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FS SERIES #4: ENABLING SMALL- AND MEDIUM-SIZED ENTERPRISE ACCESS TO FINANCE

MODEL SCOPE OF WORK

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MODEL SCOPE OF WORK

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ACRONYMS

A/R	accounts receivable
ACBA	Agricultural Cooperative Bank of Armenia
ADB	Asian Development Bank
AfdB	African Development Bank
ARCo	Rural Competitiveness Activity
ASME	Agribusiness SME Market Development Program
BDS	business development services
BEI	Business Environment Index
BG	bond guarantee
CAMEL	capital, assets, management, earnings, and liquidity
CMS	Credit Management System
COTR	contracting officer's technical representative
DCA	Development Credit Authority
EBRD	European Bank for Reconstruction and Development
EGAT	Bureau for Economic Growth, Agriculture and Trade
EU-TACIS	European Union's Technical Aid to the Commonwealth of Independent States
FSD	Financial Sector Deepening
IDB	Inter-American Development Bank
IFC	International Finance Corporation
IFI	international finance institution
IPO	initial public offering
KARF	Kenya Access to Rural Finance
KCB	Kenya Commercial Bank
KCBS	Kosovo Cluster and Business Support
KEMCAP	Kenya Microfinance Capacity Building Program
LLC	Lebanon Leasing Company
LPG	loan portfolio guarantees
MBRC	Macedonian Business Resource Center
MSME	micro-, small-, and medium-sized enterprise
MSOW	model scopes of work
NBFI	non-bank financial institution
NGO	nongovernmental organization
NPL	non-performing loan
POF	purchase-order finance
PPP	public-private partnership
SBEF	Superintendency of Banks and Financial Institutions
SEED	Support for East European Democracy
SME	small- and medium-sized enterprise
SOW	scope of work
TA	technical assistance
USG	United States government
VAT	value-added tax
WHR	warehouse receipt

INTRODUCTION

The United States Agency for International Development (USAID) Bureau for Economic Growth, Agriculture and Trade (EGAT) created the Financial Sector Knowledge Sharing Project (FS Share) to collaborate with USAID missions to develop effective and efficient financial-sector programs that increase access to financial services and develop well-functioning markets worldwide. USAID awarded Chemonics International, Inc. the FS Share delivery order under the Financial Sector Blanket Purchase Agreement. FS Share has a three-year period of performance, July 2008 through July 2011.

Through the FS Share Task Order, USAID EGAT and Chemonics proactively collaborate with missions to identify financial-sector priorities and develop strategies and programs for growing the financial sector. FS Share identifies financial-sector best practices and aggregates them through model scopes of work (MSOW), primers, diagnostic tools, best-practice case analyses, and other tools. These deliverables are disseminated to USAID missions for use in financial-sector programs. FS Share can assist with implementation and connect mission staff to external resources on best practices. In response to mission demand, FS Share delivers presentations and other knowledge-sharing endeavors.

Objective of Model Scope of Work

The objective of this model scope of work is to provide U.S. government (USG) program designers with sample language to integrate into effective programming. To complement this programming tool, FS Share has produced an accompanying primer and diagnostic checklist, included in *FS Series #4: Enabling Small- and Medium-Sized Enterprise Access to Finance*.

This FS Series was developed by FS Share consortium member Crimson Capital, with input from ShoreBank International Ltd. The Series was reviewed and edited by Chemonics International.

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ANNEX B. MODEL SCOPE OF WORK

This section provides a generic MSOW for undertaking a comprehensive analysis of SME finance markets in USAID-assisted countries. It complements and draws upon information in the primer and case studies and it can be used in conjunction with the SME Finance Diagnostic Checklist (Annex A) to ensure that all relevant points related to SME finance programming are covered.

The purpose of the MSOW is to offer a tool to USAID missions to help determine how best to proceed with the design of effective SME finance programs. It covers a generic supply- and demand-side analysis that addresses all dimensions of the existing SME finance market in a given country, identifies the impediments in the market, and prioritizes feasible market-development interventions that missions might undertake in collaboration with assisted-country partners. It also includes special consideration of the application of DCA credit enhancements to accelerate market expansion.

The MSOW has been prepared for flexible use, adaptable to the needs of individual design teams. Some missions may be further advanced than others in the analytical process, and may need to undertake only parts of the analysis. Design requirements may also vary by the geographic scope of the contemplated SME finance initiative (e.g., countrywide or different regions) and/or the targeted SME sectors (e.g., all-inclusive, urban vs. rural, selected industries, SMEs linked to specific value chains). In all cases, the MSOW will serve as a starting point for program designers, who will then construct the specific SOW needed for their particular requirements. Depending on the complexity of the effort, USAID missions may complete the analysis internally and/or via contracts with external consultants.

