SME FINANCE GUIDELINE NOTE

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GUIDELINE NOTE

CONTENTS

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Coworkers painting in a batik workshop in Kuala Lumpur, Malaysia.
(Image by AzmanL / iStock)

BACKGROUND

Each country has different demand and supply constraints and challenges to the MSME finance landscape. It is, therefore, important for national authorities to conduct a diagnostic assessment as a first step in the selection and sequencing of the tools presented in this guideline.

In addition, the MSME reform agenda should be structured around the capacity of governments to implement reforms and of regulators to effectively supervise and enforce regulations.

Sharing the experiences of both successful and failed SME finance reforms is an important learning tool, and this guide is an attempt to do just that. It synthesizes the work already done on MSME finance and identifies the latest approaches and innovations that may offer the potential for its facilitation. Based on these efforts and discussions with experts (G20 and B20 working groups, World SME Forum, SME Finance Forum), this guide is intended to serve as an initial reference for AFI members to develop appropriate guidelines and regulations for MSME finance, and to initiate useful dialogues among members. It is hoped that your responses to the lessons and experiences of this guide will stimulate wider discussions about the problems we all face, enrich our work and ensure more sustainable solutions to global access to finance for MSMEs.

INTRODUCTION

THE IMPORTANT ROLE OF MSMEs

Micro, small, and medium enterprises (MSMEs) are significant contributors to economies, especially in the developing world.

They represent more than 95 percent of registered firms worldwide, account for more than 50 percent of jobs and contribute more than 35 percent of gross domestic product.[1] The AFI Maputo Accord recognizes MSME financing as an important driver of economic growth, employment creation, and sustainable financial inclusion. The importance of MSME financing goes beyond conventional economic and social contributions, as it serves as a vehicle to provide better financing access to vulnerable groups such as women and youth, which are highly relevant to the Sustainable Development Goals (SDGs) and in line with the principle of “Leaving No One Behind” as part of the 2030 Agenda.[2]

In the longer-term, to optimize their full potential, national authorities must create an enabling environment for productive and high growth MSMEs to graduate into larger firms, redress and restructure (R&R) distressed MSMEs, and transition unproductive MSMEs rechanneling their resources to high growth businesses.

ACCESS TO FINANCE FOR MSMEs

Despite its importance, access to financing is one of the impediments to the growth of MSMEs. About 55 to 68 percent of established MSMEs in emerging markets are either underserved or unserved by financial institutions[3]. The SME finance gap in emerging economies is estimated at approximately USD5 trillion - 1.3 times the current level of MSME lending[4]. These numbers are even more staggering - at about USD8 trillion if MSMEs in the informal sector are also included.

Based on the World Bank Group's Investment Climate Surveys, SMEs perceive access to capital as the single biggest barrier to doing business in over 70% of nations (followed by access to electricity, the informal economy, tax rates and political instability).[4]

1 IFC, 2011, SME Finance Policy Guide.
2 www.oecd-development-matters.org
3 World Bank Group, 2017, “What’s Happening in the Missing Middle? Lessons from Financing SMEs.”
4 www.smefinanceforum.org

FINANCING INSTRUMENTS FOR MSMEs AT DIFFERENT STAGES OF DEVELOPMENT

As a company grows, the problems of obtaining funding for a small business change. MSMEs require a combination of debt and equity when transitioning from start-up to bigger scale MSMEs. MSMEs demand additional capital as they grow, starting with funding from 3F, the founder, family, and friends. The MSME finance landscape ranges from traditional loans to non-traditional sources such as asset-based lending and FinTech. The majority of MSMEs are having trouble obtaining funding and sustaining their businesses which may trap them in the "Valley of Death" (see Figure 1).

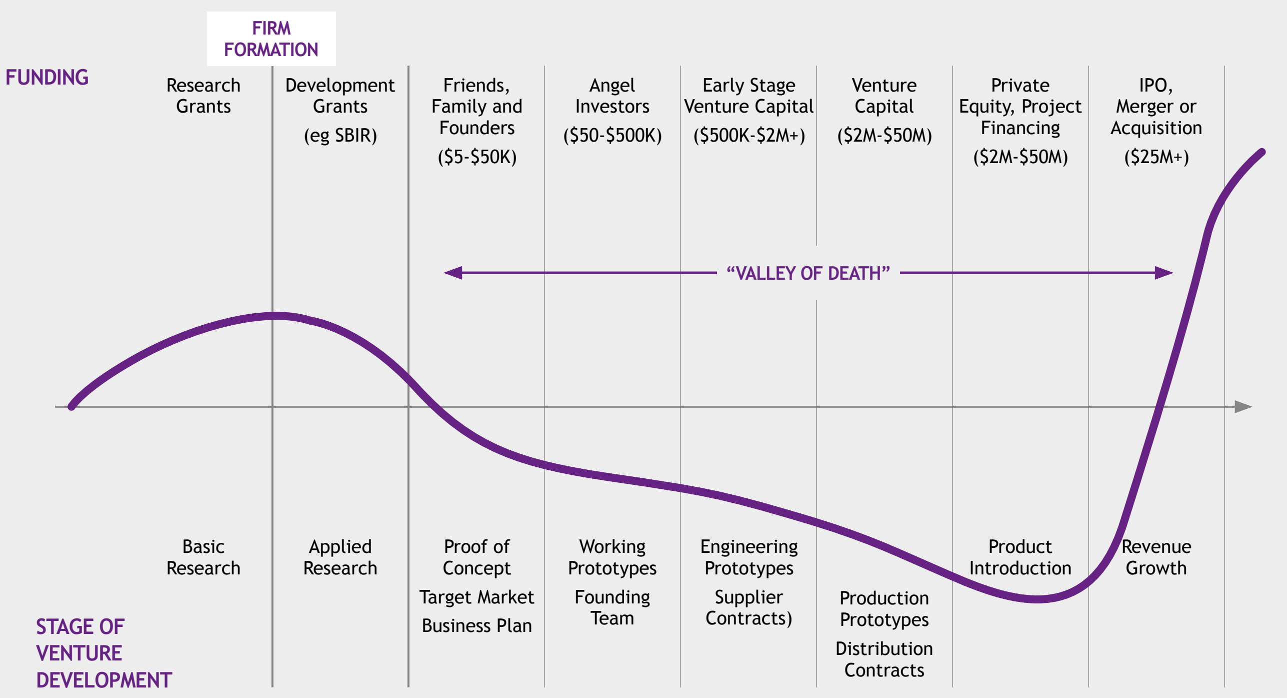
Figure 1 illustrates the typical life cycle of an MSME, and the types of funding used by MSMEs around the world. MSMEs from developing countries rely heavily on internal funds while the lack of alternative financing impedes their growth.

MSME FINANCE DATA

The availability and collection of relevant data is critical to properly assess MSME financing needs, to create a value chain ecosystem that supports economies of scale for public authorities and financial suppliers, and to rationalize business advisory services to respond to the needs of MSMEs.

Proper data on SMEs allows for their differentiation and segmentation, enabling national authorities to craft informed strategies and beneficial action plans. Ensuring timely and periodic data collection is essential to maintaining information that is reliable and up to date.

FIGURE 1: SME FINANCE INSTRUMENTS, BY STAGE OF DEVELOPMENT



Source: World Bank Group, 2017, "What's Happening in the Missing Middle? Lessons from Financing SMEs."

As highlighted in AFI Guideline No. 16: Indicators for the Financial Inclusion of SMEs, evidence-based policymaking is based on comprehensive, reliable, objective, and timely data which ensures that MSMEs have effective access to finance and that development results are achieved. When comprehensive and accurate data is available and the gaps in MSMEs' access to finance can be assessed, a benchmark for the design of effective policies can be developed while objectives and targets can be better monitored. This collective data also provides policymakers and other stakeholders with a unified framework for cross-border comparisons, which in turn, facilitates peer learning among AFI members.

Since there is no single, internationally accepted set of indicators for SME access to finance, work already conducted by international organizations, particularly the G20 Global Partnership for Financial Inclusion (GPFI) and the Organisation for Economic Co-operation and Development (OECD), can serve as a reference point for regulators to collect data that supports policymaking and monitoring. This work has informed the development of AFI's SME Finance Base Set, which can also serve as a reference.[5] Data collection, for the effective dissemination and use of SME datasets, requires the cooperation and collaboration among various national authorities and agencies.

GUIDELINES ON DATA COLLECTION

The following measures are some of the recommendations to improve the data landscape for SME finance referenced from International Finance Corporation (IFC) documents:[6]

> Identify and define the metric so that it can be compared across countries over time, then utilize it to build and implement a strategy. It should contain disaggregated data for specific groups of people, such as women and youth-owned businesses. In 2013, Malaysia's national SME definition was updated to reflect the country's economic growth from 2005.[7]

> Parameters and data indicators must be standardized to maintain data consistency and efficiency.

> The job of the national statistics agency is critical in producing high-quality, trustworthy data. The range of data collected by this institution can be expanded to include MSME financial inclusion metrics on access, utilization, and quality, as well as informal borrower and credit provider datasets.

> Develop consistent and accurate data sources for agricultural-based MSMEs seeking financing.

> Ensure that data is accessible to all.

> Connect entrepreneurs to markets and finance, rationalize and improve the coordination of business advisory services.

The key principles and dimensions of the AFI SME Finance Base Set can be a useful starting point for members embarking on such a data collection effort. The principles include:

(a) completeness
(b) usefulness
(c) consistency
(d) flexibility

The dimensions include:

(a) access indicators
(b) usage indicators
(c) quality indicators

In addition, given the increasing importance of FinTech in SME access to finance, data should be expanded to include relevant digital access and usage indicators.

Please see AFI Guideline note: How FinTech Facilitates MSME Access to Financing.

> View here

AFI recognizes the importance of the informal sector, borrowers, and credit providers in the overall MSME financing landscape. However, due to the lack of data, AFI's SME Finance (SMEF) Working Group will focus exclusively on regulated service providers.[8]

5 For more details, see: (1) IFC, 2011, "SME Finance Policy Guide"; (2) IFC for the GPFI SME Finance Subgroup, August 2011, "Strengthening Access to Finance for Women-Owned SMEs in Developing Countries: Executive Summary for GPFI Report"; and (3) IFC for the GPFI SME Finance Subgroup, August 2011, "Policy Paper on Agricultural Finance for Small and Medium-Sized Enterprises: Executive Summary for GPFI Report."

6 For additional explanation of the principles and key dimensions, see: AFI, September 2015, "Guideline Note No.16: SME Financial Inclusion Indicators Base Set," pp. 2-3.

7 https://www.smecorp.gov.my/index.php/en/policies/2020-02-11-08-01-24/sme-definition

8 https://www.afiglobal.org/sites/default/files/publications/afi_smefwg_wg_guideline_note_stg2.pdf

As detailed in an AFI Survey Report, the definition of SMEs varies from country to country, so the SME Finance Base Set relies on each country's definition, preferably one set out by law or a particular set of regulations. This, therefore, restricts the definition of SMEs to formal SMEs that have been registered by a recognized authority or agency. The SME Finance Base Set only addresses the access, usage, and quality of financial services for regulated financial service providers. Table 2 provides further details on the basic and core indicators.

In terms of the actual data to be collected, it is important to consider both supply and demand-side indicators. The OECD Scoreboard presents national data mainly on the supply side of finance sourced from either central banks or surveys of finance suppliers. The Scoreboard also includes some demand-side data collected by surveys from both private and public institutions, while recognizing the need for improvement as some of the qualitative data from the survey is anecdotal and opinion-based. Finally, it's important to note that survey methodologies vary across countries.

One example of an effective demand-side survey is the FinScope, Micro, Small and Medium Enterprise Survey Eswatini 2017 Report which measured the size and scope of MSMEs in Eswatini with the level of access to financial services for formal and informal MSMEs.[9]

Canada provides an example of a demand-side survey from a developed country. Annex 2 presents a simplified quantitative demand-side survey on Small Business Credit Conditions conducted by Industry Canada in 2010. The survey shows how policymakers can leverage high quality data without hefty administrative costs while being respondent friendly.

9 FinScope Micro, Small and Medium Enterprise Survey Eswatini 2017 Report.

TABLE 1: SME FINANCE INDICATORS

	CORE INDICATORS	WHAT THEY SHOW
1	Share of SME loans in business loans	SMEs access to finance compared to larger firms
2	SME short-term loans in SME loans	Debt structure of SMEs. % used for operations and % used for expansion
3	SME loan guarantees	Extent of public support for SME finance
4	SME guaranteed loans	Extent of public support for SME finance
5	SME direct government loans	Extent of public support for SME finance
6	SME loans authorized/SME loans requested, or SME loans used	Tightness of credit conditions and willingness of banks to lend Proxy for above indicators, however, a decrease indicates credit conditions are loosening
7	SME non-performing loans/SME loans	When compared to the ratio of non-performing loans (NPLs) for all business loans, it indicates if SMEs are less creditworthy than larger firms
8	SME interest rates	Tightness of credit conditions and risk premium charged to SMEs
9	Interest rate spreads between large and small enterprises	Tightness of credit conditions; indicates how closely interest rates are correlated with firm size
10	Percent of SMEs required to provide collateral on their last bank loan	Tightness of credit conditions
11	Venture capital and growth capital	Ability to access external equity for start-up, early development, and expansion stages
12	Payment delays	Indicator of cash flow problems; difficulty in paying and being paid
13	Bankruptcies	Rough indicator of ability to survive during a crisis

TABLE 2: CORE INDICATORS OF SME ACCESS TO FINANCE

CORE INDICATOR	UNIT	WHAT IT SHOWS
ALLOCATION AND STRUCTURE OF BANK CREDIT TO SMEs		
Outstanding business loans, SMEs	Volumes in national currency	SME demand for and access to bank credit. A stock indicator measuring the value of an asset at a given time, which reflects both new lending, bank loans that have accumulated over time and loan repayments.
Outstanding business loans, total	Volumes in national currency	
Share of SME outstanding loans	% of total outstanding loans	
New business lending, total	Volumes in national currency	SME demand for and access to bank credit. This is a flow indicator measured over one year that tends to respond faster to short-term developments and is therefore more volatile than stocks.
New business lending, SMEs	Volumes in national currency	
Share of new SME lending	% of total new loans	
Short-term loans, SMEs	Volumes in national currency	The structure of SME debt, i.e. the share of outstanding credit with an initial maturity of less than one year and more than one year, respectively. This could be considered a proxy to gauge the purpose of SME bank loans, i.e. for operational and investment needs.
Long-term loans, SMEs	Volumes in national currency	
EXTENT OF PUBLIC SUPPORT FOR SME FINANCE		
Government loan guarantees, SMEs	Volumes in national currency	Illustrates the extent and uptake of government programs and instruments supporting SME access to finance.
Government-guaranteed loans, SMEs	Volumes in national currency	
Direct government loans, SMEs	Volumes in national currency	
CREDIT COSTS AND CONDITIONS		
Interest rates, SMEs	%	The cost of SME loans and how it compares to large firms.
Interest rates, large firms	%	
Interest rate spread	Percentage points	
Collateral, SMEs	% of SMEs needing collateral to obtain bank lending	Proxies the conditions SMEs face when applying for bank credit.
Percentage of SME loan applications	SME loan applications/total number of SMEs, in %	The (unmet) demand for and use of credit by SMEs and the willingness of banks to lend.
Rejection rate	1 (SME loans authorized/ requested), in %	
Utilization rate	SME loans used/authorized, in %	
NON-BANK SOURCES OF FINANCE (ALTERNATIVE FINANCE)		
Venture and growth capital investments	Volumes in national currency and year-on-year growth rate in %	Uptake and ability to access non-bank finance instruments, including external equity for start-up, early development, and expansion stages, as well as asset-based finance, such as leasing, hire purchases, factoring and invoice discounting.
Leasing and hire purchases	Volumes in national currency	
Factoring and invoice discounting	Volumes in national currency	
DIGITAL FINANCE (ALTERNATIVE FINANCE)		
P2P lending, SMEs	Volumes in national currency	The extent of FinTech-enabled SME finance.
P2P lending as share of total loans, SMEs	%	
Challenger banks' lending, SMEs	Volumes in national currency	
Challenger banks' lending as share of total bank lending, SMEs	%	
FINANCIAL HEALTH		
Non-performing loans, total	% of total business loans	The incidence of late or non-payments of SME loans compared to the overall corporate sector. Proxies the (relative) riskiness of lending to SMEs.
Non-performing loans, SMEs	% of total SME loans	
Payment delays, B2B	Number of days	The occurrence of payment delays in the B2B sector, i.e. the difficulty in paying and being paid to capture the extent of cash flow problems.
Bankruptcies, SMEs	Number and year-on-year growth rate in %	A proxy for the overall business environment in which SMEs operate and the ability of small firms to survive economic downturns and credit crunches.

