Enhancing the contribution of MSMEs to economic development: main barriers and possible interventions

Discussion document
Tunis, 9 March 2011
Objectives of the meeting

- Recall the role of MSMEs in economic development, the main barriers to their development and the spectrum of possible interventions
- Describe concrete areas of intervention to enhance MSMEs contribution to economic development
- Discuss the relevance of the interventions described for AfDB in Africa and the Bank’s possible role
MSMEs contribute significantly to economic development in emerging countries

| Region                        | Formal SMEs, micro and informal MSMEs by region | Percent of all MSMEs | \n|-------------------------------|-------------------------------------------------|----------------------|\n| East Asia                    | 81                                              | 12                   | 7                   | 170-205                        |\n| Latin America                 | 71                                              | 23                   | 6                    | 47-57                          |\n| Sub-Saharan Africa            | 69                                              | 21                   | 10                   | 36-44                          |\n| Central Asia & Eastern Europe | 45                                              | 40                   | 15                   | 18-22                          |\n| South Asia                    | 89                                              | 8                    | 3                    | 75-90                          |\n| Mena                          | 68                                              | 22                   | 10                   | 19-23                          |\n| High-income OECD              | 52                                              | 28                   | 21                   | 56-67                          |\n| Total                         | 74                                              | 17                   | 9                    | 420-510                        |\n| Total (excluding high-income OECD) | 78                                              | 16                   | 7                    | 365-445                        |\n
**Contribution to the economy**

| Share of GDP                  | Informal | Total   |\n|-------------------------------|----------|---------|\n| East Asia                     | 29       | 66      |\n| Latin America                 | 37       | 93      |\n| Sub-Saharan Africa            |          | 45      |\n| Central Asia & Eastern Europe |          | 48      |\n| South Asia                    |          | 93      |\n| Mena                          |          |         |\n| High-income OECD              |          |         |\n| Total                         |          |         |\n
However, many barriers to MSMEs are limiting their full development potential

Main barriers

<table>
<thead>
<tr>
<th>Non Financial</th>
<th>Financial</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Regulatory and legal frameworks</strong> (e.g. heavy regulations, cost of registering companies and properties, policy environment, . . .)</td>
<td><strong>Limited access to bank financing:</strong></td>
</tr>
<tr>
<td><strong>Infrastructures</strong> (energy, transports)</td>
<td></td>
</tr>
<tr>
<td><strong>Tax system</strong> (heavy taxes on formal MSMEs)</td>
<td></td>
</tr>
<tr>
<td><strong>Corruption</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Non Financial</strong></td>
<td><strong>Financial</strong></td>
</tr>
<tr>
<td><strong>Limited access to bank financing:</strong></td>
<td></td>
</tr>
<tr>
<td>– Absence or insufficient <strong>credit information systems</strong> (e.g. credit bureaus)</td>
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</tr>
<tr>
<td>– Weak <strong>protection of creditors’ rights</strong> (e.g. loan financing legal frameworks, security laws, insolvency laws)</td>
<td></td>
</tr>
<tr>
<td>– Inadequate <strong>product offer</strong> (mainly focused on short term loans)</td>
<td></td>
</tr>
<tr>
<td><strong>Insufficient</strong> (or unavailable) <strong>equity financing</strong></td>
<td></td>
</tr>
</tbody>
</table>

SOURCE: IFC, McKinsey
There are ~400 Million MSMEs in emerging markets with a total credit gap $2.2-2.7 Trillions

<table>
<thead>
<tr>
<th>Number of MSMEs in emerging markets</th>
<th>Value of MSMEs' credit gap in emerging markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Millions</td>
<td>$ Trillions</td>
</tr>
<tr>
<td>Informal enterprises &amp; nonemployer firms</td>
<td>Of which $385-455bn in Africa</td>
</tr>
<tr>
<td>55-70</td>
<td>~70% of MSMEs in Africa are underserved$^{3}$</td>
</tr>
<tr>
<td>285-345</td>
<td>1.1-1.4</td>
</tr>
<tr>
<td>365-445</td>
<td>2.2-2.7</td>
</tr>
<tr>
<td>Total</td>
<td></td>
</tr>
<tr>
<td>25-30</td>
<td>0.8-1.0</td>
</tr>
<tr>
<td>55-70</td>
<td>~0.3</td>
</tr>
<tr>
<td>Total</td>
<td></td>
</tr>
</tbody>
</table>

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*Increasing level of uncertainty in estimates*

1 Registered enterprises typically with 5 or more employees
2 Registered enterprises with 1-4 employees
3 Do not have neither a loan nor an overdraft facility although they need it
A spectrum of possible interventions can be implemented to foster MSMEs development

Possible interventions

Remove non financial barriers
- Launch *infrastructure-building* programs
- Review *legal and regulatory frameworks*
- Create *Special Economic Zones* providing specific facilitations to SMEs (logistics and infrastructure, tax system, legal frameworks . . .)

Create a more supportive environment for funding
- Establish *financial information infrastructure* (public credit registers and Credit Bureau)
- Review *legal frameworks to protect creditors* (e.g. collateral and insolvency regimes, creditor rights, . . .)
- Review *regulation to favor MSMEs-targeted financial products* (e.g. value chain financing, leasing, reverse factoring)
- **Micro “Finance up-scaling”** to address SME segment
- Launch *capability building efforts for Financial Institutions*

Provide direct support from Public Sector
- Provide *direct financing*
- Create *credit facilities for banks* (e.g. lines of credit to finance MSMEs or co-financing initiatives)
- Create *partial credit guarantees and risk sharing facilities* on MSMEs financing
- *Equity financing funds*

SOURCE: IFC, McKinsey
## Four examples of concrete programs to overcome the main barriers against MSMEs development

