support from the IADB, Banco Pichincha introduced psychometric questionnaires in the consumer and entrepreneur segments. Over 18 months, Banco Pichincha approved 19,000 credit applications, which would have been rejected without the EFL psychometric score while increasing revenues and keeping delinquency rates within the banks expectations. In addition to this, the project introduced an automated process where applicants could undergo psychometric testing without having to go to a branch.
Source: EFL Website (2015).

¹³ Dalberg Global Development Advisors. The Growing Role of the Development Finance Institutions in International Development Policy. Copenhagen: Dalberg Global Development Advisors, 2010

¹⁴ EFL (2015) Alternative Credit Scoring in Emerging Markets. <https://www.eflglobal.com/alternative-credit-scoring-emerging-markets/>

Sector Specific Support - SMEs are a heterogeneous group in size, in growth potential, in needs and in activity. One solution does not apply to all and this is reflected in the extensive range of initiatives underway. Often the underlying instruments are the same but adapted for particular market situations. This has led to the rise in sectoral based approaches to SME financing in areas such as agriculture, energy financing and women-led SMEs (see box 3).

It is also important to note that most SME financing schemes form part of broader regulatory or market-based programmes to support inclusive growth. Enabling environments will be discussed later in this guide, however it is important to highlight that knowing your market and its needs is key to the success of any instrument.

Box 3: Targeting Women-led SMEs

Estimates show that over 70% of women-led SMEs are either unserved or underserved financially. Targeting women entrepreneurs has been a focus of MFIs, however, women-led SME financing is much less common with many programmes focusing on capacity building rather than financial tools. Although there is little evidence around which tools to use with women, there is evidence that targeting women specifically can make a difference to the growth of the SMEs they manage.

In addressing this problem, it is important to consider both supply-side issues (such as policy bias and discrimination, misconceptions about female credit risk and unfavourable credit terms) and demand-side issues (women's reluctance to apply for loans given a lack of business training and higher rejection rates). The few programmes focusing on women-owned SMEs have tended to be of limited scale and have lacked capacity building support to ensure sustainability.

The IFC has made women one of its focuses aiming to ensure that 25% of its own loans provided to SMEs through financial intermediaries go to women-owned businesses (IFC, 2013). Community banks, cooperatives and chambers of commerce can be used as non-traditional models for increasing the reach to women-owned SMEs in need of finance. Examples include:

- IDLC in Bangladesh who through their Purnota loan product provides a working capital and long term financing facility for women owned businesses
- USAID signed a DCA guarantee with the Bank of Abyssinia (BOA), Ethiopia's third largest bank, to offer loan financing assistance specifically to target women-owned SMEs by guaranteeing up to US\$4.3 million in loans over a 7-year period (2008 – 2014).
- EBRD has a specific Women-in-Business-Programme through partner banks in 16 countries.
- The IFC's Banking on Women programme brings together financial institutions and women entrepreneurs, using its investment capital to help institutions expand their portfolios while helping entrepreneurs strengthen their businesses with new forms of financing

Source: Goldman Sachs (2014). Giving Credit Where it is Due

Developed Country experiences. Much can be learnt from the experiences of developed countries. The Euro area provides a good example of where a large spectrum of public institutions participate in addressing SME financing needs. Approximately 99.8% of all European businesses are SMEs employing approximately 86.9 million people (67% of private sector employment).¹⁵ In the context of quantitative easing the ECB has recently started to provide cheap long-term funding to banks, which comes in addition to its provision of short-term liquidity.

To support the sector, a number of market-based initiatives that allow direct access to equity and bond markets have been launched in many European countries (led by Germany and France), although the scope of these varies widely. These can help SMEs to diversify their funding sources by facilitating access to external and cost-effective market-based financing. The uptake has been mixed so far and SME funding through the capital markets has yet to develop significantly. While the development of capital markets is beyond the scope of this guide, it is important to note their potential.

¹⁵ Kaya (2014). SME Financing in the Euro Area. New solutions to an old problem. EU Monitor. Global financial markets. Deutsche Bank Research.

The securitisation of SME loans is also a growth area, albeit limited. This is achieved by creating tradable or collateralisable securities linked to SME loans, thereby transferring their credit risk to the capital markets in an effective manner.

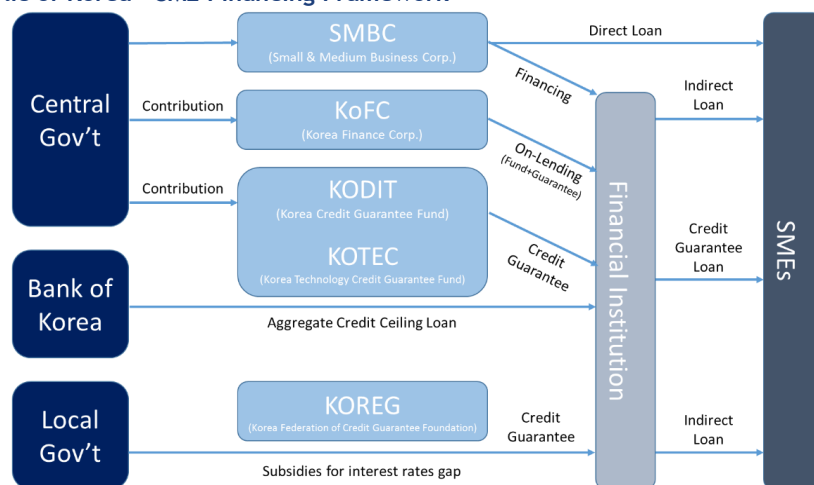
3.1 The Republic of Korea Experience

The Republic of Korea's economic development has been the envy of many countries, transitioning from one of the world's poorest nations in the 1960s, to being the 12th largest economy (in GDP).¹⁶ As of 2012, 99.9% of all companies in Korea are SMEs accounting for 87.7% of all employees.¹⁷ The sector is characterised by heavy reliance on bank funding to meet financing needs.

The Korean government has long supported SMEs as an engine of growth in the economy. Since 1979, it has supplied public funds to SMEs both directly and through credit guarantee schemes. It has also used moral suasion, for example, in 2009 in the wake of the global financial crisis banks were told to roll over loans to viable SMEs. Support for small companies has increased following the financial crisis, while large business groups have been forced to restructure. Public support for such interventions is strong, as SMEs are viewed as disadvantaged in competition with the chaebols.¹⁸

Support is delivered through a variety of institutions as illustrated in Figure 2 and focuses on three main areas – availability, accessibility and corporate restructuring.

Figure 2: Republic of Korea - SME Financing Framework¹⁹



Mechanisms for expanding the availability of credit include:

- 1) the enforcement of a specified SME loan ratio – The Bank of Korea regulates the minimum percentage of SME loans to the total loan book;
- 2) the introduction of an aggregate credit ceiling loan system – The Bank of Korea supplies a limited amount of short term funds at lower than market interest rates to FIs with a positive SME loan record;
- 3) support to policy development; and
- 4) the provision of venture capital funding through the Korea Venture Investment Corporation (KVIC).

Accessibility expansion focuses on the provision of credit guarantee institutions through KODIT (Korea credit guarantee fund established in 1996), KOTEC (Korea technology credit

¹⁶ McKinsey & Company (2013) Beyond Korean style: Shaping a new growth formula

¹⁷ Small and Medium Business Administration, Republic of Korea

¹⁸ Chaebols refer to Korea's large family-owned business conglomerates that rose to prominence in the 1960s

¹⁹ Kim and Chang (2012) Towards a Better Framework for supply of funds in Asian Financial Markets

guarantee fund established in 1986), and now KIBO (the Korea Technology Finance Corporation), as well as sixteen regional credit guarantee funds²⁰.

Corporate restructuring support targets SMEs who have faced liquidity problems following the financial crisis.

To support these initiatives, the government has promoted the use of exchange markets for SMEs, originally through KOSDAQ (which has now largely become an equity financing market for larger firms), and subsequently through KONEX (established in 2013 and specifically designed for SMEs and start-ups). The Korea Financial Investment Association (KOFIA) has also launched FreeBoard, a trading system for SME bonds.

Has it been effective? While there is no doubt that the level of growth achieved has been phenomenal, Korea's approach to SME development has not been without criticism. It has been argued that government policies in this area are too interventionist, creating market distortions, and should therefore be reduced. Some argue that the incentives for FIs to improve credit evaluation skills have been reduced, impeding the development of a market for SME financing. Interventions also allow weaker companies to survive, ones who would not have done so under normal market conditions. Finally, they can encourage SMEs to remain small so they remain eligible for support, ruling out the efficiency gains and economies of scale associated with growth.²¹ On the other hand, rapid growth in bank lending to SMEs suggests that policies to promote financing have been effective at least to some extent. In fact, SMEs received 78% of business loans in 2011, one of the highest shares among OECD countries with available data.

So what can we learn?²²

- Excessive or poorly-targeted government intervention will hinder the timely restructuring of non-viable SMEs and impede the development of the SME financing market.
- Support should focus on the most promising SMEs rather than on unequal access to funding in the marketplace.
- The price of guarantees should increase over time to discourage long-term reliance on public support.
- Avoid overlap in responsibility and actions of institutions.
- Innovations in funding should be encouraged to target specific segments (see box 4).
- Infrastructure for credit evaluation of SMEs should be strengthened where weak.
- When encouraging investment in young and start-up firms, the key is to balance investor protection and market dynamism.
- Venture capital support should be channelled through private sector VC companies relying on market based systems so as not to distort the market.
- Support for Angel investors is important – Korea has widely supported angel investors through eight matching funds and tax incentives.

Box 4: Win-Win Package Loans

Implemented by Hana Bank and the Ministry of Gender, Equality and Family in 2010, the Win-Win package loan was designed to support SMEs who have supply-chain partnerships with large corporations and, therefore, have the potential to benefit from shared growth. Loans are offered to contractors and sub-contractors based on the credit of the large-sized corporations providing SMEs with relatively cheaper cost of borrowing than when they source directly. The large corporations work with their partnering SMEs to apply for loans for partnering companies at low interest rates.

As of 2013, US\$0.32 billion of loans had been disbursed through 355 SME-Large corporation partnerships.

Source: IFC (2014) Enhancing SME Access to Finance Case Studies.

²⁰ KOREG provides support and re-guarantees to the 16 regional CGS's. It is part funded by government and part funded through membership fees and financial institution contributions. More information can be found here: <http://www.koreg.or.kr/english/index.jsp>. A detailed analysis of Korea's CGSs can be found at: http://foroiberoamericano.redegarantias.com/documentos/presentaciones/panel_31_2015.pdf

²¹ OECD (2014a), Industry and Technology Policy in Korea, OECD Publishing Paris.

²² The paper written by Jones and Kim (2014) "Promoting the Financing of SMEs and Start-ups in Korea" gives a good overview of the South Korean experience and lessons learnt.

3.2 The UK Experience

The Breedon Report estimated that between 2012 and 2016 demand for business finance in the UK could exceed supply by between £84bn and £191bn, of which between £26bn and £59bn related to SMEs. As a result, the government has introduced a broad range of initiatives to tackle the issue. A summary of how the government is supporting SME financing is given in table 1 below.²³

Table 1: UK Government Support to SMEs

Programme	Terms	Output
Loans		
Funding for Intervention Scheme	Cheaper borrowing for banks and building societies	More and cheaper loans and mortgages (does not only target SMEs)
National Loan Guarantee Scheme	Government guarantees on unsecured borrowing by banks.	Cheaper business finance by reducing the cost of bank loans under the scheme by up to 1 percentage point.
Community Development Finance	Loans to a specific disadvantaged geographic area or disadvantaged groups	Varies but can include loans to start-up companies, individuals and established enterprises from within that community who are unable to access finance from traditional sources.
Enterprise Finance Guarantee	Loan guarantee to SMEs	Facilitates additional lending to viable SMEs lacking the security or proven track record for a commercial loan.
Business Finance Partnership	Increase supply of capital through nonbank channels	First tranche of BFP funds will lend to mid-sized businesses, helping to diversify the channels of finance available to them
Business Finance Partnership: Small Business Tranche	Increase supply of capital through nonbank channels for small businesses.	Increase non-traditional finance such as peer-to-peer platforms, supply chain finance and mezzanine finance for businesses with a turnover below £75m.
Start-up Loans	Loans to young people (18-30) to start a small company	Open up finance to those who would not normally be able to access finance due to a lack of track record or assets.
Investment / Equity Finance		
Seed and Enterprise Investment Schemes	Range of tax reliefs	Help small, early-stage companies and small higher risk companies to raise equity finance through encouraging individual investors to purchase new shares in qualifying companies.
Venture Capital Trust Scheme	Range of tax reliefs	Help small higher risk companies raise equity finance indirectly through the acquisition of shares in a VCT.
Business Angel Co-Investment Fund	Co-investment fund	Support business angel investments into high growth potential early stage SMEs.
Enterprise Capital Fund Programme	Public-private venture capital funds	Address a market weakness in the provision of equity finance to SMEs by using Government funding alongside private sector investment to provide equity finance to early stage companies.
UK Innovation Investment Fund	Venture capital fund of funds	Invest in technology based businesses in strategically important sectors to the UK including digital technologies, life sciences, clean technology and advanced manufacturing.

Has it been effective? It is beyond the scope of this guide to evaluate the success or failure of all of these instruments.²⁴ However, a recent evaluation of the Small Firms Loan Guarantee Scheme, a forerunner to the Enterprise Finance Guarantee, suggested that entrepreneurial firms that are able to access new finance through the scheme achieve superior performance in the form of improved sales, job creation and exports justifying

²³ In addition to this, a number of public schemes relating to trade finance support have been put in place including the Buyer Credit facility, supplier credit financing facility, line of credit, project financing, export insurance policy, bond insurance policy, overseas investment insurance, letter of credit guarantee scheme, bond support scheme, export working capital scheme, foreign exchange credit support scheme.

²⁴ The 2012 Seeds of Change article provides a comprehensive overview of the institutions and schemes available. Davis (2012). Seeds of Change: Emerging sources of non-bank funding for Britain's SMEs.

public intervention in private credit markets. A cost-benefit analysis also suggested that the scheme justifies its costs.²⁵

Innovation: The UK is a major player in the development of new technological approaches to SME financing and government is proactively working with providers to determine the best framework to support this development while maintaining a competitive and sound banking industry. Tax benefits for marketplace investments are to be granted as part of the Individual Savings Accounts (ISAs). Furthermore, the government is considering making a referral scheme mandatory, under which banks would be required to forward declined loan applications to alternative lenders.

