Comité Latinoamericano de Asuntos Financieros
Comite Latino Americano de Assuntos Financeiros
Latin American Shadow Financial Regulatory Committee

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Small and Medium Size Enterprises Finance in Latin America: Developing Markets, Institutions and Instruments

1. Motivation

Latin America lacks formal jobs. Small and medium size enterprises (SMEs) are a major source of employment. Thus, the limited number of SMEs is the other side of the coin of the employment story. *The Committee believes the functioning and development of SMEs is critically important when considering strategies to promote the creation of new jobs in the region.*

In this context, lack of sufficient access to credit is commonly cited as a major problem facing SMEs in Latin America. Arguments explaining this development run from market imperfections (preventing an appropriate credit assessment by lenders) to a high ratio of non-performing loans (affecting the risk features of the borrowers). Policy prescriptions also vary widely ranging from those that emphasize government subsidies to this sector to others that place greater importance in the enhancement of market-oriented policies, such as the strengthening of property and creditors' rights to improve the value of collateral in credit contracts.

At present, channeling savings to SMEs has become more difficult. Banks have been regulated in order to limit their risk-taking capacity. The securities markets have very high fixed costs that make them only relevant for very large firms. Pension funds are regulated to buy only the best of these securities. In addition, no venture capital or angel capital funds have been developed in part because they cannot hope to recover their investment through IPOs. As a result, SMEs lack the markets through which they can fund their plans.

In the context of this debate and in recognition that achievement of economic and financial development in the region requires a dynamic entrepreneurial sector, the Latin America Shadow Financial Regulatory Committee: (a) identifies the severity of the financial constraint facing SMEs relative to that faced by large firms; (b) analyzes recent proposals on how to improve financing access for this sector; and (c) advances

recommendations aimed at invigorating the sector while avoiding undesirable economic distortions.

When evaluating existing evidence the Committee used the widespread definition of SMEs by which they satisfy (some or all) of the following criteria: 1) a maximum amount of workers employed; 2) a maximum volume of sales; and/or 3) a maximum size of assets. Notwithstanding, the Committee felt that such commonly used definition—which at present provides the sole systematic source of economic data on the sector—tends to be somewhat arbitrary and hide a reality that in every country there is a continuum of economic units of varying size. Moreover, existing evidence suggests that there is little transition of firms across different size categories and, hence, for most SMEs their actual size simply reflects a permanent characteristic of the nature of their business.

In this spirit, the Committee focused its analysis on identifying the financial constraints faced by a significant number of firms in the region that appear to be particularly severe in the case of SMEs. *In reaching its recommendations the Committee's guiding principle was to focus on structural policies directed at improving the functioning of financial markets and the quality of entrepreneurship.* In addition, the statement also identifies a small set of specific interventions to facilitate access to credit by SMEs.

2. The Severity of financial constraints for small and medium size enterprises

Recent studies (see, for instance, IDB, IPES (2004) forthcoming) identify five basic stylized facts for SMEs in Latin America: First, just as in industrial countries, SMEs in Latin America employ half or more of total workers reported in formal markets. Second, similarly to the situation in industrial countries, SMEs tend to have a higher failure rate than for larger firms, and, therefore, a higher proportion of non-performing bank loans. Third, in contrast to industrial countries, the Latin American region face financing constraints that affect firms across the entire spectrum of size; but the severity of the constraint is the strongest for the smallest firms. Fourth, also differently from industrial countries, SMEs in Latin America rely heavily on supplier's credit and informal sources of finance (funds from friends and family and informal lenders) and are very limited in their access to banks and other financial institutions and instruments (such as leasing arrangements or equity financing). Fifth, SMEs access to financing differs significantly across Latin American countries. For example, while the share of bank loans in total sources of finance for SMEs in Chile and Uruguay reaches more than 30 percent, this ratio is lower than 5 percent in Costa Rica.

From these stylized facts, two conclusions can be derived. The first is that, albeit with different degrees of complexity and severity, *financing issues for SMEs are a worldwide phenomenon, not exclusive to Latin America.* The second is that the higher loan rates that banks often charge to SMEs relative to large firms reflect, at least partially, two elements: (a) higher credit risk and (b) higher monitoring costs faced by creditors. Data for Chile and Argentina exemplifies the relevance of higher credit risk. In Chile, SMEs' ratio of banks' non-performing loans to total loans is about 3.6 percent relative to 0.8 percent for

large firms. In Argentina, data before the recent crisis displayed ratios of 28 percent and 10 percent respectively.[I]

The Committee identified a number of factors that explain why SMEs constitute a higher credit risk:

- SMEs are a highly heterogeneous sector, which does not lend itself easily to risk assessment using scoring techniques;
- SMEs often lack diversification in their sources of income and/or are concentrated relative to large firms, with the possible exception of SMEs oriented to the consumer segment, and may be excessively exposed to changing conditions set by large firms that exert a monopsonistic power on SMEs suppliers;
- Weak commitment by shareholders expressed in by the presence of a significant share of back-to-back financing (which can be easily withdrawn) in relation to equity;
- Insufficient collateral due to lack of capital or to asset specificity;
- Significant uncertainty regarding potential tax liabilities;
- Uncertainty derived from informal restructuring of liabilities with creditors;
- Opaqueness in balance sheets reflecting weak accounting practices, non-transparent information, and lack of clarity regarding the division between the corporation and the shareholder.

