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Report on Support to SMEs in Developing Countries Through Financial Intermediaries

November 2011

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FOREWORD

The development community has long upheld that a thriving private sector is essential for economic development. SMEs play an instrumental, but often under-recognized, role in private sector growth.

This report reviews a large body of research, and demonstrates how SMEs in developing countries are often hampered by an inability to obtain financial capital for growth and expansion. Local financial systems do not sufficiently cater to the needs of SMEs, with negative consequences for economic development. This report develops interventions to close the gap in financing, and outlines contributing roles for public and multilateral actors. It describes both the challenges and the potential for international financial institutions to work through local intermediaries and stimulate capital provision to SMEs in a financially and socially sustainable manner.

This report makes a valuable contribution to the wider debate, but much more remains to be done. Future research should address the impact of providing access to finance to SMEs, and the optimal roles and responsibilities for public sector actors. We hope that this report will serve as an inspiration and impetus to others to undertake further research.

The Steering Group,

Amit Bouri (Director of Strategy and Development, Global Impact Investing Network)

Mark Breij (Fund Manager, Cordaid)

Magatte Diop (Founder and Managing Partner, Peacock Investments)

Randall Kempner (Executive Director, Aspen Network of Development Entrepreneurs)

Bailey Klinger (Founder, Entrepreneurial Finance Lab)

Keely Stevenson (CEO, Bamboo Finance USA)

EXECUTIVE SUMMARY

This report outlines the need to provide capital to Small and Medium Enterprises (SMEs) in developing countries. It shows the impact of this capital on economic development, and the role for International Finance Institutions (IFIs) in the provision of this capital. Finally, it outlines recommendations for additional interventions and further research.

SMEs in developing countries face a financing gap that undermines economic prosperity

SMEs are a fundamental part of the economic fabric in developing countries, and they play a crucial role in furthering growth, innovation and prosperity. Unfortunately, they are strongly restricted in accessing the capital that they require to grow and expand, with nearly half of SMEs in developing countries rating access to finance as a major constraint. They might not be able to access finance from local banks at all, or face strongly unfavourable lending conditions, even more so following the recent financial crisis. Banks in developing countries are in turn hampered by the lack of lender information and regulatory support to engage in SME lending. The overall result is absence of a well-functioning SME lending market, and SMEs are impeded in their growth, with negative consequences for innovation, economic growth and macro-economic resilience in developing countries.

With targeted interventions, IFIs play an important role in closing this gap

Targeted IFI support, such as guarantees or technical assistance, helps to build up the knowledge and expertise of intermediaries with respect to SME lending, thus helping to catalyse an independently sustainable SME lending market. In this way, International Finance Institutions (IFIs) play an important role in catalysing the SME lending market in developing countries. As with any public intervention in private markets, the benefits need to outweigh the costs, potential adverse incentives and unintended consequences. However, IFIs are often better placed to support SMEs than local governments, whose support schemes often are less cost-efficient and more susceptible to political capture. IFIs achieve their cost-efficiency by working through local intermediaries, with the additional benefit of stimulating the creation of a local lending industry. Financial and social sustainability is further enhanced by judiciously selecting and screening intermediaries, applying strict lending standards and carefully calibrating controls and incentives.

A clear research agenda has been identified to further enhance the effectiveness of interventions.

Increased research and empirical evidence will help to further strengthen the case for SME support and the effectiveness of specific interventions. Additional research on the overall impact of capital provision to (different types of) SMEs on economic and social indicators would be helpful for the overall advocacy for SME interventions. Research on the optimal structure of interventions would help to further increase the financial and social sustainability of SME interventions.

METHODOLOGY

This report on SME development in developing countries through financial intermediaries was drafted by Dalberg Global Development Advisors. The analysis was conducted during a period of six weeks between February 21 and April 1, 2011. Feedback was sought and incorporated during the following months. The study was made possible through financial support from the European Investment Bank (EIB).¹ The report is based on extensive desk research, guidance from the steering group and additional interviews with experts from International Finance Institutions.²

The report is written to address external interested parties, including policy makers, civil society and the general public.

Dalberg would like to thank everyone who contributed to this report, in particular all interviewees, for their time and cooperation. Special gratitude goes out to the advisory panel:

Amit Bouri

Director of Strategy and Development, Global Impact Investing Network

Mark Breij

Fund Manager, Cordaid

Magatte Diop

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Randall Kempner

Executive Director, Aspen Network of Development Entrepreneurs

Bailey Klinger

Founder, Entrepreneurial Finance Lab

Keely Stevenson

CEO, Bamboo Finance USA

Dalberg also sought the views of Transparency International.

For questions or comments, please contact Wouter Deelder at Wouter.Deelder@dalberg.com.

¹ The EIB made suggestions on the content of the report, but did not influence the conclusions or overall recommendations

² Asian Development Bank (ADB), African Development Bank (AFDB), European Bank of Reconstruction and Development (EBRD), International Finance Cooperation (IFC) and Overseas Private Investment Cooperation (OPIC)

INTRODUCTION TO SMEs

SME definition

The term “SME” encompasses a broad spectrum of definitions. Different organizations and countries set their own guidelines for defining SMEs, often based on headcount, sales or assets.³ While Egypt defines SMEs as having more than 5 and fewer than 50 employees, Vietnam considers SMEs to have between 10 and 300 employees. The World Bank defines SMEs as those enterprises with a maximum of 300 employees, \$15 million in annual revenue, and \$15 million in assets. The Inter-American Development Bank, meanwhile, describes SMEs as having a maximum of 100 employees and less than \$3 million in revenue.⁴

In this report, we follow the European Union definition: ‘The category of micro, small and medium-sized enterprises is made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding 50 million euro, and/or an annual balance sheet total not exceeding 43 million euro.’ Small and medium enterprises are thus defined as firms with 10 to 250 employees, and more than 10 million euro turnover or annual balance sheet total.⁵ This definition is more encompassing, and much larger, especially with regards to turnover, than some others. The precise definition however, does not impact the overall conclusions and findings of this report.⁶

Figure 1 - Definition of micro-, small- and medium-sized enterprises⁷

Enterprise category	Headcount	Turnover	Balance sheet total
medium-sized	< 250	≤ € 50 million	≤ € 43 million
small	< 50	≤ € 10 million	≤ € 10 million
micro	< 10	≤ € 2 million	≤ € 2 million

³ As different organizations define SMEs differently, cross comparison can be difficult

⁴ Milken Institute, Stimulating Investment in Emerging-Market SMEs, October 2009. A range of definition is also included in the CGAP publication “Financial Access 2010”

⁵ European Commission, 2003, Extract of Article 2 of the Annex of Recommendation 2003/361/EC

⁶ The lack of a common definition has an effect on the eligibility of SME intervention schemes. For example, the Ghanaian definition allows support to all but 127 firms in the country (DEG Atrium dialogue on promoting SME)

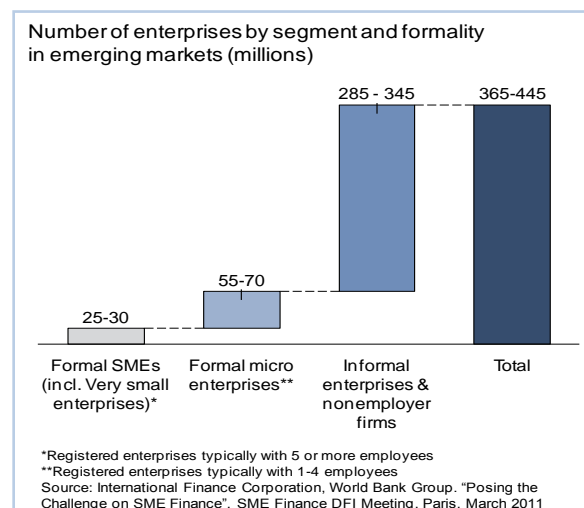
⁷ European Commission, Enterprise and Industry, 2011. “Small and medium-sized enterprises (SMEs), SME Definition” http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/sme-definition/index_en.htm

THE SME SECTOR IN THE GLOBAL ECONOMY

The SME sector is the backbone of the economy in high-income countries, but is less developed in low-income countries. The Organisation for Economic Co-operation and Development (OECD) reports that more than 95% of enterprises in the OECD area are SMEs. These enterprises account for almost 60% of private sector employment, make a large contribution to innovation, and support regional development and social cohesion.⁸ Also in low-income countries, the SME sector makes a critical contribution to GDP and employment, as shown in Figure 2, Figure 3 and Figure 4 below.⁹

SMEs include a wide range of businesses, which differ in their dynamism, technical advancement and risk attitude. Many are relatively stable in their technology, market and scale, while others are more technically advanced, filling crucial product or service niches. Others can be dynamic but high-risk, high-tech “start-ups”.¹⁰ Researchers and practitioners agree that SMEs are crucial contributors to job creation and economic growth in both high and low-income countries.¹¹

Figure 2 - Number of SMEs by segment and formality



8 OECD SME and Entrepreneurship Outlook 2005 Edition

9 Ayyagari, Demirguc-Kunt and Maksimovic, 2011. "Small vs. young firms across the world", World Bank

10 David de Ferranti and Anthony J. Ody, "Beyond Microfinance: Getting Capital to Small and Medium Enterprises to Fuel Faster Development". Policy Brief 159, The Brookings Institute, March 2007

11 SEAF, 2007. "From Poverty to Prosperity: Understanding the Impact of Investing in Small and Medium Enterprises Data Survey and Case Study Analysis of SEAF Investments"

Figure 3 - GDP contribution by sector

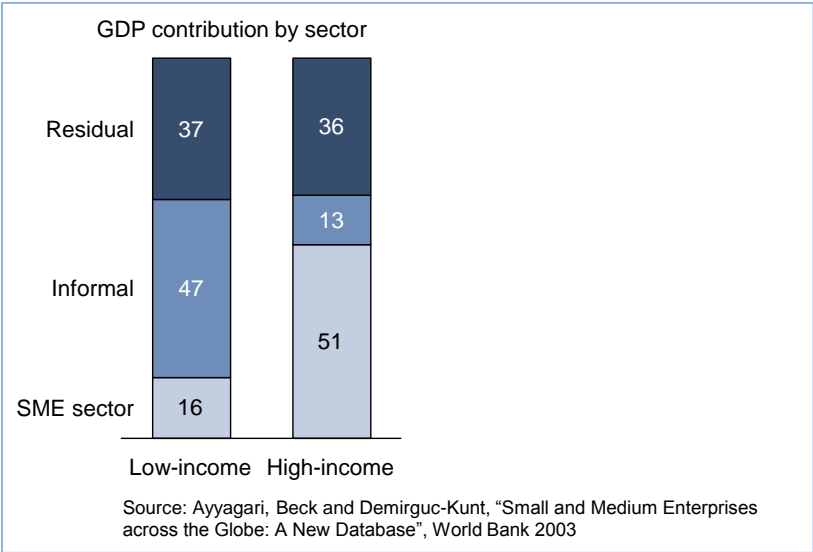
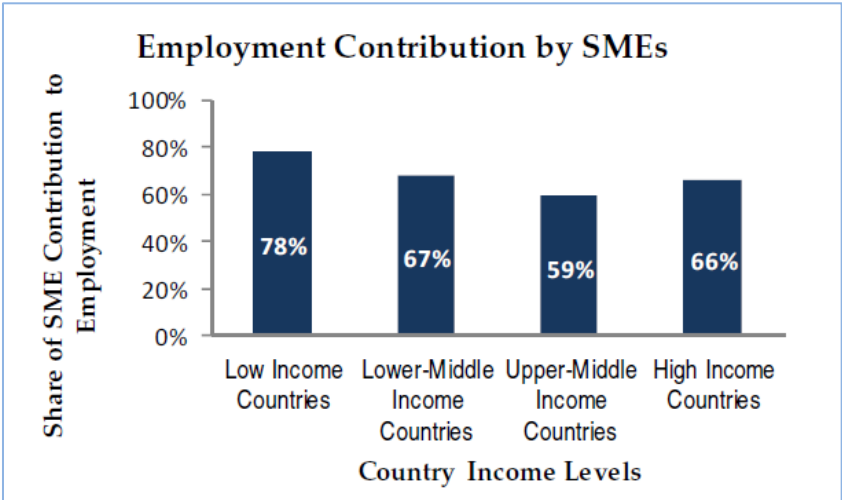


Figure 4 - Employment contribution¹²



¹² Source: Aspen Network of Development Entrepreneurs, using data from Ayyagari, Demirguc-Kunt and Maksimovic, "Small vs. Young Firms across the World: Contribution to Job Creation, Employment, and Growth", World Bank 2011

THE IMPACT OF ACCESS TO FINANCE ON SMEs

Access to finance is necessary to create an economic environment that enables firms to grow and prosper. SMEs in developing countries, however, face significant barriers to finance. Financial constraints are higher in developing countries in general, but SMEs are particularly constrained by gaps in the financial system such as high administrative costs, high collateral requirements and lack of experience within financial intermediaries. Increased access to finance for SMEs can improve economic conditions in developing countries by fostering innovation, macro-economic resilience, and GDP growth.

