

# Closing the Credit Gap for Formal and Informal Micro, Small, and Medium Enterprises



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# ABBREVIATIONS

IFC	International Finance Corporation
ILO	International Labor Organization
IMF	International Monetary Fund
G-20	Group of Twenty
GPFI	Global Partnership for Financial Inclusion
MSME	Micro, Small, and Medium Enterprise
OECD	Organization for Economic Cooperation and Development
PCG	Partial Credit Guarantee
SME	Small and Medium Enterprise
WBES	World Bank Enterprise Surveys





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# OVERVIEW

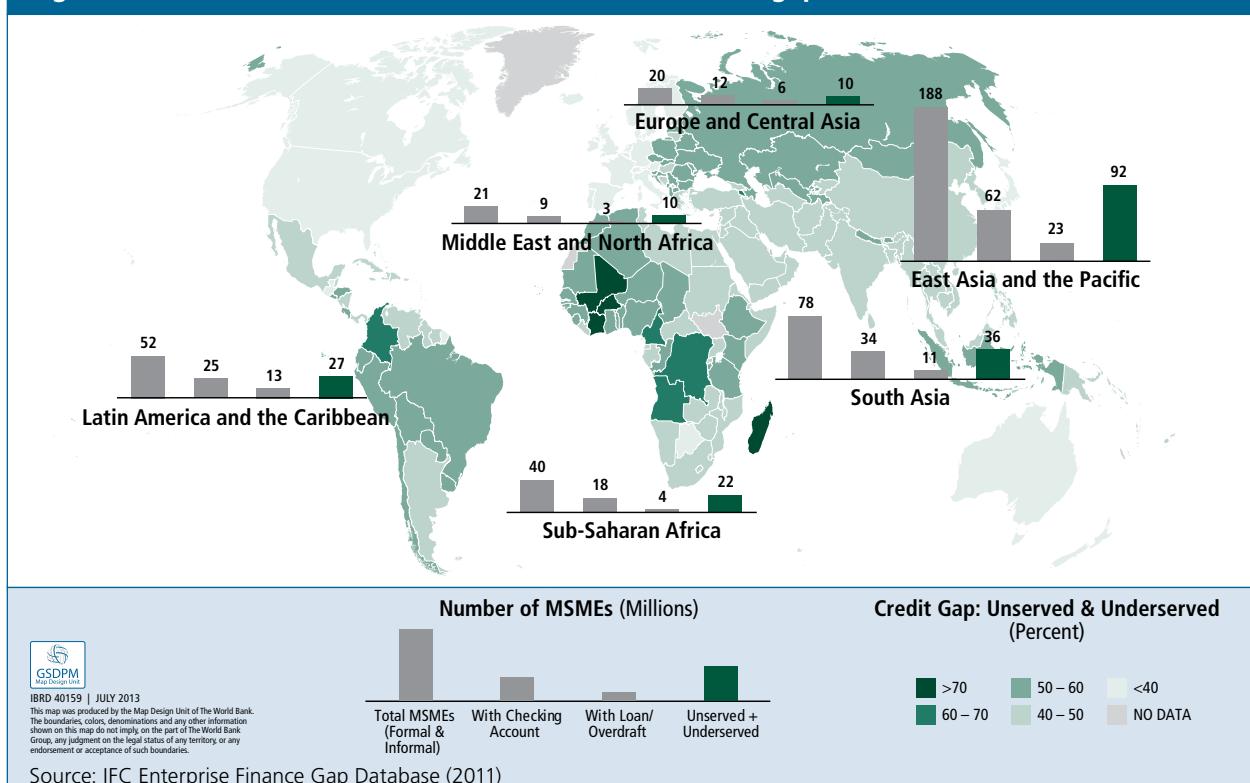
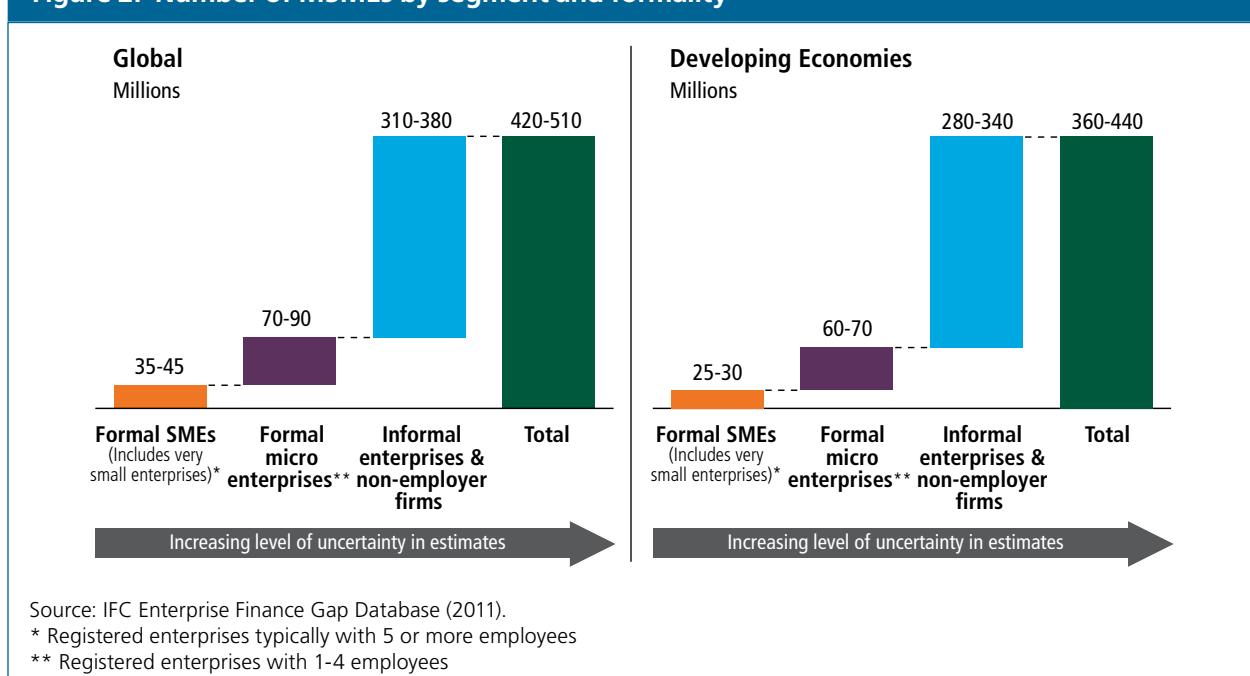
Job creation and economic growth through private sector development have become primary areas of focus for policy makers around the world in the aftermath of the global financial crisis. Recent evidence points to the importance of small and medium enterprises (SMEs)<sup>1</sup> in providing employment across countries. In addition to employing the largest number of people in aggregate, SMEs generate the most new jobs (Ayyagari *et al.*, 2011). But SMEs also face many challenges in day-to-day operations and to grow. Access to finance is often cited as one of the primary obstacles that affect SMEs disproportionately (Ayyagari *et al.*, 2012), and lack of data has made it very difficult to determine the exact size of the financing gap. Using data from the World Bank Enterprise Surveys (WBES) in 2010, IFC estimated the size of the global micro, small, and medium enterprise (MSME) financing and deposit gap, and the regional variations (Stein *et al.*, 2010). As more and better quality data became available, especially on the informal sector, IFC updated the database.<sup>2</sup> In this note, we report back on the state of the credit gap for MSMEs with this new and updated data, while providing additional focus on the sizable informal enterprise sector in the developing world.

MSMEs in developing countries face an estimated financing gap of \$2.1 to \$2.6 trillion, which is equivalent to 30 to 36 percent of current outstanding MSME credit (Figure 1). There are 200 to 245 million formal and informal enterprises that do not have a loan or overdraft, but are in need of one—also referred to as the unserved sector—or do have a loan but still find access to finance as a constraint—also referred to as the underserved sector. More than 90 percent of the unserved and underserved enterprises are formal micro enterprises or informal MSMEs. With this challenge, an opportunity arises for both policy makers and the private sector to intervene at various levels to try to encourage better banking services, higher deposit rates, and greater accessibility of capital for MSMEs.

Financing constraints are also magnified for informal firms, which tend to be small in size, and although often less productive than formal enterprises, contribute significantly to economic activity and employment. Informal firms are estimated to account for around 74 percent of all MSMEs in the world, and around 77 percent of all MSMEs in developing countries (Figure 2). Unregistered firms rely mostly on informal financing, which—although important in facilitating access to finance—is associated with lower firm growth and increased firm illegality (Ayyagari *et al.*, 2010a; Ayyagari *et al.*, 2010b).

Although a sizable amount of the unmet demand for credit lies in the informal sector, many firms remain informal as they lack the incentives or capacity to formalize. Creating the appropriate environment for firms to formalize may take a long time, as it not only requires building an enabling environment—with solid institutions, laws and regulations, infrastructure, and education—but there is also a need to identify business-oriented incentives for firms, such as access to new market opportunities and access to financial and non-financial services, making it a profitable decision for firms to register their business.



