PART II

Chapter 8

Access to finance for SMEs (Dimension 6)

Facilitate SMEs' access to finance and develop a legal and business environment supportive to timely payments in commercial transactions (Small Business Act Principle 6)

Access to finance is one of the main challenges faced by enterprises of the EaP region. According to BEEPS 2009, it is perceived as either the first or the second most important obstacle to doing business. Bank lending, the main source of external funding for SMEs, has been significantly affected by the recent country-specific and international crises. Other external sources of finance such as leasing have yet to be developed.

This chapter focuses on government policies and instruments to facilitate development of and access to external sources of finance by SMEs, according to the Small Business Act for Europe. Dimension 6 contains two main sub-dimensions: sources of external finance for SMEs and the legal and regulatory framework that supports their development. Policies to support general financial literacy, which affects both the demand for credit by SMEs and the supply of finance by financial institutions, is considered in the third sub-dimension.

Introduction

External finance in the form of public support can play an important role in supporting SMEs, particularly start-ups. It can contribute to encouraging and enhancing bank lending to SMEs, especially if such support is efficient and effectively implemented through the private sector. Sustainable development of other sources of external finance for SMEs, such as debt, equity and other financial products (*e.g.* leasing and microfinance) from financial institutions requires the development and effective implementation of a legal and regulatory framework. Improvements in the legal and regulatory environment are important in reducing barriers and stimulating bank lending to SMEs. A functioning cadastre system as well as a central and unified registry for movable assets facilitates the use of land and other assets as collateral for financing SMEs, while the protection of creditors' rights ensures recovery of that collateral in case of default. Comprehensive and accessible credit information systems reduce the information asymmetry between SMEs and financial institutions.

This chapter focuses on government policies and instruments to facilitate development of and increase access to external sources of finance by SMEs, according to the European Union's Small Business Act (SBA). Governments can also contribute to increasing awareness and building the capacity of SMEs to access external finance by helping them understand the different sources of finance and helping them choose suitable modes of financing from the full range of options. They can also help SMEs make themselves more attractive as recipients of non-bank finance.

Assessment framework

The Access to Finance dimension contains two main sub-dimensions and one additional sub-dimension covering other factors that affect the supply and demand of access to finance (see Figure 8.1).

Policies to support general financial literacy which affect both the demand for credit by SMEs and the supply of finance by financial institutions are considered within the third sub-dimension of the access to finance dimension.

Analysis

Access to finance is one of the main challenges faced by enterprises in the Eastern Partner (EaP) countries – on average 18% of SMEs. According to the Business Environment and Enterprise Performance Survey (BEEPS) 2009 of the EBRD, access to finance is perceived on average as the second most important obstacle to doing business by firms in the region (first obstacle in Azerbaijan, Georgia and the Republic of Moldova, and either third or fourth in America, Belarus and Ukraine). The majority of firms across the region perceive access to finance as a moderate to severe obstacle to doing business (from 46% in Azerbaijan to 60% in Belarus and Ukraine). SMEs largely rely on internal sources, which have been negatively affected by the current global crisis and the economic slowdown in the region over the past few years, further restricting SME growth.

Figure 8.1. **Assessment framework for Dimension 6: Access to finance for SMEs**

6. Access to finance for SMEs

6.1. Sources of external finance for SMEs

- Credit guarantee schemes
- Public start-up funds
- Business angels network
- Microfinance facilities (including credit unions)
- Leasing
- Availability of risk capital (*e.g.* venture capital, private equity funds)
- Access to stock market

