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SME Financing: Lessons from Microfinance

IN BRIEF

In recent years many development institutions have grown disappointed with the results of their own SME lending operations. Some have scaled them back considerably. But the financing needs of SMEs in developing countries remain acute. New, more sustainable methods based on market incentives must be found to encourage local financial intermediaries to serve small business clients. One especially promising approach, argues Germany's *Internationale Projekt Consult GmbH*, is to apply the successful lending technology of microfinance institutions that target individuals rather than groups.

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Few would deny that small and medium-sized enterprises (SMEs) are a driving force behind economic development. Practically every government whose economic policy is rooted in market principles regards promotion of the SME sector as a key objective. Nonetheless, since the end of the 1980s, there has been a significant decline in the extent to which multilateral and bilateral development institutions, including the World Bank[1] , have been willing to provide credit lines to improve the financing situation of this sector. Involvement in SME credit programs has been scaled back, not because SMEs' access to financial services has improved in any fundamental way, but rather because development institutions are dissatisfied with the results and the impact of traditional credit lines that were channeled to SMEs via commercial and development banks.[2]

While SME financing has been on the decline, there has been very rapid growth in the area of microfinance. Through high-profile events such as the 1997 Microcredit Summit, the public perception is that microfinance programs are the success story of development finance. Although this is far from the whole truth, as critical analysis has revealed[3] , it is nonetheless legitimate to say that some successful microfinance institutions have emerged over the last decade. They are few in number, admittedly, but their achievements have been all the more spectacular for that. Examples include ADEMI in the Dominican Republic, BancoSol and Caja Los Andes in Bolivia, Financiera Calpia in El Salvador, and BRI in Indonesia, all of whose credit

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1. See Webster, Riopelle, and Chidzero (1996)
2. See Von Pischke (1991)
3. See Schmidt/Zeitinger (1996)

technology deserves to be regarded as best practice and is characterized by the following elements:

• Loan analysis focuses on the prospective client's ability to pay (cash flow). Less emphasis is placed on collateral. The analysis is highly standardized, and loan processing times are minimal.

• Repeat borrowers are entitled to increasingly larger loans.

• Loan officers bear full responsibility throughout the entire life of the loan and are paid performance-based salaries. If payment problems occur, there is a powerful incentive structure in place for immediate follow-up.

• Appropriate decision-making and control mechanisms are in place and supported by a strong management information system (MIS) and information technology (IT) to assist in the management and administration of the loan portfolio.

Thus, there is broad agreement on the essential features of a successful, i.e. sustainable, credit technology. Programs that use such lending methodologies essentially have succeeded in solving a fundamental challenge of microfinance: the enforcement of credible contracts. This raises the question of whether the best-practice approach to microfinance holds any lessons for SME lending that would enable a fresh start to be made in this branch of development finance, avoiding the mistakes and pitfalls of the 1970s and 1980s. We approach this question from the vantage point of practitioners who – as our history of project implementation testify – initially focused on micro lending, but have also been implementing, for a number of years now, small and medium-scale lending projects[4].

Our answer is an unequivocal yes, because whether one is dealing with micro, small or medium-sized loans, the informational problems facing lenders are identical. This fact is often overlooked because the differences which undoubtedly exist between microenterprises and SMEs tend to be exaggerated to the point where conclusions drawn from the experience of successful micro lending appear to be irrelevant to small and medium-scale enterprise finance. The case frequently put forward for separating these two areas is analyzed in section two, while section three presents counter-arguments to show why this position is wrong. On this basis, section four draws lessons for SME financing from the experience of micro lending.

Arguments for drawing a distinction between micro and SME financing

The main arguments for differential treatment of micro and SME finance rests on differences in the socio-economic characteristics and the nature of demand for finance of the two groups, as well as on differences in the respective lending technologies used and the types of financial institution which implement them.

