

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

**IMPROVING THE
COMPETITIVENESS OF SMEs
IN DEVELOPING COUNTRIES**

**The Role of Finance
To Enhance Enterprise Development**



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Preface

Access to finance has been identified as a key element for SMEs to succeed in their drive to build productive capacity, to compete, to create jobs and to contribute to poverty alleviation in developing countries. Without finance, SMEs cannot acquire or absorb new technologies nor can they expand to compete in global markets or even strike business linkages with larger firms.

This selection of papers was presented at UNCTAD's intergovernmental Expert Meeting on "Improving the Competitiveness of SMEs in Developing Countries: the Role of Finance, Including E-finance, to Enhance Enterprise Development", held in Geneva on 22-24 October 2001. This publication focuses on SMEs' access to finance.

The main objectives of the Expert Meeting were to:

- review the latest trends in financial innovation for SME customers in order to improve their access to finance;
- raise awareness among policy makers about the importance of these innovations for SMEs and consider how they could be applied in developing countries;
- identify best practices at international and national commercial banks, venture capital funds and insurance companies;
- consider the role of governments and international organizations in replicating best practices in developing countries;
- analyse ways to combine financial with non-financial support as a means to reduce transaction costs and risks ; and
- identify future actions to be taken by Governments, public and private sector development agencies, international financial institutions and UNCTAD in order to improve SMEs' access to finance.

The Expert Meeting included participants from public and private banks in both developed and developing countries; regional development banks; international organizations; business associations; Governments; and academia.

The valuable contributions presented to the Expert Meeting by panellists and experts showed that while the problem of SME access to finance is being resolved in developed countries, this is unfortunately still not the case for developing ones. With the help of advances in information technology a number of leading banks, mainly in developed countries, are already putting these innovations to use to reach SME customers. Although some interesting examples do exist of successful practices in banks and financial institutions in developing countries, the question is how these practices could be more widely applied.

Part I of this publication contains a background study which describes a number of innovations used by leading banks to improve the profitability of lending to SMEs. Part II discusses the role of finance in SME competitiveness. Papers in Part III discuss innovative

approaches and successful programmes in SME finance. Part IV presents the outcome of the Expert Meeting, which includes the participants' recommendations to Governments and international organizations further to improve SME access to finance.

There is still much to be done in developing countries to encourage financial institutions to lend to SMEs as the meeting showed. In particular, Governments and business development service providers face the challenge of putting in place the appropriate regulatory framework, national policies and support services. It is our hope that this volume will contribute to meeting that challenge.

Rubens Ricupero
Secretary-General of UNCTAD
Geneva, September 2002

Contents

	<i>Page</i>
Preface	iii
PART I: BACKGROUND PAPER	1
Best Practices in Financial Innovations for SMEs	3
The UNCTAD secretariat	
Introduction.....	3
1. Financing by commercial banks – recent developments.....	5
2. Specialized institutions and programmes for SMEs: National and international level.....	22
3. Complements to finance	27
4. Equity financing –venture capital funds.....	33
5. Financing women entrepreneurs	37
6. The role of the international community.....	44
7. Conclusions.....	47
Annex I	53
PART II: ROLE OF FINANCE IN SME COMPETITIVENESS	59
Small and Medium Sized Enterprises and Economic Creativity	61
Andrew Warner, Center for International Development at Harvard University	
Introduction.....	61
1. Construction of the economic creativity index.....	66
2. Innovation, technology transfer and start-ups	68
3. Corroboration with international patent and export statistics.....	71
4. Conclusion.....	75
PART III: INNOVATIVE APPROACHES AND SUCCESSFUL PROGRAMMES IN SME FINANCE	79
A. NATIONAL INITIATIVES	81
Development Financial Institutions’ and Commercial Banks’ Innovative Schemes for Assisting SMEs in India	81
Sailendra Narain, Center for SME Growth and Development Finance	
Introduction.....	81
1. Overview of the small scale industries sector.....	81

2. Innovations	83
3. Replicability.....	86
Improving Competitiveness of SMEs in Developing Countries	89
Cuno Güttler, Rheinisch Savings Banks and Giro Association	
Introduction.....	89
1. Challenges	89
2. Solutions	90
3. Recommendations	91
Case studies of Two Leading European SME Banks	93
Case I: Rheinisch Savings Banks Group – five core competencies.....	93
Case II: Swedbank: a leading Swedish retail bank	95
Financing SMEs: Uganda’s Experience.....	97
Louis Kasekende, Bank of Uganda	
Introduction.....	97
1. Characteristics of SMEs and factors constraining their access to financial resources	98
2. Role of finance in enterprise development in Uganda.....	100
3. Programmes to support SMEs in accessing financing	103
4. Challenges for SMEs in improving their credit worthiness	107
Insurance and Financing in Tunisia.....	109
Moncef Zouari, COTUNACE	
Introduction.....	109
1. Export credit insurance Tunisia	109
2. Role of credit insurance products in export financing	110
3. Conclusion.....	112
B. INTERNATIONAL INITIATIVES.....	113
Making Small Business Finance Profitable – IFC’s Approach.....	113
Renate Kloepfinger-Todd, International Finance Corporation	
1. Why micro and small business finance?	113
2. Micro and small business finance: an emerging opportunity.....	114
3. Objectives and challenges	114
4. Solutions	115
5. Financial technologies and infrastructure.....	115
6. Capacity building	116

Innovative Approaches and Successful Programs in Commercial Banking for Financing SMEs in Transitional Economies	117
Radhakrishna Narasimham, Asian Development Bank	
1. Role of the banking sector in transitional economies	117
2. Bank lending to SME sector in transitional economies	120
3. Conclusion	124
SME Equity Finance:	
The Small Enterprise Assistance Funds' (SEAF) Experience	127
John Bays, <i>Small Enterprise Assistance Funds</i>	
1. SEAF's mission	127
2. SEAF's operations	128
3. The criteria for successful SME venture capital funds	128
4. Advantages and disadvantages of SME venture capital.....	130
5. Trends.....	131
C. COMPLEMENTARY BUSINESS SERVICES	133
Business Mentoring - Guidance for Growing SMEs	133
Brian Dunsby, Institute of Business Advisers	
Introduction	133
1. What is a small business?.....	133
2. SMEs need help	134
3. Business mentor schemes	135
4. The role of the Institute of Business Advisers (IBA).....	138
5. Developing countries.....	138
6. Conclusion.....	139
Combining Business and Financial Services	141
UNCTAD secretariat	
1. Introduction	141
2. The EMPRETEC programme	141
3. The role BDS providers in improving SMEs access to finance	143
PART IV: OUTCOME OF THE EXPERT MEETING	149

Tables

- Table 1: New funds raised for private equity / venture capital (USD billion)
Table 2: Correlation coefficients between changes across countries in survey questions and changes in GDP (1997-2000)
Table 3: Commercial banks' loans to the private sector by sectors, 1996–2000, in % of total private sector loans
Table 4: EMPRETEC installations and networking
Table 5: Summary of loan approvals

Boxes

- Box 1: ITC's activities on finance for SMEs
Box 2: Precisionair in Africa and venture capital funds
Box 3: The case of SEAF in Bolivia
Box 4: Empretec Ghana Foundation – combining financial and non-financial services

Figures

- Figure 1: Relationship between economic growth and economic creativity in the 1990s
Figure 2: The technology transfer index and innovation index in the 1990s
Figure 3: Explanation of the economic creativity index.
Figure 4: The innovation index and the ease of starting a new business
Figure 5: The relationship between the innovation index and non-resident patents per capita
Figure 6: The relationship between the technology transfer index and non-resident patents per capita
Figure 7: The relationship between the innovation index and resident patents per capita
Figure 8: The relation between the high-tech exports and technology transfer index
Figure 9: Five core competence of efficient retail bank of financing start-ups

PART I

Background Paper

Best Practices in Financial Innovations for SMEs

UNCTAD secretariat

INTRODUCTION

Specific problems of financing SMEs – lack of access

Finance has been identified in many business surveys as the most important factor determining the survival and growth of small and medium –sized enterprises in both developing and developed countries. Access to finance allows SMEs to undertake productive investments to expand their businesses and to acquire the latest technologies, thus ensuring their competitiveness and that of the nation as a whole. Poorly functioning financial systems can seriously undermine the microeconomic fundamentals of a country, resulting in lower growth in income and employment.

Despite their dominant numbers and importance in job creation, SMEs traditionally have faced difficulty in obtaining formal credit or equity. For example, maturities of commercial bank loans extended to SMEs are often limited to a period far too short to pay off any sizeable investment. Meanwhile, access to competitive interest rates is reserved for only a few selected blue-chip companies while loan interest rates offered to SMEs remain high. Moreover, banks in many developing countries have traditionally lent overwhelmingly to the government, which offered less risk and higher returns. Such practices have crowded out most private sector borrowers and increased the cost of capital for them. Governments cannot expect to have a dynamic private sector as long as they absorb the bulk of private savings. In the case of venture capital funds, they have been concentrated in high technology sectors. Likewise, the international financial institutions have ignored the plight of SMEs. For example, the Basle capital accords have not been analysed and framed with any consideration for their impact on the ability of the commercial banks to service the SME sector. These preferences and tendencies have exacerbated the lack of financing for SMEs.

Key reasons for the phenomenon

Traditional commercial banks and investors have been reluctant to service SMEs for a number of well-known reasons, which have been explored in numerous UNCTAD expert meetings.¹ They include the following:

- SMEs are regarded by creditors and investors as high-risk borrowers due to insufficient assets and low capitalization, vulnerability to market fluctuations and high mortality rates;
- Information asymmetry arising from SMEs' lack of accounting records, inadequate financial statements or business plans makes it difficult for creditors and investors to assess the creditworthiness of potential SME proposals;

¹ See for example "Issues concerning SMEs access to finance" in *Development Strategies and Support Services for SMEs: Proceedings of Four Intergovernmental Expert Meetings*, UNCTAD 2000.

"The SME-financing Gap and New Financial Products for SMEs in *Developing Countries and Eastern Europe*" *Committee of Donor Agencies for Small Enterprise Development*, Vienna, October 2000.

- High administrative/transaction costs of lending or investing small amounts do not make SME financing a profitable business.

As a result, commercial banks are generally biased toward large corporate borrowers, who provide better business plans, have credit ratings, more reliable financial information, better chances of success and higher profitability for the banks. When banks do lend to SMEs, they tend to charge them a commission for assuming risk and apply tougher screening measures, which drives up costs on all sides. Commercial banks in developing countries and countries with economies in transition often prefer to lend to government and thus the public sector crowds out the private sector. Such preferences were aptly put by a western banker in Nigeria: “We are not a charity. Why should I take risks with SMEs when I can make good money elsewhere?”² Lastly, there is also the problem of insider lending and/or cronyism which diverts finance away from SMEs.

Many governments and international financial institutions have tried to address the problems of high transaction costs and risks by creating subsidized credit programmes and/or providing loan guarantees. Such projects have often fostered a culture of non-repayment or failed to reach the target group or achieve financial self-sustainability.

Examples of such failed interventions are targeted credit schemes set up in Sub-Saharan Africa in the early 1980s by the development finance institutions (DFIs). Their aim was to provide either long-term credit or specialized services to priority sectors in rural areas. The financial policies pursued were of interventionism with governments influencing the credit flows through a system of subsidies, interest ceilings, policy-based credit allocations etc. Banks lacked the incentive to increase their efficiency or to develop their capacity for risk assessment and monitoring of loans, which contributed to a general deterioration in the quality of banks’ portfolios. In some countries the share of non-performing loan values rose to 90 per cent of the banks’ portfolios (Nissanke, 2001).

This paper focuses on the formal sector small and medium-size enterprises (SMEs) in developing countries and on improving their access to finance through innovative mechanisms. It is not the intention of this paper to discuss in detail the macroeconomic or financial frameworks that are needed to promote financial stability and employment. Macroeconomic stability and confidence in the financial system, in general, require strong institutions which can exert prudential supervisory authority. These conditions are, of course, a prerequisite for a well-functioning banking system which, if disposed, will give SMEs access to long-term finance. Financial reform is urgently needed in many countries. However, such reform is not on its own sufficient to secure SMEs access to long-term finance. Lack of structural reforms should not be used as an excuse to put off much needed work at the micro level which could increase the ability and profitability of lending to the SME sector. Rather reforms at the macro level and innovation at the micro level need to be undertaken simultaneously.

² The Financial Times 2001.

1. FINANCING BY COMMERCIAL BANKS – RECENT DEVELOPMENTS

Well-functioning and sustainable mechanisms for SME financing require institution building and a market approach. Lending institutions must improve their ability to provide financial services to SMEs through commercial mechanisms that lower costs and minimize their risk exposure. Only in this way will financial institutions find SME lending to be more profitable, and thus be encouraged to construct lending programmes targeted at SMEs.

There are also a number of trends in the financial services industry that are forcing banks to have a closer look at the SME markets. Globalization trends are increasing competition especially for servicing large corporate customers and driving down margins and fees. The improving liquidity of securities markets in many countries is increasingly providing large corporations direct access to the capital markets and allowing them to by-pass financial intermediaries. Therefore, banks are under increasing pressure to expand their business towards SME customers and to develop mechanisms to improve the profitability of lending to SMEs.

In recent years banks in developed countries have launched a number of initiatives that both improve the profitability of lending to SMEs and also provides SMEs with better access to finance and to financial products that are better tailored to their needs. A number of leading banks have demonstrated that providing financial services to SMEs can be turned into a highly profitable business.

Although the business environments in developing countries and developed countries differ in many respects, the problems of servicing SME customers are similar, namely high perceived risk, problems with information asymmetry and high administrative costs. Therefore, recent innovations in developed countries to improve SMEs access to credit can provide valuable insights for developing country banks to become more SME-oriented and to increase the volume and the quality of their services to this sector.

Initiatives undertaken by banks in the European Union and the United States

To compete effectively in the SME financing sector, banks need to provide financial services that meet the specialized needs of SMEs while coping with the high risks and costs associated with servicing them. To achieve this, an increasing number of banks have adopted separate strategies to service SME customers. The current trend is to shift from a product-based focus to a more customer oriented focus of providing packages of financial services tailored to their needs. This has the potential of considerably improving the banks' relations with the SME sector, as well as increasing the profitability of providing financial services to it. In this section we review a number of initiatives undertaken by banks to better serve the SME sector. These include:

- reducing information asymmetry of SMEs and high perceived risks by using credit scoring systems; using external information providers; risk self-assessment for the SME entrepreneurs; pricing to the level of risk; sharing risk with third parties; using covenants as an alternative to loan guarantees; and setting up special support units for high risk customers such as start-ups;
- reducing costs of lending by applying latest information technologies; streamlining the

- organization and simplifying the lending process;
- developing products better adapted to SME's needs;
- improving financial services for SMEs through training of bank staff and the segmentation of SME customers;
- cooperating with SME organizations and other business development providers in order to reduce risks and costs and combine financial with non-financial services.

Reducing information asymmetry of SMEs and improving risk management

The key for banks to improve the risk management of their SME portfolio is to have better information, i.e. to reduce the information asymmetry that they face when dealing with SME customers. To achieve this, two sets of infrastructure need to be in place. Individual financial institutions need to have efficient mechanisms in place in order to process and analyse vast amounts of data to support their decision-making. Further there is a need to have the appropriate infrastructure in place for the financial markets that enables the production of reliable and timely financial information on SMEs. Before proceeding to explore the innovative approaches that banks have undertaken to reduce information asymmetry, we highlight some of the issues regarding reliable financial information on SMEs.

(a) Financial information on SMEs

Part of the reluctance of banks to lend to SMEs is the banks' inability to evaluate risk because of the lack of reliable financial information. In well developed and stable financial markets creditors and investors usually demand and receive transparent, reliable and comparable financial information. The better the information, the higher investor confidence and the lower the cost of capital. Such financial information is provided in financial statements which follow national or even international accounting standards. Banks and regulatory authorities can even demand more information than what is publicly available or required. In addition financial analysts, rating agencies or business intelligence providers, generate information, which is available to creditors and investors.

However, even in highly developed economies, such as those in the European Union, SMEs are not required to report on their financial performance in a standardized manner if they do not reach a significant threshold in total assets, turnover and/or number of employees. This means that many SMEs in developed and developing countries do not produce reliable financial information, which could be used by creditors or investors. Instead, these users are left to specify for themselves what financial information they require thus placing a costly burden on SMEs to comply with different reporting formats. Even more important, the majority of SMEs do not generate the basic financial information that entrepreneurs need for efficient management.

After reviewing the many hurdles SMEs face in generating reliable financial information, the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) identified several desired characteristics that should be in an accounting system for SMEs. These include user-friendliness, flexibility to accommodate growth, standardized formats and adherence to generally accepted accounting practices. Such a system could reduce information asymmetry faced by creditors and investors as well as provide useful management information to entrepreneurs. The innovative mechanisms used by financial institutions for credit appraisal and rating sometimes presuppose the existence of

such reliable financial information. The basic pre-condition for using such mechanisms to reduce both transactions costs and risks is reliable accounting information. Such reliable financial information could be obtained from SMEs if the accounting and reporting requirements took into consideration both the types of transactions SMEs usually have as well as their ability to actually account for them given their level of business skills.

(b) Credit scoring systems

The challenge that banks face in managing SME risks is to make an accurate risk assessment of a large number of SME loan applications without generating high costs per application. Therefore, banks that work with large numbers of SMEs need to use automated processes in making their lending decisions in order to drive down the costs of each lending decision. This requires rather costly investment into IT systems and training of staff involved in small business lending. These investments will, however, typically pay off through efficiency gains and improved risk assessment provided that the bank holds a sufficiently large SME portfolio.

In recent years banks have increasingly adopted a new technology called credit scoring for small business lending. Credit scoring was introduced in the early 1990's especially by large banks in the United States. It was originally developed for consumer lending, where it has greatly altered the way in which banks manage consumer credit portfolios. The majority of consumer credit decisions across the globe are now automated and made using credit scoring. (Jennings, 2001) This technology is now being increasingly transferred to small business lending. Small business scoring is already well established in the United States and in Western Europe. It is also beginning to become more common in Asia.

Credit scoring is an automated statistical method used to assess the risk of default of a credit applicant. It involves analyzing large amounts of historical data on borrowers to identifying certain characteristics that predict the likelihood of the borrower defaulting on his/her loan some time in the future. These data could include, for example, the economic sector, years in business and size of assets. Using the results from this analysis, the bank can design a scorecard for evaluating the risk associated with each credit application. Using a weighted average, or some other methodology, the bank can then derive from the scorecard a single quantitative measure or credit score to evaluate the credit application. These steps can also easily be automated. There are a number of definitions of credit scoring. For example:

“The method analyses a large sample of past borrowers to calculate the probability that a *loan* applicant with certain specific characteristics will default. The system derives a single quantitative measure - the score - from a large statistical sampling of past borrowers in order to predict the future payment performance of an individual loan applicant” (Milken Institute, 2000).

“Scoring is the mathematical (statistical) process of converting data about a prospect, applicant, or customer into a quantifiable, objective forecast of some aspect of a consumer’s or small business’s behaviour. The whole concept of scoring depends on the fact that historical performance can be used to predict future performance” (Coffman, 2001).

In consumer lending large amounts of data on the performance of consumer credits and of the characteristics of borrowers are usually readily available for banks to generate reliable credit scores for different types of borrowers. For small business lending this is not necessarily the case. Especially smaller banks usually do not have a sufficiently large SME loan volume to manage credits on a statistical basis. In such circumstances banks have found that there is much to gain from sharing or ‘pooling’ data. This allows for the creation of large data sources to undertake historical analysis and enables the use of credit scoring and also other sophisticated credit tools that would otherwise not be available. One example is the use of credit bureau data to create pooled risk scores. There are also credit reference agencies that utilize this data and provide credit scoring systems directly for banks. For example, in the United States the Small Business Scoring Systems (SBSS) provides credit scoring risk models that are used by some 350 lenders. Similar systems exist in other parts of the world. For example, in the United Kingdom there are four credit reference agencies that provide “generic” scoring systems to banks lacking the “surface” or the historical database to build their own (Cade 1997).

The smaller the SME the more likely it is that the data on the firm, especially financial data, will be sparse, unreliable or even missing. In these cases banks have put more emphasis on the personal data of the owners. This information has proved to be predictive of the loan repayment. Thus, the credit scoring of the business entrepreneur augmented with information on the firm (e.g. financial condition, prior payment history, public filings, industry comparative data, years in business, industry and sales volume) is a good indicator of the future performance of a small business loan and has helped banks expand lending to SMEs.

One feature that has slowed the spreading of credit scoring systems to small business lending is the tradition in many banks to manage the small business loan portfolios alongside and in similar ways to the larger corporate customers involving case-by-case assessments of loan applications. To alter these procedures there is also a need to change the management culture of banks from a traditional “decision making approach” to a less case-by-case involved “decision managing approach”. In other words the management needs to shift its focus from individual loan decisions towards managing the decision-making tools such as credit scoring systems (Coffman 2001).

Credit scoring is actively used for small business operations by major financial institutions such as Wells Fargo, Bank of America, Chase Manhattan, NatWest Bank, Banc One and Citibank. In 1993, Wells Fargo became the first bank to use credit scoring in small business lending and by 1995 the bank was able to increase its loans to this sector by 61 per cent (Moore, 1997). According to a survey made in 1999 by Consumers Bankers Association (CBA) in the United States, automated loans processing and credit scoring are widespread practices: 92 per cent of respondents use automated systems. Furthermore, bankers continue

to refine their credit scoring systems: 52 per cent of respondents said they enhanced their credit scoring systems in the past year and 80 per cent plan to refine them during the next 18 months.

Credit scoring offers several benefits such as:

- improved management control since the management will have an almost real time picture of the level of risk associated with the whole credit portfolio. This information is crucial for controlling the level of risk that the bank will accept and for establishing an appropriate credit policy independent of subjective interpretations of individual credit officers (Dickens & Keppler, 2001);
- lower costs of underwriting loans since it reduces the amount of human intervention needed, increases the speed of approval and also reduces the training time for new credit staff;
- increased speed of loan decisions as well as the number of loans that the lender can underwrite while holding the loss rate constant, thus increasing revenues;
- improved accuracy, consistency and objectivity of decisions since the system evolves and improves over time; and
- automation of procedures.

Nevertheless, credit scoring also has some potential disadvantages:

- credit scoring is based on the analysis of historical data. In many cases, e.g. before a recession, forecasts based on past performance can be misleading.
- it can lead to unfair lending practices and have an adverse effect on some groups such as minorities and/or women who do not fit the established “risk” profile; and
- it is an impersonal tool that can substantially reduce the relationship between lenders and small businesses; less interaction between banks and SMEs can be detrimental for both sides.

Sound enterprises with limited credit histories or with sparse financial information would not qualify for credit under rigid credit scoring models. For banks, relying on a single credit score can lead to a loss of significant information about the enterprise. One way to overcome the potential problem is to segment customers according to their scores into three groups: accept directly, reject directly and review further (Jennings,2001).

Surveys have shown that small business owners feel the need to know a local banker and value a personalized service. Therefore, the challenge for banks oriented to the SME sector may be blending the two approaches, i.e. using technology to cut service costs and at the same time developing personalized services. The key to maintaining such a balance is to segment the small business customers, reserving “high touch” service for the most profitable clients while encouraging marginally profitable customers to use automated delivery channels (Stoneman, 1998).

Establishing automated credit scoring systems can also lead to a number of useful by-products for the bank. The information generated by the system can be used as a tool for segmenting clients and improving the efficiency of marketing financial products to potential clients e.g. pre-processed bank loans. Further, credit scoring can be used for pricing loans according to the level of risk. It identifies potential customers for other services and helps to target prospective borrowers. For example, in the United States, large banks are approaching small businesses with acceptable scores by direct mail, indicating to them that they have been pre-approved for unsecured loans up to US\$50,000 (Moore, 1997).

(c) External information providers

External rating could be a useful instrument to assess the creditworthiness of the upper segment of SMEs and create more transparency between banks and small businesses. It also provides a decisive help in defining an SME's position in the market place. Even if a bank also carries out its own assessment in the form of rating or scoring, an external rating by a competent institution offers such benefits as:

- evidence of creditworthiness;
- strengthens credit negotiations with banks; and
- reinforces SMEs' positions *vis à vis* their competitors and business partners.

Moreover, the rating analysis gives SMEs the opportunity to carry out sustained improvements or to take any remedial action when necessary. On their part, banks will reward the readiness of enterprises to take an intensive look at their own credit-worthiness.

External credit rating assessment for SMEs normally involves three stages. The first stage consists of the evaluation of annual financial statements (e.g. previous three to five years). Typical indicators include assets, capital and profitability. The second stage evaluates the company's business environment and the third stage is the management interview, which is useful to examine the risk potential. The analysis could be complemented with information about the credit standing of the main suppliers and customers, the enterprise's own payment record as well as its internal processes and IT systems. The rating institution will then issue a rating certificate, which enables the enterprise to make third parties aware of its financial situation without revealing any confidential information. Furthermore, rating scale measures have a worldwide acceptance, which ensures national and international recognition³ and a rapid appraisal. Of course, external rating is possible only if the SME can produce reliable financial accounts, thus the vast majority are not yet eligible for such services.

Several business appraisal and rating services have been launched in Europe, with the aim of providing risk assessments for banks, especially in cases where highly specialized skills are needed, such as high technology companies and innovative SMEs. Innovative and rapidly growing start-ups, often in the high tech sector, are seen as most attractive for banks. But, bank loan officers are not able to judge new and complex technological issues to evaluate the

³ A rating scale starts with a Triple A, which represents the top level of credit-worthiness; Double A also means a high degree of financial stability and a low risk of defaults on payment. Triple B represents a normal risk. A simple C means a barely adequate credit-worthiness and a D represents a company, which can go into liquidation.

risks involved and the chances of success. Therefore, bank staff needs the support of experts for advice on specialized areas such as innovative and high tech companies.

The German Savings Banks (DSGV) in cooperation with the scientific group, the Fraunhofer Institute, started a project called NTG (Network for Technology Expertise), a network of qualified experts who are able to evaluate risks and opportunities of innovative SMEs. The objectives of the project are: “providing a network of experts to give technical and market advice; creating a link between the bank and the experts responsible for finding and appointing the appropriate expert and controlling the quality of the work; providing a step-by-step system of expert opinion at moderate fixed prices; and ensuring rapid progression through the whole process”. Through the network, German Savings Banks can make well-founded and rapid decisions about innovative business proposals and also find the best tailor-made financing solution (European Commission, 1997).

The European Union EU is supporting a number of pilot projects to allow financial operators to develop technology-rating methodologies specifically aimed at small scale financing. Examples of such projects are the European Technology Rating and ENTAS (European New Technologies Appraisal Service). The European Technology Rating aims to design a technical/economic rating to evaluate innovative SMEs. The project will design a viable, accepted method at the European level to rate small firms with technological projects according to the risks. A key objective is the development of a scale of risk, which can be understood by any potential investor.

ENTAS is a pilot project that was set up by NatWest (UK), Deutsche Bank (D) and ING Bank (NL) and specialized expert organizations in Germany, the Netherlands and the United Kingdom. The ENTAS project seeks to build on proven technology business appraisal techniques to develop a new financial support product which can be used by banks, investment companies, business angels and other providers of early stage and small business financing to identify businesses in the technology area with high growth potential. ENTAS’ aim is to develop a usable and commercially viable appraisal technique, which enables the promotion of growth among innovative SMEs.

There are also examples of successful appraisal services in developing countries. In Colombia there is an entity called Servicio Nacional de Aprendizaje (SENA) that gives technical assistance to SMEs, which can serve as collateral at the bank. If the National Institute for Science and Technology approves the business plan or project of an SME, then this is considered as 50 per cent collateral by the bank.

Some other bank initiatives for reducing the risks of high tech and innovative SMEs are:

- cooperating with research and other specialized institutes for the provision of technology appraisal services;
- creating specialized technology teams to acquire the necessary knowledge to understand risks and select potential successful SMEs;
- making partnerships with public banks, funds or other institutions to develop a financial solution, in which the partner assumes a part of the risk;
- creating a network of experts in technology and financing for mentoring and following-up SMEs.

Nevertheless, despite the various initiatives developed by external credit rating systems for SMEs, these systems remain “too expensive, too general or unidirectional (techno-rating)”. Therefore, these services are currently only relevant to a minority of SMEs. In fact, since “most SMEs cannot be risk weighted with standard labour intensive or by neural network systems which ignore qualitative features, the best approach at the moment is a continuous improvement of the current internal risk assessment procedures by banks” (European Commission, 2000).

(d) Risk self assessment for SMEs entrepreneurs

Another way of reducing risks and the problem of information asymmetry is to inform SMEs about the risks that banks assume when they grant credit as well as the way banks evaluate their financing requests. The Forum of Private Business, an SME organization in the United Kingdom, developed a risk assessment form for self-analysis by entrepreneurs and/or financial advisors, based on the criteria used by banks for evaluating financing requests. The form is distributed by a number of British banks to their SME customers with the aim of reducing information asymmetry. Once the risk assessment form is filled in, the entrepreneur gets a risk profile of his/her business and he/she is able to understand the reasons why banks ask for information and the benefits of providing this information to banks. The Risk Assessment Form is a questionnaire with twelve different types of questions (See annex 1). According to the answers given by the entrepreneur, a total score will be obtained, which represents the risk undertaken by the bank. The higher the score, the higher the banks' risks. The risk assessment form also shows the risk-premium on top of the base interest rate that has to be paid (European Commission, 1997). It is clear that if entrepreneurs are informed about how banks evaluate the risks of their enterprises, they will be able to take the appropriate measures to reduce the risk of their enterprises and pay lower interest rates in the future. This initiative developed by the Forum has been well accepted by banks as well as the authorities who are willing to support the introduction of the form at the European level.

(e) Pricing lending decisions according to the level of risk

Another crucial aspect of risk management is pricing lending decisions properly. The traditional banking principle that the price of credit should reflect the risk still holds. However, in many cases banks dealing with large numbers of customers, using rules of thumb, have assigned the same rate of interest to a bulk of customers without paying proper attention to the risk they face. Such practices have the tendency of leading to adverse selection in the credit customers that the bank is able to attract. Modern information technology and new applications such as credit scoring and “value at risk” methods allow banks to greatly improve the pricing of their loans to better reflect the risk.

The French savings banks apply the Raroc (Risk Adjusted Return on Capital) system, which is a very detailed system of analyzing the costs and income of the client. With this system, banks can better assess the profitability of the customer by group of customers or by customer, which helps to select customers and prevent the customers' default. Although, the method is a useful tool, bank clerks are left with the final decision about the price.⁴

⁴ Workshop on corporate credit risk management, European Savings Banks Group, January 1999, Brussels.

(f) Sharing risk with third parties: loan or mutual guarantee schemes

For SMEs, lack of collateral is a significant obstacle to obtaining credit from banks. A solution to this problem could be found in cooperation between banks and third parties, e.g. loan and mutual guarantee schemes.

In European Union countries (EU), mutual guarantee schemes have emerged as a more market-driven approach than the public guarantee schemes set up by governments. Mutual guarantee schemes act as intermediaries between banks and SMEs. They involve private groupings of companies linked to sector-specific interest groups, which provide loan insurance to the banks. A Mutual Guarantee Society (MGS) is funded by the contributions of the enterprises and managed by the SMEs themselves. The fund provides financial guarantees as well as training and advisory services to its members. The bank will grant the credit, based on the assessment of the MGS and the financial guarantee. Mutual guarantee companies can also play an important role in preliminary enquiries, management and monitoring of the credit process.

Public institutions may supply counter-guarantees to the mutual fund thus increasing the fund's potential capacity. Successful examples of mutual funds can be found in France, Germany, Italy and Spain. These positive experiences have led the European Commission to support and encourage the development of such schemes.

In Italy there are more than 500 mutual guarantee schemes called the Consortia Fidi, which involves business associations (craft, wholesaling and retailing, tourism, services, manufacturing) and chambers of commerce. The mutual fund offers SMEs guarantees, combined with support for the preparation and presentation of business plans to banks. They also act as pressure groups since they help their members to negotiate soft loans and lower interest rates for regular loans. Although the Consortia Fidi is not allied with one particular bank, the Italian savings banks cooperate closely with the mutual fund. According to the banks, the guarantees generally cover medium/long-term loans for all types of investments, with lower interest rates.

There are also examples of mutual guarantee schemes in developing countries. EMPRETEC⁵ Ghana, a business development services provider, has set-up the Mutual Empretec Guarantee Scheme in cooperation with a local bank. According to the scheme, SMEs within the EMPRETEC programme can form groups in order to save together a certain amount of money, for example US\$100,000. This amount is then matched by a development agency. Following this the local bank will be in a position to loan US\$800,000 based on the US\$200,000 deposit. The Empretec groups meet monthly to discuss progress and who should be approved for a loan.

⁵ Empretec is an integrated capacity-building programme of UNCTAD that provides developing countries with the institutional framework to foster entrepreneurial capabilities and the growth of internationally competitive SMEs through training, business development services, networking and access to finance.

(g) Covenants

An alternative to official loan guarantees could be the use of covenants. A covenant is a clause in a formal debt agreement designed to protect the lender's interest. It usually covers such matters as working capital, debt-equity ratios and dividend payments. A committee established by the Federation of Finnish Industry and Employers considered the use of covenants as a security for SMEs. The committee made several recommendations: "banks should accept covenants as a replacement for collateral or as additional security; the Finnish Financial Supervisory Board should examine the use of covenants and improve their usability; and the Ministry of Trade and Industry should set up a committee in order to develop structured covenants which could be widely accepted by financial institutions". Some examples of covenants are:

- a request for the SME to report its financial status to the bank more often and in greater detail;
- an obligation for the SME to ask the bank's permission before making large investments which could endanger its solvency. The International Finance Corporation (IFC) has used this type of covenant to oblige the borrower not to incur further borrowing and to increase its debt position without consulting with the bank;
- an obligation for the bank to charge lower interest rates and fees if the financial position of the customer stays above agreed limits, with the possibility for the bank to increase interest rate margins and fees if the SME breaches these limits (European Commission, 1997).

(h) Special support units for high-risk customers such as start-ups

Banks have also developed a number of initiatives for reducing risks of SMEs in the start-up and early development stages. SMEs in these stages are especially high-risk clients for banks due to the lack of business skills, experience, strategies and resources. Moreover, the costs for adapting the bank's resources to the client's needs can be significant. Thus, banks are aware that supporting this segment of SMEs is not always profitable or cost-effective in the short term, but the support has the potential to provide fruitful results in the medium and long term, by building up a strong customer base and obtaining significant additional business and income for the bank.

The Bank of Ireland has set up an Enterprise Support Unit (ESU) that has provided 10-year funds and hands-on support to start-up SMEs. To date the ESU has lent EUR 50 million to over 550 companies. The ESU operates outside conventional criteria: personal guarantees or asset-backed securities are not taken. The ESU lends to high-risk businesses at normal rates and also participates in several seed capital funds providing tailored equity to start-up enterprises. It provides SMEs with access to business skills workshops, enterprise forums and specialist advisers throughout Ireland. These services are provided in co-operation with First-Step, a non-profit organization providing business development services (European Commission, 2000).

Reducing the cost of lending by improving the efficiency of bank operations

(a) Applying new information technologies⁶

The potential for timesaving and efficiency gains through an appropriate use of new information technologies (IT) is significant. Banks have for a long time been at the forefront in successfully applying latest IT to improve efficiency of operations in a wide variety of banking products. An area in which banks have made less progress is the standardization of financial products, although at present, developments in this field have accelerated. Technology can greatly extend a bank's reach with simple, standardized products such as a small, unsecured loan or perhaps an office equipment lease. The advantage of standard products is a significant cost reduction. Besides, standardized products can be reasonably priced and are easy to access since they are suitable for virtual banking and only require automated processing assessment. On the other hand, tailor-made products should be high in value-added since they require the participation of account managers and specialists for their assessment, processing and distribution.