**Figure 1. Formal and informal MSMEs sector—Total credit gap****Figure 2. Number of MSMEs by segment and formality**

Various initiatives to expand SME financing including building or improving financial infrastructure, partial guarantee schemes, commercial banking models and other private sector initiatives have been developed to directly target SMEs. At the global level, the Global Partnership for Financial Inclusion (GPFI) and IFC as an implementing partner of the GPFI have undertaken various studies to improve access to finance by the SME sector, including enhancing data availability and quality. This line of work identified innovative models for SME finance, established the SME Finance Forum to facilitate the debate on prevalent policy topics and showcase knowledge about SME finance, and channelled extra capital to the sector through the newly established Global SME Finance Initiative.

In addition, this report examines various operational challenges that small and informal firms face, and some formalization obstacles they often cite as the primary reasons for not registering their business. A framework to differentiate the informal sector is offered, with the intention of segmenting the vast landscape of informal firms—some of which exist today due to opportunistic behavior, while others are just trying to survive—and to better design specific interventions depending on the stage of development and the willingness of the firm to register its business. Additional research and tests are necessary to validate this framework. In this regard, new impact evaluations are designed and implemented to understand firm dynamics and identify levers that could incentivize firms to register their businesses.

Using access to formal financial services as an incentive to formalize, though desirable, may be a big challenge. This challenge is the most acute in countries where small formal enterprises have very limited access to finance. This can create an opaque scenario, as there are poor prospects of accessing capital even if informal enterprises were to formally register. Hence in the short run, attention should be on how to improve financial inclusion for both informal and formal enterprises.

On the data front, there has been progress in the last few years. The quality of data collected has markedly improved over time, but there is still a lack of consistent and high quality data on a global scale for both the formal and the informal MSME sectors, which creates a big challenge to design public and private sector interventions. Greater efforts are needed to collect more and higher quality statistical information about the MSME sector at the country level, while public and private sector, and multilateral stakeholders should also be prepared to take more risks to try to foster a more dynamic and inclusive MSME sector.

The rest of this report is organized as follows. Section I focuses on the credit gap for formal MSMEs, and offers some innovative models and interventions that can be used to more fully meet the financial and non-financial needs of formal MSMEs. Section II focuses exclusively on informal enterprises, and goes beyond the access to finance paradigm, describing the operational challenges faced by informal firms, reviewing the experiments that have tried to induce higher rates of formalization, and looking at a series of private sector models that if combined, could more fully meet the needs of informal firms.



# I. CLOSING THE CREDIT GAP FOR FORMAL MSMEs

## THE CHALLENGE REMAINS

Policies to jumpstart economic growth and promote job creation have been among the top priorities of many developing and developed economies since the financial crisis. Studies have underscored the importance of SMEs in contributing to growth and job creation, putting SME sector development among the key topics on the global development agenda. However, the ability of SMEs to spur growth and foster job creation is limited by their ability to find adequate finance. Recent data from the IFC indicates that the size of the financing shortfall is in excess of \$2 trillion, and suggests that an estimated one-half to two-thirds of formal MSMEs lack proper access to finance. This financing constraint appears to be more pronounced for women-owned enterprises. This section expands on these findings, and concludes with a review of some of the policy options available to improve access to finance for SMEs.

SMEs are closely linked with economic growth. For example, studies reveal that the relative size of the SME sector in a country and economic growth are positively related (Beck *et al.*, 2005), and formal SMEs contribute to 50 percent of GDP on average in high income countries (Ayyagari *et al.*, 2007). In addition, there is evidence that SMEs are the major sources of employment in many economies (Beck *et al.*, 2008). For example, SMEs employ around two thirds of the formal work force in OECD countries (Dietrich, 2010). According to the European Commission, the number of jobs attributed to SMEs increased by an annual average of 1.9 percent during 2002-2008, compared with 0.8 percent for large enterprises (EC, 2009). A recent World Bank research report found that SMEs are the biggest contributors to employment in low-income countries (Ayyagari *et al.*, 2011) and an IFC study revealed that small firms have the highest employment growth rates, followed by medium firms (Saliola and Bernt, 2012a and 2012b). Note, however, that further evidence is necessary to understand the quality of these jobs, and whether they benefit the poor or the excluded. Box 1 provides an overview of the link between access to finance and job creation.

One major challenge for SMEs is access to finance, which affects them disproportionately more than large firms. Studies find that banks in developing economies—compared to those in developed economies—tend to be less exposed to SMEs, and to charge them higher interest rates and fees (Beck *et al.*, 2008). This has been largely due to three factors: (i) informational asymmetries related to SMEs that create risks, e.g. banks are mostly unable to gauge the creditworthiness of SMEs and thus ask for higher charges and collateral requirements; (ii) low revenue per client; and (iii) the need for local presence, and thus for a large branch network, which may not necessarily be optimal from a cost perspective, especially in a developing country setting.

New techniques and technologies are reducing the impact of these factors. For example, McKinsey & Co. estimates that bank revenues from serving the MSME segment in emerging markets could reach approximately \$367 billion by 2015 (from \$150 billion in 2010), implying an annual growth rate of 20 percent (Chironga *et*



### **Box 1. Access to finance and job creation**

Access to finance is one of the most important constraints faced by MSMEs, in addition to weak investment climate and poor infrastructure. The financing constraint is more severe in less-developed countries, where financial markets are not well-developed, regulatory and legal frameworks are weak, informational asymmetries are persistent, and risk management systems are not as robust. A developed financial sector helps mobilize and allocate resources, and manage risks, contributing to private sector development. Finance helps economic growth, and in turn, job creation. Data show that the financial sector provides more credit to the private sector and serves a larger proportion of firms in developed countries. Domestic private credit is around 150 percent of GDP in high income countries, while it is only around 30 percent in low income countries.

At the firm level, studies have shown that having access to finance is correlated with higher job growth rates (Dinh *et al.*, 2010). According to a recent IFC study (IFC, 2013), there are four channels through which finance leads to job creation: (1) finance helps start new businesses—entrepreneurship, (2) finance helps businesses make larger investments, (3) finance provides businesses with liquidity, and (4) finance supports indirect job creation through supply and distribution chains.\*

IFC Jobs Study (IFC, 2013) concludes that to close the financing gap and to reduce the financing constraints, governments, development finance institutions, financial intermediaries and other private sector actors should all intervene. Regulatory reforms, better financial infrastructure, higher competition in the financial sector, and support measures to financial intermediaries as well as to unserved and underserved groups are among the measures that can improve access to finance, and in turn help job creation. For example, programs aimed at lowering costs of financial services for underserved and unserved SMEs can encourage job creation. Financing SMEs by targeting underserved groups such as women, youth, or poor can provide help where it is needed the most.

\* See, for example, Kapstein and Kim (2010a and 2010b) on the social and economic impact of Standard Chartered in Ghana and Indonesia.

*al.*, 2012). This estimate is based on the expectation that about 60 percent of banking revenues will be in the emerging markets during 2010-20, and the fact that new technologies and methods are available to more and more banks to overcome the traditional difficulties to serve MSMEs. For example, some private companies have developed psychometric tests to assist commercial banks in their SME credit decisions. Such tests are promising, and may be useful in significantly lowering transaction costs in the absence of SME collateral or reliable financial infrastructure such as credit bureaus. Better data availability and mining may also significantly improve the way banks manage risks.

### **Can we quantify the extent of the problem?**

There is a lack of consistent, standardized, and reliable data on the MSME segment. Even when data are available, it can be difficult—if not impossible—to make cross-country comparisons, as definitions of what constitutes a micro, small, or medium-sized enterprise are largely dependent on the local context. To fill the gap in the data landscape, IFC estimated the number of MSMEs in the world, as well as access to deposits and loans for formal and informal MSMEs, based on data from the Enterprise Surveys by the World Bank (WBES) in 2010.<sup>3,4</sup> In 2011 the estimations were updated as new data from Enterprise Surveys became available.<sup>5</sup> The database as a result of this effort, the IFC

Enterprise Finance Gap Database, will be hosted by the SME Finance Forum at [www.smefinanceforum.org](http://www.smefinanceforum.org).<sup>6</sup>

Based on this new study, the total unmet demand for credit by all formal and informal MSMEs in developing economies today is estimated to be \$2.1 to \$2.6 trillion (\$3.2 to \$3.9 trillion globally), which is equivalent to 30 to 36 percent of current outstanding MSME credit. The total number of formal and informal MSMEs is estimated to be 360 to 440 million in developing economies. Approximately 13 to 16 percent of these reported to have a loan or overdraft while 36 to 44 percent reported not having access to a financial institution loan or overdraft even though they were in need of one. Combining the figures for these unserved MSMEs with those that are underserved, a total of 45 to 55 percent of MSMEs in developing economies identify access to financial services as an operational constraint.

