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Independent Evaluation Department

CONNECTING THE DOTS

EVIDENCE THAT DRIVES CHANGE

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Unlocking the Potential of SMEs:

Innovative Financing, Risk Management, and Capacity Building

As the European Bank for Reconstruction and Development (EBRD), prepares its updated vision with the Strategic and Capital Framework, the Financial Institution Strategy, and the expansion to Sub-Saharan Africa, it is important to look at what evaluative evidence reveals about (M)SME financing – a key component of the Bank's work.

(Micro-)Small and Medium-sized Enterprises (M-SMEs)[1] are pivotal in driving economic growth and employment in developing countries and emerging economies, contributing significantly to GDP and job creation. However, their potential is hindered by a persistent financing gap – a market failure restricting their access to essential capital for growth and innovation. This stifles their efficiency and growth and reflects a broader market inefficiency in allocating resources to where they can be most impactful. In a dedicated report[2] on the (M)SME finance gap, the World Bank Group estimates that in developing economies financing gaps are even larger than previously anticipated. About 65 million or 40% of formal (M)SMEs in developing countries cannot get credit, for an unmet financing need of $5.2 trillion every year, which is equivalent to about 19% of these countries' GDP. This demands a strong response.

Multilateral development banks (MDBs) are well placed to address such market failures, because they promote fair growth and inclusiveness, especially in communities that lack services.

This issue of the "Connecting the Dots" series is a synthesis of evaluation insights on (M)SME financing and development. From a thorough review of more than 80 independent evaluation reports covering SME development and financing published since 2008 by nine evaluation departments of major International financial institutions (IFIs), eight insights have emerged.

[1] This report is a synthesis of evaluative insights from MDBs – notably the IFC, WB, AfDB, ADB, EIB, and EBRD. In it we refer to (M)SMEs as defined by each of the institutions whose evaluative insights are referred to in each section of this work. EBRD, within the context of the Small Business Initiative (SBI), classifies SMEs as enterprises that employ less than 500 people and have either an annual turnover not exceeding €50 million or an annual balance sheet not exceeding €43 million.

[2] WBG, 2017. MSME Finance Gap: Assessment of the shortfalls and opportunities in financing Micro, Small and Medium Enterprises.

8 key evaluation insights
for unlocking the potential fo SMEs

These eight evaluation findings are organized into strategic and operational lessons. They reveal some facts and key considerations for IFIs to bear in mind to fully harness the power of SME development.

Strategic-level

1

Effective SME support addresses supply, demand, and regulatory constraints holistically

2

Supporting regulations, policies, and robust financial infrastructure reduces SME financing costs

3

Blending donor and institutional funds bridges SME program resource gaps

Operational-level

4

Clear SME definitions help target, design, and monitor programs

5

Innovation and local presence balance costs and unlock SME growth potential

6

Indirect financing strengthens local value chains by empowering financial institutions

7

Risk-sharing and co-financing bridge SME lending risk gap effectively

8

Addressing the diverse needs of SME subsegments is extremely important

Strategic-level evaluation insights

1

Activities supporting SME development are most effective when they address both supply and demand-side constraints and take a holistic approach through enhanced financial infrastructure and enabling policies and regulatory frameworks.

SME financing is shaped by market supply and demands constraints. Access to finance is crucial, but it is not the only factor limiting SME development. SME growth hinges on other elements such as financial infrastructure and a supportive regulatory environment. In its evaluation, *The Big Business of Small Enterprises*[3] the World Bank[4] emphasizes "sequential engagement" in financial inclusion, highlighting the need for broader systemic reforms to develop SMEs, including enhanced infrastructure, skilled workforce access, and improved management practices.

To support SME growth, a comprehensive approach including policy reforms, regulatory improvements, and innovative financing is essential. The EBRD's Small Business Initiative (SBI) exemplifies such a strategic, multifaceted approach, focusing on financing, advisory services, and policy dialogue **across five pillars** — direct financing, indirect financing, co-financing/risk-sharing, business advisory services, and policy dialogue — to comprehensively meet SME needs. Lessons from the first evaluation of the SBI approach5 emphasize adapting to local markets, enhancing local financial and advisory capacities, and maintaining government dialogue as crucial to nurturing a favourable business climate. Evaluations from MDBs stress the role of policy dialogue and technical assistance in overcoming systemic growth barriers, urging increased coordination among MDBs, governments, and partners for a cohesive support strategy. These evaluations, including ADB's validation of *Strategies to Support Small and Medium-Sized Enterprises in the People's Republic of China and Mongolia*[6], advocate for strategic alignment with country strategies and stakeholder engagement as critical for success.

