

# What policies can improve firms' access to credit?

Thierry Tresselt

Lead Economist, Research Group, World Bank

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# Policy issue

- Focus on SMEs: they are the biggest contributors to employment across countries, especially in low income countries, and SMEs generate the most new jobs (Ayyagari, Demirgüç-Kunt, and Maksimovic, 2011). In a median country, SMEs with 250 employees or fewer generate 86% of the jobs.
- A dynamic SME sector contributes to innovation, productivity growth, and fosters competitive markets. Because of their large contribution to new job creation, SMEs are very important to reach development goals, e.g. to promote sustained, inclusive and sustainable economic growth, and to reduce inequality and eliminate poverty.
- Because of weak legal and financial institutions in developing countries, SMEs are often not able to expand and grow into larger firms, and do not contribute to productivity growth and to real GDP per capita growth as much as they could.

# SMEs are less likely to use bank finance than large firms

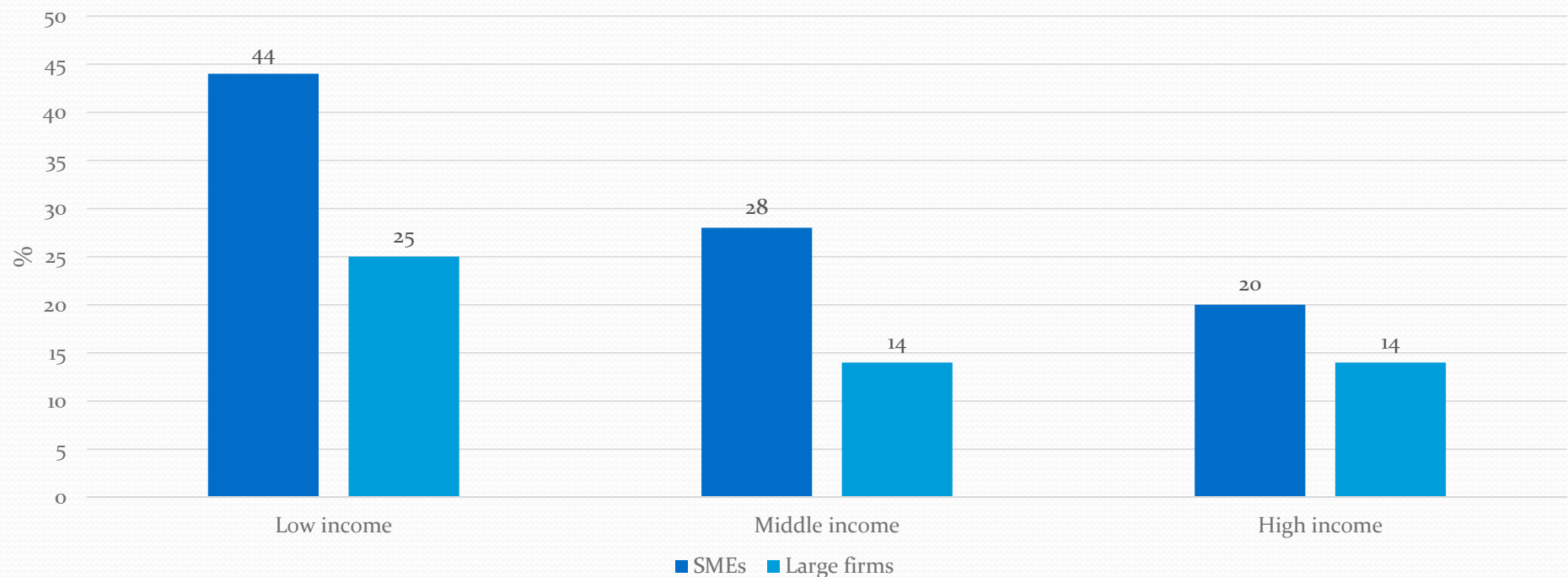
Average % of fixed asset investment financed from external sources



Source: Enterprise Surveys for 123 countries, covering the period 2006 to 2014.

# Percentage of credit constrained SMEs is greater in developing countries

% of firms that did not apply for a loan due to high interest rates, complex application procedures, collateral requirements, etc.

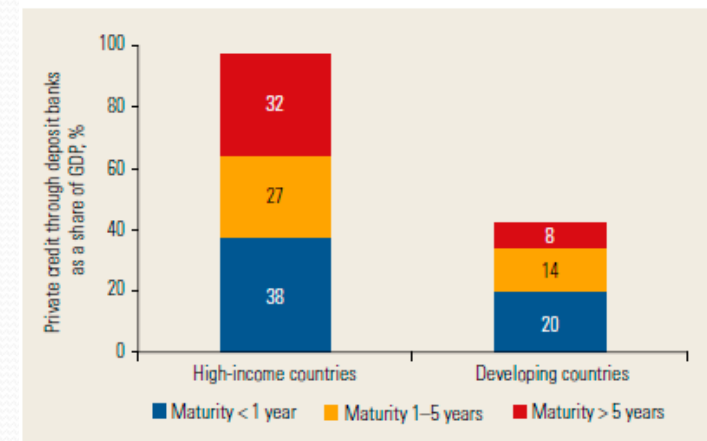


Source: Enterprise Surveys for 120 countries, covering the period 2006 to 2012.