Characteristics of the target group. The differences between micro enterprises and SMEs go beyond mere size. Microenterprises frequently operate on an informal basis, or with the legal status of a sole proprietorship. As a result, there tends to be a lack of separation between the finances of the enterprise and those of the microentrepreneur's private household, and indeed such a separation would be inappropriate. The vast majority of microenterprises employ fewer than five persons, even though official definitions may set the upper limit at 20 or even 30, as is often the case in the Central and Eastern European transition economies. Another distinguishing feature of microenterprises is that they tend to be concentrated largely in the trade sector, and usually operate in the domestic market only; their demand for credit is therefore primarily driven by a need for working capital. In contrast, SMEs usually operate in the formal sectors of the economy, tend to be fully independent legal entities and keep separate business accounts. They are more production- and growth-oriented, and their activities may extend beyond the borders of the domestic market. Consequently, they need not only working capital but also investment loans. SMEs are usually defined as companies with up to 250 employees.

Perhaps because of the well-known example of Grameen Bank, micro lending is often equated with group lending. The economic rationale behind this approach is based on the assumption that, given the small loan amounts involved, only a group-based credit technology would enable the lending institution to keep its administrative costs sufficiently low — for example, by externalizing monitoring costs to the group of borrowers. Group lending is feasible at the

4. Most of IPC's experience stems from (mostly urban-based) "high end" microfinance programs in Latin America and the NIS countries. Some of the common denominators of these programs are: individual lending methodology, a proportion (in the case of the NIS significant) of clients are registered as legal entities, a significant proportion of loans finance activities other than trade (i.e. service and production). Nevertheless, median loan sizes of $500 in Latin America and between $1,000-2,000 in Eastern Europe indicate that microentrepreneurs are the main target group of these programs.

micro level because MEs are often engaged in "survival" activities and therefore their credit demand — both in terms of the purpose for which the funds are needed and the size or maturity of the loans – is perceived to be quite homogenous and unlikely to change significantly over time. Accordingly, it can be assumed that credit groups will be relatively stable, and therefore that the saving of transaction costs is permanent. These cost savings seem to justify the use of this approach despite its negative effects from the point of view of the MEs themselves, who would prefer individual loans tailored to their specific needs.

By contrast, group lending is neither necessary nor practicable where SMEs are concerned. It is unnecessary because, by definition, the loan amounts involved are higher, and hence the unit costs are lower; and it is impracticable because of the heterogeneity of SME borrowers, which means that any attempt to group them together would be extremely difficult and expensive. SME lending must therefore be based on a traditional individual lending technology.

Lending institutions. Based on the different characteristics of the target groups and the respective credit technologies used to serve them, comparative advantages have been attributed to two different types of institutions as providers of finance: microenterprise lending is believed to be the preserve of NGOs, whereas SME lending is regarded as "proper" banking business. This reasoning coincides with the widely held belief among development policymakers and economists that microfinance is an aspect of social policy oriented towards poverty alleviation and should be subsumed under broader social programs of the kind that are usually implemented by NGOs.[5] By contrast, SME lending is business in the proper sense of the term and associated with the promotion of economic development and growth, a goal which financial institutions, and banks in particular, can play a decisive role in helping to achieve.[6]

Clearly, the idea of applying the lessons of micro lending to the design and implementation of SME lending programs will inevitably appear impracticable if seen from within this framework. Yet, as the following section shows, these arguments are based on assumptions that have been shown, in practice, to be invalid. From our standpoint, the case for a micro-based approach to SME financing rests on a different assessment of three factors: target group characteristics, lending technology, and lending institutions.

The case for a micro-based approach to SME financing

Our reassessment of the differences between micro lending and SME lending is rooted above all in the observation that the differences between microenterprises and SMEs by no means imply that a group credit technology invariably has to be used with microenterprises. Ahighly standardized credit product, a strong MIS, and productivity gains made by loan officers, are at least as effective over the medium to long term, in reducing transaction costs as the group credit technology.[7] Furthermore, bearing in mind that in many countries—particularly in Central and Eastern Europe and the former Soviet Union—microenterprises are much more heterogeneous than the blanket term "survivalists" would suggest, the use of an individual lending technology is not only possible but indeed is frequently advantageous, because it is more cost-effective.

Moreover, the dividing line between the two groups is by no means clear-cut. There are a large number of businesses which take the form of sole proprietorships, employing at most only a small number of staff who are often members of the owner's family. In this respect, what one would consider SMEs are often typical microenterprises. Yet on the other hand, they prepare sophisticated (though unpublished) accounts, are active beyond the borders of the domestic market, and require not only working capital but also (longer term) investment loans. These characteristics set them apart from microenterprises and put them closer to the SME category. In addition, a significant number of firms, not least as a result of having access to financial services geared to their needs, are able to grow out of the micro stage and graduate to the SME category. Under these circumstances, it is often impossible to organize stable borrower groups.

