Downscaling Financial Services to Latin American SMEs

A Study of Regional Barriers, Opportunities, and Best Practices for commercial banks in Brazil, Mexico, and Chile

By Cameron Davis
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I. Abstract

In this paper, the SME financial sectors of Brazil, Mexico and Chile are studied in order to understand some of the obstacles to Small and Medium Enterprise (SME) financing in Latin America and to offer solutions on how the Inter-American Bank’s Multilateral Investment Fund can encourage growth of SME financing. This gap in financing found in Latin America is important because SMEs contribute to a dynamic growing economy. When we compare Brazil, Mexico, and Chile as a group to the non-regional counterparts of Korea and Spain, we find fewer funds available for investment, weaker legal protections, and less developed human capital. When we compare across countries, we find that Brazil’s heavy government involvement and bureaucracy imposes high costs that stifle SME growth and private sector efficiency, while Mexico lacks strong financial guidelines and protections necessary for a nascent SME sector. Chile represents a strong partnership with a proactive and involved government partnering with commercial banks and SMEs in order to grow a healthy SME financial sector. In order to tackle the risk aversion, human resource failings, and institutional barriers that hinder SME financial sector growth, the MIF should develop materials or provide technical advice to banks and governments on how to specifically focus on the SME segment through specialized marketing and information efforts, working capital credit options, prioritizing institutional challenges, training of staff to better serve and understand the SME client, and lastly, on developing government SME loan guarantees that share risk between government entities and private sector banks.
II. Problem

How can the Inter-American Development Bank’s (IDB) Multilateral Investment Fund (MIF) best encourage Latin American commercial banks to downscale into Small and Medium Enterprises (SMEs) financing?
III. Background

My client, the Multilateral Investment Fund (MIF), sees expanding financing to SMEs as an important part of their mandate “to promote broad-based economic growth through private sector development, particularly microenterprises and small businesses.” The Multilateral Investment Fund (MIF) is a member of the Inter-American Development Bank (IDB), “the main source of multilateral financing and expertise for sustainable economic, social and institutional development in Latin America and the Caribbean.” Moreover, in light of the growing middle class and shrinking margins due to increased competition and saturation within the commercial banking sector from domestic and international banks, many Latin American banks have expressed interest to the MIF in understanding how to capture the opportunity that may exist in moving into this “missing middle.”

This project will serve to fill in the research gap regarding SME financing specific to Latin America. Because little work has been devoted to prioritizing the challenges facing commercial banks in Latin America trying to move into the SME space, this project focuses on existing barriers to downscaling, i.e. scaling down services from commercial banks into the SME space. Upscaling, the movement by microenterprises into the SME space was also considered, but due to time constraints and a rise in demand by commercial banks for technical expertise in how to enter the SME financing space, the MIF prefers that this project focus primarily on barriers to downscaling. These current barriers include the limited availability of reliable client information, lack of understanding of the SME sector, high administrative costs, misaligned product offerings, bank personnel unqualified to connect with SME clients, and perceived riskiness of clientele. Two key issues confront us when looking at the aforementioned barriers;

1 http://www.iadb.org/mif/about_us.cfm?language=English
2 http://www.iadb.org/en/about-us/who-we-are,5996.html
one, it is not yet understood which barriers are the most relevant to the region and should be
tackled first, and second, although there is an understanding of the general importance of the
barriers, as of yet, there has been little work offering applicable solutions that would be useful to
banks at an operational level. The purpose of this project is to offer an overview of the SME
financing space with respect to a number of sample countries, understand why barriers still exist
in these markets, and suggest operational options or incentives useful to combat the barriers to
SME financing.

Though there are many definitions of what constitutes an SME, the IFC defines Small
and Medium Enterprises as firms having two of the three following category characteristics:

**Chart 3.1: Small and Medium Enterprise Definition**

<table>
<thead>
<tr>
<th>Size</th>
<th>Employee #</th>
<th>Assets</th>
<th>Annual Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small</td>
<td>10-49</td>
<td>$100,000&lt;$3 Million</td>
<td>$100,000&lt;$3 Million</td>
</tr>
<tr>
<td>Medium</td>
<td>50-250</td>
<td>$3-$15 Million</td>
<td>$3-$15 Million</td>
</tr>
</tbody>
</table>

*Source: IFC’s SME Banking Knowledge Guide (2009)*

Expanding financial services to Latin America’s SME sector is important for a number of
reasons. First, SMEs represent a large part of employment in developing and developed nations.
Moreover, SMEs are considered to help job creation, GDP growth, economic diversification,
social stability, and private sector development.

According to the IFC and the McKinsey Database 2010, this gap in formal SME credit
for Latin America is estimated to be $US160-190 billion. The IMF’s International Financial
Statistics find that Latin America’s credit available to the private sector as a percent of GDP is
lower than that of other emerging markets, emerging Asian markets, and developed economies.
Moreover, as shown in Exhibit 3.2, when we compare Latin America to the other regions of the
world over an extended period, I find that domestic credit provided to the private sector as a percent of GDP is continually the lowest of any region in the world.