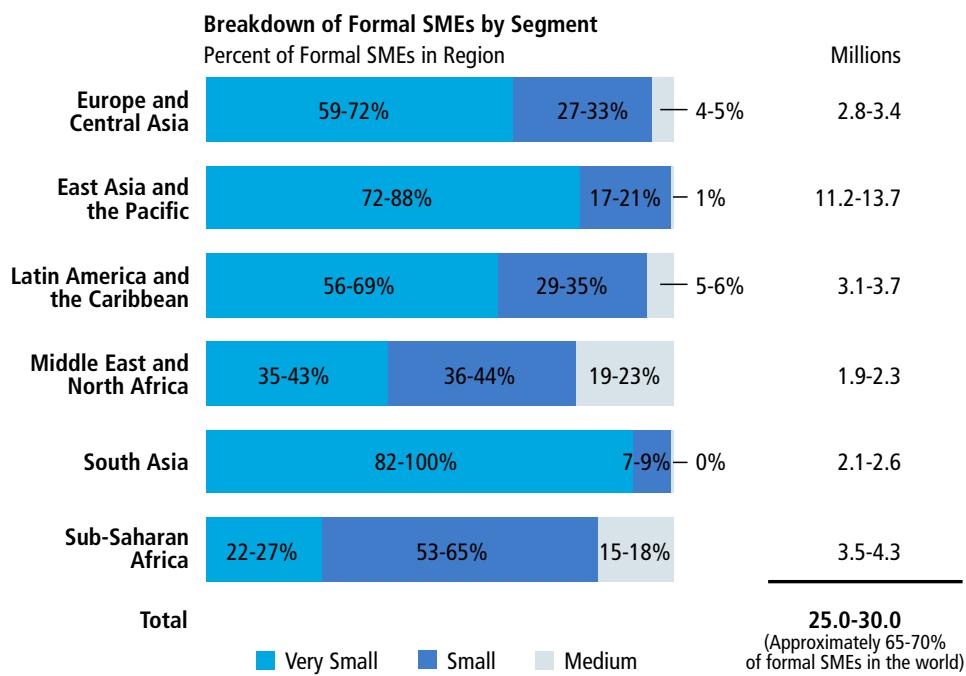
While the quality of data collected has improved over time, there is still a lack of consistent and high quality

data on access to finance on a global scale for both the formal and the informal sector, which creates big challenges in estimating these figures. WBES currently has comparable data for about 130 developing countries, primarily on the formal sector. Therefore, to reach global and regional estimates of the financing gap, country-level estimations need to be done as a first step. IFC Enterprise Finance Gap Database uses regional averages for countries with no data in the estimations.<sup>7</sup> To obtain figures for the total number of MSMEs, national statistical databases were used.<sup>8</sup>

## MSME CREDIT GAP AROUND THE WORLD

There are around 36 to 44 million formal SMEs globally, including high income OECD countries. 65 to 70 percent of these formal SMEs are in developing economies. Figure 3 shows the regional dispersion of

**Figure 3. Formal SMEs in developing economies**



formal SMEs in developing economies. In the developing world, East Asia and the Pacific is the region with the highest number of formal SMEs (11.2 to 13.7 million), while Middle East and North Africa is the one with the smallest (1.9 to 2.3 million)—although to a large extent this reflects differences in regional populations: more than 30 percent of adult population in the world lives in East Asia and the Pacific compared to slightly more than 5 percent in Middle East and North Africa. Hence, in per capita terms, South Asia is the outlier—although it also has the lowest unemployment rate, suggesting the possibility of a higher degree of informality, and/or a larger number of self-employed and micro enterprises (see Table 1). Needless to say, across all regions, there is pressing need to find employment opportunities for growing populations. The unemployment rate in Middle East and North Africa is almost 15 percent, about three times that in East Asia and the Pacific. The level of unemployment in a country or region can have pronounced effects on the level of entrepreneurial activity and in increasing the level of informality in an economy as many individuals seek opportunities to survive. Further details on the informal sector and informal enterprises in particular will be subsequently mentioned in Section II of this note.

### **Breaking down the financing gap**

Commercial banks are the major source of funding for MSMEs. Private commercial banks provide about 70 percent and 58 percent of funding to formal micro and

SMEs, respectively. Another important source is state owned banks or other government agencies. For SMEs, these provide around 30 percent of the funds, while for micro enterprises, the figure is around 21 percent. The rest of the sources include non-bank financial institutions and others.

Today, around 55 to 68 percent of formal SMEs—13.8 to 20.4 million firms—in developing economies are estimated to be unserved or underserved by the formal financial sector (see Figure 4).<sup>9</sup> This amounts to a credit gap of \$0.9 to \$1.1 trillion, and is equivalent to 26 to 32 percent of current outstanding SME credit. Almost half of this credit gap is for medium sized enterprises, while small and very small enterprises constitute 29 to 36 percent and 19 to 23 percent of the total credit cap for formal SMEs. In contrast, in developed economies, around 16 percent of formal SMEs are unserved or underserved, which amounts to a credit gap of 5 to 6 percent of current outstanding SME credit in these economies.

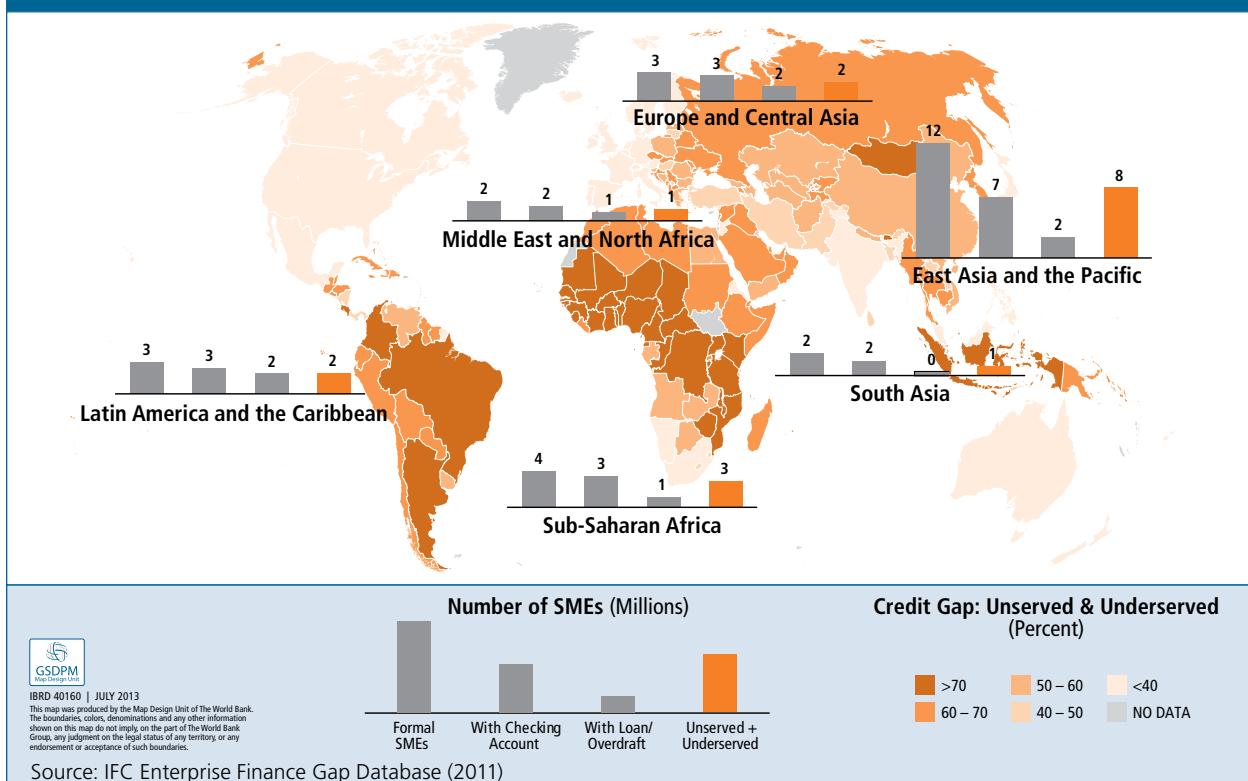
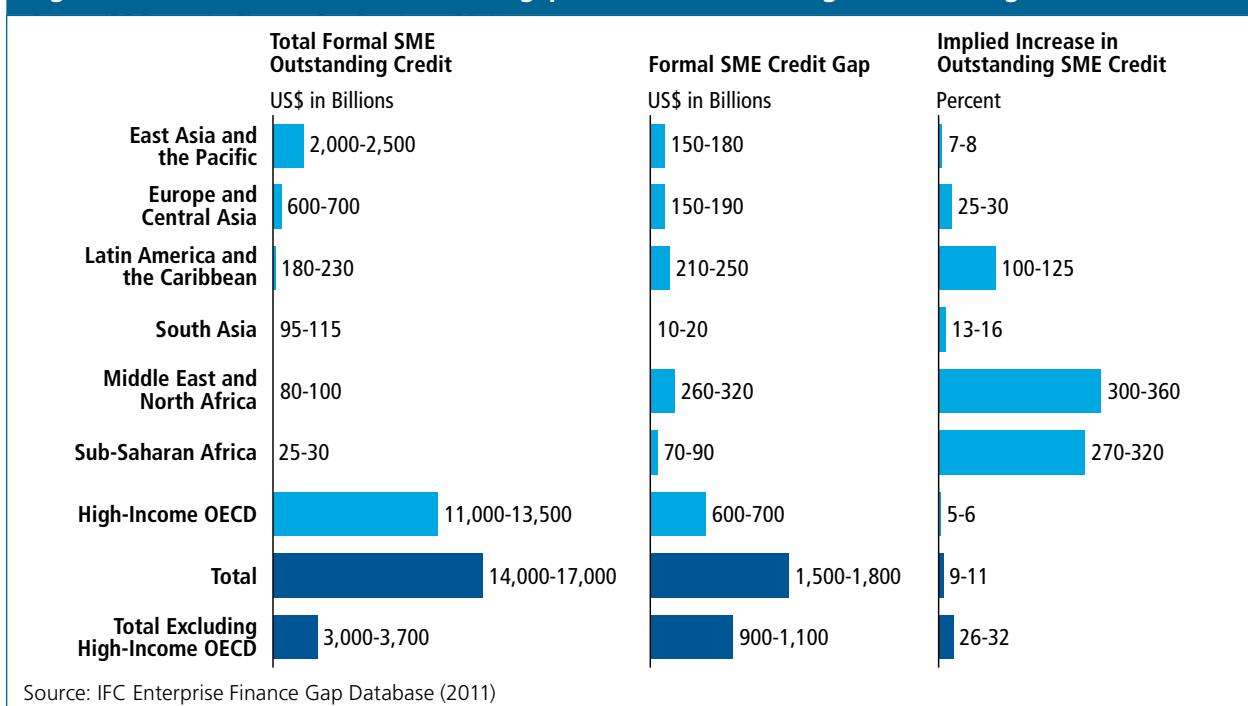
The gap relative to current outstanding SME credit varies widely across regions. For example, Sub-Saharan Africa and Middle East and North Africa would require more than 300 percent increase in outstanding SME credit to close this financing gap, compared to 7 to 8 percent and 25 to 30 percent in East Asia and the Pacific, and Europe and Central Asia, respectively (Figure 5).