<table>
<thead>
<tr>
<th>Example of program</th>
<th>Concept description</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Establishment of Credit Bureau</td>
<td>- Centralized data repository providing “positive” and “negative” credit information on borrowers (individuals, SME) allowing “more informed credit decisions” and thus increasing access to credit</td>
<td>- Strong potential contribution towards the objective to remove “Financial Barriers” via the creation of appropriate infrastructure</td>
</tr>
<tr>
<td>Set-up a risk sharing facility</td>
<td>- Market-oriented guarantee mechanisms aimed at reducing the risk of private-sector lending to specific sectors/segments</td>
<td>- Very effective tool to boost banks’ lending to specific sectors, reduce price of loans and unlock sectors’ credit potential</td>
</tr>
<tr>
<td>Creation of Special Economic Zones</td>
<td>- Dedicated industrial complex, with ad hoc infrastructure and logistic facilities</td>
<td>- Important impact in terms of avoiding most limitations to MSME development resulting from “Infrastructure” and “Legal Environment”</td>
</tr>
<tr>
<td></td>
<td>- Potential to include specific facilitations (e.g. special custom region, tax exemptions, …)</td>
<td></td>
</tr>
<tr>
<td>Micro Finance Institutions up-scaling</td>
<td>- Microfinance Institutions up-scale their models to increase their reach and serve SMEs</td>
<td>- MFI up-scaling relies often on external financial support by multilateral or development institutions in the start-up</td>
</tr>
</tbody>
</table>
Objectives of the meeting

Recall the role of MSMEs in economic development, the main barriers to their development and the spectrum of possible interventions.

Describe concrete areas of intervention to enhance MSMEs contribution to economic development:

- Establishment of a Credit Bureau
- Set-up of a Risk Sharing facility
- Creation of Special Economic Zones
- Up scaling of Micro Finance Institutions

Discuss the relevance of the interventions described for AfDB in Africa and the Bank’s possible role.
Credit Bureaus: key messages

1. A Credit Bureau allows to increase significantly the information dataset which could be used to facilitate MSME lending

2. A well structured Credit Bureau improves effectiveness and efficiency throughout all the phases of the Bank’s credit processes, and makes it possible to reinforce supervision functions at Central Bank level

3. A comprehensive program for establishing a full-fledged Credit Bureau can be structured in 3 sequential phases
A Credit Bureau collects and provides credit-related information on borrowers to support banks on credit decisions.

**Objective**
Increase the information set available for banks when adopting credit decisions and Central Bank's Supervision visibility on overall banking system.

**Input**
- Credit information
  - Customer data
  - Facility data
  - Repayment data

**Information providers**
- Banks
- Other institutions

**Information users**
- Banks
- Other institutions

**Main Credit Bureau activities**
- Gathering information on borrowers from both private and public sources
- Analysis and processing information on borrowers
- Redistribution of raw and processed credit information to credit granting organizations and other stakeholders

**Consolidated credit history**
Credit Bureau: why it represents a priority in Africa

Credit Bureau allows significant impact on SME lending …

Example 1 – effect on SME credit market

<table>
<thead>
<tr>
<th>Percent</th>
<th>Without Credit Bureau</th>
<th>With Credit Bureau</th>
</tr>
</thead>
<tbody>
<tr>
<td>49</td>
<td>27</td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>40</td>
<td></td>
</tr>
</tbody>
</table>

Percentage of SME reporting financial constraints

Example 2 – effect of default rates at country level

<table>
<thead>
<tr>
<th>Percent</th>
<th>Large banks</th>
<th>Small banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.22</td>
<td>1.31</td>
<td></td>
</tr>
<tr>
<td>2.42</td>
<td>0.52</td>
<td></td>
</tr>
</tbody>
</table>

Probability of loan granting to a SME

… but it’s currently highly under exploited in Africa

Credit information infrastructure by region

<table>
<thead>
<tr>
<th>Percent of adults</th>
<th>Public Registry Coverage</th>
<th>Private Bureau Coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sub-Saharan Africa</td>
<td>2.4</td>
<td>4.5</td>
</tr>
<tr>
<td>South Asia</td>
<td>0.8</td>
<td>3.3</td>
</tr>
<tr>
<td>OECD</td>
<td>8.8</td>
<td>59.6</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>5.0</td>
<td>10.9</td>
</tr>
<tr>
<td>Latin America and Caribbean</td>
<td>10.0</td>
<td>33.2</td>
</tr>
<tr>
<td>Eastern Europe and Central Asia</td>
<td>9.7</td>
<td>19.4</td>
</tr>
<tr>
<td>East Asia and Pacific</td>
<td>7.2</td>
<td>14.4</td>
</tr>
</tbody>
</table>

SOURCE: G20 - Financial Inclusion Expert Group, World Bank - doing business
Credit Bureaus are important enablers of healthy credit underwriting and management both at commercial bank and Central Bank levels

**At commercial bank level**

- **Credit origination**
  - Understand client segment credit needs by comparing customer peers
  - Enhance access for healthy customers (e.g., SME/SB) with clean repayment history

- **Credit underwriting**
  - Cope with lack of reliable financial data (e.g., financial statement, salary slips), which often curtails availability of credit to large parts of the population, especially small businesses
  - Enhance credit underwriting capabilities, by screening out high-risk customers (e.g., fraud detection) and fine-tuning rating/scoring models

- **Credit management**
  - Ensure responsible lending (e.g., avoid excessive credit by monitoring customer total outstanding) and portfolio management
  - Help monitoring/evaluating single positions (e.g., through early-warning signals)

- **Credit recovery**
  - Enhance early delinquency (e.g., providing access to updated customer info and asset registries)

**At Central Bank level**

- **Single entity monitoring**
  - Monitor single banking exposure by segment/product type and verify consistency with other reporting/monitoring systems

- **Systemic risk monitoring**
  - Prevent economic crises by monitoring overall lending (e.g., excessive retail lending which has caused consumer credit crises in many countries) and early warning signals (e.g., bounced cheques, unpaid bills)
Value-added services provided by a full-fledged Credit Bureau to a commercial bank

The customer life cycle mirrors the core business functions adopted by most lenders when managing customers.

