Private Sector & Development
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SME FINANCING IN SUB-SAHARAN AFRICA

Why is it difficult for SMEs to gain access to financing in Sub-Saharan Africa (SSA)? What are the prospects for improvement? This issue compares experts' views on the topic.

Contents

Editorial

By Luc Rigouzzo, ***Chief Executive Officer of Proparco***

We are very pleased to share this first issue of Private Sector and Development with you. This bimonthly magazine aims to compare the opinions of Proparco's community of investors with those of academic experts and members of civil society on the role the private sector plays in the development of South countries.

The private sector is a powerful tool for the development of poor countries. It is both the main engine for growth and job creation and an intermediary for public policy, in particular thanks to public private partnerships. In many countries it also contributes to providing essential services. Finally, even in the poorest countries, external private flows (foreign direct investment and migrant flows) and domestic flows (savings and local investment) are on a much higher scale than the amounts of public aid for development.

Yet literature on this topic remains widely underdeveloped. Private Sector and Development aims to bridge this gap. The magazine will be addressing a wide range of topics: the impacts of mobile telephony on development, the role of the private sector in access to water, the challenges of microfinance…

This first issue is devoted to the lack of access to financing for African SMEs which constitutes one of the main bottlenecks for growth on the continent.

I would like to express my warmest thanks to all the editorial team and to all the contributors to this issue. Their articles break down several preconceived ideas and go much further than simply reminding us of the structural reasons for this situation. Indeed, if credit to Africa's private sector only reaches a maximum of 18% of GDP against over 100% in developed economies (A. Tadesse, E. Sacerdoti), it is not so much due to a lack of profitability in financial intermediation on the continent (M.S. Martinez Peria), it stems mostly from an excessive perception of risk by local and international financiers (P. Collier, J. Lefilleur). Yet the experience of practitioners who have accepted to devote human resources to this market segment (P. Derreumaux, P. Hoppenot) shows that the activity of financing SMEs can indeed be profitable. This observation is also shared by all the financial intermediaries that PROPARCO has been supporting on the continent for thirty years.

As Paul Collier points out in his article, the publication of this magazine coincides with an economic crisis that may well once again reduce the availability of financing for African SMEs. This would seem somewhat illogical insofar as everyone agrees that African growth will remain much higher than in OECD countries, in particular due to the rise in demography and urbanization which are for the first time leading to the emergence of a vast domestic market.

This crisis also highlights the importance of convergence between the private sector and the public sector and underscores the need to seek economic models that reconcile profitability and developmental, environmental and social impacts. This magazine aims to contribute to the debate on the role of the private sector in this process; it is not intended to belong to Proparco alone, but to be a tool for dialogue among all the members of this North-South community who are interested in these issues.

Please do not hesitate to subscribe to this free magazine and pass on the word!

With my very best wishes.

Paul Collier is the author of *The Bottom Billion*, a book widely-acclaimed by both the press and his peers, and is an internationally-recognized academic. He has written several articles on access to finance in African countries. After leading the World Bank Development Research Group for several years, Paul Collier was appointed head of the Centre for the Study of African Economies at Oxford University. His article helps us place the issue of financing African SMEs in the context of the current global financial crisis.

Rethinking Finance for Africa's Small Firms

African banks had just started to show interest in SMEs when the global crisis reversed the tide. The risk for SMEs is that they will suddenly be barred access to credit whereas they need long-term financing more than ever before and Africa's financial systems are unable to meet this demand. This situation will only improve if there is a better dissemination of information on SSA's markets that would make it easier for investors to identify high-quality SMEs. An appropriate use of new information technologies should provide the solution.

By Paul Collier, ***Director of the Centre for the Study of African Economies at Oxford University***

I start with two brute facts of finance. Providing finance for Africa is generally rated as riskier than for other regions. Providing finance for small firms is globally rated as riskier than for large firms. The provision of finance for small African firms unfortunately brings together these two high-risk characteristics. During the recent global economic boom investors chasing returns in the face of high asset prices became willing to accept higher risks. Small African firms were just beginning to benefit from this reassessment when the boom collapsed, inducing a massive reaction in the opposite direction: the appetite for risk evaporated and with it the scope for private finance for Africa's small firms. Does this matter and, if so, what can be done about it?

Banks' reluctance to lend

For many years Africa's formal banking system faced both high risk and high transaction costs in lending to small enterprises. Such impediments largely precluded their access to formal finance.
For example, a survey which tracked bank borrowing by manufacturing firms in six African countries during the 1990s found that among those firms which wanted a loan, small firms had had substantially worse chances of getting one (Bigsten *et alii*, 2003). The study controlled for many firm characteristics such as profitability and concluded that systematic bias by lenders was the most likely explanation. Indeed, banks in Africa did not need to develop the business of lending to small firms: they were operating profitably via the easier and safer role of lending to large firms, and by holding high-yielding government debt.

As long as African economies were stagnant, this lack of finance for small firms was not that important. Growth was constrained primarily by a lack of investment opportunities so that the lack of finance was not a binding constraint. However, the extensive reforms of the 1990s in the real economy substantially raised the return on capital. Recent research compares the return on capital around the world using three different sources – firm surveys, company reports for firms listed on stock markets, and data on American foreign direct investment (Collier and Warnholz, 2009). All three sources find that Africa now has the highest return on private capital in the world. In this context, finance is likely to matter more for growth.

Paradoxically, it is when firms are growing that they are least able to finance investment opportunities from retained earnings because while growth may expand investment opportunities, it also squeezes cash flow. The deterioration in cash flow occurs because growth implies that next-period output is larger than previous-period output meaning that financing needs for future inputs are large relative to the revenues received from past sales. During the boom African economies were briefly growing at around 6 percent, finance was therefore likely to be a binding constraint for many small firms. The global recession has punctured this phase of rapid growth but Africa is still projected to keep growing: the March 2009 IMF forecast predicts a region-average growth rate of 3.2 percent in 2009, markedly higher than the negative growth projected for the OECD.

Global crisis bites

While the recession has clipped African growth it is probably squeezing the finance for small firms much more drastically. The African financial sector largely avoided the first round of the financial crisis, but second-round repercussions are now ...

Rethinking Finance for Africa's Small Firms

By Paul Collier, *Director of the Centre for the Study of African Economies at Oxford University*

... starting to matter. Many of the banks are foreign-owned and, as in other countries with foreign banks, are reallocating liquidity from their overseas branches to their home economy. This is compounded by the rapid fiscal deterioration of many African governments caused by the fall in revenues from commodity exports. Governments will need to borrow and, with the collapse of the international appetite for risk, will have to rely upon selling debt to their domestic market. Public borrowing from the banks will consequently crowd out private borrowing.

Both of these effects imply that banks will lend less to firms. Yet this reduction in the availability of credit is occurring at a time when firms are themselves being squeezed. During this squeeze, large firms will be in a better position to meet their financing needs than small firms. Some large firms hold substantial deposits in the banking system and can simply run them down.

Further, as noted above, large firms are better-placed to borrow. There is already anecdotal evidence that they are scooping up available finance from the banks. Finally, in normal times large firms extend trade credit to small firms. This is a reflection of their superior financial position: they lend to small firms because they face a lower cost of credit. However, when their own need for credit increases, large firms have the power to reduce trade credit: they protect themselves from catastrophe while small firms are forced into bankruptcy.

This suggests that the global crisis will lead to a deterioration in the already limited access to credit for small firms and that this in turn will reduce growth. The lack of finance for small firms does matter, so the question is what can be done about it.

System ill-equipped

Manifestly, a global recession of uncertain magnitude during which the appetite for risk has collapsed is the worst possible moment to expand investment finance for small African firms. Further, Africa's current financial system is ill-equipped to mediate such flows: it is designed to provide large firms with short-term loans. This is not a viable contractual form for high-risk investment financing. From the perspective of banks, if the investment fails they are exposed to the risk of default whereas if it succeeds they have little participation in the returns. From the perspective of firms, to finance a long-term commitment by means of a short-term facility at a time when banks are likely to be curtailing lending is a recipe for bankruptcy. In a high-risk environment what is most needed is long-term equity.

"The African financial sector largely avoided the first round of the financial crisis, but second-round repercussions are nowstarting to matter."

In turn, the provision of equity needs a supporting institutional infrastructure within which risks can be assessed and contained. I see no alternative to building these institutional foundations for risk capital.

Information technologies the way ahead

The institutional foundations involve improving information and the legal protections of investors. Verification systems that record small firms' transactions are needed so that they can build a track record. This information can then be linked to promising innovations in the international organization of microfinance such as those implemented by Kiva. The innovative use of information technologies applied to the linkage between firms and finance also needs to be harnessed in order to build the foundations of information.

Despite the global recession there is considerable potential for finance from the social enterprise sector: Grameen and BRAC have both demonstrated this potential. However, it is important that these flows should not become quixotic. While microenterprises show the most evident social needs, the widest scope for impact on the economy is, I think, at the next level up: small firms that could potentially grow into large ones.

If social enterprise finance confines itself to those tiny enterprises that are socially most appealing, and even worse if it ends up with poor returns on invested funds, it will reinforce the perception that Africa's small firms are not appropriate recipients of private capital.

The key role of social enterprise finance is not to provide subsidized money, but to pioneer and demonstrate that new channels are viable for private investors. Information technology potentially enables these costs of information on firm performance to be sharply reduced. That, to my mind, is the key missing link. ●

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SME FINANCING IN SUB-SAHARAN AFRICA

Maria Soledad Martinez Peria is a Senior Economist at the World Bank and a specialist in banking sectors in developing countries. In this article, she shares her extensive experience of SME financing in different parts of the world. The comparative approach she uses allows us to situate SME access to credit in Africa vis-à-vis the rest of the developing world.