The MSOW has five sections, adaptable to the specific objectives of individual missions:

1. Purpose: analysis of the SME finance market in (country/region/sector)
2. Supply-side analysis
3. Demand-side analysis
4. Conclusions and recommended market interventions*
5. Next steps

*DCA guarantee possibilities are included in the recommended interventions.

In practice, we assume actual SOWs will include an executive summary, table of contents, and annexes, as determined by the authors. The MSOW does not include any of the other elements of a contract, such as staffing, timing, budget factors, or other contract boilerplate.

Distinctions between Supply and Demand

In the MSOW, the supply-side analysis is separate from the demand-side analysis and is covered first. In practice, SME markets function on the basis of mutually agreed

transactions between suppliers (sources of finance) and borrowers (demand). Prices, terms, and conditions of credit, equity, or other financing transactions are equally important for both supply and demand analysis, as are most of the elements of the legal and regulatory regime (which affect SME borrowers and financial institution providers). There can therefore be somewhat arbitrary distinctions, when analyzing SME finance markets, between topics that are addressed under the supply side or the demand side. As a basic principle, demand is primary; viable markets are demand-driven and supply responds to demand. On the other hand, creative suppliers can and do develop and market financial products that may not have been previously explicitly demanded, but which uncover latent demand and drive new markets.

It is usually more convenient to treat the supply side first, although it can be done either way. Keeping the two categories intact facilitates and helps generate a common understanding of how markets are working — or failing. Another reason for starting with supply is that statistical data on SME credit volumes, disaggregated by financial products, are more reliable than demand data. Demand calculations must rely on multiple assumptions (e.g., the percentage of targeted SMEs that are deemed “bankable” and the average size of credit likely to be demanded). Regardless, the SOW’s principal conclusions should be an accurate-as-possible estimate of viable “unmet demand.” The estimate should be given in absolute terms (i.e., U.S. dollar equivalent volume) and in percentage of viable credit subjects (per the categories addressed by the SOW) receiving vs. not receiving credit.

MODEL SCOPE OF WORK

1. PURPOSE

[Suggested text in quotations, with comments]

“The purpose of this scope of work (SOW) is to provide comprehensive information and recommendations for the development of the small- and medium-sized (SME) finance market in (insert country, region within country, targeted SME sectors, other considerations explicitly describing the focus of the SOW).”

“The SOW comprises a detailed supply and demand analysis of the existing SME finance market (per first paragraph), identifies the impediments in the market, and ends with conclusions and recommendations that prioritize feasible market development interventions that USAID/(insert country) might undertake. (Optional) It also includes special consideration of the application of Development Credit Authority (DCA) credit enhancements to accelerate SME market expansion.”

The Purpose section should be short. Additional short paragraphs could be added citing USAID mission strategy, programming, and other concerns that place the content of the SOW in broader contexts and highlight special expectations of the exercise.

2. SUPPLY-SIDE ANALYSIS

Overview

We suggest that the supply-side analysis section start with an “overview” statement explaining what comprises a supply-side analysis. A generic overview statement (from the Primer, Section A8) reads:

“A supply-side analysis looks at the supply of SME finance and the factors that influence it, including a review of the legal, regulatory, and institutional environment and the financial institutions and markets. It determines to what extent parties can obtain efficient and equitable treatment from the legal and regulatory system, including legislation covering bankruptcy, secured transactions, and creditor rights, and to what extent the legal system enforces these laws and rights.¹ It also determines the availability of reliable information needed to conduct business, including the availability and quality of collateral registries and credit registries. It considers relevant laws and regulations for the provision of financial services, including banking laws and relevant specific financial product laws (e.g., leasing law), and assesses the capability of financial supervisors (e.g., central banks and banking superintendencies). The supply analysis should specify the number, size, and geographic coverage of the financial institutions active in the market, their professional and institutional capacity, and their range of product offerings.”

A short overview statement drawing from this generic text should be tailored to refer to the specific overall content and objectives of the supply-side analysis in the SOW. It serves the purpose of summarizing the work to be done and can end with a sentence such as, “The detailed tasks to be undertaken are specified below.”

Detailed Tasks

The actual supply-side analysis tasks will include a mix of the generic tasks/activities presented in the following list. In the more comprehensive SOWs, it is possible that most or all of the subject matter covered in the list will need to be included. More narrowly focused scopes will have a shorter list. In all cases, the specific subject matter to be included, and the actual text of each of the detailed tasks, can draw from the generic information provided below. As required and known, sources of data to be consulted, relevant reference documents, and other information to be consulted should be indicated.

