BOOSTING SME FINANCE FOR GROWTH

The Case for more Effective Support Policies

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CONTENTS

LIST OF FIGURES

LIST OF TABLES

LIST OF BOX

Foreword

Small and medium enterprises (SMEs), which account for about half of employment worldwide, provide livelihoods for billions of people and their families. Hit hard by the pandemic, SMEs needed public financing-support to remain afloat. As the crisis response shifts to recovery, the international development community is renewing focus on the fundamental question of how to help SMEs flourish. Removing the obstacles to their growth and productivity is at the heart of efforts to create more and better jobs and to eliminate poverty.

Access to financing is essential for growth, productivity, and resilience. For decades, governments in emerging market and developing economies (EMDEs) have implemented programs to improve SME access to finance, often at a large budget cost. Yet, the SME financing gap remains large, especially in the least developed countries, and public budgets are tight.

How can governments in EMDEs enhance the effectiveness of support policies for SME finance? This new World Bank report, "Boosting SME Finance for Growth: The Case for More Effective Support Policies," looks at this topic afresh and provides concrete, practical guidance to policy makers. The report draws insights from the experiences of both high-income countries and EMDEs while considering new developments that are changing the landscape of SME financing—such as the rapid emergence of new financial technologies (fintech).

The report calls for governments to prioritize improvements in the enabling environment, such as building the core infrastructure for both debt and equity financing. They should encourage the use of fintech and ensure a level playing field for alternative lenders, including fintech lenders, factoring and leasing companies, and microfinance institutions. These actions carry limited fiscal costs but could bring sizeable benefits.

Public financing programs are still needed. But governments must adopt a more evidence-driven approach for the design and implementation of support to ensure it reaches the SMEs facing the most critical financial constraints. Robust diagnostics are also essential to tailor interventions to conditions in individual countries, so that they can effectively address the challenges that limit the ability and capacity of financial institutions to reach SMEs. SME finance-support programs should also crowd in private capital. Policy makers must carefully monitor programs for the potential to displace commercial financing, especially programs that provide financing to SMEs at better terms than those available in the marketplace. Such programs can distort incentives for SMEs and for financial providers, limiting market development and availability of financing over the long term. Within this framework, we offer advice for designing and implementing programs to improve both debt and equity financing, through interventions such as lines of credit and public guarantee schemes on the debt side, and investments in equity funds to spur the financing of innovation.

Finally, the report also highlights four cases in which the challenges for SME financing have unique features that require a tailored policy approach: the financing of climate change adaptation and mitigation investments by SMEs, the financing of SMEs in the agriculture sector, the financing of women-owned businesses, and the financing of SMEs in countries affected by fragility, conflict, and violence.

The recommendations in this report should help policy makers ensure that their SME finance programs promote a thriving SME segment, thereby boosting overall economic growth, productivity, and job creation.

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Abbreviations

ADB	Asian Development Bank
agri-SMEs	agriculture SMEs
agritech	agricultural technology
AML/CFT	anti-money laundering and combating the financing of terrorism
ASEAN	Association of Southeast Asian Nations
BIS	Bank for International Settlements
CBA/NCBA	Vodafone and Commercial Bank of Kenya
CCAF	Cambridge Center for Alternative Finance
CDD	customer due diligence
CGAP	Consultative Group to Assist the Poor
CRA	credit rating agency
DFI	development financial institution
DFS	digital financial services
EBA	European Banking Authority
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
EMDEs	emerging market and developing economies
EU	European Union
FCV	fragile, conflict, and violence
fintech	financial technology
GCF	Green Climate Fund
GDP	gross domestic product
GHG	greenhouse gas
GPFI	G20 Global Partnership for Financial Inclusion
HIC	high-income country
ICCR	International Committee on Credit Reporting
IDFC	International Development Finance Club
IFC	International Finance Corporation
ILO	International Labour Organization
IMF	International Monetary Fund
IPCC	Intergovernmental Panel on Climate Change
IPO	initial public offering
KOSDAQ	Korean Securities Dealers Automated Quotations
KONEX	Korea New Exchange
KOSPI	Korea Exchange Main Board
KRX	Korea Exchange
LIC	low-income country
LoC	line of credit
M&E	monitoring and evaluation
MFI	microfinance institution
MIC	middle-income country
MSMEs	micro, small and medium enterprises
NAFIN	Nacional Financiera
NBFI	non-bank financial institution
NDFI	national development financial institution
NGF	National Guarantee Fund (Colombia)
OECD	Organisation for Economic Co-operation and Development
PCG	partial credit guarantee
PCGS	public credit guarantee schemes
PE	private equity
R&D	research and development
RXIL	Receivables Exchange of India Ltd
S&P	Standard and Poor's
SAFE	simple agreement for future equity
SMEs	small and medium enterprises
UMIC	upper-middle income country
UNEP	United Nations Environment Programme
USAID	US Agency for International Development
UNSGSA	United Nations Secretary-General Special Advocate for Inclusive Finance for Development
VC	venture capital
WSMEs	women-owned (and led) SMEs

Executive Summary

New research by the World Bank demonstrates that removing debt and equity financing constraints for small and medium enterprises (SMEs) can lead to significant gains in productivity, growth, and resilience.[1] SMEs in emerging market and developing economies (EMDEs) often consider the constraints in access to finance one of the top obstacles for business operations and growth. Indeed, smaller private firms face the largest financing constraints in middle-income countries (MICs). Removing financial frictions and distortions, thereby relaxing access to finance constraints for firms, could result in large productivity gains of up to 86 percent in MICs, with the largest gains observed among MICs with lower levels of gross domestic product (GDP) per capita. Financial constraints hinder not only the productive growth of SMEs, but also their ability to cope with adverse shocks. World Bank research shows that, during the pandemic, firms with access to external financing were better able to maintain employment levels and avoid falling into arrears. Smaller private firms had the highest probability of being financially constrained during the pandemic.

Governments have implemented different types of interventions to address the constraints hampering SME access to finance, but huge financing gaps remain. These constraints stem from the characteristics of SMEs (high credit risk, opacity, and lack of suitable collateral). In addition, lending to SMEs is marked by higher transaction costs when compared to large corporates, partly because of the smaller transaction size. These challenges are often heightened in EMDEs given additional supply-side shortcomings, such as the lack of competition in the banking sector, missing markets (for example, the lack of equity markets in some countries), and inadequate enabling environments that underlie private financing to SMEs. As a result, governments have deployed a wide set of interventions to support the enabling environment (for example, development of credit-reporting systems, secured transactions and collateral registries, and insolvency regimes) as well as targeted interventions to directly affect the supply of financing with fiscal costs (for example, lines of credit, partial credit guarantee schemes, and, increasingly, investment programs in venture capital funds). Yet, the credit gap for SMEs in EMDEs persists. The most recent estimates for the formal micro, small, and medium enterprises (MSMEs) sector as a whole place this gap at 19 percent of GDP as of 2020 (about US$5.7 trillion).[2] Similarly, the private markets for equity financing have remained underdeveloped.

Thus, the case for government support remains compelling. The need for further progress in closing the financing gaps, heightened by recent global developments that are changing the landscape of SME financing—such as the rapid emergence of new financial technologies (fintech) and the growing challenges posed by climate change—require governments to review their toolkit of interventions to maximize the effectiveness of support policies. This report supports such review by building on the experiences of both high-income countries (HICs) and EMDEs to draw insights and lessons to inform the range of interventions that governments in EMDEs should pursue to close the SME financing gap.

The Evolution of SME Financing

Banks in EMDEs remain by far the main providers of financing for SMEs. But the SME loan portfolios of banks in EMDEs remain significantly smaller than those of banks in HICs. Although SME loans have expanded in real terms between 2010 and 2020, they have declined as a share of GDP in MICs and HICs. For example, estimates in this report show that SME loans in HICs amounted to 12 percent of GDP in 2020, compared to 7 percent for MICs and 3 percent in low-income countries (LICs). Similarly, private markets for equity financing, which are critical to spur innovation, remain small in most EMDEs. Venture capital (VC) investments stood around 0.01 percent of GDP or less in EMDEs, and only a handful of countries have markets with greater depth.[3] The bulk of equity investments in private markets in EMDEs is concentrated in larger firms, more so than in HICs. Even then, the financing of mature SMEs remains underdeveloped. Including buy-out funds and growth equity, private equity (PE) funds represented 0.03 percent of GDP in MICs in 2020 versus 0.3 percent in HICs.[4]

While fintech is helping financial intermediaries reach SMEs and alternative sources of financing are expanding in select

EMDEs, the aggregate impact remains unclear. Case studies and anecdotal evidence suggest that some banks in selected HICs and EMDEs have improved their outreach to SMEs via the use of fintech—directly or via partnerships—such as embedded finance. Nonetheless, research is still inconclusive regarding the full scope of this increased outreach. Progress has been made toward expanding the range of alternative lenders. Some of these new lenders—especially, fintech lenders (digital banks and fintech lending platforms in particular)—have reached underserved SMEs, albeit mostly for short-term financing thus far. In addition, asset-based lenders are providing working capital to SMEs (for example, through factoring) and financing for investments (for example, via leasing). Capital markets solutions have also helped diversify the range of funding sources for SMEs, which can be important in turbulent times, supporting firm resiliency, as well as in normal times, supporting better financing conditions for SMEs. Specialized SME exchanges have emerged in some EMDEs, enabling SMEs to access financing from a wider range of investors for SMEs. Yet all these alternative sources of financing remain small in most EMDEs and are mostly concentrated in large, more developed EMDEs.

A Road Map for Enabling SME Finance

Governments should prioritize the implementation of an enabling environment to support SME financing. This agenda carries very limited fiscal costs, while the benefits could be sizeable. Many EMDEs have embarked on this work, but it is time to deepen and expand it. Policy makers should aim at building the core market infrastructure, fostering increased use of fintech, ensuring that an enabling environment for alternative lenders and for equity financing is in place, promoting market competition, and addressing concerns related to consumer protection. The following road map, which is consistent with the 2022 Updated G20/OECD High-Level Principles on SME Financing, outlines a list of key actions EMDEs should implement urgently, with due consideration to country contexts.

- **Action 1. Continue enhancing the availability of SME credit information.** Governments should continue to actively promote the development of credit-reporting systems, paying special attention to expanding their coverage to include alternative lenders and leveraging alternative data.
- **Action 2. Complete the enabling environment for asset-based financing, including the implementation of movable collateral registries.** The adoption of modern secured transactions laws, covering, for example, factoring and leasing, along with the implementation of movable collateral registries that formalize and provide transparency to lenders' claims, are critical to expanding asset-based financing. Lessons indicate the importance of expanding the range of assets that can be given as collateral, adopting notice-filing, online centralized (or interoperable) movable collateral registries, and effective out-of-court mechanisms to execute collateral. Other government initiatives, such as e-invoicing, should be leveraged to further the development of markets for receivables.
- **Action 3. Overhaul insolvency programs.** Specialized SME insolvency regimes should be implemented to lower barriers and improve access to out-of-court restructuring procedures and to simplify in-court insolvency proceedings to reduce their cost and complexity.
- **Action 4. Complete the enabling environment for alternative sources of financing.** Governments should support the development of a wide set of alternative lenders that can foster greater outreach to SMEs. Depending on country context, especially the level of financial sector development, the enabling environment policy agenda should include proportionate licensing regimes for microfinance institutions (MFIs), cooperatives, and fintech lending platforms; adjustments to bank licensing regimes to allow the entrance of digital banks; and, in MICs with more developed capital markets, an enabling environment for capital markets solutions supporting financing to SMEs.
- **Action 5. Foster competition.** Fintech and alternative lenders can change market structure and competition dynamics in a way that would hinder SME financing. Key areas to monitor include market entry requirements and coverage of credit reporting systems, with consideration given to the implementation of open finance programs. Governments can also explore innovative interventions, such as platforms to bring multiple financial providers together and foster competition.
- **Action 6. Develop the enabling environment for equity financing.** Focus on private markets and allowing SMEs to raise funding directly, without triggering the disclosure and governance requirements of a public offering. Depending on country context, governments should develop the enabling environment for private funds and equity crowdfunding. In EMDEs with more developed equity markets, governments should strengthen the enabling environment for SME listings.
- **Action 7. Enhance consumer and investor protection.** Governments should ensure that their frameworks against deceptive and fraudulent practices apply to new providers of financing, and across all types of

delivery channels. For capital markets, there is a need to balance easing SME access to retail investors with investor protection.

- **Action 8. Establish robust foundational infrastructure.** Digital connectivity and digital payment services are essential to leverage fintech for SME financing. Online business registration as well as broader digitalization of business operations can also support access to finance by helping SMEs build "reputational collateral" and thus a more robust credit footprint.

Toward a More Effective Use of Targeted Public Interventions

Enabling environment interventions are necessary, but they are not always sufficient. Targeted financial interventions—which carry fiscal costs but can mobilize private investment—may still be needed. In practice, in most EMDEs, a multipronged approach to public intervention is necessary to address the debt and equity financing gaps. But policy makers must be cognizant of the trade-offs in allocating resources to support each type of financing, especially when fiscal resources are scarce. Debt financing is the most important source of external financing for SMEs in EMDEs, with government support programs exhibiting widespread reach. In contrast, schemes supporting equity financing typically have a more limited reach, covering a smaller set of SMEs due to their high costs. Policy makers should be realistic about not only the desirability of interventions, but also their feasibility and impact, based on their own country contexts. While there is no rigid sequencing in the implementation of interventions, governments need to be mindful of the state of preconditions for different financial instruments. The implementation of well-designed targeted interventions, coupled with improvements in the enabling environment, should enhance SME access to finance. However, without further progress in addressing the underlying causes of the underdevelopment of the financial sector more broadly, the effectiveness of such interventions might suffer. Targeted interventions might help push the frontiers of the financial sector, but they cannot do all the heavy lifting.

Going forward, governments in EMDEs need to substantially improve the design of their targeted interventions to increase their effectiveness. Governments must adopt stronger, evidence-driven approaches to ensure that interventions benefit underserved SMEs and focus on addressing the key market failures and identified gaps. Furthermore, interventions should be designed and deployed in a way that fosters financial additionality and mobilizes additional private financing, thereby promoting the creation of financial markets and reducing the need for public sector support over time. The seven recommended actions that follow outline the agenda to improve the design and implementation of targeted interventions.

- **Action 1. Enhance data availability and diagnostic analyses to ensure outreach to underserved SMEs.** There is no universal model of interventions for all EMDEs to apply. Interventions need to be selected and designed using rigorous data-driven diagnostics of financing gaps and their underlying causes. Most EMDEs would need substantial improvements in data collection, reporting, and accessibility to ensure effective targeting of underserved segments and intermediaries serving them.
- **Action 2. Emphasize financial additionality and private capital mobilization as clear objectives of targeted interventions.** Targeted interventions in EMDEs should mitigate key market failures hindering private financing to SMEs, while making more strategic use of public funds. To this end, governments need to improve the design of interventions so that programs reach their intended beneficiaries, as defined in specific program objectives. Critically, public funds should be used to leverage additional private financing. Governments thus need to carefully evaluate the sustainability of crowding-in effects, while avoiding crowding-out effects.
- **Action 3. Deploy concessional financing sparingly.** Concessional financing should be used only in exceptional circumstances—for example, when it is critical for private capital mobilization—and should include an exit plan. Governments should thoroughly assess (a) whether market failures justify concessionality and determine the objectives to be achieved with its use; (b) the extent of potential market distortions, including crowding-out effects for private capital; and (c) the need to deploy mechanisms to mitigate such risks. Interventions should also embed graduation targets (for both SMEs and financial institutions).
- **Action 4. Leverage developmental finance provided by donors for private capital mobilization.** Governments should systematically map the global developmental financing available in the SME space and leverage it through blended finance structures

to mobilize additional private capital and reduce the need for public financing.

- **Action 5. Complement targeted interventions with non-financial support.** Programs to enhance firm capabilities are critical to building a healthy pipeline of SMEs for lending or investing. Depending on country context, programs to enhance the capabilities of financial intermediaries and investors might also be needed.
- **Action 6. Improve the evaluation of targeted interventions.** Governments should establish robust and independent monitoring and evaluation (M&E) frameworks aimed at better measuring impact, going beyond the typical statistics monitored across EMDEs, such as the number of SMEs and the volume of financing. M&E systems could also guide the design and implementation of policy interventions.
- **Action 7. Improve coordination, including by better leveraging existing development financial institutions (DFIs) while ensuring proper governance.** Governments should better leverage existing DFIs. For example, governments can ensure that any new program aimed at implementing targeted financial interventions is fully coordinated with existing DFI programs. This requires stepping up efforts to improve the effectiveness of DFIs, develop a holistic strategy for SME financing, and enhance day-to-day coordination arrangements. Finally, robust governance arrangements should be in place to (a) mitigate political interference in technical decisions; (b) ensure that political interests do not outweigh long-term program objectives; and (c) ensure proper oversight and accountability.

Debt Interventions

Governments should more deliberately use targeted interventions to foster the development of alternative lenders while continuing to strengthen bank financing for SMEs. Banks have been the key delivery partners for targeted public support. Yet while banks will remain a key funding source for SMEs, they are not sufficient to address the SME credit gap. Alternative lenders are critical to closing this gap. Thus, governments need to use interventions to foster their development. Three consequences of this requirement are the need for governments to (a) reduce the use of direct lending; (b) remove requirements that create undue barriers for alternative lenders to access interventions by relying more on proportionate requirements; and (c) consider the use of targeted interventions to address the constraints faced by alternative lenders. The type of interventions to deploy will vary depending on country context and could include the following.

- **Capitalization of partial credit guarantee (PCG) schemes:** Governments should continue to expand the implementation of PCGs as the key intervention to address problems stemming from the high riskiness (perceived and real) of SMEs, which is heightened by their opacity, lack of collateral, and limited credit histories. The implementation of PCGs, however, is complex and requires a certain level of maturity within institutions to ensure their effectiveness.
- **Lines of credit (LoCs)** should be used more selectively to address gaps in the funding markets that affect the ability of different intermediaries to serve the SME segment. In exceptional circumstances, concessional lines of credit could be used to make lending to SMEs (or a particular segment of SMEs) commercially viable for private lenders and provide better lending conditions to SMEs.
- **Other interventions:** Depending on the country context, governments could consider interventions to foster the development of capital markets solutions that can be used by both SMEs and SME lenders, such as investment programs and credit risk guarantees (or other risk-sharing arrangements).

Equity Interventions

Public interventions supporting equity finance in private markets have faced challenges in mobilizing private investors in many EMDEs, especially in LICs. This limited impact is largely the result of challenges with preconditions, which relate to uncertainty in the macroeconomic and financial environment, the limited development of an investor base, and missing components of the legal and regulatory environment for equity financing. The economic additionality that these interventions could bring for innovation and growth might lead some governments to pursue them, irrespective of the challenges. This could be an acceptable choice; however, in such context, governments should recalibrate the objectives of their interventions, understanding that they need to focus on "market creation"

and that mobilizing private investors would likely require a greater level of financial support across the whole ecosystem for a long period of time. Moreover, governments would need to address the structural problems that have hindered the development of equity financing. In any event, equity interventions, even in MICs, require a longer time horizon to reach sustained impact, with governments being ready to provide patient capital.

Overall, in supporting equity financing through private markets, governments need to apply private sector practices to improve the mobilization of private capital. In practice, this means relying on private sector structures—in particular, funds—to achieve scale and diversification. The management of funds should be professional and independent, free of government interference. Such an approach would ensure that public investments follow the market. There should also be flexibility in the type of financial instruments used, including equity as well as other forms of risk capital, such as mezzanine financing.

In addition, governments need to consider a holistic approach to developing the overall landscape for equity financing, entrepreneurship, and innovation to improve the prospects for effective policy interventions. The scope of support programs would depend on country context. These programs would likely include technical assistance for SMEs as well as support for the creation of other entities that can play an instrumental role in building the deal flow, such as incubators and accelerators. Capacity building to support the development of the investor base might also be needed. Governments in EMDEs should focus on interventions for equity financing in private markets, but for a select set of EMDEs with more developed public equity markets, governments could carefully assess the feasibility and potential impact of other interventions, such as to support SME listings.

The Need for a Tailored Approach for SMEs in Select Cases

Evidence suggests that SMEs face additional challenges to access financing in select cases that require a tailored approach to public support interventions. While there is a need for more data, research, and systematic evaluations that can better guide the design of effective interventions, some relevant cases follow here.

Women-owned (and led) SMEs (WSMEs). Addressing gender gaps in SME financing requires strong commitment from policy makers, starting with the integration of a gender lens in the design of SME access-to-finance interventions. World Bank experiences supporting governments in closing the gender finance gap highlight the importance of earmarking resources for WSMEs and relying on a wider range of financial providers for the deployment of targeted financial interventions. Governments should also place increased attention on the development of customized financial offerings for women entrepreneurs, including alternative delivery channels (that is digital channels), staff training on how to engage with women entrepreneurs, and the provision of tailored non-financial services for WSMEs to complement core financial services. These efforts should be anchored in the collection of gender disaggregated data.

Financing adaptation and mitigation efforts by SMEs. Addressing the impact of climate change on SMEs requires a recalibration of government efforts. First, policy support for SME finance needs to be rebalanced to provide greater attention to climate adaptation investments. Thus far, both policies supporting the enabling environment as well as targeted interventions have emphasized climate mitigation efforts. Second, access to finance for SME adaptation requires a bottom-up approach that prioritizes localized solutions with widespread reach across SMEs vulnerable to physical risks (such as extreme climate events). In contrast, a top-down approach could be a more effective way of supporting mitigation for SMEs. That is, government decarbonization efforts should focus on large businesses, but greater emphasis and support should be given to SMEs that are part of large businesses' global supply chains or those SMEs for which decarbonization efforts might be needed to ensure competitiveness, such as those directly exporting to countries with high sustainability standards. Third, the public good feature underlying adaptation and mitigation investments, which is often perceived as lack of a business case for such investments by individual SMEs, justifies the provision of concessional financing to SMEs. Fourth, the high uncertainty surrounding these investments tends to increase their risk versus conventional investments. Hence, policy makers could place greater emphasis on de-risking adaptation and mitigation financing.

Financing SME investments in adaptation and mitigation requires efforts to complete the enabling environment, but governments should pay close attention to unintended consequences. Taxonomies and climate-related disclosure requirements are essential building blocks of the

enabling environment for the financing of sustainable and climate-resilient projects; but they may have unintended consequences and negatively affect financing to SMEs. For instance, financial institutions may reallocate their loan portfolios away from SMEs highly exposed to physical and transition risks. They may also retrench from borrowers that are unable to provide information on climate-related risks. For SMEs, the need for additional information, and even certification in some instances, would also increase transaction costs and may discourage some SMEs from seeking financing in the first place. Akin to such challenges, if alternative lenders are not able to track climate-related risks in their own lending portfolios, they may face constrained access to funding, hindering their ability to serve their SME clients effectively.

Agriculture SMEs (agri-SMEs). Governments need to place increased emphasis on scaling up commercial financing for agri-SMEs through greater use of risk-sharing mechanisms, such as PCGs, while deploying LoCs conditioned to private capital mobilization. In addition, a wider set of financial providers should be included in these interventions, along with strengthened use of technical assistance. A key additional consideration is the need to incorporate mechanisms to strengthen the resiliency of agri-SMEs to shocks, including through insurance markets, for which public-private partnerships may be needed. Finally, governments should consider demand-side interventions to improve agri-SMEs' integration into value chains, their access to markets, and their business performance.

SMEs in countries affected by fragility, conflict, and violence (FCV). Governments should prioritize the development of the enabling environment, with emphasis on basic credit infrastructure and the infrastructure necessary to leverage fintech. Targeted interventions should focus on unlocking debt financing, especially interventions that address the high riskiness of SMEs, such as PCGs, combined with enhanced non-financial support to SMEs and financial intermediaries. Concessional financing might be warranted, but its use needs to be carefully assessed to mitigate unintended consequences, including to overall financial market development. Equity interventions should also be carefully assessed, given the greater challenges that FCV countries face in mobilizing private capital and creating financial markets. Capacity constraints and security concerns might require adjustments in the design and implementation of interventions, such as the simplification of eligibility criteria and delivery and evaluation through third parties. Finally, a holistic approach to the business enabling environment agenda is warranted.

CHAPTER 1

The Enabling Role of Access to Finance for Productivity, Growth, and Resilience

Small and medium enterprises (SMEs) are the backbone of the economy in most emerging market and developing economies (EMDEs), but they face critical challenges in access to finance. SMEs represent roughly 9 out of 10 businesses globally, account for more than 50 percent of employment in EMDEs, and contribute to 40 percent of gross domestic product (GDP).[5] Disruptions caused by the recent COVID-19 pandemic have raised global awareness about the importance of SME resilience for countries' overall economic prospects. Yet, a complex set of challenges constrains SME resilience, growth, and productivity and thus hinders their potential to create more and better jobs. SMEs in EMDEs often consider access to finance (or the lack thereof) a critical obstacle for business operations and growth.[6] Indeed, there are sizeable differences in access to debt and equity financing for SMEs in EMDEs compared to SMEs in high-income countries (HICs). For example, Didier and Cusolito (2024) show that smaller private firms, especially those with fewer than 100 employees, face the largest financing gaps in middle-income countries (MICs).[7]

Despite widespread public support programs in EMDEs, SMEs continue to face a sizeable financing gap. Government support in EMDEs has consisted of interventions to develop the enabling environment, with efforts focused on strengthening critical financial infrastructure (for example, credit information systems, secured transaction frameworks, and insolvency regimes) and targeted interventions aimed at increasing the supply of financing for SMEs (for example, via the provision of lines of credit [LoCs], partial credit guarantee [PCGs] schemes, and the implementation of investment programs in venture capital funds). Thus far, there is limited evidence that government support programs have been widely successful in fostering SME financing. The most recent estimates focus on the micro, small, and medium enterprise (MSME) financing gap and show that the credit gap for formal MSMEs has remained fairly constant in recent years. For 2019, the gap was estimated to be about US$5.7 trillion, equivalent to 19 percent of GDP and 20 percent of the overall private sector credit issued by banks in EMDEs.[8] These percentages are roughly at the same level as they were in 2015.[9] Similarly, the private markets for equity financing remain underdeveloped in most EMDEs.

Addressing the financial distortions that hinder SME access to finance could yield significant gains in economic growth and productivity and could also bolster private sector resilience.[10] World Bank research shows that smaller private firms face the largest financing constraints in MICs. Removing financial frictions and distortions, thereby relaxing firms' financial constraints, could boost MICs' productivity by up to 86 percent. Moreover, the estimations show that larger productivity gains would accrue for smaller firms than for larger firms. Importantly, these gains diminish as income levels rise. As such, countries with lower GDP per capita would benefit more from a more efficient allocation of finance toward smaller firms. Financial constraints not only hinder the productive growth of SMEs, but they also hamper their ability to cope with adverse shocks. World Bank research shows that, during the pandemic, firms with access to external financing were better able to maintain employment levels and avoid falling into arrears. Smaller private firms had the highest probability of being financially constrained during the pandemic. Countries with higher GDP per capita and with more developed financial markets had less financially constrained firms. Appendix A provides a detailed summary of this research.

Governments should thus focus on mitigating the key market failures and frictions that hinder SME access to finance.[11] These market failures relate to the inherent characteristics of SMEs, namely (a) their greater opacity (SMEs often lack credible financial statements); (b) their relatively high riskiness (this is partly a reflection of lower capabilities and financial

literacy); and (c) their lack of suitable assets for debt financing, in particular immovable assets that could be used as collateral and could also mitigate the challenges associated with (a) and (b). Due to information asymmetries and a lack of tools to overcome them, lenders face great difficulties in assessing SME creditworthiness, monitoring their actions, and enforcing repayment, which negatively affect lending to these firms. Lending to SMEs is also marked by higher transaction costs compared to large corporations due in part to the smaller transaction size. Furthermore, additional challenges emerge from the structure and level of development of the financial sector, which are more pronounced in EMDEs. A low degree of bank competition hinders bank lending to SMEs.[12] The more limited development of financial markets in EMDEs can also constrain the role of financial intermediaries and investors in SME financing. Finally, EMDEs typically have underdeveloped financial infrastructures, especially credit information systems, as well as deficient enabling environments supporting private investors, such as limited property rights, low contract enforcement, and an inefficient judiciary system.[13]

The increased use of financial technology (fintech) in SME financing has brought additional benefits and risks that require governments to adjust their interventions.[14] Fintech has the potential to address some of the critical challenges hindering access to finance for SMEs. For instance, the use of alternative data and new credit-scoring methods seems to effectively mitigate the frictions related to information asymmetries and to some extent also the lack of acceptable collateral. Moreover, fintech solutions have the potential to reduce the high transaction costs and enable scalability in SME financing by increasing digitalization and automation. However, fintech solutions do not tackle all the constraints of access to finance for underserved SMEs. The higher riskiness (perceived and real) of the SME segment remains largely unresolved by fintech solutions. While financial institutions have leveraged the predictive powers of big data and artificial intelligence for short-term, working capital loans, they have yet to explore those tools for longer-term loans.[15] Importantly, fintech's use also raises new obstacles that can constrain access to finance. For example, fintech may exacerbate risks to competition, consumer protection, and data privacy and cybersecurity. Thus, governments need to adapt their interventions to this new environment, fostering the use of fintech while ensuring that risks are adequately mitigated.

Furthermore, climate change has added another set of challenges to SME financing that requires a different set of interventions. On one hand, SMEs will need access to finance to undertake climate mitigation and adaptation efforts that can support their competitiveness and resilience. On the other hand, the financial sector's increased adoption of sustainability practices may pose additional challenges for SME financing. The additional levers of policy for the financial sector are typically composed of new reporting and disclosure requirements for regulated financial institutions related to the climate risk exposures of their portfolio. These additional reporting requirements may hinder SME financing precisely because of the opacity of small firms and their limited capacity to provide data on environmental performance. These issues can be particularly challenging when firms' capabilities and financial literacy are already in need of strengthening. Authorities thus need to support SMEs in their journey to adapt to new climate conditions by adding new targeted interventions that facilitate access to sustainable financing options.

At this critical juncture, this report will assist policy makers in EMDEs in reviewing and strengthening their access to finance support programs by providing a strategic view of the key issues involved in SME financing. This report builds on the experiences of both HICs and EMDEs, drawing on the lessons learned, to help EMDEs deploy more effective interventions. This report focuses exclusively on SMEs and does not cover microenterprises because of their unique characteristics, such as their high level of informality and sole proprietorship, which require a dedicated policy agenda. Appendix B briefly explains the key differences between SMEs and microenterprises and the impact on the policy agenda.

This report is organized into five additional chapters:

- Chapter 2 provides evidence on the evolution of external sources of financing for SMEs, contrasting EMDEs versus HICs, considering both bank and non-bank financing, and whether and how fintech is changing the landscape for SME financing. Such a diagnostic is crucial for the assessment of an adequate set of policy options.
- Chapter 3 provides a road map for EMDEs to tackle the core enabling environment necessary to foster the development of debt and equity financing for SMEs.
- Chapter 4 delves into targeted interventions to affect the supply of both debt and equity financing to SMEs, focusing on key recommendations to improve their effectiveness.
- Chapter 5 discusses four selected cases that require a tailored approach to policy support: access to finance (a) to women-owned (and led) business (WSMEs); (b) to support climate change mitigation and adaptation efforts by SMEs; (c) to agriculture SMEs; and (d) to SMEs in fragility, conflict, and violence (FCV) countries. The chapter addresses two main questions: (a) whether and how the factors that constrain access to finance for SMEs in each of these cases are different from those outlined in chapter 3, and (b) whether and how public interventions should differ from those described in chapters 3 and 4.
- Chapter 6 brings the landscape of SME financing and government support together, highlighting key messages and recommendations.

CHAPTER 2

The Evolution of SME Financing

SMEs rely on different forms of funding, both internal and external, to support their activities and growth.[16] This report focuses on external financing options, which vary according to SME size, financing needs, and risk profile (figure 2.1). The range of financing options has evolved over time in EMDEs, with fintech offering new opportunities. But what does this evolution of financing options mean for SMEs? Has financing become less of a constraint? Are banks less relevant today? Should governments rethink their support to ease the constraints hindering access to finance for SMEs? This chapter aims to shed light on these questions by offering an updated view of the SME financing landscape.

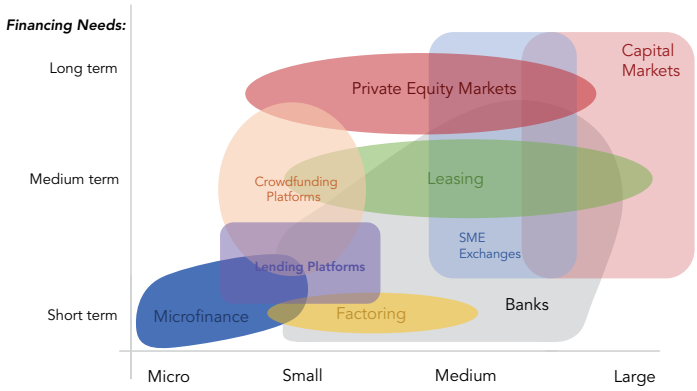
2.1 Debt Financing

2.1.1 Bank Lending for SMEs

Globally, banks remain the main source of external debt financing for SMEs in both developed and developing countries (figure 2.2). In HICs, SMEs have access to other sources of debt financing outside of banks, as these sources (for example, receivables financing, leasing) are relatively well-developed. However, this is not the case in MICs and low-income countries (LICs). In most EMDEs, bank loans account for the bulk of the debt financing for SMEs. Such dominance by the banks arguably reflects the competitive advantages of their business model, for instance, their access to relatively cheap funding from deposits and their ability to cross-sell and bundle products.