1 Including underwriting decision support tools (e.g., loan calculation)

SOURCE: “Credit Bureau Knowledge Guide” 2007, the World Bank
**Systemic risk monitoring: overall, Credit Bureaus contribute to reduce cost of credit risk and allow further growth of credit**

South African banks credit systems heavily rely on external information …

Thus significantly reducing cost of credit risk and allowing further growth of credit activities

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**Formation of Credit Bureau Association**¹ (in early 2000s) to improve Credit Bureau governance and consumer awareness and major technological and systematic changes during past few years …

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**Introduction of a new underwriting methodology. Key features:**
- Utilization of negative and positive information, largely external
- Assessment based on source of repayments, both primary (transaction and client) and secondary (collateral)

**Introduction of a new credit management methodology. Key features:**
- Behavioral scoring model based on the mix of negative and positive information, able to detect troubled clients 12-18 months in advance
- Set of precise actions as function of client risk

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1 Association of 5 private and public pre-existent Credit Bureaus (Compuscan, Experian, Traderef, Transunion, KreditInform)

**SOURCE:** Client interviews; Central Bank; TransUnion Website; Credit Bureau Association website

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MIL-VAD001-02032011-32272/MC
The development/modernization of a Credit Bureau should follow a phased approach

Example of Credit Bureau development/modernization

<table>
<thead>
<tr>
<th>Phase 1</th>
<th>Phase 2</th>
<th>Phase 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Diagnostic and program design</strong></td>
<td><strong>Develop a new Credit Bureau</strong> to improve reliability, availability and timeliness of information collected and returned to financial institutions</td>
<td><strong>Provide advanced creditworthiness analyses</strong></td>
</tr>
</tbody>
</table>

**Expected timeline**
- **Phase 1**: 3 - 6 months
- **Phase 2**: 6 - 18 months
- **Phase 3**: TBD

**Entities involved**
- **Phase 1**
  - Country supervisors department
  - Existing information structures (e.g., Credit Registry)
  - Trading commercial banks
- **Phase 2**
  - All other commercial banks
- **Phase 3**
  - Other Institutions
    - Utilities
    - Insurance Companies
    - Retailers
  - Public Sources
    - Press
    - Economic Research
  - Country supervisors department
  - Existing information structures (e.g., Credit Registry)

**SOURCE:** Team Analysis

Focus of following page
## During the diagnostic and program design phase, several issues should be considered

### Areas

<table>
<thead>
<tr>
<th>Areas</th>
<th>Key related questions</th>
</tr>
</thead>
</table>
| Regulatory environment and legal structure | - What is the most suitable **shareholding structure**? (E.g. public/private)  
- What should be the **tasks and objectives** of the Credit Bureau?  
- Should participation in the Credit Bureau be **free or compulsory**? How should it be **enforced**?  
- Can/should **access** to information be extended **to other players**? E.g., shall other financial institutions and utilities be involved?  
- How should **privacy-related issues** be dealt with?  
- How are any existing credit registries **organized and staffed**?  
- What is the optimal Credit Bureau **organizational structure**?  
- What is the **labor market** like? What skills are readily available, and at what cost?  
- How should the **banks be involved** in the implementation phase?  
- What are the **processes and procedures** followed by any existing credit registries? (Both within these registries and between them and any member organizations)  
- What are the **Bureau output** (e.g., reports)?  
- What **IT solution** looks most suitable? Which provider(s) should we choose?  
- How can we ensure **scalability** of the system?  
- What systems do future participants have in place, and what **support** do they offer for **interfaces with the Credit Bureau**?  
- What is the **complexity** of the overall IT environment, and how can we manage it?  
- What **information/data sources** are available?  
- How can appropriate **data quality** be guaranteed?  
- Should coverage extend to **all customers** (SMEs, corporate, and individuals)?  
- Should coverage extend to **all products**? (Term loans, overdrafts, LCs/LGs, mortgages, etc.) |

### NOT EXHAUSTIVE
Risk Sharing Facility (“RSF”): key messages

1. Risk sharing facilities provide a very effective tool to unlock the credit potential of a specific sector/segment by reducing risk for private lenders and decreasing loan prices.

2. Well structured risk sharing facilities are built around a clear definition of their operating models (target market, “products” – i.e., type of guarantee provided, and specific/tailored distribution model).

3. The concrete set-up of a risk sharing facility requires a thorough design of its functioning mechanisms including key processes and organization, system and policies, governance model and key financials.
1 Risk Sharing Facility ("RSF"): what it stands for

Overall goal
- Establish a **sustainable, market-oriented guarantee mechanism** that de-risks a specific sector and boosts banks’ lending in order to unlock the credit potential

Objectives and aspirations
- Increase **lending** to a specific sector
- Reduce **price of loans** by reducing **risk exposure** for private lenders (i.e. banks and financial institutions)
- Focus on **end-to-end value chains** within a chosen sector

Scope

Example: Kenya

<table>
<thead>
<tr>
<th>Decrease in interest rate</th>
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</thead>
<tbody>
<tr>
<td>Before</td>
</tr>
<tr>
<td>18</td>
</tr>
</tbody>
</table>

-8 (-44%)  

- Risk sharing facility of $5 mil provided to leverage $50 mil. in loans
- Loans were extended to over 37,000 small scale farmers, 1,000 large scale farmers and 300 agribusinesses
- To manage the loan scheme, the bank recruited over 100 new agricultural graduates
Well structured RSFs are built around a clear definition of their operating model

- **Target market**
  - Focus on specific and identifiable client categories within the chosen sector value chain (e.g., in Agriculture: Agribusiness, Processors, Farmers)

- **Products**
  - Choice the type of guarantee to provide:
    - “Single transaction based”: guarantees are awarded “one-by-one” to specific customers/loans
    - “Portfolio based”: guarantees cover a portfolio of loans; the risk sharing facility covers a predefined percent of losses (e.g. first/second loss)

- **Distribution**
  - Design and introduce a specific service model dedicated to the sector
  - Use lower risk sub-segments as “anchor point” to provide “value chain finance” solutions
Two main approaches can be employed in order to provide a risk sharing mechanism