Swedbank launched Internet Banking in 1997 and already features in the global top 10 online banks. The introduction of this service has altered the bank's structure and has led to significant cost savings. This has meant that 146 offices are being closed and staff cut by 2000.

IT offers banks the opportunity to improve their efficiency through the introduction of the following applications:

- standardization of product menus, loan applications and lending standards;
- centralization of credit analysis and document preparation;
- automation of application processing systems;
- creation of objective systems for credit analysis such as expert systems and credit scoring, which allow the improvement of risk management;
- increasing the quality of products;
- communicating with entrepreneurs;
- developing virtual banking as a new distribution channel;
- offering mass-customized financial services;
- utilizing multiple channels for more efficient delivery of financial products.

According to the American Advisory Board Company, banks that effectively adopt these strategies can double their profitability compared to competitors who do not apply them (European Commission, 1997).

⁶ The application of the latest information technologies for improving the financing of SMEs are discussed in greater detail in the background paper "E-Finance and Small and Medium-Size Enterprises in Developing and Transition Economies" (UNCTAD/SDTE/Misc.48).

(b) Streamlining the organization and simplifying the lending process

Timely credit decisions from lenders are an important factor for SMEs. Good business opportunities such as lucrative contracts or an opportunity to grow can be lost without a timely loan. The multiple administrative procedures and delays in the credit decision process are factors that discourage SMEs for applying for bank credit. Moreover, the delays in the approval procedures and loan disbursements are a burden on the enterprise's financial situation, which will push SMEs to change to another bank or look for loans in the informal sector at high interest rates. For these reasons, SMEs consider the speed of getting financing as a determining factor. Therefore, banks have made important efforts in restructuring the organization and simplifying the credit process to become more customer-oriented and retain loyal and high value SMEs. Another important benefit of streamlining is reduced administrative costs for the bank, allowing them to lend at lower rates of interest. In fact, the most profitable banks have introduced a streamlined underwriting process with simple and limited paperwork and a rapid response to loan applications. The actions taken by banks for streamlining and simplifying the credit process are:

- eliminating bureaucracy by increasing staff responsibility and their power to make decisions as well as reducing the number of layers in the loan transaction process;
- concentrating the administrative activities in specialized and automated centres and leaving sales activities to local offices;
- applying latest information technologies during the whole lending process: analysis, decision, pricing and monitoring;
- designing systems to identify and resolve bottlenecks and unnecessary long procedures;
- developing procedures for resolving customer inquiries and/or complaints about service delays.
- For instance, the German Bank "Stadtsparkasse Hannover" considerably reduced the handling time of loan requests from 11 days to less than four days. The bank decided to completely restructure the credit process to reduce overall operating time and at the same time increase the quality of the services. During the project it became clear that it was essential to give people more responsibilities in order to reduce time-consuming administrative work. The bank managed to reduce the original number of nineteen sequential administrative measures to a few simultaneous actions, which were executed by front office employees having specialist knowledge, the necessary skills to advise the customer on the spot and, even to some extent were authorised to give loan commitments.

Another example is CERA Bank (Belgium) that restructured the whole organization to improve its services for SMEs customers. In order to eliminate bureaucracy and streamline processes, it carried out an analysis of the whole organization from head office to local branches to detect bottlenecks, unnecessary long procedures and lack of cooperation. After this analysis, a plan which included the reorganization of the credit approval committee, was implemented. The account officers were given more signing authority and credit committees were staffed with more professional personnel. These changes allowed the bank to answer credit requests within 72 hours and attend to complaints in 48 hours.

On the other hand, there are banks that have created specialized SME branches with the objective of providing SMEs with more rapid solutions and a more professional service. Some Spanish savings banks set up exclusive branch offices for SMEs. The branches are located near the clients in big industrial sites. They have specialized teams to work with

SMEs and enough capacity to immediately authorize day-to-day operations. The branches operate with a certain independence from the structure that rules the other branches (European Commission, 2000).

Developing products better adapted to the needs of SMEs

Banks focusing on the SME sector have conducted extensive market research to learn more about their customers and their needs. Using the results of these studies, they have identified a number of financing gaps or problems related to the development stage of the enterprise, its activities and the macroeconomic environment and, have developed a number of specific products to better meet their financing needs.

In recent years, some banks have developed new alternative products to cover the gap in risk finance. Some examples of the alternatives offered by banks include providing seed capital for start-ups, combining risk finance with traditional loans and participating in investment funds for SMEs.

Seed capital⁷ for start-ups⁸: This form of financing includes various combined instruments such as equity, subordinated loans⁹ and soft loans. Its main characteristic is that the capital provider does not seek high return levels and may be satisfied with a “modest” return on investment. This is the case of public providers of seed capital which often do not look for making profits. On the other hand, due to national and regional approaches to help the development of SMEs¹⁰, banks are beginning to participate in the provision of seed capital. Banks assign amounts to seed capital usually through funds especially set up for this purpose, but such funds normally do not provide all the financing needed by enterprises. For example, the ING Bank (The Netherlands) created a seed capital fund that limits itself to a 50 per cent participation in the capital of any SME. Another example is the Enterprise 2000 Seed Capital Fund developed by the Bank of Ireland and Enterprise Ireland which offers a mix of equity (75 per cent) and loan finance (25 per cent) to start-ups. The loan range is from EURO 32,000 to EURO 125,000. The fund, a partnership between the State and private funds, does not require personal guarantees for the loan but post investment follow-up (European Commission, 2000).

Informal capital is capital provided by family and friends and is an important source of risk finance for SMEs. Therefore, some governments have established special regulations to offer tax reductions to informal capital providers in order to widen SMEs’ financing sources beyond relatives and acquaintances. Informal capitalists, also known as ‘business angels’,

⁷ Seed/Start-up capital is needed when the business does not have sales nor profits, but the business owner has a plan and vision. Start capital: funds to start operating the business; Seed capital: funds to develop, test and prepare a product for entry into the market.

⁸ The Global Entrepreneurship Monitor (GEM) found a direct relationship between a country’s level of entrepreneurship activity and its economic growth. Countries with a higher number of start-ups have higher economic growth (Milken Institute, 2000).

⁹ The subordinated loans rank after all other creditors if there is liquidation. Therefore, they are considered part of the capital of the enterprise and help it to get ordinary loans.

¹⁰ For example, initiatives undertaken by the European Commission to promote “growth and employment.” In 1998, the Commission launched a programme especially addressed to SMEs which provides financing for start-up and early stage development, supports the creation of transnational joint ventures and provides guarantees for the establishment of enterprises.

may take more risk and be satisfied with a lower return on investment than traditional venture capitalists. They may also have lower evaluation and follow-up costs since they invest in activities in which they have previous experience.

Banks try to take advantage of the opportunities where enterprises need a combination of risk finance and traditional loans. NatWest, for example, created a Business Angels Service that links informal investors with enterprises that need capital. Research conducted by the bank detected the need of a “well managed register of investors” from the supply side and SMEs. This evidence led the bank to implement a Business Angels pilot project. In the first phase of the project a database was set up with potential investors and their preferences, and enterprises with their requirements. The second phase consisted of matching demand with supply. Since January 1996, NatWest extended the pilot project into a national scheme that is available to private investors and SMEs. Enterprises looking for capital have access to the Angels Service through their bank’s branch or specific intermediaries (e.g. business development services, information suppliers of investment possibilities, etc.), which supply information about the application process, the enterprise’s financing aspirations and provide additional information to Business Angels. The intermediary is also in charge of introducing the enterprise to the investor. The intermediary charges fees for its services, while the NatWest Angels Service is free (European Commission, 1997).

Another kind of informal investors may be large enterprises willing to invest in SMEs. In the Republic of Ireland and the United Kingdom banks are involved in local investment funds for SMEs. This kind of initiative needs the participation of a local intermediary to encourage the enterprises to put money into the fund. Moreover, it is necessary to get together various existing local initiatives for SMEs. The banks participating in such funds provide SMEs with loans when the fund makes an investment. In the Netherlands, the ING Bank, together with a local large enterprise, created a local fund for start-ups; each contributed 50 per cent of the capital, and the ING bank provides regular loans to the enterprises in which the fund has invested (European Commission, 1997).

Furthermore, banks are increasingly selling alternative products to SMEs, such as corporate credit cards, leasing, factoring¹¹, etc. These products have a lower risk for banks and may contribute to reducing SMEs’ dependence on traditional loans. Moreover, banks are trying to ensure that SMEs are provided with an appropriate mixture of short and long term financing. This scheme is regularly reviewed by loan officers with their clients according to the development of the business.

Improving financial services for SMEs

(a) Training of bank staff

Banks that lend to SMEs recognize that the competence and experience of their staff are crucial in competing effectively for SMEs’ business and for managing the credit risk inherent in SME banking. For this reason, some banks have embarked on major training programmes

¹¹ Factoring is defined as the purchasing of accounts receivable, in the form of invoices, at a discount from their face value. It is a financial tool that provides enterprises with immediate working capital against the accounts receivable without creating debt.

and addressed their efforts to professionalize SME account managers. In fact, bank staff dealing with SMEs need a sound knowledge of entrepreneurs and their businesses in order to develop an affinity with their clients and offer them solutions adapted to their needs.

The actions taken by banks include firstly, a better selection of new account managers for SMEs. They look for candidates with an adequate background and experience in small business or with entrepreneurial skills, who can be flexible and sensitive to SMEs issues.

Secondly, banks realised that account managers need to stay longer at these positions in order to develop closer relationships with SMEs as well as a better knowledge of this sector. Therefore, banks have created a number of incentives to make it more attractive to work with SMEs. Such incentives include: giving special rewards (e.g. bonus systems which relates profit sharing to the profit generated from clients); and offering an attractive career path in the SME market segment. For example, NatWest has three different types of account managers for SMEs: Small Business Advisors, Business Managers and Corporate Managers for Mid-Corporate Businesses. The Bank of Ireland has two types of SME account managers: District Enterprise Advisers for existing and new small entrepreneurs and Area Account Managers for larger SMEs.

Thirdly, banks are putting much effort in providing specialized and quality training programmes for their personnel, especially in the areas of credit analysis and portfolio management. NatWest has set up special training programmes in co-operation with Durham University Business School (DUBS) and a support agency, Business Links, to train their SME account managers. The courses, taught by SME entrepreneurs together with experienced teachers, have a different approach since they combine classroom-based training with work experiences in SMEs. During the training courses, the account managers attend courses at the Business School for a week, and then they work in a SME for four weeks. The course enables the account managers to experience what running a small enterprise is like, which helps to improve the relationship between bankers and SME managers. In another project of NatWest, the account managers together with staff from large enterprises act as mentors for SMEs groups. Other British banks also work with business schools organizing conferences in which leaders of major SMEs organizations take part.

Swedbank has also launched special training programmes for its SMEs staff with two objectives: improving the bank's capacity for providing services adapted to the particular needs of SMEs customers; and creating a proactive and sensitive sales organization for SME clients. "In order to understand the circumstances under which many entrepreneurs work, the participants have to go through all the steps involved in setting up a company. This covers drawing up a business plan, preparing budgets, contacting the necessary authorities, etc. The students must also go through the banking process, including setting up accounts and requesting credit" (European Commission, 1997). After the course, the SME staff is better able to meet the small businesses needs and also have a better career perspective in the bank.

Fourthly, banks support the front office staff dealing with SMEs by minimizing their back office work (administrative tasks); equipping them with suitable hardware and credit risk assessment systems, and providing them with the advice of external experts for the evaluation of complex financing requests, such as those from innovative and high tech companies. These actions allow the account managers to spend more time with SME clients and make more accurate and rapid decisions.

(b) Segmentation of SME customers

The segmentation of the SME portfolio is a key condition for providing optimal financial services to small businesses. A good segmentation allows the use of the available bank resources (distribution channels, personnel and information technologies) in a more appropriate way.

Banks can use two methods (or a mixture of both) for segmenting their SME portfolio: the first one is based on their client's profitability and, the second, on the needs of the client, (e.g. size and nature of the firm). Using the first method, the Groupe Banques Populaires (France) identified three SME segments: "upper", "middle" and "lower", and each one is divided into existing and new companies. Whereas CERA Bank (Belgium) uses a segmentation method called "splitting", which is based on the needs of the client.

Nevertheless, it is not easy to establish a good segmentation method since both the banks' and clients' preferences should be considered. Besides, banks do not always have the required resources (IT systems), which can help them to have an accurate idea of the profitability per client¹². Furthermore, segmentation could not be a viable alternative for small banks with a small client portfolio or with a unique distribution channel (the branch).

Segmenting SME customers will help banks to reach a balance between optimal profit and optimal support for the client, reserving personalized services and products for the more profitable SMEs while encouraging (mainly through price incentives) marginally profitable customers to use automated delivery channels, which are less costly for banks. "The real challenge for bank managers pursuing the small business markets may be blending the two approaches. By using technology to cut service costs, banks can lower prices and boost their customer attraction. At the same time, a personalized service component will help firm up valued relationships" (Stoneman, 1998).

Cooperating with SME organizations and other business development providers

Banks have seen that an effective way to reduce risks and costs of lending to SMEs is cooperating with third parties such as SME representative organizations (e.g. business associations, chambers of commerce, etc.) and/or other business development providers. The example of the partnership of the Bank of Ireland with First Step is shown in section 2.1 and some further examples are shown below. Since SMEs' organizations have close contact and affinity-based relationships with their members, they are aware of the problems and needs of the SME sector. For this reason, SMEs organizations can play a key role in improving the relationship between banks and SMEs, cooperating with banks and at the same time improving SMEs credit-worthiness.

Therefore, banks have established a number of agreements with SME organizations, which:

- offer bank guarantees for the SMEs loans through mutual guarantee funds;

¹² Banks with new, advanced IT applications are better equipped to calculate the profit per client, per product and per market.

- offer training courses to the account officers to improve their understanding of small businesses, their exposures and needs as well as special issues about start-ups and innovative firms;
- help banks to develop customized products for SMEs, including marketing and after sales service.

Working in cooperation with business development providers could increase the ability of banks to service special SME segments, which they believe represent higher risks, such as women entrepreneurs or ethnic minorities. This type of cooperation could be useful not only for reducing risks and costs but also for identifying prospective small business applicants. Some examples of banks' cooperation with third parties are:

The Banco di Sardegna (Italy), together with Banca Nazionale del Lavoro, designed a project with the aim of improving SMEs access to finance and reinforcing the cooperation between public funding institutions, SME organizations and the banks at regional level. The main objectives of the project are to reduce the time and costs of credit applications and to support SMEs in the preparation of their business plans and financial forecasts.

The Swedish public funding institution, ALMI, in cooperation with private banks designed a package of products and services tailored to the SME needs. The packages consist of loans with favourable conditions and interest rates, such as subordinated loans that cover the top slice of risk when banks are disposed to finance the remaining part. The loans have a broad range from EURO 5,600 to EURO 564,000. The package includes the provision of a non-executive director, selected from a network of 2000 experienced entrepreneurs with the aim of strengthening the management of the enterprise (European Commission 2000).

Finally, due to the key importance of training SME entrepreneurs in order to reduce lenders' risks, some banks together with SMEs organizations and governments have developed a series of training courses. For example, NatWest, in cooperation with the Federation of Small Businesses and local education authorities offered training to entrepreneurs and those who completed the courses were eligible for lower interest rates. Later on, a survey showed that an outcome of the training was an improved relationship between banks and SMEs. In fact, improving entrepreneurs' management skills and their financial awareness will make a vast improvement in their access to finance.

Empretec Colombia (Corporacion Innovar) has benefited from the National Guarantee Fund in Colombia following a new law for SMEs. If a SME is a member of the Empretec programme and has an approved business plan, the Fund will give him/her a certificate. The SME can then present the certificate to a bank and it can substitute for 80 per cent of the collateral that the bank would have otherwise asked for. So far the results have been encouraging and banks have preferred the certificates issued by the Fund to other forms of collateral such as real estate.

2. SPECIALIZED INSTITUTIONS AND PROGRAMMES FOR SMEs AT NATIONAL AND INTERNATIONAL LEVELS

Specialized financial institutions for SMEs

Due to the limited abilities of SMEs to raise funds, several countries have established specialized financial institutions for SMEs. The main objectives of such institutions are to increase SMEs access to finance (especially long-term funds), by reducing information costs and capital costs, thus giving an incentive to commercial banks to finance SMEs.

The Netherlands was the first country to create a specialized financial institution in 1927. The Government set up the Netherlands Bank for Small and Medium Business with the participation of 25 small banks and the Government as the major shareholder. However, over the years the institution lost its SME orientation and turned to larger clients. Among other countries which have created specialized financial institutions for SMEs are Colombia, India, Japan, Republic of Korea, Pakistan and Turkey.

The experience of these institutions has been mixed. Although they have played a role in compensating for the shortage of finance to SMEs, they have often faced problems of poor performing loan portfolios, declining profitability or losses and a doubtful financial viability and sustainability. As a result, these institutions have tended to diversify their operations, reaching larger enterprises, and relying on low-cost funding from governments and external donors.

Some factors that seem to have contributed to the success of some specialized financial institutions are: relatively stable macroeconomic conditions in their respective countries, high degree of operational autonomy, diversification of their assets and sources of income, and a high priority to maintain a reasonable level of profitability. The following section reviews examples of such financial institutions and programmes for SMEs in Japan, India and Turkey and covers the European Bank for Reconstruction and Development (EBRD). See also the articles by Renate Kloeppinger-Todd on the International Finance Corporations (IFC)¹³.

(a) Japan Finance Corporation for Small Business (JFS)

The case of the specialized financial institutions for SMEs of Japan is often cited as an example of success since these institutions have significantly contributed to enhance SME access to finance. In Japan there are three groups of financial institutions that provide funds to SMEs, the private sector financial institutions, the private financial institutions for SMEs and the government financial institutions. The first group includes commercial banks, regional banks, trust banks and long-term credit banks. The second group constitutes the financial institutions specializing in SMEs such as mutual banks, credit associations and credit cooperatives. The third group is made up of three government financial institutions for SMEs: Japan Finance Corporation for Small Business (JFS), National Life Finance Corporation and the Central Cooperative Bank for Commerce and Industry (Shoko Chukin

¹³ Making Small Business Finance Profitable – IFC’s Approach” Renate Kloeppinger-Todd, page 107 in this publication.

Bank). These three government financial institutions provide 10 per cent of the total loans to SMEs in Japan, and according to studies¹⁴ they have contributed to the increase in total loans to SMEs.

The example of the Japan Finance Corporation for Small Business (JFS) is a useful illustration to understand the way government financial institutions for SMEs work in Japan. The JFS was established in 1953 with the objective of providing long - term financing at low interest rates, which is difficult to obtain from private financial institutions. In order to lend to SMEs, JFS adopted the “agency loan system” which consists of using private financial institutions as “agencies” to make loans through them. Eligible agencies are healthy financial institutions that have appropriate information on borrowers and suitable screening and monitoring procedures. Nowadays, a vast number of the private financial institutions in Japan are part of the agency loan system. However the majority of the agencies are credit associations and credit cooperatives, which are considered as private financial institutions specializing in SMEs. The agency loan system in Japan has contributed to building a nationwide network of agencies providing loans to SMEs at lower cost¹⁵.

JFS shares liability with its agencies. Thus, agencies assume 80 per cent of the risk and the remaining 20 per cent is assumed by the government financial institution. Furthermore, JFS pays a commission to the agencies for their loan services to cover the costs of lending. This mechanism may act as an incentive to grant loans to SMEs. JFS also finances SMEs by extending direct loans through its 61 loan offices throughout the country.

JFS provides a wide range of different types of “funds for business” such as funds for entering new fields, dealing with environmental problems, overseas investment and operating funds with preferable long-term conditions. Moreover, JFS supplies loans for disaster recovery to SMEs affected by changes in the economic and financial environment, or by damages caused by natural disasters. The JFS approach integrates funding with useful information on how to make optimal use of funds. After loans have been arranged, JFS offers its Business Information Services¹⁶ which provide information to small entrepreneurs to solve their management problems through a database containing information on 50,000 SMEs clients nationwide¹⁷. Furthermore, the Business Information Services help enterprises to find and expand business opportunities through a vast client network and assists them with advice.

In February 2000, JFS created a new programme called “Loans that Foster New Business with High Growth Potential” in order to support venture companies and SMEs entering into new businesses with high growth potential. An important characteristic of this scheme is that

¹⁴ See for example Mori, 1999.

¹⁵ There are 679 agencies and approximately 24,000 offices (as of March 31, 2001).

¹⁶ In September 1998, JFS became the first financial institution in Japan to acquire ISO9001 certification for the information services offered through its offices.

¹⁷ JFS assists SMEs on their management problems and provides them with useful examples based on the information on small business management that the institution has accumulated over time. According to customers' requests, JFS can arrange a meeting with companies which have successfully solved their management problems.

JFS finances enterprises having insufficient collateral and also provides funds by accepting bonds issued by the company.

The success of government specialized financial institutions in Japan may be explained by the fact that private financial institutions for SMEs were developed in parallel with government financial institutions, and because a system for private financial institutions to provide credit to SMEs was well established. Private financial institutions for SMEs are the key for the effective operation of government specialized financial institutions, since they have an adequate access to information about their member companies and are able to collect the required information about their customers at lower costs. Furthermore, their members deposits are the main sources of funds of private financial institutions for SMEs. Therefore, the possibility to offer low-cost financial schemes such as agencies' loans to SMEs is a way to attract customers and, at the same time generates positive propaganda for the government's SME scheme thus contributing to its growth (Mori, 1999).

(b) Small Industries Development Bank of India (SIDBI) ¹⁸

The Small Industries Development Bank of India (SIDBI) is a specialized financial institution of the Central Government of India. It was established in 1990 with the aim of being the principal financial institution for the promotion, financing and development of SMEs in the country. SIDBI is now considered to be one of best development banks in the world and functions as the key instrument for financing SMEs. SIDBI supplies low-interest funds to financial institutions which in turn finance SMEs under a refinancing system and promotes medium and long-term lending to SMEs.

SIDBI channels its assistance to SMEs through:

- direct financing which includes working capital loans, direct bill rediscounting, leasing, foreign currency loans and equity assistance, which are dispensed through SIDBI's 38 branches;
- indirect financing which consists of providing refinancing and rediscounting of bills of Primary Lending Institutions (PLIs), including banks and State level institutions which together have about 65,000 outlets in the country. Some of these institutions receive lines of credit instead of refinancing; and
- promotional and development services which include the provision of loans, grants and technical support to NGOs and institutions in the technological and managerial areas that may be able to implement the SIDBI's programmes. Also, the SIDBI has established formal agreements with government organizations, research and development institutions and industry associations to promote its SME programmes.

During the last five years, SIDBI has introduced a number of innovative programmes to supply the financial needs of SMEs. These programmes focus not only on providing credit but also on development and support services to SMEs through the "Promotional and Developmental (P&D) Schemes". Such schemes aim to ensure technology up-grading,

¹⁸ See also the article in this publication "Development Financial Institutions' and Commercial Banks' Innovative Schemes for Assisting SMEs in India", Sailendra Narain, page 79 in this publication.

human resource development, enterprise promotion, environmental and quality management and market promotion.

Some examples of the recent programmes created by SIDBI to improve the provision of credit for SMEs are (Narain, 2001):

- a National Equity Fund Scheme for projects up to INR (Indian rupee) 1.0 million. The scheme charges only one per cent for the service;
- special credit windows to assist women entrepreneurs and women NGOs to set up production and training centres addressed to empower women and motivate them to undertake entrepreneurial ventures;
- a direct discounting of bills scheme created to cope with the problem of delayed payment of bills for purchases made from SMEs, usually from large enterprises and the public sector. Under this scheme their bills are directly discounted by SIDBI and the SME suppliers are paid after presenting the bills properly accepted by the purchasers. On the bills' expiration date, purchasers will directly pay the due amounts to SIDBI;
- a number of venture capital funds (ten regional funds, one national fund and one overseas fund) especially addressed to IT industries. Moreover, SIDBI is planning to set up a venture capital fund dedicated to bio-technology;
- a new credit guarantee fund scheme that guarantees loans up to a limit of INR 2.5 million and demands as a prerequisite that the bank does not take any collateral or third party guarantees. It must be pointed out that this new scheme takes into account the mistakes made by a former Guarantee Scheme for SMEs operated by the Reserve Bank of India for over 30 years which failed due to operational incompetence¹⁹.

As a complement to these programmes, SIDBI, with the cooperation of the Indian Banks Association and the National Institute of Bank Management, has organized sensitization programmes directed at bank managers for financing the SSI sector. The idea is “reposing confidence in the minds of banks that lending to SSI is cost effective with calculated risk” (Narain, 2001).

(c) **Turkiye Halk Bankasi (Halkbank)**²⁰

Halkbank is a public bank²¹ established in 1938 with the aim of supporting SMEs. Its special emphasis is on SME projects that are productive and create exports. The bank has 15,000 staff, 806 branch offices, three partner banks in Hungary, the Netherlands and Turkmenistan and Representative Offices in Belgium and Switzerland. Halkbank has also a leasing company, an insurance company and a venture capital institution (“Equity Participation Company”). Moreover, it has established a Credit Guarantee Fund with the participation of the chambers of commerce and the German organization, GTZ.

In recent years, Halkbank focused on a special programme for SMEs called “Incentive Fund Credits.” This programme grants credits based on two criteria: the type of region where the

¹⁹ Banks left the scheme due to complicated procedures for making claims and the difficulties of being reimbursed.

²⁰ Information provided by the SME Credit Division of Halkbank as of October 2001.

²¹ Bank authorities have informed that at present (October, 2001) the bank is undergoing privatization process.

SME originally operates (developed or underdeveloped region) and the scale of the enterprise (micro, small or medium). Interest rates, credit limits and equity participation vary according to these criteria. In the last three years, such programmes have allocated about USD 100 million to 6,600 entrepreneurs whose businesses created 50,000 new job opportunities. Another attractive credit programme offered by the bank is the “Young & Women Enterprise Credit Line”, a programme particularly addressed to those small entrepreneurs who want to start new businesses. Approximately 26,000 young and women entrepreneurs have been supported by the initiative.

In the course of its operations, Halkbank felt the need to combine credits for SMEs with consultancy and information services. Thus, it established five technical consultancy centres as well as 15 domestic and two international information offices. All centres are linked to the Euro Info Centre-BC-NET and its services are free of charge.

(d) European Bank for Reconstruction and Development (EBRD)

A key objective of the EBRD is to support the development of micro, small and medium-sized enterprises (SMEs) in central and Eastern Europe and the Commonwealth of Independent States (CIS). A good example of EBRD programmes in such regions is the Russian Small Business Fund (RSBF). Since 1994 the RSBF has granted more than 58,000 loans for a total amount of US\$615 million to micro and small enterprises in 80 towns and cities from the Russian Federation.²²

The main goals of the RSBF are to focus on the financing of micro and small enterprises and reinforcing the lending capacity of Russian banks in order to ensure a sustainable long-term access to finance for micro and small enterprises. EBRD grants three to five year loans directly to partner Russian banks. Besides financing, EBRD offers technical assistance to implement a suitable methodology which ensures commercially viable lending activities. Thus, its main actions are focused on the introduction of customer oriented and efficient lending procedures, and reducing bureaucratic obstacles. Since RSBF seeks to maximize its geographical outreach, the programme has been implemented not only in the regional capitals of the Russian Federation (e.g. St. Petersburg, Yekaterinburg, Novosibirsk and Vladivostok) but also in “satellite” towns and some remote areas, usually underserved by banks.

The RSBF programme offers two types of loans:

- micro-loans: maximum amount of US\$30,000 with a maturity of up to three years. Loans are for sole-owner enterprises, having up to 30 employees. Over 90 per cent of all RSBF borrowers receive micro-loans with an amount of less than US\$30,000; and
- small loans: maximum amount of US\$200,000 with a maturity of up to three years. Loans are for sole-owner enterprises, having up to 100 employees.

²² EBRD/RSBF presentation in Moscow, August 2001.

Some of the main aspects of the methodology that the RSBF has introduced in Russian partner banks are:

- intensive training of staff in credit analysis and portfolio management which are considered the key areas;
- a more flexible approach to collateral; such flexibility has been justified with the high repayment rates obtained;
- loan terms and amounts increase according to the repayment history of the client;
- management systems to improve management efficiency and lower transactions costs;
- decentralized structures and delegation of authority to trained staff at the branch level.

3. COMPLEMENTS TO FINANCE

(a) Insurance

In order to limit the costs of default, a bank usually requires a loan applicant to provide up-front a certain amount of collateral to cover the loan value. The availability of such collateral is a key determinant for a loan approval decision by the bank. However, a widely recognized problem is that SME entrepreneurs tend to have little or no physical security to offer as collateral. In addition, banks are confronted with a new phenomenon in regarding collateral. The shortening life cycle of products and of the usefulness of fixed investment combined with large fluctuations in share and property prices tend to reduce the certainty that collateral can offer in cases of repayment problems. This suggests that banks need to consider lowering their valuation of collateral.

To supplement for collateral, there are a number of types of insurance available to SMEs that can reduce the lender's risk and potentially improve SME access to credit. Some of the more typical schemes include loan or mutual guarantee schemes and export credit insurance. Basic insurance, such as property and life insurance, also play an important role in SMEs' access to credit. If the business of the entrepreneur is not properly insured, banks are unlikely to grant credit to the SME. This constitutes a problem especially in developing countries, where insurance markets are not well developed and where basic insurance is either not available or prices exceed the paying capacity of small businesses.

Loan guarantee schemes are set up by governments and international financial institutions such as the International Finance Corporation with the purpose of covering some portion of the losses incurred if borrowers default on loans, thus reducing the perceived risk of SMEs to the lending institutions. The objectives of these schemes are: to help small entrepreneurs with good projects but little collateral to obtain loans; to encourage banks to overcome their reluctance to deal with SMEs; and to provide banks with the opportunity to learn more about how to deal with SMEs' loan-portfolios and how to lend profitably to SMEs.

The loan guarantee schemes provide a guarantee to the lending institution against a fee (which varies between one per cent and four per cent of the loan amount) paid by the bank or passed on to the borrower. Most schemes offer guarantees of between 60 and 80 per cent of the loan amount. One of the major arguments in favour of guarantee schemes is that these funds can leverage (five times or much more in developed countries). This means that for each US\$ 1.0 million in the fund, a volume of US\$ 5 million or more in credits to SMEs can be guaranteed. Loan guarantee schemes are quite widespread. A study financed by the United

Kingdom's Overseas Development Administration in 1997 identified around 70 credit guarantee schemes that are operating in all parts of the world - some of them in the least developed countries²³.

There is no international consensus that loan guarantee schemes are an effective way of improving SMEs' access to formal bank loans. They have been criticized for a number of weaknesses such as moral hazard and adverse selection problems, high administrative costs due to inadequate procedures and inexperienced/reliant staff dealing with SME loan portfolios. There have also been delays in paying claims, which undermine the banks' trust in guarantors, and low demand by SME borrowers, as well as banks' limited outreach. In the past many of the loan guarantee schemes failed due to mismanagement of the guarantee funds.

Some of the problems identified above could be resolved if bank staff were properly trained and motivated to deal with SMEs. The administrative costs of credit appraisal and monitoring SMEs could also be reduced by outsourcing these activities to business development service (BDS) providers. Lastly, moral hazard could be reduced by giving partial loan guarantees versus full loan guarantees. In order for a guarantee scheme to be efficient all parties – the SME, the bank and the guarantor – should be involved in the risk sharing. To avoid repeating past failures, guarantee schemes should be constructed on solid principles such as:

- **additionality:** the introduction of the guarantee has a significant role to play in the decision making process of the bank in granting credit to those SMEs which were previously rejected;
- **viability:** ability to cover running costs as well as any losses;
- **credibility:** the guarantee must be easily obtained in case of a default and the fund should be professionally run;
- **trust:** the guarantee scheme should inspire trust in all financial institutions and should foster long-term relationships between banks and borrowers.

In France, local SMEs give guarantees to each other. There are 115 active Mutual Guarantee Funds, backed by 300,000 trading and industrial enterprises. Founded by SMEs on a voluntary basis, they help satisfy the credit needs of fellow enterprises. The purpose of the Mutual Guarantee Societies is to safeguard the professional and personal activities of their shareholders, rather than to generate profits. They make contact with SMEs who require loans at a local level, in cooperation with a regional bank. The bank, however, does not play an exclusive role as intermediary. A Mutual Guarantee Society consults with the banks when checking guarantee requests but plays the leading part in the decision process. The assessment criteria used consists of judging the entrepreneur as an individual, the business proposal, the sector and the financial indicators.

Credit Insurance is a special category of insurance covering mainly the seller's risk of not getting paid after the delivery of his goods. Among others it has been actively used for mitigating the risks of foreign markets and is better known as export credit insurance. More specifically, export credit insurance is a guarantee against payment defaults by foreign

²³ Actually only 61 of the schemes were studied in detail. Of these 23 were in OECD countries, six in the CIS, 15 in Latin America, 11 in Asia and six in Africa (Levitsky, 1997).

buyers, cancellation of specific orders by foreign clients and defaults on debt repayment by the exporter to the lending institution providing finance facilities. Export credit insurance schemes are especially beneficial for SMEs seeking to internationalize their activities. There are a number of different types of structures that can accommodate credit insurance schemes. In most cases, the most efficient solution is to form a specialized credit insurance company. Whether it should be a private or a public institution depends exclusively on the emergence of private initiatives to enter such a market. Often the most efficient approach has been to combine private and public efforts to supply export credit insurance. At present this facility is not being widely used for SMEs.

Credit insurance can substitute for traditional trade finance instruments such as letters of credit or factoring and in that respect it is regarded as a category close to trade finance. The latter is broadly defined as financing that an enterprise needs to cover costs arising from production and sale of its products before the actual payment is received. A credit insurance policy can be used as collateral by the insured to get bank financing and hence to cover production and delivery costs. Although this paper focuses more on SMEs access to long-term financing to undertake productive investment, the need for short-term finance, such as trade finance, is a highly pressing issue for SMEs. The lack of such finance can severely deter the further development of an enterprise. Moreover, in developing countries, trade finance is usually dominated with the most expensive forms of payment. Pre-payment and confirmed irrevocable letters of credit are still the most common forms of payments. Developing flexible and reliable credit insurance arrangements could among other things improve SMEs' access to working capital and trade finance, reduce costs and hence help to remove this primary obstacle to SME development.

The Israel Foreign Trade Risk Insurance Corporation Ltd. provides insurance against export-related risk. Exporters buy coverage for goods and services for up to 90 per cent of their value against commercial risks, such as bankruptcy and protracted defaults, as well as political risks, which include war, political upheaval, currency restrictions, confiscation, and other discriminatory actions in the buyers' countries. In 1999, the insured exports amounted to US\$3.65 billion and the number of insured countries reached 96. Such insurance is particularly beneficial to SMEs as it provides leverage for financing through the guarantee of their export revenues.

The Trade Finance programme of the ITC (International Trade Centre – UNCTAD/WTO), formerly Export Financing – is designed to facilitate access to finance of SMEs exporting from developing and transition countries. It provides technical cooperation to strengthen schemes and mechanisms offered by financial institutions in both private and public sectors, in the field of export finance, short-term trade credit and credit insurance and guarantees, and to build up the capacity of entrepreneurs and credit officers dealing with credit and financial risk management. The programme is targeted at three distinct levels where constraints and needs require a different set of activities:

- Enterprises, i.e. public and private manufacturers and traders, with particular attention to SME's in developing and transition countries;
- Financial institutions, which include banks and other financial service providers such as discount, factoring and forfaiting houses, export-import banks, export credit insurance and guarantees;

- Financial environment, which is composed of the banking framework, public sector financial institutions and schemes, as well as the structure of public and private finance service providers and facilitators.