Bank financing to SMEs: what are Africa's specificities?

Using bank survey data, this article compares the scale and type of bank lending to SMEs in Africa to that available outside the region. The data shows that bank financing to SMEs in Africa is less significant, more short-term, and more expensive than in other developing countries.

By Maria Soledad Martinez Peria[1], ***Senior Economist at the World Bank***

Maria Soledad Martinez Peria
World Bank

Maria Soledad Martinez Peria is a Senior Economist in the Finance and Private Sector Development Team of the Development Economics Research Group at the World Bank. Her published work has focused on banking systems and access to finance in developing countries. She is currently conducting research on bank financing to SMEs, the impact of migrant remittances and the consequences of the recent financial crisis. Prior to joining the World Bank, Ms Martinez Peria worked at the Brookings Institution, the Central Bank of Argentina, the Federal Reserve Board, and the IMF. She holds a PhD in economics from the University of Berkeley and a BA from Stanford University.

Policy-makers all over the world show a keen interest in the subject of SME financing. This can be explained by both the contribution that SMEs make to the private sector and the common perception that SMEs are credit constrained. These are significant factors for African economies where SMEs account for close to 50 percent of employment[2]. Furthermore, enterprise surveys conducted by the World Bank reveal that close to 40 percent of small firms and 30 percent of medium-sized firms perceive access to finance as a major stumbling block to the growth of their operations[3].

African banking survey

Using newly gathered data collected through a survey of banks conducted in 2007/8, this article quantifies the scale and type of bank lending to SMEs in Africa and compares it to lending available to SMEs in the rest of the developing world (see also Beck *et alii*, 2008). We specifically analyze information obtained from 16 banks in 8 African countries (Ethiopia, Kenya, Malawi, Sierra Leone, South Africa, Swaziland, Zambia, and Zimbabwe) and from 64 banks operating in 30 developing countries outside of the region. The banks included in the survey are among the largest 5 in each country.

We compare bank financing to SMEs in Africa vis-à-vis financing available in other developing countries from various standpoints. First, we examine the scale of financing by comparing the share of loans directed to SMEs (as a percentage of total lending) and the percentage of applications approved (out of total SME loan applications received). Second, we consider the type of lending by comparing the percentage of SME loans devoted to investment and the share of SME loans that are secured. Third, we examine the cost of SME lending by comparing the fees and interest rates charged on these loans. Finally, we analyze the riskiness of SME loans by comparing the share of non-performing SME loans in Africa with the rest of the developing world. The table p.5 displays the results.

Low levels of financing in Africa

Our data shows that bank financing to SMEs in Africa is less significant and more short-term than in other developing countries. This is particularly the case for small firm financing. In the large group of developing countries, bank loans devoted to financing small firms average 13.1 percent, while only 5.4 percent of loans are allocated to such firms by banks in Africa. Similarly, bank approvals for loan applications by small firms in non-African developing countries average 81.4 percent, whereas only 68.7 percent of such applications are approved by banks in Africa. Furthermore, while an average of 47 percent of small business loans are used to finance investments (as opposed to working capital) in non-African developing countries, the figure only reaches 28 percent in African countries. Importantly, all these differences are statistically significant.

Bank lending to SMEs in Africa is also more costly than in other developing countries. Fees charged on SME loans in Africa - an average of 1.97 percent of the loan value for small firms and 1.79 percent for medium-sized firms - are generally almost twice as high as in other developing economies. Interest rates on SME clients are also 5 to 6 percentage points higher on average in Africa than elsewhere in the developing world. For instance, banks in Africa charge on average close to 15.6 percent for loans to their best small firm borrowers, whereas interest rates in other developing countries hardly exceed 11 percent for these clients.

At the same time, SME loans in the region appear to be riskier than those in other developing ...

Bank financing to SMEs: what are Africa's specificities?

By Maria Soledad Martinez Peria[1], *Senior Economist at the World Bank*

... countries. This may be at the root of the higher interest rates observed in Africa. Indeed, the share of non-performing loans (NPLs) among small firm loans in Africa averages 14.5 percent compared to 5.5 percent in other developing countries. The NPL ratio for medium-sized firms is also higher in Africa (6.8 percent) than in other countries (5.1 percent), but the difference in means is not statistically significant.

Why African banks are reluctant to finance SMEs

How can we explain the differences found in the scale, cost and riskiness of bank financing to SMEs in Africa compared to the rest of the developing world? While a full analysis of this issue is not possible here, banks' responses to questions on the factors that drive and impede SME financing across countries can prove revealing (see figures opposite). In non-African developing countries, more than three quarters of banks respond that the perceived profitability of the SME segment is a key driver for their involvement with SMEs, whereas only two thirds of African banks point to this factor as being important. At the same time, less than 40 percent of banks in non-African developing countries indicate that macroeconomic factors are a significant obstacle to their involvement with SMEs, yet 60 percent of banks in Africa point to the state of the economy as constraining their involvement with these businesses. These responses suggest that policy-makers in Africa have a role to play - more so than elsewhere in the developing world - in helping to promote SME finance by adopting sound macroeconomic policies that reduce risks and increase profitability when doing business in Africa and financing firms in the region. ●

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[1] *The views expressed in this article are my own and do not represent the opinions of the World Bank or its Executive Directors.*
[2] *IFC Micro, Small and Medium Enterprises Database. http://rru.worldbank.org/Documents/other/MSMEdatabase/msme_database.htm*
[3] *Calculations made using data from enterprise surveys available at http://www.enterprisesurveys.org.*

Testing for differences in firm financing features between banks operating in African and in non-African developing countries

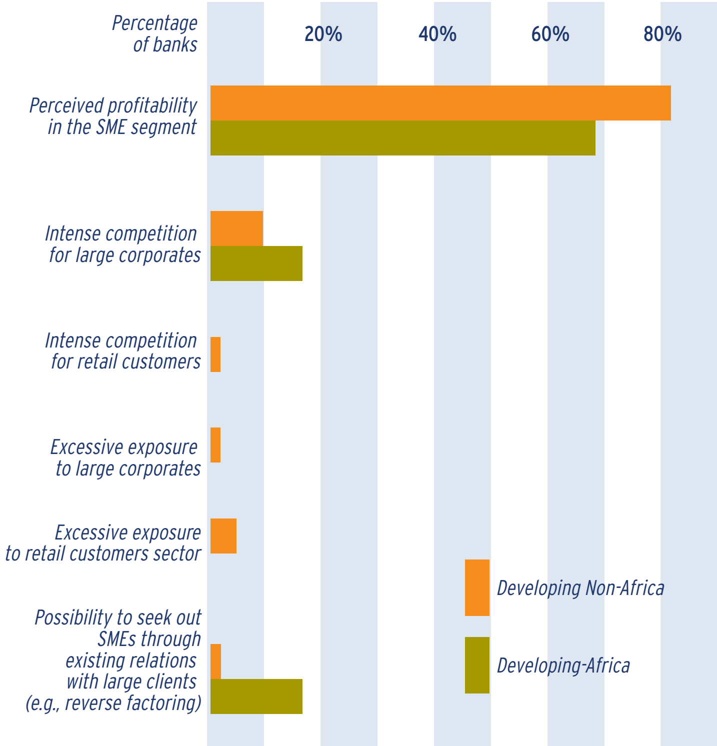
Variable	*Firm Type*	*Mean for Non-African developing countries*	*Mean for African developing countries*	*t-test for differences in means developing- Africa vs. developing-non-Africa*
Share of total loans (%)	SEs	13.05	5.44	-2.21**
	MEs	13.88	12.83	-0.17
Share of applications approved (%)	SEs	81.40	68.73	-1.77*
	MEs	82.36	70.68	-1.28
Share of loans for investment (%)	SEs	47.01	28.24	-2.36**
	MEs	47.23	37.04	-1.27
Share of secured loans (%)	SEs	81.71	74.40	-0.73
	MEs	83.29	79.33	-0.50
Loan fees (% of size of loan)	SEs	0.95	1.97	2.61**
	MEs	0.81	1.79	2.51**
Interest rates on best clients (%)	SEs	11.12	15.66	2.22**
	MEs	9.68	15.42	2.88**
Interest rates on worst clients (%)	SEs	15.43	21.45	2.63**
	MEs	13.58	20.08	3.02***
Share of non-performing loans (% of total loans)	SEs	5.47	14.47	2.05*
	MEs	5.07	6.84	1.00

SE stands for small enterprises. ME stands for medium-sized enterprises.
,,*** denote significance at 10, 5, and 1 percent, respectively.*

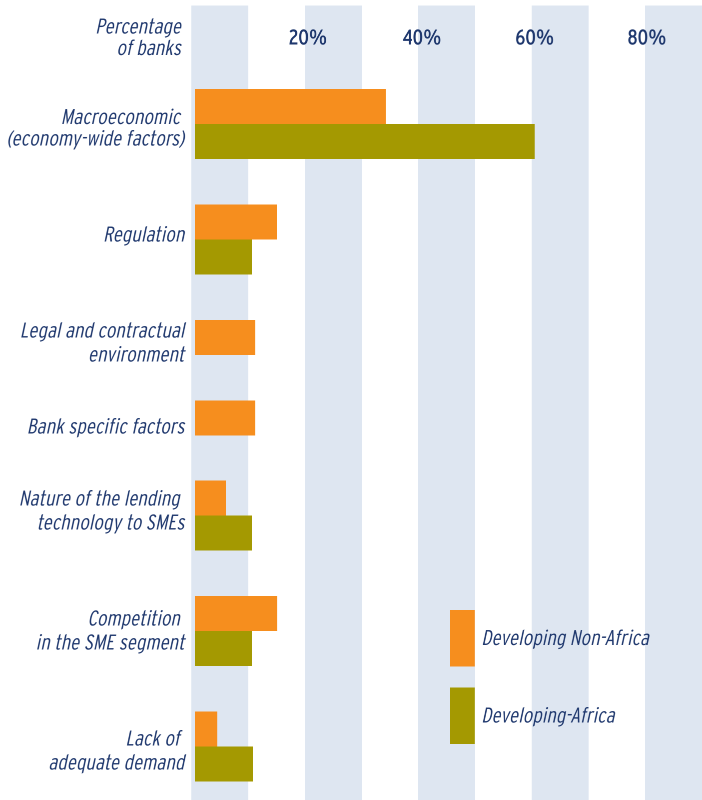
Bank financing to SMEs: what are Africa's specificities?

