9.1: Introduction

This chapter extensively presents the researches of World Bank group (De la Torre et al. 2007, Bataa Ganbold 2008 and Malhotra et al. 2006). The major highlight of the chapter is how financial institutions have resolved or worked around the constraints of MSEs. Malhotra et al. (2006) demonstrate that SMEs are usually more credit constrained because of the following reasons namely financial sector policy distortions, lack of know-how on the part of the banks, information asymmetries and high risks inherent in lending to SMEs. The SMEs’ constraints to access to finance are pictorially represented in figure 9.1.

![Figure 9.1: Access to Finance Constraints](image)

**Source:** Constructed from secondary data.
In the terminology of Beck and de la Torre (2007), one can classify the options to expand the access in two dimensions or frontiers. They are individual financial institutions’ frontier and the country or Government frontier. In the sections that follow, the constraints as mentioned above are discussed with possible solutions from the financial institution’s frontier across the globe.

9.2: Access to Finance Constraints

A firm’s ability to access finance is directly related to the presence of well-functioning financial markets that connect firms to lenders and investors. In their efforts to respond to market failures, governments have often intervened heavily in financial markets in ways that are explained in figure 9.2, with overall poor results, that are explained by policy distortions. Second is bank’s lack of know-how on MSMEs and the information asymmetry. The banks have to gauge their risk in lending to MSMEs. Hence, the banks need to know about the MSMEs, their operations, financial ability and others. The information on MSMEs is not easily available. The third constraint of access to finance is the nature of MSMEs operations.

The following tree diagram explains these three constraints to MSMEs in their access to financial services with greater details.
9.3: Policy Distortions

9.3.1: Interest Rate Ceilings

Some times Government mandates the financial institutions to lend the MSMEs at below-market interest rates (priority sector lending). The offering of loans at lower interest rates discourages banks from lending to higher-risk borrowers such as SMEs. The banks charge clients the full cost of service provision via the interest rate and sometimes via fees. Good examples include Bank Rakyat Indonesia’s (BRI) microfinance portfolio that has been profitable since 1986; CrediAmigo in Brazil was fully financially sustainable in 3 years of its launch in 1998; Agricultural Bank of Mongolia disbursed 8,78,000 loans between late 2000 and February 2004, while maintaining an arrears rate consistently below 2 per cent.
9.3.2: State Owned Projects and MSMEs

State owned projects often receive priority than lending to MSMEs. Large state-owned enterprises are typically seen as less of a credit risk and as more likely to receive support from local governments and party officials (World Bank 2004a).

9.3.3: Directed Credit and Guarantees

The Government often directs the financial institutions to give credit to some identified high priority sectors. This directed credit distorts market forces. Many directed loans go to unprofitable projects and are often not repaid. Consequently, banks end up incurring losses, which retards development of the financial market (World Bank 2004c). Similarly, the credit guarantees offered by governments are typically meant to encourage lending to riskier SME clients by sharing the default risk with banks. This can lead to moral hazard on the part of both borrowers and lenders making borrowers less willing to repay and banks less attentive to credit risk and to monitoring borrowers. This results in huge Non Performing Assets (NPAs) for the banks. Instead of Government guarantee, group guarantees can be used. For example, individual loans by the Banco do Noreste of Brazil are backed by guarantees from peer group members.

9.3.4: Legal and Regulatory Framework

Though various innovative forms of financing MSMEs such as leasing, factoring, and venture capital have been introduced in most financial markets, the lack of supportive legislation, regulations, and tax treatment have often restrained their growth.
9.3.5: Judiciary and Property Rights

The lack of an effective legal system to enforce laws impedes the development of a deeper credit market.

9.4: Banks Lack of Know-how and Information Asymmetry

9.4.1: Smaller Loan Size vs. Transaction Costs

SMEs typically require relatively small loans when compared with large firms. The transaction costs associated with processing and administering loans are fixed, and banks often find that processing small amount of SME’s loan is thus inefficient and costly. They lack the techniques, such as credit scoring to increase volume and lower costs. A number of banks around the globe have learned the lending and pricing strategies that allow them to compensate for the high transaction costs of making many small loans and have adopted risk management techniques commensurate with higher risk profiles of their MSME clients.