Source: Core indicators based on OECD Financing SMEs and Entrepreneurs 2017, except for access to digital finance.

LEGAL AND REGULATORY FRAMEWORKS FOR SME FINANCE

THE ROLE OF REGULATORS

OBJECTIVES

All formal financial intermediaries are regulated in some measures by government regulatory bodies, typically the central bank and the securities and exchange commission (SEC). In rare cases, regulatory authority and responsibilities may reside with other government agencies, usually a special group of intermediaries (as in the case of SBICs in the US which is discussed later).

Central banks usually regulate deposit-taking and lending intermediaries, primarily banks. Their core regulatory functions are to protect the financial system and prevent crises. SECs typically regulate non-bank financial intermediaries, such as stock exchanges, investment advisors, securities brokers and public companies listed on exchanges. The core function of SECs is to protect investors, including individuals, businesses, and endowed organizations. There are some financial intermediaries that are not clearly classified as banks or securities-related businesses and may be regulated by either the central bank or SEC, depending on the country. Some intermediaries in some countries are regulated by both. Insurance companies are an example of financial intermediaries that may be regulated by either or both.

POLICY GUIDELINES

To design and implement a legal and regulatory framework that enables and facilitates SME finance, regulators can take the following steps as indicated in the SME Policy Guide 2011 (pg. 16):[10]

a) Make a case for government intervention in the market

- Define the regulatory philosophy as well as the policy goals.
- Create a transparent and open regulatory decision-making process; and
- Examine market failure to discover issues that need to be solved and decide whether government intervention is necessary.

b) Create and implement effective policy measures

- Identify measures, including non-regulatory ones, that address the problem as it has been recognized;
- Evaluate the benefits and costs of each possible policy proposal using a structured regulatory impact assessment; and
- Design and implement the chosen regulatory solution while incorporating concerns such as clarity, consistency, proportionality, and accountability in mind.

c) Create efficient enforcement policies

- This will ensure the effectiveness of regulatory measures; and
- Enforcement actions should be fair, transparent, and well-integrated into the entire regulatory decision-making process.

d) Carry out an ex-post evaluation

- This will assess whether the regulation is still relevant in its current form or if its objectives may be achieved more effectively in another manner.[11]

One of the issues that rising and developing economies face is a lack of people and financial resources, as well as regulatory and supervisory ability. This is exacerbated by the informality with which MSMEs operate, making it difficult to adequately plan and address their needs. Adding tasks with insufficient resources reduces the effectiveness of reforms.

As a result, regulators may want to start with a basic institutional structure that is more compliance or rules-based, then progress to a more complex regulatory framework as markets, regulatory and supervisory capacities evolve over time.

10 https://www.ifc.org/wps/wcm/connect/dd44ba10-4469-4054-ac68-5deec1a335ac/G20_Policy_Report.pdf?MOD=AJPERES&CVID=jkWST-A

11 For more details, see: "Principles and Report on Innovative Financial Inclusion from the Access through Innovation," Sub-Group of the G20 Financial Inclusion Experts Group, 25 May 2010.

BANGLADESH BANK'S SME LENDING GUIDELINES

The share of MSME credit to total loans and advances remained at a lower level—22%—prior to Bangladesh Bank intervening with lending guidelines in 2010. Banks and NBFIs in Bangladesh did not consider the MSME segment profitable due to the perceived risk associated with SME financing. However, in 2010, Bangladesh Bank issued the first comprehensive MSME lending guideline for banks and NBFIs, "SME Credit Policies and Programmes." The target-based lending practices and development strategies for women entrepreneurs stipulated in the guidelines have significantly increased the level of MSME access to finance over the last six years. The target for MSME lending is not imposed by the central bank; rather, banks and NBFIs independently determine their targets every year and Bangladesh Bank simply monitors whether they have been met using pre-determined indicators.To push banks and NBFIs to achieve their targets and boost MSME lending, Bangladesh Bank also puts a significant emphasis on target performance and achievements (including women entrepreneur financing) in determining the banks' CAMELS rating. In addition, Bangladesh Bank recently issued two other policies to incentivize MSME lending by banks and NBFIs.These are: lowering the provisioning ratio of unclassified loans to MSMEs; and raising the limits of maximum lending amounts to small entrepreneurs.

These interventions have had a major impact on the level of and access to MSME financing in Bangladesh. The annual credit disbursement to MSMEs has more than doubled, from USD6,695 million in 2010 to USD14,375 million in 2015. Over the last six years, more than 350,000 new cottages, micro and small entrepreneurs, including 25,000 women entrepreneurs, have gained access to credit. Bangladesh Bank's interventions in MSME lending have ultimately resulted in about a two-percentage point increase in the share of MSME credit to total loans and advances in Bangladesh.

Source: THE ROLE OF FINANCIAL REGULATORS IN PROMOTING ACCESS TO FINANCING FOR MSMEs LESSONS FROM THE AFI NETWORK, Guideline Note No. 23, August 2016.

PRUDENTIAL REGULATION AND LENDING GUIDE- LINES FOR SME FINANCE

MACROPRUDENTIAL REGULATIONS

The 2008-09 global financial crisis magnified challenges for SME finance where policymakers need to balance stability and promoting growth. The refining standards under Basel III had an adverse impact to the SME lending.[12]

Basel III has become both the benchmark and global framework for the regulation of bank capital, liquidity, and leverage, and aims to address the deficiencies in financial regulations that led to the global financial crisis. Specifically, the provisions of Basel III improve the quality of capital requirements which makes banks adverse to riskier portfolios like SME finance. As Basel III provisions are implemented, the cost of capital for banks is expected to increase the cost of borrowing for bank clients, especially MSMEs.

WHY DOES BASEL III AFFECT LENDING TO MSMEs?

While financial stability brings substantial benefits to MSMEs, they are typically the first to feel the impact of a financial crisis, as there is a perception that they are risky borrowers and are generally rated/scored below that of large corporations. Under Basel III, banks are required to reserve extra capital, thus limiting their lending to only secured portfolios and imposing guarantees and collateral for riskier lending such as MSME loans.

HOW DOES BASEL III AFFECT LENDING TO MSMEs?

As Basel III is being implemented, banks will face two choices: credit pricing or credit rationing. Credit pricing means setting up higher cost of funds due to limited credit supply while credit rationing limits the funds available for MSME financing. Also, the cost of funds for MSMEs is likely to be higher due to less bargaining power. Both choices affect access to financing and require the intervention of regulators to ensure fund availability and affordability for MSMEs.

To cushion the impact of Basel III, based on the 2017 BBVA Research Working Paper on the Impact of Capital Regulation on SMEs Credit by José Félix Izquierdo, Santiago Muñoz and Ana Rubio and Camilo Ulloa, an additional supporting factor (SF) defined as 0.7619 was included in the capital requirements regulation (CRR) of SME exposures in banks' balance sheets.[13] Once SMEs complete the financing criteria, they can multiply their risk-weighted assets to the SF, bringing about lower capital requirements.

12 For a description of Basel III provisions, see: Financial Stability Board: http://www.fsb.org/

13 BBVA Research Working Paper on the impact of capital regulation on SMEs credit by José Félix Izquierdo, Santiago Muñoz and Ana Rubio and Camilo Ulloa (2017).

BOX 2: REPUTATION AND COMPETITION AS INCENTIVES FOR IMPLEMENTING BASEL III

Regulators in EMDEs are not merely adopting Basel III because these standards provide an optimal technical solution to financial stability risks, regulatory decisions are also driven by concerns about reputation and competition, providing:

> **A signal to international investors.** Incumbent politicians may adopt Basel standards as a signal of sophistication to foreign investors. For example, in Ghana, Rwanda and Kenya, politicians have advocated the implementation of Basel II and III, and other international financial standards, as part of a drive to establish financial hubs in their countries. However, adoption can be selective, as seen in the case of Kenya. While the Central Bank of Kenya has sought to improve its regulatory and supervisory framework and looked to international standards as the basis for these reforms, liquidity requirements in Kenya are simpler than those of Basel III, but arguably better tailored to the country's banking system.

> **Reassurance for host regulators.** Banks headquartered in EMDCs may endorse Basel II or III as part of an international expansion strategy as they seek to reassure potential host regulators that they are well regulated at home. One example is Nigeria, where large domestic banks have championed Basel II and III adoption at home as they seek to expand abroad. Their regulatory fervor has been met with reluctance among politicians who fear that a rapid regulatory upgrade may jeopardize weaker local banks.

> **Facilitating home-host supervision.** Adopting international standards can facilitate cross-border coordination between supervisors. In Vietnam, for example, regulators were keen to adopt Basel standards as their country opened up to foreign banks and wanted to ensure they had a "common language" with which to facilitate the supervision of foreign banks operating in the country.

> **Peer learning and peer pressure.** Even while acknowledging the shortcomings of Basel II and III, developing country regulators often describe them as international "best practices" or "the gold standard," and there is strong peer pressure in international policy circles to adopt them. In the West African Economic and Monetary Union (WAEMU), for example, regulators at the supranational Banking Commission are planning an ambitious adoption of Basel II and III with the support of the IMF. Domestic banks, however, have limited cross-border exposure and show little enthusiasm for the regulator-driven embrace of Basel standards.

Source: Adapted from Thorsten Beck, Emily Jones and Peter Knaack, 15 October 2018, "Basel standards and developing countries: A difficult relationship." Originally in Jones, E., and A.O. Zeitz (2018), "Regulatory convergence in the financial periphery: How interdependence shapes regulators' decisions," Global Economic Governance Programme Working Paper, Blavatnik School of Government, University of Oxford.

MICROPRUDENTIAL REGULATIONS FOR MSME FINANCE

Notwithstanding Basel III and other impositions on SMEs, policymakers and regulators should encourage financial institutions to extend financing to MSMEs via two of the most common prudential regulations, namely lower risk weights for MSME loans and lower liquidity requirements. Other interventions include easing the financing process and imposing certain quotas for financial institutions to disburse lending to MSMEs from their total lending portfolios.

POLICY GUIDELINES

The new regulatory reforms promote stability for advanced and emerging market and developing economies (EMDEs). The application of Basel III was predominantly adopted for developed countries and not compulsory for EMDEs and the degree of implementation has varied across countries.[14] Because the Basel III recommendations were initially designed with large, internationally active banks in mind, they may not meet the stability needs of EMDEs, which grapple with different sources of fragility and may find the proposed tools and policies less effective.

Nevertheless, many countries are adopting and adapting Basel II and III to different extents depending on the status and sophistication of their financial sectors. A key challenge for EMDEs that implement Basel III is to achieve economic and financial goals with robust financing landscapes for improved SME access to finance while observing domestic financial stability. Besides financial stability, reputation and competition are contributing to the decision of Basel II and III adoption (see Box 2).

IFRS 9 will change the way banks book provisions on financial assets, such as loans and bonds, by requiring banks to make appropriate provisions in anticipation of future potential losses, rather than the prevailing

14 Jones, E. and A.O. Zeitz, 2018, "Regulatory convergence in the financial periphery: How interdependence shapes regulators' decisions", Global Economic Governance Programme Working Paper, Blavatnik School of Government, University of Oxford.

15 Thorsten Beck, Emily Jones and Peter Knaack, 2018, "Basel standards and developing countries: A difficult relationship," 15 October. The case study countries are: Ethiopia, Ghana, Vietnam, Tanzania, Angola, Nigeria, Kenya, Bolivia, Rwanda and Pakistan.

16 Weis, T., 2017, "The political economy of Basel implementation in Ethiopia," Global Economic Governance Programme Working Paper, Blavatnik School of Government, University of Oxford.

practice of providing only when losses are incurred. This implies that banks will recognize provisions from the day a loan is extended, including undrawn commitments. In short, with the adoption of IFRS 9, banks may have to increase provisioning, which could affect their earnings. In trying to deal with potentially higher provisioning, banks may restructure or reprice loans, making them more expensive for borrowers with riskier credit profiles.

AFI members should assess their own situation and decide how to incorporate the provisions of Basel III. A recent comparative analysis of 11 low and middle-income countries (LMICs) shows that the adoption of Basel II and III varies.[15]

The analysis observes the stakeholder interest within the financial system. Of the 11 countries, Ethiopia lies at one end of the spectrum with no adoption of Basel II nor III due to a lack of technical, competitive, or reputational incentives.[16]

On the other hand, Pakistan has adopted Basel II and III to a significant degree driven by the internationalization of banks and motivation towards compliance and best practices.[17]

Bolivia is an example of competing influences between attracting foreign capital by adopting Basel III versus the mitigating the issue of financial inclusion and domestic development. Significant interventionist policies have been grafted onto draft legislation, such as interest rate caps and credit targets to certain economic sectors.[18]

SECURED TRANSACTIONS FRAMEWORK

OBJECTIVES

An asymmetry in information about actual credit risks and the perceived risks of lending to MSMEs has led lenders to impose strict financing requirements for MSME borrowing which includes the use of fixed assets as collateral to mitigate any default risk. However, most MSMEs, particularly small businesses, do not possess fixed assets rather moveable assets like livestock, accounts receivable equipment and intellectual property. Regulators and policymakers should apply a secured transactions framework and moveable collateral registry, thus ensuring protection to lenders (with security rights to the asset) and allow MSMEs to leverage their moveable collateral to secure loans from financial institutions.[19]

POLICY GUIDELINES[20]

A modern, secured transactions system will have the following elements:

a) A stand-alone law (e.g. secured transactions law or personal property law) instead of provisioning it in within the existing sphere.

b) Apply a broad scope of secured transaction laws for any type of assets, transaction procedures and parties involved.

c) Establish a priority scheme for creditor claims.

d) Impose speedy and inexpensive enforcement.

