Triodos Facet

# Finance for Development

## Improving access to financial services for sustainable SMEs in Africa

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## INTRODUCTION

A well-functioning domestic financial sector is essential for poverty reduction and sustainable development. Research indicates that a 10% increase in the "private credit/GDP ratio" reduces poverty ratios by 2,5 – 3 percent points (Claessens & Feijen, 2006). African governments and international donors invest considerable resources in financial sector development in Africa. These investments initially focused on liberalisation and privatisation of the financial sector and on the development of the microfinance industry (van der Putten et al, 2006).

In recent years, attention has started to shift towards SME finance. Although micro-enterprises contribute to poverty alleviation, there is a growing awareness that SMES – focusing on capital accumulation and risk taking – have a greater potential for sustainable economic development.

The SME sector in Africa, however, has remained rather insignificant. The lack of access to financial services for SMEs is considered to be an important obstacle for growth. In most African countries, entrepreneurs experience difficulties obtaining credit or equity between €50.000 and €500.000. If the development potential of SMEs is to be unleashed, their access to financial services must be improved.

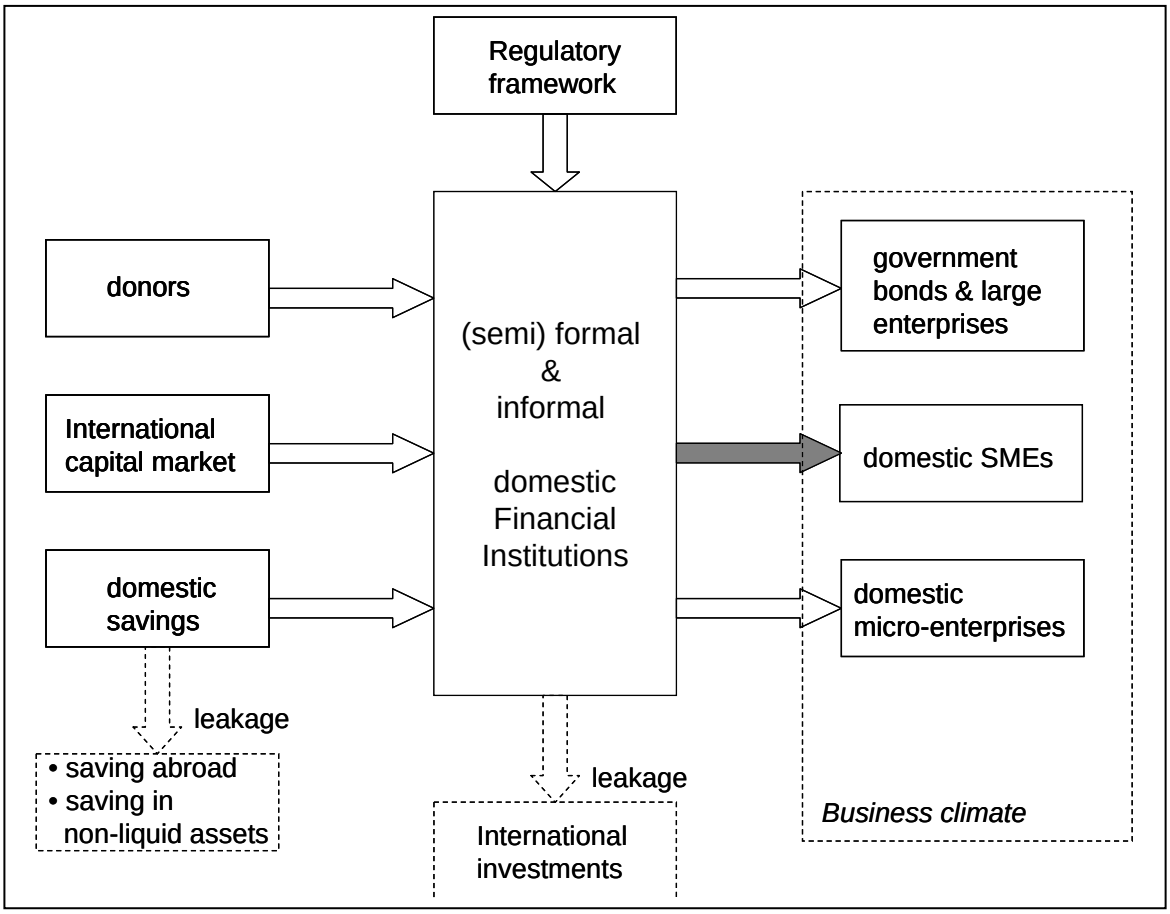
This paper aims to shed light on how access to financial services for sustainable SMEs in Africa can be improved. The first part[1] of this paper reports on the bottlenecks for SME finance. In addition, interventions are proposed at the regulatory framework, the financial institutions and also the SME sector itself. Finally, we contend that access to finance is a necessary but not sufficient criterion for developing a sustainable SME sector in Africa. The second part of this paper focuses on how financial institutions can contribute to an SME sector that is financially, socially and environmentally sustainable.

