Chair's Summary

of the G20 Workshop

"Helping SMEs Go Global – Moving Forward in SME Finance"

on 23-24 February, 2017

G20 GERMANY 2017

Introduction and Summary

On February 24, 2017, the workshop "Helping SMEs Go Global – Moving Forward in SME Finance" at KfW in Frankfurt am Main, Germany, brought together more than 150 experts from G20 countries, development finance institutions, and the private sector to discuss questions related to financing for small and medium-sized enterprises (SMEs). The workshop was a key event in the Finance Track of the German G20 presidency and was organised jointly by the Federal Ministry of Finance, the Federal Ministry for Economic Cooperation and Development, KfW, and the SME Finance Forum. KfW hosted the event. The outcomes of this workshop will feed into discussions in the G20 going forward.

Session 1: Fostering SME Finance in Sustainable Global Value Chains

This session focussed on the growing importance of sustainability standards and how innovative financial models can help to integrate SMEs into sustainable global value chains (GVCs). To promote this goal, the G20 Global Partnership for Financial Inclusion (GPFI) is conducting a stocktaking study under the German presidency with support from the World Bank Group (WBG) and the German Development Institute (DIE) to identify, map and analyse existing financing models, good practices and policies and partnerships with regard to SME integration into sustainable GVCs.

Large international corporations are increasingly seeking to guarantee social and ecological standards in their global value chains which to a large extent consist of SMEs. SMEs need to respond to these demands and invest in their production processes. Several examples of innovative financing solutions were presented.

A large multinational company introduced its vendor financing programme which it implements within the framework of the IFC's Global Trade Supplier Finance programme programme, embedded in a supply chain platform. The idea is to set incentives to implement sustainability standards by reducing financing cost for sustainable suppliers. IFC adopts a financing structure with tiered pricing of short-term working capital, offering lower costs for those suppliers that meet social and environmental standards.

A software company's digital tracing tool (used on smart/mobile phones) for agricultural commodities makes farmers more bankable through increased data availability and thus helps them access finance. It was stressed by an investment firm focused on sustainable and socially responsible micro-, small and medium-sized enterprises in developing countries that having a viable business case is the key element in SME financing and that usually SMEs welcome additional capacity building and support to further develop their enterprise.

It was emphasised that it is important for development finance institutions to help local banks to promote social and environmental standards for their SME clients. Representatives of the B20 highlighted that one of the biggest challenges for SMEs is that they rarely have enough collateral to access finance, and suggested that using big data to reduce the need for collateral could be worthwhile. They recommended governments should put an emphasis on the implementation of existing policies, especially in Africa. They also underlined the importance of: 1) improving the financial infrastructure for SMEs, in line with the G20 Action Plan on SME Financing, and better assessing the impact of financial regulations on lending to SMEs; 2) improving SMEs' access to diversified financial instruments, especially by developing appropriate risk-sharing and mitigating; 3) fostering the financial inclusion and financial literacy of SMEs through digital technology innovation. SMEs' access to data was also mentioned as a restraint.

To sum up, key elements to help SMEs invest enough in raising their environmental and social standards include:

- Setting up a sound legal and regulatory framework for SMEs and effectively enforcing these laws and regulations in all countries and on all levels.
- Exploring existing financing models and developing new models that reward positive environmental and social practice.
- Discussing the potential of sector-wide sustainability ratings (for SMEs) that would provide common standards and hence be comparable.
- Encouraging public and private sector to work hand in hand.

All panellists and speakers agreed that successful approaches need to be replicated and scaled. Consumers play a vital role: their demand creates a perceived need to adhere to social and environmental standards.

Session 2: The Role of Innovative Finance in SME Development

Several fintech companies were able to demonstrate the value that fintech can have in helping SMEs access finance.