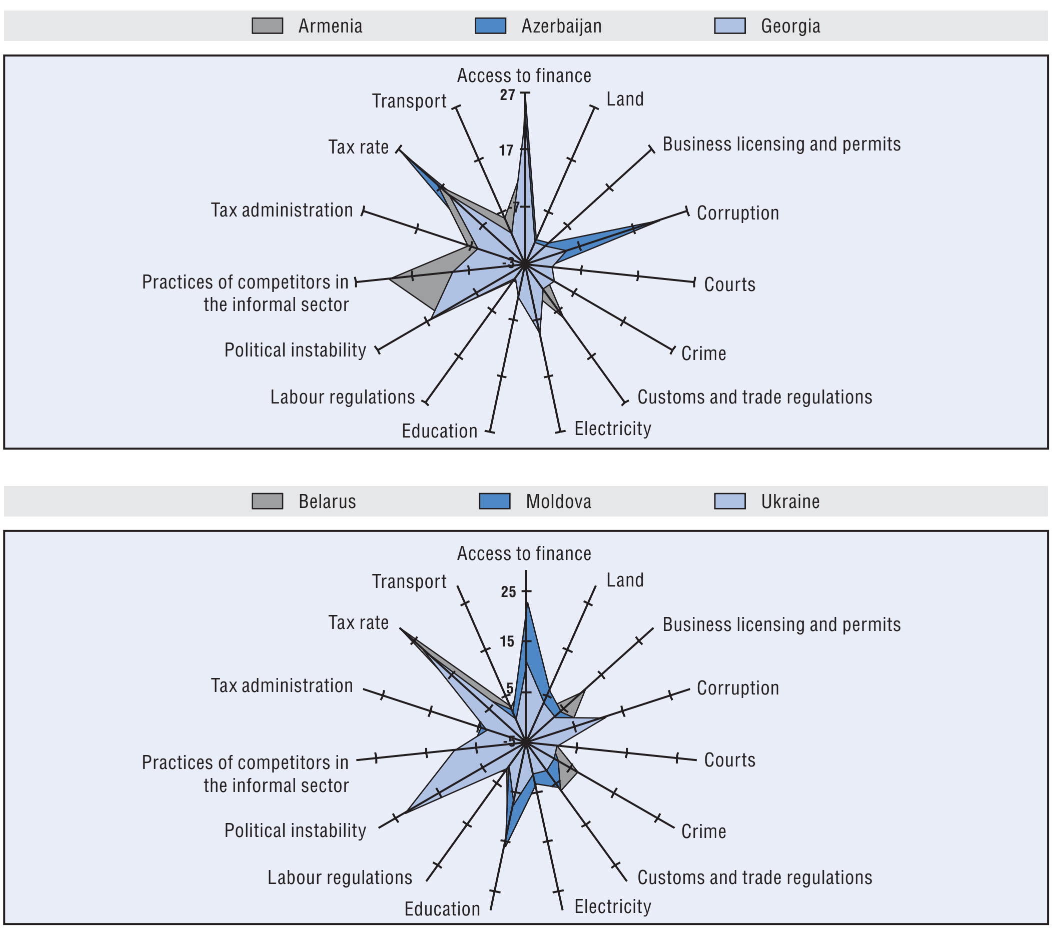
6.2. Legal and regulatory framework

- Cadastre
- Credit information services
- Registration systems for movable assets
- Collateral and provisioning requirements
- Creditor rights

6.3. Other factors that affect demand and supply of finance

- Financial literacy

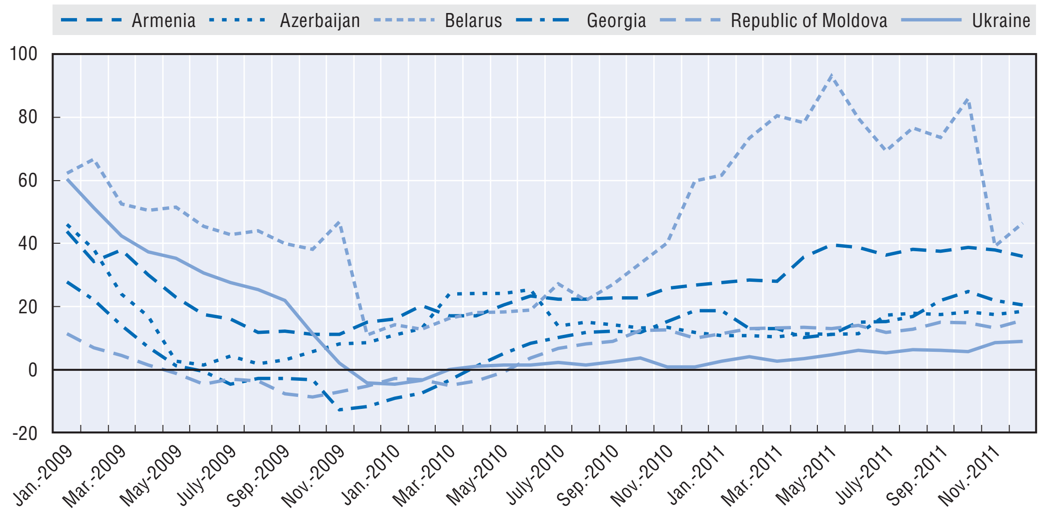
Figure 8.2. **Results of BEEPS 2009 for the EaP countries**