Furthermore, the differences between the microenterprises and SME target groups do not alter the fact that the underlying problems associated with lending to both groups are essentially identical. One indication of this is that in many countries there is an observable tendency for the formal financial sector to practice credit rationing toward both target groups. The underlying problems in both cases are the lack of reliable information, the lack of traditional collateral, and the difficulty of enforcing contracts. Accordingly, the core elements of a successful micro lending program can be

5. While this popular belief is refuted by the experience of profitable formal microlenders (such as Bancosol and BRI-UD), it should be noted that these examples are few in number and that the majority of formal sector microfinance institutions are themselves NGO transformations.
6. See Levine (1996)
7. See Gonzales-Vega, et al. (1997), Schmidt/Zeitinger (1994, 1998)

UKRAINE: GERMAN-UKRAINIAN FUND

The financial system in Ukraine is comprised essentially of the former state-owned banks, which still dominate the banking sector, and a small number of private sector intermediaries founded since the start of the transition process in 1992. Until recently, it was fair to say that none of the banks were really interested in catering to the financing demand of the micro and small enterprise sector.

The banks' loan portfolios consisted of a few large loans which were often non-performing. Lending was constrained in particular by bureaucratic requirements stemming from the days of central planning and by continual changes in relevant legislation which created great uncertainty as to precisely what the law was in a given case. Thus, it is not surprising that the few privately owned banks that were established in Ukraine did not automatically begin providing financial services to the micro and small enterprise sector.

In 1997, using resources from the German government's TRANSFORM program, Kreditanstalt für Wiederaufbau (KfW) provided $5.5 million for the establishment of a revolving credit fund, the German-Ukrainian Fund (Deutsch-Ukrainischer Fonds, or DUF). It works with five partner banks offering micro and small loans at their branches—Agiobank, Avalbank, VA Bank, Privat Bank and Kiev Privat Bank. The program currently operates in a total of 12 regions of Ukraine.

In designing the program, care was taken to incorporate incentives for the commercial banks, regarding in particular the assumption of credit risk and borrowing costs. The interest margin for the banks is, on the one hand, high enough to make it seem worthwhile for them to assume the full credit risk, and to allow returns that will motivate them to supply the new product on a lasting basis. On the other hand, the rate of interest charged to the banks is sufficiently low to keep the interest rates paid by sub-borrowers at a level which will attract customers from both the service and production sectors and also avoid adverse selection, which can easily occur if interest charges are too high. Due to the strong demand within these sectors for loans to finance investment in fixed assets, the banks cater primarily to the upper segment of the micro and small enterprise market, with the average loan amount working out to around $16,000. The fact that lending focuses on this segment underscores the DUF's commitment to supporting the creation of a new stratum of medium-sized businesses—and of a middle class—in Ukraine.

The micro and small loans were so well received that the funds provided by KfW were completely disbursed in a single year, with all loan repayments being "recycled" in the form of new lending. Needless to say, the Russian financial crisis, which came to a head in August 1998, has impacted Ukraine. But the most recent figures for the DUF show that both the number and volume of disbursements have reached record levels, and that the arrears rate is in line with international standards.

As with most downscaling projects, the key to successful acceptance of the innovative financing services in Ukraine was intensive advisory assistance. Because the technical assistance package provided for support to be made available over a sufficiently long period, several generations of local loan officers have been trained and the new product has been accepted by the partner banks and fully integrated into their operations.

However, downscaling is not the only meaningful approach for microcredit projects in Eastern Europe. The creation of new target group-oriented banks is also a possibility. And indeed, given the problems encountered in the Eastern European environment—crisis-prone financial sectors, large numbers of unstable financial institutions, and the difficulties involved in convincing bankers that micro and small enterprise lending can be a profitable complement to their other lines of business—starting a new bank is an attractive option.