A searchable database of capital providers was presented which aims at mapping all types of alternative capital including crowd funding, venture capital, impact funds, angel investing networks and semi-public funds, helping SMEs in developing countries to identify providers of finance. The tool also helps to understand which sectors and countries are relatively strong or weak in various types of financial sector development. Another fintech company drew lessons on the difficulty of addressing fraud and collusion and the costliness of collection when serving SME clients directly. As a result, the company shifted the focus of the business model away from lending and collection towards services for financial institutions.

A third fintech company's franchise system allows individual entrepreneurs to start providing financial services in their communities where these were previously lacking. This benefits both individuals and SMEs, and has helped in particular to take women out of poverty. The fourth and final fintech company that presented its business model offers a mobile banking solution with biometric identification and credit scoring for unregulated microfinance institutions in Africa. This allows them to digitise their business easily and exchange individual credit information on borrowers among each other, reducing loan defaults, non-performing loans and fraud.

In a panel discussion between private and public sector representatives there was agreement that banks and fintech companies are likely to become even more closely integrated in the future. At the same time, financial stability, cybersecurity and consumer risks have to be monitored closely.

The experiences of several of the fintech firms showed that women were investing strongly in their communities and that access to finance (including through fintech) could have transformational impacts on the communities. Another lesson learned from the fintech companies was the importance of understanding how local markets work in order to learn how to export fintech business models to foreign markets. It was also emphasized that the personal element, for example through having agents to collect payments, remains important, and cannot be replaced entirely by technology.

A discussion of big data highlighted that there are rapid developments in this field and that a far broader range of data is being collected and used in SME financing. Good data is essential to lowering barriers to financing for SMEs, but the right balance needs to be found between data access and privacy. It was suggested that the G20 could help serve as convening power on questions of regulation regarding data protection.

In his lunchtime speech, a prominent angel investor emphasised the importance of having an entrepreneurial culture. Being successful should not be punished, he said; neither should failure imply stigmatisation.

Session 3: Best and Avoidable Practices of Enabling SME Access to Finance: The Role of Development Banks

During this session, which was co-organised by the International Development Finance Club (IDFC), development banks presented lessons learned on what works best in SME financing. Within the IDFC, 23 like-minded national and sub-regional development banks around the world have bundled their expertise and knowledge. Fourteen IDFC members are from G20 countries. Furthermore, selected members of the IDFC which offer SME financing agreed on a Lessons Learned summary, which is contained in the Annex.

A special focus was on the diversification of products, especially digital solutions: An online loan facilitation platform by a development bank created a market place with 20,000 participating banks which has considerably sped up the process of finding suitable financing options for MSMEs and generated greater market transparency. It was emphasised that development finance institutions (DFIs) can take on the role of market makers and focus on areas where the market is not yet developed, creating an ecosystem for innovation and helping the private sector to “test the water”. At the same time, DFIs need to strictly adhere to the principle of subsidiarity to avoid crowding out the private sector, e.g. by limiting their market share. Purpose-specific product development and integrated SME financing services combining loans with capacity development of SMEs were further priorities.

Lessons learned from de-risking SME financing were also described. A holistic approach linking measures to improve the business environment (macro level) with the support of intermediary organisations, e.g. chamber of commerce and incubators (meso level), as well as risk sharing mechanisms, capacity development and refinancing lines to financial institutions (micro level) proved successful.

Another example for de-risking SME financing and the mobilisation of private capital is via structured funds, especially in a highly underbanked region such as Africa. Banks' risk perception towards SMEs is distorted to some degree and risk aversion is sometimes increased by regulation. Commercial banks lack knowledge about SMEs, particularly in typical sub-sectors such as agriculture. Specialised investment funds are a vehicle to bring in finance and business knowledge, as well as the private sector capital to jointly serve SME needs. While the cost of doing business is rather high for the banking sector due to small ticket sizes for SMEs, these fund structures cover their costs.

Further lessons learned were:

– While digital platforms help to close the gap in SME financing, data infrastructure and data regulation on citizen information and data protection still need to be developed further.
– Monitoring and data collection is crucial to follow up on the development of the SMEs receiving support, particularly to assure additionality.
– Local presence is key.
– Regulators need to keep the regulatory environment open for structures like specialised funds to continue financing SMEs in underserved regions.