15 Thorsten Beck, Emily Jones and Peter Knaack, 2018, “Basel standards and developing countries: A difficult relationship,” 15 October. The case study countries are: Ethiopia, Ghana, Vietnam, Tanzania, Angola, Nigeria, Kenya, Bolivia, Rwanda and Pakistan.

16 Weis, T., 2017, “The political economy of Basel implementation in Ethiopia,” Global Economic Governance Programme Working Paper, Blavatnik School of Government, University of Oxford.

17 Naqvi, N., 2017, “The political economy of Basel implementation in Pakistan,” Global Economic Governance Programme Working Paper, Blavatnik School of Government, University of Oxford.

18 Knaack, P., 2017, “The political economy of Basel implementation in Bolivia, Global Economic Governance Programme Working Paper, Blavatnik School of Government, University of Oxford.

19 World Bank Group, 2015, “Doing Business Report.”

20 established by the international community in the UNCITRAL Legislative Guide for Secured Transactions, which is endorsed by the World Bank Group, as reflected in both the “World Bank Principles and Guidelines for Insolvency and Creditor Rights Systems” (revised 2005) and the IFC Guide on “Secured Transactions and Collateral Registries” (2010).

THAILAND'S BUSINESS COLLATERAL ACT

Thailand's Business Collateral Act B.E. 2558 (2015) was published in the Royal Thai Government Gazette on 5 November 2015 and became fully effective on 2 July 2016. The objective of the Act is to provide SMEs with greater access to sources of investment for their businesses and to boost Thailand's economic growth. Under the Thai Civil and Commercial Code (CCC), the only security a borrower could pledge was a mortgage,and only land and buildings could be mortgaged. Borrowers, or a pledgor, also had to deliver the pledged property to the lender to create a valid and binding pledge. A floating charge was an alien concept. The Act eliminates restrictions on the sorts of assets that can be used as collateral. A security provider's business, right of claim, or movable property used to conduct a business, such as machinery, inventories, or raw materials, real estate, intellectual property, or any other asset specified in the ministerial rule can now be used as collateral. The Act establishes a new type of commercial collateral contract between a borrower or security provider who agrees to supply pre-agreed assets and a lender or security receiver who lends money against such assets.

The following are some of the Act's key provisions:

> An individual or a legal corporation can act as a security provider. Security receivers, on the other hand, must be a financial institution (or any person specified in the ministerial regulation).

> A security provider holds the right to own, use, trade, dispose, transfer, or mortgage the collateral, including using it in the manufacturing process, as long as the security provider is not able to further pledge the collateral under the Act; otherwise, the pledge will be voidable.

> A written business collateral contract must be made and recorded centrally.

> The Ministry of Commerce's Department of Business Development will establish a new office called the Business Collateral Registration Office, with responsibility for the registration of securities, including the amendment and cancellation of registration records, as well as making those records public.

> Regardless of whether or not the collateral is transferred or assigned to a third party, a security receiver has a preferential right to debt payments from the collateral before other creditors.

> Enforcement action against a business that is registered as collateral must be carried out by a licensed security enforcer.

> The Act also specifies how assets and businesses submitted as collateral would be enforced, which differs from the CCC. If the Act's collateral is also mortgaged, the mortgagee has the option of enforcing the mortgage via the Act's procedures.

If revenues obtained from the enforcement are insufficient and the security provider is a third party, the creditor can make a claim against the debtor for the shortfall, but not against the security provider, and any agreement to the contrary shall be illegal.

Source: Clifford Chance, 2016, "Introduction to the Business Collateral Act B.E. 2556 (2015), 15 August."

MOVABLE ASSETS AS COLLATERAL FOR SME FINANCE: THE EXPERIENCES OF CHINA AND MEXICO

China

In 2005, China embarked on reforms of its movable collateral framework to encourage financing against valuable movable assets. Before the reforms, the use of movable collateral under Chinese law, especially intangible collateral such as accounts receivables, was a key constraint for SME financing as bank lending was largely based on real estate collateral which SMEs do not typically possess. The reform process had three phases: development of a property law; creation of an electronic registry for accounts receivables and leases; and the training of lenders to use movable assets as a basis for lending. Since China's reform of a movable collateral framework and establishment of the receivable's registry, SMEs can now use a wider range of assets, such as receivables, as a basis for borrowing. In the three years (2008–11) since the new system began operating, lenders have granted more than USD1.5 trillion in loans secured with receivables to more than 100,000 businesses, more than half of which are SMEs. These system reforms have also led to the development of leasing and factoring industries, which have grown substantially over the same period.

Mexico

Mexico has progressively introduced reforms to its secured transactions legal system over the last few years. However, the one that transformed the lending scenario for SMEs was the creation of a nationwide movable collateral registry in October 2010. With the new registry, the number of loans to businesses has increased by a factor of four, to around 23,000 in June 2011. These 23,000 loans have generated more than USD70 billion in financing to businesses, with SMEs accounting for more than 90 percent of the firms receiving those loans. The reform has also saved borrowers an estimated (cumulative) USD1.3 billion in registration fees associated with the registration of security interest in the previous system. About half the loans granted have gone to agribusinesses and farmers.

Source: G20 Stocktaking Report, 2010; de la Campa, 2010. Reproduced from the IFC's "SME Finance Guide."

AUSTRALIA'S PERSONAL PROPERTY SECURITIES REGISTER: AN EXAMPLE OF A WELL-FUNCTIONING COLLATERAL REGISTRY

Under the oversight of the Australian Financial Security Authority, which has more than 100 full time employees, the Personal Property Securities Register records the security rights on personal property, fiduciary transfer of titles, financial leases, assignment of receivables, retention of title sales and judgment claims. Launched on 30 January 2012, the registry implemented a two year transitional period during which secured parties were provided temporary protection of security rights. In 2014, the number of new registrations reached over 2.36 million. Searches soared from nearly six million in 2012 to over 7.3 million in 2014, a sign of rising confidence in the new collateral registry and regime.

Registrations can be made against individual and organizational grantors, and physical presence is not required. A standard registration form is provided with free text for some collateral classes. No additional documentation is required to be uploaded to the system. A flat fee is charged, which varies based on the registration duration. Any interested party can search online using the debtor's identifier, serial number, or registration number, among other criteria. The registry then produces an "exact match" search. If someone is unable to perform an online search, the contact center of the collateral registry provides technical support, performing the search on behalf of the user and sending them the results via email.

Despite the high volume of records, the collateral registry has yet to receive any complaints. An administrative mechanism known as the "amendment demand process" is in place to resolve any disputes that arise. The registrar of the Personal Property Securities Register is responsible for its administration. If the registrar receives a complaint that the registration of a party is invalid, they would be tasked with ascertaining whether the registration should be discharged from the registry.

Source: Australian Financial Security Authority (https://www.afsa.gov.au/); World Bank Group, 2018, "Improving Access to Finance for SMEs: Opportunities through Credit Reporting, Secured Lending and Insolvency Practices."

Given the relatively weak financial infrastructure and human resources in EMDEs, these economies could begin with the following reform measures for secured transactions:

a. Raise awareness of the relevance of secured transactions and collateral registry among policymakers, relevant stakeholders, and market players;
b. Regulate a simple practical law within a local context and financing landscape;
c. Establish a cost-effective and sustainable moveable collateral registry;
d. Build and enhance the capacity of stakeholders on secured transactions and moveable collateral registry targeting financial service providers and SMEs; and
e. As part of an existing mechanism, develop out-of-court enforcement mechanisms and capacity building programs for judges and enforcement officers for security interests.

INSOLVENCY MECHANISMS

OBJECTIVES

Insolvency mechanisms allow distressed businesses to exit the market through the orderly resolution of multiple creditors' claims. Since MSMEs are less sustainable with a higher failure rate than larger businesses, insolvency frameworks play a crucial role in their life cycle. A sound framework facilitates MSMEs in the lending process as the time and cost of insolvency proceedings may discourage unprofitable MSMEs from going to court and ultimately leads to them ceasing operations.

Regulators can make provisions in corporate bankruptcy laws to fast-track bankruptcy procedures for corporate MSMEs. However, non-corporate, smaller MSMEs require a new legal framework that covers personal insolvency law. This framework can facilitate small business owners under the following situations:

1) Give temporary protection to small business owners experiencing a short-term liquidity crisis from creditors to plan for their debt rescheduling or consolidation.
2) Facilitate vulnerable small business owners to repay creditors and return productive assets to the economy.
3) Discharge small business owners from their debt. In the case of a sole proprietorship, the outstanding obligations of the individual remains in perpetuity, unless specifically forgiven by creditors.

Insolvency regulations and mechanisms should specifically focus on MSME conditions, including the use of asset resolution to solve MSME indebtedness. However, mechanisms vary across countries depending on their ecosystem and infrastructure. Out-of-court workout (OCW) is a flexible insolvency practice that negotiates a multilateral contractual agreement with creditors to change a debtor's asset and liability composition without judicial intervention thus avoiding the liquidation of MSMEs. Only a few countries have implemented OCW as it is rarely used in practice.[21]

OCWs were first introduced by UK regulators during the industrial recession of the mid-1970s, when commercial banks experienced high levels of non-performing loans (NPLs). Known as the London Approach, the Bank of England implemented a series of informal agreements between debtors and banks to rehabilitate distressed but potentially viable firms. Details of the guiding principles of the London Approach are specified in IMPROVING ACCESS TO FINANCE FOR SMEs, Opportunities through Credit Reporting, Secured Lending and Insolvency Practices, May 2018 (World Bank Group).[22]

Thailand is one of the countries that adopted its version of the London Approach to out-of-court workouts (CDRAC) in 1998 via companies that restructured during the Asian financial crisis (1998-2001).[23]

The 2008 global financial crisis prompted several other countries to adopt the London Approach as defaults and illiquidity for many MSMEs led to an increase in NPLs. Courts became overburdened due to the inadequacies of insolvency procedures and a lack of capacity for voluntary restructurings[24].

Another option is pre-insolvency proceedings, which take place prior to a business formally going into bankruptcy via collective proceedings to restructure the liabilities of a distressed debtor. The proceedings, tied with a contract, avoid the start of a formal insolvency under the supervision of a court or administrative authority. It is vital to incorporate pre-insolvency proceedings as one of the main components for an insolvency framework.

Recent insolvency reform trends include specialized insolvency proceedings, which are a combination of expediated and simplified judicial debt restructurings targeting firms of a specific size or market, though it's only applicable in a few countries.[25]

21 IMPROVING ACCESS TO FINANCE FOR SMES, Opportunities through Credit Reporting, Secured Lending and Insolvency Practices, May 2018 (World Bank Group).

22 Garrido, 2012 in https://documents1.worldbank.org/curated/en/316871533711048308/pdf/129283-WP-PUBLIC-improving-access-to-finance-for-SMEs.pdf, p. 41.

23 Kawai, M., and H. Schmiegelow, 2013, "Financial Crisis as a Catalyst of Legal Reforms: The Case of Asia," ADBI Working Paper 446, Asian Development Bank Institute, Tokyo.

24 Nigam, N. and A. Boughanmi, 2016, "Can Innovative Reforms and Practices Efficiently Resolve Financial Distress?" Journal of Cleaner Production 140 (3): 1860–71.

25 For further details, see: The World Bank Group's "Improving Access to Finance for SMEs: Opportunities through Credit Reporting, Secured Lending and Insolvency Practices" (2018). The study draws on Doing Business data obtained through a questionnaire administered by the World Bank Group to legal experts, insolvency practitioners and judges in 190 economies, as well as available literature.

POLICY GUIDELINES

In broad terms, a regulatory framework for personal/ small businesses should cover:[26]

a. A simple and transparent process for distressed entrepreneurs to rescue their businesses;

b. A clear method to liquidate the business if it fails, which includes repaying creditors in a timely manner and discharging remaining debts;

c. Protection for creditors, which includes lifetime limits on the number of times an individual can go bankrupt and punishments for fraudulent behavior; and

d. A balance between debtor and creditor protections.

In more practical ways, regulators can decide whether any of these insolvency channels suit their specific conditions and put relevant regulations and mechanisms in place. Some options are outlined below.

OUT OF COURT WORKOUTS (OCW)

Common features of a legal framework for OCW are as follows:

i. A standstill period in which creditors cannot make any claims.

ii. A requirement of good faith negotiations.

iii. A recommendation to disclose all relevant information (for the debtor and creditors).

COLOMBIA'S INSOLVENCY REGIME

In 1999, as Colombia was in the grips of a financial crisis and facing a backlog of failing businesses entering an extremely inefficient bankruptcy process, the country pursued reforms of its bankruptcy code. Law 550, as it is known, streamlined the reorganization process by establishing shorter statutory deadlines for reorganization plans, reducing opportunities for appeal by debtors and requiring mandatory liquidation in cases of failed negotiations.

The pre-reform reorganization process was so inefficient that it failed to separate economically viable firms from inefficient ones. Following the reforms, the country's insolvency system separated viable enterprises from unviable ones, allowing the former to restructure and liquidating the latter.

By substantially lowering reorganization costs, the reform improved the pool of firms being reorganized and made the bankruptcy system more efficient.

Source: Giné and Love, 2006, "Do reorganization costs matter for efficiency? Evidence from a bankruptcy reform in Colombia," World Bank.

OUT-OF-COURT WORKOUTS IN LATVIA

In 2009, Latvian authorities devised a strategy to implement voluntary debt-restructuring techniques such as OCWs, despite having one of the highest levels of indebtedness in Europe. The Ministry of Justice, the state Insolvency Administration, the Latvian Commercial Bank Association, the Latvian Certified Insolvency Process Administrator Association, the Latvian Labor Confederation, the Foreign Investors Council in Latvia, the Latvian Chamber of Commerce and Industry, and the Latvian Borrowers Association formed a consultative committee.

In August 2009, the Consultative Committee established voluntary out-of-court settlement rules based on the INSOL principles, which were adjusted to conform with Latvia's insolvency structure. The rules were posted on the Ministry of Justice's website, and the government held workshops and training sessions to create awareness and promote their use among stakeholders (banks, insolvency practitioners). The OCW standards have been identified by Latvia's leading banks as critical in tackling the widespread debt concerns in the corporate sector that have resulted from the financial crisis.