Numerous studies highlight access to finance as one of the driving factors of an enabling economic environment. The World Bank and the International Finance Cooperation (IFC) rank economies according to their ease of doing business; in this framework, the ability for business to get credit is an important criterion.¹³ The Global Entrepreneurship Monitor (GEM) Entrepreneurship Framework Condition also highlights entrepreneurial finance, defined as the availability of financial resources for SMEs in the form of debt and equity, as one of the key factors for stimulating and supporting entrepreneurial activity.¹⁴

Access to finance helps all firms to grow and prosper.¹⁵ The Investment Climate Surveys of the World Bank show that access to finance improves firm performance. It not only facilitates market entry, growth of companies and risk reduction,¹⁶ but also promotes innovation and entrepreneurial activity.¹⁷ Furthermore, firms with greater access to capital are more able to exploit growth and investment opportunities.¹⁸ In other words, aggregate economic performance will be improved by increasing the access to capital.¹⁹

SMEs face disproportionate barriers to finance, especially in developing countries.

SMEs face a financing gap. Financing for SMEs is limited, particularly when compared to commercial debt for large firms and microfinance (see Figure 5 and Figure 7 below). When asked to name the most severe obstacles to growth, SMEs worldwide listed financing constraints as the second most-severe obstacle, while large firms placed it only fourth.²⁰

Often, the costs and risks of serving SMEs are perceived to be too high by commercial finance. Microfinance loans, on the other hand, are too small to meet SME capital needs. For example, if a rural

13 World Bank, IFC, 2011. "Economy rankings" <http://www.doingbusiness.org/rankings>

14 Global Entrepreneurship Monitor, 2010. "GEM 2010 Global Report"

15 Interview with Thorsten Beck, March 2011

16 Beck, Thorsten and Demirgüç-Kunt, Asli, 2008. "Access to Finance: An Unfinished Agenda". *The World Bank Economic Review*, Vol. 22, Issue 3, pp. 383-396, 2008

17 Klapper, Leora, Luc Laeven, and Raghuram Rajan. 2006. "Entry Regulation as Barrier to Entrepreneurship." *Journal of Financial Economics* 82(3):591-629

18 Beck, Thorsten, Asli Demirgüç-Kunt, and Vojislav Maksimovic. 2006. "The Influence of Financial and Legal Institutions on Firm Size." *Journal of Banking and Finance* 30(11):2995-3015.

19 World Bank, Chapter 2: Firms' Access to Finance: Entry, Growth, and Productivity http://siteresources.worldbank.org/INTFINFORALL/Resources/A099583-1194373512632/FFA_ch02.pdf

20 World Bank Group, Enterprise Surveys Database, 2010.; <http://www.enterprisesurveys.org>; "World Business Environment Survey" (WBES) of more than 10,000 firms in 80 countries

coffee producer needs a loan of \$300,000, the request may be too large for the local microfinance institution, but too small, risky and remote for commercial banks. This financing gap is referred to as the “missing middle”, and is illustrated in Figure 6.

Financial constraints are greatest in low-income countries. The World Bank Enterprise Surveys reveal that, for example, in low-income countries, on average 43% of businesses with 20 to 99 employees rate access to finance or cost of finance as a major constraint to current operations. In high-income countries, only 11% of businesses of the same size rate access to finance as a constraint.²¹ According to the IFC, the total financing gap for formal SMEs outside the high-income OECD countries is indicatively and preliminary estimated to be potentially as high as US\$700-850 billion.^{22, 23}

Increased access to finance will foster efficient growth in the SME sector.

Small firms are disproportionately handicapped by a lack of finance, but they receive a stronger boost in growth than large firms if financing is provided. Financing obstacles affect small firms more than large firms. Small firms not only report higher financing obstacles, but they are also more adversely affected by these obstacles.^{24,25 26,27} Figure 8 shows that financing obstacles in small firms have almost twice the effect as obstacles in large firms.²⁸ This might be due partly to a lack of other financing sources, and partly because it hinders SMEs from taking advantage of economies of scale. Esther Duflo and Abhijit Banerjee have argued that production technologies follow a step-function, and that credit might be needed for SMEs to make the jump to the next step (e.g. move from manual to automatic production).²⁹

21 World Bank Group, Enterprise Surveys Database, 2010.; <http://www.enterprisesurveys.org>; “World Business Environment Survey” (WBES) of more than 10,000 firms in 80 countries

22 Excluding high-income OECD countries

23 IFC, 2011. “Posing the Challenge on SME Finance”, DFI Meeting in Paris

24 Beck, Thorsten, Aslı Demirgüç-Kunt, and Vojislav Maksimovic, 2005. “Financial and legal Constraints to Firm Growth: Does Firm Size Matter?” *Journal of Finance* 60 (1): 137–77.

25 The International Bank for Reconstruction and Development, The World Bank, 2008. “Finance for all? Policies and pitfalls in Expanding Access”

26 There is an alternative path, argued by among others Karlan and Appel (More than Good Intentions) that argues that evidence from the world of micro-finance shows that sometimes profitability is enhanced by using loans consolidate or shrink firms.

27 This effect has been observed in the field by among others Banerjee and Duflo, in their randomized study of SME lending in India, and described in Beck, Thorsten and Demirgüç-Kunt, Aslı, 2008. “Access to Finance: An Unfinished Agenda”. *The World Bank Economic Review*, Vol. 22, Issue 3, pp. 383-396, 2008

28 Thorsten Beck, 2007. “Financing Constraints of SMEs in Developing Countries: Evidence, Determinants and Solutions”

29 Abhijit V. Banerjee and Esther Duflo, *Poor Economics: A Radical Rethinking of the Way to Fight Global Poverty*, PublicAffairs, 2011

Figure 5 - Total value of the gap in SME credit³⁰

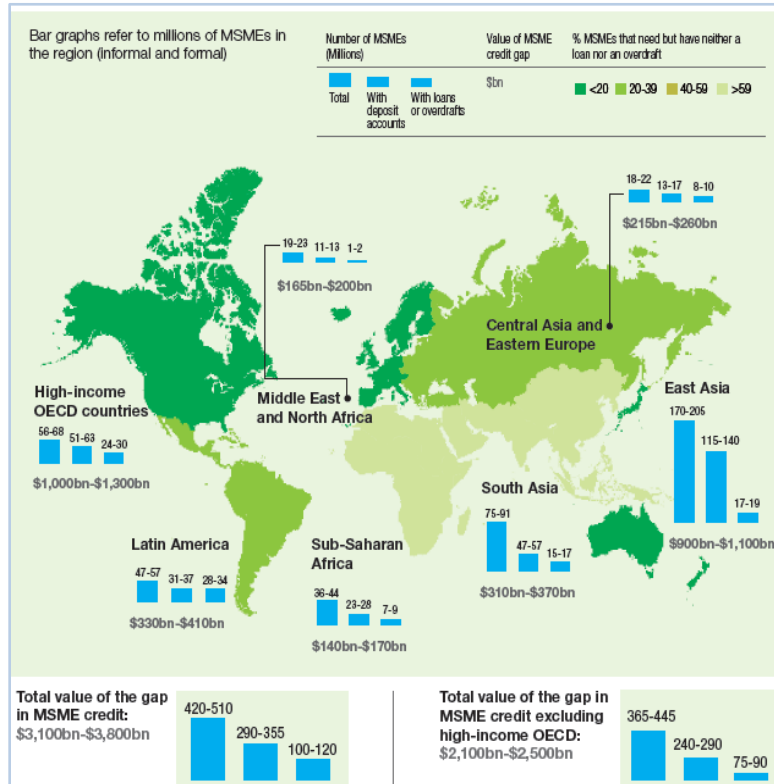
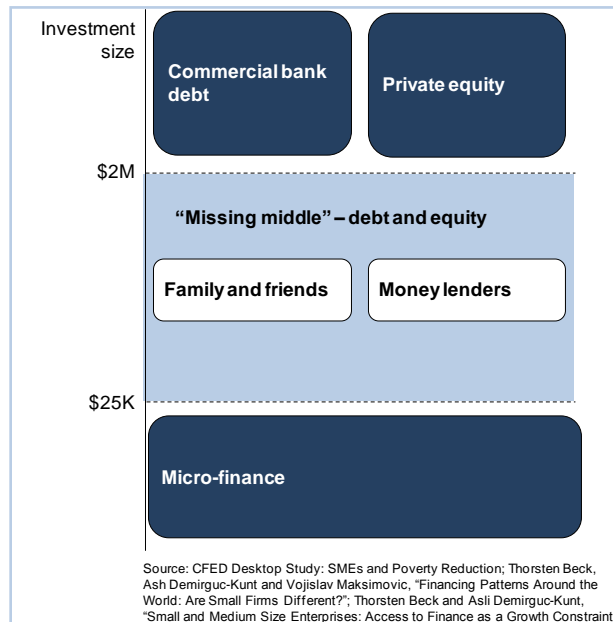


Figure 6 - "Missing middle" of SME financing³¹



30 Peer Stein, International Finance Corporation, Tony Goland, McKinsey & Company, Robert Schiff, McKinsey & Company, "Two trillion and counting - Assessing the credit gap for micro, small, and medium-size enterprises in the developing world". International Finance Corporation, McKinsey, October 2010

31 The upper and lower limits of the missing middle are indicative, and subject to different interpretations and definitions among practitioners

Figure 7 - Access to finance as a major constraint to operations

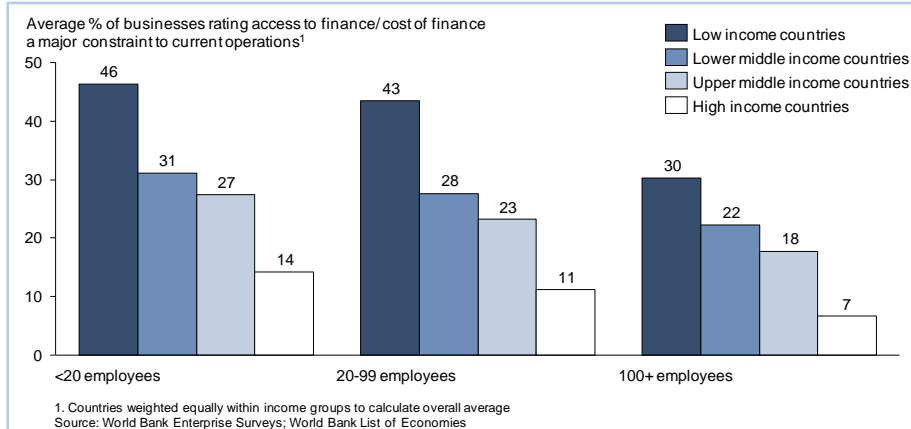
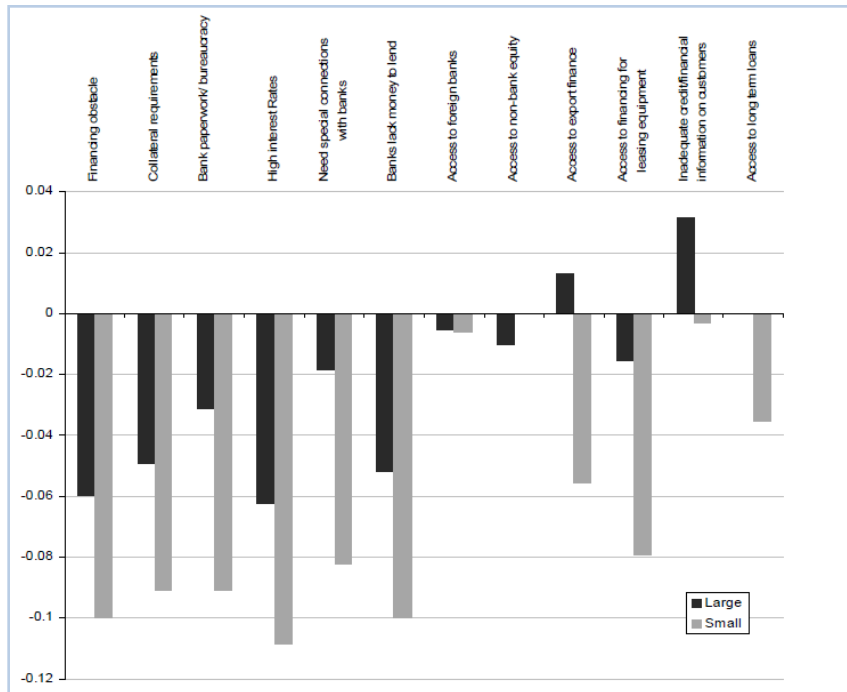


Figure 8 - Impact of growth limiting factors across firms of different sizes³²



³² Beck, Thorsten, Aslı Demirgüç-Kunt, and Vojislav Maksimovic. 2005. "Financial and Legal Constraints to Firm Growth: Does Firm Size Matter?" *Journal of Finance* 60, 137-177

IMPLICATIONS OF SME GROWTH FOR DOMESTIC ECONOMIC DEVELOPMENT

Increased SME growth has a direct effect on GDP growth due to increased output, value add and profits. The GDP contribution per SME is the difference between the return on capital and the cost of capital. Returns on capital are often high, with different datasets showing ranges up to 20-30% a month (for the most capital-strained firms), which is considerably higher than typical interest rates.^{33,34,35} The GDP contribution can be illustrated on a micro-level by looking at the additional economic activity generated by a hypothetical loan, as shown in figure 9 below. This example gives a simplified view on how a SME owner who invested his loan into the purchase of imported goods increases consumption and GDP. This example does not cover the significant multiplier effect in the wider economy, through the increased economic activity of employees and suppliers.³⁶ The relationship between increased SME and GDP growth is touched upon in the World Bank's report, *Finance for All: "If entry, growth, innovation, equilibrium size, and risk reduction are all helped by access to and use of finance, it is almost inescapable that aggregate economic performance will also be improved"*.³⁷