Many of the innovations have originated in serving clients at the lower end of the private sector spectrum using microfinance technologies. Bangladesh’s Grameen Bank and Indonesia’s BRI were the early leaders in adopting microfinance techniques and has achieved phenomenal success in terms of scale and lowered costs. BRI’s risk management techniques rely on sticks and carrots: cutting off non-performing clients from future access to finance, making site visits to clients that coincide with repayment schedules, and providing incentives for timely repayment in the form of a refund of 25 per cent of the interest payment on the loan. Loan officers are also given incentives, which can account for a significant component of their earnings, for
initiating and maintaining quality portfolios. The key characteristic cutting 
across developing country commercial banks applying microfinance principles 
to MSMEs finance is that they have focused on relationship-intensive banking 
rather than more traditional transactions banking.

Wells Fargo in the United States is an exception to the relationship- 
banking model that illustrates how a sophisticated information infrastructure 
can increase SMEs’ access to finance.

Banco do Noreste in Brazil contract its loan officers through 
employment agencies on a temporary basis for the micro-finance business in 
order to keep fixed costs low while it experiments with a new product line. In 
Armenia, the first stage of credit screening was devolved to village 
associations.

9.4.2: Difficulty in Adapting to New Technologies

Bank’s bureaucratic procedures are not allowing them to practice 
innovative lending technologies. ShoreBank invested considerably in training 
bank officers on cash flow lending and credit analysis when starting up SME 
banking operations in Azerbaijan and Georgia.

9.4.3: High Cost of Credit Information

For markets to allocate resources efficiently, all market participants 
must have the same relevant information. This non-availability of information 
creates biases against lending to MSMEs. The Agricultural Bank of Mongolia 
hires its loan officers from the communities it serves, which means that they 
understand communities’ risk profiles and have communities’ trust.
9.4.4: Lack of Access to Third Party Information

Lenders’ lack of knowledge of their clients and of information on clients’ credit profiles and histories reinforce their perception of the high risk involved in lending to SMEs. One way to overcome the high cost to lenders of directly screening and monitoring clients is through the establishment and use of credit bureaus as third party information providers. Credit bureaus are standard practice in most developed countries and are gradually becoming more common in developing countries. The banks in Kazakhstan and Paraguay received this expertise from Internationale Projekt Consult, an international company based in Germany with equity stakes in SME banks worldwide; Banco do Noreste received TA from ACCION International, one of the leading networks of microfinance banks in the world; the banks in Azerbaijan and Georgia received assistance from ShoreBank International, Ltd., the consulting arm of the pioneer community bank ShoreBank in the United States; the Agricultural Bank of Mongolia received support from Development Alternatives, Inc., a specialised international consulting practice; the European Union provided significant TA to the Agricultural Cooperative Bank of Armenia during 1997-2000; and in Serbia, the International Finance Corporation (IFC) provided significant training programmes for local banks, leasing companies, SMEs, and business service providers, complemented by building the capacity of Serbia’s Association of Leasing Companies.
9.4.5: Inconsistent Financial Statements and Audits

As SMEs are often not required to adopt any of national or international accounting standards when preparing their financial statements, large discrepancies arise in the ways firms report their financial positions. Auditing such statements can be labour and time intensive, which raises the cost of loan processing for SMEs. In addition, even audited financial statements can be unreliable.

9.5: High Risks of MSME Operations

9.5.1: Vulnerability and Turnover

SMEs are intrinsically riskier borrowers than large firms. Schiffer and Weder (2001) use a worldwide sample of firms and demonstrate a negative relationship between firm size and level of risk. This is the case because SMEs are more vulnerable to market changes and often have inadequate management capabilities because of their smaller size.

9.5.2: Management Weakness

Despite evidence that lack of access to finance constrains many MSMEs, actual effective (or bankable) demand may itself be constrained by weaknesses in firm management and the dossiers their management can present when applying for credit.