The generic tasks for the supply-side analysis are divided into four sub-sections:

- (A) The Financial System
- (B) Financial Intermediaries and SME Finance Products
- (C) Legal and Regulatory Environment
- (D) SME Finance Supply-Side Market Impediments

¹ In assessing the total environment for conducting business, the World Bank has constructed a Business Environment Index (BEI) in which countries are scored for property-right protection, contract enforcement, cost-of-entry regulations, and efficiency of the bankruptcy system.

(A) The (insert country) Financial System

- Task: Provide an overview of the financial system in (country). Factors to be considered and described should include most or all of the following:
 - (1) The degree to which the system is dominated by government-owned vs. private financial intermediaries
 - (2) Restrictions on foreign ownership of bank shares
 - (3) The degree to which there are government policy controls on interest rates and fees (e.g., usury laws) or allocation of finance (e.g., directed credits to defined economic sectors, financial repression) vs. no government restrictions
 - (4) The overall sophistication of the financial sector in terms of diversity of financing instruments (the three principal categories being traditional bank lending, asset-based finance, and equity capital)
 - (5) The overall level of competition in the system (e.g., number of intermediaries, profit margins, presence of foreign firms)
 - (6) The geographic reach of financial services (e.g., savings, credits, equity) (i.e., Are they concentrated in one or two cities or present in all regions?)
 - (7) The overall status of the financial regulatory system and the stability of the system in recent time (e.g., incidence of bank failures, systemic financial crises, capital flight)
 - (8) Whether Basel II is in place or planned to be in place
 - (9) Currencies used in financial transactions (e.g., strictly local currency, mix of currencies — dollarization, use of euro, etc.), currency stability (e.g., foreign exchange regime, inflation, devaluation frequency)
 - (10) The degree to which financial services are being delivered to different categories of enterprises by size (e.g., large enterprises, SMEs, and microenterprises)
 - (11) Previous/existing interventions in specific financial institutions by donors/technical assistance (TA) providers in the area of SME lending enhancement

In the actual SOW, this task should highlight the most relevant information needed by program designers to provide a concise overview of the financial system. Many of the elements of the system are fully detailed in the tasks that follow.

(B) Financial Intermediaries and SME Finance Products

- Task: Specify the number, size (deposits, other indicators), ownership, geographical coverage, and the financial intermediaries currently operating in (country), using the following categories:
 - Commercial Banks
 - Community Banks

- Savings and Loan Cooperatives
- Specialized Financial Institutions
- Equity Finance Institutions

This task provides a map of finance providers (universe of suppliers) in the country. Other categories can be added or titles of categories changed to best reflect country situations. Lists of the individual intermediaries should be placed in an annex, in tables showing size by deposits, total loan portfolio, total equity investment portfolio, or other key portfolio indicators.² Ownership (i.e., government or private, national or foreign) and geographic reach within the country should be recorded. “Specialized Financial Institutions” are intended to include finance companies, leasing companies, and other entities that are not authorized to take deposits. “Equity Finance Institutions” are intended to include venture capital companies and other private equity investment entities. *Note:* Many countries have specialized microfinance institutions that operate legally as commercial banks, with a separate legal status, or as NGOs. If needed, these institutions could be listed in an additional category.

- Task: Specifically for SMEs, specify and elaborate upon the SME finance products currently offered by the financial intermediaries, using the following categories:
 - Traditional Lending (e.g., short-term credit lines/overdrafts and medium-term loans)
 - Asset-Based Lending
 - Equity Capital
 - Guarantee Facilities

For each of these categories, this task will define and describe the products offered in the existing market. It will then provide information about which financial intermediaries are engaged in each type of SME finance, quantify the volume of SME lending or SME equity investment that is currently registered, and describe the typical terms and conditions of the SME finance being provided (e.g., interest rates, tenor, collateral requirements, gearing ratios). For traditional lending, the intermediaries will include commercial banks and cooperatives. For asset-based lending, defined as “alternative” finance (including accounts receivable [A/R] lending, warehouse receipts [WHR], factoring, purchase-order finance [POF], and leasing) the intermediaries will include commercial banks (directly or through subsidiaries), cooperatives, and specialized financial intermediaries. For equity capital and guarantee facilities, the intermediaries will be entities dedicated exclusively to those objectives.

In this task, it is particularly important to provide data on the quantity of SME finance being provided, in terms of dollar-equivalent volume and numbers of

² Consideration should also be given to undertaking a capital, assets, management, earnings, and liquidity (CAMEL) ratio analysis of the banks and financial institutions, taking care to compare only those institutions that are similar.

SME clients. Finance for SMEs needs to be carefully defined to exclude finance provided to large enterprises or microenterprises. The output on this part of the task (finance volume) will be compared with the estimate of total demand by SMEs for each type of SME finance (again by finance volume) to derive overall estimates of unmet demand for each type of SME finance product.