# Availability of long term credit is often seen to be a critical characteristic of a developed financial system

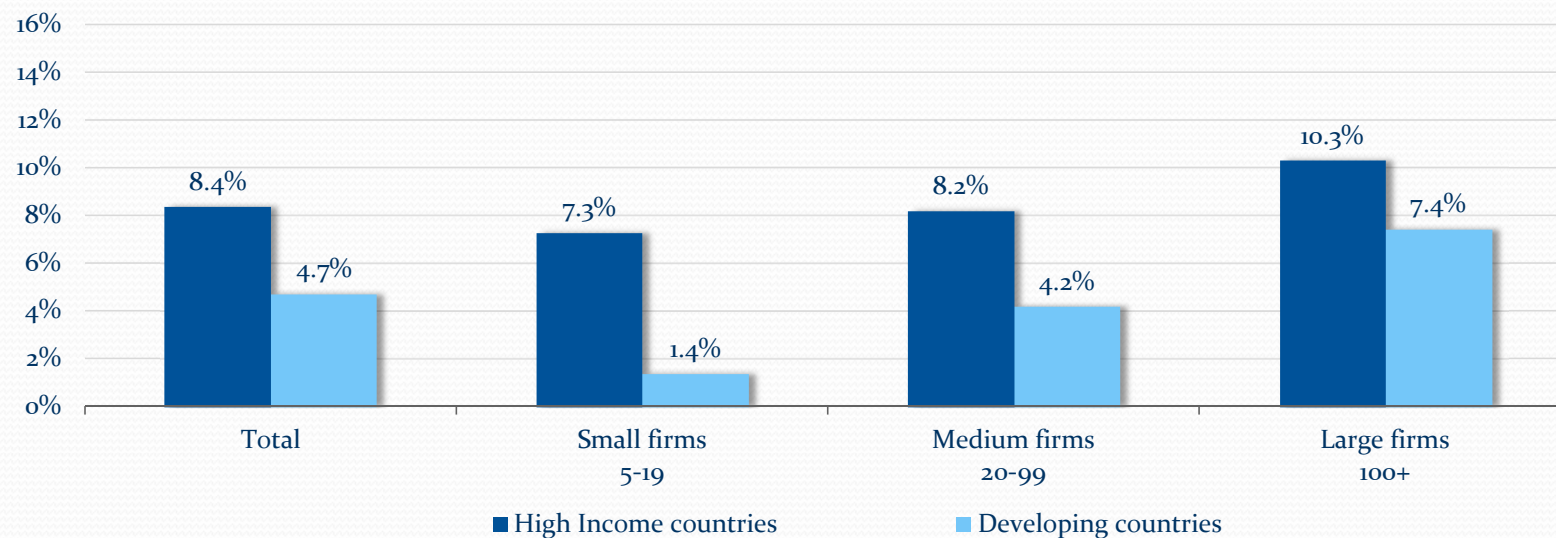
- **Sustainably extending maturity structure is a key policy challenge (Global Financial Development Report 2015/16)**
  - Firms become vulnerable to roll-over/liquidity risk and therefore reluctant to undertake fixed investments with adverse consequences for growth
  - Long-term finance is also critical for investments in infrastructure
- **LT finance is disproportionately affected by market failures and policy distortions**
  - LT finance is “scarce” if it is optimal but undersupplied due to market failures and policy distortions
- **Increased policy interest in recent years**
  - Global financial crisis decreased availability for some segments (syndicated loans; widened financing gaps, for example for SMEs and infrastructure investment)
  - G-20/G-30 – voiced policy concern calling for policy measures to remove the barriers that constrain provision of LT finance.

**FIGURE 0.4** The Relationship between Greater Financial Depth and Longer Debt Maturity by Country Income Group, 1999–2012



# Use of long-term debt by firms is more limited in developing countries, particularly for SMEs

Firms' Median Long-Term Debt to Assets Ratio Across Countries and by Firm Size, 2004-2011