9.6: Government Interventions in Improving MSME Access to Finance

This section focuses on the country actions or Government frontier in improving access to finance by creating the right environment for MSMEs to flourish. The Figure 9.3 explains three different views on the Government interventions to foster a country’s financial development.
While most agree that some type of government intervention to encourage financial development is necessary, there is less agreement regarding the specific nature of this intervention. Answers to this question tend to polarise in two highly contrasting but well-established views: the interventionist and the laissez-faire views. The interventionist view argues that an active public sector involvement in mobilising and allocating financial resources is needed to broaden access to credit, as private markets fail to expand access. In contrast, the laissez-faire view contends that governments can do more harm than good by intervening directly in the financial system and argues that government efforts should instead focus on improving the enabling environment, which will help to reduce agency problems and transaction costs and mitigate problems of access. A third view is emerging in the middle ground, the pro-market activism view, favoring direct government interventions in non-traditional ways. This third view is in a sense closer to the laissez-faire
view, to the extent that it recognises a limited role for the government in financial markets and acknowledges that institutional efficiency is the economy’s first best, but, it does not exclude the possibility that in the short run, while institutions are taking time to build and consolidate, some government actions undertaken in collaboration with market participants may be warranted.

A study by Stratos Papadimitriou and Panos Mourdoukoutas (2002) described three models adopted by the Governments of US, Israel and Ireland, helped start-up firms in financing and particularly start-up equity financing. The paper says that US policy makers have been indirect and ‘passive’ partners providing funds and creating the regime conducive to the growth of venture private capital industry. Israeli policy makers have been less indirect and ‘catalysts’, taking equity positions in start-ups and in venture capital funds in partnership with private sector. Irish policy makers have been direct ‘active’ investors, setting up and managing start-up venture capital funds.

International experiences suggest three complementary roles that Governments can play to facilitate the broadening of access to finance for SMEs namely,

1. Improving legal and policy framework
2. Strengthening institutional and information infrastructure and
3. Making rational direct intervention
9.6.1: Improving Legal and Policy Framework

The quality of legal systems, property rights, and the presence of mechanisms for reliable information have been found especially important for small firms (Beck, Demirgüç-Kunt, and Maksimovic, 2005). Small firms and firms in countries with poor institutions use less external finance, especially less bank finance. Better protection of property rights increases external financing of small firms significantly more than that of large firms, mainly due to more bank and equity finance. Some of the good practices around the world by which the policy environments can help MSME access to financial services are (i) Liberalise interest rates, (ii) Promote competition, (iii) Have supportive regulations, (iv) Reduce and rationalise direct public sector intervention and (v) Improve judicial and legal framework.

9.6.1.1: Liberalise Interest Rates

Interest rates need to cover three kinds of costs; the cost of funds for lending; the risk of loan loss; and the costs of administration. Such as, identifying and screening clients, processing loan applications, disbursing loans, collecting repayments, and managing the non-repayment of loans. The proportion of administrative costs per dollar spent are higher for heavily relationship-dependent MSME finance techniques than for commercial lending. These costs must be recovered through interest rates higher than those other financial institutions charge but they are still significantly lower than the only alternative often available in the informal credit markets.
Interest rate ceilings discourage the provision of small loans by making recovery of the high administrative costs of such lending impossible. At the same time, borrowers should not have to pay for inefficiency. Governments can help lower rates without compromising sustainability by promoting competition and innovation as strategies for improving efficiency and lowering prices. Some of the good practices available include BRI of Indonesia, Banco do Nordeste of Brazil, Kazakhstani banks, Paraguayan banks, and ShoreBank of Caucuses—to provide financial services on commercial terms.

Table 9.1 gives the annual interest rates of commercial banks, microfinance institutions and informal sources of select countries.

<table>
<thead>
<tr>
<th>Country</th>
<th>Commercial banks</th>
<th>Microfinance institutions</th>
<th>Informal sources (moneylenders)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>18-63</td>
<td>120-720</td>
<td></td>
</tr>
<tr>
<td>Cambodia</td>
<td>12-15</td>
<td>18-24</td>
<td>60-120</td>
</tr>
<tr>
<td>Nepal</td>
<td>11.5—18.0</td>
<td>18-24</td>
<td>60-120</td>
</tr>
<tr>
<td>India</td>
<td>12-15</td>
<td>20-40</td>
<td>24-120% (varies by state)</td>
</tr>
<tr>
<td>Philippines</td>
<td>24-29</td>
<td>60-80</td>
<td>120+</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>10-13</td>
<td>2.0-35</td>
<td>180-240</td>
</tr>
</tbody>
</table>


9.6.1.2: Promote Competition

The evidence of Honohan (2004) suggests that one important way to enhance access is through improving competition in banking systems. This can be done often than improving the institutional environment. Also increasing competition and opening up can bring in (newer) technology and know-how. In Mexico, for example, close to 50 per cent of credit for those with no banking
relationship comes from department stores (Solo, Caskey, and Duran, 2004). In addition to the general view that competition can help with access, there is specific evidence that allowing greater entry by foreign banks can further enhance access. (General evidence on the effects of foreign bank entry is reviewed in Clarke et al. 2003). Latin American study found that foreign banks with small local presence do not appear to lend much to small businesses, but that large foreign banks in many cases surpass large domestic banks (Sanchez et al. 2002).