The availability of credit is not the only issue for SMEs: 6.6 to 8 million SMEs around the world do not have

**Table 1. The distribution of formal SMEs and unemployment across regions**

	# Formal SMEs (Range, Millions)	Adult Population (Ages 15+, Millions)	Unemployment Rate (Ages 15+, %)	# Adults/Formal SME (Range)
<b>High Income OECD</b>	11.0	14.0	8.5	61
<b>Europe and Central Asia</b>	2.8	3.4	9.3	96
<b>Middle East and North Africa</b>	1.9	2.3	14.5	99
<b>Latin America and the Caribbean</b>	3.1	3.7	7.0	113
<b>East Asia and the Pacific</b>	11.2	13.7	4.3	137
<b>Sub-Saharan Africa</b>	3.5	4.3	6.9	114
<b>South Asia</b>	2.1	2.6	3.8	430

Source: IFC Enterprise Finance Gap Database (2011), World Bank World Development Indicators (latest available).

**Figure 4. Formal SME sector—Total credit gap****Figure 5. Formal SME sector—Total credit gap relative to outstanding SME credit, regional variations**

access to deposit services either, and the total value of the deposit gap is estimated at \$300 to \$360 billion.<sup>10</sup>

When analyzing the same set of data, but for the formal micro sector, the total number of formal microenterprises is estimated to be around 70 to 90 million globally—60 to 70 million of which are in developing economies. An estimated 52 to 64 percent of the formal microenterprises in the developing economies are unserved or underserved. This amounts to an estimated credit gap of \$0.4 to \$0.5 trillion in developing economies, and of \$0.5 to \$0.6 trillion including high income OECD countries. Figure 6 shows the regional dispersion of the credit gap. As is the case for SMEs, microenterprises also suffer a gap in deposit services, which is estimated to be \$195 to \$238 billion in developing economies.

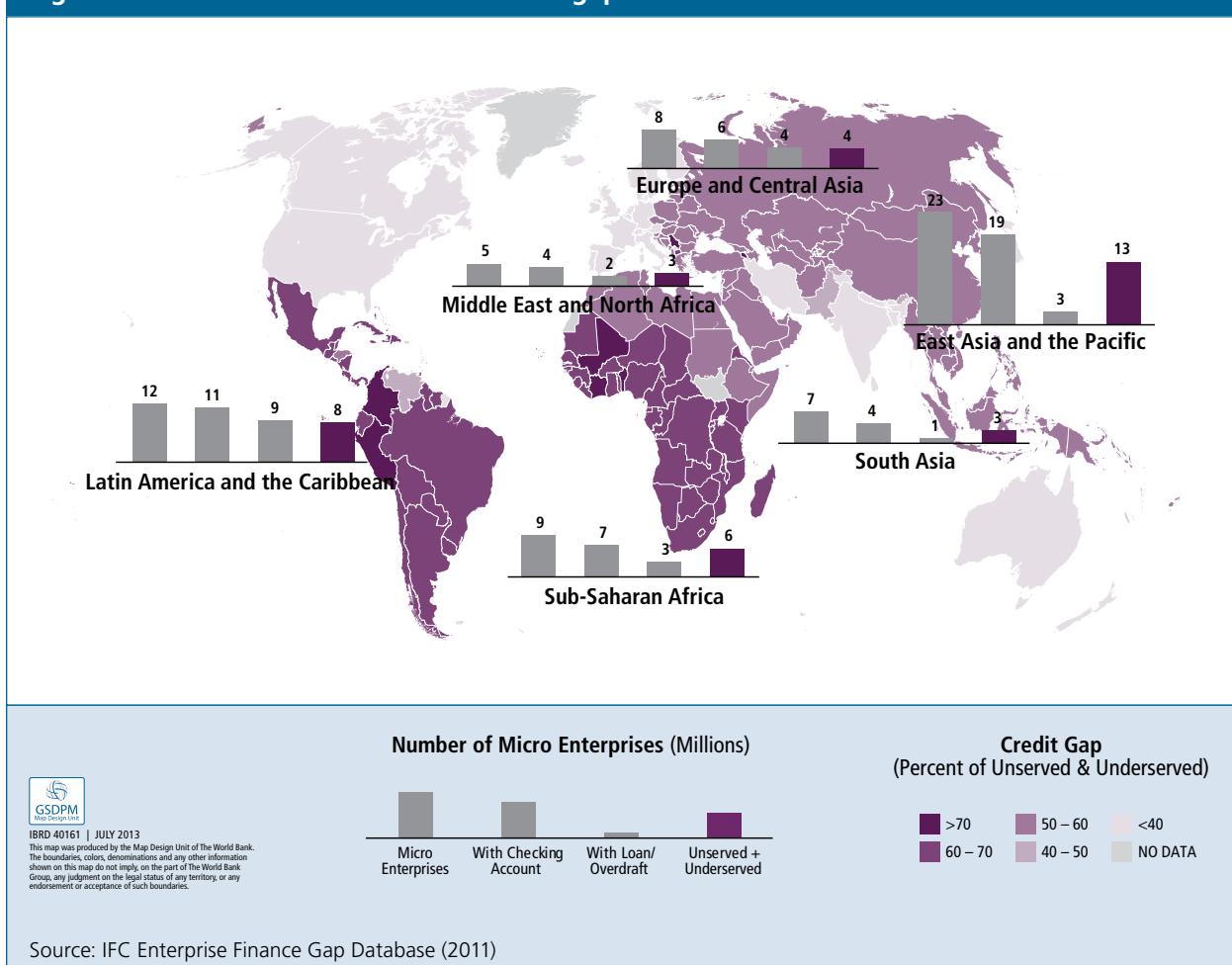
## WHAT CAN BE DONE?

What is the recipe to close the MSME credit gap and to help create jobs? A few options to close the financing gap include—but are not limited to—regulatory reform to support the enabling environment, strengthening financial infrastructure, implementing specific public programs, and private initiatives specifically tailored for SMEs.<sup>11</sup>

### Financial infrastructure and partial guarantee schemes (PCGs)

Recent financial infrastructure reforms in China demonstrate the effects of regulatory reforms in

**Figure 6. Formal micro sector—Total credit gap**



improving SME lending. In 2004, China began a reform of its movable collateral framework to encourage financing against valuable moveable collateral. Before the reform, bank lending took place mainly through real estate collateral, which SMEs often did not possess. Moveable assets accounted for over fifty percent of assets owned by Chinese SMEs. There were three main phases to the establishment of the movable collateral framework which included: the development of a property law; the creation of an electronic registry for pledging assets; and training for lenders in order to teach them how to use moveable assets as a basis for lending. In the first two years following the adoption of the property law and the establishment of the electronic registry for account receivable, total commercial loans involving moveable assets grew by an annual rate of 21 percent, while the value of loans increased by 24 percent. By May 2013, in a period of 5 ½ years, cumulatively about one million registrations—including loans based on accounts receivable and financial leases—have been recorded by the Credit Reference Center (collateral registry) in China. These transactions involved at least 36 trillion Yuan in total amount disbursed (1 US\$ = 6.2 Yuan).<sup>12</sup>

PCGs are also a successful example of specific public programs to support SME access to finance. Such PCGs were instituted in several developed and developing countries, and were noted as a market-friendly type of intervention—though they may add little value unless they are properly designed or evaluated (Saadani *et al.*, 2011).<sup>13</sup> Designing PCGs optimally requires managing the complex balance between high outreach and additionality, and financial sustainability (Saadani *et al.*, 2011). Studies have shown that PCGs have the ability to extend further financing to SMEs. In Canada, for example, it is estimated that 75 percent of the total guarantees used in the country were being used by firms that would have faced difficulties obtaining a loan in the absence of the scheme (Riding *et al.*, 2007). FOGAPE—a public fund to guarantee loans to small firms in Chile—used innovative design parameters that include targeting small firms (low ceiling), instituting variable coverage ratio (70 to 80 percent), having a unique bidding procedure where banks can bid for the guarantees according to the risk profile of the SMEs,

and establishing a risk-based approach with reasonable fees that depend on the default rates. FOGAPE has an annual reach of 30,000 guarantees and a low net loss ratio of 1.5 percent (IFC, 2011a).