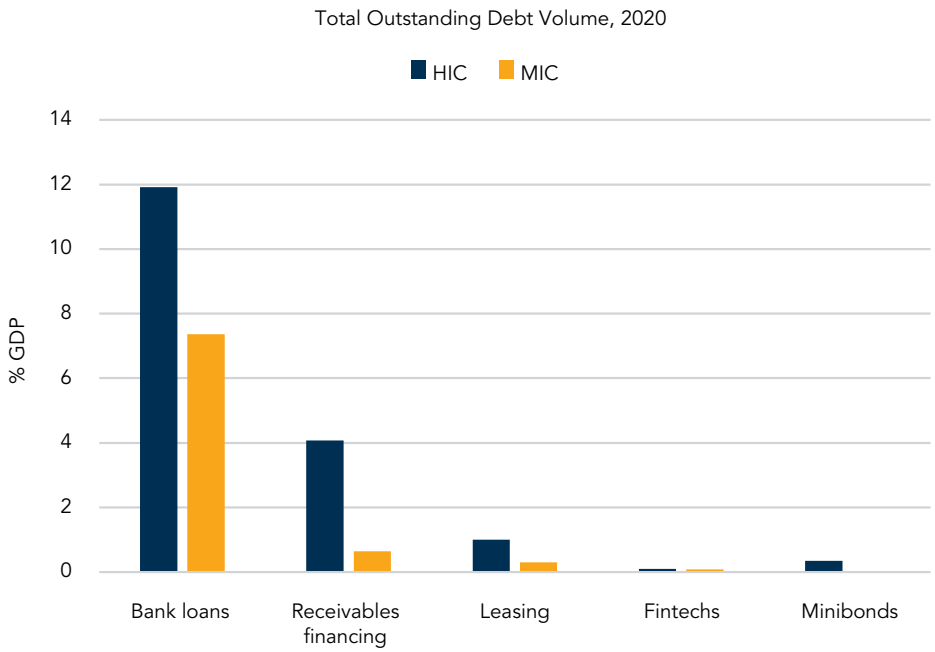
Despite being the main source of debt financing, bank lending to SMEs is still relatively underdeveloped in EMDEs. For example, the volume of SME loans is smaller in MICs than in HICs when measured as a share of GDP. In 2020, SME loan volume represented 7.4 percent of GDP for MICs versus 11.9 percent for HICs. Although comprehensive data for LICs are limited, evidence from a small subset of countries indicates that SME bank loans represented an even smaller share of GDP, estimated at 2.6 percent for the median country.[17] SME loans expanded in real terms between 2010 and 2020, but they have declined as a share of GDP in MICs and HICs. The MIC-HIC differential has remained relatively stable over time. The small size of the banking sector in EMDEs explains, at least in part, the underdevelopment of bank financing to SMEs. Research also shows that economic and financial development is positively correlated with SME loans from banks.[18]

FIGURE 2.1
Sources of Financing for SMEs



Source: Original figure for this publication.

FIGURE 2.2
Composition of Debt Financing for SMEs around the World



Source: Original calculations for this publication based on data from International Monetary Fund, Organisation for Economic Co-operation and Development, Asian Development Bank, World Bank, Factoring International, World Leasing Yearbook, Cambridge Centre for Alternative Finance, Moody's, Bank for International Settlements, and Standard and Poor's (S&P).

Note: The figure shows the median across countries within income groups. The data in the figure are as of 2020, except for digital banks (within fintech) which are as of 2019. Fintech debt includes only SME loans from digital banks, big tech, and digital lending platforms. SME bank loan data cover 78 countries (31 HICs, 47 MICs), receivables financing data cover 83 countries (HICs: 44, MICs: 39), leasing data cover 49 countries (HICs: 31, MICs: 18), digital banks data cover 10 countries (HICs: 7, MICs: 3), big tech data cover 28 countries (HICs: 6, MICs: 22), and digital platforms data cover 61 countries (HICs: 34, MICs: 27).

Existing evidence suggests that banks are leveraging fintech for SME financing; however, the specific impact of such change has not yet been quantified. Globally, banks have started to adopt fintech solutions through various means, including in-house initiatives; acquisition of fintech firms; and strategic partnerships, such as embedded finance.[19] Growing evidence indicates that some banks in selected HICs and EMDEs have expanded their outreach to SMEs—see appendix C for selected examples. Nonetheless, more research is needed to reveal the true scope of the evolving landscape.

2.1.2 Fintech Lenders

New financial providers leveraging fintech solutions ("fintech lenders") have emerged, but they remain relatively small players and have a more active presence in select HICs and MICs. Digital banks represent the largest segment for SMEs among these new financial providers, although their lending volumes remain small when compared to the incumbent banking sector. As of 2020, the total portfolio of digital banks amounted to US$660 billion worldwide, with SME loans estimated at about 10 percent of the total.[20] Thus, compared to the overall size of banks' portfolios, their importance in SME financing is still limited.[21] Digital banks in HICs account for 60 percent of digital bank assets worldwide, those in China for another 30 percent, and the rest in a few large MICs.[22] In some countries, digital banks have become large players in the SME segment. For example, in the United Kingdom, digital banks have established themselves as a dominant force in SME lending since starting operations in 2015.[23] Likewise, in China, Mybank has served over 45 million SMEs, which is about one-third of SMEs in China.[24] Digital lending platforms have also gained prominence in the SMEs space.[25] As of 2020, digital lending platforms had facilitated US$44 billion in debt financing to SMEs globally.[26] Akin to trends in digital banks, lending platforms are operating across many EMDEs, but volume-wise, their importance is concentrated in HICs and selected EMDEs.[27] While big tech firms are growing players in SME financing, the bulk of their financing is channeled through digital banks or through traditional banks, often under an embedded finance model.[28] Estimates indicate that big tech had facilitated about US$700 billion in loans as of 2020, 10 percent of which went to SMEs.[29]

Growing evidence indicates that fintech lenders have been reaching underserved SMEs. For example, compared to banks, digital lending platforms have financed riskier SMEs, according to studies conducted in Germany, the United Kingdom, and the United States. These studies also show that the lending volumes of digital lenders have been larger where bank coverage has been lower.[30] In China, more than three-quarters of SMEs served by digital banks were first-time borrowers.[31] Similarly, evidence from a recent World Bank survey shows that fintech lenders across HICs and EMDEs have targeted underserved segments, including SMEs.[32] Case studies highlight the use of alternative data and enhanced credit-scoring methods as key factors for fintech lenders' greater outreach to SMEs.[33]

Despite their outreach to underserved SMEs, fintech lenders face marked challenges in scaling up operations. Fintech lenders that do not take deposits, such as digital lending platforms, have difficulty accessing funding at competitive rates. Digital banks have struggled to create revenue sources that extend beyond transaction fees. Big tech companies have yet to settle on the extent to which their financial activities belong to their core business model and are deployed at scale.

2.1.3 Asset-Based Financing

Asset-based financing can be particularly attractive for SMEs as it can mitigate their lack of immovable assets and heightened credit risk by working with alternative sources of collateral.[34] Receivables financing, also referred to as factoring, can be an important source of short-term, working capital financing for SMEs. Long payment periods have been a recurring challenge for SME operations. Factoring allows SMEs to use the invoices originated from the sale of their goods and services to secure short-term financing. Moreover, for financiers, the risk of these transactions is largely based on the credit risk of the (higher quality) buyer, not the credit risk of the SMEs. Another asset-based financial product is leasing, which significantly lowers the credit risk of a borrower, as the risk for leasing providers is limited to the value of the leased asset itself, whose ownership tends to remain with them until the end of the contract. Leasing provides financing for longer-term, capital investments for SMEs. Research has shown that, indeed, SMEs with limited immovable collateral, who are subject to high information asymmetries, and are thus perceived by lenders as posing a higher credit risk, are more likely to finance investments with leasing.[35] SMEs in construction and manufacturing, in particular, have benefited from access to leasing.[36]

Fintech solutions have given a boost to receivables financing, but financing volumes are relatively small in EMDEs. Different types of factoring platforms have emerged, some based on traditional factoring, and others based on reverse factoring.[37] Some platforms are on-balance-sheet lenders, akin to a lending institution; other platforms are closer to capital markets and simply connect SMEs and investors, thus providing off-balance-sheet financing. These platforms can reduce transaction costs, increase the speed of transactions, and facilitate access to finance for SMEs in remote areas. Platforms, especially in countries that have implemented e-invoicing, can also reduce the risk of fraud

and facilitate enforcement as transactions are recorded in a centralized system. Finally, online platforms allow SMEs to build a credit history, which can facilitate access to other forms of financing. These fintech platforms for receivables financing remain relatively small in EMDEs, with financing volumes estimated at US$686 million in MICs in 2020. The global fintech market for receivables financing is currently estimated at US$4.2 billion, which equals about 1 percent of the total receivables financing market as of 2020.[38]

Fintech has also facilitated leasing, for instance by providing better risk management tools. Digital technologies, such as global positioning systems and machine learning solutions, can make it easier to track and evaluate the state of a leased asset. The emergence of online market auctioneers for used products has improved the liquidity of secondary markets for movable assets in HICs, which allows leasing companies to better manage risks.

Asset-based financing is more developed in countries with supportive legal and regulatory frameworks, effective out-of-court enforcement mechanisms, and robust financial infrastructures, especially credit information systems.[39] Asset-based financing requires modern secured transaction laws that can provide efficient mechanisms to constitute security interest. In addition, it requires well-functioning collateral registries, offering cost effective usage and easy accessibility (for example, online registries). Recent evidence indicates that robust credit information systems have also played a role in asset-based financing. These markets are thus typically more developed in HICs and a select set of MICs. Receivables financing is particularly well-developed in HICs, which account for almost 80 percent of global volumes.[40] Upper-middle-income countries (UMICs) account for the bulk of the remaining 20 percent. Factoring volumes for the total market (that is, not just SMEs) surpassed 5 percent of GDP for the median HIC in the sample but were only about 0.8 percent for the median MIC in 2020. Similar patterns are observed in leasing markets: financing volumes for the total market were 2 percent of GDP for the median HIC and 0.65 percent for the median MIC in 2020.[41]

2.1.4 Capital Markets

Capital markets solutions, such as minibonds and debt funds, allow SMEs to tap into a different set of financiers.[42] Access to capital markets not only brings diversification of funding sources to SMEs but also may provide additional benefits. For example, minibond issuers have been able to obtain lower interest rates on their subsequent bank loans.[43] Bonds have mostly been issued by medium companies (owing to a de jure or de facto minimum issuance size), whereas debt funds have supported a wider range of SMEs, as these funds can invest in a range of assets (from receivables to SME loans and minibonds).[44] Some of these debt funds buy the assets from SME lenders, others originate the assets themselves.

Capital markets have also provided SME lenders with indirect mechanisms to support SME financing. Specifically, capital markets solutions have been used by SME lenders to improve their funding structure, allowing them to compete more effectively in credit markets, which in turn can result in an expansion of financing to SMEs, improvements in lending conditions, or both. In many countries, banks (and other SME lenders, to a lesser degree) use capital markets to raise long-term funding through relatively simple instruments, such as plain vanilla bonds. In more sophisticated capital markets, both banks and other SME lenders have also resorted to instruments more directly tied to their SME portfolios, such as the securitization of their SME loans.

Beyond stable macrofinancial conditions, the development of capital market solutions for SMEs typically occurs when certain preconditions are in place. For example, minibond markets often emerge in countries with relatively well-developed corporate bond markets, whereas debt funds often require a strong asset management industry. Both types of instruments also require a strong base of investors, especially institutional investors. Moreover, their development usually requires the implementation of specialized legal and regulatory regimes. Overall, capital market solutions for SMEs are more readily available in HICs and a few large, financially developed, EMDEs. For example, minibond issuances have been concentrated in Europe, and only a few other countries, such as Argentina, China, Peru, and the Republic of Korea have developed the segment at a more limited scale. Debt funds have grown rapidly over the past 10 years, especially in HICs and some MICs, such as Brazil and Mexico, but only a small fraction of the funds have targeted SMEs. In contrast, plain vanilla issuances by SME lenders can be found across a wider range of EMDEs, as they only require basic corporate bond markets. Other instruments, such as SME loan securitization, remain niche products, even in HICs.[45]

2.2 Equity Financing for SMEs

2.2.1 Equity Financing for Innovative Firms

Although the majority of SMEs rely on debt as their main source of external financing, equity financing can be powerful in spurring innovation.[46] Innovative activities are inherently risky and generally entail investments in intangible assets, such as research and development (R&D), that provide limited collateral value. Consequently, these investments can be hard to finance with debt. While equity can fund any type of investment, it often disproportionately benefits firms with investments in such innovative activities.

Private markets, especially venture capital (VC), are the main source of equity financing for SMEs; however, they remain small in most EMDEs.[47] While the median HIC country has VC investments at around 0.3 percent of GDP per year, such investments stand at about 0.01 percent of GDP (or less) in MICs, and only a handful of EMDEs have markets with greater depth (figure 2.3).[48] Moreover, fewer firms obtain financing from VC in EMDEs compared to HICs. For example, VC investments did not reach more than 10 companies per million people in a given year in any EMDE country during 2010–19, whereas among HICs, VC investments often reached more than 80 companies per million people.

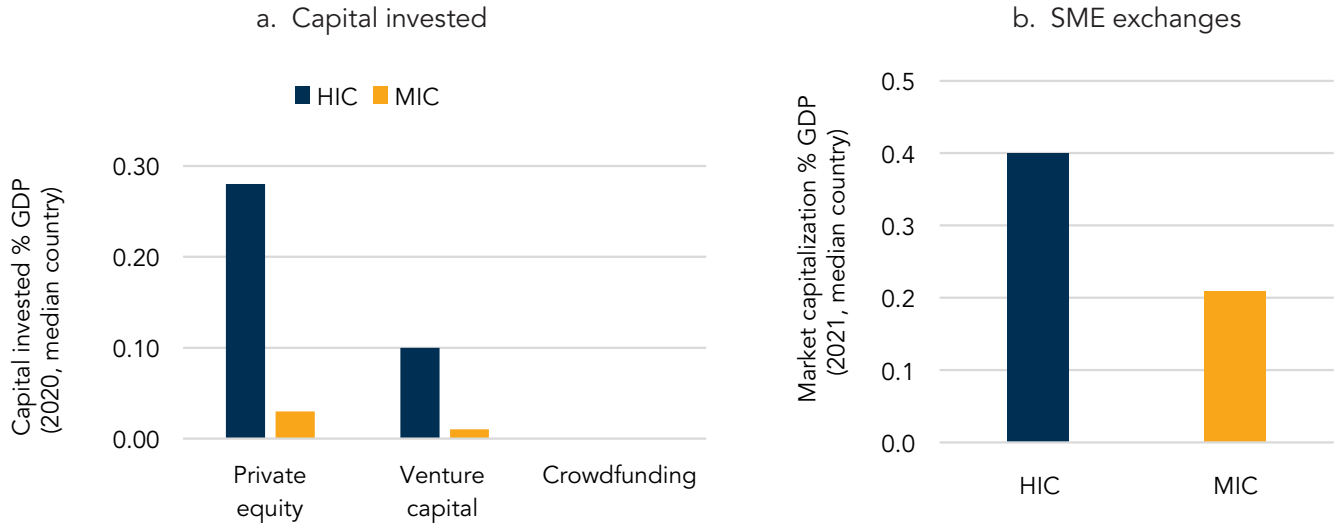
VC investments in EMDEs are concentrated in relatively large and mature firms.[49] Contrary to popular perception, VC investments have limited reach to startups and young firms, not only in EMDEs, but even in HICs.[50] VC arguably plays a more prominent role in funding the next stage of the innovation cycle, when companies commercialize their innovation.[51] In fact, the bulk of VC investments is concentrated in firms that are five years old or older in both UMICs and HICs.[52] In addition, VC investments in MICs are concentrated in relatively larger firms than VC investments in HICs. For example, during 2010–19, firms with more than 350 employees accounted for about 70 percent of the volume of VC investments in MICs compared to 35 percent in HICs.

VC investments have focused on a narrow set of high-tech sectors in both HICs and EMDEs. Historically, VC funds have typically funded segments in which the uncertainty about the viability and commercialization of ideas can be resolved within the time frame of VC financing cycles (typically between 8 and 10 years).[53] Overall industry size and performance may also play a role, as they affect not only the risk-return profile of the VC transactions, but also the exit options for investors. Over the recent past, the focus has been on high-tech sectors, with the top-five segments for global VC investments during 2010–19 being technology, media, and telecommunications; mobile; software as a service; artificial intelligence and machine learning; and e-commerce.[54] These top-five segments accounted for more than 70 percent of the value of VC investments and more than 70 percent of the number of firms that received VC investments, not only in HICs, but also in MICs.

Fintech has started to play a role in the financing of innovative firms through crowdfunding platforms, but these platforms remain markedly small in most EMDEs. While VC funds are dominated by professional investors, crowdfunding platforms have enabled retail investors to fund SMEs directly through equity and quasi-equity instruments.[55] Research in HICs suggests that crowdfunding platforms are more likely to fund highly innovative, high-risk companies that may otherwise fail to raise capital from VC funds.[56] However, whether those companies are able to obtain follow-on funding from other sources and thrive in the long term remains an open question. These platforms have developed mostly in HICs and a few MICs (for example, Brazil, India, Malaysia, and South Africa). According to Cambridge Center for Alternative Finance (CCAF) data, equity crowdfunding reached US$2 billion globally in 2020, which represents less than 0.1 percent of the VC industry.[57]

The limited institutional investor base and the small scale of private markets for equity financing explain, at least in part, the focus of VC investments on larger and more mature firms in EMDEs.[58] With a limited range of investment opportunities in smaller markets, the stakes are higher for each individual transaction. Thus, equity investors have incentives to be more risk averse and focus on larger and more mature firms whose viability and credibility are likely to be well established. These credentials also enhance investor exit options. The lack of a robust domestic investor base is another important factor. Although foreign investors can play an important role for market development, research shows that these investors tend to be less informed about local markets and are more risk averse than domestic investors. Hence, they favor larger and more mature firms.[59] For example, VC investments in MIC companies with investor participation from HICs were almost double the size of VC investments with only domestic investors.[60]

FIGURE 2.3
Composition of Equity Financing around the World



Source: Original calculations for this publication based on McKinsey, Datastream, and CCAF.

2.2.2 Equity Financing for Mature SMEs

Private equity (PE) funds have reached only a few larger SMEs, and thus have not been a consistent source of financing for mature SMEs. PE financing, including financing through buy-out and growth equity funds, represented about 0.03 percent of GDP in MICs in 2020, compared to 0.3 percent of GDP in HICs (figure 2.3). While the volume of PE financing is larger than the volume of VC financing, PE has funded fewer SMEs as transactions are significantly larger. In 2020, the median transaction size for VC investments in MICs was estimated at US$300,000, while the amount climbed to US$6 million for PE investments.[61] Hence, PE financing is typically only a viable source of funds for larger SMEs, which often benefit from equity funding to turn their companies around and improve profitability.

Over the last 20 years, SME exchanges have emerged in a wide range of economies, but less than half of these exchanges remain active. The traditional public equity markets have not successfully attracted SMEs.[62] Disclosure and corporate governance requirements are costly, compliance is difficult, and in many cases, SMEs are reluctant to open their capital to third parties. Furthermore, the limited liquidity of SMEs, the lack of research coverage, and the small ticket size hamper investor interest. Consequently, specialized SME exchanges have emerged and are often grounded on lighter listing requirements than those of the traditional public equity markets. Their strategies have varied. Some SME exchanges target mature, profitable SMEs (for example, the Alternative Investment Market in the United Kingdom, Alternext in France, and the National Stock Exchange and the BSE in India), while others brand themselves as hubs for high-tech companies (for example, KOSDAQ in Korea and Mothers Exchange in Japan). Some of the latter set seem to have created positive spillovers for the VC industry, arguably by enhancing the exit options for investors.[63] (See appendix C.) There are currently 90 SME exchanges worldwide, although only about 40 percent of them, in HICs and large MICs (such as China, in particular), are active.

However, a more complex set of challenges affects equity financing in EMDEs. The underdevelopment of both private and public equity markets in EMDEs points to challenges in expanding equity markets more broadly.[64] Such challenges include a thin pipeline of companies ready to invest; a shallow investor base; and deficiencies in the enabling environment for equity financing, including inadequate investor protection (for example, for minority shareholders) and corporate governance issues.[65]

2.3 Summary

SMEs continue to face both debt and equity financing gaps; addressing these gaps will require deliberate government intervention. While progress has bridged some of these challenges, especially in certain MICs, substantial gaps remain particularly marked in LICs. Against this backdrop, governments in EMDEs should continue to prioritize access to finance for SMEs. However, the evidence presented in this chapter highlights the need to revisit the toolkit of interventions, both for the enabling environment and for targeted interventions. This revised toolkit should place increased emphasis on alternative sources of debt financing and the role of equity financing for innovation and growth. It should also reflect the new environment in which SME financing is taking place, especially regarding the increased use of technology. Furthermore, when determining the range of interventions to deploy, governments should be mindful of the preconditions necessary to develop specific types of financing solutions. Governments should also consider the role that a stable macroeconomic environment and robust institutions play in fostering the development of a vibrant financial sector. These issues will be covered in the next chapters.

CHAPTER 3

A Road Map for Enabling SME Finance

As a starting point, governments should focus on urgently completing a core enabling environment agenda to support SME financing. While empirical research highlights the importance of a wide range of issues for SME financing, from economic fundamentals to solid institutions, governments should continue to prioritize components of the enabling environment that can materially impact SME financing.[66] Implementing this agenda carries very limited fiscal costs, yet the benefits could be sizeable.

The core agenda pursued by many EMDEs for the last 20 years remains highly relevant, but enhancements should be pursued, and new areas of attention added. The core policy agenda has focused on three main components: (a) the development of credit-reporting systems; (b) the implementation of frameworks for secured transactions along with collateral registries; and (c) the implementation of effective insolvency frameworks. These core components aim to mitigate key market failures and challenges that affect SME financing, in particular their opacity (that is, lack of reliable financial information), their lack of "suitable" collateral, and their higher credit risk (perceived and real). Lessons learned from policy implementation in HICs and EMDEs reinforce the relevance of these components, but also reaffirm the need to deepen reforms. In addition, new areas should be brought to the core agenda, focusing on the development of an enabling environment for alternative lenders and for equity financing. For purposes of this report, alternative lenders are any lender that is not a traditional bank.[67] As these reforms are implemented, other areas will require updating, including a greater focus on consumer protection and competition. Finally, the enabling environment to leverage financial technology constitutes a cross-cutting issue. The following road map, which is consistent with the 2022 Updated G20/OECD High-Level Principles on SME Financing, provides guidance specific to EMDEs regarding key actions needed to urgently implement this extended core agenda while recognizing that country context matters.

3.1 Action 1. Continue Enhancing the Availability of SME Credit Information

Credit reporting systems can mitigate critical market failures that affect SME financing, especially information asymmetries between lenders and SMEs, by providing objective information that lenders can use in their credit risk assessment processes. These systems also allow SMEs to build a credit history that they can use as "reputational collateral" to access formal credit outside established lending relationships. Existing evidence has positively linked credit reporting systems with SME lending.[68]

Governments in EMDEs should continue to actively promote the development of effective credit reporting systems. Removing legal obstacles for the exchange of credit information is the first step toward developing these systems. Still, experiences in EMDEs indicate that, in many cases, governments need to establish the necessary incentives for such information exchange to take place. Depending on country context, such incentives could include mandatory reporting. In countries where credit reporting systems do not

develop organically, governments should actively engage in supporting their creation, as many EMDEs have done.[69] In addition, governments have a key regulatory role: (a) ensuring a level playing field in information access for new entrants; (b) ensuring open and equal access to credit reporting systems for regulated and unregulated lenders; (c) identifying and eliminating anticompetitive pricing policies; and (d) preventing the formation of closed user groups.[70]

Once credit reporting systems are established, governments should focus on ensuring the inclusion of alternative lenders and on enhancing the availability of alternative data. Regarding the former, banks are often reluctant to extend information sharing arrangements to alternative lenders. In addition, these lenders may need technology upgrades to fulfill reporting obligations. Thus, governments can play a critical role in expanding the participation of alternative lenders in credit reporting systems via regulation and capacity building initiatives. Regarding the latter, research indicates that alternative information, such as information on payments (for example, from utility bills and other financial transactions) and information on internet usage, can help capture the footprint of underserved SMEs, allowing them to establish their creditworthiness versus potential lenders.[71] Specific elements of alternative data to be covered vary depending on country context. For example, in Guyana, credit bureaus have access to utility data; in Kenya, they have access to mobile payments data; and in the United Kingdom, they have access to information on house rents. The use of such data, however, raises concerns about data privacy and data protection when individuals' personal information is involved.[72] Governments should thus foster the responsible use of alternative data by enacting the necessary regulations and guidance. [73]

Governments should also explore expanding access to government data to lenders. Government agencies hold a wide range of data relevant for SME financing, including data on business registration, tax, and land records. Accessing such data can be time-consuming and costly. Improving access in an efficient manner, such as via automated, online interfaces, while supporting their inclusion in credit-reporting systems (for example, in credit bureaus), could substantially enhance the information environment for SME financing. For example, in India, automated access to government data platforms has enabled banks to approve MSME and personal loans online in under an hour, down from 20 to 25 days in the past.[74] In Argentina, the Ministry of Production is implementing a digital platform that will consolidate financial and economic information on SMEs, including financial information from the tax authorities. SMEs will control who has access to this information, and they will be able to provide it to regulated financial institutions.

3.2 Action 2. Complete the Enabling Environment for Asset-Based Financing, Including the Implementation of Movable Collateral Registries

Asset-based financing remains limited in EMDEs, despite legal reforms aimed at facilitating its use. As summarized in chapter 2, asset-based financing brings distinctive benefits to SMEs, as it addresses critical challenges that affect their financing, including the lack of "suitable" collateral and credit history. This is why, during the last two decades, governments in EMDEs have worked on implementing legal frameworks for secured transactions (for example, factoring and leasing), along with the implementation of collateral registries, especially for movable assets, that formalize and provide transparency to lender's claims thus helping to lower the cost of defaults and the risk of fraud.[75] However, several challenges continue to affect the use of asset-based financing. There are obvious benefits of real-estate collateral—titled property—which include stable pricing and deep secondary markets. For other assets, such as intellectual property, reliable asset valuation and secondary market liquidity are harder to assure. Other key challenges hindering the development of asset-based financing include a lack of intermediaries familiar with this type of instrument, and thus, a corresponding lack of appropriate risk management mechanisms. Finally, in many countries, the legal frameworks and the institutional arrangements supporting such transactions are still incomplete. The latter type of challenges is more profound in jurisdictions with civil law systems, which have been more reluctant to embrace a number of fundamental approaches of modern secured transactions legislation, such as notice-based registries and extrajudicial enforcement.[76] Furthermore, in some EMDEs there are still limitations in the type of assets that can be used as collateral for debt financing. In addition, in some EMDEs, collateral registries operate with obsolete

information technology systems or are paper-based, making it costly for potential lenders to obtain information. In some EMDEs, there are separate registries for different types of assets, and the lack of interoperability makes more difficult for potential lenders to conduct complete searches of the status of SME assets.

Governments should review the progress and challenges in their respective countries in completing the enabling environment for asset-based financing. The implementation of modern secured transactions laws is particularly important, especially the inclusion of a wide range of assets as acceptable collateral, and the adoption of notice-based registries and effective out-of-court mechanisms to execute collateral. As explained above, for some EMDEs, other important measures might include moving to online centralized (or interoperable) collateral registries and covering movable assets, which can help lower transaction costs and speed up the constitution of liens. Governments should also consider enhancing capacity building for financial intermediaries.

Finally, cross-country experiences highlight the benefits of coordinating this agenda with other government initiatives. Two notable areas for policy support are (a) the implementation of electronic receipts, which can support deeper markets for receivables financing, and (b) government procurement initiatives, which can further the development of both receivables financing and purchase order financing. Appendix C provides examples of how some countries in Latin America have effectively leveraged e-invoicing to foster receivables financing.

3.3 Action 3. Overhaul Insolvency Regimes

Effective and efficient insolvency regimes can improve SME access to finance. A robust insolvency regime is essential for both the financial and private sectors. Growing evidence indicates that insolvency regimes provide lenders with greater certainty and predictability in the recovery of defaulted loans, thus allowing them to price the risk of defaults more efficiently. Similarly, entrepreneurs are more willing to enter the market when they are not putting their entire personal fortunes at risk.[77] Moreover, effective insolvency systems enable the reorganization of viable businesses[78] and ensure that non-viable businesses can quickly exit the market, allowing the reallocation of assets to more productive firms.

Yet, globally, the development of insolvency regimes still requires significant progress. A key lesson learned from the experience of HICs and EMDEs is that "ordinary" regimes do not usually work for SMEs, as such regimes usually focus on the challenges of insolvency for large corporations.[79] The COVID-19 pandemic has provided impetus to reforms aimed at developing specialized regimes for SMEs. In addition, the World Bank Insolvency and Creditor Debtor Regimes Principles, revised in 2021, provides updated global guidance. The principles encourage countries to (a) lower the barriers to access and encourage early utilization of out-of-court restructuring procedures and hybrid procedures (that is, those conducted largely out of court, with minimal court intervention) and (b) simplify in-court insolvency proceedings to reduce cost and limit complexity, including cutting procedural steps. Jurisdictions such as Australia, Chile, Spain, and the United States have implemented these types of frameworks.

3.4 Action 4. Complete the Enabling Environment for Alternative Sources of Financing

Banks will remain a key source of external financing for SMEs; therefore, their regulation remains a critical element of the enabling environment for SME financing. Prudential regulation introduced with the Basel III reforms increased the capital requirements for banks on their SME loan portfolios, although the final version contains a favorable treatment for specific sets of SME loans that EMDEs can apply. Research has not found evidence of persistent material negative impact of this framework on SME lending, albeit the impact differs across SMEs and countries (see appendix C). In light of the lessons learned from previous crises about the importance of prudential regulation for the overall health of the banking sector, EMDEs are encouraged to pursue the implementation of

regulatory frameworks that are consistent with the Basel standards.

But banks alone cannot address the SME credit gap. As summarized in chapter 2, alternative lenders can fulfill important gaps in the SME financing space because (a) their business models are directly oriented toward underserved segments (for example, microfinance institutions; MFIs), (b) the type of financing they offer is more accessible to SMEs (for example, asset-based financing for SMEs that lack adequate collateral or credit history), or (c) they adopt different credit assessment methodologies (for example, fintech lenders leveraging big data). Thus, it is critical for EMDEs to ensure that the enabling environment supports the development of alternative lenders. Table 3.1 provides a stylized view of the necessary elements of the enabling environment for different alternative lending sources, along with the preconditions for their scalability.

TABLE 3.1
Key Sources of Alternative Finance in EMDEs

Type	Where alternative lenders are likely to develop	Key preconditions for scalability	Key enabling environment
Factoring and leasing	LICs and MICs, but more likely to develop in MICs	• Availability of long-term financing that supports the funding of financial providers	• Modern secured transactions law, including notice-filing collateral registries and effective out-of-court enforcement
Microfinance institutions and cooperatives	LICs and MICs	• Availability of long-term financing that supports the funding of financial providers	• Differentiated regime for deposit-taking versus non-deposit-taking financial institutions, with proportionate requirements
Digital banks	LICs and MICs, but more likely to develop in MICs	• Enabling environment for digital financial services (DFS)	• Reforms to banking licensing requirements (mainly to eliminate the need for physical presence)
On-balance-sheet fintech lending platforms	LICs and MICs	• Enabling environment for DFS • Availability of long-term financing that supports the funding of financial providers	• No additional framework beyond the existing one for consumer lending institutions
Off-balance-sheet fintech lending platforms and debt-based platforms	LICs and MICs, but more likely to develop in MICs	• Enabling environment for DFS • Availability of a robust investor base (retail and overtime institutional)	• Exclusion of lending and debt-based crowdfunding from the requirements imposed in public offering regulations under specific circumstances • Specialized licensing regime for the platforms, with proportionate requirements
Bond issuances by SME lenders	MICs, and to a lesser extent, financially developed LICs	• "Basic" corporate bond markets; credit rating services; robust institutional investor base	• No additional specialized framework • Issuances rely on the basic regime for public and private offers, including the regulatory framework for CRAs
SME loan securitization	MICs	• Well-developed corporate bonds markets • Robust credit rating services • Robust institutional investor base	• Legal structures that ensure bankruptcy remoteness • Regulatory framework for securitization (emphasis on standardization, disclosure, and retention requirements) • Regulatory framework for CRAs

Type	Where alternative lenders are likely to develop	Key preconditions for scalability	Key enabling environment
Minibonds issued by SMEs	MICs	• Well-developed corporate bonds markets • Robust credit rating services • Robust base of high-net-worth individuals • Vehicles to pool bonds and make them attractive to institutional investors	• Proportionate regime for SME issuances (that is, simplified offering documents, less frequent periodic reporting, and a discrete list of material events) • Proportionate listing requirements • Potential reforms needed to institutional investors regulations (especially if issued under private offering) • Regulatory framework for CRAs
SME debt funds	MICs	• Well-developed mutual fund industry • Established pipeline of SME assets (minibonds, loans, receivables) • Mainly focused on sophisticated investors (professional and institutional investors)	• Specialized regime for debt funds, allowing investments in alternative assets, including loans and receivables • Greater flexibility to funds available only to professional investors

Source: Original table for this publication.

