Financing MSMEs International Best Practices

BEFIT 2019 – Catalyzing Cottage and Small Industries to Drive Bhutan's Economic Diversification

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MSMEs are the bedrock of country’s economy

95% registered firms worldwide

50% of total global jobs

35% contribution to Gross Domestic Product (GDP) in many emerging markets.

a powerful force for integrating women and youth into the economic mainstream

MSMEs require these interventions for growth…

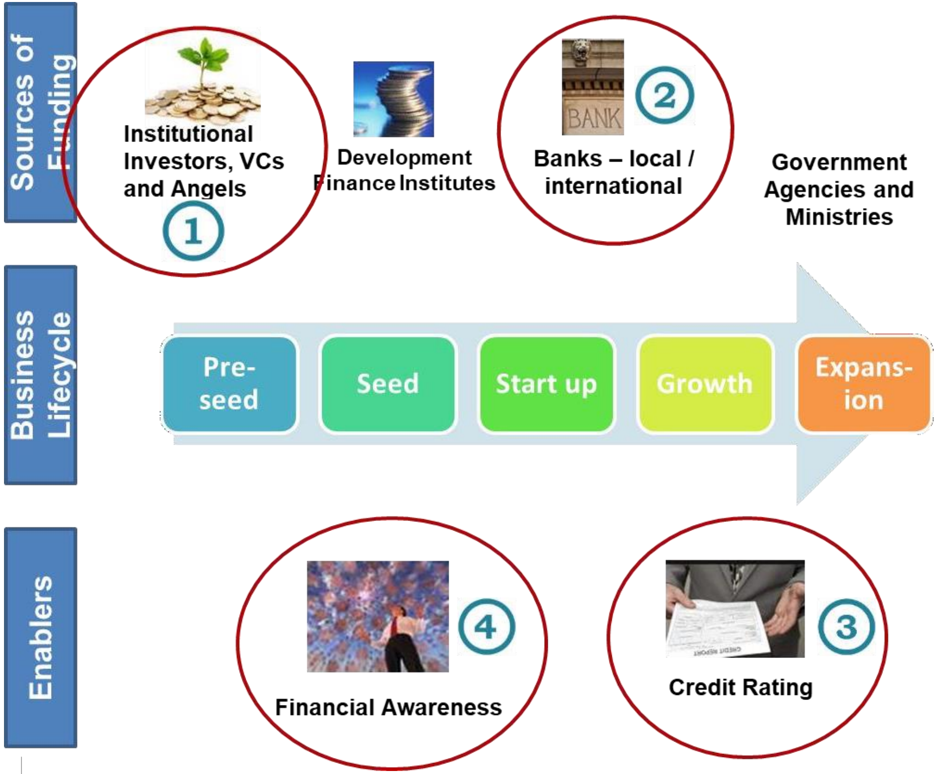
1. Legal & Regulatory Environment
2. Market Access
3. Access to Financing
4. Innovation & Technology Adoption
5. Human Capital Development
6. Infrastructure

…and access to financing is one of the main impediments to tackle….

Access to Financing

- According to Investment Climate Surveys, in over **70%** of countries, SMEs cite access to finance as the single biggest obstacle to them doing business
- Between **55%** to **68%** of formal SMEs in emerging markets are either **unserved** or **underserved** by financial institutions and the **credit gap** of formal SME enterprises stands at between **$0.9** to **$1.1 trillion**

Challenges related to Access to Financing…..