<table>
<thead>
<tr>
<th>Description</th>
<th>Implications</th>
<th>Especially relevant to</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Single transaction</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>▪ Guarantees awarded to <strong>specific customer loans</strong> (up to a predefined portion)</td>
<td>▪ <strong>Skills/FTEs required in the fund</strong> to evaluate single files</td>
<td>▪ Investment type loan to large farmers (above a certain limit, e.g. $1m)</td>
</tr>
<tr>
<td>▪ <strong>One-by-one application screening</strong> and decision making by the fund (on top of the screening in FIs)</td>
<td>▪ Possibility to <strong>support banks in developing credit evaluation capability</strong> for agriculture</td>
<td>▪ Can be extended to unbanked small farmers given a well designed process</td>
</tr>
<tr>
<td>▪ Fund covering losses <strong>every time a guaranteed loan defaults</strong>¹ (up to the guaranteed amount)</td>
<td>▪ Important to <strong>shape sound eligibility criteria</strong> not to “dry up” the fund capital</td>
<td>▪ Works well when there is little information on the borrowers</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Portfolio approach</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>▪ Guarantees covering a “portfolio” of loans</td>
<td>▪ <strong>More limited capability building on agricultural credit evaluation</strong></td>
<td>▪ A number of <strong>banked small farmer loans</strong></td>
</tr>
<tr>
<td>▪ Fund mainly focused on <strong>defining policies and monitoring</strong> (file screening just as audit/control activity)</td>
<td>▪ <strong>Lower FTE requirements</strong></td>
<td>▪ Works well when there is good credit understanding of borrowers and strong capability in FIs</td>
</tr>
<tr>
<td>▪ Fund covering a <strong>pre-defined percent of losses</strong> on the overall portfolio (e.g., first loss/second loss)</td>
<td>▪ Important to understand <strong>expected default rate and its distribution</strong> determine key parameters of loss sharing</td>
<td></td>
</tr>
</tbody>
</table>
Portfolio approach: a deep dive on the possible alternatives to cover losses

How it works:
- Fund covers x% of all losses in A and B regions
- Banks cover all losses in C region and (1-x%) in A and B

Implications:
- Banks may end up decreasing the average portfolio quality in proportion to the percentage covered by the RSF

How it works:
- Fund covers x% of losses in B region
- Banks cover all losses in A and C region and (1-x%) losses in B region

Implications:
- Banks are incentivized to maintain a good average portfolio quality (as write-offs up to the expected loss do not receive any mitigation by the fund)
Lending penetration can be increased through value chain financing

### Rationale and concept

- The actors involved along the agricultural value chain are characterized by **different credit worthiness**, e.g. agribusiness enjoy better “credit standing” compared to small farmers, which allows them higher access to credit

- **Value chain financing** has the objective to **shift perceived risk of lending transactions** towards the **more credit-worthy actors** involved in the underlying commercial contract

<table>
<thead>
<tr>
<th>Position of “better credit name” in the commercial transaction</th>
<th>From “traditional” approach</th>
<th>To “value chain financing” approach</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Buyer</strong> (e.g. Nestle buying products from farmer)</td>
<td>▪ Provide working capital finance to seller</td>
<td>▪ Provide pre-financing to buyer</td>
</tr>
<tr>
<td><strong>Seller</strong> (e.g., Monsanto selling seeds to farmers)</td>
<td>▪ Provide working capital finance to buyer</td>
<td>▪ Alternatively provide working capital finance to seller and use receivables as collateral</td>
</tr>
<tr>
<td></td>
<td>▪ Provide post-financing to seller</td>
<td>▪ Provide receivable finance to seller</td>
</tr>
</tbody>
</table>
### The concrete set-up of risk sharing facility requires a thorough design of its function mechanisms

<table>
<thead>
<tr>
<th>Processes and organization</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Design the fund structure around:</td>
</tr>
<tr>
<td>- 2 “core business processes”: Credit and ALM</td>
</tr>
<tr>
<td>- Targeted “support processes”, e.g., accounting, audit, financial control, etc.</td>
</tr>
<tr>
<td>▪ <strong>Outsource</strong>, by leveraging on existing capabilities as much as possible</td>
</tr>
<tr>
<td>▪ <strong>Select outsourcers</strong> on the basis of their qualifications, skills and track record</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Systems and policies</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Introduce a <strong>credit assessment form</strong> based on 2 filters</td>
</tr>
<tr>
<td>- <strong>Pre-screening – knockout indicators</strong> which are necessary conditions to continue with credit assessment</td>
</tr>
<tr>
<td>- <strong>Creditworthiness analysis</strong> – after pre-screening, assess borrower’s eligibility for the specific lending transactions</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Financials</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ <strong>Costs</strong> consist of credit losses and administrative costs</td>
</tr>
<tr>
<td>▪ Revenues generated by guarantee fees and ALM margins (potential 3rd party donors at later stage)</td>
</tr>
<tr>
<td>▪ <strong>Aim is break-even</strong></td>
</tr>
<tr>
<td>▪ <strong>Capital balance</strong> to be maintained over time: the fund’s capital should cover at least unexpected credit losses and VaR from ALM activities</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Governance</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Establish RSF as <strong>independently governed fund</strong> able to self-sustain over time</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Enablers</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Create <strong>information sharing mechanisms</strong> (e.g., credit bureau)</td>
</tr>
<tr>
<td>▪ Introduce appropriate, reliable <strong>accounting standards</strong></td>
</tr>
<tr>
<td>▪ Establish effective <strong>legal environment</strong>, e.g.,</td>
</tr>
<tr>
<td>- Effective bankruptcy procedures</td>
</tr>
<tr>
<td>- Clear guarantee/collateral enforcement rules</td>
</tr>
</tbody>
</table>
Objectives of the meeting

Recall the role of MSMEs in economic development, the main barriers to their development and the spectrum of possible interventions

Describe concrete areas of intervention to enhance MSMEs contribution to economic development:

- Establishment of a Credit Bureau
- Set-up of a Risk Sharing facility
- Creation of Special Economic Zones
- Up scaling of Micro Finance Institutions

Discuss the relevance of the interventions described for AfDB in Africa and the Bank’s possible role
Special Economic Zones: key messages

1. Special Economic Zones are becoming increasingly common in many economies and allow to contribute significantly to economic growth.