Box 1

ITC's activities on finance for SMEs

ITC runs a programme entitled Trade Finance – formerly Export Financing – that focuses specifically on facilitating access to finance for exporting and importing SMEs. On-line information can be easily obtained at the Web subsite www.intracen.org/tfs. The present box provides information on ITC's activities relevant to some of the topics presented in this paper.

Credit scoring: *Three years ago ITC conducted a wide survey on the methodology used by development and commercial banks in evaluating credit requests from SME clients. Although common denominators were found, very few banks had adopted a standard and systematic credit evaluation procedure. Credit scoring, reserved usually to consumer credit was found usefully employed by just a handful of banks. ITC therefore decided to partner with three of these banks in order to develop a simple, practical credit card scoring system adapted to SMEs, to be used as a regular procedure when banks receive credit requests. The ITC Score Card System introduces professionalism and speed in the analysis of credit requests from entrepreneurs; it also removes another basic constraint faced by SMEs, namely the lack of trust by adding badly needed objectivity. The generic Score Card System is either used as such or further tuned to suit specific local conditions. The system was completed recently. It is being adapted in a few countries and put directly on line to be directly accessed by bank officers. South East Asia, North Africa and Central America are the regions where the demand seems highest.*

Covenants: *Without being directly a financing tool, a few specific positive covenants can alleviate, but only to a limited extent, one of most serious constraint to increased lending i.e. lack of or insufficient collateral. Negative covenants can be used too, for the same effect: Typical examples are the negative covenants used by IFC (World Bank group) to obligate the borrower not to incur further borrowing and not to increase its debt position without consultation with the bank. ITC offers some products to SMEs in the legal sphere to reduce the information asymmetry faced by entrepreneurs and creditors. ITC has developed models of international contracts and practical manuals for SMEs. It also offers training seminars on contract drafting and dispute resolution, and on international trade law. More specifically, ITC has prepared a reference guide on drafting legal clauses for the most current types of financial contracts. The guide will soon be interactive to facilitate the search for quick answers. Finally, ITC assists lawyers and professionals to build up their research and documentation centres.*

Developing financial tools better adapted to SMEs needs: *Several agencies, including ITC, have been trying to assist development and commercial banks to set up practical schemes specifically designed for SMEs. An ITC regional programme in Asia, in partnership with ADFIAP (the Association of Development Finance Institutions in Asia and the Pacific), has been devoting considerable efforts to create awareness for such a need and has been instrumental in creating SME sections in several local financial institutions. In addition, ITC has been helping some countries to establish Export Development Funds: examples are in Ghana, Nepal and Tanzania. These schemes*

have several points in common: a simple format for a request for credit, accelerated procedures, simplified reporting requirements, lower than average interest rates and non-traditional security structures. It is in this last area that most work has still to be done, possibly by drawing on micro-credit experience.

Improving financial services for SMEs - training of bank staff: ITC's perception is that junior credit officers in developing countries' banks are frequently under pressure to assist SMEs ("Managers and Directors have no time") and it is at this level that capacity building has to be created. ITC has therefore developed a tool of a general nature entitled "How to evaluate trade credit requests". This manual is targeted at bank lending officers and can become the basis to train trainers. In conjunction with the Score Card System it can form a complete package. Another series of manuals, targeted this time at enterprises, can be used by bank officers to guide their client in preparing their requests for credit and their business plans. This series is entitled "How to Approach Banks" and has been customized in several countries to suit local conditions. ITC is also developing an on-line version in a few countries to strengthen bank-client relationships.

Specialized Financial Institutions for SMEs: In addition to the above, ITC has cooperated closely with SIDBI (Small Industry Development Bank of India) to enhance their offer of practical services to small enterprises. Two guides have been adapted to India and co-published: Trade Secrets and How to Approach Banks.

Credit Insurance: UNCTAD, UN-ECE and ITC have been working together to enhance the use of Credit Insurance as a tool for export promotion. They have organized large joint events covering Africa and Eastern Europe. ITC has assisted a few countries in setting up Credit Insurance and Guarantees Schemes, in particular in Southern Africa. It has also produced a practical guide on Export Credit Insurance and Guarantee Schemes aiming to help central bankers and policy makers to set up credit insurance systems. The manual has been widely used, including by the World Bank in awareness building and in training on the occasion of the setting up of the Regional Credit Insurance Facility for Southern Africa.

Financing women entrepreneurs: Recently, ITC has developed a directory of financial sources for all SMEs and in particular those run by women entrepreneurs and which have the potential to be involved in international trade. This directory is well advanced with the target to list and provide concrete details on lending terms and conditions of the widest range of institutions from specialized banks to bilateral and international donors as well as NGOs. The database, available on line on ITC's website, will be distributed to an ever increasing number of institutions and associations supporting women entrepreneurs. It will naturally be helpful to all small entrepreneurs.

On ITC's drawing board is an Intuitive Guide to Obtain Finance for Small Businesses: "A guide for women and men entrepreneurs" (provisional title). It aims to bridge the first gap met by SSMEs (small SMEs) when they are considering borrowing for the first time from the formal sector. This is targeted at small entrepreneurs possibly with little business experience seeking answers to questions they feel embarrassed to ask. This may be caused by lack of information, cultural and traditional reasons or values or simply out of fear of complicated bank procedures.

Leasing

There are two types of leasing. One form is financial leasing, in which the leased equipment is treated as if it were the property of the customer by both sides of the contract. The customer is responsible for maintenance of the property throughout the contract period. The other form is operational leasing, in which the responsibility for registration and maintenance of the equipment remains with the financing company. The customer only makes monthly payments to the company, as agreed in the lease contract. In operational leasing, the rents collected from the customer during a contract period do not cover the full cost of the equipment, since it is to be returned to the financing company at the end of the contract period. This type of leasing is particularly popular in the high-tech industry, which is characterized by rapid rates of technological innovation and the continuous need for equipment upgrading. Compared to traditional loans, from the financing company's point of view, the credit risk is higher in leasing. The outstanding debt balance cannot be called in regardless of the condition of equipment. The value of equipment depends on factors beyond the control of the financing company, such as the timing of new models being introduced to the market, the taxation rate, overall economic conditions, etc.

However, leasing is a convenient option to help SMEs meet their needs for business equipment in the sense that:

- Collateral is not required for the contract and the customer can finance up to 100 per cent of the equipment value;
- A contract can be written with some flexibility according to the customer's cash flows;
- Tax policies generally allow for the depreciation of equipment;
- The financing company is likely to have a good relationship with the equipment supplier due to a large volume of transactions, and this can help accommodate the customer's needs;
- The economies of scale enjoyed by the financing company may be passed on to the customer in terms of reducing the costs of equipment usage;
- Not only equipment but also technical expertise will be offered to the customer; and
- Approval time is short.

On the other hand, a number of drawbacks exist, and leasing may not be suitable for all SMEs. For example:

- Missing a lease payment can lead to the re-possession of equipment and in turn to the termination of the SME's operations;
- Tax advantages granted on lease payments may not be as large as those granted on interest payments if SMEs purchase equipment with a loan;
- Availability of equipment that can be leased may be limited.

Finarca began operations in Nicaragua in 1997 specializing in the financing of equipment and machinery. It has established funding relationships with a number of international organizations and investors. At the local level it has established alliances with leasing and vendor companies. Finarca has a special leasing programme for SMEs, especially for transportation and delivery vehicles, machinery for dairy products, bakeries and leather

products and copying and printing machines. Typical amounts range from US\$10,000 to US\$300,000, and the duration of leases is from 24 to 60 months. Some of the benefits of financial leasing that Finarca mentions are tax benefits, accounting benefits, flexible terms, no collateral requirement and up to 100 per cent financing. Experience indicates that sponsors need to be committed, local regulatory and government agencies should be involved, support and advice is important but micro-management should be avoided, and specialization does bring advantages.

In Pakistan, the Swiss Agency for Development Cooperation (SDC) actively supports leasing to micro and small enterprises. The SDC decided to work in the leasing industry in Pakistan in order to test the potential for private sector financial institutions to contribute to the development process and to test the viability of leasing as a source of finance for small enterprises. The SDC works through partner companies, the first of which was the Network Leasing Corporation (NLC), established in 1995 and it received SDC support shortly thereafter. NLC provides lease financing and development services for small and micro enterprises. NLC has been able to generate a lease portfolio of US\$6.3 million with 1,700 clients and has received a rating from an internationally recognized agency allowing it to access capital directly from the financial markets.

4. EQUITY FINANCING – VENTURE CAPITAL FUNDS

Venture capital involves the provision of investment finance to private small or medium-sized companies in the form of equity or quasi-equity instruments not traded on recognized stock exchanges. It is long-term risk finance where the primary return to the investor is derived from capital gains rather than dividend income. Venture capital investors are actively involved in the management of the investee company, with the intention of helping to assure the success of the venture.

A distinction is usually made between venture capital and seed capital. Seed capital refers to direct equity capital in start-ups in the initial rounds of finance. Venture capital, on the other hand, refers to the next round of finance in companies that have achieved stability and have strong growth potential.

A venture capital fund would typically invest in an SME in a high-growth sector looking to expand its operations. Venture capital can also play a role in buy-outs of more established companies. The involvement of a venture capitalist is usually from two to four years, after which the venture capitalist will typically either sell the shares of the company on a stock exchange, e.g. an initial public offering (IPO), or sell the whole stake in the company, e.g. to a more established competitor.

Venture capital has the potential of offering a valuable source of finance complementing the more traditional credit finance provided by commercial banks. Some of the fundamental reasons hindering SMEs from obtaining credit from commercial banks and other credit institutions are less important in attracting venture capital. The advantages of venture capital are:

- Venture capitalists are willing to accept higher risks than traditional banks in exchange for

potentially large gains from the sale of shares in the company.

- Venture capitalists do not require collateral from borrowers.
- Operating costs are lower due to the absence of high interest rate payments.
- Venture capital – by nature – is long-term or at least medium-term capital, in contrast to short-term loans from banks.
- The managerial know-how provided by venture capitalists can in some cases be more valuable to the start-ups or SMEs than the actual financing received.

However, there are also a number of drawbacks.

- As in traditional bank lending, operating costs associated with lending a small amount may discourage investors.
- The need for highly liquid markets is not as pressing compared to open-end funds or mutual funds, since venture capital funds have a long-term involvement in the companies they invest in. Nevertheless, an exit mechanism is necessary for venture capitalists to attain capital gains. This is difficult in almost all developing countries except those with emerging capital markets. Other mechanisms such as guaranteed buy-backs do not seem realistic for SMEs.
- As the majority of companies that venture capitalists invest in either fail or yield only modest profits, successful ventures must generate large enough returns to cover losses incurred from the less successful investments. The need for potentially very high profits rules out the bulk of SMEs and start-ups that do not have the potential of becoming future mega-companies and is one reason venture capital is concentrated in certain sectors such as high technology.

Table 1
New Funds raised for private equity/venture capital (US\$billion)

	United States		Europe	
	Private equity	<i>of which:</i> Venture capital	Private equity	<i>of which:</i> Venture capital
1980	2.2	2.1		
1985	5.5	3.0
1990	10.3	2.6	5.8	na.
1995	41.1	8.2	5.7	na.
1996	45.2	10.6	10.1	na.
1997	73.8	15.7	22.7	na.
1998	105.4	28.0	22.8	7.5
1999	108.1	46.6	27.1	12.9

Source: European Private Equity and Venture Capital Association (EVCA), various Yearbooks, National Venture Capital Association (NVCA), various Annual Reports, Asian Venture Capital Journal, *The 2000 Guide to Venture Capital in Asia*.

The table above serves to illustrate two distinctive features of venture capitalism, namely the leading role of the United States in pioneering venture capitalism and the very strong growth of venture capital during the past few years. To a large extent the strong growth in recent years is linked to the boom experienced by the high-technology sector. In the United States

some 2/3 of venture capital is invested in the information technology sector. This highlights the point that venture capital focuses on high-growth and high-risk sectors of the economy.

To date the United States has clearly been the most important market for venture capitalism. A number of the country's leading corporations – Federal Express, Microsoft and Intel to name a few – received venture capital in their early stages, which demonstrates the important role that venture capital funds play in the economy. Some key aspects of the leading position of the United States arise from enabling legislation and a business culture that promote entrepreneurship. However, in recent years Europe as well as some areas of Asia have been quickly catching up.

In developing countries the role of venture capital - especially commercially oriented capital – has been very limited. Only big and/or relatively advanced emerging markets have been targeted by a small number of internationally active venture capital funds. Typically, developing countries lack potential investment opportunities (a large number of young enterprises with strong growth potential), and exit possibilities are usually restricted to a sell-back to the original promoters, which does not allow for profits comparable to those achievable through listing or trade sales to strategic investors. Furthermore, investing in local SMEs in developing countries often involves working with entrepreneurs who are not familiar with conventional financing relationships and business practices, which substantially increases the amount of work required from the investor.

There are, however, a number of development-oriented venture capital funds that are relatively active in the developing and transition countries. One of the more active players in the field is the Small Enterprise Assistance Funds(SEAF) which is presented in more detail in the article by John Bays²⁴.

There has also been a trend among international and national development finance institutions to set up venture capital funds in developing countries. One such example is the Tanzania Venture Capital Fund. It is a creation of several institutions: the Commonwealth Development Corporation (United Kingdom), the Netherlands Development Finance Company (FMO), the German Investment and Development Company (DEG), and others, and has a capitalization of US\$7 million (See Box2). The Asian Development Bank also participates in a number of equity funds such as the Mekong SME Fund (MSMEF) and the SME Investment and Restructuring Fund (SIRF) in Thailand. The MSMEF's objectives are to invest equity and debt in SMEs located in the Mekong Region, i.e. Lao People's Democratic Republic, Cambodia and Viet Nam. The fund is a public-private partnership and works in cooperation with the Mekong Project Development Facility (MPDF), which was funded in 1997 by IFC, JBIC, NorFund, Swiss, Dutch and other development agencies. The total fund size is US\$20 million. In Thailand, the SIRF was created to revitalize the SME sector after the financial crisis in mid-1997. It has a capitalization of US\$100 million and it constitutes a closed-end fund with a ten year life.

The Nordic countries have also been active in providing venture capital to SMEs in developing and transitional countries through companies such as Finnfund, Norfund and Swedfund. Finnfund mainly works with SMEs through vehicles such as the SEAF Central and Eastern Europe Growth Fund and the Trans Balkan SME Equity Fund. Norfund typically

²⁴ "SME Equity Finance: Guidance for Growing SMEs", John Bays, page 119 in this publication.

invests in developing countries either through direct investments or through local investment funds. Recent SME related investments include the Trans Balkan SME Equity Fund, SEAF Sichuan SME Investment Fund in China and CASEIF in Central America. Norfund has also recently established with CDC (Commonwealth Development Corporation) a joint company for management of funds in SMEs improving Norfund's reach in the Southern hemisphere. Swedfund has also been involved in the SEAF Sichuan SME Investment Fund. Other initiatives of Swedfund include the Baltic SmallBiz Fund, a venture capital fund that invests in SMEs in the Baltic countries, North-Western Russia and Poland.

The European Investment Bank (EIB) has established venture capital funds in Africa. The funds have been used to acquire an equity share in small enterprises and to provide business guidance to these enterprises. The objective was to realize commercial returns by participating in profits and capital gains. The success of these investments in Africa (i.e. rate of return and percentage of failures) is not that different from performance in other regions. All in all, in 2000 the EIB made available 215 million euros in risk capital to African and some other developing countries²⁵. Some of the observations made by the EIB include the following:

- macroeconomic instability makes it difficult to make earnings projections;
- management skills are in short supply in Africa;
- uneven accounting and auditing standards provide opportunities for “massaging” numbers;
- a minority stake in a company does not always bring a solid voice in the company;
- exit from the investments is complicated.
-

Box 2

Precisionair in African and Venture Capital Funds

Name: Precision Air Services Ltd. (Precisionair)

Description: Private airline in the United Republic of Tanzania

Established: 1993

Jobs created: 145

Owners: Founder Michael N. Shirima, local venture capital funds

Financing: Raised more than US\$733,000 in critical early-stage venture capital through the Africa Project Development Facility.

Precisionair, the first privately owned commercial airline in the United Republic of Tanzania, is an example of how finance is essential for an SME to grow.

Starting small: The founder of Precisionair, Mr. Shirima is a model of entrepreneurship in Africa. He started his small business in 1987 with only two planes, aerial sprayers serving large farms. A few years later, a severe drought in Tanzania forced him to change to another field: passenger service, and he identified tourists as the prime target. For this new venture, Shirima required new airplanes but he did not have all the capital needed. However, he continued his plans and opened Precision Air Services Ltd. in 1993.

Recent trade and investment liberalization contributed to a significant development of tourism in the United Republic of Tanzania, a country with spectacular wildlife and natural wonders. However,

²⁵ Figure includes investments in Caribbean and Pacific States, but excludes South Africa.

many of the key sites were far from the main international arrival points. Thus, Shirima's aim was to provide tourists with a suitable means of transport, to easily reach popular destinations.

Raising funds: Shirima, a former executive at the "defunct" East African Airways, knew that for building Tanzania's first privately owned airline would require substantial outside capital. Therefore, he approached the Africa Project Development Facility (APDF)²⁶, which after a thorough feasibility study confirmed the viability of the project and found potential investors. Thus, Precisionair could raise US\$333,000 in equity financing from the Tanzania Venture Capital Fund (TVCF). This financing, used for acquiring new airplanes, was critical for building the enterprise. Since then the company has expanded considerably. In 1996, Precisionair approached the APDF again in order to replace the airplanes with larger and faster airplanes. This time it was able to raise US\$400,000 from the East African Development Bank. Today, Precisionair has seven aircrafts that can transport 176 passengers each.

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Impact: Precisionair has contributed remarkably to Tanzania's recent tourism²⁸ boom through its regular scheduled air services that enables tourists to reach key attractions. Moreover, the company provides affordable and reliable domestic transport for the local business community.

Source: SME FACTS, a World Bank Group SME Department publication, Vol. 2, No. 2, January 2001.

5. FINANCING WOMEN ENTREPRENEURS

There is an increasing awareness among policy makers of the important contribution that women entrepreneurs can make to employment and the economic growth of their countries. According to the National Foundation for Women Business Owners (NFWBO), women entrepreneurs represent one-quarter to one-third of the total business population (OECD, 2000). In developed countries such as the United States, women own 38 per cent of the small enterprises operating in the country, which employ 52 per cent of the private sector workforce and generate 51 per cent of private sector output (Milken Institute, 2000). Moreover, in some countries such as Brazil, the Republic of Ireland, Spain and the United States, women are creating new enterprises at a faster rate than men (OECD, 2001).

²⁶ APDF, founded in 1996, is an IFC (International Finance Corporation)-managed multi-donor initiative to support SMEs.

²⁷ APDF, founded in 1996, is an IFC (International Finance Corporation)-managed multi-donor initiative to support SMEs.

²⁸ According to government estimates, between 1995 and 1999, tourism created 490,000 new jobs.

Nevertheless, several studies have shown that women in developing and developed countries have serious difficulties to access finance especially for start-ups, but also for the expansion of established enterprises.

Studies have shown that women entrepreneurs who deal with financial institutions are often confronted with problems of gender bias. “Gender bias refers to lender behaviour that fosters inappropriate consideration of the applicant’s gender in the credit underwriting and approval process. Gender-biased behaviour can severely hamper women seeking small business credit and impede the formation of profitable customer relationships, even before customers’ needs or loan requests are assessed” (Woos, 1994: 9). Besides, when there is gender bias at high levels of management, loan requests will require additional and unnecessary documentation, additional guarantees or co-signers or other conditions different from male applications.

Some examples of the difficulties that women experience when working with financial institutions are: a general lack of interest in women entrepreneurs’ projects; questions from loan officers regarding personal and family situation such as the spouse’s view of the business, marriage plans, plans for childbearing or other remarks unrelated to the financial aspects of the application; delays in the loan application process; limited information about alternative financial products and lack of explanations when financing requests are denied. However, evidence has showed that once women obtain loans they can be “good credit risks” since they have low default rates. For example, “experience with micro-financing, where the vast majority of client borrowers are women, shows high repayment rates, with figures of 95-98 per cent. The lesson of this experience is that financial institutions should reconsider the potential of their women clients” (UNCTAD, 2000).

Particular difficulties encountered by women entrepreneurs

Due to social-cultural constraints, women often have a more difficult time accessing finance than male entrepreneurs forcing them to depend on their savings or that of their relatives and on informal sources of finance. The particular difficulties encountered by women entrepreneurs may be explained by the following:

- The small size of the enterprises: women entrepreneurs own small enterprises and are on average more likely to have micro-enterprises, located in the service and retail sectors. Thus, women require small loan amounts that are not considered profitable by banks.
- The lack of collateral: women in general have less personal capital/fewer assets to start a business or to be used as collateral. This may be due to social and legal disadvantages, such as lower wage income or limitations in the ownership of property. “In many countries, women cannot even hold land titles, thus they are effectively barred from formal sector credit. Another type of constraint is the requirement for the male spouse’s co-signature; and it is also often a requirement that women must obtain a guarantee declaration from their husband or father” (International Labour Organization, ILO, 1999). Moreover, since women’s enterprises are usually in the service sector and do not have tangible assets for collateral, such firms rely mainly on intangibles assets (which are difficult and costly to evaluate for financing institutions).
- The lack of skills: women entrepreneurs have lower educational levels and less professional experience than male entrepreneurs. They lack management skills and

competencies in finance and accounting, which are key to improving access to finance. Furthermore, due to social and educational factors, they fear complicated bank procedures and lack confidence to deal with lending institutions and effectively convey their business proposals.

- The lack of information: women entrepreneurs often lack information on the existence of credit facilities, financial instruments, networks and borrowing conditions of financial institutions.
- The lack of track records: women entrepreneurs have difficulty showing past business performance information or a continuous business activity since they are often forced to interrupt their careers to take care of their families.
- The family obligations: women entrepreneurs normally combine their business activities with their family obligations, which may be viewed with distrust by financial institutions.

In addition to these particular difficulties encountered by women to access finance, evidence has shown that there are insufficient data about women entrepreneurs, their needs, demands and available financing mechanisms, which is a significant obstacle to creating financing programmes adapted to their needs.

Financing programmes adapted to the needs of women entrepreneurs

Recent research in developed countries (Europe, Canada and the United States) shows that there is a new wave of financing instruments available to women entrepreneurs. This is the result of the increased concern about the difficulties that women encounter to raise capital for their businesses and the awareness of their potential contribution to employment and economic growth. Financial institutions, governments and private initiatives have developed new financing strategies to increase women's access to capital. Conventional lending practices have been revised, and special programmes adapted to the particular needs of this group have been designed.

Some successful elements which help to improve the effectiveness of credit granted to women entrepreneurs and reduce the risk of default include:

- advisory services and/or training;
- monitoring after the loan is given;
- partnerships with other organizations;
- simplified lending processes.

According to financial intermediaries, some other factors contributing to well-functioning programmes for women entrepreneurs are low or no requirements for collateral as security for loans, and preferential financing conditions in interest rates, in applications' costs and in repayment terms (OECD, 2000).

Advisory services and/or training are generally given before granting loans and sometimes training is a compulsory condition to obtain financing. The monitoring of the performance and the management of women's businesses are also a common tool used after the loan is given. These measures help to improve the competitiveness of women's enterprises as well as to identify obstacles and opportunities that may arise. Partnerships are usually made with business development institutions that assist women entrepreneurs in developing and

assessing their business projects, preparing business plans or marketing studies and creating links with the business environment and government institutions (OECD, 2000).

A number of financing programmes for women entrepreneurs are run by governments and non-profit organizations. However, financial institutions have started to target women entrepreneurs due to an increased pressure to treat women's applications in a more favourable way or because they have recognized women as a new market of significant size with growth potential²⁹.

A primary objective of women entrepreneurs' financing programmes is to encourage self-employment and they are addressed to the micro-enterprises sector. According to the International Labour Organization (ILO), "since women operate generally in the small and very small end of business scales, in developing and developed countries, a strategy to improve the supply side of financial services largely coincides with micro-credit programmes. These programmes are characterized by a minimum of formality, rapid disbursements, links between savings and credit, follow-up, loans conditioned by repayment performance and market interest rates. While most banks cannot offer such a package, unless they are fully compensated for the additional costs and covered against eventual risks, they are occasionally interested in a sub-contracting arrangement with retail agents like NGOs" (ILO, 1999).

Governments and non-profit organizations support women entrepreneurs in a number of ways such as dedicated guarantee programmes; incentives for lenders to provide funding especially for women's start-ups (e.g., favourable tax treatment for lenders as well as for borrowers); marketing programmes that inform loan officers on the particular needs of women entrepreneurs; public grants; equity schemes and programmes that provide intensive training in business management and technical assistance. However, a common form of support is granting loans on preferential terms through interest rate subsidies or preferential treatment of women in credit allocation for SME programmes (OECD, 2000).

Some examples of effective programmes created to improve women's access to finance are described below:

In the United States, the Small Business Administration (SBA) is a federal agency whose mission is to provide technical services and capital to SMEs. Its lending programmes are created legislatively and are federally funded. SBA provides loans through a network of lending partners such as private financial institutions, Certified Development Companies and non-profit micro lenders. Loans are available for existing and start-up businesses.

The SBA has created a variety of programmes that facilitate the financing of SMEs, and some of them are especially targeted at women entrepreneurs. Among the most important programmes are the loan guarantee schemes through which the government guarantees 50- 80 per cent of loans (maximum amount is US\$750,000 and US\$1 million) made to qualified small businesses. Moreover, these guarantee programmes have been enhanced by additional

²⁹ This is the case especially in developed countries such as the United States, where "the figures published by the 'National Foundation for Women Business Owners' (NFWBO) on the importance of women business owners in this country played an important role in reducing misperceptions and increasing the private sector's appreciation for and commercial interest in women-owned businesses" OECD, (2000: 55).

initiatives that include:

- low documentation loans for amounts under US\$150,000: e.g., SBA Low Documentation Programme that streamlines the loan process and provides a SBA guaranteed response to a loan application within three days;
- pre-qualification of borrowers seeking US\$250,000 or less: e.g., Pre-Qualification Pilot Loan Programme which enlists non-profit organizations to assist borrowers during the loan process, evaluating the feasibility of the project, developing a business plan and preparing the loan application; and
- provision of technical assistance: e.g., Community Express Loan Programme.

Community Express Loan Programme³⁰ is an innovative pilot programme of the Small Business Administration (SBA) in conjunction with the National Community Reinvestment Coalition (NCRC) and several national banks. The programme links together some elements, such as guarantees (80 per cent for loans up to US\$100,000 and 75 per cent for loans up to US\$250,000), simplified loan processes and partnerships with technical assistance providers. The programme targets low and moderate-income zones, women and businesses owned by minorities. The key component of the Community Express Programme is the technical and management assistance that the borrower receives before and after the loan is granted. The lender works with the NCRC which is in charge of selecting qualified technical assistance from non-profit organizations. “Each borrower is paired with a local technical assistance provider, who designs an action plan that includes appropriate pre- and post-loan support, monitoring and technical assistance. The technical assistance and follow-up provide added protection against default and may be viewed as a form of collateral enhancement” (Milken Institute, 2000: 42).

SBA has also created programmes to stimulate venture capital. Small Business Investment Companies (SBICs) are SBA-licensed venture capital enterprises that provide equity capital, long-term loans, debt equity and management assistance to SMEs. Furthermore, there are specialized SBIC (SSBICs) that target socially and economically disadvantaged entrepreneurs and since 1998 the SBA created SBICs dedicated to women entrepreneurs.

A special United States scheme which provides equity to women entrepreneurs businesses is Capital Across America, a Small Business Administration (SBA)-licensed investment company that targets this group. The scheme, introduced in 1998, is run on a commercial basis in partnership with several commercial banks. The scale of loans is larger in relation to other women entrepreneurs’ schemes, with a minimum amount of US\$250,000 to a maximum of US\$1.5 million. The scheme focuses on business growth and loans cannot be used for a start-up. Capital Across America provides long-term loans, which are given for a minimum of five years and are based on projected cash flow. The fund does not require any collateral, and there are no fees for making loans. An important element is that the loan looks like equity but it does not involve ownership by Capital Across America. The loan agreement includes monthly compulsory monitoring. Capital Across America focuses on enterprises that are not in the technology sector or that have a low level of technology (e.g., manufacturing, wholesale distribution, transportation). The scheme, advertised by the press, has been very

³⁰ This programme is part of SBA’s New Markets Initiative, which aims to spur economic development and job creation in underserved communities through assistance to small businesses that have difficulty obtaining traditional loans (Milken Institute, 2000).

selective: from 100 applications during the first four months of existence, only five received financing.

There are also private initiatives that offer their valuable contribution in expanding women's access to finance. This is the case of Mama Cash in the Netherlands, a non-profit organization that has raised a loan guarantee fund. Mama Cash provides (additional) guarantees to persuade bankers to offer loans to female start-ups without enough collateral. The loan guarantees of Mama Cash are given "subject to a number of criteria being satisfied, including submission of a full business plan and the prospect that the entrepreneur will be able to support herself from the business after one year". Mama Cash provides guarantees only to borrowers whose financing requests were refused by local banks. The guarantee is limited to 50 per cent of the loan and the other half must be covered by the bank, which in turn can use the support of the public guarantee scheme. Moreover, Mama Cash helps women who want to start a new business by advising them on how to improve their business plans and directing them to other specialized advice, if required. One of the objectives of Mama Cash is to concentrate on the areas that are not well served by banks or other institutions.

Credit scoring techniques³¹ could be an obstacle for women to access financing due to their particular difficulties in presenting financial information, lack of collateral and track record, since women are often forced to interrupt their careers to attend to family obligations. A solution to this problem could be the development of credit scoring models better adapted to women entrepreneurs' business risks.

Count-Me-In is a non-profit organization in the United States that provides small loans to women who do not qualify for conventional bank loans. This organization is developing a credit scoring technique appropriate for women that will measure a woman's work, personal experience and business development potential. This new model will assess credit worthiness more accurately by including information regarding specific experiences that impacted the applicant's economic life such as divorce, extended child care responsibilities, lack of personal credit or credit acquired in the name of a spouse" (Milken Institute, 2000:29). In addition, because credit scoring reduces the relationship between lenders and small businesses, some lenders in the United States have established a "second look" procedure to evaluate prospective borrowers who were not accepted through the credit scoring system. Under this procedure, rejected borrowers are able to submit additional information. "Analyzing the borrower's business prospects as well as the character of the person enables banks to make more loans, increasing their own business while being more responsive to the needs of their local market" (Milken Institute, 2000:31).

Fleet Boston Financial created an internal programme to address the particular needs of women entrepreneurs. Guided by a profit-driven strategy, the bank found that women entrepreneurs could be a "large, profitable and growing new market". Thus, the bank segmented women as a subgroup of the Small Businesses Division and created a new department with the aim of identifying women entrepreneurs' needs and channelling the available resources (internal and external) to this segment. The programme incorporated

some successful lending practices such as combining financial services with technical assistance and making partnerships with other service providers.

³¹ Regarding credit scoring techniques see Section 2.1.

In 1998, Fleet Boston Financial launched the programme called “Women Entrepreneurs Connection” (The Connection), which offered a variety of products, information, advisory services and networks to start-ups and existing businesses. An important part of the programme was the training given to loan officers on successful lending practices to women entrepreneurs. “The Connection team functions as a facilitator in the loan process and may obtain reconsideration for applications rejected on the basis of credit scoring (...) The Connection may intervene where credit has been denied and work with women to develop a plan for getting to credit-ready status. The Connection works with Fleet’s Community Development Group to review loans rejected on the basis of credit scoring and, under some circumstances, aid in getting a loan approved through reconsideration under a special service loan program known as a ‘second look’” (Milken Institute, 2000: 24).

Furthermore, to facilitate the provision of equity, the Connection has partnered with an investment bank and other venture funds created to make equity investments exclusively in women entrepreneurs’ businesses. Other partnerships have been established with organizations that provide technical assistance and training to women, such as the Center for Women Enterprise which offers courses, consulting, loan packaging and micro-lending services. The Center works with banks and the government to help its customers to get loans. Lastly, the Connection sponsors networking events where women can make contacts to find financing sources.

A recent initiative emerged in the “Second OECD Conference on Women Entrepreneurs in SMEs”, held in Paris in November 2000, where four international banks (Bank of Ireland, Fleet Boston Financial Corp. of the United States, Royal Bank of Canada and Westpac Banking Corporation of Australia) announced the creation of a Global Alliance of Banks committed to sharing best practices among banks and improving finance for women entrepreneurs. Each of the banks participating in the alliance has already developed a set of best-practice parameters for providing financial services to women entrepreneurs. Now they want to share this expertise in order to improve further the services they offer.

Improving women entrepreneurs’ access to finance

The above mentioned programmes and initiatives, including those of SIDBI (India) and Halkbank (Turkey) in section 3.1, are good examples which can positively contribute to expand women’s access to finance in developing countries, where most women face constraints in accessing finance. To effectively address these constraints, support measures and training programmes are often useful. Training needs to be directed towards bank loan officers to help them understand the special problems women entrepreneurs face. Banks also must adapt their credit scoring techniques to fit the profile of successful women entrepreneurs. Women entrepreneurs also need training in order to successfully present their financial information and business plans to banks and to understand the bank’s criteria for evaluating their proposals.

Governments and development organizations might encourage banks to be more gender sensitive by:

- setting targets for banks in terms of the percentage of their loan portfolio allocated to

- women entrepreneurs;
- encouraging banks to appoint women to their boards of directors and involve women entrepreneurs in the dialogue on SME financing;
 - supporting the collection of statistics and more information about women entrepreneurs' businesses, their needs, the obstacles they face and the available financing mechanisms;
 - promoting gender-sensitivity among policy makers and bank authorities;
 - providing education and training to women entrepreneurs to help them satisfy banks' requirements. Training is especially needed in management skills, finance, accounting, preparation of business plans and other necessary procedures for getting finance from the formal financing sector;
 - promoting the creation of dedicated lending schemes at different levels: credit and equity finance;
 - disseminating good practices.

6. THE ROLE OF THE INTERNATIONAL COMMUNITY

The role of the International Community in improving SMEs access to finance is two-fold. On the one hand there is the need to promote a stable, diverse, well-functioning financial system, which is capable of effectively servicing SMEs as well as other sectors in the economy. In most developing countries such a system is still missing. Creating such a framework is a highly complex task involving macroeconomic policies, financial regulations and strengthening institutions. International organizations should play a role in supporting developing countries in this task. On the other hand there is the need for financial organizations to work on the micro level initiatives that impact SMEs access to credit more directly. There is a temptation for international organizations to focus first on the macro level initiatives and to postpone the micro level initiatives for later. However, both macro and micro level developments should ideally be carried out simultaneously.

A starting point for international organizations can be to improve the awareness of banks, policy makers and other stake-holders of problems that SME entrepreneurs face in obtaining finance. This should also translate into more resources allocated for tackling problems faced by SMEs. One concrete action could be to encourage countries that receive debt relief as part of the Highly Indebted Poor Countries (HIPC) initiative, to increase their support for SMEs via credit guarantee schemes and equity funds. There is also the need to improve awareness of SME issues within the international organizations. In this respect there has been progress in recent years. Many organizations have set-up special units focusing on SMEs and increasingly SMEs are noted in the strategies and policies of the organizations. Nevertheless, there has been a tendency to focus on either micro level organizations or larger corporations.

The efforts of international organizations in promoting SMEs access to credit could be organized around the following lines: international regulations and standards, facilitating policy dialogue, technical assistance to improve market infrastructure, measures to overcoming reluctance of banks to lend to SMEs.