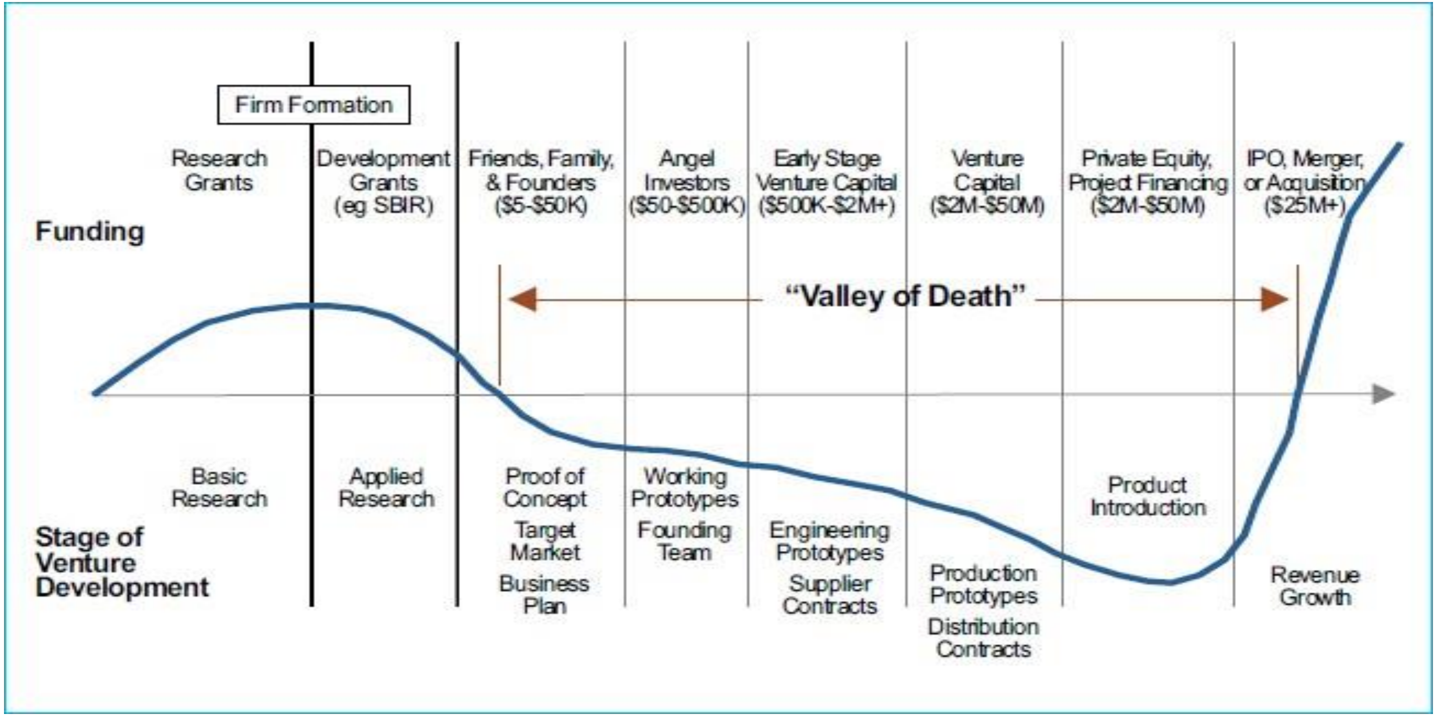


1. **Underdeveloped non-banking** sector limits SME avenues in **early stages**
2. **Banks are risk averse** – focus on growth stages, proven technology and asset based industries
3. **Poor creditworthiness of SMEs** limit capability to secure formal funding
4. **SMEs' lack know-how and resources** to successfully apply for funding

Financing landscape for MSMEs

Financial Service Providers (FSPs)	Enablers	Other Financing Avenues	FinTech
1 Banking Institutions (BIs)	1 Guarantee Schemes	1 Venture Capital Companies	1 Equity Crowd Funding (ECF)
2 Development Financial Institution (DFIs)	2 Government Funds	2 Leasing and Factoring Institutes	2 Peer-to-Peer (P2P)
	3 Credit Information	3 Microfinance Institution	3 Supply Chain Financing Platform
	4 Credit Assessment		
	5 Micro Insurance		
	6 Collateral Registries Platform		

SME Finance Instruments at Different Stages of MSME development



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

Role of Regulators and Supervisors in financing MSMEs

1. Collection and analysis of data on access to finance
2. Providing the legal and regulatory framework in support of MSME access to finance
3. Interventions promoting MSME finance:

Traditional Regulatory and Policy Approaches

- **A** Improve or Build Sound Legal and Judiciary Infrastructure
- **B** Establish Prudential Regulations for SME Lending
- **C** Build Effective Credit Infrastructure
- **D** Targeted Direct Interventions, Bridging Market Imperfections

Leveraging on Digital Finance and Alternative Data

- **A** Re-regulation of banks: financial stability
- **B** New payment systems create new sources of financial information
- **C** Regulations for Data Protection and Privacy
- **D** Regulations for Crowdfunding

4. All formal financial intermediaries are regulated in some measure by the regulatory bodies of governments, typically the central bank and the securities exchange commission (SEC).

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

Secured Transactions Framework

A modern secured transactions system will have the following elements:

ELEMENT 01 — **Stand-alone** to regulate all aspects of security interests in movable property

ELEMENT 02 — **Broad scope of secured transactions** law that allows all types of assets as collateral for loans and credit revolving facilities

ELEMENT 03 — **Equal treatment** to all transactions secured by movable property

ELEMENT 04 — **Simple procedures** for the **creation** and **enforceability** of security interests in movable property

ELEMENT 05 — Movable collateral registries to notify parties about the existence of a **security interest** in movable property and to establish the **priority of creditors** vis a vis third parties

ELEMENT 06 — **Priority schemes for creditors**

ELEMENT 07 — **Speedy and inexpensive enforcement** mechanisms to realize security interests

Case studies: Secured Transactions Framework

Country	Reform	Details
1 Thailand 	Business Collateral Act	The Act provides **SMEs greater access to sources of investment** for their businesses, and thereby help boost Thailand's economic growth. Under the Act, the **limitation on the type of assets** that can be **given as collateral was eliminated**. It is now possible to have a business, a right of claim, moveable property of the security provider used in operating businesses such as machinery, inventories or raw materials, real property, intellectual property or any other assets as specified in the ministerial regulation as collateral. The Act creates a new form of contract known as a business collateral contract between a borrower, or security provider, who agrees to provide pre-agreed assets, and a lender, or a security receiver, who in turn lends money against those assets.
2 Mexico 	Movable Assets as Collateral for SME Finance	The reform has transformed the lending scenario for SMEs in Mexico by creating a nationwide **movable collateral registry** in 2010. With the new registry, the number of loans to businesses has increased to around 23,000 in June of 2011 that has generated more than US$70 billion in financing to businesses and SMEs accounting for more than 90% of the firms receiving those loans. About half of the loans granted have gone to agri-businesses and farmers.

Source: Clifford Chance, 2016, Introduction to the Business Collateral Act B.E. 2556 (2015), 15 August; G20 Stocktaking Report, 2010; de la Campa, 2010. Reproduced from IFC SME Finance Guide

Insolvency Regime: Giving MSMEs second chance

- Legislation on personal/SME insolvency should therefore provide for:
  - a) A transparent process by which entrepreneurs can seek to rescue their troubled businesses (including methods for making proposals to creditors for plans of arrangement);
  - b) A clear method for liquidating the business should the business fail, repaying creditors in a timely manner, and discharging the remaining debts;
  - c) Clear protections for creditors, including lifetime limits on the number of times an individual entrepreneur can go bankrupt and punishments for fraudulent behavior; and
  - d) Balance between debtor and creditor protection.
- In more practical ways, regulators can decide whether any of the insolvency channels outlined above, suits their specific conditions and put in place relevant regulations and mechanisms. Some options are outlined below:
  - A Out of Court Workouts (Example: Latvia)
  - B Pre-Insolvency Proceedings
  - C Specialized Insolvency Proceedings (Example: Argentina)

Source: Modern principles of secured transactions systems have been established by the international community in the UNCITRAL Legislative Guide for Secured Transactions, which is endorsed by the World Bank Group. as reflected in both the "World Bank Principles and Guidelines for Insolvency and Creditor Rights Systems (revised 2005)" and the IFC Guide on "Secured Transactions and Collateral Registries" (2010).