For many EMDEs, strengthening the regulation of MFIs (and cooperatives) should be a priority. As will be discussed in chapter 5, microfinance institutions and cooperatives are key intermediaries that provide financing to underserved sectors, including agriculture SMEs (agri-SMEs) and WSMEs. However, in some EMDEs, they are not subject to financial regulation, whereas in others they are subject to very stringent requirements. Thus, for many EMDEs, ensuring that MFIs and cooperatives that are deposit-taking institutions are subject to financial regulation, under a proportionate regime, should be a priority.[80]

Selective reforms based on country context are needed to ensure that specialized fintech lenders can operate on a level playing field.[81] A key reform pertains to potential changes to the licensing regime of banks to allow the entrance of digital banks. This might entail, for example, adaptations to physical presence requirements. Economies like Brazil; Hong Kong SAR, China; Malaysia; Mexico; Singapore; and Thailand have revised and provided guidance on the application of the licensing regime of banks to digital banks.[82] In addition, governments should consider the creation of licenses for new types of financial intermediaries. Notable examples include the lending platforms discussed in chapter 2, whereby such platforms function as intermediaries bringing together SMEs, and investors. Approaches have varied across countries, but in the European Union and the United States, specialized licenses are being created to allow these new entities to provide such services under proportionate requirements, in addition to traditional securities intermediaries and exchanges.[83] Research indicates that many platforms operate in more than one jurisdiction, which also highlights the importance of international coordination and cooperation. The set of specific reforms for a given country will depend, in particular, on the level of development of the respective country's financial sector. For instance, factors such as the existence of a robust base of retail and institutional investors plays a role in the development of these platforms. Therefore, they are more likely to thrive and scale up in MICs, where the broader enabling conditions for their operation are likely to be more developed. Thus, governments should be mindful of their own country contexts in prioritizing these reforms.

MICs with relatively well-developed capital markets should consider the implementation of an enabling environment to foster capital markets solutions for SME financing. Capital markets solutions can help SME lenders obtain long-term funding, allow SMEs to diversify their funding sources, and can also lead to additional benefits in terms of improved lending conditions. However, as discussed in chapter 2 and summarized in table 3.1, capital markets solutions require a range of additional preconditions to develop. Authorities need to be cognizant of such preconditions when determining how to prioritize the development of the enabling environment for these solutions.

3.5 Action 5. Foster Competition

Increased fintech adoption and the emergence of alternative lenders could bring changes in market structure and competition dynamics that negatively impact SME financing.[84] For banks, leveraging fintech can lower the outreach costs to SMEs and expand the banking sector's appetite for the SME segment.[85] In the absence of new entrants, technology-driven economies of scale and scope could lead to increased market concentration. External competition from challenger digital banks and other specialized fintech lenders (including big tech firms) could alter market structure. As summarized in chapter 2, in some countries these non-bank financial players are partnering with banks rather than competing with them, which could exacerbate market concentration effects.[86] In turn, this could result in the benefits of fintech accruing to financial institutions, rather than leading to a material impact on SME financing. Hence, it is critical to foster competition, ensuring a level playing field across the different providers of financing to SMEs.[87] Important aspects to watch are the following: entry requirements, which should be proportionate to the undertaken risks, and thus should not constitute an entry barrier for alternative lenders; accessibility to credit information, whereby coverage should be extended to alternative lenders; and extension of the framework for consumer protection to new types of lenders.

Depending on country context, governments should consider "open finance" reforms aimed at allowing third parties, acting on behalf of customers, to directly access information held by financial institutions and initiate transactions.[88] Open finance has the potential to deepen financial services and foster innovation and competition in the financial sector by allowing the development of new business models as well as new service providers. Governments have started to acknowledge this potential, while recognizing the opportunities that open finance creates to streamline access to finance for SMEs and promoting financial inclusion. Several jurisdictions have implemented, or are in the process of implementing, open finance frameworks. The United Kingdom and European Union are at the forefront of this agenda, with larger EMDEs, like India, Mexico, and Türkiye, following suit.

Governments in both LICs and MICs should consider additional innovative interventions that foster competition and can potentially improve SME access to financing. An example of an innovative intervention is the development of electronic platforms to bring financial intermediaries together to compete for SME credit. Development financial institutions (DFIs) in Colombia, India, and Mexico have developed and operated such platforms. While the financial institutions could create such platforms themselves, active participation by DFIs may be necessary to overcome coordination failures among financial institutions. Other types of innovative measures that do not require public funding could also be considered. The British Business Bank provides one such example, as it requires the largest banks to provide information on rejected SME loans to alternative platforms for the consideration of alternative lenders. Appendix C provides additional details.

3.6 Action 6. Develop the Enabling Environment for Equity Financing

As discussed in chapter 2, equity financing is critical for innovation and growth. Table 3.2 summarizes the important features of the enabling environment needed for specific equity financing solutions as well as key preconditions.

As a first step, governments in EMDEs must ensure that the legal and regulatory framework for capital markets provides space for SMEs to raise funding in the private markets. This can be achieved through exemptions that allow companies to tap equity investors without triggering the obligations of disclosure and corporate governance associated with public markets under specific circumstances (for example, where capital raising is largely confined to professional investors or the amount raised is limited).[89] In addition, governments should develop a framework for the private fund industry. In countries with a well-developed domestic institutional investor base, governments should also determine if changes are needed to their investment regulations, such as pension funds, to allow them to invest in this type of asset.[90] In tandem, governments should consider initiatives aimed at enhancing their capacity to make these investments. Countries with a strong foreign investor base also need to ensure that their foreign direct investment laws do not create barriers or cumbersome procedures that stifle financing from foreign investors. Finally, taxation can become a competitive issue versus other jurisdictions.

Depending on country context, governments should consider developing the enabling environment for equity crowdfunding. Equity crowdfunding platforms provide SMEs access to retail investors under a streamlined disclosure regime. The challenge for EMDEs is to strike a balance between easing SME access to a wider range of investors while also providing adequate investor protection. Many countries have addressed this tradeoff through a combination of measures that include limits to the amount companies can raise along with limits to the amount that investors can fund, as well as due diligence obligations for the platforms. Nonetheless, existing evidence suggests that equity crowdfunding is more likely to thrive and scale up in countries that already have relatively well-developed equity markets.[91] Thus, governments need to be mindful of country context in prioritizing the development of these frameworks.

EMDEs with well-developed equity markets should develop the enabling environment to support SME listing. The key elements in the enabling environment are proportionate disclosure and corporate governance requirements for SME offerings.[92] But actions by the exchanges to support SME listings are also needed. Such actions include streamlining performance, disclosure, and governance listing requirements and lowering listing costs. Some of the more successful SME exchanges have implemented a wider range of measures that seek to address investors' concerns about the quality of SME listings, the availability of information, and secondary market liquidity. Among the adopted measures are the following: requirements for the participation of specialized intermediaries to support companies' compliance with listing obligations; support to research coverage, in some cases with subsidies for a number of years; and adoption of market-making requirements. Finally, cross-country experience indicates collective investment vehicles that can pool SME assets (such as small cap funds) can make SME listings more attractive to institutional investors.

TABLE 3.2
Key Sources of Equity Financing in EMDEs

Type	Where equity financing solutions are likely to develop	Key preconditions for scalability	Key enabling environment
Coinvestment with angel investors	LICs and MICs	• Pipeline of companies • Existence of angel investors	• Exemptions to public offering (maximum number of investors, maximum amount raised, type of investors targeted)
VC, SME growth funds and, private equity funds	MICs, and to a lesser extent, some LICs	• Robust pipeline of companies • Robust set of professional investors	• Licensing framework for fund managers • Regime for private funds that exempts them from authorization or subjects them to "simple" registration • Depending on investor base, changes to the investment regulations of pension funds to allow them to invest in PE/VC • Regime for foreign direct investments that provides efficient procedures for registration and exit • Tax regime that provides for tax neutrality
Equity crowdfunding platforms	MICs	• Relatively well-developed equity markets • Robust base of retail investors	• A streamlined disclosure regime for SMEs, exempting their offerings from authorization by the securities regulator • Limits to the amount companies can raise through platforms and to the amount that retail investors can invest in platforms and in one single company • Licensing regime for crowdfunding platforms, with proportionate requirements

Type	Where equity financing solutions are likely to develop	Key preconditions for scalability	Key enabling environment
SME offerings, including through SME exchanges	MICs	• Relatively well-developed equity markets; High net-worth individuals • Collective investment schemes to pool equity offerings and attract institutional investors • Specialized SME exchange to support liquidity	• Proportionate system for SME offerings (that is, simplified offering document, less frequent periodic reporting, and a discrete list of material events • Less stringent corporate governance requirements) • Proportionate listing requirements

Source: Original table for this publication.

3.7 Action 7. Enhance Consumer and Investor Protection

The increased use of fintech in the SME financing space poses new risks to SMEs. Fintech has facilitated the entry of new financial providers who are spurring the development of new financing products and new delivery mechanisms. However, the conditions of such financing, and of the roles of different participants in the transactions (such as in embedded financed), are not always clearly explained to SME borrowers.[93] Thus, governments and financial regulators need to ensure that the legal and regulatory frameworks against deceptive and fraudulent practices apply to financing providers (incumbent or new) and across all types of delivery channels.[94] In addition, consumer protection laws should apply to individuals as users of financial services, for both personal and business purposes.[95] Considering the country context, governments should carefully assess whether to expand the scope of consumer protection frameworks toward small firms. When expanding consumer protection obligations to cover small firms, governments must strike a balance between maximizing the potential benefits and limiting the unintended consequences (from associated costs and restrictions) to ensure these obligations do not negatively impact access to finance. Currently, approaches vary significantly across jurisdictions, with some jurisdictions extending some consumer protection elements (though not all) beyond private individuals to a subset of firms.[96] The use of fintech exacerbates other operational risks, such as cybersecurity. Therefore, financial regulators should ensure that operational requirements imposed on financial intermediaries remain robust. Finally, financial supervisors should adapt their supervision to capture the risks brought by fintech, new financial intermediaries, and new business models.

Similarly, increased reliance on capital markets solutions, whether traditional- or fintech-based ones, carries investor protection risks. Many of the capital markets solutions for SME financing have a higher level of risk than traditional products (that is, corporate bonds and equity). This is why, in practice, many of these products are only offered through private placements, which limits the possibility of retail investor access. However, lending and equity crowdfunding platforms provide retail investors with direct access to SME offerings. In these cases, governments and financial regulators have used a combination of mechanisms to mitigate investor protection risks, including limits on the amount that retail investors can invest in this type of offering and warnings about the risks associated with these investments, in addition to the imposition of disclosure requirements regarding the role of the platforms and the conditions under which companies are obtaining financing from investors.[97] Countries have also required platforms to assess how well investors understand these products prior to allowing investments.[98]

3.8 Action 8. Establish Robust Foundational Infrastructure

Robust basic digital infrastructure and digital financial infrastructure are key components of the ecosystem that enables the adoption of fintech and the development of alternative fintech lenders.[99] Digital connectivity underpins the provision of digital financial services (DFS). Overall, it includes the following: (a) ensuring the smooth functioning of an information, communication, technology network with broad coverage throughout the country and a reliable power supply; (b) access to basic mobile telephony services—voice, text, and special system messaging services; and (c) access to data services (3G and above), which can improve the user experience through application based delivery of DFS services. Application based DFS services, with detailed information on the users' digital footprint and behavioral characteristics, also enable more tailored products and credit assessments for SMEs. Similarly, digital public infrastructure is crucial.[100] For example, digital payment infrastructure is the gateway to financial access and can play a role in access to finance as well. Digitizing payments generates alternative data, which can be helpful for SME financing, as outlined above; reduces transaction costs; and increases transaction efficiency, especially for business customers located in remote areas. The experience of several EMDEs (for example, Brazil and some EMDEs in East Africa) demonstrate how interoperable mobile money, faster payments, and other systemic interventions in the digital payment space can improve access to finance.

Other public and private digitalization initiatives, such as online registration of SMEs, and digitalization of SME processes can further support access to finance. Online SME registration can support SME access to finance by increasing the efficiency of customer due diligence (CDD) processes while enabling a more robust digital footprint for SMEs.[101] Similarly, digitalization of SME processes can help SMEs build their alternative data. Most SMEs lack the scale to develop their own unique digital platforms and thus need to partner with large digital platforms. Such platforms could include e-commerce platforms for goods (for example, Amazon and Lazada), service platforms (for example, Grab and Food Panda), and providers of broader digital tools to enhance businesses operations (for example, Microsoft or Amazon Web Services).

CHAPTER 4

Toward a More Effective Use of Targeted Public Interventions

Governments around the world have resorted to targeted interventions to affect the supply of financing to SMEs. There is no globally accepted typology for targeted interventions.[102] In this report, targeted interventions are defined as public interventions that aim to directly affect the supply of financing available to SMEs, but also carry fiscal costs. Table 4.1 provides a stylized view of the interventions deployed in EMDEs along with the market failures such interventions seek to address.

There is no consolidated information on the size nor the scope of targeted support in EMDEs, but World Bank experience indicates that governments in EMDEs have often prioritized interventions aimed at addressing the SME credit gap. Many EMDEs have relied on a combination of direct lending to SMEs (mostly via DFIs, such as development banks) and intermediated interventions (that is, the government, in many cases via a DFI, provides a line of credit to financial intermediaries, so that in turn they provide the financing to SMEs).[103] In most EMDEs, banks have been the main intermediary through which these interventions have been deployed. More recently, governments have increasingly contributed to the capitalization of PCG schemes, which provide protection to lenders against credit losses arising from their SME lending portfolio.[104] In a few larger EMDEs, public interventions (for example, investment programs and de-risking tools) have also been used to mobilize investors to SME financing via capital markets solutions. See appendix D for an example of the type of interventions deployed.

Increasingly, EMDEs have also deployed interventions to expand access to equity financing for SMEs. In most cases, equity interventions have largely focused on financing startups, given the lack of active VC markets to support the financing of innovation. However, governments in some EMDEs have also supported equity financing for growth SMEs. Financing SMEs through VC funds has been the main type of intervention deployed by governments around the world. These schemes typically rely on a single dedicated fund in EMDEs with less developed capital markets, and on a fund-of-funds approach in larger and more developed EMDEs, whereby the government invests in a plurality of existing funds. In many cases, support programs have also included a small allocation to direct coinvestments alongside angel investors. To different degrees, governments in EMDEs have adopted other types of support programs to build the entrepreneurial ecosystem. A limited number of EMDEs have implemented targeted interventions aimed at supporting SME listings in equity markets. These programs have usually focused on subsidies to their listing in SME exchanges and tax benefits to attract investors.

Overall, governments need to substantially improve the design and implementation of targeted interventions to enhance their effectiveness. This impetus is particularly important at the current juncture when governments are facing tight fiscal space due to the economic impact of the COVID-19 pandemic. The rest of this chapter draws on the lessons learned from the targeted interventions in both HICs and EMDEs to shape guidance for policy makers in EMDEs.

TABLE 4.1
Targeted Interventions Supporting SME Finance

Type of intervention	Problem that they seek to address	Differences in use between EMDEs and HICs
Debt interventions		
Direct lending	• Provides flexibility in the range of challenges to be addressed, but does not mobilize private capital	• Many DFIs in EMDEs use direct lending for SMEs, either as their solo approach or in addition to an on-lending approach.
Lines of credit (LoCs)	• Address the funding challenges of financial intermediaries (for example, lack of long-term financing) that hinder their ability to lend to SMEs • De-risks SMEs by altering their risk-return profiles, when provided at concessional terms	• In HICs, LoCs have been deployed through a wide range of lenders, including not only banks but also alternative lenders, such as digital banks and asset-based lenders. In EMDEs, the main channel for deployment has been banks.
Partial credit guarantee schemes	• Mitigate constraints from high credit risk, limited collateral, and limited information in SME financing by providing a guarantee against credit losses generated by SME loans (or the SME portfolio), for a fee • Can trigger capital "savings," for regulated entities	• Globally, the main users of these schemes have been banks; but depending on the country, other alternative lenders have had access. Some countries have separate funds/windows for some types of non-alternative lenders.
Other credit guarantees used with capital market solutions	• Mitigate credit risk, by providing a guarantee against losses generated by SME-related assets	• These types of guarantees are used more frequently in HICs, covering different capital markets solutions (for example, minibonds, SME funds, SME securitization). • Some larger EMDEs have programs for some of these solutions.
Investments in different capital markets solutions	• Provide scale via signaling effect • Can also have demonstration effects	• Investment programs are used more frequently in HICs, mainly in connection with different types of debt funds and lending platforms.
Equity interventions		
Investments in funds	• Provide scale via signaling effects • Can have demonstration effects • When provided at concessional terms, can also de-risk SMEs by altering their risk-return profile	• In HICs, they support both innovation and growth. • In EMDEs, the focus has been on VC funds.
Direct coinvestment	• Support the development of angel investors • Address specific gaps in the marketplace that funds are not fulfilling	• These are used in both HICs and EMDEs.
Equity guarantees	• De-risk SMEs by altering SME risk-return profiles via reduction of potential for losses	• Use of equity guarantees is limited across both EMDEs and HICs, likely because a similar effect can be obtained through asymmetric return arrangements.
Tax incentives to investors	• De-risk SMEs by altering SME risk-return profiles via improvement of returns	• These are available in a wide range of HICs, and some EMDEs. Scope varies by country, but in many cases, they cover a wide range of SME investments (that is, not only for investments in VC funds, but for investments in SMEs more broadly as long as not listed in public markets).

Source: Original table for this publication.

No comprehensive cross-country evaluation of targeted interventions programs in EMDEs has been conducted to date; however, indirect evidence suggests that design challenges have impacted program effectiveness.[105] The existing evidence and World Bank experience supporting countries in deploying these types of interventions point to three interrelated challenges in program design across EMDEs: (a) lack of clarity in the objectives of the interventions; (b) problems with targeting, both in terms of the eligibility for SMEs as well as the financial intermediaries used as delivery partners; and (c) deficiencies in monitoring and evaluation (M&E) frameworks. Addressing these three dimensions should create a positive feedback loop, in which assessments based on M&E frameworks would not only reveal the impact of support policies, but also identify lessons that could form the basis of revisions to the design and implementation for these programs in the future. M&E frameworks would thus allow for evidence-based course-correction in public support programs. An additional challenge relates to the fragmentation of interventions across multiple government departments and public entities, including DFIs, which could potentially create gaps in support, or even duplication of efforts that can lead to an inefficient use of public resources.

The recommended actions below provide a framework to tackle these challenges. They are applicable to any government or public entity that deploys targeted interventions, as defined in this report, to support access to finance for SMEs.[106]

While targeted interventions might help push the frontiers of the financial sector toward improving SME access to finance, such interventions cannot do all the heavy lifting. World Bank experience supporting EMDEs in implementing targeted interventions suggests that the effectiveness of targeted interventions in EMDEs has been hindered by incomplete enabling environments as well as by challenges emerging from the level of development and structure of the financial sector in EMDEs. The implementation of both the enabling environment actions, summarized in chapter 3, along with the implementation of well-designed targeted interventions should lead to improvements in SME access to finance. But without further progress in addressing the underlying causes of the underdevelopment of the financial sector more broadly, the effectiveness of targeted interventions in EMDEs might still suffer and waste public resources.

4.1 Action 1. Enhance Data Availability and Diagnostic Analyses to Ensure Outreach to Underserved SMEs

There is no such thing as a typical SME, nor are they all similarly constrained in accessing financing. SMEs range from mom-and-pop operations to high-technology firms on the verge of a public offering, some may be high-growth firms, while others are low-growth SMEs, and so on. Admittedly, SMEs do share some common critical features that hinder their access to finance, yet not all SMEs are equally constrained, nor do they need the same type of financing. The composition of SMEs and the extent to which they are constrained varies across countries. Thus, country-specific conditions matter, namely, the demand side (that is, SMEs themselves), the supply side, and the broader financial and economic environment. For instance, the level of development of the financial sector (that is, market concentration, degree of diversification of funding sources, availability of long-term funding markets) can disproportionately impact the availability of financing for some SME segments or the availability of certain financing instruments.

Accordingly, the set of SMEs that benefit from targeted interventions should vary across countries. A unique and consistent definition of SMEs at the country level can help enhance the effectiveness of the broader support agenda for SMEs. For example, the adoption of such definitions can facilitate data collection and analyses, can mitigate coordination failures by establishing a focal point for policy action, and even signal policy priorities. Many countries have indeed adopted such definitions for policy purposes. However, such definitions should constitute the starting point to select the set of firms that should benefit from targeted financial support. Rigorous country diagnostics are necessary to understand which SMEs segments face the largest financing gaps and can thus help policy makers better define (and possibly narrow down) the universe of potential beneficiaries of targeted financial interventions.

Furthermore, there is no set of standardized interventions that all EMDEs can apply, as country context matters. Determining which interventions to deploy, as well as their specific design, should also be driven by such country diagnostics. Governments should strive to target the SMEs that would benefit the most from interventions (that is,

first-time borrowers), and consider, as appropriate, specific "windows" for the most underserved SMEs. The diagnostics should also inform the choice of intermediaries to deploy the needed interventions, ensuring they are delivered through financial intermediaries that can effectively reach the underserved segments. For example, the inclusion of alternative lenders might be critical to reach underserved segments. Thus, eligibility criteria should not be limited to banks. Similarly, in the context of equity financing, the eligibility criteria could point to fund managers with experience in strategies that are in line with the identified financing gap.

In practice, a multipronged approach is likely needed in most EMDEs to address the debt and equity financing gaps. While equity and debt financing play important, but distinct, roles in supporting SMEs along their life cycles, policy makers must be cognizant of the trade-offs in allocating resources to support equity versus debt financing, especially when fiscal resources are scarce. Debt financing is the most important source of external financing for SMEs, and support programs can have widespread reach. In contrast, given the scarcity and cost of equity financing, equity interventions should be deployed more selectively, reaching a smaller set of firms, typically innovative SMEs and SMEs with high growth potential, especially when other long-term funding sources have not fully developed. Policy makers should also be realistic about not only the desirability of these interventions but also their feasibility and impact, based on the realities in their own countries, especially the existence of preconditions that can affect the scalability and impact of the interventions. As discussed below, a careful balancing of the different objectives pursued with different interventions might be needed.

Most EMDEs would need to substantially improve availability and access to firm-level data to support robust country diagnostics and ensure adequate targeting of their interventions. In many EMDEs, there are huge data gaps relevant for an assessment of the landscape for SME financing. There is a major gap in standardized, accurate, granular, and frequent data on firm financing, especially for smaller private firms. While several countries have taken important actions to expand their statistical capacity, EMDEs still need to step up efforts to develop and improve the building blocks for effective and comprehensive data collection, including the adoption of regular firm-level surveys and financial institution surveys. Policy makers must therefore prioritize data collection, reporting, and accessibility, especially firm-level financial data and analysis, to foster evidence-based policies in tackling the challenges of the SME financing gap. In the short term, governments should complement existing information with qualitative assessments, including ad-hoc surveys. In tandem, governments should develop and enhance their SME (finance) data frameworks at the national level. They should also consider measures that can help consolidate existing data from different public entities and enhance governments' understanding of the SME sector. One example of such an initiative is SME observatories, which have been implemented in countries such as France and Morocco with the objective of creating a hub of information and knowledge on SMEs.[107]

4.2 Action 2. Emphasize Financial Additionality and Private Capital Mobilization as Clear Objectives of Targeted Interventions

Targeted interventions in EMDEs should mitigate key market failures hindering SME finance, while making more strategic use of public funds. In many EMDEs, interventions supporting access to finance have been used too broadly, including to support social protection goals. Going forward, it is essential for governments to reassess the role of these interventions and focus their programs on addressing key market failures that prevent viable SMEs from accessing financing. Governments should place greater emphasis on improving financial additionality and crowding in private capital, while minimizing distortions and outright avoiding a crowding-out effect. The direct engagement of private capital is critical for the long-term development of SME financing.

Important corollaries can be drawn from the emphasis on private capital mobilization. First, it places a higher bar on direct interventions (that is, interventions made directly by a government entity or public institution without the participation of private financial intermediaries) as this type of interventions is unlikely to mobilize private capital. Second, care must be taken that interventions mobilize "new" private funding, and do not lead to crowd-out effects, although measuring additionality is complex.[108]

That is, policy makers need to emphasize the role of public support programs in crowding-in private financing, rather than displacing it. To this end, at a minimum, governments should conduct a market analysis to understand the existing level of financing by the private sector and estimate the potential crowding-in impacts of the public intervention, including conducting simulations, as appropriate. Third, in some EMDEs, especially LICs, achieving private capital mobilization, and in particular achieving sustainable participation of the private sector, might be challenging given the structural problems that affect the development of the financial sector. In this context, government interventions would need to fulfill a role of market creation, which would likely require interventions over a longer period of time. At the same time, policy makers would need to work to address the structural challenges that hinder private financing. Without such additional actions, public support might not effectively mobilize private sector financing and develop financial markets in a sustainable manner, regardless of the amount of financial resources deployed.

4.3 Action 3. Deploy Concessional Financing Sparingly

Concessional financing carries high risks.[109] Both EMDEs and HICs have used concessional financing to alter the risk-return profile of a loan or an investment, and thus make commercially viable the financing of a specific underserved sector (for example, agri-SMEs), a specific type of financing (for example, long-term loans), or allow intermediaries to provide financing at below market rates. While justified in some instances, such as in cases of clear positive externalities (for example, financing SMEs' investments in adaptation or mitigation to address the impact of climate in their operations), concessional financing can negatively impact overall private market development. Concessionality carries the risk of reducing the incentives for financial intermediaries or investors to commit their own funding. This is the case when interventions provide concessional financing to SMEs, as doing so may reduce their demand for financing at market rates. Private financial institutions are then unable to compete with support programs. Such use of concessionality can lead to crowding-out effects. Similarly, concessionality deployed via cheaper funding to financial intermediaries to incentivize their engagement with the SME segment (which does not always translate to lower interest rates or longer-term financing for SMEs) can lead to moral hazard, as intermediaries or investors may lower their selection standards.

Thus, concessional financing should be used sparingly and deliberately to achieve a specific benefit in the SME financing space. In deciding about the provision of concessional financing, governments should thoroughly assess (a) whether market failures justify the use of concessionality in the first place and the objectives to be achieved with such interventions, as explained above; (b) the extent of the potential distortions that it could bring; and (c) whether mechanisms can be put in place to mitigate such risks. The recurrent use of concessional financing should prompt an assessment of whether additional policy actions, for example, in the enabling environment, are needed. However, identifying the degree of concessionality needed involves a counterfactual assessment that is difficult to make in practice. Drawing a line between concessional and commercial financing is also difficult, as in some instances, "commercial" pricing might not exist. Overall, the use of concessional financing should constitute a temporary measure. Authorities should explicitly develop an exit strategy and graduation targets, as appropriate. To this end, at the design stage, authorities should assess the additional policy actions that might be needed to support the removal of concessional financing at a later stage, including actions in the enabling environment.

4.4 Action 4. Leverage Developmental Finance from Donors for Private Capital Mobilization

Some EMDEs have had access to concessional financing from public and private donors in connection with SME financing programs. In many cases, this support has been associated with underserved segments, such as WSMEs and agri-SMEs, and more recently to green financing. The scope has varied from grants for capacity building to financing risk-sharing arrangements (for example, to establish a PCG facility). Yet, in many cases, this support has not been directly linked to the objective of mobilization of private capital for complex reasons—from the fact that many donors have not yet prioritized such mobilization to the complexities that a blended finance structure might bring.

Going forward, governments should better link development financing with their own private capital mobilization goals in a blended finance approach.[110] Governments should systematically map the global developmental financing available in the SME space and maximize their use via blended finance structures to increase private capital mobilization and potentially lower the need for public funding. A key example is the Green Climate Fund that supports the financing of climate change adaptation and mitigation investments in EMDEs.[111] National development banks in some EMDEs, such as Nacional Financiera (NAFIN) in Mexico, are going through the accreditation process that will allow them to tap fund resources for their own SME programs. In addition, global private sector initiatives providing blended finance for private financial intermediaries exist for segments such as agri-SMEs[112] and WSMEs.[113] Thus, it is important that governments also map these initiatives to systematically assess where public funding is most needed.

4.5 Action 5. Complement Targeted Interventions with Non-financial Support

Cross-country experience indicates that programs to enhance SME capabilities are critical to improve the effectiveness of targeted interventions. For example, financial intermediaries in many EMDEs frequently point to the lack of a healthy pipeline of SMEs as a key constraint for lending or investing. Governments in EMDEs have increasingly linked their financial interventions to technical assistance programs for SMEs, both for debt and equity financing. Appendix D provides an overview of the different types of complementary programs that EMDEs can implement. These programs are a critical addition to the financial education programs that many EMDEs have in place and that in some cases identified SMEs as a target group.[114]

In addition, depending on country needs, governments may also consider deploying programs to enhance the capabilities of financial intermediaries and investors. Programs for financial intermediaries could be instrumental in expanding and diversifying funding sources. For instance, training for alternative lenders in key operational areas (for example, risk management) or for new products (for example, asset-based financing) can help them expand their reach to SMEs. These programs can also benefit smaller banks and foster competition. While existing programs are more prevalent in connection with debt financing, they can also be beneficial in the context of equity financing, especially where support programs aim at developing a domestic fund management industry. In the context of capital market solutions for SMEs, World Bank experience indicates the need to consider capacity building for institutional investors, such as pension funds, to help increase their awareness and understanding of the new instruments and their risks.

4.6 Action 6. Improve the Evaluation of Targeted Interventions

Establishing programs to assess the impact of targeted interventions is key to ensuring accountability and enabling the fine tuning of interventions. Accountability through increased transparency is paramount in an environment of limited fiscal space. It is critical for governments to evaluate interventions to demonstrate that public resources are being used effectively. Such evaluations can also support the effectiveness of interventions by enabling the implementation of adjustments when interventions do not reach their intended objectives. This is an area where there is much room for improvement in both HICs and EMDEs, although progress has been made in selected HICs.[115] Based on World Bank experience supporting EMDEs in implementing targeted interventions, in the short term, governments in EMDEs should focus on setting up clear objectives for their interventions and transforming such objectives into timebound targets that can be monitored and adjusted as needed. In the medium term, governments should establish independent M&E frameworks, anchored on robust data frameworks and the adoption of well-established techniques (for example, the use of control groups) for the evaluation of program impacts, especially in terms of additionality and private capital mobilization.[116] In addition, governments should leverage different types of public institutions and private stakeholders, such as statistical and auditor general offices, as well as universities and think tanks, to promote and institutionalize independent evaluations as an accountability tool.

4.7 Action 7. Improve Coordination, Including by Better Leveraging Existing DFIs, and Ensure Proper Governance

In many EMDEs, multiple government departments or public agencies are often involved in the design and implementation of targeted interventions supporting SME finance. For example, interventions targeting specific underserved segments might be under the responsibility of different ministries (for example, finance, agriculture, innovation), which might lead to the existence of separate vehicles and arrangements to deploy them (for example, the creation of separate interventions under different ministries with specific objectives in the SME space, such as programs to expand financing for agri-SMEs or programs to expand financing for innovation). In tandem, there might also be DFIs, including development banks, with a mandate to deploy targeted interventions on the SME finance space.[117] The dispersion in the deployment of public sector support for improving SME financing creates the potential for gaps and overlaps that can lead to an inefficient use of public resources.

In this context, governments should ensure that they adequately leverage existing DFIs, for example by ensuring that any additional program that is created is fully coordinated with existing DFI programs. This in turn requires two distinct sets of efforts. First, efforts to improve the effectiveness of DFIs. A recent World Bank report provides nine recommendations to improve the effectiveness of DFIs, which are all consistent with the recommendations included in this report (see box 4.1). Second, efforts to enhance coordination. This should include the development of a holistic strategy for SME financing that considers all entities involved in this space, as well as appropriate arrangements for day-to-day coordination (for example, coordination committees).

Finally, strong governance arrangements should be in place to ensure that the objectives of public interventions are achieved.[118] While specific governance structures might vary depending on the legal nature and structure of the implementing agencies,[119] the overriding lesson from the World Bank experience supporting EMDEs in implementing targeted interventions is that governance arrangements need to be robust to (a) mitigate the potential for political interference in technical decisions, especially regarding the selection of the intermediaries to deploy the corresponding interventions and the SMEs to receive support; (b) ensure that political interests do not outweigh long-term project objectives; and (c) ensure proper oversight and accountability.