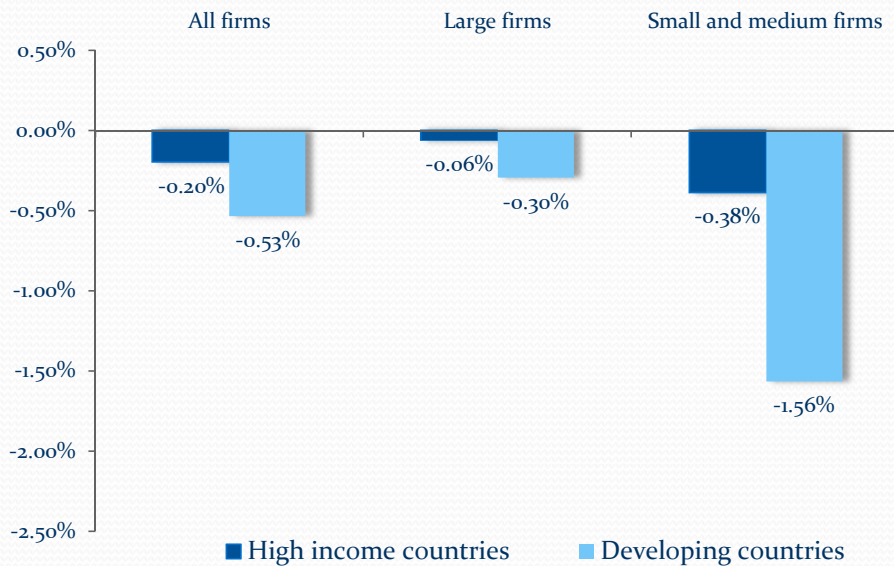


Source: GFDR 2015/16 and Demirguc-Kunt, Martinez Peria and Tressel, 2015

# Use of debt and long-term finance reduced since the global financial crisis

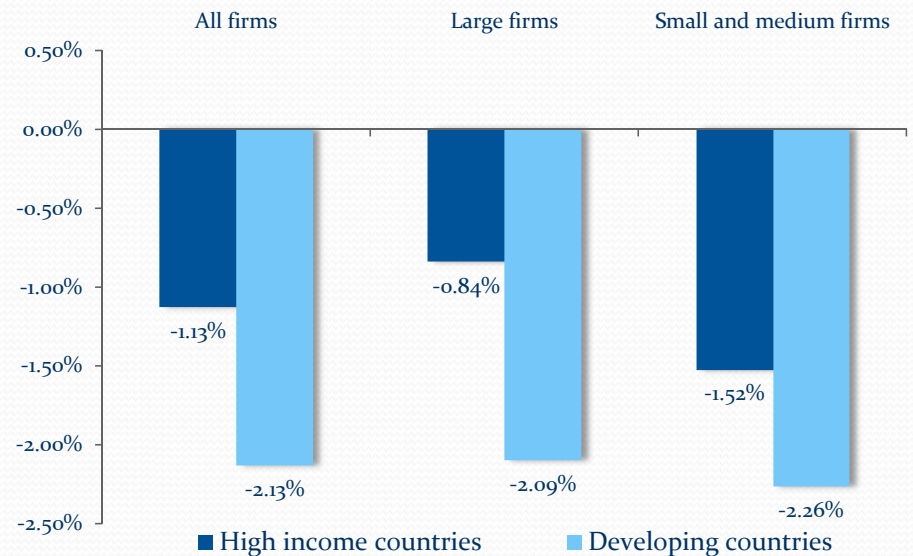
## First a reduction for SMEs in developing countries

Average Change in Long-Term Debt to Total Assets between 2004-07 and 2008-09



## Then spread, but impact remains larger in developing countries and for SMEs

Average Change in Long-Term Debt to Total Assets between 2004-07 and 2010-11



Source: Demirguc-Kunt, Martinez Peria and Tressel, 2015

## Lending to SMEs, especially at longer maturities, inhibited by informational problems and transaction costs (Global Financial Development Reports 2014 and 2015/16)

- SMEs often do not have adequate records and accounts to document firm performance when applying for a loan
- To compensate for missing information, lenders may ask for collateral, but SMEs often lack adequate collateral
- High fixed costs of financial transactions (or of contract enforcement) render lending to small borrowers unprofitable
- Higher lending costs and greater risks are reflected in higher interest rates and fees for SMEs than for larger firms



# Direct state interventions to enhance access to credit can be problematic

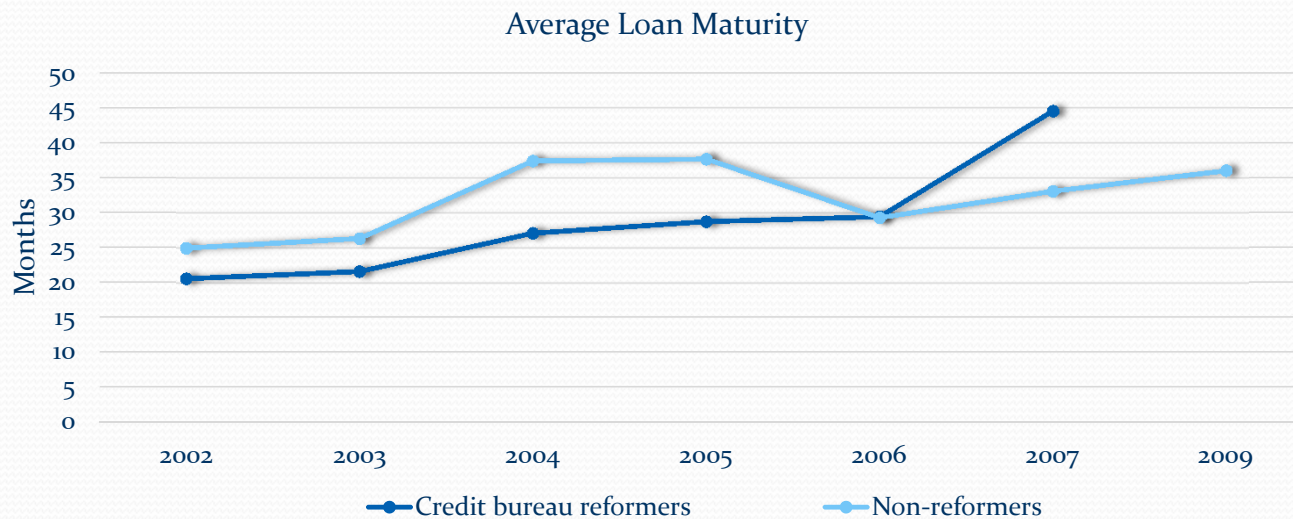
- Range of interventions:
  - State-owned banks
  - Directed credit
  - Subsidies
- Underlying institutional problems often remain unaddressed
- Political capture impedes effectiveness