## Commercial banks and other financial institutions

A variety of financial institutions, and even real sector companies are providing solutions to better serve the SME sector, especially in competitive markets where different sized institutions are allowed to be licensed to provide financial services. Examples of private sector initiatives to support SME finance include supply chain finance solutions, which will be discussed in more detail in Section II, and tailored financial services and products targeting SMEs, developed by various financial institutions. Best practice banks in developing economies have been able to profitably lend to this sector by combining a set of criteria that fully meet the customer life-cycle of the small and medium entrepreneur. These include (1) a strategic focus in the sector and fully understanding the segment's economics to identify the best customers to serve; (2) market analysis to segment the customer base, to improve acquisition and to reduce costs by optimizing the products and services offered; (3) appropriate sales culture and distribution channels to increase revenue by cross selling and up-selling; (4) activation and retention strategies in place to sustain a solid and loyal customer base; (5) a solid risk management structure with sound credit risk and collection departments to optimize lending and minimize losses; and (6) information and database management technology to develop risk scoring models, value models, and customer preference models to fully understand the risks and manage the critical moments of the customer life-cycle (IFC, 2012b).

There are multiple examples of best practice banks in SME lending. ICICI Bank in India, for example, strategically serves the SME market by segmenting the market into three groups including: a Corporate Linked Enterprise Group; a cluster Banking Group, consisting of pre-defined and pre-selected customer industry clusters with good market opportunities; and a Business Banking group where all other businesses are placed in

(IFC, 2010). Another example is Türk Ekonomi Bankası (TEB) which, despite being a latecomer to the Turkish SME banking sector, has become a market leader among Turkish banks by instituting an array of the practices described above, and by experimenting with new approaches to improve SMEs' business preparation and growth. TEB offered a range of innovative non-financial services including training services specifically focused on gaining competitiveness, increasing access to information, and building the business capacity of SMEs. Ultimately TEB was able to increase customer loyalty and expanded its core SME customer base from 20,000 customers in 2005 to over 700,000 SMEs in 2011 (IFC, 2012a).

Commercial banks are also using innovative approaches to serve women-owned SMEs. Earlier best practice examples include Garanti Bank in Turkey, which extended \$158 million in loans to women entrepreneurs during 2006-2010 using a package including non-financial services designed for women entrepreneurs, along with loans and supplementary banking products. Access Bank PLC of Nigeria loaned \$35.5 million to women entrepreneurs throughout the same period, using a similar package (IFC, 2011a). Box 2 reports the extent of the financing problem women entrepreneurs face, and illustrates a few approaches to overcome the challenges.

Continued and greater efforts are necessary to collect more and high quality data, and to conduct impact evaluations to determine the true impact of such initiatives, as well as to develop models and interventions that try to reduce financial disparities and increase the quantity of loan and lines of credit that fund the working capital and investment needs of SMEs in developing countries.

## G-20 and financial inclusion

Financial inclusion also became a priority in the global development agenda, as illustrated by the recent efforts led by the G-20. At the 2009 Pittsburgh Summit, the G-20 launched a one-year Financial Inclusion Experts Group (FIEG), which later evolved into the GPFI in 2010 at the Seoul Summit. The GPFI prioritized SME finance as one key area of the global financial inclusion agenda, and formed an SME Finance Sub-Group, led by IFC as an implementing partner. The G-20 activities to support SME finance include (1) the SME Finance Challenge in 2010—a competition to identify models that enable access to finance for SMEs, and supported the establishment of the SME Finance Innovation Fund for the Challenge Winners; (2) the SME Finance Forum in 2012—an inclusive knowledge sharing web platform for SME finance data, research, and best practices; (3) the Global SME Finance Initiative in 2012—to expand financial services to SMEs including women-owned businesses through an investment facility, advisory services for banks targeting SMEs and the development of financial infrastructure. The initiative, through its investment facility, provides financing to banks including risk sharing mechanisms to help them mitigate the risks of moving into more challenging underserved SME markets; (4) the Women's Finance Hub in 2013—an initiative to improve access to financial services for women entrepreneurs and promote the sharing of knowledge and best practices.

## Box 2. Financing women-owned businesses

Women entrepreneurs contribute greatly to the formal economy. An estimated 31 to 38 percent of formal SMEs in developing economies are owned fully or partially by women (IFC, 2011b).<sup>\*</sup> Women-owned SMEs face the same challenges as every other SME. However, these challenges are usually amplified, and/or harder to overcome. And these seem to reflect the size of women-owned enterprises: they are mostly very small and small firms.

Is this by choice, or are women entrepreneurs specifically constrained? In terms of access to finance, there is evidence that women entrepreneurs have a disadvantage compared to their male counterparts. IFC (2011b) reports that across the developing world, more women-owned SMEs cite access to finance as a major constraint than SMEs with no women ownership. Other studies state that terms of loans for women entrepreneurs are more unfavorable when compared to those for men.<sup>\*\*</sup> Around 5.3 to 6.6 million women-owned SMEs in developing economies, which amount to 63 to 69 percent of women owned SMEs, are estimated to be unserved or underserved by financial institutions.<sup>\*\*\*</sup> This amounts to a credit gap of \$260 to \$320 billion.

Access to finance by women-owned enterprises is constrained by legal and regulatory environment, firm-specific/owner-specific characteristics (e.g. education, training, size of firm, etc.), and cultural barriers, which may impact women entrepreneurs disproportionately, in addition to other barriers to access faced by SMEs in general. Although microfinance has partly filled the credit gap for women entrepreneurs, there is need to move beyond microfinance as many women-owned businesses need more varied services and products, and larger loans than microfinance institutions can provide.

While promoting greater gender equality across the board can help women entrepreneurs in getting finance, it is also important for financial institutions to understand the importance of women-owned businesses in their markets. Better data and analysis are necessary to visualize the size of the market, and the needs of women entrepreneurs.

Market research reveals that women-owned enterprises, in general, do not require new and specific products designed for them. They need the same products and services as others. What is needed is custom-tailored marketing for women, specific distribution channels, and effective customer management by financial institutions. Recent case studies conducted by IFC with “best practice” banks such as Westpac and RBS show the importance of (1) establishing a female-friendly, distinguishable brand, (2) providing a number of non-financial services to women (e.g. capacity building, networking, and information dissemination), and (3) a holistic view and full integration of women program into the businesses of the bank. A recent case in point, the WE Initiative by BLC Bank of Lebanon, shows the relevance of this approach. Since the launch of the program, BLC was able to double the ratio of the value of loans to women-owned SMEs to the value of loans to SMEs. While similar in spirit to the case of BLC Bank, Rawbank of Democratic Republic of Congo used specifically designed products to target women in addition to targeting women through specific distribution channels and effective customer management, especially to address challenges faced by women entrepreneurs in DRC such as lack of credit history and collateral, as well as registering businesses, and getting husband’s permission to open an account.

The global financial inclusion agenda is increasingly underlining the significance of advancing gender equality. For example, to promote and improve access to financial services by women entrepreneurs, the GPFI launched the Women’s Finance Hub in April 2013—a platform to share knowledge and best practices—managed by IFC ([www.womensfinancehub.org](http://www.womensfinancehub.org)).

\* An enterprise is defined as women-owned if at least one of the owners is a woman (regardless of share).

\*\* See, for example, World Bank (2008).

\*\*\* Source: IFC Enterprise Finance Gap Database (2011).



## II. INFORMAL MSMEs: THE MISSING MAJORITY

### INFORMAL MSMEs: AN INTRODUCTION

Addressing the needs of small and informal firms is an important priority for policy makers and development practitioners. An estimated 80 percent of all enterprises in developing economies—approximately 280 to 340 million—are informal firms,<sup>14</sup> and the informal sector in developing economies absorbs around 60 percent of the labor force. However, informality is associated with low levels of economic development and poverty, and it can induce lower productivity levels and lower quality jobs.<sup>15</sup> The degree of informality varies significantly across developing economies. For example, at the low end of the scale, studies have estimated that the percentage of employment in the informal sector in non-agricultural activities is less than 10 percent for countries such as Serbia, Mauritius, Ukraine, and the Russian Federation. At the high end of the scale, the percentage surpasses 75 percent for countries such as India, Mali, and Bolivia. As a result, different country strategies to cope with informality may be necessary depending on the degree of informality present in the economy (ILO, 2011).

