

Annex III. Access to Finance for Small and Medium-Sized Enterprises in the MENAP and CCA Regions

The growth of small and medium-sized enterprises (SMEs) is critical to raising and diversifying economic growth and generating employment in the MENAP and CCA regions. However, deficiencies in the legal and financial infrastructure, poor SME financial reporting standards, and banks' lending capacity constraints hamper SMEs' access to finance. Further steps are therefore needed to strengthen legal and financial infrastructure, particularly credit and collateral registries, commercial courts, and bankruptcy regimes. Banks can enhance their capacity to lend by developing customized products tailored to SMEs, as well as by addressing weaknesses in their balance sheets and improving their risk management systems. Islamic finance holds promise for improving SME access to finance in the region, contingent on improvements in legal and financial infrastructure, and on development of appropriate SME products. Improving data on SMEs and funding gaps is critical for designing effective SME policies.

SMEs, Inclusive Growth, and Access to Finance

SMEs have been the engines of economic growth and employment for developed economies; they could also play an important role in generating inclusive growth in MENAP and the CCA, thereby reducing current income inequalities. In most of the member countries of the Organisation for Economic Co-operation and Development, SMEs account for more than 95 percent of enterprises and up to 70 percent of employment (<http://www.oecd.org/statistics/>). By contrast, while SMEs account for between 80 percent and 95 percent of formal sector enterprises in MENAP and the CCA, they only contribute about 30 percent of GDP and 20–50 percent of private sector employment. The contribution of SMEs to total employment is even lower in the MENAP oil-exporting countries because of the large share of public sector employees.

Limited access to finance for SMEs is one of the main obstacles to their growth in the MENAP and CCA regions. More than 50 percent of firms in the MENAP region do not have access to credit, and a third of firms identify lack of access as a major constraint. Although bank lending is the main source of financing for firms of all sizes,

SMEs account for less than 8 percent of total lending, 13 percent for non-GCC countries, and about 2 percent for the GCC. A similar pattern is observable in the CCA, although the magnitudes vary (Figure A3.1).

Factors Constraining SME Access to Finance

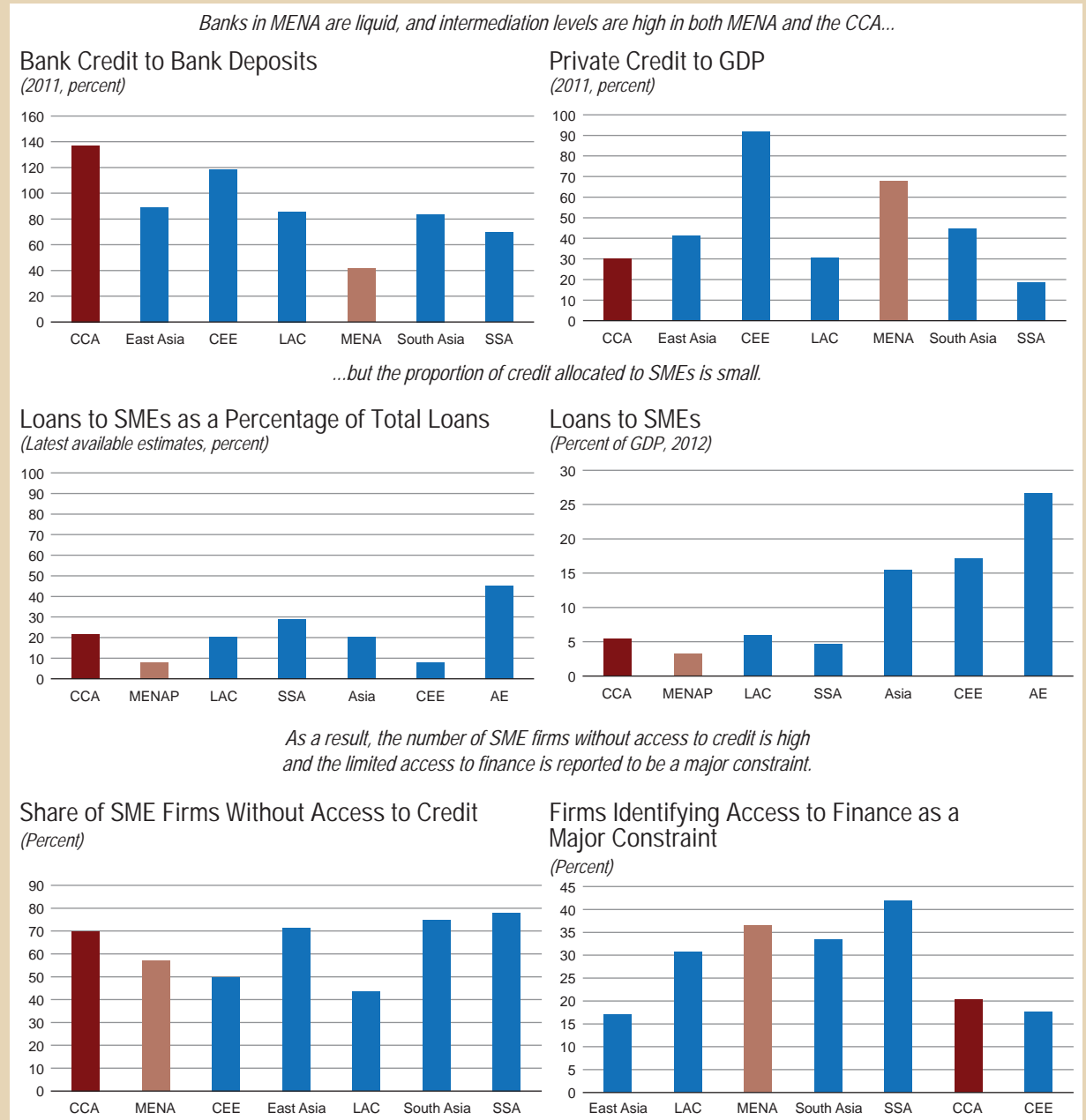
SMEs' limited access to finance reflects the interaction of demand, supply, institutional, regulatory, and other policy factors. The factors are also generic to both regions, except for the government crowding out, which is specific to some MENAP countries. More specifically:

