1. SME Finance Constraints and Responses
2. Innovative Approaches Can Ease Constraints
3. Implications for Policy and Regulation
1 SME FINANCE CONSTRAINTS AND RESPONSES

2 INNOVATIVE APPROACHES CAN EASE CONSTRAINTS

3 IMPLICATIONS FOR POLICY AND REGULATION
# SME Finance Constraints – Responses

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## SME Finance Constraints – Responses

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Lack of Usable Collateral
Secured Transactions (Financial Infrastructure)

Develop simple laws and regulations based on best practice principles

Establish clear priority schemes for claims on collateral.

Modernize movable collateral registries

Simplify the creation of security interests in movable property

Create unitary legal ST systems, not fragmented

Ensure a broad scope of secured transactions law

Allow all types of assets to be used as collateral
Information Assymetry, Lack of Usable Collateral
Design Features of Partial Credit Guarantee Schemes

**Additionality**
Capacity to stimulate financing for SMEs that would not otherwise have been available:
In Canada, 75% of guarantees are used by firms that would not have been able to obtain a loan otherwise. In Chile, the guarantee scheme increases the probability of small firms to get a loan by 14%.

**Leverage**
Ability to ‘leverage’ PCG endowment on lending activity:
Good practice for ratio of outstanding guarantee commitments to the underlying funds of the PCG scheme is 6-7 times.

**Transparency**
Clear and reliable procedures for claims and payments. Critical for building trust with financial institutions and ensuring high uptake of guarantees.

**Cost Efficiency**
Appropriate fee level, sound risk management, efficient operational procedures. Sustainability not essential, but many inefficient and ineffective schemes.

**Ability to Stimulate Markets**
Stimulate the SME lending business and the creation of new financial products; Counter-cyclicality.
Coverage ratios should ensure sufficient protection against default risk, but not too high to reduce incentives for sound lending and credit risk management.

Fees should be risk-based and contribute to financial sustainability.

Payment rules should take into account effectiveness of collateral and insolvency regimes.

PCGs can support the capacity (skills, systems, products) of banks to provide SME finance.

Evaluation mechanism: to measure outreach, additionality and sustainability.
Lack of Financing Sources and Products
Equity Investment, SME Exchanges

- Increasing SME access to equity markets can involve a range of interventions, including:
  - Improvements in disclosure and governance
  - Improvements in minority shareholder protection
  - A stronger domestic institutional investor base and greater participation of foreign investors

- Setting up SME stock exchanges or junior markets can, under certain circumstances, improve the supply of equity investment to SME.

- However, the performance of many of these exchanges, particularly those in lower-income countries, has been underwhelming, with only a handful of SMEs electing to list on certain markets and little new capital raised.
Less formal, more lightly-regulated capital markets can cater to SMEs

Lessons from successful SME exchanges, such as the Alternative Investment Market (AIM) in London, the MESDAQ in Malaysia, and the KOSDAQ in Korea include:

- The size of qualified SMEs should not be capped at very low levels, as this may have adverse effects on liquidity and discourage the participation of fund managers.
- The public float should have a minimum size (e.g., 10%), to maintain liquidity.
- A large minimum number of shareholders may be necessary to improve liquidity.
- Lock-up periods of 6-12 months or longer during which certain shareholders (with 5 percent or more of the shares) cannot sell their stake following an IPO can prevent the early exit of corporate insiders and curtail insider trading.
1 SME FINANCE CONSTRAINTS AND RESPONSES

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## Innovations & Technology easing Constraints

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Psychometrics

• The use of psychometrics can enable lenders to enhance traditional scorecard building techniques with more predictive tools: computer-based questions relating to character, abilities and attitude to identify high potential, low risk entrepreneurs.

• Example: **Entrepreneurial Finance Lab** (*Brazil, India, Indonesia, Nigeria, Peru, South Africa, US)*.

“Big Data” Analytics

• The analysis of alternative data sets such as cell phone histories and transactional data represent new ways for assessing the creditworthiness of enterprises currently without access to finance.

• Examples: **Experian MicroAnalytics** (*global presence*) and **Cignifi** (*Brazil, Ghana, Mexico, US*) deliver credit scoring based on airtime usage; **ZestFinance** (*US*) uses any available data, everything from financial information to technology usage.

Digital Footprints

• With increasing technology and internet access, the expansion of “digital footprints” allow for alternative ways to assess borrower creditworthiness and spot and prevent identity fraud.