Another area where the UK may provide a glimpse into the future for developing countries is through the **development of capital markets** and the **securitisation of SME loans**. The London Stock Exchange's AIM is by far the best-known exchange through which SMEs can sell their shares to the UK public, however, several smaller markets are also trying to attract SME business. Securitisation has the potential to bridge the gap between SMEs' funding needs and the availability of bank loans, by allowing banks to partly offload SME credit risks and transfer them from their balance sheets to the capital markets. At present, this segment is still very small and SME understanding of this mechanism is minimal.

Box 5: It's not just about Supply

A recent study showed that despite UK SMEs being perceived as relatively sophisticated, there was still a reliance on traditional forms of finance and a lack of awareness of other financing options available. This has implications for policy makers and emphasises the importance of addressing demand side constraints.

- 56% of SMEs in the UK have used external finance in the last 3 years. The types of finance used are bank overdraft (31%), credit card finance (22%), a loan from an individual (16%), a bank loan or commercial mortgage (14%) and leasing/hire purchase (13%).
- Equity finance is less commonly used. Of those using equity finance this was mainly from friends and family or other businesses rather than venture capitalists and business angels.
- Non-bank sources of finance including mezzanine and peer to peer lending were used by less than one per cent of businesses.
- Study on tax incentives generating investment showed negligible effect.

Businesses were cautious about using alternative funding sources. Whilst 49% would consider leasing or hire purchase, only 23% considered peer to peer lending, 16% invoice finance, 8% equity finance from VCs or business angels. Just 4% would consider mezzanine finance, and 3% equity through crowd sourcing.

Source: *BMG Research (2013) SME Journey Towards Raising External Finance*

What can we learn?

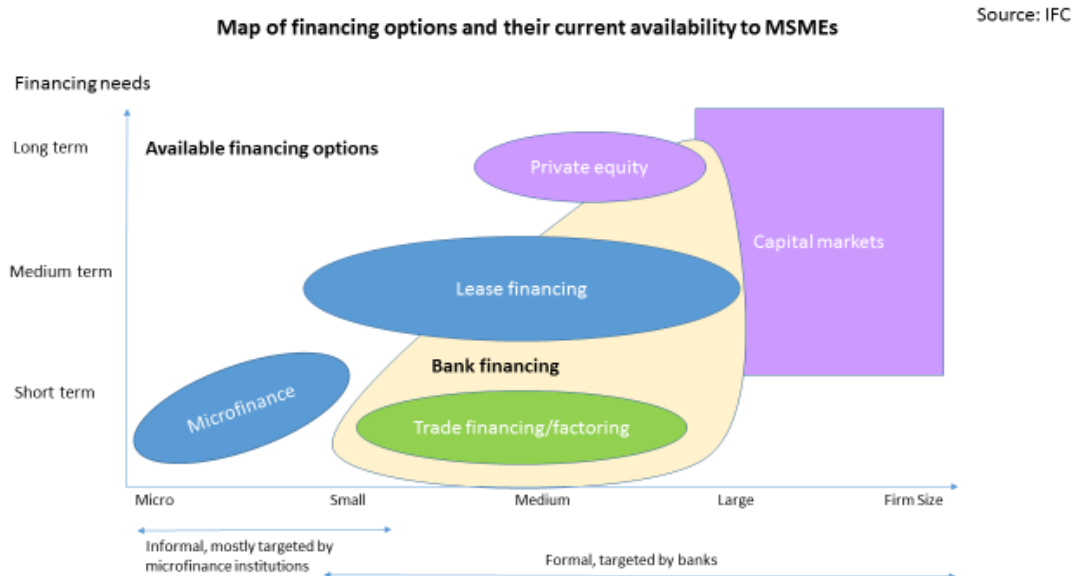
- It is not all about supply (see box 5). Support needs to be provided to SMEs to ensure they are aware and able to access different sources of finance available.
- Embrace new technology – development partners should work with governments to ensure that an appropriate regulatory structure is in place to encourage the development of this sector while maintaining the integrity of the market.
- Review and adapt – instruments should be continually reviewed and adapted to ensure they remain relevant and continue to deliver their objectives.
- Next stages – the ability of SMEs to access finance through capital markets should be considered as part of the longer-term development of SME finance.

²⁵ Cowling, Marc and Siepel, Josh (2013) Public intervention in UK small firm credit markets

4 Financial Instruments - What works?

A broad range of instruments is now available to financial providers globally, though provision in developing countries is mixed due to both demand and supply side constraints. Figure 3 illustrates the typical use of instruments by size of organisation.²⁶

Figure 3: What financial products do SMEs use?



This section will present a selection of key, available instruments, review the evidence as to their success and highlight issues to be considered by development partners when designing SME financing schemes.

4.1 Partial Credit Guarantee Schemes

A partial credit guarantee (PCG) fund is a risk transfer and risk diversification mechanism. It lowers the risk to the lender by guaranteeing repayment of part of the loan in the event of default.

Overview. A PCG fund can help diversify risk by guaranteeing loans across different sectors or geographic areas. Partial (and full) credit guarantee funds have existed at least since the beginning of the 20th century and have become more popular over the past decades.

PCG schemes feature prominently among donor interventions.²⁷ While they also exist on a purely private basis (and increasingly public/private schemes are becoming more common), governments and donors have been aggressively pushing for their establishment to overcome the limited access to bank credit SMEs face. These schemes have been put in place with or without supporting technical assistance (TA). By providing a guarantee, such a scheme can:

- Help overcome the lack of collateral of most SMEs (and thus the issue of risk);
- Compensate for low profit margins due to the high cost of lending to the SME sector;

²⁶ IFC and McKinsey and Company (2010). Two Trillion and Counting. Assessing the credit gap for micro, small and medium-size enterprises in the developing world.

²⁷ For an overview of the literature on PCGs, see World Bank (2007) and Beck, Klapper, Mendoza (2010).

- Produce additionality.²⁸

The funding of PCG schemes can also be motivated by resolving coordination failures between private-sector entities, which prevents them from pooling their resources to operate their own schemes effectively. The rationale for PCG schemes is summarised in the simple logic model below.

Figure 4: Simple Results Chain for Credit Guarantee Schemes



PCG schemes can operate on a local, country, regional or even global level and can consist of different types of guarantees covering a broad range of financial products including loan, trade finance and cash flow management products.²⁹ Donors operate directly and through DFIs and NGOs that generally provide both funding and TA support. While potentially losing some autonomy in terms of scheme focus and decision-making, large DFI managed schemes can improve value for money through economies of scale and experience in implementation. A general overview of the pros and cons/risks of PCG schemes is summarised in table 2.

Table 2: Credit Guarantee Schemes - Advantages and Challenges

Advantages	Risks/challenges
<ul style="list-style-type: none"> • Overcome bank’s risk aversion to lend to SMEs caused by information asymmetry • Overcome failure of collateral based lending, especially where contract enforcement is weak • Effective in leveraging large sums of additional lending • Potential cost reduction for lending to SMEs • Improve the loan appraisal capabilities of the banks and systems of monitoring • Overcome the risk of innovating new business models, products, outreach mechanisms • Achieve financial and economic additionality and transformation of sector 	<ul style="list-style-type: none"> • Demand side weaknesses make for high rates of NPLs without and with the scheme. • Potential low demand for a CGS. Lack of liquidity or better returns from other asset classes prevent additional SME lending • Risk of low additionality (the SME lending would have happened anyway) • Potential abuse of the PCG scheme by the banks and SMEs (moral hazard risk that excessively risky loans are placed under the CGS) • Cost of guarantee premiums makes for untenably high cost of borrowing • Unwillingness of the banks or borrowers to pay for the guarantee making the scheme underused • Failure of the scheme to change behaviour & business models results in failure to deliver wider, systemic impacts.

Increasingly donors are using PCG schemes as part of a broader tool kit to address financial sector market issues (see box 6) and to address specific welfare objectives by using such schemes to promote the growth of priority sectors such as technology, women-led SMEs or agribusiness.

Issues of appropriate pricing, funding and the institutional structure are important. While such schemes could be run on a self-sustainable basis, they often involve significant subsidies and contingent fiscal liabilities to cover losses. While it is difficult to compute such costs prior to operation, it is even more difficult to measure the benefits or additionality, i.e. the share of borrowers that would not have gained access to finance if it were not for the PCG. Ultimately, the cost of any government intervention has to take into

28 Financial additionality is ensured through the requirement that guaranteed loans are only issued to borrowers that have exhausted all other sources of funding (Cowling and Siepel, 2013). Economic additionality can be assessed in terms of firm level growth and spillovers.

29 The types of guarantees provided are determined by the nature of the individual scheme but can include loan guarantees, loan portfolio guarantees, portable guarantees, bond guarantees, partial guarantees or full guarantees. Products covered can include advance payment guarantees, bank loans, bank guarantees, commercial paper, contract financing, finance bonds, invoice discounting, loans from NBFIs, letters of credit, pre-shipment receipts, performance and bid bonds, purchase order financing, trade and commercial bills, transaction liabilities and warehouse receipts.

account the return on each dollar of taxpayer's money in such an intervention compared to other interventions, including interventions outside the financial sector.

The extent to which PCG schemes can leverage funding is measured by the ratio of outstanding guarantees to equity (multiplier) and is one way of judging success. In determining ideal levels of leverage, the default rate must be considered as schemes must be able to meet their obligations but ideally should not hold surplus funding. Multiplier rates vary between 3 and 20 (generally dependent on the risk of the portfolio). Funds in the MENA region, for example, have a relatively low multiplier at 3.4 (with average coverage ratios of 68%). At the other end of the spectrum, Hungary has a multiplier of 20 (largely due to the high share of guarantees that are counter-guaranteed by government) with coverage ratios of 90%.³⁰

Evidence. There have been few rigorous impact assessments of PCG schemes, though the few that have been undertaken point to a somewhat positive effect.³¹ Two separate studies suggest that the Chilean scheme has generated additional loans for new and existing bank clients and that the additional loans have led to higher sales and profit growth.³² However, another study questions the additionality effect as approximately 80% of the firms that benefit from the guarantees had bank loans in the past³³. Comparative evaluations are few and far between due to heterogeneity across schemes. More evidence is needed in this respect.³⁴

Despite the debate over their impacts, it is generally agreed that guarantee schemes must be carefully designed and continuously evaluated if they are to stand a chance of delivering the desired public policy objectives. Without this, guarantee schemes can result in the misallocation of resources, the crowding out of private collateral and unnecessarily increasing public debt.

Box 6: Business Finance for the Poor - Bangladesh (BFP-B)

The DFID funded BFP-B programme, takes a market systems approach to ensuring that SMEs gain access to the financial services from which they are currently excluded. The 5-year programme consists of three components:

First, it will introduce a sizeable number of new borrowers to Bangladesh's private commercial banks by providing partial loan guarantees to qualifying SMEs under the Credit Guarantee Fund. Secondly, the Business Finance Challenge Fund is designed to spearhead innovation in financial sector products and delivery channels and to spur development of demonstrably useful and practical business advisory services aimed at making SMEs more commercially minded, better managed, and better prepared to expand and prosper. Finally, the Policy Component will actively engage with stakeholders from banks and other FIs to regulators, academics and representatives of donor agencies, to solicit and promote ideas designed to strengthen the enabling environment for SMEs.

Box 7: PCG Schemes vs Loan Subsidies

A 2009 study examining alternative forms of support by government to SMEs found that government agencies with tight budget constraints are better off providing guarantees rather than subsidising loans. Guarantees have certain advantages over direct subsidised government lending. Firstly, the final lending decision stays with a market-based, private-sector entity – the bank –, which has the expertise and the necessary technology to evaluate credit applications and projects. This is likely to ensure a more efficient selection among borrowers than if the task is carried out by a public agency (and, given that the guarantee is partial, some part of the risk remains with the lender). Second, compared to direct lending programmes, guarantee schemes have much lower initial cash flow needs, and as such, have a leverage component. As a result, they can be used when fiscal constraints are tight.

Source: Arpina, Lóránth & Morrisson (2009).

³⁰ Saadani, Arvai & Rocha (2010). *A Review of Credit Guarantee Schemes in the MENA region*. World Bank.

³¹ See Lelarge, Sraer, and Thesmar (2010) in the case of the French credit guarantee scheme and Larraín and Quiroz (2006) for Chile

³² Cowan, Drexler, and Yañez 2009; Larraín and Quiroz 2006

³³ Benavente, Galetovic, and Sanhueza 2006

³⁴ The OECD-DAC's Working Party on Development Finance Statistics has embarked on an effort to capture the impact of guarantees in order to feed the OECD-DAC work to modernise statistics on external development finance post-2015.

So What Works? Table 3 discusses characteristics of successful schemes and highlights issues to be considered when designing such schemes³⁵.

Table 3: Credit Guarantee Schemes - What Works?