Barriers such as limited banking capacity and regulatory challenges create a need for innovative financial products and policy-based solutions to facilitate SME financing. *The Evaluation of the EIB Group Risk Enhancement Mandate*[7] highlights how the geographic concentration of EIB Risk Enhancement Mandate (EREM)[8] reflects disparities in market sophistication and the impact of regulatory frameworks on the uptake of financial instruments. Innovative financial products -- insurance, leasing, fintech, and peer-to-peer financing, among others -- have emerged as partial solutions to overcome regulatory constraints.

These innovations underscore the potential for policy-based loans and technical assistance in promoting beneficial laws and regulations, as shown in IDB's *Evaluation of Work Through Financial Intermediaries*[9] and the ADB's *Kazakhstan: Small and Medium Enterprise Investment Program Validation.*[10] These instruments can be particularly effective in addressing the financing constraints faced by SMEs.

To support SME growth, a comprehensive approach including policy reforms, regulatory improvements, and innovative financing is essential

[3] WBG, 2014. *The Big Business of Small Enterprises: Evaluation of the World Bank Group Experience with Targeted Support to Small and Medium-Size Enterprises between 2006-12.*
[4] WBG, 2023. *Financial Inclusion: Lessons from WBG Experience 2014-22.*
[5] EBRD, 2017. *Evaluation of the Small Business Support Programme.*
[6] ADB, 2021. *Strategies to Support Small and Medium-Sized Enterprises in the People's Republic of China and Mongolia.*
[7] EIB, 2021. *Evaluation of the EIB Group Risk Enhancement Mandate.*
[8] EREM is the EIB Group Risk Enhancement Mandate. It includes a number of different products used as alternative financing tools to meet market needs. EREM consists of: EREM Asset-Backed Securities (ABS) Credit Enhancement, EREM Cooperative Banks & Smaller Institutions (CBSI), EREM SME Initiative (contribution to the upper mezzanine tranche of the overall SME Initiative structure), EREM Social Impact Finance.
[9] IDB, 2016. *Evaluation of IDB Group's Work through Financial Intermediaries: SME Finance Background Report.*
[10] ADB, 2019. *Kazakhstan: Small and Medium Enterprise Investment Program Tranche 2 Validation.*

2

Evaluation evidence shows that supporting efficient regulations and policies alongside a robust financial infrastructure is essential to reduce the costs associated with SME financing.

Combining policy initiatives with financing and business advisory services has been effective. *EBRD's Agribusiness Strategy Evaluation (2019–23)*[11] showed that integrating policy dialogue with financing and advisory services effectively addressed sectoral challenges and made it easier for SMEs to access finance by strengthening local banks' abilities to assess and manage risks related to agribusiness operations. Mechanisms like the Risk Sharing Facility have also proven effective in easing access to finance, not least because they reduce the perceived risk of lending to SMEs and reduce collateral requirements. IEVD's evaluation, *EBRD Women in Business Programme in Turkey*,[12] similarly underscores the critical role of regulations, policies, and robust financial infrastructure in enhancing SMEs' access to finance, particularly women-led enterprises. The evaluation pointed out that the First Loss Risk Cover was a critical element that served as an effective risk-sharing mechanism and incentivized lending to riskier segments like women-led SMEs (WSMES).

External evaluations, such as the *Assessment of EBRD's operations under the Small Business Impact Fund*[13], also emphasize the pivotal role of regulations, policies, and robust financial infrastructures in reducing the costs associated with SME financing. The ADB's validation in the Maldives[14] highlights the successes and difficulties of creating supportive frameworks and infrastructure for SME financing – and draws a similar conclusion on the significance of policy support.

Lastly, evaluations such as IDB's *Evaluation of Work Through Financial Intermediaries: SME Finance Background Report*[15] emphasize the role of financial infrastructures such as credit bureaus and collateral registries and a strong regulatory framework in enhancing SME lending. Outdated creditor protection laws and excessive capital requirements have been identified as barriers to lending to smaller businesses.

3

Blending donor funds with institutional funding has proven effective in addressing resource gaps for SME support programs.

Leveraging a mix of donor funds and institutional funding addresses resource gaps and enhances the financial stability of SME support programs. Evaluative evidence shows how this approach not only leverages the strengths of different funding sources but also enhances the financial stability and reach of these programs. Blending donor funds with institutional funding (e.g., EBRD funding through the Shareholder Special Fund) can fill gaps in donor resources, enhancing the financial stability of SME support programs.