According to the Financial and Capital Market Commission, most Latvian banks have adopted these principles into their internal procedures, making it easier for creditors and debtors to agree on adjustments to debt repayment arrangements. This has allowed debtors to continue doing business without having to file for bankruptcy in court, which has freed up resources in the court system. Creditors and debtors can also use the OCW to resolve collective action issues by imposing standstills or moratoriums, as well as encouraging transparency and good faith in discussions.

Source: Erbenova et al., 2011; Latvia Ministry of Justice, "Guidelines for Out-of-Court Debt Restructuring in Latvia," https://www.tm.gov.lv/

PRE-INSOLVENCY PROCEEDINGS

Pre-insolvency proceedings are a type of business reorganization that takes place before a company becomes bankrupt. Insolvency laws are normally applied by a court or an administrative authority and are the consequence of arrangements made throughout the proceedings with minority creditors that have been authorized by a qualified majority of the affected creditors.

26 For more details, see: The World Bank's "Principles for Effective Insolvency and Creditor Rights Systems" (the Principles), which distils international best practices on the design of these systems, emphasizing contextual, integrated solutions and the policy choices involved in developing these solutions.

OCW is based on the desire and approval of creditors to participate in the workout. A restructuring moratorium forms part of the pre-insolvency proceedings in certain legal systems. The moratorium is similar to the OCW standstill period, except that the standstill period is a voluntary arrangement between creditors and the debtor, but the moratorium is legally compelled.[27]

Pre-insolvency proceedings are not adequately regulated or not regulated at all by insolvency laws. Different countries apply different pre-insolvency procedures since there are no comprehensive standards. This hinders cross-border enforcement, contributes to financial loss for creditors and shareholders and restricts the reorganization of groups of companies in other jurisdictions.[28]

SPECIALIZED INSOLVENCY PROCEEDINGS[29]

In-court corporate insolvency procedures balance growth and market stability by allowing viable businesses to endure or be efficiently closed while ensuring creditors maximize the value on their assets. The drawbacks of these procedures are that they can be complicated, time-consuming, and costly with rigid structures[30], which could mean that by the time either the company or debtors initiate insolvency proceedings, the business may no longer be viable with a loss of value.[31]

By allowing targeted, faster, and simplified debt restructuring or liquidation procedures, specialized bankruptcy proceedings may lower the risk of corporate collapse.[32] By tailoring procedural regulations and minimizing the burden on businesses without sacrificing vital creditor safeguards, several economies have begun to create streamlined, flexible, and accessible bankruptcy mechanisms.[33]

Some countries have introduced Specialized Insolvency Proceedings that focus on flexible commencement standards, a streamlined method for the participation of creditors, in each procedural phase, as well as expedited mechanisms and lower expenses.[34] The proceedings also need to balance the incentive of debtors (moratorium) and creditors (flexibility) in negotiating a settlement (reorganization plan).

DIFFERENT APPROACHES TO SPECIALIZED INSOLVENCY PROCEDURES

One of two approaches has been taken by economies that have implemented regulatory reforms in this area. To make the insolvency framework more efficient and less costly, the first option is to rely on the general insolvency framework and provide exceptions, in particular technical procedures for basic claims. The second option is to implement a new insolvency procedure that is specifically geared to the needs of small businesses.

Specialized insolvency proceedings for MSMEs have been implemented in Japan and the Republic of Korea. The Japanese SME insolvency framework differs from regular insolvency procedures in that it has a shorter schedule, more specific eligibility and initiation restrictions, and more flexible standards for proof and challenge of claims.

Other countries, such as Argentina, Germany, and Greece, have created exceptions to their insolvency laws for “small cases.” In Argentina, for example, forming a creditors' committee is not required in cases involving less than 20 unsecured creditors for businesses with fewer than 20 employees (this is required in conventional bankruptcy proceedings). In Greece, debtors with assets of less than 100,000 euros (USD123,000) are entitled to start simplified processes that include an expedited verification process for creditors' claims.

The 17 OHADA economies in Africa have developed a single insolvency framework that has streamlined the reorganization process for small businesses. A reorganization plan must be adopted within two months under this fast-track method; there is no necessity to hold a general meeting of creditors or for the judge to oversee every step of the process, and there is no right of appeal.

Source: Source: The World Bank Group, 2018, “Improving Access to Finance for SMEs: Opportunities through Credit Reporting, Secured Lending and Insolvency Practices.”

27 The World Bank Group, 2018, “Improving Access to Finance for SMEs: Opportunities through Credit Reporting, Secured Lending and Insolvency Practices.”

28 European Commission, 2012, “Proposal for a Regulation of the European Parliament and of the Council amending Council Regulation (EC) No 1346/2000 on insolvency proceedings.”

29 Typically, specialized proceedings can also be referred to as “simplified proceedings” and offer various procedural advantages, such as shorter statutory limits, fewer creditors’ meetings, limited court appearances, fewer opportunities for appeal, less judicial oversight and lower court fees.

30 Goudzwaard, T.M., 2014, “Introducing pre-insolvency procedures in the European Insolvency Regulation: A search for common grounds to introduce pre-insolvency procedures in the European regulatory field,” University of Amsterdam, Faculty of Law.

31 IMF, 2014, “Global Financial Stability Report: Moving from Liquidity to Growth Driven Markets.”

32 European Commission, 2011, “Insolvency proceedings in the context of EU company law European Parliament resolution of 15 November 2011 with recommendations to the Commission on insolvency proceedings in the context of EU company law (2011/2006(INI)).”

33 World Bank, 2016, “Insolvency and Creditor/ Debtor Regimes Task Force Report.”

34 Garrido, Jose, M., 2012, “Out-of-Court Debt Restructuring,” World Bank Group, Washington, DC., visit: http://documents.worldbank.org/curated/en/417551468159322109/Out-of-court-debt-restructuring

ALTERNATIVE SME FINANCE INSTRUMENTS:[35] LEASING AND FACTORING

OBJECTIVES

Access to finance for MSMEs can be facilitated by NBFIs, which can offer a range of non-bank instruments. Two widely used instruments are (a) Leasing and (b) Factoring.

LEASING AND FACTORING

Leasing is a complementary source of investment finance while factoring is an alternative source of working capital, particularly in countries with weak credit infrastructure.

According to Klapper 2006, the financial concept of factoring is defined as a type of "supplier financing in which firms (seller) sell their creditworthy accounts receivable at a discount (generally equal to interest plus service fees) and receive immediate cash from a specialized institution (factor)."[36] The lender buys a firm's invoices at a discount rate and in the event of non-recourse, the lender will collect the invoices straight from the parties that owe the money. Also, in factoring, the supplier can transfer their credit risk from risky MSMEs to a more quality buyer (factoring house).

On the other hand, leasing gives the opportunity for MSMEs without any collateral to secure a loan as it focuses on the firms' ability to generate cash flows from their operations to make the lease payments.

A new form of factoring known as "Reverse Factoring or Supply-Chain Financing" has emerged as a popular financial tool whereby financial institutions buy invoices only from quality credit buyers and not from a portfolio of buyers of specific sellers. This is an alternative financing option for risky suppliers (SMEs) to get loans, especially in countries with weak credit information systems.

Regulators and policymakers can incentivize the factoring house and NBFIs via tax restructurings, legal and regulatory environments and more recently, through the introduction of technological platforms targeting wider financial access to unserved MSMEs with variety of financial products at lower costs.

POLICY GUIDELINES ON LEASING

The IFC's "Leasing in Development: Guidelines for Emerging Economies (2009)" proposed the following legislative framework:

a. Define leasing and the rights and responsibilities of the parties to a lease.
b. Develop a unified registry for movable collateral where all security interests are recorded and protected.
c. Clearly define the process for registering leased assets.
d. Clearly define and enforce repossession procedures.
e. Ensure the right of the lessor (as owner) to repossess a leased asset, regardless of the type of breach by the lessee.
f. Ensure that tax laws are not biased against leasing. Income tax treatment of leasing and loans should be similar, and value-added tax rules should clarify that a leasing operation is a financial service, not the sale of a good or rental; and
g. Insolvency regimes must clarify the rights of lessors and lessees under bankruptcy. Lessors' rights (as a secured lender) under bankruptcy should be preserved as leased assets do not belong to the insolvent company and should be returned to the owner (the lessor).

FOSTERING SME LENDING THROUGH LEASING IN JORDAN

In 2006, Jordan's Ministry of Industry and Trade, in collaboration with the IFC, launched a program to improve Jordan's leasing environment and encourage and boost leasing activity. The project's main activities included:

(i) assisting policymakers in drafting, lobbying, and promoting leasing legislation based on best practises;
(ii) consulting and training leasing stakeholders (e.g. financial institutions, equipment suppliers, and investors);
(iii) raising awareness of the benefits of leasing to SMEs in financing business assets; and
(iv) promulgating leasing legislation.

35 Here, alternative finance refers to leasing and factoring. However, alternative finance can encompass several other non-bank lending instruments, such as intellectual property (IP) financing, equity type financing for small growing firms, such as angel investing, venture capital, mezzanine financing and small business investment companies (as in the US and Malaysia). In addition, there are FinTech-enabled alternative finance instruments, such as crowdfunding, which will be discussed in Volume 2 of this Guideline Note.

36 Klapper, L., 2006, "The Role of Factoring for Financing Small and Medium Enterprises," Journal of Banking and Finance 30 (11): 3111-12.

Laws have since been introduced on leasing, movable leased assets registration instructions, registration instructions for leased vehicles, and internal procedures for land registration. Financial leasing has become more favorable as a result of the program, and Jordan's leasing market has grown significantly.

Source: G20 Stocktaking Report, 2010; reproduced from SME Finance Guide, 2011.

POLICY GUIDELINES ON FACTORING

A strong and satisfactory legislative framework for factoring should facilitate the sale, or assignment, of receivables with less need for reliance on other legal options such as bankruptcy law. However, factoring requires good contract enforcement and historical credit information on all buyers, which is inadequate in most emerging countries.

THE SUCCESSFUL IMPLEMENTATION OF FACTORING PRACTICES IN MEXICO

Nacional Financiera (NAFIN), a Mexican development bank that has provided movable asset financial products since 1980, illustrates the successful implementation of factoring and reverse factoring (supply chain finance). Established with the advice of the World Bank Group, NAFIN's provides reverse factoring services to SMEs through its cadenas productivas (productive chains) program. The program's main feature links small, risky suppliers with large, creditworthy, often foreign-owned firms that buy from them. Small firms can then use the receivables from their larger clients to secure loans.

Participating SMEs must be registered with NAFIN and have an account with a bank that has a relationship with the buyer. Following a factoring transaction, funds are transferred directly to the supplier's bank account and the factor becomes the creditor (i.e. the buyer repays the bank). The factor collects the loan amount directly from the buyer after a period of 30 to 90 days. NAFIN requires that all factoring services are offered without additional collateral or service fees, at a maximum interest rate of seven percentage points above the bank rate (five percentage points, on average), which is about eight percentage points below commercial bank rates. All factoring is conducted without recourse, which allows SMEs to increase their cash holdings and improve their balance sheets.

The sale of receivables from the supplier to the factor and the transfer of funds from the factor to the supplier are done electronically. NAFIN's electronic platform provides 98 percent of its factoring services online, reducing both time and labor costs while improving security. The electronic platform allows all commercial banks to participate in the program, giving national reach to regional banks. NAFIN has grown rapidly thanks to this technology, increasing its factoring market share from two percent in 2001 to 60 percent in 2004. NAFIN's platform also reduces fraud, which is systemic in the factoring business in the US and other developed economies. Since only large buyers canenter new receivables, sellers cannot submit fraudulent receivables. Moreover, since the bank is paid directly by the buyer, suppliers cannot embezzle the proceeds.

The success of the NAFIN program highlights how the use of electronic channels can reduce costs and provide a larger portfolio of financial services to SMEs. The case also underscores the importance of legal and regulatory support—Mexico's electronic signature and security laws have proven critical to NAFIN's success and could be a model for other developing economies.

Source: NAFIN Annual Reports for 2015, 2014, 2013 and 2012 (http://www.nafin.com).

POLICY AND MARKET DEVELOPMENT INITIATIVES

CAPACITY BUILDING AND TRAINING

Building the capacity of the banking sector and disseminating appropriate MSME data are important in SME finance for three reasons: (a) banks can identify high-value economic opportunities with MSMEs and determine whether they are feasible; (b) financing systems can be developed and instruments adapted to MSMEs rather than only large corporates; and (c) banks can reduce or mitigate information asymmetry from the demand side and provide better information and advice to their SME customers on available services, products and schemes.

The central banks of India and Malaysia have taken measures to improve the supply side capability by providing specific training programs and advisory services for banks. These measures have made inroads in curbing information asymmetries, reducing perceived lending risks, and enabled banks to better understand MSME risks, while at the same time providing opportunities for MSMEs to acquire better knowledge about the right financial products while improving their capabilities on financial management and record-keeping.[37]

FINANCIAL EDUCATION AND AWARENESS

Financial education mitigates the main issue of information asymmetry both from the supply and demand side. This is an important element of SME access to finance policies as it raises public knowledge of the initiatives and services offered to MSMEs and builds capacity in financial management, helping more financially knowledgeable and bankable entrepreneurs. From the supply side, FSPs with better information of MSMEs reduce the perception and adverse risk of MSMEs.

FINANCIAL EDUCATION PROGRAMS IN BANGLADESH AND MALAYSIA

Bangladesh Bank recently implemented the Skill for Employment Investment Program (SEIP) with financial support from the Asian Development Bank (ADB) and the Swiss Agency for Development and Cooperation (SDC). The project aims to train 10,200 people in the next three years and each course has a separate module on MSMEs. Meanwhile, Bank Negara Malaysia (BNM) conducts regular outreach and awareness programs, including some in collaboration with financial institutions and other agencies.

BNM has a dedicated SME Promotions team that regularly participates in events, seminars, and exhibitions nationwide. Financial education topics are routinely included and geared to the attendees and focus of the events.

Source: AFI, 2015, "Guideline Note 16: SME Financial Inclusion Indicators Base Set."

MALAYSIA'S TRAIN-THE-TRAINERS PROGRAM ON SME FINANCING

Bank Negara Malaysia's Train the Trainers (TTT) Program on SME Financing was developed in collaboration with financial institution associations, including SME Corporation Malaysia, Credit Guarantee Corporation Malaysia Berhad, Credit Bureau Malaysia Sdn. Bhd. and Agensi Kaunseling dan Pengurusan Kredit. The TTT program trains a pool of financial institution officers nationwide to become trainers and conducts a series of briefings for internal staff and training sessions for SMEs. The program is part of a continuous effort to enhance the capabilities of financial institutions to deliver quality advisory services and address the information gaps faced by SMEs.