With regard to terms and conditions, this task will also identify the typical features of each type of currently transacted SME finance product, including as relevant: (1) interest rates (monthly, annualized); (2) overdraft financing vs. term loans; (3) tenor (length of credit agreement); (4) collateral requirements (real property, pledged assets, other guarantees); (5) special features of asset-based finance; or (6) specific conditions of equity capital finance. In the case of guarantee facilities, if these exist in the market, their specific terms should also be recorded (e.g., percentage of credit covered, fee rates).

This task should conclude with an assessment of the current profitability of the SME finance products. How interesting is this business for the intermediaries? Some intermediaries may be way ahead of others (market setters) and be highly successful (profitable). Others may be engaged only marginally in a given product market. How much competition is there, by finance product and geographic markets? Are there intermediaries who are expressing interest in entering markets? If so, why? This information will help determine recommendations for market development.

(C) Legal and Regulatory Environment

Two dimensions of the legal and regulatory environment affect the supply-side analysis: the financial sector and the commercial law regime.

- Task: For each of the following entries, describe and provide a summary assessment, as relevant, covering: (a) the quality of current laws/policies; identification of gaps in the legislative framework; (b) implementation of the laws/policies, identifying the institutions charged with implementation, their effectiveness, and gaps in essential institutional capacities; and (c) the enforcement of the laws/policies (i.e., the effectiveness of judicial/court systems in carrying out timely, transparent, and fair enforcement actions.³)

(1) Financial Sector Laws and Regulatory Institutions

- Banking Law
- Asset-Based Financial Product Laws
- Capital Market Laws
- Bank Regulation and Supervision

³ With regard to commercial courts, do such courts exist and how effectively do they operate? What is the average time frame from instituting legal proceedings against a defaulting borrower and obtaining judgment? Is the court system inherently or marginally corrupt?

- Capital Market Laws and Regulation Institutions
- Credit Bureau Law and Institutions
- Rating Agencies

(2) Commercial Law Regime⁴

- Company Law and Registries
- Property Law
- Contract Law and Enforcement (including Credit Recovery)
- Collateral (Secured Transactions) and Collateral Registries
- Bankruptcy Law
- Competition (Anti-Monopoly) Law
- Accounting and Auditing Services

In this task, the actual SOW would include only those entries relevant to the SME finance analysis being conducted. For each entry chosen, the scope should specify, as known, the existing laws/policies, implementing institutions, any specific concerns that need to be addressed, and other background information to be consulted by design teams.

(D) SME Finance Supply-Side Market Impediments

Based on the data and analysis prepared in (A), (B), and (C), above, the macro factors of the financial system, the volumes of SME finance currently in place and disaggregated by finance product, and the status of the key legal and regulatory laws and institutions will be identified. Interviews and information collected in the above tasks, and further surveys/interviews with banks and other intermediaries, will provide the basis for Task (D).

- Task: Identify and elaborate upon the key supply-side market impediments in the current (insert targeted SME market). Describe how the mitigation or removal of the impediments could solve obstacles to commercial bank lending, asset-based lending, and equity finance for SMEs and lead to potential significant expansion of the market. A non-exhaustive list of commonly cited impediments, drawn from the Primer, case studies, and other experience, is given below, but should be used, modified, or supplemented depending on the design team's analysis:
 - Limited prior involvement of intermediaries in SME finance (sector, urban-rural distinctions, if relevant); high costs of SME lending (real or perceived) vis-à-vis lending to large enterprises; consequent wariness to enter new markets
 - Lack of credible financial information, particularly for smaller SMEs; opaque information, no audited financial statements or obligations to make

⁴ The financial-sector laws/institutions are most specifically tied to the supply side. The commercial law regime is treated here, but it is equally important for both the supply and demand analysis because it directly affects decisions by lenders, investors, and clients (SMEs seeking debt and/or equity finance).

public disclosure; blurred line of demarcation between personal and business finances