With respect to monitoring costs, it is well known that banks face a number of intermediation costs that are fixed *per project* and do not depend on the size of the loan. This feature combined with a higher default risk for SMEs implies that, *even if there were no differences in obtaining information regarding the behavior of SMEs relative to large firms,* prudential banking practices would result in higher loan charges for SMEs than for larger firms.

In light of the characteristics enumerated above, the Committee believes that recent prudential regulatory changes, although contributing to safer banking, have resulted in additional pressure on SMEs to reduce their opaqueness. At the same time such changes have reduced the value to banks of collateralized lending as capital requirements have been strengthened and the new prudential standards are increasingly based on the use of cash-flow analysis.

Taken together, an overall analysis of the facts suggest a "systemic" problem regarding financial constraints in Latin America that manifests itself in more severe terms for SMEs given the particular characteristics of these institutions.

[I] International evidence indicates that between 5 and 10 percent of all firms die every year for reasons unrelated to the economic cycle. The exit rate is higher among young and small companies. For example, near 10 percent of companies die before turning one year; the failure rate falls slowly in the following years, and over a 10-year period, mortality rates remain over 60 percent.

3. Developing markets, institutions and instruments

The Committee believes that the "first line of attack" in support of SMEs should be to first identify and then remove the constraints that (1) limit access to finance to all kinds of firms regardless of size and (2) impede SMEs in Latin America to have the same kind of access to credit than their counterparts in industrial countries.

Removing restrictions that inhibit bank competition, and promoting the creation of new instruments for securitization, factoring, and leasing, can go a long way to improve SMEs financing without imposing undesirable distortions. Likewise governments should make strong efforts to avoid crowding out financial and capital markets and provide for macroeconomic stability.

At the same time, the Committee believes that the available information does not *automatically* call for any form of direct government intervention, and does not support policy recommendations that transfer the risk from a riskier segment of firms to the general population via allocations in the fiscal budget. Moreover, the Committee is concerned that subsidizing SMEs to "keep them alive" generates a perverse incentive to banks and other potential creditors since these institutions will lose their motivation to discriminate between "good" and "bad" projects. The Committee strongly believes that growth and development can only be served if financial institutions strengthen their capacity to differentiate by "quality" of projects when extending loans. Policies aiming at protecting firms only because there are small do not fit the bill in the development agenda.

3.1. Bank regulatory issues

Bank capital requirements as recommended by Basel I and, most recently by Basel II also penalize SMEs. Basel I assigns the same risk weight (100 percent) to all kind of private sector projects, *regardless of the risk characteristics of the endeavor*. Clearly, this penalizes good firms of all sizes, but especially SMEs, who, in contrast to large corporations, do not have as much access to non-bank sources of external finance.

Also a peculiarity of the new approach is that while firms rated below B- (according to the Standard and Poors classification) will be assigned a risk weight of 150 percent, unrated firms will be assigned a risk weight of 100 percent. This, of course, generates an incentive for weak firms to remain unrated. Moreover, since the cost of obtaining a rating is punitive for most SMEs, the likely outcome would be that most of these companies face a risk weight of 100 percent, defying the inherent purpose of Basell II of differentiating according to risk. *The Committee recommends that this distortion in the proposed Basel II be eliminated.*

3.2. Financial infrastructure

Legal procedures should be introduced to facilitate the orderly restructuring of liabilities of SMEs at accessible costs. Banks should be encouraged to write off unrecoverable credits. Sound banking practices call for increased collateral and guarantees when information about a borrower's capabilities is scarce and/or costly to obtain and

monitor. As discussed above, worldwide, monitoring SMEs is relatively more costly than monitoring large firms. However, in Latin America this situation is worsened by the lack of appropriate mechanisms to generate and provide the information necessary for the assessment of creditworthiness. This implies that collateral requirements will tend to be higher in the region than in the industrialized world, further increasing the difficulties of SMEs in Latin America to access credit.

Based on the argument above, the Committee believes that the risks and costs of bank loans to SMEs could be reduced if countries (a) have in place effective credit information bureaus, and (b) adequate property registries.

Credit information bureaus can provide information about SMEs current and historical payment profiles regarding financial (and eventually other type of) debts. The system should give historic as well as current information regarding arrears and default. The banking system should have access to the bureaus. Additionally, information should be available, for banks confidential use, regarding SMEs overall indebtedness. This information should be updated frequently in order to prevent a sudden increase in debt over short periods of time.

Mobilizing scarce collateral is a serious problem in several Latin American countries because of the severe difficulties with property records. While these difficulties adversely affect all type of owners, SMEs are drastically hurt given their particular need for supplying collateral to access credit. *The Committee recommends that registry systems in the region be reformed to deliver a true guarantee of ownership as well as a speedier processing at lower costs*. This would reduce banks' transaction costs by allowing them to solely rely on the information recorded in the registry to validate that an SME demanding a loan or willing to put a piece of property as collateral is the valid and legal owner of the property.