• Examples: **DemystData** (*Hong Kong, US*) and **Lenddo** (*Colombia, Mexico, Philippines*) use online reputation and social media analytics; **BehavioSec** (*Sweden, US*) uses behavioral biometrics (i.e. distinguishing behavior such as how hard or fast we type) to verify identity.
Data (on SME payments, contracts behavior) can be used to lower the cost and risk of financing MSMEs.

Electronic payments enable data to be collected instantly and more comprehensively.

Electronic payments enable data to be collected instantly and more comprehensively.

**Financial Service Provider**

Production loans
Factoring, working capital loans, trade finance.

**Supplier**

Suppliers can provide inputs on credit

**SME**

**Buyer**

(processor, exporter, wholesaler)

Buyers can provide credit to help secure production

*Innovative Approaches: Supply Chain Finance - Big Data*
Lack of Usable Collateral, Financing Sources, Products
Policy Response: Enabling Regulatory Frameworks for Factoring

- Clear laws governing contracts between parties and assignment of receivables, are needed
- Further challenges include: tax regime, enabling regulation of NBFIs, weak legal environment for enforcing contract compliance.
- Factoring can provide working capital finance to opaque sellers. How factoring can work:

SME sells to a large firm

The SME needs working capital to produce more inventory and uses its accounts receivable as collateral. The factor purchases the accounts receivable. The SME receives a % of the face value of the accounts receivable.

In 30 days, the factor receives the full payment from the large firm, and the SME receives the remaining % of the total, less interest and service fees.
Lack of Usable Collateral, Financing Sources, Products
Policy Responses: Electronic Platforms, Public Procurement from SMEs; Electronic security and signature legal framework

- The public sector can be a major buyer of goods and services from SMEs.
- The public sector can effectively link SMEs to supply chain finance and to factoring.
- Electronic security and signature laws, and market facilitation platforms, can facilitate supply chain and factoring transactions with SMEs.
- Chile Compra is a public, electronic system for purchasing and hiring based on an internet platform that caters to companies, public organizations, and citizens.
  > Largest business-to-business site in Chile with more than 850 purchasing organizations including businesses, government ministries, public services, hospitals, etc.
  > Registered companies are mostly MSMEs (97% of total), providing a volume of US$6.5 billion in 2010.
  > The participation of MSMEs in government purchases helped double their overall share in Chilean economy.
- It is also critical that Governments pay SMEs promptly, in order to avoid otherwise viable SMEs incurring cash flow problems.
Nafin (Mexico) uses an electronic platform to provide on-line factoring and contract financing services, which allows cheaper, quicker and safer transactions.

Reverse factoring (relies on the creditworthiness of the corporate buyer) combined with a competitive platform, enables smaller SMEs to secure financing based on contracts with corporates or government.

Nafin has extended over US$ 9 billion in financing (~US$600,000 monthly); over 1.2 million transactions – 98% to SMEs.

The NAFIN Factoring Agreement (earlier stage production finance also available):

1. **Day 1**: Supplier S, Buyer B, and Factor F sign contracts with NAFIN to allow factoring.
2. **Day 10**: S receives a purchase order from B, due in 40 days.
3. **Day 50**: S makes a delivery to B, and B posts a *documentos negociables* on its NAFIN Web site, payable to S in 30 days.
4. **Day 80**: B repays F directly the full amount of the *documentos negociables*. S uses the NAFIN Web site to factor its receivables from B with F (at an average interest of bank rate + 5%) and receives today the full amount of the *documentos negociables*, less interest.
**Lack of Financing Sources, Products**

**Innovative Approaches: Crowdfunding and P2P Lending**

- Crowdfunding platforms, which can provide more direct and efficient ways of accessing funding by using web platforms to cut out the middleman, are on the rise. They aim to offer borrowers cheaper loans and investors access to a new asset class.

- Examples: **Cumplo (Chile)** and **SocietyOne (Australia)** are P2P lending platforms, web-based and mobile respectively.

- Alibaba-backed **PPDai (China)** was the first online platform (social lending site) for P2P small unsecured loans in China.
Lack of Access Points
Innovative Approaches

Point-of-sale Innovations

• **Square** *(US)* leverages mobile access to expand payment card acceptance among merchants, by offering a minimalist card reader that plugs into mobile phones, transforming them into a POS device.

• Square now processes over US $8 billion in payments annually and was valued at over US $3 billion.

• Square’s success inspired other startups to adapt this model in less developed markets, such as **Blitzpay** *(Mexico)*, **Ezetap** *(India)* and **Pagpop** *(Brazil)*.

Mobile-based KYC

• Companies like **Backbase** *(Netherlands, Singapore, UK, US)*, **Jumio** *(Austria, UK, US)*, **PhotoPay** *(Europe)* and **Soon** *(France)* use mobile image capture to prepopulate or verify customer data (e.g. real-time credit card or ID scanning and verification).