BOX 4.1

Lessons Learned from Efficient National Development Financial Institutions (NDFIs)

Lesson 1. Identify the unmet needs and factors preventing private sector involvement, and consider all public policy interventions available, beyond provision of public sector funding, to address the problem.

Lesson 2. Set up a mandate or mission statement for NDFIs focused on complementing private sector and crowding in private investors to provide financial solutions to identified underserved segments or projects while preserving financial sustainability.

Lesson 3. Design NDFI facilities focused on servicing credit-constrained borrowers to ensure additionality.

Lesson 4. Develop a range of instruments to leverage private sector funding.

Lesson 5. Use preferential lending sparingly when large externalities can be justified. NDFIs need to ensure that when subsidies are necessary, they are channeled in a transparent and non-distortionary way.

Lesson 6. Operate the institution as a financial sector company not a public agency.

Lesson 7. Ensure that the institution is effectively managed, and the incentives of management and staff are aligned with the objectives of the institution through effective corporate governance, risk management, and mechanisms to evaluate the performance of NDFIs.

Lesson 8. Ensure that NDFIs are properly supervised by the financial supervisory agency and that the institution operates on a level playing field.

Lesson 9. When the environment is not conducive to NDFI effectiveness, operate in second tier and raise funds in international capital markets.

Source: Gutierrez and Kliatskova (2021).
Note: NDFI = national development financial institutions.

4.8 Additional Recommendations for the Design of Debt Interventions

Governments should more deliberately use targeted interventions to support alternative lenders. In many EMDEs, banks have been the main intermediary through which interventions have been deployed. While banks remain the key funding source for SMEs, as indicated in chapter 2, alternative lenders can fulfill important gaps in SME financing. Hence, governments in EMDEs should use targeted interventions to foster the development of alternative lenders. Appendix C discusses the example of how the British Business Bank incorporated the diversification of funding sources as a core objective of its interventions.

To this end, governments should first focus on reducing their use of direct lending. As indicated earlier, many EMDEs still rely on direct lending to affect the supply of SME financing. Direct lending can be an effective mechanism to address financing constraints affecting SMEs, as it supports the quick delivery of financing to underserved segments. Nonetheless, its use has raised concerns. Effective deployment of direct lending requires a high level of institutional maturity and robust governance arrangements to mitigate potential government interference and to ensure proper risk management. Such conditions are difficult to attain in EMDEs. Moreover, this type of intervention does not address the underlying market failures in SME financing. Hence, it does not help create the conditions to unlock commercial lending, nor does it leverage private financing in any way. Direct lending should be used sparingly, for a limited period of time, when sizeable externalities justify its use.

Governments should avoid barriers in access to support programs for alternative lenders by reviewing the eligibility criteria for financial intermediaries. For example, in many EMDEs, PCGs can only be accessed by banks or the requirements for access to PGCs are skewed toward banks. Such design gives banks the upper hand in dealing with key risks when serving SMEs. Adopting requirements to access support programs related to the soundness of financial intermediaries is necessary to ensure proper risk management. However, governments should establish proportionate

requirements that foster accessibility by financial institutions other than incumbent banks. Depending on country context and the objective of interventions, such institutions might include MFIs, asset-based lenders, and on-balance-sheet fintech lenders.

Governments should deploy interventions aimed at tackling the specific challenges faced by alternative lenders. For example, funding is a key challenge for many alternative lenders, as it affects their ability to expand their portfolios and deepen their engagement with underserved SMEs. Unlike banks, most alternative lenders do not have access to deposits. In fact, many rely on funding from banks. In addition, other sources of long-term funding, such as capital market financing, might not be available to them. Governments can thus support alternative lenders using targeted interventions, such as LoCs, or creating refinancing facilities to improve access to (long-term) funding. Such measures can enable the expansion of alternative lenders' SME portfolios and improve financing conditions for SMEs.

Mix of Interventions Supporting Debt Financing

For most EMDEs, LoCs and PCGs remain the main types of deployed intermediated interventions. However, depending on country context, governments may need to recalibrate their use.

- **Capitalization of PCGs.** PCGs should constitute the key targeted intervention to address, on a permanent basis, problems stemming from the high riskiness (perceived and real) of SMEs, which is heightened by their opacity, lack of collateral, and limited credit histories.[120] Still, the implementation of PCGs is complex and requires a certain level of institutional maturity. A set of core principles, summarized in appendix E, should guide their development.[121] These principles call for the establishment of PCGs via separate legal entities, with strong governance and risk management arrangements and highlight the need for robust oversight to ensure the credibility of the schemes. In practice, PCGs around the world differ in their design—specifically in elements such as management structure, operating rules, and the characteristics of guarantees, including the coverage ratio and pricing. These design choices can be critical to the effectiveness and financial sustainability of the schemes, as they affect administrative costs and influence the participation of financial institutions and SMEs and can even impact loan default rates. In fact, a key challenge for PCGs in many EMDEs is the limited uptake by financial intermediaries, which should call for a review of their design, especially of the incentives for financial institutions and SMEs embedded in the schemes.
- **LoCs.** LoCs have been used frequently in EMDEs to support SME financing in different contexts, due to their relative simplicity and flexibility compared to PCGs.[122] However, they often do not address the fundamental challenges hindering SME financing in EMDEs, such as those related to the characteristics of SMEs themselves. Therefore, without additional policy actions, the potential for graduation from these interventions is limited. Furthermore, when LoCs are offered at concessional terms for SMEs, the risk of crowding-out private capital increases, as borrowing at commercial rates becomes unattractive for SMEs. In addition, LoCs potentially require a greater amount of public resources compared to PCGs. As EMDEs implement PCGs, LoCs should be used more selectively, with their use focusing mainly on addressing gaps in the funding markets that affect financial intermediaries' ability to serve the SME segment. Country circumstances—such as the specific role that different intermediaries play in financing specific underserved SMEs—would determine the types of intermediaries that should benefit from these interventions. For example, for many EMDEs, LoCs could be targeted to MFIs, asset-based lenders, and, for a smaller set of EMDEs, also fintech lenders. In exceptional circumstances (for example, when there are significant positive externalities), concessional LoCs could be used to make commercially viable the financing for SMEs, and to improve lending conditions (for example, longer maturity, lower interest rates). In practice, in many EMDEs the dividing lines between LoCs at market prices or LoCs at concessional terms are blurred. For instance, LoCs are in many cases given to enable credit at longer maturities for which there might not be any market price. Thus, it is critical that authorities monitor whether LoCs (at concessional terms or simply provided at favorable conditions) do in fact translate into benefits for SMEs (for example, in the form of new products or improved terms such as better maturities or more favorable interest rates).[123]
- **Other interventions.** Based on country context, governments could consider other types of interventions, such as creating refinancing facilities for regulated alternative lenders to address, on a more permanent basis, their funding constraints. In any case, their deployment typically requires a certain institutional maturity. Governments should also consider the competitive implications of such alternative arrangements to ensure a level playing field across the range of financial providers actively engaging with SMEs.

MICs with more developed capital markets should consider deploying interventions designed specifically to foster capital markets solutions for debt financing for SMEs. There are four main types of such interventions:

investment programs, credit risk guarantees, tax incentives, and subsidies. Country context should determine the specific set of capital market solutions to develop (whether plain vanilla issuances by SME lenders, SME loan securitization, minibonds, debt funds, or lending and bond-based platforms that operate off balance sheet) and the type of intervention to deploy. Such decisions should also depend on an assessment of the viability, sustainability, and potential benefits of further developing each of these solutions to deepen SME financing. Chapter 2 provided a stylized view of the key preconditions and the enabling environment necessary for each of these capital market solutions to guide governments' choices. Cross-country experience indicates that, in many cases, more than one intervention would be needed to mobilize private investors, as highlighted in the examples of Colombia and Italy, discussed in appendix C. Overall, governments should be guided by the principle of using the minimum amount of public resources necessary to crowd-in private capital.

- **Investment programs:** This is the most basic type of intervention that can be deployed. It is aimed at providing scale to a specific capital markets solution through signaling effects associated with government investments. This intervention could also be associated with demonstration effects, although it does not alter the risk-return profile of SME investments.

- **Credit risk guarantees:** For many jurisdictions, investment programs might not be sufficient to mobilize specific types of investors, thus making additional interventions necessary. One such intervention is credit risk guarantees. Cross-country experience, especially from EMDEs, suggests it is effective in attracting institutional investors toward riskier instruments, as this set of investors tend to have conservative risk appetites (dictated by regulation in some cases, restricting their investments to high-rated securities). There is, however, a delicate balance between such credit enhancements and the economics of the instruments themselves. While credit enhancements might bring instruments to a desired rating, in practice, their pricing might render them financially unviable.[124]

- **Tax incentives:** Although tax incentives are used to alter the risk-return profile of SME investments, their use should be carefully assessed against the market failures hindering access to finance for SMEs. Some investors may already enjoy favorable tax treatments, which limits the impact of separate tax incentives for SME investments. Similarly, for some institutional investors, like pension funds, addressing credit risk concerns might be critical to align SME investments with their own risk appetite.

- **Subsidies**: Subsidies have been used to foster the direct use of capital markets, especially by medium companies. They aim to lower the costs of accessing the markets and include, for example, benefits in connection with specific issuance or listing costs.

4.9 Additional Recommendations for the Design of Equity Interventions

Although public support is considered critical to crowd-in private investors to equity financing, such interventions have had limited impact in many EMDEs, especially in LICs.[125] The empirical evidence on the effectiveness of interventions remains scarce, as many schemes supporting equity financing in EMDEs are relatively recent. However, qualitative assessments point to significant differences between larger EMDEs and smaller jurisdictions. In smaller jurisdictions, especially within LICs, the ability of public interventions to unlock private investor participation in an impactful and sustainable manner remains an open question. This difference in the impact of interventions across countries is largely the result of challenges with preconditions, which relate to uncertainty in the macroeconomic and financial environment; the lack of a robust pipeline of companies; the limited development of a domestic institutional investor base; the lack of consistent exit options for investors; and in some cases, the lack of some basic components of the legal and regulatory environment for equity financing, among other challenges. Some of the challenges could be addressed through parallel interventions; but other challenges are structural in nature and are thus more complex and would require more time to resolve.

In this context, governments (especially governments in LICs) that wish to pursue this type of intervention should recalibrate their objectives to place greater focus on market creation. Focusing on the role of market creation implies

that governments must be willing to initially accept a limited level of private capital mobilization, which in some cases, can only be achieved with concessionality. It would also likely require more widespread and prolonged financial support across the entire ecosystem of entrepreneurship, innovation, and equity financing. Governments might accept this level of support, given the potential economic additionality of these interventions for innovation and economic growth. But governments must be mindful of the implications of this recalibration of objectives, including the potentially large fiscal costs of these interventions. Governments would also need to work on complementary interventions to address the structural challenges affecting private sector participation in the market to increase the probabilities of graduation from these interventions. In any event, equity interventions, even in MICs, require a longer time horizon to reach sustained impact, and governments should be ready to provide patient capital.

Mix of Interventions Deployed to Support Private Equity

Governments should apply private sector practices to improve the mobilization of private capital, relying on a fund-of-funds approach whenever possible. Private sector structures, in particular funds, are critical to achieve scale and diversification. Early lessons from HICs and EMDEs indicate that investment, through a fund of funds, should be the preferred approach. Under this approach the government invests in companies indirectly, via the structuring of a fund, which in turn invests in a plurality of other funds structured by private sector fund managers, and in which private investors also invest. This approach was initially adopted by countries members of the Organisation for Economic Co-operation and Development (OECD), with increased adoption coming from larger EMDEs over time. This approach provides scale and mitigates the risk of concentration in one fund (and fund manager), thus ensuring diversification of investment strategies. Compared to private investors, this approach ensures that government investments follow the market. However, early lessons indicate that governments should retain the flexibility to use direct coinvestments alongside private investors that would conduct their own due diligence, thus allowing governments to also follow the market. For example, direct coinvestments in companies alongside angel investors could foster the development of a network of angel investors that could support early-stage financing. It could also help address specific market gaps not fulfilled through a fund-of-funds approach.

An in-depth market analysis should be the basis for identifying the type of funds in which to invest, determining the type of instruments to deploy, and informing other design elements of the program. The identification of the key market gaps should dictate the selection of SMEs to target and, consequently, the type of funds in which the government should invest (for example, early stage, growth, late stage). In addition, an understanding of the investor base should guide design decisions, such as the domicile of the funds. Appendix C provides insights regarding the types of flexibilities that some countries have introduced in their programs to address the needs and preferences of foreign and domestic investors. For instance, some EMDEs have allowed investments in foreign funds provided that a percentage of their assets are invested in domestic companies. World Bank experience supporting EMDEs in implementing targeted interventions indicates the need to incorporate flexibility in the financial arrangements and the instruments, allowing coverage of not only equity but also other instruments, such as convertible bonds and mezzanine and subordinated debt. The latter can still provide risk capital, while mitigating some of the concerns that have hampered the interest of SMEs for equity financing, particularly those associated with SMEs' reluctance to open their capital to third parties.

As a result of the nascent state of their equity markets, LICs that have implemented investment programs have not been able to apply a fund-of-funds approach and have instead relied on investing in a single dedicated fund. The fund is structured by the government, with the expectation that it will bring private sector investors to it; thus, it is sometimes called a hybrid fund. This approach is unlikely to close the existing financing gaps of SMEs, nor is it likely to meet the follow-on needs of companies that are able to obtain financing from the fund. It is also unlikely to mobilize private capital at scale. In this case, the choice of a single hybrid fund is driven by country context. Small countries that are not regionally well integrated would not be able to resort to a fund-of-funds approach, as there would not be enough fund managers locally or regionally interested in supporting SMEs in these markets, even though there could be SMEs in need of equity financing. Governments that choose to pursue this type of intervention should thus be realistic about what can be accomplished and as stated earlier, should focus on market creation, working in parallel to address structural challenges that limit their ability to mobilize private capital in a sustainable manner.

Governance arrangements are key in mobilizing private investors, irrespective of specific intervention designs. Governance arrangements are meant to instill confidence in investors by ensuring that fund management is professional and that decisions are based on market and business opportunities. In practice, this means using professional fund managers and investment committees integrated by independent experts who can make investment decisions without government interference. Government oversight is still necessary to ensure the achievement of program

objectives, for example, in terms of outreach to specific SME segments and financial additionality. But oversight should not take place through direct participation of the government in investment decisions, but rather through other mechanisms, including strong M&E frameworks, as discussed in the previous section.

To limit market distortions and ensure sustainability, financing should be provided on commercial terms; however, EMDE experience indicates that some level of concessionality may be necessary to crowd-in private investors, particularly for riskier investments. This recommendation is relevant, for example, for EMDEs attempting to attract foreign investors. In this case, governments may use concessionality to offer returns comparable to the returns that these investors would obtain through investments in other countries, including in HICs. In practice, the type of concessionality has varied. In many cases, it has involved asymmetric returns (for example, the government caps its returns, or it accepts a larger share of the losses, akin to a guarantee); in other cases, it has involved the government bearing certain costs of the fund (such as, paying part of the fund management fees).

Cross-country experience indicates the need for broader support programs for more impactful investment interventions. The scope of these programs depends on country context.

- **Technical assistance, grants, and performance-based financing to support the development of the deal flow:** As highlighted above, the lack of a robust pipeline of companies to invest in is often mentioned as a key constraint for private investors in EMDEs. Governments have increasingly combined their financing support with technical assistance programs aimed at enhancing firms' capabilities and providing investment readiness grants. Other types of grants to SMEs should be used under limited circumstances, for example, when they are needed to support innovation but are unlikely to distort private financing. Public support can also foster the development of other entities that play an instrumental role in building the deal flow, such as incubators and accelerators. This type of support has varied, from launch grants to performance-based financing to align incentives.
- **Capacity building to support the development of the investor base:** In some EMDEs, there is a need to further develop the base of angel investors, which can be a source of early-stage equity capital and expertise. Governments have been instrumental in developing angel networks and providing capacity building. In addition, in countries where domestic institutional investors (such as pension funds and insurance companies) are mobilized, capacity building programs to increase understanding of these investments have proven to be valuable.

Governments should use tax incentives carefully. Tax incentives to investors have been deployed in many countries, including most of the countries with well-developed VC industries.[126] Nonetheless, the effect of such incentives in attracting private equity financing remains unclear. Research has not found a relationship between tax incentives and the level of equity financing.[127] The use of tax incentives by many countries to make investments in SMEs more attractive to foreign investors, might lead some EMDEs to provide similar incentives; however, in doing so it is critical that EMDEs evaluate their fiscal cost and effectiveness in mobilizing private capital and, more generally, in bringing financial additionality. In addition, governments should holistically assess whether concessional financing is already being provided and the potential impact of combining it with tax incentives.

Finally, equity guarantee programs could be explored. Guarantees can be used as an alternative to investment programs when SMEs and investors have strong concerns about government interference. In practice, there has been limited use of equity guarantees globally as governments have deployed other instruments with a similar overall objective of changing the risk-return profile of SMEs for investors, while acting through different levers (for example, tax incentives). An in-depth understanding of country context is needed to assess which instrument can best address the needs in the marketplace.

Mix of Interventions Deployed to Support SME Listings

Governments should assess the feasibility and potential impact of interventions to support SME listings. Globally, few countries have implemented interventions beyond equity financing interventions in private markets. Moreover, qualitative evidence raises questions about the long-term impact of such interventions on SME listings. Below is a list of the interventions that have been deployed.

- **Non-financial support to build the pipeline of SMEs coming to market.** Some countries have established support programs, akin to investment readiness programs for private equity financing, but, in this case, support is aimed at helping SMEs prepare for public listings.
- **Financial support to SMEs.** Some countries have reduced specific fees, such as listing fees, to attract SMEs listings. Other countries (for example, Jamaica, Kenya, and Thailand) have used tax exemptions.[128]
- **Tax benefits for investors in SME listings.** In some countries, tax benefits for investing in SMEs have been extended beyond equity financing in private markets to also cover SMEs listed in SME exchanges.

CHAPTER 5

Selected Topics

5.1 Women-Led SMEs

Globally, only one in three businesses are owned by women.[129] Female participation in business ownership is positively correlated with countries' income level, but only to a small extent. In LICs, about 25 percent of businesses have a female owner, whereas in MICs and HICs, the rates are slightly higher at around 33 percent. This rate also varies across and within regions, from a low of 18 percent in South Asia to a high of 50 percent in Latin America and the Caribbean.[130]

Financial exclusion is a significant challenge for women entrepreneurs attempting to start, operate, or expand their businesses. More than 1 billion women do not use or do not have access to the financial system.[131] The International Finance Corporation (IFC) estimated that worldwide, a US$300 billion gap in financing exists for formal women-owned small businesses, and more than 70 percent of WSMEs have inadequate or no access to financial services. Women in EMDEs also face more challenges to accessing DFS, as they have less access to mobile technology. Estimates indicate that EMDEs have 200 million more male than female cell phone owners.[132]

Are the challenges affecting WSMEs access to finance the same as those affecting men-led businesses?

WSMEs suffer additional constraints to access financing than male operated businesses. While there is consensus that WSMEs face a larger financing gap relative to male operated businesses, the empirical evidence on the root causes of this gap is mixed. Overall, it points to three types of factors affecting WSMEs access to finance: structural differences, supply-side discrimination, and demand-side aversion to external sources of financing.[133]

There are structural differences in WSMEs compared to male operated businesses. WSMEs tend to concentrate in less productive sectors, have lower levels of business capital and labor, fewer tangible assets to offer as collateral, and are less willing to compete and to adopt advanced business practices; all of which affect the evaluation that lenders and investors made of their businesses. Such differences are largely the result of gender-specific constraints that emerge from the context in which women operate, their endowments, and household-related factors. These constraints ultimately affect the decisions women make as entrepreneurs.[134] In this regard, women are heavily influenced by social norms surrounding education, permissible economic activities, and interactions with buyers and suppliers, especially in less developed countries, all of which affect women's ability to conduct business. For example, social norms may prevent many women in some EMDEs from accessing safe and reliable transportation (limiting their mobility), access to information (including informal communication networks), and participation in training. Women's disproportionate responsibility for child- and eldercare constitutes another social norm that influences their economic participation by limiting their personal time. Moreover, women often lack authority over the allocation of household assets and face pressures to share their own resources. A cultural environment favoring male dominance and decision making limits women's ability to control the revenue generated by their businesses. Legal and regulatory constraints in family law and inheritance also play a role in women's ability to own property and access

collateral. According to World Bank's *Women, Business, and the Law* 2024, to this day, nearly 25 percent of economies limit women's property rights.[135] Lastly, women also lack access to legal identification and credit histories more often than men. Overall, these underlying social norms and legal constraints directly affect business growth and performance.

In addition to these structural differences, there are other constraints, including behavioral ones, emerging from both the demand and the supply side. On the demand side, many women entrepreneurs do not even apply for financing, thus self-selecting out of financial markets. Empirical evidence points to low financial literacy, high risk aversion, or fear of rejection (or a combination of these factors).[136] On the supply side, there is research backing the existence of gender biases from lenders and investors.[137] While some of these biases relate to discrimination, others emerge in the context of imperfect information, where data on indicators such as creditworthiness are difficult and costly to obtain by financial providers.

These barriers have a tangible impact on access to both debt and equity financing. World Bank experience in the field, along with several country studies, shows that in addition to being less likely to have a loan, women entrepreneurs are more likely to face higher interest rates, stand a greater chance of being required to collateralize a higher share of the loan, and more often must rely on shorter-term loans compared to male entrepreneurs. Regarding equity financing, businesses founded by women receive only a fraction of the overall funding from investors. In 2020, only 2.3 percent of global VC investments went to businesses with female founders.[138] This pattern holds in spite of the fact that businesses owned by women tend to deliver higher returns on investment—more than twice as much per dollar invested—and stronger cumulative revenues (nearly 10 percent more) over a five-year period compared to businesses led by men.[139] In the case of startups, most entrepreneurs identify lack of investors and shortage of funding as a barrier. For women entrepreneurs attempting to build startups, these barriers are further aggravated by two factors: (a) women have lower access to networks of investors compared to men, and (b) investors perceive women-led enterprises as riskier than other investments.

Which intermediaries serve WSMEs? Are recent developments changing the landscape of their financing?

The sources of finance for women entrepreneurs differ greatly by segment, with alternative lenders playing a critical role for smaller businesses. Women with established, mature businesses are most likely to access financing through commercial banks. However, for the vast majority of WSMEs, especially smaller businesses and first-time borrowers, NBFIs, notably MFIs, represent their primary lender. As mentioned earlier in this chapter, women's access to venture capital funds is very limited.[140]

Experiences with recent innovations highlight fintech's potential in expanding WSME access to finance, while also revealing some specific challenges for a greater take up of fintech lending solutions by WSMEs. See appendix C for selected examples. Although robust evidence is not yet available, alternative credit scoring is showing promise in addressing the drawbacks of lack of collateral and reliance on traditional credit information for WSME access to finance. For example, the use of psychometric tests in Ethiopia has supported the development of loans with reduced collateral requirements.[141] Credit scoring also holds potential to mitigate gender bias in credit origination, if properly designed.[142] In addition, tailored products that rely on technology to reduce the time to obtain a loan and provide convenient access to funds, such as automatic and on-tap disbursement of funds, can be particularly useful to women. At the same time, the Consultative Group to Assist the Poor's (CGAP's) research with 400 micro and small enterprises in India, Kenya, and Peru found widespread lack of trust in fintech providers, particularly among the smallest, poorest, and women-owned businesses. The limited number of recourse mechanisms users have to enforce their rights and the lack of transparency on the use of customer data were identified as key sources of concern.[143]

Should public interventions that support WSMEs differ from standard SME financing interventions?

The trends and innovations highlighted above confirm the relevance of an extended core enabling environment for the policy agenda for WSMEs. The examples illustrate the importance of alternative lenders and the potential role of fintech to expand WSME access to finance; thus, substantiating the appropriateness of strengthening the enabling environment for fintech and for alternative lenders. The examples also highlight the importance of a robust consumer protection framework to mitigate mistrust in fintech lenders.

A tailored approach to targeted interventions is needed. Existing research shows that gender-neutral programs that seek to support entrepreneurs are not sufficient to address the constraints faced by WSMEs, and in some instances, may instead widen existing gaps. Therefore, governments need to integrate a gender lens into the design and implementation of SME financing interventions, for which the collection of gender disaggregated data is critical. In practice, a tailored approach is needed, one that explicitly tackles the specific constraints

affecting WSMEs access to finance, be they structural differences in the women-led businesses, women's aversion to seek external financing, or lender or investor biases. While acknowledging that WSMEs in different segments may require different approaches,[144] the interventions[145] listed below seem to have a greater impact on WSMEs compared to SMEs more broadly.

Governments should include a wider set of finance providers in their interventions. Interventions should be accessible for alternative lenders more broadly, including MFIs, cooperative financial institutions, and fintech lenders, in addition to commercial banks. These alternative financial providers tend to have a wider network and better outreach among WSMEs.

Governments should also consider earmarking public funds for WSMEs. Governments can increase the availability of funds for WSMEs either by imposing targets or by offering additional incentives for financial institutions to lend to women entrepreneurs. This approach is more common for LoCs and PCGs. In the case of support for equity finance, for all the reasons noted in this section, such programs face the risk of lack of WSMEs that can attract private investors in a way that allows appropriate disbursements of funds.

Customized financial offerings for WSMEs are essential. These include (a) developing alternative delivery channels to women entrepreneurs who are unable or unwilling to come to a branch; (b) training staff on how to engage with women entrepreneurs; and (c) delivering non-financial services to complement financial services. Existing evidence suggests that there are combined benefits of training and credit and grants for female entrepreneurs.[146] In addition, research shows that certain types of training have a greater impact on WSMEs. Training programs addressing socioemotional skills and gender-specific content—as opposed to standard managerial training programs—have proved to have an impact in numerous contexts and pay for themselves through increased profits over the long term.[147]

Finally, a multipronged approach is necessary to effectively close the financing gaps for WSMEs. Notably, addressing foundational aspects related to the business environment, such as legal and regulatory constraints, as well as restrictive social and cultural norms, is key when focusing on WSMEs. Only by tackling such issues, would governments be able to mitigate the structural differences between WSMEs and male operated businesses.

5.2 Financing Investments in Mitigation and Adaptation to Climate Change for SMEs

Climate change is affecting SMEs by increasing their vulnerability to physical risks and transition risks.[148] Regarding physical risks, the increased frequency and intensity of natural disasters pose critical challenges for SMEs due to their limited coping mechanisms. Regarding transition risks, the environmental footprint of the vast majority of SMEs is relatively small and, at first glance, suggests a limited need for investments in mitigation. However, SMEs at the aggregate arguably have a sizeable impact. But estimates for EMDEs are rare.[149] Importantly, there are also transition risks associated with the global shift toward a low-carbon economy. A subset of SMEs has increasingly faced pressures to act and adopt mitigation strategies to comply with more stringent regulations and taxes as well as well as with growing client demands for environmental sustainability in global markets.[150] That is, SMEs would need to act to remain competitive in the marketplace or risk being left behind.[151] Constraints in access to finance, both ex ante and ex post in case risks materialize, render SMEs vulnerable to these risks brought on by climate change. Policy interventions must play a pivotal role in addressing the barriers that hinder investments in more resilient and sustainable practices for SMEs, while also fostering private financing.

Are the challenges of access to finance for SMEs' adaptation and mitigation investments different than those affecting SMEs more generally?

The landscape for adaptation and mitigation financing is marked by financial market failures that can lead to marked underinvestment, by both SMEs and financiers alike. While the traditional barriers of SME access to finance, as discussed earlier in this report, still apply, a number of additional challenges further constrain the undertaking and financing of adaptation and mitigation investments by SMEs.

Externalities and lack of pricing mechanisms lead to misaligned incentives to invest. One critical market failure relates to externalities and the public-good nature of climate change related investments, which leads to mispricing of benefits, costs, and risks. For example, green investments often generate positive externalities—for example, reduced greenhouse gas (GHG) emissions and reduced air pollution—that are not fully internalized by individual SMEs.[152] There can also be externalities in adaptation investments—for example, technology spillovers that can benefit a wider set of businesses. Moreover, adaptation investments by individual

SMEs can contribute to sector-wide resilience and stability. Carbon pricing mechanisms are starting to be used around the world to price some of these externalities—namely, the negative externalities associated with GHG emissions. However, carbon credit markets are still in their nascent stage in most EMDEs, and there are marked challenges in leveraging these markets for SMEs, at least in the short term. For instance, the limited capabilities of SMEs can be a major barrier as the use of carbon markets is administratively costly and requires significant measurement efforts—including data validation of the project design, accurate data gathering and reporting, and responsiveness to third party verifiers during on-site inspections. In the absence of effective pricing mechanisms for these externalities in EMDEs, there are misaligned incentives to invest.

Mismatched time horizons and high uncertainty discourage investments. Although investments in mitigation can increase the operational efficiency of SMEs, they often require large upfront expenditures, and returns have long payback periods. In the case of adaptation investments, benefits usually take the form of lower expected losses associated with climate-related risks, which are not only hard to quantify, but also may not be material to SMEs in the short term. Furthermore, the high uncertainty regarding the magnitude and frequency of extreme weather events weakens the business case for such investments.[153] The uncertainty about the magnitude and timing of financial returns can discourage financing, as lenders favor short-term returns, partly due to the high riskiness of SMEs.

There are also marked informational inefficiencies that exacerbate uncertainties and perceptions of risk. The high uncertainty surrounding mitigation and adaptation investments is amplified by data gaps on climate-related information, posing challenges for SMEs, financiers, and policy makers alike. Limited knowledge and capabilities intensify the challenges from climate data gaps and can hinder effective risk management practices, especially for "new risks"—for example, greenwashing risks and transition risks. Limited awareness and capabilities can be particularly constraining because of the economic and financial complexities and the rapidly evolving nature of the landscape for climate-related investments and finance.

The underdevelopment of the financial infrastructure for climate-related investments further complicates this already intricate informational environment. Globally, standards to classify sustainable activities (along with non-sustainable activities, in some cases) are lacking. There is also limited harmonization in disclosure and reporting of climate-related investments, including standardized metrics and reporting frameworks for environmental impact evaluation. In the absence of formally agreed-upon standards, market players tend to introduce their own, resulting in a lack of comparability, reliability, and accountability, leading to higher transaction costs and increasing greenwashing risks, which in turn can reduce the attractiveness of these investments. The international sustainability standards recently issued by the International Sustainability Standards Board will partially mitigate this problem. Yet, EMDEs will likely face challenges in implementing them. Furthermore, information challenges can be more constraining for SMEs due to their opacity, as information on environmental performance is even more scarce.

What is the role of financial sector policies in supporting SME adaptation and mitigation investments?

Thus far, support to the enabling environment for firm financing has predominantly focused on climate mitigation efforts rather than adaptation.[154] Taxonomies, along with climate-related and environmental disclosure standards, are essential elements in building the enabling environment for financing sustainable and climate-resilient projects. Existing standards have focused primarily on climate change mitigation efforts rather than adaptation, with emphasis placed largely on the management of GHG emissions. For example, existing taxonomies tend to focus on defining sectors and activities that can be classified as "green," with the aim of making them more attractive to lenders and investors. In fact, many taxonomies do not make explicit reference to how financing can support climate change adaptation or resilience in the face of climate shocks.[155] Similar observations can be made in the case of disclosure and reporting requirements.

Targeted interventions have also placed greater emphasis on climate mitigation efforts, rather than on adaptation efforts. A survey of DFIs, which are leading players in climate finance in EMDEs, shows that they strongly favor mitigation investments.[156] While support to SME financing has mainly been offered through direct lending, governments have also supported SMEs with equity and grants, largely for clean and climate technologies.[157] PCGs are being adapted to support the financing of green initiatives of SMEs in a small but expanding set of countries, typically through the adoption of "green" windows.[158] These windows should be aligned with taxonomies and disclosure frameworks to ensure that the schemes themselves can manage climate-related risks while facilitating sustainable finance to SMEs.[159] The links among PCGs and taxonomies and disclosure frameworks exacerbates existing biases in policy frameworks toward climate mitigation investments.

Financial sector policies aimed at supporting SME finance need to be rebalanced to provide greater attention

to adaptation, with emphasis placed on improving the effectiveness of government support to mobilize private capital. Addressing the imbalance in policies requires a shift in the understanding of the importance of adaptation investments for SMEs while recognizing the distinct challenges of fostering adaptation investments, such as the lack of clear metrics for assessing adaptation outcomes.[160] The rebalancing in public policy approach is particularly important because global climate finance is heavily focused on mitigation, with estimates showing that more than 90 percent of total financing went toward mitigation efforts during 2017–20.[161] Estimates indicate that private capital accounts for 54 percent of mitigation finance, whereas the public sector provides almost all of the adaptation financing. These statistics characterize not only the more advanced state of development of private markets for mitigation investments, but also a sizeable gap in adaptation financing, with limited private capital mobilization associated with public support.