International Regulations and Standards

International organisations play an important role in the formulation of international financial regulations and standards. New international regulations – if introduced without considering the SME point of view, could have an adverse effect on SMEs access to finance e.g. through excessively complicated and costly procedures only suited to more established enterprises. Therefore, the impact on SMEs should be taken into account when new regulations and standards are considered.

A current example is the impact of the new capital adequacy requirements, the so called Basel II accord, on the provision of credit to SMEs. These have been largely drawn with larger corporations in mind, thus creating the risk of worsening the position of SME borrowers as compared to other borrowers. A further example is to consider the needs of SMEs when formulating international standards for accounting. Many developing countries which are adopting international standards as their national standards have introduced a system which is beyond the technical competence of most SMEs. ISAR³² has been working to promote user-friendly accounting and reporting systems for SMEs that provide useful financial information to managers, creditors and investors and which are geared toward the technical capabilities of SMEs.

Facilitating policy dialogue

Creating an enabling environment in which both banks and SMEs can thrive requires that financial regulators have a clear view of the issues facing banks and SMEs. International organizations can play a role as facilitators for policy discussions by bringing together policy makers with banks and representatives of the SMEs. This involves assisting in the creation of strengthened channels for public-private sector dialogue in which both sides could engage in an open and frank exchange of ideas. A recent UNCTAD survey on best practices in public-private sector dialogue highlights the underlying principles and effective mechanisms needed to promote effective dialogue. They include the need for well structured consultative panels that meet periodically with a fixed agenda to exchange information on relevant issues and are representative of all relevant stakeholders (UNCTAD 2001). Steps should be taken to ensure that the SME community is sufficiently represented in these discussions, e.g. through small business associations etc.

Technical assistance to improve market infrastructure

There are a number of micro level activities that can be undertaken by international organizations to improve the market infrastructure for lending to SMEs without engaging in fundamental revision of the financial system of a country. For example an important step is to create credit bureaus or other means for banks to share credit information with each other. This would reduce costs and improve the quality of information on the SME client, thus reducing perceived risks of SME customers. It would also enable the use of modern lending mechanisms such as credit scoring. The above, of course, does not reduce the need to make more fundamental changes in the market infrastructure in many developing countries. For example the ambiguity of property rights in developing countries severely hampers the development of formal credit programmes accessible to SMEs.

³² See 2.1 a

Overcoming the reluctance of banks to lend to SMEs.

A traditional approach of international financial institutions has been to provide local financial institutions with credit lines for on-lending to SMEs. This approach has succeeded in pushing banks to delivering some financing to SMEs, but results have been limited by cumbersome administrative procedures, weaknesses in the management of banks, and the difficulty in originating and then monitoring the loans to SMEs. Rarely have internationally driven SME lending operations succeeded in developing local capacity to provide quality financing to SMEs in a sustainable way. There is also the risk of creating market distortions when direct financing is provided. Successful cases have usually involved local banks that were already SMEs oriented, and most new banks were convinced of the benefits of lending to SMEs.

In order to achieve sustainable results in improving SMEs access to finance, local financial institutions should consider lending to SMEs as a profit making business in which lending decisions are made according to sound business principles. This implies that the final decision on terms and conditions of loans should be left to the local financial intermediaries to decide on sound business criteria, even in cases where the financing for the loans is provided by international financial organizations. Thus, there is a balance of setting appropriate guidelines and targets that ensure that the funds are used in the intended way and at the same time ensuring that the local financial institutions are left with sufficient room for decision making.

Another way for international organizations to persuade local financial institutions to lend to SMEs is to demonstrate through successful examples that lending to SMEs can be a highly profitable business. For example in developed countries a many commercial banks already rely on the SME sector for their profits as fierce competition for larger corporate customers has driven down profit margins in this sector. There are also a number of successful examples in developing countries of profitable lending programmes to SMEs. Such examples could be used to persuade banks to increase their efforts in enhancing their SME operations.

Profitable lending to the SME sector usually requires that the bank puts into place the appropriate structures for servicing SME customers and also invests in learning how to lend successfully to this target group. To achieve this, substantial efforts in capacity building are needed to ensure that banks have the required skills and technology to service their SME customers in an efficient way. International organizations can play an important role in this process. Designing training programmes for management and staff is one way to build the capacity of local financial institutions. Entering into partnerships with international organizations and transnational banks is also an efficient way to strengthen the management of the banks and to disseminate financial innovations in SME banking.

Capacity building efforts also need to be extended to SMEs. In many cases SMEs are not aware of the different financial options that are available to them and fail to seek financing in the first place. Furthermore, SMEs skills are limited in preparing the financial information and business plans that banks need to make lending decisions. In addition, the management skills required to run an expanding business successfully need to be improved. Here business development service providers, with the support of the international community, can play a pivotal role in improving SMEs credit worthiness.

A major reason for SMEs being overlooked by banks is that they are perceived as high-risk customers generating relatively low profitability due to substantial transaction costs. Partnerships between banks and business development services providers have the potential for reducing these problems. BDS providers have a comparative advantage in pre-screening potential SME clients, helping in providing clear business plans and in improving financial information generated by the SMEs as well as providing risk assessment and monitoring services for the banks. Outsourcing these activities to BDS providers reduces the transaction costs and information asymmetry of lending to SMEs and has the potential to improve SMEs access to finance without causing market distortions. Successful examples are the demand-driven EMPRETEC and Enterprise Africa programmes.

Creating diversity

SMEs and their need for finance differ in many ways depending on their growth objectives, risk and return profiles etc. To accommodate the different financial needs of SMEs efficiently, the financial sector needs to be composed of a variety of different types of financial institutions providing different types of financial services. International financial institutions can play a catalytic role in promoting the diversification of the financial sector by working through different types of financial institutions including credit institutions, insurers, venture capital funds and leasing companies. For example, they can join with governments and private partners to create public-private venture capital funds and investment banks for assisting SMEs.

7. CONCLUSIONS

A well-regulated and properly functioning financial system is a necessary but insufficient condition for ensuring SMEs access to finance. Improving SMEs access to finance requires that financial institutions construct profitable and efficient credit and equity programmes for this sector. In recent years, banks and other institutions in developed countries have launched a number of innovative approaches which have made SME financing profitable. As a result SME financing in developed countries has increased because:

- lending to SME clients pays off handsomely if the risks are managed properly;
- an increasing external pressure from governments, SME organizations and the media which encourages the development of appropriate financial services for the SME sector;
- increased competition between banks and with other service providers. If competition develops, banks are likely to go beyond their traditional clients and explore new markets;
- the participation of SMEs as shareholders in the management of banks (this is especially the case of savings banks and cooperatives).

Mechanisms for reducing high risks and costs of lending to SMEs

Some of the initiatives undertaken by commercial banks in developed countries to reduce risks and costs of SMEs financing include:

- credit scoring systems which automate SMEs lending and improve credit risk management; they also offer the possibility to approach SMEs having acceptable scores

- through direct mail campaigns;
- external credit appraisal/credit ratings to assess risks of the upper segment of SMEs. Such external services have been created especially to support bank staff when specialized skills are needed to assess, for example, high technology and innovative SMEs;
 - risk self-assessment for SME entrepreneurs which reveals the risk assumed by banks and the way banks evaluate the SMEs' risks;
 - application of IT in the whole lending process: analysis, pricing and monitoring;
 - decentralized structures, i.e. specialized departments and SME branches which provide SMEs with more rapid solutions and a more professional service;
 - streamlined lending processes with simple and limited paperwork and rapid response to loan applications;
 - a well designed plan to reach SMEs with products and services better adapted to their needs;
 - segmentation of SME customers which balances optimal profit and optimal support for clients, offering personalized services for profitable customers, and encouraging less profitable ones to use automated delivery channels.

The need for an active support of specialized financial institutions and/or public funding institutions

The experiences of specialized financial institutions for SMEs in developing countries have been mixed. Although they have contributed to increased access of SMEs to long-term funding, they also have experienced low profitability and unsustainability. Factors contributing to the success of these institutions include diversification of their products, reliance on self-mobilized resources and a commercial orientation. Specialized financial institutions and public funding institutions in general can reduce the financial risks of private commercial banks through loan guarantee and counter-guarantee programmes; participating in equity funds for SMEs, especially in those areas not covered by traditional funds (seed capital and start-ups); creating credit windows for those SME segments with difficulties to access loans from the banking system (women entrepreneurs, start-ups, micro-borrowers, ethnic minorities); offering incentives (commissions) to financial intermediaries managing credits or seed capital/equity funds addressed to special SME segments; providing technical support to NGOs or other institutions which could be able to implement SME programmes.

The need for well managed loan or mutual guarantee schemes

Loan guarantee schemes in developing countries have suffered from a number of weaknesses such as moral hazard, inadequate procedures and delays in paying claims, which have discouraged banks to take part in such schemes. However, lessons have been learned from unsuccessful schemes and, if managed properly, such schemes can contribute to increased bank lending for SMEs. Some practical rules for effective loan guarantee schemes include: they should be addressed mainly to SMEs with good business projects; they should be adequately staffed in order to process and handle claims without delay; they should take immediate remedial actions when certain default levels are reached; they should establish a vigorous loan recovery once the guarantee is paid out; the lender should assume some part of the risk. Accordingly, lenders should assume at least 30 to 40 per cent of the risk with a 20 per cent minimum. Mutual guarantee schemes have a more market-driven approach than public guarantee schemes since these schemes are funded by the contributions of the enterprises and managed by SMEs themselves. To enhance the potential capacity of these

funds, they could be supported by public-sector counter-guarantees which have an advantage compared with direct guarantees or subsidies.

The need for alternative sources of funds

Traditional bank credit remains one of the major sources of finance for SMEs. There is a need to explore alternative sources of funds which could contribute to reducing SMEs' dependence on bank credits. Venture capital and leasing could be significant sources of long term funds which at present are underdeveloped. In spite of a number of initiatives from international and national development finance institutions, venture capital funds for SMEs in developing countries are limited. When such funds are available, they are concentrated in high-growth and risk sectors (hi-tech industry) of the economy. An appropriate legal and regulatory framework as well as a favourable tax regime and a business culture that promotes entrepreneurship could contribute to their growth. On their part, banks should be encouraged to offer SMEs alternative products such as corporate credit cards, leasing, factoring, composite loans (both long-term and working capital), seed capital and to participate, together with large enterprises, in local investment funds for SMEs.

The need to combine financial with non-financial support through cooperation between banks and business development services (BDS) providers

Banks tend to charge SMEs high interest rates and to adopt a rigorous and pre-emptive approach with respect to collateral because of the difficulty they face in identifying creditworthy and promising SMEs. The most efficient way to encourage lending to SMEs is to improve existing institutions' ability to construct profitable and efficient SME lending programmes. This can be achieved by minimizing the risks through appropriate tools and methodologies to assess the creditworthiness of potential SME borrowers and to lower the overall costs of lending to SMEs, as reviewed in the above sections.

The current review has provided strong evidence that commercial banks will lend to SMEs if there is a way to decrease transaction costs and risks. Commercial banks in developed countries have pioneered many techniques for reducing the costs of dealing with SMEs. These include credit scoring, client segmentation, direct mail campaigns, mutual guarantee schemes, risk self-assessment and external business appraisals. How effective will these techniques be in developing countries? Here the evidence points to the necessity of combining financial with non-financial business services if credit-worthy SMEs are to be identified and assisted in developing the necessary management, marketing, networking skills to successfully expand their businesses. Given the lack of sensitivity of bank loan officers to SME problems, commercial banks are probably not the most effective source of technical assistance. It would be better for financial institutions to partner with existing business service providers than to start a new, unfamiliar and possibly costly activity.

Business development services (BDS) providers can play an important role in this process because they are close to their clients and they have direct knowledge of the enterprises' financial status and past performance. BDS providers are often better placed than financial institutions to identify potential clients, ascertain their credit-worthiness, disseminate adequate financial and accounting techniques, pre-screen project proposals, monitor repayment, exert peer pressure, and maintain one-to-one contacts during the entire payback period. Thus, the complementarity between BDS providers and financial services helps to:

- minimize both the risk and transaction cost to creditors and investors;
- make access to credit and equity less costly and less cumbersome for SMEs.

There are a growing number of examples of partnerships between BDS providers and financial institutions. In the previous sections partnerships have been explored between the private sector and the German Savings Banks, NatWest, Bank of Ireland, Deutsche Bank, ING Bank, Banco di Sardegna and Banca Nazionale del Lavoro.

In developing countries, a number of BDS programmes such as EMPRETEC link credit delivery to the business development requirements of SMEs. EMPRETEC is designed to build the capacity of SMEs, transform them over time into creditworthy borrowers, and make them more attractive to financial institutions and venture capital funds. Enterprise Africa, a BDS programme of UNDP modelled on EMPRETEC, has developed a joint credit delivery scheme.

Financial institutions can contract out to BDS providers the credit appraisal or assessment, credit scoring and the credit monitoring processes such as in the case of Enterprise Africa. It is usually less costly for the BDS providers to do this than for financial institutions because the BDS providers know the track record of the entrepreneur and have usually assisted him/her in drawing up a viable business plan. Thus, BDS providers can function as a credit “window” that improves access to finance. The link between financial and non-financial service providers not only reduces risk and transaction costs of financial institutions but also increases the sustainability of the BDS provider.

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Annex I

RISK SELF-ASSESSMENT FOR SMEs ENTREPRENEURS

FORUM OF PRIVATE BUSINESS'S RISK ASSESSMENT FORM

Questions 1 to 5 deal with a measure of your current business and the quality of your borrowing proposal. No measure has been or could be made of this: but you and your bank may want to do so.

1. How much do you want to borrow? £
2. What will the money be used for?: _____
- 3.
- | | |
|----------------------|--|
| Type of Business | |
| Sales Turnover | |
| Number of Employees | |
| Profit as % of Sales | |
| Gearing | |
4. Location _____
5. Do you have a cash flow forecast which shows that the money can be repaid? Yes No
- If "yes" Over what period do you expect to repay the borrowing? months
- (NB- overdraft has to be repaid)
- If "no" What proof do you have that you will be able to repay the borrowing?

Questions 6 to 11 will be 'scored'. Your bank may have a different view from yours. They may have a different measuring method. But what matters is that you discuss to agreement some logical and repeatable measurement of risk to determine your 'Risk Score'. The Risk 'Score' table shows different ranges of interest rates. Your bank may legitimately disagree with these. Again, the only thing that matters is that you and your bank discuss them to agreement. Ideally on some logical, repeatable method so that as your risk score changes, as it will, the interest rate fluctuates with it.

6. What is your past business experience?					Max per person	Borrower	Key Staff	
							No. 1	No. 2
Years in business	0-1	1-2	2-4	4+	6			
Range:								
Score:	1	2	4	6				
Turnover of business	<£ 100K	<£ 300K	<£500K	<£ 500K+	6			
Range:								
Score:	1	2	4	6				
Profitability	<-5%	< 0%	<5%	5%+	6			
Range:								
Score:	0	2	4	6				
Gearing	1:1	1.5: 1	2: 1	4:1	6			
Range:								
Score:	1	2	4	6				
Position	Owner/MD	MD	Director		16			
Range:								
Score:	8	5	3					

Experience Range: Score:	Finance 5	Mktg/Sales 5	Admin 5	Technical 5	20			
Sub-total					60			

	Max Score	Your Score
Business Experience	180	

7. What has been the overall trend? Or have you proved your ability to make your plans work?					Max Score	Your Score
Range	Very Positive	Positive	Stable/Unproven	Erratic/Decline		
Score	20	10	5	0	20	

8. What is your management control information?				Max Score	Your Score
Accounting: Weekly Gross Income & Expenditure, Aged Debtors & Creditors, Bank reconciliations Monthly Profit & Loss Quarterly Profit & Loss. Balance sheet Annual Audited Accounts. Bank Report				10 10 10 10	
Financial Management: Business Plan Cash Flow Budget Three Year Plan				10 10 10 10	
Sub-total				80	

As an alternative to Question 8 you and your bank may be able to agree a simple yardstick of your business, such as number of sales or jobs per day or a clear understanding of your "break-even point" which is just as accurate as the above.

9. What will you show the bank? (Or the alternative measures agreed in question 8)					Max Score	Your Score
Accounting: Score:	Week 10	Month 10	Quarter 10	Annual 10		
Financial: Score:	Bus. Plan 10	Cash Flow 10	Budget 10	3 Year Plan 10		
Sub-total					80	

10. Character of Borrower - Stability and Dependability?					Max Score	Your Score
Range Score	Exceptional 20	Above Average 10	Average 5	Below Average 0	20	

11. Will/Are we able to work together?						Max Score	Your Score
Range	Very Well <-----				> Not very well		
Score	1	2	3	4	Not at all	20	
	20	10	5	0	-400		

12. Your Escape Route or Banker's Security			Max Score	Your Score
Resale value of security £ X		Grand Total	400	
Amount of Borrowing £ Y				

If the ratio X:Y is more than 1:1 the risk score index should be reduced by at least 1.

RISK SCORE TABLE

SCORE INDEX	SCORE	INTEREST RATE OVER BASE
1*	300-400	1.5%
2*	250-300	1.5%
3	200-250	1.5%-2.5%
4	150-200	2.5%-3.5%
5	100-150	3.5%.5.5%
6	50-100	5.5%-7%
7**	0-50	over 7%

*It is unlikely that any small business will reach these scores

** At this level of risk it is unlikely that the bank will lend

Source: European Commission, "The Second Round Table of Bankers and SMEs", 1997.

NOTES OF EXPLANATION

If in doubt call MIS on 01565 634467

INTRODUCTION

We have just come out of recession. The bank has lost a lot of money lending to small businesses in the late eighties/early nineties. Most of us can't grow from retained profitability.

All these statements mean that we, as small business owners, need to improve our case to the bank when we need to:

1. make sure we are able to borrow the money we need
2. make sure we feel secure that the bank will not reduce or remove the lending
3. to ensure we pay the right level of interest.

The FPB's Risk Assessment Form is only a guide. Many bankers will have different ideas. But it will help you to understand the risk, so lets get started!

Question 1

Record here the amount of money you want to borrow.

It would be unusual if this was not accompanied by a Business Plan and/or Cash Flow Forecast to prove the amount of borrowing is "right" and that it can be repaid.

Question 2

Record here what the money will be used for: The more specific the better. Banks and all other financiers lend by overdraft facility for working capital and term loans for capital expenditure.

Other forms of finance that need to be considered are HP and leasing.

Question 3

Give a brief description of your business. This will help the bank and you to see the borrowing in its true light.

Gearing is

$\frac{\text{FIXED ASSETS}}{\text{TOTAL BORROWING}}$

Banks like this ration to be 1:1 or more.

Question 4

Location – more than address. Add other relevant information if you consider it will affect the bank's attitude to your business.

Question 5

Banks like to see repayment periods of less than 10 years for loans and 3 years for overdrafts.

It may be that you have a simple way of showing your ability. If so, use it. Generally these simple measures are best.

Question 6

Banks want to be sure that you can manage a business. No matter how hard you state what you will be able to do, what you have done cuts more ice!

- A. How long have you and your top team been involved with business? The longer the better.
- B. The higher the turnover the better, but not if the business was unprofitable.
- C. The higher the profit the better.
- D. The lower the gearing the better, see question 3 for definition
- E. The more important the position the better.
- F. The wider the experience the better.

Now, score yourself as owner/borrower and your next two key staff.

From the bank's point of view, if the borrower is the only experienced member of the team then the risk is so high that you might be expected to provide insurance cover on your life to repay the bank.

Do not be too concerned if your score in this question is low because as you grow you will be able to improve it.

Question 7

What matters most about your past experience is how successful you were. Again, what you have done is more important than what you say you are going to do.

You will need proof here! The only way is accounts.

Question 8

This question sets out the whole spectrum of management control information and it is unlikely that any small business will score maximum marks.

However, if your score is low in other sections, it is a way of reducing the risk. Why? Because if you are the person lending the money you might have the same feeling as the bank. Can this person manage the money I am lending so I can be sure I will get it back?

You might be surprised to see a weekly requirement. The Gross Income, Gross Expenditure, Aged Debt, Aged Creditors and Bank Reconciliation are all very easily found from your own books and in tough times the most successful businesses to do this.

What is "Your Own Business Measure"? many businesses indicate that there is one measure that tells them all, e.g.

- Number of covers per day in a restaurant
- Number of sales and number of jobs in retail
- Sales production per hour in manufacturing

Of course you will need to convince your bank, but if your measure is accurate you will.

Question 9

Of course it is one thing to have the information yourself but are you prepared to show it to the bank in good and bad times?

Some small business owners believe the less you tell the bank the less they will have against you. But, nobody likes surprises about lending and borrowing money. If you can survive tough times you are better risk. So keep the bank informed.

Question 10

When we, as employers, employ people we make assessments about the character of new staff. There is no mystery, so does the bank!

Question 11

Simply, can you work with the bank and can it work with you? It is clear if you can't work together, no matter how high the score, it will not work. Hence the -400 points.

Question 12

The above risk assessment is all based on the success of the business - but businesses can, and do, go wrong. So you need to consider the vulnerability of your business in relation to your personal assets.

1. What if you lose your key partner or employee?
2. How wide is your customer base? How many eggs do you have in your basket?
3. What if you suffer a large bad debt?
4. What if you fall out with your banker?

The usual way to offset these vulnerabilities is to consider an escape route – the route you will be able to take to protect yourself and your family.

So, if you intend to borrow £X, where could you find this £X to repay the bank? Would you:

1. Repay from savings?
2. Sell your assets: business assets, building, plant, stock etc.
personal assets, house, jewellery etc.
insurance – sell policies.

Banks call this escape route “security” and if you pass some of this security over to the bank you should expect the bank to recognise a reduction in risk and hence a reduction in the margin. Of course, the quality of the security will be an important factor, i.e. cash savings are ideal but the fluctuating resale value of stocks is not as good.

Score Index

Having made your score see what index your FPB Risk Assessment has given it. Then read across to find the interest rate band.

The banker may not, and probable will not, agree with either. Does that matter? No, be prepared to discuss it to agreement.

Then you will know how the bank measures the risk and what you can do to improve the risk. Improve the risk and the bank should charge you less interest. The bank should have a lower bad debt and hence more profit. Everyone is happy!

PART II

Role of Finance in SME Competitiveness

Small and Medium Sized Enterprises and Economic Creativity

Andrew M. Warner³²

INTRODUCTION

There is considerable interest in SMEs in developing countries. There are probably two main reasons for this. One is the belief that SME development may prove to be an effective anti-poverty programme. The second is the belief that SME development is one of the building blocks of innovation and sustainable growth. These two reasons are of course linked because most of the international evidence says that growth and real poverty reduction go hand in hand. If SME development helps growth, more than likely it helps reduce poverty as well.

The second of these propositions – the link between SME development, growth, and in particular sustainable growth – is the subject of this paper. To my knowledge, these issues have not yet been empirically investigated on the basis of wide-ranging cross-country evidence.

When thinking about SMEs, it is worth asking whether it is smallness precisely that is important rather than the fact that they are new. New start-up enterprises are likely to be small, at least at first. But every country has small enterprises that have been around for some time for the simple reason that they are not very successful and have never grown.

A crucial question is why some small enterprises stay small. They may not have potential to grow, due to poor quality of management or the markets in which they are participating may not have much growth potential. A second reason is that some market inefficiency such as poor information may result in limited access to financing. In this second case there would be a stronger reason for intervention than the first. But the issue needs to be proven on a case-by-case basis.

This brings us to the proper policy to pursue regarding SMEs. Simple promotion of SMEs through subsidies to enterprises with employment below a certain level would be poorly targeted because one would end up supporting many stagnant SMEs. In addition, there would be a disincentive to grow and loose access to the subsidy. It may be possible to design better programmes that intervene by subsidizing financing. Some of these programmes are discussed in other articles of this publication.

³² Research Fellow, Center for International Development at Harvard University.

In setting SME policy, it is helpful to consider it in conjunction with policy towards entry barriers. Such a comparison will force one to ask directly whether it is small enterprises that need to be supported and why, versus simply support for new enterprises. Many of the dynamic benefits people have in mind when thinking of SME's really apply to new enterprises rather than small enterprises. A policy of directly promoting start-ups or relatively new SME's may be a better policy package than policies predicated only on the size of the enterprise.

This paper shows evidence for the proposition that new SME's or start-ups can influence growth and development by acting as complements to other engines of growth such as innovation and transfers of technology. This does not exclude the possibility that SME development may affect growth independently of innovation and technology transfers. But the interaction with innovation is an important hypothesis to test in its own right. The paper presents the results by merging international data on innovation with data on start-ups, and summarizes the results by presenting an index of economic creativity. After presenting the index, the paper shows that the economic creativity index is indeed positively associated with recent rates of economic growth. This provides evidence that start-ups play a role in long-term growth by facilitating innovation or diffusion of innovation through an economy.

Let us begin with a summary of what is measured by the economic creativity index. This index is composed of three parts.

- primary innovation;
- technology transfer;
- low barriers to start-ups and SMEs.

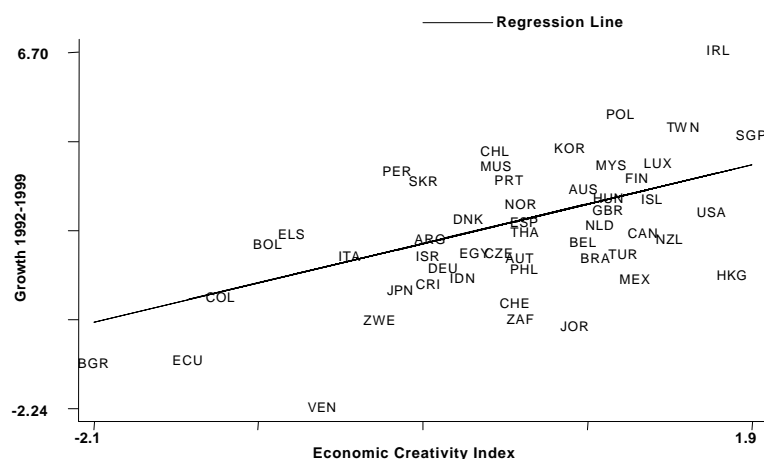
Countries are given high scores on the economic creativity index if they have high ratings on either of the first two (innovation or technology transfer). A healthy start-up environment boosts the rating still further.

Figure 1 shows the evidence that the final Economic Creativity Index is indeed correlated with growth rates, with growth in the 1990's³³ plotted on the vertical axis against the economic creativity index on the horizontal axis. The graph shows that the faster-growing countries have tended to be those with high scores on the economic creativity index. As described in more detail below, the index basically gives credit to economies that are either innovators themselves or are active in attracting inward transfers of technology. Economies are further credited if they have institutions that facilitate the emergence of new businesses,

³³ Growth is measured starting with the low-point of each countries recession in the early 1990's. This means 1992 for the United States but 1993 for most European countries such as Germany and France.

since these often are the carriers of the new technologies. This index correlates with growth in the 1990s, before and after taking into account a number of additional growth determinants.³⁴

Figure 1
Relationship between economic growth and economic creativity in the 1990's



If we look more closely at countries with high scores on economic creativity in Figure 1, the Republic of Ireland and Singapore are examples of technology-transfer countries while the United States and Finland are examples of innovative economies. Both kinds of countries score high on the index. The figure also shows that several countries that are in the southeast of the figure (relatively low growth, high economic creativity) have experienced economic

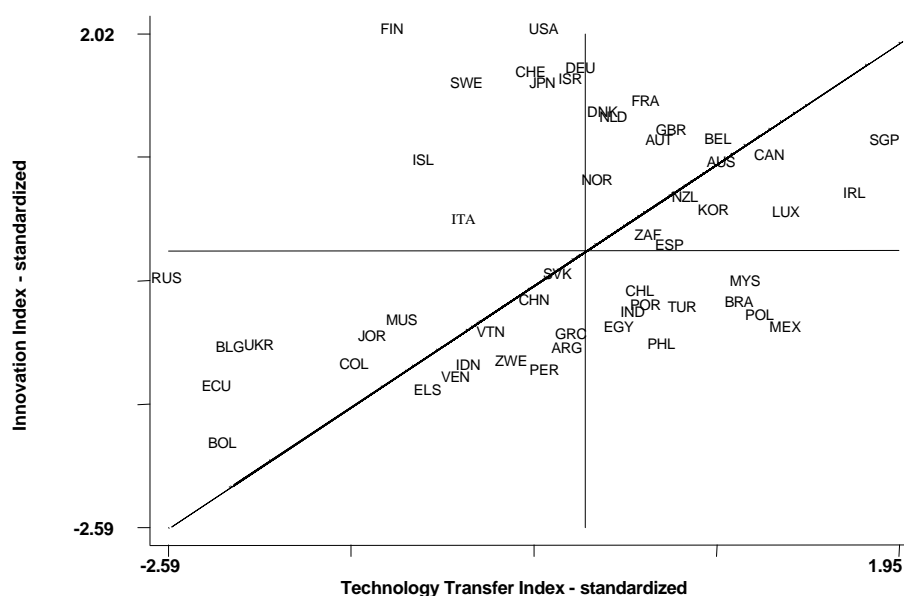
³⁴ In more technical research conducted in the preparation of this report, regressions were estimated with average per-capita growth during 1992-1999 regressed on the following list of variables: the log of per-capita GDP in 1992; the economic creativity index measured with data from the 1999 Global Competitiveness Report; the International index, the Finance index, and an indicator variable measuring if a country had a severe economic crisis during the period. Tests were conducted that indicated that four former centrally planned economies, China, the Russian Federation, Ukraine and Vietnam, were outlying observations in these regressions. Of the variables above, all were statistically significant in repeated specification tests, with the occasional exception of the International index, whose significance sometimes depended on the definition of which countries qualified as economic crisis countries. Several other variables were found not to be significant after controlling for the variables above. This list included the average investment rate, an index of the rule of law, an index of institutional quality, financial depth (already measured somewhat in the finance index), average government expenditures as a share of GDP, ethnic-linguistic fractionalization, and Freedom House's economic freedom index. However, the Freedom House Index was occasionally significant.

crises during the 1990s – Mexico, Hong Kong, Jordan. The index is not designed to explain these cases, so it is no surprise that they are at odds with the general positive association in the figure.

The graph in Figure 2 shows which countries rank highly on innovation and transfers of technology. Countries towards the southeast tend to be relatively better at inward transfers of technology than innovation. Countries towards the northwest are relatively better at innovation. Countries towards the southwest are not good at either.

Figure 2

The technology transfer index and innovation index in the 1990s



The relation between economic growth and economic creativity in the 90s depicted in Figure 1 is a statistical association, and does not by itself prove that economic creativity causes growth. However, additional evidence lends support to the idea that causality is not running from growth to the indicators.

To show this, we have to note first that the economic creativity index is composed of several questions about technology from the executive opinion survey. We can check from past reports if the average answers to these questions tend to rise in economies where GDP is also rising. If so, this would be evidence that growth affects the technology indicators.

One of the questions we have asked in the survey is “whether your country’s position in technology is among the world leaders”. This is measured on a scale of 1 to 7 where 1 indicates strong disagreement and 7 indicates strong agreement with the statement. The important point is that the *change* in this question has been uncorrelated with the change in GDP over the past four years.

This lack of correlation is true for all of the other survey questions that make up the economic creativity index: changes in the average score for each country have not correlated with changes in GDP over the past four years. Included in this assessment are questions about math and science in schools, evaluations of scientific research institutions, R&D spending, licensing of foreign technology, policy towards foreign direct investment, availability of venture capital, ease of obtaining loans with little collateral, ease of starting a new business, and the extent to which companies innovate on their own. The results are summarized by the correlation coefficients in Table 1 below. A correlation coefficient of either +1.0 or -1.0 indicates a perfect correlation; a correlation coefficient of 0 indicates no correlation. All of the correlation coefficients in table 1 are essentially zero. This lends support to the idea that economic creativity causes growth and not the other way around.

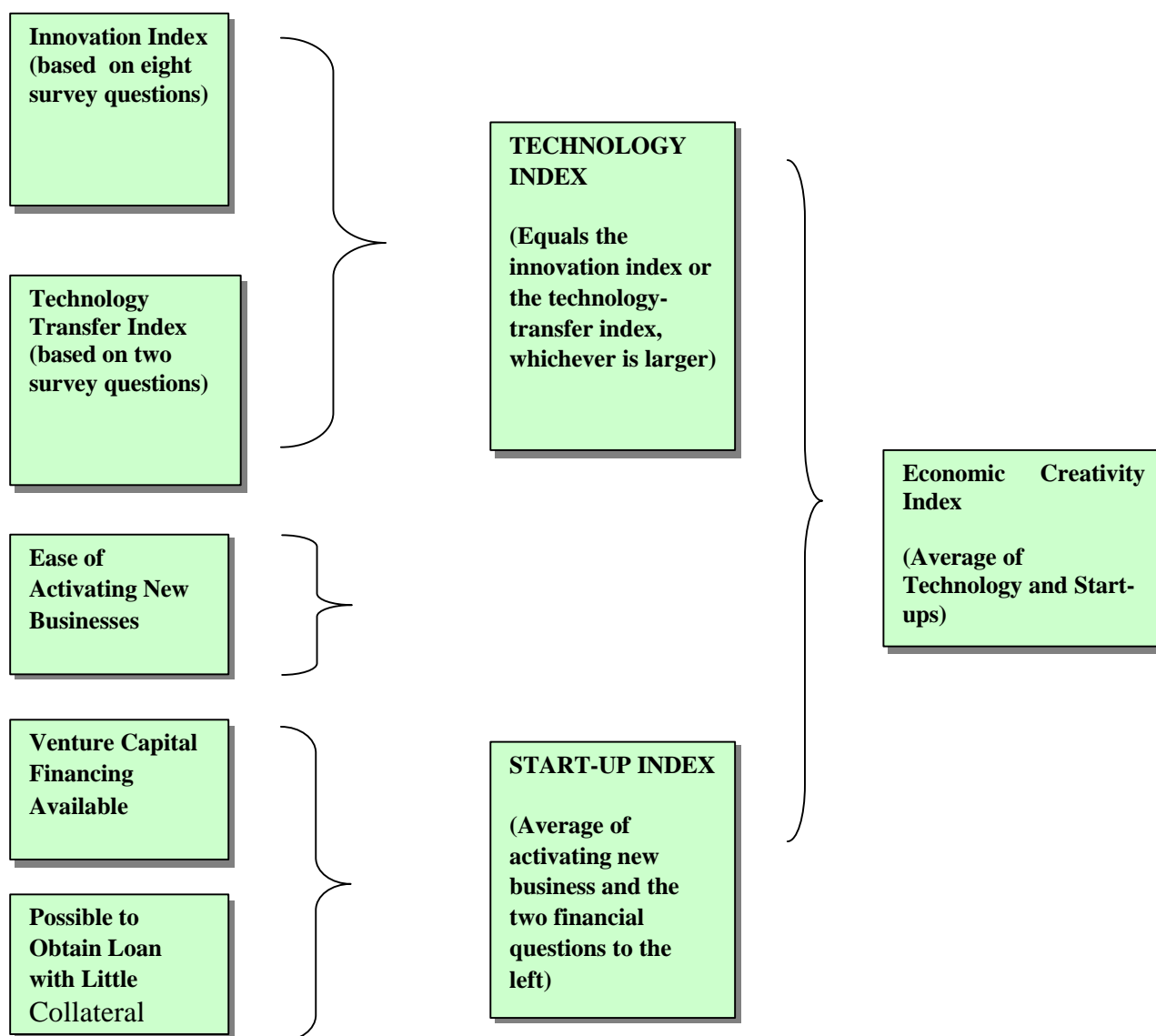
Table 2
Correlation coefficients between changes across countries in survey questions and changes in GDP (1997–2000)

Overall Technology	+0.03
Quality of science and math in schools	-0.10
Quality of scientific research institutions	-0.05
Public R&D spending	+0.14
Business R&D spending	+0.09
Research collaboration with universities	-0.02
Foreign direct investment is source of technology transfer	+0.02
Licensing is source of technology transfer	-0.14
Intellectual property is protected	-0.17
Venture capital is available	+0.15
Starting a new business is easy	+0.05

1. CONSTRUCTION OF THE ECONOMIC CREATIVITY INDEX

As mentioned in the introduction, the economic creativity index is an attempt to bring together in one measure several important aspects of innovation, technology transfer and diffusion, together with the institutions that facilitate innovation and diffusion.