By Maria Soledad Martinez Peria[1], ***Senior Economist at the World Bank***

Key drivers for bank involvement with SMEs, by type of country



Key obstacles to bank involvement with SMEs, by type of country



SME FINANCING IN SUB-SAHARAN AFRICA

Emilio Sacerdoti has held several managerial positions in connection with Africa at the IMF and has gained extensive experience in the different financing issues facing the continent. In this article, he puts forward a macroeconomic approach that allows us to take an objective look at the issue of financing Africa's private sector in general and provides us with observations on the last ten years.

Credit to the Private Sector in Sub-Saharan Africa: Developments and Issues

Despite signs of progress, SSA is still lagging compared to other regions when it comes to scaling up the volume of loans allocated to the private sector. If it is to catch up, some progress needs to be made in areas such as information dissemination, the appropriateness of bank products, the regulatory environment and loan securitization. The last aspect is essential for SME lending activities, as the latter generally cannot provide sound guarantees. This issue of securing loans could be overcome by applying the principles of microfinance to SME financing.

By Emilio Sacerdoti, ***Advisor at the African Department of the International Monetary Fund***[1]

It is well documented that financial deepening is much less developed in SSA than in most of the emerging market countries, with some exception such as South Africa and Mauritius, which have developed financial systems. Yet great strides have been made over the last decade and this has helped boost GDP growth rates in SSA countries. Since 2000, most of these countries have seen higher growth rates for private sector credit than for nominal GDP. The trend is encouraging and has been underpinned by lower inflation in most African countries and headway in liberalizing interest rates and foreign exchange markets which has given banks more flexibility to mobilize and allocate financing to creditworthy borrowers.

Africa lagging

Yet despite these encouraging results, the ratio of credit to the nongovernment sector to GDP remains relatively low. In most SSA countries, even those where growth performance has been high over the last decade (Benin, Burkina Faso, Ethiopia, Ghana, Mali, Mozambique, Niger, Rwanda, Tanzania, Uganda, Zambia...), the ratio of bank private sector credit to GDP was still under 20 percent in 2007 (see table p.9). Indeed, in 2007 few SSA countries reached ratios of over 20 percent: Botswana, Kenya, Nigeria, Senegal, Swaziland and Togo (20 to 25%), Seychelles (35%), Cape Verde and Namibia (roughly 50%), and Mauritius and South Africa (over 75%).

In contrast, over the last decade this ratio has risen sharply in many of the world's emerging market countries where financial intermediation had previously tended to be low. In Latin American and Asian countries such as Brazil, Costa Rica, Colombia, Mexico, India and Sri Lanka, ratios were low in 2000 but have risen by half and in 2007 topped the 40 percent mark in most cases. Central and Eastern European countries, where ratios were also low at the turn of the decade, have experienced a credit boom which has pushed the ratio over the 40 percent mark in most countries. Hence, while Africa has seen an overall improvement in the various forms of financial intermediation, the pace of progress has been faster in the rest of the world. This is a source of concern.

There has been much analysis on how to deepen financial intermediation in Africa in order to scale up access to credit, especially for SMEs. What is needed is more reliable systems for collateral, land titles and credit guarantees, that must give sufficient security to creditors; better information systems must be implemented via well -developed credit bureaus; leasing needs to be developed by removing legal and judicial constraints that hamper repossessions; tax rules that prevent lessors from deducting capital depreciation as well as taxes applied to the repayment of principal by lessees must be suppressed; mutual guarantee schemes need to be developed so that SMEs can benefit from the support of other members; instruments are needed to mobilize long-term savings that give longer terms for investment financing; swifter judicial credit recovery procedures are required and judicial systems must be more equitable in terms of debtor protection and creditor claims.

Signs of progress

Over the last decade the African continent has made headway in reforms to improve legal, administrative and judicial arrangements in these areas. But progress has been uneven. Credit information systems have been established in Kenya, Tanzania, Uganda, Mozambique and Zambia, although there is still room for improvement ...

[1] *The views expressed in this article are those of the author and should not be attributed to the IMF, its Executive Board or its management.*

Credit to the Private Sector in Subsaharan-Africa: Developments and Issues

By Emilio Sacerdoti, *Advisor at the African Department of the International Monetary Fund*

... in their operation, as well as in the legal environment allowing for access to this information to non banking institutions.

Accounting standards have improved in many countries and have thus strengthened account transparency. An example is the introduction of the SYSCOA uniform accounting system in Western African Economic and Monetary Union (WAEMU) member countries in 2001. The creation of a regional bond market in WAEMU countries and the start of a similar market in Central African Economic and Monetary Community (CEMAC) countries have also helped mobilize long-term financing; bond markets have deepened in Ghana, Kenya, Tanzania, Uganda and Zambia and have made it easier for larger companies and financial institutions to raise capital. SMEs may not have access to these markets, but they can benefit from their development via support from financial institutions and large firms that can enhance their financing. Payment systems have also improved throughout the continent, facilitating transaction settlements between economic agents.

While these improvements are encouraging, there is still a long way ahead to bring the various institutional arrangements close to best practices. Credit information systems still need to improve in terms of coverage and access, auditing standards need to be reinforced and the small size of markets – with some exceptions such as the WAEMU regional market or the South African capital market – still limits access to long-term financing. More progress towards establishing regional capital markets, such as the efforts underway in the East African Community, will help create deeper capital markets. Due to the limited bond market, regional development banks such as the BOAD in the WAEMU, the BDEAC in the CEMAC area as well as some public national development banks, play an important role in providing long-term financing. The risk is that non-economic factors may influence these institutions' credit allocations. Moreover, these large institutions are not sized to target SMEs and can at best have an indirect effect on SME financing via financing for large firms.

Judicial reforms slow

It is probably fair to say that progress has been slowest in judicial system reforms aiming to strengthen title regimes, particularly land titles, speed up collateral recovery procedures and enforce judgements. It is still a lengthy and difficult process to recover credit or realize guarantees in most countries what explains why banks remain extremely cautious when selecting borrowers and continue to have high collateral requirements. This is particularly true when banks deal with SMEs since it is probably more difficult to realize guarantees with these counterparties than with larger corporate clients that can post better collateral. In many countries borrowers can adopt a series of delaying tactics to block creditors' efforts to collect delinquent loans, recovery fees are high, and accountants and lawyers specialized in insolvency issues are scarce. With low confidence in the mechanisms for collecting overdue loans, it is not surprising that banks remain very liquid and prefer to invest in government bonds.

Private sector access to bank credit is consequently limited. There are no easy solutions to these difficulties, as improvement in judicial and administrative systems may run counter to important vested interests. The title regime is complex on much of the continent as property has been held in communal form and the issuance of individual land titles may go against long-standing traditions.

In addition, efficient judicial systems require the allocation of important additional resources for legal personnel training, court equipment and information systems. Countries facing pressing needs in the social sectors and in basic infrastructure have traditionally neglected these areas.

Firms reluctant to seek loans

Data on SME access to credit is not systematically available. Some information has been collected **...**

Emilio Sacerdoti
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Emilio Sacerdoti graduated from Bocconi University in 1969 and obtained a PhD at Yale University. He was formerly an economist at Banca d'Italia, assistant to the Italian Executive Director at the IMF, economist and senior economist at the IMF and finally division chief and advisor in various IMF Departments. Since 1988, Emilio Sacerdoti has been mission chief to numerous African and Middle Eastern countries and, more recently, mission chief to Madagascar, Gabon, Tunisia, and Niger.

Credit to the Private Sector in Sub-Saharan Africa: Developments and Issues

By Emilio Sacerdoti, *Advisor at the African Department of the International Monetary Fund*

... by a series of World Bank country Investment Climate Assessment (ICA) reports which typically survey a number of firms and collect data on how many firms applied for loans, the number of loan rejections and reasons for them, why firms do not apply for loans... These assessments are, however, made infrequently and general conclusions on credit trends in SSA cannot consequently be drawn.
World Bank ICA surveys in countries such as Cameroon, Kenya, Mali, Rwanda, Senegal, Tanzania and Uganda indicate that most of the collateral posted for loans is constituted by real estate (land and buildings), and, to a lesser extent, by owner's own assets, machinery and equipment and accounts receivable. In Kenya (World Bank, 2004) small firms appear to be less likely to own collateral and are reported to be more credit constrained than larger firms. A larger share of small firms never applied for a loan. It is also worth noting that the ICAs report that a majority of firms surveyed in these countries have never applied for a loan and small firms are more likely never to have applied, although the share of firms that never applied differs from one country to another (it is lower for instance in Kenya than in Tanzania and Uganda). Reasons for not applying include high interest rates, too high collateral requirements, complexity of procedures and no need for credit. It is likely that collateral requirements are heavier in countries where contract enforcement is weaker, stronger enforcement would consequently help expand credit access.