The panellists also agreed on certain areas that need to be developed further:

1. For common currencies, a market for hedging is available, e.g. via funds like the Currency Exchange Fund (TCX), but for "exotic" currencies, new approaches to provide local currency financing at a competitive cost need to be developed, e.g. by subsidising hedging costs. At the same time, regulatory reforms and institution building are essential to develop local capital markets.
2. There is a strong need for building up domestic financial and capital markets as well as local bond markets.
3. There are an increasing number of African private equity firms ready to invest in SMEs: There is no lack of capital, but there is a lack of good projects to be funded. Therefore development banks could work with those firms to support the preparation of bankable projects.

Session 4: SME Finance – The Role of Public Policy

Participants stressed the importance of the G20 work on effective implementation approaches for the G20/OECD High-Level Principles on SME Financing as well as the G20 Action Plan on SME Financing and its Implementation Framework (developed by the World Bank Group) as guiding documents for policy makers. The G20 Action Plan on SME Financing focuses on credit infrastructure to promote access to finance to SMEs and reduce the cost of financing. The policies that are emphasised are: firstly, improvements of the credit reporting framework for SMEs; secondly, reforms that allow banks and non-banks to lend to SMEs against movable collateral; and thirdly, insolvency reforms. This year, under the German presidency, G20 countries are undergoing a benchmarking exercise regarding their current practices in these policy areas compared with international standards. This will help to identify priority areas for reforms to be implemented at the national level, as well as for monitoring progress in the implementation of such reforms. Furthermore, G20 countries will support non-G20 countries who wish to make improvements in these areas.

The G20/OECD High-Level Principles on SME Financing are a set of 11 high-level principles which broadly cover multiple policy areas affected by SME financing. G20 and OECD members are currently collecting effective implementation approaches to support these principles.

The OECD presented the initial results of the survey on Effective Approaches to Support the Implementation of the G20/OECD High-Level Principles on SME Financing. The survey indicates that all participating governments are working to identify gaps and improve the evidence base on SME financing. Several countries have developed databases on credit ratings to improve bank financing for SMEs. The report on effective implementation approaches will be presented to the G20 Finance Ministers and Central Bank Governors.

Some of the main policy reforms that Turkey has implemented include improved credit infrastructure, particularly for secured transactions, and a moveable collateral registry, promotion of equity-based financing especially for innovative SMEs and a credit guarantee scheme.

The UK's bank referral scheme, which was launched last year, requires traditional banks to refer small businesses to alternative lenders if they are rejected for a loan. A UK fintech company presented its approach to match SMEs to alternative lenders.

Fintech companies were found to have a critical role as a market disruptor. They have helped banks become more efficient and improve their ability to serve customers by forcing them to invest in innovation, research, and understanding customer demand.

Both private-sector participants and policymakers agreed that holding discussions with the private sector before implementing a reform is beneficial for identifying bottlenecks and for increasing the acceptance and effectiveness of reforms.

Summing up, some of the policy efforts proven to promote SME access to finance are:

1. Developing country specific diagnostics and strategies,
2. Strengthening the financial infrastructure, which includes payments systems, credit reporting, secured transactions and collateral registries and insolvency regimes,
3. Designing effective government support mechanisms such as guarantee schemes,
4. Building consistent and reliable data sources on SME finance

Another issue raised in the discussion was lack of access to insurance for SMEs. It was suggested that the G20 include this issue in its SME agenda.