Figure 3
Explanation of the Economic Creativity Index.



Reading from left to right, we first construct an index of pure innovative activity, which is based on eight survey questions. We also construct an index to measure which countries are most active in international technology transfer. This we call the technology transfer index.

Since countries can get technology either by inventing it themselves or by importing it, we measure an overall technology index by whichever of these components is largest – after they have been scaled to have similar units. The key idea is that countries get credit on the technology index for either innovation or technology transfer. From an economic point of view, what is important is that the country participates in the newest technologies and innovations, not whether it innovates itself. To raise GDP through technology-related activities, a country needs to achieve value-added at some stage of the process, not necessarily the inventive stage.³⁵

Next we construct an index of start-ups, or ease of starting new enterprises. Old enterprises often have a greater economic incentive to defend the status quo, simply because they themselves are sellers of existing products embodying existing techniques. Typically staff has been trained to produce and market existing products, equipment is tailored to produce existing products, and management structures are optimized around the needs of existing production techniques and processes. All this can be summarized in the idea that the economic value of the human and physical capital of older firms will drop somewhat if new products replace old products.

New goods and services create value for enterprises, so all enterprises have an incentive to innovate and to accept outside innovations. The difference is that old enterprises have a downside in addition to the upside of innovation, while new firms only have an upside³⁶.

³⁵ The extent to which home-based innovation and technology transfer complement or substitute for one another in their contribution to growth and development is a debatable point. It is certainly true to some extent that the Republic of Korea's excellence at inward transfers of technology are enhanced by its own homegrown innovative capacity; and new industries in an innovative country surely benefit from actively importing related technologies. The either/or approach in the economic creativity index in this paper leans more towards the view that the two are substitutes, but that should not be taken to deny that complementarities can be significant in some contexts. We have not found any positive evidence that we can account for recent international growth patterns better by adopting the complements approach rather than the either/or approach adopted in this paper. The two polar positions are that home innovation and technology transfer are either completely complementary or completely substitutable. In practice a position in the middle is probably a more accurate description of the relationship. For example in Figure 2 there are no countries in the extreme northwest or southeast, which would be the case if countries were strictly specialized in either technology transfer or technology innovation. What we tend to see is that countries at the top in innovation tend to be around the middle in transfer. The point for this paper is that there is specialization, although not to the extreme, but to a degree. To support this it is enough to point out that the data are not highly positively correlated.

The cross-country evidence also supports a position somewhere in the middle. If technology transfer was only effective at promoting growth if countries were at the top in innovation, then we would see that only countries at the northeast of the picture would grow fast, but clearly this is not the case in Figure 2. A maximum function thus seems closer to the truth than a multiplicative function that the extreme case of complementarity would imply.

³⁶ In reality, the impact of the introduction of an innovative product on existing products is a continuum. The value of existing products that are substitutes will fall; the value of existing products that are complementary will rise. And the more so the greater the extent of substitutability or complementarity. Since the bulk of innovative activity in any given time is marginal improvements on existing products rather than quantum leaps to completely new kinds of products, substitutes usually dominate. This probably means that, overall, innovative activity tends to reduce the economic value of existing products.

Many new enterprises come about after entrepreneurs leave older large enterprises, because the incentive structure in the older enterprises prevented them from realizing the full potential of the innovation. For this reason, the ability of an economy to activate start ups is likely to be an important complement to innovation, and is an important way to facilitate technology transfer across countries and diffusion of the new techniques across different sectors within countries.

Reading down on the left of Figure 3, the start-up index is an average of two parts: whether financing is available and whether it is easy overall to start a new business. The former is measured by averaging two questions: whether venture capital is available for risk-taking entrepreneurs, and whether it is easy to get a loan with a good business plan but little collateral.

Reading now to the right of Figure 3, to incorporate the notion that access to technology and start ups are both important for a complete innovative package, the final economic creativity index is an average of these two indexes. The incorporation of the start up index as a vital complement to innovation is what requires the use of the term economic creativity rather than something like technological creativity. The economic creativity index is shown in Table 6.

Having described the overall structure, we now turn to a greater explanation of the various components of economic creativity, as well as tests against hard data to corroborate each component of the index.

2. INNOVATION, TECHNOLOGY TRANSFER AND START UPS

Although it is reasonably clear what innovation is, it is obviously not a simple thing to measure accurately. Most people would intuitively grasp after a few minutes of reflection that innovative ideas emerge in the minds of people and then go through some degree of the following: further elaboration, communication, refinement, implementation and imitation. Attempts to measure innovation can be broadly classified into measures of inputs to innovation, measures of outputs of innovation, and measures of by-products or symptoms of innovation. Some common input measures include spending on R&D, education, technical education, and number and quality of scientific research institutions. The most common output or by-product of innovation is to measure the number of patent applications or patents granted per-capita. Michael Porter and Gregory Bond, in the Global Competitiveness Report (1999) presented an innovation measure that combined several of these input and output measures. Furthermore, there are also attempts to measure the value of an innovation. These include counts of patents weighted by forward citations, average years of renewal of patents, number of countries in which the patent is applied for, and the number of subsequent legal claims associated with a given patent.

Our approach to measuring innovation is partly analytical and partly based on empirical results. In the executive opinion survey, we ask about inputs to innovation such as R&D spending by the government and also by private businesses. We ask for ratings of the quality

of scientific research institutions, of higher education and math and science education in schools. Regarding outputs of innovation, we ask respondents to rate directly whether their country is a technological leader, and we ask whether companies tend to develop their own products and processes. To understand whether the country has incentives in place to encourage innovators, we ask for ratings of the extent of intellectual property protection. We also ask questions about technology transfer and things that complement innovative activity such as access to financing for venture capital and ease of starting businesses. The full list of questions that are relevant to the innovation subject is given below, together with the number of the question so that the reader can look at the country-rankings at the end of the book. If the number 99 appears next to the question number, it means that the question was taken from the 1999 report.

- 7.01 Your country is a world leader in technology.
- 7.04 Scientific research institutions in your country are world class.
- 7.05 (99) Your country commits substantial public resources to R&D.
- 7.07 The business sector in your country spends heavily on R&D.
- 7.06 Research collaboration is close between universities and industry.
- 7.08 (99) Companies in your country are aggressive in absorbing new technology.
- 7.09 Intellectual property is protected.
- 7.09 (99) Foreign direct investment is a source of technology transfer.
- 7.08 Licensing of foreign technology is a common way to get technology.
- 8.05 Is it possible to obtain a loan with a business plan and no collateral?
- 8.13 Venture capital available for new business development.
- 10.04 Starting a new business in your country is easy.
- 11.01 Competitive advantages of companies due to unique products.
- 11.04 Companies pioneer their own new products.
- 11.05 Product designs developed locally.

What is interesting is that when we examine correlations between these questions, there is a group that is highly inter-correlated. This group comprises the first seven questions and then also the last three. Each of the ten questions in this group has a common denominator in that they measure some aspect of innovation. The questions outside this group are either about technology transfer or the financial system or the ease of starting a new business, but are not asking specifically about innovation. Therefore, in line with this evidence, we measure the innovation index as the average of these ten questions. The fact that they are highly inter-correlated supports the idea that there is an underlying innovative phenomena that they are measuring. It also means, from an empirical point of view, that the rankings from such an index are not much affected from omitting one or two questions from the group.

After grouping together the innovation questions, it is quite natural to put the questions regarding technology transfer together in a group and the three questions about start ups together in a group. The technology transfer index and the start up index is then just a simple average of the questions in each of these respective groups.

Although the innovation questions are highly correlated with each other and the technology transfer questions are highly correlated with each other, it is clear from Figure 2 above that innovation and technology transfer indexes are not highly correlated. Countries tend to specialize in either of these two dimensions. Mexico, Poland, Brazil, Luxembourg, the Republic of Ireland, Canada, and Singapore all score high on technology transfer but are around the middle regarding innovation. In contrast, the United States, Sweden, Finland, Germany, Israel, Japan, Switzerland and France are high on innovation but not on technology transfer. The Russian Federation has a very low ranking regarding licensing and foreign direct investment to support technology transfer but is rated at about the middle on innovation.³⁷

Figure 4 shows that countries that are good on the innovation index also tend to have financing available for start-ups. However there are three important exceptions to this rule: Japan, Germany and Switzerland. All three of these are innovative countries that nevertheless have not grown rapidly in the 1990s. The argument here is that these countries have not grown rapidly because their innovative advantages are not effectively put into practice through new start-ups. This figure hints at the complementary role that start-ups can play in supporting innovation, a result that is embodied in the economic creativity index.

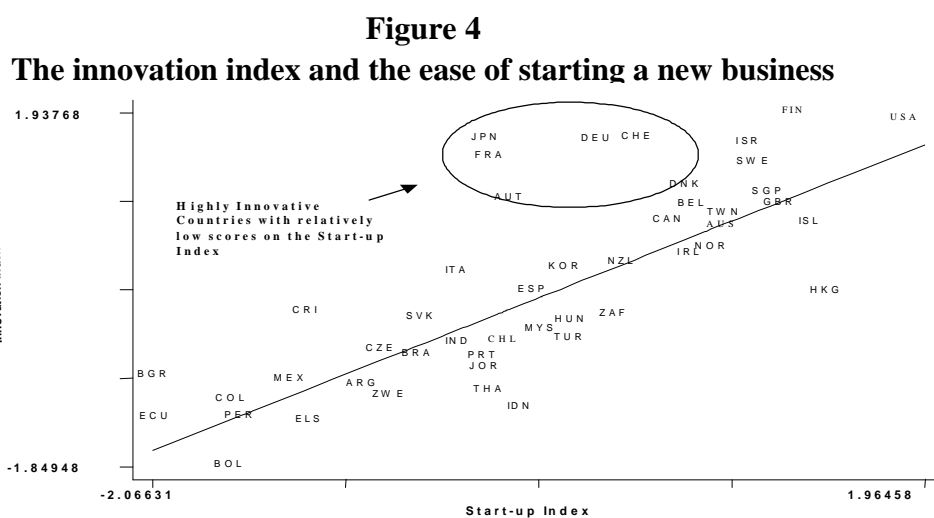


Figure 4 together with figure 3 serve to illustrate which kind of countries score high on the economic creativity index. Figure 3 shows that economic creativity is the average of the technology index and the start up index. In figure 4 we have graphed important components

³⁷ The locus of innovation in the global economy may be more accurately described in terms of there being different groups or sub-cultures of innovative activity in many countries, rather than certain countries as a whole being innovative. Nevertheless, there are countries that have especially active innovators and it makes sense to talk about innovative countries.

of each of these. Innovation is an important part of the technology index and ease of start-ups is the essence of the start up index. Countries in the northeast of these figures will score highly on the economic creativity index.

3. CORROBORATION WITH INTERNATIONAL PATENT AND EXPORT

Statistics

To verify that the innovation index is measuring something real about the extent of innovation in each country, we have compared it with international patent information from the World Intellectual Property Organization. There has been a long debate and a long history of research that uses patent data as an indicator of innovative activity. Inventors clearly have a financial incentive to patent when they make inventions, and the more so the more valuable the invention. So there is little doubt that patent data is an important indicator of innovation. What clouds the use of patent data is that the extent of patent activity should also be influenced by the ease of patent regulations, which varies across countries, and also the extent to which patent claims can be effectively defended in the court systems, which also varies across countries. Furthermore, an alternative to patenting is simply for companies to try to keep trade secrets to themselves. Whether this can be done effectively varies by industry and product, so we should also expect the extent of patenting activity to be influenced by the industrial structure of each country. All this adds up to saying that cross-country patent data is likely to be a good but not perfect indicator of innovation.³⁸

The simplest patent indicator is the number of resident patents granted per capita during a fixed time period. In Figure 5 we show the relation between our innovation index and resident patents granted per capita (an average of the years 1993 and 1997). As the reader can see, the innovation index is strongly correlated with the intensity of recent patent activity.³⁹ This result supports the conclusion that the innovation index is capturing something real about innovative activity.

³⁸ Patent data have long been used in English and American Economic history writings as indicators of innovation. Ashton (1948) pointed to the rise in patents in the early years of the British Industrial Revolution as evidence that a new wave of innovation was an important cause of the Industrial Revolution. Schmookler (1966) argued that in the United States historical patent data were a better measure of inventive output than lists of inventions. Grilliches (1998, p. 335) summarizes recent research using patent statistics in the United States, particularly the finding that patent statistics are highly correlated with R&D expenditures across firms, indicating that patents are good indicators of inventive activity, and useful in the absence of R&D data. Nevertheless, some important economic inventions do not get patented, or have their patents invalidated by courts, and many patents turn out to be useless, or are simply not about something that could benefit an economy. The evidence on how the propensity to patent varies by industry is in Freeman and Soete (1997).

³⁹ The patent data are from the web site of the World Intellectual Property Organization (www.wipo.org).

Figure 5 shows patents granted to residents of the country. The World Intellectual Property Organization also has data on patents granted to non-residents. This is potentially an alternative indicator of technology transfer, since it indicates that companies are trying to protect technology imported from abroad. For many of the same reasons that resident patents are an imperfect indicator of within-country innovation, non-resident patents are also likely to be an imperfect indicator of technology transfer. Branches of foreign companies can often register as domestic legal entities, so some technology transfer activity probably appears as a patent granted to a legal resident rather than a legal non-resident. Furthermore, a lot of technology transfer activity such as setting up factories in other countries simply does not require a large number of patents.

With these limitations in mind, we show in Figure 6 the relation between the technology transfer index and the log of the number of non-resident patents granted per capita, again using an average of 1993 and 1997 data. There is a positive relation, that is significant in a statistical sense, but the relation is not nearly as close as that between patenting and innovation. This is not surprising given that there are several a priori reasons not to expect a close relationship.

Figure 5
The relation between the innovation index and non-resident patents per capita

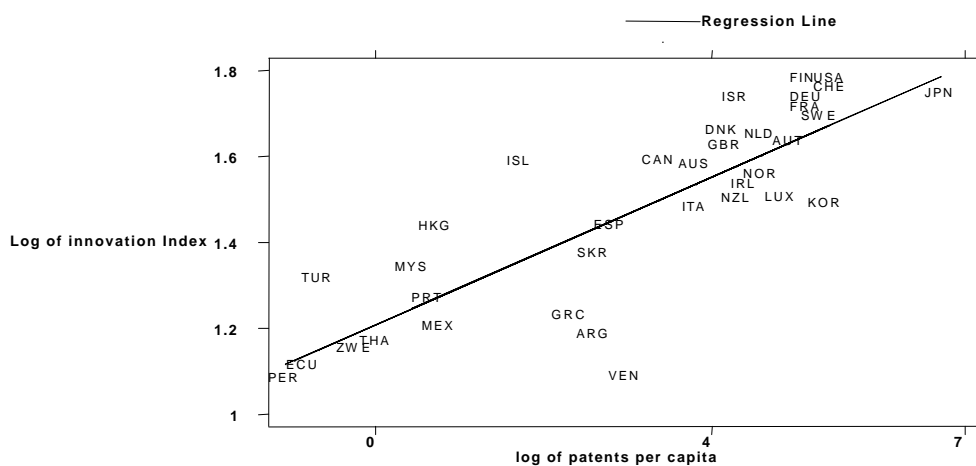
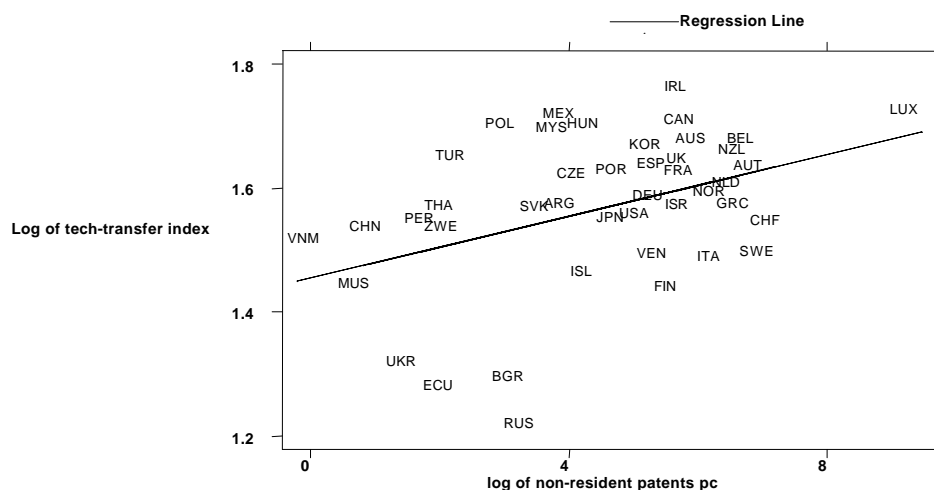


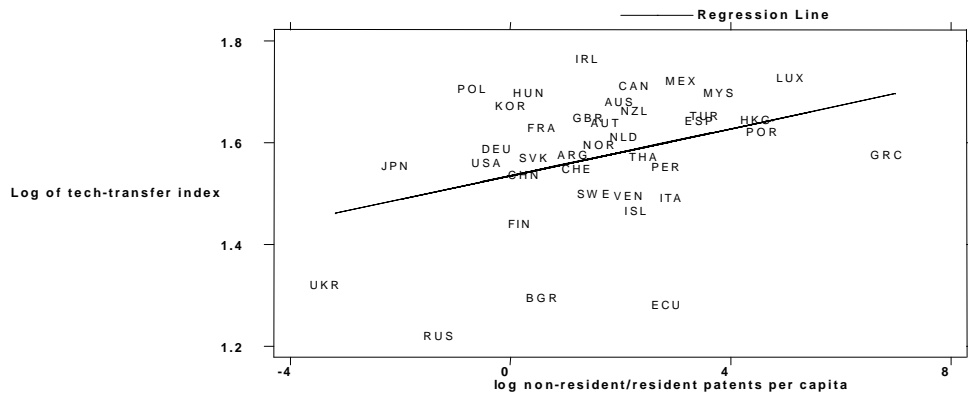
Figure 6
The relation between the technology transfer index and non-resident patents per capita



Note from Figure 6 that countries such as Mexico, Poland, Malaysia and the Republic of Ireland score high on the technology transfer index based on the survey but not all of them score high on the non-resident patent data. The Republic of Ireland, Malaysia, Mexico, and Poland to some extent, have achieved rapid growth, rapid growth in exports and high technology exports in recent years by opening their doors to international enterprises and letting the enterprises decide what stage of their processing to locate in each country. They participate in technology transfer but not at stages of the production process that require patenting. If so, this kind of technology transfer activity would be revealed by trade data on high-tech exports but not in patent data. To check this idea we also look at the relation between the technology transfer index and data on high technology exports.

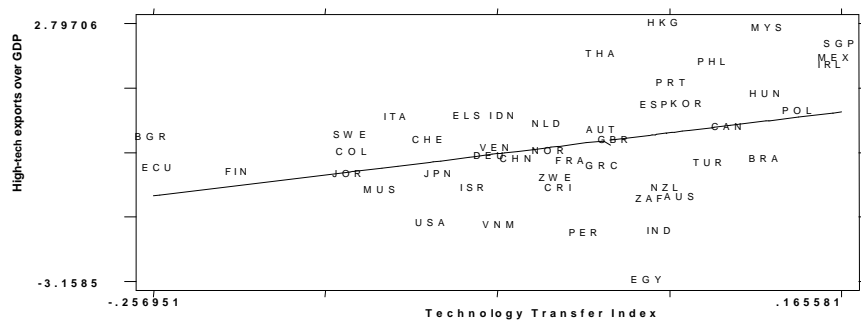
Since countries that are technological innovators will also export high technology, we expect high-tech exports to depend both on the extent of innovation and technology transfer in the sending country. This is confirmed by statistical analysis and summarized in Figures 7 and 8 below. Figure 7 shows the positive relation between high tech exports and the innovation index, after controlling for technology transfer. Figure 8 shows the positive relation between high-tech exports and the technology transfer index, after controlling for innovation.

Figure 7
The relation between the innovation index and resident patent per capita



Considered together, the results with patent data and the results with high-tech export data, provide the empirical justification for our derivation of innovation indexes and technology transfer indexes from survey data. The responses to the executive opinion survey are generally positively correlated with other, independently derived, measures of innovation and technology transfer.

Figure 8
The relation between high-tech exports and technology transfer index



4. CONCLUSION

This paper has described the reasoning and the empirical justification behind the economic creativity index. The basic justification is analytical: that it is an international measure of innovation and effective diffusion of innovations and this is at the heart of the growth process. Many, perhaps most, goods and services are completely transformed within a generation, and replace older goods because they produce higher value added. Since growth is nothing more than a rise in value added per person, innovation and change are clearly central to economic performance.⁴⁰

The economic creativity index is also justified empirically, since it is correlated with economic growth in the 1990s, and remains so even after controlling for a number of other potential determinants of growth, often showing those alternative explanations for growth to be insignificant. This list of additional factors includes saving and investment rates, measures of institutional quality and the rule of law, measures of financial depth, measures of ethnic diversity, measures of economic crises, and the starting level of GDP per capita. Statistical analysis provides evidence that the following have helped determine growth rates in the 1990s: economic creativity, economic crises, saving rates, openness to international trade, and initial income levels. For this reason, the growth competitiveness index is based on these kinds of indicators. Justification for the notion that what the economic creativity index measures causes growth rather than the other way around, is found in the fact that changes in the element of the index are uncorrelated with growth over the last four years, together with the fact that, as just mentioned, the level of the index is indeed correlated with growth.

The justification for the idea that effective innovation requires not just technological prowess but complements to innovation such as the availability of credit and activation of new economic structures comes from the evidence above in Figures 6 and 7 above. Some innovative but nevertheless slow-growing countries such as Japan, Germany, Switzerland, and France and Austria to some extent, are shown to have abnormally low scores on financing of start-ups and activation of new enterprises for their levels of pure innovation. A measure of innovation that adjusts for this explains the growth data in the 1990s better than a measure that does not. The justification for the idea that a county can grow rapidly through innovation *or* technology transfer is based on a priori grounds but also from the fact that an index that takes this into account explains the growth data better than one that does not.

The justification for the use of our particular measure of innovation and technology transfer comes from the fact that they are designed to be comprehensive and from the fact that they are correlated with observable by-products of innovation and technology transfer such as patents and high-tech export activity.

⁴⁰ The idea that innovation is probably the single most important engine of long-term growth and development is widely shared by growth economists and economic historians, but is not undisputed. It is one of the driving ideas behind the so called 'endogenous growth' literature Romer (1990), Aghion and Howitt (1998) and has been stressed by historians of the Industrial Revolution such as Landes (1969) and Mokyr (1999) and economists studying developing and transition economies such as Gomulka (1990).

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PART III

***Innovative Approaches And Successful
Programmes In SME Finance***

A. NATIONAL INITIATIVES

DEVELOPMENT FINANCIAL INSTITUTIONS' & COMMERCIAL BANKS'

INNOVATIVE SCHEMES FOR ASSISTING SMES IN INDIA

Sailendra Narain⁴¹

INTRODUCTION

This paper attempts to project the recent innovations undertaken by some of the development financial institutions (DFIs) and commercial banks for financing small and micro enterprises in India, take stock of the lessons learnt and assess the possibilities of their replicability in developing countries.

Despite various liberalizations and schematic changes to meet the emerging requirements of the sector, availability of finance continues to be a major problem for small enterprises. Realizing this fact, some of the DFIs and forward looking commercial banks have put in operation a number of innovative schemes, the Small Industries Development Bank of India (SIDBI) being in the lead. The majority of the experiments have started showing good results.

1. OVERVIEW OF THE SMALL SCALE INDUSTRIES SECTOR

The small-scale industries (SSI)⁴² sector plays a significant role in the Indian economy. For the past one decade, it has been consistently registering about three per cent higher real growth rate (8.9 per cent during 1999–2000) compared to the growth recorded by the

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⁴² In India, the industrial sector has two broad segments viz., (a) Small Scale Industries (SSI) and (b) Others (i.e. medium and large industries). The Government of India notifies the definition of small-scale industry from time to time based on the investment ceiling. The present definition is, "an industry in the small scale sector shall have investment in plant and machinery not exceeding INR 10 million" (approx. US\$22,000). A sub-component of micro enterprises, known as the "Tiny Sector" forms part of the overall SSI sector. Medium sized industries are out of the purview. India, thus, follows the concept of SSIs and not SMEs.

industrial sector as a whole. With about 3.4 million registered SSI units in the organized sector, the sector is the second largest employer, after agriculture. At the end of March 2000, it employed about 19 million persons. The SSI sector contributes over 41 per cent of the total industrial production, 31 per cent of the country's total exports, and jointly with traditional industries (such as Khadi, village, handloom, handicrafts, sericulture, and coir) the relative percentage goes up to 58 per cent.

Policy changes

In order to sustain the pre-eminent position of the SSI sector in India, the government, the Reserve Bank of India (central bank), DFIs and commercial banks have been taking proactive steps and effecting changes in their policies to meet the new challenges posed by the liberalized economic policies and the WTO regime. Policy changes have also been made, more particularly in pursuance of the recommendations made by the Narasimham Committee on second generation financial sector reforms, the Abid Hussain Committee and most recently the Dr. S .P. Gupta Committee, constituted by the Government of India and the Planning Commission.⁴³

Finance

Traditionally, India has two sets of financial institutions for assistance to the SSI sector (a) commercial banks which mainly provide short-term working capital and (b) DFIs which extend long-term credit for capital investments. Of late, the cooperative banks have also started giving short-term loans to micro enterprises and the rural non-farm sector primarily in the rural areas.

While the SSI sector has gained considerably from liberalization, with about 18 per cent of its share in the total of net bank credit, finance particularly short-term credit continues to be a major problem. Short-term finance presently available to the sector falls much below the 20 per cent of their annual production as recommended by the Nayak Committee.

The flow of long-term loans for capital investments from DFIs has, by and large, been adequate. The total term loan requirements of SSI at INR 130,000 million during the 9th plan period have been met far in excess of the target by the DFIs and the estimated requirement of INR 360,000 million during the 10th five year plan by the Planning Commission is also likely to be met in full.

⁴³ Dr. Narain served as a Member on the last two committees

Constraints

Viewed from the small entrepreneurs' angle, major financial problems are: inadequate availability of working capital, a wide time gap between working capital and term loans, banks' insistence on collateral and third party guarantees, higher promoters' contribution, a risk averse banking system for small projects, delayed payment of bills by large industries, PSUs and government departments.

The DFIs and commercial banks generally view small projects fraught with risk due to non-disclosure by the borrowers, lack of authentic information on technology, markets, and investment potentials, a high rate of obsolescence of technology, low quality standards, heavy reliance on traditional channels of debt, high transaction costs, inability to sustain market fluctuations and sagging international competitiveness.

2. INNOVATIONS

Taking cognisance of the constraints, the emerging needs and rising competition in the domestic and international markets, some of the DFIs and forward looking commercial banks have deployed innovative mechanisms to cater to the financial needs of SSIs. A spurt in such innovative programmes has been witnessed in the last five years. Some of the major innovations the majority of which has been introduced by SIDBI, are described below:

Informatics

SIDBI, the Government of India's Development Commissioner, the Small Industry Service Institutes, the National Small Industry Corporation, the State Bank of India, the Canara Bank, the Syndicate Bank, the Punjab National Bank etc., have undertaken industrial potential surveys and developed project profiles both in English and the regional languages for the benefit of entrepreneurs in taking fast investment decisions. Industry and their associations have been assisted to adopt electronic media for accessing vital information and doing business with banks. Associations have been assisted to set up information centres with Internet connectivity, on commercial lines. Even private initiatives have been funded for the purpose. Regular mechanisms have been set up by SIDBI to publicise R&D innovations, ready for commercialization through the venture capital routes. It also extends assistance to widely spread STD/ISD telephone booths to enlarge them into cyber cafes.

Technology

Technology and quality management issues have received high priority in the last five years. A special financial scheme known as the Technology Development and Modernization Fund

(TDMF) is jointly operated by SIDBI and the Government of India under which concessional loans are provided for technology up-gradation, modernization, quality control and environment management projects in the small-scale industrial sector. Sector specific technology funds viz., leather, textiles and jute are also available. SIDBI, the Government of India and the State Bank of India run UPTECH programmes for technology development in identified clusters. UNIDO has joined the institutional arrangements for cluster development. In order to promote quality standards, SIDBI provides loan assistance to SSI units to take up total quality management (TQM) exercises to undergo quality certification processes. On successful completion the Government of India gives INR 75,000 as a grant to each unit.

Assistance is provided for setting up technology parks and incubation centres, which have mainly been picked up by IT related service providers. SIDBI has set up a technology bureau for small enterprises for exporting and importing technologies and for assisting in setting up joint ventures. SIDBI serves as the backstop financial institution for such activities. The Rural Industrialization Programme (RIP) of SIDBI is aimed at promoting viable micro industries in rural areas, under which SIDBI positions an expert implementing agency at its own cost to identify entrepreneurs, provide suitable training, arrange finance and provide escort service till they start commercial production. As at the end of March 2001, 50 districts in 14 States have been covered through 25 implementing agencies resulting in the setting up of over 8000 small units; of which about 1000 units are owned by women entrepreneurs. Under environment management initiatives, 48 demonstration centres have been assisted and they are being replicated in various states.

HRD, upgrading of skills and enterprise development

The human resource development (HRD) programme for the SSI sector is being conducted through (i) the Small Industries Management Development Programme (SIMAP), which targets graduate unemployed youths with the overall objective of providing competent managers to the sector, and (ii) the Skill & Technology Upgrade Programme (STUP) which aims at enhancing the technology profile of SSI units. These programmes are conducted through 18 national institutions. The evaluation of SIMAP indicated that about 50 per cent of the candidates got final placements and others were able to get suitable placements within three to six months at an average salary of INR 4000 per month. About 50 of the trainees were females. Short duration, limited follow-up and inadequate awareness among prospective candidates, were some of the weaknesses identified in the programme.

Financial assistance for entrepreneurship development programmes (EDPs) conducted through non-governmental organizations (NGOs) and specialized institutions in various forms and content are common to many of the financial institutions. Special EDPs are also conducted for women, rural youths and less privileged sections of the society. An evaluation of such programmes has placed the success rate at 36 per cent whereby trained candidates could set up their own ventures. The Entrepreneurship Development Institute of India at Ahmedabad runs regular courses funded by financial institutions in enterprise growth and

development. Family run businesses are also kept in purview. SIDBI in collaboration with the Indian Banks Association and the National Institute of Bank Management has organized a number of bank managers sensitization programmes for financing the SSI sector.

Marketing Initiatives

For the first time, SIDBI has taken a lead by recognizing marketing activities at par with industry and has developed financial schemes for assisting both tangible (setting up of show emporia, trade and exhibition centres) and non-tangible projects (such as brand development, production of technical brochures and audio-visual aids for market promotion, participation in trade fairs, buyers and sellers meet etc.). Under the bank's Rural Marketing Scheme, three broad product groups: leather and leather products, handicrafts and processed food have been identified for liberal assistance. Such innovative ventures are especially funded out of the Market Development Fund, part of which is earmarked for women entrepreneurs. Under the Government of India's Brand Equity Fund set up by the Commerce Ministry, special dispensation is rendered to SSI ventures at concessional rates.

The Exim Bank, the State Bank of India and SIDBI are sanctioning a Buyers' Line of Credit to financial institutions and banks in other countries to promote exports of capital goods from India manufactured by small-scale industries.

Innovative Credit

In order to ward off the long felt problem of a wide gap between availability of working capital and term loans, almost all commercial banks have started giving composite loans (both term loans and working capital) under one roof. This scheme has especially helped the smaller of the small. The Government of India through SIDBI operates the National Equity Fund scheme for equity type assistance for projects up to INR one million for a service charge of only one per cent. On the same lines, SIDBI also runs the Mahila Udyam Nidhi scheme for assisting women entrepreneurs and the Mahila Vikas Nidhi scheme for assisting women NGOs to set up production-cum training centres. To meet the problem of delayed payment of bills of SSI manufacturers, commercial banks discount issuance bills under the bills marketing scheme, with a rediscounting facility from SIDBI. SIDBI's direct discounting of bills scheme has worked very well. Under the scheme, bills exposure limits are granted to the large scale purchasing industries. On supplies made to them by SSI units, their bills are directly discounted by SIDBI and 100 per cent payments made to the SSI suppliers on presentation of the bills duly accepted by the purchasers, (generally large industries, public sector units and government departments). On the due dates, purchasers have to make direct payments to SIDBI. This provides about 8000 SSI units with payment soon after the supplies are made. The only problem in this scheme is that of accommodation bills fraudulently made by some of the large industries. This calls for a very close vigil on such transactions. In the last few years, the Indian SSI sector has made a valuable contribution to the field of software and IT related services. This has been largely possible due to venture capital funds (VCs) set

up by financial institutions and also by the private sector. Apart from setting up 10 regional VCs, one national fund and one overseas fund for IT industries, SIDBI is now contemplating setting up a special VC fund dedicated to bio-technology. General purpose VC funds have been operationalized by IFCI, ICICI, the State bank and SIDBI. A number of foreign funds have also found places in the Indian market.

Leasing and hire purchase schemes which are being operated by non-banking finance companies (NBFCs) and the National Small Industry Corporation have recently gained ground. The rate of defaults is minimal in the case of NBFCs mainly due to close monitoring and follow-up undertaken by them on a regular basis.

In order to encourage banks to lend liberally to the SSI sector, The Government of India and SIDBI have recently set up a new credit guarantee fund scheme under which loans up to INR 2.5 million are guaranteed, the precondition being that neither collateral nor third party guarantees should have been taken by the banks. The efficacy and viability of the scheme cannot be established at this point of time as it is hardly one year old. Earlier, a similar guarantee scheme for SSI operated by the Reserve Bank of India for over 30 years failed because the claims out paced the resources. Banks opted out of the scheme due to complex procedures for making claims and almost no payments against the claims being made for years. The new scheme takes into account the lacunae of earlier schemes. The ECGC runs a well-established scheme for exporters including small-scale exporters.

State-of-art infrastructure

This is one area where not many initiatives have been taken in India. The only milestone has been the setting up of technology parks for the IT industry assisted by the financial institutions. These parks serve as nurseries for innovations. Some of the banks have given assistance under their rural housing cum-production schemes to facilitate easy access to workplaces. SIDBI has assisted industry associations to set up exhibition grounds for trade fairs and business meetings with the latest facilities. The one set up in Tirupur, Tamil Nadu, is a successful example of this innovation.

3. REPLICABILITY

On closer examination of these innovations, it is felt that except for internet banking, e-commerce and capital market related programmes, almost all the initiatives taken in India can be successfully replicated in any developing economy. Pre-conditions for their successful implementation are:

- the creation of an enabling environment;
- the introduction of simple mechanisms;

creating full awareness of the programmes and usefulness;
reposing confidence in the minds of banks that lending to SSI is cost effective with
calculated risk.

The objectives can be achieved through well-knit training programmes for the SSI sector and sensitization of financial institutions and banks.

IMPROVING COMPETITIVENESS OF SMES IN DEVELOPING COUNTRIES

Cuno Güttler⁴⁴

INTRODUCTION

SMEs contribute substantially to a stable economic environment and to the development of the economy. To achieve stable economic development the business of SMEs must be supported. They need especially financial and consulting services which help them to overcome difficulties during the start-up phase or to carry out their normal business activities. Local retail banks are the natural partners for SMEs but they themselves are also facing many changes and challenges on their markets which have an impact on their relationship with SME. This is true for banks in developing as well as in developed countries. Examples of some of the challenges can be summarized as follows:

1. CHALLENGES

1. European banks work in a demanding international and national regulatory environment. One of the issues of great importance to is the Basle-II-talks which could result in an increase in the cost of lending to the SME sector. This is only one particular problem but it shows quite well the impact of the regulatory environment on the banks' business and their relations with this very important customer group.

