Realising Africa's Potential: SME Finance and Skills

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African SMEs have the potential to provide jobs for their working-age youth. Yet there are key impediments – access, risk, regulation and acumen – to them receiving financing. Addressing the perceived high risk of lending to SMEs has evoked considerable interest. Two potential solutions are cash flow-based lending and portfolio guarantees. Beyond this, offering opportunities – especially by developing skills – to the millions caught in poverty will require engagement.

PS&D

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Supporting small and medium enterprises (SMEs) has become a hot topic in the international development community. The reason is that they produce much of developing countries' GDPs and have the potential to provide employment for their working-age youth. For example, SMEs account for 95% of African businesses, 80% of employment, and 33% of GDP. Yet there are challenges for SME financing in emerging markets. Most SMEs have trouble accessing the finance they need to grow, despite governments' and international development organizations' awareness of their key role in economic growth, and these bodies' efforts to meet the challenges.

LIMITING ACCESS TO “HAVES

For most in developed countries, access to finance is a given. Africa is a different story – for most, access to finance is very limited. Where long-term loans exist, they are often reserved for banks’ top customers, have high interest rates, and may be made in hard currency to avoid local currencyrisk.

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Thus SMEs looking to finance property or equipment are rarely able to secure a loan to match the estimated life of the capital expenditure concerned, and must instead rely on short-term financing, with much higher – and often unaffordable – monthly repayments, causing cash flow problems. African banks limit long-term financing because they must carefully manage the term structure of their assets and liabilities. Without active local bond markets and longterm interbank lending, they have to rely on customer deposits for financing. To remedy this, many DFIs are actively lending to the financial sector at long tenors, frequently stipulating that the funds be on-lent to SMEs. However, for risk reasons, DFIs still want to lend in hard currency.

Another obstacle for SMEs in obtaining finance is their perceived riskiness. For example, one bank in Guinea reports requiring 80% collateral to lend to SMEs. This limits the pool of would-be entrepreneurs able to get credit and does not help solve poverty. The perceived high risk of SMEs is more acute for women and young people. To resolve this, DFIs deploy technical assistance to FIs, to help them gauge risk and offer risk-reduction schemes targeted at encouraging SME lending.

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REFORMING REGULATIONS AND ENABLING SKILLS

Another factor limiting finance to SMEs is regulation. Governments, central banks, and regional monetary authorities are tasked with establishing and implementing the rules to ensure a healthy financial system. In doing so, they must strike a balance in the supply of credit. Some African countries have restrictive rules that inhibit banks from lending to SMEs; for example, a bank in Mauritania reports that borrowers are normally required to have a 120% guarantee in real estate to back up a loan. In these countries, the restrictive regulations are harmful, and reform is needed to spur SME growth.

Another problem in developing countries is a lack of business acumen among small business owners and employees. A lack of understanding of basic accounting methods is common across Africa, hence problems with financial management, including presenting financial statements and business plans to potential lenders. DFIs and NGOs offer support, but demand far outstrips supply. This problem, a skills gap, would be best addressed by coordinated national education policies that make basic business skills a part of the school curriculum and encourage an entrepreneurial mindset.

Of the four areas of challenge – access, risk, regulation and acumen – for SME financing in developing countries, addressing the perceived high risk of lending to SMEs has evoked the most interest. Two potential solutions are cash flow-based lending and portfolio guarantees.

ENGAGED LENDING LIMITS LIABILITY

With traditional lending, the loan is based on collateral; the implication of default is repossession of the pledged asset. Yet this method does not encourage economic growth, because of the limited number of aspiring business owners who have the assets to pledge. An alternative is to base lending on predicted cash flow. This necessitates loan officers taking a hands-on approach with entrepreneurs to understand their businesses and to prepare financial statements that indicate estimated future cash flows1. In the process, lenders develop a clearer idea of borrowers' ability to repay, as well as their true needs for financing. It also results in a closer relationship between the two parties.

Furthermore, loan officers are privy to the early warning signs of payment problems, and they can then offer remedies. While some collateral will still be required, the clearer picture of risk allows banks to demand less than with the traditional collateral-focused method. Because most defaults are due to inability – rather than unwillingness – to repay, taking less collateral does not necessarily encourage default. And the relationship that is formed by engaging with entrepreneurs usually reduces any unwillingness to pay.

Another tool for addressing risk is partial portfolio guarantees for SME loans, usually by DFIs. Under these guarantees, the DFI offers to absorb a certain amount (commonly 50%) of any eventual losses by financial institutions for loans to SMEs. The FI pays a guarantee fee, like an insurance premium, but it is usually subsidized, to encourage using the guarantee to attain development goals. Proparco currently offers the ARIZ guarantee and the European Commission has launched an extensive EFSD guarantee program, which provides risk mitigation products through a number of DFIs, including the AfDB's Africa SME Program.

ENVISIONING AFRICA'S GROWTH: A MULTIPARTY PARTNERSHIP

Portfolio guarantees take the form of either firstloss or second-loss coverage. With a first-loss guarantee, the DFI absorbs a portion of SME loan defaults as soon as they occur, usually with a cap. With the latter, the bank that made the SME loans absorbs the defaults up to a specified amount, at which point the DFI steps in to reimburse further losses. Both mechanisms are useful, but are for different purposes.

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Every lender expects not to be repaid on some portion of the loans it makes. This is referred to as the expected loss; it varies by country, economic environment, types of borrowers, etc. Many banks are reluctant to lend to SMEs because they predict that SMEs are riskier and will increase their expected loss. So, for example, where a bank's loss may increase from 6% to 8% of the amount it lends out because of expanding its SME lending or lending to higher credit-risk groups, a DFI could provide a first-loss guarantee to cover the additional 2%, leaving the lending bank's expected loss at 6%. This is a good tool for encouraging additional SME lending, which otherwise would not happen.

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A second-loss guarantee is more akin to disaster risk insurance. The guarantee fee is usually less expensive, and the DFI is less likely to have to pay anything out. Using the example above, the guarantee would kick in when losses reach, say 10% – an unexpected loss. The lending bank still increases its expected loss to 8%, but it will get some relief if its risk calculations were wrong or if something disastrous happens, forcing losses over 10%. This sort of guarantee could be useful in situations where there is potential political risk, severe natural disaster risk, overexposure of an economy to a particular commodity's price, etc., but it is unlikely to encourage lending institutions to increase their overall SME financing activities.

SME FINANCING AND SKILLS: KEYS TO GROWTH

Financing SMEs is key to developing poor countries' economies and creating jobs for their expanding youth populations. Yet the challenges involved in getting the required financing to SMEs in a practical and sustainable way are significant. However, there are several tools that can help overcome the obstacles. A wellthought- out approach providing liquidity, risk mitigation, regulatory reform, and support for education and skills-building would help address the challenges involved in building the private sector in developing countries, thus offering opportunities for millions caught in poverty.

1: This is an approach espoused by Frankfurt School of Finance & Management, which has provided a wealth of training to emerging market financial institutions, including under the Africa SME Program.