Expanding Access to Finance for SMEs in Honduras

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Abstract

Small and medium-sized enterprises (SMEs) are critical for the economic development of countries like Honduras, yet this segment faces a significant financing gap hindering its growth and productivity potential. Action to expand access to finance for SME is imperative considering financing is “the enabler” for the development of these companies. The objective of this study is to identify ways to expand access to financial services for SMEs in Honduras, focusing mainly on the role of financial intermediaries in the country. Two experts on SME finance from the Inter-American Development Bank (IDB) and the International Finance Corporation (IFC) were interviewed on the subject. Drawing from the work and experiences of the IDB and IFC, literature review, and the characteristics of the Honduran market, recommendations for a country initiative to expand access to finance for SMEs in Honduras are given. Finally, SME finance models identified as best practices are presented as a way to share valuable insights with financial intermediaries.

Introduction

Small and medium-sized enterprises (SMEs) are critical for the economic development of countries like Honduras, yet this segment faces a significant financing gap hindering its potential growth and productivity. Action to expand access to finance for SME is imperative considering financing is "the enabler" for the development of these companies. The objective of this study is to identify ways to expand access to financial services for SMEs in Honduras, focusing mainly on the role of financial intermediaries in the country. Drawing from the work and experiences of the IDB and IFC, literature review, and the characteristics of the Honduran market; recommendations for a country initiative to expand access to finance for SMEs in Honduras are given.

Expanding Access to Finance for SMEs in Honduras

I. Background

Different countries and international organization use their own guidelines to define "SMEs," and these may vary by number of employees, sales, or assets. For the purpose of this study, SMEs are defined based on the guidelines used by the International Finance Corporation in the World Bank's Enterprise Survey (See Appendix 1). Data from the Enterprise Survey, which measures different factors shaping the business environment within a country, is an important component of this study.[1]

Firm Size	Number of Employees
Micro	1-4
Small	5-19
Medium	20-99
Large	100+

SMEs as Key Actors of Economic Development

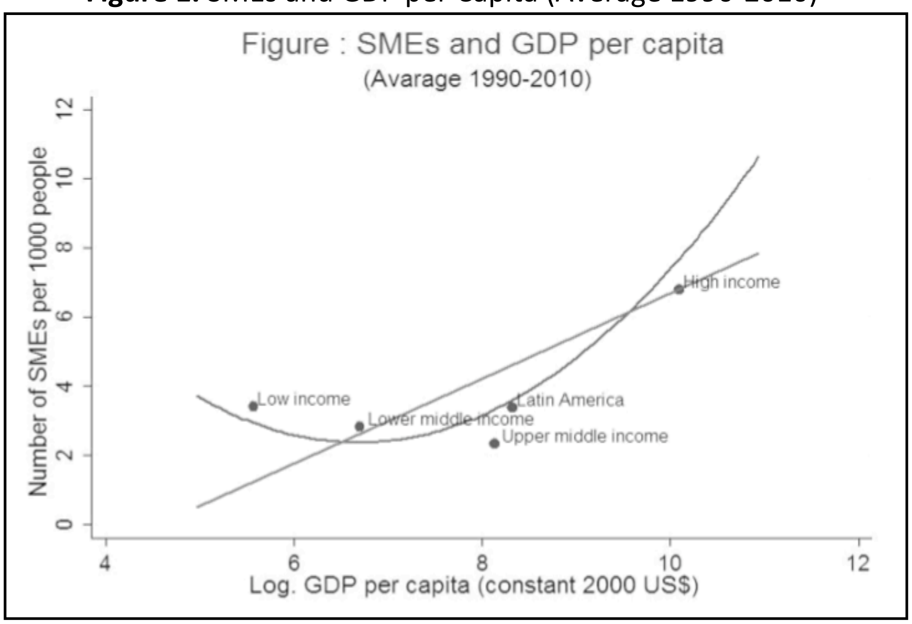
Small and medium sized enterprises (SMEs) constitute an innovative segment critical for economic development of emerging countries like Honduras. They play a major role in creating jobs, generating income for low-income people, fostering social stability, and the development of a dynamic private sector. Studies indicate that formal SMEs contribute up to 45% of employment and up to 33% of GDP in developing economies; and they could be having an even greater contribution.[2] "A typical Latin American country could have increased income per capita by 54% since 1960 if its income per capita if its productivity had grown like the rest of the world." [3]

[1] *Honduras Country Profile*. (2010). Enterprise Surveys. World Bank.
[2] *Scaling-Up SME Access to Financial Services in the Developing World.* (2010). International Finance Corporation.
[3] *The Age of Productivity*, *Development in the Americas.* (2010). IDB.