2. SMEs face a very competitive environment due to e.g. the globalization process and new technologies. In this environment they need a full range of products that not only solves their pure financial problems but also gives them additional consulting services. This includes the case of the start-up of a business, the overall financial operations and the international business of SMEs. Retail banks have to adapt their products to these new needs.

3. To achieve economies of scale retail-banks have to standardize and automate the processing of their products. E-business plays a major role because it helps to automate the process on the clients' side and improves the contact with the SMEs particularly in remote areas. Automation also leads to more cost efficiency. Retail-banks have to reduce their transaction costs to be competitive and to be capable of offering standard products on a very cost-effective level.

⁴⁴ Director, Rhenish Savings Banks and Giro Association.

4. To get in touch with SMEs retail banks have to reorganize their distribution channels. According to their customer segmentation they have to find the best ways to satisfy the needs of their clients. All possible channels have to be used. Therefore, there is a need for multi-distribution channel management. Access to the products must be as convenient as possible for the customers. In e-business a high security standard has to be maintained.
5. Risk management is another major issue. Not only must retail banks have to clearly analyse the underlying risk of credit, they also have to price the products according to the specific risk of the client.
6. The overall decisive factor is staff. Training of staff members is of high importance. Those who are dealing with SMEs need a high level of education and have to be capable of analysing the situation of a SME in an appropriate way.

2. SOLUTIONS

To help SMEs in the environment described above efficient retail banks in developed and developing countries need core competence in the following main areas: automation, distribution, marketing, credit policy and management.

1. Automation means the use of advanced technology concerning the internal process as well as in the e-business area. All processes must be reviewed and adjusted to reach high efficiency and cost effectiveness. Front and back offices must be separated.
2. Distribution channels must be structured according to the needs of the customers and must provide access to tailor-made services. The branch network must be differentiated according to customer segmentation. A multi channel management is needed.
3. Marketing must be based on an efficient “selling-culture”. Pricing must be inline with the risk structure. Product development especially must take into account the needs of SMEs.
4. The credit policy of the bank must be supported by credit scoring and rating tools. Retail banks in developing countries must modify those tools in accordance with their environments.
5. Top management needs a clear vision of the bank’s future business model. In developing countries the management must have a clear position in terms of the SMEs business and must support this field within the bank. It also has to cooperate with the government and the regulatory bodies to improve the situation for SMEs and their business with them. An MIS system should be in place to support the risk evaluation and provide a view on the performance of the bank.

3. RECOMMENDATIONS

Local retail banks are those banks, which must be supported if the access of SMEs to financial services and their overall competitiveness are to be improved. They know the local markets and the players on those markets very well. If legislation does not allow them to do business with SMEs then the legislation should be modified. SME business is a profitable business so retail banks must be encouraged to start services to these enterprises. Bearing in mind the special situation of retail banks in developing countries there are several fields where an efficient policy for those countries has to take into account.

1. Local retail banks in developing countries have to be supported by international experts. Programmes from the government, international financial institutions or regional development banks should aim at improving the capability of local retail banks to enter the SME business. Technical support and credit programmes should be provided to those banks. This support must help those banks to develop the core competence that retail banks need to best serve these clients.
2. International help must be based on the cooperation of multinational financial institutions, associations of retail banks in developed countries, retail banks in developed countries, regional development banks, governments of developing countries and retail banks in developing countries.
3. Together they should cooperate in analysing the situation of the country and the strength and weaknesses of the local retail banks.
4. Programmes must be implemented to make the necessary adjustments concerning the overall legal framework of the banking industry and the SMEs.
5. The techniques which are used in developed countries must be modified to the needs of the retail banks in developing countries.
6. An initial funding for a revolving credit programme should be initiated by the government or international donors.
7. To achieve sustainable development the support should be given on a continuous basis.

CASE STUDIES OF TWO LEADING EUROPEAN SME BANKS

CASE 1: RHEINISH SAVINGS BANKS GROUP – FIVE CORE COMPETENCIES⁴⁵

The Rhenish Savings Banks Group is among the leading SME bankers in Germany. It belongs to the German Savings Banks Group, which consists of over 500 independent savings banks. A major part of its profits is generated from business with the SME sector and it has a market share of some 60 per cent. The success of the group as an SME banker is based among other factors on the five core competencies outlined in figure 1, namely a sophisticated credit policy, highly effective automated processes, efficient distribution channels, efficient marketing and a strong management strategy.



A sophisticated credit policy means that the group applies up-to-date credit techniques such as credit scoring and pricing to risk. These are supported by the use of the most recent IT-technologies. Highly effective automated processes are crucial for achieving cost effectiveness. This includes the application of advanced technologies to both front office and back office operations and outsourcing when in-house operations are more costly.

⁴⁵ Source: Cuno Güttler. Rhenish Savings Banks and Giro Association. Presentation for the Expert Meeting on Improving Competitiveness of SMEs. UNCTAD. Geneva. 22–23 October 2001.

Efficient distribution channels includes the segmentation of customers, tailor made services/products for different types of customers, differentiated branch network and a multi-channel approach to delivery of financial services. The Group has a wide branch network that gives it both a strong local and national presence. The regular branch network is complimented with specialized branches and the Internet is widely used to deliver new financial services. The Internet, although a global platform, brings the bank even closer to its markets and customers. For example, customers can have access to the bank's databases and manage their accounts and cash systems via the Internet. Nevertheless, the wide branch network remains vital for the group in preserving a strong presence at the local level and for obtaining information on local market conditions. The fact that the Group consists of over 500 independent savings banks means that the delivery channel is very decentralized. Through use of modern IT and automation the decentralized organization provides its customers with a diversified range of financial products that are adapted to local market conditions, and are cost-effective.

Efficient marketing includes product development, database marketing, competitive pricing and adopting a "selling culture" within the organization. For example, the Group has taken steps to intensify the use of its databases to encode the specific needs of different customer segments. This allows the group to expand the range of financial products tailored to the needs of its customers and also to target the services more efficiently to the relevant customers through segmentation. There is also increasingly a need for consulting services that provide support to SMEs in their business.

Strong management means that the top management has a clear view of the objectives of the bank, a performance oriented culture as well as payment packages and up-to date management information systems (MIS). The management is supported by a highly skilled staff that is continuously being trained in SME related topics. Training is provided both to strengthen the general knowledge of the staff on SMEs and their business environment as well as on specialized financial products and services offered to SME customers. The training modules are also continuously updated to reflect changes in the business environment. Recently emphasis has been put on providing training on risk management, credit scoring and balance sheet analysis. There is also an increasing need to train the staff in providing consulting services to customers.

CASE II: SWEDBANK: A LEADING SWEDISH RETAIL BANK ⁴⁶

(a) Customer base

Through alliances and partly-owned businesses, Swedbank reaches a large customer base in the Nordic and Baltic countries. Its customers range from private individuals, local businesses, large companies, municipalities and county councils, to nationwide organizations. Every second Swede is a customer of the bank. With regard to microenterprises and SMEs⁴⁷ the group has a market share of about 40 per cent. Microenterprises generate 35 per cent of the bank's profits from business with enterprises, 40 per cent from small enterprises and only 25 per cent from medium and large corporations.

(b) Complete range of financial products

The Bank offers a complete range of financial products and services and has a leading position in most of the product segments. The bank ranks in first position in savings and investments (household deposits, mutual funds, individual pension savings etc), housing (mortgage loans, real estate brokerage) and the corporate market (deposits, lending, instalment financing and leasing).

(c) Multi distribution channel

Individual SMEs generate relatively small revenues. Therefore, keeping distribution costs down is important. The use of telephone and Internet as distribution channels, especially for various transactions, increases the accessibility for the customers and decreases the costs for the bank. Today most of the in and out payments are available via telephone or Internet. The use of such services frees time for branch people to work with more complex issues, such as general advice to SMEs and financing. Nowadays 40 per cent of the SwedBank's clients are connected to the telephone-bank and almost 35 per cent are connected to the Internet-bank. This number is increases rapidly.

(d) Risk Management

SMEs are still regarded as high-risk borrowers vulnerable to market fluctuations due to insufficient assets, low capitalization, and high mortality rates. For its part, Swedbank does not apply higher credit-loss rates to SMEs compared to other enterprises. The following mechanisms are used to manage SME risk:

⁴⁶ Source: Håkan Berg. Swedbank. Presentation for the Expert Meeting on Improving Competitiveness of SMEs. UNCTAD. Geneva, 22–23 October 2001.

⁴⁷ Micro enterprises (less than 5 employees) are highly dominant in Sweden and they represent 92 per cent of the market, small enterprises (5–19 employees) represent 6 per cent and medium-size enterprises (at least 20 employees) represent 2 per cent of the market.

- credit scoring that is based on historic and other financial information;
- risk classification instruments that are based on current international research systems to identify potential candidates for insolvency;
- a model of deeper financial analysis based on local branch knowledge such as rating, business logistics, funding and networking is used in an efficient way.

A widely spread network of diversified local branches is crucial for running a successful SME-oriented bank. To improve the quality of its services, the professional profiles and functions of staff in branches should differ according to the local needs and the market segment that is targeted. Programmes such as Training and Certification of SME clerks have produced good results.

(e) Skilled customers

A fruitful relationship between the bank and its customers requires that the customers are also skilled in certain key areas, such as IT. In 2000, about 70 per cent of Swedbank's micro and SME clients did not use the Internet or e-mail. To improve the situation, Swedbank in partnership with several actors (such as the Swedish Telecom and the National SME Organization), established a project that would help SME entrepreneurs learn more about IT and the Internet. More than 20,000 enterprises joined the classes.

Conclusions

According to Swedbank's experience the key elements of a successful SME bank should include the following:

- a network of local branches and local knowledge;
- continuous work to develop staff skills;
- partnerships to improve customer skills;
- establishing a structured risk management system;
- gradually building a sufficient IT-system supporting the local business;
- gradually building efficient distribution through self-service channels.

FINANCING SMES: UGANDA'S EXPERIENCE

Louis Kasekende⁴⁸

INTRODUCTION

The main argument for favouring SMEs⁴⁹ in developing countries is that they are increasingly playing a strategic role in economic growth and development through their contribution to the creation of wealth, employment, and income generation. In more developed economies, the dynamic arguments for the existence of SMEs have been stressed in terms of their being more innovative and constituting a seedbed for the development of new firms.

In Uganda, SMEs are increasingly taking the role of the primary vehicles for the creation of employment and income generation through self-employment, and therefore have been tools for poverty alleviation. SMEs also provide the economy with a continuous supply of ideas, skills and innovation necessary to promote competition and the efficient allocation of scarce resources.

In addition, strong SMEs in Uganda such as Capital Radio, Kabira International School, Masaba Cotton Co. Ltd and Africa Basic Foods were formed through joint venture arrangements with foreign partners from the United Kingdom and the United States. These and other SMEs have provided domestic linkages such as the link between agriculture and industry and between small-scale enterprises and large-scale industries. This has created opportunities for employment and income generation both in rural and urban areas at relatively low cost, thus ensuring a more equitable income distribution. In turn, the stimulation of activities in both rural and urban areas has mitigated some of the problems that unplanned urbanization tends to create, offering an efficient and progressive decentralization of the economy. Thus, SMEs play a crucial role in creating opportunities that make the attainment of equitable and sustainable growth and development possible. It is estimated that

⁴⁸ Deputy Governor, Bank of Uganda.

⁴⁹ SMEs are widely defined in terms of their characteristics, which include the size of capital investment, the number of employees, the turnover, the management style, the location, and the market share. Country context plays a major role in determining the nature of these characteristics, especially, the size of investment in capital accumulation and the number of employees. For developing countries, small-scale generally means enterprises with less than 50 workers and medium-size enterprises would usually mean those that have 50–99 workers. In Uganda, a small-scale enterprise is an enterprise or a firm employing less than 5 but with a maximum of 50 employees, with the value of assets, excluding land, building and working capital of less than Ugshs. 50 million (USD 30,000), and an annual income turnover of between Ugshs. 10–50 million (USD 6,000–30,000). A medium-size enterprise is considered a firm, which employs between 50–100 workers. Other characteristics have not been fully developed.

there are 800,000 SMEs in Uganda, providing employment and income generation opportunities to low income sectors of the economy.

Due to their characteristics however, SMEs in Uganda suffer from constraints that lower their resilience to risk and prevent them from growing and attaining economies of scale. The challenges are not only in the areas of financing investment and working capital, but also in human resource development, market access, and access to modern technology and information. Access to financial resources is constrained by both internal and external factors. Internally, most SMEs lack creditworthiness and management capacity, so they have trouble securing funds for their business activities such as procuring raw materials and products, and investing in plant and equipment. From the external perspective, SMEs are regarded as insecure and costly businesses to deal with because they lack required collateral and have the capacity to absorb only small amount of funds from financial institutions. So they are rationed in their access to credit because of high intermediate costs, including the cost of monitoring, and difficulties in enforcing loan contracts.

To overcome some of the constraints, the government and other players such as the Bank of Uganda (BOU), have designed programmes and policies to support SMEs that are market-driven and non-market distorting. The government has, for example, created stable macroeconomic conditions, liberalized the economy, and encouraged the growth of the micro-financing business. In conjunction with donors, the government has designed a medium-term competitive strategy and a Rural Financial Services Programme to benefit SMEs. A micro-deposit-taking Institution (MDI) bill is also before Parliament for enactment. When passed into law, the act will guide the development and sustainability of micro-finance institutions while at the same time allowing them to collect deposits. Nevertheless, the challenge to SMEs in accessing financial services will also depend on how they themselves increase their creditworthiness.

1. CHARACTERISTICS OF SMEs AND FACTORS CONSTRAINING THEIR ACCESS TO FINANCIAL RESOURCES

In Uganda, strong SMEs tend to be located in urban and peri-urban centres and are usually registered. However, they face a number of constraints, which include difficulty in employing competent people with skills in financial management because of the salaries such people demand, financial problems arising from late payments by debtors, and the inability to raise their own finance and access financial services from formal sources. This category of SMEs usually looks to the banking sector and other financial intermediaries for instruments to finance working capital and to provide credit for short-term liquidity management. However, they often fail to access the financial resources in the required amounts because banks evaluate them on the basis of a checklist, including:

- Audited financial statements for the last three years including management accounts;
- Project proposal highlighting strengths, weaknesses, opportunities and threats;

- Financial projections;
- Monitoring costs;
- Credit or default risk because of the problem of information asymmetry;
- Enforcement costs.

Financial and accounting records are rarely in place, and where they are available, their accuracy is usually doubted. In instances where bank financing is provided, it is in most cases in amounts that are insufficient and at a high cost in relation to the term to maturity of loans and the real expected return on investment. In Uganda, loans are of a short duration, normally less than five years, and the average interest rate is way above the inflation rate. In the circumstances, it may be difficult for borrowers to realize a high enough real returns to finance repayments.

Weak SMEs on the other hand, employ less than five people, mostly family members, are usually not legally registered, apply simple and relatively backward technology in production and, therefore, the quality of their products are likely to be poor. They may suffer from limited market access and fierce competition from many rival producers. This category of SMEs usually does not have proper physical structures such as premises from which to operate business, and accessible roads and utilities, which are major impediments to accessing formal sector credit. In addition, there is a general lack of professionalism within this category of SMEs in terms of strategic planning procedures, decision-making processes and business planning, and management in general.

Generally, the smaller the enterprise, the less likely its management will understand the need for financial management and the poorer the understanding of financial management. Likewise, the size and the distance from major cities/urban centres are negatively related to the level of awareness of financial instruments. That is, the smaller the size of the enterprise and the farther away from the city/urban centre the enterprise is, the less aware the firm is of the financial instruments available. This makes them vulnerable to shocks to revenue or costs and, therefore, they are unlikely to expand beyond the rate of investment supported by retained profits. This explains why the turnover of a typical SME in Uganda is estimated at only Ushs. 10 million (US\$6,000) a year. Thus, low rates of return, lack of good financial records, and lack of collateral reduces their creditworthiness. It is no wonder then that their demise is considerable. Nevertheless, MFIs are increasingly filling the gap by providing finance to this category of SMEs, albeit at higher interest rates than those offered by the traditional banks.

2. ROLE OF FINANCE IN ENTERPRISE DEVELOPMENT IN UGANDA

Banking Sector Financing

Unfortunately for Uganda, the financial system is small and with limited linkage to the real economy. Uganda's saving/GDP ratio is about 12 per cent including both private and public sector savings compared to the continental average of 17.7 per cent. The ratio of money supply to GDP is only 12 per cent. There is only one bank branch per 180,000 people in Uganda, compared to an average of 7,000 per bank branch in the Common Market for East and Southern Africa (COMESA) countries. Moreover, bank branches are concentrated in the urban centres. Out of 123 branches, 64 are found in the four largest urban areas. In the year 2000, total assets of the banking sector, as a ratio of GDP, stood only at 26 per cent compared to 50 per cent in neighbouring Kenya. Total loan portfolio, as a percentage of GDP, is only six per cent. These statistics reveal that the domestic banking system plays a sub-optimal role in facilitating development in the sense that it is not financing much real economic activity. Worst still, the Table below shows that distribution of credit is lopsided against agriculture and in favour of trade financing and manufacturing. Yet agriculture is the main stay of the economy. But even the little credit that flows into agriculture is concentrated on marketing as opposed to production. Although this is not surprising⁵¹, the Table shows that the share of agricultural credit to total credit has been declining steadily over the last five years.

Table 3
Commercial Banks' Loans to the private Sector by Sectors, 1996-2000,
in per cent of total private Sector Loans

	1996	1997	1998	1999	2000
Agriculture	19.49	19.21	16.24	10.32	7.12
Agriculture: Production	1.17	1.29	2.86	2.15	1.82
Agriculture:					
Crop Finance	18.32	17.92	13.38	8.17	5.37
Manufacturing	26.74	21.73	26.19	32.43	33.00
Trade	45.55	50.52	47.92	45.63	50.18
Transport, Electricity & Water					
Building and Construction	5.14	3.02	3.12	4.51	6.48
Mining and Quarrying	0.06	0.07	0.06	0.01	0.01
Annual Growth	32.2	2.2	29.4	1.4	8.0

Source: Bank of Uganda

Several factors account for this low level of financial intermediation in Uganda:

First is the limited dispersion of the banking branch network, as most banks prefer to concentrate their activities in the urban areas where they enjoy economies of scale. In addition, there are few large-scale and viable investment opportunities in the rural areas. Recently, however, the resulting vacuum in financial services delivery, especially in rural areas, has been partially covered by micro-finance specialized institutions in the form of savings and credit organizations (SACCOS), financial service associations (FSAs), and non-governmental organizations (NGOs).

Secondly, there have been persistently high non-performing assets that have pervaded the banking system for a prolonged period of time. This situation was partly a result of a low culture of loan repayment compounded by economic decline suffered in the 1970s and 1980s. It should however be pointed out that the ratio of non-performing loans in the total loan portfolio has markedly dropped from 38.1 per cent in December 1996 to about 5.1 per cent as at March 2002.

Thirdly, while there is a low level of monetization in the overall Uganda economy, the formal banking sector is liquid and has played a significant role in facilitating private transfers, recorded at US\$80.5 million in 1990/91 and US\$539 million in 1997/98. However, the lending activities of the banking system tend to concentrate on less risky and higher-yield short-term lending especially for trade and working capital. Their risk aversion tendency is based on the experience of poor loan repayments (particularly on agricultural loans) over many years. This has led to exceptionally high real lending rates and interest rate spreads. Since 1994 interest rate spreads have remained at between 15–20 per cent, while lending rates have fluctuated between 10–25 per cent since 1996. It should be noted that these high rates also constrain private sector demand for credit.

Fourthly, the vast majority of deposits in the financial sector tend to be short-term (up to six months) and are hardly appropriate for funding long-term lending on a large scale because of maturity mismatches.

Fifthly, the financial institutions themselves have suffered from governance and management weaknesses that have resulted in weak internal controls, inability to accurately assess lending risks, monitor loans and recover loans. In some situations, there have been shortages of skills and strong social pressures on loan officers to favour certain borrowers, especially those who are politically connected. The failure to correctly assess the creditworthiness of borrowers arises because of information asymmetry and the resultant adverse selection problem. To circumvent this problem, banks have generally required firms to pledge more collateral than the value of the credit they receive and/or limited their services to prime borrowers whose reputation, collateral and other types of guarantees reduce default risk to a minimum.

Equally significant, is the inability of the judicial system take a relatively long time to dispose of cases involving breaches of contracts. This increases enforcement costs, which has discouraged bank lending to successful SMEs. However, efforts are underway to strengthen the commercial justice system by upgrading the capacity of commercial courts and revising commercial legislation.

Micro-Financing

This industry has proved to be a reliable delivery vehicle for financial services to SMEs. It consists of licensed institutions, NGOs, and cooperatives, as well as a large collection of associations ranging from women and youth clubs to loosely organized bodies. They offer credit, savings, payments and insurance services to their clients.

The strength of MFIs is that they serve the rural areas at low cost. Their service delivery is flexible, which makes it easy for weak SMEs to access financial services from them. Their weaknesses lie in their weak operational and management information systems, poor internal controls, limited access to technical assistance, and dependence on donor funding. A centre has been set up at the Uganda Institute of Bankers to address the issue of capacity building of these MFIs.

Lease Financing

Leasing has been an alternative means of financing capital investment of SMEs with minimum initial outlay. In Uganda, the industry is still too small and young comprising only one leasing company, namely DFCU leasing.

Venture Capital Financing

Venture capital has become an established investment vehicle in developed economies and is becoming increasingly popular in developing economies. Venture capital involves the provision of investment finance to SMEs in the form of equity or quasi-equity instruments not traded on a recognised stock exchange. It is long-term risk finance whose primary return to the investor are capital gains rather than income. Venture capital investors actively get involved in the management of the companies that they invest in to ensure the success of the venture. In Uganda, the scope of venture capital is still limited. Only two organizations namely DFCU and EADB have active venture capital funds. In addition, the European Investment Bank, through its APEX loan to government offers equity instruments in financing SME's.

Equity Financing

Uganda's capital market became fully fledged with the inception of the Uganda Stock Exchange (USE) in 1998. However, most SMEs cannot take advantage of the Exchange because of listing rules regarding disclosure requirements, which require companies to provide credible information to investors.

The banking sector has offered equity financing to a few successful SMEs. For example, UGACHICK LTD receive equity financing from Messrs Development Finance Company of Uganda (DFCU), the East African Development Bank (EADB) and the European Investment Bank (EIB).

Financing Through Mergers and Acquisitions

There is no data to suggest that mergers and acquisitions are practised among SMEs.

Credit Purchase Financing

Although there is no official data on the magnitude of credit purchases, this has been a very popular way in which SMEs have bought raw materials for processing. Those in retail business have benefited having to pay for stocks only after sales have taken place. This type of financing has depended largely on the trust and the reputation of the SMEs with their suppliers.

3. PROGRAMMES TO SUPPORT SMEs IN ACCESSING FINANCING

In view of the important role SMEs play in economic development, the government and other institutions, including BOU, are creating a positive environment and support programmes for SMEs. The objective is to eliminate institutional barriers and provide access to formal credit and banking services to creditworthy SMEs. This section discusses the macroeconomic environment and support programmes that have benefited SMEs in terms of access to financial resources.

Macroeconomic Stability

The Government of Uganda launched an Economic Recovery Programme (ERP) in May 1987, followed by a series of rehabilitation and development plans. Initial efforts were aimed at rehabilitating the production sectors and infrastructure, especially transportation on which the economy depended. Inflation was tackled by imposing strict controls on budget spending and by curbing monetary expansion. Problems in the balance of payments were addressed by

liberalizing the exchange rate, encouraging exports and seeking donor support. The trade regime has been fully liberalized, and there are no restrictions on both current and capital accounts.

In addition, the government pursued with vigour, a policy of privatizing parastatals, with the result that more than half of them have been divested. An investment law was introduced in 1991 to allow repatriation of profits by foreign investors and this was immediately followed with the establishment of the Uganda Investment Authority as a one-stop centre for investors. A capital market was also established in 1998 though its activities are still few. Monetary policy changed from use of direct controls to use of indirect instruments. The main thrust of monetary policy is to maintain stable and low inflation, and ensure the stability of the exchange rate and the financial sector.

In response to these efforts, the domestic economy has registered an average growth rate of seven percent per annum over the past 10 years. Macroeconomic stability has also been restored. The inflation rate, which was on average 108.4 per cent per annum during the period 1986–1992, has declined sharply, posting a negative inflation for the six months to April 2002. This has created an enabling environment for savers and investors. Gross domestic investment has averaged 14.3 per cent per year since 1988 and 15.3 per cent since 1990. Financial savings as a percentage of GDP, increased from 1.4 to over 12.7 per cent between 1990/91 and 2000/2001. However, Uganda's small open economy has meant that SMEs are now more than ever, facing pressures of trade liberalization as domestic markets are no longer the preserve of domestic SMEs.

Government Support Policies and Programmes

The government has produced comprehensive plans for a framework for the development of the economy. One of these plans is the revised Poverty Eradication Action Plan (PEAP), which has become the national planning framework. Derived from the PEAP is the Plan for Modernization of Agriculture (PMA). The PMA aims to modernize agriculture by commercializing it and supporting information dissemination, especially in the field of new technology and techniques of production. The third and equally important policy framework emanating from revised PEAP is the Medium-Term Competitiveness Strategy (MTCS) for the private sector. This framework aims to provide an enabling environment for the private sector to:

- make profits;
- have a higher capacity to create more jobs;
- operate in a free and fair environment;
- attract private sector investment; and
- have a strong export base.

In order to operationalize the policy frameworks, the government is committed to the provision of infrastructure in terms of industrial estates and marketing services, including extension services and training. With donor assistance, the government is also implementing focused programmes such as Rural Financial Services, which aims at expanding outreach of sustainable micro-finance, School Leavers and Youth Enterprises Schemes, and Business Uganda Development Services (BUDS).

In addition, a Macro and Small-Scale Enterprises Policy Unit has been established in the Ministry of Finance, Planning and Economic Development to specifically fine-tune SMEs policies, and a Commercial Division of the High Court has been established to expedite the disposal of commercial cases. It is hoped that operationalization of these policy initiatives will result in the rapid development of SMEs.

Measures to enhance the capacity of commercial banks to carry out better risk analysis of borrowers and to reduce the impact of non-performing assets, include the effort to establish a credit reference bureau at the Institute of Bankers. A private company has recently set up a credit reference bureau in Kampala and is likely to take over the credit information bureau at the Institute of Bankers.

BOU Financial Support Schemes

The Bank of Uganda operates a number of credit schemes and support programmes on behalf of itself, the government and donors. The credit schemes provide loans to SMEs in the private sector through licensed banks while the support programmes are for building the capacity of financial institutions, including MFIs.

The credit schemes include:

- Apex Private Sector Loan Scheme (Apex), which was designed to support small and medium scale private sector enterprises in manufacturing, agro-processing, and services, including tourism;
- Export Refinance Fund (ERF), which was designed to provide working capital in support of exports of non-traditional exports;
- Distressed Flower Project Fund (DFPF), which was established to rescue flower firms recently found to be facing some distress especially with regard to working capital and the replacement of green houses;
- Export Promotion Fund (EPF), which is part of the Apex credit line, was established to assist exporters to promote their exports and identify new markets;
- Development Finance Fund (DFF), which was established mainly to support production in the agricultural sector. It is however, being phased out because of its poor performance.

Other credit schemes administered in the past include:

- Investment Term Credit Refinance Fund (ITCRF);
- Cotton Sub-Sector Development Project (CSDP) and
- Rehabilitation of Public Enterprises (RPE) project.

The Support Programmes include the following schemes:

- Export Credit Guarantee Scheme launched in December, 2000 to support the export of non-traditional products;
- African Rural and Agricultural Credit Association (AFRACA);
- DANIDA funded Rural Financial Services Component (RFSC).

Performance of the BOU Support Schemes

The analysis of the impact of the BOU support programmes for SMEs is continuing. Preliminary evidence indicates that most companies that received loans under these schemes are doing well in terms of the expansion of activities and the jobs that they have created. There is also some evidence that some export companies have increased their export capacity and are now having access to financial services directly from commercial banks. The most remarkable achievement is that the default rate on the loans is low.

Other Institutions that support SME's and other private sector enterprises include:

- Private Sector Foundation which administers the BUDS;
- Uganda Manufactures Association (UMA);
- Uganda Investment Authority (UIA);
- Uganda National Chamber of Commerce and Industry (UNCCI);
- Export Promotion Board (EPB);
- Uganda Small Scale Industries Association (USSIA).

Micro-Finance

Recognising both the role of the financial sector in economic development and the weaknesses in Uganda's financial sector in the delivery of the desired financial services, the Government of Uganda, together with BOU as a major stakeholder, has designed a policy framework for MFIs, which has been adopted by the Cabinet. In addition, a MFI law has been drafted. When enacted, it will allow BOU to licence and supervise only the deposit taking micro-finance institutions to safe guard deposits. An Apex institution will superintend some credit only MFIs, while the rest of them will operate as member-based institutions.

4. CHALLENGES FOR SMEs IN IMPROVING THEIR CREDITWORTHINESS

Even with support from government and other agencies, there are challenges SMEs in Uganda have to face to improve their creditworthiness. SMEs have to improve their management systems and adopt modern management techniques if they are to benefit from the opportunities offered by the formal sector. They need to improve their financial records and accounting systems. Proper records need to be kept and maintained and the books of accounts have to be clear and should reflect a realistic picture of their operations and financial conditions. A good system and books of accounts are not only helpful to the banks; they are also crucial in managing and monitoring business as well as guiding tax authorities.

INSURANCE AND FINANCING IN TUNISIA

Moncef Zouari⁵⁰

INTRODUCTION

Given the profound changes taking place in the world which have the effect of opening up markets and removing protectionist barriers, exports today are of strategic importance and a major element in the economic systems of developing countries and economies in transition. Exports play a key role in improving the economic situation and in stimulating investment, production and employment.

This new trading environment undoubtedly offers export development opportunities for the SMEs of these countries, but it is also extremely demanding because of stiffer competition. Without adequate support from the financial system, these SMEs are unlikely to be able to take advantage of the opening up of foreign markets. Support for the financial system is not simply limited to financing export transactions but extends to covering the risks involved in these kinds of transactions, since banks need to make sure that SMEs will be able to repay any loans they provide.

1. EXPORT CREDIT INSURANCE IN TUNISIA

The export credit insurance scheme in Tunisia was set up in 1984 as part of the government's export promotion strategy. The scheme is intended to guarantee the successful outcome of export or export-related transactions by assuming responsibility for losses arising from commercial or political risk, disasters or any other risk inherent in such transactions. Several reforms were introduced under the law enacted in April 1997 to make the scheme more effective and bring it more into line with Tunisia's policies on economic liberalization and integration in the world economy.

⁵⁰ President Directeur Général, Compagnie Tunisienne pour l'Assurance du Commerce Extérieur. COTUNACE.

The main schemes administered by the Compagnie tunisienne pour l'assurance du commerce extérieur (COTUNACE - the Tunisian foreign trade insurance company set up in 1984) covers:

- its own commercial risks as an underwriter;
- political and similar risks on behalf of the State's export risk guarantee fund;
- risk of non-repayment of export pre-financing loans under the pre-shipment export financing guarantee fund.

COTUNACE offers services and products tailored to the needs of exporters seeking to strengthen their position in traditional markets, capture new markets or facilitate export-related transactions. The first task of COTUNACE is, however, to prevent the SME exporter from even starting to do business with a dubious client. To do this, it uses a risk selection process based on a credit check of the exporter's clients using a database on export counterparts that is constantly enhanced and updated.

The insurance coverage for non-payment by the foreign buyer is designed to reassure the exporter that its commercial transactions will not end in failure. If non-payment is due to one of the risks covered, COTUNACE assumes the ensuing financial responsibility and compensates the exporter for 80 per cent of the commercial risk and 90 per cent of the non-commercial risk. These percentages are 85 per cent and 95 per cent respectively for small exporters. The scheme also covers for example losses arising from non-performance of an export contract, the loss of company equipment being used to perform a service contract abroad, and losses arising from a security company being called in.

2. ROLE OF CREDIT INSURANCE PRODUCTS IN EXPORT FINANCING

SMEs in developing countries and in economies in transition usually do not have the collateral required by banks to grant them loans. Credit insurance can however, improve the creditworthiness of a SME thus reducing the need for collateral when negotiating a loan. It also has advantages for the banks as they can avoid the bad publicity arising from liquidation of the SME's assets in cases of non-payment. Also any provision that improves the borrowers financial standing will also ultimately reflect positively on the bank's loan portfolio.

COTUNACE has a wide range of guarantees that can be of benefit to banks that are financing SMEs during the different phases of their export process. Products such as "pre-shipment credit insurance and financing", "insurance against non-performance of a contract" and "export pre-financing loans guarantee" deal with short-term coverage, whereas products such as "bond insurance" and "post-shipment credit insurance and financing" deal with longer-

term coverage. COTUNACE aims to offer these products to SMEs at rates that are carefully calculated not to put too much strain on their budgets so as to allow them to be competitive in the international market.

Pre-shipment credit insurance and financing

SMEs need bank financing starting from the pre-shipment phase, when they have to finance the purchase of inputs, and pay for labour and other costs, in order to satisfy their export orders. To facilitate access by Tunisian SMEs to pre-financing bank loans, COTUNACE offers exporters and their bankers products covering two groups of risk connected with the conduct or situation of the buyer or the buyer's country, and risks inherent in the export trade itself.

Insurance against non-performance of a contract

Insurance against losses resulting from non-performance of a contract covers the losses actually incurred by a company in filling orders from a buyer as a result of:

- liquidation (legal insolvency) of the buyer, cancellation of the order by the buyer or the latter's refusal to take delivery of the merchandise;
- political events or disasters (war, revolution, seizure, nationalization, natural disaster, etc.).

Export pre-financing loans guarantee

This guarantee covers the risk of non-repayment of export pre-financing credits owing to the SME's failure to produce the goods, that is, its inability to fulfil the export transaction in accordance with the terms of its contract with the foreign buyer. The assessment of this risk focuses on the company's competence, the way it is managed and its professionalism and business integrity, and is carried out jointly by the exporter's bank and COTUNACE.

The main objective of this guarantee is to enable a large proportion of Tunisian SMEs to make a quicker transition from the international subcontracting phase to a direct export phase including the purchase of inputs at international market prices, which will greatly increase their income and thereby make it possible to improve product quality, increase investment and diversify export markets.

Bond insurance

This insurance is aimed at partially exporting companies operating under the temporary admission or industrial warehousing scheme. Bond insurance implies that COTUNACE

provides customs authorities with a permanent and comprehensive surety bond covering all the importer's customs obligations.

Post-shipment credit insurance and financing

Companies also need export financing once they have produced the merchandise, as their competitiveness in foreign markets and their ability to win export orders depends largely on their ability to offer attractive payment terms to purchasers. However, longer payment periods pose greater problems for the company's liquidity. Credit insurance makes it easier for companies to persuade banks to take into account money owed to them by companies abroad. COTUNACE therefore offers exporting SMEs various options to cover the risk of the buyer defaulting as a result of commercial or political risk or disasters.

Depending on the needs of the companies, insurance against non-payment due to either commercial risks (liquidation of the buyer or simply the buyer's insolvency) or non-commercial risks (war, revolution, non-transfer, natural disaster, etc.) is provided either in the form of customized cover for large one-off transactions, or permanent renewable cover equivalent to the payments received in respect of exports. This coverage is also available as part of a flat-rate insurance policy, which gives SMEs extra flexibility at the management level.