The way ahead

In this environment, microfinance principles, whereby groups of loan applicants are jointly responsible for loan repayments, can help unlock credit in systems where contract enforcement is weak. The main limitation of microfinance is the small size of loans. However, in a number of countries such as Senegal and Benin, the strongest microfinance networks have been able to receive credit lines from traditional banks and have consequently been able to raise loan sizes. This suggests that the development of adequate mutual guarantee schemes among firms could be an important avenue for unlocking credit and promoting credit access for SMEs.
In conclusion, the road for developing access to credit in SSA remains difficult and challenging, but experience in other regions of the world shows that the obstacles can be surmounted if appropriate reforms to address the basic needs of credit systems are implemented. This includes more accurate information, adequate accounting standards, proper product diversification, functioning credit recovery mechanisms and contract enforcement, including for collateral recovery. ●

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Bank credit to private sector as a ratio to GDP (%)

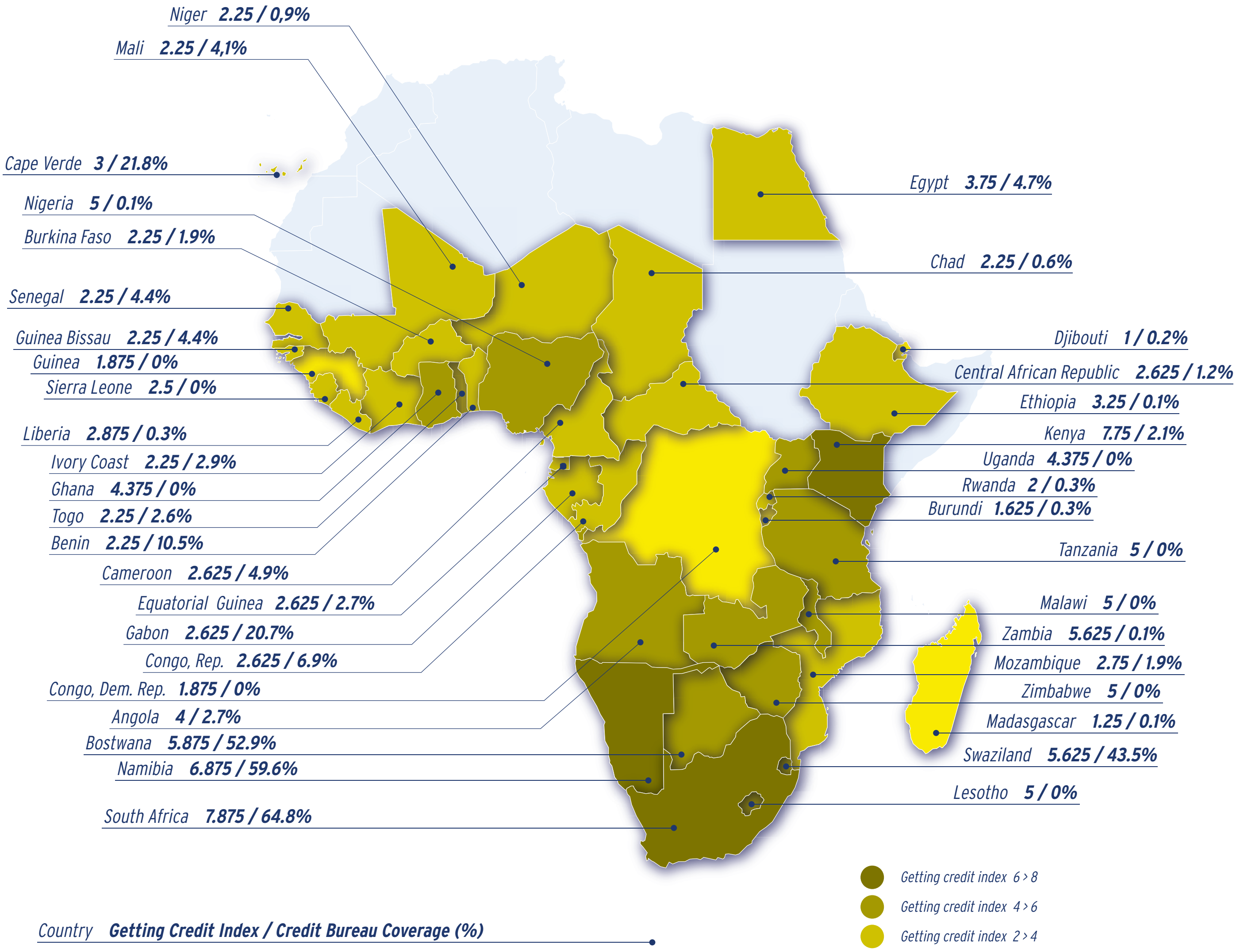
	2000	2007
Angola	1.2	7.9
Benin	10.6	17.6
Botswana	12.5	17.9
Burkina Faso	10.9	16.8
Burundi	17.2	20.1
Cameroon	7.8	8.9
Cape Verde	38.1	44.5
Central African Rep.	4.3	6.4
Chad	3.5	2.7
Comoros	8.4	5.7
Congo, Dem. Rep. of	0.7	2.8
Congo, Republic of	5.8	2.4
Côte d'Ivoire	15.0	14.7
Equatorial Guinea	2.7	2.5
Eritrea	26.5	24.6
Ethiopia	17.9	17.3
Gabon	8.3	10.2
Gambia, The	11.5	14.9
Ghana	1.2	16.8
Guinea	3.5	6.2
Guinea-Bissau	7.2	4.9
Kenya	25.2	25.3
Lesotho	13.9	9.0
Madagascar	8.1	9.0
Malawi	4.6	6.2
Mali	15.0	17.2
Mauritius	56.7	76.7
Mozambique	1.5	1.2
Namibia	42.3	55.6
Niger	4.6	8.8
Nigeria	109	18.3
Rwanda	9.5	10.2
São Tomé & Príncipe	4.2	27.1
Senegal	16.5	21.8
Seychelles	15.4	314
Sierra Leone	1.9	4.5
South Africa	64.5	75.3
Swaziland	12.0	23.1
Tanzania	3.9	12.4
Togo	16.0	18.8
Uganda	5.5	9.6
Zambia	6.7	10.0
Zimbabwe	14.31	157.2

Source: IMF, International Financial Statistics, www.imfstatistics.org

SME FINANCING IN SUB-SAHARAN AFRICA

Key Data

SME access to financing remains more limited in Africa than elsewhere in the world. There are of course considerable differences between African countries, but these financing constraints still remain the biggest stumbling block to the development of these companies on the continent.



Country **Getting Credit Index / Credit Bureau Coverage (%)**

The Getting Credit Index computed by the World Bank measures the extent to which a country's legislative and regulatory environment fosters credit activity. This index takes into account the institutional environment relating to the circulation of information in the financial sector as well as legislation relating to bankruptcy and guarantee enforcement.

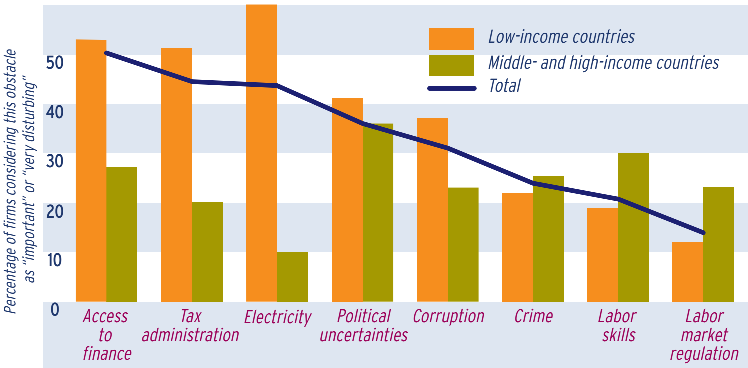
The Credit Bureau (public and private) Coverage, which was also designed by the World Bank, measures the proportion of the adult population for which information on credit behavior is recorded by (at least) one credit bureau in the country.

