EU-CELAC Business Summit

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Concept Note for Workshop 3

Access to finance and financial instruments

The important role of Small and Medium-sized Enterprises (SMEs) in the economy and methods to improve their access to finance has been a key topic in global dialog on development in events like the Special Summit of the America's Declaration of Nuevo Leon, Mexico in 2004, and in the most recent G-20 Summits. The EU-CELAC Summits have also highlighted the importance of SMEs, most recently in the IV EU-Latin America and Caribbean Business Summit in Santiago, Chile, in 2013. Building on these elements, the following outlines some areas of discussion on the topic of SME access to finance for the V EU-CELAC Business Summit in 2015 in Brussels, Belgium.

1. Workshop Background: The Rationale

Productive SMEs are an important part of economies worldwide, and Latin America and the Caribbean is no exception. Nonetheless, in the region the predominance of high levels of informality, low levels of innovation and limited financial market depth act as brakes on the growth of SMEs and limit their contribution to increased productivity. Chief among these barriers is the financing gap for formal SMEs which has been estimated at US$210-250 billion a year (IFC 2013).

Research shows that well-functioning financial markets are linked to increased productivity. Firms' ability to invest and grow depends on both viable business opportunities and access to finance for starting and expanding business, trade and working capital. Notably, the Region has lower financial depth than East Asia and other developed market economies. Underdeveloped financial markets are less effective in channeling capital to those productive investments; entail higher costs of capital, and lower availability of credit.

SMEs also play an important role in domestic and international production chains, either directly through exporting or indirectly through supply chains. Firms that can compete internationally are more efficient and productive. Yet, SMEs face structural barriers that limit access to overseas markets owing to their size, skills gaps, need to upgrade products and processes, and limited access to finance. Overcoming these barriers requires a better institutional framework, a range of financial instruments, and increased opportunities for trade and investment.

The ability to scale up solutions for SMEs is challenging. Some financing practices that can improve the scale of SME financing options include credit lines provided by larger financial intermediaries that "downscale" to reach the SME market via trade finance, working capital, investment loans, and other financing instruments. Alternatively, larger corporate clients that can be used to "pull up" SMEs through their value chain with financing that encourages them to upgrade production lines and improve market opportunities for smaller firms. In this context, the European Union plays an important role as the region's largest source of new Foreign Direct Investment (FDI) and the second largest trade partner. Access to long-term financing is a crucial element to enhance EU business cooperation and investment in LAC and vice-versa, especially for SMEs.

Increasing access to finance for SMEs is not a trivial matter. Efforts to expand financing require not only the appropriate legal framework -- including those underpinning bankruptcy and property law, secured transactions, and credit information - but also a host of financial instruments that allow firms to allocate risk efficiently. Furthermore, there are complementary factors like technology, business services, and new approaches to reaching SMEs that can both boost the supply of credit and capital and, at the same time, increase demand for financing from the business sector.

This session will address solutions to fund SMEs in today's increasingly global economy. The aim is to focus on three topics that will contribute to unleashing the productive potential of SMEs in Latin America and the Caribbean.

2. Workshop Focus: The Agenda

How to integrate SMEs into the Global Economy: SMEs that operate in global markets are more productive owing to the gains from market size, their ability to innovate, and greater access to knowledge and technology. Yet, for the most part, smaller firms face important structural impediments to their participation in the global economy. Unlike larger firms, they often do not have the wherewithal to develop new businesses in foreign markets. Establishing an operational presence in a new country requires resources and investment that many firms cannot afford.

To reach global markets, smaller firms can participate in value chains of larger corporates. SMEs can benefit from linkages with larger *anchor* firms that already have access to global markets, while larger firms can benefit by developing local partners that provide tailored products and services. These anchor firms can provide training, knowledge transfer, and supplier finance. Global value chains help SMEs upgrade, innovate, and access new markets. By developing innovative financing schemes to support larger firms develop their value chains financial intermediaries can promote the development of productive SMEs. Trade and supplier financing will help SMEs to expand production into new markets, and requires banking and business partners that are willing to fund firms throughout the economic cycle.

Longer-term investment financing is also needed for capital expenditure and growth in both the EU and LAC regions. For that reason, the EIB and IDB have partnered to create a financing facility that will encourage inter-regional FDI by SMEs. The facility will support SMEs in Europe to reach markets in Latin America and the Caribbean and vice-versa. The arrangement offers an opportunity to deepen existing economic ties and improve the flow of technology and ideas between these regions. Similarly, financing large corporates can generate new business opportunities for SMEs when projects target creating new supply and distribution channels in local economies.