• **Kofax** *(global presence)* uses a device’s camera to match a customer’s face to photographic identification.
Financial Capability
Innovative Approaches

Automated Financial Advice

- A growing number of firms, such as Money On Toast (US), Vaamo (Germany), Your Wealth (UK), Yseop (France, UK, US) are using software to automate the production of financial advice.
- Other firms such as Atsora (Poland) and ITSector (Portugal) provide small business with online financial dashboards.

SME Financial Management

- Companies such as Greendizer (Morocco), Jack Henry (US) and Luminous (Australia, India, South Africa, UK, US) propose solutions to small business in terms of invoicing and accounting information and financial document storage.
- Xpenditure (Belgium, US) offers expense management solutions that automates the process from receipt to accounting.
- Tiendatek (Colombia, Mexico) offers smartphone-based inventory management and stocking tools for SMEs. In addition to the software, shopkeepers with a tablet and a barcode scanner can register transactions, get useful metrics and charge credit cards.
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Implications for SME Finance Policy Frameworks

• Innovative approaches do not replace the need for responses, but do mean that responses need to be more carefully targeted and designed (additionality is critical). For example:
  – State bank providing retail financing, or underwriting electronic platform to match up SMEs with banks and factoring companies?
  – Ensuring policy framework is in place to enable online transactions, contract enforcement, factoring
  – Credit information can be transformed by non-traditional data brokers which ‘mine’ available social or transactions data
  – Viability of financing SMEs can be dramatically improved through increased info available through supply chain relationships (electronic payments and invoices, databases for managing this info)
  – Public financial awareness initiatives can leverage potential for low cost outreach through automated financial advice

• Risks related to innovative approaches also need addressed through Policy Frameworks
  – Regulatory framework updated in line with new providers and products?
  – Supervisory capacity strengthened to effectively understand and monitor new providers and products?
  – Non-financial regulators also relevant, eg telecoms regulator
  – Financial consumer protection, financial capability, and data security/privacy concerns addressed?
## Implications for SME Finance Policy Frameworks

### Overview

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<td>Usable collateral</td>
<td>Supply chain relationships, contracts</td>
<td>Legal Framework for factoring, NBFIs, electronic signatures. Public procurement from SMEs</td>
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<tr>
<td>Lack of Financing Sources and Products</td>
<td>Crowdfunding, P2P lending, also supply chain relationships</td>
<td>Supervisory capacity to understand and monitor risks of new financing models?</td>
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<td>Lack of Access Points</td>
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<td>Bank vs Telco roles, regulation &amp; supervision of payments services providers, interoperability…</td>
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<td>SME Financial capability</td>
<td>Personal financial management, automated advice</td>
<td>How best to leverage, content, also consumer protection</td>
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Annex

Selected World Bank Group Resources for SME Finance Policy Frameworks
The World Bank offers a comprehensive set of instruments to support policy and legal reforms, financial infrastructure development, guarantee mechanisms, regulatory standards, financing platforms, etc.

- Instruments include financing, policy advice, data, and technical assistance.
- Active Micro and SME Finance lending portfolio of $3.4bn.
- Over 100 technical assistance and data/research projects in MSME Finance.

Global
- Global standards, principles, and technical guides, e.g. for Impact Assessment, SME Finance Policies

Global
- Financial Inclusion Support Framework (launched April 2013)

MENA region
- Technical assistance through the MENA MSME facility (joint WB-IFC)

India
- Financing through Small Industries Development Bank; support to expand insurance for agribusiness SMEs & farmers

Jordan
- MSME Finance investment loan, TA/advisory services, SME Finance diagnostic

Tunisia
- Working capital for SMEs post-revolution, through MSME Finance investment loan, alongside TA

70+ countries
The WBG provides technical assistance and capacity-building to accelerate the design and implementation of country-led SME Finance reforms and initiatives, through the FISF.

Surveys and diagnostics, Capacity building for regulators

Technical Assistance and Capacity Building for implementation
Knowledge Resources for SME Finance Policy
- in addition to the SME Finance Forum

 Responsible Finance Website
responsiblefinance.worldbank.org

 Financial Inclusion Strategies
bit.ly/FIStrategiesReferenceFramework

 SME Finance Impact Assessment Framework
bit.ly/SMEFinanceImpactAssessment

 Good Practices for Financial Consumer Protection
bit.ly/GoodPracticesConsumerProtection

 SME Finance Policy Guide
worldbank.org/financialinclusion

 General Principles for Credit Reporting
bit.ly/GeneralPrinciplesCreditReporting