Honduras' decrease in productivity relative to the US between 1960-2005 was of -48%. The segment's contribution to economic growth in the Latin American region is being hindered by the so-called "missing middle."[4]

In Latin America, SMEs are generally smaller than in developed economies and they are less productive. One of the obstacles for formal SMEs in the region is uneven competition due to the large number micro and small firms operating in the informal sector. Structural factors mixed with costs factors push firms to the micro informal segment, or the large segment. Consequently, the middle ground shrinks bringing down overall productivity for the region. Poor performance of the segments is linked to both financial and non-financial barriers including weak institutional capacity leading, high transaction, high operational costs, and structural factors such as labor skill level.[5]

Figure 1. SMEs and GDP per Capita (Average 1990-2010)

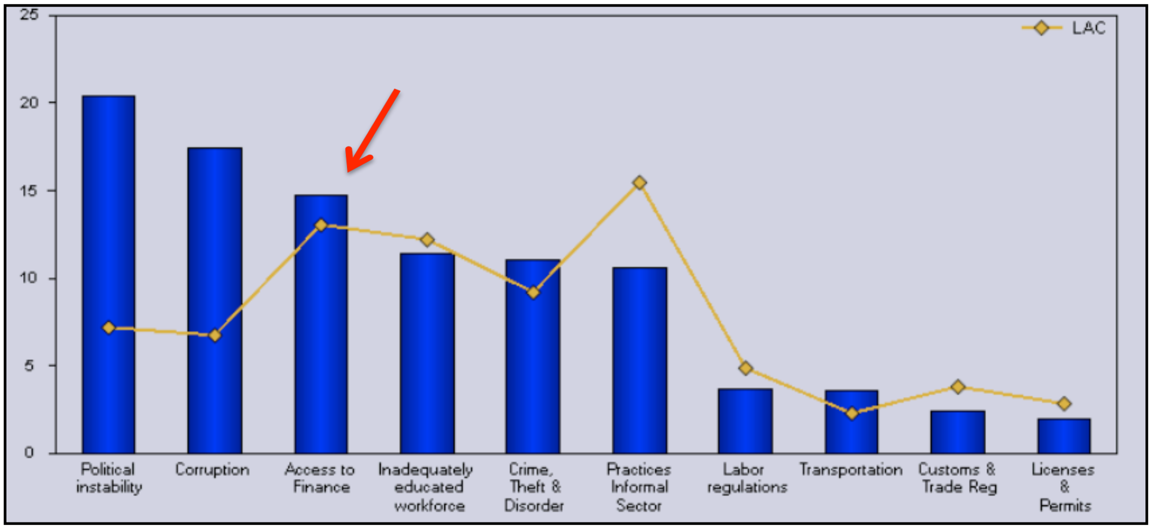


Source: IDB, 2011

[4] *The Age of Productivity*, *Development in the Americas.* (2010). IDB.
[5] Chrisney, Martin. The IDB's Role in Supporting SMEs. (2011). Inter-American Development Bank.

II. Top Business Environment Constraints in Honduras

Figure 2: Percentage of Firms Identifying the Problem as the Main Obstacle



Source: Honduras Country Profile, IFC Enterprise Survey (2010)

Access to Finance as a Key Constraint

Access to financial services is an essential driver of business expansion and is vital to develop a vibrant SME sector. In many emerging markets; however, access to financial services for SMEs remains severely constrained. Furthermore, research shows that in the developing world, access to finance is a greater obstacle for small firms than for large firms and the probability of being credit constraint decreases as firm size increases.[6] In Honduras, financial constraints are significantly greater for SMEs than for larger firms. Enterprise survey shows that 32.5% and 26% of small and medium firms, respectively, report access to finance as a major constraint for business development compared to 1.8% of large firms (See Figure 3).[7] As a result, this financial constraint impedes their growth and development as businesses.