2. Successful establishment of Special Economic Zones requires to carefully address a series of prerequisites.

3. A comprehensive program for establishing a Special Economic Zone can be structured in 2 sequential phases.
Special Economic Zones are becoming increasingly common in the world

The number of Special Economic Zones has expanded significantly over the last 40 years ...

<table>
<thead>
<tr>
<th>Number of countries with economic zones</th>
<th>1970</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Egypt and Morocco Economic Zones:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Created more than 100,000 jobs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Accounted for ~10% of total FDI and ~15% of export</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Library of Economic Zones in appendix

SOURCE: Special Economic Zones and Economic Transformation; U.N. ESCAP 2005; World Bank; team analysis
Special Economic Zones could significantly contribute to economic growth

Main assumptions:
- ~1,000 operating companies
- ~15,000 units of direct employment (~30,000 of indirect employment)\(^1\)
- Average value added per employee of ~75,000 USD
- Indirect GDP estimated from comparison with similar SEZs and emerging countries\(^2\)

Contribution to industrial GDP USD billion:
- GDP generated by service activities established in the zone (e.g., hotel, restaurants, retailers, etc.)
- Industrial GDP (2007)\(^3\)
- Direct GDP impact
- Indirect GDP impact
- Total industrial GDP
- +20-25%

Strong potential contribution from foreign investors via FDI, fostering the development of needed skills and capabilities at local level

---

1 Assuming 15 employees per company and a 2:1 ratio of indirect/direct employees, as per international Word Bank benchmarks
2 GDP multiplier assumed in the range 0.8 – 1.3
3 Excluding infrastructure sector and Public and Social sectors

SOURCE: IMF/Ministry of Planning, World Bank, team analysis
International experience suggests that 15,000 direct jobs could be a conservative aspiration for a Special Economic Zone.

Direct employment per Special Economic Zone
Thousand direct employees

<table>
<thead>
<tr>
<th>Region</th>
<th>Employment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia pacific</td>
<td>62</td>
</tr>
<tr>
<td>World average</td>
<td>30</td>
</tr>
<tr>
<td>UAE</td>
<td>21</td>
</tr>
<tr>
<td>Thailand</td>
<td>15</td>
</tr>
<tr>
<td>Mexico</td>
<td>12</td>
</tr>
<tr>
<td>Egypt</td>
<td>10</td>
</tr>
<tr>
<td>SSA</td>
<td>9</td>
</tr>
<tr>
<td>Morocco</td>
<td>9</td>
</tr>
</tbody>
</table>

SOURCE: ILO; World Bank
The total investment required to set up the special economic zone would be in the range of 4 USD bln.

**Development cost**

<table>
<thead>
<tr>
<th>Area</th>
<th>Cost Range (USD billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial</td>
<td>1.0-1.2</td>
</tr>
<tr>
<td>Residential</td>
<td>1.6-1.8</td>
</tr>
<tr>
<td>Commercial</td>
<td>0.6-0.8</td>
</tr>
<tr>
<td>Light infra-structure</td>
<td>0.4-0.6</td>
</tr>
<tr>
<td><strong>Total cost</strong></td>
<td>~4.0</td>
</tr>
</tbody>
</table>

**Main assumptions**

- Average 1,000 sqm/company of warehouse and office space (~1,000)
- Average 200 sqm/household of residential space (~1,100)
- Service/commercial area equivalent to 40% of residential area (Intl benchmark) (~1,200)
- Based on international benchmarks (~150)

**Estimate does not include:**
- Port/airport
- Roads
- Infrastructure works outside the economic zone
- Government direct return on the investment (e.g. rents, tax revenues, ...) to be assessed

1 Based on Middle East and North African countries benchmark, 2009

SOURCE: Gardiner&Thobald, Press search, team analysis
Although economic zones can be very successful, risks of failure are present

### Success stories

<table>
<thead>
<tr>
<th>Geographical Location</th>
<th>Description</th>
</tr>
</thead>
</table>
| **Shenzhen (China)**  | - A strong governance body empowered to reform (e.g., fiscal policy, reinvestment of earnings and loans in new urbanization projects) made Shenzhen a very successful economic zone.  
- GDP growth in the first 15 years was >20% yoy\(^1\)  
- 3 Mln employees created, $43 bn export |

| **Aqaba (Jordan)**   | - Aqaba has a strong focus on ease of doing business (one-stop-shop, online registration process), an effective governance, and very favorable regulation and taxation.  
- The zone is a huge success, with committed investments of $8 bn the first 5 years, and additional $12 bn by 2009 alone |

| **Jebel Ali (Dubai)** | - Strong leverage of regulatory and tax incentives (100% foreign ownership, 100% profit repatriation, 0% corporate tax for 15-30 years) and very good infrastructures contributed to the success of Jebel Ali.  
- Over 6000 companies, including more than 100 Fortune 500 were established, with over 13.000 jobs created |

### Failure stories

<table>
<thead>
<tr>
<th>Geographical Location</th>
<th>Description</th>
</tr>
</thead>
</table>
| **Cartagena (Colombia)** | - Cartagena Free Zone (Colombia) was located in a swamp, resulting in:  
  - Very high development costs for tenants  
  - Poor access infrastructure  
  - Inadequate living standards  
- Only 19 small firms established with <1.000 jobs\(^2\) |

| **Bataan (Philippines)** | - The economic zone was developed in a poor-site location in terms of logistic infrastructures (160 Km to Manila, no close port/airport).  
- Only ~50 companies settled  
- Employment was almost constant for 10 years (CAGR 1992-2002 was 1%) |

| **Zolic (Guatemala)** | - Poor vision and strategy development led to inadequate estimates of demand and marketing support caused the Zolic zone (Guatemala) to have 24,000 square meters of unused factory space |

\(^1\) Overall China <10%  
\(^2\) Target was 6.000

SOURCE: World Bank, public sources, team analysis
Framing a program to establish a Special Economic Zone

Lessons learnt from international benchmarking

- **Establish** an up and running, **successful** Special Economic Zone is the final outcome of a **long-term transformation journey**, typically requiring a number of years.