# To facilitate access to credit and lengthening of its maturity, policy should promote

- Political and macroeconomic stability
- Contestable and sound financial system with strong regulation and supervision of banks
- Strong legal and contractual environment that protects creditor rights
- Market-oriented government policies to strengthen financial infrastructures
  - Credit information sharing (private credit bureaus)
  - Movable collateral laws and registries
  - Creditor rights (e.g. insolvency regimes) and contract enforcement
- ... and to promote diversification of instruments (credit guarantees with strong governance and incentives, legal framework for factoring and leasing)

# Credit bureaus foster access to finance

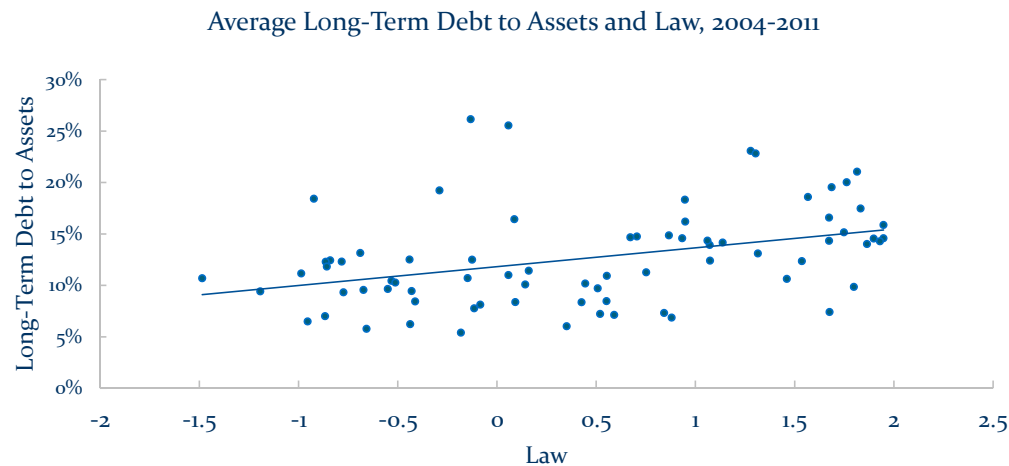
- Information sharing through credit bureaus reduces lenders' need to monitor and discipline firms through short-term debt (Magri 2010)
- Firms' use of external finance and average loan maturity lengthens after the introduction of a private credit bureau, but not after the introduction of a public credit registry (GFDR 2015/16 and Martinez Peria and Singh 2014)
- Beneficial effects are more pronounced for smaller, less experienced, and more opaque firms.



Most credit bureau reformers introduced a credit bureau in 2004 or 2005

# Sound legal environment and creditor rights help improve SME access to finance

- Firms tend to use more external financing and longer maturities with a more efficient legal system and better developed contracting environment and these results are causal: creation of Debt Recovery Tribunals in India (Gopalan et al. 2014)
- A sound legal environment and better enforcement of contracts are positively associated with the use of long-term debt especially for SMEs (Demirguc-Kunt, Martinez Peria, Tressel, 2015a).