In addition to access to credit, there are a number of challenges that informal firms face to operate and to register their business. This section will first explore some of the operational challenges that informal firms face and will propose a framework that could be used to differentiate informal enterprises to more efficiently meet their needs in the future. Some of the challenges that firms face to register their business will then be discussed, citing various interventions to encourage firms to formalize their business. The evidence thus far in inducing greater rates of formalization will also be summarized. Lastly, specific private sector models and approaches that directly or indirectly target small and informal firms will be presented. These, if used in a systematic fashion, could increase informal firms' access to markets, banking services, and raise their capacity to operate their businesses. This could in turn change the incentive paradigm for informal sector firms that are both willing and able to register their business, hence inducing higher rates of formalization in the future.

The focus of Section II is not limited to access to finance. Additional topics are discussed to describe the framework and potential solutions to address the critical areas that could strengthen the operations and sustainability of informal enterprises in the short run, with an aim of helping more firms formalize in the long run.

#### Defining informality

The definition of informality varies across countries and institutions. Historically three basic paradigms (Dualist, Structuralist, and Legalist/de Soto) have been established to explain the existence of the informal sector. The Dualist paradigm argues that the informal sector is the residual component of an economy, and it exists as a subsistence economy, reflecting the inability of the formal economy to provide enough jobs. The Structuralist paradigm argues that the informal and formal sectors are interdependent, and the informal sector is part of—and subordinate to—the formal sector: the informal



sector provides cheap labor, inputs, and products to formal firms, and contributes to the economy's flexibility and competitiveness. The Legalist/de Soto paradigm argues that the informal sector is comprised of businesses that prefer to operate informally to evade the exorbitant costs of complying with regulations (Chen, 2007).

Informality is composed of both informal firms and informal employment. The former being defined as all firms that are unregistered with the registration office, municipality, or tax authority, or owners and employers of micro enterprises that employ few paid workers (WBES Informal Sector Survey; ILO, 2012). Informal employment is defined as employment without a contract, unregistered with the relevant authority such as the social security agency or Ministry of Labor, and employment not entitled to receive social security benefits (ILO, 2012).

### The informal MSME landscape and access to finance

Data on the number of informal firms and on the number of credit constrained informal enterprises are relatively scarce. When approximating the absolute size of the informal MSME sector in developing economies, IFC estimated that South Asia and East Asia and the Pacific have the highest number of informal MSMEs, followed by Latin America and the Caribbean, Sub-Saharan Africa, and Middle East and North Africa. Figure 7 shows the regional variation of informal MSMEs in developing economies with estimated results on the number of firms with checking accounts, loans and overdrafts, and the number of informal firms that are unserved and underserved. When looking at access to credit and making a comparison with all informal MSMEs, approximately 55 percent of enterprises in developing countries have been estimated not to have credit at all, or not to have enough credit to grow their business. The credit gap for informal MSMEs when measured in percentage terms is most acute for Sub-Saharan Africa and East Asia and the Pacific. Compared to the formal MSME sector, the credit gap for informal enterprises is larger in South Asia and for some countries in southern Africa and East Asia and the Pacific where large populations of informal enterprises exist.

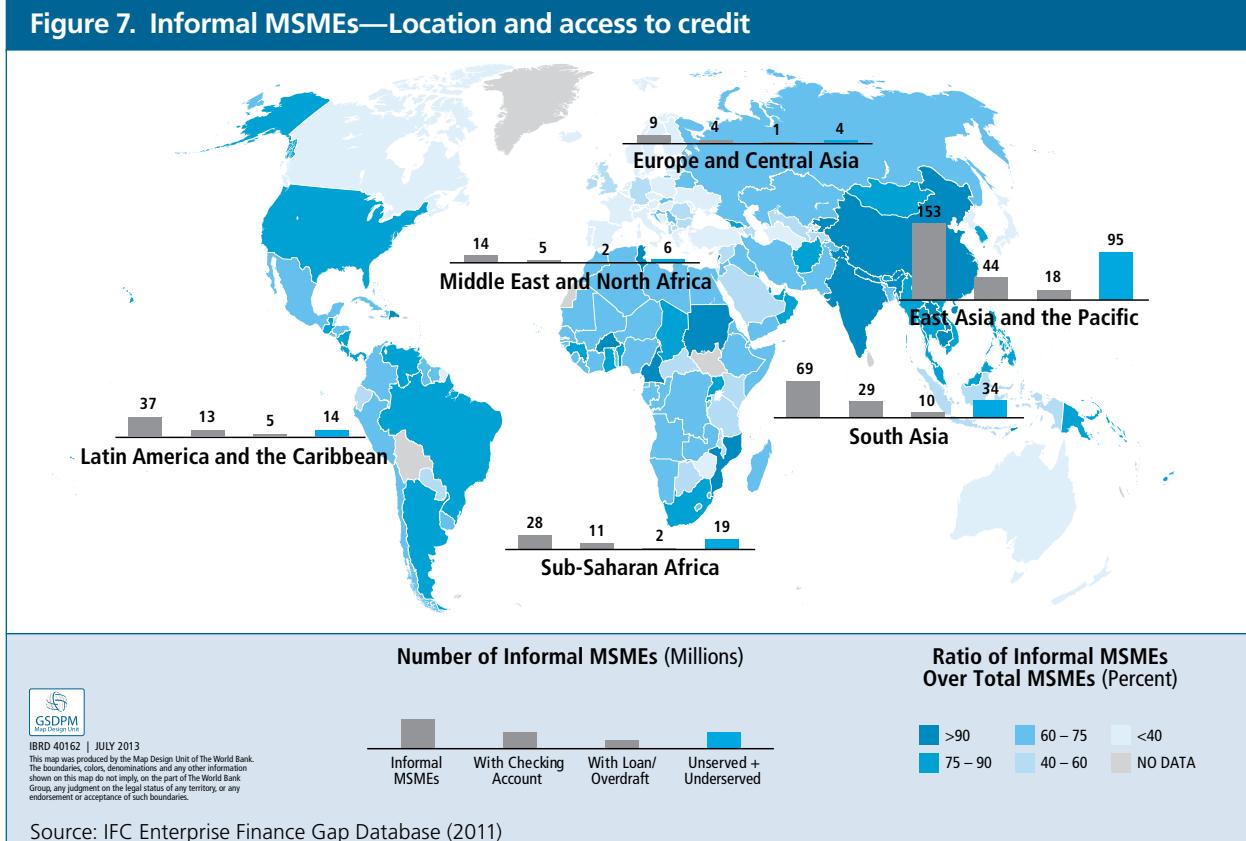
## OPERATIONAL CHALLENGES FOR INFORMAL MSMEs

Evidence from the WBES informal sector surveys across 15 developing economies shows that access to finance is one of the leading operational challenges cited by informal firms that obstruct the sustainability and growth of their enterprise, with the problem getting more severe as the size of the firm grows. Other operational challenges include crime, theft, and disorder; access to land; and corruption. Formal sector firms in these same 15 countries also state that access to finance is the leading operational challenge—but with the problem becoming less acute as the size of the firm grows—followed by political instability, practices of informal sector competitors, and access to electricity.<sup>16</sup>

### Opportunity vs. necessity firms

When differentiating informal sector firms, some studies have noted that there are both opportunity and necessity type firms in the informal sector. Opportunity firms are those that began operations because they wanted to take advantage of a business opportunity, while necessity firms are those that began operations because the entrepreneur had to find a means to survive. Analyzing the characteristics and performance of firms across the two categories, studies note that opportunity firms showed 180 percent higher sales than necessity firms in the manufacturing sector and 30 percent higher sales in the services sector, while productivity levels were higher by 200 percent in the manufacturing sector and 30 percent higher in the service sector. In terms of access to finance, necessity firms had lower number of bank accounts, lower number of separate banks from personal accounts to run their businesses, and greater use of internal funds to fund working capital and investments. The owners of opportunity firms also showed higher levels of education and a greater willingness to formalize in the future.<sup>17</sup>