- Lack of or unreliable credit bureaus (distinguish between government credit registries and private credit bureaus)
- High collateral requirements, resulting in underserved markets due to lack of sufficient real collateral among potential SME borrowers
- Lack of understanding of alternative asset-based lending products; need for new product development and testing; better understanding of value-chain financing, opportunities for POF, lending based on cash flows, A/R, factoring, etc.
- Need for strategies to mitigate risk in SME finance: soft collateral; payments tied to cash flows; direct payments to suppliers; gearing ratios (debt/equity); enhanced risk-assessment methodologies; special efforts to enlighten intermediaries on managing risk; expanding finance portfolios and profitability
- Weaknesses in the legal/regulatory environment: need for new or improved laws/policies; structural reforms of implementing institutions, such as collateral registries, bankruptcy/commercial courts and trustees, competition agencies, bank supervision, capital market institutions, etc.
- Weak or arbitrary enforcement mechanisms (e.g., lack of capacity in legal system to enforce claims against borrowers via effective credit-recovery laws; absence of alternative dispute resolution mechanisms or quick settlement procedures for small claims)
- For relatively newer asset-based lending, need for new or improved legislation/policies/implementation for leasing, WHRs, factoring, and other alternative financing mechanisms
- Lack of sufficient liquidity for SME finance, via deposits and/or other funds sourced by intermediaries; correct match between short-term/medium-term assets and liabilities; potential for tapping new depositors through linking savings accounts and new credit products
- Is the government distorting market liquidity through the issue of treasury bills and bonds?
- Insufficient physical bank infrastructure (geographic reach in targeted regions) and technological infrastructure (software, hardware applied to SME finance operations)
- Insufficient competition in the overall financial sector, lack of incentives to enter new markets/gain market share
- Problems arising from earlier policy mistakes, in particular, overuse of subsidized government credit programs that historically have led to market distortion, high default rates, and a culture of non-payment

For this task, it will be useful to indicate, if possible, the differing degree of importance of the impediments, and how their mitigation should be prioritized and sequenced.

3. DEMAND-SIDE ANALYSIS

Overview

We suggest that the demand-side analysis section start with an “overview” statement explaining what comprises a demand-side analysis. A generic overview statement (from the Primer, Section A8) reads:

“The demand-side analysis considers the demand for SME finance and the extent to which that demand is being met. It should indicate the number of SMEs in the targeted region or sector and the number of people employed. It should also address the size of enterprises, sectoral specialization, annual sales, and the degree of concentration. The relationships among SMEs inside the value chain and discernible patterns in trade credit among enterprises are important considerations, as is the level of financial sophistication among the entrepreneurs in the target sector and region. The demand-side analysis should express the exact nature of SME financing needs; it should consider whether the SMEs need working capital for items such as raw materials, packaging, and transportation, or whether investments in capital equipment would be useful.”

A short overview statement drawing from this generic text should be tailored to refer to the specific overall content and objectives of the supply-side analysis in the SOW. It serves the purpose of summarizing the work to be done and can end with a sentence such as, “The detailed tasks to be undertaken are specified below.”

Detailed Tasks

The actual demand-side analysis tasks will include a mix of the generic tasks/activities presented in the following sub-sections. In the more comprehensive SOW, it is possible that most or all of the subject matter will need to be included. More narrowly focused scopes will have a shorter requirement. In all cases, the specific subject matter to be included and the actual text of each of the detailed tasks can draw from the generic information provided. As required and known, sources of data to be consulted, relevant reference documents, and other information to be consulted should be indicated. Formal surveys can also be commissioned.⁵

The demand-side tasks are divided into four sub-sections:

- (A) Importance of SMEs in the Economy
 - (B) SME Finance Needs
 - (C) Legal and Regulatory Environment
 - (D) SME Finance Demand-Side Market Impediments
- (A) Importance of SMEs in the Economy

⁵ For example, a 2005 SME market study was commissioned in Ecuador and conducted by Habitus Investigacion, S.A., a local firm. The comprehensive study and survey reviewed data from the superintendency of companies and the small business chambers to estimate the size of the SME sector and demand for different SME finance products, with a focus on Quito and Guayaquil. The study was inspired by the potential to apply successful microfinance techniques to the lower end of SMEs.

- Task: Define as precisely as possible the number of SMEs in the economy, including definitions of SMEs, share of GDP output, share of total employees, disaggregation by industry sector, participation in exports, and other features such as linkages to larger enterprises through value chains, sub-contracting, franchising, out-grower arrangements, and other transactions. *Note*: The information collected and analyzed will be for the country as a whole, for regions within the country, and/or targeted industry sectors, depending on the specific SOW.

Definitions of SMEs must be clear, and they will vary by country contexts (i.e., the size and complexity of the overall economy) and macroeconomic data used by different countries. The design team will determine and explain the definition used, considering and drawing from the following parameters, as relevant:

- Dividing lines between SMEs and large enterprises, and between SMEs and microenterprises. Whatever the key criterion or criteria used for the definition, the higher end will mark the demarcation line with large enterprises, and the lower end will mark the demarcation line with microenterprises.⁶
- Key measures: The most frequently used criterion in defining SMEs is the number of employees (the numbers often used are a minimum of 10 and a maximum of 200). Another frequently cited measure is total sales revenue (turnover), using figures that relate to the size of the economy in question. Other approaches that are especially instructive in SME finance projects use average size of SME credits, a common starting point being no lower than \$20,000 and rising to a high-end amount of up to \$250,000.⁷ None of these criteria is fully satisfactory, but a definition must be chosen and adhered to, and ideally should be identical to or not deviate significantly⁸ from definitions used in central bank or other statistics within the country.