Such a rebalancing is particularly relevant for SMEs in EMDEs. While mitigation investments are essential to avoid global catastrophic scenarios, in the context of SME financing in EMDEs, individual SMEs contribute little to global emissions, and transition risks primarily affect a relatively small subset of SMEs, notably those involved in global value chains and exposed to global market pressures. In contrast, physical risks seem to affect a wider set of SMEs, especially in light of the limited penetration of insurance within the segment, leaving them potentially exposed to large losses. SMEs in EMDEs are particularly exposed to climate-related hazards, such as cyclones, floods, droughts, sea level rise, and coastal erosion, due to these countries' geographic location and extensive coastlines. There is also a greater share of SMEs in climate-sensitive sectors, like agriculture and fisheries. Additionally, inadequate infrastructure and limited capacity for early warning systems in many EMDEs can amplify the impacts of natural disasters.

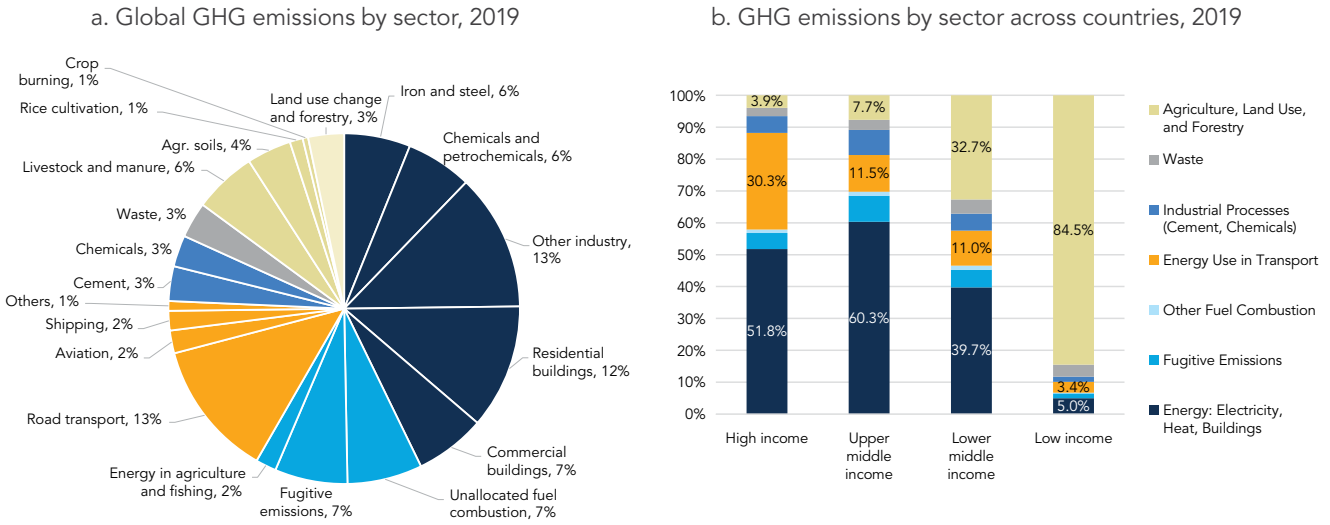
How can targeted interventions better support SMEs' adaptation and mitigation efforts?

Supporting access to finance for SME adaptation requires a bottom-up approach with widespread reach that goes beyond size-based targeting. Vulnerabilities to physical risks depend, to a large extent, on SMEs' geographical location, their sector of operations, their existing risk management strategies, and of course, on the type of climate shocks they are vulnerable to. Effective support thus requires localized solutions with broad outreach across SMEs, specifically designed to help SMEs enhance physical risk management strategies.[162]

In contrast, a top-down approach could be more effective in supporting SMEs facing high transition risks associated with the global shift toward low-carbon economies. While individual SMEs have a low carbon footprint, some SMEs face pressures to improve their carbon footprint to remain competitive, ensuring access to markets and participation in global value chains. Support to mitigate the impact of such transition risks should thus be deployed in a top-down approach, whereby efforts focus on large companies active in global markets, but greater emphasis is placed on supporting SMEs that are part of their value chains or SMEs for which decarbonizations efforts might be needed to ensure competitiveness, such as those directly exporting to countries with high sustainability standards. In some EMDEs, complementary support might also be needed for SMEs operating in specific, high-emitting sectors, for which their decarbonization can lead to a material contribution to the countries' nationally determined contributions. Finally, it is important to bear in mind that mitigation efforts focused on firms more broadly (that is, the demand for energy) may not be as impactful as those focused on greening the energy supply (that is, power generation and distribution).

It is critical that targeted interventions be aligned with and supportive of countries' broader climate change mitigation and adaptation strategies, hence policy support needs to reflect country context. Consider climate finance for mitigation: energy broadly accounts for almost 75 percent of global GHG emissions, but zooming in on EMDEs shows a markedly different picture (figure 5.1). GHG emissions from energy account for around 5 percent of the total in LICs, but they are more than 60 percent in UMICs, largely reflecting differences in economic structures. Transport accounts for 30 percent of GHG emissions in HICs, but significantly less in EMDEs. In contrast, agriculture, land use, and forestry activities play a much larger role in EMDEs. A similar argument applies for adaptation investments.

FIGURE 5.1
GHG Emissions around the World



Source: Original calculations for this publication based on data from Climate Watch and from World Resources Institute (2023).

While there is limited information on the extent to which governments are providing concessional financing to SMEs, externalities justify their use.[163] Such support should not be aimed at providing liquidity to financial institutions, but rather at providing incentives to SMEs so that they make the needed investments to address the challenges posed by climate change, fostering access to cheaper sources of funding, thereby enhancing the business case for these investments. Concessional financing may also be appropriate for emergency financing, after SMEs are hit by natural disasters or extreme weather events. Access to finance can be particularly challenging, as SMEs may have lost the assets that formed the collateral basis for debt financing, and their business viability may come into question. But policy makers should be careful in the design of policies to avoid disincentives for adaptation investments.

The higher risks of climate-related investments highlight the need for risk-sharing support, for instance, through PCGs.[164] This high riskiness, perceived and real, of both adaptation and mitigation investments in comparison to conventional investments is explained in part by the marked uncertainties, mismatched time horizons, and inefficiencies in the informational environment. The main objective of de-risking interventions, such as PCGs, is to adjust the risk-return profile of investments for lenders, thereby fostering capital mobilization.[165] PCGs can also be leveraged to provide emergency finance to viable SMEs. The design of PCG schemes must carefully monitor for unintended consequences. For example, favoring "green" or penalizing "brown" SMEs may exacerbate barriers in access to finance.

Governments can leverage DFIs to play a catalytic role in fostering change in the financial sector.[166] In EMDEs, DFIs often have the scale and the ability to catalyze private capital, as well as the necessary tools to provide long-term funding and support riskier projects, key features for financing mitigation and adaptation investments. For instance, DFIs can support private capital mobilization through the design of innovative financial instruments by acting as first movers and setting standards and through demonstration effects, among other innovations. DFIs can support capacity building efforts, for example, by providing technical assistance to SMEs and lenders on the management of physical and transition risks. Building capabilities and raising awareness should be an integral part of the policy agenda more broadly.

What is the potential for unintended consequences from the "new" financial regulation?

The new levers of policy to support greater sustainability and resiliency in the financial sector may have unintended consequences that negatively impact financing to SMEs. Taxonomies and climate-related disclosure requirements are essential building blocks of the enabling environment for the financing of sustainable and climate-resilient projects. Harnessing investment opportunities should go closely with risk management. That is, the financial sector can only mobilize finance for climate change if financial intermediaries can effectively manage climate risks in their own portfolios. Thus, the importance that financial supervisors require banks and other financial intermediaries to imbed climate risk into their

risk management frameworks. At this stage, the empirical evidence remains limited, but policy makers should carefully monitor the implementation of these new frameworks and requirements to avoid unintended consequences.

First, financial institutions may retrench from borrowers that are unable to provide information on climate-related risks. To the extent that SMEs may be unable to provide such information, precisely because of their opacity, financial institutions may be unable to assess climate risks for these SMEs and may limit financing. Transaction costs would also increase for financial institutions (for example, due to additional due diligence processes) and may render smaller transactions simply not cost effective. For SMEs, the need for additional information, and even certification in some instances, would also increase transaction costs and may discourage some SMEs from seeking financing in the first place.

Second, financial institutions may reallocate their lending portfolio away from clients that are highly exposed to climate-related risks. For example, Miguel, Pedraza, and Ruiz-Ortega (2022) show that a micro-prudential policy in Brazil requiring banks to incorporate environmental risks into capital assessments induced large banks to reallocate their lending portfolio away from exposed sectors.[167] This negative spillover effect of financial regulation would apply not only to SMEs highly exposed to physical risks but also to those exposed to transition risks (that is, SMEs operating in high-emitting segments).

Third, non-bank financial institutions (NBFIs) could also be adversely impacted by climate-related financial regulation. Some of these financial institutions, such as MFIs, are important providers of financing for SMEs in EMDEs. To a large extent, they tend to rely on funding from commercial banks. Akin to the challenges faced by SMEs themselves, if NBFIs are not able to track climate-related risks in their own lending portfolios, they may face constrained access to funding, hindering their ability to serve their SME clients effectively. In fact, this unintended consequence of the new financial infrastructure could affect the broad set of alternative lenders borrowing from banks. In addition, the adoption of climate-related financial regulation for NBFIs themselves could increase their operational costs, which would be particularly challenging for smaller NBFIs with limited resources and capacity.

5.3 Financing Agri-SMEs

Are the challenges affecting access to finance for agri-SMEs the same as those faced by other SMEs?

Agri-SMEs tend to have higher risk profiles and are subject to greater uncertainty than other types of SMEs, thus agri-SMEs face greater challenges in access to finance.[168] First, agri-SMEs are highly exposed to climate-related risks, both directly, for example, when an extreme weather event affects production, and indirectly, for example, through commodity price volatility. Second, their business model is highly seasonal. This constrains their cashflow and puts a premium on risk management capabilities, which is often lacking among agri-SMEs in many EMDEs. Third, in many EMDEs, agri-SMEs are marked by a high degree of informality in business operations, which leads to inadequate financial records. Fourth, the limited enforceability of the assets of agri-SMEs, including the traditional land tenure systems in some EMDEs, aggravates the aforementioned challenges. Female farmers and entrepreneurs, whose presence in the agriculture sector is more prominent than in other sectors, are particularly vulnerable, as they are rarely landowners and do not have assets to be pledged as collateral (see section 4.8). Overall, these unique features create a high level of opaqueness and uncertainty that adds complexity to the provision of financing to the segment. In addition, serving agri-SMEs can be costly for financial providers, as agri-SMEs tend to be spread out over remote, rural areas.

The agri-financing gap and its rippling effects on food security, food price inflation, and ultimately on countries' economic growth expose the urgent need to improve access to finance. Three quarters of the developing world lives in rural areas, and about 9 out of 10 people depend directly or indirectly upon agriculture for their livelihoods. While the lack of access to finance has a profound impact on the growth of agri-SMEs themselves, it also affects countries' productivity, competitiveness, and economic growth. Estimates show an annual formal financing gap of about US$106 billion.[169] The multiple shocks of the COVID pandemic, Russia's invasion of Ukraine, and food price inflation have intensified the needs of agri-SMEs to access finance to improve productivity and strengthen food systems. Furthermore, the escalating impacts of climate change underscore the need to strengthen the resilience of SMEs, as well as bolster their competitiveness, thus adding another layer of urgency to improve access to finance (see section 5.2).[170]

Which intermediaries serve agri-SMEs? Are recent developments changing the landscape of their financing?

The landscape of agri-SMEs lenders includes a wide range of players, with alternative lenders playing an important role

for smaller agri-SMEs. While banks continue to represent a large share of the value of formal external financing for agri-SMEs, they tend to focus on more mature, less risky, larger borrowers. These borrowers are typically traders and processors in cash crop value chains. At the other end of the size distribution of agri-SMEs, non-banking institutions, such as MFIs and cooperative financial institutions, tend to provide financing to commercial farmers, cooperatives, and microenterprises as an extension of their traditional retail business. Depending on country context, factoring and leasing providers also engage with agri-SMEs, with the latter typically supporting the purchase of equipment and machinery. Despite the uniqueness of agri-SME borrowers, the offering of tailored products, backed by specialized staff, remains limited. Many agri-SMEs sitting in between these two ends of the distribution of enterprises remain largely unserved by the formal financial sector as they are too small and too risky for banks and too large for NBFI financing.[171] In addition, equity financing has funded a select set of agri-SMEs, such as SMEs leveraging the use of technology (agritechs) or large, established agri-SMEs such as local food and beverage manufacturers.[172] In practice, agri-SMEs often rely more on internal and informal financing sources than on formal financing.

Similar to the trends for SMEs in other sectors, digital financial solutions are helping agri-SMEs increase their access to finance. The adoption of mobile finance has allowed the digitalization of payments across agriculture value chains, which in turn has paved the way for the provision of credit, especially for smaller, more informal agri-SMEs thanks to the traceability and transparency of financial flows along these chains. Other emerging solutions include financing based on agriculture credit scoring leveraging alternative data (for example, farming yields and geo-localization information to track climate risks) as well as digital e-commerce marketplaces and platforms that offer financial and non-financial services. For example, Digi Farm (a division of Vodaphone) in Kenya offers digital payments and credit solutions to agri-SMEs along with non-financial support, such as access to agriculture inputs and markets. Amazon Fresh in the United States, Pinduodo in China, and Jumia operating in 14 countries are offering short-term finance to agri-SMEs on their platforms through partnerships with financial institutions.

Another source of financing for agri-SMEs is value chain financing, which is anchored in steady business transactions between producers and off-takers in the value chains. Furthermore, as resilience of individual producers to climate change is becoming increasingly critical for stronger value chains and risk management in financing, examples of climate-linked value chain finance models are on the rise. These include sustainable payable finance and loans for sustainable agriculture. These financial solutions leverage the connections between participants in a value chain and their connections with lenders to facilitate access to finance and encourage investments in procedures, tools, and machinery that can reduce greenhouse gas emissions and encourage climate-smart practices. These mechanisms have been developed by food and beverage suppliers. For example, the Unilever Sustainable Living program provides access to sustainable finance to over 500,000 smallholder farmers and 5 million agriculture retailers. Similar approaches have been observed in several countries and with other large suppliers. Fintech is also improving value chain financing, especially through the use of blockchain technology. Its benefits of allowing the traceability and verifiability of product flows, to include practices used for farming and harvesting all the way to consumers and payments flows, are highly effective features to unlock financing.

However, value chain financing has developed around strong and well-organized value chains, where agriculture productions are transferred from farms to downstream processors and traders efficiently. Value chain finance solutions often require a holistic approach consisting of building trust and business relations among the main value chain actors and strengthening farmer organizations for greater volume and quality of produce while facilitating finance along the flow of agriculture goods. For products such as export commodities and perishable products, this model can be effective and scalable, but for products with weaker value chain links, such a solution may not be feasible. For example, staple commodity value chains, such as wheat, maize, and rice, are often difficult to organize given the high volume of transactions outside of contracts between producers and off-takers.

Should public interventions that support agri-SMEs differ from standard SME financing interventions?

The trends and innovations highlighted above confirm the relevance of an extended core enabling environment. The above examples illustrate the importance of fintech in improving agri-SME access to finance, and thus the need for a robust enabling environment, from digital connectivity and digital payment services to a supporting enabling environment for the entrance of new fintech players. They also show the importance of supporting the enabling environment for alternative lenders more broadly.

In EMDEs, targeted interventions in the agri-SME space have extensively relied on direct subsidies, matching grants, and donor funding, especially for commercial farms and producer cooperatives, based on their high socioeconomic importance as well as food security concerns. Purely commercial finance for agri-SMEs remains relatively small and limited to the

small set of agri-SMEs that are well-known to local financial institutions. The vast majority of public support programs in EMDEs have provided some form of concessional funding (subsidies and grants), with limited links (if any) to the development of private markets at commercial terms. In fact, concessionality to either agri-SMEs or to financial providers, in many instances, discourages financing at commercial terms (see discussion in section 4.3). Overall, these interventions have not addressed key market failures underlying access to finance to agri-SMEs. Hence, most agri-SMEs remain constrained in access to formal sources of finance.

Going forward, governments should strengthen their efforts to scale up commercial financing, leveraging blended finance and more market-based mechanisms for interventions as part of a coherent policy to support the sector. Increasingly, in many EMDEs, LoCs, first-loss schemes, and PCGs have been developed with a targeted allocation incentivizing financing to agri-SMEs for investments in agriculture equipment, logistics, warehouses, irrigation systems, and climate technologies, but on conditions that require financial institutions to add their own funding. In some countries, governments also support agri-SMEs lenders' access to capital markets. However, at the same time that these market-based mechanisms are being implemented, heavily subsidized interventions are also being deployed in both the agriculture and financial sectors. Therefore, it is critical that governments adopt coherent policies that are conducive to more private sector participation.

In supporting scaling up of commercial financing, governments should consider the inclusion of a wide set of finance providers in support programs. In addition to commercial banks, these include MFIs, cooperative financial institutions, and new digital financial providers (including alternative lenders, such as digital agriculture marketplace platforms), among others. These alternative lenders would expand the outreach to a greater set of agri-SMEs, as many may already be providing financial services to these companies. In practice, this means that PCGs and LoCs may require targeted awareness-raising campaigns and special provisions in their design, which are catered to these institutions. Depending on country context, this could also mean supporting access to capital markets for a wide range of agri-SME lenders. This might require government guarantees or de-risking support. Agri-SME lenders in some EMDEs, such as India, Thailand, and Vietnam, are frequent issuers of corporate bonds (see discussion in section 4.8).

In addition, governments should complement financial interventions with mechanisms to address the low capacity of both agri-SMEs and financing providers. In practice, this means that financial sector interventions may need to embed a technical assistance component to address the limited capabilities of firms and financial providers. On the supply side, in addition to basic agriculture finance training, support for financial product innovation tailored to the needs of the segment, leveraging value chain finance and DFS, could be impactful. On the demand side, small farmers, especially women and cooperatives, often require basic financial and business training.

Agricultural insurance can play an important role in facilitating investment and access to finance as well as increasing resilience to shocks. Evidence shows that insurance, alongside credit and other financial services, can help farmers better manage climate shocks and prepare for, and recover from, such shocks. In addition to the provision of timely funding after the occurrence of shocks, insurance supports access to credit by reducing the credit risk to lenders.[173] It can also positively influence investment behaviors, increasing expenditures into productive inputs, activities, and technologies.[174] Across EMDEs, there is a growing range of products to de-risk agri-SME production from climate shocks and facilitate access to finance. Such products include weather index and area yield insurance targeted at producers, meso insurance to protect the agri-portfolio of lenders, and contingent credit instruments, which provide finance to agri-SMEs in the case of a predefined production shock akin to an insurance mechanism.

However, cross-country experience demonstrates that strong partnerships between the public and private sectors are required to develop effective and sustainable agriculture insurance markets. Many initiatives for insurance and other financial risk management tools have failed to achieve scale and sustainability in EMDEs due to a variety of obstacles, including low trust, weak enabling environment, and limited technical capacity, among other design features that did not consider incentives to agri-SMEs and insurance providers. Alongside private risk capital, expertise, and networks, there is a critical need for public investments in areas such as premium subsidies to build experience and trust in insurance; data gathering, distribution, technology and analytics; institutional and governance frameworks; financial education; and institutional capacity building.

The interventions discussed above are just one part of the solution to closing the agri-SME financing gap. Exposure to the segment will continue to be limited if the agriculture sector remains largely informal, unprofitable, and vulnerable to external shocks. Therefore, governments need to deploy complementary interventions to tackle structural characteristics that render the segment risky, prone to uncertainty, and vulnerable to shocks. Such interventions would improve the competitiveness and overall business performance of the agriculture sector, including value chains.

5.4 SMEs in FCV countries

Are the challenges affecting access to finance for SMEs in fragility, conflict, and violence (FCV) countries the same as those affecting SMEs in non-FCV countries?

While FCV countries should not be treated as one homogenous group, these countries share common factors that acutely constrain SME financing and broadly restrict SME operations. FCV country context covers a wide range of challenging situations, ranging from weak institutions and social fragility to high risk of conflict and actual violent events or war.[175] Admittedly, the underlying causes for each FCV country's situation can differ widely. Yet, World Bank experience suggests that the three elements—fragility, conflict, and violence—are often interrelated and mutually reinforcing, creating a common set of challenges for SMEs, albeit with different intensities based on country context.

FCV countries are typically characterized by weak, highly unpredictable business environments that impose marked constraints on SMEs, making them riskier investments than SMEs in non-FCV countries. In general, FCV countries exhibit high levels of political and economic volatility, often accompanied by weak legal frameworks and institutions. Altogether, these factors create an unstable environment for doing business. To different degrees, corruption, rent seeking behavior, and lack of trust, especially trust in the government, further exacerbate unpredictability, and weaken the rule of law. Depending on country context, critical public services and infrastructure necessary for businesses to operate might not be provided by the government on satisfactory terms, including basic services, such as transport networks, utilities, and even security. In response, companies tend to develop coping mechanisms that, in turn, can negatively affect their profitability. Such is the case for security, which is chronically lacking in FCV countries. Unsafe operating conditions can undermine business safety, threatening staff, assets, and infrastructure, and can lead to significant operational challenges, such as those associated with supply chains and logistics. Ultimately, businesses may incur additional costs from having to pay for security. In addition, SMEs might face hurdles to access the global market—for instance, some FCV countries are not part of the global financial infrastructures (for example, the International Bank Account Number system), which can constrain the ability of SMEs to import and export. Survey data show that, in this environment, businesses tend to display a higher degree of informality compared to non-FCV countries. Overall, SMEs tend to be less productive and more vulnerable to shocks, partly because of the constraints imposed by this challenging environment.[176]

Marked supply-side challenges further limit SME access to finance. Financial markets are often underdeveloped in FCV countries, with fewer sources of financing. In fact, missing or incomplete markets are common financial market failures in FCV situations. While banks tend to be the main providers of financing in most FCV countries, they tend to serve a relatively small share of private enterprises, despite evidence of strong demand. Other lenders, such as MFIs, may exist, but they typically face greater challenges serving SMEs in FCV situations than in non-FCV contexts. This is due to the higher risk of SMEs and the more challenging environment in which these lenders operate, which includes less opportunities to access stable long-term financing. In small island fragile states, the lack of size of these markets is an important constraining factor, as it limits the scope for gains from economies of scale, which is an important feature for the financing of SMEs. In some countries, there are also marked gaps in the enabling environment for SME financing, which are compounded by the general weaknesses in the rule of law and institutions. For example, information asymmetries in credit markets may be more pronounced due to a lack of functioning credit-reporting systems, while lenders are not able to rely on the judiciary to enforce contracts and deal with defaults. Furthermore, the penetration of digital infrastructure is lower in FCV countries, thus affecting the development of innovative solutions based on fintech.[177] Government ownership of banks and financial intermediaries, in addition to political influence in credit allocation decisions may distort credit markets and build inefficiencies into the banking system. Various forms of market control through regulation may also hinder competition and outreach to SMEs. Survey data show that overall access to finance is a major obstacle to SME business operations in FCV countries. While, on average, 38 percent of SMEs have a bank loan or line of credit in non-FCV countries, only 19 percent of SMEs have such credit in FCV countries. Similarly, both the share of SMEs in FCV countries using banks to finance working capital and investments and the share of working capital and investments financed by banks are at about half the levels observed in non-FCV countries.[178]

Limited capacity among SMEs, the financial sector, and policy makers is a key overriding constraint in FCV countries. Many actors (for example, multilateral development banks and donors) embed limited capacity in their own definitions of FCV. For example, the OECD states that "fragility is the combination of exposure to risk and insufficient coping capacity of the state, systems and/or communities to manage, absorb or mitigate those risks."[179] Limited capabilities hinder SMEs' growth and their ability to adequately manage risks and withstand shocks. Limited capabilities can also constrain

policy design and implementation, thus thwarting the ability of countries to develop realistic transition plans out of their own FCV situations.

Should public interventions that support SME finance in FCV countries differ from standard SME financing interventions?

In FCV countries, understanding the best types of interventions for SME access to finance is an ongoing endeavor. World Bank support has produced some preliminary lessons discussed below.

Completing the enabling environment for SME financing should be at the forefront of the policy agenda for many FCV countries. Depending on country context, governments, especially in LICs, should prioritize a policy agenda focused on ensuring that both the basic financial infrastructure, including credit information systems, and the basic digital infrastructure to support fintech solutions are in place. Digital payments have developed in some of the most challenging FCV environments, suggesting that fintech could play an important role in FCV countries more broadly.[180]

The need for diagnostics to identify and tailor targeted interventions is even more critical in FCV countries. The FCV context is often thought of as a continuum rather than a binary concept, where a common set of challenges exist, albeit at different degrees or intensities, even within countries.[181] However, differences in the degree to which challenges apply can materially impact the choice, design, and implementation of interventions. For example, implementing targeted interventions might require entirely different approaches based on the extent to which public institutions are either generally weak or completely ineffective. Further, such diagnostics can be particularly challenging in FCV settings owing to constraints in data availability and accessibility. For example, in some FCV countries, even aggregate data on lending to SMEs are not available. Hence, depending on country context, when quantitative diagnostics are not feasible, policy makers may need to rely on qualitative assessments.

Capacity constraints may warrant adjustments to the design and implementation of interventions. For example, limitations in institutional and financial sector capabilities might lead to simplified eligibility criteria for financial institutions and SMEs, along with streamlined compliance and due diligence processes. In some contexts, policy makers should also consider deploying interventions through third party implementing agencies to overcome limited institutional capabilities in the government and mitigate the risks of capture due to corruption. Automation and digitalization could go a long way in minimizing these risks, as well as security concerns. For the same reasons, policy makers should place strong emphasis on M&E frameworks through third parties. Policy makers could also consider the use of iterative approaches that continuously assess the situation on the ground, adapting existing interventions and innovating new ones as the situation changes.

Governments should emphasize policies to unlock debt financing, paying particular attention to the high riskiness of SMEs. As indicated above, SMEs in FCV situations are often riskier. Not only do they face more volatile and uncertain operating conditions, but their level of informality is higher, which results in a more challenging information environment, marked by limited availability of financial information. In this context, risk-sharing instruments that seek to mitigate these challenges, such as PCGs, can be particularly effective. Evidence suggests that PCGs have been impactful in a number of FCV countries. Afghanistan serves as one example, where a recently implemented credit guarantee facility has made important strides in expanding SME financing, including for women-owned businesses. However, policy makers need to be cautious when designing such schemes, as capacity constraints can limit deployment because of their inherent complexity. In some FCV economies, such as West Bank and Gaza, international donors have set up credit guarantee facilities directly available to lenders.[182] If the adoption of PCGs is not feasible due to capacity constraints, greater reliance on LoCs might be warranted.

While adopting concessional financing might be beneficial, it is critical to carefully assess its need. Governments should seek to use concessional financing, including donors' funding, in a manner that fosters private capital mobilization and financial additionality more generally. Examples of concessionality include (a) support of the establishment and expansion of PCGs to increase lending by financial intermediaries, (b) support of more affordable and longer-term financing to SMEs by financial intermediaries, and (c) use of grants to foster innovation in product design by private financial intermediaries. In some circumstances, concessionality may also be called for to support the continued provision of services by lenders whose operations might be affected by the weak and uncertain business environment of FCV countries. For example, grants were important in Yemen to support the operations of the microfinance industry after the war, when the industry found itself with portfolios at risk soaring into the double digits.[183] Grants to SMEs have been frequently used in FCV countries. In many cases, governments argued that these grants were justified by the role that SMEs play in building socioeconomic stability and resilience via the provision of jobs as well as goods and services, including food, water, health,

education, and transportation, all of which contribute to the resilience of communities. This latter role is particularly prominent where the state may be absent or too weak to be effective. Even so, similar to the recommendations for non-FCV countries discussed above, it is critical to assess potential distortions caused by concessional financing to mitigate unintended consequences. Such considerations are particularly important in the case of grants to support financial intermediaries and SMEs that may be needed in some FCV contexts. Their indiscriminate use can hinder the development of private financing at commercial terms. Hence, governments need to strike a difficult balance. When needed, governments should consider relying more on matching grants that can mitigate the risks of supporting unviable firms, while leaving pure grants to more limited or exceptional circumstances. This was the case, for example, when pure grants were used to support SMEs in Lebanon right after the explosion in the Port of Beirut in 2021. Similarly, emergency resilience grants were provided in Yemen to farmers and fishermen to support food production and jobs within conflict affected communities.

The provision of non-financial support, particularly technical assistance to both lenders and SMEs, appears more critical for FCV countries than for non-FCV countries. Lenders might require enhanced support due to the relatively low level of financial sector development and the challenging operating environment. Depending on the country, technical assistance could cover support to different types of SME lenders to enhance their governance and risk management practices as well as support the development of an enabling infrastructure. For example, in Burkina Faso, Burundi, and the Democratic Republic of Congo, governments have been supporting the digital transformation of non-bank financial intermediaries (for example, MFIs and savings and credit cooperative societies) through the creation of shared information and management systems. Technical assistance could also support the development of tailored products for SMEs, including leveraging fintech via the use of pilot programs. For example, with technical support from different programs, including from international donors, banks in countries such as Libya and Yemen have opened SME units.[184] This technical support has included the development of tailored loan products, along with cash flow analysis techniques to assess the credit worthiness of SMEs (replacing high collateral requirements) and other analytical and client outreach tools to address the particular financing concerns and challenges of SMEs. Banks have adapted the tools to the local capacities and cultural practices—for example, adapting them to the principles of Islamic Ijara. SMEs are also likely to need enhanced support, for instance, to strengthen managerial capabilities.

While equity financing programs have also been adopted in FCV contexts, their deployment requires a more careful assessment than in non-FCV countries, as the conditions for private capital mobilization tend to be even more challenging. Examples of programs that have achieved some of their objectives include the equity investment program implemented in Lebanon by Kafalat (iSME). This program was able to support the growth of innovative SMEs through a combination of grants for concept development and coinvestments with VC funds and other institutional investors. Still, the program had limited reach and was not renewed. Other FCV countries, such as Iraq, are currently implementing similar types of programs. In line with the discussion in chapter 4, the ability of these programs to mobilize private financing at scale and in a sustainable manner seems limited given the overall macroeconomic and financial conditions of these countries. While the economic additionality that these interventions can bring might justify their use, the situation of FCV countries calls for a more careful assessment of their costs and sustainability.

To the extent that many of the most pressing challenges for SME financing in FCV countries stem from a weaker business environment that affects both SMEs and financial intermediaries alike, the impact of enabling environment and targeted interventions in SME access to finance might be limited. This does not mean that governments should not undertake interventions focused on SME access to finance. Instead, governments should adopt a holistic approach to tackling the various elements of SME business environment challenges. Early lessons indicate the importance of actions to (a) support political and macroeconomic stability, (b) strengthen legal and institutional frameworks as well as governance,[185] and (c) improve access to basic infrastructure (for example, transportation networks and utilities), among others.

CHAPTER 6
Conclusion

The case for governments to support SME financing remains compelling. In spite of progress made in particular countries, the financing gap for the whole MSME sector remains wide, at about 19 percent of GDP for EMDEs as of 2019. At the same time, the case for government support programs to expand SME financing remains strong, as novel research shows that addressing constraints in access to finance can lead to significant productivity gains and increase the resilience of SMEs.

The starting point for governments should be urgently completing the enabling environment. This agenda carries very limited fiscal costs, while the benefits of expanding SME financing could be large. Many countries have started this work, but it is time to deepen and expand it. This report has provided a road map with eight actions aimed at building critical financial market infrastructure that can mitigate the challenges hindering SME financing, including those deriving from SME characteristics (information opacity, high risk, and lack of collateral). This set of core actions also aims to ensure that the legal and regulatory frameworks to foster the use of fintech and to support the development of alternative lenders and equity financing is in place, while mitigating competition and consumer protection concerns.

However, targeted interventions, which carry important fiscal costs, are also needed. This report has highlighted the important, but distinct, roles of debt and equity financing, and thus the potential need for targeted interventions across both types of financing. However, policy makers must be cognizant of the trade-offs, especially when fiscal resources are scarce. Debt financing remains the most important source of external financing for SMEs, and support programs can have widespread reach, whereas due to the scarcity and cost of equity financing, programs to support it would typically have a more limited reach, covering a small set of firms. Policy makers should be realistic about not only the desirability of policy interventions but also their feasibility and impact, based on their own country contexts.

Going forward, governments must improve the effectiveness of their interventions by adopting a stronger, evidence-driven impetus in their design. This report has provided a set of seven actions to improve the design and implementation of interventions. The overriding messages are the need for governments to improve their analysis of the financing gaps and their underlying causes to better target interventions and deploy them in a manner that fosters financial additionality, including sustainable private capital mobilization. All this requires a significant data upgrade. The implementation of well-designed targeted interventions, coupled with a more supportive enabling environment, should bolster improvements in SME access to finance. Nevertheless, without further progress in addressing the underlying causes of the underdevelopment of financial systems, the effectiveness of interventions might still suffer. Targeted interventions might help to push the frontiers of the financial sector, but they cannot do all the heavy lifting.

For debt interventions, the key overriding message is that governments need to use them more deliberately to foster the development of alternative lenders while continuing to strengthen bank financing for SMEs. Banks have been the main delivery partners for public interventions. Yet, while banks will remain a key source of funding for SMEs, they will not be sufficient to close the credit gap. Alternative lenders are critical to closing such gaps. Hence, governments need to use interventions to foster their development. Consequently, governments must (a) reduce their direct lending; (b) remove requirements that create undue barriers for alternative lenders to access interventions, for instance, by relying more on proportionate requirements; and (c) consider the use of

targeted interventions to address the constraints faced by alternative lenders. The type of interventions to deploy will vary based on country context, whereby larger and more developed EMDEs should consider additional interventions aimed at further developing capital markets solutions.