9.6.1.3: Have Supportive Regulations

It also appears that substitutes to bank finance are imperfect, e.g., small firms do not use disproportionately more leasing or trade finance compared to larger firms. Beck, Demirguc-Kunt and Soledad Martinez Peria (2007) found that firms in countries with higher levels of financial system development and greater outreach report lower financing obstacles, with this association stronger in less economically developed countries. The case in point is Bolivia’s banking regulation reform. In Bolivia, banking regulations limited unsecured lending to 25 per cent of capital, yet nearly 100 per cent of the portfolio of the main bank lending to micro enterprises at the time (BancoSol) was unsecured. Enforcing standard loan documentation requirements and standard reporting requirements would have made lending impossibly expensive. The banking supervisor waived these requirements given the bank’s strong position as one of the country’s best-performing banks based on its capital adequacy, asset quality, management, earnings, and liquidity ratings (Malhotra 2004a).
9.6.1.4: Reduce and Rationalize Direct Public Sector Intervention

Evidence suggests that less MSME credit is available in nations where state-owned banks hold large market shares (Berger and Udell 2005). Nevertheless, Banco do Noreste in Brazil and BRI’s Unit Desa network in Indonesia show that state-owned banks can introduce programmes to reach MSMEs under the right conditions of autonomy, leadership, and performance orientation. Both enjoy complete operational autonomy, run on private commercial banking principles, and are rare exceptions to the general state of politicised and poorly managed state-run financial Institutions. The actions of the government of Kazakhstan provide another case in point.

9.6.1.5: Improve Judicial and Legal Framework

As had been stated earlier, Governments should develop the laws and commercial codes that define property rights and the judicial institutions and processes that make them credible. A country’s commercial law on collateral liens is critical in determining the efficacy of collateral in a loan contract. Romania provides an interesting example for the use of movable assets as collateral, one that addresses one of the constraints that SMEs face in accessing capital.

9.6.2: Strengthening Institutional and Information Infrastructure

Two of the successful measures implemented by governments to strengthen the institutional infrastructure for the SMEs are: (1) supporting relevant training and technical assistance for interested financial institutions and (2) providing or facilitating initial financial support.
The experience of the banks in Paraguay illustrates the binding constraint of bank know-how through TA (Technical Assistance) in developing strong SMEs portfolios. The government of Paraguay implemented financial sector reforms, including liberalising interest rates, eliminating subsidised interest rates, and improving banking regulation and supervision. The reforms and the resulting banking system consolidation created a highly competitive banking industry thirsting for new clients and markets. These broad reforms, coupled with the high quality TA provided to the participating banks as part of the programme, produced positive results.

The Kazakhstani government used its own funds not to subsidise the interest rate, but to pay for TA to build private banks’ capacity to serve this important market segment for the long haul.

The Agricultural Cooperative Bank of Armenia (ACBA) provides an excellent example of how innovative use of a government loan helped a private bank expand in rural provinces, strengthen its capital base, and become the largest bank in Armenia. Despite strong demand for rural loans in Armenia, banks were hesitant to risk extending credit to farmers and village associations. The government of Armenia borrowed funds from a multilateral agency and passed on half the money in the form of a grant to the Agricultural Cooperative Bank of Armenia, a private cooperative bank, to build its equity base and incubate an early demonstration of sustainable agricultural support services.

An enabling legal framework should encourage information sharing among lenders. The availability of information about payment performance through credit bureaus has been empirically shown to increase the availability of loan to SMEs (Ganbold 2008). Further, surveys show that the time needed to
process loans, the costs of making loans and the extent of defaults are all higher without credit bureaus (Berger and Udell 2005).