How to lever digital solutions for SME funding: In the digital age, electronic platforms are now an essential tool to expand financial flows across borders and within economies. New innovations are increasing access to finance, improving the exchange of information, building business-to-business connections, and providing learning tools for SMEs. For example, the advent of peer-to-peer lending in many countries offers borrowers new funding sources with more streamlined processes and lower interest rates than would be available through banks and other traditional lenders.[1] The use of data

[1] There are several P2P lending platforms in LAC which are enjoying rapid growth, including Cumplo in Chile that has channeled over US$40 million in financing to SMEs.

mining techniques to evaluate credit risk lowers the costs of monitoring supplier credits.[2] While new web-based credit evaluation tools lower the costs and risk to financial intermediaries that downscale to reach smaller firms by using psychometric credit evaluation techniques.[3]

To expand business networks, platforms like ConnectAmericas pair SMEs with distributors and sales opportunities to reduce the costs and uncertainty associated with international expansion.[4] These web-based platforms can also source capital for firms, through partnerships with local financial institutions, private equity firms, and other investors. InvestAmericas is such a tool that connects companies in the region that need funding with local and international investors. The site allows to investors to find promising companies that fit their investment criteria. It also allows firms to access capital that is not available from traditional sources. These new technologies offer the potential to scale up lending and services to reach a broader segment of firms in LAC and increase partnerships with firms abroad.

How to develop and deploy value-added business services for SMEs: In addition to new sources of financing, complementary measures are needed to enhance the creditworthiness of firms. These value-add business services address the gap between the firms' need for finance and its ability to formulate a creditworthy business plan and structure collateral. These business services include those that provide training, upgrade firm governance and transparency, offer product certifications meeting international standards, identify innovative firms with significant growth potential, and offer technical support to prospecting for and entering into new markets. These types of services are linked to credit demand - firms that have received a loan or recently applied for one are more likely to request these productivity-improving business services. From this perspective, it is important to design of value-added business services for SMEs that also improve their access to finance.

To have the greatest impact, these value-added business services should target markets where improved creditworthiness will raise the effective demand for credit and improve productivity. Three such markets segments are highlighted here:

- Women-led firms face higher interest rates and collateral requirements than other firms owing to cultural and legal barriers. Currently women-led firms account for less than one quarter of all small businesses in LAC and steps to increase this share will boost productivity growth in the region. New approaches include training credit officers to reach this underserved market and targeted financing lines that present a win-win opportunity for Banks and businesses.
- The transition to a low-carbon economy offers promising opportunities for smaller firms to innovate with new technologies, improve energy efficiency, and conserve other scarce natural resources. Investments for the "greening" of SMEs can have both positive effects on the environment and the bottom line. The use of energy audits and other diagnostic tools can identify new investments for firms that have relatively quick payback periods and improve operational efficiency. Such measures are particularly important in economies that are dependent on costly and volatile fuels that make SMEs less competitive.
- The most dynamic segment among SME's are "younger" firms. These firms have greater potential for growth and job creation than more established larger firms. To reach this segment requires different financing instruments, including venture capital and private equity – both of which are intensive in the provision of advisory services. However, in Latin America and the Caribbean, the equity ecosystem is missing factor – from start up through IPO. Efforts to bridge that gap include

[2] Programs like Trefi, being tested in Peru, provides discounts to suppliers who have receivables from SMEs and uses credit histories to measure a price risk.

[3] A pioneer in this area is Entrepreneurial Finance Lab a G-20 award winner that has tested this model globally and in Latin America with support from the Inter-American Development Bank and Multilateral Investment Fund.

[4] The IDB spearheaded the creation of ConnectAmerica, a social network for businesses in Latin America and the Caribbean. The site connects firms across the Region. It also connects them with financial institutions that provide financing for international expansions and trade. Currently, there are over 23,000 businesses participating in the community.

programs to identify SMEs with high growth potential which has been used in Korea and is now is being transferred to Latin America and the Caribbean by the Inter-American Investment Corporation.[5] These efforts provide advisory services to help SMEs with high-growth potential gain traction in the market. Reaching younger, more dynamic SMEs requires a 'bundle" of tailored financial and advisory services for this segment.

3. Workshop Results: The Expected Recommendations

Support for dynamic, formal enterprises is a key to improving growth and equity. Notably, SMEs, especially in their early stages, create more jobs and increase sales more rapidly than other firms. Financial instruments are a key to success, particularly when focused on increasing linkages with international markets, leveraging digital solutions for access to funding and its delivery, and when targeted to specific market segments. For these reasons, the participants support:

- Renewed efforts by global financial institutions to innovate in supporting SME access to international markets and global supply chains. Increased access to external markets will help boost productivity as firms expand production and compete globally. Particular attention should be given to the role of value chains and mechanisms to increase trade finance, supplier financing and long-term investment funds for SME investing abroad.
- Increased use of digital technology to deliver financial services through web-based platforms that can overcome barriers to access by firms. Businesses should actively participate in these new digital platforms for financing, partnering, market prospecting, learning, and knowledge sharing to expand their networks and increase their value to SMEs.
- Targeting financial instruments to reach specific segments of the SME market. Three areas were discussed where important productivity gains can be made by better targeting. First, expanding access to credit for women-led businesses which are a currently underserved market. Second, developing and deploying financial tools for the "greening" of SMEs through energy audits and financing for energy efficiency and renewable energy as a way to lower operating costs, with viable payback periods, and positive environmental impacts. Third, developing tools to support high-growth SMEs with equity capital and advisory services in order to stimulate job growth and productivity gains in the regions' economies.

4. Contacts

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[5] The IIC, with support of the Export-Import Bank of Korea, has launched a Hidden Champions program in Trinidad and Tobago.