- Apart from obstacles arising from unfavorable investment climates, SMEs face several nonfinancial barriers related to their own capacities, including lack of financial accounts and unavailability of reliable credit histories.
- Banks are reluctant to lend, or they may charge a higher risk premium or demand high collateral requirements from SMEs because of the perceived higher credit risk associated with information asymmetries and lack of collateral to cover this risk. Higher transaction costs discourage banks from lending to SMEs, but banks' lending capacity is also constrained by their lack of customized products and risk management capabilities.

Prepared by Inutu Lukonga (team lead), Sami Ben Naceur, Gregory Hadjian, and Abdullah Al-Hassan.

Figure A3.1

Access to Finance: An Overview



Sources: Asian Development Bank (2013); European Investment Bank (2013); International Finance Corporation, IFC Enterprise Finance Gap database; IMF, Financial Access Survey; Organisation for Economic Co-operation and Development (2013a); World Bank (2010).

Note: AE = advanced economies; CEE = Central and Eastern Europe; LAC = Latin America and the Caribbean; SSA = sub-Saharan Africa.

- Financing alternatives outside the banking sector are limited. Nonbank financial institutions, such as microfinance institutions, leasing companies, and private equity or venture capital firms, which could also provide capital, are underdeveloped

in both regions. Capital markets are developed in selected countries, but in most cases they do not include listings by SMEs which, in some cases, are precluded by stringent listing costs and disclosure requirements.

- Nonperforming loans (NPLs) are high in many countries' banking systems and have the potential to discourage lending in general, particularly to SMEs. Specialized financial institutions that were established to extend credit to SMEs have had only a limited impact, in large part because of governance problems, with many burdened with high NPLs.
- Although banking systems are large, loan concentrations are high, reflecting the focus of banks on large borrowers. A lack of competition in some countries (for example, Algeria) has also contributed to low lending to SMEs, with large public banks specializing largely in lending to large state-owned enterprises and private banks focusing on the most profitable segments of large private businesses and trade finance.
- In addition, large government financing needs crowd out the private sector in a number of MENA countries, particularly the Arab Countries in Transition.