![Exhibit 3.2: Domestic Credit to Private Sector](image)

**Source: Global Development Finance Database, The World Bank**

However, in Latin America, the size of the SME sector is smaller than that of other regions. For example, according to the International Labor Organization, only 15.4% of employment in Latin America comes from SMEs, versus, 37.9% in the European Union. Though other institutional and macroeconomic policies go hand in hand with the creation of a strong Latin American SME segment, lack of financing is routinely identified as a main growth barrier. SMEs are less served by traditional banking and NGOs than large or micro enterprises. At the lower end of the banking sector, NGOs and Microfinance Institutions (MFIs) have begun offering financial services to microenterprises, those companies with fewer than 10 employees or $100,000 in assets or annual sales revenue. At the high end of the banking sector, large Latin
American businesses are relatively well served by traditional commercial banks. Between traditional banking and MFI, however, many SMEs cannot access financing. For example, when we compare Mexican, Brazilian, and Chilean financial indicators for SMEs to those of large businesses (Exhibit 3.3), we see that SMEs do not use bank credit as much as large enterprises.

<table>
<thead>
<tr>
<th>Country</th>
<th>Small Enterprises</th>
<th>Medium Enterprises</th>
<th>Large Enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>43%</td>
<td>68%</td>
<td>90%</td>
</tr>
<tr>
<td>Chile</td>
<td>65%</td>
<td>62%</td>
<td>87%</td>
</tr>
<tr>
<td>Mexico</td>
<td>12%</td>
<td>8%</td>
<td>23%</td>
</tr>
</tbody>
</table>

One reason for this reason might be that Latin American banks are more risk averse when compared to other regions. In fact, if we look at the capital to asset ratio, a measure of how much cash banks hold on reserve to cover defaults, losses, or bank runs, Latin America is the most cautious region in the world.
Another barrier facing Latin America is the small size of the skilled labor market. The 2010 World Economic Forum on Latin America stressed a focus on improving education to make the region more competitive. In The Economist Intelligence Unit’s “Skills to Compete: Post-secondary education and business sustainability in Latin America,” 85% of the 192 Latin American executives surveyed believed that their labor force did not have sufficient skills. The leaders cited lack of hard and soft skills as a weakness in their labor pool and as a drain on their productivity, whether it is from lost productivity by weakly trained hires, lack of available talent, or having to invest heavily to train unprepared hires. A recent article in Georgetown University’s Globalization, Competitiveness, and Governability Journal titled “The Prevalence and Impact of the Skills Gap on Latin America and the Caribbean” found skills gaps across industries, but particularly in higher in knowledge sectors. Moreover, if we look at the skills gap in Latin America, we find that the region is second only to the Middle East and North Africa in terms of firms identifying labor skill as a major issue.

### Table 3.4: Bank Capital to Asset Ratio (%)

<table>
<thead>
<tr>
<th>Region</th>
<th>Bank Capital to Asset Ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sub-Saharan Africa (all income levels)</td>
<td>1.86</td>
</tr>
<tr>
<td>East Asia &amp; Pacific (all income levels)</td>
<td>9.1</td>
</tr>
<tr>
<td>Europe &amp; Central Asia (all income levels)</td>
<td>7.5</td>
</tr>
<tr>
<td>Latin America &amp; Caribbean (all income levels)</td>
<td>9.95</td>
</tr>
<tr>
<td>Middle East &amp; North Africa (all income levels)</td>
<td>9.4</td>
</tr>
<tr>
<td>North America</td>
<td>7.65</td>
</tr>
</tbody>
</table>

Source: Global Development Finance Indicators, 2011
If we apply this skill gap to the financial sector, we can assume that the banking sector, as a high-skilled knowledge based sector, faces a shortage of strong human capital. What this may mean is that Latin American commercial banks with limited manpower do not allocate their most talented individuals to working with SME clients, as the SME sector is considered less lucrative than more prestigious large account clients. Those individuals that do work with SME clients may not have the correct training or education to serve the clients well. When I broke this information down at a country and business size level, I found that this skill gap extended from small to large businesses, affecting SME businesses that might be attempting to expand and applying for financing. It also applies to those large banks and businesses attempting to offer services to SMEs.
IV. Regional Comparison – Brazil, Mexico, and Chile vs. Korea and Spain

When we compare the same three economies of Brazil, Mexico, and Chile to other sample countries, such as Korea and Spain, we see striking differences. The initial picture (Chart 4.1) clearly shows that financing is a larger issue for firms in Brazil, Mexico, or Chile, than Korea or Spain. When we compare the indicator variable “getting credit” from the World Bank’s Ease of Doing Business report, we see a similar trend, with all three Latin American nations having a substantially worse score.