[11] EBRD, 2023. *Food for Thought in Challenging Times: Evaluation of the Agribusiness Strategy 2019–23.*
[12] EBRD, 2020. *EBRD Women in Business Programme in Turkey – EvD Review.*
[13] EBRD, 2022. *Assessment of EBRD's operations under the Small Business Impact Fund.*
[14] ADB, 2020. *Maldives: Inclusive Micro, Small, and Medium-Sized Enterprise Development Project Validation.*
[15] IDB, 2016. *Evaluation of IDB Group's Work through Financial Intermediaries: SME Finance Background Report.*

Operational-level evaluation insights

4 Clear definitions of small and medium enterprises (SMEs) across organizations and financial intermediaries can help target beneficiaries, design effective programs, and accurately monitor outcomes.

Evidence from evaluations by the IDB Group[16] and the World Bank Group[17] illustrates the complications arising from differing SME definitions, leading to challenges in measuring program impact and growth, and potentially hindering the delivery of effective services and the relevance of projects.

Lack of a clear (M)SME definition "makes it difficult to assess the relevance of the research findings for SMEs and their generalizability across different contexts" and hinders data collection and monitoring, according to a World Bank evaluation.[18]

Evaluation evidence advocates for definitions that are both relevant to local contexts and practical, with clear criteria that can accommodate SME subsegments such as WSMEs, thereby bolstering the efficacy and efficiency of development efforts.

5 Innovation and local presence are key to balancing costs and opportunities associated with direct SME financing and to unlocking the potential for SME growth beyond what the market can provide.

Direct financing to SMEs presents challenges of scalability and sustainability and requires a unique blend of conditions to be effective. Reflecting on the EBRD's approach compared to that of other MDBs, the IDB's *Evaluation of Direct Support to SMEs*[19] highlights the critical role of a strong local presence in enabling direct SME financing to understand and meet SMEs' needs effectively and to ensure swift processing times.

Where financing options for small businesses are scarce, the EBRD steps in to provide direct funding, targeting companies with clear growth potential. The EBRD's strategy involves providing direct funding to SMEs having potential for growth and supplementing financial aid with business advisory services to enhance management practices and operational efficiency.

SMEs can benefit from value-chain development and technical assistance that the market cannot provide. An example from EBRD's Agribusiness evaluation[20] in Tunisia shows the effectiveness of EBRD support in improving olive oil quality and brand development for export through targeted technical assistance and training programs.

Direct financing to SMEs can be resource-intensive by demanding that MDBs be fully engaged with beneficiaries, willing to absorb associated risks, and deeply knowledgeable about the local business environment. Innovative models like EBRD's Venture Capital Investment Programme demonstrate how operational efficiencies and external advisory input can reduce costs and foster targeted support for innovation, according to IEvD's *Evaluation of the Venture Capital Investment Programme*.[21] For example, involving an external advisory committee for project appraisal enhanced program agility and alignment with market practices and enabled targeted, efficient support for innovation.

[19] IDB, 2017. *Evaluation of Direct Support to SMEs by the IIC.*
[20] EBRD, 2023. *Food for Thought in Challenging Times: Evaluation of the Agribusiness Strategy 2019–23 and early results of its implementation.*
[21] EBRD, 2023. Financing for Innovation An evaluation of the Venture Capital Investment Programme I (2012-2019)

6 Evaluation work highlights that indirect financing through financial institutions (FIs) enhances local value chains and strengthens the financial ecosystem by empowering the FIs.

Indirect SME financing enhances local capacity and FI value chains, diversifying funding sources and leveraging local expertise and networks – including unlocking local currency funding to mitigate foreign exchange volatility for SMEs. This approach has proven effective, according to evaluations from the IDB Group,[22,23] and the ADB.[24] It also works well across various financing strategies and during crises, showing its resilience and adaptability. Local currency lending is crucial in reducing the risks of SME funding, as both ADB's evaluation[25] and the FCDO's evaluation[26] demonstrate, stressing the importance of aligning loan and operational currencies to prevent exchange rate risks.

Besides commercial banks, cooperative banks and smaller institutions can often better meet the needs of SMEs because of their local ties, as noted by the EIB.[27] The use of non-sovereign guarantees and SME securitisation,[28,29] supports local currency financing and addresses liquidity needs by elevating bonds to investment grade and facilitating the sale of bundled loans to investors. Indirect financing, supplemented by diverse financial mechanisms, therefore offers a scalable, cost-efficient solution to bolster SME financing, underscoring the necessity for targeted interventions to meet SMEs' varied financing needs. Embracing a variety of financing mechanisms, including guarantees and securitization, can further support these diverse needs, demonstrating that tailored interventions are needed to address the range of challenges SMEs face in accessing finance.