Source: World Bank

Getting Credit Index and Credit Bureau Coverage

	Getting Credit	Credit Bureau Coverage (%)
OECD	6.01	64
Eastern Europe	5.74	22
Latin America & Caribbean	4.85	44
East Asia & Pacific	5.29	36
Central and South Asia	4.03	8
Sub-Saharan Africa	3.46	13
Middle East & North Africa	3.18	9

Main obstacles to development for Africa SMEs, by type of country



Source: Rapport sur la compétitivité en Afrique 2007, African Development Bank

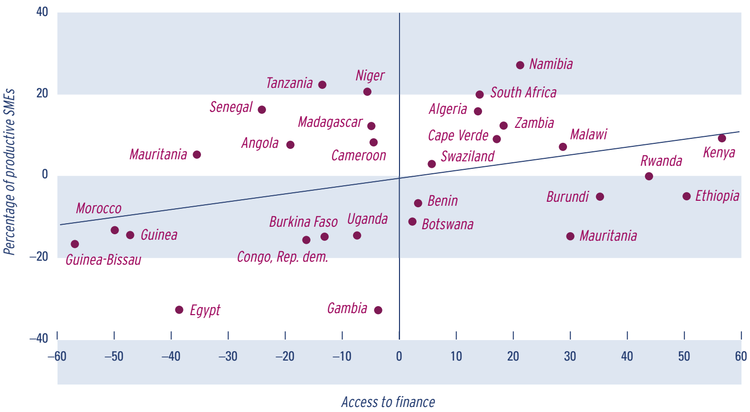
Credit demand and constraints across african enterprises

in %	Small enterprises	Medium enterprises	Large enterprises
No credit demand	34.0	39.8	32.5
Credit constrained*	41.2	28.2	11.9
Received Loan	24.8	32.0	55.6

Source: Investment Climate Surveys. Calculations are based on surveys from Kenya, Madagascar, Senegal and Uganda

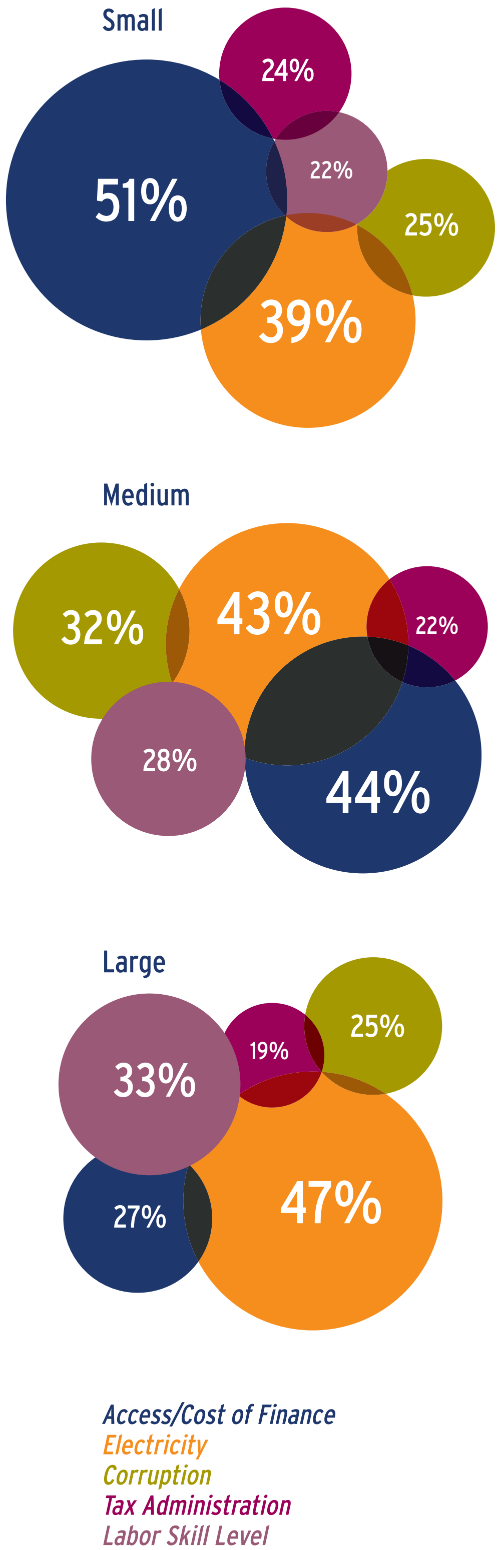
*Includes firms that applied for a loan and were rejected and firms that did not apply since they (i) did not have sufficient collateral, (ii) found the application process too difficult, (iii) found interest rates too high or (iv) espected to be rejected.

Access to finance and productivity of SMEs



Source: Rapport sur la compétitivité en Afrique 2007, African Development Bank
Note: the regressions take into account GDP per capita, the number of years of existence, the scale of exports and the origin of capital. Given that the graph only indicates partial regressions, it shows the expected values considering GDP per capita and the characteristics of the companies. The latter are deemed to be "productive" if their added value per worker is higher than the regional median for companies employing between 11 and 150 people.

Main obstacles to development for African companies, by size of company



Source: Investment Climate Surveys, World Bank

SME FINANCING IN SUB-SAHARAN AFRICA

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.

By Julien Lefilleur, ***Investment Officer at Proparco***

Julien Lefilleur
Proparco

Julien Lefilleur graduated as an engineer from the École Centrale de Paris and obtained a PhD in economics at the Sorbonne University (Paris 1). He is an investment officer at Proparco where he is specialized in Sub-Saharan African financial systems. He is also an associate researcher at the *Development and Globalization* research center at the Sorbonne University.

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 (Africapractice, 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[1] 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 ...

[1] 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"

Financing SMEs in a context of strong information asymmetry

By Julien Lefilleur, *Investment Officer at Proparco*

... 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 (Africapractice, 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 therefore 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[2]. 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. ...

[2] *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

Financing SMEs in a context of strong information asymmetry

By Julien Lefilleur, *Investment Officer at Proparco*

... 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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SME FINANCING IN SUB-SAHARAN AFRICA

The Development Bank of Southern Africa (DBSA) is one of the biggest donors to the private sector in Africa. Although it is more specialized in infrastructure financing, The DBSA also supports SMEs and has extensive experience of Southern African economies. In this article, its Executive Vice-President, Admassu Tadesse, stresses the importance of SMEs in Africa's socio-economic landscape and puts forward solutions to improve conditions for their access to financing.

A Perspective on SME Financing in Africa

SMEs may account for the bulk of firms and employment in SSA, yet they contribute very little to GDP. This is partly due to the financing constraints they meet. However, these firms have considerable socio-economic impacts and it is therefore essential to support their development. In order to do so, bankers and other donors must call on the support of intermediaries that have extensive knowledge of this segment and they must also provide technical assistance in addition to their financing.

By Admassu Tadesse, ***Executive Vice-President of the Development Bank of Southern Africa***

Development of South countries is a challenging pursuit in the 21st century, not simply because we are currently in the grip of a profound global economic crisis, or because Africa - and to a large extent most of Latin America - spent the last two decades of the 20th century locked in economic crises, but also because we are now more aware of the fact that development is as much about empowerment, participation and sustainability, as it is about generic increases in economic activity. In many parts of the world, economic development has, indeed, not managed to adequately create jobs, safeguard the environment or reduce economic inequalities, both between and within countries.

In this context, the role of SMEs has taken on even greater significance both in Africa and all over the world. In SSA, the SME sector accounts for over 90% of all enterprises of which 70 to 80% are micro and very small enterprises. They provide the main source of jobs and income for Africans after subsistence agriculture (see Table p.17). Significantly, African women entrepreneurs own more than half of African SMEs and up to 70% of Africa's vast rural population is active in formal and informal SME sectors. In spite of this, in most African countries SMEs contribute less than 20% to gross GDP whereas the figure can reach up to 60% in high-income countries.

70%
of Africa's vast rural population is active in formal and informal SME sectors

Rationale for supporting SMEs

It is now more deeply understood and widely acknowledged that SMEs play a key role in generating a pattern of economic growth that is generally labour-intensive, pro-entrepreneurship and competitive. This helps contribute to broad-based development and poverty reduction. The relatively minimal capital needs of SMEs generally observed also foster an efficient use of capital, which is a scarce factor of production in developing countries. In addition to these highly desirable social and efficiency-enhancing attributes of an SME-friendly pattern of economic growth, SMEs tend to make use of available local resources, thus minimizing transport and engendering environmental sustainability.

The socio-economic rationale for SME financing, development and support is not difficult to understand. One factor is that SME profits are not dependent on long production runs and small firms can consequently produce smaller quantities to serve small local markets. The SME sector thus serves as a 'nursery' and a proven training ground for 'higher level' entrepreneurship and innovation. Their product ranges tend to reflect local technology and are often seen as more likely to satisfy the needs of the poor than large enterprises' products or foreign technology.

In addition, SMEs not only satisfy local needs by making differentiated varieties of products, by being spread all over the country they also help ensure some form of equitable distribution of income-earning opportunities. SMEs are also usually locally-owned and controlled: they can therefore strengthen the extended family as well as other social systems and cultural traditions.

For the economy as a whole, Brusco (1992) argues: "Small businesses are likely to be more resilient to depression and to offer a steadier level of employment than large ones; their activities and locations are diverse, they depend on a wide variety of sources and types of raw material, and their owners, ...

A Perspective on SME Financing in Africa

By Admassu Tadesse, *Executive Vice-President of the Development Bank of Southern Africa*

... if only for the want of any alternative, are likely to stay in business and maintain at least some activity and employment in conditions where foreign investors would have closed their factories".

The fact that the vast majority of people in SSA live in rural areas and depend on agriculture and informal economic activities underpins the SME sector's importance to Africa. Indeed, most economic agents produce on a small-scale level, even if many market their commodities through cooperatives or agricultural marketing associations.

Financing SMEs in SSA

Across the board, access to, and cost of, finance are a major development issue in Africa. In recent investment climate surveys of entrepreneurs it was identified as the leading constraint in private sector operations and growth. This is the case in both absolute and relative terms vis-à-vis the severity of finance as a private sector constraint in the rest of the developing world.