### Table 3.6: % of Firms Identifying Labor Skill Level as a Major Constraint

<table>
<thead>
<tr>
<th>Size</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large</td>
<td>33.8</td>
</tr>
<tr>
<td>Medium</td>
<td>33.5</td>
</tr>
<tr>
<td>Small</td>
<td>30.3</td>
</tr>
<tr>
<td>Regional Average</td>
<td>31.5</td>
</tr>
</tbody>
</table>


### Chart 4.1: Percent of Firms Identifying Access to Finance as a Major Constraint


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3 These countries were chosen after conversations with MIF and Duke officials, with a preference for relatively developed nations from multiple regions.
A number of reasons for this weak performance can be seen. When we compare indicators across countries, three strong initial issues emerge as possibilities. The first is the obvious difference in GDP per capita leading to a lack of liquidity. At $30,200 and $29,500 for Korea and Spain, respectively, this number is more than twice the amount in any of the Latin nations. Such a difference in income and indirectly, disposable income should increase liquidity in Korea and Spain, as their citizens invest in financial products, giving banks more capital to lend. The second barrier would be the difference in certain institutional factors, specifically in the area of legal protection. As we compare Korea and Spain to Brazil, Mexico, and Chile, we consistently find that Korean and Spanish legal protections are stronger. If we look at the strength of legal rights in Brazil, Mexico, and Chile, we find that as a group, they are consistently lower than those of Korea and Spain. The same can be said for the rankings of strength of contract enforcement; Brazil, Mexico, and Chile are consistently ranked lower in the rankings than Korea and Spain.

**Exhibit 4.2: Cross Country Legal Indicators**

<table>
<thead>
<tr>
<th>Strength of legal rights index (0-10)</th>
<th>Enforcing Contracts Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>3</td>
</tr>
<tr>
<td>Mexico</td>
<td>5</td>
</tr>
<tr>
<td>Chile</td>
<td>4</td>
</tr>
<tr>
<td>Spain</td>
<td>6</td>
</tr>
<tr>
<td>Korea, Rep.</td>
<td>7</td>
</tr>
</tbody>
</table>

Source: Ease of Doing Business, 2011

The last issue that we must address is the continued weakness in human capital in Brazil, Mexico, and Chile. The populations in Spain and Korea are more educated than their Latin American counterparts. As we see in Table 4.3, the expected time in school in Latin America is lower than that of Spain or Korea. This lack of investment in human capital means that the labor
pool may not have the training necessary to properly offer financial services to SMEs, and that SMEs may be considered risky or not financially literate enough to receive financing.

V. Sample of Country Barriers

A simple comparison of indicators across Brazil, Mexico, and Chile show a number of striking differences, the most notable is that the size and the financial access given to SMEs in Chile seems more robust than that of Brazil and Mexico. General credit levels, measured by domestic credit provided to the private sector as a percent of GDP and total credit to total GDP, at 96% and 74%, respectively, are higher than in Brazil or Mexico. Moreover, when we specifically look at the size of the SME sector, we find that Chile also has a higher percentage of individuals employed in SMEs and a higher percentage of businesses coming from the SME sector than either Brazil or Mexico.

Table 5.1 shows credit bureau coverage and depth of credit information to illustrate the disconnect in these Latin American countries does not necessarily stem from asymmetric information on the part of Latin American banks, i.e. lack of credit information. In “depth of credit information” all three countries were in the top third of nations, scoring a 5 or 6 out of 6. This World Bank Index measures rules affecting the scope, accessibility, and quality of credit information available through public or private credit registries. The three countries also seem to
have decent credit bureau coverage, as illustrated by Private and Public Credit Bureau Coverage⁴.

Table 5.1: Three Country Comparison

<table>
<thead>
<tr>
<th>Category</th>
<th>Brazil</th>
<th>Mexico</th>
<th>Chile</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP Per Capita</td>
<td>$10,900</td>
<td>$13,800</td>
<td>$15,500</td>
</tr>
<tr>
<td>Domestic Credit Provided to Private Sector (% of GDP)</td>
<td>54%</td>
<td>21%</td>
<td>96%</td>
</tr>
<tr>
<td>Total Credit/GDP</td>
<td>46%</td>
<td>18%</td>
<td>74%</td>
</tr>
<tr>
<td>Percentage of Employment in SMEs</td>
<td>31%</td>
<td>19%</td>
<td>31%</td>
</tr>
<tr>
<td>Percent of SME Businesses</td>
<td>6%</td>
<td>4%</td>
<td>19%</td>
</tr>
<tr>
<td>Depth of Credit Information (1-6)</td>
<td>5</td>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>Private and Public Credit Bureau Coverage</td>
<td>83%</td>
<td>78%</td>
<td>67%</td>
</tr>
</tbody>
</table>

Sources: CIA World Factbook, World Development Indicators Database, IMF Statistics, International Labor Organization Paper

A. Brazil

As we look at Brazil’s SME financial climate, we find that lack of SME financing is a major barrier. 55% of all firms in Brazil consider access to finance as a major constraint. For small and medium enterprises, this number is 50% and 56%, respectively.