Source: Business Environment and Enterprise Performance Survey (BEEPS), 2009.

According to the BEEPS survey, bank lending accounts for the majority of external financing for firms, accounting for 60 to 90% of external funding (with the remainder coming mainly from supplier credit). This is particularly the case in Belarus and the Republic of Moldova.

Figure 8.3. **Domestic credit growth in the region (in %, 2008-11)**



Note: Belarus' figures include all lending to non-financial sector not only private sector.
Source: IMF-IFS statistics.

However, bank lending remains generally low across the region with domestic credit to the private sector between 18% of GDP in Azerbaijan and 56% in Ukraine in 2011, compared to over 140% of GDP in the EU area. Bank lending has been significantly affected by the global economic crisis. SMEs are especially vulnerable because the risk associated with lending to this sector is deemed by banks to be greater (*e.g.* in terms of insolvency). There was a significant slowdown in credit growth across the region at the beginning of 2009, with the largest drop in Armenia, Georgia and the Republic of Moldova. There was a small recovery in 2010 and 2011 in all countries except Belarus where credit growth decelerated (and declined in real terms) due to the balance of payments crisis. Government support to banks in Armenia counterbalanced somewhat the effect on bank liquidity and lending in 2010-11. Overall, non-performing loans have increased between 2008 and 2009. In some countries such as Azerbaijan and Ukraine this trend has continued into 2011.

Table 8.1. **Banking sector indicators**

	Domestic credit to GDP		NPLs as % of total loans		Asset share of foreign owned banks	Asset share of state owned banks
	2008	2011	2008	2011	2010[1]	2010[1]
Armenia	17.8	32.6	4.4	4.8	67.5	0.0
Azerbaijan	16.5	19.5	2.2	6.4	9.1	41.6
Belarus	28.6	41.7	2	4.5	20.6	77.9
Georgia	33.2	32.8	12.8	8.6	89.3	0.0
Republic of Moldova	36.5	33.6	5.2	9.7	41.5	12.5
Ukraine	73.7	56.0	4.2	16.4	47.8	16.9

1. End of 2008 for Belarus.
Source: WEO, National sources and EBRD banking survey.

Sources of external finance

While bank lending is the main source of external finance for SMEs in the region, it remains insufficient and has been reduced even more due to the crisis. Other sources of finance for SMEs such as leasing have also been affected by the crisis. This is due both to a shortage of funding sources (that often come from banks) and a deterioration in portfolio quality. Government policies and effective public financial support are important to bridge the increased financing gap for SMEs during a crisis. They must encourage bank lending to SMEs amid an increased aversion to risk. Further improvements in the business environment are important for attracting future investors and developing other sources of finance such as private equity finance.

Public support can be used to address market failures and stimulate private sector lending through credit guarantee schemes and start-up support schemes. Such schemes provide soft loans for SMEs requiring less or no collateral. Well-implemented credit guarantee schemes through the private sector can facilitate access to credit by SMEs and can contribute to the integration of small and medium-sized businesses into the financial market. The private sector should play an important role in the implementation of such facilities to ensure that resources are allocated efficiently. However, public financial support in the EaP region has been affected by fiscal constraints. At present, public support by means of credit guarantee schemes is provided through banks in Armenia. In the Republic of Moldova it is provided through the Small and Medium Entrepreneurship Development Centre Fund and the Organisation for SME Sector Development. In Ukraine, credit guarantee schemes are largely under state control and are provided through the state-owned Ukreximbank. In Azerbaijan, the National Fund for Entrepreneurship Support has been providing interest-rate subsidised loans to SMEs through the banking sector since 2004. Credit guarantee schemes are currently under consideration in Belarus and Georgia.