SME growth also impacts GDP indirectly, through increased innovation and macro-economic resilience of the overall economy. Every year new SMEs enter the market, representing 5 to 20% of the existing number of firms. Smaller firms are often the most dynamic and innovative, and can be a test ground for new business ideas.³⁸ Although nearly half of all start-ups will fail within 5 years, a few of them will grow to become large firms, and replace incumbents. This process yields positive structural changes to the economy, can lead to large productivity gains, and is shown to be linked to GDP growth.^{39,40,41,42}

Finally, a stronger SME sector can bolster a country's resilience by broadening and diversifying the domestic economy, thereby reducing the vulnerability to sector-specific shocks and fluctuations in international private capital flows.^{43,44}

33 For example, as described in http://siteresources.worldbank.org/INTFR/Resources/FPD_Issue_1.pdf, real returns to capital for SMEs in Mexico have been 20-33% per month

34 World Bank Surveys

35 A similar phenomenon was observed in microfinance with annualized returns on capital of 70% annually in one study (Karlan, Dean and Jacob Appel, *More than good intentions*, 2011, Penguin)

36 SEAF, 2007. "From Poverty to Prosperity: Understanding the Impact of Investing in Small and Medium Enterprises Data Survey and Case Study Analysis of SEAF Investments"

37 World Bank, "Finance for all, policies and pitfalls in expanding access", 2008

38 Klapper, Leora, Luc Laeven, and Raghuram Rajan. 2006. "Entry Regulation as Barrier to Entrepreneurship." *Journal of Financial Economics* 82(3):591-629

39 Global Entrepreneurship Monitor, 2010. "GEM 2010 Global Report"

40 Scarpetta, S., P. Hemmings, T. Tresselt and J. Woo (2002), "The role of policy and institutions for productivity and firm dynamics: evidence from micro and industry data", OECD Economics Department Working Papers, No. 329

41 DEG Atrium dialogue, "Promoting small and medium Enterprises, Their importance and the role of Development Finance Institutions in supporting them, November 2010

42 Fogel, Kathy & Morck, Randall & Yeung, Bernard, 2008. "Big business stability and economic growth: Is what's good for General Motors good for America?," *Journal of Financial Economics*, Elsevier, vol. 89(1), pages 83-108, July.

43 World Bank, "Finance for all, policies and pitfalls in expanding access", 2008

44 Griffith-Jones, Stephany, Judith Tyson, Pietro Calice, The EIB and SMEs: Key lessons for Latin America and the Caribbean, 2011

More research is needed to understand the impact of SMEs on other economic development drivers.

The annex to this document gives an overview of key economic studies on SMEs. However, the overall body of research is limited. As the World Bank’s report, Finance for All, concludes: “*lack of systematic information is one of the reasons why empirical research has been limited*” and “*little empirical evidence links access to finance to development outcomes*”.⁴⁵ Many stakeholders want to understand the impact of SME growth on cluster formation, formalization or gender and economic inequality. However, no or few studies exist on these topics, with exception of the study by Beck, Demirgüç-Kunt and Levine, which points out a lack of a link between SME growth and the alleviation of income equality or poverty alleviation.⁴⁶ With a lack of empirical research, it is often hard to distinguish between an absence of evidence and evidence of absence.

Box 1: Examples of impact – the Small Enterprise Assistance Fund

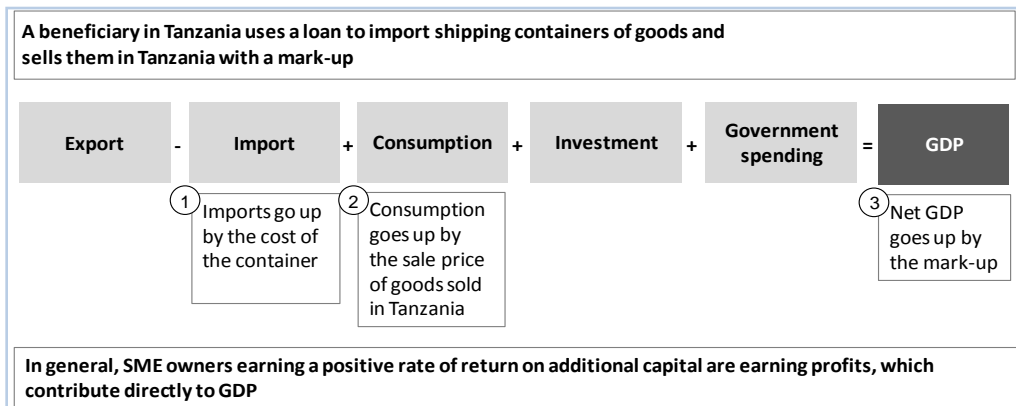
A study conducted by Small Enterprise Assistance Fund (SEAF) highlights the economic impact of investments in SMEs. It found that:

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

Note: SEAF is a privately managed investment fund that provides growth capital and business assistance to SMEs in emerging and transition markets, based in Washington DC

Source: SEAF, 2007. “From Poverty to Prosperity: Understanding the Impact of Investing in Small and Medium Enterprises Data Survey and Case Study Analysis of SEAF Investments”. Five of the firms studied are in Central and Eastern Europe and five are in Latin America. Their annual sales range from US\$ 0.3 million to US\$ 17 million. Their businesses range from handembroidered children’s clothes to electronic components and media products, though many are in food production and processing. Their numbers of employees range from 4 to 308.

Figure 9 - SME contribution to GDP growth



45 World Bank, “Finance for all, policies and pitfalls in expanding access”, 2008

46 Beck, Thorsten, Asli Demirgüç-Kunt, and Ross Levine, SMEs, Growth and Poverty: Cross-Country Evidence, 2005

Box 2: Impact on taxation

SME growth increases government income from taxation. Revenues and profits of SMEs contribute to governments' corporate tax income. Moreover, they stimulate increased indirect taxes (such as value-added taxes). There might also be additional tax income through the taxation of the profits of the investment funds and banks, depending on the local capital gains taxation laws.

The location decision by funds is based on more factors than taxation. Funds make their location decision by combining the need for appropriate financial regulation (e.g. anti-money laundering legislation), political stability and rule of law, a developed financial system, and a financial service industry (e.g. accounting, auditing, legal), with the ability to facilitate cross-border capital transfers. Many African financial systems do not meet these criteria, as the systems are yet underdeveloped, with many systems smaller in size than a mid-sized bank in Continental Europe.⁴⁷ Only a limited set of global financial hubs offer the required services at a competitive price. For example, Mauritius has by far the most developed financial, legal and administrative ecosystem for financial cross-border transactions in Africa. A large number of Africa-focused funds, with both African or international fund managers, have therefore chosen to locate their funds in Mauritius.

Tax revenues would, in some cases, be relatively higher if capital for SMEs was provided by a local rather than a foreign lender / investor. Some NGOs⁴⁸ have criticized private equity funds that are not domiciled in mainland Sub-Saharan Africa. In order to understand this argument, it is helpful to split the tax burden in the three main components: 1) corporate taxes by the SME, 2) taxes paid by the limited partners, and 3) taxes paid by the general partners.^{49,50} As described above, regardless of the location of the investment fund financing them, SMEs pay corporate taxes in their countries of residence. The taxation of general and limited partners is influenced by their country of residence, the location of the SMEs, cross-border taxation legislation and overall capital gains tax rates. In some cases, the tax revenues from the limited and general partners to the government of the investment country would be higher if they were to be based in this same country. In other cases, there would be little to no difference, as there are many African countries that have low to no capital gains taxation.⁵¹

47 Beck, Thorsten and Demirgüç-Kunt, Asli, 2008. "Access to Finance: An Unfinished Agenda". The World Bank Economic Review, Vol. 22, Issue 3, pp. 383-396, 2008

48 For example, campaigns promoted by CEE Bankwatch Network, Bretton Woods Project, Both Ends, Urgewald, Les Amis de la Terre, Campagna per la riforma della Banca Mondiale, Weed

49 A diagram of the structure of a typical investment fund is included in the annex

50 There are other smaller tax components, such as the taxes paid between the fund management company and the income taxes of employees. This assumes a treatment of the investment vehicle as a "pass-through" or "look-through".

51 Furthermore, capital gains are seldom taxed at source

Party	1 SME	2 Limited partner	3 General partner
Example	SME in Kenya	EIB in the EU	Manager in Mauritius /South Africa/other
Type of profit	SME profit	Capital gains ~80% + ~20%	
Tax rate	Local corporate tax rate	0%	Based on location
	↓	↓	↓
	Taxes on profits are paid to local government	All profits are reinvested into projects in the ACP	Profits are taxed based on general partner location

This effect is less significant with regards to IFI investment. The limited partners in the fund, such as the IFIs, receive 80% of the capital gains of the fund. The location of the limited partners is independent of the location of the fund. For example, the EIB is based in Luxemburg, and furthermore, is tax-exempt due to its status as an international financial institution. By its mandate, however, it reinvests any capital returns, including capital gains and dividends of its private equity investments, back into developing countries. The taxation of the general partners (taxation on ~20% of the capital gains) is linked to the fund location and eventually to the countries of residence of the international partners and members of the management team.⁵²

In summary, increased investment in SMEs will increase tax revenues, regardless of the location of the investment fund. The location of the fund will only influence the size of this increase. Especially in the case of IFI investment, this effect is relatively small. Investment funds will make location decisions largely based on their need for stable and sophisticated financial environments that facilitate cross-border investment. Thus, rather than regulating location decisions, the best course of action would be to support the improvement of local financial systems.

⁵² Depending on national legislation, the fund might either be seen as "pass-through" and not taxed, or there might be a usually relatively limited taxation (e.g. a withholding tax of 3% of foreign dividend income in Mauritius)

BARRIERS TO FINANCE FOR SMEs

The following section will first look at debt financing, and the reasons why regular banks provide insufficient debt to SMEs. It will demonstrate that the access to finance gap is a complex problem driven by several factors including lower returns, higher risk perceptions, an uninspiring regulatory environment, and a lack of intermediary skills, experience and capacity.

Debt financing

Banks are not adequately providing SMEs with capital in developing countries. As described in previous sections, there is large financing gap for SMEs in developing countries. The top five banks serving SMEs in non- OECD countries reach only ~20% of formal micro enterprises and SMEs.⁵³ As shown in figure 10, in Sub-Saharan Africa, this number is even lower, at 5%. Nearly 25% of SMEs in emerging markets have a loan but are financially constrained, and almost 60% do not have a loan overdraft, but need one, as shown in Figure 11. This deteriorated further during the 2008-2010 financial crisis.

Banks can often earn high returns in their core markets, giving them little reason to take on additional risk in the SME market. Banks in countries with immature financial systems often face little competition and a low threat of entry and can therefore earn handsome returns by lending to large public and private players.^{54,55} Banks in Africa are among the most profitable, earning often returns in equity in the 15-25% range, as shown in Figure 12.⁵⁶ They might realize the potential of the SME market, but they have little incentive to move outside of their comfort zone and develop SME products.⁵⁷ As Paul Collier observed: *“African banks were operating profitably via the easier and safer role of lending to large firms, and holding high-yielding government debt.”*⁵⁸ As a result, in the words of a manager of one leading African bank *“we have only scratched the surface of the SME market.”*^{59,60}

Banks incur higher administrative costs by lending to SMEs. The costs of lending to SMEs are relatively high, as loan sizes are small, and the transaction costs per loan are relatively constant.^{61,62, 63} This reduces incentives for regular banks to lend to them. The difference in fees, interest rates and relative share of loans to SMEs for African and non-African banks is shown in Figure 13.

Banks have difficulty providing long-term capital. Banks in developing countries are often reliant on short-term liabilities (such as deposits). There are few traditional long-term borrowers, such as pension

53 IFC, 2011 Posing the Challenge on SME Finance” DFI Meeting Paris, March 2011

54 USAID, Paul L. Freedman, 2004. “Designing loan guarantees to spur growth in developing countries”

55 Expert interviews

56 Mark Napier, Including Africa - Beyond Microfinance, CSFI, 2010

57 For example, a recent survey of 91 banks in 45 developed and developing countries found that over 80% of these banks perceived the SME sector as a large market with good prospects (Beck, Demirgüç-Kunt, Martinez Peria, 2008)

58 Paul Collier, “Rethinking Finance for Africa’s small firms”. Proparco Private Sector Development, Issue 1, May 2009

59 Dalberg study for the AFD on credit guarantees (to be published)

60 Competition in the banking sector thus has a direct effect on the ease of financing for SMEs, as pointed out in Beck, Thorsten and Demirgüç-Kunt, Asli , 2008. “Access to Finance: An Unfinished Agenda”. The World Bank Economic Review, Vol. 22, Issue 3, pp. 383-396, 2008

61 Compared to e.g. lending to large companies

62 Costs per loan do not linearly decrease as the loan size declines

63 David de Ferranti, Anthony J. Ody 2007. “Policy Brief #159 Beyond Microfinance: Getting Capital to Small and Medium Enterprises to Fuel Faster Development”, The Brookings Institution

funds, that can provide long-term liabilities to banks. Banks are thus challenged, to avoid a mismatch in the maturities of assets and liabilities, in providing long-term capital to their borrowers (including SMEs). In some countries and regions, such as West Africa, local regulation might further curtail the banks' ability to attract long-term funding⁶⁴, leading the AFDB to conclude that "*Maturity mismatch, stringent bank regulations, and an underdeveloped capital market characterize the West Africa Economic and Monetary Union (UEMOA) region*".⁶⁵ As shown in the next chapter, IFIs can play an important role in addressing the duration gap by providing long-term capital at favourable rates.