Design Feature	Overview of Issues	Best Practice
Target groups	<ul style="list-style-type: none"> Targeting the scheme (e.g. on specific sectors, geographies) can help maximise the additionality effect. However, too specific targeting can increase the bureaucratic costs (e.g. through verification). 	Moderate targeting
Government Institution vs Separate Entity	<ul style="list-style-type: none"> Where schemes are initially implemented through a public institution, they should eventually be transferred to a stand-alone entity. There are examples of purely private-sector initiatives, such as Italy's network of mutual guarantee schemes, "Confidi". 	Establish a legally separate entity
Funding / Costs / Profits	<ul style="list-style-type: none"> If fees are too high, lenders might be reluctant to use the fund, and it can result in the exclusion of good customers. While fees should cover operating costs, the fund itself should be able to cover cost of claims. Most schemes receive lump-sum payments to set up the fund but additional funding options include a levy on participating banks, continued subsidies through soft loans and direct budgetary appropriations. 	Operate on a profit-making basis to cover operating costs with reserves in place Keep fees proportionate
PFI, staff and management capacity (TA vs no TA)	<ul style="list-style-type: none"> The selection of PFIs is key to success or failure of a fund. It is necessary to have experienced local staff and representatives of borrowers and lenders in the scheme's management. Evidence shows that TA to support small scale lending for banks can have an impact on the long-term sustainability of the scheme. Training and advice for borrowers can also impact the demand for loans and increase attractiveness to lenders through provision of guidance on preparation of loan applications, financial statements etc.³⁶ 	Capacity of implementing organisations key to success of fund. TA in credit analysis and product design can ensure sustainability.
Size of Bank / Centralisation vs Decentralisation	<ul style="list-style-type: none"> Both large and small banks can deepen services to SMEs through the use of guarantee funds Small banks often have an advantage in understanding niche segments while large banks are better suited to developing innovative approaches in areas such as credit scoring. Commitment to the SME segment is more important. Decentralisation can also show positive results working through a branch network of participating banks (e.g. Japan), but this does result in a costlier solution. 	Capacity to reach out to SMEs and commitment more important than size of banks
Selective vs portfolio approach	<ul style="list-style-type: none"> Individual loan-level guarantees involve the guarantee agency in the screening stage to review eligibility and risk profiles. In this approach, lenders will usually first approve the loans and then seek a guarantee approval on the borrower's behalf. The "portfolio" model allows lenders, to assign guarantees to higher risk loans or targeted borrowers and inform the guarantors after the loans are approved or the loan defaults. While the loan-level approach might allow for more careful screening and risk management, it is also costlier for the credit guarantee fund. 	Selective approach at pilot stage followed by hybrid scheme allowing guarantees to be extended to a portfolio of loans up to a limit, after which loans would be screened.
Type of lending	<ul style="list-style-type: none"> At a minimum, funds should be available for extension of guarantees for working capital, funds for investment and leasing. 	Define purpose, products, loan size and limits

³⁵ The World Bank identified some best practice principles for designing PCG schemes: Principles (for Public Credit Guarantee Schemes for SMEs), Consultative Document: World Bank (2015). The IFC also provides guidance on the optimal design of credit guarantee schemes in its IFC SME Finance Policy Guide (2010)

³⁶ This can, however, lead to potential problems. Firstly, it is important to ensure that the SME does not see the loan as a form of donor assistance. Secondly, banks must evaluate SME risk and not use donor engagement as a proxy for creditworthiness. (AFD 2012)

	<ul style="list-style-type: none"> ▪ Definition of maximum loan sizes and limits on exposure to any single borrower and lender should be established. 	
Collateral vs no collateral	<ul style="list-style-type: none"> ▪ Guarantees can help close the financing gap by substituting collateral provided with credit protection provided by an external guarantor. ▪ Guarantees and collateral are often used together on the same loan. This is not a problem if no overlap exists between the share of the loan covered by the collateral and the one covered by the guarantee. ▪ Partial collateralisation can also reduce the borrower's incentive to default. However, guarantees clearly do not meet their objectives in broadening credit supply if they are used as a backup protection on a collateralised loan. 	Caps on the level of collateral can be used to ensure additionality criteria is upheld. ³⁷
Sharing of risk / Screening and Monitoring	<ul style="list-style-type: none"> ▪ Under a first loss guarantee (also known as a joint and several guarantee), the fund is required to pay an agreed percentage of the outstanding loan at the moment of the default. The remaining is covered by the lender, which can also retain the proceeds from the realisation of any collateral provided by the defaulting borrower. ▪ A final loss scheme will consider any recovered monies, which are shared in a pre-agreed ratio between the financier and the guarantor. ▪ Clear division of responsibility between guarantor and lender should be established with screening and monitoring functions the responsibility of the lender. 	Risk sharing mechanism and responsibilities for screening and monitoring should be well-defined with partner institutions.
Coverage rates	<ul style="list-style-type: none"> ▪ Appropriately set coverage rates ensure an equitable distribution of risk among all participating parties (guarantor, lender and borrower). ▪ Too low a coverage ratio might reduce the value of the guarantee and dampen take-up, while too high a coverage ratio could incentivise the lenders to take excessive risk. 	Coverage ratio defined to take into account take-up and risk
Defaults and Claims	<ul style="list-style-type: none"> ▪ Trigger conditions for default should be clearly defined and claims handled in a timely fashion. ▪ A vigorous post-claim loss recovery procedure should be established. 	Clear definition and claim recovery process
Regulation and supervision	<ul style="list-style-type: none"> ▪ The scheme should be subject to prudential standards and supervision, including capital adequacy requirements, loan portfolio evaluations and provisions, mandatory accounting standards and establishment of a debtors reporting system. ▪ The best supervising body will be dependent on the country involved. 	Scheme should be subject to legal and regulatory supervision
Sustainability and Longevity	<ul style="list-style-type: none"> ▪ Schemes should aim at self-sufficiency and stability by building up reserves with plans in place to ensure progression to a sustainable stand-alone entity. ▪ Although may be appropriate to limit length of guarantees for individual firms (e.g. start-ups) there is no reason why the scheme itself should be limited in its lifetime once operating sustainably. ▪ Partial reinsurance of the scheme with a counter-guarantor could be considered. 	Sustainability achievable through build-up of reserves from appropriately priced guarantees.

In determining the most appropriate features and characteristics of individual funds the implementer should be clear (and realistic) about desired outcomes. A guarantee is unlikely to influence the strategic direction of a FI but may increase volumes of lending (demonstrating profitability of the segment), may accelerate ventures into new markets and may encourage new approaches to lending or credit analysis.

³⁷ See Vienna Initiative Working Group on Credit Guarantee Schemes, 2014

It is also important to ensure coordination among schemes to avoid duplication of efforts and overlap in targeted groups. In some countries (e.g. Kenya), multiple initiatives are in place with providers unaware of the existence of each other's schemes.³⁸ In some cases, FIs have signed up to the schemes but are not using them with some loan officers unaware of their existence. In particular countries where schemes have failed (be it financially or due to limited take-up) it is crucial to understand what caused these failures and address any regulatory or broader financial sector constraints as part of a package of interventions. The sharing of good practice is encouraged and forums such as the SME Finance Forum can contribute to this.

Box 8: Financing Women Owned SMEs, Ethiopia

Through its Development Credit Authority (DCA) guarantee programme, USAID worked with the Bank of Abyssinia (BOA), Ethiopia's third largest bank, to offer loan financing assistance specifically to target women-owned SMEs by guaranteeing up to US\$4.3 million in loans over 7 years (2008-2014).

The programme successfully demonstrated that women are credit-worthy, however, analysis showed that the guarantee has not influenced BOA's credit underwriting policies which are standard across SME lending activities and based on collateral. This has been largely due to an overall restrictive regulatory environment requiring, for example, 85% of loans disbursed by a commercial bank to be collateralised. This demonstrates the importance of the regulatory environment surrounding the CGS. In addition to this, research has shown that a risk-sharing mechanism by itself may be insufficient in convincing bank partners to lend to women-owned SMEs. It is crucial to identify the full cross selling, customer loyalty, and market-share benefits that support the business case.

Source: Heather Kipnis (2005) *Financing Women-Owned SMEs: A Case Study in Ethiopia*. QED Group for USAID.

4.2 Credit/Equity Lines to Financial Institutions

Credit / Equity Lines refers to the provision of financing to banks and non-bank financial institutions, to increase the amount of finance available to SMEs.

Overview: Providing credit or equity lines to financial institutions in developing countries is particularly favoured by both bi- and multilateral DFIs. In addition to this, loan or equity funds can be managed by the private sector, governments or donors directly. The largest funds receive support from multiple donors and can invest in many FIs regionally or even globally.³⁹ Financial support is often complemented by TA, which can lead to increased capacity in SME banking and can contribute to both a quantitative increase in the FI's business with SMEs as well as a qualitative improvement of the FI's product offering (i.e. more accessible and/or longer-term credit). The increased quantity and quality of credit for SME customers is expected to impact SME decision-making with regard to growth strategies (investments) and employment, and encourage sustainable business models. A simple logic model for this rationale is illustrated below:

Figure 5: Simple Results Chain - Credit/Equity Lines to FIs



³⁸ From interview with Chris August, Credit Guarantee Expert and Team Leader of DFID's Business Finance for the Poor, BFP-B programme in Bangladesh (January 2015).

³⁹ Examples of funds are numerous but include: (i) European Investment Fund (part of the EIB group) - provides loans and equity to banks as part of its broader portfolio of support to SMEs <http://www.eif.org/index.htm>. (ii) Credit lines to banks also forms part of DFID's Global SME Finance Initiative.

The advantages and risks of this mechanism are highlighted in Table 4:

Table 4: Credit/Equity Lines to Banks - Advantages and Risks

Advantages	Risks/Unintended Consequences
<ul style="list-style-type: none"> • Private sector FIs are better than development or government institutions at targeting and reaching the healthiest and most creditworthy SMEs. • FIs are better at assessing and analysing risk. • FIs are commercially and not politically driven. • Market based investment decision making minimises market distorting effects. • Cost – development partners do not manage funds directly resulting in cost efficiencies. In the cases of large funds economies of scale can be achieved since management and administration can be leveraged across a larger pool of funds. • Additionality – Instrument targets risky funding that would not be otherwise done in the market. • Transformation – strengthening of FIs can have positive impacts on the broader financial system. • Demonstration – successful examples of funding SMEs can encourage others to enter the field thereby increasing the level of funding and keeping prices competitive. • Sustainability – particularly where the FI has realigned its strategy to focus on the SME segment, sustainability is likely beyond the term of funding. 	<ul style="list-style-type: none"> • Crowding out of private sector investment can occur when DFIs are providing cheaper finance than can be raised elsewhere (i.e. by local investors); this can be mitigated by adopting market rates. • Lack of additionality: <ul style="list-style-type: none"> (i) in cases where investment is made in countries where the banking system is already liquid. (ii) Increases the incentive for local banks to earn money by lending money provided by others. (iii) DFIs are lending to the ‘best’ FIs instead of taking the risks that others are unwilling to take. (iv) when investors continue to fund ‘successful’ FIs rather than exiting once they have achieved the demonstration effect. • Focus generally is on strengthening FIs rather than increasing their ability to serve a specific segment and therefore funds may not always reach intended recipients • May reduce competition in market, acting as a disincentive for others to expand business to SMEs. • When investing in large DFI facilities that subsequently invest in banks, development partners can sacrifice control over the funds’ direction and impacts

Evidence: Much of the available evidence in this area focuses on the success of institutions or funds rather than specifically focusing on the impact on SMEs themselves. Where evidence is available, findings show that effectiveness is influenced by:

- the type and quality of partner financial institution (PFI),
- extent and quality of supporting TA,
- the type of financial inputs provided,
- the conduciveness of sector and macroeconomic environment.

The evidence to support the use of these instruments in reaching target areas is mixed (see box 9). In many cases, funding to banks is made with the prime objective of contributing to the FI’s overall strategy and needs. This is justified as the investment provides it with resources it cannot raise in the local credit or capital market, which will lead to the growth of all bank strategic portfolios, including SMEs. However, without specific incentives attached to the majority of funds provided, funding does not always filter down to the target portfolio. Loans in foreign (hard) currency, for example, may have the effect of increasing lending to larger corporate customers who have a need for it at the expense of SMEs. Arguably, however, such lending will also free up other resources, such as domestic deposits that can then be lent to SMEs.

Box 9: A Review of IFC Investments

Concerns over the effectiveness of IFC’s core model of using financial intermediaries were raised in a recent evaluation by the World Bank’s Independent Evaluation Group (IEG). A review of 166 IFC investment projects that target SMEs through FIs showed that only 20% of the projects define SMEs and have provisions mentioning SMEs as beneficiaries.

In addition to this, “for this evaluation, IEG reviewed 82 IFC investment projects that sought to support SMEs through financial intermediaries. Of these, around 40% did not meet SME financing targets.” Evaluators found that the macroeconomic environment and changes in the FI’s strategy, especially in the case of banks, were key determinants of failure. In addition, the IEG also state that “equally problematic in gauging efficacy is the secrecy surrounding the clients of banks supported by IFC”. According to the IEG, “it is unclear what impact these investments are having at the firm level and there has been no attempt to assess impact through a systematic study”.

Source: Romero and Van de Poel (2014). IEG (2014).

So what works? It is clear that there is a role for this type of development funding, however, there is also considerable scope for improving the effectiveness of such schemes to ensure sustainability of impact. Table 5 discusses the characteristics of successful schemes and highlights issues to be considered in the design of programmes.

Table 5: Credit/Equity Lines to FIs - What works?

Design Feature	Overview of Issues	Best Practice
Reaching target groups	<ul style="list-style-type: none"> ▪ Funding may not reach target segments as it is supporting general funding capacity of the FI. ▪ Long term strategic change of FIs may not be achieved by funding alone. ▪ Where funding is limited, FIs may have little incentive to expand product offering away from most profitable segments. 	Incentives for targeting SME sector supported by TA
Partner Financial Institutions	<ul style="list-style-type: none"> ▪ Strategy and commitment to SME sector more important than size. There is evidence that smaller financial institutions have an advantage in reaching out to SMEs nearby, whereas larger financial institutions might be better placed to use new and innovative lending techniques. ▪ Capacity of institutions to work with SME sector (particularly in specialist areas such as agriculture) is important. 	Size not important. Identify PFIs committed to SME segment
Type of Investment	<ul style="list-style-type: none"> ▪ Credit or Equity? Funding should be provided according to the binding constraint and the extent to which it provides leverage. ▪ Loans are usually made in foreign 'hard' currency which may favour on-lending to larger companies who have a greater demand for this. 	Consider key constraints of PFI and potential for leverage
Country focus	<ul style="list-style-type: none"> ▪ To ensure additionality and ensure funds are not market distorting, investments should focus on markets that are underdeveloped and poorly served. ▪ Ensure markets are not already liquid 	Target poorly served illiquid markets
TA	<ul style="list-style-type: none"> ▪ Complementary TA can make a big difference in ensuring sustainability beyond the lifetime of the programme.⁴⁰ ▪ Supporting TA to encourage uptake by SMEs can also be valuable. ▪ Effective TA can include: <ul style="list-style-type: none"> - helping management develop an SME strategy by defining objectives, client segments, products, marketing and distribution channels and staff; - assisting in the reduction of operating costs by encouraging implementation of SME banking best practice; - improving credit risk management and supporting improvements in lending practices and loan portfolio risk management systems; and - providing sector specific support in target areas where technical knowledge is required (e.g. agriculture). 	TA adapted to specific needs of institution and sector
Cost and Exit Strategy	<ul style="list-style-type: none"> ▪ Development partners need to weigh up the cost of intervention through larger funds and balance this with loss of control over activities. ▪ Investors should also have a strategy for exiting investments once they have achieved the demonstration effect and private investors are ready to supply substitute funds 	Value for money should be considered. Exit strategy put in place
M&E	<ul style="list-style-type: none"> ▪ In order to ensure greater accountability and focus on target segments, development partners need to be able to measure the impact of funding. ▪ PFIs should be tasked with showing results in return for the funding they receive. This may involve improving MIS systems and TA. 	M&E requirements built into design of programme

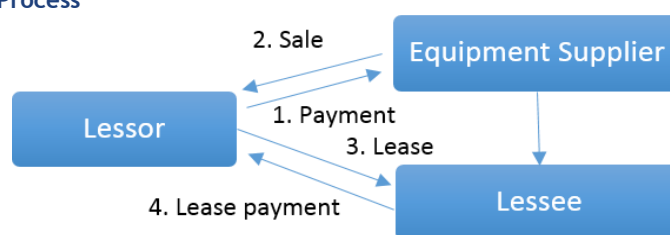
⁴⁰ It has been argued that offering 'free' TA with the provision of loans or equity acts as a subsidy to the bank and gives them a competitive advantage over other lenders thus discouraging competition in the market. It does, however, significantly improve the chances of sustainability of operations after the funding ceases and when the culture and strategy of the bank is committed to the SME segment. In most cases, the long-term impacts of TA can therefore be considered to outweigh the risks of distorting competition

4.3 Lease Finance

Lease Finance allows SMEs to obtain equipment and capital goods even when they lack the credit history or collateral to access traditional loan products.