One of the largest issues facing Brazil is heavy bureaucratic costs. Though Brazil is the largest economy and banking sector in the region in terms of sheer size, it also has some of the highest costs of financial mediation. When we break down Brazil’s Ease of Doing Business ranking, we see low rankings in nearly every indicator.

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⁴ Private and Public Credit Bureau coverage is a summation of Public and Private Credit Bureau Coverage. Public credit registry coverage reports the number of individuals and firms listed in a public credit registry with current information on repayment history, unpaid debts, or credit outstanding. Private credit bureau coverage reports the number of individuals or firms listed by a private credit bureau with current information on repayment history, unpaid debts, or credit outstanding. The number is expressed as a percentage of the adult population. Per the World Bank’s Global Development Finance Database, 2011.
The underlying reasons behind these weak rankings are often time or number of procedures. It takes an average Brazilian business 120 days and 15 procedures to start a business, 411 days and 18 procedures to gain a construction permit, and 2600 hours per year to file taxes. These are some of the highest numbers in the world. When Small and Medium businesses in Brazil were asked to name their biggest challenge by the World Enterprise Survey, the percentage of businesses ranking tax rates as their largest challenge was overwhelmingly first, and tax administration was second. If we add these two tax issues together, we can consider tax--related issues the primary issue by 46% of all Brazilian businesses. For small and medium enterprises, these numbers are even more startling, with these two tax-related issues accounting for 50% and 49% for Brazilian Small and Medium enterprises, respectively. This burden discourages micro-enterprises, the largest group of businesses in Brazil from formalizing or growing into the SME sector, in fear of taxes or bureaucratic red-tape.
On the supply side, i.e. the commercial banking side, we also see over-regulation and substantial government involvement as significant issues. Though domestic credit is available to the private sector, much of this financing comes not from commercial banks, but from government financial institutions. Of the top four banks in Brazil, two of them, Banco do Brasil and Caixa Economica, are government-run or controlled. The other two, Banco Itau and Banco Bradesco, are domestic, private banks. In fact, only approximately 20% of deposits in Brazil are held by international banks.

Moreover, beyond the crowding out, it is unsure if the Brazilian government or domestic banks even function well. A recent study by the World Bank indicated that Brazil has not only low-performing loans, but high operational expenses and scarce credit availability. In order to cover the riskiness of the non-performing loans, the banks charge even higher interest rates, further discouraging SMEs from seeking financing. These are just a few of the issues that we see in the Brazilian banking system, possibly due to its large government and domestic market share.

That being said, there are success stories. The banking sector in Brazil is currently being buoyed by Brazil’s rising middle class. A number of banks have done well offering services to this previously underserved segment. Specifically, Banco Itau has become more profitable over the past decade by expanding its credit card services to the burgeoning middle class consumer and business owner, growing their services by double digits in the past ten years. This case
illustrates the desire for short-term credit for middle class consumers (and indirectly SMEs) and the success that a bank can have if it focuses on providing these services.

B. Mexico

Mexico, like Brazil, has financing issues which fall more heavily on small and medium enterprises. Small and medium enterprises have far fewer lines of credit or loans from financial institutions and far less usage of banks to finance either investments or expenses than large businesses.

**Table 5.5: Mexican Credit Usage Description**

<table>
<thead>
<tr>
<th></th>
<th>Small</th>
<th>Medium</th>
<th>Large</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firms with Line of Credit or Loans from Financial Institutions</td>
<td>11.66%</td>
<td>7.57%</td>
<td>22.51%</td>
</tr>
<tr>
<td>Firms Using Banks to Finance Investments</td>
<td>1.86%</td>
<td>2.64%</td>
<td>12.11%</td>
</tr>
<tr>
<td>Firms Using Banks to Finance Expenses</td>
<td>4.22%</td>
<td>7.82%</td>
<td>20.31%</td>
</tr>
</tbody>
</table>

Source: World Development Indicators Database, 2011

Whereas many Brazilian issues stem from government involvement, most notably burdensome taxes and regulations, Mexican barriers seem to be more evenly dispersed among the various issues of informality, corruption, tax rates, access to finance, political instability, and inconsistent electricity provision, with few substantial differences between small, medium, and large enterprises. It must be noted that informality plays the largest role for SMEs.

