

Proparco actively supports the development of banking sectors in SSA. Julien Lefilleur, an investment officer in the Banking and Capital Markets Division, has been working on projects to refinance African banks for several years. In this article, he stresses the extent to which information asymmetry hampers bank financing for SMEs and puts forward several ways to overcome this obstacle and enhance loan securitization.

# Financing SMEs in a context of strong information asymmetry

*The acuteness of information asymmetries between bankers and entrepreneurs, which cannot be offset by adequate loan securitization, constitutes one of the main stumbling blocks to SME financing in SSA. The gap between banks and SMEs can, however, be narrowed by developing financial systems that are more adapted to local contexts. In addition, by promoting sustainable guarantee funds – based, for instance, on the principles of microfinance – banks would be able to share their risks and would therefore be encouraged to penetrate these markets. These are two avenues for reducing the risks perceived by banks and, consequently, for giving SMEs better access to financing.*

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Despite the weight SMEs carry in local economies and the key role that they play as engines for economic development, SME access to financing in SSA is extremely limited. First, banking penetration rates are very low in SSA – the total amount of loans to the private sector only averages 18% of GDP (World Bank, 2006) – and second, it is mainly major corporates that benefit from the bulk of financing. According to several studies (Africappractice, 2005; IMF, 2004; Aryeetey, 1998; World Bank, 2006), difficulties in gaining access to financing constitute the main stumbling block for SME development in SSA, far ahead of problems of corruption, deficient infrastructure and abusive taxation. These studies estimate that between 80 and 90% of SMEs experience important financial constraints. This can be easily understood in view of the reluctance of banks vis-à-vis SMEs in SSA, which can be clearly seen in their accessibility and eligibility criteria (see table p.13). Banks' overcautiousness towards SMEs can be explained by several factors: the volume effect which leads to high unit costs, the risks on these counterparties, banks' lack of long-term resources, information asymmetry between entrepreneurs and bankers, or even the difficulty to secure SME loans (Lefilleur, 2008).

This article focuses on the last two constraints which seem to have a particularly deterrent effect since they cause banks to overestimate risks. While most of the other obstacles are structural to SSA markets and may therefore be difficult to overcome, risks stemming from information asymmetry and securitization difficulties could be minimized by the development of financial systems that are more adapted to local environments.

This article consequently explores several avenues for mitigating these risks.

## Information asymmetry and lack of loan securitization

Several factors, that are specific to the SSA context, are at the root of this information asymmetry between entrepreneurs and bankers. The first is that most SMEs evolve in the informal sector and are therefore not in a position to give banks the minimum information they generally require (contact details, legal documents, financial statements...). In addition, for SMEs evolving in the formal sector, the absence of accounting standards – or, on the contrary, the excessive level of accounting information required by OHADA<sup>1</sup> standards in the case of West and Central Africa – as well as the lack of independent, competent and credible accounting firms, have an impact on the quality of financial information transmitted to banks (Kauffmann, 2005; IMF, 2006). Moreover, it may be in the interest of entrepreneurs to disseminate extremely limited or even erroneous information in order to evade taxes. Finally, there is usually no tools that would allow banks to learn about the payment behaviours of their new clients. Credit bureaus either do not exist or are ineffective. In this context, informal communication between banks and entrepreneurs must make up for this deficiency in classic communication channels. The entrepreneur's reputation and his/her proximity to the bank are just as important as the quality of financial statements transmitted to the bank.

In this context of strong information asymmetry, banks should be able to mitigate risks ...

<sup>1</sup> OHADA is the French acronym for "Organisation pour l'Harmonisation du Droit des Affaires en Afrique" translated in English as the "Organization for the Harmonisation of Business Law in Africa"

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... by taking guarantees. However, mortgage are generally difficult to enforce: tangible assets (excluding land) have practically no market value due to the fact that the narrowness of markets often means that there are no buyers, whereas land (when land titles exist) or leases (when contracts have been duly registered) can generally only be transferred once agreement has been obtained from the public authorities, what turns out to be a long and difficult process in most cases. Collateral would then often seem to be the necessary prerequisite for loan allocations (Africappractice, 2005), which excludes the majority of entrepreneurs as they lack sufficient resources. In any case, guarantees do not appear to be the best way to mitigate risk due to the complexity and length of security registration and recovery procedures - particularly when one considers the amounts at stake - as well as the weaknesses in judicial systems and the uncertainties over the outcome of recovery procedures (IMF, 2006).