Impact of Global Regulatory Initiatives

Financing of SMEs could face some headwinds from global regulatory initiatives, in the form of reduced availability of funding and increased cost of borrowing. Basel III requires banks to have tighter risk management, higher and better quality equity capital, and improved liquidity, including better matching of funding exposures. The increase in the leverage ratio, owing to the raising of the credit conversion factor for trade finance from 20 percent to 100 percent in Basel III can increase capital and drive up the cost of conducting trade finance. The likelihood that SMEs in MENAP and the CCA will bear the brunt of the adjustment in lending is high: SMEs carry higher risks, and, particularly in these regions, are concentrated in trade and construction. Moreover, the costs of due diligence needed to comply with anti-money laundering/combating the financing of terrorism regulations and the United States' Foreign Account Tax Compliance Act is also leading some international banks to

withdraw correspondent relations with banks in the MENAP region and to curtail lending to SMEs in the region.

Recent Reforms

Promoting access to finance for SMEs has been on the global reform agenda since the global financial crisis, and on the national agendas of most MENAP and CCA countries. However, the reforms have had only a moderate impact on improving access to finance, in large part because they have been partial, incomplete, or ineffective. Table A3.1 indicates areas where countries have implemented reforms, and Figure A3.2 compares the progress made by the two regions.

- In the MENAP region, the focus has largely been on strengthening credit information systems that enable lenders to assess borrower creditworthiness and providing subsidized credit and other financial support. Less progress has been made with reforms related to property transfer registration that facilitates collateral-based lending; protecting minority shareholders, which is needed to improve the ability of companies to raise capital; or strengthening the insolvency regime and the efficiency of the judiciary system to help enforce contracts and protect lenders in insolvency. World Bank reports indicate that none of the countries in the region have laws that comply with modern international best practices, and in most countries bankruptcy is criminalized. In addition, while many countries have established credit registries, the coverage of the credit registries is limited in MENAP countries.¹ Subsidized credit,

¹ Figure A3.2 shows the number of economies that have moved up on the legal rights and credit information indexes. The legal rights index measures the protection of the rights of borrowers and lenders through collateral laws and the protection of secured creditors' rights through bankruptcy laws. The credit information index indicates the scope and accessibility of credit information distributed by public credit registries and private credit bureaus.

Table A3.1. Reforms and Institutional Arrangements to Enhance SME Access to Finance

	Legal and Credit Information Infrastructure					Other	
	Registering Property	Credit information	Protecting Investors	Enforcing Contracts	Resolving Insolvency	Credit Guarantee	Financial Support Programs
MENA COUNTRIES							
GCC							
Bahrain	✓	✓					✓
Kuwait		✓			✓		✓
Oman		✓				✓	✓
Qatar		✓		✓			✓
Saudi Arabia	✓	✓	✓		✓	✓	✓
United Arab Emirates	✓	✓	✓				✓
ACT							
Egypt, Arab Republic of		✓		✓			✓
Jordan		✓		✓		✓	✓
Morocco	✓	✓	✓			✓	✓
Tunisia	✓	✓	✓			✓	✓
Yemen, Republic of		✓					
Other MENA Countries							
Algeria		✓		✓			✓
Djibouti	✓				✓		
Iran, Islamic Republic of	✓		✓	✓			
Iraq							✓
Lebanon		✓				✓	✓
Syrian Arab Republic		✓					
West Bank and Gaza	✓	✓		✓		✓	✓
CCA Countries							
Armenia		✓	✓	✓	✓		✓
Azerbaijan	✓	✓	✓	✓			
Georgia	✓	✓	✓	✓	✓		
Kazakhstan	✓	✓	✓	✓	✓	✓	✓
Kyrgyz Republic	✓		✓	✓	✓	✓	✓
Tajikistan	✓	✓	✓		✓		
Turkmenistan	n.a.	n.a.	n.a.	n.a.	n.a.		
Uzbekistan	✓	✓		✓	✓		✓

Sources: World Bank, 2014 Doing Business Survey; and country authorities.
Note: n.a. = data not available; SME = small and medium-sized enterprise.

provided through specialized financial institutions, has met with limited success because of weak corporate governance that has resulted in high NPLs. Credit guarantee schemes (CGSs) are reported to have been ineffective.