Banks have difficulty providing tailored foreign exchange products. SMEs seek financing in currencies that match their income streams, to prevent foreign exchange mishaps. SMEs that have income in foreign currencies (e.g. USD for a cocoa trader) want debt in the same currency. Alternatively, an SME with only local currency income wants to avoid dollar-denominated debt. Banks in developing countries sometimes face restrictive local regulation and limited forex availability that make tailored foreign exchange solutions more difficult.⁶⁶

Banks have limited information, skills and regulatory support to engage in SME lending. There are a variety of different forms of SME lending, as shown in Figure 14. Many forms, however, are difficult to implement in developing countries. The countries often have weak accounting standards, and the SMEs have little to no accurate financial statements on their revenues, profits and ability to pay (see Figure 15). Furthermore, there is often little to no general market data available on the SME market and specific sub-sectors (e.g. default rates).⁶⁷ This limits the potential for lending based on financial statements or small business credit scores. Therefore, banks primarily engage in relationship-based or other forms of collateral-based lending, rather than cash-flow based lending. Banks tend not to provide financing for working capital to SMEs, which is cited by SMEs as one of the areas of greatest need. The lack of collateral for some borrowers and/or clear recourse legislation (e.g. ability to claim collateral) however, can complicate the possibilities to do collateral based lending (e.g. asset-based, real-estate or equipment lending). Finally, banks need specific skills to engage in the different forms of SME lending. A recent Dalberg survey showed that the difficulty in establishing credit-worthiness was a key barrier, with 80% of banks stating challenges in this area.⁶⁸ Lack of these skills can lead banks to shun the SME market in its entirety, and invest only in high-yielding sovereign government debt, or it can translate into inadequate risk management, leading to lower repayment rates and returns. Some recent initiatives, such as the IFC SME banking guide, are aimed at decreasing this skill gap.

These characteristics of the banking system generate unfavourable lending conditions for SMEs.⁶⁹ The higher costs, lack of skills and higher (perceived) risks of investment in SMEs translate into high interest rates and collateral requirements (see Figure 13 and Figure 16). Banks sometimes charge more than

64 The regulations by the Banque Centrale des Etats de l'Afrique de l'Ouest - (BCEAO) stipulate that the ratio of medium and long term loans to time deposits (transformation ratio) must not exceed 25 percent

65 <http://www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/Development%20Research%20Brief%20No%203%202010%20Lengthening%20Financial%20Contracts.pdf>

66 This effect is not present in dollarized economies (e.g. Nigeria, Ghana) or liberalized foreign exchange regimes (e.g. the CFA Zone)

67 For example, 70% of banks state that lack of credit bureaus in their country hampers SME lending (SME Banking Guide)

68 Dalberg study for AFD on credit guarantees (to be published)

69 Thorsten Beck Asli Demirgüç-Kunt María Soledad Martínez Pería, 2008. "Bank Financing for SMEs around the World - Drivers, Obstacles, Business Models, and Lending Practices"

150% of the loan amount in collateral, and interest rates might be 5 to 6% higher than in the rest of the world.^{70,71,72} Furthermore, posting collateral is complicated by the fact that most SMEs operate in environments with weak property rights and poor contract enforcement (see Figure 17), in which borrowers do not have legal titles to house or land, and therefore cannot use these as collateral.^{73,74,75}

SME lending is further held back by a self-reinforcing market failure. The lack of SME lending leads to higher costs and lack of familiarity and knowledge, which in itself can lead to adverse selection (only the riskiest SMEs seek external financing), which in turn can lead to higher costs and interest rates, and less lending. Stiglitz and Weiss showed that this vicious cycle/market failure can lead to an end-state in which no SME lending takes place at all.⁷⁶

Equity financing

A nascent industry of equity providers has emerged in developing countries. Whereas the previous sections discussed the barriers in the provision of debt, this section focuses on equity. As discussed in the previous chapter, SMEs can grow into large firms on a combination of equity investment by the founder⁷⁷, debt and retained earnings. However, the provision of external equity (“private equity”) becomes relevant to facilitating changes in ownership of these larger SMEs, for example when the founder wants to retire. Secondly, there is a sub-set of SMEs, especially start-ups with highly uncertain and fluctuating cash-flows, that are harder to finance through a debt model, and are better suited to external equity investment (“venture capital”).

Historically, there were few external equity providers in developing countries, whether private equity or venture capital. The venture capital and private equity industry is still relatively new, and most players have not expanded beyond the developed world. Furthermore, equity financing is hampered by similar reasons as debt financing (e.g. asymmetric information, lack of reliable financial information).⁷⁸ Finally, entrepreneurs in developing countries have little familiarity and affinity with the equity model. However, over the last decade a private equity industry for developing countries has surfaced, due to the efforts of pioneers such as Business Partners.⁷⁹ Dalberg identified 192 private equity funds supporting SME investment in emerging markets and developing countries with an aggregated capital of US\$7 billion. Many of these funds were created in the last five years, and 60% of them focused on Sub-Saharan Africa.⁸⁰

70 The collateral requirements should be seen in the context of the other barriers. Collateral requirements in Germany are 124% for small firms and 130% for medium firms, yet access to finance is not considered a major barrier to SMEs in Germany

71 Brian Milde, 2008 “Closing the gap: Reaching the missing middle and rural poor through value chain finance” Enterprise Development and Microfinance; Green Leeds, Roger S. 2003. “Financing Small Enterprises in Developing Nations”, New York: Transnational Publishers

72 Maria Soledad Martinez Peria, “Bank financing to SMEs: What are Africa specificities”, Proparco Private sector magazine, May 2009

73 USAID, Paul L. Freedman, 2004. “Designing loan guarantees to spur growth in developing countries”

74 de Soto, Hernando. 2000. “The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else”. New York: Basic Books

75 In Africa, “less than 10% of the continent’s land is formally owned, and barely one African in ten lives in a house with title deeds” Source: The Economist. January 17, 2004. “Survey: How to make Africa smile - a survey of sub-Saharan Africa,” Special Section 6.

76 Stiglitz, J. E., and Weiss, A. (1981). Credit Rationing in Markets with Imperfect Information, American Economic Review 71, 393–410

77 Often augmented by friends and family

78 DEG Atrium dialogue, “Promoting small and medium Enterprises, Their importance and the role of Development Finance Institutions in supporting them, November 2010

79 Business Partners Limited is a specialist risk finance company for formal small and medium enterprises (SMEs) in South Africa, and selected African countries (<http://www.businesspartners.co.za/>)

80 Dalberg analysis, 2009

These players focus mostly on large- and medium-sized firms, and would commonly not invest in smaller SMEs. However, some specialized investment firms have emerged, such as Bamboo Finance⁸¹, which focus on financing small enterprises that have an intentionally positive social impact and address poverty beyond local economic stimulation. In addition, albeit still at a very small scale, the first local venture capital funds have started to emerge in developing countries.

Box 3: Overall effects of the financial crisis on SMEs in developing countries

The financial crisis of 2008-2010 increased the financing gap for SME financing. Banks tightened lending standards during the financial crisis. This resulted in shortened maturities, increased collateral requirements and higher interest rates. Foreign banks reallocated liquidity from their overseas operations, and governments increased their borrowing to cover deficits.¹ This led to a crowding out of financing for market players, such as SMEs, who already had limited access to financial support, and were thus most affected by the tightened lending standards.

The impact of the crisis on companies (including large firms and SMEs) in the developing world has initially not been as marked as in the developed world or in emerging economies. This is mainly due to their comparatively lower reliance on foreign financing and weaker linkage (de-coupling) with the world markets. However, the economies still suffered from delayed effects (secondary shocks) due to the impact through trade and capital flows. Trade flows can be effected by lesser demand for exports (e.g. commodities), and financial flows can be effected due to reduced remittances and due to foreign banks reallocating funds back to their home markets⁸². As mentioned above, firms in all economies will suffer from reduced credit availability, while SMEs in developing countries also suffer from reduced trade credit by larger firms.¹

Countries in the ACP regions were, however, exposed to country-specific crises. Countries in Africa provide different levels of access to SME finance. Similarly, these countries are affected by different local crises (e.g. conflicts, disasters) and windfalls that accompanied the financial crisis, creating a divergence in impacts.

Impact data is only emerging slowly. The financial crisis is still a recent event. Sufficient data is not yet available to assess the impact of the recent financial crisis on SME access to finance.² In addition, the effects of the economic crisis on financial regulation are still not clear. Changes in the international financial architecture might decrease the attractiveness of investing in developing countries. Thus, the impact of the financial crisis on developing countries, and on SMEs in particular, might only become clear in

⁸¹ Bamboo Finance is a commercial investment firm specializing in the financing of global social entrepreneurship by supporting innovating enterprises addressing poverty through affordable healthcare, housing, water, energy and the like. (<http://www.bamboofinance.com>)

⁸² Due to the relative low levels of equity invested by foreign banks in African subsidiaries, it is unclear whether this reallocation of capital happened in practice (Beck and others, Finance in Africa)

the coming years.

Sources:

- 1 Paul Collier, "Rethinking Finance for Africa's small firms". Proparco Private Sector Development, Issue 1, May 2009
- 2 Scaling-Up SME Access to Financial Services in the Developing World; Financial Inclusion Experts Group, SME Finance Sub-Group; October 2010, International Finance Cooperation, World Bank Group, G 20 Seoul Summit 201

Figure 10 - Number of SMEs reached by banks⁸³

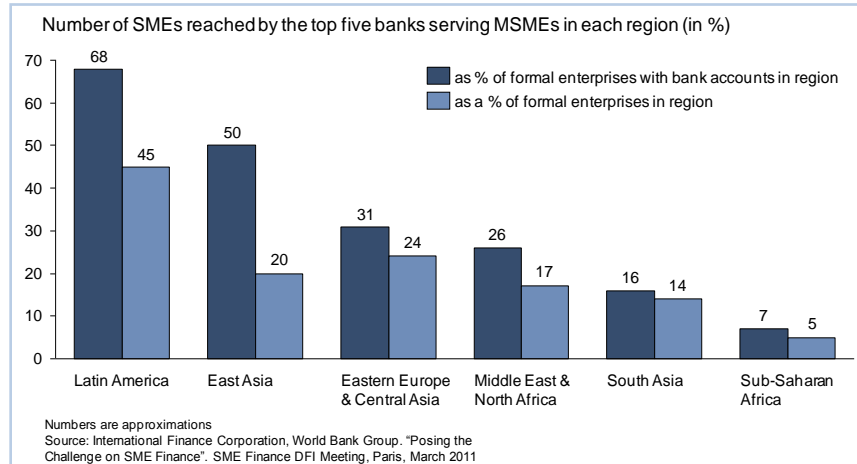
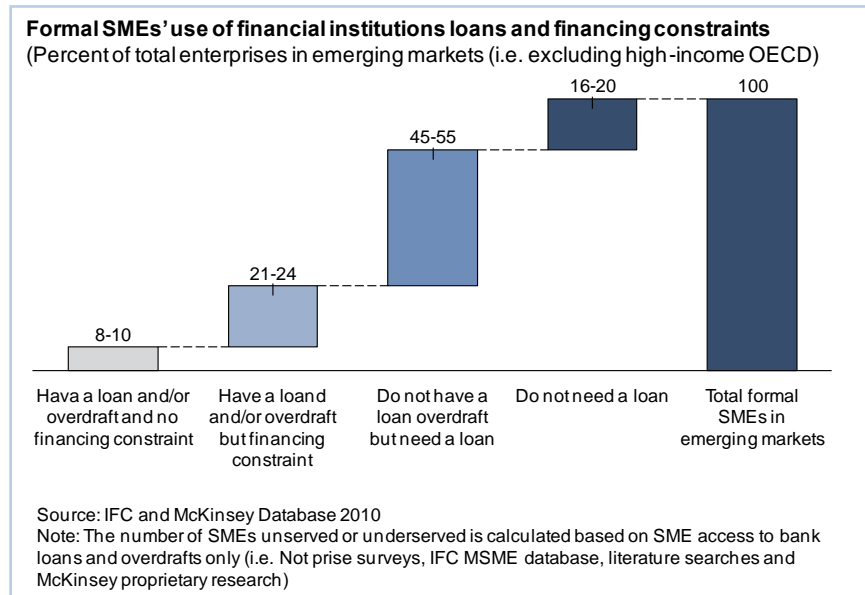