[1] This part is based on the findings of the study that Triodos Facet undertook for the Dutch Ministry for Development Cooperation (DGIS). The study investigated the supply and demand for SME finance and bottlenecks in six selected developing countries. Of these six countries, 3 were African: Tanzania, Rwanda and Zambia.

## BOTTLENECKS FOR SME FINANCE

The market for SME finance is characterised by various players (see figure 1). SMEs obtain their loans or equity from domestic financial institutions (banks, venture capital funds, etc.), which acquire capital through domestic savings, the international capital market and donor funds.

*Figure 1: The local capital market*




The financial institutions have various investment and lending opportunities, including domestic SMEs. In practice, most financial institutions chose to invest their assets in government bonds or abroad. The key issue is to assess which bottlenecks obstruct SMEs' access to financial services.

First of all, money is not the problem, at least not on the short to medium term. In all three countries, the financial sector is highly liquid. The FSAP conducted in Tanzania (IMF, 2005) states that: "the availability of loanable funds is unlikely to be a constraining factor in the medium term" (p. 4). Despite the availability of funds, banks have not yet developed a greater SME orientation. The bottlenecks that are relevant are located at three levels: the regulatory environment, the financial institutions and the SMEs.

**The regulatory and legal environment**

Firstly, Basel II rules seem to make it less attractive for banks to lend to SMEs as they focus heavily on risk coverage and high provisioning. The Zambian central bank has reviewed the regulation and reduced the statutory reserve requirements to stimulate SME lending.

Secondly, in all three countries, registration of property is a time consuming and costly process, limiting entrepreneurs' ability to offer collateral. In addition, banks are reluctant lending to the SME sector because of difficulties with contract enforcement and execution of collateral. When lenders can more easily force repayment and execute collateral, they would be more willing to extend credit.

**The financial institutions**
In all three countries, the knowledge gap is mentioned as the most important bottleneck. Banks lack information on the size of the SME sector, its potential economic impact and cannot identify high potential SMEs. In addition, banks shy away from SME lending because they consider it an expensive and risky business. However, the experience with microfinance has shown that with appropriate technology lending costs can be reduced substantially. Moreover, small businesses are no less credit-worthy than larger enterprises. The absence of well-functioning credit bureaus limits risk assessment of individual clients. When lenders know more about potential borrowers and their credit history, they will extend more credit. Another very important bottleneck is the lack of adequate loan methodology and lending products for SMEs, such as loans based on projected cash-flow, instead of fixed assets. Rwanda offers an interesting exception in this case, where all banks offer SME loan products.

**The SMEs**
The absence of good, innovative and risk-taking SMEs, limits the investment opportunities for financial institutions. Especially in Rwanda, but also in Tanzania and Zambia, the lack of entrepreneurs is considered a major bottleneck. One interviewee stated: "Good bankable ideas are what is most crucial. The private sector in Rwanda has a challenge to come up with good ideas for business"[2] . In addition, many SMEs are unable to present a business plan and formulate a loan request. Thus, we cannot just blame the banks for the poor development of the SME finance market. SMEs are part of the problem since they cannot express a solid and well-formulated demand for credit and other financial services.

## INTERVENTIONS

Based on the assessment of the bottlenecks, interventions are located at three levels: macro, meso (industry) and micro level.

At the **macro-level**, changes in the regulatory environment are necessary to stimulate banks to issue medium-term loans and equity investments. In addition, investments to improve the business climate are necessary. All three countries score below average on the ease of doing business (OECD 2006)[3] . For example, the costs for starting a formal business in Rwanda are 188% of the average income. Also improvements in the legal framework – especially the registration of property and execution of collateral – are necessary.

Interventions at the **meso-level** aim at closing the information gaps identified. Particularly, conducting sector studies is a promising avenue to map the terra incognita. At the moment, none of the three countries had any quantitative information on the size of the market for SME finance or the outstanding SME credit. Providing financial institutions with practical information on promising SME sectors and their need for financial services can help to raise awareness on the business case for SME finance.