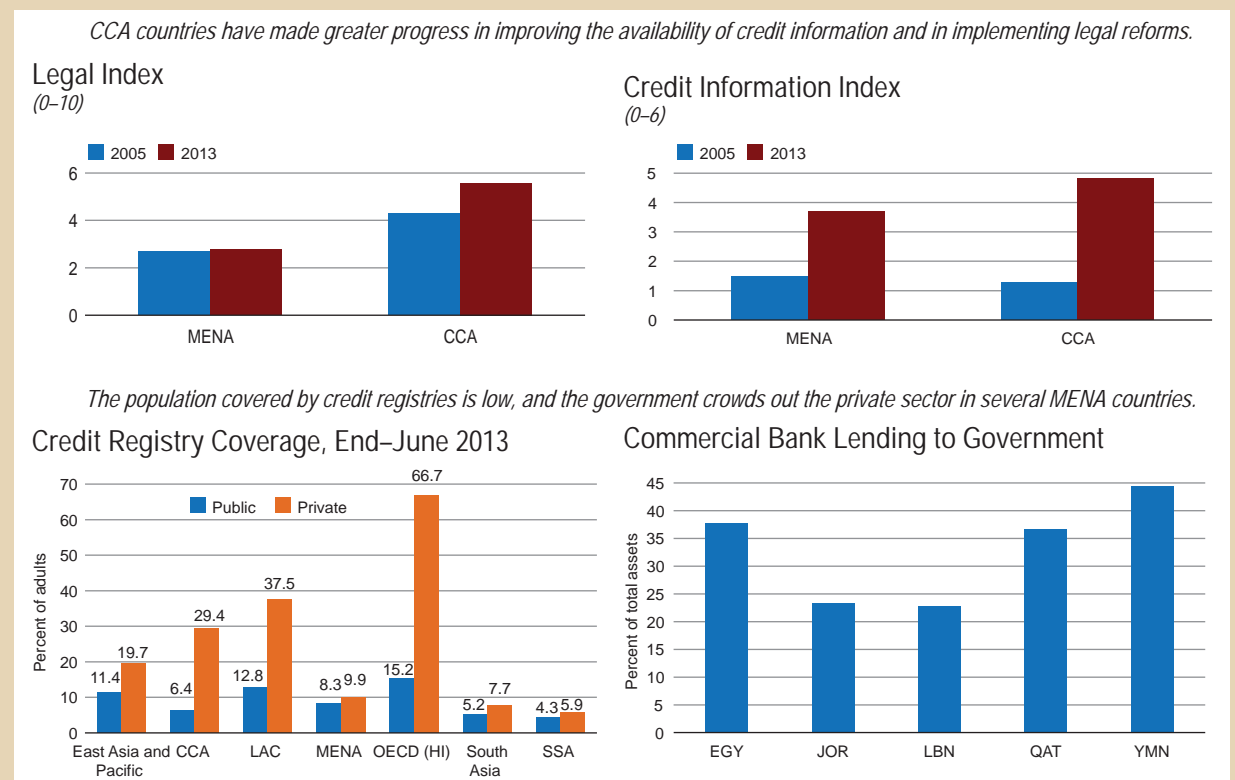
- The CCA countries, by contrast, have implemented reforms that more comprehensively cover property registration, credit information, protection of investors, enforcing contracts, and insolvency regimes. The coverage of credit registries is also much higher. CGS and financial support programs have been implemented in a few countries. Leasing has expanded more rapidly, driven

by foreign European banks and regulatory arbitrage in some cases.

For both regions, the lack of quantitative, up-to-date, and consistently monitored data for the size of the SME segment and the magnitude of SME funding gaps remains an obstacle to a better understanding of the SME sector in the region and to development of appropriate policies. Although enterprise surveys have somewhat improved the availability of data on formal SMEs, important gaps remain in the data needed to evaluate the needs of the sector, to assess progress and thereby provide a basis for a better-informed public discussion, and to help with evaluating the effectiveness of government policies and programs.

Figure A3.2

Indices for Legal Rights and Credit Information



Sources: World Bank Doing Business, 2006 and 2014; and country authorities.
 Note: LAC = Latin America and the Caribbean; OECD (HI) = Organisation for Economic Co-operation and Development high-income countries; SSA = sub-Saharan Africa.

Islamic Finance

The Islamic finance industry has attracted the attention of policymakers as a way to expand financial inclusion and tap into excess savings to finance investment. According to the International Finance Corporation (2014), there is a huge demand for Islamic products among SMEs in the MENAP region, where approximately 35 percent of such businesses are excluded from the formal banking sector because of a lack of Shariah-compliant products.² The funding shortage is most acute in countries such as Morocco, Pakistan, and

² The International Finance Corporation undertook a survey of nine countries including Egypt, Iraq, Jordan, Lebanon, Morocco, Pakistan, Saudi Arabia, Tunisia, and Yemen.