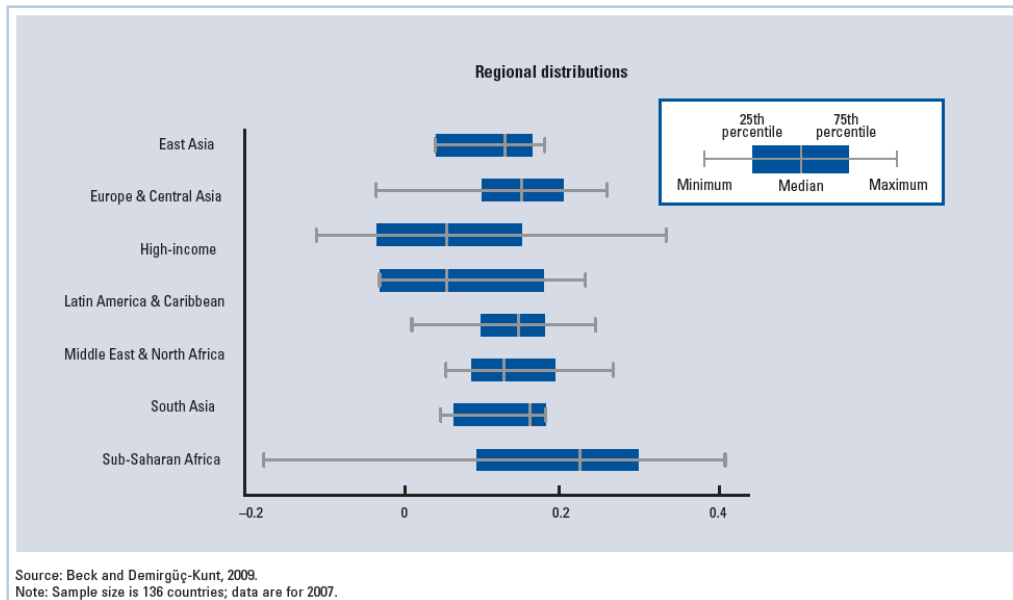
Figure 11 - Financing constraints of SMEs⁸⁴



⁸³ IFC, 2011 Posing the Challenge on SME Finance" DFI Meeting Paris, March 2011

⁸⁴ Formal SMEs consists off those SMEs that are incorporated and registered, for example with the tax authorities, in contrast to informal SMEs

Figure 12 - Bank's return on equity across regions^{85, 86}



85 Thorsten Beck, Tilburg University and the Centre for Economic Policy Research (CEPR), Michael Fuchs, The World Bank, Marilou Uy, The World, 2007. "BankFinance in Africa: Achievements and Challenges"

86 The x-axis of the graph is return on equity, in % (0.2 = 20%)

Figure 13 - Differences in SME lending within and outside Africa

Testing for differences in firm financing features between banks operating in African and in non-African developing countries

Variable	Firm type	Mean for Non-African developing countries	Mean for African developing countries	t-test for differences in means developing-Africa vs. developing-non-Africa
Share of total loans (%)	SEs	13.05	5.44	-2.21**
	MEs	13.88	12.83	-0.17
Share of applications approved (%)	SEs	81.40	68.73	-1.77*
	MEs	82.36	70.68	-1.28
Share of loans for investment (%)	SEs	47.01	28.24	-2.36**
	MEs	47.23	37.04	-1.27
Share of secured loans (%)	SEs	81.71	74.40	-0.73
	MEs	83.29	79.33	-0.50
Loan fees (% of size of loan)	SEs	0.95	1.97	2.61**
	MEs	0.81	1.79	2.51**
Interest rates on best clients (%)	SEs	11.12	15.66	2.22**
	MEs	9.68	15.42	2.88**
Interest rates on worst clients (%)	SEs	15.43	21.45	2.63**
	MEs	13.58	20.08	3.02***
Share of non-performing loans (% of total loans)	SEs	5.47	14.47	2.05*
	MEs	5.07	6.84	1.00

*SE stands for small enterprises. ME stands for medium-sized enterprises.
 ***, **, * denote significance at 10, 5, and 1 percent, respectively.*

Figure 14 – types of SME lending

Technology	Type	Borrower	Information
Relationship lending	Relationship	Opaque	Soft
Financial statement lending	Transaction	Transparent	Hard
Asset-based lending	Transaction	Opaque	Hard
Factoring	Transaction	Opaque	Hard
Leasing	Transaction	Opaque and transparent	Hard
Small business credit scoring	Transaction	Opaque	Hard
Equipment lending	Transaction	Opaque and transparent	Hard
Real estate-based lending	Transaction	Opaque and transparent	Hard
Trade credit	Transaction	Opaque and transparent	Soft and hard

There are different ways to lend to SMEs. (Taketa, Udell, 2006). The type of borrower, a lack of information and a lack of legislation can complicate / close off a number of these lending technologies.

Source: Taketa, K. and G. F. Udell (2007) Lending Channels and Financial Shocks: The Case of Small and Medium-Sized Enterprise Trade Credit and the Japanese Banking Crisis. *Monetary and Economic Studies* 25(2): 1-44.

Figure 15 - Availability of financial information of SMEs

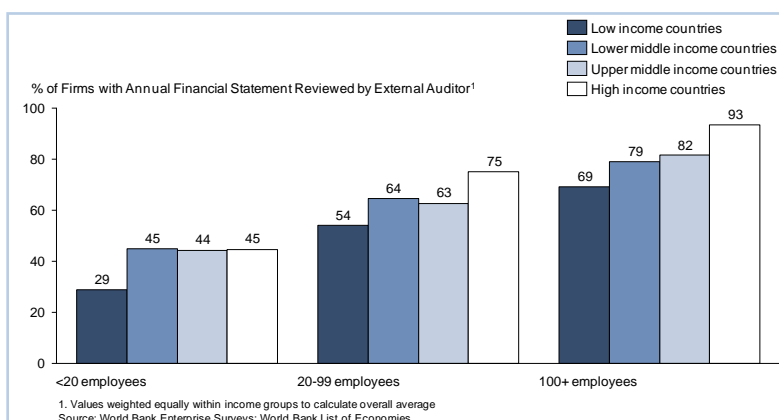
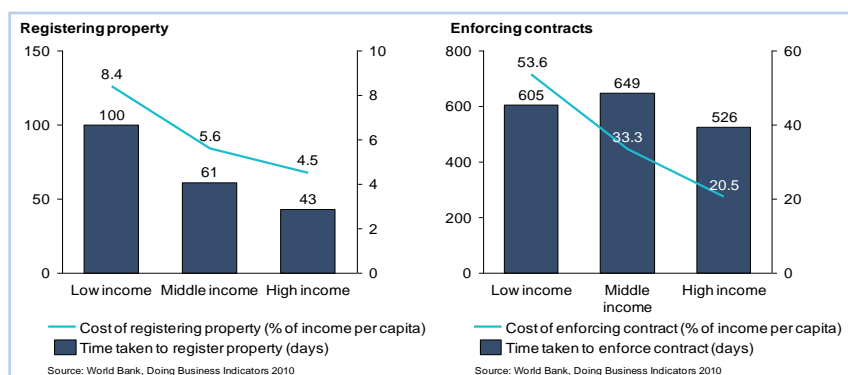


Figure 16 - Financing obstacles for SMEs⁸⁷

Region	Locations to submit loan applications (out of 5)	Minimum amount for a SME loan (% of GDP/cap.)	Fees on a SME loan (% of GDP/cap.)	Days to process
Sub-saharan Africa	2.51	760	15.77	12.04
Latin America and Caribbean	3.82	141	1.15	10.68
Asia	2.45	790	2.93	23.93
Eastern Europe and Central Asia	2.80	441	2.58	8.15
Middle East and North Africa	3.21	339	10.66	12.47
OECD	3.91	14	1.34	6.38

Figure 17- Cost/time taken to register property and enforce contracts



87 Julien Lefilleur, "Financing SMEs in the context of strong asymmetry of information". Proparco Private Sector Development, Issue 1, May 2009

THE ROLE FOR IFIs IN SME FINANCING

IFIs play a substantial role in improving access to finance for SMEs in developing countries. They are often better placed to perform this role than individual donor governments or local governments, due to the IFI model of working through intermediaries, the provision of technical assistance, as well as benefits in cost efficiency, incentive alignment and sustainability.

IFIs have built up extensive portfolios of SME loans and investments. IFIs have exhibited strong interest in development interventions in the SME space. SME financing programs combine three IFI priority areas: private sector development, promotion of access to finance and SME growth.⁸⁸ The total amount of capital committed by IFIs to SMEs in developing countries is difficult to estimate, as data isn't available for every individual SME portfolio. Besides the provision of capital, IFIs have invested significantly in activities and programmes around policy advice, technical assistance and capacity building.⁸⁹

It is likely that IFI engagement in the SME space will increase further in coming years. The interest of the global community in SMEs shows no sign of diminishing: they were on the agenda during recent G20 meetings, including the Pittsburgh meeting, which emphasized the need to “scale up successful models of SME financing”⁹⁰, and the meeting in Seoul, where government leaders and IFIs launched a new facility to support innovative SME financing models.

IFIs target the barriers that limit access to finance for SMEs. IFIs provide capital and technical support to address the barriers outlined in the previous chapter. Through the provision of long-term capital and tailored foreign exchange products, they help to strengthen the matching of the type and structure of assets with the liabilities for intermediary banks. Their support helps overcome barriers in skills, information and regulatory support, both through the experience gained by intermediaries in on-lending of the provided capital, and through capacity-building interventions. Finally, they improve the wider lending environment by supporting regulatory frameworks and developing the overall lending infrastructure (e.g. supporting creation of credit agencies).

IFIs are generally better placed than other public actors to support SMEs in developing countries. The scale and skills of IFIs, combined with their operating model of working through local financial intermediaries, allow them to support SMEs more efficiently and effectively than individual member governments in donor countries or local governments in developing countries. The following paragraphs outline the main advantages:

⁸⁸ IFIs include in the context of this chapter also bilateral financing institutions, such as development financing institutions (DFIs)

⁸⁹ Scaling-Up SME Access to Financial Services in the Developing World; Financial Inclusion Experts Group, SME Finance Sub-Group; October 2010, International Finance Cooperation, World Bank Group, G 20 Seoul Summit 2010

⁹⁰ The G20 Financial Inclusion Experts Group (FIEG) was launched in Pittsburgh. From: DEG Atrium dialogue, “Promoting small and medium Enterprises, Their importance and the role of Development Finance Institutions in supporting them, November 2010

- Alignment of incentives.** Government schemes to support SME investment are common, but they have had mixed effectiveness.⁹¹ The effectiveness and efficiency of many attempts by local public actors to increase SME lending has been judged as “problematic”⁹² and “doubtful”.^{93,94} The lack of impact is sometimes linked to the direct management of credit facilities by public actors, the misuse of funds to foster political rather than economic objectives, or the subversion of loans for political goals.⁹⁵ IFIs are much less likely to be captured by local interests, as they are significantly less sensitive to local stakeholders, focus explicitly on long-term sustainability, and operate at arm’s length by using financial intermediaries. Therefore, the incentives of IFIs are likely to be more compatible for sustainable SME support than those of local public actors.
- Improved cost-efficiency.** IFIs operate by working with financial intermediaries. This approach improves cost efficiency in comparison with direct lending to SMEs, the model used by some local governments. IFIs would face two main challenges if they lent directly to beneficiaries; first, IFIs do not possess the capacity to serve and monitor the large number of potential clients in emerging markets (350-450 million), and second, most IFIs based in developed countries have cost structures that would not allow cost-effective selection and monitoring of beneficiaries in developing countries. Working through local intermediaries not only reduces costs, but also enables IFIs to take advantage of the local intermediaries’ knowledge of and closeness to the final beneficiary. In addition, it allows IFIs to analyse and mitigate potential risks more effectively.⁹⁶ This argument is supported by IFC evaluations that suggest direct financing is costly and ineffective in meeting the needs of clients⁹⁷, and historically there has been a shift away from direct investment toward “wholesaling” SME support through financial intermediaries.⁹⁸ Other evaluations have shown that *“some of the best-regarded schemes do not conduct retail assessments but instead rely on an assessment of the intermediary.”*⁹⁹

Finally, the overall cost-efficiency of most IFIs’ SME facilities is corroborated by the fact that they are profitable and self-sustaining, which unfortunately is not true of many local government schemes.¹⁰⁰

- IFIs are capable of offering an integrated approach toward SME finance.** The previous chapter described how the access to finance gap is a multifaceted problem, driven by a lack of capital, as well as by a lack of intermediary skills, experience and capacity, and a lacklustre regulatory environment. IFIs have an advantage in the sense that they can offer technical assistance and capacity building alongside financial support, and provide support and interventions to

91 Scaling-Up SME Access to Financial Services in the Developing World; Financial Inclusion Experts Group, SME Finance Sub-Group; October 2010, International Finance Cooperation, World Bank Group, G 20 Seoul Summit 2010

92 World Bank, 2004, “World Development Report 2005: A Better Investment Climate for Everyone”, Washington D.C.: Oxford University Press

93 Levitsky, Jacob, Credit guarantee schemes for SMEs – an international review, Small Enterprise development, 1997

94 World Bank, “Finance for all, policies and pitfalls in expanding access”, 2008, page 163

95 World Bank, “Finance for all, policies and pitfalls in expanding access”, 2008, page 163

96 Final beneficiary can be defined as the local SME receiving IFI financing through the local financial intermediary. Example: The IFC provides financing to a Kenyan Bank, which on-lends this money to a local SME, which uses the money to invest in its farming activities

97 Private sector development strategy – directions for the World Bank Group, April 9, 2002

98 Private sector development strategy – directions for the World Bank Group, April 9, 2002

99 World Bank, “Finance for all, policies and pitfalls in expanding access”, 2008

100 The presence of profitable lending opportunities that are not arbitrated away by other market players is a potential indication of market failure

strengthen the lending environment. These interventions can help, for example, to reduce the probability and impact of defaults in the loan and portfolio, and to reduce the overall transaction costs to investors/lenders.¹⁰¹ Interventions to reduce the probability of default are linked to decreasing information asymmetries, such as investment in credit bureaus.¹⁰² An example of an intervention to reduce losses in case of a default would be the creation or streamlining of collateral recovery procedures.¹⁰³ IFIs' capabilities to operate integrated programs differentiate them from other actors.