Source: Demirguc-Kunt, Martinez Peria and Tressel, 2015

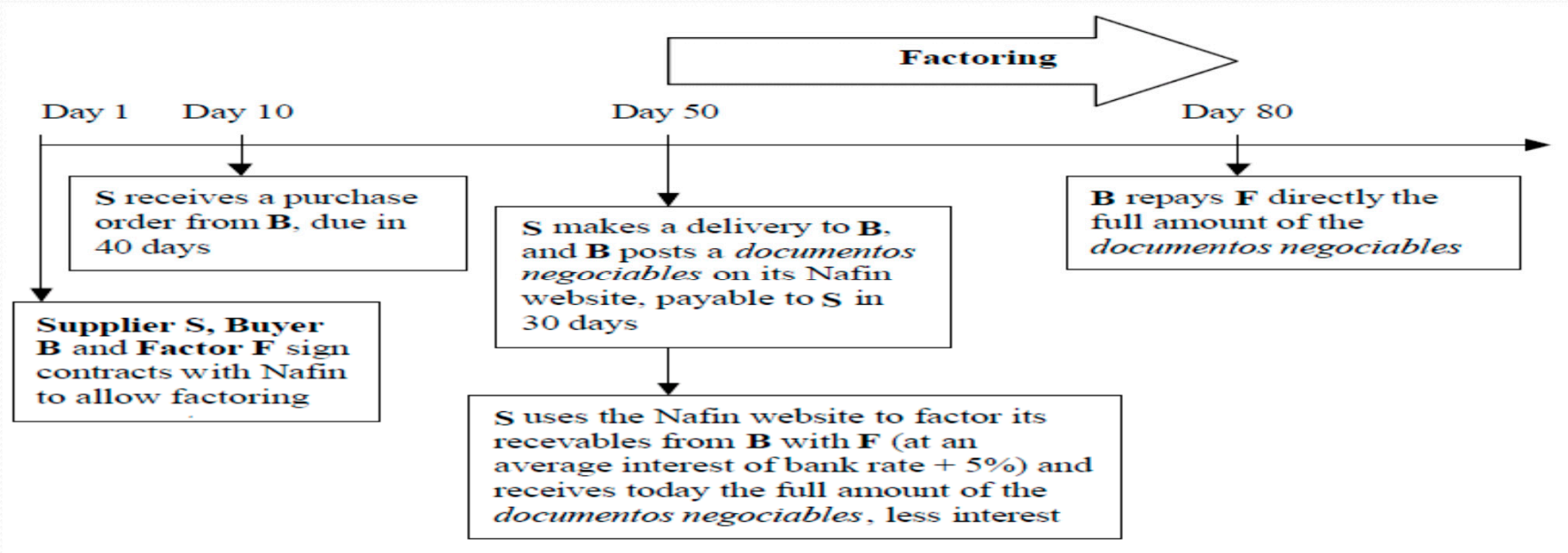
Legal efficiency and better contract enforcement tend to disproportionately foster the use of long-term debt by privately-held firms relative to publicly-listed firms, and by SMEs relative to large firms

# Movable collateral laws and registries can help access credit, especially for SMEs

- Most loans require collateral that SMEs don't have
  - SMEs tend to have more movable assets, such as machinery or equipment, than immovable property
  - Banks are often reluctant to accept movable assets as collateral
    - 90% of movable property that could serve as collateral for a loan in the U.S. would likely be unacceptable in Nigeria
- Appropriate laws
  - Do not impose limits on what can serve as collateral
  - Allow creditors to seize and sell collateral privately
  - Give creditors first priority over collateral
- Introduction of movable collateral registries has been found to increase SMEs' access to finance (Love, Martinez-Peria and Singh, 2014)

# Factoring relies on credit risk of larger firms and can facilitate working capital finance for SMEs

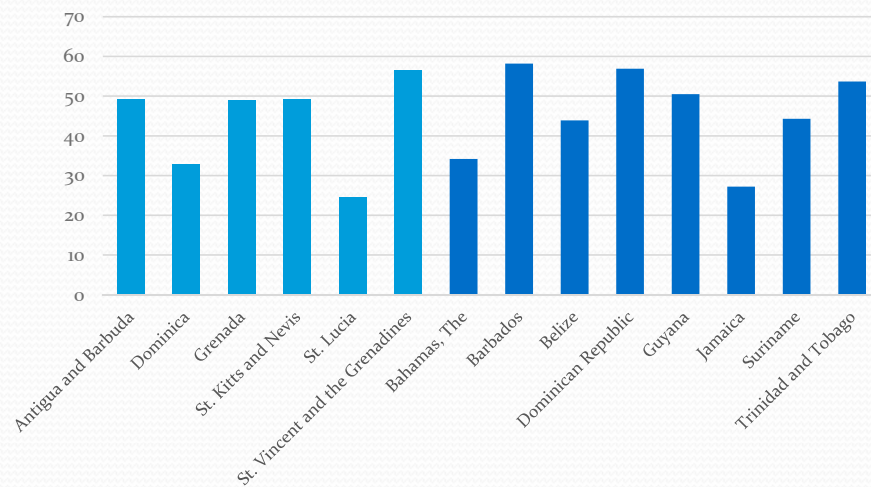
NAFIN in Mexico (Klapper 2005)



- Factoring requires an appropriate legal framework
  - For example, allow firms to transfer receivables to the factor, giving the factor the right to enforce payment without further consent of the firm