Some of the good examples towards this include Argentina, the Dominican Republic, and Peru, where public and private registries complement each other and share data. In Sri Lanka, the credit bureau is a public-private venture, with the initial capital of 51 per cent held by the central bank declining as more commercial financial institutions join the registry. In the Czech Republic, Guatemala, India and Mexico, private bureaus are being formed in joint venture with foreign firms, which provide TA and expertise (World Bank, 2004). Apart from credit bureaus, strong accounting standards and credible accounting firms are necessary for SMEs to have informative financial statements. Reducing SMEs’ opacity by means of simplified, standardised charts of accounts would pave the way for additional forms of transactional lending technologies that depend on hard information, such as lending based on financial statements (Malhotra et al. 2006).

Another good example is Wells Fargo, a private financial services company in the United States, which is an exception to the relationship-banking model. It also illustrates how a sophisticated information infrastructure can increase SMEs’ access to finance. Use of the credit scoring model means that Wells Fargo accepts loan applications by mail or telephone. No collateral, financial statements or tax returns are required. Two-thirds of all decisions are made automatically based on the scorecard and the remaining one-third through 15-minute reviews. As a result, Wells Fargo’s costs for processing small business loans of US$30 per loan are among the lowest in the industry.
9.6.3: Making Rational Direct Intervention

9.6.3.1: Provision of Market Infrastructure

A number of recent country experiences have shown that by some specific interventions access can be enhanced. In India, for example, discussions are underway to use existing networks (e.g., the postal system) to allow the delivery of new financial services by many other public and private providers. The idea is that the technology and information backbone of existing public or other networks need not be exclusively limited to one provider enabling banks to reach areas where it might not be profitable to open branches. An innovative approach to increase the availability of financial services in remote areas has been adopted by the Brazilian government through the use of correspondent banking arrangements (Kumar et al. 2005).

Correspondent banking refers to arrangements whereby banks outsource services typically undertaken at branches, like receiving loan applications, making deposits and withdrawals, and paying invoices to non-financial institutions with a significant network of outlets, such as convenience stores and supermarkets. This process significantly reduces the cost of providing financial services. According to Kumar et al. (2005), initial investment for a correspondent outpost in Brazil can be as low as 0.5 per cent of those for a traditional bank branch, and the operating costs are negligible if existing employees and communication networks are used. This has resulted in a significant geographical expansion in access to financial services. In Brazil, lottery houses and post offices are used by the federal savings bank Caixa Economica Federal (CEF) to distribute financial services.
Another example of a government intervention designed to help reduce the costs of providing financial services in unbanked areas for private financial intermediaries is the Mexican development bank BANSEFI. BANSEFI has the mandate of spearheading the development of semi-formal and informal financial institutions (called popular savings and credit institutions), including a variety of credit unions, savings and credit associations, cooperatives, and NGOs that serve regions where the presence of commercial banks is minimal or non-existent (De la Torre et al. 2007).

9.6.3.2: **Credit Guarantee Systems**

Credit guarantee systems are mechanisms in which a third party, the guarantor, pledges to guarantee loans to a particular group of borrowers. Credit guarantee systems reduce the lender’s expected credit losses—even if the probability of default remains unchanged—acting as a form of insurance against default. Public credit guarantee systems are widespread. According to Graham Bannock and Partners (1997), there are at least 85 countries with some type of government credit guarantee programme. The general experience with credit guarantee systems, especially in developing countries, has been poor to mixed, at best: most systems have depleted their reserves due to high credit losses and bad investment decisions and in many cases they have been designed to channel funds to certain sectors without due regard to loss rates (De la Torre et al. 2007). Government-operated guarantee schemes have been fraught with problems, the most typical being the increased moral hazard for banks, as well as for borrowers, as banks may be less motivated to supervise loans properly or to pursue collection if the bulk of loans is covered by a
guarantee. Establishing criteria and verifying that additional lending under such programmes goes to SMEs that would have otherwise been excluded is extremely difficult.