This is certainly the case in Ukraine, where the DUF, IFC, the EBRD, and other investors have joined forces to build a new financial institution, the Microfinance Bank of Ukraine, which will be established in the near future. The owners have emphasized that they intend to create a financial institution that offers banking services tailored specifically to the demand of private micro and small enterprises, which should enable the Microfinance Bank to avoid many of the problems inherent in the downscaling projects mentioned in the main text. Since the demand for credit in the micro and small enterprise sector far exceeds the amount currently being supplied to this market, the credit operations of the Microfinance Bank should be very successful. And this should, in turn, demonstrate to the other commercial banks in Ukraine that lending to the target group can in fact be a profitable business.

applied to SME lending operations. This is not to say that these elements should be transferred uncritically, without any adjustments or modifications. For example, in the case of micro lending, information asymmetry can be overcome by conducting a form of credit analysis which takes into account the borrowers' entire socio-economic circumstances, including their private households. The same purpose is accomplished in the case of SMEs by conducting a thorough analysis of the firm's ownership structure. Yet this is a difference of practical detail, rather than of principle. Another important modification that needs to be made when adapting micro lending technology to an SME program is that, whereas in the case of microenterprises only the actual cash flow generated by current business operations is taken into consideration when deciding whether or not to approve a loan application, in the case of SMEs it may be appropriate to include the estimated cash flow that is likely to be generated by the planned investment for which the loan is being sought. However, this distinction is relatively minor by comparison with the much more significant difference that exists between cash flow-based lending on the one hand and collateral-based lending on the other.[8]

Largely irrespective of the credit technology used, it has become the generally accepted view that micro credit-granting NGOs which are not rooted in the formal financial sector do not constitute an appropriate institutional base for a sustainable – i.e. cost-covering and profitable – micro-lending operation. Only formalized, profit-oriented financial institutions are capable of supplying the target group with appropriate financial services on an enduring basis. This goal can be achieved by pursuing either a "bottom up" approach (upgrading an NGO into a formal financial institution) or a "top down" approach (cooperating with existing commercial banks to downscale their operations).

In the context of an upgrading process, an NGO may serve as the starting point for a micro-credit project; however, transforming the NGO into a formal financial institution with committed owners is the key to ensuring that the target group has lasting access to an appropriate supply of financial services. A formal financial institution can accompany the growth of its micro customers, thereby automatically progressing into small and possibly even medium-scale lending, without necessarily losing its original focus. Another argument for formalization is that only a fully formalized financial institution is capable of supplying the target group with other financial products, in addition to credit, which they need in order to develop their business. These include not only savings facilities but also other services which are directly related to credit, such as business accounts. The few specialized formal financial institutions already in existence are finding that the combined target groups (both microenterprises and SMEs) are making very active use of these facilities.

The experience of projects based on a downscaling approach show that it is possible after all – thanks largely to an intensive and well-designed technical assistance input – to build micro and small credit departments within commercial banks and to establish lending to microenterprises and SMEs, as a permanent feature of the business strategy of a commercial bank.[9] Thus, the ostensible institutional antagonism between micro credit on the one side and small and medium-scale financing on the other ceases to exist: commercial banks and other formal target group-oriented financial institutions are the only suitable vehicles for sustainable micro, small and medium-scale lending.

Implications for SME projects and credit lines

The lessons learned from our experience can be summarized as follows:

- Lending to both microenterprises and SMEs basically poses the same problem, namely that of organizing a sustainable credit business under information asymmetries that cannot be adequately offset using conventional lending instruments, in particular collateral.

- Recognition of this fundamental similarity leads to the application of the same credit technology under the roof of the same type of institution, i.e. a formal financial institution.

- The conclusion to be drawn from this experience is that micro and SME projects should be conceived and designed along basically the same lines.

- In practice, this has not generally been the case. The design of traditional SME credit projects has been guided by the false assumption that the conditions for SME lending in developing countries and transition

8. In practice, we have found that the vast majority of loan officers who were initially trained for micro-lending activities have the potential to become lenders to SMEs also. While additional skills are required in order to deal with the collection and analysis of more formal and complex business data, there is no fundamental difference in terms of the overall information asymmetries. The informational value of official business data (which SMEs are generally able to provide) is usually dubious, except for the fact that they are intended to reduce tax obligations and minimize outside interference. In essence, the credit analyst has to reduce these informational asymmetries for SMEs in the same way as he/she would in the case of microenterprises.