The financial sector of most African economies is characterized by very low levels of financial intermediation and weak capital markets which cannot effectively supply the financial resources and other products needed by the private sector, in particular the SME sector, which generally lacks the scale, collateral and relationships for formal financing. This is partly reflected in the ratio of liquid liabilities to GDP, which averages 32 percent in Africa, compared with 49 percent in East Asia and the Pacific and 100 percent in high-income countries. Similarly, the ratio of private credit to GDP averages 18 percent in Africa, compared with 30 percent in South Asia and 107 percent in high-income countries, whereas the ratio of private credit to GDP averages 11 percent in low-income countries in Africa but 21 percent in low-income countries outside Africa.

Existing financial intermediaries in Africa typically focus on a handful of large companies and government bonds. Lending to SMEs is hampered by lack of knowledge of the sector, high transaction costs, limited staff capacity in financial institutions, poor credit culture among some target SMEs as well as underdeveloped tools to identify and mitigate risks associated with lending to SMEs. This results in a preference for large borrowers and the purchase of government bonds. SME markets in SSA are not only small and fragmented, they are severely complicated by lack of information. In general terms, SME financing gaps can be explained by three factors. The first is the merit-based explanation that many SMEs lack the requisite collateral and other risk protection in order to effectively access available loans at competitive prices. The second explanation is the lack of management and absorptive capacities on the part of African SMEs to profitably utilize available capital. The third is that there are extraneous factors that tend to discriminate against SMEs with certain attributes, the main factors being the gender of owners (women-owned enterprises are typically disadvantaged), the age of the firm (newer SMEs with no track record receive little or no financing), the location of firms (rural enterprises, for example, have restricted access to financing), and lack of political (patronage) connections.

The situation is even more challenging when considering risk capital as it is even more difficult to raise than debt capital. Unlike the rest of the world, start-up facilities, venture funds or angel investors are practically inexistent in the region. It has been observed that many venture funds in Africa behave more like private equity funds than real venture funds. Institutional weaknesses and complexities in many of the region's countries do not help improve appetite for SME risk. The informal and family nature of most SMEs in Africa also constitutes a stumbling block. Many potential investors find the lack of information and professionalism in SMEs to be a constraint in their dealings.

From a wholesale DFI perspective, the experience of supporting SME financing has thrown up some important lessons. Firstly, it is very ...

Admassu Tadesse
Development Bank of Southern Africa

Admassu Tadesse is Executive Vice-President of the Development Bank of Southern Africa (DBSA) which is based in Johannesburg. He has worked all over Africa for the past 15 years, particularly in Southern Africa. Admassu Tadesse serves on a number of boards, notably the SADC DFRC Board of Trustees (Deputy Chairman), Proparco, AFD's FISEA Fund, the World Economic Forum's EPA Initiative, and GAIN Africa - a joint initiative of the Bill-and-Melinda-Gates Foundation, the World Bank and the UN. He is an economist, banker and expert in international development finance.

A Perspective on SME Financing in Africa

By Admassu Tadesse, *Executive Vice-President of the Development Bank of Southern Africa*

SME share in employment in Africa

South Africa	21%
Burundi	20%
Cameroon	19%
Ivory Coast	33%
Kenya	38%
Malawi	39%
Tanzania	32%
Zambia	37%
Zimbabwe	15%

Source: Ayyagari et alii, 2007

... important to identify appropriate intermediary partners with adequate commitment and capability to reach SMEs. Secondly, SMEs must be supported with more than just funds. Other non-financial support is needed and must be appropriately focused: industry-relevant advice, financial management tools and affordable business services, market networks, especially linkages with big business and export markets, on the job training... This additional support is crucial in enhancing management capacity, especially in financial and institutional areas, and access to markets.

The way ahead

In spite of the significant contributions made by SMEs to GDP, employment and livelihoods, SSA's SMEs continue to face a plethora of challenges that inhibit their growth and development beyond mere survivalist modes of activity. Access to, and cost of, finance remain two leading constraints.

While there have been substantial and rapid recent improvements in financial sector development in the region, much still needs to be done, especially in the SME sector which is strategically very important as a driver of high quality socio-economic development.

The use of SME facilities, venture funds and targeted equity funds that enable non-specialist SME financiers to partake in SME financing through intermediaries can be an important mechanism for getting long-term development finance into SME development. However, the quality of a SME fund not only lies in its ability to source a diverse group of financiers, it also depends on its knowledge of the sector, its client monitoring and its ability to provide a comprehensive package of finance and advice.

A 2007 report by the African Economic Research Consortium explored the question of the public sector's direct role in financing SME development. It reflected the complexity of the matter when it indicated that public sector initiatives to support the financing of small firms can be justified if market flaws result in access gaps and uncompetitive terms. However, it cautioned that in the absence of market failure, a direct role by the public sector could cause distortions if non-viable firms are subsidized at public expense. It rightly points out that where public sector sponsored interventions are undertaken, the financing gaps must be clear and, more importantly, it must be demonstrated that firms seeking special SME finance actually merit financing. ●

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SME FINANCING IN SUB-SAHARAN AFRICA

Bank of Africa Group is present in 12 countries and is one of the biggest banking groups with local capital in Sub-Saharan Africa. Its strategy focuses on SMEs and it is today one of the most exposed players in this segment of Africa's economy. In this article, Paul Derreumaux, its co-founder and President, draws on his experience at BOA Group and analyzes relations between banks and SMEs in Africa. He is aware of the brakes that are prejudicial to their collaboration and describes the solutions that have been envisaged or implemented at BOA.

The difficulties banks face in financing SMEs in Sub-Saharan Africa: who is to blame?

Firms and banks alike would seem to be responsible for the lack of SME financing in SSA: firms because of their shortfalls in meeting the classic requirements of the banking sector and banks because they could mobilize more resources in order to penetrate the SME segment. BOA's experience has shown that this client base could provide an interesting outlet for banks, provided they tailor their operating methods to the specificities of SMEs.

By Paul Derreumaux, ***Chairman and Chief Executive Officer of Bank of Africa***

Relations between banks and SMEs have always been very similar to those between an old couple who constantly blame each other yet have to live together. This situation is no doubt especially true in SSA where banks have traditionally dominated financial systems, leaving little leeway for SMEs seeking alternative financing to bank loans. As is often the case, both sides share the blame and both actors show real weaknesses in their capacity to respect the requirements and practices of the other. However, profound changes are currently taking place on both sides which bodes well for the medium-term outlook.

Banks have been influenced by their shareholders, their working methods and their management rules, and by the effects of increasingly restrictive regulations, and feel comfortable with reliable financial statements validated by auditors. They also want to see their clients' firms with well-organized and well-managed structures. They always ask firms to give a clear and accurate vision of their future and require them to have substantial equity so that they can face the unexpected. Finally, banks always hope to back up their financing with sound guarantees that allow them to meet the requirements of their supervisory authorities.

It is extremely difficult for SMEs in SSA – regardless of their business or country – to put all this together. Indeed, experience shows that it is impossible for nearly all private firms with local capital - including large firms, as well as firms that have long been in business, have a steady turnover and good profitability - to present all the attributes that would allow them to meet the classic criteria required by banks. Most of the economic apparatus in Sub-Saharan countries thus suffers from a lack of structuring – the exception being major international corporates and State companies – which explains the extent of the difficulties encountered by both banks and SMEs to work together and their constant mutual dissatisfaction. In view of this dilemma, what could be the main respective responsibilities for these two "partners" which cannot do without each other?

Lack of structuring in firms

On the corporate side, banks have three major concerns. The first is the widespread lack of equity in SMEs. This weakness can be explained by promoters' reluctance to seek other shareholders, the scarcity of available treasury, as well as the frequent underestimation of operating and investment costs in budgets and the underassessment of the capital required to reach the target turnover. Borrowing consequently often weighs heavily on financing plans which leads banks to toughen their naturally reticent stance or to ask for a lot of guarantees. An unbalanced financial structure also prevents firms from reaching break-even point and makes them even more vulnerable. The second major obstacle for banks is the lack of organization in SMEs, particularly in terms of human resources, accounting, administrative management and control functions. Business leaders – including in the biggest SMEs – are often the sole decision-makers in their firms. The modest, often fledgling, formalization creates a breeding ground for errors, fraud and works against the regularity of processes. This can be particularly prejudicial for firms in the manufacturing sector, and notably for exporting firms. There is usually too little reflection prior to action, yet such reflection ...

The difficulties banks face in financing SMEs in sub-saharan Africa: who is to blame?

By Paul Derreumaux, *Chairman and Chief Executive Officer of Bank of Africa*

... could help ensure the stability of manufacturing and marketing processes. Control, both internal and by auditors, is pushed into the back seat which makes it difficult to swiftly detect a firm's weaknesses. This can also encourage inclinations towards non-transparency on the part of promoters and can cause banks to lose their equanimity towards SMEs. Finally, the third main obstacle is firms' lack of forward-looking vision. Too many fledgling firms were born on an impulse on the part of the entrepreneur, without any in-depth analysis of the market or competition. This often leads to disillusion in terms of turnover and, consequently, in repayment capacity for bank loans. Too many start-ups oversize their investments when they go into business, instead of designing their project step by step and, as a result, are sure to jeopardize any chance of profitability. Too many budding SMEs make a very sketchy analysis of their potential and growth rates and consequently handicap their future, even if their businesses do get off to a perfect start.