Alternative MSME finance Instruments: Leasing and Factoring

Instruments

Legislative Framework

1

Leasing

- Define leasing and the rights and responsibilities of the parties to a lease
- Develop a unified registry for movable collateral where all security interests are recorded and protected
- Clearly define the process for registering leased assets
- Clearly define and enforce repossession procedures.
- Ensure the right of the lessor (as owner) to repossess a leased asset, regardless of the type of breach by the lessee.
- Ensure that tax laws do not bias against leasing
- Insolvency regimes must clarify the rights of lessors and lessees under bankruptcy

Case Study: Jordan

2

Factoring

- Facilitate the sale, or assignment, of receivables
- Depends relatively less on the business environment than traditional lending products.
- In a weak business the factored receivables are removed from the bankruptcy estate of the seller and become the property of the factor. In this case, the quality and efficacy of bankruptcy laws are less important. Nevertheless, factoring may still be hampered by weak contract enforcement and requires good historical credit information on all buyers. In many emerging markets the credit information bureau is incomplete (i.e., may not include small firms), or non-bank lenders, such as factors, are prohibited from joining. In the case of exporters, it might be prohibitively expensive for the factor to collect credit information on firms around the world.

Case study: Mexico

SME Finance Base Set

- The key principles and dimensions of the AFI SME Finance Base Set can be a useful starting point for members who embark of such data collection effort.
- Key principles underlying AFI's SME Finance Base Set:
  - A Completeness
  - B Usefulness
  - C Consistency
  - D Flexibility
- Key dimensions include:
  - A Access indicators
  - B Usage indicators
  - C Quality indicators

Source: Guideline Note 16: SME Financial Inclusion Indicators Base Set

Credit Information System (CIS)

01 Provides lenders with **accurate and credible information** that reduces the risk of lending (loan losses).

02 **Credit reporting systems** comprise Public Credit Registries (PCRs) and Private Credit Bureaus (PCBs)

03 PCR and PCB play two key functions in a financial system: **support banking supervision** and **promote access to finance**

04 An effective CIS requires **credit reporting service providers** to collect sufficient, relevant, and usable data to promote, increased coverage and facilitate a more reliable database.

Source: Guideline Note 16: SME Financial Inclusion Indicators Base Set

Credit Information System (CIS)

CIS

- Establishing scope of data and type of data contribution
- including all relevant and available data (positive and negative data related to individuals and to businesses)
- participation of non-regulated entities
- defining responsibilities and liabilities of each participant
- ensuring that data is detailed at the account level
- including historical data
- preserving consumers' rights, such as the right to object to the information being collected, the right to be informed, the right to access data, and the right to challenge data

Case study: Credit Registry – Bank Negara Malaysia

Credit Guarantees

- A common form of public intervention to increase access to credit for SMEs is through credit guarantee schemes (CGSs), which provide:

  Third-party partial credit risk mitigation to lenders - absorbing a portion of the lender's losses (risks) on the loans made to SMEs in case of default, in return for a fee

- As the lenders carry part of the SME loan default risks, CGSs involve less room for distortions in credit markets than more direct forms of intervention such as state-owned banks.

- CGSs can notably be a useful instrument to address information imperfections/asymmetry in the medium-run, especially in countries where institutional environment is weak, in coordination with credit registries, and by building the credit origination and risk management capacity of lenders (e.g. through technical assistance for the setup of SME units in banks).

Credit Guarantees

Pre- conditions for the success of CGS

1. Regulations to ensure contract enforcement, fair resolution of contracts, and those related to insolvency, collateral, consumer protection, and private property
2. Independent judiciary and well-regulated legal, accounting and auditing systems
3. Comprehensive set of accounting standards and rules
4. A sound financial system able to effectively originate and manage credit