**Table 5.6: Percent of Business Which Consider Issue Primary Obstacle to Business**

<table>
<thead>
<tr>
<th>Obstacle</th>
<th>Mexico</th>
<th>Small</th>
<th>Medium</th>
<th>Large</th>
</tr>
</thead>
<tbody>
<tr>
<td>Practices Informal Sector</td>
<td>19.01</td>
<td>18.84</td>
<td>18.52</td>
<td>23</td>
</tr>
<tr>
<td>Corruption</td>
<td>17.86</td>
<td>19.84</td>
<td>13.61</td>
<td>9.29</td>
</tr>
<tr>
<td>Tax Rates</td>
<td>10.63</td>
<td>8.1</td>
<td>15.72</td>
<td>22.97</td>
</tr>
<tr>
<td>Access to Finance</td>
<td>8.64</td>
<td>10.16</td>
<td>3.94</td>
<td>7.7</td>
</tr>
<tr>
<td>Political Instability</td>
<td>8.49</td>
<td>6.67</td>
<td>13.27</td>
<td>13</td>
</tr>
<tr>
<td>Electricity</td>
<td>8.12</td>
<td>8.56</td>
<td>6.99</td>
<td>6.96</td>
</tr>
<tr>
<td>Tax Administration</td>
<td>7.5</td>
<td>10.06</td>
<td>0.7</td>
<td>1.42</td>
</tr>
<tr>
<td>Crime, Theft &amp; Disorder</td>
<td>7.33</td>
<td>4.2</td>
<td>18.59</td>
<td>3.34</td>
</tr>
</tbody>
</table>

Source: World Development Indicators Database, 2011
One other large difference between the Mexican and Brazilian economies is the domination of the banking sector by a few large foreign banks. In 1997, the Mexican government relaxed restrictions on foreign ownership of banks, and the market share of international banks grew from 16% in 1997 to 76% in 2002. Foreign banks currently account for around 80% of the market share in terms of assets, with 76% of the total market owned by BBVA Bancomer (Spanish), Banamex (US), Santander (Spanish), HSBC Mexico (English), and Scotiabank Inverlat (Canadian). If we add the 12% share that Mexican bank Mercantil Del Norte has, we find that 92% of the market is owned by six banks. This unabashed switch to a heavily concentrated mostly foreign credit system has had a positive impact on bank performance and operations in Mexico, but it has not, however, expanded credit services in Mexico. Thorsten Beck and Maria Peria, using number of municipality bank branches and number of loans and deposits in Mexican banks, found a decrease in financial services from 1997-2005 by Mexican banks that were acquired by foreign entities. This may be due to lack of competition within the banking sector stemming from a small number of players acting in an oligopolistic manner, or continued focus on large corporate clients with offices in other countries.

An October 2010 article in LatinFinance titled “Best Bank – Mexico,” seemed to corroborate this lack of client focus, citing common practices of charging high fees and steep interest rates from a “powerful banking oligopoly.” Stanford’s Stephen Haber agrees with this assessment. In his paper “Why Banks Don’t Lend: The Mexican Financial System,” he concluded that oligopolistic practices in Mexican Banks were holding back credit. In his four year study of Mexican banks, he found that larger banks tended to extend less credit as a percent of assets than their smaller peers. He also found that when large Mexican banks gave out loans, they assumed less risk than their smaller counterparts, directly earning more money by charging more fees and
commissions and indirectly earning more profit by having reduced administrative costs. The other factor that he concluded was key to holding back the Mexican banking system was a historically weak system of contractual rights. This connects to the idea that the initial quick opening of the Mexican banking sector was not accompanied by strong regulation or oversight by the Mexican finance ministry, central bank, or the national banking and securities commission.

C. Chile

In Chile, we find a healthy banking sector in which major obstacles to business growth do not appear to stem from institutional failures, over-regulation, or lack of regulations. If we look at the major obstacles to doing business in Chile for SMEs and businesses in general, we find that the most significant issues are not tax administration or licenses and permits, but a diverse set of daily operational issues such as informal sector practices, consistent and reliable electricity, inadequately educated work force, and crime, theft and disorder. Unlike Brazil’s few singularly large issues, the dispersed nature of Chile’s issues illustrate a lack of major stumbling blocks.

Unlike Mexico, however, the government has played a role in creating a safe and competitively regulated space for banking. The Government Banking Act thoroughly supervises, regulates, and partially insures against cyclical losses. These programs, combined with prudent and stable macroeconomic policy, have encouraged expansion of lending, growth, and operational efficiency in banks. In fact, the banking sector in Chile is quite diverse and competitive, with only one state bank and a robust presence from a large number of foreign and domestic players. Moreover, the government programs of FOGAPE, a small enterprise partial
guarantee fund which shares risk that commercial banks take on SME loans, and CORFO, a
government agency that offers specialized training and finance to encourage technological activity,
investment projects, and export-related activities, regional integration, and education
scholarships, have been instrumental in growing SME financial access. This balanced marriage
between sound public sector regulation and framework and strong private sector expertise has
allowed the Chilean banking and SME sector to fare better than those in Brazil and Mexico.

However, challenges do exist for SMEs in Chile. Like much of Latin America, knowledge
sectors like banking are constrained by lack of well-equipped staff. 42% of Chilean firms still
include lack of skilled labor as a constraint to business. This harms SMEs trying to successfully
build their businesses, and banks lack the talent pool necessary to better serve SMEs. In-person
interviews with the members of the Chilean Association of Banks and Financial Institutions,
BancoEstado, Banco BCI, and the Economic Commission for Latin America and the Caribbean
corroborated several of these findings: First, they note that SME-focused banking talent and
training at the branch level could be improved, and second, they still consider a knowledge gap
in understanding SME businesses an issue in growing SME-specific financial services. Third,
many of the SME owners who apply for funding lack the financial understanding or business
knowledge to be considered for credit services. This lack of understanding of financial terms
adds to mistrust of and discomfort with the banking system and implies that the SME owner is
likely to be reticent to seek bank financing.
VI. Key Takeaways

When we look at the region as a whole, we find that Latin America has low domestic credit to the private sector when compared to other regions. We also find that banks are relatively risk averse. Lastly, we can see that SMEs in Latin America use those loan products which focus on day-to-day expenses, rather than investments. We also find that Latin America is behind most of the rest of the world in terms of its strength of human capital.