Overview: In leasing the provider (lessor) owns the equipment and allows the applicant (lessee) to use it in exchange for periodic payments.⁴¹ Leasing, in effect, separates the legal ownership of an asset from the economic use of that asset. In this manner the lessee can access equipment that they would not otherwise be able to purchase while ensuring that the lessor has the certainty of repossession if the lessee defaults (see figure 6). In general, leasing results in lower transaction costs compared to loans and can be particularly relevant for rural and agricultural small-scale operators and in countries where the business environment is weak (i.e. post-conflict and fragile states). Generally, leasing products are offered by banks, leasing companies (owned by banks), or private leasing companies.

Figure 6: The Leasing Process



In recent years, leasing mechanisms have become much more common in the developing world as relevant accounting rules and regulation have been put in place. This analysis focuses on leasing itself but it is important to note that there are forms of asset backed financing which can play a similar role. For example, factoring (the discounting of sales receivables), is attractive for SMEs who are supplying large credit-worthy buyers, as it does not rely on information about the SME itself, but rather on their counterpart buyer. Alternatively, under a factoring contract, the finance provider purchases the seller's accounts receivable, and assumes the responsibility to collect repayments.⁴² The main advantages of leasing programmes are summarised in table 6.

Table 6: The Advantages of Leasing Finance

For SMEs	For Providers
<ul style="list-style-type: none"> ▪ Allows SMEs to access/purchase productive assets they could otherwise not afford ▪ No/low collateral required beyond leased asset. ▪ Cost is competitive with traditional credit, due to benefits of collateral and low processing and transaction costs. ▪ Provides access to medium term finance which is particularly difficult for SMEs to access. ▪ Islamic compliance: leasing is seen as an interest-free product and considered the same as a rental. “Ijarah” is a kind of leasing relevant within the MENA region. 	<ul style="list-style-type: none"> ▪ The lessor maintains legal ownership of the asset and can exert greater control over the investment. ▪ The lessor can monitor assets more easily. ▪ Lessors can actively apply specialised knowledge, providing the opportunity to extend product lines. ▪ Increases customer base and provides additional marketing channels for financial services. ▪ Improved credit scoring and processing systems that can be applied across finance providers

⁴¹ Both finance and operational leases are available. At the simplest level, under a finance lease all the risks and rewards incidental to ownership of an asset are transferred to the lessee from the lessor. An operational lease is a lease agreement in which risks and rewards associated with the asset are not transferred to the lessee and stays with the owner of the asset. This analysis focuses primarily on finance leases as this is the primary stage in leasing development in most developing countries.

⁴² Originally limited to domestic contracts, international factoring has become popular as it eases the credit and collection burden created by international sales for exporters.

For Market Development	For the Broader Economy
<ul style="list-style-type: none"> ▪ Contributes to the development of overall domestic financing market. ▪ Increases financial sector competition, having the effect of reducing the general cost of finance. ▪ Can play a critical role in bringing in small businesses into the formal financial system - as informal businesses have access to lease financing, they start to build a history of financial transactions addressing information failure and providing an incentive to formalise. 	<ul style="list-style-type: none"> ▪ Leasing finance can have knock on effects on equipment manufacturers and encourage infrastructure improvements. ▪ Leasing can support the global climate change and environmental and sustainability agenda - Lack of financing for energy efficiency equipment is identified as a major barrier to the development of this industry.

Although leasing remains a small part of most SME financing portfolios, it is increasingly seen as a key way of bridging the gap for the smallest of SMEs and can be a stepping-stone to accessing different levels of finance within the formal financial sector. Donor initiatives focus on removing the main barriers to the development of a leasing industry and can consist of a combination of institutional reforms, TA to leasing agencies and banks, and supporting financing through other channels (e.g. PCG schemes).

Evidence: Leasing alongside factoring can be very relevant for SMEs and can be particularly appropriate for targeting specific areas, such as sustainable energy and rural finance.⁴³ Being an asset-based lending form, it can also serve as an SME lending tool for foreign-owned and larger banks, which have a disadvantage in the relationship-based lending model used by small and regional banks. There are many examples where interventions in the leasing industry have been particularly effective (see box 10 and 11).⁴⁴

Direct subsidisation of leasing companies has been somewhat controversial. In many countries, it is perceived that providing lease finance to certain sectors (e.g. agriculture) will provide a means to overcome the difficulties these sectors face. However, this is rarely effective, and may actually even negatively affect the broader market by distorting competition, crowding out private investment and acting as a disincentive for new players.

So what works? Unlike some of the other instruments discussed in this guide, development partners aren't usually directly involved in the delivery of the lease finance instrument. As a result, the design of programmes to promote the leasing sector focuses on strengthening the sector itself to ensure that products meet the needs of SMEs. The following should be considered:⁴⁵

Box 10: Case Study - Leasing Provides Access to Finance Uzbekistan's SMEs

Uzbek Leasing has partnered the IFC Leasing Advisory Program in Central Asia since 2002. With declining banking penetration rates the financing needs of SMEs were not being met. Without access to term finance, SMEs were unable to implement investment plans and modernise existing facilities. IFC provided advisory services to Uzbek Leasing and granted them a loan targeted at addressing the scarcity of term foreign currency financing available for businesses to fund imported production equipment. This combined with regulatory support, TA at the company level and awareness raising in the market resulted in the leasing market in Uzbekistan growing by US\$220 million from 2001-2007. Uzbek Leasing has also served as a model that has led other leasing companies to launch operations in Uzbekistan.

Source: IFC Leasing Guide (2009).

⁴³ For a discussion on particular issues relating to rural leasing please see USAID (2006) RAFI notes, Rural Leasing Issue II. RAFI Notes Series. USAID's Offices of Agriculture and Microenterprise Development.

⁴⁴ By applying a panel data approach on a sample of ten Eastern European transition countries over the period 1999 to 2006, Haiss and Kichler (2009) showed that leasing contributes positively to economic growth. The paper goes on to suggest that leasing is complementary to credit, not a substitute for it.

⁴⁵ The IFC Global Leasing Toolkit provides a detailed guide to the introduction of leasing schemes and also focuses on those areas expected to make up the major portion of the future growth of the leasing industry specifically, agricultural leasing, sustainable energy equipment leasing and Islamic leasing.

Table 7: Leasing - What works?

Design Feature	Overview of Issues	Best Practice
Target groups	<ul style="list-style-type: none"> Leasing is particularly relevant in the most vulnerable countries, including fragile and conflict-affected markets, which usually have weak business environments and in which small entrepreneurs do not have a significant asset base and credit history. Leasing can be most useful for agriculture and other equipment focused sectors such as sustainable energy financing. 	Most impact in underserved environments with small agricultural or equipment focused SMEs with little borrowing capacity
Legal and regulatory framework	<ul style="list-style-type: none"> The appropriate legal and regulatory system is a vital pre-condition for success and sequencing is crucial when considering broader programmes in this sector. The establishment or upgrading of collateral registries can be critical in this context 	Critical to establish such framework first
TA	<ul style="list-style-type: none"> TA can play a key role in ensuring the sustainability of programmes. Often banks are offering leasing alongside other more traditional products that bank officers will lean towards as they know them better. NBFI providers may need support in developing a sustainable funding strategy that allows them to compete with larger bank providers. (Evidence from the IFC from a review of their Leasing Advisory Services Programs suggests that there needs to be flexibility in the TA provided focusing on the unique requirements of the target market). 	To be most effective TA should be adapted dependent on sector needs and FI capacity.
Funding	<ul style="list-style-type: none"> Funding (in particular longer term funding) can be a core constraint for banks and NBFIs in expanding operations in this sector. Loans, equity finance or provision of guarantees can help overcome this constraint 	Determine which funding constraint is binding
Support to Banks or Leasing Companies	<ul style="list-style-type: none"> Private leasing providers are generally the first players to enter new leasing markets, particularly in the most frontier markets. These companies may initially have an advantage in pricing, and they play a strong development role, but their advantage can be eroded quickly as banks enter the market.⁴⁶ Private providers often need to develop a unique selling point to survive – this could be in the form of specialist knowledge of a particular technical or geographic sector. Banks often need support in the processes and credit management techniques required in what is often a new product area for them. 	Both types of provider can play a significant role but often need differing support to succeed.
Partner Financial Institutions	<ul style="list-style-type: none"> Choice of PFIs is critical. Knowledge of the SME sector and commitment to its development is a key determinant of success. Development of leasing associations should be considered to support the industry. As leasing providers develop, there may be the opportunity for providers to securitise portfolios of lease receivables, which can assist in deepening the securities market (if present) and create new investment products. 	Competition can help lower financing rates and expand financing volumes and programmes should encourage this
Infrastructure	<ul style="list-style-type: none"> Should be a sufficient presence from equipment suppliers and an ability for them to supply and service/maintain the assets. 	Asses market linkages and ability of equipment suppliers to support the development of leasing
Demand-side	<ul style="list-style-type: none"> Awareness raising amongst SMEs should be considered as well as TA to support their 'readiness' for financing. 	Marketing and TA to support target SMEs
Type of financing	<ul style="list-style-type: none"> Financial support to leasing providers should be given dependent on need and be structured in such a way to avoid market distortion (can include loans, guarantees or equity) in leasing providers. It is also important to develop a clear exit strategy⁴⁷ 	Define purpose, products, loan size and limits

⁴⁶ IFC's experience indicates that NBFIs are more vulnerable to adversity than banks because of their limited access to and relatively higher cost of funding.

⁴⁷ IFC review of best practice in this area can be found at:

<http://www.ifc.org/wps/wcm/connect/5f99ac004aaaadb68137d39e0dc67fc6/Leasing.pdf?MOD=AJPERES>

Box 11: Leasing - The Evidence

IFC Africa Leasing Facility - launched in 2008 to promote the role of leasing in 15 Sub-Saharan African countries. The main goal was to increase the volume of lease transactions carried out in the region, to create the enabling environment for the leasing sector, to raise public awareness, build the capacity for lessors and other stakeholders, and mobilise investment capital. An evaluation found that the programme met its objectives with 10 leasing laws or regulations introduced and the adoption and implementation of recommendations resulting in a stronger enabling environment. It could not, however, determine whether the target volumes of 6,090 lease transactions (value of at least US \$609 Million) had been met. The study did find that a multi-country approach was effective in terms of value for money, reducing cost per country from \$1million to \$230,000 per country.

The 2006 World Bank paper, **Buffalo, Bakeries, and Tractors**, reviews cases from Pakistan, Uganda and Mexico reinforcing the case for supporting the development of leasing services in rural areas. The case studies found that leasing is a key way for rural SMEs to access finance for the first time. They did, however, also find that in two out of the three cases additional collateral is requested to secure the funding provided. Finally, all three cases considered had benefited from access to government or donor funds to jumpstart their leasing operations.

Sources: IFC End of Programme Evaluation (2014), Haiss and Kichler (2009) and World Bank (2006)

4.4 General Equity Funds to SMEs

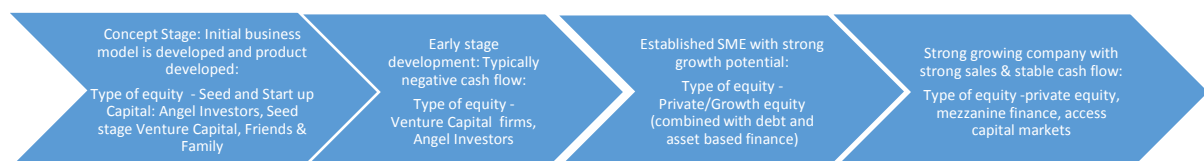
Equity financing refers to the provision of money in return for an equity stake, such that the investor shares in the profits and losses of the SME.

Overview: From an investor's perspective, an equity investment in a company has the potential for significant capital gains if that company is successful. From the SME's perspective, it provides an additional source of capital to grow the business, which is not subject to roll-over risk (i.e the risk that a bank or NBFIs will not renew a loan).

As with debt, SMEs find it difficult to access the equity funding needed to grow their business. The SME equity gap arises when the amount of capital that would be invested in a well-informed and competitive market is different to the amount actually invested. This market failure can be explained by imperfect or asymmetric information between finance providers and SMEs.

Why do SMEs need equity funding? In the early stages of SME development, when cash flow is not yet regular, bank debt is often not available in sufficient amounts making equity (through formal or informal sources) the primary source of finance. Even well-established SMEs face a number of challenges when trying to access local or international capital markets. The cost of raising capital tends to be considerably higher for SMEs, partly because of the perceived greater risk associated with lending to or investing in such enterprises and the compliance costs associated with accessing capital markets (where present). The scale of the equity gap has been exacerbated by recession and by the decline in bank lending in recent periods.⁴⁸ The type of equity support generally required depends on the stage of development of the SME. Figure 7 summarises these stages.⁴⁹

Figure 7: Equity Financing needs at different stages of SME growth



⁴⁸ Wilson and Wright (2015). The Equity Gap and Knowledge based Firms

⁴⁹ It is important to note that this equity finance is usually complementary to other forms of debt finance, invoice and supply chain finance particularly in the 3rd and 4th stages.

The sub-optimal provision of equity funding to SMEs provides a justification for intervention by governments and development partners. This largely mitigates a key argument against public sector involvement revolving around the crowding out of private investment. The positive externalities relating to R&D spend and innovation can also provide a rationale for such schemes.

Investment through capital markets aside, there are 3 main types of equity investment:

- Private equity – the direct provision of long-term financing in return for an equity stake in a company. It can include venture capital, (the seed to expansion stages of investment), management buy-outs and buy-ins and angel investment⁵⁰.
- Investment funds – investors pool money and are issued shares (or units if a trust structure) in the fund itself. The fund then invests in individual companies.
- Preferred equity (or mezzanine equity) is a class of ownership in a company that has a higher claim on the assets and earnings than common equity but does not carry voting or management rights. This type of equity tends to be used to finance more sophisticated SMEs who are better equipped to access finance. As a result, we will not focus on this in this guide.