Credit Guarantees

16 Principles:

1. Established as an independent legal entity based on a sound and clearly defined legal and regulatory framework to support the effective implementation of its operations and the achievement of its policy objectives
2. Have adequate funding to achieve its policy objectives, and the sources of funding, including any reliance on explicit and implicit subsidies, should be transparent and publicly disclosed
3. Legal and regulatory framework promote mixed ownership of the CGS, ensuring equitable treatment of minority shareholders
4. Be independently and effectively supervised based on risk-proportionate regulation scaled by the products and services offered
5. Have a clearly defined mandate supported by strategies and operational goals consistent with its policy objectives
6. Have a sound corporate governance structure, with an independent and competent board of directors appointed according to clearly defined criteria.
7. Have a sound internal control framework to safeguard the integrity and efficiency of its governance and operations
8. Have an effective and comprehensive enterprise risk management framework which identifies, assesses and manages the risks related to its operations

Credit Guarantees (cont.)

16 Principles:

9. Adopt clearly defined and transparent eligibility and qualification criteria for SMEs, lenders and credit instruments
10. Guarantee delivery approach should appropriately reflect a trade-off between outreach, additionality and financial sustainability, taking into account the level of financial sector development of the country
11. Guarantees issued by the CGS should be partial, providing the right incentives for SME borrowers and lenders, and designed to ensure compliance with the relevant prudential requirements for lenders
12. Adopt a transparent and consistent risk-based pricing policy to ensure that the guarantee program is financially sustainable and attractive for both SMEs and lenders
13. Claim management process should be efficient, clearly documented and transparent, providing incentives for loan loss recovery, and aligned with the home country's legal and regulatory framework
14. Be subject to rigorous financial reporting requirements and have its financial statements externally audited
15. Periodically and publicly disclose non-financial information related to its operations
16. The performance of the CGS, in particular its outreach, additionality and financial sustainability, should be systematically and periodically evaluated and the findings publicly disclosed

Leveraging Fintech on SME Financing

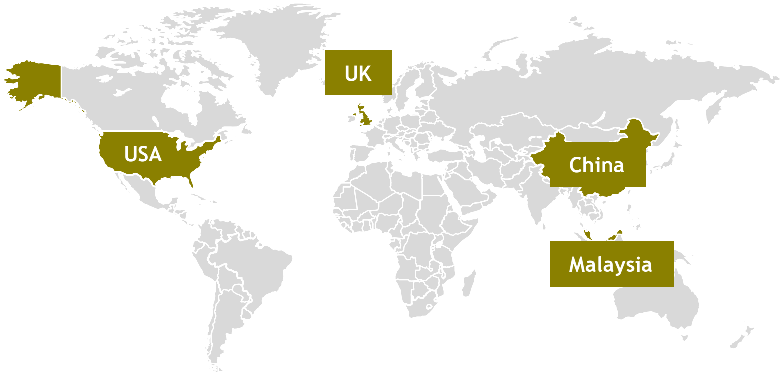
Alternative Finance Instruments through FinTech:

1 Equity Crowd Funding (ECF)

2 Peer-to-Peer (P2P)

3 Initial Coin Offerings (ICO)

Top players for Alternative Finance



Benefits of Alternative Finance

- SME Access to Finance ranked 1st on Alternative Finance.
- Majority of regulators report a positive impact from alternative finance on both SME finance and consumers' access to finance. There is also a strong perception that alternative finance has a positive impact on competition in financial services and in financial inclusion.
- However, this must be balanced against the statutory objectives of regulators such as protecting consumers, ensuring market integrity and promoting financial stability. Fraud, capital losses, and money laundering are considered the most significant risks by surveyed regulators across all three alternative finance activities.
- MSMEs are among the more prominent catalyzers of alternative finance. By model P2PC or Peer-to-peer crowdfunding is the model with the higher volume ranking, with USD 243.5 bil. market, with 153 bil. (62.7%) directed to MSMEs. P2P C Lending Model is the largest model globally and contribute significantly to Micro financing (USD153.20 bil.)
- In terms of Gender: reward-based crowdfunding is highest among women, however ECF is largely among male investors ("boys' club"). Gender based inclusion.

Source: World Bank – CCAF Alternative Finance Regulation Survey, Interim Report 20 June 2019

THANK YOU

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