The TTT program raises awareness of the various funds and financing schemes, capacity building initiatives and financial and advisory services available to SMEs and improves their understanding of financing requirements.

This enables SMEs to gain access to financial services and improve their capabilities, particularly in financial management and business strategy. Bank Negara Malaysia conducted a TTT workshop in December 2015, covering comprehensive modules that addressed knowledge gaps related to access to financing. A CD of the TTT modules was also developed to support staff training and capacity building. It includes videos of presentations by resource officers, slide presentations, trainers' notes, frequently asked questions and relevant e-brochures.

SME Corp, in partnership with the Malaysian Association of Banks, held 22 SME finance seminars across the country. The resource officers were chosen from a pool of trainers that represent financial institution associations. To generate awareness of TTT programs available for SMEs nationwide, BNM created and distributed video teasers via social media and partner websites.

Source: AFI, 2016, Guideline Note 23: The Role of Financial Regulators in Promoting Access to Financing for MSMEs: Lessons from AFI Network.

37 AFI Guideline Note 23, The Role of Financial Regulation in Promoting Access to Financing for MSMEs..

CREDIT INFORMATION AND CREDIT BUREAUS FOR SMEs

CREDIT INFORMATION SYSTEMS (CIS)

Credit information systems are vital to assess the creditworthiness of MSMEs as they provide lenders with reliable information that reduces the risk of default. Two of the main credit reporting systems available, Public Credit Registries (PCRs) and Private Credit Bureaus (PCBs), support banking supervision and promote access to finance by mitigating any risks of vulnerable groups like MSMEs for lenders.

Public Credit Registry (PCR) contains data collected by central banks and financial regulators and incorporates additional information from commercial banks and financial institutions. The data is used to predict a bank portfolio's performance and returns some of the data to lenders in the form of basic credit reports. Lenders then use the reports to evaluate a potential borrower's creditworthiness and monitors their performance. An effective credit reporting system reduces a lender's operating costs and improves access to credit for small borrowers. It also facilitates non- collateralized lending by providing sufficient information about a borrower's credit repayment history to compensate for the unavailability of collateral.

Public Credit Bureaus (PCBs) collate data from a broad range of financial and non-financial institutions then distribute it to participating members via a common information-sharing platform. The data incorporates "positive" credit history data that is valuable to prevent over-indebtedness.

By leveraging data, credit scoring is another statistical tool that calculates the probability of prospective borrowers to service their loans. Credit scores are generally higher than a single assessment from credit history. The application of credit scoring started with individuals and has now extended to MSMEs. In addition to credit scores, SME Corp. Malaysia applies SME Competitiveness Rating for Enhancement (SCORE), a supplementary tool to credit scoring that rates and enhances the competitiveness of SMEs based on their performance and capabilities.[38]

POLICY GUIDELINES

a. Credit Information Systems need to collect and disseminate relevant, reliable, and useful data by identifying mandatory data parameters and access to real-time data.

b. An insufficient information environment requires data collection within and beyond the financial services industry. Credit bureaus complement these services via credit scores.

c. In addition, credit-reporting service providers effectively identify potential borrowers and allow access to public data via intergovernmental cooperation. Key elements of a credit-reporting regulatory framework include:

   i. Identifying the scope and usage of data
   ii. Including positive and negative data for individuals and SMEs
   iii. Incorporating non-regulated entities
   iv. Defining the roles, responsibilities, and liabilities of participants
   v. Data is at the account level and includes historical data
   vi. Consumer protection on consumer data and rights

India has introduced SME rating agencies to generate and provide additional information to prospective lenders. Some elements that require improvement, however, include the degree of independence of the rating provider and level of profitability of the agencies. This was resolved with the government's intervention through the Development Financial Institution (DFI) at the regional level to equalize the fixed costs while offering national expertise.

38 AFI Guideline Note 23, The Role of Financial Regulation in Promoting Access to Financing for MSMEs..

CREDIT BUREAU SINGAPORE

CBS was established in 2002 as Singapore's first commercial credit bureau, with the goal of assisting lenders in making faster and more informed loan decisions. CBS noticed at the start of the financial crisis, with the help of the Singapore government, that financing to SMEs was tightening and that further measures were needed to eliminate information asymmetry. CBS is one of Southeast Asia's few private credit bureaus that collects information on both consumers and companies. CBS has access to the trade credit data of thousands of Singaporean companies because to its partnership with Dun & Bradstreet. CBS created a proprietary credit scoring tool in May 2010 in collaboration with Fair Isaac Corporation to precisely evaluate the risk (probability of default) connected with SMEs' credit applications.

The score's algorithm combines credit history data from the company, including trade credit experience complemented with the personal credit history of the company's owner and key stakeholders. This mixed score is particularly useful to determine the risk profile of smaller enterprises, where specific financial data is either unavailable or frequently incorrect.

Source: International Finance Corporation (IFC), 2011, SME Finance Policy Guide; IFC, 2010, Scaling-Up SME Access to Financial Services in the Developing World.

CUSTOMIZED PRODUCTS FOR SMEs IN THAILAND

SME credit scores

The National Credit Bureau of Thailand started providing FICO SME ratings to banks and financial institutions in May 2016 to help them better analyze the creditworthiness of SMEs. The FICO SME Score is calculated using an experimentally determined model and data collected by the National Credit Bureau of Thailand and Business Online Public Company Limited, a private research business, to estimate the likelihood of delinquency of more than 90 days in the next 24 months. It generates a three-digit number ranging from 490 to 813 in eight risk bands ranging from AA to HH, which ranks SMEs in order of risk.

The higher the score, the lower the risk

The lender may receive up to five "reason codes" to aid in the interpretation of the score. Lenders can use the scores to make faster, more accurate, and consistent lending choices. Lenders can also utilize the FICO SME Score to back up their “Retail-IRB” (Internal-Ratings-Based) approach to determining the required minimum regulatory capital. The score can be applied to a variety of products and lenders, and can also be used to make decisions throughout an account's life cycle.

Source: International Finance Corporation (IFC), 2011, SME Finance Policy Guide; IFC, 2010, Scaling-Up SME Access to Financial Services in the Developing World.

COMPANIES DATABASE: FIBEN

Companies Database (France) The Banque de France manages FIBEN, a corporate database established in 1982 to aid in the implementation of monetary policy and to assess the credit quality of bills issued for rediscounting. The FIBEN database, which comprises data necessary for credit risk analysis (identification, legal event, management, indebtedness, financial evaluation) is a key instrument to analyze risk, make choices, and monitor enterprises, and is accessible to credit institutions and public economic authorities.

Companies can also refinance through the banking system, utilizing private bills as collateral and relying on the central bank’s payment system operations for support. The total amount of loans extended to SMEs in France was USD262.4 billion as of November 2009.

Between November 2008 and November 2009, credit granted by banks to SMEs climbed by more than 1.9 percent, while credit granted to the private sector as a whole decreased by 0.9 percent.

Source: International Finance Corporation (IFC), 2011, SME Finance Policy Guide; IFC, 2010, Scaling-Up SME Access to Financial Services in the Developing World.

CREDIT REGISTRY: BANK NEGARA MALAYSIA

Following the 1997 Asian financial crisis, Bank Negara Malaysia realized the value of exchanging credit data to improve lending decisions and prevent over indebtedness.

The Central Credit Reference Information System (CCRIS) initiative was started by the bank, and it is now the region's most comprehensive collection of financial data. Almost all Malaysian lenders use the data set, which includes information on both persons and businesses.

The CCRIS database is one of the best instances of a modern public registry, however, it has limits in the SME sector, even though it meets the needs of the retail sector. Recognizing these flaws, Bank Negara Malaysia is working with the Credit Guarantee Corporation of Malaysia and the private sector to offer more SME-centric services.

Source: International Finance Corporation (IFC), 2011, SME Finance Policy Guide; IFC, 2010, Scaling-Up SME Access to Financial Services in the Developing World.

CREDIT GUARANTEE MECHANISMS FOR MSMEs

OBJECTIVES

A common public intervention to increase access to credit for MSMEs is credit guarantee schemes (CGSs) which, in return for a fee, provide third-party partial credit risk mitigation to lenders by absorbing a portion of the lender's losses (risks) on the loans made to MSMEs in case of default. As lenders assume part of the risk for default, there is a reduced chance of distortion in credit markets with CGSs than more direct forms of intervention, such as state-owned banks.

CGSs can be a particularly useful instrument to address information gaps in the medium-term (especially in countries with weak institutional environments) in coordination with credit registries, and to build the capacity of lenders to originate credit and manage risk (e.g. technical assistance to set up SME units in banks). CGSs can also be leveraged to provide counter cyclical financing to MSMEs during an economic downturn and the accompanying risk aversion and potential credit crunch. CGAs may also have some advantages relative to lenders in spreading and diversifying risks. If lenders face restrictions preventing them from diversifying their loan portfolios (e.g. because their portfolios are geographically concentrated or focused on certain types of borrowers), guarantors may be able to spread out and diversify the risks by providing guarantees to several lenders.

CGSs can be established by either the private sector or public sector. A popular form of private CGA is a mutual guaranteed association (MGA) in which members of small business organizations deposit money into a fund that guarantees loans to members of financial institutions. The advantage of MGAs is that member firms have better information about each other than lenders, as MGAs typically evaluate their members carefully and can thus act as a screening device, reducing asymmetric information problems. The fact that other firms are willing to accept joint responsibility for a loan to a firm sends a positive signal to lenders about the quality of their credit. Moreover, MGAs have a group liability structure because all borrowers backed by the scheme have a financial stake in the guarantee fund—there is a cost for all members if other members default and therefore incentives to monitor each other, reducing moral hazard issues.[39]

If private CGSs can address information asymmetries and risk diversification issues, why are public CGAs prevalent in so many countries? Governments often get involved in these schemes in two different ways: (1) by providing funds to private guarantee schemes, such as MGAs, and (2) by setting up a public credit guarantee scheme.[40] Unlike MGAs, public CGSs do not typically have better information about borrowers than lenders, and thus do not directly reduce information asymmetries.

In addition, while credit guarantees can serve as a substitute for collateral, they do not reduce moral hazard and adverse selection as does collateral because borrowers are not pledging their own assets and thus do not face an additional cost in case of default. On the other hand, public CGSs might reduce information asymmetries, at least in the long run, by acting as a subsidy for lenders to learn about new groups of borrowers.

In short, public CGSs can be a useful instrument to enhance access to finance for certain groups of borrowers, but their success and financial sustainability hinge on proper design. From a regulator's perspective, it is important to ensure that CGSs are designed and operated to achieve both outreach and additionality in a financially sustainable way.[41] Reaching MSMEs that are credit constrained involves risk taking and financial losses. Public CGSs are not expected to make a profit, but they should be financially sustainable in the long-term (i.e. able to contain losses and ensure an adequate equity base vis-à-vis their expected liabilities) through sufficient funding, effective risk management and sound operational rules. CGSs are established to address market failures that prevent MSMEs from accessing credit at socially desirable levels. Hence, they are not an end in themselves, but a means to solve a problem. It is, therefore, essential that market failures are comprehensively analyzed to identify and define the problems to be addressed, and to determine whether there is evidence that government intervention through a CGS is justified. It is also important that

39 Honohan, P., 2010, "Partial Credit Guarantees: Principles and Practice," Journal of Financial Stability 6, 1–9.

40 According to a survey of CGSs around the world conducted by Beck, Klapper and Mendoza (2010), the majority of CGSs in developing and emerging economies are public schemes, while the majority of CGAs in developed countries are MGAs. MGAs are particularly common in Europe. For example, Italy has about 950 MGAs, Germany 24, Spain 20, and France 10.

41 "Outreach" refers to the number of guarantees issued by CGSs and the number of outstanding guarantees. In principle, the greater the outreach, the stronger the impact of the CGS on SMEs. However, the impact of the CGS on the supply of credit to SMEs will also depend on whether guarantees are mainly extended to SMEs that are credit constrained, either in terms of access or unfavorable conditions, such as cost and maturity (financial additionality).

CGSs are phased out as information asymmetries (i.e. banks' perceptions of SME risks versus actual risks) are addressed over time.

Public CGSs around the world differ by design, notably the management structure's operating rules, and by the characteristics of their guarantees, such as the coverage ratio and pricing. These design choices can be critical to the success and financial sustainability of CGSs because they influence the participation of financial institutions, administrative costs, and loan default rates[42].

POLICY GUIDELINES

The World Bank Group and the Financial Sector Reform and Strengthening Initiative (FIRST) have developed a set of principles for the design, implementation, and evaluation of public CGSs for SMEs, which are summarized below.[43] As noted by the World Bank and FIRST, the success of CGS depends on several preconditions, including: (a) regulations to ensure contract enforcement, fair resolution of contracts and those related to insolvency, collateral, consumer protection and private property; (b) A highly-regulated legal, accounting, and auditing system, as well as an independent judiciary systems; (c) a complete collection of accounting rules and regulations; and (d) a healthy financial system capable of effectively originating and managing credit. With these preconditions, the World Bank and FIRST have set forth the following guidelines:[44]

- **Principle 1:** To facilitate effective implementation of its operations and achieve its policy objectives, the CGS should be constituted as an autonomous legal organization based on a sound and clearly defined legal and regulatory framework.
- **Principle 2:** The CGS should be well-funded to pursue its policy goals, and the sources of finance, including reliance on explicit and implicit subsidies, should be transparent and open to the public.
- **Principle 3:** The legislative and regulatory structure should encourage mixed ownership of the CGS, ensuring that minority shareholders are treated fairly.
- **Principle 4:** Based on risk-proportionate regulation scaled by the products and services delivered, the CGS should be supervised independently and effectively.
- **Principle 5:** The CGS should have a well-defined mandate that is backed up by strategies and operational goals that are in line with its policy goals.
- **Principle 6:** The CGS should have a strong corporate governance framework, with an independent and competent board of directors who are recruited based on predetermined criteria.
- **Principle 7:** To ensure the integrity and effectiveness of its governance and operations, the CGS should have a strong internal control architecture.
- **Principle 8:** The CGS should have an enterprise risk management framework in place that identifies, assesses, and manages the risks associated with its activities.
- **Principle 9:** For SMEs, lenders, and credit instruments, the CGS should establish clearly defined and transparent eligibility and qualifying standards.
- **Principle 10:** Given the country's level of financial sector development, the CGS's guarantee delivery approach should adequately represent a trade-off between outreach, additionality, and financial sustainability.
- **Principle 11:** The CGS should offer partial guarantees, with the correct incentives for SME borrowers and lenders, and geared to assure lenders' compliance with key prudential regulations.
- **Principle 12:** To ensure that the guarantee program is financially sustainable and appealing to both SMEs and lenders, the CGS should implement a transparent and consistent risk-based pricing strategy.
- **Principle 13:** The claim management procedure should be efficient, well-documented, and transparent, with incentives for loan loss recovery and a legal and regulatory framework in place in the home nation.
- **Principle 14:** The CGS should be held to strict financial reporting standards and have its financial statements audited externally.
- **Principle 15:** The CGS should make non-financial information about its operations available to the public on a regular basis.
- **Principle 16:** The CGS's performance, as well as its outreach, additionality, and financial viability, should be examined systematically and on a regular basis, with the results made public.

