

SME Opportunities for Financial Markets: Background Information

Financing social inclusion starts in LAC's financial sector. The financial sector is the engine of financial innovation, capital mobilization, global integration and job creation. The Inter-American Development Bank's (IDB's) Structured and Corporate Finance Department, Financial Markets Division (SCF/FMK) seeks to use the financial sector's influence to further the business case for engaging SMEs and promoting a more sustainable model of banking.

Why the Financial Sector?

The financial sector is known for fostering economic stability and growth by encouraging the efficient allocation of capital and offering extensive outreach in all major productive sectors. In Latin America and the Caribbean (LAC), financial markets maintain lower market entry and transaction costs, in addition to compensating for the region's weaker capital markets.¹ The financial sector cuts across economies, geographies and cultures, and, for better or worse, its business principles and practices have a ripple effect economy-wide. Recent literature underscores the relevance of the financial sector in the global economy:

- "The economic development of any country depends on the extent to which its financial system efficiently and effectively mobilizes and allocates resources."²
- "Financial development disproportionately benefits the poor; improvements in the functioning of the formal financial system exert a particularly beneficial impact on the economic opportunities of the poor."³
- "... the level of financial development is a good predictor of future rates of economic growth, capital accumulation and technological change."⁴
- "Lack of credit is one reason why there is so much dispersion in the productivity of firms. Without credit, productive firms cannot expand and less productive firms cannot make technological changes and investments needed to raise their productivity."⁵



Why Banks?

Almost every person and every business has at one point interacted with or been affected by a bank. Banks are considered cost-effective channels to reach end-borrowers who operate along the supply chain and in high-impact productive sectors, such as renewable energy, energy efficiency, agribusiness, housing, education and trade. As key players in allocating capital, promoting competition, influencing corporate culture and stimulating economic development, banks can positively impact credit, liquidity and economic growth. An IDB study revealed, **"Banks are a key player in the allocation of capital and, hence, in stimulating economic development. In fact, bank credit and GDP per capita are highly correlated."**⁶

Banks' policy leadership, through participation in voluntary standards, such as the Millennium Development Goals, Global Compact and UN Principles of Responsible Investment, indicates that banks recognize the long-term market incentives, including portfolio diversification, risk mitigation, revenue growth and reputational advantages, that exist by committing to financial inclusion and sustainability.

¹ World Bank. 2009. "Banking the Poor," Washington, DC.

² RAI Foundation. 2009. "Lesson 29: Development Finance Institutions," RAI University, India.

³ Demirguc-Kunt, et al. 2008. "Finance and Economic Opportunity," World Bank, Washington, DC.

⁴ Levine, Ross. 1997. "Overview of Financial Development and Economic Growth: Views and Agenda," World Bank Policy Research Working Paper No. 1678, Washington, DC.

⁵ IDB. 2009. *The Age of Productivity*. Washington, DC.

⁶ IDB. 2005. *Unlocking the Credit*. Washington, DC.

Why SMEs?

Small and medium enterprises (SMEs) play a significant role in economic development, job creation, innovation and competitiveness. SMEs are vital in the economic supply chain by contributing to the following:



- Diversification of goods and services
- Market competition and knowledge
- Technological innovation
- Social sustainability
- Efficiency and job creation along the productive supply chain, i.e. distribution, production, retail and service providers, among others.

SME statistics reveal their influence as market players as well as their untapped potential. SMEs account for:

- 95% of registered firms worldwide and in LAC⁷
- 60-70% of employment in developing countries⁸
- 40-50% of average GDP globally and 20-35% in LAC⁹
- 17 million formal enterprises in LAC with MSMEs accounting for 98% of them¹⁰

However, unmet demand hinders SME performance. SMEs state access to credit and non-credit financial products as a key barrier to growth. This is followed by the high cost of financial products and the lack of human resource expertise.¹¹ Eighty-seven percent of SME employers admitted to having personal banking products while only 51% have professional financial products, and 44% of SMEs admitted to adopting personal financial products for business purposes.¹²

The gap in credit finance for formal SMEs in LAC is an estimated US\$125 to US\$155 billion, suggesting a market opportunity for the IDB, along with other multilateral development banks, the public sector, private investors and organizations to boost SME financing.¹³ This is especially relevant to the region's "missing middle," the segment of the population where SME financial requirements are considered too large for microfinance institutions but too small, risky or costly for traditional banking products. Strengthening access to financial products and services for SMEs has the potential to increase sales and assets, human capital, firm efficiency, diversification of goods and services, technology and social and environmental practices.

Why Downscale?

By scaling down commercial products and services to meet the specific needs of SMEs and the missing middle, financial intermediaries benefit from executing a more inclusive approach to banking.

- According to a FELABAN study, 9 out of every 10 banks in LAC have a SME commercial area, 8 consider SMEs part of their core business, and 3 have SME portfolios that account for more than 60% of their total portfolio.¹⁴
 - The most significant barriers to financing include the difficulty to measure repayment capacity (according to 67% of FIs evaluated); SME informality (53%); and unstable corporate governance structures (44%).¹⁵
 - Out of every 10 banks, 8 would be interested in receiving technical assistance for SME business development, and currently, 4 out of every 10 banks receive technical assistance to train personnel to develop SME knowledge and strategy.¹⁶
- Major banks report ROAs of 3-6% for SME operations compared with 1-3% bank-wide.¹⁷
- Assets for SME lending have higher operating incomes and operating profits than for bank lending as a whole.¹⁸

Coupled with new revenue sources, portfolio diversification and risk mitigation, downscaling strengthens banks' ability to compete in an increasingly competitive financial marketplace. Moving forward, banks can better address their SME clients' needs by further developing credit scoring models, risk-adjusted pricing and dedicated, decentralized SME departments.

⁷ Moreno, Luis. 2007. "Extending financial services to Latin America's Poor." *The McKinsey Quarterly*.

⁸ IDB and MIF. 2008. "High Growth Small and Medium Enterprises (HGSMES) in Latin America Emerging Economies." Document prepared by IDB and MIF for the OECD Kansas City Workshop, May 8.

⁹ Ibid.

¹⁰ IDB and MIF 2008.

¹¹ Beck, Thorsten, Demirgüç-Kunt, Asli, Martinez Peria, Maria Soledad. 2008. "Bank Financing for SMEs around the World," November, World Bank Policy Research Working Paper Series No. 4785.

¹² Nielsen Company and Visa. 2007. "Perspectivas de las PyMEs en América Latina," August.

¹³ IFC and McKinsey & Company. 2010. "Two Trillion and Counting: Assessing the credit gap for MSMEs in the Developing World." October.

¹⁴ D'Alessio IROL. 2007. "Tracking the Propensity of Financial Institutions in LAC to Finance Small and Medium Enterprises." FELABAN, MIF, IIC.

¹⁵ Ibid.

¹⁶ Ibid.

¹⁷ IFC. 2009. "The SME Banking Knowledge Guide," Washington, DC.

¹⁸ Ibid.