- **The IFI model stimulates sustainable local financial systems.** IFI support can play a crucial role in building strong and sustainable local financial systems in developing countries. First, IFIs do not “crowd-out” other private sector investors. They target market imperfections that result in a lack of financing for creditworthy borrowers. Thus, IFIs aim to provide capital that would not be provided by other parties, and do not replace the efforts of other private sector actors (i.e. the provided capital is “additional”). Secondly, by working through intermediaries, IFIs help these players gain skills, experience and a track record. Capital and support from IFIs in the form of credit appraisal and technical assistance can reduce the barriers for local institutions to operate in the SME sector. The lenders may eventually acquire sufficient skills and information to lend to SMEs without assistance.¹⁰⁴ Thirdly, IFIs support both local and foreign intermediaries, in contrast to many other players. Foreign banks can play a beneficial role by introducing competition, increasing efficiency and transmitting knowledge and skills; in doing so, they contribute to a stronger local financial ecosystem.^{105,106} Beck, Fuchs and Uy observe that foreign bank activities tend to have a positive overall effect on the efficiency and stability of countries' financial systems.¹⁰⁷ Overall, the IFI model will help to strengthen the local financial system, and will allow intermediaries in poorer countries with currently underdeveloped capital markets to raise financial resources locally in the long term. In the meantime, however, intermediaries, the SME sector and the economy as a whole will benefit from the capital and skills provided by IFIs.¹⁰⁸

Box 4: Breakdown of types of SME financing by IFIs:

Credit lines

Credit lines are loans to intermediary banks and financing institutions. These institutions pass on the loans to local SMEs in support of their investment projects.

Guarantees

101 Scaling-Up SME Access to Financial Services in the Developing World; Financial Inclusion Experts Group, SME Finance Sub-Group; OCTOBER 2010, International Finance Cooperation, World Bank Group, G 20 Seoul Summit 2010

102 Emilio Sacerdoti, “Credit to the private sector in Sub-Saharan Africa, developments and issues”. Proparco Private Sector Development, Issue 1, May 2009

103 Emilio Sacerdoti, “Credit to the private sector in Sub-Saharan Africa, developments and issues”. Proparco Private Sector Development, Issue 1, May 2009

104 Honahan, P., 2008. “Partial Credit Guarantees: Principles and Practice”, Trinity College Dublin, Prepared for the Conference on Partial Credit Guarantees, Washington DC, March 13-14, 2008

105 World Bank, “Finance for all, policies and pitfalls in expanding access”, 2008

106 Beck, Thorsten, Demirguc-Kunt, Asli, 2006. “Small and Medium-size enterprises: Access to Finance as a Growth Constraint”

107 Beck, Thorsten, Michael Fuchs, and Marilou Uy, Finance in Africa – Achievements and Challenges, 2009.

108 European Investment Bank, 2011

Credit guarantees insure/guarantee part of the credit risk for banks. The IFI takes on part of the credit risk for intermediaries by committing to reimburse the intermediary if the final beneficiary fails to repay a loan.¹⁰⁹

Private equity investments

IFIs provide financing to private equity funds, whose managers in turn invest the IFIs' and other private investors' money in equity of businesses in developing countries. The private equity funds acquire a share of ownership of the SME's business, and, by making additional capital available to them, enable them to grow and expand their economic activity.

Box 5: The IFI intermediary model: Controls and Incentives

IFIs aim to promote optimal behaviour by their intermediaries at the lowest possible costs. The following paragraphs outline the key elements of this model.

The IFI objective is to align incentives with the intermediary. IFIs are careful to minimize moral hazard (i.e. reckless conduct¹¹⁰) or adverse selection at the level of FIs or SMEs. The IFI support needs to be structured so that the incentives of the intermediary are aligned with those of the IFI, which is done by leaving part of the financial risk with the intermediary. This maintains incentives for the intermediary to screen beneficiaries thoroughly. Numerous 100% or near-100% government guarantee schemes have resulted in excessive defaults.¹¹¹ Most IFIs do not take more than 50% of the financial risk of the final beneficiaries. There is on-going academic research on the optimal structure of credit guarantees and on on-lending standards that create the right incentives for the intermediary.¹¹²

IFIs have developed environmental, social and governance standards for their intermediaries. IFIs delegate the selection and the monitoring of final beneficiaries to the FIs. However, all IFIs have statutory policies on environmental, social and governance standards (ESG) issues, and thus have developed control frameworks to ensure that FIs follow these standards and improve the intermediaries' internal monitoring processes. At the same time, the complexity of standards and the monitoring costs need to be as low as feasible, in order to reduce negative consequences for FI competitiveness.¹¹³

IFIs use similar approval and disclosure processes to safeguard the ESG impact of their investments. Dalberg completed a benchmark analysis between the different IFIs

¹⁰⁹ Guarantees can be partial or full, and can be at the level of individual borrowers or at the level of the portfolio

¹¹⁰ Borrower might also engage in more risk-seeking behavior if he knows that the loan is guaranteed by a third party.

¹¹¹ USAID, Paul L. Freedman, 2004. "Designing loan guarantees to spur growth in developing countries"

¹¹² Scaling-Up SME Access to Financial Services in the Developing World; Financial Inclusion Experts Group, SME Finance Sub-Group; OCTOBER 2010, International Finance Cooperation, World Bank Group, G 20 Seoul Summit 2010

¹¹³ Expert interviews with IFIs

on their approval and disclosure processes. IFIs' approval procedures are largely similar, regarding both debt and equity. For example, none of the IFIs can publicize the names of beneficiaries without their consent, due to the need to respect client confidentiality. The annexes of this document give a summary of this benchmark analysis.

Public discussions need to maintain a focus on the balance between the costs and benefits of intermediary monitoring. The IFI on-lending through financial intermediaries is a principal-agent problem where the principal (the IFI) needs to monitor the performance and actions of the agent (the financial intermediary).¹¹⁴ There needs to be a balance between the costs and benefits of monitoring the agent; it is possible that the costs of increased monitoring outweigh the marginal benefits.¹¹⁵ Although it still might be possible to decrease the amount of undesired behaviour in this case, the overall monitoring cost increase would be disproportionately large. Public money in this case would be wasted, and the beneficiaries of the IFIs in the developing world would lose out. Dalberg cannot estimate at the moment whether the optimal trade-off between monitoring costs and benefits has been achieved, and we realize that donors and IFI management are highly sensitive to the performance shortcomings of the financial intermediary. However, we do observe that the realization that there is a trade-off between costs and benefits, and a potential optimum in which there might be a limited amount of incidents, is often absent from stakeholder discussions.

¹¹⁴ There are additional principal-agent problems between the funders of the IFI and the IFI, and between the FI and its borrowers

¹¹⁵ The trade-offs in monitoring and information costs in principal-agency problems has among others been explained by Paul Milgram and John Roberts in "Economics, Organization and Management"

RECOMMENDATIONS AND ADDITIONAL RESEARCH

- Stimulate additional research on the impact of capital provision to SMEs on economic indicators at the micro- and macro-level. There is a large amount of anecdotal information on impact, but few systematic, controlled studies.¹¹⁶ Figure 18 shows wide academic consensus that the topic of SMEs in development is heavily under-researched.
 - Analyse the effect of access to finance on the financial (growth and profitability) and operational characteristics of individual firms
 - Analyse the aggregated effect of increased capital on the sectoral and macro-economic levels (e.g. GDP, output, employment), including different socio-economic groups
 - Analyse the effect on organizational behaviours (e.g. innovation) and on social impact (e.g. female participation in the workforce, minority inclusion, etc.)
 - Work toward a differentiated understanding of the impact of SME financing on different sectors (e.g. agriculture, services) and lending channels
 - Support initiatives to harmonize SME definitions among stakeholders to facilitate collecting and comparing data

- Stimulate additional research on the effectiveness of IFI interventions. There are (too) few studies on the effectiveness of different forms of capital and technical assistance provision to FIs.
 - Analyse the effects of different financial structures (e.g. loan conditions, risk sharing on credit guarantees) on incentives and performances. As noted in “Scaling-Up SME Access to Financial Services in the Developing World,”¹¹⁷ it would be helpful to have an IFI-coordinated initiative on core principles – guarantee schemes, best practices in coverage ratios, eligibility criteria, payment rules, etc.
 - Analyse the effectiveness of different technical assistance packages, especially with an eye on strengthening intermediary capacity to provide independently responsible lending and investment in the long-term

- Evaluate the best balance and timing of the different interventions in the wider portfolio of supporting interventions around SME financing.
 - Analyse the comparative cost-effectiveness of interventions that strengthen financial structures, such as those focused on strengthening property rights and contract law (e.g. collateral recovery procedures), and those that aim to reduce information asymmetries (e.g. credit bureaus and harmonized accounting systems) in relationship to direct financial support to SMEs^{118 119}

¹¹⁶ For example, the DEG Atrium report refers to “A recent review of SME programs in Mexico found 151 programs that were evaluated in qualitative and rudimentary ways which did not allow an assessment of the costs and benefits of the interventions

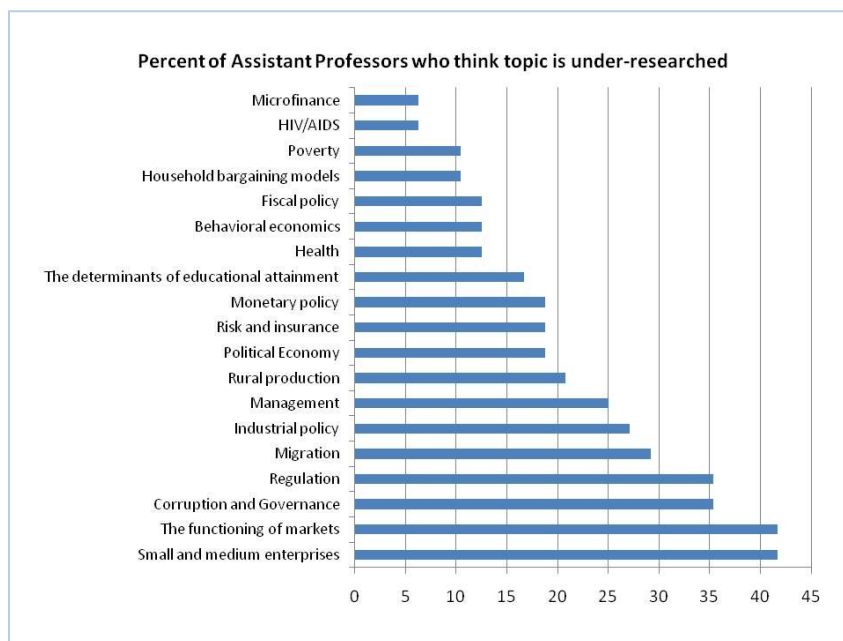
¹¹⁷ Scaling-Up SME Access to Financial Services in the Developing World; Financial Inclusion Experts Group, SME Finance Sub-Group

¹¹⁸ Emilio Sacerdoti, “Credit to the private sector in Sub-Saharan Africa, developments and issues”. Proparco Private Sector Development, Issue 1, May 2009

¹¹⁹ Emilio Sacerdoti, “Credit to the private sector in Sub-Saharan Africa, developments and issues”. Proparco Private Sector Development, Issue 1, May 2009

- Provide technical assistance and capacity building that prepares for the post-IFI era. The role of the IFI in its support to FIs is inherently time-limited.
 - Provide capacity building efforts that could lead to well-managed, sustainably financed SME support mechanisms (especially credit guarantees) at the national level. These mechanisms could be government led, but also could be independent guarantee funds, following the example of the Namibian Small Business Credit Guarantee.¹²⁰
 - Technical assistance should help to strengthen controls for IFI-provided financing, but efforts are required as well to build the financial infrastructure and control framework for the post-IFI era. There should be support to change the strategic or operational capacity and behavior of FIs to monitor ESG issues, even for non-IFI funding.
- Increase the available aggregated information (e.g. sectoral/geographic) on SME on-lending (debt).