42 For a discussion of good practice design, see: Juan Carlos Gozzi and Sergio Schmukler, 2016, "Public Credit Guarantees and Access to Finance," Warwick Economics Research Paper Series.

43 For more information, see: The World Bank Group and FIRST Initiative, "Principles for Public Credit Guarantee Schemes for SMEs."

44 For more information, see: The World Bank Group and FIRST Initiative, "Principles for Public Credit Guarantee Schemes for SMEs" and https://www.firstinitiative.org/sites/all/libraries/pdf.js/web/viewer.html?file=https://www.firstinitiative.org/sites/default/files/101769-REVISED-ENGLISH-Principles-CGS-for-SMEs.pdf

EXPERIENCE WITH CGSS: DESIGN ISSUES

In designing a publicly funded credit guarantee scheme, the first question is whether the scheme should be entirely publicly managed or if all or some of its activities should be outsourced to the private sector. According to Beck, Klapper, and Mendoza (2010), the government is substantially involved in the operations of the guarantee fund in most nations. Loan assessment and recovery, on the other hand, are normally handled by the lenders whose loans are guaranteed. This strategy appears to help credit guarantee schemes maintain their financial viability. Loan losses are often larger in schemes where the government selects borrowers and recovers debts than in schemes where the lender does these functions.

The second question concerns assessing the creditworthiness of borrowers. Based on international practice, lenders that have a credit appraisal infrastructure in place are more cost-effective in assessing the creditworthiness of the borrowers being guaranteed. By the end of the 1990s, the Korea Credit Guarantee Fund (KODIT), which appraises every loan, had operating expenditures of 7.7% of its guaranteed loans (Honohan, 2009). Colombia's Fondo Nacional de Garantas (FNG) assessed all loans in-house at first, with operating costs of 4.2 percent of outstanding guarantees. It then transitioned to a system where most loans are appraised by the lenders themselves, decreasing operating expenses to less than 2% of the guaranteed amount.

Another design issue is the coverage ratio, or the percentage of an individual loan's value that the scheme guarantees. As the scheme only guarantees a portion of the loan's value, the lender bears some of the credit risk. Thus, it encourages the lender to thoroughly examine and monitor the loans covered by the guaranteed scheme, this helps align the incentives of the guarantor and the lender.

Another key factor to consider is how claims are handled. Claims procedures that are both costly and time-consuming can make the system less transparent and reliable, perhaps discouraging lenders from participating. As a result, establishing clear guidelines for when and how to pay out guarantees, as well as processing claims without a lengthy and expensive verification procedure, are critical concerns. According to Green (2003), early guarantee systems in many developing nations lacked defined parameters under which lenders might claim a guarantee, resulting in disputes between financial intermediaries and these schemes. Another important design consideration for public credit guarantee schemes is how to calculate guarantee fees. There is the question of how to structure the payments. Some credit guarantee systems impose a fixed cost for all sorts of guarantees, while others charge different rates depending on the guarantee or guaranteed loan's attributes. For example SEBRAE in Brazil charges greater costs for loans with longer maturities (Green, 2003), whereas FNG in Colombia charges fees that rise with the coverage ratio.

Yet another design issue is financial sustainability. In terms of financial sustainability, public credit guarantee regimes have had a mixed track record. As previously stated, the fee from most of these schemes is insufficient to meet running expenses. For example, Beck, Klapper, and Mendoza (2010) discovered that 11 of the 15 public credit guarantee systems in their survey that provided complete financial data had operating losses. According to their survey, the median public credit guarantee program charges 1.5 percent of the guarantee amount in fees, has 9% administrative costs, and 5% credit losses. Even if fee income does not fully cover total costs, public credit guarantee schemes can be financially sustainable in theory since operating losses can be offset by investment income from guarantee funds.

Source: Beck et al., 2015, "Colombia's Fondo Nacional de Garantías"; and Augusto de la Torre, Juan Carlos Gozzi and Sergio Schmukler, 2017, Innovative Expériences in Access to Finance: Market-Friendly Roles for the Visible Hand? World Bank Group.

THE UK'S SMALL FIRMS LOAN GUARANTEE SCHEME (SFLG)

Under this small business guarantee scheme, which commenced in 1981, banks could lend up to GBP250,000 to eligible businesses and have 75 percent of any default losses met by the government. However, as the scheme matured, losses mounted. In 2004, the Graham Report documented bad debt losses of approximately 20 percent. However, an ex-post review published in 2010 commissioned by SFLG concluded that it had been highly successful, with a substantial amount of additionality, and the positive effects of the "loans obtained in 2006 show the overall benefits outweigh the cost to the economy in terms of gross value added". The report did not fully analyze the cost of the defaults of the scheme against the purported benefits. In 2009, SFLG was replaced by the Enterprise Finance Guarantee scheme, which increased the size of eligible loans to GBP1 million. However, just three years later, an investigation by The Guardian newspaper (23 February 2013) concluded that the scheme had misused over GBP 200 million (USD300 million) of the funds that had been used for the guarantees.[45] Further investigations reached similar conclusions,[46] and there were reports that the scheme was being investigated by public prosecutors for misuse of funds by the banks.

Source: Marc Cowling, 2010, "Economic Evaluation of SFLG," BIS. The Graham Report, 2004. Teresa Graham was asked by the Chancellor of the Exchequer, Gordon Brown, and Secretary of State for Trade and Industry, Patricia Hewitt, to carry out a review of the Small Firms Loan Guarantee (SFLG). The Guardian, February 23, 2013.

45 Source: Alavi, Hamid, 2008, "Preshipment Export Finance: Do Guarantees Help?" Smart Lessons Note, World Bank Group.

46 Postshipment finance is finance provided against shipping documents (exchange bill purchasing). It is also provided against duty drawback claims. The guarantees described in this Guideline Note do not cover postshipment financing. In providing postshipment finance, banks or other providers rely on the exporter's access to export credit insurance, which is usually provided by the export credit agency of the exporting country.

PRE-SHIPMENT EXPORT FINANCE GUARANTEES (PEFG) FOR SME EMERGING EXPORTERS

Many developing-country MSME emerging exporters lack access to short-term working financing to fund their export transactions. To help improve access to capital, several countries have established pre-shipment export finance guarantee (PEFG) facilities.

THE PROCESS OF EXPORTING AND EXPORT FINANCE

There are at least three categories of hazards, or risk perceptions when dealing with pre-shipment and post-shipment export finance:

- **Non-payment risk,** often known as buyer risk, is the possibility that a foreign buyer will fail to pay exporters.
- **Non-performance risk,** also known as supplier risk, is the possibility that the exporter will not complete the order, will be unable to manufacture the product due to technical difficulties, or will be unable to deliver it on time and in accordance with the price and quality standards specified in the export order or letter of credit (L/C).
- **Other risks in the transaction process,** such as transportation hazards, are referred to as third-party risk.

Financial institutions will not provide financing for export transactions if the actual or perceived risks are too high in comparison to the return on investment. As a result, credit enhancement instruments have been devised to cover a portion of the risks associated with export transactions during both the pre and post-shipment stages. Export credit insurance, for example, protects banks against non-payment risks, whilst pre-shipment export finance guarantees cover a portion of the risk of non-performance. Transportation, fire, and other types of insurance cover other risks.

AVAILABILITY OF PRE-SHIPMENT EXPORT FINANCE

To fulfil export orders, businesses require pre-shipment funding. The majority of pre-shipment finance comes from the exporter's own resources, buyer credit, or short-term borrowing from financial institutions. Nevertheless, financial institutions may choose to accommodate major, well-known exporters' pre-shipment funding needs over emerging and small exporters (ESEs). One explanation is that many banks, particularly in emerging markets, have underinvested in the procedures and training required to properly assess non-performance risks. Instead, they prefer collateralized lines of credit, which are used at the discretion of the business. As a result, large and well-known exporters can use bank overdraft arrangements backed by their collateral to generate pre-shipment working capital. ESEs, on the other hand, lack appropriate internal resources and, as a result of their perceived high credit risks, are unable to obtain short-term bank loans or credit. Even if these exporters have a verified L/C, banks may demand a pledge of the exporter's assets before extending a pre-shipment credit.

This market failure is due to bank information asymmetry concerning ESEs' capacity to execute export orders according to buyers' quality, pricing, and delivery standards (i.e., non-performance). Most export insurance companies' export credit insurance and guarantees do not address this market problem. Instead, they shield exporters and banks that provide export financing from non-payment risks posed by overseas customers, rather than non-performance risks posed by exporters.

PRE-SHIPMENT EXPORT FINANCE GUARANTEES

PEFGs are designed to incentivize financial institutions to provide pre-shipment financing to ESEs with credible export contracts whose perceived non-performance risk exceeds their real risk. The PEFG accomplishes this by ensuring a percentage of short-term pre-shipment export loans, so temporarily taking on some of the (seen) risks.

As a result, it enables financial institutions to assess ESE non-performance risks over time, paving the way for the development of long-term pre-shipment financing for ESEs. Since it is transaction-based and self-liquidating, the PEFG approach differs from existing SME guarantee schemes. A government agency could build, operate, and administer PEFG facilities (normally the export credit insurance agencies or Export-Import banks).

POLICY GUIDELINES

The following seven principles are critical to the success of PEFG schemes. In addition to an effective incentive regime that does not penalize exporters, it should:

a. **Ensure that everything is simple.** PEFG designs must be simple such that bank participation does not raise transaction costs or place an undue strain on ESEs due to the guarantee fee. Exporters interested in PEFGs should provide information that focuses on the export transaction rather than the firm's detailed asset, liability, and net worth information.

b. **Maximize the social advantages.** PEFGs should not be viewed as profit-generating vehicles. Instead, a PEFG operation's social benefits must outweigh its social costs. Additional value-added exports, tax revenues, and jobs are all examples of social benefits. Net defaults (gross defaults minus recoveries), administrative costs, and the opportunity cost of the PEFG fund are all social costs.

c. **Moral hazard should be kept to a minimum.** Exporters must fund a portion of their pre-shipment export financing needs themselves. Similarly, commercial banks must bear some of the risks associated with pre-shipment export finance default.

d. **Provide easy access to PEFGs.** ESEs, including indirect exporters, should be eligible for PEFGs if they have one of the following:
   (a) confirmed export L/Cs issued in countries with low political risk;
   (b) export credit insurance coverage for non-L/C-based exports or exports to politically risky countries; or
   (c) back-to-back domestic L/Cs.

e. **In the event of a default, promptly refund the banks.** Both the anticipated and actual risks of exporters' manufacturing non-performance should be covered by the PEFG. The PEFG, rather than the banks, would bear the expense of default owing to non-performance or bad faith.

f. **Assess risk, but only after the fact (ex-post basis).** Through enterprise visits by guarantee officers and the backing of well-developed information networks, the PEFG agency would screen out exporters with sufficient production facilities. It would also ex-post check out exporters with a history of loan misuse (bad faith). The PEFG agency or banks, on the other hand, should not seek to assess individual exporters' manufacturing non-performance risks ex-ante. Accurately assessing such risks would necessitate significant capabilities and experience, which are typically prohibitively expensive to create in a PEFG agency.

g. **With exporters and banks, establish credibility, a solid reputation, and trust.** To achieve these goals, four conditions must be met: (a) a strong and proactive management team with aggressive guarantee officers; (b) sufficient resources to cover claims; (c) clear PEFG coverage and payment rules; and (d) quick and transparent processing of guarantee applications and claims based on these rules.

While certain PEFG facilities have proven to be successful in encouraging banks to provide pre-shipment financing without guarantees, others have not. The example of Tunisia demonstrates the importance of following the aforementioned guidelines while establishing a PEFG facility.

TUNISIA'S EXPERIENCE WITH PEFGS

The World Bank-supported Export Development Project launched a USD5 million PEFG facility in Tunisia in 2000. The project also supported technical advisory during the beginning of the facility's development, primarily to inform Tunisian counterparts about best practises in pre-shipment export finance guarantees around the world, as well as to advise on the facility's operational, managerial, and skill requirements.

Tunisia's experience shows that the amount to which the above criteria are utilized determines PEFG performance and success. The method operated well when the principles were properly enforced at the start of the PEFG facility, but it performed poorly afterwards when they were ignored. The facility's architecture was straightforward: it guaranteed up to 90% of non-performance risks connected with pre-shipment export loans issued by participating banks to ESEs with maturities of up to 180 days, with an average of 50%. Borrowers paid a monthly premium of 0.15 percent; the premium was set at this amount to ensure that exporters did not face a significant financial hardship.

Buyer non-payment, buyer country risk, marine disasters, and other hazards were not covered by the plan, which was handled by the Export Insurance Agency (COTUNACE). The guarantee application process was straightforward, and information on the export transaction rather than the borrower's financial situation was necessary. To advertise and operate the plant, a proactive and professional management team was first put in place.

The PEFG plant was supposed to have a big impact on the economy with an expected present value of net social benefits over the next five years at USD277 million.

This projection was based on the premise that all PEFG rules would be followed, ensuring that demand for the facility would grow over time and loan defaults would decrease. Increased demand would result in a progressive increase in the guarantee coverage ratio (the ratio of outstanding guarantees to the original fund) from two in the first year to fifteen in the fifth year. It was also projected that for every USD1 million in extra exports, 100 jobs would be generated. Yet, Tunisia's PEFG had irregular results (see Table 3).

There were two distinct phases of the facility:

1. Outstanding results in the first six months. The facility issued 43 guarantee certificates in the first six months, exceeding the facility's performance expectations for that time period (representing USD2 million in guaranteed loans and USD3.4 million in extra exports). The management staff was powerful and proactive throughout that time, led by COTUNACE's CEO. The team made regular visits to businesses and began compiling a database of client risk information. The CEO of COTUNACE maintained adherence to all operating modalities and standards for PEFGs as the head of the Ministry of Finance's Risk Agreement Committee (RAC). He also oversaw a large-scale marketing and education campaign for banks and businesses on the availability, goals, and principles of PEFGs.

2. Following this initial success, there was a sharp drop in performance. The facility's performance was well below expectations after six months. The management team was reassigned to another assignment, and a less-skilled team was formed, consisting of a part-time manager with minimal institutional support, no business strategy, and no clear grasp of, or commitment to, PEFG principles.