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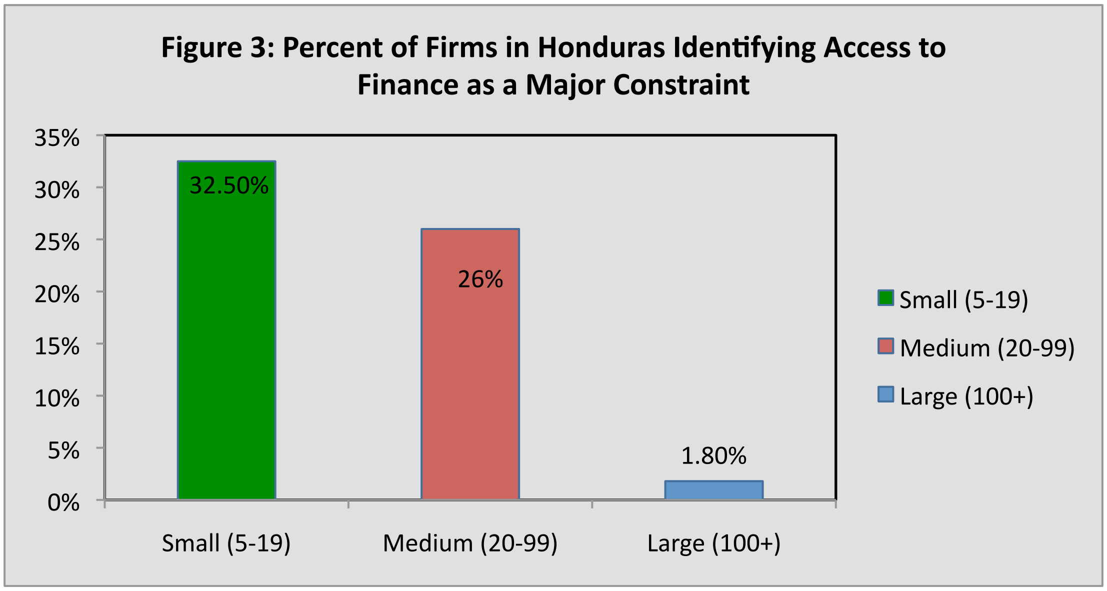
[6] *Scaling-Up SME Access to Financial Services in the Developing World.* (2010). International Finance Corporation.
[7] *Honduras Country Profile*. (2010). Enterprise Surveys. World Bank.



Source: Honduras Enterprise Survey Data, IFC (2010)

III. Non-financial Barriers to SME Development

SME development is usually hindered both by financial and non-financial barriers; which in some cases have very strong relationships. Costs incurred in registering property or enforcing contracts are closely related to the financial infrastructure. Removing these obstacles would result in an increase in collateralizable assets. Complicated regulatory procedures are a major constraint for SMEs who lack the capacity of larger firms to navigate through bureaucratic systems. Research shows that lower entry and registration costs promote formalization and result in growth of the SME segment.[8]

Some of the non-financial barriers Honduran firms report as their main business environment obstacles are political instability, corruption, inadequately educated workforce, practices of competitors in the informal sector, lack of electricity, and heavy regulations. Constraints disproportionately affect smaller firm more than large firms. For example, 65% of small firms identified corruption as a major constraint compared to 40% of large firms. Electricity

[8] *Scaling-Up SME Access to Financial Services in the Developing World.* (2010). International Finance Corporation.

was identified as a major constraint by 36% of small firms and 27% of medium firms, compared to 19% of large firms. About a quarter of small and medium firms considered business licensing, permits, and tax rates as a constraint compared to about 5-7% of large firms.[9] On top of these investment climate obstacles, certain characteristics of the SME itself like their lack of management skill and financial literacy can put them at a disadvantage when trying to access credit.

The Legal and Regulatory Framework

An effective legal and regulatory framework is crucial to preserve financial stability and promote access to finance. The framework includes the laws and regulations for financial markets, institutions, and instruments used in a country as well as the respective bodies of regulations and guidelines. In some cases, financial regulation such as interest rate ceilings can discourage lending to the SME segment.