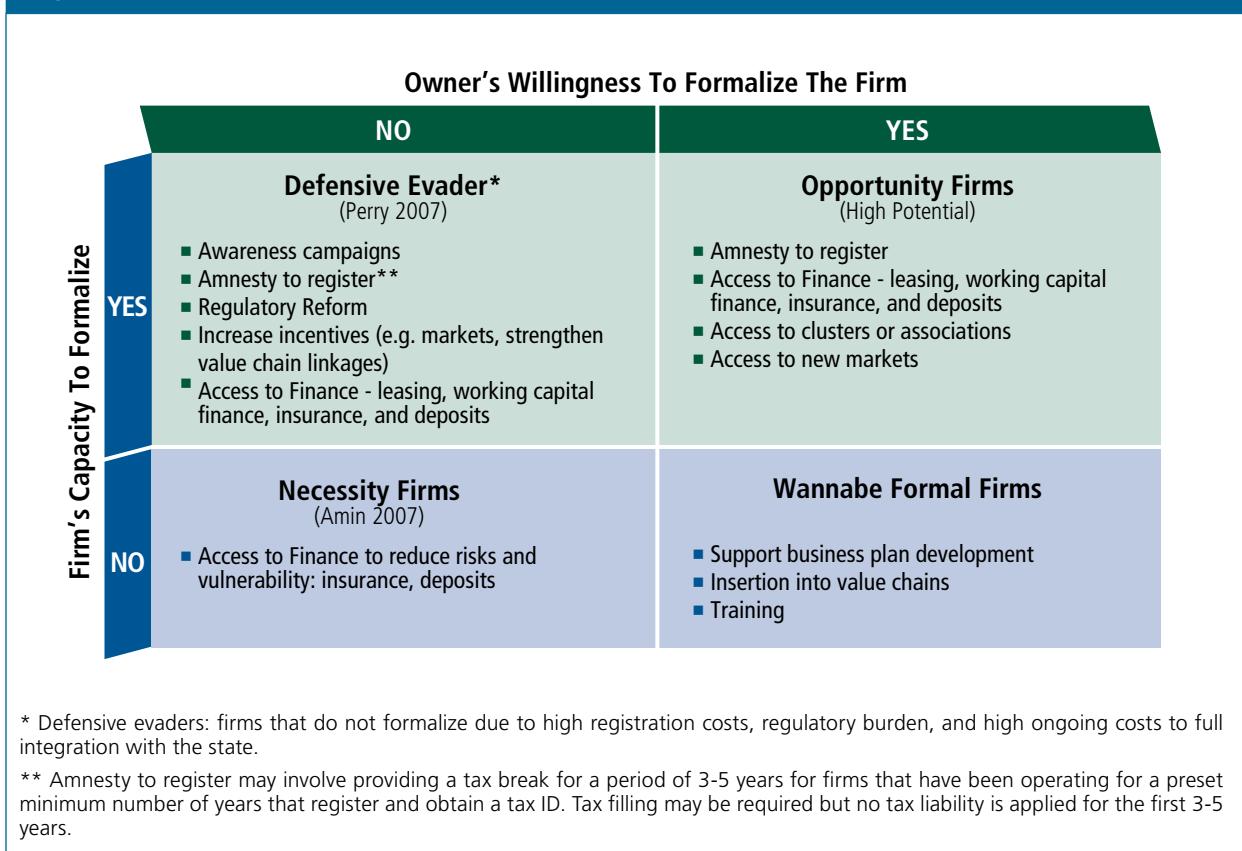
Data from the 15 informal sector surveys conducted as part of the WBES show that firms willing to register their business were found to have higher rates of access to education, finance, and markets. These firms,

**Figure 7. Informal MSMEs—Location and access to credit**

compared to firms not willing to register, have a higher share of bank accounts, separate bank accounts to run their business, and their median annual sales were higher by 31 percent for the manufacturing sector, by 48 percent for the retail sector, and by 460 percent for the service sector. In addition, a higher share of firms willing to register were found to be part of a value chain in the manufacturing and service sector, and suppliers were a key source of financing for informal firms in the manufacturing sector. Further analysis of high potential firms—firms defined as willing to register, that are part of a supply chain, and whose owners have a minimum level of education of secondary school—showed similar results: they have greater access to bank accounts, separate business accounts to run their business, and higher median annual sales, and a higher share of firms fund working capital and investment needs through suppliers and customers. These high potential firms account for only 4.3 percent of the total informal sector firms across the 15 countries.

## A framework for informal enterprises

It is possible to develop a framework to differentiate informal sector firms between those firms willing and not willing to register, as well as firms that have and do not have the capacity to formalize. Figure 8 shows a 2x2 matrix with such a classification—illustrating a range of interventions that could potentially suit each segment to strengthen the firm's capacity to operate, as well as interventions that could increase the rate of formalization. For example, the upper left quadrant shows the classification of firms that have the capacity to formalize, but their willingness to do so is low. Possible interventions could include awareness campaigns and an amnesty to register the business by providing tax breaks for a period of 3 to 5 years for firms that register their business and obtain a tax ID, coupled with a set of factors that increase the incentives for firms to formalize—such as strengthening value chain linkages and providing new market opportunities

**Figure 8. Informal MSMEs framework**

for firms, as well as greater access to finance through a variety of products such as leasing, working capital loans, insurance, and deposit products. In contrast, the bottom right quadrant shows the firms that have the willingness to register, but their capacity to do so is low. Interventions for these set of firms could include training and business plan development to increase their financial literacy, and insertion into value chain to strengthen the market opportunities for their operations and increase the chances of firm survival rates.

Working with opportunity firms or high potential firms, firms in the upper right quadrant of the matrix, presents a very interesting opportunity for intervention, given that these firms have the highest potential for

growth in the future. The data from the informal sector surveys of the WBES also show that these firms have a tendency to have higher levels of productivity and sales. From a public policy perspective, if these firms were to formalize in the future, government authorities may potentially reap higher levels of tax revenue from these businesses' future operations compared to other firms in the informal sector that register their business. Interventions for these set of high potential firms could include an amnesty to register, greater access to finance, the provision of new market opportunities, and access to clusters or associations that could also help strengthen the market opportunities for firms, thereby increasing the incentives to register the business.

## CHALLENGES TO FORMALIZE AND EXPERIMENTS TO INDUCE FORMALIZATION

According to the 15 informal sector surveys by WBES, the main reasons that firms state for not registering their business are the lack of information on how to register an enterprise, the time to complete the registration process, taxes that registered businesses would need to pay, and the lack of perceived benefits from formalization. Studies have also indicated that high entry costs, strict labor regulations, lack of access to resources such as land, credit and taxes, as well as complicated registration procedures are also important factors that have been identified to contribute to low rates of formalization.<sup>18</sup>

Experiments and interventions in Bangladesh, Bolivia, Peru, and Sri Lanka show that simplifying business registration channels, reducing registration costs, and providing greater information on the benefits of registering a business have proven to have had little effect to increase the formalization of firms.<sup>19</sup> One impact evaluation conducted in Sri Lanka went further than just offering greater information and reimbursed for registration costs by offering a cash lump sum payment equivalent to two month's median profits. This experiment induced half of the firms that were offered such an incentive to register their business. Additional analysis conducted for a sample of 387 Sri Lanka micro and small firms showed that as a result of the cash grant, monthly profits for male owned firms increased by US\$8 to \$12 per month—equivalent to 6 to 12 percent of their real monthly return. For female owned firms, the experiment found no short or long term effects, as there was capital diversion to the household. In terms of firm survival rates and employment generation, the results showed an increase in firm survival rates by 10 percent and a positive but insignificant impact on employment and capital stock levels. In addition to the monetary incentives that increased the registration incentives, 15 percent of firms found formalization to be advantageous because it permitted the enterprise to sell goods and services to the government and/or other registered businesses (de Mel *et al.*, 2012b).

The results from these experiments show that future experiments must go beyond simplifying registration and cost recovery. Further data and understanding of the incentives that convince entrepreneurs to register their business is needed. Such incentives may involve combining a series of elements such as access to market opportunities, access to finance, capacity building, and simplifying business registration. One impact evaluation currently in progress by the World Bank in Malawi, for example, combines costless registration procedures with information sessions, and the provision of business bank accounts. Preliminary results from this experiment show a 70 percent take up rate for business registration and only a 5 percent take up rate for tax registration.<sup>20</sup> Future experiments and interventions may need to also focus on the provision of market opportunities for firms that make registering a business a profitable decision even when incurring a tax liability. To do so, further research is needed to understand how business associations, for example, or large corporations with value chains could be approached to assist in the design of a more attractive package for small informal firms interested in expanding their customer base and potential sources of revenue.

## PRIVATE SECTOR MODELS AND APPROACHES TO MEET THE NEEDS OF INFORMAL FIRMS

Formalization should be a priority from a public policy and private sector perspective, given that formalization could lead to higher tax revenues, better quality jobs, access to new markets, suppliers, and clients, more reliable supply chains, and higher rates of productivity, to name a few examples. Registered firms have better access to technology and human capital, and by complying with the law the firm has better business predictability, and may avoid situations where paying fines or bribes is the norm to stay in business (Perry *et al.*, 2007; and Alcazar *et al.*, 2008). Formal firms may also access the judicial system for any contract enforcement procedures. Formal firms have better access to credit, especially in some countries where a tax ID or registration certificate is needed to open a bank account. However, not all firms

have the capacity or willingness to formalize, and it is important to identify various models and approaches that can address the needs of informal firms. This can help them operate more effectively, thus allowing more informal firms to survive—and for some to grow their business—making it attractive to register in the future. Evidence from impact evaluations conducted in Bangladesh and Sri Lanka, for example, show that for all firms with five or more employees, registration rates surpassed 90 percent in Bangladesh, while the same figure was over 70 percent in Sri Lanka. The evidence confirms the understanding that the larger the business is, the higher the likelihood that the business will register.<sup>21</sup>

There are a number of private sector models and approaches that directly or indirectly target small and informal firms which should be studied further to understand the challenges, key success drivers, and the enabling environment that have allowed private sector intermediaries to work with small and informal firms. The models and approaches include:

- a micro distribution and retail model that manufacturers and wholesalers are using to integrate micro and small retail firms into their business distribution chains;
- mobile and e-transaction platforms that can be leveraged to overcome problems with high transaction costs and to increase penetration rates in the small and informal sectors;
- small business banking solutions to overcome the typical barriers that financial intermediaries face when servicing micro and small firms;
- supply and value chains to better integrate the small and informal businesses, providing them with new market opportunities to increase their business potential and profitability.