The facility's scope and coverage shrank, and banks lost faith in the facility's ability to share non-performance risks. Many banks reverted to ex ante risk assessment, which not only slowed down the financing process but also increased administrative costs and reduced outreach to emerging exporters. In the absence of effective oversight and follow-up by the PEFG management team, a few banks used PEFG as a supplemental guarantee for experienced exporters (one firm used it 28 times, and two firms used it 18 times), rather than as a catalyst to help new exporters obtain pre-shipment funding. The RAC's refusal to reimburse banks for two incidents of loan defaults caused by the borrower's bad faith further harmed the PEFG scheme's reputation. At the time of the PEFG's closure, 27 of the 57 claims had been rejected, only 22 had been fully compensated, and eight had remained unpaid.

Source: Tunisia Export Development Project files. a. USD1.8 million during the first six months of 2000. b. USD3.1 million during the first six months of 2000.

TABLE 3: OVERALL FUND PERFORMANCE: COMPARISON OF OBJECTIVES AND RESULTS

PERFORMANCE EVALUATION		2000	2001	2002	2003	2004
TOTAL AMOUNT OF GUARANTEE COVERAGE ($ MILLION)	Estimate	5.0	10.0	15.0	20.0	25.0
	Actual	2.1[a]	2.6	2.0	5.1	3.6
ADDITIOANL EXPORTS GENERATED ($ MILLION)	Estimate	7.4	14.8	22.2	29.6	37.0
	Actual	3.7[b]	4.1	3.4	10.0	8.2
ANNUAL RATE OF DEFAULT	Estimate	7.0%	5.0%	4.0%	3.0%	2.0%
	Actual	5.7%	24.7%	23.5%	2.5%	5.3%

Source: Tunisia Export Development Project files. a. USD1.8 million during the first six months of 2000. b. USD3.1 million during the first six months of 2000.

POLICY GUIDELINES

1. **The seven elements described previously are crucial to a PEFG's performance and success.** In theory, appropriate use of PEFGs can result in tremendous economic benefits, but in order to obtain these benefits, all PEFG rules must be followed.
2. **Pre-shipment export financing programs demand a high level of managerial knowledge and commitment to succeed.** Any otherwise sound instrument might be ruined by erratic administration. For schemes like PEFGs that aim to be a catalyst for overcoming export financing restrictions, having a competent and credible management team building good relationships with financial institutions is crucial. Proper promotion and marketing of the plan, notably by banks, which are the ultimate beneficiaries of PEFGs, is also essential.
3. **PEFG facilities must have safeguards to decrease the risk of loan misuse,** but if a loan defaults owing to a borrower's bad faith, the facility should reimburse the lending bank.
4. **Decisions about PEFG coverage should be based mostly on the underlying export transaction.** Ex ante assessment of exporters' manufacturing non-performance risks will slow down the process and go against the goals of PEFGs.

PAPUA NEW GUINEA: SME ACCESS TO FINANCE PROJECT

Background

The Government of Papua New Guinea (PNG) aims to increase the size and economic contribution of the domestic private sector, which consists mainly of SMEs, with a focus on generating employment.

Despite large external investments in PNG's resource sector, private-sector activity in the formal economy remains low. Women and young people are especially dependent on small-scale informal businesses for their livelihoods. There are significant constraints to SME growth and investment, primarily access to credit, despite sufficient liquidity in the banking sector.

There are two main reasons for this. First, SMEs often lack the collateral, information or guarantees to meet commercial bank requirements for lending. Second, banks perceive high levels of risk in lending to SMEs. Addressing these impediments should enable SMEs to engage more actively in economic growth, job creation and poverty reduction across PNG.

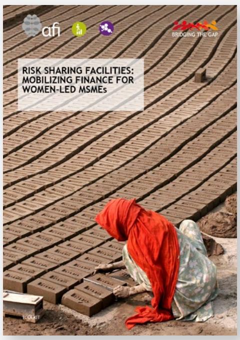
With the support of the World Bank Group's International Development Association (IDA) and International Finance Corporation (IFC), the Government of PNG established a risk-sharing facility and technical assistance mechanism for SMEs, commercial banks involved in SME lending and relevant government agencies that support the growth of SMEs.

About the Project

For the Government of PNG, the primary objective of the Small and Medium Enterprise Access to Finance Project is to provide access to sustainable credit for SMEs, and thereby contribute to growth in SME employment and incomes. The project will provide support to develop the managerial and financial skills of SMEs, with particular attention to women entrepreneurs, and to enhance the capacity of commercial banks to manage credit risks.

There are four components to the project:

1. **Developing a risk-sharing facility (RSF) in partnership with local financial institutions -** This will partially guarantee a portfolio of new loans from commercial banks to SMEs of up to USD116 million and is expected to immediately accelerate commercial bank lending to emerging and established SMEs. The Government of PNG (through the IDA credit) and the IFC will cover 50 percent of all principal losses in the portfolio of new SME loans.
2. **Technical assistance for financial institutions -** Performance-based technical assistance will be provided to private banking institutions. This is expected to allow commercial banks to develop long-term procedures for sustainable lending to SMEs.



Detail of RSF can be accessed here: https://www.afi-global.org/publications/risk-sharing-facilities-mobilizing-finance-for-women-led-msmes/

> View here

3. **Capacity building for SMEs -** This will consist of four sub-components: (a) training SMEs in management and financial skills; (b) focused mentoring and coaching for SMEs; (c) targeted training for women entrepreneurs; and (d) training for provincial government commerce division staff.
4. **Capacity building for the Government of PNG - This will improve the government's capacity to implement and monitor the project, and to develop an updated SME strategy and policy.

Source: World Bank (https://documents1.worldbank.org/curated/pt/128631468286309886/P1207070Projec1t0110Appraisal0Stage.doc)

DIRECT MONETARY INTERVENTION

Direct monetary intervention (DMI) offers targeted MSMEs with low-cost loans and refinancing through subsidized credit and refinancing programs. This sort of funding allows MSMEs to minimize their operating costs and could be an effective way for the government to encourage entrepreneurship, reduce poverty and income disparity, and stimulate economic growth. According to the report, these programs have been implemented mostly by government bodies other than the financial regulator.

An enabling regulatory framework and adequate financial infrastructure are essential to facilitate MSME access to finance. But MSME credit markets are imperfect which require direct government interventions to boost the market. These direct interventions include grants, subsidies and tax breaks that target a certain segment of MSME sectors which are channelled by dedicated government agencies. They can be channelled via a state bank and DFI or cooperative in the form of a soft loan, interest subsidies and ceilings, credit guarantees or credit insurance, seed capital, venture capital, loan quotas, loan waivers and the promotion of promissory notes. However, direct monetary interventions may distort the market to some extent, thus require close supervision to targeted group and be time bound.

Strategic direct government interventions help finance vulnerable groups with inadequate access to financial resources, such as women and youth SMEs, and can also act as a catalyst in financing start-ups and high-growth SMEs which are not on the radar of mainstream financial institutions.

Challenges of direct government interventions include:

a. Difficulties ensuring that financial support reaches the target group.
b. Public interventions may lead to the idea of the “Grantepreneur” where an entrepreneur relies on government grants and weaker financial discipline in the SME debt market.
c. From the supply-side, moral hazard issues inhibit financial institutions from implementing SME finance systems and instruments and improving risk management techniques.
d. Reduced market competition with a ‘crowding-out’ effect which discourages SMEs from using non-subsidized financial products.

In designing interventions, policymakers should avoid disincentivizing private sector providers of financial services to serve the MSME segment. They should also have built-in monitoring and evaluation mechanisms to measure impacts and ensure the desired effects are being achieved.

Finally, public intervention should focus on tackling market imperfections and information asymmetries, and should, in general, remain temporary and be phased out as the desired effects on MSME access to finance are achieved.

SUBSIDIZED CREDIT AND REFINANCING PROGRAMS

Direct government interventions such as interest rate ceilings and direct financing look appealing in facilitating access to financing for MSMEs, but they may depress MSME lending volumes while adding costs and risks. While these schemes reduce the cost of debt for the eventual beneficiaries, they do not address the underlying challenges to MSME finance (information asymmetries, market imperfections, high cost of operations in some countries due to a lack of proper infrastructure or high energy costs, etc.)

In general, the cheaper the financing, the less likely it will reach the target group. The main problem is interest rate subsidies. Cheap loans are rationed, and rationing opens the door to political considerations. There is also a risk that borrowers will expect permanent subsidies, which would be costly and unsustainable. In most cases, regulators may wish to focus on the financing basics. A higher interest rate formulation should include a risk premium to cover untested groups (MSMEs). Alternatively, for a sustainable and longer-term approach, it is more productive to channel financial assistance for training, research and technology of new product developments.

MEXICO'S SIEBAN PROGRAM

To address the transaction costs of lending to small borrowers, the Mexican development agency (FIRA) introduced SIEBAN (Sistema de Estimulos a la Banca), a program that provides subsidies to cover the administrative and screening costs of serving small borrowers. This subsidy applies to loans to low-income rural producers from commercial banks, credit unions or financial firms for the first time. The subsidy is a fixed amount that varies with the size of the loan (a maximum of 16.7 percent of the amount borrowed in the case of smaller loans).

These subsidies can be used to obtain credit from different financial institutions, thereby fostering competition. In turn, financial institutions are required to provide a borrower's information to the credit bureau to help them establish a credit history. The subsidy decreases over time and is temporary—three years in duration—based on the premise that once borrowers have established a credit history, screening costs for financial institutions should be significantly lower, tackling information asymmetries and eliminating the need for subsidies.

Source: Malhorta, Mohini, Yanni Chen, Alberto Crisculolo, Qimiao Fan, Iva Ilieva Hamel, and Yevgeniya Savchenko, 2006, "Expanding Access to Finance: Good Practices and Policies for Micro, Small, and Medium Enterprises," World Bank.

ANNEX 1: GOVERNMENT PROGRAMS TO INCREASE PRIVATE INVESTMENT IN SMEs[47]

Governments can increase the amount of capital available for investment in SMEs either by investing public funds or making it more attractive for private capital to invest in these companies. The most successful government support programs have been based on public-private partnerships (PPP) in which investment decisions are made by independent fund managers, and where there is significant equity participation by private investors. The objective of investors is to generate the highest risk-adjusted rate of return on their capital. Consequently, governments can attract private capital either by increasing the potential rate of return to investors in a venture fund or by reducing the investor's risk of loss. Specific plans include:

> **Direct investments in SMEs or venture capital financing.** Many governments have started with this approach, but most have concluded they have neither the staff nor the motivation to manage such a program, which involves a high number of individual investment decisions and continuing support for investee companies.

> **Direct participation, or "seeding" of venture funds,** as France provides for investors in younger companies. A government invests on the same basis as private investors, thus increasing the size of the fund and allowing greater diversification of its investments. Germany offers a variation of this, which involves a co-investment with venture funds.

> **Government loans or loan guarantees to licensed venture funds** that would invest within government guidelines or guarantees of fund borrowings. The US Small Business Investment Company program (SBIC) and the program of the US Overseas Private Investment Corporation (OPIC) use this kind of support, offering loans or loan guarantees at twice the value of the private capital of the fund. Since the interest rate on the government debt is well below the profit expectations of a venture fund, excess returns flow to private investors, increasing or leveraging their potential rate of return.

> **Leveraged equity participation by government in private equity funds.** This practice has been offered as an option by the SBIC program since 1994, and by the Australian Innovation Investment Program.The government provides two-thirds of the capital of a venture fund, but takes only a government interest rate plus 10 percent of the fund's profits. Any excess profits flow to equity investors that have provided only a third of the fund's capital. This again enhances, or leverages, the profit potential to the private investor.

SME INVESTMENT PARTNER (SIP): HIP 3 - SME MASTERPLAN 2012-2020

A successful variation of this was Israel's Yozma Fund, which invested in early venture capital funds 10 years ago. Investing 40 percent of the total, the Israeli government agreed that the funds could repurchase the government's share within five years, at cost plus a nominal interest rate. This again provided leverage for private investors without subjecting them to the risk of an obligation that would take precedence over their own investment in the fund.

> **Loss insurance:** Governments have provided guarantees against loss for investors as a way of encouraging them to invest in venture funds. The US state of Oklahoma guarantees investments in state-sponsored seed and early-stage investment funds. OPIC guaranteed the principal and interest on two-thirds of the investment in some of its funds, thus assuring investors they would, at worst, recover their investment at the end of the ten-year fund life.

> **Tax credits,** as Canada has offered, directly offset a percentage of an investor's capital investment so long as the fund invests in target sectors of the economy. Other governments have offered reduced tax liability on profits earned from investments in SMEs. Based on trends in these countries and discussions with those responsible for many of these programs, we conclude that best practices in government support have been based on PPPs in which investment decisions are made by independent fund managers and where there is significant equity participation by private investors.

47 This Annex is based on a background note prepared by Tom Gibson in 2013 during the design of Malaysia Small Investment Programme (HIP3).

This allows the following balance:

- The government can generally target the investments of the fund to areas where there is a public policy objective, by size or industry sector, geographic location, or other criteria, as a condition of providing financing.
- Private capital increases the total amount available for investment, so the government does not have to provide all the funding.
- Independent managers are focused on making investments that are sustainable and can be sold, allowing funds to be reinvested or returned to the government and private investors. With a purely public fund, the temptation is to have job creation or economic development as a sole objective, which can result in permanent investment in marginal companies.
- Private investors share the risk and take responsibility for oversight of the program.
- Fund managers can be compensated with a share of the profits, providing motivation that can attract qualified people.
- Successful government-supported funds can provide a track record for the manager to raise a completely private fund in future.

INTERNATIONAL PRACTICES IN GOVERNMENT-SUPPORTED INVESTMENT

These government interventions can be further divided into the following seven categories:

DIRECT INVESTMENT

> **Canada:** Canada has a tradition of government involvement in the promotion of business. This is demonstrated in the venture capital arena by its two principal programs. The Business Development Bank invests directly in SMEs.

> **Germany:** Germany's BJTU program provides matching funds for individual investments in small high-tech firms, plus a 50 percent equity guarantee for the first five years of an investment.

> **Hungary:** Two state-owned venture funds have been invested but have not produced meaningful results. The government is now organizing additional funds in combination with the European Union, regional development agencies, international development organizations and private sources.

> **India:** The Small Industries Development Bank of India (SIDBI) set up a venture fund in 1994 to invest directly in small companies and in venture funds. The total size is now USD27.5 million. More recently, SIDBI has been focused on supporting investment funds (see the next section).