With regard to the share of SMEs in total GDP output, total exports, and total employment, these statistics should be available in government macroeconomic databases and/or World Bank/regional development bank databases. If not, best estimates need to be made and the methodology explained.

With regard to the other features, it is suggested that one or more of the following sets of disaggregated information be presented, again depending on the focus of the SOW.

⁶ In actual SME market-development activities performed by a USAID mission, these lines can and likely will be crossed at the edges, but the basic distinctions separating SMEs from large enterprises and microenterprises will remain. A survey of individual banks' definitions of SMEs should be conducted.

⁷ Using the credit-size measure, a further distinction often becomes apparent between small-scale SMEs and larger SMEs. Small-scale SMEs are not microenterprises but require relatively low amounts of credit (under \$50,000), which tend to be less available than higher average credit amounts for the larger SMEs.

⁸ See the work cited in the Primer by Gibson and Van de Vaart, *Defining SMEs: A Less Imperfect Way of Defining Small and Medium Enterprises in Developing Countries*, The Brookings Institution, 2008.

- Breakout of SME numbers/data by industry sector (i.e., standard sectors such as agriculture, manufacturing, construction, retail, tourism, and professional services) or further disaggregated within a standard sector (e.g., leather products within manufacturing, coffee or cacao production within agriculture)
- Value chain breakouts (e.g., SMEs acting as subcontractors, out-growers, franchises, or other suppliers providing similar goods to larger enterprises such as processors and exporters)
- Formal vs. informal SMEs — an important consideration, especially for SME finance projects where the objectives are to increase access to formal financial intermediaries

(B) SME Finance Needs

Three tasks are recommended in analyzing specific finance needs. The first considers needs by type of finance product and factors affecting demand. The second looks at ancillary business development (non-finance) services and how needs for business development services (BDS) interplay with demand for finance. The third task involves the quantification of potential demand, using assumptions on percentages of SMEs that can (or should) seek formal external finance and estimated average amounts of finance solicited per SME.

- Task: Debt and Equity Finance Needs by Product: Analyze and describe SMEs' needs for external finance, for each of three categories of SME finance products.
 - Traditional Short-Term Credit Lines/Overdrafts and Medium-Term Loans
 - Asset-Based Lending
 - Equity Capital

For this task, reference should be made to the figures provided in sub-section (B) of the supply-side analysis, which show the actual amounts of credit and/or equity finance currently transacted between SMEs and financial intermediaries. The levels of current SME finance should be interpreted in terms of SME needs vs. actual access to finance. With regard to traditional loans, which factors diminish credit requests and/or credit approvals? Examples that might be cited in the SOW, depending on country situations, include high real collateral requirements, high interest rates and other fees and commissions, concern by SME owners about the risks of indebtedness, loss of ownership control (equity investments), or costs associated with accepting formal sector finance (taxes, employee benefits, etc.). SMEs may also lack knowledge of finance products, particularly asset-based finance in the form of leases, A/R discounting, factoring, or finance tied to purchase orders. How can orientation to the advantages of the alternative finance products stimulate higher demand? With regard to equity capital, most SMEs start with their own savings or investments by family members and other individuals. In what circumstances are SMEs at the higher end of the scale likely to consider seeking external venture capital investments to finance business expansions?

This task should also report on evidence of other forms of credit currently being used by SMEs. Two examples are (1) trade credits among enterprises (e.g., supplier credit by providers of equipment purchased by SMEs, buyer credit [advances] for delivery of products against purchase orders) and (2) loans by informal money lenders. These sources of finance tend to be less reliable and may carry substantially higher costs than formal sector credit.

- **Task: Business Development Services (BDS):** Describe the availability and use by SMEs of ancillary BDS, and their interplay with demand for SME finance.

This topic is treated separately; there is a long history of linkages between financial and non-financial services for SMEs. What is the status of the BDS industry for SME clients? Are SMEs using and paying for BDS services (full-cost basis, subsidized basis via government or donor programs)? Do BDS providers help link SMEs to sources of formal SME finance (e.g., in connection with business plans developed with BDS assistance)? What other professional non-finance services are being accessed by SMEs, including lawyers and accountants?

This task should also cover SME business associations, as well as SME chapters within national or regional chambers of commerce and industry. These associations often play key roles in informing and educating SME members on the availability of finance products and how to take advantage of them.