Gaps in the legal and regulatory framework of developing countries becomes evident with the low levels of development of financing options such as leasing and factoring. In countries where financial infrastructure remains weak, legislation promoting leasing and factoring can help expand access to finance for SMEs. Surveys conducted by the World Bank show that banking regulations that promote market competition are an important driver of SME lending. Regulations allowing the entry of sound and efficient banks may reduce margins in traditional business lines and encourage banks to diversify into SME banking. Legislation that promotes leasing and factoring also promotes access to finance by SMEs, especially in environments where financial infrastructure remains weak.[10]

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[9] Honduras Enterprise Survey Data. (2010). IFC.
[10] *Scaling-Up SME Access to Financial Services in the Developing World.* (2010). International Finance Corporation.

IV. Financial Barriers to SME Development

While larger firms tend to rely more heavily on equity and formal debt financing, SMEs rely more heavily on trade credit and informal sources of finance. SMEs usually require financial services like cash management, insurance, and transfers; which can be offered by commercial banks. As firms grow, the availability of external sources of funding becomes crucial, and the lack of developed financial markets is a major constraint for SMEs in Honduras.[11]

SME Credit Gap

The lack of reliable and consistent sources of data on the SME segment and their access to financial services makes it difficult to quantify the SME finance gap; however, studies clearly indicate access to finance is a great challenge. The likelihood of a small firm having access to a bank loan in low-income countries is about a third of what it is for a medium-sized firm, and less than half of what it is for a larger firm.[12]

- SME Credit Gap Estimated at $50-60 billion in LAC[13]
- McKinsey estimates there are about 900,000 to 1.3 million formal sector SMEs in Latin America.
- 800,000 to 1.2 million of these SMEs have bank accounts but only 400,000 to 500,000 have a loan.
- More than 60% of SMEs in Latin America do not have a loan but need one.

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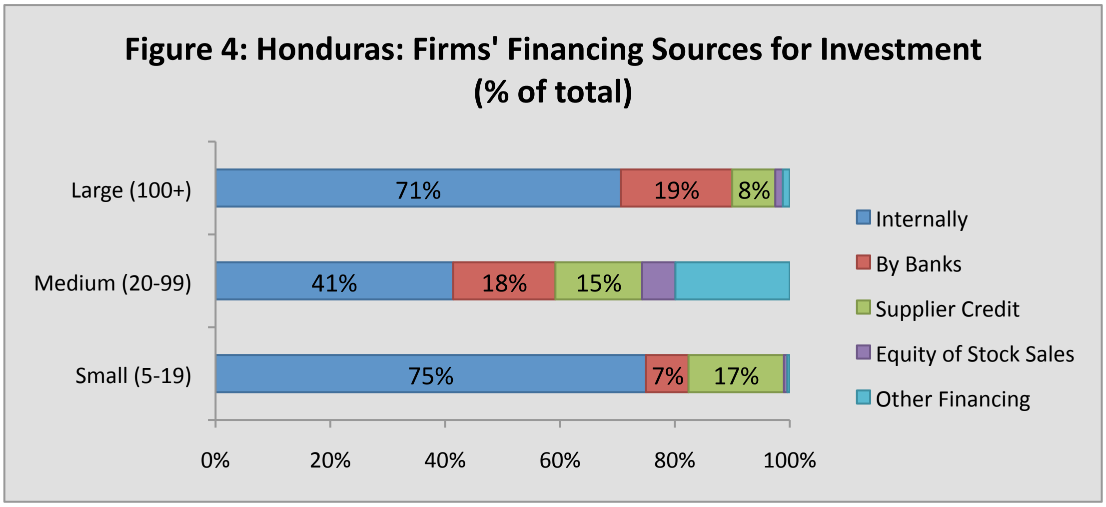
[11] IFC, 2010
[12] IFC, 2010
[13] IFC/McKinsey Research, 2010.