Because banks are reluctant to lend in the absence of a credit history, public start-up funding facilities are essential for the initial development of a business. These publicly-funded schemes are designed to encourage new and growing businesses and may target specific groups of individual entrepreneurs (such as women or young entrepreneurs). Ideally, such funding programmes are self-sustainable and operate throughout the country, providing a wide range of start- up funding products. Start-up funding remains scarce in the EaP region, although some pilot projects have been implemented in the Republic of Moldova (such as the Youth Empowerment Programme) and Armenia. The National Fund for Entrepreneurship Support in Azerbaijan provides special funds to start-ups, mainly targeting women and young entrepreneurs.

Business angels are individuals who invest in start-ups and growing companies in return for an equity stake in the company. Investments by business angels work as a tool used to fill the gap between venture capital and debt finance, especially for start-ups. Government awareness should be raised to promote and/or attract investors in order to develop a competitive business angel network. There is little or no business angel activity in the region, although there has recently been increased government awareness of this activity in Belarus and Georgia. Since November 2010, a Business Angels and Venture Investors Network (BAVIN) is being developed in Belarus. The Georgian government has also completed a pilot project to investigate the functioning of a business angels' environment.

Providers of microfinance for microenterprises often operate within the structure of not-for-profit organisations such as non-governmental organisations (NGOs), credit unions and other financial co-operatives. They provide different kinds of services including credit, savings, insurance, money transfers and other financial products. Governments can assist the microfinance sector, notably by liberalising banking services in order to facilitate deposit-taking and the long-term sustainability of microfinance institutions (MFIs). They can also regulate the sector, especially in terms of appropriate skills and excessive risk taking. An MFI network is well developed in both Armenia and Georgia and an appropriate institutional structure is in place. According to the Microfinance Information Exchange (MIX), microlending (including by banks) was 6% and 4% of GDP in Armenia and Georgia respectively. However, MFIs in the country lack the necessary capital to meet the demand for microlending. A regulatory framework is in place, except in Belarus where it is still in draft form, and microfinance is available in the other countries of the region, mainly from the state or donor organisations which offer only a limited range of products.

Leasing is an attractive financing tool for SMEs, particularly as a complement to bank loans since it offers uncollateralised lending which is well suited to the needs of SMEs. A fully functioning legal framework and adequate regulation and supervision are both necessary to ensure the proper skills for the development and sustainability of leasing activities. Legislation related to leasing is implemented in almost every country of the region, although a special law on leasing is not in place in Belarus and currently under consideration in Armenia. Leasing activities remain very low and the range of products offered is limited to auto-leasing. Leasing activity in Belarus and Ukraine is the highest among the countries of the region although it represents only 3% of GDP. Leasing of equipment and machinery also remains very low.

Risk capital is an important long-term source of finance for SMEs, both for setting up new businesses and for expanding growing firms. An important and necessary condition for the development of equity capital – in addition to a good general business environment – is the creation of related legislation. It should be in line with best practices of corporate governance and should provide for different exit possibilities. Legislation related to risk capital is undeveloped in Belarus and the Republic of Moldova. In Armenia and Azerbaijan, laws relating to investment funds have recently been adopted. Overall, the use of risk capital is in the early stages of development in the region. Private equity activity is low even in Ukraine, a country that has the most advanced private equity activity in the region, but where the committed equity capital was only 0.5% of GDP in 2010. Venture capital is practically non-existent.