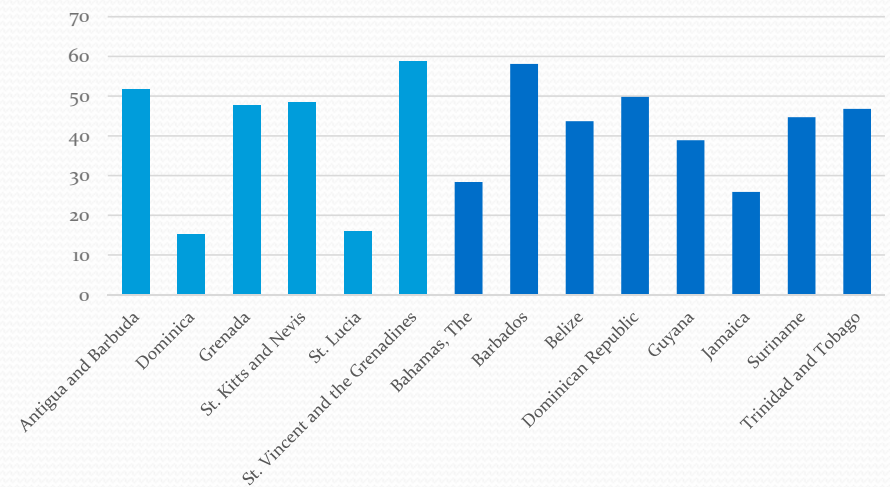
# Use of bank credit in the Caribbean

Firms with a bank loan or line of credit (%), 2011



Source: Global Financial Development Database, World Bank.

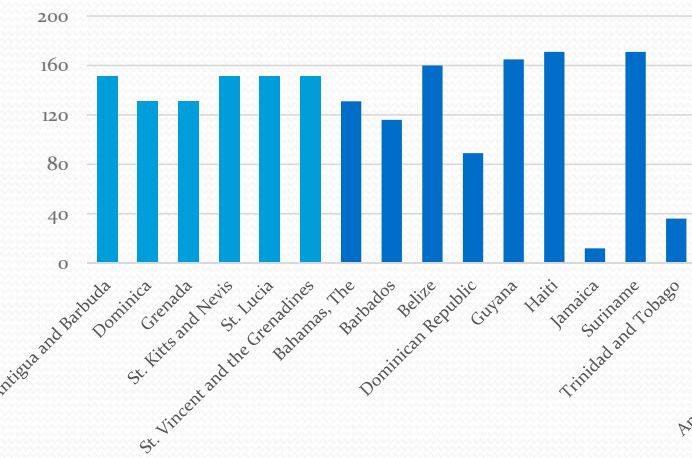
Small firms with a bank loan or line of credit (%), 2011



Source: Global Financial Development Database, World Bank.

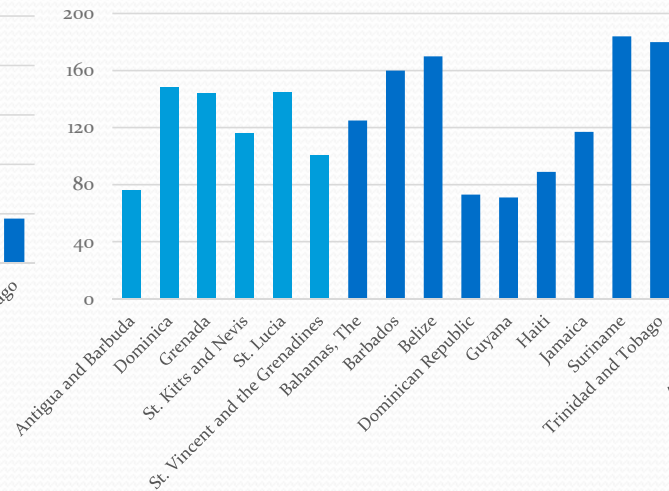
# Low Doing Business Rankings in the Caribbean

Getting credit, national rankings, 2014



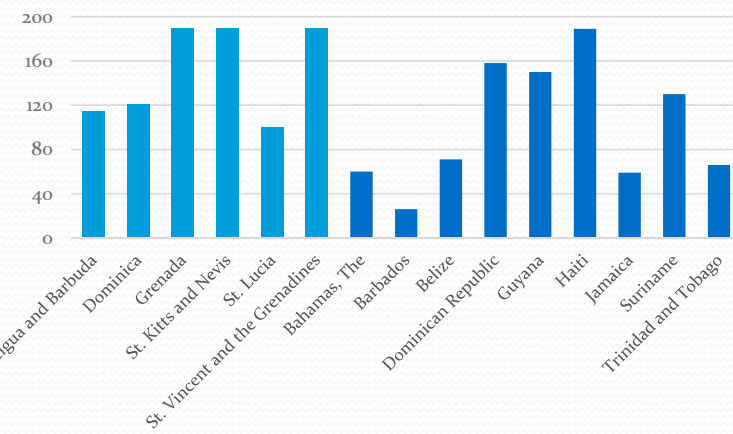
Source: Doing Business, World Bank.

Enforcing contracts, national rankings, 2014



Source: Doing Business, World Bank.

Resolving insolvency, national rankings, 2014



Source: Doing Business, World Bank.