Source: Honduras Enterprise Survey Data, 2010

Financial Infrastructure

The financial system within a country includes both a financial institution structure and a lending infrastructure. Financial institution structure refers to the financial institutions present in the market and the competition among them. The lending infrastructure refers to the existing rules and conditions usually set up by governments, which affect financial institutions and their ability to lend to different borrowers. Differences between these two elements may affect the quantity and type of funding available for SMEs by affecting the lending technologies financial institutions use to provide funds.[14]

Financial institutions may have a comparative advantage in transactions lending technologies or relationship lending. Transactions lending technologies are based on hard quantitative data like financial ratios from financial statements or credit scores assembled by credit bureaus, and these become the basis for lending decisions. In contrast, soft qualitative information is gathered through contact over time with the SME, and may include information on the character and reliability of the owner based on direct contact over time and information from suppliers and customers. While hard data is easy to verify and transmit, soft information is usually

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[14] Berger, Allen and Udell, Gregory. *A More Complete Conceptual Framework for SME Finance. (2004).* World Bank.

based on direct contact with the loan officer and is harder to be transmitted and verified by others. Usually large financial institutions who can take advantage of economies of scale tend to have a comparative advantage in transactions lending, while smaller institutions have an advantage in relationship lending based on soft information.[15]

Lack of Efficient Financial Markets

Efficient financial markets connect investors to lenders and reduce the reliance on internal funds (entrepreneur's own savings or retained earnings) and informal sources of funding. External sources may informal coming from family, friends, or supplier finance; or formal coming from bank debt or equity. In many cases, supplier credit becomes an important source of financing for SMEs used for short-term capital needs.[16]

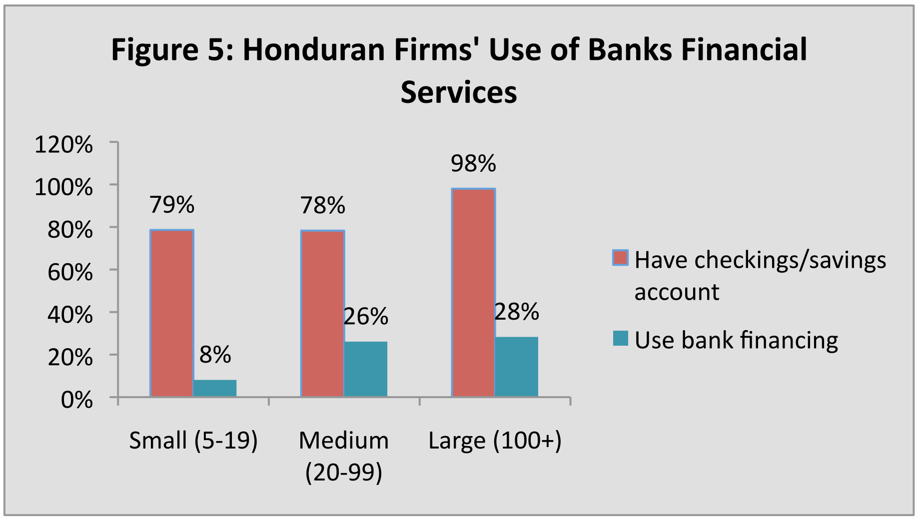
The enterprise survey shows that Honduran firms tend to rely heavily on internal funds to finance their investments, suggesting the inefficient financial intermediation in the country. Only 8.1% of small sized firms and 26% of medium sized firms surveyed in the enterprise survey reported using banks to finance investment. Collateral requirement also increase as firm size decreases. The survey also shows that the value of collateral needed for a loan was 298% for small firms, 144% for medium firms and 84% for large firms.[17]

Limited Financing Options[18]

SMEs are usually constrained in the funding they can obtain from larger institutions using transactions technologies due to their lack of hard information like accurate financial statements. One of the key challenges is to support banks to extend credit facilities to SMEs who already have checking/deposit account with them (See Figure 5). Nonetheless, certain transactions technologies

[15] Berger, Allen and Udell, Gregory. *A More Complete Conceptual Framework for SME Finance. (2004).* World Bank.
[16] IFC, 2010
[17] Honduras Enterprise Survey Data. (2010). IFC.
[18] IFC, 2010

like small-business credit scoring, asset-based lending, and factoring may be well-suited for SMEs depending on certain characteristics and the financial institutions structure.[19] Unfortunately, these sources of SME financing are also less developed in developing countries.[20]