3. CONCLUSION

COTUNACE thus offers a very diversified range of services that meet many of the needs of exporters, especially SMEs, which form the backbone of the Tunisian economy. It is a leader in the insurance market for local exports and exports to Arab and African countries. It is making a positive contribution to the development of Tunisian SMEs by:

- improving exporting SMEs access to new export markets, including those involving risk;
- offering their clients competitive payment terms.

They are protected against the risk and the financial costs of non-payment and against the other risks to which they are exposed:

- due to COTUNACE's selection and supervision process, SMEs can improve the way they manage their customer portfolio;
- thanks to their insurance and, in particular, pre-financing loan guarantees, SMEs have less need of collateral to obtain bank loans;
- exporting SMEs can more easily make the transition from subcontracting to exporting finished goods.

B. INTERNATIONAL INITIATIVES

MAKING SMALL BUSINESS FINANCE PROFITABLE – IFC’S APPROACH

Renate Kloepfinger-Todd ⁵¹

1. WHY MICRO AND SMALL BUSINESS FINANCE?

Micro enterprises and small businesses account for the major share of employment in many developing countries. These enterprises thrive because they offer low-income populations opportunities for economic self-sufficiency. During economic crises, micro enterprises and small businesses are often the most resilient, serving as a crucial backbone of the domestic economy. Yet, despite their size and importance, these businesses rarely have access to the savings, credit and payment services provided by banks. Financial services for these ‘under-served’ businesses have been lacking for several reasons including the high transaction costs and perceived credit risks associated with small loans, and the unreliability of financial information from entrepreneurs that operate outside the formal economy. Consequently, these entrepreneurs must resort to informal channels with little flexibility and high costs.

Micro enterprises and small businesses cite the lack of financial services as one of the primary constraints to the growth of their enterprises. If economic development is to reach the millions of poor people around the world that run profitable microenterprises and small businesses, ways must be found to encourage formal financial systems to be more inclusive, so that large numbers of these under-served business people can obtain high quality financial services. Given IFC’s experience as a risk-taking financial investor in emerging markets around the world, it is well placed to help address this issue. Consequently, micro and small business finance (MSB) is increasingly playing a larger role in IFC’s financial sector strategy.

⁵¹ Principle Financial Specialist, International Finance Corporation (IFC).

2. MICRO AND SMALL BUSINESS FINANCE: AN EMERGING OPPORTUNITY

IFC's increased emphasis on banking services for the under-served comes at an opportune time. The globalization of the financial services industry has created fierce competition for the small pool of large and mid-size corporate clients in emerging and transition economies. As a result, new incentives have been created for financial intermediaries to move downstream to target the largely unclaimed micro enterprise and small business market. IFC aims to make micro and small business finance profitable and sustainable for financial institutions by improving risk / reward ratios so that they become attractive investment choices for financial intermediaries. In doing so, the volume and range of financial products available to micro enterprises and small businesses will substantially increase.

3. OBJECTIVES AND CHALLENGES

IFC aims to provide leadership for a massive global scale-up of commercially-oriented financial institutions (FIs), which will multiply the range, volume and reach of financial products for the under-served micro and small enterprise sector. IFC's efforts focus on two areas of intervention:

- Creating basic information services and infrastructure accessible to FIs in a country;
- Helping individual FIs, including microfinance institutions (MFIs) to profitably serve micro and small businesses.

The biggest challenge for small business finance lies in the fact that most commercial banks, that would be the natural providers of financing, are approaching this market - if at all - by using their existing corporate lending methodologies and processes, rather than developing market-specific approaches. The results are high transaction costs and poor asset quality. In addition, financial, communication and information technologies that have proven their value for small business finance in developed markets have yet to be field-tested and adapted for the relevant market conditions in developing countries. Financial institutions need to meet these challenges in order to achieve profitability in small business finance by:

- reducing the cost of acquisition of new customers;
- retaining credit-worthy customers;
- maximizing profit contribution per customer;
- optimizing fee income and interest income;
- reducing the cost of delivering the best possible service = quality at low transaction cost;
- maintaining a high quality portfolio.

4. SOLUTIONS

One of the principal ways to increasing the access of small businesses to formal financial services is to create conditions that encourage FIs to serve small businesses. The old unprofitable approach of providing limited services to a limited number of customers needs to be replaced by a ‘mass-customized approach’ that uses technology to increase the number of small business clients but at the same time reduces transaction costs, improves asset quality and broadens service offerings. The result is a business model that offers a complete set of financial services tailored to the needs of individual small business clients with an improved bottom-line contribution per customer, thus enhancing profits for the FI. This approach involves:

- identifying and adapting viable business models for IFC client FIs;
- introducing financial technologies that improve profitability and increase efficiency;
- investing in FIs that target small businesses; and
- building management expertise and knowledge through strategic partnerships, technical assistance and training.

5. FINANCIAL TECHNOLOGIES AND INFRASTRUCTURE

IFC launched a financial technologies global initiative in 2000 to help financial intermediaries such as banks, leasing companies and micro-finance institutions to profitably serve micro enterprises and small businesses by capitalizing on innovations in financial, information, and communication technologies. These technologies include lending strategies that have revolutionized the United States’ market for small business credit in the 1990s. Among them are credit scoring, mobile banking and broadened ATM networks. IFC is initiating several pilot projects in different parts of the world that will adapt proven business models and technologies to the respective market and situation of the partner FIs.

Development of the financial infrastructure is a pre-condition if FIs are to make effective use of technologies such as credit scoring. Reliable information from credit bureaus enables lenders to make rapid credit decisions driven by data and forecasting models, rather than relying exclusively on subjective assessments of credit officers. These tools hold great potential for micro and small business finance in emerging markets. IFC is engaged in several initiatives to build this critical infrastructure.

6. CAPACITY BUILDING

Common to all approaches to the development of micro and small business finance is the need to combine financing with well-targeted technical assistance in order to bring needed operating know-how, expertise, and MIS/IT systems to FIs and MFIs. IFC advisory services focus on:

- market studies, feasibility studies and business plans for FIs and MFIs seeking to engage profitably in the delivery of services to micro and small businesses;
- building the institutional capacity of FIs and MFIs;
- capacity building of management and staff;
- development of new products, systems and technologies to enhance productivity and better meet the needs of clients.

Advisory services range from stand-alone technical assistance (TA) and one-project TA, to regional replication and TA linked with parallel investments or follow-up investments. Using this comprehensive approach, IFC aims to increase its development impact, closely aligned with its mission, to promote sustainable private sector investment in developing countries, help to reduce poverty and improve people's lives.

INNOVATIVE APPROACHES AND SUCCESSFUL PROGRAMMES IN COMMERCIAL BANKING FOR FINANCING SMES IN TRANSITIONAL ECONOMIES

Radhakrishna Narasimham⁵²

1. ROLE OF THE BANKING SECTOR IN TRANSITIONAL ECONOMIES⁵³

The role and objective of banking systems in formerly centrally planned economies was totally different from those in market economies. In both Western Europe and North America, banks constituted the principal source of credit for SMEs⁵⁴ throughout the 1950s, 1960s, and 1970s until their capital markets developed in the 1980s to offer SME entrepreneurs alternative sources of capital. This was because the banking sector was entirely in private ownership but regulated rigorously albeit prudentially. Central banks did not assume activist roles. Deposit insurance was established by governments as a form of security for bank deposits. Since banks were privately owned and accountable to their shareholders, they sought efficient financial intermediation and profitability as the rationale for their very existence. Banks' credit and intermediation decisions were autonomous as was their risk

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⁵³ The contents of this paper are based on certain cardinal hypotheses. **First**, SMEs must *a priori* have a potential competitive advantage in the economy, which can be actualised catalytically, through the timely availability of credit. Timely availability of credit can add value to the success of SMEs provided they have a potential competitive advantage and operate in an enabling environment not distorted by uneconomic fiscal, regulatory, credit and exchange rate policies. From this, it follows that conversely, in the absence of competitive advantages (listed above) for the SME sector, directing credit to the SME sector could be an exercise in value subtraction. **Second**, a financially sound banking system is necessary for efficient financial intermediation. Efficient financial savings and investment decisions that need comprehensive, timely and accurate information and prices and interest rates that reflect their underlying supply and demand conditions. This means that there should be no directed credit. The efficient monitoring of financial markets depends on decentralized decision-making and risk taking by banks when banks themselves assume the risks in credit intermediation. This would facilitate the economic delivery of credit to those sectors which have a competitive advantage to absorb and use such credit to add value to their output and, to enable such borrowers to repay their loans on schedule. Potential competitiveness of the SME sector, coupled with that of the commercial banking sector, are necessary ingredients for successful lending to SMEs.

⁵⁴ The term *small and medium-sized enterprises* in the context of transitional economies refer to those enterprises which: (i) usually employ less than 500 person; and (ii) are engaged in highly capital intensive sectors such as mining, steel manufacture, petroleum refineries, chemical industries, automobile manufactures, machine building, shipbuilding, and substantially privately owned (i.e. its ownership should no be vested with the state). The above definition is illustrative and not necessarily exhaustive.

assumptions. Their lending to SMEs was dictated by their independent policies for profitability and risk diversification and not based on any governmental fiat.

By contrast, in transitional economies⁵⁵, the banking sector during the days of central planning was entirely state-owned and controlled. Its role was restricted to controlling the release of centrally planned and budgeted expenditure to ensure realization of state planned production targets. Banks did not make independent credit decisions as all bank credits were directed by the state planning authority. Banks had no incentive to develop tools such as risk management, credit appraisal, and project screening or selection mechanisms for assessing income generation and solvency of their borrowers. Such countries originally began with mono-banking systems. Subsequently, sector-specific banks evolved. Several state-owned enterprises generally in the large-scale manufacturing or extractive sector established banks, which funnelled public deposits and lent them back to their owners. This narrowly focused sector-specificity among banks resulted in a high degree of loan (and risk) concentration. It also resulted in close relationships between banks and their owner-borrowers when credit decisions were not always made on financial criteria. Banking regulation and supervision varied in rigor but was more activist than prudential. This was a remaining vestige of the era of central planning.

The formal ending of central planning in the early 1990s saw the emergence of several new privately owned banks with high risk portfolios, which continued to remain concentrated. Generally, a low level of bank assets combined with high inflation saw limited opportunities for the growth of banks' balance sheets. High inflation resulted in high nominal interest rates, which had severe implications for banks' ability to raise long-term funding. This in turn created liquidity problems for them. Banks' capitalization remained low by the Basle Standards. The ratio of bank deposits to GDP also remained low, indicating a low level of banking penetration. This reflected a low confidence level in the banking system, which could be attributed to (i) fear of collapse of the banking institution itself (as was witnessed during the Russian financial crisis of 1998), and (ii) tax authorities' discretion for search and seizure of bank deposits without adequate legal due process to the depositor. These factors combined with high inflation, limited banks' ability to raise adequate funding. Banks, although nominally privatized, continued to be managed as de facto state-owned financial institutions. Banks' non-performing portfolios increased rapidly. In some countries such as Kazakhstan or the Kyrgyz Republic the rate of bank failures was high. In others such as Uzbekistan, the government extended sovereign guarantees to directed loans made by banks

⁵⁵ The term *transitional economy* refers to an economy that was formerly centrally planned but subsequently began moving towards the market with varying degrees of decentralization or privatisation of the means of output. During the central planning era, all or substantially all enterprises in the economy were State-owned. Their output targets were determined according to the central plan. Enterprises did not have any autonomy in their output decisions based on market demand. Their financing was also provided for by the State in accordance with the central plan.

to specified state-owned enterprises often at less than market interest rates. The share of SMEs in bank lending therefore remained low compared with figures for OECD countries.

In some transitional economies (e.g. Kazakhstan), governments, and the central banks under World Bank or IMF led stabilization programmes have sought the closure, merger and re-capitalization of poorly performing banks. Central banks adopted prudential regulatory and supervision standards and mandated the accepted Basle Standards of capital adequacy for banks. Simultaneously, banks were required to classify their portfolio on a qualitative basis and make loan loss provisions accordingly. Their increased capitalization through mergers or acquisition was used to strengthen their financial condition. In other transitional economies, the government or the central bank assumed a significant portion of banks' non-performing loans, replacing them with relatively more liquid government bonds. For newly reformed and re-capitalized banks such bonds constituted safer and more liquid portfolios than lending to SMEs. Further in transitional economies, particularly in Commonwealth of Independent States countries, under the conditionalities of IMF or World Bank structural adjustment programmes, as part of overall inflation control measures, fiscal deficits had to be curtailed severely. Government borrowings from central banks had to be only through new treasury bills, whose interest rates tended to be higher than the inflation rate. The high real interest rates which resulted had two effects which acted as disincentives to bank lending to SMEs. First, banks found that keeping their liquidity in short-term treasury bills was both relatively safe and profitable. Safe, because the risk of default by the state on its treasury obligations was considered less than in lending. It was profitable because the short-term (risk adjusted) real yield was indeed high. This had the effect of crowding out borrowers from the private sector from banks. Secondly, high real interest rates on sovereign short-term debt stunted the growth of a long-term debt market, whose interest rates could have constituted a benchmark for the pricing of long-term lending to SMEs. Banks, now subjected to stricter prudential supervision, wished to avoid maturity mismatches by lending long against a relatively short-term funding base, particularly in the absence of long-term benchmark rates.

2. BANK LENDING TO THE SME SECTOR IN TRANSITIONAL ECONOMIES⁵⁶

Problems in the banking system itself at the macro-level

Banks' major constraints in SME lending were (i) a dearth of long-term funding for banks for reasons stated earlier; (ii) crowding out of the private sector by government borrowings; (iii) low level of banks' capitalization; (iv) absence of long-term benchmark lending rates; (v) directed credit albeit in a diluted form (through sovereign guarantees, which could sometimes constitute a moral hazard); (vi) distortions in domestic interest rates which made it difficult for banks to price their lending;⁵⁷ (vii) credit decisions based on ownership and propinquity rather than on financial criteria; and (viii) in countries following restricted exchange practices such as multiple exchange rates which in effect subsidized the import of capital goods and taxed exports, banks were reluctant to lend in foreign exchange to SMEs whose repayment capacity would have been constrained by any major exchange rate depreciation.

Problems faced by banks at the micro-level

The major problems banks faced internally in lending to SMEs were (i) lack of access to long-term loanable funds and particularly so in foreign exchange needed for financing SMEs' capital investments; (ii) lack of adequate experience in the appraisal of project-finance lending to SMEs; (iii) lack of credit culture in banks to monitor and supervise loans after disbursement until recovery; (iv) poor standards of accounting and financial disclosure in transitional economies which made banks reluctant to rely on SME borrowers' financial statements and insist instead in adequate collateral; (v) SMEs' lack of collateral for their lending operations; and (vi) high transaction costs for SMEs in transitional economies due to regulatory leasing and fiscal distortions prevalent in these countries towards SMEs, which raised their (SMEs') working capital costs disproportionately, thereby questioning the SMEs' viability in the banks' judgment, which made SME lending a higher credit risk.⁵⁸

⁵⁶ The development of SMEs in transition economies varies enormously from region to region. In Central Europe and the Baltic Republics, SMEs are well developed and play a considerable role as engines of growth. Poland has two million SMEs while the Czech Republic and Hungary have one million each. SMEs in these countries employ nearly half its workforce and account for half of the GDP (Masaru Honma "*SME Development in Transitional Economies*"). By contrast in Uzbekistan, SMEs contributed to merely 7.6 per cent of employment and eight per cent of GDP (Ministry of Macro-Economics and Statistics, Republic of Uzbekistan) in Kazakhstan SMEs accounted for 40 per cent of total employment and 13 per cent of GDP (Ministry of Macro-Economics and Statistics, Republic of Kazakhstan). The focus of the analysis in this paper has been centred primarily on the SME sectors in Kazakhstan and Uzbekistan. Instances of SMEs elsewhere will be cited as a comparison where relevant.

⁵⁷ In some countries, banks were required to compulsorily lend certain amounts to SMEs from their liquidity pool at subsidized interest rates. To avoid doing so, banks deliberately placed their liquidity either with the Central Bank or treasury bills which they considered safer even if it meant they had to cut back on other lending. While it may have deprived banks of perceived opportunities for profit by lending to larger industries, it nonetheless enabled them to avoid their perceived risk of lending to SMEs.

⁵⁸ The increased bureaucratic cost of doing business did not necessarily generate higher returns, which in the absence of collateral made lending more risky.

The absence of collateral or foolproof steps for its enforcement warrants special mention since it has been an important factor inhibiting bank lending to SMEs particularly as banks do not rely on their borrowers' past financial statements or projected earnings as the bases for their credit decisions.⁵⁹ In many transition economies, property rights, particularly for land are not clearly established. Judicial processes for the foreclosure of loans through the enforcement of collateral are oftentimes dilatory and cumbersome. Valuation of collateral presents another problem for banks particularly in countries such as Kazakhstan where some erstwhile Soviet-era industrial cities (particularly those built around a single industry) rapidly became depopulated, following the closure of such industries and the migration of the cities' population which decreased demand for real estate. These developments resulted in the reduction of the estimated value of real estate in a particular area, which further increased banks' reluctance to accept land as collateral except at a steep discount (for reasons of perceived fall in value or difficulty in enforcement) which could make loans unattractive to borrowers.

Innovative mechanisms used by commercial banks to address constraints to SME lending by serving their SME customers better

ADB processed two loans to Uzbekistan for financing SME development. Both were credit lines channelled through commercial banks albeit under sovereign guarantee. The banks have demonstrated their innovativeness in overcoming constraints within the country's context in serving their SME customers better. The banks obtained long-term credit lines from ADB for 15-year durations. This in turn allowed the banks to lend to their sub-borrowers for durations of, longer than could be obtained in the market commercially. It was also for a longer duration than what the banks themselves could obtain in the market commercially. Moreover, by borrowing from ADB for 15 years and lending to SMEs for durations of eight years, the banks were able to recycle loan funds from repayments and use these recycled funds to make new loans to SMEs. This recycling process increased both the banks' and SMEs' access to long-term funds.

ADB mandated that its (ADB's) loan could finance not more than 75 per cent of the total cost of any sub-project. At least 25 per cent of the cost of each sub-project had to be financed by sponsors' equity. This provided banks some level of comfort. Where the borrowers lacked the 25 per cent minimum equity contribution, but whose projects were otherwise viable, the banks scouted for co-equity investors from other venture capital sources in the country.

⁵⁹ This is because (as discussed), banks do not have adequate appraisal skills, which could have enabled them to appraise a potential loan on the basis of its future cash flows, and poor financial disclosure standards would not be able to provide banks a true picture of a borrower's real worth.

Both the ADB's loan to the commercial banks (through the government) and the banks' lending to the sub-borrowers were also denominated in US dollars. Since the loans were US dollar-denominated, their pricing was benchmarked by reference to six months' LIBOR, thereby overcoming another constraint in the pricing of loans caused by domestic distortions.

ADB's loan financed only the foreign exchange component of a project's cost. The banks were therefore careful in the selection of end-borrowers. They chose those end-borrowers whose projected cash flows were forecasted to be adequate for repayment of loans even in the event of devaluation. Banks preferred lending to sub-borrowers who had foreign exchange earnings. For its part, ADB conducted extensive policy dialogue with the government and was able to persuade the latter that (i) all foreign exchange to be obtained by SMEs in the country for acquiring imported inputs or repaying loans to banks would be at the market (over-the-counter) rate and not at the overvalued official rate; and (ii) any foreign exchange surrendered by SME exporters to the government would also be at the market rate and no longer at the overvalued official rate. The government guaranteed the availability of foreign exchange to SMEs at the market rates by decree.

Taking the cue from ADB's policy dialogue, the banks themselves in some cases were willing to make working capital loans to SMEs in local currency to complement their dollar loans at rates similar to LIBOR⁶⁰ but adding several percentage points premium.

The commercial banks benefited significantly from ADB's technical assistance grants provided with its loans. The grants financed the remuneration of expatriate credit and accounting advisors to the local banks. The advisors revamped the banks' credit policies to train the banks' credit officers to determine a potential project's future cash flow and take a credit decision based on such cash flows. The foreign credit advisors also helped promising local entrepreneurs to prepare sound business plans that would be acceptable to the banks. Knowing the generally poor state of locally audited financial statements of prospective borrowers, (owing to poor disclosure and reporting standards) the expatriate accountants recast completely the borrowers' financial statements to raise them to a standard acceptable to banks to make rational credit decisions. ADB's technical assistance to the banks benefited them from a holistic way (i) improving their appraisal capacity, thereby enabling banks to make their credit decisions based on future cash flows; (ii) imbibing in them a credit culture and consciousness; and (iii) enabling them address at the micro-level the problems of poor accounting standards which inhibited bank lending to SMEs.

ADB's loan provided banks with a supply of long-term foreign exchange funds to lend to worthy borrowers. ADB's strict sub-project criteria (financial internal rate of return, debt-service coverage ratios, debt-equity ratios, etc.) provided coordinates to the banks in making rational credit decisions and in choosing their end-borrowers carefully. Most importantly,

⁶⁰ London interbank offered rate.

ADB's policy dialogue with the Government of Uzbekistan helped the government to reduce greatly the distortions in its exchange rate policies and practices to enable SMEs to realize their potential competitive advantages. ADB's policy dialogue with the government also helped the government to pass legislation considerably freeing SMEs from multiple regulatory and licensing requirements, thereby reducing SMEs' transaction costs in terms of economic rent. Saving such transaction costs helped to reduce their working capital requirements and made them less credit risks for commercial banks.

Problems of collateral and alternatives thereto

Given their relative inexperience in making credit decisions on the basis of future cash flows, and given the poor state of their accounting standards, banks have traditionally relied on collateral as a means of risk reduction. Banks have a large, and more or less stable, pool of funds, usually with different maturities. It is true that transition countries with underdeveloped volumes of savings cannot supply long-term funds in large amounts. Yet the banks very often could do considerably more to offer medium and longer-term funds, even without such a medium and long-term refinancing basis, simply through a more determined term transformation. But this is not attempted often enough. As a rule moreover, the banks are not sufficiently innovative to offer to the market a larger range of term-deposit or securitized funding products. The banks' first mission is to transform credit risk on the basis of their supposed specific expertise in this field and the averaging principle applied therein (ie. risk diversification). Banks must therefore find a suitable middle way between risk aversion and risk propensity. In the transition countries, the banks have a very short track record in genuine credit experience, evaluation, and thus real credit-risk transformation. Since the banks in transitional economies in the past were little more than liquidity channels on behalf of the central economic plan and not real risk evaluators and transformers, their pronounced risk-aversion in the period of transition (after some initial "wild" phases) should hardly be surprising – the more so since the now commercial banks had inherited substantial non-performing debt from the not so glorious past. Financial markets in transition economies are not yet adequately developed to create asset-backed securities, which would have enabled banks to create credit adequately out of their portfolios. As collateral has constituted a problem for SMEs, two other alternatives were explored by banks for lending to SMEs without adequate collateral. These are discussed below.

Impact of leasing on financial sector development 61

Through leasing, banks and other lending institutions are able to reach SMEs, widening the range of clients for the banks. Leasing companies lend to small enterprises on the basis of cash flow and not exclusively on the lessee's credit history or additional collateral. In the initial stage of leasing, lessors usually borrow money from banks and other lending institutions; banks thereby acquire a broader base of medium-term assets in which to invest.

⁶¹ Source: Veronica Cheltmakh, Role of Leasing in Transitional Economies.

As a leasing company grows, it can issue notes or bonds on the securities market. Lessors can also securitize their lease receivables, thus creating another marketable security. This phase occurs when a leasing market matures. It must however be pointed out that lease financing can only facilitate the investment capital requirements of SMEs. It cannot be used to finance an SME's working capital requirement. A problem also arises in the valuation of imported lease assets and changing depreciation thereon in a market with rapidly deteriorating exchange rates.

Third party credit guarantees

Third party credit guarantees usually from the government have been resorted to for SME related lending by banks. In several instances, governments have extended guarantees to commercial banks to secure their "priority" lending. Government guarantees could be construed as a moral hazard if they encouraged commercial banks to make poor credit decisions. However, in ADB loans the credit risk remains with the commercial bank concerned. The sovereign guarantee is applicable only on repayment to ADB. Usually under ADB loans, the commercial bank in the borrowing country opens a letter of credit on behalf of its borrower. When goods are shipped against this letter of credit, the commercial bank pays for the goods against their documents of title. Thereafter, ADB reimburses that commercial bank directly through its correspondent account. The commercial bank's liquidity is thereby balanced. The commercial bank usually converts this initial trust receipt loan (on which it made payment against documents) to its borrower into a term loan. However, the commercial bank is duty bound to recover the loan from its borrower and repay ADB through the government. Only if the bank fails to repay ADB will the government step in (as a guarantee) to repay that instalment. In such a situation, the government is called up to pay under the principle of subrogation and may recover the money from the banks and/or the borrowers. By extending a sovereign guarantee, the government is benefiting from ADB's low cost of funds given ADB's excellent credit rating. The sovereign guarantee in turn enables ADB to extend long-term lending through the government for SME development.

3. CONCLUSION

The provision of finance to small and medium enterprises in transitional economies at market interest rates presents challenging opportunities for commercial banks. It helps them to diversify their portfolio and hence help reduce concentration risk. Through extensive networking, it could also help commercial banks raise and diversify their deposit and other funding bases. This would be beneficial to banking penetration and more efficient financial intermediation. It would provide them invaluable experience in strengthening their credit appraisal skills and in developing new and innovative financial products tailored to the specificity of each market. It could provide banks with the knowledge of efficient financial intermediation without the confines of collateral. Rhetorically speaking, it could enable banks

to think about what to lend for rather than what to lend against. This could play a catalytic role in improving capital formation in transitional economies. In the ultimate analysis, lending to SMEs should be seen as an opportunity by banks for profit optimization rather than a state mandated directive.

SME EQUITY FINANCE: THE SMALL ENTERPRISE ASSISTANCE FUNDS' (SEAF) EXPERIENCE

John Bays ⁶²

Early stage equity investment is an alternative and complementary source of funds for SMEs, which can help small enterprises from developing countries to enhance their access to additional sources of long-term financing. Among the issues discussed in this article are the elements of successful risk capital funds in reaching SMEs, advantages and disadvantages and the latest trends in SME equity financing.

1. SEAF'S MISSION

The Small Enterprise Assistance Funds (SEAF) is an active fund manager based in Washington, D.C. that has been dedicated since 1990 to equity and risk capital investments in SMEs in emerging markets. SEAF started initially in Poland in 1990 and concentrated predominantly on Central and Eastern Europe countries. In 1997 the organization initiated operations in Latin America with the opening of a fund in Peru followed by the start of operations in Bolivia in 2000. SEAF also maintains operations in China and is undertaking new initiatives in India, Central Asia and the Philippines, and is also expanding operations in Latin America to include Colombia, Chile, Brazil and Argentina.

The primary mission of SEAF is to provide SMEs with private equity financing linked to technical and administrative assistance. Most of the markets where the funds operate are underserved and there is a thirst for equity finance. Another important goal is to generate commercial returns since, according to SEAF's experience, without generating commercial returns, the SME risk capital industry will not be able to attract private capital and will not be sustainable over the long-term. An ultimate goal of SEAF is to promote the creation of capital markets for SMEs, which in emerging markets have so far remained underdeveloped.

⁶² Regional Director, Small Enterprise Assistance Funds (SEAF), Bolivia

2. SEAF'S OPERATIONS

SEAF manages 14 funds for multilateral and private investors throughout the world. The SEAF Management company, SEAF Management LLC, is a for profit subsidiary of the Small Enterprise Assistance Funds. The profit orientation in the venture capital industry is vital to have the necessary incentives to attract the right types of people in order to manage these funds and select proper investments. Normally, the deal flow is generated using local contacts, partners, various associations, targeted industries and project filtering. Each fund is operated with staff of approximately five investment personnel primarily individuals with experience in the local markets where the funds operate. SEAF's portfolio of investments system-wide comprises more than 190 investments of an average size of slightly more than US\$300,000 per investment. SEAF uses equity, quasi-equity and debt investment combinations to finance the growth of the SME's in which it invests. SEAF has also successfully exited 35 of its investments and has capital currently under management or committed to new initiatives totalling approximately US\$300 million.

3. THE CRITERIA FOR THE SUCCESSFUL SME RISK CAPITAL FUNDS

According to the SEAF experience, successful investment managers must emphasize certain key success factors. Some of the most important elements include the following:

- Experienced fund managers: the evidence about equity finance for SMEs in developing countries has shown that there is a desperate need for experienced fund managers. Many people have intervened in venture or equity capital, without having the necessary expertise, and there have been dreadful results because of that lack of experience;
- significant and high-quality deal flow: this is a difficult element to be found in developing countries because if you take the model of the venture capital industry developed by the United States in the 40s., 50s., and 60s., it relied essentially on quality business plans, well presented financial statements and projections. These elements are lacking in most of the markets where SEAF works. Most businesses do not have business plans and many have two or three sets of accounting records eroding confidence in the entrepreneurs and financial projections. These elements can hinder the development of a flow of quality projects;
- professional business managers: there is also a lack of management experience in many of the enterprises to which SEAF directs investment. In general, most entrepreneurs are very much dedicated to what they do. They may be a production or sales person but they do not have the overall ability to manage a growing venture. Therefore, a competent and motivated management team is fundamental for the success of an SME;

- adequate deal size: when SEAF started managing funds in 1990, it concentrated on many small deals. However, experience has shown that to be successful it is necessary to broaden the scope of the size of the financial investment in order to have deals in the portfolio that could be capable of producing returns sufficient to “make the fund”, thereby returning all the equity that has been invested by the shareholders plus a handsome return;
- added value through collaboration with technical assistance providers and the provision of assistance in securing additional financing: this is a key criterion for SEAF. Adding value to SMEs is fundamental since for most of these enterprises not only is financing growth indispensable, but they also need some form of additional training, opening of new markets, technology, and all the different things that an experienced business operator can bring to an SME, along with equity capital. To do that, SEAF collaborates strongly with technical assistance agencies and provides assistance in securing additional financing to support the continued growth of these operations.

As an example of “added value”, which is essential if equity capital is going to work, SEAF with the support of a grant from the Swiss Government, developed a business-to-business web site portal (www.SMExport.com) to enhance the value of its SMEs, helping them to get their products to markets. The web site is now functioning and there are four Bolivian companies and one Peruvian company that are currently listed on line with this company. Furthermore, SEAF business development units (BDU), located in the Netherlands and the United States (Washington), work on opening new markets for SMEs and bringing purchasers to the producers. By taking goods and samples to New York to fashion designers, by visiting trade shows with the different enterprises, by conducting market research and sourcing technology, SEAF adds values to the enterprises in the funds it manages. All this is a part of the value added that SEAF does in order to make these SMEs successful.

SEAF has also established partnerships with local associations (chambers of industries, exporters, etc.) or the so called, business development services (BDS) providers to keep up a quality deal flow of SMEs and reduce SEAF costs in analysing those deals (selection process). In addition, SEAF works with several donor agencies. In Latin America SEAF has worked with the Swiss Government to fund the initial set up of the [SMExport.com](http://www.SMExport.com) initiative. SEAF also works with another Swiss organization, which is FUNDES (Fundacion de Desarrollo Sostenible), based in Costa Rica and founded by Swiss donors. FUNDES has worked in collaborating with technical assistance and together with SEAF designed a diagnostic programme that allows SEAF to really know what the businesses and the entrepreneurs are about before making an equity investment decision.

In fact, as SMEs need handholding in the pre and post-finance stages, BDS providers as well as donor agencies could play a key role providing resources and elaborating programmes dedicated to increasing the knowledge, expertise and competencies of SMEs, bringing their entrepreneurs to a level that they can interact with commercial banks or private equity funds in order to obtain financing.

4. ADVANTAGES AND DISADVANTAGES OF SME RISK CAPITAL

The risk capital industry offers advantages and disadvantages for SMEs. According to SEAF's experience, one of the advantages is that it can provide extremely profitable returns if run properly. During recent years, the SEAF experience has enabled the organization to properly combine analysis, investment and assistance to generate successful returns from SME investment. SEAF is convinced that SME risk capital investing can be an extremely profitable method of investment by selecting promising, often undervalued companies and providing them with growth capital.

Nevertheless, SME equity capital funds also have disadvantages. They are not appropriate for all SMEs, particularly for smaller companies that lack the production or service quality and scalability to effectively compete. Equity risk capital is correctly targeted at companies with prospects for substantial growth within five years following investment. Although investment will likely include technology companies, there are many manufacturing, service and processing companies that have quality goods and services that can compete internationally in niche markets.

In addition, equity investment for SME's requires a significant involvement from fund managers in SME mentoring and support. Not all fund managers are prepared to do it. Therefore you need someone who is committed and available to work hand in hand with the SME entrepreneurs. Furthermore, since developing countries have illiquid markets, exit strategies are a difficult issue for SME venture capital funds. In the case of SEAF, the fund actively searches for prospective exit opportunities such as a strategic purchase by a competing firm even before making the initial investment.

For example, in the Jolika Bolivia SRL enterprise (see Box 3 below), when SEAF was doing the due diligence on that company, the fund looked at competition and found that the competition would be keenly interested in this type of company because this enterprise is a niche player and makes a specific product in the industry. Then SEAF pre-shopped the company before actually signing the investment deal. Since that time SEAF has continued to visit prospective buyers. There is an ongoing obligation and a need to make sure that there are qualified purchasers. Since the funds' enterprise investment cycle has a duration of between three and seven years, the fund manager needs to be ever conscious of possible exit alternatives and aggressively pursue the best options. In addition, one of the things learnt through the SEAF's experience is that there are different experts for different jobs in venture

capital. For instance, the person who raises the fund or that manages the initial deals is probably not the person to find the exits needed to generate the successful portfolio return. Both in Europe and in Latin America, SEAF has hired skilled individuals that are able not only to shop the portfolio for exits but also to structure the deals for those exits.

5. TRENDS

The latest trends in private equity investment demonstrate that there exists the need to attract private pension funds, insurers and other private investors who are looking for high percentage returns. Governments have recognized the dynamic nature of the SME sector, which means that there are government resources available for equity capital investment in SMEs, but these resources are insufficient and serve only as a catalyst for private investment. Providing commercial returns on investments will continue to be necessary in order to ensure the sustainability of the industry. The development of partnerships between the public and private sectors and creative mechanisms for channelling resources to equity funds will help to further promote the involvement of private investment dedicated to SMEs.

A number of trained fund managers are also beginning to show success in the market. The existence of a number of qualified fund managers helps to form a critical mass of investment professionals and further develops a culture of equity capital in each of the countries where SEAF operates.

SEAF has found that quality SMEs in its managed portfolios can attract follow-on private equity capital for future growth and are interesting candidates for sale to strategic purchasers. A trend of obtaining successful exits from SME investments is an encouraging factor and will continue to strengthen the interest of the private sector in investing in SME equity funds.

Box 3
The Case of SEAF in Bolivia

SEAF started in Bolivia in March 2000 with committed funds of US\$8.6 million. To date, SEAF has reviewed 194 projects, which reflects a very intensive search to keep up the deal flow, and it has engaged in nine projects for investment for a total of US\$5.2 million. Most of the companies which the fund looks at are high growth companies and export oriented. This can be understood by the small size of the Bolivian market and the few economic resources available to promote the growth of the companies in which SEAF can invest. The average deal size has been US\$575,000 (equity and debt), with an average revenue growth of 41 per cent.