- **Task: Quantification of Demand:** Provide an accurate-as-possible estimate of total potential demand by SMEs (nationwide or a targeted group of SMEs) for the three principal SME finance products (i.e., traditional bank loans, asset-based loans, and equity investments).

The methodology for these calculations should begin with the total number of SMEs being considered. Of this number, a judgment (assumption) will be made regarding the percentage of the SMEs that will, given mitigation or removal of the market impediments presented in sub-section (D) below, become “bankable” subjects of credit or equity investments. Experience suggests that no more than 60 percent of the SMEs will, or should, become credit subjects under favorable circumstances. Perhaps no more than 5 percent would be subjects for equity investments. Then, a second assumption will be made on the average amount of credit (by product, traditional loan, or asset-based product) or equity investment that the SMEs will need and seek. As indicated earlier, it is likely that average credit amounts will be at least \$20,000 per SME. It is more difficult to project likely average equity investment amounts. Multiplying the bankable SME investors by the average amounts will yield the total potential demand in dollar terms. It is prudent to consider high and low assumptions for the two principal variables, and to end with a range of lower and higher potential demand estimates. Actual potential demand is likely to be close to the middle of the two estimates, although it is best to err on the low side.

(C) Legal and Regulatory Environment

- Task: Analyze SMEs' perceptions of the legal and regulatory environment affecting their ability and decisions to seek finance.

SMEs, like suppliers of finance, need to have confidence in the financial sector and commercial law regimes that affect the SME finance markets. Both supply and demand participants in the markets need to rely on the quality of the laws, policies, implementing institutions, and judicial enforcement on all of the 14 legal and regulatory subjects listed in sub-section (C) of the supply-side analysis (not re-listed here but to be included in this task). Each side needs to be ensured and believe that the laws are understood, fair, effectively implemented, and impartially enforced. Without these assurances, the SME finance markets will be compromised and will not be expandable consonant with USAID mission objectives. In this task, the actual SOW should cite the subjects among the 14 listed that are relevant to the demand side of the market and the degree to which SMEs are well-protected or to which structural reforms of the laws, policies or institutions need to be undertaken.

(D) SME Finance Demand-Side Market Impediments

Based on the data and analysis prepared in (A), (B), and (C) above, the importance of SMEs in the economy, SME needs for finance disaggregated by product and other factors, and the status of the key legal and regulatory laws and institutions will be identified. Interviews and information collected in the above tasks, and further surveys/interviews with SMEs, will provide the basis for Task (D).

- Task: Identify and elaborate upon the key demand-side market impediments in the current (insert targeted SME market). Describe how the mitigation or removal of the impediments could solve obstacles to commercial bank lending, asset-based lending, and equity finance for SMEs, and lead to potential significant expansion of the market. A non-exhaustive list of commonly cited impediments, drawn from the Primer, case studies, and other experience, is given below but should be used, modified, or supplemented depending on the design team's analysis:
 - Disincentives among SMEs to seek formal finance and become formal sector companies required to pay taxes and employee benefits, incur other costs, and be subject to other regulations
 - Disincentives linked to illegal but profitable activities in the informal sector (e.g., coca production)
 - High collateral requirements that are beyond the reach of SMEs (e.g., urban real estate valued several times a loan amount)
 - Wariness, often justifiable, of taking on debt, including concerns on hidden fees, lawsuits, and protections of borrower rights. This is also

informed by awareness, in certain countries, of prior subsidized SME credit programs that led to non-payment behavior, which honest SMEs want to avoid.

- Perceived high cost of credit (interest rates plus fees and commissions)
- Lack of easy access to financial providers' bank branches and offices, especially in rural areas, and related transaction costs (e.g., travel time)
- Lack of flexible, agile short-term credit products that have reasonably low cost (interest rates), meet SME working capital requirements, and are understood and easily administered. Such products include both traditional credit lines and alternative asset-based lending products.
- Absence of complementary savings services from deposit-taking institutions, offering reasonable income on term deposits. Savings products are frequently as important as credit products in responding to demand by SME owners and their families.
- Underutilized advice on SME finance options that could be provided by SME business associations (e.g., orientation on the advantages of asset-based loans, facilitating contacts with financial intermediaries, and monitoring new financial services initiated with SME members)
- Regarding equity finance, need for orientation and knowledge among SMEs ready to seek equity partners on rules, regulations and protection mechanisms, distinctions between private equity and shares listed with stock exchanges, etc.

For this task, as for the supply-side analysis, it will be useful to indicate, if possible, the differing degree of importance of the impediments and how their mitigation should be prioritized and sequenced.