Over the last decade, development partners have expanded their participation in SME equity funds although they remain a relatively small portion of most portfolios. The instrument is considered to be one of the riskier forms of SME finance. Despite this, equity funds that focus on SMEs are being recognised as potentially profitable with significant development impact potential. Investing in SME focused equity funds allows development partners to connect with SMEs that they otherwise would be unable to reach directly.

Governments are also increasingly introducing schemes to encourage investments in equity through tax breaks for investors (discussed in section 4.5).

Evidence: Equity investment in SMEs is growing at a fast rate. According to African Private Equity and Venture Capital Association, private equity funds invested \$8.1 billion in African companies in 2014, the second highest total ever after the \$8.3 billion in 2007. This trend is set to continue.

There is evidence that industries in which private equity funds are active, are better governed and tend to increase productivity, output and employment more than those without.⁵¹ There is, however, a lack of cross fund comparisons on equity funds and much of what we have learnt is from individual case study examples (see box 12). Israel provides a good example of where schemes to promote the venture capital sector have resulted in a flourishing industry⁵².

Box 12: The Evidence

Africa Agricultural Capital (AAC) is an East African venture capital fund established in 2005 and investing in growing SMEs who play a key role in East Africa's agricultural markets.

A 2011 evaluation, profiling 5 of its investees who comprise around 30% of the portfolio by value, found significant business growth arising from investment, with total turnover across the five businesses increasing by 30% since investment. Profits and customer numbers had also risen. All have since gone on to raise third party investment.

Small Enterprise Assistance Fund, (SEAF) is a privately managed investment fund that provides growth capital and business assistance to SMEs in emerging and transition markets.

A recent review of the SEAF found that:

- every dollar invested by SEAF in a SME generates an additional twelve dollars in the local economy.
- 72% of new jobs generated go to unskilled or semi-skilled employees.
- SEAF companies sustained an average annual employment growth rate of 26% and a wage growth rate of 25%, surpassing national growth rates for each country

Source: Gatsby Foundation (2011). SEAF (2007)

⁵⁰ Angel Investors refer to established entrepreneurs or high net worth individuals who may invest in early stage companies for reasons that are altruistic and not just financial.

⁵¹ Globalization of Alternative Investments: The Global Economic Impact of Private Equity Report, 2010, WEF

⁵² See Lerner (2010) The future of public efforts to boost entrepreneurship and venture capital for an overview of the growth of the venture capital industry in Israel.

Business incubators and accelerators are intermediaries that support the venture capital industry by preparing companies for growth and investment. These organisations provide a combination of capital, mentorship, technical support, infrastructure, and other critical resources. Unlike VC firms, incubators and accelerators are not funds as such and generally provide only small amounts of financing. Through its focus on start-ups and early stage SMEs, evidence shows that careful planning of incubators may present a pathway to stimulate economies particularly in developing countries.⁵³

The growth in angel investment provides a great opportunity for SMEs, however, it is not without its difficulties. Many angels are focused on returns and lack the organisational structure to efficiently source the best deals. In some countries development partners have stepped in to help formalise groups of angels, resulting in cost and transactional efficiency, improving deal sourcing and providing training for the angels themselves (e.g. USAID Jordan Competitiveness Programme).⁵⁴

So What Works? It is clear that equity finance can be a beneficial source of risk-financing for SMEs (including high-risk SMEs) in their early stages. It is important to stress, however, that it is more mid-sized rather than smaller businesses that will be willing to accept outside equity owners and that are large enough to provide the sufficient absolute return for such equity investors to justify the fixed costs of screening and monitoring. It also has the benefit of potentially providing a good return to investors and can be a key way of combining private and public sector funding in sustainable investment models.⁵⁵ In addition to a supportive legal, regulatory and tax framework discussed in section 5, table 8 highlights best practice in considering programme design.

Table 8: Equity Finance - What Works?

Design Feature	Overview	Best Practice
Fund structure / Attracting Investment	Combining public and private funding provides opportunities to leverage investment. For example, CDC reported that during 2004-2008 it committed \$ 7.1 billion to funds that attracted three times the amount from commercial investors. In their 2008 Report, the AsDB reported an even higher mobilisation factor, of over \$8 for every \$1 invested.	Blending private and public funding to leverage further private investment
Fund Size	SME focused private equity funds, with average investments below \$2 million, have generally produced relatively low financial returns ⁵⁶ . This outcome has been a reflection of: <ul style="list-style-type: none"> high transaction costs, comparatively small overall size of the funds with resulting difficulties to attract good managers, and absence of exit prospects in markets without liquid stock markets. 	Investments over \$2m to ensure economies of scale in operation
TA	<ul style="list-style-type: none"> Supply side: Equity fund management requires highly skilled staff which is often lacking in developing countries. Demand side: SMEs may not have the skill sets required to access equity investment or even the knowledge of them. Developing a pipeline of investment ready SMEs ensures sustainability of deal flow. TA can increase chances of success of investments targeting operational improvements. 	TA to support both demand and supply side stakeholders
Type of equity product	Start-up and early stage companies may benefit more from working with VC funds and angel investors while private equity and general equity funds may be more appropriate for SMEs in their early growth stage.	Dependent on stage of development of SME
Timing / Exit Strategy	<ul style="list-style-type: none"> Equity investment often requires long-term commitment by donors which can be against conventional practices. Impacts may not be seen in the short term and this needs to be recognised in any M&E strategy There will be many failures and a few high return successes. 	Development partners need to commit to longer term financing and

⁵³ Busler (2013). The Effect of Business Incubation in Developing Countries. European Journal of Business and Innovation Research Vol. 1, No. 1, March 2013, pp.19-25

⁵⁴ From interview with Patrick Ball. January 2016.

⁵⁵ Impact investments are investments made into companies, organisations, and funds with the intention to generate social and environmental impact alongside a financial return.

⁵⁶ Bortes, Sinha and Gretteve (2011)

	<ul style="list-style-type: none"> Clear but patient and flexible exit strategies can be helped by encouraging the crowding-in of private sector investment. 	have clear exit strategy
Monitoring and Evaluation	<ul style="list-style-type: none"> M&E needs to be incorporated into conditions of investment. By careful transaction structuring and intensive monitoring after investment, the private equity fund managers can avoid many of the problems that deter banks and other financiers from investing⁵⁷. 	Evidence can incentivise further investment.
Demonstration effect	<ul style="list-style-type: none"> Successful initiatives have a good potential to attract other investors. E.g. Norfund acting as a first mover in Angola's first private equity fund; and DEG's⁵⁸ role as co-founder of the Kyrgyz Investment and Credit Bank when no other local banks offered long-term finance.⁵⁹ 	Be alert to first-mover opportunities to catalyse investment
Sustainability and impact	<ul style="list-style-type: none"> Equity investing has the potential to influence investees' social, environmental, and governance policies and has an advantage over debt products in this respect. Evidence that funds need not trade-off financial for social returns. Evidence suggests bridging the equity gap can make a significant contribution to economic development. 	Incorporate social, environmental and governance standards into investment models / Impact investment

4.5 Financial government benefits for SMEs

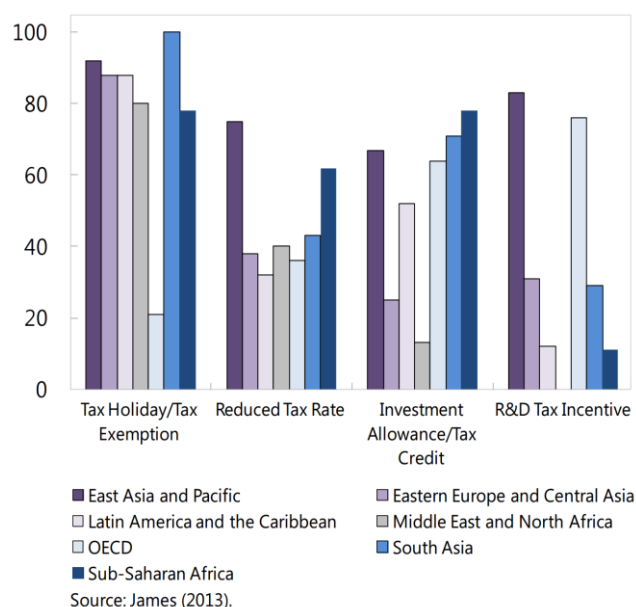
Financial benefits that government can provide to support SME development refers to tax benefits to SMEs (e.g., tax holidays, VAT threshold, tax allowances or credits for certain investments, preferential tax treatment) and tax relief for others investments in SMEs.

Overview: SMEs are often the recipients of preferential tax policies that larger companies do not benefit from. This is justified as benefits can provide an incentive to grow, innovate and can offset the high costs to SMEs of tax compliance and administration. Tax incentives can take many different forms and figure 8 represents the prevalence of tax incentives globally. We will discuss a selection of these below.

Tax Holidays occur when companies are given a certain amount of time during which they do not have to pay tax or pay reduced taxes. These are particularly relevant for small SMEs in their start-up phase. Moldova, for example, fully exempts newly created SMEs from profit tax for a period of three years and provides a 35% reduction of taxable income for the following two years. There is however, much criticism of tax holidays particularly in developing countries. The system can provide an incentive for SME owners to cease the operation of a business just before the tax holiday reaches an end to subsequently re-establish under a new name. The implications for tax revenue generation can also be significant and avoiding open-ended tax holidays that erode the tax base indefinitely is essential.

A tax holiday scheme is also not appropriate for highly profitable start-up SMEs and this problem can be avoided by establishing a ceiling for the tax holiday scheme. In Singapore,

Figure 8. Regional Prevalence of Tax Incentives (Percent)



⁵⁷ Lerner, 2004

⁵⁸ Subsidiary of KfW, the German government-owned development bank.

⁵⁹ Bortes, Sinha and Grettve (2011). How do DFIs measure the development returns to investment in private enterprises? A review of the literature. Nathan Associates London Ltd.

for example, SMEs are exempt from profit taxation in the first three years of operation only for profits up to SGD 100,000 (USD\$66,000)⁶⁰.

Promoting Research and Development (R&D) and investment in capital assets. A generally more efficient alternative to tax holidays is the design of targeted incentives to address specific operational challenges or to promote investments to facilitate growth. Stimulating R&D and investment in capital assets has been one area in which tax incentives have proved to be successful.

The provision of tax incentives can influence an SME’s decision making process as they effectively lower the cost of capital (see box 13). R&D and capital investment can have considerable impact on an SME’s productivity, invention and innovation, and therefore such incentives will ultimately improve economic performance and increase wealth.

In addition to this, the ideal level of R&D in society is usually higher than the levels invested by the private sector alone. This is because private investors cannot keep all the benefits that their R&D generates although they bear the full cost. Tax incentives can help raise the amount spent on R&D towards the desired level. It is important to remember, however, that in countries where the capacity for carrying out R&D activities is limited by human capital constraints, the case for such tax incentives is less compelling, and other measures (such as incentives for technology transfers⁶¹) may be better suited to boost productivity.

Box 13: Do Tax Incentives influence R&D Decisions?

A 2007 study on R&D incentives in the UK finds that, while tax policy on R&D expenditure and R&D-related investment provides substantial incentives for firms with small R&D programmes, the costs associated with making tax claims absorb much of the potential benefit. These firms face a costly, complicated, and time-consuming process that cancels out much of the benefits arising from the tax policy.

Tax incentives can also fail to influence behaviour as tax relief is claimed after the expenditure and there is a risk that it will not be allowed. This risk is taken into account in investment decisions. Similarly, if SMEs are cash constrained and they cannot receive up front benefits, they may not have the resources required to undertake the initial investment despite the fact that they could reclaim some of this cost after the event.

Source: Derregia and Chittenden (2007).

VAT Exemption. Many governments set a sales threshold below which SMEs are exempt from paying value added tax (VAT). Raising these exemption thresholds can reduce the tax burden for SMEs and allow them to invest the money saved in business growth. Thresholds vary widely. The UK gives a comparatively lenient example whereas Denmark is at the other end of the spectrum. In Mexico, Sweden and Spain there is no threshold at all. The advantages and disadvantages are summarised below:

Table 9: Advantages and Disadvantages of VAT Thresholds

Advantages	Disadvantages
<ul style="list-style-type: none"> • Allows increased expenditure on core business activities • Minimises burdensome and costly compliance with VAT laws and regulations. • From a tax administration point of view SMEs contribute little to the overall VAT yield, while the administrative burden to collect VAT from a large number of SMEs is high. 	<ul style="list-style-type: none"> • higher thresholds result in a loss in tax revenues • tax discrimination • provides an incentive for SMEs to stay below the threshold • can reduce business credibility – some businesses prefer dealing with suppliers with a VAT number • Distortion of competition between registered and non-registered companies.

Countries also have schemes allowing VAT to be reclaimed on goods and services that are bought for business use. This generally also comes with a paperwork requirement

⁶⁰ IFC (2007). Designing a Tax System for Micro and Small Businesses. A guide for Practitioners. The World Bank Group (in collaboration with DFID)

⁶¹ Technology transfer is the process of developing practical applications for the results of scientific research.

although some countries have introduced schemes to mitigate this such as the UK's rapid disbursement scheme or optional VAT flat rate scheme.

Cost of tax compliance and administration. It can be argued that the resources that SMEs direct towards tax compliance are resources that could otherwise be used for reinvestment, facilitating future growth⁶². As a result, there is a belief that taxes and a complex tax system put disproportionate pressure on smaller businesses. Cumbersome tax systems are also one of the main reasons for the prevalence of informal economies in many countries.

Introducing a simplified taxation system can overcome these issues. The benefits and disadvantages of a simplified tax system are summarised in table 10:

Table 10: Advantages and Disadvantages of a Simplified Tax System

Advantages	Disadvantages
<ul style="list-style-type: none"> • Lower compliance costs • More predictable tax liabilities • Less interaction with tax administration • Generally lower tax burden 	<ul style="list-style-type: none"> • No incentive to improve bookkeeping • No relief in case of loss making • Potential disincentive to grow • Risk of abuse • Fairness concerns

Tax relief for investments in SMEs encourages individuals and companies to invest in small and growing businesses by effectively subsidising the risk they are taking. This form of investment (whether direct or through venture capital or equity funds) can provide valuable support to businesses seeking finance to develop and grow.