The stock market can also be used as a source of long-term finance for SMEs. A legal framework allowing for the listing of low-capitalised companies could be beneficial to SMEs. Such a framework gives them access to funds outside traditional financing and encourages improvements in the SMEs' profiles and credibility, as well as improving the transparency and corporate governance of the listed entities. Nevertheless, SMEs may have difficulties in participating in listings on stock exchanges, as listings usually entail high costs and a high level of red tape which includes a number of accounting and auditing procedures. The cost of overcoming information asymmetries for SMEs also makes it hard for investors to invest in these small firms. This is particularly notable in EaP countries where the average size of SMEs is small and the SMEs lack financial transparency. However, while stock markets are generally operating in the region, the scope of their activities, outside government securities, is very limited. Market capitalisation ranges between 1.5% of GDP in Armenia and 29% of GDP in Ukraine and markets are not liquid across the region. A generally low level of conformity with corporate governance standards and the lack of a domestic institutional investor base both affect the development of capital markets.

Table 8.2. **Scores for sub-Dimension 6.1: Sources of external finance for SMEs**

		Armenia	Azerbaijan	Belarus	Georgia	Republic of Moldova	Ukraine
6.1.1.	Credit guarantee schemes	3	2.5	2	2	3	3
6.1.2.	Public start-up funding	2.5	2.5	2	2	3	1
6.1.3.	Business angels network	1	1	2.5	2.5	1	1
6.1.4.	Microfinance facilities (including credit unions)	3	4	2.5	4	3	3
6.1.5.	Leasing	2.5	3	3.5	3	3	3.5
6.1.6.	Availability of risk capital (*e.g.* venture capital, private equity funds)	2	2.5	2	3	2	3
6.1.7.	Access to stock market	2	2	2	2	2	3
Weighted average		***2.29***	***2.50***	***2.36***	***2.64***	***2.43***	***2.50***

Source: Small Business Act assessment conducted in Eastern Partner countries (2012); see Scores and Methodology for further information.

Legal and regulatory framework

Public policies for improving the legal and regulatory environment can help stimulate bank lending in general and to SMEs in particular. Developing adequate information systems such as business registration systems, credit bureaus, accounting standards and collateral registries would help to bridge the gap related to the lack of credit information on SMEs. Moreover, the legal environment clearly affects the ability of banks to recover collateral. In this respect, rules which ensure the enforcement of creditor and property rights and adequate bankruptcy laws are the cornerstones of a legal system that facilitate lending to SMEs.

Cadastre is an official register of the quantity, value and ownership of land and real estate. A fully functioning cadastre, easy to access and fully documenting the ownership of land and property is important for the use of land as collateral for SMEs. Overall cadastre systems are in place across the region and the efficiency of their operations has improved in the recent years. Georgia has a fully functioning cadastre launched by the Georgian National Agency of Public Registry (NAPR) and available online since 2007. Online registration services exist in Belarus and the Republic of Moldova. Nevertheless, land ownership has not yet been fully documented in Belarus and Ukraine.

Credit information systems contain data on the credit status of borrowers who are active in a financial system. They help to overcome information asymmetries and to facilitate the pledging of property as collateral by owners of SMEs. Such registers should cover all available credit information. The information should be complete and reliable, as well as widely and easily accessible. Public credit bureaus are usually managed by the central bank, mainly for supervisory purposes, while private credit bureaus are often established by financial institutions. Armenia and Georgia both have a private credit bureau in place, with wide coverage and accessibility. In Azerbaijan and Ukraine credit information services are in place but with access limited to financial institutions only. In Belarus, they are subject to a fee for non-state entities. The private credit bureau was only recently established in the Republic of Moldova.

A central and unified registry for moveable assets also facilitates the use of assets other than real estate as collateral for SME lending, and serves to control the use of the same collateral for multiple loan applications. A registration system for moveable assets is in place and fully functioning in Georgia and the Republic of Moldova. In Georgia it is also available online. Information is hardly accessible in other countries, or is limited to vehicle registration only (*e.g.* Belarus).

Excessively strict rules on the level of collateral and provisioning requirements may constrain bank lending to SMEs. Bank lending remains largely collateral-based and collateral requirements are generally high. Some commercial banks provide more flexible collateral requirements or use guarantees for smaller loans.