Annex:

Lessons Learnt by Development Banks[1] on Long Term Financing for SMEs

The workshop brought together representatives of bilateral and sub-regional development banks. This summary offers a synthesis of the panel and workshop discussions and has been prepared by selected members of the International Development Finance Club (IDFC) offering SME financing (namely AFD, CABEI, CAF, HBOR, KfW and SIDBI). In spite of differences in context and perspective, a broad consensus has emerged among these bilateral, national and sub-regional development banks represented on the panel in session 3 "Best and Avoidable Practices of Enabling SME Access to Finance – The Role of Development Banks" on some key lessons and recommendations based on their experiences. The focus of this summary is on long-term financing for SMEs and different instruments – a concern which is also reflected in the G20 Action Plan on SME Financing.

1. Pursue a **holistic approach** for sustainable long-term SME financing. A sound strategy for promoting long-term SME financing rests on three pillars[2]: (i) Create conducive framework conditions and infrastructure, (ii) Strengthen capital markets and private investments, and (iii) Enhance access to integrated SME financing, including capacity development for SMEs. For the strategy to be effective, interventions at different pillars and at various levels (macro, meso, micro) need to be well coordinated and integrated.

Pillar 1: Create Conducive Framework Conditions & Infrastructure

2. As development banks, promote other **national and sub-regional development banks**, such as members of the IDFC have been pursuing via experience exchange and joint initiatives. They can be important catalysts for economic development, in particular for the local financial market and SMEs. Development banks can play an important role as thought leaders and **pioneers** in new instruments and products, as **facilitators** between commercial banks, SMEs and other stakeholders, and as **anchor investors** for crowding-in the private sector by de-risking potential investments. Local commercial banks in turn have the local network and the cost structure to reach out to SMEs. Additionally, development banks often have an influential **advocacy** role vis-à-vis policymakers and regulators. In times of economic distress, development banks need to support the efforts of the government by undertaking **counter-cyclical interventions**. In countries without national development banks, sub-regional development banks adopt these crucial roles.

3. Adhere as Development Finance Institutions (DFIs) strictly to the **principle of subsidiarity** and avoid any crowding-out of local or private financing partners. DFIs should provide external support only when local or private initiatives are not yet in place or play the role of market makers for new or enhanced financial products or services needed by SMEs. - The DFIs need to continuously reinvent and redefine their role. They have to adapt with the changing needs and state of the economy for the benefit of SMEs.

[1] *Development banks* include (i) multilateral and bilateral development banks engaging at the global or international and regional level, (ii) sub-regional development banks focusing on several countries within a region and (iii) local or national development banks with a mandate in a specific country. The term *„Development Finance Institution (DFI)"* is synonymously applied for most bilateral development banks at the international level and some subsidiaries of multilateral development banks.

[2] See https://www.kfw-entwicklungsbank.de/PDF/Download-Center/Materialien/2017_Nr.2_KMU_EN.pdf for graphic illustration.

DFIs should also promote specialised institutions that cater to SMEs' various needs, e.g. MSME rating, collateral registries, web-based services and venture capital.

4. Create an enabling **legal and regulatory framework for digital finance and data use.** The new ventures in digital finance are showing promising results. However, there are several market and regulatory barriers to sustaining and up-scaling the operations. Regulations should ensure a healthy growth of digital finance providers such as fintech companies while monitoring possible financial stability risks. Development banks can play a proactive role in building the necessary infrastructure for transaction and client identification systems, e.g. establishing a big data platform as a public good while safeguarding consumer data protection and responsible finance at the same time.

5. Enforce international **environmental, social and governance (ESG) standards.** Development banks should be managed based on sound commercial principles. First of all, they must follow high standards of good governance, transparency and disclosure to avoid the pitfalls and mistakes of the past, e.g. political interference and corruption. In addition, widening their financing approach with the aim of increasing the capacity of SMEs to cope with international ESG standards is a prerequisite for the long-term business success of their SME clients and lasting development impacts. Also, by integrating the private sector in developing and developed countries into standard-setting partnerships on the national and international level, SMEs and their employees will benefit through increasingly sustainable and transparent global production.

    Example: The Textile Partnership is a multi-stakeholder initiative aimed at improving social, ecological and economic standards all along the textile supply chain (www.textilbuendnis.com).