- .....But the key success prerequisites should be thoroughly addressed early on in the journey.

**Key activities**

- Design the **strategic vision**
  - Target sectors
  - Investors **value proposition**
- Assess **enablers and economic feasibility**
  - Expected Impact
  - Investment requirements
- Prepare **implementation**: set up early stage governance, detailed plan
- Launch investor **roadshow** and get initial expression of interest

**Take-off: establish the prerequisites**

- **Infrastructural upgrade** and urban development
  - Detail the concept
  - Execute interventions
- **Tenant attraction**
  - Secure critical mass
  - Establish proper contracts
- **Governance and Regulation**
  - Staff/reinforce key positions
  - Enact detailed regulations

**Typical timeline**

- 1-1.5 year: laws/regulations implemented, infrastructure upgrade tendered, key positions staffed
- ~ 5/6 months
- 4/5 years

**Detailed in the following page**
Establishing the prerequisites: possible program approach

Four partially overlapping work-streams

Overall duration: 5 months

1. Vision and economic strategy
   - Analysis of international case studies
   - Review of local context
   - SWOT analysis & sector strategy
   - Investors’ value proposition

2. Overall feasibility strategy
   - Assess socio-economic impact
   - Estimate target land use mix
   - Define infrastructure and funding requirements

3. Governance and regulation
   - Review the overall institutional set-up
   - Define the needed organizational improvements
   - Assess the required regulatory enablers

4. Syndicate concept and launch investor road-show
   - Present the key components of the vision to relevant stakeholders
   - Validate financial estimates
   - Scan and short-list potential
   - Prepare and launch investor road-show

Months

1 2 3 4 5

Overall duration: 5 months
Objectives of the meeting

Recall the role of MSMEs in economic development, the main barriers to their development and the spectrum of possible interventions

**Describe concrete areas of intervention to enhance MSMEs contribution to economic development:**

- Establishment of a Credit Bureau
- Set-up of a Risk Sharing facility
- Creation of Special Economic Zones
- Up scaling of Micro Finance Institutions

Discuss the relevance of the interventions described for AfDB in Africa and the Bank’s possible role
MFIs: key messages

1. MFIs reach over 150 million poor around the world but the exponential growth has been limited to a limited number of MFIs

2. Transformation of nongovernmental microfinance providers into regulated commercial financial institutions would substantially increase access to financial services for millions of MSMEs

3. MDBs can help an important role in the commercialization of nongovernmental MFIs by providing capital and supporting the transformation program
Microcredit relies on forward-looking incentives, community relationships, and pressure to ensure repayment.

Group lending – Borrowers form groups and meet regularly (e.g., weekly) with loan officer to loan disbursal and repayment. Members motivate/pressure each other to repay and otherwise act responsibly. Poor repayment rates could cut off borrowing for entire group.

Individual lending – Loan officers make regular visits to ensure strong relationships and receive collections. Failure to repay cuts off individual lending relationships.

Many of the original MFIs relied on group-lending approaches (e.g., Grameen); some government-sponsored programs also take this form through self-help groups (e.g., in India).

Loan officer has extensive community knowledge and develops close working relationships with borrowers.

Microfinance institution (MFI) sends loan officers into communities to coordinate risk assessment, loan origination, and collections.

Many MFIs, as well as state-sponsored development banks (e.g., Bank Rakyat Indonesia), adopt the individual-lending approach.

Normally, individuals can borrow only for small businesses, not consumer purchases.

Once borrowers repay a loan, the next can be bigger. This process of new loans upon repayment can repeat indefinitely. The access to larger loans in the future is a major incentive for repayment.
Micro Finance Institutions have experienced significant success in the last 20 years

**Growth in the number of microcredit borrowers**

- **Millions of people**

<table>
<thead>
<tr>
<th>Year</th>
<th>1998</th>
<th>99</th>
<th>00</th>
<th>01</th>
<th>02</th>
<th>03</th>
<th>04</th>
<th>05</th>
<th>06</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value</td>
<td>21</td>
<td>24</td>
<td>31</td>
<td>55</td>
<td>68</td>
<td>81</td>
<td>92</td>
<td>113</td>
<td>133</td>
<td>155</td>
</tr>
</tbody>
</table>

**Financial institutions’ return on equity**

- **Percent, 2009**

- **Leading national microcredit provider**
- **Commercial banks**

- **BancoSol**
  - 34%

- **Bolivian banks**
  - 20%

- **Compartamos**
  - 43%

- **Mexican banks**
  - 12%

- **Mibanco**
  - 33%

- **Peruvian banks**
  - 22%

- **SKS**
  - 22%

- **Indian banks**
  - 15%

**SOURCE:** Standard and Poor’s, MIX Market; Superintendencia de Bancos y Entidades Financieras (Bolivia); Superintendencia de Banca, Seguros y AFP (Peru); National Banking and Securities Commission (Mexico); Bankscope; Microcredit Summit Campaign; World Bank; LeapFrog Investments

- **IPO in 2007, with valuation of $1.5 billion**
- **Highest growth of any stock listed on Mexican exchange in 2009**
- **Plans to launch IPO this year**
However, of the thousands of MFIs . . .