9. See Schor (1997)

RUSSIAN FEDERATION: RUSSIA SMALL BUSINESS FUND

In order to assist Russia's transition to a market economy the European Bank for Reconstruction and Development (EBRD) has targeted one of its largest lending programs in the Russian Federation to the small enterprise sector which plays a prominent role in providing new employment in an economy plagued by recession.

The Russia Small Business Fund (RSBF) is a $300 million program which has been jointly funded by the EBRD and the G-7 countries. Since 1994 it has provided onlending funds to a number of commercial banks in Russia. The credit lines are tied to a technical assistance package which the EBRD makes available to those banks which take a genuine interest in developing a new market in the area of small business lending. RSBF advisors help the participating banks to develop an appropriate lending technology for a group of clients with whom they previously had not worked with, and whom they presumed to pose extremely high default risks.

After starting in three pilot regions, the program expanded to a total of 28 participating regions and cities by mid-1998. The range of partner banks includes small regional banks as well as Sberbank, the state-owned savings bank with the largest branch network in the country. The EBRD provided the credit lines directly to the participating banks which in turn had to assume 100% of the risk of the subloans. The RSBF consists of two components: In the Micro Loans Program, credits ranging from $100 to $20,000 are disbursed to companies with a maximum of 20 employees. The Small Loans Program targets larger companies with up to 75 employees. Its loan sizes range from $ 20,000 to $125,000, with the proceeds only eligible for use in financing service and production activities.

One of the core activities of the technical support team is the selection and training of loan officers who, over the course of several years, become experts at small business lending. The vast majority of these new loan officers have been retained by the partner banks, and indeed, many have moved on to take over management positions in their institutions. The program is utilizing best practice micro credit technology as it is commonly employed in other countries, and has adapted the micro credit analysis to fulfill the requirements of larger investments as they are routinely carried out by the Small Loans clients.

In terms of outreach, the RSBF has been quite successful. Since the beginning of operations, 29,500 credits had been disbursed for a total sum of $366 million. The average outstanding micro credit amounted to $4,085, while the outstanding small loans averaged $ 40,207.

Repayment performance has also been exemplary: The program's arrears rates have consistently been below 3%, and since the beginning of the RSBF the losses incurred by the partner banks did not exceed 0.5%.

Russia's financial crisis had a number of severe effects on the RSBF: Some of the participating banks became insolvent and had to be dropped from the program. Arrears, especially in the predominately dollar-denominated small loans program, rose significantly but were subsequently reduced to pre-crisis levels. By the end of 1999, the RSBF's monthly output had achieved pre-crisis levels.

economies are similar to those in developed countries, whereas in fact they much more closely resemble the conditions that govern micro lending. Consequently, traditional SME lending projects have incorporated elements of design and implementation which, although not inherently wrong, were nonetheless inappropriate because they failed to address the core problem issues of information, security, and contract enforcement and therefore failed to produce the desired results.

For example, SME credit projects are frequently designed on the misconception that lack of funds, or at least, lack of affordable funds, is the only reason that commercial banks do not practice SME financing on their own initiative. Another typical mistake is to incorporate into the project a training component which seeks to impart state-of-the-art western credit know-how, without first examining whether there is a chance of this method and style being appropriate in the specific lending context. Project designers also frequently overlook the fact that owners and managers of partner institutions are not at all interested in an institutional transformation which involves changing the target group orientation, the credit technology, and the way the bank organizes its lending operations.

To exaggerate for the sake of emphasis, the outcome of the project looks more often than not like this: A few long-term loans are issued by the bank's top executives, taking advantage of the cheap and long-term funds provided. Meanwhile, three or four local loan officers, having received training from a senior bank specialist, find that they are unable to apply their newly acquired skills because the market is different than in Western countries and/or because of their marginal position within the bank's power hierarchy or its organizational structure and processes. If this predicament is compounded by some of the other characteristic flaws of traditional credit lines – a narrowly defined group of eligible enterprises, subsidized interest rates and a highly complicated decision-making and reporting structure imposed by the donor organization (e.g. final decisions on loans to be disbursed to borrowers in Chisinau are taken in Washington, London or Frankfurt) – the failure of the SME program is virtually inevitable.