TABLE 4: GOVERNMENT SUPPORT PROGRAMS FOR SME EQUITY FINANCING AND VENTURE CAPITAL

COUNTRY	DIRECT INVESTMENT	INVESTMENT IN FUNDS	LOANS / GUARANTIES	LEVERAGED INVESTMENTS	LOSS INSURANCE	TAX CREDITS	TAX ADVANTAGE	DISCONTINUED PROGRAMS
AUSTRALIA				x				
BELGIUM		x						
BRAZIL	x							
CANADA	x	x				x		
FINLAND					x			
FRANCE		x						
GERMANY		x			x			
HUNGARY	x	x (preferred)					x	
INDIA	x	x (preferred)						
IRELAND	x	x (preferred)						x
ISRAEL				x			x	
KOREA			x					
MEXICO	x	x						
THE NETHERLANDS				x				x
SWEDEN								x
UK				x				x
USA			x	x				
INTL DEV INSTS		x						

- > **Ireland:** Enterprise Ireland is a new government agency that consolidated three former agencies, and which together, have invested in over 500 companies in Ireland. Due to the difficulty and cost of managing a direct investment program, Enterprise Ireland has moved steadily towards support of investment funds with private investors and managers (see the next section).
- > **Mexico:** Two development banks, NAFIN (manufacturing) and Bancomext (export financing) promote SME development by providing capital and business assistance. NAFIN invests directly in SMEs and venture capital funds (SINCAS), along with wealthy individual investors and public market listings.
- > **Brazil:** The Brazilian development bank, BNDES, has made direct equity investments and loans to SMEs, but is now shifting its focus to investing in funds managed by independent managers.

INVESTMENT IN FUNDS

- > **Belgium:** Belgium's Investment Company for Flanders (GIMV), established in 1980, is credited by the OECD as pioneering the concept of government-funded venture capital run by independent private management. Most of its investments have been in high-tech companies, and it has been successful enough to attract private capital, which now represents a minority ownership of the fund. The other two regions of Belgium have government-funded investment funds, but these are principally (but not exclusively) investing in industrial companies. The operations of these two funds are more closely controlled by the government.
- > **Brazil:** As already noted, the Brazilian Development Bank is shifting from direct investment to investment in independent investment funds.
- > **Canada:** In addition to direct investments in SMEs, Canada invests in seed capital funds and makes loans to these companies. About half of all venture capital investments in Canada are made by Labor-Sponsored Venture Capital Corporations (LSVCCs), which are mutual funds that make direct equity investments and are managed by private fund managers. Provincial governments also sponsor privately managed venture capital funds.
- > **France:** Using a portion of the proceeds of the privatization of France Telecom, the French government provides up to 30 percent of the capital for a private venture capital firm, providing it agrees to invest at least half its funds in concerns less than seven years old. The government's investment is proportional to the fund's agreement to invest in such companies, i.e. if half the funds are invested, the government will invest 15 percent of the total fund capital; if all the funds are invested, the government will invest 30 percent.
- > **International financial institutions:** Virtually all international development finance agencies invest in direct equity investment funds in emerging markets to support economic development. The IFC (World Bank), European Bank for Reconstruction and Development, and the national development agencies of the US, UK, Germany, Sweden, Norway, and Switzerland are among this group. Typically, these organizations invest on the same terms as other investors in funds managed by independent managers.
- > **Ireland:** Enterprise Ireland has co-invested in funds with private investors, and together with the European Union, has established 16 private sector funds investing in seed and venture capital. In partnership with the Bank of Ireland, an "Enterprise 2000" fund was established to make small investments and loans to young companies.
- > **Mexico** (see the previous section).

FUND LOANS/GUARANTEES

- > **Germany:** (see the previous section)
- > **Korea:** The Government of Korea loans up to 20 percent of the capital for Start-up Promotion Funds, which receive their capital from private investors and are managed by private fund managers. These funds must invest 40 to 50 percent of their assets in start-up companies but are free to invest the remainder as they choose.
- > **United States:** The SBIC program, administered by the US Small Business Administration (SBA), is the largest and oldest government-support program for venture capital in the world. In its over 40 years of operations, SBIC has invested over USD21 billion in nearly 120,000 financings to US small businesses, including successes such as Intel Corporation, Apple Computer, Federal Express and America Online.

ANNEX 2: EXAMPLE OF A SIMPLIFIED QUANTITATIVE DEMAND-SIDE SURVEY ON SMALL BUSINESS CREDIT CONDITIONS – INDUSTRY CANADA, 2010

CREDIT CONDITIONS SURVEY 2010

Hello, my name is (interviewer) and I am calling from XXX on behalf of Industry Canada to conduct a short 15-minute survey on the financing of small and medium-sized businesses. Are you the person who would oversee corporate finances, the owner, chief financial officer, or accountant?

(Note: If the respondent replies "no", ask: "May I speak to the person who would best be able to answer the survey?")

We are conducting a national survey on the growth characteristics of small and medium-sized businesses; the results of the survey will be used to guide public policy. The survey should take less than 10 minutes.

Can I continue or schedule a better time?
Yes (Rebook if requested)
No

[Persuaders:
Let me assure you that we are not trying to sell you anything and that this interview is completely confidential.

Your participation is voluntary and the information you provide will not identify you or your business.

We are calling on behalf of Government of Canada, and this survey is registered with the Canadian Research Registration system of the Marketing Research and Intelligence Association.

It is important that we speak with as many different businesses as possible; your opinion will help us with future policy issues]

Number of questions:	
Section A (Screening):	4
Section B (General Financing):	4
Section C (Debt Financing):	6
Section D (Lease Financing):	2
Section E (Equity Financing):	2
Section F (General Business Information):	5
Section G (Owner Information):	4
Total:	27 questions

A. SCREENING QUESTIONS

The following are screening questions to determine if the business is in scope.

A.1 Just to confirm, are you:

(Note: Read all)

a) The Business Owner
b) The person in charge of finance in your business
c) Other
d) Refused

If A.1= "c" or "d" → Go to A.2, Else → Go to A.3

A.2 We are looking to speak with the person who is knowledgeable about the business characteristics finances. Are you the correct person?

Yes [Continue]
No [Ask to speak to the correct person]

A.3 Is your business classified as a non-profit organization, a co-operative, a joint venture, or a government agency?

Yes
No
Don't know / Refused

If "yes" or "don't know / refused" → READ: Since this survey is for private for-profit businesses, we will not need to proceed with the survey. Thank you for your participation.

A.4 Excluding the owner(s) of the business, how many paid full-time and part-time employees did the business have in 2010?

[NOTE: Do not include contractors or sub-contractors, e.g. in the construction industry, builders use sub-contractors, plumbers, etc. who have their own business. They are not employees and should not be counted.]

Full-time ______ Part-time ______ Don't know / Refused

B. GENERAL FINANCING

B.1 What types of external financing did your business seek in the 2010 calendar year?

(Note: Read list and MARK ALL THAT APPLY.)

a) Did not seek any external financing
b) New mortgage or refinancing of an existing mortgage
c) New term loans
d) New line of credit or increase in existing line of credit
e) New credit card or increase in existing credit limit
f) Leasing
g) Trade Credit
h) Equity
i) Other, please specify:
j) Don't know / Refused

If B.1 = "a" ➞ Go to B.2 Else ➞ Go to B.3

B.2 What was the main reason why your business did not seek external financing in the 2010 calendar year?
[Note: Read list and mark only one main reason]

a) Financing not needed
b) Investment project postponed
c) Thought the request would be turned down
d) Applying for financing is too difficult
e) Cost of financing is too high
f) Other, (Please specify) ______ [Do not read]
g) Don't know / Refused ➞ Go to F.1

B.3 What was main intended use for the financing requested that was requested in the 2010 calendar year? Was it for:
(Note: Read list and mark only one main intended use)

a) Fixed asset
(Prompt: Fixed assets are assets that the business expects to use for an extended period, such as land, buildings, vehicles, machinery, and equipment.)
b) Working capital / operating capital such as inventory or paying suppliers (
Prompt: Funds used to finance the day-to-day operations of the business such as the purchase of inventory or paying suppliers.)
c) Research and development
(Prompt: R&D expenditures refer to expenditures meant to bring a new product to market or to improve an existing product.)
d) Debt consolidations
e) Enter a new domestic market
f) Enter a new global market
g) Other (Please specify):[Do not read - Probe for other reason if nothing above]
h) Don't know / Refused

B.4 What is your main supplier of finance?
(Note: Alberta Treasury Branches (ATB) should be considered a domestic chartered bank. Read the list and mark only one main supplier of finance)

a) Domestic chartered bank (specify):
b) Foreign bank or subsidiary of a foreign bank (specify):
c) Credit union / Caisses populaires (specify):
d) Leasing company
e) Government institution, for example BDC, EDC, FCC (specify):
f) Other (specify): ______ [Do not read]
g) Don't know / Refused

C. DEBT FINANCING

If B.1b, B.1c, B.1d OR B.1e = "YES" ➞ Go to C.1
Else ➞ Go To section D

C.1 In the most recent debt financing request in the 2010 calendar year, what was the dollar amount requested?
(Prompt: Please provide your best estimate)

a) $
b) Don't know
c) Refused

C.2 What was the amount that was authorized because of your 2010 request?
a) $
Note: Write $0 if the loan was rejected
b) Request is still under review
c) Don't know
d) Refused

If C.2a = "$0", ➞ Go to C.3 If $0 < C.2a ➞ Go to C.4
If C.2=b ➞ Go to section D

C.3 Which of the following reasons were given as to why the loan was rejected?
[Read list and mark all that apply]

a) No reason given by the credit supplier
b) Insufficient sales or cash flow
c) Insufficient collateral or security
d) Poor credit history or lack of credit history
e) Project was considered too risky
f) Other reason
g) Don't know / Refused ➞ Go To section D

C.4 What was the annual interest rate on the loan? [Respondents can answer a percentage or a prime plus a percentage.]
a) ______ % ➞ ask if it is a fixed or variable rate?
fixed ______ variable ______ Don't know / Refused
b) Prime +
c) Don't know
d) Refused

C.5 What was the length of term of the loan?
a) ______ months *[Please make sure to enter the right number.] 1 year = 12 months*
2 years = 24 months
3 years = 36 months
4 years = 48 months
5 years = 60 months
6 years = 72 months
7 years = 84 months
8 years = 96 months
9 years = 108 months
10 years = 120 months
b) Not applicable

c) Don't know
d) Refused

C.6 What collateral were you asked to provide to obtain the loan?
(Note: Read list and MARK ALL THAT APPLY.)
(Prompt: Collateral are any assets pledged as security for the payment of a debt.)

a) None
b) Business Asset (including land, buildings, materials and equipment, inventories, accounts receivable, financial assets)
c) Personal Assets
d) Intellectual Property
(Prompt: Intellectual Property is intangible property that is the result of intellectual activity and includes patents, trademarks, or copyrights.)
e) Other (Please specify: ______) [Do not read]

D. LEASE FINANCING

If B.1f = "YES", → Go to D.1 Else → Go to Section E

D.1 In the most recent lease financing request in the 2010 calendar year, what was the dollar amount requested?
(Prompt: Please provide your best estimate)

a) $
b) Don't know
c) Refused

E. EQUITY FINANCING

If B.1h = "YES", → Go to E.1 Else → Go to Section F

E.1 In the most recent equity financing request in the 2010 calendar year, how much financing was requested?
(Prompt: Please provide your best estimate)

a) $
b) Don't know
c) Refused

E.2 What was the amount that was authorized?
a) $
b) Don't know
c) Refused

F. GENERAL BUSINESS INFORMATION

F.1 In which sector does your business primarily operate?
Goods-Producing Sector:

a) Agriculture, Forestry, Fishing and Hunting (NAICS 11)
b) Mining and Oil and Gas Extraction (NAICS 21)
c) Construction (NAICS 23)
d) Manufacturing (NAICS 31-33) Please specify: ______
Services-Producing Sector: ______
e) Wholesale Trade (NAICS 41)
f) Retail Trade (NAICS 44-45)
g) Transportation and Warehousing (NAICS 48-49)
h) Professional, Scientific and Technical Services (NAICS 54)
i) Accommodation and Food Services (NAICS 72)
j) Other Services (Please specify: ______)
k) Other than goods and services, (Please specify : ______)
l) Don't know / Refused

F.2 How many years has the company been in existence?
a) ______ year(s)
b) Less than one year
c) Don't know
d) Refused

F.3 What was the value of the following business financial figures for your 2010 fiscal year?
(Prompt: Please provide your best estimate.)

a) Total business revenues $ ______ / Don't know / Refused
b) Profit/net income, before taxes $ ______ / Don't know / Refused
c) Total Assets $ ______ / Don't know / Refused
(Prompt: What is the approximate total amount of all financial and non-financial assets that the business owns?)
d) Total Liabilities $ ______ / Don't know / Refused
(Prompt: What is the approximate total amount of all short-term and long-term debt that the business owes to its creditors?)

F.4 In 2010, estimate the percentage of the total sales that came from the following geographic market regions:
(Prompt: Please provide your best estimate)
(Note: Should add up to 100%, but if it does not, do NOT correct this with the respondent as it can easily become too time consuming - Calculate but not forced. If it equals between 90% and 110%.)

a) Your market (same municipality or region) ______ % / Don't know / Refused
b) Rest of your province/territory ______ % / Don't know / Refused
c) Rest of Canada ______ % / Don't know / Refused
d) United States ______ % / Don't know / Refused
e) Rest of the World ______ % / Don't know / Refused

F.5 In the 2010 calendar year has the business developed or introduced:
(Note: Read every option and mark all that apply.)

a) Product innovation
(Prompt: a new or significantly improved good or service to the market)
b) Process innovation
(Prompt: a new or significantly improved production process or method)
c) Organizational innovation
(Prompt: A new organizational method in your business practices, workplace organization or external relations. It must be a result of strategic decision taken by management)
d) Marketing innovation
(Prompt: A new way of selling your goods or services this requires significant changes in product design or packaging, product placement, product promoting or pricing)

G. OWNER INFORMATION

G.1 What is the age of the majority owner?
(Prompt: In the case of equal partnership, please report the average age of the partners)

a) ______ years
b) Don't know
c) Refused

G.2 How many years of experience does the majority owner have in owning or managing a business?
a) ______ years
b) Less than one year
c) Don't know
d) Refused

G.3 What is the gender of the majority business owner?
a) Male
b) Female
c) Equal ownership (50-50 ownership)

G.4 What is the highest level of education attained by the majority owner?
a) Less than high school diploma
b) High school diploma
c) College / cegep / trade school diploma
d) Bachelor's degree
e) Master's degree or above
f) Don't know / Refused

H. QUESTIONNAIRE CONCLUSION

H.1 In the event that we conduct a short follow-up questionnaire in the next two years, would you be willing to complete it?

Yes ______ No ______

If H.1=yes → Go to H.2

If H.1=no → Go Conclusion Text

H.2 As the follow-up survey will be electronic, could you please provide us with your email address?

____

____

CONCLUSION TEXT:

Léger Marketing & Industry Canada thank you for your participation.

Thank you for taking time to participate in our survey. It provides us with pertinent information on the financing of Canadian small businesses.

Please note any comments you have regarding this questionnaire

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