**Distribution of MFIs**

<table>
<thead>
<tr>
<th>Tier</th>
<th>Description</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 1</td>
<td>Mature MFIs with strong operational and financial track records; top ~60* institutions report 2%-6% return on assets (ROA) and 5%-15% return on equity (ROE)</td>
<td>1%</td>
</tr>
<tr>
<td>Tier 2</td>
<td>Successful but smaller or lesser-known MFIs at or near profitability</td>
<td>20%</td>
</tr>
<tr>
<td>Tier 3</td>
<td>High-potential MFIs not profitable because of early stage, operational inefficiencies, or lack of capital</td>
<td>70%</td>
</tr>
<tr>
<td>Tier 4</td>
<td>Mix of smaller MFIs that may not even target profitability: total focus on social impact, post-conflict settings, programs for the lower end of the pyramid</td>
<td>92%</td>
</tr>
</tbody>
</table>

*Average for 60 MFIs reporting to Micro Banking Bulletin (2001)

Sources: “Tapping the Financial Markets for Microfinance,” GFUSA; Micro Banking Bulletin 10
... Only few have reached significant scale

Microcredit market share of top lenders
2009, Percent

- Top 10: 45%
- Top 11-50: 24%
- Top 51-100: 10%
- All others: 22%

% 100% = 91 million active borrowers (from 1,115 MFI)

Microcredit market share of top 10 lenders

- VBSP (Vietnam): 8%
- Grameen Bank (Bangladesh): 7%
- BRAC (Bangladesh): 7%
- SKS (India): 6%
- ASA (Bangladesh): 4%
- Spandana (India): 4%
- SHARE (India): 3%
- Bandhan (India): 3%
- PSBC (China): 2%
- CompartamosBanco (Mexico): 2%

Source: Microfinance Information Exchange
In fact, many traditional MFIs struggle to grow as they face a series of challenges.

**Challenges for the traditional microfinance model**

- **Limited access to capital** (e.g., MFIs need billions in capital injections around the world, while leading MFIs in Latin America and South Asia are already reporting borrowing cost increases of up to 400-450 bps due to the financial crisis)

- **Do not offer products beyond microcredit – limited ability to meet customers’ full financial services needs** (e.g., limited product range, typically focused on working capital credit, without electronic payments, savings or insurance products)

- **Labor-intensive approach leads to high costs and difficulty in achieving scale**
  - Labor costs are high, especially given low revenue potential per customer\(^1\)
  - Limited economies of scale
  - **Challenging to find needed talent** (e.g., loan officer and branch manager)

---

\(^1\) Costs vary significantly, from ~$10-15/borrower in India to $150-200/borrower in Mexico

SOURCE: CGAP, MIX Market; World Bank, “Microfinance Meets the Market”; interviews; team analysis
Transformation of nongovernmental MFIs into regulated commercial financial institutions would help overcome some of the challenges...

Path toward commercialization

<table>
<thead>
<tr>
<th>Applying commercial principles</th>
<th>Full commercialization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased cost recovery</td>
<td>Utilization of market-based sources of funds</td>
</tr>
<tr>
<td>Achievement of operational self-sufficiency</td>
<td>Achievement of financial self-sufficiency</td>
</tr>
<tr>
<td></td>
<td>Operation as a for profit institution within the financial system</td>
</tr>
</tbody>
</table>

Allow to increase outreach by allowing:

- **Access to wider source of capital**: by raising capital from savings, borrowing from commercial banks and accessing capital markets’ and private investors’ capital
- **To offer of products beyond microcredit**: such as deposit and insurance
### Example of non-profit MFIs that have successfully transformed in large profitable banks . . .

<table>
<thead>
<tr>
<th>Country</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Perú</td>
<td>Incorporated in 1988 as a bank after 20 years operating as NGO in order to tap capital markets and keep growing. Solid growth from early on.</td>
</tr>
<tr>
<td>Bolivia</td>
<td>Started as NGO and turned into a bank after 6 years (1992) to overcome regulation constraints and to keep growing and meet large unmet demand. Huge success based on innovative technology + extensive knowledge/experience acquired during NGO years.</td>
</tr>
<tr>
<td>Mexico</td>
<td>Abandoned NGO status to search for new funds. Profitable business model adapted to low-end and to specific MF.</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>Historical leader of the microcredit movement, the Government turned into a bank in 1983 to guarantee its continued success on a profitable and sustainable business model from day 1.</td>
</tr>
<tr>
<td>India</td>
<td>Became a Non-Banking Finance Corp. In 2005 after 8 years as NGO to tap commercial capital markets and keep growing its customer base and broaden its product range.</td>
</tr>
</tbody>
</table>
...helping provide credit to larger MSMEs

MFI that have transformed from NGOs to for profit organizations

**SOURCE:** MIX; ADB; team analysis
Compartamos went from being a small non-financial institution to a worldwide recognized microfinance bank

<table>
<thead>
<tr>
<th>Inauguration</th>
<th>Re-constitution</th>
<th>Debt Issuance</th>
<th>Bank Authorization</th>
</tr>
</thead>
</table>

- 1990: Compartamos, an institution focused on providing credit to micro companies began operations in Mexico.
  - It had the main objective of providing credit to micro entrepreneurs that did not have access to banking services
  - Rural areas in Mexico were the ones targeted by this new institution
- Its main source of funding was through donations
- 1999: Observing their funding limits, Compartamos decided to constitute itself as a private non-bank lending institution (Sofol)
  - As a Sofol, Compartamos would be able to obtain funding through private equity investment, debt, and government loans
  - Besides micro loans, it was not able to provide banking products such as deposit accounts, mortgages etc.
- 2002: It was approved, by the Mexican Stock Exchange, to issue bond certificates to the public
  - It became the first microfinancial institution to issue debt in the stock market without any collateral institutions
  - Compartamos started playing the role of a financial intermediary between investors and micro borrowers
- 2006: It obtained the authorization from the National Banking and Securities Commission to operate as a bank
  - It can provide deposit products to its customers, and increase its loan products to the same target market
  - In 2007, it made its IPO in the Mexican Stock Exchange and in several international stock exchanges as well. (it issued 29.9% of its shares with a value of 312 USD million)
  - In 2008 added to IPC1

By searching for new ways of obtaining funds, Compartamos has been changing its legal constitution (institution, Sofol, bank); however, it has never modified its main objective of providing microloans to rural communities

1 Mexico’s Stock Exchange main index

SOURCE: Mexican Banks Association, Economic Commission for Latin America and the Caribbean
The commercialization of nongovernmental is a complex process that requires a comprehensive program encompassing several areas.