Establishing effective credit bureaus helps banks to assess the risk profile of individual clients. In Tanzania, a credit bureau has been founded. However, the lack of a national identity system for individuals reduces its effectiveness.

Another way to close the information gap is to share good practices on SME lending between financial institutions. The systematic collection and dissemination of best practices has contributed to the success of microfinance. Sharing best practices in SME finance reduces costs for newcomers, raises awareness and allows banks to compare their performance with industry benchmarks.

The banking sector in Africa is unknown and therefore unloved. Only 15% of the adult Zambians have a bank account. Less than 5% of the entrepreneurs would consider approaching a bank when in need of finance (Finmark, 2006). Unfamiliarity with financial institutions is one reason why many entrepreneurs do not apply for a loan and why banks do not take them serious. By promoting banks

[2] Mr. David Kuwana, managing director of Banque Commerciale du Ruanda (March 2007).

[3] According to OECD indicators on the ease of doing business, Zambia is 102nd (of 170), Tanzania 142nd and Rwanda 158th (OECD 2006).

accounts, banks get to know (potential) entrepreneurs through non-credit type of financial services. At the same time, clients build a track record and trust towards the bank.

Interventions at the **micro-level** involve building the capacity of financial institutions. The main conclusion of our study is that providing capital alone is not enough to stimulate SME finance. For example, as per 2006 about $38 million was available in credit lines for SMEs in Rwanda. However, the availability of this money has not lead to a substantial increase in SME lending (CAPMER, 2005). Capacity building can help financial institutions with developing a SME orientation and adopting appropriate lending technology, such as client selection and risk analysis. The Dutch Rabobank offers technical assistance to the NMB bank in Tanzania, in which it has acquired a minority share. Being aware of the need for SME finance, the Rabobank helps the NMB to develop SME lending products such as factoring, invoice discounting and leasing. Rabobank will provide similar technical assistance to recently acquired banks in Zambia and Rwanda. Also IFC provides technical assistance to financial institutions to improve their SME focus and develop SME oriented services.

The SME sector itself is part of the problem, and therefore part of the solution. A strong case can be made for investing in entrepreneurship development and business support services. Investing in education, vocational training and business support is necessary to enhance the entrepreneurial attitudes and develop business skills. This will ultimately result in more entrepreneurs with good, bankable business ideas. In Tanzania, a business plan competition has been initiated by Business in Development Network in cooperation with four Tanzanian Banks. Moreover, business support organisations help SMEs with developing managerial skills and preparing loans requests that meet the banks' criteria. The IFC and the African Development Bank provide technical assistance to SMEs, such as mentoring and business skills training.

## FINANCIAL INSTITUTIONS AND SUSTAINABLE SMES

The private sector is considered an important partner for sustainable development. Whereas most attention is directed towards multinationals, the debate for a sustainable SME sector has started[4]. SME's are often part of multinational value chain and *collectively* have a considerable impact on natural resources and social development.

Also for financial institutions, sustainability becomes increasingly important. Firstly, from a risk-management perspective, clients that are involved in hazardous operations may threaten the bank's reputation. Secondly, operating along the principles of sustainability also offers opportunities to improve financial performance. After all clients that reduces energy or waste could also decrease their operational costs[5]. A study on venture capital funds in Africa revealed that 90% developed some form awareness on sustainability (Triodos Facet, 2005). However, just one venture capital fund has developed a practical policy towards sustainability. Many financial institutions consider sustainability as being too complex, too costly and too vague.

The relevant question is what practical steps financial institutions can take to enhance the development of a sustainable SME sector? Over the past years, Triodos Facet supported financial institutions (predominantly microfinance institutions) with integrating sustainability in their operations. Specifically, we developed a hands-on tool to measure and improve the non-finance impact of MFI clients.

Triodos Facet developed factsheets that help loan officers assessing the performance of their clients regarding relevant social and environmental criteria. A factsheet describes the most common unsustainable situation for enterprises in that sector (such as use of hazardous chemicals) and gives practical suggestions for improvement. (see figure 2 for an example).

[4] For example, see the special issue (December 2005) of the Journal of Business Ethics on CSR for SMEs.
[5] For a discussion of the business case of sustainability for SMEs: Jeurissen, Pater & Cappon (2005).