For equity interventions, the key overriding message is that governments need to apply private sector practices to improve the mobilization of private capital. In practice, this means relying on private sector structures, in particular funds, to achieve scale and diversification. The management of funds should be professional and independent, free of government interference. Government oversight is key for the achievement of government objectives (for example, in terms of additionality), but this should be done through other bodies and mechanisms, including a strong M&E framework. This report has acknowledged the challenges that EMDEs, in particular LICs, face in mobilizing private capital to equity financing. LICs that may want to pursue these interventions might need to focus on market creation, which would likely require interventions over a longer period of time, while working in parallel to address the structural challenges that prevent further participation of private investors.

Governments need to take a tailored approach to tackle the challenges affecting specific subsets of SMEs, in particular agri-SMEs, WSMEs, SMEs in FCV countries, and financing SMEs for adaptation and mitigation to climate change. This report has provided guidance to this effect.

- In the case of WSMEs, governments should integrate a gender lens in the design of SME interventions. Potential tailored measures include earmarking programs explicitly to these firms and including a wider range of financial intermediaries for their deployment, with special attention paid to the development of financial products tailored to women entrepreneurs.
- Governments should recalibrate the support they are providing to SMEs to tackle climate change challenges by undertaking a risk-based approach, whereby the relative merits of two risks are considered: physical risks and transition risks. A wider range of SMEs are vulnerable to the former, hence, governments should place greater emphasis on adaptation efforts, through a bottom up approach. Financing mitigation efforts should continue to be focused on large businesses, but greater emphasis should be placed on the trickle-down effects to SMEs in their value chains, through a top-down approach. Such an approach places greater emphasis on the SMEs that are most vulnerable to transition risks. Efforts to complete the enabling environment, including developing and implementing effective taxonomies and disclosure requirements, along with improving availability and access to data, are essential. Governments also need to actively monitor the implementation of policies that seek to embed climate-change related risks in the risk management frameworks of financial intermediaries, to mitigate the possibility of unintended consequences for SME financing.
- In the case of agri-SMEs, governments should strengthen their efforts to promote the development of commercial financing, for instance, through greater use of risk-sharing interventions and the inclusion of a wider range of financial intermediaries for their deployment. A key additional consideration is the need to incorporate mechanisms to strengthen the resiliency of agri-SMEs to shocks, including through insurance markets, for which public-private partnerships may be needed.
- In the case of SMEs in FCV countries, governments should rely on a fully customized approach that takes into consideration the intensity of the different challenges affecting these countries. Governments should emphasize policies to unlock debt financing, paying particular attention to interventions to address the high riskiness of SMEs, such as PCGs. Concessional financing might be needed to support the operation of lenders and SMEs, but its implementation needs to be carefully assessed to mitigate potential unintended consequences. Capacity constraints might call for simplifications in the design and implementation of interventions, which can affect the range of feasible interventions in these countries.

Finally, access to finance is only one factor underlying SME productivity and growth. Beyond the broad macroeconomic factors, SME productivity is also affected by a broader set of micro factors, including the business environment, SME capabilities, and access to markets. This report has already highlighted the importance of providing non-financial support to SMEs, jointly with financial support, as a key factor to improve the effectiveness of support policies. It is critical that governments develop a holistic approach to their SME support agenda.

Appendix A. Misallocation of Firm Financing

Novel empirical evidence quantifies the SME financing gap and its sizeable negative impact on aggregate outcomes, such as productivity and growth.[186] This has been an elusive feature in discussions of firms' access to finance, especially in EMDEs. SMEs are considered the backbone of the economy in most EMDEs, but they face critical challenges in access to finance that hinder their potential to create more and better jobs. Drawing from a newly constructed data set of 2.5 million firms across MICs and HICs, the research shows that financial market inefficiencies—namely, financial frictions and market failures—constrain financial flows to these firms. In turn, this misallocation of finance hinders firms' ability to invest and even use inputs efficiently, thus negatively impacting their performance, and ultimately aggregate productivity and growth. Novel estimates show that mitigating these inefficiencies, thereby relaxing the constraints on firms' access to debt and equity financing, can lead to aggregate productivity gains of up to 86 percent in MICs, with the largest gains observed among less developed MICs. These gains stem from a reallocation of financial resources toward financially constrained yet productive firms.

Costly misallocation of finance is very detrimental to SMEs, particularly those with fewer than 100 employees that tend to face the largest financing gaps in MICs. The estimates show that smaller firms would benefit the most from a more efficient allocation of capital across firms, especially those in less developed countries. These firms typically face a substantial financing gap in both debt and equity. On average, the smallest private firms in the sample have debt-to-assets (leverage) ratios of around 65 percent in HICs, whereas similarly sized firms in MICs have leverage ratios averaging 40 percent. The smallest private firms in MICs have even lower leverage ratios, around 20 percent, indicating a much more limited use of debt financing. The differential in leverage ratios between firms in MICs and HICs declines with firm size, with virtually no differences observed among the largest private firms and publicly listed firms. Smaller, innovative private firms in MICs make limited use of not only debt financing, but also external equity financing. Private markets for equity financing in EMDEs are shallow and concentrated, financing relatively large firms, which constrains the availability of equity financing for smaller, innovative firms. For example, private firms with more than 350 employees accounted for roughly 70 percent of venture capital investments in MICs during 2010–19, compared to 35 percent in HICs.

Debt is a crucial source of financing for SMEs, but equity financing can be powerful in promoting innovation. Although the estimations show that the misallocation of finance across firms stems in large part from a level effect (an inefficient allocation of the total amount of finance to firms), the results also indicate that countries with more knowledge- and technology-related outputs, and thus arguably a larger share of firms engaging in innovative activities, would benefit the most from improvement in the financing mix (the allocation of capital between debt and equity). That is, countries with more innovative activities could obtain sizeable productivity gains from rebalancing the composition of financing to firms and improving their access to equity finance. These results highlight that firms' capital structure matters for aggregate productivity, at least in part because of the value of equity financing for innovative firms. Yet, venture capital financing is skewed toward a narrow set of high-tech sectors, suggesting that equity financing might play a limited role in advancing technological change in EMDEs.

Financial constraints not only hinder firms' performance, but also constrain their ability to cope with adverse shocks. The results of World Bank's data show that during the COVID-19 pandemic, many firms in EMDEs were unable to mitigate the effects of the shock, partly because their access to external sources of financing was limited. Firms that had access to external financing were better able to maintain employment levels and avoid falling into arrears. Moreover, access to diversified sources of financing can help firms weather shocks. For example, the results show that capital market financing can replace bank lending during banking crises, allowing firms to mitigate the adverse effects of the crisis on performance and employment. Hence, firms with limited access to multiple sources of financing are more exposed to the effects of negative shocks. For smaller firms in EMDEs, which are often dependent on banks for external finance, small fluctuations in bank credit can have sizeable effects on their investments and growth.

The original findings in the report provide strong analytical underpinnings for existing, practical knowledge in supporting SME financing and highlight important implications for financial sector policies that address

financing gaps for firms in EMDEs. Debt constitutes the largest and most important source of external finance for a vast majority of private firms around the world. Hence, the core focus of policy initiatives aimed at fostering firm financing should be on supporting widespread and efficient access to debt financing for SMEs. That is, the targeting of policy support should reflect the more acute financing gaps for smaller firms in a country. Targeted interventions should intentionally focus on improving information on SMEs; de-risking SMEs and creating missing markets. The goal should always be graduation, in which market-based financing for SMEs develops. Importantly, this size-based targeting in policies should not translate into unconditional support to firms simply based on their size. The viability of firms is critical, for instance, to avoid supporting the proliferation of zombie firms.

Policy support needs to take a differentiated approach for debt and equity financing. Targeting is a more complex yet even more important imperative for equity financing, due in large part to the scarcity of this financing source in EMDEs. The targeting of programs for equity financing should go beyond a size-based approach, recognizing that for a subset of SMEs—notably, innovative ones—balanced access to debt and equity financing would be invaluable. The results suggest that policy interventions to support equity market development are more likely to succeed when certain preconditions are in place, such as the existence of a strong institutional investor base and a supportive entrepreneurial environment. These conditions are more likely to be observed among the more developed MICs, raising questions about the effectiveness of interventions in less developed countries. Policy makers must thus be cognizant of the trade-offs in allocating resources to support equity financing versus debt financing, especially when fiscal resources are scarce.

A supportive enabling environment is the backbone of firm financing. While not directly targeting smaller private firms, policies fostering the enabling environment for debt and equity financing tend to entail disproportionate benefits for this set of firms, thereby complementing more targeted interventions. This is the case for policies aimed at strengthening the financial infrastructure, such as credit information systems and insolvency frameworks. On the latter, estimates show that deficiencies in insolvency systems can distort incentives—for example, by supporting inefficient loan evergreening—that increase the likelihood and prolong the survival of zombie firms. The findings show that weak insolvency systems lock up not only capital, but also labor in low-productivity uses. To the extent that labor released from exiting firms is absorbed by more productive firms, there could be significant gains in aggregate output.

In supporting access to finance for firms, policy makers need to consider the unique circumstances of each country and prioritize evidence-based policies that address the challenges of the SME financing gap. A rigorous, data-driven assessment of the key constraints on firm financing and their underlying causes within the context of individual countries is important not only for the design of policies (for example, to enhance the effectiveness of targeted support policies), but also for policy implementation (for example, by enabling the implementation of effective monitoring and evaluation frameworks). However, there is a generalized lack of data on the financing of private firms across the developing world, which is particularly marked in countries where data are most needed, such as those with underdeveloped financial systems, where financial inefficiencies can be more constraining. Improving the availability of and access to data is thus crucial for a more effective policy agenda supporting firm financing in EMDEs.

Appendix B. Microenterprises

Microenterprises play a pivotal role in supporting the livelihoods of low-income workers in EMDEs. There is no unique definition of microenterprises. For this report, microenterprises are defined as firms with less than 10 employees. It is estimated that the majority of enterprises in EMDEs are microenterprises, although there is no reliable and consistent cross-country data for EMDEs. In OECD countries, microenterprises comprise between 70 and 90 percent of the enterprises and these employ, on average, 29 percent of the workforce.[187] In EMDEs, these figures are likely to be higher, and the proportion of lower-income and vulnerable populations relying on microenterprises for their livelihoods is likely to be higher still.

Microenterprises are not a monolith. Sawhney et al. (2022) highlight the significance of five dimensions of enterprise segmentation: (a) the sectors in which they operate, (b) the entrepreneurial mindset, (c) the growth stage in which they are, (d) the entrepreneur's gender, and (e) the size of the enterprise.

Despite the heterogeneity of microenterprises and their non-financial needs, there are some commonalities when it comes to the need for financial services. Most microenterprises rely on some form of credit to support their growth and sustainability at some point in their lifecycle. Yet, according to IFC estimates, a gap of US$4.9 trillion for microenterprises alone, equivalent to 8 percent of the GDP of EMDEs, remains.

Are the challenges affecting microenterprises' access to finance the same as those affecting SMEs?

Many of the challenges that hinder microenterprises' access to finance are similar to those affecting SMEs; however, some features are more prevalent in microenterprises.

- **Informality**. Most microenterprises, especially those run by people with low incomes, operate in an environment where the costs of formality (for example, taxes, regulatory requirements, reduced competitiveness, literacy, and numeracy) exceed the benefits to their businesses. This informality of microenterprises makes traditional financial institutions leery of the regulatory and financial risks of working with them.
- **Credit risk uncertainty**. Partially because of the informality, as well as challenges related to literacy and accounting competencies, credit providers are unable to access reliable financial information or to assess the credit risk of microenterprises the way they would for a larger enterprise. Microenterprises and their owners are unlikely to have information in credit bureaus or reliable financial statements. This uncertainty regarding the business cash flows is compounded by the fact that most microentrepreneurs comingle business and personal finances. Microenterprise loans often go toward consumption, and consumer loans are often used for microenterprise finance.
- **Lack of collateral**. Creditors often seek to mitigate risk with collateral requirements, but low-income microentrepreneurs are unlikely to have the right kinds and quantities of assets. And if they do, they will be less likely to put those assets at risk.
- **High operating expenses and low transaction sizes**. Even if able to overcome the informality and credit risk uncertainty, the marginal costs of originating and managing microfinance loans are extremely high relative to the small ticket sizes involved. These fundamental business-model dynamics are the primary driver of relatively high interest rates in the microfinance sector.
- **Distrust.** Customers often distrust formal financial service providers, sometimes with good reason, and prefer to rely on informal financial service providers (especially friends and family).

Have the external sources of finance for microenterprises been the same as for SMEs?

Overall, microenterprises have relied less on banking financing than SMEs. Similar to SMEs, most microenterprises rely first on informal and quasi-formal sources of finance, especially social networks of family and friends, as well as informal money lenders and small-scale community financing initiatives like village saving and loan associations and rotating savings and credit associations. As with SMEs, suppliers often provide microenterprises with credit in the form of payment terms to buy their products. Among formal financial service providers, MFIs play a more important role in their financing than banks, as do financial cooperatives.

Banks have been an important provider of financing, but mostly through consumer loans and credit cards.

These financial service providers have employed a variety of strategies to overcome the barriers of microenterprise finance. In the case of the well-known group loan method of microfinance pioneered by Grameen Bank and others, credit groups reduce the risk of default through the cross guarantees group members provide each other, and they decrease the cost of providing small ticket loans by bundling them. In the individual model of microfinance, loan officers are trained to develop estimated financial statements for microenterprises and use those estimates as the basis for lending decisions.

Similar to SMEs, a new generation of solutions to overcome the same barriers and to provide improved financial services to microenterprises is taking shape via fintech. Reduced reliance on brick-and-mortar branches and increased reliance on digital payments infrastructure, like mobile money, lowers the expense of providing small ticket financial services. Digital data trails, especially those that are close proxies to cash flows, like inventory or payments data, enable more efficient and accurate risk assessments. The ability of companies to leverage application programing interfaces to make connections within their own technology stacks, and with those of other partners, makes solutions more agile and effective. Hommes et al. (2022) highlight how these trends are enabling different fintech business models to serve microenterprises. As summarized in chapter 2, these business models or channels are important also for SME financing.

Is the nature of policy interventions needed for microenterprises the same as for SMEs?

Given the higher presence of informality and sole proprietorship, policy interventions for access to finance of microenterprises should focus first on the financial inclusion of the individuals. From a policy perspective, informality has multifaceted consequences ranging from the risk of criminal tax evasion (possibly reaching the volume of money laundering) to the lack of official financial reports and documents required for onboarding formal businesses (for example, business license and registration). For formal businesses, the relevant policy element that many (if not most) microenterprises share is that they operate as sole proprietors. Because of these two characteristics (informality and sole proprietorship), policy makers should first focus on policies supporting financial inclusion of individuals, as their benefits are likely to extend to microenterprises.

At the very basic level, this means implementing four regulatory enablers of DFS: (a) regulation of e-money, (b) risk-based requirements for anti-money laundering and combating the financing of terrorism (AML/CFT; that is, proportionate customer due diligence; CDD), (c) regulation of agent networks that allows financial service providers to use third-party agents as their distribution channel, and (d) financial consumer protection tailored to the full range of financial service providers and products—providing a necessary margin of safety and confidence.

In addition, as summarized in chapter 3, policy makers must ensure that financial markets can reap the benefits of fintech and innovation while ensuring consumer protection. Newcomers such as fintech platforms and digital banks see potential in serving the microenterprise segment as they believe they can address many of the financing challenges through technology (for example, collaborative CDD, alternative credit scoring) and partnerships (for example, embedded finance, open finance).[188] If they succeed, it would send a strong signal to incumbents to follow suit. And if they fail because of some of the same regulatory limits that arguably hinder the engagement of incumbents with the segment, it would send a signal to regulators to reconsider their approach.

Appendix C. Selected Experiences

Fintech Innovation in the Banking Sector: Global Examples[189]

Much of the innovation taking place through increased adoption of fintech for SME lending has been centered on banks themselves. While there is scarce evidence on whether these developments have changed the landscape for SME financing, case studies can offer a glimpse into the potential for synergies to expand lending to SMEs.

- In *Asia*, big techs (such as Alibaba, Grab, and Kakao) have spearheaded digital credit to SMEs. While they can leverage the large volumes of customer data, which has been invaluable for credit decisions, they often have lacked the know-how, access to financial infrastructure, regulatory backing or access to cheap sources of funding to lend to SMEs at large scale. Consequently, they have either partnered with commercial banks or set up their own bank. For example, Alibaba in China has set up Mybank, Kakao in Korea launched Kakao bank, and Grab has obtained a digital banking license in Malaysia. A few digital lending platforms have followed a similar path—examples are Paytm, Lendingkart, KoinWork, and Xendit.
- In *Europe*, digital lending platforms—such as Funding Circle, LendingClub, and October—have stood out in the SME segment. Albeit they were often set up as independent platforms, many have partnered with banks to foster growth. In some cases, revenues from banking-as-a-service provided by these platforms have surpassed revenues from direct loan intermediation. One relevant example is October in Europe. In 2020, it launched a new service, offering technology-based credit assessment tools, fraud detection, and customer interface solutions to commercial banks and other financial intermediaries against a fee. A number of banks adopted October technologies—such as BPI France, Solution Bank, and Engie—and leverage the technology to enhance their own digital offerings to SMEs.
- In *Africa*, telecoms and e-payment providers have become the dominant fintech players. Initially, they expanded the payment infrastructure to the unbanked population, and in a second phase, they have started to offer lending products, targeting both retail and SMEs. Many have partnered with commercial banks. One example is Safaricom in Kenya. In 2012, Safaricom launched M-Shwari (short-term digital loans) and Fuliza (digital overdraft) with Vodafone and Commercial Bank of Kenya (CBA/NCBA). Later, they also partnered with KCB bank. CBA/NCBA and KCB have disbursed about US$2.5 billion in SME credit as of August 2022 through these two products. In South Africa, JUMO has partnered with MANSA Bank to roll out its lending services in Côte d'Ivoire. Fawry in the Arab Republic of Egypt has registered as a microfinance institution to be able to provide credit products.
- In *North America*, there is a greater mix in the SME credit segment of big tech, digital payment providers, digital lenders, and digital banks. But, as in Asia and Europe, many non-bank players have looked toward banks and incumbent financial institutions to develop their SME lending business. For example, Amazon has partnered with Goldman Sachs, while PayPal has partnered with Wells Fargo.
- In *Latin America*, digital banks, such as Nubank and C6 in Brazil and MACH in Chile, have been actively engaging in the SME credit market.

The partnership of these new fintech players and banks has often brought benefits to both parties. Non-bank financial providers, such as digital lending platforms, typically face higher funding costs than banks and their expansion is often hindered by funding availability. A fintech-bank partnership allows these new players to overcome the funding constraints in a cost-effective manner. In addition, they gain access to a large customer base, leveraging the reputation of the partner bank. Banks can increase their outreach via the product innovation brought by fintech. However, these partnerships can also add risks. For example, "lax" credit origination standards on the side of the fintech player could lead to higher than expected losses for the banks.

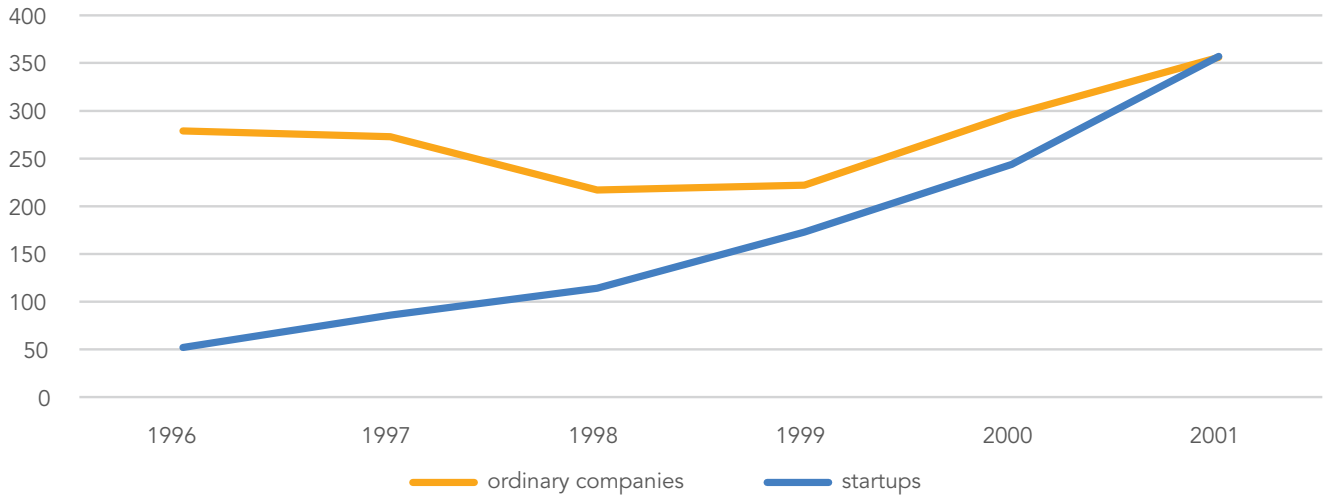
Linking VC with SME Exchanges: The Experience of the Republic of Korea[190]

Over the past 30 years, Korea has developed three distinct boards on the Korea Exchange (KRX) which cater toward the

different life stages of a company. The Korea Exchange Main Board (KOSPI) is the main board and is reserved for large and profitable companies; listing requirements are high. In addition, the Korea Securities Dealers Automation Quotation (KOSDAQ) and the Korea New Exchange (KONEX) were set up as IPO markets for SMEs, with a focus on technology startups. In contrast with the KOSPI, the KOSDAQ and the KONEX emphasize the possibility of future growth; and listing requirements such as firm size, firm age, and profitability are lighter and more flexible than those in the KOSPI. Altogether, the three boards have been set up to function as growth ladders.

The KOSDAQ has developed into an important exit route for VC funds. The KOSDAQ was first introduced in 1996 to support venture companies, particularly technology companies, in raising capital. Initially, the number of listings on the new KOSDAQ market did not increase much, but with the introduction of a special track in 1999 that simplified the listing process for government-certified technology companies, the number of new listings almost doubled. Before 1999, about 85 percent of the listed companies were ordinary SMEs, and only about 15 percent were startups. After 1999, the share of startups among the listed companies grew rapidly, reaching 50 percent in 2021 (figure C.1). Particularly, tech ventures were attracted to the KOSDAQ. With the transition toward a technology, venture-focused board, the KOSDAQ has become a popular route for VC funds to exit their investments. As of 2019, over 50 percent of IPOs were backed by VC funds (table C.1). As of June 2021, the KOSDAQ had a market capitalization of 427 trillion won (US$379 billion), and 1,506 listed companies.

FIGURE C.1
Number of Listed Companies at the KOSDAQ in Early Days of Development



Source: Nomura Foundation.

TABLE C.1
VC-Backed IPOs at the KOSDAQ

	2014	2015	2016	2017	2018	2019
Number of IPOs	67	109	70	78	90	97
Number of VC-backed IPOs	33	60	36	40	47	53
% VC-backed IPOs	49.3%	55%	51.4%	51.2%	52.2%	54.6%

Source: Korean Distribution Science Cooperation.

The KONEX was introduced in 2013 in response to increasingly stricter listing requirements at the KOSDAQ and subsequently higher barriers for startups to list and VC funds to exit their investments. With the burst of the information technology bubble in the early 2000s and several breaches of investor trust throughout the decade, the capital markets regulator gradually tightened listing requirements. As a result, the average age for companies to list on the KOSDAQ increased from 9 years in 2004 to 13 years in 2011. The size of the listed companies also increased, with the typical KOSDAQ firm reaching an average sales volume of about US$100 million. Owing to these stricter requirements, the government chose to establish the KONEX, which has fewer listing requirements. In contrast to the KOSDAQ, the KONEX is a market exclusively for professional investors. Many small enterprises and startups tend to list in the KONEX first and then list on the KOSDAQ or KOSPI after growing large. Thus, the KONEX has developed into one possible springboard for listings at the two other boards: on average, eight companies moved up to the two other boards each year. For many VC funds and founders, the KONEX has become an alternative means to recover their investments; they initially list their companies at the KONEX and then sell their shares to other investors later. Therefore, besides being a springboard for the KOSDAQ and the KOSPI, the KONEX also promotes secondary trade among VC and PE funds. As of June 2021, the KONEX had a market capitalization of 7 trillion won, with 137 listed companies. Thus, the KONEX remains significantly smaller than the KOSDAQ.

Deepening Asset-Based Lending through E-Invoicing Implementation and Selected Reforms to Factoring Laws: The Experience of Chile and Peru[191]

In Latin America, the process of digitization of commercial receipts has been triggered by the need to tackle business informality and improve tax collection. However, electronic receipts can minimize key operational risks involved in factoring, such as the risk of fraud (for example, due to the double sale of receipts), and thus help achieve scale. In this context, in tandem with the implementation of e-invoicing, countries such as Chile and Peru have introduced targeted reforms to their factoring laws to make the sale of receipts more efficient and foster the creation of marketplaces for receivables. Key reforms included the establishment of a maximum period for buyers to reject a receipt and the availability of abbreviated judicial procedures for the recovery of unpaid debt connected to receipts. Regarding the first type of reform, in both Chile and Peru, the respective laws now establish that if a receipt is not rejected within the specified timeframe, the receipt is considered accepted for all legal purposes, which in practice means that the seller can now use it with confidence for factoring. On the latter, once this timeframe has expired, the receipt becomes an "executive title" (in Chile) or a "security" (in Peru), which means that the owner of the receipt can request its payment in an abbreviated judicial process, similar to a check.

Together, these features have improved the factoring industry in these jurisdictions. For example, in Chile factoring has increased since it was made mandatory in 2014, growing by 50 percent on average and reaching US$29 billion in 2021—equivalent to over 8 percent of GDP. Different business models coexist—including banking factoring, specialized factoring companies, and digital platforms that act as marketplaces for the sale of receivables—bringing together companies in need of liquidity with investors. The experience of Peru is following a similar path: the implementation of mandatory electronic invoices has boosted the industry. As per information provided by the Ministry of Production, the bulk of the entities selling receipts are MSMEs.

Basel III Impact on SME Financing: Summary of Key Empirical Research

The impact of prudential regulation on SME financing has been the subject of debate particularly in the context of the discussions and the implementation of the Basel III framework. As approved, the Basel III framework provides for two sets of treatments (both preferential compared to the treatment of unrated corporates) for exposures to SMEs depending on their characteristics: (a) retail SMEs receive a flat 75 percent risk weight on all their exposures and (b) unrated corporate SMEs receive a flat 85 percent risk weight on all their exposures.

Financial Stability Board Evaluation for G-20 Jurisdictions[192]

In 2018, the Financial Stability Board conducted a qualitative and quantitative analysis of the impact of the capital and liquidity requirements on SME financing, focusing on G-20 jurisdictions. The evaluation did not find material and persistent negative effects on SME financing in general. However, it highlighted that more stringent risk-based capital requirements under Basel III may have temporarily affected growth and tightened the conditions of SME lending in some jurisdictions for the least capitalized banks. But these effects were not homogeneous across jurisdictions. The evaluation also provided some evidence of reallocation of bank lending toward more creditworthy firms after the introduction of reforms, but it highlighted that this effect was not specific to SMEs. Finally, feedback from stakeholders suggested that macroeconomic conditions and factors other than financial regulation were the most important drivers of SME financing trends.

World Bank Analysis for Emerging Markets[193]

In 2019, World Bank staff conducted additional research focusing on the impact of the implementation of Basel III on the access to finance of SMEs in 32 EMDEs. The authors found that for EMDEs, Basel III had a moderately negative effect on SME access to finance. The results suggested that SMEs that already had a banking loan prior to Basel III implementation could have been affected less than those that only had a bank account. This in turn reaffirmed practitioners' view that once SMEs have an established relationship with a bank, they typically do not face problems in renewing credit.

Zooming in on the implementation of Basel III in the EU[194]

The Basel III framework has provided room for jurisdictions to include a favorable treatment for SME loans into their national regimes. The EU introduced the "supporting factor" in 2014—a reduction of capital requirements associated with SME loans of 23.81 percent, which provides an incentive for banks to lend to eligible SMEs.

The existing evidence on the impact of the supporting factor is mixed. The initial evaluations of the European Banking Authority failed to identify any increase in access to finance for SMEs, relative to large firms. More recent evaluations have found positive effects. However, some of this research has found that the positive effects were not consistent across all SME segments, and that they have not benefitted micro and small firms.

Selected Examples of Interventions to Foster Competition in the Lending Industry

Mexico: Development of a Factoring Platform[195]

In 2001, NAFIN, Mexico's national development bank, created an online platform (Cadenas Productivas, or Productive Chains) to facilitate factoring transactions. The program was anchored in the notion of supply chains, whereby it is the buyers who invite their suppliers, very often SMEs, to the platform. Suppliers choose the invoice they want to have factored and open it up for auction to the participating institutions, which in the case of NAFINs' platform are banks. All factoring transactions are done without recourse.

The program experienced a significant expansion between 2001 and 2010, with over 11 million factoring transactions amounting to more than US$90 billion completed during this period—equivalent to about 1 percent of Mexico's GDP annually. Many suppliers participating in the program did not have access to external financing before, relying on trade credit and internal funds to finance their activities. In recent years, the program's growth has slowed down because private banks developed their own SME products, including proprietary electronic platforms for factoring. In other words, the government's support has become less relevant as the industry has matured. However, NAFIN's role was crucial in the industry's development. As of December 2020, NAFIN supported over 390 chains with over 14,000 suppliers.

India: Development of a Factoring Platform[196]

The Receivables Exchange of India Ltd (RXIL), is a joint venture between the Small Industries Development Bank of India, a national development bank in India, and the National Stock Exchange of India. It started its operations in 2017, offering an online platform where companies can auction their invoices at competitive prices to banks and non-bank financial institutions. To initiate a transaction, either the seller (factoring) or the buyer (reverse factoring) uploads an invoice to the online platform. The respective counterparty, the buyer or the seller must accept the invoice before it can be factored. Once accepted, the invoice is posted on the website and is open to financial institutions to post their interest rates and bid on the invoice.

As of June 2022, the RXIL platform had reached over 11,000 MSME suppliers, working with 53 factors and over 800 buyers. On average, the monthly factoring and reverse factoring volumes are the equivalent of US$213 million. Although those numbers are significant in absolute terms, they remain marginal compared to the size of India's economy. The lack of a broad network of large, credit-worthy buyers is one of the key challenges that seems to be hindering RXIL from growing faster. The reasons seem to be multiple, such as the fear of exposing their supply chain to competitors, the reluctance to relinquish any rights to dispute the services and goods delivered after the invoice has been accepted, or the competition from banks who already provide large corporates with similar offers.

For those MSMEs already benefiting from RXIL's factoring platform, interest rates have come down significantly, standing at 4–6 percent compared to the 12–15 percent available through banks directly.

Colombia: Development of a Platform for Microcredit[197]

In January of 2022, Bancoldex, the SME development bank of Colombia launched Neocredito, an electronic platform that is bringing together different types of financial intermediaries to compete in the microcredit market. The platform allows microentrepreneurs to connect

with several financial partners simultaneously to receive competitive financing offers. The platform simplified the documentation for the application of loans of less than US$10 million by natural persons, thus expediting approval and disbursement. As of March 2023, about US$2 billion in loans to microentrepreneurs had been disbursed, and about 10,000 microenterprises had registered with the platform.

United Kingdom: Creation of a Finance Referral Program[198]

In 2016, the United Kingdom created a finance referral program. The program requires nine of the biggest banks to pass on the details of small businesses they have turned down for financing to government designated alternative platforms. These platforms are in turn required to share the details, in anonymous form, with alternative finance providers.

Since it was launched in November 2016 until 2019, nearly 19,000 small businesses who were rejected for finance from one of the big banks have been referred under the scheme. Over 900 businesses had secured more than 15 million pounds. Since the Q4 2017 the conversion rate for SMEs who had contact with the platform has been over 10 percent, in line with market expectations.

The Inclusion of Diversification of Funding Sources as a Key Objective of Government Interventions: The Case of the British Business Bank[199]

The British Business Bank was created in 2014 to address market weaknesses in the provision of finance to SMEs in the United Kingdom. It initially set four market-oriented objectives focused on improving the finance marketplace for smaller businesses: (a) increase the supply of finance, (b) help increase the diversity of finance, (c) address regional imbalances in access to finance, and (d) encourage and enable SMEs to find appropriate finance.

The inclusion of diversification of funding sources as a separate objective rests on the premise that continuing to widen the range of finance options available to smaller businesses—by supporting increases in the number, type, and capabilities of finance providers and platforms—helps ensure that smaller businesses can access finance on terms that best suit their business challenges.

To deliver on its objectives, the British Business Bank undertakes a range of finance programs and non-financial activities for smaller businesses across the United Kingdom, at all stages of development. For their finance programs, its main business model is to work indirectly through delivery partners, which are financial services providers for smaller businesses (such as banks, non-bank lenders, equity funds, and private debt funds). For most of its programs, this indirect approach enables it to leverage in third-party funding in addition to its own funding, maximizing the impact of its interventions.