### Strategic decisions

- **Marketing and competitive positioning**: gather market intelligence, determine the ideal product mix, and develop and communicate the brand for the new institution.
- **Strategic and business planning**: develop a strategic business plan for internal use and as part of the license application, and provide a prospectus for potential investors.
- **Funding structure**: determine and develop an appropriate capital structure and how to access funding to finance growth as a regulated institution.
- **Ownership and governance**: address issues related to ownership and the need for a sound governance structure appropriate for a regulated shareholder institution.
- **Legal transformation**: outline options to legally transform the NGO or project into a shareholding company (or other form) and the various legal issues that need to be addressed during transformation.

### Operational implications

- **Human Resources Management**: outline how transformation fundamentally changes the human resources requirements of an MFI and how to meet these new requirements.
- **Financial Management**: manage financial issues that arise due to transformation, particularly asset and liability management and treasury management, and organize the new institution to carry out these activities.
- **Management information systems**: solve the numerous issues regarding management information systems that need to be considered with transformation and adding savings services to the institution.
- **Internal Control and Audits**: review the need to ensure adequate internal controls and audit processes as a regulated institution.
- **Customer Service and Operations**: highlight the increased need for a focus on customer service and the various changes to operations, including significant upgrades to the branch network, required with transformation.
MDBs can support the commercialization of nongovernmental MFIs by providing capital or by supporting commercialization programs.


Role of IFC in microfinance

- Leading global investor in microfinance working with more than 100 institutions in over 60 countries (committed more than $1.2 billion with an outstanding portfolio of $750 million)
- IFC Microfinance Advisory Services comprise $61 million in grantfunding representing 72 microfinance projects (of which about 50 are MFI investee clients.)

Project’s objectives

- Supporting transformation of MFIs based in Azerbaijan, Kazakhstan, Kyrgyz Republic and Tajikistan into banks or deposit-taking organizations in order to make their businesses more sustainable

Approach

- Supporting capacity building: provide technical assistance required to support the several strategic and operational decisions as well as provide training
- **Provide Access to Finance:** to achieve commercialization, nongovernmental MFIs must raise capital from savings, borrow from commercial banks, or obtain investments from private investors. IFC acts as market facilitator by enhancing these vehicles for funds
- **Promote an enabling Environment:** leverage IFC relationship with regulators to improve the regulatory framework, to encourage better governance, build consumer confidence, reduce geographic limitations and promote efficiency
Objectives of the meeting

- Recall the role of MSMEs in economic development, the main barriers to their development and the spectrum of possible interventions
- Describe concrete areas of intervention to enhance MSMEs contribution to economic development
- Discuss the relevance of the interventions described for AfDB in Africa and the Bank’s possible role
Promoting comprehensive program for supporting MSME development

Key steps required to launch a comprehensive MSME development program

1. **Assessment of the opportunity**
   - Identify “priority countries-regions” where removal of financial barriers to MSMEs development could create the highest impact

2. **Consensus building**
   - Discuss and syndicate MSMEs development related initiatives with key constituencies at country/regional level

3. **Support to the implementation**
   - Support MSMEs development programs as:
     - Funding provider
     - Competence builder

**Strategic mission**

*Foster MSME development in Africa by promoting a comprehensive program to remove the structural barriers*
Assessment of the opportunity

Focus

Identify “priority countries-regions” where removal of financial barriers to MSMEs development could create the highest impact

Key issues to address

What is the size of MSME “financing gap” in the main African economies?

What is the impact of reducing this gap on overall economic development?

What could be priority levers to activate in order to reduce the gap?

Main components of the program

- Analysis of MSMEs market structure by country/region
- Assessment of MSMEs financing gap

- Quantification of direct/indirect impact of MSMEs growth on key economic indicators (e.g.: GDP, employment etc.)
- Estimation of the effect on MSMEs growth of actions targeted to reduce MSMEs financing gap

- Identification of most important barriers preventing increase in MSMEs financing
**Consensus building**

**Focus**

*Discuss and syndicate MSMs development related initiatives with key consistencies at country/regional level*

---

**Key issues to address**

- **What are the main investments required to implement MSMEs finance development programs?**

- **Who could provide required financial support?**

---

**Main components of the program**

- Preparation of comprehensive and detailed “business cases” including:
  - One-off costs
  - Investments required
  - Sensitivity/scenario analysis

- Launch of “Investor Roadshow” among:
  - African oriented funds
  - Other investors
  - NGO/Other panels
## Support to implementation

<table>
<thead>
<tr>
<th>Type of initiative</th>
<th>Potential role for AfDB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Bureau</td>
<td>Funding: Finance Central Banks/States in their relationship with specialized suppliers</td>
</tr>
<tr>
<td></td>
<td>Technical Assistance: Support in the definition of the functioning specifications</td>
</tr>
<tr>
<td>Risk Sharing Facility</td>
<td>Funding: Contribute to Risk Sharing Facility’s Capital</td>
</tr>
<tr>
<td></td>
<td>Technical Assistance: Provide trainings support for credit risk assessment</td>
</tr>
<tr>
<td>Special Economic Zones</td>
<td>Funding: Consider participation to infrastructure finance for creation of SEZs</td>
</tr>
<tr>
<td></td>
<td>Technical Assistance: Assist participants to SEZs in preparing business plans</td>
</tr>
<tr>
<td>MFI up-scaling</td>
<td>Funding: Provide stable funding to newly established banks</td>
</tr>
<tr>
<td></td>
<td>Technical Assistance: Support establishment of full-fledged banking processes and systems</td>
</tr>
</tbody>
</table>

**Focus**

Participate to MSMEs development programs as:
- Funding provider
- Competence builder (Technical Assistance)