6. Pursue **monitoring & data collection** of SME finance with regard to employment trends and innovation in SMEs receiving support, as well as conduct SME panel surveys. Albeit challenging, such monitoring should be technically sound but operationally feasible, and should become an integral part of national data systems and credit reporting, if possible based on internationally harmonised standard indicators. This would offer a joint and integrated platform for all financiers to follow up and serve as a mechanism to appraise additionality and accountability.

    Examples: The KfW-Mittelstandspanel is an annual tracking survey conducted among a representative selection of small and medium-sized enterprises in Germany.

Pillar 2: Strengthen Capital Markets & Private Investments

7. Continue to promote structures for **crowding-in private capital for SME finance.** Private investors generally consider SMEs to be a high-risk sector. **Structured funds** are a possible vehicle and legal structure where the high-risk profile of SMEs is segmented into different risk-return tranches for public and private investors. It is an effective instrument for a joint approach to mobilising private capital and leveraging scarce public resources in a public-private partnership (PPP). Structured funds require a domicile which allows structuring and meets investors' requirements, which mainly include transparency, a reliable regulatory framework and sufficient investor protection. Luxemburg provides these conditions, but Germany does not; neither do the target

regions. Even if developing countries do not provide an adequate regulatory space, they can still benefit from the advantages of the foreign domicile of the fund.

> **Examples**: (i) REGMIFA provides mid- to long-term loans, particularly in local currency, for African MFIs and has got 13 private investors on board (www.regmifa.com).
> (ii) The Africa Agricultural and Trade Invest Fund (AATIF) provides senior debt, mezzanine or guarantees and has managed to mobilise private capital (www.aatif.lu).

8. Foster the long-term **development of local capital markets** by attracting or activating local investors – both institutional and retail investors – and by encouraging the formation of pools of long-term savings, possibly for a region, depending on market size. Development banks have a role in structuring and accompanying early-stage capital market instruments and transactions, such as local bonds issued by SME financiers, or simple securitisations in more advanced capital markets. Given their position in international capital markets, international development banks and DFIs can initiate and enhance local currency refinancing.

> **Example:** The African Local Currency Bond Fund (ALCBF) invests in bond issues by local financial institutions to allow access to local-currency loans for MFI and MSME customers (www.alcbfund.com).

9. Innovate **instruments for local-currency financing**. Cross-border finance generally exposes local stakeholders – including governments, the corporate sector and the banking sector – to significant currency risks. Donors and international financiers should step up efforts to develop solutions for local-currency financing, at least until local capital markets are sufficiently developed to tap local sources. Innovative instruments such as hedging facilities can mitigate currency risks. In some markets with particularly large currency fluctuations, it can even be temporarily necessary to assume currency risks via structured funds, or subsidise hedging costs in order to make deals viable. Furthermore, donor governments may consider providing part of official development assistance (ODA) in local currencies, either directly or through adequate guarantee mechanisms.

> **Examples**: (i) The Currency Exchange Fund (TCX) provides hedging solutions for currencies where market hedges are not yet available.
> (iii) The Lending for African Farming Company (LAFCo) offers direct local-currency financing for SMEs to promote local and regional value chains in food production (www.lendingforafricanfarming.com).
> (iv) GuarantCo provides credit guarantees that enable infrastructure projects to raise debt finance in local currency (www.guarantco.com).

Pillar 3: Enhance Access to Integrated SME Financing

10. Support the whole **range of financial service providers relevant to SMEs** including banks, leasing companies and microfinance institutions (MFIs). In many countries, the lower end of the SME spectrum is served by MFIs rather than the formal, regulated banking sector. As very small enterprises generally operate in the informal sector of the economy, strengthening MFIs in many countries is a key prerequisite for access to finance for SMEs.