Specific performance indicators that are associated with the diversification objective include the number of new delivery partners; the value of commitments to new delivery partners; the stock of finance through non-Big Five banks; and new commitments to non-bank and challenger bank lenders through its Investment Program.

Selected Examples of the Use of Interventions to Foster Capital Markets Solutions for Debt Financing

Italy[200]

In 2012, Italy made important changes to its legal framework, through the Development Decree, to allow unlisted medium companies to issue minibonds, under a proportionate disclosure plan. Reforms were made to the legal and regulatory framework applicable to institutional investors to foster their investment in these bonds, and, in parallel, targeted interventions were deployed to align their risk return appetite. In particular, minibonds and funds that invest in them can access the guarantees provided by the SME Central Fund. In addition, tax benefits were granted to both the companies issuing minibonds and the investors. As of December 2022, there were 1,016 companies with minibonds issued, of which 663 were SMEs as per the European definition, or 65.3 percent. For 2022 alone, there were 254 issuers of which 178 were SMEs, amounting to 70.1 percent, compared to 66.5 percent in 2021.

Colombia[201]

In 2019, A2censo, the first debt crowdfunding platform of Colombia, started operations. As part of the strategy to promote the development of this type of alternative financing, the National Guarantee Fund (NGF) entered into an agreement with A2censo to provide it with access to it, whereby individual companies using the platform to raise funding can request a guarantee from the NGF, with the NGF covering losses up to 50 percent of the amount lent to a company by investors in the platform. In parallel, Bancoldex, the SME development bank, committed to coinvest in each issuance, up to 20 percent of the total amount raised. As of December 2022, more than 9,800 investors have participated in the platforms, and more than 120 issues have been backed with guarantees from the NGF, with a disbursement amount of US$57 billion. Of the

amount disbursed, 10 percent went to microenterprises, 47 percent to small companies, and the remaining 43 percent to medium enterprises.

The Impact of the Investor Base in the Design of Interventions to Expand Equity Financing[202]

A deep understanding of the overall country context and of the potential investor base is key to ensuring that the design of interventions maximizes the mobilization of external capital. One key design aspect refers to the domicile of the funds.

From a political perspective, governments are pressured to invest in domestically domiciled funds. Domestic institutional investors might also prefer domestic funds, as they might offer domestic investors greater legal certainty and, potentially, tax benefits that they might not enjoy in investments abroad. In some countries, institutional investors might also face limitations on investing in foreign vehicles. In contrast, many foreign investors have strong preferences for vehicles constituted in foreign jurisdictions with tried and tested legal and tax frameworks.[203] Furthermore, many foreign investors prefer to invest in regional funds, which offer them country diversification.

Balancing these interests is not easy. Some EMDEs have chosen to invest only in local vehicles. In some cases, this choice might not hinder their ability to attract foreign investors. This has been the case of larger EMDEs, with a strong pipeline of companies. However, some EMDEs might not have the leverage with foreign investors to persuade them to invest via local funds. Countries such as Egypt, Jordan, and Saudi Arabia have included investments in regional funds, domiciled in foreign plazas, in their fund-of-funds approach, conditioned to meeting a particular leverage ratio. Furthermore, some of these jurisdictions have established lower leverage ratios for these regional funds than what is targeted for domestically domiciled funds as part of their efforts to attract foreign investors.

Flexibilities are also starting to be implemented in connection with the legal domicile of SMEs. Increasingly, startups from EMDEs with global ambitions are choosing to establish their legal domicile in foreign plazas with strong venture capital markets. Some EMDEs are broadening eligibility criteria to enable them to support these SMEs, so long as they keep their basis of operations in their countries.

Selected Examples of Innovation in Women's Access to Finance

Use of Alternative Scoring: The Experience of Ethiopia[204]

In environments where women are less likely than men to own fixed assets that can serve as loan collateral, alternative credit scoring can be a powerful tool to expand lending. For example, the Women Entrepreneurship Development Project in Ethiopia has worked on the implementation of an alternative credit scoring technology, based on psychometrics, to enhance a financial institution's ability to lend to female entrepreneurs. The choice of a psychometrics test responds to country context. Financial technologies dependent on mobile phones or internet access are less viable in a market like Ethiopia, where only 16 percent of the population uses the internet and 51 out of 100 people have mobile phone subscriptions. Thus, psychometrics has emerged as a promising option for creating a better picture of Ethiopian borrowers. Unlike other fintech data solutions, psychometrics could create data on borrowers that did not exist before. In the context of Ethiopia, the psychometric test has been adapted to include more visual and interactive exercises for members of the population with low literacy levels and limited familiarity with digital technology. As of October 2019, more than 14,000 women entrepreneurs took out loans, and 66 percent of clients were first-time borrowers. As a result of the project, participating MFIs increased the average loan size by 870 percent and reduced the collateral requirements from an average of 200 percent of the value of the loan to 125 percent. The average project loan has resulted in an increase of over 40 percent in annual profits and nearly 56 percent in net employment for Ethiopian women entrepreneurs.

Use of Tailored Training: The Experience of Mexico[205]

In Mexico, a program provided business training and specialized services to female entrepreneurs in marginalized communities. The program offered a combination of training on hard skills (for example, traditional managerial skills) and soft skills (for example, training on emotional intelligence). It trained 2,500 female entrepreneurs in five different states. Women who completed the hard and soft skills training had higher weekly profits, spent more on inputs and salaries, had higher access to financing opportunities such as buying or selling with credit, and had increased the number of paid workers more than those who completed only the hard skills training.

Developing Gender Differentiated Digital Credit Products: The Experience of India[206]

In India, CGAP is currently working with Aye Finance, a fintech organization focused on microenterprises to develop a gender differentiated digital credit product. The product provides a working capital loan for WSMEs and tailors its approach to women at every step of the service chain. This includes adjusting the loan size, relaxing eligibility requirements for collateral and firm location, or getting approval from a male relative, as well as designing a gender inclusive application process that minimizes visits to the branch and adding a separate call center. In addition, it reviews the credit scorecard for gender bias and allows for flexible repayment terms, including digital payments through a QR code.

Similarly, Kinara Capital in India offers unsecured business loans without property collateral to registered MSMEs from the manufacturing, trading, and services sectors. The HerVikas Program is a business loan specially designed for women-owned businesses. MSME women entrepreneurs can get a 1 percent discount on the interest rate on their loans without submitting any additional documents. Women entrepreneurs can apply for a HerVikas loan online and get the loan disbursed in the applicant's bank account within 24 hours.

Appendix D. Firm Capability and the Connection to Access to Finance

Finance is a key input to the ability of firms to improve their productivity, grow, and generate sustainable jobs. How (and how well) finance is utilized by these firms depends on a number of factors including general business conditions, the firm's specific market conditions, and their internal capabilities.

These internal capabilities include the ability to develop and effectively implement a coherent strategy and business planning; the effective recruitment and management of staff; the development and maintenance of formal systems; the capacity to enter new markets and obtain new clients; and the ability to incorporate new technologies and develop new products. Lastly, it also includes the capacity to generate and manage internal financial resources (management accounting, financial planning, costing) and, where necessary, access external finance.

Although general business conditions are beyond the influence of any one firm, their internal capabilities regulate how well they navigate these broad conditions and their immediate markets (for example, existing and new clients, channels to markets, competitors), and how effectively they manage the types of changes in their own operations that can improve productivity and create jobs. This applies to all SMEs, from new microbusinesses to established medium manufacturers,[207] as the management capabilities of firms are increasingly recognized by economists as being a direct driver of firm performance and of firm survival.

There are various interventions aimed at improving firm capability that complement access to finance interventions.[208] These instruments generally involve advice and training, but vary in their intensity, focus, and sophistication according to the type of SME being targeted, as different SME segments have different capability issues. Table D.1 provides some examples.

TABLE D.1
Selected Types of Access to Finance Related Capacity Building Interventions

Set of SMEs	Examples of type of finance	Examples of capability improvement instruments
Micro-firms	Micro-finance	• Business training/mentoring/coaching • Finance specific—financial management training
High-tech startups	Equity (early-stage VC)	• Accelerators, incubators, mentoring • Finance specific—investment readiness for early-stage VC
Established SMEs	Bank financing, factoring	• Business planning, management improvement advice • Finance specific—financial training, business advice
Growth SMEs	Early-stage PE, lending	• Growth company programs, networks • Finance investment readiness for early-stage PE

Source: Original table for this publication.

As can be seen from the table, there are various types of interventions:

- Diagnostics—tools to help SMEs understand their financial performance, can include benchmarking data so firms can be compared to peers. Delivery model includes face to face and online.
- Business training—the provision of training to founders, owners, and chief executive officers of SMEs on various aspects of SME management can be narrowly focused on one area (for example, financial management) or more general. Delivery model is generally "one to many" with set curricula and can be online. Effectiveness relies on the quality of trainer and implementation support.

- Mentoring and coaching—advice by experienced businesspeople and entrepreneurs may be about a specific topic (for example, finance) or general support. Delivery model is one to one; effectiveness relies on quality of mentor and whether there is rapport with SME.
- Management improvement advice—typically provided by consultants. the advice can be narrowly focused on one issue or more broadly structured support involving diagnostics (of issues) and support for the implementation of changes and improvements. Delivery model is tailored to SME; effectiveness relies on the quality of advisor and motivation and capacity of SME to engage in improvement processes.
- Incubation and acceleration—structured 3-to-6-month programs for young firms, generally offered in cohorts involving a mix of training, coaching, and peer activities. Effectiveness relies on quality and rigor of training and quality of support network.
- Investment readiness—training and coaching to address impediments in SMEs to attracting external financing. Tailored to specifics of firm. Effectiveness relies on the quality of provider, capacity of SME to improve, and alignment with investor requirements.

Firm-level interventions can combine the provision of access to finance and firm capability improvement services—incubators and accelerators typically combine both. Seeking access to finance can act as a trigger for firm-level capacity improvement. Many SME chief executive officers and managers are not aware of their relative operational, financial, and management performance versus peers. They often lack sources of formal advice (few have boards or use management consultants), so the process of seeking external funding can be a trigger to seek external help because their finance request was unsuccessful, because the finance provider suggested they would benefit, or because management support was part of an integrated finance-advice package.[209]

However, despite its potential impacts, SME capacity building support often needs to be subsidized because SMEs will rarely be able to fund it themselves, and although finance providers may be able to provide some support to improve their potential pipeline, it is often insufficient. This type of support may be less relevant with initiatives that are designed to inject liquidity into the market and provide working capital (for example, COVID or natural disaster support) to SMEs.

Similar to access to finance interventions, those setting up programs need to measure the effectiveness of these programs by evaluating their impact, costs, and scalability. Furthermore, establishing a strong governance framework is critical to ensuring that firms in the applicable underserved sector (that is, WSMEs, agri-SMEs, startups) have equal access to these services and that the programs are phased out if ineffective.

Appendix E. The Principles for Public Credit Guarantees

Public credit guarantees have become a popular tool used by governments around the world to channel credit to MSMEs. Although public credit guarantee schemes (PCGS) could emerge and develop privately, in many cases, governments participate in these schemes, often directly. A survey of credit guarantee schemes around the world shows that over 30 percent of these schemes have some form of state ownership, with governments playing a bigger role in funding and management than in risk assessment and recovery.[210] The median scheme around the world has outstanding guarantees equivalent to 0.11 percent of GDP and focuses on firms with fewer than 100 employees.[211] However, the size, outreach, costs, and performance of these schemes vary widely across countries.[212] The largest and more established guarantee schemes operate in developed countries, including Canada, Japan, the United States, and several European countries.

In response to the widespread state involvement in credit guarantee schemes around the world, the World Bank has issued a set of principles for the design of public guarantees that are efficient and financially sustainable.[213] The World Bank principles cover four key areas:

- **Legal and regulatory frameworks.** PCGS should be established as independent legal entities on the basis of a sound and clearly defined legal and regulatory framework to support the effective implementation of its operations and the achievement of its policy objectives, thereby enhancing its credibility and reputation. The legal and regulatory framework should also promote public-private mixed ownership, which has the advantage of reducing moral hazard on the part of the scheme itself, lenders, and MSME borrowers by introducing peer pressure, shared responsibility, and transparency in the decision-making process. The PCGS should have adequate funding, with clearly identified sources. PCGS should be primarily funded out of equity endowments, which can be complemented by long-term concessionary loans either from government sources or from multilateral and bilateral institutions. The PCGS should not borrow from public or private debt markets to prudently manage their capital structure. PCGS should be independently and effectively supervised based on risk-proportionate regulation.
- **Corporate governance and risk management.** The PCGS should have a clearly defined mandate supported by strategies and operational goals consistent with policy objectives, sound internal controls, and solid risk management framework. The mandate of PCGS should be set in the legislation that establishes the scheme and include, at minimum, the target MSMEs and the main lines or lines of business of the scheme. The PCGS should have a sound corporate governance structure with an independent and competent board of directors, appointed according to clearly defined technical criteria, to ensure that business decisions respond to economic and financial considerations and are free of political influence and interference. An effective and strong system of internal controls, including internal audit and compliance functions, is recommended to safeguard the integrity and efficiency of PCGS operations and governance. A robust risk management framework that allows PCGS to accurately identify, measure, assess, and manage the risks they face (credit risk, liquidity and market risk, and operational risk) in a timely manner—and to determine that they hold adequate capital against those risks—is a critical component of the overall corporate governance framework.
- **Operational framework.** PCGS should adopt clearly defined eligibility and qualification criteria for MSMEs, lenders, and credit instruments. These criteria should be publicly communicated and periodically reviewed to ensure adequate targeting. Typical eligibility criteria for borrowers include a combination of firm size (based on the number of employees, total revenues, or loan size), subsector, geographical location, and age. The eligibility criteria may also consider firm performance, including viability and profitability. Credit instruments covered by a PCGS typically include working capital and investment finance. Whereas working capital finance may be important for sustaining jobs in MSMEs that are vulnerable to insolvency because of insufficient short-term credit, investment finance is essential for

job creation and long-term economic growth. Overall, the eligibility criteria and application requirements should be simple, unified, and available electronically, to facilitate adoption by both lenders and borrowers. The online system should also include the processes of information update, claim submission, and payment of fees and commissions. In addition, establishing efficient, transparent, and simple claim procedures can increase credibility and encourage participation. The trigger conditions for claim submission should specify the maximum period allowed after a missed payment or payments and should not be conditional on initiating legal action against the MSME borrower, although lenders should proactively continue their efforts to recover the debt. In well-designed systems, claim settlement should not take place after the conclusion of the debt recovery process, as these processes can be lengthy and may discourage lender participation. Evidence from schemes around the world indicate that such an approach has not led to greater claim rates or greater risk-taking behavior, with losses hovering around 2 percent.

- **Credit risk must be shared appropriately among the PCGS, lenders, and borrowers, to avoid moral hazard on the part of lenders and MSMEs.** Sharing credit risk ensures that the right incentives are in place to keep default and claim rates as low as possible. For example, coverage ratios (measured as the fraction of the loan value that is guaranteed) need to leave enough risk for lenders to motivate them to properly assess and monitor borrowers, while covering credit risk and moral hazard to promote lender participation. The appropriate coverage ratio should be determined based on the MSME target sectors. For example, higher coverage may be granted to MSMEs operating in sectors with higher potential for job creation or job preservation, or to early-stage firms. Coverage ratios around the world are typically higher than 50 percent, though they vary across countries (table E.1). But higher coverage should entail higher fees. That is, the PCGS should charge fees on the basis of the riskiness of the underlying loan, which is reflected in the combination of the coverage ratio, exposure at default, and loss given default. The fees charged by PCGS around the world vary between 0.5 and 4 percent of the guaranteed amount per year.
- **Monitoring and evaluation.** PCGS should be subject to rigorous financial reporting requirements, should have their financial statements audited externally, and should also periodically and publicly disclose non-financial information related to their operations, such as social and economic commitments made and outcome. The performance of PCGS—in particular their outreach, additionality, and financial sustainability—should be systematically and periodically evaluated, and the findings from the evaluations publicly disclosed.

TABLE E.1

Coverage Ratios and Pricing Policies around the World

Economies	Coverage ratio			Variations in coverage ratio	Commission fees
	Min.	Max.	Avg.		
Canada	85%	85%	85%		2% of total loan value + 1.25% p.y. of outstanding loan value
Chile	50%	80%	65%	80% for small firms (loans up to US$100,000); 50% for medium firms (loans up to US$400,000)	1% to 2% p.y. of guaranteed amount; higher fees for banks with greater risk
France	40%	70%	55%	40%–50% on average; 60% for innovative firs; 70% for startups	0.6% p.y. (for 40% coverage) to 0.9% p.y. (for 70% coverage)
Malaysia	30%	100%	65%	Depends on type of borrower and instrument	0.5% to 3.6% p.y., varying with the riskiness of the borrower
Republic of Korea	50%	90%	70%	90% for high-risk borrowers; 50% for low-risk borrowers	0.5% to 3% p.y., varying with the riskiness of the borrower and the size of the loan
United States of America	75%	85%	80%	75% for loans greater than US$150,000; 85% for smaller loans	2% to 3.5% of loan value + 0.55% of outstanding amount; higher fees for larger loans

Source: Original table for this publication based on World Bank staff assessments conducted before the COVID19 pandemic.
Note: Avg. = average; max. = maximum; min. = minimum; p.y. = per year

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Notes

1 See Didier and Cusolito (2024).

2 See IFC (forthcoming).

3 See Didier and Cusolito (2024).

4 See Didier and Cusolito (2024).

5 See for example Ayyagari, Beck, and Demirgüç-Kunt (2007), Ayyagari, Demirgüç-Kunt, and Maksimovic (2014), ILO (2019), and the SME Finance Forum's MSME Economic Indicators Database 2019. There is no universal definition of SMEs. In general, many countries use the number of employees, assets, and revenues, either separately or concurrently, as defining criteria. Moreover, the specific threshold to define a SME tends to vary across countries. The most widely used parameter defines microenterprises as businesses with fewer than 10 employees and SMEs as those with fewer than 250 employees. See for example Khanna et al. (2017).

6 See for example Antoniou, Guney, and Paudyal (2008), Ayyagari, Demirgüç-Kunt, and Maksimovic (2013, 2018), Bancel and Mittoo (2002), Beck, Demirgüç-Kunt, and Maksimovic (2005, 2008), Booth et al. (2001), Caprio and Demirgüç-Kunt (1998), Demirgüç-Kunt, Martinez Peria, and Tressel (2020), Demirgic-Kunt and Maksimovic (1998, 1999, 2002), Giannetti (2003), de Jong, Kabir, and Nguyen (2008), and Lerner and Schoar (2005).

7 Although there is virtually no variation in leverage ratios across firms of different sizes in HICs, smaller private firms tend to have significantly lower debt-to-assets ratios than larger firms in MICs. The differential among similarly sized firms between MICs and HICs declines as firms grow, with virtually no differences observed for larger private firms and publicly listed firms.

8 Persistent issues of lack of available data, including firm-level survey data, have limited the ability to estimate the gap beyond 2019, as well as to provide a disaggregation of the supply and demand of formal finance by size, gender, and sectors. Such estimates would benefit from more and better standardized data collection from stakeholders. See IFC (forthcoming).

9 In addition to the finance gap in the formal sector, there is estimated to be an additional US$2.1 trillion in potential demand for finance from informal enterprises in developing countries. This figure is sizeable and is equivalent to 8 percent of the GDP in EMDEs. See IFC (forthcoming).

10 See Didier and Cusolito (2024).

11 See for example de la Torre, Gozzi, and Schmukler (2017).

12 See for example Frame, Srinivasan, and Woosley (2001), Jappelli and Pagano (2002), Kallberg and Udell (2003), Love and Martínez Pería (2015), and Love and Mylenko (2003).

13 See for example Agoraki, Delis, and Pasiourasc (2011), Agostino and Tivieri (2010), Beck et al. (2008), Cetorelli (2004), and Leon (2014, 2015).

14 In this report, fintech refers to new financial technology. The development of fintech has led to the emergence of new business models and new players (sometimes also referred to as fintechs). Some of these new players offer credit themselves (for example, digital banks and some lending platforms), whereas others focus on the provision of fintech-based services to or in partnership with incumbent financial institutions to enhance their businesses (for example, companies that provide credit scoring methodologies). In addition, incumbent financial institutions themselves have adopted fintech solutions. In practice, the boundaries of these different fintech adoption channels are blurred. Consequently, measuring the extent to which fintech adoption is taking place is challenging. The study team is not aware of any robust assessment that has been conducted to date. See Didier et al. (2022) and CCAF, World Bank and World Economic Forum (2022).

15 In this report, "big data" refers to large data sets that may be analyzed computationally to reveal patterns, trends, and associations, especially relating to human behavior and interactions.

16 Most SMEs self-fund their activities from internally generated revenues. Self-funding remains an important source of financing, particularly among young SMEs, and also constitutes a common practice among many family-owned businesses.

17 World Bank calculations for this publication based on International Monetary Fund Financial Inclusion Data, ADB SME Monitor and Organisation for Economic Co-operation and Development SMEs and entrepreneurs' data and the World Bank development indicators; data are limited to HICs and MICs.

18 See for example Beck et al. (2008) and Beck, Demirgüç-Kunt, and Maksimovic (2005).

19 In this report, embedded finance refers to the integration of financial services like lending, payment processing, or insurance into non-financial businesses' infrastructures without the need to redirect to traditional financial institutions. Embedded finance models have increased, including the following: (a) e-commerce platforms providing or enabling working capital lines to merchants selling on their websites (Amazon, Mercado Libre, Lazada, and Jumia); (b) logistics platforms offering per-ride insurance, vehicle finance, or advances against receivables for trips in progress (Grab and Kobo360); and (c) wholesale order management and payment systems providing inventory finance or consignment sales of consumer goods stocked by small and micro-retailers (Amigo PAQ, AwanTunai, and N-Frnds). See Saal (2021).

20 See Moody's Investors Service (2022).

21 World Bank calculations for HICs and MICs, drawing from International Monetary Fund Financial Inclusion Data, ADB SME Monitor and Organisation for Economic Co-operation and Development SMEs and entrepreneurs' data and the World Bank development indicators.

22 See Moody's Investors Service (2022).

23 See British Business Bank's website, https://www.british-business-bank.co.uk.

24 See Business Wire (2022).

25 See Business Wire (2022).

26 See CCAF, World Bank, and World Economic Forum (2022).

27 See CCAF, World Bank, and World Economic Forum (2022).

28 In this report, big tech firms are large technology companies such as Amazon and Apple, as well as e-commerce platforms such as Amazon. Big tech firms can trigger changes in the financial services industry, given the amount of user data they hold coupled with their size and customer reach.

29 See Gambacorta, Khalil, and Parigi (2022).

30 See for example De Roure, Pelizzon, and Thakor (2022) and Jagtiani and Lemieux (2017).

31 See Lu (2018).

32 See CCAF, World Bank, and World Economic Forum (2022).

33 See Frost et al. (2019), Gambacorta et al. (2019), and Goldstein, Jagtiani, and Klein (2019).

34 In this report, asset-based financing refers to different types of financial contracts where financing is based on the value of collateral, from asset-based lending, to factoring and leasing, and other types of contracts such as merchant cash advances and warehouses receipt financing. This note focuses on factoring and leasing, given their importance volume-wise in comparison to other contracts. The term factoring is used to refer to different types of financial contracts in which financing is based on receivables (credits), thus encompassing both transactions in which such receivables are sold and transactions in which the receivables are used to obtain a loan. Leasing is used to refer to a financing agreement in which an asset (for example, vehicles, machinery, equipment) is made available for usage against periodic payments. The term encompasses both financial and operational leases. A financial lease essentially functions like a secured loan whereby the asset a company wants to buy serves as collateral.

35 See Chigurupati and Hegde (2010), Sharpe and Nguyen (1995), Slotty (2009), and Yan (2006).

36 See Kwaak et al. (2021).

37 In this report, reverse factoring refers to buyer-led financing whereby the business to which the SMEs provides the goods and services facilitates the financing arrangements. This usually entails large corporations that arrange for their banks to provide financing to their suppliers, from their own credit lines (supply chain financing).

38 See, for example, CCAF, World Bank, and World Economic Forum (2022).

39 See Klapper (2006).

40 See International Factoring Association.

41 The statistics for factoring and leasing reflect total market volumes; no information is available on a cross-country basis on the share of financing to SMEs.

42 See Carvajal et al. (2020).

43 See Politecnico MIlano, Osservatori Entrepreneurship Finance & Innovation, 9° Report italiano sui Minibond, 2023.

44 In many countries, the bulk of this financing has taken place through purely private markets, but more recently some jurisdictions have developed organized markets for "minibonds" to make them more attractive to investors.

45 For a summary of preconditions see Carvajal et al. (2020).

46 See for example Brown, Fazzari, and Petersen (2009), Brown and Petersen (2009), Brown, Martinsson, and Petersen (2013, 2017), Carpenter and Petersen (2002), and Chemmanur, Krishnan, and Nandy (2011).

47 In this report, VC funds are used to refer to collective investment schemes that are not offered to the public at large and that invest in young companies with growth potential. This definition covers investment in a wide range of companies. In practice, however, over the last 40 years, changes in the VC industry have narrowed this investment focus and led to concentrated investments in technology companies. See Lerner and Nanda (2020). Moreover, proprietary databases tend to classify equity investments through private markets as either VC or PE, as defined in this report. VC funds invest in companies through a variety of instruments including equity, preferred equity, convertible debt, mezzanine loans, and subordinated loans.

48 World Bank (2023) shows that, relative to HICs, VC in EMDEs is more underdeveloped than public equity markets are.

49 See Didier and Cusolito (2024).

50 For example, there has been a substantial increase in financing available for more mature, late-stage start-ups more recently in the United States. For instance, late-stage start-ups are raising larger amounts of capital in the private markets from a growing pool of traditional and new investors. See Ewens and Farre-Mensa (2022).

51 See, for example, Da Rin, Hellmann, and Puri (2013) and the references therein, which are largely focused on developed countries.

52 For example, less than 1 percent of the VC invested went to firms younger than three years, less than 12 percent went to firms younger than five years in MICs, and roughly half of the VC financing in lower-middle-income countries went to firms older than 10 years. See World Bank (2023).

53 See, for example, Lerner and Nanda (2020).

54 See Didier and Cusolito (2024).

55 For example, other instruments used are convertible notes and simple agreement for future equity (SAFE). The latter is an agreement between the company and the investors whereby the company promises to provide the investor an equity stake if certain trigger events occur.

56 See, for example, Walthoff-Borm, Vanacker, and Collewaert (2018).

57 See CCAF, World Bank, and World Economic Forum (2022).

58 Exit conditions can also play an important role for equity financing in private markets. A popular perception is that initial public offerings (IPOs) constitute the main exit route for equity investors in private markets. Although VC-backed firms may represent a large share of IPOs, IPOs account for a small fraction of VC exits, even in countries with well-developed markets such as the United States. On average, IPOs represent about 12 percent of the exits from equity investments in private markets in HICs and upper middle-income countries, typically the most innovative and promising ventures. However, the understanding of non-IPO exits constitutes an important knowledge gap, especially in EMDEs. See World Bank (2023).

59 Lerner (2013) notes that in most of the entrepreneurial hubs that have emerged over the past two decades, critical early investments were not made by domestic investors, but rather by sophisticated international investors.

60 See Didier and Cusolito (2024).

61 World Bank calculations based on Pitchbook data.

62 In this report the term "traditional public equity markets" is used to refer to the issuance of shares under the public offering requirements along with their listing in the exchanges under the ordinary listing requirements.

63 For example, in Korea, the VC industry has developed in tandem with the Korean Securities Dealers Automated Quotations (KOSDAQ) exchange. In Japan, IPOs in the Mothers exchange have provided an exit option to VC investments.

64 The level of patents in a jurisdiction has also been found to be a predictor of VC activity, highlighting the role of venture capital in the financing of innovation. For a review of the existing empirical research, see the online literature review (forthcoming).

65 Existing empirical research points to institutional drivers, such as rule of law and investor protection, as well as financial deepening as some of the determinants of VC activity. See the online literature review (forthcoming).

66 For a summary of relevant research, see Fouejieu et al. (2020).

67 Therefore, the definition of alternative lenders covers a wide range of financial intermediaries, including asset-based lenders, digital banks, lending platforms, and capital markets solutions.

68 For example, Ayyagari et al. (2016) use the introduction of credit bureaus as an exogenous shock to the supply of credit in over 4 million firms in 29 EMDEs and find that the resulting access to finance is associated with higher employment growth, especially among micro, small, and medium enterprises. See also Berger and Udell (2006**),** Brown, Jappelli, and Pagano (2009), Love and Mylenko (2003), and Martinez Peria and Singh (2014).

69 A review of selected experiences in public-private partnerships for the development of private credit bureaus is included in chapter 5 of World Bank (2012) *Global Financial Development Repor 2013t: Rethinking the Role of the State in Finance*. See also World Bank (2019a) *Credit Reporting Knowledge Guide*. In addition to their role in fostering credit bureaus, governments in many EMDEs have been directly involved in the development of credit registries. Credit registries collect and compile information from regulated financial institutions to support the financial supervision function. Generally, information is collected on large credit exposures. Credit registries also provide credit reports that show aggregate loan exposures to the regulated financial institutions that submit data to the credit registry. Thus, their objective and coverage are different from that of private bureaus.

70 See World Bank (2011), World Bank and ICCR (2022).

71 There is no universally accepted definition of alternative data. The International Committee on Credit Reporting (ICCR) defines it as "ways to collect and analyze data on creditworthiness which are 'alternative' to conventional methods, such as documented credit history." It has been broadly categorized into (a) structured data—for example, utilities, mobile phone, rental information and taxes, and (b) unstructured data—for example, social media and internet usage, emails, text and messaging files, audio files, digital pictures and images. What alternative data entails varies depending on the country, since it depends on the kind of information collected in each jurisdiction. As a result, what is alternative in one market can be traditional in another. See ICCR (2018).

72 The use of alternative data gives rise to data protection issues relating to personal information about the individuals involved. The G-20/OECD High Level Principles on Financial Consumer Protection, adopted in 2022 state in Principle 11 that "Consumers financial and personal information should be protected through appropriate control and protection mechanisms. These mechanisms should define the purposes for which the data may be collected, processed, held, used and disclosed (especially to third parties). The mechanisms should acknowledge the rights of consumers regarding consenting to data-sharing, accessing their data, being informed about breaches impacting their data, and seeking redress such as the prompt correction and/or deletion of inaccurate, or unlawfully collected or processed data. There should be co-operation among oversight bodies responsible for consumer data protection and privacy". See https://web-archive.oecd.org/2022-12-12/648348-G20_OECD%20FCP%20Principles.pdf. In addition, the use of alternative data and automated approaches for credit risk assessments have the potential to introduce biases into lending

decisions. For example, there is the potential for discrimination biases (for example, gender, race, and geographical location) that arguably have a larger impact on underserved segments. The opacity of the algorithms makes it particularly difficult for policy makers to address these biases, complicating the adoption of safeguards to mitigate them. These challenges might indirectly affect small firms, especially microenterprises given the close connection between the enterprises and their principals. Therefore, they highlight the importance of a robust data privacy and protection framework that protects individuals that use financial services, whether for personal purposes or for their businesses.

73 For examples of guidance, see World Bank and ICCR (2022).

74 See Pazarbasioglu et al. (2020).

75 Collateral registries perform two main functions. First, they provide transparency of the existence of a security interest over a particular asset, thus eliminating the risk that a borrower pledges the same asset as collateral to secure other loans without the knowledge of the lender. Second, they also make transparent the seniority of existing registered security interests and other unsecured creditors. So functioning collateral registries are critical for the expansion of secured transactions. The introduction of collateral registries for movable assets in particular has been shown to improve firms' access to bank finance as well as to lower interest rates and extensions in loan maturities. See, for example, Calomiris et al. (2017), Campello and Larrain (2016), and Love, Martinez Peria, and Singh (2014).

76 See World Bank (2019b).

77 See World Bank (2014b).

78 For instance, rescue financing can be introduced via a tailored insolvency framework, which can help SMEs avoid resorting to liquidation when they could be saved by simply accessing insolvency solutions.

79 A typical insolvency framework in EMDEs is characterized by high costs, lengthy timelines, and heavy procedural formalities, all of which stand as obstacles to SMEs and deter them from accessing insolvency regimes. In addition, there is some overlap between personal and corporate insolvency proceedings in the case of smaller firms, especially for sole proprietors. For instance, the fact that the owners of sole proprietorships sometimes use their personal assets to guarantee business loans introduces a complexity rarely addressed by existing insolvency systems. This calls for insolvency regimes with an efficient discharge of the natural person entrepreneur. For more details, see for example World Bank (2017).

80 The Basel Committee on Banking Supervision has acknowledged the need for a proportional regulatory and supervisory framework for MFIs, including lower capital requirements in exchange for a more limited set of permitted activities. See Basel Committee on Banking Supervision (2010).

81 For high-level guidance regarding the regulation and supervision of fintech in EMDEs, see Alonso Gispert et al. (2022).