# Diagnostic in Caribbean countries

- Supply: Bank-based collateral based financial system, crowding out by sovereign
- Demand: many small firms with credit risk (NPLs)
- Weaknesses in infrastructure (information sharing, resolving insolvencies, enforcement)

# Policy implications

- Institutional platform: The Caribbean Growth Forum (CGF) launched in 2012 help shape national agenda of growth enhancing reforms and track the implementation of actions
- Sound banking system with good risk management (address NPLs)
- Diversify lending instruments
- Continued effort in strengthening credit infrastructure:
  - credit bureaus
  - insolvency regimes and creditor rights
  - movable collateral registries

# Ongoing World Bank projects

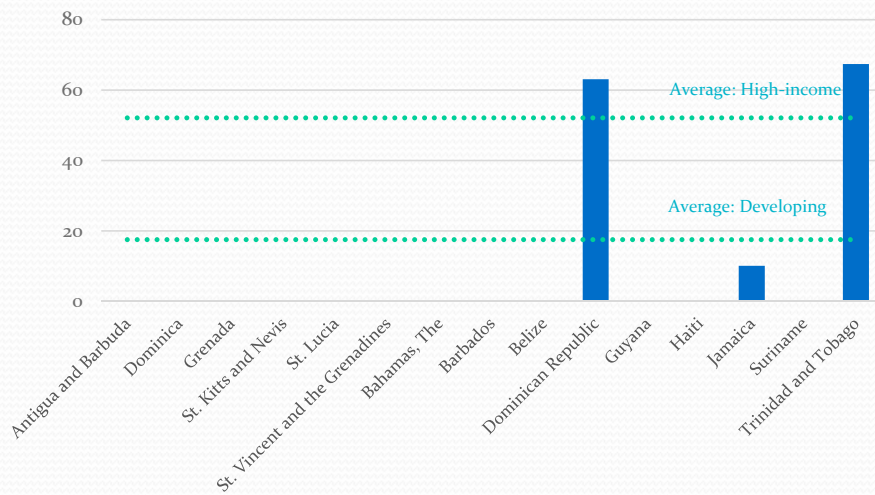
- Caribbean Credit Bureau Project - Caribbean wide : helped Guyana, Belize, Barbados, Bahamas, OECS to develop a regulatory framework for credit bureaus
- Insolvency legislation : helped Trinidad and Tobago develop insolvency regulations; currently working with St Lucia on a new insolvency legislation
- Movable collateral registry : ongoing work in the Dominican Republic and Saint Lucia
- SME guarantee fund : current work in Jamaica and OECS
- Financial consumer protection and financial inclusion strategy : Jamaica



Additional slides

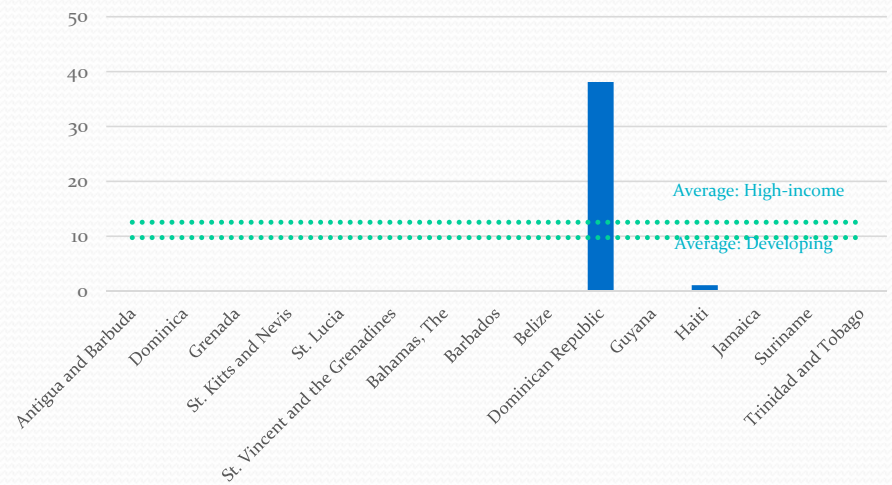
# Information sharing

Credit bureau coverage (% of adults), 2014



Source: Doing Business, World Bank.

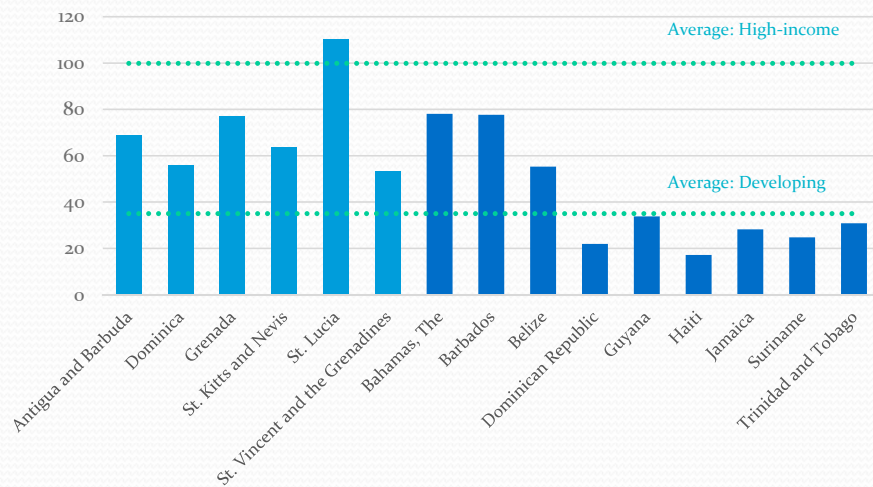
Credit registry coverage (% of adults), 2014



Source: Doing Business, World Bank.