As part of these schemes, investors can deduct from their taxable income part of the cost of investment in certain types of companies or venture capital funds. In some countries, like the UK, investors are given income tax relief when they purchase new shares in qualifying companies, they are also charged capital gains tax at a lower rate and allowed to offset any losses on the sale of shares against income tax. Examples of these schemes include the Seed Enterprise Investment Scheme, Enterprise Investment Scheme and Venture Capital Trust Scheme in the UK. To date the UK schemes have supported over 22,000 businesses, with over £17.5 billion of funding provided.⁶³

Investment incentives can be specifically targeted to particular sectors and are particularly widespread as a means of attracting foreign direct investment in developing countries. An assessment of tax incentives introduced in Malaysia in 1986 concluded that, while they succeeded in stimulating domestic investment, foreign investors were primarily influenced by other factors (including macroeconomic stability and the quality of infrastructure). At the same time, they came at a very high cost.

So what works? The choice of incentive and how it is structured is key to success. The design of a complete tax system that encourages SME growth and investment is beyond the scope of this guide.⁶⁴ It is clear, however, that well-targeted incentives that directly reduce the cost of capital to SMEs, such as investment tax credits for R&D, have been used with some success. The type of incentive can be tailored for specific sectors or used to target investment priorities, for example increased wear and tear allowances for investment in farming machinery (Zambia) or training and research expenses deductible from taxable profits (Rwanda).⁶⁵

In reviewing how governments can be supported in the design of appropriate incentive schemes, the following should be considered:

⁶² Complex and burdensome tax systems are consistently identified as a barrier to doing business in the World Bank's Doing Business Surveys.

⁶³ HM Treasury (2015). Tax-advantaged venture capital schemes: response to the consultation on ensuring continued support for small and growing businesses. Crown copyright 2015

⁶⁴ IFC (2007)

⁶⁵ A discussion of the instruments in use globally can be found in IGC's 2012 Review of Investment Incentives.

- **Understand costs** - a rigorous cost-benefit analysis of any potential tax incentives should be undertaken to determine the point at which the size of the benefit outweighs the loss in tax revenues. If certain allowances are not found to be cost effective, they should not be continued.
- Promote the **transparency** and monitoring of incentive systems - the process for review should be formalised and discussed with investors and other key stakeholders (e.g. regional trade groupings).
- Consider how to reduce the **cost of compliance** - supporting initiatives such as increasing the financial literacy of SMEs reduces the burden of tax compliance on SMEs and can remove the need for oversimplified tax rules.
- Review **access to tax consultancy services** – such services either by private tax consultants or small business associations can be an effective way of supporting SMEs to comply with their tax obligations.
- Evaluate **efficiency of tax administration** system –support government institutions in improving the capacity to implement, monitor and police the system imposed.
- Assess **availability of IT** - IT combined with relevant MIS can assist SMEs in the preparation of necessary financial material thus reducing the cost of compliance.
- Consider the **appropriate size of incentives** - for government policy to be effective the incentives have to be significant enough in size to mitigate the risk taken by the SME when making uncertain and irreversible investments.

4.6 Loan and Grant Funding to Support SMEs

This section will consider both loan and grant funding. We will first highlight common grant mechanisms at work in promoting an increase in availability of SME finance (match funding and challenge funds) and then go on to look at the increasingly complementary use of both loan and grant funding (blending) to achieve development goals.

Grant mechanisms. Grants are transfers made in cash, goods or services for which no repayment from the recipient is required.

Overview: There is often a grant element to donor and DFI funding. Grants can be financial, for example where funds are supplied at below market rates or with a repayment holiday, or can be 'in-kind', through the provision of TA. In addition, specific grant mechanisms have been developed to promote innovation or stimulate certain desired development outcomes and we will focus on these in the context of addressing the SME financing gap. While the level of funding to SMEs, whether through equity, debt or direct funding is critical, it is also recognised that new products, services and delivery mechanisms are needed to ensure that these funds are channelled effectively. Stimulating innovation is one way that these grant mechanisms can play a key role.⁶⁶

A matching grant is a one-off, non-reimbursable transfer to project beneficiaries. It is provided for a particular purpose and it is provided on the basis that the recipient makes an agreed contribution (usually at least 50%). Grants and matching contributions can be either in cash or in kind, or a combination of both.⁶⁷

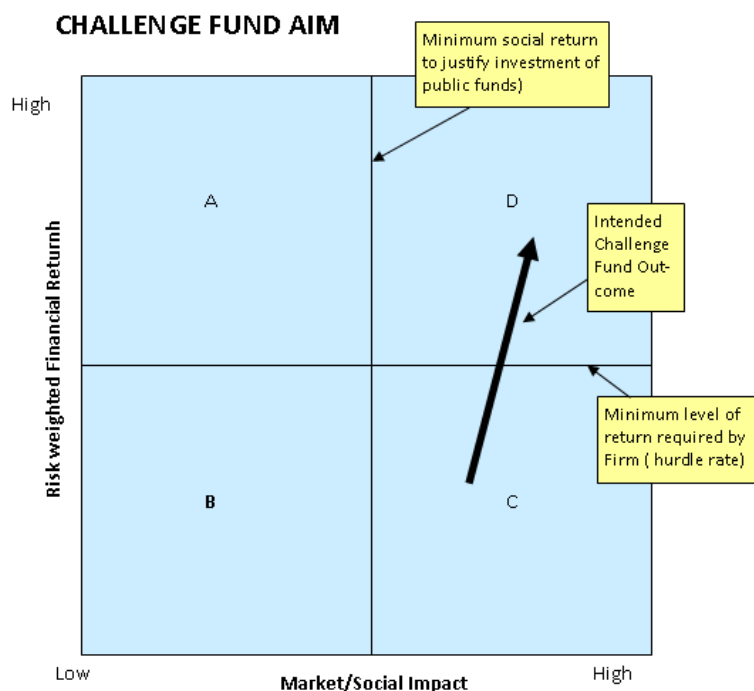
Challenge funds are a variation of a matching grant allocated on a competitive basis. The mechanism allocates financial support to innovative projects, to improve market outcomes with social returns that are higher/more assured than private benefits, but with the

⁶⁶ It is recognised that there are a plethora of funds available including adaptation funds, impact investment funds, innovation funds, managed funds, social funds, research grants, social impact funds.

⁶⁷ IFAD (2012). Matching Grants. Technical Note. International Fund for Agricultural Development.

potential for commercial viability. Challenge funds aim to provide the smallest possible financial contribution to a socially worthwhile project to make it less risky and more financially sustainable to the private promoter. That is: moving from the bottom right to the top right quadrant in figure 9.

Figure 9: How does a challenge fund work?



Challenge funds can be relatively small and single country focused (e.g. SME Finance Innovation Challenge Fund in Tanzania) or can be very large and operating regionally or even globally (e.g. Africa Enterprise Challenge Fund).

So how can such grants play a role in bridging the SME financing gap? They can part-fund projects to induce innovation in the financial sector. This could be for the design of new financial products for SMEs (e.g. the Financial Inclusion Challenge Fund in Pakistan which piloted a range of value chain financing models for agribusiness) or trialling innovative credit scoring techniques or new delivery mechanisms to reach a greater number of SMEs. The benefits of challenge funds in triggering this

process are:

- Aligns development and business objectives.
- Harnesses the strengths of the private sector to generate and test new ideas, abandon them if they do not work, and scale up those that do.
- Triggers innovation, by helping to speed up the implementation of new business models/technologies that combine potential commercial viability with high social impacts, but where the commercial returns are uncertain, and therefore high risk.
- Requires grantees to at least match the funding provided by the challenge fund, as an indication of their commitment to the commercial viability of the project

Evidence: The evidence on the success of such schemes is mixed (see box 13). Critics argue that there is no conclusive evidence that challenge funds generate systemic change. Even worse, these mechanisms may have market distorting effects including:

- Promoting non-viable or non-feasible enterprises or projects.
- Substituting savings with external grants.
- Crowding out financial institutions.
- Crowding out private investment.
- Misallocating scarce resources.
- Supporting asset creation among groups of people, instead of individuals, which may lead to lack of care and maintenance of the assets received or failure to achieve satisfactory levels of profit.

As a result of this, possible distortive effects should be identified during project design, together with suggestions for how these can be dealt with.

On the other hand, there is positive evidence as to their impacts. Evaluations of the DFID funded Business Linkages Challenge Fund and Financial Deepening Challenge Fund, found that both funds demonstrated positive results in helping the private sector to overcome the initial risk of projects.⁶⁸ Challenge funds have also been shown to encourage better business practices among grantees because their criteria require solid corporate governance and transparent financial management. Evidence also supports the potential for catalytic effect⁶⁹.

So what works? A recent study on how enterprise challenge funds can be made to work better suggests that there is not a correct blueprint for fund design, but instead this will be very dependent on the objective and context of the fund itself.⁷⁰ The available evidence indicates that the management of the challenge fund is key. Although challenge funds are traditionally considered as a 'light-touch' instrument, sufficient funding should be in place to ensure robust design and sufficient market system and sector-specific research to maximise the potential for catalytic effect, without disadvantaging other businesses in the sector⁷¹.

Box 14: SME Financing Challenge

In 2010, G20 members agreed to commit \$528 million to G20 SME Finance Challenge. The challenge aimed to identify providers, projects and path-breaking models having the potential to increase SMEs' access to financial services at scale. 14 winners were chosen with 13 projects eventually contracted.

Winning projects ranged from psychometric credit scoring, equipment leasing for rural SMEs and farms, energy efficiency and renewable energy finance and data analysis based risk management leading to improved credit decisions for SMEs.

A 2014 evaluation found limited evidence about the development impact of the projects at SME level. Attribution of impacts was difficult and only seven grantees achieved the project targets. Despite this, the total of SMEs accessing financial services equalled 46,000 with a total loan value of \$270 million. The differences in outreach performance are substantial. While one grantee, a technology provider focusing on asset and liability management, contributed to the funding of 33,000 SMEs by client MFIs, seven of the projects reached fewer than 500 SMEs each.

Source: Enclude (2015)

Blended finance is the complementary use of loans and grants to achieve development objectives, where loans are transfers for which repayment of principal and interest by the recipient is required.⁷²

Overview: Blended Finance represents an opportunity to drive significant new capital flows into high-impact sectors, while effectively leveraging private sector expertise in identifying and executing development investment strategies.⁷³ The grant portion tends to be either in the form of TA, interest rate subsidies or direct investment grants. Typically the grant element is provided by donors or other philanthropic funders while DFIs or the private sector supply the loan itself. Blended finance can be used for a range of development objectives with recent high profile projects in the infrastructure and clean energy sectors. It can be, however, equally as relevant for increasing access to finance for SMEs.

⁶⁸ Irwin, D. and Porteous, D. (2005) *Financial Deepening Challenge Fund Strategic Project Review*.

⁶⁹ Pompa (2013). Understanding challenge funds. Overseas Development Institute.

⁷⁰ Adam Brain, Nilima Gulrajani and Jonathan Mitchell (2014). Meeting the challenge: How can enterprise challenge funds be made to work better

⁷¹ Defining robust eligibility criteria is key to ensuring that market distortion is minimised and additionality is upheld. Fund managers must also implement a thorough due diligence process on projects and grantees.

⁷² More specifically, the WEF defines blended funding as 'the strategic use of development finance and philanthropic funds to mobilize private capital flows to emerging and frontier markets'. A more detailed analysis of blended capital, its role and strategies for scaling up can be found in WEF (2015) Blended Finance Vol. 1: A Primer for Development Finance and Philanthropic Funders.

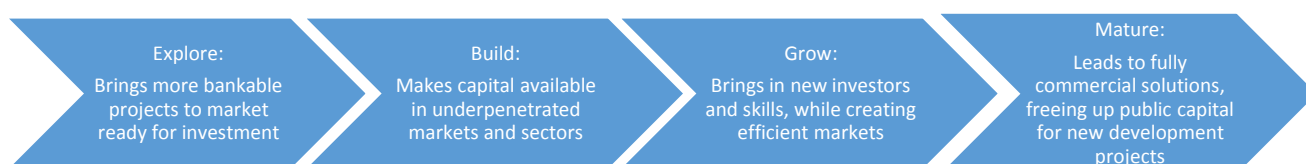
⁷³ WEF (2015) Blended Finance Vol. 1: A Primer for Development Finance and Philanthropic Funders

Blended Finance has three key characteristics:

- Leverage: use of development finance and philanthropic funds to attract private capital.
- Impact: investments that drive social, environmental and economic progress.
- Returns: financial returns for private investors in line with market expectations, based on real and perceived risks and the potential to accelerate inclusive growth.

The benefits of blended finance by stage is illustrated in figure 10.

Figure 10: Blended Finance - Stages of Development⁷⁴



Evidence: The Redesigning Development Finance Initiative (RDFI) estimates that there is already at least \$25.4 billion invested in over 74 Blended Finance funds and facilities, in addition to hundreds of projects receiving blended finance at the project level, in emerging and frontier markets.⁷⁵ This in itself shows initial successes in leveraging funding. Many donors are further increasing their exposure in this space. The EC, for example, has set up an EU Platform for blending in external cooperation, dedicated to facilitating the scaling up of blended resources. There is little evidence to date, however, on how effective this funding has been in achieving development objectives and, in particular, in addressing the SME financing gap. As a result, consistent and transparent mechanisms for measuring impact should be a focus of implementing partners.

So what works? While it is too early to consider specific features, the following issues should be considered when designing a programme:

Table 11: Blended Finance - What works?

Design Feature	Overview of Issues	Best Practice
Additionality	<ul style="list-style-type: none"> ▪ There is a risk that blended funding can crowd out market-based funding or prevent the emergence of market-based funding sources. 	<ul style="list-style-type: none"> ▪ Funding should be used to catalyse investments that would not otherwise happen and to accelerate development impact in key sectors.
Sustainability	<ul style="list-style-type: none"> ▪ Commercial sustainability should be aimed for within a specified timeframe (dependent on nature of project). 	<ul style="list-style-type: none"> ▪ Establish an exit strategy ▪ Encourage crowding in of market based lenders (consider systemic and project risks that can lead to negative demonstration effects).
Objectives	<ul style="list-style-type: none"> ▪ Development objectives should be balanced with financial incentives. ▪ Relationships with funders and investors that possess similar development goals and complementary investment goals can be useful. 	<ul style="list-style-type: none"> ▪ Avoid crowding out private sector finance. ▪ Social environmental and development objectives should be matched with commercial aims.
Design	<ul style="list-style-type: none"> ▪ Transparency should be a priority while protecting commercial confidentiality. ▪ Consistency is critical: mainstream and standardise approaches to programme implementation focusing on scalable investment structures and workable products. 	<ul style="list-style-type: none"> ▪ Recognise diverse private sector incentives and needs. ▪ Define clear mandates and strategies for engaging private sector investors

⁷⁵ These numbers include all blended finance initiatives and not just those relating to SME financing. WEF (2015) Blended Finance Vol. 1: A Primer for Development Finance and Philanthropic Funders

4.7 Innovative and Technology based Solutions (FinTech)

FinTech is the combination of technology and innovative business models in financial services.