Figure 18 - Topics that academic researchers think are under-researched or are interested to see more research on:¹²¹



120 Julien Lefilleur, "Financing SMEs in the context of strong asymmetry of information". Proparco Private Sector Development, Issue 1, May 2009

121 These responses come from approximately 50 assistant professors in the U.S. and at international universities who do development research. They answered what topics they think are under-researched or that they would be particularly interested in seeing more research on. Graphs and explanation from <http://blogs.worldbank.org/impactevaluations/what-are-the-under-researched-topics-in-development-according-to-young-faculty>

ANNEX I – COMPARISON OF INVESTMENT STANDARDS ACROSS IFIs

This section compares the high-level approval process and lending standards of the leading IFIs. Six IFIs (ADB, AFDB, EBRD, EIB, IFC and OPIC) have been compared on their i) pre-approval process of beneficiaries, ii) the transparency of intermediary information and iii) the transparency of beneficiary information for both debt and equity investments.¹²² The table below provides a summary overview of the results. More information can be found in the annex.

In summary, IFIs are closely aligned on the pre-approval process of beneficiaries and the amount of information disclosed. All IFIs delegate the pre-approval process of beneficiaries to intermediaries. With respect to information disclosure on intermediaries, all IFIs disclose the amount invested in intermediaries on its debt and equity investments. There are some differences between IFIs in the amount of information disclosed on the intermediaries' ESG performance. No IFI discloses beneficiary data on debt, although some do so on the equity side (with prior Private Equity fund approval).

Debt financing

IFIs use similar mechanisms to pre-approve final beneficiaries. IFIs delegate responsibility to intermediaries for the pre-approval process.¹²³ All financial intermediaries are however pre-approved, and all IFIs have systems and procedures in place (including environmental and social assessment), with which the intermediaries have to comply and regularly report. When there is a high likelihood that a project will have an adverse environmental impact, it is either assessed more stringently or excluded from the portfolio.

All IFIs interviewed share information on their intermediaries. Though they differ in the content and quantity of information shared with the public, all IFIs disclose the amount invested for each intermediary. Three IFIs (EBRD, AFDB, EIB) disclose the environmental, social and governance information only in aggregate form or in the form of examples in their different brochures and publications. Two IFIs (ADB, and IFC) disclose the amount invested as well as the ESG performance on each of its financial intermediaries. The EIB discloses the amount invested per intermediary, as well as the aggregated ESG performance across the intermediaries. None of the IFIs can make the names of beneficiaries public without their consent, due to the need to respect client confidentiality.

¹²² The assessment of the processes and impacts of the lending standards is out of scope for this project and would require an in depth audit.

¹²³ The EIB has however a final approval on whether or not it accepts the final beneficiary as suggested by the financial intermediary

DEBT				
	Pre-Approval		Transparency and disclosure	
	Approval of beneficiary		Reports on intermediaries	Reports on beneficiaries
	Does the IFI pre-approve beneficiaries?	Is a project with a high likelihood of an adverse environmental impact assessed more stringently than a project with no environmental impact?	Are the names of intermediaries, the amounts invested in intermediaries and ESG performance communicated to the public?	Are the names of beneficiaries, the amounts invested in beneficiaries and ESG performance communicated to the public?
IFI				
ADB	No	Yes	Name of intermediary: yes Amount invested: yes ESG: yes	Name of beneficiary: no Amount invested: no ESG: no
AFDB	No	Yes	Name of intermediary: yes Amount invested: yes ESG: no	Name of beneficiary: no Amount invested: no ESG: no
EBRD	No	Yes	Name of intermediary: yes Amount invested: yes ESG: no	Name of beneficiary: no Amount invested: no ESG: no
EIB	Yes	Yes	Name of intermediary: yes Amount invested: yes ESG: aggregate	Name of beneficiary: no Amount invested: no ESG: no
IFC	No	Yes	Name of intermediary: yes Amount invested: yes ESG: yes	Name of beneficiary: no Amount invested: no ESG: no
OPIC (to be completed / confirmed)	No	Yes	Name of intermediary: yes Amount invested: NA ¹²⁴ ESG: NA	Name of beneficiary: no Amount invested: NA ESG: NA

¹²⁴ No information was obtained and/or validated from/by OPIC on these dimensions.

Equity financing

IFIs use similar mechanisms to pre-approve final investments. No IFIs pre-approve beneficiaries for equity investments through investment funds. These IFIs delegate the pre-approval responsibility to fund managers, and all IFIs appraise the capacity of the fund managers. The IFIs can influence decisions on investment policies through their seat on the advisory committee of the fund, but generally do not interfere in investment decisions. Furthermore, the IFIs have systems and procedures that fund managers have to comply with and report on (including environmental and social assessments).

All IFIs interviewed share information on their fund managers. Information disclosure differs in the type and amount of information shared with the public. Two IFIs (EBRD and EIB) disclose the amount invested for each fund manager. Environmental, social and governance information are not disclosed systematically but in aggregate form or in form of examples in the different brochures and publications. The IFC provides financial and ESG information.¹²⁵ The ADB and AFDB only make general project information and the amount invested available.

Information disclosure on beneficiaries of private equity investments differ across IFIs. With regards to the information disclosure on beneficiaries, the EIB, ADB, AFDB and EBRD do not disclose any information on the final beneficiary. The IFC and OPIC provide basic project information on beneficiaries that the funds they invest in are willing to share.

IFIs might disclose additional information in the case of individual information requests. Information on fund managers and beneficiaries, however, is shared only after consultation with the fund managers. Information on the beneficiaries is communicated less frequently due to confidentiality agreements.

All IFIs follow similar approaches to non-compliance in taxation. All IFIs follow international regulations and have policies toward non-compliant tax jurisdictions. These policies prohibit investment in funds that are domiciled in black-listed jurisdictions.^{126, 127}

Box 6: Restrictions to information disclosure

The benchmark analysis shows that restrictions to disclose information on beneficiaries are due either to legal confidentiality agreements or to a negative impact on the beneficiary's competitiveness. IFIs mentioned that in many cases, especially for private equity investments, they are bound to confidentiality agreements between the final beneficiary and the intermediary. In the case a confidentiality agreement is signed, a confirmation from each beneficiary would be needed to disclose information. IFIs have further raised the issue that if intermediaries are not comfortable with disclosure of information, they might reduce their lending and investment activities with the

¹²⁵ Amount invested

¹²⁶ European Investment Bank, 2010. "EIB Policy towards weakly regulated, non-transparent and uncooperative jurisdictions" http://www.EIB.org/attachments/strategies/ncj_policy_en.pdf

¹²⁷ <http://www.oecd.org/dataoecd/50/0/43606256.pdf>

respective IFIs. The disclosure of information, even if it is in an aggregate form in which the name of the beneficiary is not mentioned, can negatively affect the beneficiary's competitiveness. If, for example, the sector as well as the country in which the SME operates is very small, aggregate information could easily reveal the final beneficiary.

Source: Interviews

EQUITY				
	Pre-Approval		Transparency and disclosure	
	Approval of beneficiary		Reports on fund managers	Reports on beneficiaries
	Does the IFI pre-approve beneficiaries?	Is a project with a high likelihood of an adverse environmental impact assessed more stringently than a project with no environmental impact?	Are the names of fund managers, the amounts invested in fund managers and ESG performance communicated to the public?	Are the names of beneficiaries, the amounts invested in beneficiaries and ESG performance communicated to the public?
IFI				
ADB	No	Yes	Name of fund manager: yes Amount invested: yes ESG: no	Name of beneficiary: no Amount invested: no ESG: no
AFDB	No	Yes	Name of fund manager: yes Amount invested: yes ESG: no	Name of beneficiary: no Amount invested: no ESG: no
EBRD	No	Yes	Name of fund manager: yes Amount invested: yes ESG: no	Name of beneficiary: no Amount invested: no ESG: no
EIB	No	Yes	Name of fund manager: yes Amount invested: yes ESG: no	Name of beneficiary: no Amount invested: no ESG: no
IFC	No	Yes	Name of fund manager: yes Amount invested: yes ESG: yes	Name of beneficiary: yes if in accordance with fund Amount invested: no ESG: no
OPIC (to be completed/confirmed)	No	Yes	Name of fund manager: yes Amount invested: NA ESG: on each intermediary	Name of beneficiary: yes if in accordance with fund Amount invested: NA ESG: NA

***Information in aggregate form:** Intermediary - no information on the intermediary, but on a country or sector basis is disclosed e.g., the IFI has invested x M USD through intermediaries in the construction sector in Africa; beneficiary - no information on the beneficiary, but on a country or sector basis is disclosed e.g., the intermediary has lent x M USD to the construction sector in Kenya

ANNEX II – STEERING GROUP

Biographies of Steering Group members:

- **Marc Breij.** Marc serves as fund manager for Cordaid’s Financial Services fund (Euro 60 million), which invests in MFIs and SME funds in developing countries. Marc was a member of Cordaid’s Investment Committee before joining the company. He represents Cordaid on various SME and microfinance funds, like Dia Vikas, WMF and InReturn. Marc served for 18 years at ABN AMRO Bank in various domestic and international management positions, lastly in the role of Executive Director and Global Head of Country Risk Management. Marc is currently also partner at MetisGRC, a risk management and governance consultancy firm. Marc holds a master degree in Economics at Tilburg University.
- **Amit Bouri.** Amit serves as Director of Strategy and Development of the Global Impact Investing Network. He focuses on strategic planning, program development, and external relations. His work in impact investing began when he was a strategy consultant with the Monitor Institute. At Monitor he was part of the team that produced the Investing for Social & Environmental Impact report (2009) and supported the business planning for the GIIN and several of its initiatives. Amit holds an MBA from Northwestern University's Kellogg School of Management, an MPA from Harvard University's John F. Kennedy School of Government, and a BA in Sociology and Anthropology from Swarthmore College.
- **Magatte Diop.** Magatte has more than 25 years of experience in international finance, investing and management. He is the founder of Peacock Investments and ILICO. Magatte was Vice President and Regional Director for CITIBANK/CITICORP for West and Central Africa. Magatte supervised the bank's relationships with more than 200 financial institutions including central banks, development banks, commercial banks and government agencies in the Africa region. Magatte Diop is also President of the African Chamber of Commerce in the United States, and is active in a number of initiatives on the promotion of investment between the US and Africa. He holds a Master of Business Administration (MBA) from the Stern School of Business at New York University.
- **Randall Kempner.** Randell is the first Executive Director of Aspen Network of Development Entrepreneurs, and oversees ANDE’s extensive agenda, including efforts to develop standardized social and environmental metrics for impact investment and the ANDE Capacity Development Fund, a \$1m facility which supports capacity building within the SGB sector. Randall has nearly 20 years of experience in the field of national and international economic development.
- **Bailey Klinger.** Bailey is the founder of the Entrepreneurial Finance Lab and a fellow at Harvard’s Centre for International Development. His research focuses on entrepreneurship and SME finance. He has consulted for the World Bank, the IADB and numerous country governments. He has a MPA in International Development and a PhD in Public Policy from Harvard.
- **Keely Stevenson.** Keely is the CEO of Bamboo Finance USA, a leading SME investment fund. Keely has experience in investing in and supporting social entrepreneurs on five continents.

Keely worked previously in East Africa for the Acumen Fund, where she supported the establishment of Acumen's Nairobi office. Keely was the first employee hired by the CEO of the Skoll Foundation, where she designed grant programs for social entrepreneurs and led the team who created the world's first online community for social entrepreneurs. Keely studied politics at UC Berkeley, and earned an MBA at Oxford University.