Therefore, SME credit projects, just as much as micro credit projects, require a comprehensive institution-building approach comprising the following elements:

• Building up/strengthening human capital (especially lending operations and management)

• Building up/strengthening organizational structure

• Building up/strengthening credit procedures

• Establishing/strengthening target group orientation as a permanent feature of the institution's mission and its governance structure

• Establishing/strengthening the financial and political independence of the lending institution

The choice of project partner(s) in itself is a key factor and can potentially spell the difference between the success or failure of a program. Great care therefore should be exercised when selecting partner institutions. The selections should be based on the following two criteria: (i) *financial stability*, to ensure that the investments associated with institution building, which may be very substantial, are not put at excessive risk by the possibility that the partner institution will soon have to close down as a result of its past lending, or the activities of its other departments; and (ii) *target group orientation*, or at least a credible manifestation of willingness to serve the target group in the future. Target group orientation means more than paying lip-service to the idea of wanting to cater to microenterprises and SMEs; rather, it implies a willingness on the part of owners and managers to accept the strategic and organizational ramifications of the institution-building process and to impose the appropriate changes on their institutions. Unfortunately, experience

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PARAGUAY: MICRO GLOBAL PROGRAM

At the beginning of the 1990s, a large number of financial institutions were operating in Paraguay. Spurred by increasing competition, banks which were already making consumer loans saw a move into the microenterprise market as a welcome opportunity to expand their operations.

The Inter-American Development Bank (IDB) supported Paraguay in its efforts to foster the development of the microenterprise credit market by providing a $20 million loan to the central bank in 1992. This funding was accompanied by a technical assistance package which was delivered in the framework of a "Micro Global" and implemented by IPC.

Afirm foundation for the successful execution of the program was laid on three different levels. The first task was to choose the initial group of retail institutions based on the criteria of financial stability and target-group orientation. The importance of conducting a thorough assessment of financial stability was underscored by subsequent events: Paraguay has experienced serious banking crises in recent years, but none of the financial institutions that were originally selected to take part in the program have been affected by these crises, and today three of them—Visión de Finanzas, Financiera Familiar and Financiera Grupo Interfisa—are particularly active in the microcredit market.

The second step was to create a funding mechanism: A program management unit was set up at the central bank to channel funds to the participating banks and to monitor their application. A largely automatic rediscount mechanism ensures that onlending resources are disbursed rapidly and efficiently to the retail institutions.

The most important element of the project is, however, the third: technical assistance furnished to the partner institutions. An initial attempt to introduce the new product by simply adding it to the banks' existing credit facilities proved unsuccessful. It failed because microcredit was not really accepted by bank staff as a part of their institutions' regular business. Intensive assistance and supervision, continuous training, and the provision of support at all levels were needed to firmly establish the new organisational structures and internal incentive systems required to make micro and small loans a truly integral part of the partner banks' product lines. Thus, the example of the IDB's microcredit program in Paraguay shows that the principal challenge in this type of financial sector development measure is to transfer know-how at all levels of the partner institutions. This is the only way to make the risks of introducing an innovative product like microcredit manageable. In interventions of this type, advisers must be able to exert a certain amount of influence so that the requisite institutional modifications can be made.

Looking back, the Micro Global Program has more than met expectations. Sustainable microenterprise credit facilities have been established. At the end of 1999, the combined portfolio of all outstanding loans issued under the program stood at about $23.9 million, representing around 30,000 loans. Microlending has proved to be profitable, and as a result, some partner banks have begun to use their own funds to make loans to microenterprises outside of the IDB funding line.

has shown that the more stable and successful a partner bank's other business operations are, the harder it becomes to convince its senior officers of the need for change. Therefore, a trade-off between stability and target group orientation is often inevitable. To diversify risk, it makes sense to cooperate with several banks simultaneously – three is usually a good number. The cost of such an approach may be higher, but the investment pays off in the end. For one thing, it is only a temporary measure. For another, it is, in our opinion, the only way to ensure that an SME credit line is successfully implemented – unless one is lucky enough to find a partner institution which already comes very close to embodying the ideal vehicle for an institution-building program. That such banks do exist is shown by Webster/Riopelle/Chidzero (1996), whose analysis revealed that the successful SME credit lines were the ones that were implemented by precisely that kind of institution. Turning this conclusion on its head, it shows that success depends on working with the right kind of institution. And that if no such institutions exist, they must be created. ■