82 For Hong Kong SAR, China, see the revised Guideline on Authorization of Virtual Banks (Guideline) on May 30, 2018; for Malaysia, see https://www.bnm.gov.my/documents/20124/938039/20201231_Licensing+Framework+for+Digital+Banks.pdf; for Singapore, see https://www.mas.gov.sg/regulation/banking/digital-bank-licence; for Mexico, see https://www.dof.gob.mx/nota_detalle.php?codigo=5610487&fecha=28/01/2021#gsc.tab=0. Policy makers should also review whether physical presence requirements apply to other types of regulated financial lenders in their jurisdictions.

83 In the European Union, as per the Crowdfunding Service Provider Regulation, the operation of a crowdfunding platform can be undertaken by specialized entities, with proportionate capital requirements as well as by regulated financial intermediaries, such as credit institutions and investment firms. In the United States crowdfunding platforms can be operated by funding portals, which are specialized intermediary subject to proportionate capital requirements, and brokers' dealers.

84 For an overall analysis of the potential impact of fintech in financial services and a discussion of policy implications, see Feyen et al. (2022).

85 In a Market Participants Survey conducted in 2021 close to 90 percent of bank respondents expected digital transformation to help reduce the costs of MSME lending. However, 48 percent expected MSME lending to become more concentrated, while 31 percent anticipated less concentration. The Market Participants Survey found that 60 percent of commercial banks saw a risk of losing MSME lending customers and 63 percent saw a risk to the profitability of this business line due to digital transformation of the market. See Teima et al. (2022).

86 Direct competition by big tech companies is generally more prevalent in EMDEs where financial systems are at an earlier stage of development, and there is a lower penetration of financial services. See Teima et al. (2022).

87 Studies that use market concentration as a proxy for competition found mixed results in relation to its effect in access to finance. Studies focused on direct measures of competition and contestability show that access to finance is easier in more competitive banking sectors. See chapter 3, "The Role of the State in Promoting Bank Competition," in World Bank (2012).

88 There is no single definition of open finance, although there is broad agreement on the multilateral nature of consumer data exchange between banks and financial institutions on the one hand and third parties on the other, based on consumer choice. The Bank for International Settlements (BIS) defines open banking as sharing and leveraging customer-permissioned data by banks with third party developers and firms to build applications and services, including those that provide real-time payments, greater financial transparency options for account holders, and marketing and cross-

selling opportunities. This term is defined differently depending on the jurisdiction, and the concept of open banking has evolved to open finance and ultimately to open data, allowing for broader scope of data and participants to the framework.

89 There are different ways in which countries define a space for private offering. In some countries this is done directly (that is, by including a definition of private offering), while in others is done indirectly (that is, a private offering is any offer that does not meet the conditions of a public offering). Either way, in practice in many countries there are limits to the amount that can be raised through a private offering and limits to the number of non-professional investors that can be targeted through a private offering. These types of limits seek to precisely balance investor protection concerns with the interest of allowing companies easier channels to access the capital markets, particularly SMEs.

90 In some EMDEs, the investment regulations for pension funds limit their ability to invest in securities that are not publicly offered or listed, thus preventing them from investing in PE and VC funds.

91 See Carvajal et al. (2020).

92 In some exchanges, SMEs are allowed to list without the need for a public offering. In these cases, the markets are not directly accessible to retail investors; rather only to professional investors, including high-net worth individuals, institutional investors, and a limited number of retail investors (based on the country definition of private placements). Many SME markets in Europe are structured in this way.

93 For example, in the context of embedded financing, a platform might steer financing to the financial providers that pay higher commissions or might not disclose in a clear manner all the fees that apply.

94 Prohibitions against such practices are increasingly viewed internationally as necessary for the good functioning of markets and thus often apply beyond the range of consumer protection requirements that tend to be more targeted.

95 Financial consumer protection seeks to address asymmetries in the relationship between the providers and the users of financial services. In general, in EMDEs this imbalance is as acute for microenterprises as for individuals, as microenterprises tend to be closely associated with their owner or principal (and, in practice, they are often one and the same—that is, a sole trader or entrepreneur). In this context, from a policy perspective, the sensible practice is to apply consumer protection laws to individuals as users of financial services, including use for both personal and business purposes.

96 For example, the G-20/OECD High Level Principles on Financial Consumer Protection adopted in 2022 state that "while the meaning of financial consumer is not defined so as not to restrict coverage, it is generally considered to include private individuals at a minimum but may also include micro and small enterprises however defined by jurisdictions." See https://web-archive.oecd.org/2022-12-12/648348-G20_OECD%20FCP%20Principles.pdf

97 This includes the requirement that platforms provide information about how the credit risk assessment is conducted in the case of lending- or debt-based platforms and what type of due diligence on the businesses applying for financing is conducted by the platforms in the case of equity crowdfunding platforms. It also requires the provision of clear information about fees.

98 For a review of investor protection issues involved in capital markets solutions see Carvajal et al. (2020).

99 For more detailed on the enabling environment for DFS, see Pazarbasioglu et al. (2020).

100 See GPFI (2023).

101 Digital identification fulfills the same critical role in connection with individuals.

102 There is no global database that identifies the type of targeted interventions that governments have pursued to address financing gaps for SMEs, whether for HICs or EMDEs. For EMDEs, this chapter is based on a desk review conducted by World Bank staff based on public sources, including relevant publications such as by Gutierrez and Kliatskova (2021) and Carvajal et al. (2020), and World Bank experience in the field assisting EMDEs in improving SME access to finance. For HICs, key resource materials include OECD publications: Koreen, Laboul, and Smaini (2018), OECD (2015, 2020, 2022a), and Thompson, Boschmans, and Pissareva (2018).

103 The results of a World Bank survey on DFIs conducted in 2017 indicated that many DFIs use direct lending for SMEs, either as their solo approach or in addition to an on-lending approach, whereby DFIs act as wholesale banks providing LoCs to private sector banks. According to this survey, 10 percent of DFIs provide loans and other financial services only in second tier, 40 percent only provide loans to final borrowers, and 50 percent use a combination of the two. See Gutierrez and Kliatskova (2021).

104 Although credit guarantee schemes could emerge and develop privately, in many cases governments participate in these schemes, often directly. A survey of credit guarantee schemes around the world shows that over 30 percent of these programs have some form of state ownership, with governments playing a bigger role in funding and management than in risk assessment and recovery (Beck, Klapper, and Mendoza 2010). See World Bank and FIRST Initiative (2015).

105 This is not strictly a problem of EMDEs. A recent report on impact evaluation of SME support programs by the OECD found that comprehensive evaluations are also missing in OECD countries. See OECD (2023).

Multilateral development banks have conducted evaluations of their SME support programs to EMDEs, which are publicly available. Overall, many of these evaluations point to problems with the design of some of the interventions that have affected their effectiveness, in particular the sustainability of the targeted outcomes. In addition, empirical research has

been conducted by different stakeholders (including academics and staff from multilateral development institutions) to evaluate the financial additionality of a selected set of interventions related to, in particular, lending, including subsidized lending, public guarantee schemes, venture capital, and taxation. The overall conclusion of such research is included in the analysis of the respective interventions in the body of this Note. For the evaluations of the programs of the World Bank, see Campos et al. (2019) and World Bank (2014a). For other multilateral development banks see for example: for the African Development Bank see Independent Development Evaluation (2020), for the Asian Development Bank see Independent Evaluation (2018), for the European Investment Bank (EIB) see EIB (2022; 2023a, 2023b), and Amamou, Gereben, and Wolski (2020), for the European Bank for Reconstruction and Development (EBRD), see EBRD (2018), and for the Interamerican Development Bank, see Murcia et al. (2016). See also the accompanying online literature review (forthcoming) for a summary of the existing empirical research that is publicly available.

106 Thus, these recommendations are equally applicable to DFIs, including development banks, in the deployment of SME finance interventions.

107 In France, the SME Observatory was created in 2005 and is managed by Bpifrance, the French public investment bank, whose mission is to provide support to MSMEs. In Morocco the SME Observatory was created in 2013 as a result of a public-private partnership, spearheaded by Bank Al Maghrib. One of the key objectives of the Observatory is to consolidate information on SMEs. To achieve this objective, the Moroccan Observatory has concluded data exchange agreements with Bank Al Maghrib, the General Tax Directorate, the National Social Security Fund, and the Moroccan Office of Industrial and Commercial Property.

108 Measuring additionality in the context of private capital mobilization is complex. To have additionality, an intervention should lead to additional finance by the private sector to SMEs or an investment that would not have otherwise taken place. That would be the case, for example, if a bank or microfinance institution would not have provided financing to an SME in the absence of a line of credit provided by the government or if an investor would not have invested in a fund that invests in SMEs in the absence of government investment. This presupposes that the intervention is not crowding out the private sector—that is, that it is not leading financial intermediaries or investors to commit fewer resources because the government is committing its own. Determining such additionality is a counter factual that is very difficult to establish.

109 Governments have provided concessional funding in two ways: (a) via cheaper funding to financial intermediaries to incentivize their engagement with the SME segment, and not always translated to better conditions for SMEs (for example, lower interest rates) or (b) via cheaper financing to SMEs themselves, with financial institutions typically receiving some spread over market rates.

110 Blended finance is a structuring approach, not an investment approach. There is no globally accepted definition for blended finance. Overall, most definitions include the following four structures: (a) concessionary capital on below-market terms to reduce the cost of capital or provide an additional layer of protection to private investors; (b) guarantee or insurance on below-market terms to reduce lending risks; (c) a grant-funded technical assistance facility that can be used pre- or post-investment to strengthen commercial viability and development impact; and (d) grant-funded transaction design or preparation to set up new investment vehicles. For a review of challenges mobilizing blended financing in EMDEs, see Bartz-Zuccala et al. (2022).

111 The Green Climate Fund (GCF) is a fund established within the framework of the United Nations Framework Convention on Climate Change to assist developing countries in adaptation and mitigation practices to counter climate change and support the achievement of their nationally determined contributions goals toward low-emissions, climate-resilient pathways. GCF is mandated to invest 50 percent of its resources in mitigation and 50 percent in adaptation in grant equivalent. At least half of its adaptation resources must be invested in the most climate-vulnerable countries (small island developing states, least developed countries, and African States). The GCF can structure its financial support through a combination of grants, concessional debt, guarantees or equity instruments to leverage blended finance and crowd in private investment for climate action in developing countries. Governments can access the GCF through multiple accredited entities, including national DFIs, provided they fulfill the requirements of the fund.

112 See for example the Agri3Fund and the Africa Agriculture and Trade Investment Fund.

113 See, for example, the Women Entrepreneurs Opportunity Facility.

114 While still limited, the existent empirical research indicates that financial literacy influences financial attitudes, financial behaviors, organizational capabilities, and performance of SMEs. See Graña-Alvarez et al. (2024). See Atkinson (2017) for a stock taking of financial education efforts for SMEs in 21 jurisdictions.

115 The OECD conducted a review of SME support evaluation programs across OECD countries. The report identified 50 reliable evaluations, but the main message is the need for countries to improve their evaluation frameworks. To this end, the report also provides a set of recommendations. See OECD (2023).

116 Economic additionality refers to whether interventions achieve higher objectives or development goals, such as the creation of jobs, or higher productivity in firms. It is important to note however, that many other factors beyond access to finance affect a firms' growth and productivity, such as the business environment, firms' capabilities and access to markets, and more generally, the macroeconomic environment. A recent OECD report on the evaluation of the impact of SME programs, recommends using three basic sets of indicators

across all SME programs to assess and compare their effectiveness: sales, jobs and firms' survival. Assessment of economic additionality usually involve the use of control groups. See OECD (2023).

117 In this report, DFIs are defined as financial institutions with policy objectives that are closely related to the economic development of a country or given sector and are typically focused on financing productive investment through the provision of medium- and long-term funding. According to a global dataset of 521 DFIs, as of 2020 there were 136 DFIs with the specific mandate of supporting SMEs, with US$1.8 trillion in assets. In addition, several large DFIs with generic mandates also support MSMEs. See Gutierrez and Kliatskova (2021).

118 An entity's governance framework specifies the allocation of rights and responsibilities between its different stakeholders and articulates the rules and procedures for decision -making (World Bank, 2014b).

119 For governance arrangements in development banks see Gutierrez and Kliatskova (2021), for PCGs, see World Bank and FIRST Initiative (2015), and for funds, see Divakaran et al. (2022).

120 Overall, the existing empirical research points to a positive correlation between PCGs and the levels of SME financing. The empirical effect on the interest rate is more ambiguous, with a mix of positive, negative, and insignificant coefficients. Just a couple papers deal with the ratio of long-term debt and the number of lending relationships (borrowing from new banks), uncovering a positive effect in both cases. There is little to no evidence produced on the effect of this instrument on improving access to finance to SMEs willing but unable to enter formal credit markets. There is no indication in the literature that these programs massively serve first-time borrowers. Instead, they seem to assist pre-existing bank clients. For more information see the online literature review (forthcoming).

121 For best practices see Goffe, Hammersley, and Rustom (2021).

122 The existing empirical research points to a positive correlation between LoCs and bank debt. In addition, lending programs appear to lower the interest rate charged on SME loans—but this conclusion is not unanimous. A positive effect on loan maturity is picked up by a couple of studies that investigated this issue. There is some scarce but positive evidence of a less cyclical SME credit behavior as well as a positive externality effect on the access to credit by other banks in the aftermath of the intervention. Subsidized lending seems to exert a positive impact on access to credit and different SME performance indicators. Little to no evidence is produced on the effect of this instrument on improving access to finance to SMEs willing but unable to enter formal credit markets. There is no indication in the literature that these schemes massively serve first-time borrowers. Instead, they seem to assist preexisting bank clients. See the online literature review (forthcoming).

123 That is, a condition imposed for European Investment Bank (EIB)-supported loans in the contracts with financial intermediaries that benefit from their lending, which is done either at favorable (lower interest rates) or longer maturities that what is available in the market. See EIB (2022).

124 Unviable either because there is no third party willing or able to provide such enhancement due to costs or because the resulting rate of return is no longer attractive to institutional investors. See Carvajal et al. (2020).

125 Most of the empirical research on VC has focused on its economic additionality (for example impact on innovation and sales). Bai et al. (2021) found that public entrepreneurial finance crowds in (as opposed to crowding out) private financing, especially in countries with appropriate rule of law and a previously developed private VC market. See the online literature review (forthcoming).

126 In a study of the effectiveness of tax incentives in the VC industry in Europe, the European Commission found that tax incentives were used to support venture capital and business angels across the European Union (EU) 28 and selected OECD countries. The study found that tax incentives had been implemented by 19 of the 36 countries in the sample. In terms of the EU-28, the study found a marked contrast between the EU-15 and other member states in the prevalence of tax incentives, which the study attributed to the differences in the level of venture capital and business angel investment activity and differences in preferences for the use of targeted tax incentives. Instead of trying to assess their impact, the EU study identified a set of best practices in structuring these incentives based on an analysis of the scope, qualifying criteria, administration, generosity, and stability of the schemes. See European Commission (2018).

127 See the online literature review (forthcoming) for a summary of the existing empirical research.

128 As indicated by Carvajal et al. (2020), many exchanges have concerns that tax incentives would attract companies that are mainly interested in avoiding taxes but are otherwise not ready or suitable for listing on an exchange. If the quality of companies coming to market is poor, the reputation of the exchange can be damaged. In addition, some tax authorities are concerned about the loss of immediate tax revenues from these tax incentives, while others consider that the increased transparency and the potential for growth of listed firms will increase tax revenues in the medium to long term. Policy makers need to weigh in on these tradeoffs.

129 See World Bank Gender Data Portal.

130 See World Bank Gender Data Portal.

131 See World Bank (2022).

132 See GSMA (2020).

133 A summary of the global evidence on the causes of the credit gap can be found in Cirera and Qasim (2014). For Africa, Campos et al. (2019) offer a more recent in-depth analysis of key factors affecting WSME access to finance. Finally, Pavlova and Gvetadze (2023) summarize

the evidence for Europe. This latter publication provides a theoretical framework to analyze the causes of the credit and VC gaps that can be applied globally.

134 In the context of an analysis of factors holding back women's business performance in Africa, the World Bank identified nine of them, broken down into three categories of constraints: (a) contextual factors: legal discrimination, social norms, and gender-based violence; (b) endowments: education and skill gaps, confidence and risk preferences, finance and assets, and access to networks and information; and (c) household-level constraints: household allocation of productive resources and time constraints and care. See for example Campos et al. (2019), Boden and Nucci (2000).

135 In 21 economies women do not have the same rights over immovable property, including land; in 41 economies daughters do not have the same right to inherent as their brothers; and in 43 economies a female surviving spouse does not have the same inheritance rights (World Bank 2024).

136 See Morsy (2020), and Ongena and Popov (2015).

137 See Pavlova and Gvetatdze (2023), and Alibhai et al. (2019).

138 See Teare (2000).

139 See Abouzahr (2018).

140 See Plaitakis and Staschen (2020).

141 See Campos et al. (2019).

142 See Kelly and Mirpourian (2021).

143 See Sawhney et al. (2022).

144 Acknowledging the differences in WSMEs across segments highlights the need for different interventions to close their financing gap. Notably, it is even more relevant to consider the goal of the interventions when designing specific support policies. For example, if the goal is to maximize outreach to WSMEs (say based on the number and volume of WSMEs reached), support policies should recognize that WSMEs are more concentrated among smaller size businesses and in specific sectors, such as services and retail.

145 A number of existing reports, some of them produced recently, have collected and summarized evidence on which interventions demonstrably move the needle to support women in starting and growing businesses. These reports also include a review of the most common interventions on access to finance and summarize the evidence regarding the most promising interventions. Some of these reports include Burga et al. (2021), Buvinic, Furst-Nichols, and Pryor (2013), Campos et al. (2019), and World Bank (2018),

146 See for example Cucagna et al. (2020).

147 See for example Campos et al. (2018).

148 For a more in-depth discussion, see Carvajal and Didier (2024).

149 See OECD (2021, 2022b). In the latter, OECD argues that SMEs account for at least 50 percent of GHG emissions and 30–60 percent of energy use of the business sector in OECD countries. There are no cross-country estimates of emissions from SMEs in EMDEs. One challenge in accurately assessing the emissions share of SMEs is the limited availability of data. Many SMEs in EMDEs operate informally or have limited resources and capabilities to measure and report their environmental impact, making it challenging to obtain comprehensive information on their footprint.

150 The European Union's (EU's) carbon border adjustment mechanism is a tariff that will be imposed on certain types of carbon-intensive products that are imported into the countries in the European Union. This carbon border tax will be initially applied to imports of carbon-intensive goods, such as cement, iron and steel, aluminum, and fertilizers.

151 See World Bank (forthcoming).

152 These externalities can also be negative, for instance with costs rather than benefits not being internalized. For example, when environmental costs are not internalized, there may be overinvestments in non-environment-friendly sectors, such as those that cause environmental damages.

153 A growing body of research emphasizes that informational frictions are one of the most binding constraints for scaling up sustainable and climate-resilient investments. These investments are often perceived as high risk not only because of mismatches in the time horizon but also due to heightened uncertainty stemming from limited information related to (a) technologies (for example, uncertainty about the technical feasibility of adopting a new, sometimes untested, technology; lack of track records of new technologies leading to uncertainty about their profitability; uncertainty about whether newer, more advanced alternatives will emerge, rendering these investments outdated); (b) markets (for example, uncertainty about evolving demand and competitiveness in the marketplace); and (c) policies and regulations (for example, lack of clarity, stability, predictability, or even inconsistency in government policies). See for example OECD and ASEAN (2021).

154 As noted, there are measurement challenges regarding the quantification of outcomes for adaptation investments, with a lack of standardized metrics. Unlike mitigation, which can be measured in terms of emissions reductions or energy savings, the impacts of adaptation efforts are often context-specific and hard to quantify in monetary terms.

155 See for example UNSGSA (2023). .

156 See Dalhuijsen et al. (2023). The bias toward mitigation investments is further evidenced in other studies, such as the International Development Finance Club (IDFC), which suggests that US$146 billion of the US$185 billion green finance provided by IDFC members in 2020 is dedicated to climate mitigation. See IDFC (2021). Similarly, Naran et al. (2022) shows that around 89 percent of climate finance from DFIs is dedicated to climate mitigation.

157 Survey results indicate that the most widely used instruments to provide green financing is lending. DFIs provide first- and/or second-tier lending, with short- to

long-term loans and credit lines, some at concessional terms. See Dalhuijsen et al. (2023).

158 Some EMDEs have started to explore PCGs to support adaptation activities, especially post-disaster financial support through disaster-triggered guarantee programs (for example, Morocco's Central Guarantee Fund). However, such initiatives are still at an incipient stage of development. See World Bank (2022). See also Inclusive Green Finance Working Group and Alliance for Financial Inclusion (2022) and OECD (2022b) for a discussion of some PCGs in some EMDEs.

159 World Bank (2022) argues that the lack of taxonomies or disclosure frameworks should not preclude PCGSs from supporting climate-related financing support. PCGSs should leverage existing taxonomies available in other jurisdictions to prevent greenwashing risks, to allow for the certification of green assets and investment projects, and to facilitate risk analysis. Similarly, PCGSs should encourage partner financial institutions and SMEs to disclose climate-related information in line with frameworks in use in other jurisdictions if domestic ones are not available. Such guidance is particularly relevant for SMEs as disclosure frameworks tend to be in a more advanced stage of implementation for financial institutions and large corporates, they remain largely underdeveloped for SMEs.

160 Outcomes on risk reduction from climate adaptation investments are typically expressed in specific ways to the respective sector or context of these investments (for example, as agricultural yields, health benefits, or reduced water stress). This highlights that "adaptation has no common reference metrics in the same way that tonnes of GHGs or radiative forcing values are for mitigation" (IPCC 2014).

161 See Buchner et al. (2021). Even if extensive global mitigation efforts are implemented, there are large needs for financial resources for adaptation (IPCC 2023). *The Adaptation Gap Report* by the United Nations Environment Programme (UNEP) estimates that annual adaptation costs in developing economies will be in the range of US$155 billion to US$330 billion by 2030 (see UNEP 2021).

162 While financing adaptation requires specific-localized solutions, financing mitigation is more standardized. The response mechanisms to improve energy efficiency and adopt renewable sources of energy tend to be similar across a wide range of country context and SMEs can use a similar set of financial tools to manage transition risks.

163 The existing data suggest that very limited debt financing is being granted at concessional rates. According to estimates from the Climate Policy Initiative, only 12 percent of total climate finance to firms in the form of debt financing was characterized by either low-cost or concessional debt in 2020 (Buchner et al. 2021). But there is no information on who are the main beneficiaries of these financial flows. Anecdotal evidence suggests that public institutions (DFIs) are providing concessional financing to SMEs, either directly or through LoCs, in many cases for energy reduction and energy efficiency purposes and for greater adoption of renewable energy.

164 For more details on this recommendation, see World Bank (2022).

165 Dalhuijsen et al. (2023) suggests that DFIs can play a role to reduce regulatory and policy risks. For instance, DFIs could act as a bridge between local governments and the market to address key concerns and uncertainties about the policy and regulatory environment for green investments and drive necessary reforms to improve the enabling environment, in addition to offering de-risking instruments such as political risk guarantee, first loss provisions, and loan loss reserves.

166 See for example Dalhuijsen et al. (2023) for a review of the lessons learned from greening DFIs.

167 See Miguel, Pedraza, and Ruiz-Ortega (2022).

168 For this Note, the definition of agri-SMEs includes all players involved in agriculture value chains from farm to fork. These include commercial individual and groups of farmers and all SMEs involved in agriculture and food pre- and postharvest systems (for example, production systems, agritech companies, storage and transportation systems, processing and market infrastructure systems, wholesaling and retail infrastructure, exports related systems). Developing a sustainable access to finance for agri-SMEs requires involving all the different lenders across the chain as they have different targets and roles.

169 This estimate does not include smallholder farmers with limited commercial activities. The financial need of this segment is estimated at US$240 billion annually and over 70 percent remains unmet (ISF Advisors 2019).

170 Global agrifood systems are responsible for approximately 30 percent of global greenhouse gas emissions; however, agri-SMEs in EMDEs seem to contribute very little to this total. The bulk of emissions in the sector are generated by large-scale, intensive commercial agriculture in Europe, the Americas, and China. For instance, sub-Saharan Africa and Southeast Asia contribute respectively 10 percent and 12.5 percent of the global agrifood systems emissions. Nevertheless, SMEs would need to contribute to their mitigation efforts to remain competitive and part of global chains.

171 Other financiers, such as development banks and impact investment funds, support agri-SMEs in some EMDEs but the volume of financing is far smaller than the latent demand.

172 See for example ISF Advisors (2022).

173 See for example Alderman and Haque (2007); Carter, Galarza, and Boucher (2007); Carter, Cheng, and Sarris (2016), and Santos and Barrett (2011).

174 See for example Berhane et al. (2014), Cai (2015), Cole and Xiong (2017), Elabed and Carter (2013), Hill et al. (2019), Jensen and Barrett (2017), and Karlan et al. (2014).

175 There is in fact no agreed upon definition of FCV, and different actors categorize FCV in different ways. Many in fact refer to it as a continuum rather than a binary concept. For example, Assaf et al. (2021) consider

countries within the entire fragility spectrum using a continuum that synthesizes social, economic, and political outcomes produced annually by the Fund for Peace's Fragile States Index. The index is a composite made up of cohesion (security apparatus, factionalized elites, group grievance); economic (economic decline, inequality, human flight/brain drain); political (state legitimacy, public services, human rights/rule of law); and social (demographic pressure, refugees or internally displaced persons [IDPs], external interventions) indicators estimated for 178 countries.

176 See Assaf et al. (2021).

177 While the past decade has seen a high degree of technology-driven innovation catalyzed by rising penetration rates of mobile internet services in low-income countries, the World Bank Enterprise Surveys still highlight a drastic digital divide for FCV countries—with relatively depressed internet penetration rates and use of digital communication by enterprises (email and websites) in fragile situations. See Assaf et al. (2021).

178 See Calice (2023).

179 See OECD (2022c).

180 For example, the World Bank has engaged with policy makers in South Sudan and Somalia in the development of a digital payment ecosystem and the needed enabling environment. In Mozambique, a World Bank project focused on government-to-person transfers to vulnerable populations exposed to conflict, violence, natural disasters (including flooding, tropical cyclones, and droughts), and food insecurity. The project has facilitated digital payments to more than 130,000 social assistance beneficiaries. A similar project is being developed in Burkina Faso.

181 The degree in which a country is affected by fragility, conflict, and violence may vary across different parts within the country, and the intensity of these three elements can vary accordingly.

182 See Proparco Group AFD (2023).

183 See Assaf et al. (2021).

184 See USAID (2022).

185 See for example Beck, Demirgüç-Kunt, and Martinez Peria (2011).

186 This appendix is based on Didier and Cusolito (2024).

187 See OECD (2017).

188 See Staschen and Meagher (2022), Jenik and Zetterli (2021), Plaitakis and Staschen (2020), and Lyman et al. (2019).

189 World Bank staff assessments.

190 World Bank staff analysis based on Binh et al. (2020).

191 World Bank staff assessments.

192 See Financial Stability Board (2019).

193 See Fisera, Horváth, and Melecký (2019).

194 See European Banking Authority (2016), Mayordomo and Rodriguez-Moreno (2017), and Dietsch, Henri Fraisse, and Lecarpentier (2019).

195 World Bank staff assessment based on information on NAFIN's Annual Report 2021.

196 World Bank staff assessment based on RBI TReDs monthly statistics, June 2022.

197 World Bank staff assessment based on Bancoldex website.

198 World bank staff assessment based on Schammo (2019), HM Treasury, Bank Referral Scheme: Official Statistics.

199 World Bank staff assessment based on British Business Bank website.

200 See Politecnico MIlano, Osservatori Entrepreneurship Finance & Innovation, 9° Report italiano sui Minibond, 2023.

201 World Bank staff assessment based on A2censo and Bancoldex websites.

202 World Bank staff assessments.

203 The choice of an offshore jurisdiction is driven by multiple considerations, such as the availability of a robust regulatory regime, the level of regulatory oversight desired, confidence in the rule of law, tax efficiency and neutrality, and the availability of appropriate investment instruments not existent in the host country. Reputable offshore domiciles typically also have a deep and experienced pool of service providers. Specialized investment funds trying to attract global investors also consider domiciles that provide tax treaty networks ensuring that cross-border investors are not double taxed. See Divakaran et al. (2022).

204 See World Bank (2019d).

205 See Cucagna et al. (2020).

206 World Bank staff assessment based on CGAP (2022) and Kinara Capital website.

207 See for example Bloom and Van Reenen (2010).

208 This type of support may be less relevant with initiatives that are designed to inject liquidity into the market and provide working capital (for example, COVID-19 and natural disaster support) to SMEs.

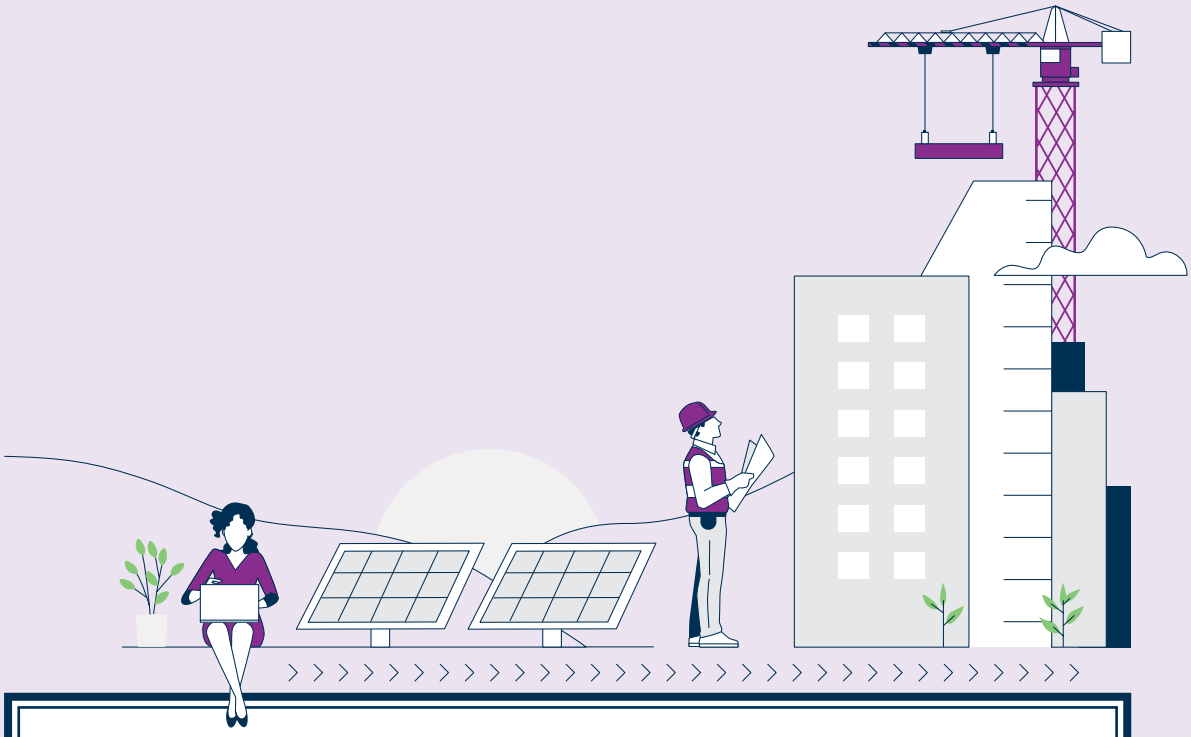
209 Japan has traditionally combined loan guarantees with compulsory business advice in their SME schemes.

210 See Beck, Klapper, and Mendoza (2010).

211 See Calice (2016).

212 For surveys of partial credit guarantee schemes, see Beck, Klapper, and Mendoza (2010) and Honohan (2010).

213 See World Bank and FIRST Initiative (2015).



Access to finance is one of the most significant constraints on the ability of Small and Medium Enterprises (SMEs) to grow and create jobs in emerging market and developing economies (EMDEs). Despite the vast array of support programs rolled out by governments in EMDEs to bolster SME financing, often at a large budget cost, the debt and equity financing gaps remain wide. Moreover, global shifts, including the rapid rise of new financial technologies and the escalating challenges of climate change, are reshaping the SME financing landscape.

This report "*Boosting SME Finance for Growth: The Case for more Effective Support Policies*" offers strategic and actionable guidance to policy makers in EMDEs in reviewing and strengthening their access to finance support programs. Drawing on insights from the experiences of both high-income countries and EMDEs, this report emphasizes the urgent need to improve the core enabling environment for SME debt and equity financing. It provides a roadmap to guide EMDE policy makers in achieving this. While such reforms are necessary, cross-country experiences show that they are usually insufficient on their own. Targeted financial programs to increase both debt and equity financing to SMEs remain essential to bridge financing gaps effectively. This report outlines a set of recommendations for optimizing these interventions to maximize their impact and the effective use of public funding.

This report also underscores the importance of a differentiated approach to address the unique challenges faced by specific SME segments, particularly those of women-owned enterprises, SMEs in agriculture, SMEs in fragile and conflict-affected states, and those seeking financing for climate change adaptation and mitigation.