Overview: Over the last few years, we have seen a proliferation of low cost, technology based financial products and platforms. By addressing some of the key constraints to the growth of SME finance, Fintech has huge potential to impact SMEs globally.

Largely emerging as a response to the recent financial crisis and the advancement of technology, the FinTech industry has grown rapidly.⁷⁶ At present, representation in the developing world is relatively small, however, based on the speed at which many countries have adopted advances such as mobile money technology it is expected that FinTech will play an increasingly important role over the next few years. The core characteristics of the sector are:

- Lending tends to be unsecured, which benefits SMEs who struggle to access collateral based finance;
- Investors have a higher risk appetite than traditional financial intermediaries;
- Use of innovative credit scoring models (such as psychometric testing⁷⁷), which benefits SMEs and start-ups with limited verifiable information;
- Speed (transactions approved quickly) and convenience (no need to visit branches which catalyses flows of capital within and between communities, irrespective of distance);
- Low cost base (no branches and less personnel) resulting in competitive rates and can give providers a buffer against the higher risk loans that they underwrite;
- Not subject to the same levels of compliance as traditional financial institutions, though this might change as regulatory frameworks catch up;
- Innovation in payment systems - the use of mobile phones (in particular) has transformed the money transfer and mobile payments sector allowing companies to make transactions through their phones or tablets and;
- Increased competition as new providers challenge the role of traditional banks.

This analysis focuses on the key products and platforms emerging. Of particular importance to small business are: Marketplace (peer-to-peer) lending; Crowdfunding; Merchant and e-commerce finance; Invoice finance and supply chain finance. Technology has also made a big impact on the collection of information, payment processing and the credit decision-making process and this is considered in section 3.

Marketplace or peer-to-peer lending (P2P) refers to the practice of matching investors and borrowers through online platforms without going through a traditional FI such as a bank. In the UK alone, \$2.5 billion was issued by more than 40 SME marketplace lenders in 2014, with \$4.4 billion projected for 2015. The largest originators in the UK include RateSetter (\$457 million), Funding Circle (\$432 million) and LendInvest (\$236 million).⁷⁸ P2P allows SMEs to access funding quickly and usually more cheaply than through banks. Investors benefit from the ability to diversify their risks quickly and cheaply across a wide group of counterparties.

In developing countries, marketplace lending is growing, for example, AFB has started to issue loans from as little as \$100 to both formal and informal SMEs in Kenya, Ghana, Tanzania and Zambia. The World Economic Forum provides estimates that 60-80 countries now have at least one marketplace platform operating or lined up to launch in the near

⁷⁶ From 2013 to 2014, equity investment into FinTech companies alone has quadrupled from \$4 billion to more than \$12 billion and this trend is expected to continue. Accenture (2015): The Future of Fintech and Banking: Digitally disrupted or reimagined?

⁷⁷ For example the Entrepreneurial Finance Lab: <https://www.eflglobal.com/>

⁷⁸ WEF (2015). The Future of FinTech. A Paradigm Shift in Small Business Finance.

future. However, in spite of this rapid growth, total market share is still less than 1% of total bank lending on a global scale.⁷⁹

Crowdfunding differs from P2P lending in that it raises small amounts of money for a project or venture rather than for a company itself from a large number of people - again typically through an online platform. Crowdfunding is beginning to bridge the gap that traditional somewhat risk-averse venture capital cannot fill focusing on innovative, early-stage companies.⁸⁰

There are two main types of crowdfunding: reward based crowdfunding and equity based crowd funding. Rewards based platforms provide something in return for the money invested such as the first versions of the product or service being funded. Equity based platforms provide backers with shares of a company in exchange for the money pledged.

Crowdfunding websites have the benefits of creating transparency and open communication by enabling investors to engage with companies over time to monitor their progress and continue to support their success as the company grows. The technology also removes geographical barriers allowing investors to engage globally which may be significant considering the large diaspora of many developing countries. Box 15 provides an example of crowdfunding at work in Africa.

Operational Finance. Managing the trade credit cycle can be challenging for SMEs putting pressure on cash flow management and ultimately liquidity. Delayed payment is a serious issue for SMEs. The FinTech advances in this area are summarised in table 12.

Box 15: Kenya Climate Innovation Centre

Crowdfunding has been particularly successful in funding renewable energy projects. In 2015, the Kenya Climate Innovation Center (KCIC) - a World Bank and infoDev initiative — launched the first support programme for crowdfunding in East Africa. In its pilot phase, the programme helped six clean-tech ventures design, develop, and launch their online crowdfunding campaigns.

KCIC with the technical support of Crowdfund Capital Advisors (CCA), has developed a set of advisory services specifically designed to help local green ventures conduct effective crowdfunding campaigns and utilise the full range of crowdfunding platforms focused on African projects.

Source: World Bank (2015).

Table 12: Trade and Supply Chain Finance - A summary of products.

Product	What is it?	How does it work?
Merchant and e-commerce finance	Small businesses selling their goods on platforms such as Amazon, eBay or Alibaba are now offered working capital lines and loans by those platforms ⁸¹ .	Payment processors and e-commerce platforms can be better placed than traditional lenders to assess the risk of advancing money as they can view a significant portion of daily transactions. The collection process is also simplified as payments flow through their systems and processors can take repayments directly from revenue received.
E-invoice management portals	Evidence shows that if invoices are sent out quickly, it greatly increases the likelihood of getting paid, regardless of the credit terms.	Invoice management portals (e.g. Tradeshift). can help automate receivables management and streamline the end-to-end process. The timing of the payment, however, still remains at the buyer's discretion.
Invoice Finance	Online receivable finance companies now allow small businesses to monetise outstanding receivables quickly and easily. Compared to traditional off-line factoring, online invoice finance is flexible tool and quick.	Accounting software can be integrated within the invoice finance platform allowing SMEs to apply for loans based on the value of receivables. As the application is processed mostly automatically, payment can be received almost instantly. A transaction history is built up over time making future applications even more straightforward.

⁷⁹ The paper produced by the World Economic Forum (2015) provides a detailed overview of the current provision of FinTech instruments.

⁸⁰ The World Bank paper (Crowdfunding's Potential for the Developing World 2013) provides a detailed outline of the potential of crowd-funding including a 'crowd-funding readiness' self-assessment tool.

⁸¹ Players in this field include Amazon, Alibaba, Rakuten, Paypal, Square Capital, iZettle, TelMex

Supply Chain Finance (SCF)	Unlike invoice finance, which usually does not rely on the cooperation of buyer, SCF is typically initiated by the buyer. Traditional SCF involves a high degree of cooperation between the supplier and the buyer. Formal programmes allow suppliers the ability to opt for early payment of invoices at a discount.	Traditional SCF programmes involve complex legal frameworks and are only efficient to operate at larger scale. A FinTech solution offers efficiency at lower scale, making working capital accessible to the entire supply chain by linking to an online portal. SMEs benefit from cheaper cost of working capital relying on the greater creditworthiness of their customer.
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Evidence: The impact and effectiveness of FinTech as a development tool will become apparent over the next few years. It is, however, clear that it has an important and complementary role to banks as a source of SME finance and has the potential to provide a cost-effective way of targeting specific sectors. These platforms have the potential to drive economic growth by efficiently mobilising and channeling savings towards investment-ready, growth-orientated enterprises in key sectors of developing countries.

So what works? In most cases, it is too early to tell. However, we have highlighted areas below in which development partners could contribute to the growth in this sector:

- *Support development of regulation.* Regulation is currently limited and support to regulators in this area could be key. In developed countries efforts are underway to develop a self-regulatory framework through the development of trade associations. The European Crowd-funding Network, for example, was launched in 2012 with the goal of creating a regulatory model for Europe.
- *Direct funding of marketplace lenders* to target specific areas (could be through investments or guarantees). For example, the EIB is planning to lend £100m to UK small business through the popular online lender Funding Circle.
- *Support development of industry organisations.*
- *Provision of TA.* Development partners can support the capacity of providers. For example, young FinTech organisations can be advised on how to scale up their SME lending in a prudent way by improving risk management techniques and portfolio modelling. TA can also be provided to SMEs to ensure they are prepared and able to access the new products available.
- *Provision of tax incentives for investment* – to encourage ‘crowding in’ of commercial investors although this should be balanced with the regulation requirements that this may entail. In the UK, for example, tax benefits for marketplace investments are to be granted as part of the ISA scheme.
- *Government support mechanisms for encouraging the take up of alternative financing.* Government can also play a coordinating role among private stakeholders and facilitate the dialogue between private parties and public institutions.
- *Promote best practice in information sharing and access to internet and technology services.* In order for these instruments to work, access to reliable internet or mobile data networks must be widespread.
- *Pilot Concepts.* Donors could assist in piloting new concepts at the grassroots level, and help to scale workable solutions into larger projects that support innovation.
- *Explore how existing development oriented structures* such as climate investment innovation centres may benefit from the platforms and products developed.
- *Provision of further research* including specific analysis on how these instruments can support specific sectors or countries.

Box 16: Crowdfunding. Developed Country Evidence

Current evidence is limited, however, after seven years of crowdfunding companies, the Australian Small Stock Offering Board (ASSOB) shows that 86% of companies crowdfunded on its platform were still operating in 2012. This contrasts with a figure of 40% of non-crowdfunded (non-ASSOB) companies that fail after three years.

Debt crowdfunding in the UK has demonstrated successes in providing returns to investors. Since 2007 investors in companies listed on U.K.-based Funding Circle have completed financing totalling over £156 million, achieving an annualised return of 5.8% with a 1.6% default rate.

Source: World Bank (2013).

4.8 Summary Table

Financial Instrument	Types of SMEs effective for	Conditions of Success	When does it work?	Impact and sustainability	Risks / Unintended Consequences
Credit Guarantee Schemes	Growth oriented but collateral constrained SMEs who have struggled to access formal finance	<ul style="list-style-type: none"> Partner FIs committed to SMEs. Appropriate pricing to ensure sustainability beyond donor support. Informed loan officers and development of products relevant to SME segment (supported by TA). Establishment of separate legal entity after pilot stage. Strong management team 	<ul style="list-style-type: none"> Effectiveness maximised when partnered with a SME focused financial institution which is committed to growing the segment. Example: Jordan Loan Guarantee Corporation providing guarantees of up to 85% to banks since 1994 	<ul style="list-style-type: none"> There must be demand for guarantees. Over-supply of donor funding is an issue in some countries affecting utilisation and impact. Self-sufficiency can be achieved ensuring impact is sustained Has been shown to increase the levels of lending to SMEs where used, although sustainability of impact is a bit more questionable after support is removed. 	<ul style="list-style-type: none"> Risk of low additionality where markets already liquid. Low take up due to ill-informed loan officers Moral hazard, i.e, excessively risky loans put through the scheme Failure to change business models effecting sustainability of initiative post funding. Can be market distorting as loans given to previously 'unbankable' SMEs.
Credit/Equity lines to banks/FIs for SMEs	Growth oriented SMEs in underserved or illiquid financial environments	<ul style="list-style-type: none"> Choose appropriate FI partners Ensure incentives in place to channel funds to SME portfolio Ensure additionality criteria upheld. 	<ul style="list-style-type: none"> Particularly effective when combined with TA. Example: Türk Ekonomi Bankası (TEB) who with IFC support increased SME clients from 20,000 to 700,000 from 2005 to 2011. (RTI International 2011) 	<ul style="list-style-type: none"> Sustainability most prevalent in cases where banks are committed to SME segment and have the internal capacity to adopt appropriate process and risk management techniques. Measurement of impact currently weak and M&E should be included in instrument design. 	<ul style="list-style-type: none"> Banks do not always channel funds to SME portfolios. Can crowd out domestic investment May reduce competition in the market. FIs become reliant on external funding.
Leasing	<ul style="list-style-type: none"> Small SMEs who are collateral constrained. Agricultural SMEs. Muslim borrowers as considered to be 'interest-free'. Sustainable energy or other capital intensive sectors 	<ul style="list-style-type: none"> Effective laws and regulations governing leasing transactions, clear accounting standards, an appropriate tax regime Choice of partner institutions critical. Product must be tailored to the specific segment. 	<ul style="list-style-type: none"> Can be particularly effective in agricultural sector and in fragile/post-conflict states. When combined with TA impact is more sustainable. Example: Central and South Eastern European transition economies (Haiss and Kichler 2009) 	<ul style="list-style-type: none"> Can reach sections of SME segment that would not be eligible for formal lending especially when tailored to specific need. Can bring small businesses into the formal financial system. Can increase competition Can offer long-term benefits for those reached if structured and sequenced appropriately. 	<ul style="list-style-type: none"> Direct subsidisation of leasing companies can be harmful to the development of the leasing industry distorting the market and reducing competition. Assistance to banks can squeeze out smaller private leasing companies.
Equity Funds to SMEs	Early stage and high risk SMEs who need funding for growth.	<ul style="list-style-type: none"> Well informed and efficient fund managers with good local knowledge 	<ul style="list-style-type: none"> Support effective when type of equity product tailored to stage of development of company. 	<ul style="list-style-type: none"> Unlike lending have the potential to influence social and environment behaviours. 	<ul style="list-style-type: none"> Crowding out of private sector investment. If equity investments are made without supporting