7 Risk-sharing and co-financing are proven to be very effective at bridging the gap between the real and perceived risks of SME lending.

Evaluation evidence[30] highlights the benefits of combining grants, concessional financing, and risk-sharing to enhance lending terms and mitigate the risk for SMEs. Despite the high perceived risk of SME financing, mechanisms such as blended finance can alleviate investor concerns, as demonstrated by the EBRD's support to El-Roda in Egypt and for biomass boiler projects in Ukraine.[31] The World Bank's evaluation findings[32] emphasize the effectiveness of the International Development Association's Blended Finance Facility in strengthening SMEs through a mix of funds and IFC investments. Risk-sharing measures such as the financial guarantees in the IFC's support to the Bank of Africa in Ghana, not only reduce collateral requirements for MSMEs but also promote lending growth, proving their worth in encouraging banks to finance higher-risk SMEs. The EBRD's evaluation of the Risk Sharing Framework[33] further illustrates the importance of such strategies in enabling SME projects, especially in challenging markets like Central Asia, by facilitating transactions that would be unviable through direct lending alone.

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22 IDB, 2016. *Evaluation of IDB Group's Work through Financial Intermediaries: SME Finance Background Report.*
23 IDB, 2017. *Evaluation of Direct Support to SMEs by the IIC.*
24 ADB, 2020. *Synthesis Note: Responding to COVID-19: Lessons from Previous Support to Micro, Small, and Medium-Sized Enterprises.*
25 Ibid.
26 FCDO, 2021. *Evaluating CDC's Financial Institutions Portfolio.*
27 EIB, 2020. *Evaluation of Cooperative Banks and Smaller Institution Instruments.*
28 IDB, 2022. *Corporate Evaluation: Evaluation of Guarantee Instruments at the IDB Group.*
29 EIB, 2017. *Operations Evaluations: Evaluation of the EIF's Securitisation Activities 2004-2015.*
30 EBRD, *2023. Food for Thought in Challenging Times: Evaluation of the Agribusiness Strategy 2019–23*
31 Ibid.
32 *WBG, 2019.* World Bank Group Support for Small and Medium Enterprises: A Synthesis of Evaluative Findings.
33 EBRD, 2023. *Food for Thought in Challenging Times: Evaluation of the Agribusiness Strategy 2019–23*

8 SMEs are not homogenous and face different barriers to success and finance. Addressing the diverse needs of SME subsegments is extremely important.

Evaluation evidence suggests that targeted approaches, particularly for groups like women entrepreneurs or the "missing middle" of aspiring female entrepreneurs, require distinct project designs, data management, and deliberate strategies for engagement.[34]

Without such specificity from the outset, projects may struggle to reach their intended audiences effectively. ADB's synthesis note on Covid-19[35] stresses the importance of integrating gender considerations and the use of sex-disaggregated data throughout the project lifecycle to improve monitoring and clarity on impacts and the project's theory of change. Similarly, EBRD's targeted financing and advisory services, like Women in Business and Youth in Business indirect lending programs, or direct financing such as the Direct Financing Facility for SMEs, and the Venture Capital Investment framework are recognized as appropriate to help and address the growth challenges unique to each different segment and target group.[36,37,38]

Effective project design and comprehensive monitoring, emphasizing the importance of detailed market studies prior to implementation, are critical for SME financing programs to be successful, as various evaluations assert, including those of IEVD[39] and the Office of Evaluation and Oversight of IDB's[40] assessments. These evaluations reveal challenges in attributing SME financing outcomes to specific interventions, pointing to a gap in connecting finance access with improvements in SME performance. This calls for clear eligibility criteria, specific indicators for tracking development outcomes from the outset, and a robust understanding of program contributions to key performance indicators.

Targeted approaches, particularly for groups like women entrepreneurs or the "missing middle" of aspiring female entrepreneurs, require distinct project designs, data management, and deliberate strategies for engagement.

[34] IFC, 2019. *Banking on SMEs: Trends and Challenges Perspectives from SME Banking Leaders*
[35] ADB, 2020. *Synthesis Note: Responding to COVID-19: Lessons from Previous Support to Micro, Small, and Medium-Sized Enterprises.*
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[37] EBRD, 2023. *Financing for Innovation An evaluation of the Venture Capital Investment Programme I (2012-2019).*
[38] EBRD, 2018. *Operation Evaluation: National Bank of Egypt, SME Loan, Women in Business Loan, and Energy Efficiency Loan.*
[39] EBRD, 2017. *Evaluation of the Small Business Support Programme.*
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