Successful schemes have been operated by ACCION International and RAF AD (Recherches et Applications de Financements Alternatifs au Développement), two international non-governmental organisations that have focused on an intermediary-wholesale model. Successful private initiatives also include guarantees of bonds or securitised assets issued by financial institutions catering to MSMEs. For example, in the 1990s, USAID provided a 50 per cent guarantee for two two-year coupon bonds with face values of US$1 million issued by BancoSol, a Bolivian bank specialising in microfinance (Inter-American Development Bank 1998). In 2003, USAID provided partial guarantees for a series of short-term corporate debt securities (commercial paper) totaling US$12 million issued by a financial institution in Armenia to raise capital for loans to exporters (USAID 2003). In 2004, IFC provided a 34 per cent partial credit guarantee for a bond issuance of Mex$500 million (US$43.4 million) by Financiera Compartamos, a leading microfinance institution in Mexico.

Good example in public credit guarantee system is FOGAPE (Fondo de Garantía para Pequeños Empresarios), a state fond designed to provide partial credit guarantees to loans issued by commercial banks to small firms in Chile, has been considered a success story in terms of fostering market activity while minimising the problems that have characterised previous guarantee schemes
The fund is administered by Banco Estado, a public commercial bank, which charges a fee for its services. FOGAPE functions as a classical guarantee fund, sharing the risk of default on eligible loans and charging a guarantee premium. The commercial relationship was established between FOGAPE and the banks.

9.6.33: Transaction Cost Subsidies

Access to credit by small borrowers, especially in developing countries, has usually been hindered by many difficulties, including lack of usable collateral, no credit histories, and no reliable records. Also, small borrowers usually seek to borrow small amounts, making the transaction costs of lending per unit too high (De la Torre et al. 2007). To address high transactions costs of lending, Governments provide subsidies, which are required to support the administrative costs and loan losses from defaults. There is a view that these subsidies just aim at increasing credit use, and do not address any of the underlying problems of access. Whether subsidies can help solve the problems of access is an open question.

A good example towards this is a programme in Mexico, called SIEBAN (Sistema de Estímulos a la Banca) to provide subsidies to cover the administrative and screening costs of serving small borrowers, that was introduced by FIRA, the development agency. In this case there was no risk shifting to the public sector. Financial intermediaries receive only fixed initial subsidy and have incentives to adequately access borrower’s credit quality,
since they bear all the costs in the event of default. Another important feature of SIEBAN is that it requires the intermediaries to register borrowers in the credit bureaus, thus reducing information asymmetry.

9.63.4; Public Direct Lending

The experience of public financial institution in the provision of credit has been negative leading to poor loan origination and even poorer loan collection, wasteful administrative expenditures, overstaffing, plain corruption, and political manipulation of lending. An open question is whether there is any role for the provision of public credit in fostering financial development and if this type of intervention can be designed in a way that ensures that at least no harm is done (De la Torre et al. 2007:40).

Some of the good examples of successful direct lending include the Village Bank programme of the Bank Rakyat Indonesia, which show that public institutions can provide credit to rural producers in an efficient, market-friendly way. They highlight the role of several mechanisms in increasing efficiency, such as shifting from disbursing credit to motivating loan recovery, establishing a hard budget constraint, increasing management autonomy, introducing innovative systems for both clients and employees to encourage repayment, and increasing staff accountability. Bank Rakyat Indonesia is one of the early leaders in adopting microfinance techniques and has achieved phenomenal success in terms of scale and lowered costs.

The microfinance lending operation implemented by Banco Estado, a public commercial bank from Chile has also been considered a successful
experience of provision of credit by a public financial institution (Benavente 2006), A key factor for the success of Banco Estado’s microfinance programme has been the implementation of a new organisational structure tailored to meet the needs of micro entrepreneurs. Banco Estado has also established new incentive systems for employees. An important change in this respect has been the increase in the fixed portion of the remuneration of account executives, in order to reduce incentives to focus solely on loan disbursement.

9.7: Financing Options / Technologies / Instruments

This section describes other finance instruments, such as factoring, leasing, Investor equity or venture capital and securitisation, which are successfully applied by different entities to make financing available for SMEs. The radial diagram in Figure 9.4 pictorially represents various funding options available for MSMEs world wide.