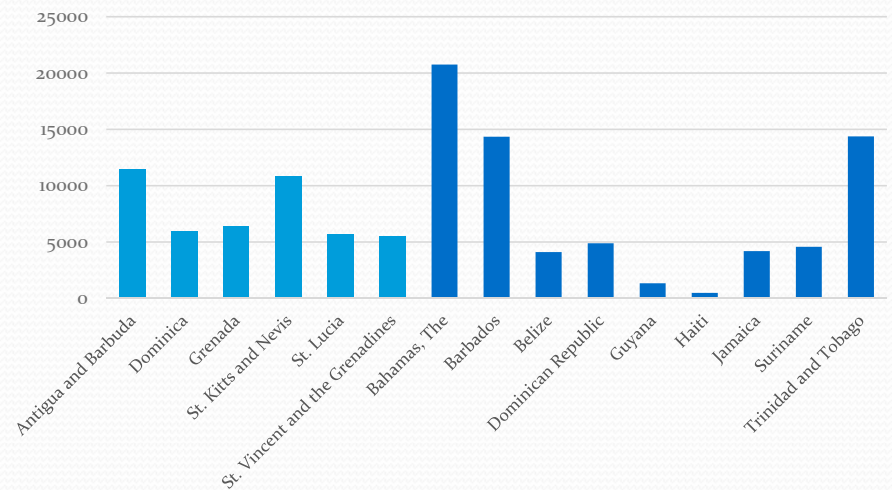
# Financial development

Private credit by depository money banks to GDP, 2013



Source: Global Financial Development Database, World Bank.

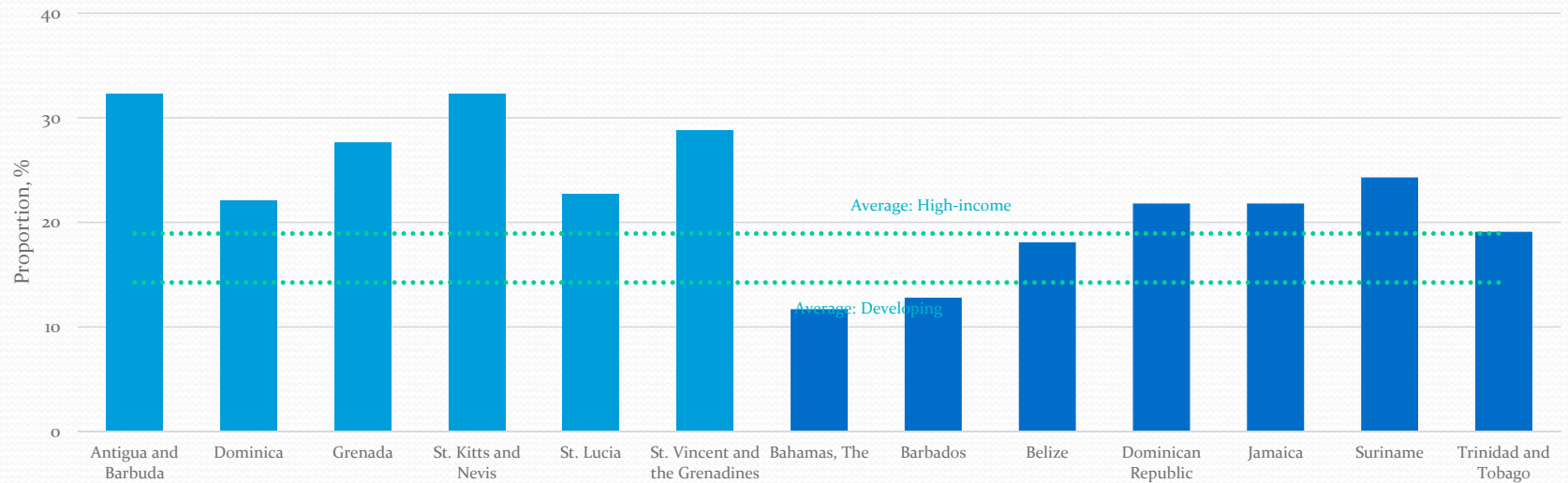
GDP per capita, constant 2005 USD, 2013



Source: World Development Indicators, World Bank.

# Financing of investment

Fixed investments financed by banks, all firms, 2010



Source: Enterprise Surveys, World Bank.