## Bridging the divide between banks and SMEs

This strong information asymmetry, which cannot be offset by satisfactorily securing loans, has two significant implications. First, it increases transaction costs (risk assessment and supervision) which - given the low level of committed amounts - leads to a problem of economies of scale. Second, it leads to inaccurate risk assessments with risks often being overestimated by banks. This overestimation of risk, coupled with high operating costs on SME loans, prompts banks to avoid these counterparties or offer rates which are too high. It is the-

refore necessary to reduce information asymmetries between financial intermediaries and SMEs in order to give the latter better access to financing. One solution would be to promote the development of smaller commercial banks or rural banks, ideally with local capital. This would indeed reduce economic, geographical and cultural distances between banks and SMEs (Kauffmann, 2005).

For traditional banks - often with foreign capital - that want to move into the SME market, the development of credit units for SMEs is becoming an increasingly widespread solution. In some cases, such as in Nigeria, these units can be common to several banks. In order to support the rapid development of these structures in SSA, donors are implementing technical assistance programs that aim to strengthen the capacities of banks to handle SME loan activities<sup>2</sup>. These units are specialized in SMEs, can meet their needs and can, in some cases, provide technical assistance to entrepreneurs. Another practice increasingly adopted by traditional commercial banks in order to work with SMEs involves partnerships with certain institutions that a priori have a better knowledge of these counterparties: NGOs, non-financial service providers, microfinance institutions (MFIs), leasing companies, SME federations... These partnerships benefit both parties: these institutions lack resources and consequently have low financing capacities, but they do have sound knowledge of small-scale entrepreneurs and extensive experience of working locally - banks lack this experience, but they do have resources. ...

<sup>2</sup> Donors' operations for SMEs do not exclusively concern banks. Development finance institutions (DEG, FMO, Proparco...) are increasingly investing via investment funds specialized in Africa. They consequently provide support that helps SMEs upgrade, particularly in terms of organization and governance.

## Barriers to SME loans

Region	Locations to submit loan applications (out of 5)	Minimum amount for a SME loan (% of GDP/cap.)	Fees on a SME loan (% of GDP/cap.)	Days to process
Sub-saharan Africa	2.51	760	15.77	12.04
Latin America and Caribbean	3.82	141	1.15	10.68
Asia	2.45	790	2.93	23.93
Eastern Europe and Central Asia	2.80	441	2.58	8.15
Middle East and North Africa	3.21	339	10.66	12.47
OECD	3.91	14	1.34	6.38

Source: Author's calculations based on World Bank, 2008

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... Such partnerships are generally fruitful and must be encouraged. In the same perspective, another way to reduce information asymmetry is to increase the number of intermediaries between the lender and the final borrower. Banks can consequently lend to recognized agents that have better access to SMEs (cooperatives, professional associations...). An example of this model can be seen with the partnership between Barclays Bank of Ghana and Ghana's "Susu collectors" associations (World Bank, 2006).

## Developing more effective guarantee mechanisms

One solution for reducing banks' aversion to SMEs also involves developing more reliable guarantee mechanisms so that lenders are not dependent on judicial administrations that are often deficient when it comes to enforcing classic securities. Numerous "independent" guarantee funds dedicated to SMEs sprang up during the 1990s for this very reason. These entities met a real need for banks which consequently increased their level of financings to SMEs. Funds of this type set up in SSA can be classified into four categories. The first involves national, regional or pan-African funds created on the initiative of local public authorities, sometimes in partnership with donors. The Fonds de Garantie Malgache (Malagasy Guarantee Fund) and the Small Business Credit Guarantee in Namibia (national funds) as well as the African Solidarity Fund and the African Fund for Guarantee and Economic Cooperation (pan-African funds) are examples that fall within this category. The second category concerns funds set up on the initiative of donors, such as the Guarantee Fund for Private Investments in West Africa (GARI Fund, managed by the BOAD), the ARIZ Fund (managed by AFD), as well as USAID and IFC funds for instance. The third group concerns funds set up by countries' commercial banks. These funds are less common, but they do exist in Nigeria for example. Finally, the fourth type of fund is set up by homogeneous interdependent professional groups organized as cooperatives.

This last type of guarantee fund – mutual guarantee companies – is not very developed in SSA, but is interesting in the sense that it is based on a principle that has been proven to work: promoters are also clients (De Gobbi, 2003). These mutual guarantee companies are therefore based on interdependence between the different members which creates solidarity among them, following the example of MFIs, tontines in West Africa or stokvels in Southern Africa. The success of MFIs has led certain SSA banks to start applying the principles of microfinance to SME financing by promoting the creation of business clusters that are all interdependent and together finance a mutual guarantee fund that allows banks to cover their loans. The threat of being excluded from the network is enough to facilitate the fulfilment of contracts by borrowers. The relationship of confidence between firms and financial institutions can be considerably strengthened by the permanent interactions between the clusters and the financial institutions and by the reputation a firm enjoys within the cluster. This facilitates access to credit with lower interest rates. The strong development of these mutual guarantee companies in Asia, South America, North Africa and the Middle East (De Gobbi, 2003) bears witness to how effective these funds are in combating the problem of access to financing for SMEs. ●

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