Jolyka Bolivia SRL: producer of parquet flooring from certified woods

SEAF's first investment in Bolivia was in a producer of hard wood flooring from certified woods. The fund took a 35 per cent equity holding for an initial US\$400,000 investment. In addition SEAF gave the company US\$200,000 in convertible debt and US\$260,000 as short term subordinated debt. The success of Jolyka Bolivia SRL has been dramatic, taking into account that it was a company that had a mature debt of US\$1.9 million and when SEAF entered into the company it was technically in default. Then SEAF worked with the banking sector and was able to renegotiate the company's debt. Six months after the entrance of SEAF, from August 2000 until the end of March 2001, the fund took the company sales from US\$ 800,000 to US\$ 2 million, and sales of US\$ 4 million were projected for the end of the year 2001. But, these positive results were achieved not only because of the finance, but there was obviously a value- added component that contributed to the success. For example, SEAF imposed financial controls. It made sure that the enterprise had in place an adequate cash flow management system and it opened new markets for the company through the establishment of distributions systems in the United States and in Germany. The idea was to help the company to reach markets where its product sales could grow. In addition, Jolyka Bolivia SRL was included in the web site SMExport.com.

C. COMPLEMENTARY BUSINESS SERVICES

BUSINESS MENTORING GUIDANCE FOR GROWING SMEs

Brian Dunsby⁶³

INTRODUCTION

The purpose of this paper is to bring the expertise that is available in developing countries to help new SMEs to start up and existing SMEs to grow. It does not describe a long-range consultancy service, but instead presents a local model, which enables the establishment of a framework for small business support.

1. WHAT IS A SMALL BUSINESS?

In the United Kingdom there is a typical mixture of small, medium and large businesses - nearly 95 per cent have fewer than 10 employees. If the companies in the 10–249 employees range are added 99.8 per cent of British businesses are SMEs. That is out of a total of 3.7 million businesses in the United Kingdom. These figures also remarkably similar to those found in other countries. Small business is however, not just about statistics. To quote from Prof. Allan Gibb, Durham University Business School:

- small business is a way of life;
- it is about personal risk;
- it means managing interdependencies;
- know-who & know-how most important;
- small business means standing alone;
- it means the buck really stops with you ;
- it means learning by doing.

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The simplest model to understand the small business sector is where small businesses are described as a tripod or a three-legged stool:

- product or service know-how;
- marketing and sales ability;
- finance and accounting skills.

Out of the three legs there is usually one very strong leg, the product or service knowledge that the entrepreneurs bring to their business. Sometimes they also have marketing and sales ability and expertise to take their products or services to the market place and obtain orders. Rarely do the SME entrepreneurs have the finance and accounting skills that are needed to make a success.

2. SMEs NEED HELP

When SMEs are asked what sort of help they need, the first thing they say is help with their marketing and sales to get more orders. Then it is finding finance, controlling cash flow and the associated accounting and credit control procedures. Below is the help that SMEs need in the United Kingdom ranked in order of priority. This list probably applies in many parts of the world:

- marketing and sales;
- finding finance, cash flow;
- accounting , credit control;
- computers and IT;
- employment;
- production quality;
- health & safety.

With regard to finding finance, the real problem is not the shortage of finance but the lack of sound proposals worthy of financing, especially for small business owners, particularly the micro end of the spectrum, the 0-9 employee businesses where usually there is just one leader in the business. They do not have a management structure in place and are very much on their own. They need help and guidance, a confidential assessment of their ideas and options in a positive, non-threatening manner before they go along and ask the bank for money. They do not have the confidence to approach the bank without such support and in many cases the banks rebuff them if they have not done their homework correctly.

3. BUSINESS MENTOR SCHEMES

In the United Kingdom there is a multiplicity of business development services. There are in fact too many. It is confusing and SMEs do not know where to go. At the end of their search they are usually put in touch with one of these various functions, which all support SMEs:

- information officers;
- business advisers;
- business counsellors;
- business mentors;
- trainers and assessors;
- management consultants.

The model that the Institute of Business Advisors (IBA) has found most useful, which is now being exploited in other parts of the world, is the concept of a mentor - taken from Greek mythology – “experienced and trusted adviser”. When translated into the business sector a mentor refers to someone who is experienced in business, trustworthy and professional, trained and up-to-date in their advice. These people should be either voluntary or on a low fee structure, but not a full fee consultancy service.

Again in the United Kingdom and the Republic of Ireland there are a series of business mentor schemes, for example:

- Business Links - UK SBS;
- The Prince’s Trust – Business;
- Northern Ireland - LEDU North Star Programme;
- Enterprise Ireland – Forbairt.

The Enterprise Ireland (Forbairt) scheme has been a long-running and very successful business mentoring programme. The key to all of these schemes is that they enrol as business mentors people with substantial business experience who can then translate their experience to guide the new entrepreneur.

These principles have also been developed in South Africa. The South African Banking Council, conscious of the needs of their emerging sector, particularly from the previously disadvantaged communities, has promoted the Women’s Enterprise Scheme particularly and the also the Young Enterprise Scheme. The banks have come together under the Banking Council of South Africa with a scheme known as “SIZANANI”. It makes available funds in

Rand equivalent to US\$1,000 up to US\$5,000. These are small amounts of money, but absolutely vital for a start-up family business to get under way. Likewise for larger sums, the KHULA Mentor Programme operates along similar lines. The government's NTSIKA Credit Guarantee Scheme backs all of these schemes.

Business mentoring stages

The key to these programmes is the connection between finance and non-financial support. The scheme in each case goes through these stages:

- initial meeting to build empathy;
- diagnostic evaluation, SWOT⁶⁴ and funding;
- action plan – markets and money;
- monthly review meetings and accounts;
- emergency help-line and call-out.

The initial meeting is with a selected business mentor, who appears to meet the needs of the client in terms of industry experience, geographical location and technical skills. That initial meeting builds empathy, leading to a mutual understanding and respect for the innovation and enterprise of the entrepreneur, complemented by the expertise and experience of the mentor.

The diagnostic evaluation phase is critical. Then a business plan is drawn up by the client, not drawn up by the mentor, but guided by the mentor in such a manner that market potential and the money needs of the business are quantified and put onto a time-scale according to the banking community's needs.

Once the mentor and the bank have approved the business plan, and the funding has been made available, the business begins. A monthly review meeting is then critical to look at the results and the performance in terms of sales and the accounts. In addition to the monthly review there is always the emergency help-line. At any stage, the client feels able to call on his business mentor with his latest problem, talk it through and maybe have a special meeting.

The concept is well recognised and these schemes are working well in the United Kingdom and South Africa, where they have almost been so successful that the problem is in their administration and the demands being placed upon the system.

⁶⁴ Strengths, Weaknesses, Opportunities, and Threats Analysis – Typically a part of a business appraisal that identifies the market potential and the management ability of the team and the financial needs and what security and repayment they can offer.

United Kingdom quality frameworks

It is vitally important to have a quality framework for business mentors. The Institute of Business Advisers United Kingdom Quality Framework incorporates all of these elements:

- business Experience – four alternatives routes;
- business Management Training – check list;
- business Adviser Training – core skills;
- business Adviser Experience – wide range;
- adviser Competence Assessment vs. Standards;
- continuing Professional Development (CPD);
- professional Indemnity Insurance (PII);
- code of Conduct + annual undertakings.

Business experience

Business experience is fundamental for the mentor, but it is available by a number of alternative routes. Business management training should have been acquired in a ‘former life’ as business managers in their own business or a large company. There is also a check-list to control this. Likewise there are training requirements for a new adviser or mentor of the core skills in client relationships, marketing for a small business and finance for a small business. Then it is important that they gain advisory experience under supervision. There is also a comprehensive adviser competence assessment programme measured against set standards.

Continuing professional development, or keeping up-to-date is much more important. The chartered accountancy world has long recognised that it is no use taking your finals and resting on your laurels for the rest of your life. It is also vital to have a professional indemnity insurance scheme in place that protects the client in the unlikely event of anything going wrong. Also a code of conduct with annual undertakings to put the client first and avoid conflicts of interest.

The benefit of business experience is the fundamental bedrock on which the scheme rests. Business advisers with the relevant experience can:

- relate to the client’s situation and show empathy;
- quote real-life examples to illustrate options;
- recognise strength, weakness, opportunity, threat;
- apply a balanced judgement of business risks;
- diagnose underlying problems - resolve with client;
- prioritize alternative options and courses of action;

- motivate clients to set objectives and take action;
- show clients how to tackle future problems alone.

4. THE ROLE OF THE INSTITUTE OF BUSINESS ADVISERS (IBA)

The IBA mission statement is: “To promote and develop for the public benefit the profession of advising, counselling, mentoring and training small and medium-sized enterprises” Members put the client first and they have been doing so since 1989. In the United Kingdom there are now over 2,000 members. The aims of the IBA, on a not-for-profit, voluntary, self-regulatory basis, are to:

- prescribe education, training, experience;
- set standards of professional conduct;
- identify and promote training and CPD;
- encourage, conduct or promote research;
- publish books, literature, journals, etc.;
- hold conferences, meetings, seminars;
- establish branches, areas, divisions, etc.;
- collaborate with government and others.

Protecting the client is crucial. IBA members are available nation-wide through a variety of business support organizations. IBA does not contract directly to the client, but instead provides the professional framework for those who do work in the many business development services. Confidentiality and the code of conduct are critical, as are professional skills and business experience. The institute has put in place a formal accreditation process with designated letters AIBA, MIBA and FIBA. The IBA provides a national source of information and contacts and it has a credit brokerage and debt counselling licence, which enables members to advise people on their finances in accordance with British law.

5. DEVELOPING COUNTRIES

How can this be extrapolated to developing countries? The following points are all recognised as relevant for developing countries:

- SMEs are vital for economic growth;
- banks are reluctant to finance SMEs;
- how to assist business start-ups;
- how to stimulate growth;
- how to improve profitability;
- how to improve survival.

IBA is now trying to create a new global network of bodies similar to the IBA which can stimulate the provision of such teams of local professional people in different countries. The objectives of the new global network are to:

- help SMEs reach global markets;
- help SMEs in developing countries;
- exchange ideas and best practice;
- facilitate world-wide networking;
- promote the profession world-wide;
- uphold professional standards.

Expertise is to be matched to the need so together we aim to stimulate the growth of SMEs in the developing world in a manner already found to be successful in the United Kingdom.

Expertise:	Needed by:
<ul style="list-style-type: none"> ◆ industry expertise ◆ technical skills ◆ support experience ◆ overseas work experience ◆ language skills ◆ freedom to travel ◆ not too expensive 	<ul style="list-style-type: none"> ◆ governments ◆ aid agencies ◆ trade groups ◆ banks & funds ◆ new investors ◆ entrepreneurs ◆ growing SMEs

6. CONCLUSION

Business mentoring is a proven way to enable successful entrepreneurs and business managers to pass on the benefit of their own experience to small and growing businesses within their own region. Subsidized programmes are needed to promote the scheme and “match” the needs of the clients with the skills and experience of the mentors. However, once the client recognises the value of the mentor they are usually willing and able to pay a sufficient fee for their ongoing services, which can make the scheme self-financing.

COMBINING BUSINESS AND FINANCIAL SERVICES

UNCTAD secretariat

INTRODUCTION

In this paper we discuss the role of business development services (BDS) in improving SMEs access to finance. Our focus is on the Empretec⁶⁵ programme, which is UNCTAD's main vehicle for promoting entrepreneurship. We explore the positive externalities that membership in a BDS programme brings to entrepreneurs in accessing finance. We also take a look at specific actions that the BDS provider can take to lower the obstacles that entrepreneurs face in gaining access to finance. We start with a general overview of the Empretec programme, we then move to examining in more detail the link between BDS programmes and access to finance, and we conclude with a case study of Empretec Ghana Foundation.

1. THE EMPRETEC PROGRAMME

The Empretec programme is UNCTAD's capacity-building programme that provides training, technical assistance, and an institutional framework to foster entrepreneurial capabilities and the growth of internationally competitive SMEs in developing countries and in transition economies, and in particular in the least developed countries (LDCs). More specifically, the programme:

- identifies promising entrepreneurs;
- provides them with training aimed at strengthening their entrepreneurial behaviour and business skills;
- assists them in the preparation of business plans and in accessing financing for their business ventures;
- helps to arrange mutually beneficial links with larger national and foreign companies;
- and puts in place long-term support systems to support the growth and internationalization of their ventures.

⁶⁵ The name Empretec is derived from the Spanish words "emprendedores" (entrepreneurs) and "tecnología" (technology).

Towards this end, UNCTAD, as implementing agency, establishes national institutional structures and networks, which have the capacity to implement the Empretec programme according to best practice standards. UNCTAD/Empretec is responsible for transferring the Empretec concept to the host country and assuring the programme's sustainability over time.

The Empretec concept was first introduced as a United Nations pilot country programme in Argentina in 1988. The aim was to assist SMEs to grow, internationalize, and form mutually beneficial linkages with transnational corporations (TNCs). Since then additional country programmes have been initiated in 24 Latin American, African and the Mediterranean Basin countries. During 2001 some 35,000 SMEs had received assistance from Empretec Centres. The country programmes operate relatively independently and offer business development services that are demand driven and adapted to the specific needs of the country. Many of the country programmes have reached sustainability – that is, they are able to cover operating costs. Currently 23 countries have requested Empretec but funding has not been secured.

Table 4
Empretec installations and networking

Empretec project phase	Countries
Phase I: Request for an Empretec project and initial discussions	Algeria, Angola**, Azerbaijan, Benin*, Burkina Faso**, Cameroon**, Cambodia, Cape Verde**, Cuba, Estonia, Guinea Bissau, Latvia, Liberia, Lithuania, Malawi*, Malaysia, Mauritania*, Mexico, Russian Federation, Sao Tomé, Thailand, Togo**,
Phase II: Programming mission, consensus with government, identification of counterpart, drafting of project document	Bolivia, Costa Rica, Ecuador, Guyana, Honduras, Lebanon, Nicaragua, Paraguay, Peru, Tanzania*, Tunisia
Phase III: Recruitment of staff, including the Director, establishment of the Advisory Board, installation of project, initial Entrepreneurship Training Workshop	Guatemala, Jordan, Mauritius*, Palestinian Territory, Romania, Uganda**
Phase IV: Operationalization of full project, putting in place basic training and services, certification of local trainers, setting up a national association	El Salvador, Morocco, Mozambique**, Namibia*, Nigeria*, Panama, Senegal*, South Africa*
Phase V: Maturity of project, offering customized training and other services, progress towards financial self-sustainability, establishing of legal entity (e.g. foundation, trust)	Argentina, Botswana*, Brazil, Chile, Colombia, Ethiopia**, Ghana, Uruguay, Venezuela, Zimbabwe

* Through the Enterprise Africa Programme (UNDP)

** Through joint UNCTAD and Enterprise Africa Programme (UNDP)

2. THE ROLE OF BDS PROVIDERS IN IMPROVING SMEs ACCESS TO FINANCE

There are several reasons for a banker when making a loan, to favour an entrepreneur who is part of a recognized BDS programme over an entrepreneur who is not. First of all, the fact that the entrepreneur is associated with a business development programme lends some credibility to the entrepreneur in the eyes of the banker. In the case of Empretec, the entrepreneur – also referred to as the empreteco – has gone through a selection process in which both the personal qualities of the entrepreneur as well as the potential of the business model are evaluated before the entrepreneur is selected to join the programme. Thus, the empreteco has already been pre-screened before he/she enters the bank.

Furthermore, by participating in the programme the empreteco acquires critical management skills needed for running a business, learns how to devise a viable business plan with the assistance of the Empretec Centre and has access to its advisory services. The empreteco is also part of a network of other empretecocos that provides him/her with valuable business contacts and also puts some peer pressure on performance. From the banker's point of view all of the above mentioned factors contribute to the likelihood that the entrepreneur will be capable of running his/her business successfully and ultimately repaying the loan.

The element of peer pressure is emphasized when the number of empretecocos exceeds a certain “critical mass”, normally of 200-300 entrepreneurs in a country. At this point the empretecocos form a network of small business leaders that is relatively well known to the local economy. The personal and business performance of an empreteco can thus contribute among other things to a more positive attitude of the bankers towards the empretecocos in general.

Another benefit is that an empreteco is more likely to “speak the same language as the banker”. In other words the empreteco, with the assistance of the Empretec staff, will be able to conduct negotiations, prepare loan applications and business plans and disseminate financial information that meets the standards required by the bank. This will simplify and speed-up the processing of the loan application for the bank and ultimately lead to a credit evaluation process that is both of higher quality and less costly for the bank.

The role of Empretec could be summed-up as “guarantor” of an entrepreneur without providing actual loan guarantees, through evaluating both the personal qualities and the business model of the empreteco, by furnishing the empreteco with certain business skills, and in assisting him or her in providing a verifiable track record of enterprises as well as a well formulated business plan.⁶⁶

⁶⁶ However, in the Empretec Ghana programme empretecocos do “guarantee” each other through a mutual loan association.

These benefits however, stem from the partnerships between the entrepreneur and the BDS provider. Further benefits can be achieved via partnerships between the bankers and the BDS providers. This is an area that was overlooked in the early stages of Empretec, but is now an area of focus for the programme. One indication of this is that the partners through which the Empretec Programme operates in countries are increasingly banks. Nowadays some 60 per cent of the Empretec national counterparts are in fact banks. It is also an indication that banks find value in the Empretec programme.

For a bank there is a clear interest to help its SME customers avoid some of the typical management and market difficulties that could undermine their business and jeopardize repayment of the loans. Many banks already provide additional consulting and advisory services to their clients that are similar to those provided by BDS providers. However, in many cases this is very costly for the bank or it might not have the necessary expertise in-house. Therefore, a partnership with a BDS provider is a natural way forward as they are better placed to provide these services at a lower cost. There are also obvious advantages for the BDS provider as it is easier to recruit SMEs to a programme if there are concrete financial advantages to it.

Outsourcing certain typical banking activities, such as credit evaluation, monitoring and scoring, could help to reduce administrative costs. Especially in cases where the BDS provider already works closely with the SME, the additional costs of credit evaluation or monitoring could be very low. The potential improvement in SMEs financing could be significant as high transaction costs are often cited as a major obstacle. These services are, however, regarded by banks as part of their core banking activities. Therefore, the BDS provider would have to have a very strong reputation before the bank would be willing to outsource these services to it.

Empretec has in recent years been very active in seeking to expand its operations towards providing financial services alongside non-financial services. In doing this it has forged partnerships with banks. In the box below a closer look is taken at the efforts of Empretec Ghana Foundation to provide financial services to SMEs.

An area in which Empretec has also been active in regard to banks, is in promoting the development of an entrepreneurial culture within the banks, so called “intrapreneurship”. Banks in developing countries are often criticized for overlooking the business sector in lending operations, especially the SMEs, and focusing on less risky customers such as governments and large enterprises. Empretec has started a programme to train bank managers to understand the realities of the SME sector and to generate an atmosphere of entrepreneurship within the banks as a way to enhance bank lending to SMEs.

Box 4

Empretec Ghana Foundation – combining financial and non-financial services⁶⁷

Background

Empretec Ghana Foundation (EGF) began in 1990 as a project of the United Nations Development Programme, Barclays Bank Ghana Limited and the Government of Ghana. In 1994, Empretec was transformed into a foundation in order to sustain its programmes.

The initial focus was on building skills of entrepreneurs by providing training to improve the entrepreneurial and management necessary for growth. The programme has developed to include a comprehensive range of consultancy and other advisory services aimed at improving the operational efficiency and profitability of enterprises. The finance gap as it affects small enterprises soon became apparent and the programme developed further to include financial services. The core activities of Empretec Ghana are training, consultancy and advisory services and financial services.

Training

The training programme includes the traditional Entrepreneurship Development Programme (EDW) and many management training courses covering such topics as managing your finances, effective supervision, time management and customer care.

Some new initiatives in the Training Department include the introduction of the business growth programme (BGP), for owners managing the transition into growth companies. Such companies need more formalized procedures and the owners have to delegate to new managers/supervisors.

Another exciting new training initiative has been the Doctors Programme which has run for the past two years training medical doctors in private practice to manage their surgeries as business enterprises.

Consultancy and advisory services

This department has offered the traditional post-training services of health check/counselling, business plan preparation, management of a roster of consultants, linkages and export development. The department had done some loan facilitation/monitoring work and this quickly revealed the need for additional initiatives to unlock credit facilities for empretecos.

The most important financial services include:

⁶⁷ Peter Morton, Empretec Ghana Foundation

Credit Sourcing Centres

This started as a UNDP project in February 1996. The initial capital of US\$700,000 that was provided by the UNDP has been rolled over three times. The fund was converted into cedis (the local currency), at that time and yielded 1.14 billion cedis and this has been the only source of funds used in running the scheme from 1996 to date.

In the implementation of the scheme, credit centres were established in five regional capitals. The scheme now operates in four locations, Kumasi, Takoradi, Weija and Accra. Loans contracted from the scheme can be used to finance both working capital and fixed assets of the beneficiary enterprises. Repayment periods range between 12 and 18 months for working capital and equipment financing respectively. Interest rates charged have been at a relatively lower rate of 35 per cent per annum since the inception of the scheme. This contrasts with normal bank rates in excess of 50 per cent per annum over the period. The rate is expected to be reviewed in line with current market trends. Security requirements are minimal. Assets of the enterprise together with third party personal guarantees are acceptable as security for the loan. No collateral is required.

The scheme has been quite successful and as at 31 December 2001, the initial capital has been rolled over to finance US\$2.24 million in loans to 1052 beneficiaries. Roughly 63 per cent of these beneficiaries were women. The scheme has performed much better when analysed in cedi terms. In all the initial capital of 1.14 billion cedis has been rolled over more than five times and financed 5.846 billion cedis in loans at 31 December 2001.

Table 5
Summary of loan approvals

Year	Cum loan Approvals \$'000	Cum No. of beneficiaries	Gender Distribution		Recovery rate
			Male	Female	
1997	854	382	163	219	92%
1998	1,557	631	246	385	90%
1999	1,889	747	268	479	89%
2000	2,042	840	321	519	89%

A private limited liability company, Empretec Finance Company, has been registered to operate the scheme. It will be majority owned and managed by Empretec, with the participation of other institutions interested in the development and financing of Ghanaian SMEs. This will assure the continued running of the scheme, this time as a non-bank financial institution. The necessary applications have been submitted to the Bank of Ghana for a licence to operate as a finance company.

In order to make a meaningful impact on the Ghanaian market, Empretec proposes to gradually expand its lending activities under this scheme by increasing its client base as well as the average amount of its loans to a level more in line with the financial needs of high-growth SMEs.

Empretec has set itself to achieve a portfolio of US\$1.25 million by the end of 2003. With the existing fund balance of US\$211,594, an additional funding of roughly US\$1.0 million will be required for the period up to 2003. Empretec is thus looking for strategic partners from both local and external sources to provide the needed capital for its credit sourcing operations.

The MEGA Foundation

This is a form of Rotating Savings and Credit Association (ROSCA) or a mutual loan guarantee association sponsored by Empretec Ghana Foundation with support from DFID. It was inaugurated in December 1996, with four groups and total membership of 31. The MEGA Foundation was registered in December 2000. As at 31 December 2001 there were 405 members in 37 groups spread around the country.

Loanable funds have been generated mainly through members' contributions, DFID matching funds and accrued interest paid by the participating bank:

the bank provides a multiplier of four;

the loan guarantee fund had reached 1.702 billion cedis at 31 December 2001 with loanable funds at 6.808 billion cedis. Total loan disbursements stood at 3.500 billion cedis at 31 December 2001 paid out to 121 beneficiaries;

loan sizes have ranged between two million to 90 million cedis;

loan repayment periods of three to 18 months have been granted;

the scheme started with interest rates charged at seven per cent above base rate. This contrasts with open market interest rates of eight per cent above the base rate;

the scheme now charges interest at four per cent above the base rate.

Memorandum of understanding (MOU)

The above two schemes have not been able to fully satisfy the credit demands of Empretec clients. Thus the Consultancy and Advisory Services Department continues to explore various schemes to expand access to credit for Empretec clients. To meet the medium-term financing needs of clients a MOU with the General Leasing and Finance Company Limited (GLFC) has been negotiated to provide finance to acquire various fixed assets. Under the terms of the MOU, the organizations will collaborate in providing finance and consultancy services to selected entrepreneurs and businesses. Services that are provided include credit monitoring, preparation of business plans and feasibility studies, provision of client accounting and bookkeeping systems as well as training, counselling and other technical support. The benefits for entrepreneurs from EGF are both lower costs and a fast track processing of applications for leasing.

Secondly, to provide other sources of working capital for clients, MOUs have been signed with two of the smaller commercial banks in Ghana to provide short-term loans to applicants introduced by Empretec. Similar MOUs are being negotiated with banks that are willing to participate in such schemes.

PART IV

Outcome of the Expert Meeting

IMPROVING COMPETITIVENESS OF SMEs IN DEVELOPING COUNTRIES:

THE ROLE OF FINANCE, INCLUDING E-FINANCE, TO ENHANCE ENTERPRISE DEVELOPMENT

Outcome of the expert meeting

1. The Expert Meeting on Improving the Competitiveness of SMEs in Developing Countries: The Role of Finance, including E-Finance, to Enhance Enterprise Development examined a range of issues for consideration by the Commission on Enterprise, Business Facilitation and Development pursuant to paragraphs 119 and 156 of the Bangkok Plan of Action (TD/386). Experts made presentations and exchanged views on trends in financial innovation and best practices at the international and national levels.
2. The experts noted that sustainable economic growth is strongly related to the rate of enterprise creation and technical innovation. Vigorous enterprise creation depends on a nation's entrepreneurial culture and the ease with which businesses can be started and financed.
3. They recognized that many financial institutions in developed and developing countries find it difficult to serve small and medium-sized enterprises (SMEs) because of high perceived risk and high transaction costs and lack of experienced personnel and appropriate corporate structures, which bias them against SMEs, including those created by women entrepreneurs. The key to securing access for SMEs is to improve the ability of financial institutions to seriously expand and make more efficient the delivery of financial products, both offline and online, for different segments of SMEs. It is important for financial institutions to know their markets and customer needs and offer packages of tailor-made products, as well as automatic and standardized ones.
4. They equally stressed that the advent of the Internet, with the possibility of achieving enormous efficiency gains, including much lower transaction costs, faster communication and unparalleled networking opportunities, has brought about new opportunities and challenges for SME access to finance and in particular to e-finance.
5. The experts reviewed a number of innovations used by international and national financial institutions to facilitate SME finance. Local financial institutions in developed countries, which have been particularly successful in serving the SME market, have found that it is highly profitable. Their strategy is to improve their core competencies by adopting sophisticated credit techniques such as credit scoring, strengthening management and information systems and developing highly efficient automatic processes, efficient marketing and distribution, and developing close ties to clients. The experts also discussed complements to finance such as insurance and guarantee schemes that could increase a bank's ability and

interest in terms of servicing SMEs. They considered how such innovations could be widely applied to developing countries, where the conditions for SME development are often much less favourable.

6. They also observed that in developing countries equity funds and especially venture capital funds have greater difficulty in serving SMEs or even identifying fundable ones. Such difficulties severely limit the amount of equity and venture capital funds available to SMEs in developing countries and particularly in LDCs. In the case of the LDCs, there is a special need for public-private investment funds devoted to the support and promotion of SMEs and information infrastructure development.

7. During the second part of the meeting, the experts stressed the revolutionary impact of open Internet technologies and platforms on financial services. In particular, they discussed the development of online payments with or without the use of cards, Internet banking, e-trade finance and e-credit insurance. The discussion centred on adapting these online financial services to the needs of SMEs and in particular SMEs from developing and transition economies.

8. The experts paid special attention to a number of innovations in the financial industry to reduce costs and risks, including modern Internet-based data mining technologies making it possible to build up huge credit information databases and apply modern credit analysis and related credit appraisal, scoring and rating techniques, permitting the appraisal of SME credit risks and the rapid processing of their credit applications. They considered how those innovations could be introduced or further developed in developing countries.

9. They agreed that the provision of medium and long-term finance should be closely linked to the delivery of business development services so as to improve both the viability of SMEs and their ability to repay loans. They urged that partnerships be struck between financial institutions, business associations, networks of entrepreneurs and business development service providers.

10. Lastly, they noted that the international financial system can influence the availability of domestic and external resources and in particular long-term finance for productive purposes in developing countries. They therefore requested that their recommendations on ways and means of increasing SME access to finance should be made available to the next preparatory meeting of the UN conference on Financing for Development in Monterrey, Mexico, in March 2002.

11. The experts examined a number of best practices that can facilitate SME access to finance and recommended the following for consideration by governments:

Governments

Finance

- (a) Maintaining prudential supervision of the financial sector, taking into account the specific requirements for medium and long-term investment finance for SMEs, and ensuring that commercial lending to SMEs is on a sustainable basis;
- (b) Avoiding crowding out of the private sector by excessive borrowing from national financial institutions;
- (c) Designing loan guarantee schemes that reach target beneficiaries, ensure balanced risk sharing and avoid moral hazard;
- (d) Requiring commercial banks to disclose the composition of their loan portfolios, particularly the percentage of loans going to SMEs ;
- (e) Encouraging banks to implement good corporate governance practices and transparent procedures and, within this framework, to appoint independent outside experts with a knowledge of SMEs to their boards of directors;
- (f) Improving the reliability of financial information provided by SMEs by adopting user-friendly accounting and reporting requirements;
- (g) Promoting an institutional framework for SME support services;
- (h) Supporting public-private sector partnerships for SME venture capital funds and investment funds ensuring a level playing field for all market participants;
- (i) Adopting regulatory and legal frameworks that allow for the establishment and best use of financial sector infrastructure such as credit bureaus and other information sharing solutions, while maintaining appropriate privacy laws;
- (j) Creating conditions for promoting local capital markets;

Public and private sector

E-finance

- (k) Creating a technology-neutral e-commerce and e-finance friendly regulatory environment and developing secure methods of electronic transmission of commercial messages, e-signatures and e-contracts, which should be considered as legally binding by contracting parties;
- (l) Adopting flexible regulations and creating a supportive institutional environment to encourage the introduction of e-payments, Internet banking,

online trade finance and credit information and other e-finance relevant to SMEs in developing and transition economies and ensure public–private cooperation in that respect;

- (m) Developing a conceptual framework to allow systematic collection of data on e-finance;
- (n) Encouraging a variety of partnerships and joint ventures between local and foreign e-finance service providers in order to ensure the possibility of rendering efficient services to customers at local, regional and global levels;
- (o) Improving international coordination among national financial supervisory authorities to better manage systemic risks related to the borderless nature of e-finance;
- (p) Developing online credit information, credit scoring and rating databases for SMEs from developing and transition economies to facilitate and shorten their credit appraisal process and hence improve their access to finance and e-finance both locally and internationally;
- (q) Creating local, regional and global e-finance platforms with the active participation of financial service providers and other companies from developing countries and making them accessible to developing country SMEs;
- (r) Developing online business development and information services and supporting capacity building for SMEs in respect of getting online access to business opportunities and facilitating online matching of best conditions for their financing requirements;
- (s) Supporting SMEs in acquiring technologies and skills required to pay and be paid online, as well as entering into longer-term trade-related e-financing arrangements;
- (t) Laying foundations to develop a strategy for online access to longer term e-finance for SMEs;
- (u) Developing alternative bilateral and multilateral online payments and financing arrangements, such as online clearinghouses, and making it possible to expand productive and trading frontiers of SMEs from developing and transition countries.

Development agencies and international financial institutions

- (v) Bringing the recommendations of the Expert Meeting to the attention of governments and national development finance institutions;
- (w) Bringing the outcome of the Expert Meeting to the attention of the forthcoming UN Conference on financing for development in Mexico;
- (x) Supporting SME associations in setting up infrastructure to collate and update SME data;

Finance

- (y) Developing, whenever appropriate, debt swaps within existing aid budgets as a means of strengthening local financial institutions by providing them with medium and long-term finance for SMEs, also taking into consideration finance and guarantee schemes in local currency. Debt swaps should also be used to provide business development services. This could be useful to complement the HIPC debt alleviation facility and for countries not benefiting from the facility. When dealing with capacity building, development agencies should be ready to enter into full partnerships with public and private stakeholders and share risks and responsibilities;
- (z) Promoting user-friendly accounting and reporting systems for SMEs that would provide uniform (within the country) and useful financial information to managers, creditors and investors;
- (aa) Disseminating information on financial innovations and assisting commercial banks in developing core competencies in credit policy making, risk management, credit information and management systems, and efficient marketing and distribution;
- (bb) Developing/strengthening programmes that assist commercial banks in developing countries to train bank management and staff to better appraise SME credit risk, particularly in the case of women entrepreneurs;
- (cc) Encouraging banks to develop contractual relations with business development service providers to better identify opportunities and to provide efficient follow-up services;
- (dd) Joining with governments and private partners in creating public-private venture capital funds and investment banks to assist SMEs;
- (ee) Urging development banks to adopt a sectoral approach to:

- (i) Policy dialogue with governments and domestic national banks to create an enabling environment for SME support;
 - (ii) Long-term assistance through loans and equity to local institutions with a perspective of long-term sustainability;
 - (iii) Complementary capacity building for financial institutions and SMEs via business development service providers;
- (ff) Developing common standards and systems to link commercial banks and micro-finance institutions to increase outreach and accelerate the mainstreaming of productive poor into the formal financial system;

E-finance

- (gg) Facilitating, through policy dialogue, financing and technical cooperation, the introduction of a technology-neutral regulatory and institutional environment for e-finance;
- (hh) Encouraging, through training, co-financing and various partnerships between local and international financial service providers, the introduction of e-finance and related financial innovation by banks and other financial service providers from developing and transition countries and thus demonstrating to them possibilities to tap into e-finance related efficiency gains;
- (ii) Participating through co-financing and technical assistance in the creation of local and regional e-finance platforms of various types with a view to improving the quality of services rendered to SMEs and other customers;
- (jj) Assisting the SME sector in developing and transition economies to acquire e-finance related technologies and skills as a part of improving their competitiveness and participation in the global economy;
- (kk) Supporting governments, public and private sector entities and NGOs in fulfilling the above-mentioned recommendations on e-finance;
- (ll) Doing a more effective job of networking and creating clearing houses for information and experiences relating to types of infrastructure to support e-finance, in close consultation with private market participants;
- (mm) Exploring a more structured approach to transfer of knowledge and training and associated cooperation between public agencies;

Commission on Enterprise, Business Facilitation and Development

- (nn) Selecting a topic for the next two years which develops coherent approaches to SME finance, e-finance and non-financial business support services, taking into consideration the work of other agencies, in order to contribute to the effectiveness of UNCTAD's research, intergovernmental discussions and technical cooperation and ultimately to UNCTAD XI;

UNCTAD

- (oo) Continuing its research on financing for SMEs particularly in the fields of new technology acquisition, export credit, e-finance and e-economy, which are critical for the competitiveness of SMEs and their participation in the global economy;

Finance

- (pp) Completing its work on a user-friendly accounting framework for SMEs that will allow them to produce transparent, reliable and uniform financial and business information and reporting back to the Commission as soon as possible;
- (qq) Ensuring, in its technical cooperation programmes for entrepreneurship, that business development services are linked to financial services and developing the necessary products and services within its programmes in order to facilitate this;
- (rr) Developing, together with other relevant international agencies, programmes for women entrepreneurs to facilitate their access to finance, extra-budgetary funds permitting;

E-finance

- (ss) Continuing systematic research into various online financial services and their impact on economic development and in particular on opportunities opened up for SMEs to improve their access to finance and e-finance;
- (tt) Organizing regular fora, including regional seminars and group training, to sensitize governments, central banks, financial service providers and the corporate sector in developing and transition countries to the advantages of electronic finance at the local, regional and global levels;
- (uu) Incorporating the aspects of e-finance that are more relevant to the needs of SMEs into UNCTAD technical cooperation activities in the area of e-

commerce, and ensuring coordination and synergies with other international organizations active in this field;

- (vv) Encouraging governments, central banks and financial institutions to collect information on e-finance and to use it for analysis, intergovernmental deliberations and technical cooperation.