Creditor rights refer to the legal provisions in place which preserve the creditors' ability to enforce claims against their debtors. Appropriate legal provisions would establish procedures to settle creditors' claims and would govern the enforcement of rights held by different classes of creditors. A legal environment which protects creditors' rights by providing adequate enforcement mechanisms is likely to be beneficial for bank lending to SMEs, as such rules would facilitate debt collection by creditors. An appropriate legal framework with enforcement of creditors' rights remains a challenge across the region. The legal frameworks on secured transactions in most countries do not fully ensure the necessary rights for secured creditors and their implementation does not guarantee effective collateral recovery in case of default.

Table 8.3. **Scores for sub-Dimension 6.2: Legal and regulatory framework**

		Armenia	Azerbaijan	Belarus	Georgia	Republic of Moldova	Ukraine
6.2.1.	Cadastre	4	3.5	3.5	4.5	4	3
6.2.2.	Credit information services	5	3.5	2	4.5	2	3
6.2.3.	Registration systems for moveable assets	3	2.5	3	5	4	3.5
6.2.4.	Collateral and provisioning requirements	3	2	2.5	3	2	2
6.2.5.	Creditor rights	2	3	2	3	2	1.5
Weighted average		***3.40***	***2.90***	***2.60***	***4.00***	***2.80***	***2.60***

Source: Small Business Act assessment conducted in Eastern Partner countries (2012); see Scores and Methodology for further information.

Financial literacy

Improving general financial literacy is important for both the demand and supply sides of finance to SMEs. The government could help by developing a national strategy that integrates a methodology for evaluating the level of financial literacy and promotes educational programmes. Financial literacy levels are low across the region, as indicated by the generally low level of bank accounts held by the population, and little has been done to develop a national strategy to assess these levels or to promote financial education programmes.

Table 8.4. **Scores for sub-Dimension 6.3: Other factors that affect demand and supply of finance**

		Armenia	Azerbaijan	Belarus	Georgia	Republic of Moldova	Ukraine
6.3.1.	Financial literacy	2	2	2	2.5	2	3

Source: Small Business Act assessment conducted in Eastern Partner countries (2012); see Scores and Methodology for further information.

Box 8.1. **Legal and regulatory framework in Georgia**

Georgia has significantly improved the legal and regulatory framework that facilitates access to finance for SMEs.

The National Agency of the Public Registry is in charge of the registration of moveable assets in Georgia. Since its creation in 2004, the public registry has undergone successive reforms and has been supplemented with additional functions including online registration of moveable assets in 2009 as well as geodesy and cartography functions in 2011. The online registration system allows for any moveable asset to be used as collateral and thus facilitates access to bank loans by small businesses.

The online pledge registry is particularly beneficial for SME lending given the growing demand for credit by small and medium-sized enterprises. The online pledge registry is centralised and fully operational throughout Georgia.

The following aspects and services are or will be available in the National Agency of the Public Registry:

- Any business may use moveable assets as collateral while retaining possession of the assets.
- Any financial institution may accept moveable assets as collateral.
- The law allows businesses to grant a non-possessory security interest in a single category of revolving moveable assets without requiring a specific description of the secured assets.
- A general description of debts and obligations is permitted in collateral agreements, which allows for all types of obligations and debts to be secured by stating a maximum secured amount in the security agreement rather than a specific amount for each obligation.

Credit information services are provided by **CreditInfo Georgia**. Data relating to credit history are stored on the system for more than two years and are available online. This credit bureau has been active since 2005 when Georgia joined Credit Info, the international provider for credit information. Data on outstanding and repaid loans are provided by the credit bureau. The data are available 24 hours a day, seven days a week. Users can consult credit history through "My creditinfo service". Fees for using the service vary from GEL 15 to 50. Furthermore, a monitoring function automatically alerts users in the event of a change in critical credit information.