4. CONCLUSIONS AND RECOMMENDED MARKET INTERVENTIONS

Conclusions

The conclusions drawn from the analysis should include the following three parts:

- **Task:** Determine and state, as accurately as possible, the current market coverage of viable (bankable) demand. The measure should be in U.S.-dollar terms. The denominator in the equation is the viable *demand*, using the result of the quantification of demand task in Section 3. The numerator is total current *supply*, using the result of the tasks completed in Section 2. The resulting ratio is the percentage of market coverage.

The market coverage ratio will be estimated for the individual SME financial products under consideration, and can be aggregated for all SME finance. They will be countrywide or limited to selected geographic regions (or urban vs. rural zones), and be all-inclusive in terms of industry sectors or limited to selected sectors, depending on the USAID mission's needs. Finally, while these ratios are for SME credit (or equity) volumes in dollar terms, data on numbers of clients

receiving finance (supply) vs. total numbers of viable clients (demand) can be used to produce ratios based on clients.

The unmet demand will be analyzed to determine degrees of market saturation and market failure. Particularly in cases where a reasonable percentage (30 percent or more) of viable demand is already being met, the analysis will also inform program designers on where and how the SME markets are functioning well. In these cases, special care should be taken in designing market expansion initiatives to avoid disruptions or distortions of the existing markets.

- Task: Spell out the exact nature of SME financing need(s) that the USAID mission should address, and the results in terms of market expansion that might be accomplished via a concerted market-development initiative. The needs will include traditional debt finance (short-term credit lines and medium-term loans for working or fixed capital), alternative asset-based lending, and/or equity finance.

For this task, the mission may have predetermined certain SME finance products and markets that are to be addressed in the SOW. These needs should be directly addressed in the conclusions. Other needs that have emerged from the analysis but that may not have been previously identified should also be included.

- Task: Prioritize the SME financing needs in terms of impacts that can be anticipated through implementation of a concerted initiative, and indicate the most critical supply-side and demand-side market impediments that should be tackled (indicate sequencing of actions as relevant).

This task should answer the key questions centered on potential market expansion impacts. In general, the volume of finance, and the numbers of clients served, should increase significantly in absolute and percentage terms.

This task, by specifying the most critical impediments to be mitigated or removed, will also lead directly to decisions on the mix of interventions to be included in the contemplated market development initiative.

The conclusions presented should also present relevant interconnections between the impacts of the initiative and broader USAID strategic objectives in the country.

Recommended Market Interventions

- **Task:** From the conclusions, as well as the detailed supply-side and demand-side analyses, briefly outline the possible content for one or more USAID SME finance initiatives.

No suggested content for this sub-section is offered. The actual SOW, however, should provide the detailed instructions to designers on what the USAID mission requires in terms of detail and elaboration. Where it is planned to proceed almost immediately to the full-scale design of one or more projects, the information to be included may be much more substantial, including recommendations on inputs for a project (e.g., specific technical assistance, training, study tours) as well as outputs. At a minimum, however, the SOW should ask for a list of the highest-priority SME finance market interventions deemed to be feasible and achievable within a defined timeframe.

Development Credit Authority

- **Task:** Identify possible uses of DCA credit enhancements and guarantees as a means to remove market impediments and accelerate the expansion of new SME finance markets.

DCA facilities are very often an additional mechanism that USAID missions apply to SME finance market initiatives. They take multiple forms, including:

- Loan portfolio guarantees for financial intermediaries that provide SME finance using their own funds (liquidity) to extend credits to a large number of SME clients
- Loan guarantees for financial intermediaries that lack sufficient liquidity for SME finance operations and utilize the DCA guarantee to access finance from third-party lenders
- Bond issue guarantees for similar liquidity-need purposes, involving DCA guarantees of bonds issued in the local market
- Other DCA guarantee products

As a rule, DCA guarantees cover no more than 50 percent of the risk of default on SME credits extended by the financial intermediaries. They usually cover up to five years of activity, and require origination and utilization fee payments by the intermediaries. The fees are not onerous, and intermediaries approved for DCA guarantees use the guarantee cover in calculating their overall risk in entering new and relatively untested SME finance markets. The availability of a DCA guarantee can be a decisive factor for intermediaries in making final decisions to enter a new market and to do so at a pace and intensity consistent with USAID impact expectations. Finally, two of the principles governing DCA approval decisions (by DCA/Washington as well as USAID missions) are (1) *additionality*, meaning assurances that the SME finance activities supported by the guarantee

would not have gone forward without the DCA guarantee and (2) *utilization*, meaning an expectation that the amount of DCA guarantee cover provided will be as fully utilized as possible by the recipient intermediary.

5. NEXT STEPS

(Optional)

If included in an actual SOW, this section will briefly lay out the next steps involved in proceeding to full-scale design of a SME finance initiative. It will include activities to be undertaken, calendars, levels of effort, budgets, and other elements as required.

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