When we compare Brazil, Mexico, and Chile to each other and to Korea and Spain, we find a number of trends. First, when Brazil, Mexico, and Chile are compared to South Korea and Spain, we find that access to finance is a larger barrier in the Latin American nations. Possible reasons include higher GDP per capita of Korea and Spain that can be invested in banks and later lent out, stronger legal rights which Korean and Spanish citizens and businesses enjoy, and more abundant human capital found in Korea and Spain.

As we compare across these countries, a simplified explanation of the evolution or development of the SME sector and its access to finance begins with the macroeconomic setting, moves to the institutional framework, and ends with operational issues. For a country to have a healthy SME sector, it must have a stable macro environment, a strong institutional framework, and address its operations issues. The best example from this study is that of Chile.
Chile’s healthy economy and strong institutional framework, i.e. balance between government involvement in the economy and private sector development, has allowed the country to tackle the third-order operational issues, and grow a healthier SME sector than Brazil and Mexico. Chile’s government has been especially proactive in crafting laws which effectively regulate the lending industry while continuing to allow Chilean banks to function with profit-driven private sector efficiency. They have become proactively involved in growing the SME sector through government funded programs such as FOGAPE specifically designed to lower risk associated with SME lending. The remaining operational issues include a lack of understanding of clientele needs, lack of talented and well-trained individuals to focus on SME needs, and lack of financial literacy and business education on the part of SMEs applying for financing.

In Mexico, though we see a country with institutions that make doing business relatively easy, we find a market still grappling with macroeconomic issues. Informality, corruption, and crime, theft, and disorder, are some of the highest ranked issues that SMEs face. Moreover, the unregulated quick consolidation and control of the Mexican financial sector by foreign banks
means that the space is not a properly competitive market and banks gaining rents may have little
incentive to extend lending to less lucrative SMEs.

In Brazil, though a healthy economy and political landscape exists, its institutional
framework is overly burdensome for SMEs. The country’s high tax rates and administrative
issues place a burden on SMEs trying to expand or formalize. Long wait times and high number
of procedures to register as a business, gain a construction permit, register property, and enforce
contracts make it difficult for SMEs to enter the formal lending space.

VII. Review of Barriers

When we look across the Brazilian, Mexican, and Chilean SMEs seeking financial services, we
see a number of emergent themes that may be relevant to commercial banks trying to serve this
market.

A. Liquidity/Risk Related Issues – Compared to developed nations such as Korea or Spain,
Latin American banks have less access to funds that can be invested in SME financing. The
recent financial slowdown may also exacerbate the tendency of Latin American banks to
hold back funding to SMEs. Moreover, risk aversion in the commercial banking sector may
mean that even when funds are present, money is not lent out.

B. Institutional Barriers – The institutional barriers to seeking finance raise the cost of
offering services to SMEs. Specifically, barriers of high tax rates and burdensome tax
administration, lengthy bureaucratic processes, and lack of legal protection dissuade SMEs
from formalizing or add costly layers to seeking bank financing. Moreover, governments
may have weakly designed or poorly enforced financial regulations. Government regulations that are either too burdensome, as in the case of Brazil, hurt SME financing, and those that are too lax can hollow out the competitiveness of a sector, as in the case of Mexico’s financial oligopoly.

C. **Human Resource Failings** – Banks, facing a skills gap in well-trained workers, may not have staff that understands the size or needs of the SME market. Lack of education and training for the SME owner seeking bank funding means that the SME is less likely to understand and trust the bank’s financial jargon and less likely to be approved for a loan because he is not able to articulate in financial terms his needs and strengths. Weak human capital on the supply and demand side leads to a disconnect between the bank and SME consumer. This disconnect leads to banks having a lack of understanding of consumer needs in terms of product offerings and the necessity of working capital solutions, relevant marketing materials, and SME client-focused staff and services.

**VIII. Policy Solutions to Barriers**

In order to counteract the lack of liquidity, institutional barriers, and human resource failings that hinder SME financing, governments should partner with commercial banks to encourage injection of liquidity into SME markets by lowering the inherent risk factor facing banks in lending to SMEs and simplify key business rules and processes. As we have seen in the Chilean model, a concerted balance of government regulation and private sector needs is key to a healthy financial sector in general, and the growth of financial services available to SMEs. A sharing of risks by central governments and commercial banks focusing on SME markets should
attack the lack of liquidity issue and ease accessibility of funds for SMEs. Simplification of key rules and processes should attack those issues which discourage informal businesses from moving into the formal sector. Governments should lower the costs, number of processes, and time related to taxes, tax administration, and registering a business, while offering a safe, legal environment in which SMEs can operate. This will make it easier for SMEs to formalize and access finance as legitimized businesses.