ANNEX III – LITERATURE OVERVIEW OF SME INVESTMENT

The following pages give an overview of some key research papers on SME Investment, collected by the Milken Institute¹²⁸

Author(s)	Year	Title	Purpose	Results	Implications	Type of document
Bank Financing of SMEs in Emerging Markets						
Beck, Thorsten, Asli Demirgüç-Kunt, and María Soledad Martínez Pería	2008	Banking SMEs Around the World: Lending Practices, Business Models, Drivers and Obstacles [DRAFT]	Presents results of surveys of large banks around the world that document the state of SME financing across countries and compare it to large firm financing.	Across countries, banks perceive SMEs as a profitable endeavor and almost all banks have SME clients. Only small differences exist between banking to SMEs relative to large firms; differences exist more between developed versus developing countries in terms of exposure, lending practices, business models, drivers and obstacles to SME financing.	Contrary to popular belief, large banks in developing countries do serve SMEs and find them to be an attractive segment. The authors state that this paper is a "first step in better understanding SMEs financing from the supply side."	Working paper
de la Torre, Augusto, María Soledad Martínez Pería, and Sergio L. Schmukler	2008	Bank Involvement with SMEs: Beyond Relationship Lending	Questions the common belief that SMEs are underserved by large and foreign banks because SMEs' opacity makes them dependent on relationship lending, for which small and niche banks have a comparative advantage.	Using data from 12 developed and developing countries, the evidence suggests that all types of banks view SMEs as a strategic sector and are expanding or planning to expand their operations aggressively in this segment.	Since the developing countries studied were middle-income, more research needs to be done on bank involvement in lower-income countries. Furthermore, the evidence does not prove that SMEs in these countries receive adequate financing, but it does show that larger banks find this sector financially attractive and potentially can fill some of the financing gap.	Working paper

¹²⁸ Milken Institute, Stimulating Investment in Emerging-Market SMEs, October 2009

Financing Constraints for SMEs in Emerging Markets (General)						
Beck, Thorsten	2007	Financing Constraints of SMEs in Developing Countries: Evidence, Determinants, and Solutions	Surveys empirical research on SMEs' financing constraints and offers policies to minimize existing obstacles.	Three types of policies would support SMEs in overcoming constraints in accessing capital: (1) market-developing policies aimed at improving a country's contractual and information frameworks and macroeconomic performance, (2) market-enabling policies, such as regulatory frameworks that enable leasing and factoring and promote competition in the financial sector, and (3) market-harnessing policies that attempt to prevent imprudent lending.	Developing countries' governments have a clear role in improving their institutional environment, providing regulatory frameworks, and fostering competition, however it is less clear how successful government may be in market-activist policies, such as credit guarantee schemes.	Working paper
Risk Capital for SMEs in Developed Countries						
Bannock Consulting	2001	Innovative Instruments for Raising Equity for SMEs in Europe	Gives an overview of SME equity finance in Europe and possible ways to close the capital gap.	Public-sector approaches to increase the supply of equity capital to SMEs include direct investment in SMEs by publicly-funded agencies, overhead subsidy to private SME investors, loss-sharing/loan repayment forgiveness for SME investors and/or upside return boost, minority public investment in SME investment funds on subordinated terms, and leverage to SME investors on moderate commercial terms guaranteed to private funders (like the SBIC program in the U.S.).	The authors conclude that the European Investment Fund should experiment with a leverage program to increase the supply of risk capital. In comparison, loss-sharing guarantees can be expensive and introduce distortions into the SME investment market.	Report

European Investment Fund	Not dated	CIP: SME Guarantee Facility: Guarantee Policy and Operational Guidelines for Equity and Quasi-Equity Guarantees	Sets out the policy for the European Investment Fund's SME Guarantee Facility, the purpose of which is to support investments in SMEs with growth potential "to reduce the particular difficulties which SMEs face because of their weak financial structure and to assist SMEs achieve business transfers."	EIF provides guarantees, co-guarantees and counter-guarantees up to an amount of EUR 500,000 to financial intermediaries (from eligible European countries) covering investments in the seed and start-up phase, mezzanine financing and/or risk capital operations.	Equity guarantees may increase the amount invested in SMEs as some of the investor's risk is reduced. Similar programs could be set up for developing country investments.	Policy
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Risk Capital for SMEs in Emerging Markets						
Gibson, Tom	2008	Financing Equity Creatively	Reviews the inability of African commercial banks to provide adequate capital to SMEs and presents strategies for increasing SMEs' access to risk capital.	Shareholder loans, as opposed to pure equity, reduce investors' risk and increase their current income. Risk capital intermediaries may capitalize their funds using diverse financial instruments which reflect investors' differing return objectives. Governments can introduce programs, such as tax incentives, to increase private sector participation in SME risk capital.	Increasing the availability of non-asset-based financing is critical to support Africa's SME sector and contribute to the continent's economic growth.	Paper prepared for a conference
Hoff, Belinda, Mareike Hussels, Virginia Barreiro, Ray Cheung, Jesse Last, and David Wood	2007	On the Frontiers of Finance: Investing in Sustainable SMEs in Emerging Markets	Provides an overview of the current landscape of financing for sustainable SMEs (companies that capitalize on commercial opportunities while also generating social and environmental benefits), clarifies key challenges, and offers solutions to bring the sustainable enterprise finance sector to scale.	Through interviews with leading sustainable SME funds, the authors identified challenges that the funds faced, including difficulty with fundraising, monitoring and evaluating investments, and providing technical assistance.	To scale-up sustainable SME finance, efforts should focus on increasing collaboration among aggregators, VC funds, and local banks; improving the coordination and effectiveness of blended capital (for example, by educating investors and donors about blended capital models); and standardizing monitoring and evaluation approaches.	Paper prepared for a conference
Lerner, Josh, and Ann Leamon	2007	A Note on Private Equity in Developing Countries	Seeks to identify some of the key challenges and opportunities that private equity investors face in developing countries.	The growth of private equity activity in the developing world can be attributed to the economic progress of developing nations, as well as the perceived decrease in investment opportunities in developed nations. While private equity is similar in some ways across countries, developing nations differ in terms of how they raise funds, invest, and exit.	The authors expect that private equity in developing countries is likely to mature over time and become similar to that of developed nations.	Chapter in a book

UNEP Finance Initiative	2007	Innovative Financing for Sustainable Small and Medium Enterprises in Africa	Offers recommendations to remedy the demand- and supply-side challenges of SME financing and provides case studies of successful funds, including the Acumen Fund, Grofin, E+Co, and Root Capital.	The author presents the following recommendations to investors working in Africa: educate investors about blended value approaches to financing, build local groups to strengthen local institutions and banks, train African fund managers, conduct more research on SME financing, explore mechanisms to align investor objectives, organize a focused workshop in each region of Africa, and partner or tap into existing institutions and networks to deliver objectives.	Despite the number of challenges faced in emerging markets, the experiences of the four organizations profiled in the study provide lessons on how to invest in these markets successfully.	Paper prepared after a conference
Cumming, Douglas, Grant Fleming, and Arrmin Schwienbacher	2006	Legality and Venture Capital Exits	Considers the impact of a country's legal environment on exits of private equity investments using a new dataset of 468 venture capital-backed companies across 12 Asia-Pacific countries.	A country's legal system is much more directly connected to facilitating VC-backed IPO exits than the size of a country's stock market. This result is in direct contrast to conventional wisdom that stock markets by themselves facilitate venture capital markets.	The findings indicate that legality is a central mechanism which mitigates agency problems between investors and entrepreneurs, which thereby fosters IPOs and venture capital markets.	Journal article
Ponsolle, Josephine	2006	Equity Investments in SMEs in Developing Countries	Outlines SMEs' need for equity finance, two successful existing models of private equity for SMEs (the U.S. SBA's Small Business Investment Company program and Business Partners' equity fund), IFC's direct equity investments and indirect investments through funds, and some issues that need to be addressed.	Among other topics, the author describes the success of the U.S. SBA's Small Business Investment Company (SBIC) program in stimulating the flow of private equity capital to SMEs, and questions whether international institutions could try a similar public-private partnership.	Issues to address the equity gap include the lack of access to leverage in developing countries, the possibility of instituting public-private partnerships or incentives for funds to improve performance, whether to invest in business angel networks and successful funds like Business Partners, and whether to focus on only high-growth SMEs vs. lifestyle SMEs.	Presentation

Wang, Jiansheng	2006	IFC's Experience in Investing in Private Equity in Emerging Markets	Provides an overview of what private equity funds are, and how the International Finance Corporation approaches private equity investment in emerging markets.	The author outlines the process of making private equity investments, which includes surveying markets for deals, performing due diligence, approving the investment, negotiating the contract with management, closing the fund, regular monitoring of the investment, and exit.	Emerging markets pose a number of unique challenges. To maximize developmental impact, IFC looks for skilled fund managers who create value, negotiate control mechanisms (e.g., tag along and drag along rights), invest in owners who want to develop a company and then sell it, and have deep knowledge of the local market.	Presentation
Lerner, Josh, and Antoinette Schoar	2005	Does Legal Enforcement Affect Financial Transactions? The Contractual Channel In Private Equity	Explores how the nature of a developing country's legal system affects private equity investments.	Investments in countries with better legal enforcement typically use convertible preferred stock and have greater contractual protections. Investors in countries where legal enforcement is difficult tend to rely on obtaining majority control of the firms they invest in, use debt more often, and have more board representation.	A country's legal system greatly affects the structure of private equity transactions. Relying on ownership instead of contractual protections seems to be only a partial remedy as these investments tend to have lower valuations and returns.	Journal article

<p>Oluwajoba Abereijo, Isaac, and Abimbola Oluwagbenga Fayomi</p>	<p>2005</p>	<p>Innovative Approach to SME Financing in Nigeria: A Review of Small and Medium Industries Equity Investment Scheme (SMIEIS)</p>	<p>Reviews SME private equity financing in developed countries, in developing countries (including the experience of Small Enterprise Assistance Funds, SEAF), and in Nigeria through its SMIEIS (which was started in 2001 and requires all banks in Nigeria to set aside 10 percent of before-tax profits annually for SME equity investments).</p>	<p>To be successful in private equity financing for SMEs, Nigeria's banks have to attend to challenges related to deal flow, investment structuring, monitoring and value enhancement, and exit strategies.</p>	<p>Nigerian banks may increase equity financing for SMEs by partnering with business development services that will increase the competencies of SMEs, providing training to the banking industry, arranging pre-investment exits, encouraging entrepreneurs to accept external help and ownership, and having a government that can assure a conducive investment and stable political environment.</p>	<p>Journal article</p>
<p>Bachrach, Carlos</p>	<p>2003</p>	<p>Background Paper: Small Enterprise Investment Funds and Capital Markets in Latin America and the Caribbean</p>	<p>Reviews the evolution of venture capital and private equity investments in Latin America, the origins of the venture capital industry in the U.S., and Israel's successful venture capital development.</p>	<p>The U.S. and multilateral institutions sponsored the earliest venture capital investments in Latin America and have remained strong contributors. Institutional private equity funds started to appear there around 1995. Latin America must overcome a number of hurdles to improve the environment for private equity investment.</p>	<p>The international experience in venture capital has identified a number of lessons for success, including the need for a supportive legal, regulatory, tax, and financial framework; a large group of skilled VC investors; a large base of entrepreneurs assisted by a network of service providers; success stories that incentivize further investment; and patience and flexibility in identifying appropriate exits.</p>	<p>Report</p>

Leeds, Roger, and Julie Sunderland	2003	Private Equity Investing in Emerging Markets	Discusses the surge in private equity funds in emerging markets in the mid-90s and the subsequent decrease in funds as their performance did not meet investors' expectations.	Private equity funds in emerging markets underperformed as a result of developing countries' low standards of corporate governance, weak legal systems, and limited options for exit.	Along with local government improvement of regulations and leadership from development finance institutions, emerging market private equity fund managers can improve investment performance by having an on-the-ground presence in the investment country, taking a hands-on role to enhance company value, being more discerning in their deal selection, and mapping out creative exit strategies.	Journal article
Boot, Gijs M.	2002	Symposium on Winning Strategies in SME Finance: Exits	Highlights the various methods of exits and their advantages and disadvantages.	Possible methods of exit include write-offs, IPOs, trade sales, MBOs, and financial sales. Whereas IPOs are usually not an option for SMEs, trade sales are very suitable and can be a cheaper, faster, and simpler exit. MBOs are often the route when other routes fail. Financial sales are a possibility in some circumstances.	Investors need to address exit issues upfront and build the structure of the exit into the deal. A contingency plan should also be included. Exit should be a keystone in the company's strategy. Investors' networks play a key role in identifying potential buyers.	Presentation

SMEs' Effect on Economic Growth						
Beck, Thorsten, Asli Demirgüç-Kunt, and Ross Levine	2005	SMEs, Growth and Poverty: Cross-Country Evidence	Provides the first cross-country evidence on the links between SMEs and economic growth and poverty alleviation using a new database on SMEs.	Although the authors found a strong relationship between the size of the SME sector and economic growth, they did not find that SMEs cause growth. They also found no evidence that SMEs alleviate poverty or decrease income inequality.	The results provide evidence against directly subsidizing SME development to accelerate growth and reduce poverty.	Working paper
Stock Exchanges for SMEs						
Yoo, JaeHoon	2007	Financing Innovation: How to Build an Efficient Exchange for Small Firms	Outlines the steps needed to build an efficient exchange that would provide risk capital for SMEs.	Creating a market for SMEs in a developing country requires running the market as an independent entity either inside or outside the main exchange, supporting competition in the local venture capital industry, and enhancing transparency and coordination in supportive public programs.	A market architecture supported by effective institutions and industrial policies is critical to the success of an SME exchange.	Policy brief
Friedman, Felice B., and Claire Grose	2006	Promoting Access to Primary Equity Markets: A Legal and Regulatory Approach	Examines legal and regulatory measures that can be taken to promote access to the primary market in emerging market economies.	Facilitating the development of primary markets in developing countries would require: (1) a supportive environment (e.g., basic protection of property rights), (2) elements of basic market structure (e.g., fair settlement procedures), (3) disclosure requirements, (4) corporate governance requirements, and (5) enforcement.	Although capital market development depends on many factors, including a favorable macroeconomic environment, an appropriately designed and effective legal and regulatory framework can help to encourage market growth and to increase access to finance for all companies, including SMEs.	Working paper

Smith, Brad	2006	Global Review of SME Alternative Markets, Boards of Trade, Stock Exchanges or OTC Markets and Cross Border Listing Programs	Offers a preliminary report on SME Alternative Markets, Boards of Trade, Stock Exchanges or OTC Markets, and Cross Border Listing programs, as part of a larger research initiative on capital markets for SMEs.	Based on internet research, the authors identified 51 separate SME exchanges/listings, other lower-tier listings, and OTC Boards across 38 countries (including three in Africa, three in South America, and one in the Middle East).	This research indicates a worldwide trend toward the expansion of capital markets and investment listings targeted to SMEs. This comes as countries face pressure to develop their own SME listing programs to avoid outflows of capital.	Report
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