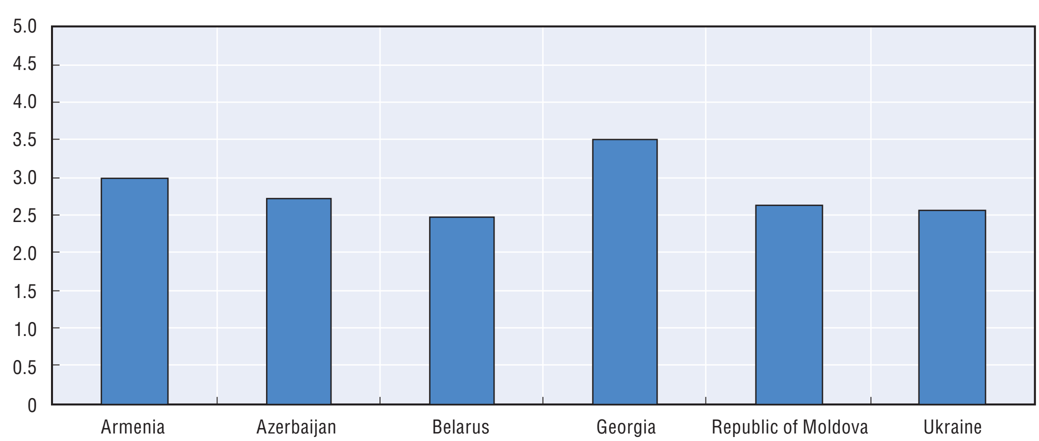
The way forward

Despite improvements, particularly prior to the global economic crisis, access to finance for SMEs remains an important challenge for EaP countries. Bank lending, which is the main source of external funding for SMEs, has been significantly affected by the recent country-specific and international crises. Although there has been some recovery in credit growth in the region since 2010, banks remain cautious about taking risks. The effect of the crisis on the performance of firms and the increase in non-performing loans, in addition to a decline in funding sources and greater uncertainty, have made banks more averse to risk. Slower growth in the region and uncertainties in the Eurozone continue to inhibit credit demand. Although the region is not well integrated financially, a potential disorderly deleveraging of Eurozone parent banks could affect capital inflows, possibly generating a credit crunch in Ukraine where banks rely on parent-bank funding.

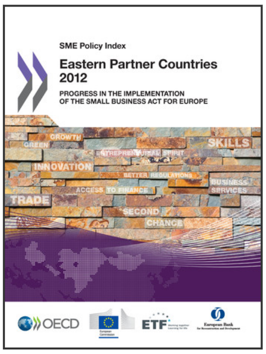
Other external sources of finance such as leasing are yet to be developed as an alternative source of finance for SMEs and are also affected by the crisis. Private capital is scarce and equity markets are rather small and illiquid. Public support for SMEs is relatively small and limited by fiscal constraints in most countries (apart from Azerbaijan). Progress in the development of a legal and regulatory framework is heterogonous across countries. While cadastre and credit information systems are developed in Armenia and Georgia, and a unified collateral registry is in place in Georgia and the Republic of Moldova, the enforcement of creditors' rights is generally weak across the region. Financial literacy remains low but recently the government is increasingly aware of this issue.

Enhancing competition and a greater level of sophistication in the banking sector would also benefit SMEs in obtaining access to finance. The funding model for many banks in the region remains a challenge, with a need to develop more local currency sources of funding and longer-term funding. There is increased policy attention to de-dollarisation, and efforts have started to build/strengthen local capital markets. General improvement of the business environment and corporate governance standards is necessary to increase investment opportunities and attract more private equity capital into the region. Building of a domestic institutional investor base (*e.g.* through insurance and pension reform) and related exit opportunities would also help develop equity capital. Reducing the number of administrative procedures and regulations would increase the effectiveness of state financial support. An effective and easily accessible central collateral registry in Armenia, Azerbaijan and Belarus is important for enhancing access to finance for SMEs. The establishment of a private credit bureau in Azerbaijan and Belarus would benefit SMEs by improving information coverage and overcoming information asymmetries. The legal environment which protects creditors' rights by providing adequate enforcement mechanisms for the retrieval of collateral should be strengthened across the region. Increasing knowledge and general awareness of financial issues would also be beneficial to SMEs. For example, it could encourage them to apply for a loan.

Figure 8.4. **Weighted scores for Dimension 6: Access to finance for SMEs**



Source: Small Business Act assessment conducted in Eastern Partner countries (2012); see Scores and Methodology for further information.



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