Within the private sector, banks should consider segmenting their services to specialize in the SME market. Initial interviews with Chilean banks cited that connecting with the SME segment is important to counteract human resource failings that we see in Latin American banks and businesses. Understanding the SME owner will allow banks to offer a successful suite of services and products that meet specific SME needs.

IX. Operational Issues, Solutions, and Best Practices.

A. Lower Risk – Encourage Government-Funded SME Guarantee Programs

With respect to liquidity, the specific operational challenge has to do with cautious commercial banks facing financial constraints and having to choose to invest their limited funds into a portfolio in which they believe that they can receive the highest return with the lowest risk. The SME sector, though perhaps lucrative, contains a higher risk because it is less familiar. One way to lower this risk is for governments to insure a percentage of loans that commercial banks lend to SMEs. This way, the government can share the risk without having to act as a financial intermediary that administered loans or rated the creditworthiness of SMEs. In Chile, the government guarantee program FOGAPE has been instrumental in commercial banks expansion
of finance to SMEs. In FOGAPE, commercial banks apply to the government-run BancoEstado for insurance that can back a certain percentage of the loan, based upon loan size (See Table 8.1 for details).

Table 8.1: Chilean FOGAPE Coverage

<table>
<thead>
<tr>
<th>Enterprise Beneficiary</th>
<th>Maximum Loan Amount Insured</th>
<th>Maximum Percentage Insured</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro and Small</td>
<td>$ 135,000</td>
<td>80%</td>
</tr>
<tr>
<td></td>
<td>$ 225,000</td>
<td>50%</td>
</tr>
<tr>
<td>Medium</td>
<td>$ 675,000</td>
<td>50%</td>
</tr>
<tr>
<td>Large</td>
<td>$ 2,250,000</td>
<td>30%</td>
</tr>
<tr>
<td>Exporters</td>
<td>$ 225,000</td>
<td>80%</td>
</tr>
</tbody>
</table>

Source: FOGAPE, 2011, Translated to April 10th US $ via current US $ to UF Rate

B. Institutional Barriers – One-stop shops, SME institutional barrier report by country, and concerted efforts to build public-private partnerships

The operational issues that can be tied to institutional barriers are, first, the burdens that SMEs face in terms of taxes, time, and processes, and tangentially second, weakly designed or badly enforced financial regulations. As we have seen in Brazil and Mexico, strong barriers exist that hinder SMEs with regard to the amount of time and resources they must devote to over-regulation. One possible solution to this problem would be for governments to have simplified procedures, tax codes, and rates for businesses. Other recommendations that might require less political maneuvering would be for the MIF to encourage the creation of an independent agency focused on providing a “one-stop shop” of services, such as the US Small Business Association, where SMEs could learn about how to register property, incorporate, file taxes, and seek legal adjudication or the creation of knowledge products by governments or the MIF to explain how SMEs can formalize and seek financing. The last recommendation that the MIF may consider would be to develop a ranking of most relevant SME institutional challenges.
by country. This would give national banking and government officials a roadmap to prioritize which institutional failings to attack first.

In order to change the second barrier of weakly designed or badly enforced financial regulations, a change would have to come from the political and business landscape in each given country. Because this process is complicated, slow, and would involved a large number of diverse and even controversial parties, it is not suggested that the MIF lobby for a direct change to the institutional landscape. Instead, one option would be for the MIF to encourage concerted efforts at partnerships between the private and public sector so that laws are formulated and enacted in a way that favors prudent and intelligent financial regulation and reform.

C. Human Resource Failings – Segmenting operations in marketing, products, and staffing services

In order to attack the third barrier of human resource failings, the MIF should speak with banks or create materials which focus on understanding and serving the needs of the SME client. Anecdotally, banks with strong SME portfolios, such as Banco BCI in Chile or Banco Itau in Brazil have, at some level, been successful in working with SMEs because they have specialized and separated their SME operations from non-SME operations. First, understanding the client’s demographic in terms of education, lifestyle, employment, and financial literacy is a key first step for banks to create marketing plans which are clear, informative, relevant and appealing to clients. Efforts should be made to avoid financial jargon that might be seen by clients as misleading or too complicated to understand. Second, after marketing clearly to clients, banks should focus on having products which tie in to SME clients. Specifically, as most SMEs use their loans for expense-related activities instead of investment activities, working capital models,
such as factoring should be incorporated into the bank portfolio offering. Lastly, banks should focus on training staff who can comfortably deal with the SME client on a face-to-face basis. Due to the wariness that SME owners have towards large banks, the lack of quality financial data that SMEs have, and the somewhat limited financial literacy, the SME banker should focus on building an ongoing relationship with the client in order to build trust, find proxies to value a firm’s creditworthiness and needs, and to clearly explain the layman’s terms of financial agreements. Moreover, if banks are going to truly be successful with the SME client, they should consider first, valuing firms and their creditworthiness based upon expected future cash flows, and second, having a specific department, branch, or bank brand which specializes and deals primarily with the SME borrower.