11. Continue to support **diversification of financial products** and multiple sources of finance for more developed SMEs, including asset-based finance (e.g. leasing, factoring, warehouse receipt financing), different forms of debt (e.g. syndications, private placements), hybrid products (e.g. subordinated loans, mezzanine finance) and equity products with special consideration for venture capital and private equity financing. Development banks can help to promote venture capital ecosystems, such as working with regulators to create the appropriate legal framework and training potential fund managers. Development banks can also pave the way for trade finance to foster integration of SMEs into global value chains, as well as purpose-specific financial products, e.g. promoting clean production and energy efficiency. Many of these products can be financed by commercial banks and, where necessary, complemented by enhancements (e.g. guarantees) offered by development banks.

> **Examples:** (i) SIDBI offers a Trade Receivables e-Discounting System (TReDS) addressing delayed payments in the MSME sector.
> (ii) CABEI has launched a Green MSME Initiative on Energy Efficiency and Renewable Energy.

12. Develop and upscale **risk-sharing arrangements** and **risk transfer solutions (insurance)** to de-risk SMEs for the commercial banking sector. This includes guarantees on market terms for commercial banks or credit enhancements such as first loss or mezzanine positions in structured transactions. To control moral hazard, guarantee instruments must adhere to sound principles in design, governance, policy and procedures.[3] Development banks or other specialised guarantee institutions have an instrumental role to play by providing risk-sharing mechanisms as well as participating in the structuring and underwriting of the instruments. Some development banks have experienced that smaller SMEs are less risky than larger ones.

> **Example:** The ARIZ Credit Guarantee Programme by AFD is a risk-sharing instrument for commercial banks that provide loans to SMEs.

13. Embrace **digital finance solutions** for the benefit of SMEs.[4] Digital finance is disrupting the lending landscape by leveraging non-traditional data sources (e.g. social media, utility bill payments, telecommunications data), digital ID systems, e-KYC, block-chain applications etc. to more efficiently appraise and provide loans. These innovative solutions and digital payment systems significantly reduce transaction costs, especially for hard-to-reach client groups, and ease access to credit for SME customers. Digital finance also increases competition, as non-traditional service providers including fintech companies and mobile network operators (MNO) increasingly provide digital finance solutions This induces conventional banks to similarly adopt digital innovations... Moreover, digital finance is witnessing increasing traction from investors.

> **Example:** SIDBI has developed a platform for online loan facilitation (www.udyamimitra.in) and a portal for information, registration and applications for financial assistance (www.standupmitra.in).

14. Continue to promote **awareness and financial literacy** on the variety of financial products available to banks and SMEs. Due to the relative complexity of some of the

[3] A set of principles have been proposed by the World Bank: *Principles for Public Credit Guarantee Schemes for SMEs*. 2015.
[4] ref. *G20 High-Level Principles for Digital Financial Inclusion* which were adopted by the G20 under the Chinese Presidency in 2016.

products, awareness and financial literacy measures should be aimed at raising the understanding of the risks and opportunities offered by different products. Commercial banks and MFIs – through their direct customer relationship – have an important function in financial education of their SME clients. The role of development banks is to assure financial literacy programmes are developed and followed up.

15. Continue to provide **capacity development for local financial institutions (supply side)** as well as **for SMEs (demand side),** complementary to financing. Targeted long-term finance alone will not remove the obstacles for SMEs in financial markets, because commercial banks often lack the know-how and experience of working with SMEs. Hence, SME financing has proven to be more successful when it is combined with technical assistance for developing appropriate policies, structures, financial products, human resources, risk and ESG management systems. Moreover, enhancing sector knowledge can significantly improve risk management, e.g. in agricultural finance. Offering demand-driven co-financing or advisory services to financially viable SMEs to improve accounting, entrepreneurial skills and financial management will enhance the financial skills of SME management, their capacity to prepare bankable projects, and ultimately their access to finance.

    Examples: (i) Combined approaches of financing and capacity development are offered by CABEI and SIDBI ("Credit Plus").
    (iii) GroFin Small and Growing Businesses Fund combines business consulting with mezzanine finance (www.grofin.com).