Banks lack dedicated resources for SMEs

Banks, for their part, have at least three significant shortcomings. The first is their weakness in supervising their portfolios. In view of the understandably fragile nature of SMEs in terms of organization and forward-looking vision, bankers should closely follow firms' day-to-day running, the relevance of their investments and the difficulties they meet. SMEs are naturally reluctant to allow banks to fulfill their advisory role, banks should consequently systematically take the initiative, yet they do not do so. This lack of supervision on the part of banks can be explained by several factors: the recent increase in supervision requirements for the main traditional client base (corporates and private clients) imposed by regulations, the lack of time due to the sheer number of extremely varied SME files to deal with, and the low level of profitability of this supervision compared to other activities. This can create a vicious circle, since this lack of supervision actually causes files to deteriorate which in turn makes banks even more averse to SMEs. The second shortcoming for banks, partly responsible for the first, stems from the fact that banking teams lack a specific reference framework based on in-depth experience of SME financing. The diversity of SMEs – in size, sectors, characteristics or in terms of support required – is, of course, at the root of this situation and explains the difficulties encountered when developing solutions. Efforts to improve this are inadequate. In most cases, banks continue to suffer from a lack of departments specialized in SMEs, a lack of procedures adapted to the limited available financial information and supervision indicators, limited innovation capacities in terms of acceptable guarantees and a total absence of specific training in SME financing for credit analysts and client advisors. These are all factors that prevent banks from having any greater interest in SMEs. Finally, the third shortcoming for banks is related to the institutional environment where deficiencies penalize banking activities. Indeed, despite real progress brought about by the Organization for the Harmonization of Business Law in Africa (OHADA[1]), certain lingering weaknesses in the legal framework (for instance, in terms of guarantees' enforcement) and the serious and widespread shortcomings of the legal apparatus make it extremely difficult to recover bad loans. These difficulties reduce interest in SME financing further still and, at the same time, lead banks to impose stiffer conditions for their financing. Similarly, the multiplicity, complexity, and sometimes rather unorthodox pressures from the administration – economic police, tax office, social security – weaken even further SMEs that - pressured by banks - are willing to join the formal sector.

Bank of Africa provides solutions

Under the combined effect of all these factors, SMEs do not obtain the support they require from banks. Yet banks that do take the risk of actively turning towards SMEs suffer from a high rate of non-performing loans and sizeable operating losses and consequently receive a poor return on their efforts. Various solutions that may greatly improve relations between banks and SMEs are, however, gradually being implemented. Four examples can be given based on Bank of Africa Group's experience.

The first – and undoubtedly the most decisive – is risk sharing with other institutions. In addition to the direct interest this has for banks which can minimize potential losses, this sharing promotes awareness among other donors of the essential nature of this public and the inherent difficulty of meeting its needs. Two main approaches are conceivable and are currently being tested by the BOA network. The first is a general approach and involves using a portfolio of guarantee lines granted for a given amount that may be allocated to an SME portfolio freely selected by the bank. The International Finance Corporation (IFC) has ...

[1] *French acronyme for Organisation pour l'Harmonisation du Droit des Affaires en Afrique.*
[2] *Fonds africain de garantie et de coopération économique (FAGACE), African Solidarity Fund (ASF), Fonds de garantie des investissements privés en Afrique de l'Ouest (GARI), Assurance pour le risque des investissements (ARIZ).*

Paul Derreumaux
Bank of Africa

Paul Derreumaux graduated from Sciences Po, the Paris Institute of Political Studies, and began his career at Lille University before leaving for Côte d'Ivoire where he was Advisor to the Ministry of Planning for three years and, subsequently, Advisor to the Cabinet of the Ministry of the Economy, Finance and Planning. He began developing the BOA network in 1982, first in Mali, then in Benin. He is today President of Bank of Africa Group which operates at some 170 sites in 12 countries.

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... allocated this type of guarantee line, covering 50% of risk taken by the bank, to BOA Mali for FCFA 1.5 billion. It should shortly be implementing a similar mechanism for the four BOAs in East Africa for an amount totaling USD10 million. The second approach is based on individual guarantees whereby banks submit files to guarantee funds which study them on a case-by-case basis. These funds have grown in number over the years: FAGACE, ASF, GARI in West Africa, or ARIZ[2] (created by AFD) for the whole of Africa, are some examples. The effectiveness of these mechanisms is, however, closely tied to the quality – which is still often poor – of balance between rigour in managing these funds and flexibility in using the guarantees.

A second conceivable solution for bringing banks closer to SMEs is to create specialized departments within banks. BOA Mali's experience during the operation with IFC showed that this type of specialization can really make a positive contribution. A team of two people, supervised by a foreign technical assistant specialized in this segment, is specifically dedicated to SMEs. Analysis criteria, specifically adapted to the case of SMEs, have been defined for credit supervision. These criteria are based much more on firms' activities and expected incomes than on guarantees provided by promoters. These efforts are a clear example of the bank's will to be at the service of SMEs and mean that the latter can benefit from clearly identified correspondents that use a language they can relate to. Results have so far been conclusive and the same type of organization has been envisaged for other Group structures in the short term.

A third area to explore in order to improve relations between banks and SMEs involves diversifying financing tools offered to SMEs. Leasing and factoring should be included in the range of instruments that can be used. However, the development of these instruments is hampered firstly by the fact that they are often outside the realms of SME culture and, secondly, by regulations that are generally not very favourable for these specialized instruments. Efforts to promote the widespread use of these instruments must, however, be pursued. Indeed, the three leasing companies in the BOA network have been demonstrating their viability and benefits for over 10 years now.

The fourth avenue has as yet not been sufficiently exploited and relates more to the future. It aims to complete and renew the range of guarantees capable of better securing SME files. New areas should be explored besides mortgages which are often inappropriate. For instance, feasible and promising solutions would be the joint guarantee provided by persons known to the bank, the creation – often evoked, but never implemented – of mutual guarantee companies on a sectoral or geographical basis, or partnering of SMEs with major companies via subcontracting (thus providing strong guarantees in terms of levels of activity).

The increase in competition among SSA banks will play a key role during the current changes. It will lead all banking institutions to scale up and accelerate their efforts to ensure they hold a strong position in this important SME segment. States will also have a key role to play. Indeed, the creation of a more explicit legal and fiscal framework that is more restrictive and resolutely turned towards development will be decisive for better cooperation between these two "enemy sisters". ●

Access to credit in different parts of the world

Region	Getting credit	Registering property	Protecting investissors	Enforcing contract
Sub-saharan Africa	114	127	113	122
Latin America and Caribbean	64	93	83	108
Central Asia	107	73	111	70
East Asia ant Pacific	65	70	61	71
South Asia	77	89	74	121
Eastern Europe and Central Asia	42	67	70	54
Middle East and North Africa	113	77	93	113
OECD	37	53	61	36

Source: For each index, the table gives the average ranking for a chosen region. The average ranking is obtained by averaging the rankings of all the countries belonging to the region (the most efficient country being ranked No. 1). Source : Doing Business (www.doingbusiness.org), The World Bank, 2009

Investisseur et Partenaire pour le Développement (I&P) is a private finance company that provides financial and managerial support to microfinance institutions and SMEs in Africa. I&P operates via private equity investments and, in certain cases, loans. In this article I&P's President, Patrice Hoppenot, presents the main stumbling blocks that a finance company can face when seeking to invest in SMEs in SSA and describes the solutions provided by I&P.

Private equity investment in Sub-Saharan African SMEs

SME financing cannot be enhanced simply by scaling up volumes of financing. SMEs need to upgrade so that they can meet the eligibility criteria of bankers and other investors. I&P is aware of the difficulties met by promoters and can - subject to certain conditions - provide equity and loan products as well as technical assistance.

By Patrice Hoppenot, ***Chairman of the board and co-founder of Investisseur et Partenaire pour le Développement***

Patrice Hoppenot
Investisseur et Partenaire pour le Développement

Patrice Hoppenot graduated from the Mines de Paris executive engineering school as a civil engineer and was awarded an MBA from the University of Chicago. He spent the first part of his career in the industry. In 1988, he founded the European private equity fund BC Partners which went on to become one of the major independent financial investors in Europe specialized in LBO operations. In 2001, he set up Investisseur & Partenaire pour le Développement (I&P), an investment company dedicated to promoting entrepreneurs in Africa and investing in SMEs and microfinance institutions. I&P is today present in over ten African countries. Patrice Hoppenot also serves on the boards of several companies listed on the Paris Stock Exchange.

All development players see SME finance in SSA as a key issue: a number of conferences have addressed the topic and new solutions are constantly being sought. Indeed, SMEs create formal employment and help boost the entrepreneurship. They also contribute to the emergence of an industrial fabric that can service the needs of Africa's big corporates which often have to resort to services and products from outside Africa due to the lack of local suppliers. SMEs must have the capacity to boost economic development in SSA, yet SME networks are sadly underdeveloped in many African countries.

Lack of financing may constitute a stumbling block to the development of an SME fabric but unfortunately it cannot be removed simply by scaling up volumes of financing. The issue of SME financing must be addressed in a comprehensive manner and, in particular, by taking into account the needs of these businesses in terms of technical assistance. Indeed, SMEs must be supported so that they can upgrade in order to have access to bank loans and private equity investments by professional investors.

Need to join the formal sector

First of all, SMEs must join the formal sector in order to gain access to financing. Yet formal SMEs in SSA are practically an exception, which is understandable in view of the heavy taxation and costs they are subject to: tax on profits, VAT, social contributions, formal accounting with auditors... They are also a favourite target for tax inspectors which often do not have the most ethical methods. All these costs put a heavy burden on operating accounts. Accounting obligations are an important sign of progress but they are often ill-perceived. These reasons explain why the bulk of SMEs remain in the informal sector where they only have access to informal finance or limited finance from microfinance institutions. Yet formal legal and accounting frameworks can help SMEs gain easier access to bank credit and can help them do business with big clients or clients similar to themselves. They can consequently finance their growth. Unfortunately only a handful of entrepreneurs join the formal sector.