	More tailored for medium-sized firms	<ul style="list-style-type: none"> Often needs long term commitment by development partners Clear exit strategy needed supported by development of equity market. 	<ul style="list-style-type: none"> When TA, incubators or accelerators to provide necessary support to SMEs making them 'investment ready'. 	<ul style="list-style-type: none"> Can influence governance structures of firms. Demonstration effect leverages private investment leading to long-term growth. 	development of equity market as a whole, may result in inability to access other investment when donor funding is removed.
Financial Government Benefits to SMEs	<ul style="list-style-type: none"> Dependent on specific instrument but can be particularly effective when targeting small or newly formed technology or capital focused SMEs. 	<ul style="list-style-type: none"> Benefits of the incentive must outweigh the administrative costs of applying for them. Incentives must be significantly large to encourage changes in investment decisions. As most benefits are applied for after the event, the system should provide confidence on delivery. 	<ul style="list-style-type: none"> Well-targeted incentives that directly reduce the cost of capital to SMEs, (such as investment tax credits for R&D) and encourage investment. Bloom et al (2002) using data from 9 OECD countries covering the years 1979 to 1997 found significant impact of fiscal R&D incentives. 	<ul style="list-style-type: none"> Impact and sustainability dependent on the nature of instrument although evidence suggests that well targeted and designed fiscal measures can stimulate research and development leading to firm growth and sustainability. 	<ul style="list-style-type: none"> Tax holiday can be prone to abuse incentivising SMEs to dissolve before end date. Similarly, VAT thresholds provide an incentive for staying small. Benefits can act as a subsidy to sections of the market causing distortion.
Grants and Loans / Blended Finance	<ul style="list-style-type: none"> Broad range of SMEs. Can be particularly for SMEs seeking to innovate but lacking the resources to do so. 	<ul style="list-style-type: none"> Blended Finance – strong partnerships with clear mandates. Balance of commercial and development objectives Challenge Funds – transparent, competitive, well-managed process the focuses on projects with potential for commercially sustainability. 	<ul style="list-style-type: none"> Blended Finance- Demonstration effect crowds-in private sector investment in areas where access to finance most required (e.g., clean energy financing). Challenge funds. Challenge is well focused on key issue and innovation results in transformational change. e.g. M-PESA mobile money transfer. 	<ul style="list-style-type: none"> Combined effect of commercial finance with donor support including TA can provide a holistic approach to investment leveraging private sector investment and ensuring sustainability. Grants such as challenge fund have the potential to trigger systemic change through innovation 	<ul style="list-style-type: none"> Blended finance can be considered as a subsidy to a company impeding competition. Can be market distorting, crowding out private investment Can support projects that wouldn't be commercially viable on their own. Misallocation of resources.
Innovative and Technology based Solutions (FinTech) – including P2P & crowdfunding	SMEs who are unable to access traditional forms of finance due to lack of collateral or track record	<ul style="list-style-type: none"> New platforms ability to attract investment. Awareness amongst SME community and willingness to access alternative financing mechanisms. New products relevant to SME financing needs. 	<ul style="list-style-type: none"> Development partner support currently limited to helping the development of the sector and direct funding of individual platforms, e.g. EIB planned investment in Funding Circle. Almost no evidence to success at present (beyond indications of growth) and, therefore, best practice is limited. 	<ul style="list-style-type: none"> Market driven. Early indications show that platforms have been effective. Can be effective way of leveraging private sector investment. Can provide competition in the market and addresses specific market failures (such as information asymmetry). Removes geographic barriers to investment. 	<ul style="list-style-type: none"> Broader impacts not yet known. Not widely regulated at present. Technological infrastructure may not exist in many developing countries to allow fair access.

5 Enabling Environment Preconditions

The effectiveness of interventions by bi- or multilateral institutions depends on the institutional and macroeconomic environment of the respective countries. An extensive academic and policy literature has pointed to socio-economic and institutional preconditions for sustainable financial deepening.

Macroeconomic stability: Lenders and borrowers are only willing to agree to long-term financial contracts in a stable monetary environment. In the absence of such, contract parties often resort to foreign-currency lending, which brings its own problems with it, especially in the case of borrowers with limited or no foreign currency earning. In the absence of such a stable environment, donors often step in with direct long-term funding or guarantee schemes. High monetary uncertainty, however, renders the proper pricing of guarantees or lending rates difficult and ultimately prevents such donor funding being replaced with market-based funding.

Contractual framework: Creating, perfecting and enforcing contractual claims is at the core of financial transactions. Institutions such as collateral registries (for both immovable and movable assets) are critical, as is the ability to enforce claims effectively and speedily through the court system. Many of the interventions discussed above depend on a minimum standard of contract enforcement, including leasing contracts, which rely on assets claims being enforceable in court.

Informational framework: Minimum standards of accounting and auditing practices can reduce assessment and screening problems faced by lending institutions. Similarly, sharing of borrower information through credit registries or credit bureaus can reduce non-performance of loans and increase competition, as it allows borrowers to accumulate “reputation capital” in the form of good loan performance history.⁸² Effective information sharing is also important for the entry of new players in the financial system.

Regulatory and supervisory framework: Designed primarily to foster the stability of banks, it also has an important impact on the efficiency and competition of financial service provision. Effective regulation and supervision can minimise the risk of bank failure and the costs of such failures for non-shareholders and the broader economy. On the other hand, restrictive entry conditions and restrictions on activities can undermine competition and reduce efficiency, with these effects falling mostly on SMEs.

The effectiveness of the different interventions discussed above rely on these preconditions. While many of the interventions aim at reducing risks, they still leave (and should do so) a residual risk with the FI, which will price it according to the environment it works in. In addition to this, demonstration and catalytic effects depend on other FIs and new entrants being able to offer similar products and services.

The macroeconomic and institutional frameworks, however, also impose an upper limit in terms of impact that one can expect from these interventions. Long-term financial deepening is related to the underlying fundamentals in an economy. While donor interventions and funding can provide bridge options, only a market-based financial system can contribute in the long-term to the development of the local private sector and economy. The ideal intervention is one that combines bridge funding with an impact on institution building, as illustrated in the example programme in Section 6.

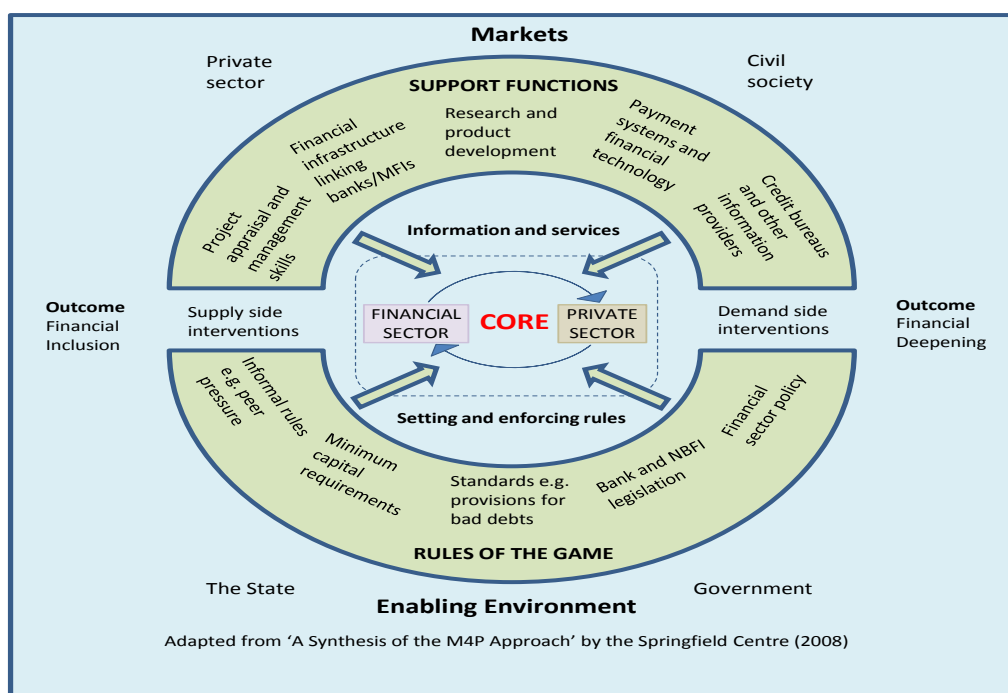
Having a high share of SMEs operating in the informal sector can also undermine interventions such as tax holidays or credits, as only formal companies can benefit from them. In addition, these different constraints also undermine access to finance, as they increase the (perceived) riskiness in the eye of lenders, making access effectively impossible or prohibitively expensive.

⁸² There is an extensive literature on this – see among others Brown, Jappelli and Pagano (2013).

6 Recommendations and Conclusions

The financing instruments discussed are as diverse as the SMEs they serve. As a result, there is no one-stop solution for identifying the ideal financing mechanism. Even within countries, diversity between geographical area, industry sector and stage of SME growth results in the need for a tailored approach that addresses specific need and aims to overcome the key constraints faced by the target segment. Any intervention should be provided on the basis that it will be additional, catalytic and sustainable, thus minimising market distortions and donor dependence. The broader enabling environment is also critical to consider and any programme must work within the development of the market system as a whole (see figure 11):

Figure 11: Market System for Financial Systems Development.⁸³



This section will focus on the issues to be considered when designing a comprehensive SME financing initiative and will go on to provide an example financing programme.

Know your market: In the context of the broader market environment, the initial analysis should build on inclusive growth diagnostics to determine the key constraints in the target sector. In many countries, for example, there is plenty of liquidity in the system so funding itself is not the constraint and, in fact, additional funding will not help. As a result, the preliminary analysis must conclude that the intervention is justified. Specifically key steps in any diagnostic exercise should include:

- Identification of target segment highlighting differences within this segment (e.g. industry type, stage of growth, management characteristics);
- Identification of vulnerable stakeholders (e.g. women, youth) and issues faced;
- Analysis of needs of target segment and key constraints to accessing finance (e.g. availability of collateral, availability of financial information etc.);
- Identification of key market failures that the financing tools need to address and that might undermine the effectiveness of additional funding;

⁸³ An illustrative example of what intervention using a market systems approach might look like and a more detailed discussion on what works for market development can be found in Sinha, Holmberg and Thomas (2013). What Works for Market Development: A review of the Evidence. UTV Working Paper 2013:1. SIDA.

- Review of current financial provision including key players and products and services provided (may include formal and informal sectors);
- Evaluation of past and current initiatives by government or development partners in the same countries or similar settings elsewhere, considering their success or failure and reasons for this;
- Review of capability of existing organisations within the sector (including FIs and relevant industry bodies) and, therefore, the need for supporting TA;
- Review of financial literacy of target segment and 'readiness' for financing products.
- Review of the level and extent of establishment of capital and debt markets;
- Determine status of current supervisory, regulatory and legal structure; and
- Consider what supporting institutions are present (e.g. credit information bureau, industry associations etc).

Selection and design of appropriate instruments and supporting initiatives. In terms of the financial instruments themselves, we have highlighted best practice for each in earlier sections and this should be considered when planning the specific design features of financing programmes (an example financing programme is given in box 17).⁸⁴

Questions to ask in this process include:

- *Choice of instrument.* Would a combination of instruments be appropriate? (e.g. credit guarantee scheme supported by a policy component to consider broader regulatory and supervisory issues).
- *Demand side issues.* Is usage the issue rather than access? Is there a demand for this financing instrument? Does it address the short-term or long-term needs of the sector?
- *Partner identification.* Are the proposed PFIs committed to and capable of working in the SME sector?
- *Product development.* In addition to increasing the availability of finance, will the chosen mechanism encourage the development of products and services appropriate to the sector?
- *Process development.* How will the programme support delivery mechanisms and process improvements such as improvements in risk management techniques)?
- *TA requirements:*
 - Supply side. Does the programme consider the training needs of FIs?
 - Demand side. Will supporting TA or business development services to SMEs enhance the effectiveness of the financial instrument?
- *Role of technology/innovation.* Are the target segments better served by non-traditional financing? How can the programme encourage innovation and development in this area?
- *Market distortion.* Will the intervention meet additionality criteria? (i.e. will it only make investments that private investors are unwilling or unable to make)?
- *Exit strategy.* What are the plans for exiting the investment once the programme has achieved the desired demonstration effect and private investors are ready to supply substitute funds?
- *Cost effectiveness.* How cost-effective is the proposed instrument? In general the greater the level of intervention the greater the cost and stand-alone projects can be less cost-effective than investment through larger programmes.
- *Coordination amongst donors.* What are other donors doing? Is the planned scheme targeted effectively? Is there the potential for working with other development partners?

⁸⁴ It is important to note that this is a very simplified analysis and the real world will clearly be more nuanced and complex. It does, however, illustrate how issues can be considered to develop a comprehensive initiative.

- *Sustainability issues.* Is there the potential for sustainability beyond the intervention?
- *Working with the private sector.* Is there the potential for leveraging private sector investment? How can the programme best encourage this?
- *Buy in from government.* Does the programme have government support?

There would be significant benefits to further research in this area to enhance our knowledge on the impacts of SME financing tools leading to improvements in the effectiveness of support. A common approach to measuring the success of these instruments could be developed, (including a greater number of cross comparison studies) allowing us to identify best practice in catering for the needs of specific target groups in particular (for example women-led SMEs). This could include the development of standardised M&E frameworks with specific milestones and benchmarks for different types of interventions. The coordination of donors and initiatives such as the SME financing forum go some way in allowing us to learn from the sharing of best practice, however, there is more that can be done.

Finally, the adoption of technology and recent high levels of innovation in product development has huge potential to revolutionise the SME financing sector particularly with regards to the supply of finance to SMEs, risk management techniques available and mechanisms for accessing finance. As a result, development partners should consider how they can add value in this area and work with governments and providers to determine how these instruments can sit within the broader market system.

Box 17: Example Financing Programme

Country situation: Fragile state, underdeveloped financial sector, heavy reliance on agriculture, poor regulatory and legal structure, limited donor involvement in SME financing.

Focus market: Rural/agricultural market, banks and NBFIs have limited but growing presence in SME financing market, MFIs present, no capital or debt markets, limited private sector investment.

SME characteristics: Small but growing SMEs (formal and informal). Lack of collateral resulting in limited access to formal financial markets so heavy reliance on internal funding, women-led firms prevalent, lack of financial management capacity or awareness of financial products available.

Key financing constraints: Access to finance particularly medium to long term to allow purchase of capital equipment.

Proposed solution: Strengthen leasing sector and provision of working capital finance. The following financing tools should be considered:

- Credit guarantee fund to FIs – targeting rural SMEs and encouraging FIs to expand product range to include leasing products (with support of TA)
- Direct loans/equity to leasing organisations combined with TA – strengthen the financial and operational capacity of young leasing organisations. Encourage development of sector focused products. Ensure competition between bank and NBFIs providers in the market place.
- Challenge Fund – to encourage innovation in the sector. Challenge could be to banks and NBFIs to develop new products or delivery mechanisms to increase access to finance.
- Capacity Building – both demand and supply side TA to support capacity of FIs and ability of SMEs to access finance.

Enhance regulatory, legal and accounting structure – programme could work with relevant authorities to design and implement laws and regulations governing leasing transactions. Or, could tackle tax issues that can impact the effectiveness of leasing programmes.

Justification: Support will meet additionality criteria and has potential to have a catalytic effect on the industry encouraging the crowding-in of private sector investment if successful. Enhancing the strength of banks and NBFIs and appetite for working in sector also improves chances of sustainability and the likelihood of success of the exit strategy.

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