### The micro distribution and retail model

A number of corporate clients in the manufacturing, service, and wholesale sectors—such as Coca Cola in East Africa, Grupo Martins and Tribanco in Brazil, and Mi Tienda in Mexico—are working with small and informal firms using a micro distribution and

retail model. The business model relies on expanding the provision of products and services by leveraging the existing small retail outlets, many of which are located in rural areas and are informal in nature, developing specific products that match the needs of small firms, and making customized deliveries to small retail shops given their operational constraints to store large quantities of inventories. Because small retail outlets have financial and managerial capacity constraints, large corporations have also included a set of training and coaching initiatives to better educate the business entrepreneurs. In addition, some have created specialized financial solutions such as inventory purchases on credit to ease the access to finance constraints that small and informal firms face to operate and finance their working capital needs (IFC, 2011c).

### Mobile banking and e-transaction platforms

A second model includes the use of mobile and e-transaction platforms to reduce the transaction costs that financial intermediaries face when trying to reach small and informal businesses. Examples include FINO PayTech (FINO) in India, which deploys field agents to enroll consumers in rural and semi-urban regions of India and conducts low-cost electronic transactions. Its service model relies on the provision of biometric smart cards used for saving accounts and transferring funds, point of sale terminals, and accounting and management information systems. FINO has a client base consisting of 27 banks, 15 government entities, and four insurance agencies. Other examples include YellowPepper, which is a leading mobile financial network in Latin America and the Caribbean and which has over 3.6 million monthly users in nine countries, conducting 18 million financial and informational transactions per month. The YellowPepper business model has relied on mobile banking solutions enabling banks to deliver financial services via mobile phones, m-wallet solutions obtained via a pre-paid account accessed using the mobile devise, and business to business (B2B) products which facilitate mobile payments and collections between large corporate clients such as Coca Cola and SABMiller and their suppliers, distributors, and retailers (IFC, 2011c).

## Small business banking solutions

The provision of small business banking solutions is a third approach that can be studied further. The most common challenges that financial intermediaries face when servicing small and informal firms include poor customer knowledge, lack of skills and literacy of the owners of MSMEs, low profitability, lack of collateral, assets, credit history, and land registry certificates, among others. However, financial intermediaries in various developing countries have been able to overcome these barriers through various means including cash flow based lending, introducing psychometric tests to identify the higher ability entrepreneurs, and leveraging leasing solutions when the firms do not have any collateral or assets to pledge in exchange for investment financing.

In addition, one large bank in East Asia is actively targeting small firms by identifying the interconnections and fund flows that these firms have with other firms in the bank's portfolio. Many of the small firms are informal given the bank's own definition of informality, which is based on a firm's ability to generate reliable financial records. The bank starts the enterprise-bank relationship by first opening a deposit account for the informal firm. This allows the bank to monitor the firm's cash flows, which are then used to determine the creditworthiness of the firm as a potential borrower. Based on past banking records and receipts obtained from the firm, the bank acts as a financial advisor by helping the firm (re)construct its financial statements. A final credit verification is done by obtaining references from the suppliers and customers of the firm before a loan can be approved and disbursed.

Other banks such as Türk Ekonomi Bankası, Standard Chartered Bank, and ICICI Bank are using non-financial advisory services such as financial literacy and business operations training, face-to-face or web seminars, web portals and e-learning courses, as well as specialized small business consulting services to increase the capacity of the firm, strengthen the client-bank relationship, and determine which firms and what sectors are of lower risk to lend to. Offering such non-financial services is increasingly becoming an interesting opportunity for banks looking to strengthen the long-term bank-client relationship, while greatly

benefiting and strengthening the capacity of the SMEs receiving these services, notwithstanding the need to more systematically documenting the business case and return on investment in some of these cases (IFC, 2012).

## The supply chain model

Finally, supply and value chains can be used as a private sector model to provide market opportunities for informal firms. Large corporations, notably in the extractive industries, power, tourism and hospitality, agribusiness and forestry, and telecommunication sectors, want reliable and standardized supply chains for the production and distribution of their products and services. Several multinational companies have prerequisites for companies that become part of their value chains that involve, among others, having a registered business. This presents a great opportunity to identify large corporations and multinationals that would be interested in working with small and informal firms by providing market opportunities and training for registered firms that become part of their value chain. This approach could provide informal firms with greater incentives to integrate themselves into the formal economy, giving the firms the possibility of accessing new clients, contracts, and market opportunities. To do so, various factors may also be needed to successfully integrate the firms into the value chains. For example, in Sri Lanka a business association of rickshaw motorcycle drivers was instrumental in helping several rickshaw entrepreneurs obtain the licenses, training, and connections that were needed to integrate their operations with a large luxury hotel interested in providing reliable local transportation services to their clients. Removing business registration barriers is also a key component to make it an attractive option for firms to register their business and become part of the corporate supply chain.



# ENDNOTES



- 1 This report discusses both SMEs and MSMEs—the latter also includes micro-enterprises. Most of the existing literature and data have focused on SMEs, although the IFC Enterprise Finance Gap database incorporates data that also includes micro-enterprises to the extent possible. This report uses the term MSME unless a relevant data set or study refers only to SMEs.
- 2 The analytical support for both rounds of this initiative was provided by McKinsey & Company.
- 3 This study and the current one define micro, very small, small and medium enterprises as follows: micro (1-4 employees), very small (5-9 employees), small (10-49 employees), and medium (50-250 employees). Informal MSMEs include MSMEs that are not registered with the municipality or tax authority and all nonemployer firms (independent of registration).
- 4 See Stein et al. (2010) for the results of this study and <http://www.enterprisesurveys.org> for details on World Bank Enterprise Surveys (WBES) methodology and data.
- 5 The updates include: (i) 17 updated surveys - 14 in Latin America, in addition to China and India; (ii) 12 new surveys - 7 in Middle East and North Africa; (iii) informal sector data for 15 countries, all of which were used as a basis to gauge the informal sector credit gap for the current study.
- 6 The SME Finance Forum is a collaborative knowledge sharing platform for data, research and best practices for SME finance. It promotes the dissemination of good practice guidance to agencies, donors and regional networks to improve the effectiveness of the industry.
- 7 The extrapolated data is not useful as a stand-alone country-level estimate, but rather should be used in calculating regional and global values. Country-specific characteristics must be factored in the estimation method for the estimates to be used at the country level.
- 8 These were published earlier in the IFC MSME Country Indicators. See Kushnir et al. (2010) and <http://www.ifc.org/msmecountryindicators>.
- 9 Access to finance as a constraint has an impact on both the unserved and the underserved enterprises. The IFC Enterprise Finance Gap Database uses four credit constraint levels (1) well-served, (2) underserved, (3) unserved (4) no need. While “unserved” and “no need” definitions are based on factual data reported by firms to Enterprise Surveys, “well-served” and “underserved” distinction depends on data on “perceptions”, i.e. the question which asks the respondents whether access to finance is a constraint.
- 10 Deposit services include transactions, checking, and savings accounts as well as time deposits.
- 11 See IFC (2010) and IFC (2011a) for a more complete set of approaches.

- 12 See *China Credit Reference*, a monthly publication (in Chinese) by the Credit Reference Center of the People's Bank of China; also IFC China Team.
- 13 Various well-established schemes in developed and developing countries have received a lot of attention given their long track record and their design parameters which includes Canada's SLFP, Chile's FOGAPE, France's OSEO, and Korea's KODIT, among others.
- 14 IFC Enterprise Finance Gap Database (2011).
- 15 See, for example, Loayza and Rigolini (2006); Schneider (2006); Perry *et al.* (2007); ILO (2011).
- 16 WBES informal sector surveys were conducted for the following countries (along with formal sector surveys): Angola, Argentina, Botswana, Burkina Faso, Cote d'Ivoire, Cameroon, Cape Verde, the Democratic Republic of Congo, Guatemala, Madagascar, Mali, Mauritius, Nepal, Peru, and Rwanda.
- 17 Amin (2009) based on WBES in Ivory Coast, Madagascar, and Mauritius; also Bruhn (2012) using data from Mexico.
- 18 Such studies include Oviedo *et al.* (2009), Bruhn (2012), Amin (2009), Straub (2005), Maloney (2004), and de Mel *et al.* (2012a).
- 19 Impact Evaluations were reviewed for Bangladesh (De Giorgi and Rahman, 2013), Bolivia (McKenzie and Sakho, 2010), Peru (Alcazar *et al.* 2008), Sri Lanka (de Mel *et al.* 2012a), and Malawi (preliminary - Campos, Goldstein, and McKenzie, 2013, preliminary results from ongoing impact evaluation, World Bank Group).
- 20 Source: Campos, Goldstein, and McKenzie (2013), preliminary results from ongoing impact evaluation, World Bank Group.
- 21 Bangladesh Firm Census (2010) conducted by EGI, with a sample size of 55,817 firms (McKenzie and Rahman, 2010) and Sri Lanka Firm Census (2008) conducted by the Sri Lanka Longitudinal Survey of Enterprises (SLLSE), with a sample of 2,865 firms (de Mel *et al.*, 2012a).

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