In addition, the quality of collateral arrangements critically depends on the presence of an adequate enforcement of creditor rights, and the efficient functioning of national as well as sub-national judicial systems.

3.3. New financial intermediaries: subordinated loans

A mutual-fund-like institution whose assets are composed of a diversified portfolio of loans to SMEs and whose liabilities are shares owned by institutional investors, including pension funds as potentially important participants, can help to develop asset markets. Since such investors can provide long-term (and possibly less senior) loans, it makes the package of financing more complete, with banks taking the shorter-term maturities and these mutual funds investing long-term.

The Committee recommends implementation of the appropriate regulatory changes that would allow a wider participation of pension funds in the capital market, subject to adequate risk management.

3.4. Second tier banking

It is well known that past experiences with development banks and agencies in the region have not been generally satisfactory. This situation has brought the desirability of these institutions to be questioned. However, if properly designed and implemented, they can play a useful role in various ways.

Long-term bank financing is still scarce in the region. This is because of difficulties that commercial banks find in tapping long-term funds. Second tier banking (STB) could fill this gap but needs to be limited in scope, since the government, while contributing with supplying medium and long-term financing to banks participating in this program, should not absorb SMEs credit risk. The main features of this STB program would be:

a) in creating the institution, the government contributes capital, which is used to cover the institution's initial operational expenditures and to cover eventual losses;
b) during a transition period, STB financing could be funded by medium- term loans from the government. The STB should later apply for IFIs medium and long-term lending or issue medium-term debt guaranteed by IFIs;
c) STB funds should be auctioned among commercial banks, whenever possible. The latter, and not the STB, would lend to SMEs. Loans need to be assigned only to projects that fulfill predetermined selection guidelines. There should be no guidelines related to sectors, regions or type of projects;
d) the STB should be self-supporting. This means that its loan interest rates mentioned in c) would have to be, as a minimum, equal to its average cost of funds plus the user cost of capital, operational expenditures and expected losses;
e) commercial banks should assume the responsibility of servicing their debt with the STB, independently of whether banks debtors repay their credits or not. Commercial banks would be free to charge market-determined loans interest rate to the SMEs.

In addition to help providing long-term finance to SMEs, STB may play a role in organizing schemes that link large firms, SMEs and banks facilitating the development of factoring of invoices without recourse. Nacional Financiera of Mexico, for instance, is running a successful scheme of this type.

Also, by providing medium and long-term export credit in similar conditions as those available to their competitors in other countries, STB financing can contribute to leveling the playing field to Latin American exporters.

3.5. Mutual guarantee societies

One way to integrate SMEs into the banking system is through the creation of mutual guarantee societies, as they exist in Spain and Italy. These institutions provide guarantees to SMEs that these use in order to obtain bank loans. These institutions can be set up in a cooperative manner, with an initial support from the national or local government. They may facilitate the process of getting the SMEs into the financial system. If they are successful they can accompany the process of industrial development in other ways, as conditions change.

Based on the above-mentioned successful experiences, these societies have been already established in several countries in the region. So far, however, the results have been modest.

3.6. Technical assistance

Deficiencies in education and the acquisition of skills are a severe problem in Latin American countries, directly hurting the development of a dynamic entrepreneurial sector. While the permanent solution of this problem lies in the adequate provision of social services and the establishment of appropriate incentives in the educational system, the benefits from these efforts take a long time to materialize. Under these circumstances, a case could be made for the provision of government-financed technical assistance programs for SMEs related to the fact that accounting standards and financial documentation processes used by a large number of SMEs in the region are weak and limited in scope. More generally, there is a widespread lack of essential business skills in SMEs, such as the ability to perform strategic planning and financial analysis, and little capacity for organizational and operational management.

As part of the government role in education, a program could be designed to help SMEs prepare technically sound financial statements when applying for banks loans. Specifically, consultants could work with SMEs managers providing technical assistance in improving accounting procedures and standards, taking advantage from internet and software developments aimed at that purpose. In addition, the program would include teaching SMEs the know-how needed for the preparation of application forms to banks related to business plans, investment project evaluation, its cash flows assumptions, determinants and projections, sensitivity analysis, and stress tests under different scenarios.

In the context of this program: (a) the government would allocate resources to finance advisory services for improving accounting and financial management of SMEs, when applying for bank loans; (b) commercial banks would be in charge of operating the advisory program, given their the best position to know the informational and presentation requirements for SMEs to be considered creditworthy; (c) to avoid excessive use of government funds, guidelines would determine which SMEs would have access to the program; and (d) last but not least, government funds used for this purpose would need to be considered, at least partially, in the form of a loan rather than a gift to reduce the potential for moral hazard.

If properly managed and limited in size, the Committee believes that a technical assistance program has the potential of contributing to reduce costs in the provision of bank financing to SMEs, would have a limited fiscal cost, and may contribute to improving permanently the accounting and financial standards of SMEs. Furthermore, this program

could have an overall positive externality by improving the human capital of SMEs generally.

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