Saudi Arabia,³ where local SMEs are reluctant to consider conventional banking alternatives. In addition, a number of Islamic financial products are suitable for expanding credit to SMEs, especially participatory schemes such as *mudarabah* (profit sharing) and *musarakah* (joint venture), which allow Islamic banks to lend on a longer-term basis to projects with higher risk-return profiles, and leasing, which circumvents the problem of collateral.

³ In Saudi Arabia, for example, up to 90 percent of SMEs are reported to be specifically looking for Shariah-compliant banking services, and some Islamic banks in Saudi Arabia are reported to have registered phenomenal growth in their SME loan books. SMEs in Morocco and Jordan also have a strong preference for Islamic banking (54 percent and 45 percent, respectively). In other countries, the ratio ranged between 20 percent and 35 percent.

However, Islamic banks have not capitalized on this latent demand: their assets predominantly consist of debt-like products such as *murabaha*. The potential to significantly narrow the SME funding gap is limited by a number of factors. First, as with conventional banks, credit risk concerns limit the Islamic banks' exposure to SMEs against the backdrop of weak financial infrastructure relating to credit information systems and insolvency regime. In addition, to tap the underlying potential, Islamic banks need to build capacity and develop Shariah-compliant products to cater to SMEs. Second, unlike risk management in conventional banks, risk management in Islamic banks remains comparatively weak, and the regulatory environment in many countries is not yet tailored to Islamic finance. There is also a shortage of expertise in Shariah rules and courts that are conversant with Shariah jurisprudence to adjudicate in commercial cases.

Empirical studies that have assessed the impact of Islamic finance on access also show positive, but limited, evidence of an impact of Islamic banking on financial access. AbuShanab and others (forthcoming) examined the degree to which a greater presence and/or activity of Islamic banks affected financial access and depth. The econometric analysis found a weak correlation between Islamic banking assets and access to finance. These results are consistent with the findings of a 2013 World Bank study (Demirgüç-Kunt, Klapper, and Randall 2013) on financial inclusion, which suggests that increasing the number of Shariah-compliant financial institutions can make a positive difference to the operations of small firms in Muslim-populated countries by reducing barriers to formal services.

Policy Recommendations

The factors constraining access have been well identified, and the challenge for countries has been to create an enabling environment. A comprehensive strategy is needed:

- *Reforms to improve legal and financial infrastructure need to be expedited.* Recent reforms have been uneven and partial, failing to address the

lingering deficiencies in the legal and financial infrastructure, particularly the need to improve coverage of credit registries, ensure effective operation of commercial courts, and enact and enforce insolvency regimes. Addressing infrastructure constraints is also critical for increasing the penetration of Islamic financial products.

- *Financial institutions need to develop customized products for SMEs.* Banks' business models need to be better tailored to SME lending and risk management. Public-private partnerships, including partnerships with international financial institutions, can help in this regard, through training and technical support. Islamic finance can help improve SME access to finance in countries where segments of the consumer market do not demand financial products for religious reasons, but for Islamic banks, as for conventional banks, increased credit supply will require an enabling environment.
- *Development of the nonbanking sector could help ease funding constraints.* Development of suitable alternatives to bank finance, particularly leasing and factoring, could also help increase access to finance for SMEs. Alternative listings on capital markets that require less stringent disclosure requirements could also open venues where SMEs could raise long-term capital.
- *Careful use of credit guarantee schemes might help.* Financial infrastructures address constraints related to collateral-based lending, but where collateral is lacking there is also a need to consider introducing CGSs where these are absent, and improving their operations where they already exist. Identification of factors that have rendered CGSs ineffective will be key.
- *Better data collection on SMEs' access to finance is needed.* Data would help policymakers and financial institutions to better understand the needs of the sector and to develop more targeted support measures. Computerized business registries would further facilitate the data-gathering process, and would serve as an important first step for firms joining

the formal sector. Annual business and financial reports can provide important measures over time on the size and trends of the SME sector.

Finally, although financial access is critical for SME growth, its expansion should not be

achieved at the cost of financial stability: hence, these reforms need to be accompanied by steps to improve financial supervision. Another supporting policy is fiscal prudence: reducing the crowding-out of the private sector by government borrowing can act as a relevant driver for banks to increase SME lending.