Figure 9.4: Funding Options Available for MSMEs Worldwide

Source: Constructed from secondary data.
9.7.1: Factoring

Factoring is a form of supplier finance whereby firms sell their creditworthy accounts receivable at a discount (interest plus service fees) and receive immediate cash. Underwriting is based on the risk of the accounts receivable and, therefore, on an assessment of the creditworthiness of the buyer in relation to that of the SMEs supplier. This makes it an important financing instrument for SMEs that lack collateral or credit histories. Nacional Financiera (NAFIN), a state-owned development bank in Mexico with 32 branch offices nationwide, developed a so-called productive chains programme to link large, creditworthy buyer firms with small, risky firms unable to access formal finance. Participating in the factoring programme are 190 big buyers (45 per cent of the private sector) and more than 70,000 SME suppliers. 20 domestic banks and finance companies act as the factors. The NAFIN factoring programme operates on an electronic platform that provides factoring services online. The Web site has a dedicated page for each big buyer, while small suppliers are grouped into chains with those big buyers with whom they have business relationships.

9.7.2: Leasing

Lease is a contract between two parties whereby the lessor provides an asset for use by the lessee for a specified period of time in return for specified payments. It is a medium-term financial instrument for procuring machinery, equipment, and other fixed assets. Leasing focuses on the lessee’s ability to generate enough cash flow from business operations to service the lease
payment, rather than on the balance sheet or credit history. This makes it advantageous for SMEs, which typically lack collateral or credit histories. IFC is involved with a promising intervention to build the leasing industry in Serbia. IFC’s assistance consists of five parts: undertaking a market research study on the demand for leasing products, working with stakeholders to draft a leasing law, providing training programmes for staff of financial and leasing institutions and of SMEs, initiating national awareness campaigns on leasing, and helping to set up the National Association of Leasing Companies.

9.7.3: Venture Capital

Investor equity (Venture Capital) is another source of potential funding available to SMEs, but equity markets in many developing countries are insufficiently developed to make this a reality for most SMEs. One business model is the Small Enterprise Assistance Funds (SEAF) in Macedonia, a non-governmental organisation headquartered in the United States. SEAF provides equity funds and post investment TA to SMEs through affiliated commercial investment companies in 14 countries. Business Partners Limited has used a similar approach to provide debt and equity financing, mentoring, and property management services to SMEs in South Africa.

9.7.4: Securitisation

Securitisation is a process where assets are pooled and transferred to a third party (commonly referred to as special purpose vehicle or SPV), which in turn issues securities backed by this asset pool. Typically, several classes of securities (called tranches) with distinct risk-return profiles are issued.
Innovations abound in this market and several types of assets have been included in the collateral pool, ranging from cash instruments (e.g., mortgages, loans, bonds, credit card receivables) to synthetic exposures (e.g., credit default swaps). The structured finance market in developed countries has experienced significant growth over the last years (BIS 2005b). In the case of developing countries, although the volume of transactions has also increased significantly, structured finance markets are still small and underdeveloped.

Some of the good examples include FIRA (Fideicomisos Instituidos en Relation con la Agricultura, Agricultural Related Trust Funds), a Mexican development-oriented financial institution that provides second-tier funding to the agricultural sector that has recently promoted several structured finance transactions. FIRA charges a fee for its services as arranger and also for the provision of the guarantees. FIRA requires all investors participating in this scheme, which are financial institutions, to use its second tier lending to purchase the securities issued by the SPV. Number of public sector bodies acted as facilitators in Decuritizing SMEs loan portfolios in European countries and USA such as EIF, KfW and Spanish FTPYME Programme.

9.8: Twelve Lessons for India from International Best Practices

Following are the 12 possible lessons that India can emulate towards expanding the access to finance for MSMEs inferred from the discussions so far carried out.
Lesson 1: Towards Providing Financial Services on Commercial Terms Instead of Having Interest Rate Ceilings - This can be done via increased interest rates and sometimes via fees. India can emulate the models of Bank Rakyat Indonesia, CrediAmigo in Brazil, Agricultural Bank of Mongolia, Banco do Nordeste of Brazil, Kazakhstani Banks, Paraguayan Banks, and ShoreBank of Caucuses.

Lesson 2: Towards Group Guarantee - India can emulate Banco do Noreste of Brazil where individual loans are backed by guarantees from peer group members.

Lesson 3: Towards Reducing Transaction Costs - (i) Focus on relationship-intensive banking rather than more traditional transactions banking: India can emulate BRI, (ii) Use sophisticated information infrastructure: India can emulate Wells Fargo Model, of USA, (iii) Use local expertise: India can emulate Armenia, where the first stage of credit screening was devolved to village associations and the Agricultural Bank of Mongolia, which hires its loan officers from the communities it serves, which means that they understand communities’ risk profiles and have communities’ trust.