*Figure 2: Example Factsheet*

**A1 Agriculture – Crop Growing**

| OBSERVE<br>*The Client is ...* | ANALYSE<br>*There is a risk if ...* | DISCUSS<br>*What is important ...* | SUGGEST<br>*Suggest the client to ...* |
|---|---|---|---|
| ... using (a) machine(s) | [H&S] Machines look unsafe, ill maintained, have dangerous parts<br>[H&S] No safeguards are available and/or used when necessary<br>[E] Leakages, disposals, liquid waste or wastewater drains to stream/river/pond/soil | • Well maintained machines are safe, not dangerous and cheaper in use<br>• Operating a machine with proper safeguards prevents accidents<br>• Machines can leak oil/lubricants and that will spoil drinking water<br>• Malfunctioning Electricity is dangerous and create fallout | ① Position machines on a safe spot and cover dangerous moving parts<br>① Take up maintenance routine, follow strict maintenance and lubrication practices for the moving parts of equipment<br>① Keep machines in good shape and clean<br>① Experience operators only<br>① Provide and use safeguards (goggles, gloves, mask)<br>① Re-use scrap / disposals<br>① Stop leakages and draining liquid waste<br>① Establish contingency plans for accidents<br>① Have fire fighting equipment and first aid kit available |
| ... using chemicals/ lubricants/pesticides/fertilizers | [H&S] No safeguards are used when necessary<br>[H&S] No relevant Material Safety Data Sheets (or other safety leaflet) are available<br>[H&S] Storage is unsafe, since unlocked, near sleeping/ eating | • Applying/handling toxic substances with proper safeguards prevents illness<br>• Safe storage prevents from chemical reactions, explosions, fire, leakages and intoxication | ① Do not over-use chemicals<br>① Consider integrated pest control<br>① Provide and use safeguards when working with chemicals (mask, goggles, gloves, overall)<br>① A separate storage is created, locked away from children and living/eating rooms<br>① Establish contingency plans for accidents<br>① Have fire fighting equipment and first aid kit available |
| ... clearing forest for land cultivation | [E] Forest is managed unsustainable (illegal and/or without reforestation plan) | • Deforestation, if not performed carefully and in a sustainable way causes land erosion and degradation, and eventually mud streams and water floods | ① Agree only on permitted and sustainable forms of use of pristine land<br>① Apply reforestation: plant new trees |
| ... employing children | [L] Children are being employed | • Children should receive education, proper nutrition and health care. They should be protected from abuse and discrimination, able to play and enjoy their childhood | ① Have children help with light duties only<br>① Only outside school hours and pupils must have time and designated place to do homework<br>① Children do not operate hazardous machines |

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| Background, relevant legislation, minimal requirements | Solutions, tips, further information |
|---|---|
| - ILO Conventions 138 and 182<br>- No wastewater/disposal without permit<br>- Don't install diesel generator sets without approval certificate<br>- Have MSDS available when working with chemicals | - Farmers should use pesticides that are permitted.<br>- Farmers should consider to carry out integrated pest management (biological – physical – chemical)<br>- Fix leaks promptly Dripping joints can waste over 76 liters of water a day<br>- In case there is no waste disposal facility: Contact (alone or in collaboration with other entrepreneurs) local council and ask for improved public service |

For example, loan officers can use the factsheets to assess the health and safety situation or environmental risk of their clients that use machinery, or chemicals. The factsheet also helps the loan officer to suggest improvements that mitigate the risk. Moreover, it also helps loan officers to identify possible tangible opportunities for cost reduction such as waste reduction, use of sustainable energy sources or switch to biological production.

These factsheets have been used and tested in trainings with MFI field officers in India, Peru, Bolivia and Cambodia[6]. In the near future, similar tools will be developed for financial institutions that focus on SME lending on the African continent.

## CONCLUSION

SMEs in Africa need access to financial services. This paper identified the most important bottlenecks and interventions to overcome them. Obviously, there is no quick-fix and providing "just money" is not enough. Instead, resources must aim at capacity building for the financial sector and the SME sector.

The financial sector must be supported in getting to know the SME sector and developing appropriate financial products for them. Moreover, supporting the financial sector to operate along the principles of sustainability is also required. At the moment, few tangible tools exist that help the financial sector in Africa to assess and enhance the non-financial impact of their SME clients. The fact sheets developed by Triodos Facet, can be used as a starting point.

Assistance for SMEs must focus on developing entrepreneurship and enhancing management skills. Raising awareness on sustainability and developing practical tools for SMEs to integrate sustainability in their business is also a relevant area for interventions. Support for entrepreneurs is indispensable: without sustainable entrepreneurship money has no value!

[6] As part of a FMO training on Social and Environmental Aspects of Microfinance

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