SMEs must upgrade

The problem of access to finance is obviously not resolved by joining the formal economy. Promoters that want to set up and manage an SME and make it viable must have ambition, a sound project, a clear strategy, sufficient resources (with a sizeable amount in equity) to meet financial needs and real management skills. Since promoters generally lack financial resources and tend to underestimate their needs, there are only very few projects that come to fruition. It is therefore a risky business that few investors or bankers accept to finance, unless the promoter controls a sizeable fortune or has sufficient guarantees. SMEs that are efficient, well established in their markets and managed by professional teams are the only ones able to raise funds through borrowing or equity. The solution to the problem of SME financing consequently lies first and foremost in generally upgrading SMEs. It is indeed very unusual to find SMEs with a level of management that allows banks to lend the amounts required with an acceptable level of risk, even if the business does have interesting potential.

I&P provides solutions to promoters that manage SMEs or wish to set up a company by building partnerships with them. I&P provides equity, while remaining a minority shareholder, loans and technical assistance under a "partnership pact" that sets out the conditions for the partnership. A relationship of trust needs to be built between the ...

Private equity investment in Sub-Saharan African SMEs

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... parties. Indeed, promoters often perceive a capital increase or the introduction of a new shareholder as a loss of control and can consequently take up a defensive position.

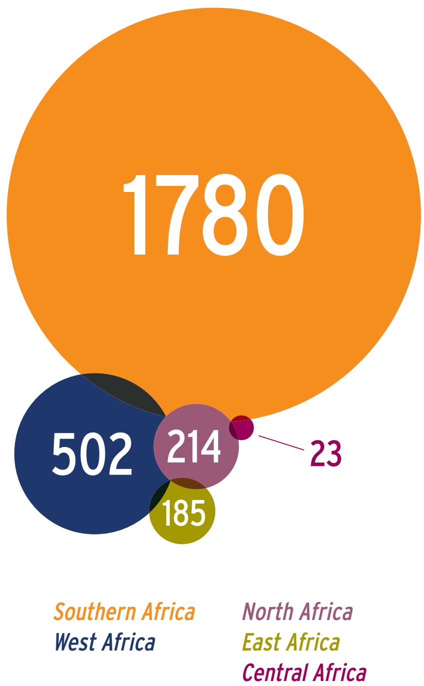
The promoter's main undertakings relate to transparency, implementing a rigorous accounting system, the regular transmission of performance indicators, I&P presence on the Board of Directors (if applicable), sharing important or strategic decisions and consultation with I&P for executive recruitment. I&P undertakes to be available to support SMEs in their development, to help define their strategy and organization and, according to its resources, to provide technical assistance and consulting services that may be required for the SME to improve its performance and acquire expertise in its activity. I&P takes a field approach and its investment officers conduct a minimum of three missions a year to each of its partner businesses. They also have regular contacts with promoters via Internet which means they can monitor businesses and quickly step in when required.

Comprehensive technical assistance

Technical assistance is mainly provided to set up management accounting and performance indicator dashboards that allow the main indicators to be monitored. It is also provided for executive recruitments and the definition of executive positions, industrial management, sales force organization and, more generally, strategy. Technical assistance missions are decided jointly by the investment officer and the promoter. Depending on the type of assistance, missions are conducted by volunteers from "Entrepreneurs & Développement" association (set up by I&P), retired experts and local consultants, particularly for issues relating to accounting and information systems. It is worth noting that I&P's geographical distance from its partners may pose obvious disadvantages, but it does give responsibility to the ...

The rapid growth of private equity in Africa

Private equity investment in Africa is experiencing rapid growth: in 2007, the inflow of private funds in Africa was estimated at USD 3bn (+22% compared to 2006). Yet this amount remains marginal compared to global flows (0.6% of the global total and 7% of the total for emerging countries) and is still focused on certain African countries. South Africa receives the bulk of investments (52%), followed by Nigeria (19%), Zambia (12%), and Morocco (4%). Investments focus on three sectors: distribution (27%), financial services (25%), and telecoms (12%). The main investors, such as ECP, Zephyr Management and Helios Capital, only take positions on mature companies and neglect venture capital and start-up capital activities. Development capital consequently represents 55% of funds raised, while venture capital is only marginal with less than 14% of flows.



Location of Investments (USD millions)

Source: Geiss et Alii, 2008

... promoter and its team. The promoter consequently does not over-rely on I&P and I&P is not tempted to interfere.

Promoting SME autonomy

Once SMEs have upgraded they can refinance themselves via local banks. Working capital finance is often the most needed and the most difficult to finance. The aim of I&P is to allow SMEs to grow, become completely autonomous, profitable and eligible for bank financing. Once they have reached this stage, which can take from a minimum of three years to six or seven years, I&P seeks to sell its shares in agreement with the promoter. This exit strategy may turn out to be a delicate issue in view of the lack of liquidity on these markets. However, I&P can rely on intermediaries that have extensive knowledge of the local market (bankers, businessmen...) and interesting deals always find investors. European firms may even be candidates.

Results from I&P's approach have generally been conclusive since most SMEs that have been partners for over three years have reached profitability. However, it is a costly business (transport, technical assistance, low amounts invested compared to time spent, high risk...). Fortunately, volunteers with extensive experience of SMEs provide support to I&P for business upgrading and the European Union meets part of the cost of technical assistance.

Thanks to these conditions, I&P's approach is sustainable, has an effective impact and its shareholders should receive a small return on their investment. But most importantly, I&P's experience shows how it is possible to finance and promote SMEs in SSA. ●

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Spotlight on an investment in a Nigerien SME

XPharma (name of business undisclosed) is a pharmaceutical distributor with Nigerien capital set up by two local promoters in Niamey in 2001. Two other major pharmaceutical distributors with suppliers in France are also present on the market. I&P contacted XPharma in 2005 at a time when the company was experiencing serious financial difficulties after several years of deficit. The accounts were badly kept due to a lack of skilled staff and the client and supplier accounts were unreliable. Banks had begun to withdraw their financing and the company was finding it increasingly difficult to purchase supplies due to the lack of funds and, consequently, to reach a reasonable level of turnover. However, the promoters were aware of their mistakes and were willing to re-inject capital and review their commercial strategy. I&P had already had a positive experience of a partnership with a pharmaceutical distributor in Mali. It considered that XPharma did have some strong points: an excellent temperature control installation, unexploited commercial potential and, especially, open-minded managers who were willing to benefit from technical assistance and had the capacity to bring in financing. Finally, there was potential to build synergies with the two independent distributors. A full audit conducted by a competent Nigerien accounting firm gave a clear assessment of the financial situation, treasury requirements and the outstanding client debts to be recovered. In 2006 the parties agreed to subscribe to a FCFA 130 million capital increase with a 50% share for the promoters and 50% for I&P which then held 21% of the capital. I&P also allocated a FCFA 65 million subordinated loan with a 3-year maturity that could be converted into shares at I&P's sole discretion. Finally, the promoters managed to mobilize loans from local banks by providing personal guarantees. The company was gradually restructured in agreement with the promoters: an experienced financial director was hired; reliable information and management systems were implemented; the commercial strategy was reviewed to focus more on Niger's underserved interior while continuing to deliver to Niamey's pharmacies; client payments and financial margins were closely monitored. 2006 was still a difficult year due to a few remaining accounting errors and a slower start than expected for activities. I&P decided to convert its loan in 2007 which meant its shareholding rose to 26%. Local banks accepted to finance XPharma's working capital requirements. In 2007 turnover rose by 40% and in 2008 it rose by 30% and reached FCFA 1.75 billion. XPharma's net income for 2008 topped the FCFA 40 million mark. The company today employs around ten people and has become profitable and sustainable.

Lessons-learned from this issue of *Private Sector and Development*

By Julien Lefilleur

Africa's SME fabric remains underdeveloped in comparison with the rest of the developing world. This is partly due to the financing constraints that these companies face. Furthermore, conditions of access to credit for SMEs might suddenly deteriorate with the international crisis as these companies will probably be the first victims of the growing shortage of liquidity. This lack of financing for SMEs can be explained by the fact that classic lenders and investors are highly reluctant to finance these counterparts. In a context of acute information asymmetry, the perceived risks seem indeed insurmountable, especially since it cannot be offset by a satisfying securitization. Moreover, SMEs are often informal, lack organization, and generally do not meet the eligibility criteria of "classic" lenders and investors. In this context, the latter must deploy considerable resources to penetrate this segment and must, in particular, provide technical assistance along with their financing to help companies improve their standards. Experience shows that in these conditions the SME segment can prove to be a profitable market. However, the solution to the problem of SME financing cannot depend only on the goodwill of actors in local financial systems. A substantial and sustainable improvement in conditions of access to resources for these companies requires changes in the credit environment of African markets that would reduce the risk perceived by lenders and investors. This involves developing financial systems that are more adapted to local contexts, in particular by taking advantage of progress in information technologies in order to bridge the gap between banks and SMEs. Similarly, it is necessary to take action to secure credit. The use of the principles of microfinance which allow guarantees to be mutualized within a community of borrowers could prove fruitful. These different possibilities could be explored by donors in order to help improve financing for African SMEs.

Your reactions are welcome: revue_spd@afd.fr

In our next issue

What role can/must the private sector play in access to water and sanitation in developing countries?

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