Table 8.2: Barriers and Solutions to SME Financing In Latin America

<table>
<thead>
<tr>
<th>Barrier</th>
<th>Policy Solution</th>
<th>Operational Issue</th>
<th>Operational Solution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks Consider SMEs Risky</td>
<td>Share or Lower Risk</td>
<td>Commercial bank financial constraints</td>
<td>SME Government Backed Insurance</td>
</tr>
<tr>
<td></td>
<td></td>
<td>High costs of taxes, time, processes, lack of legal protection.</td>
<td>One stop shop</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Governments may have weakly designed or badly enforced financial regulations</td>
<td>Concerted private-public partnership</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Government and financial sector lacks understanding of issues most relevant to SME development</td>
<td>SME National Institutional Ranking</td>
</tr>
<tr>
<td>Institutional Barriers</td>
<td>Simplify key rules and processes for SMEs to operate formally or access finance</td>
<td>Complicated Marketing Materials not understood or trusted by SMEs</td>
<td>Simpler non-financial jargon marketing materials.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Incorrect Product Offering does not connect with day to day needs of SMEs</td>
<td>Factoring or other working capital options</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Untrained SME client facing staff &amp; services</td>
<td>Train staff to connect, focus on building relationship, sizing business differently</td>
</tr>
</tbody>
</table>

T
X. Prioritization of Solutions

As we look towards solutions, it is necessary that the solutions offered are not only academically sound, but also realistically useful to the MIF. In order to prioritize, I created a matrix which compared the six operational solutions, based upon conversations with IADB officials, my own research, and in-person field interviews. I compared the issues based upon criteria I chose in conjunction with my team at the MIF; to what extent clear examples of the solution exist, to what extent the solution aligns with the goals of the MIF, the cost for the solution to be implemented, the benefits in the short and long term, and lastly, the usefulness and replicability of the solution to other areas. The issues were ranked one to five, with five being the highest. Their sum represents a total score of the issues. These scores are subjective and may change slightly based upon the weighting that the MIF gives to certain considerations or differences of opinion in ranking numbers.

Though a one-stop shop or a concerted-public private partnership may be strong contenders to bettering financing to the SME space, the prioritization matrix shows the difficulty of implementing such institutional policies and their misalignment with MIF goals. Instead, the MIF should focus on those options which encourage SME lending relatively simply by focusing on processes, people, and products. According to my research, I believe that the best way the MIF can do this is to focus on these options by developing technical material or knowledge advice to banks and governments. Specifically, the MIF should focus on the following:

1. Creating marketing and informational guidelines focused on the SME consumer;
2. Designing better working capital credit options and other financial products SME consumers need;

3. Producing training materials and guidelines to train bank staff to better serve and understand the SME client;

4. Developing a ranking of largest barriers to SME growth at the country level, prioritizing SME issues so government officials and business leaders can create policy solutions to the most pressing issues facing SMEs specifically in their country; and,

5. Building an operational plan and best practice for member countries interested in implementing their own SME loan risk guarantee programs.

<table>
<thead>
<tr>
<th>Operational Solution</th>
<th>Clear Example to Follow</th>
<th>Alignment to MIF Goals</th>
<th>Ease Of Implementation</th>
<th>Benefit</th>
<th>Replicability/Scaleability</th>
<th>Total Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simple, relevant, informational marketing materials.</td>
<td>4</td>
<td>5</td>
<td>4</td>
<td>4</td>
<td>5</td>
<td>22</td>
</tr>
<tr>
<td>Factoring/working capital options</td>
<td>4</td>
<td>5</td>
<td>4</td>
<td>4</td>
<td>5</td>
<td>22</td>
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<tr>
<td>SME National Institutional Ranking</td>
<td>5</td>
<td>5</td>
<td>4</td>
<td>3</td>
<td>4</td>
<td>21</td>
</tr>
<tr>
<td>Train staff to connect with SME borrower</td>
<td>4</td>
<td>5</td>
<td>3</td>
<td>3</td>
<td>5</td>
<td>20</td>
</tr>
<tr>
<td>SME Government Backed Insurance</td>
<td>5</td>
<td>3</td>
<td>2</td>
<td>5</td>
<td>4</td>
<td>19</td>
</tr>
<tr>
<td>One-stop shop</td>
<td>3</td>
<td>3</td>
<td>2</td>
<td>5</td>
<td>2</td>
<td>15</td>
</tr>
<tr>
<td>Concerted private-public partnership</td>
<td>2</td>
<td>3</td>
<td>2</td>
<td>4</td>
<td>2</td>
<td>13</td>
</tr>
</tbody>
</table>
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