Lesson 4: Towards Improving Legal and Policy Framework: Promote High Competition - India can emulate Mexico, where close to 50 per cent of credit for those with no banking relationship comes from department stores.

Lesson 5: Towards Having Supportive Regulations - India can emulate Bolivia (BancoSol), where the banking regulations has limited
unsecured lending to 25 per cent of capital, yet nearly 100 per cent of the portfolio of the main bank lending to micro enterprises was unsecured at that time.

**Lesson 6: Towards Reducing and Rationalising Public Sector Intervention** - Provide autonomy, leadership and performance orientation to state owned banks: India can emulate Banco do Noreste in Brazil and BRI’s Unit Desa network in Indonesia. Both enjoy complete operational autonomy, run on private commercial banking principles, and are rare exceptions to the general state of politicised and poorly managed state-run financial institutions.

**Lesson 7: Towards Improving Judicial and Legal Framework** - India can emulate Romania, which provides an interesting example for the use of movable assets as collateral.

**Lesson 8: Towards Strengthening Institutional Infrastructure** - India can emulate Kazakhstan, which uses its own funds not to subsidise the interest rate, but to pay for Technical Assistance (TA) to build private banks’ capacity to serve this important market segment for the long haul.

**Lesson 9: Towards Direct Intervention** - (i) In providing market infrastructure: India can emulate Brazil, where lottery houses and post offices are used by the federal savings bank Caixa Economica Federal (CEF) to distribute financial services and also in use is the practice of correspondent banking, (ii) Use innovative institutions in providing access: India can emulate BANSEFI, Mexican development bank, which has the mandate of spearheading the development of semi-formal and informal financial
institutions (called popular savings and credit institutions), including a variety of credit unions, savings and credit associations, cooperatives, and NGOs that serve regions where the presence of commercial banks is minimal or non-existent.

**Lesson 10: Towards Providing Credit Guarantee** - (i) Guarantee to securities: India can emulate USAID and IFC, which guarantees bonds or securitised assets issued by financial institutions catering to MSMEs. USAID to BancoSol, Bolivia, IFC to Financiera Compartamos, Mexico, FOGAPE (Fondo de Garantia para Pequenos Empresarios), a state fund designed to provide partial credit guarantees to loans issued by commercial banks to small firms in Chile.

**Lesson 11: Towards Transaction Cost Subsidies** - Providing low subsidy with added incentives: India can emulate FIRA’s SIEBAN (Sistema de Estimulos a la Banca) of Mexico, where financial intermediaries receive only fixed initial subsidy and have incentives to adequately access borrower’s credit quality.

**Lesson 12: Towards Direct lending through Microfinance** - Providing credit through a public financial institution: India can emulate Village Bank programme of the Bank Rakyat Indonesia and microfinance lending operation implemented by Banco Estado, a public commercial bank from Chile.
9.9: Conclusion

This chapter has discussed the constraints faced by MSEs worldwide with specific reference to access to finance. The chapter cites many international good practices and experiences that help reduce these constraints by direct and indirect government interventions and through innovative practices of financial intermediaries. India can take many lessons from these international experiences and twelve such lessons are listed. Alternative funding options such as leasing, factoring, venture capital and securitisation were also discussed with good international experiences.
10.1: Introduction

This chapter provides a brief summary, major findings, conclusions and relevant policy implications of the study. This chapter also suggests the areas for further research.

10.2: Summary

Micro and Small Enterprises (MSEs), worldwide form an integral part of both developed and developing economies including India, provide considerable contribution to various areas like employment, exports, industrial output, industrial prosperity and social progress. There are many country-level and microeconomic studies that have assessed the importance of SMEs in the economic development and industrialisation process. There are evidences on the links between MSEs, economic growth and poverty alleviation. The literature survey on finance and economic development demonstrates that inadequacies in relation to finance are the key barrier to firm growth. While ranking all the obstacles that firms face in doing business, it was found that financing rank at the top for MSEs than larger firms. Further, lack of finance was found as the immediate reason for a business failure. The World Bank study (2006) also revealed that 90 per cent of small enterprises surveyed stated that credit was a major constraint. Hence, it has been concluded that financial constraints affect the smaller firms most adversely.