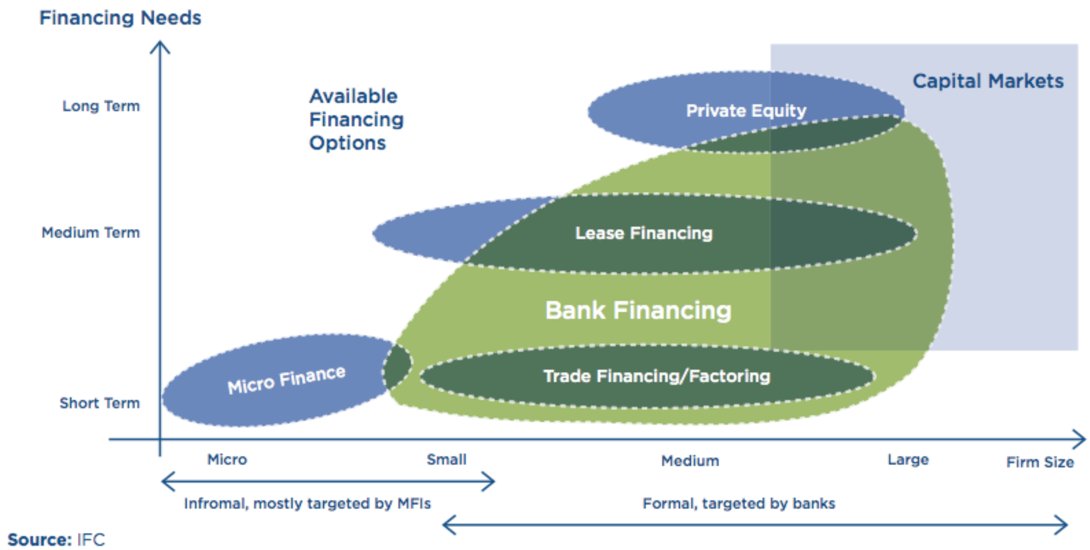
Source: Honduras Enterprise Survey Data, 2010

According to IFC research, the SME finance coverage in developing countries appears limited to only a few financing options. Figure 6 illustrates the SME finance coverage by looking at the most commonly used financing tools. While traditional banking models typically serve larger firms, commercial banks have become better suited to serve the small and medium firms in developing countries, but they limit their SME activities to fully secured working capital facilities. Microfinance institutions have developed certain business models that provide loans to smaller firms, but they have limited ability to accompany firms as they grow offer additional non-lending products that are critical to clients. Leasing and factoring volumes remain small and are less developed in emerging countries like Honduras. A very limited number of innovative SMEs with clear growth potential are able to access venture capital. Lending to SMEs usually starts with a

[19] Berger, 2004
[20] IFC, 2010

credit relationship based on short-term finance, which enables banks to build credit histories with borrowers.[21]

Figure 6: SME Finance Coverage



Leasing and Factoring as alternatives for SMEs

Leasing helps with the problem of collateral and become and important complementary source of investment finance, especially in countries where the collateral regime and the information infrastructure are weak. Leasing focuses on the firm's ability to generate cash flows from business operations to service the leasing payment, rather than on its credit history or ability to pledge collateral. In case of payment default, leasing providers can claim repossession and sale of the leased asset, which provide additional risk mitigation. Leasing can also be beneficial from a demand side perspective, as small entrepreneurs may be reluctant to give their personal assets as collateral for a loan. [22]

[21] IFC, 2010
[22] IFC, 2010

Factoring can become an important complementary source of working capital finance for SMEs in countries where the financial infrastructure presents gaps. Factoring entails the purchase by the lender of a firm's accounts receivables and the collection of invoices from the parties that owe money. This financial instrument addresses the problem of SME opacity by focusing on the quality of the obligor. In recent years, reverse factoring has made low-risk loans to high-risk suppliers such as SMEs possible. Fnancial institution purchases receivables only from high-credit quality buyers. Reverse factoring is particularly useful for SMEs in countries with weak credit information systems. [23]

Main Challenges for Financial Intermediaries

What is limiting financial intermediaries from lending to SMEs?

1) *Data opacity of SMEs:* The common lack of information (such as reliable financial statements) is a challenge when dealing with transactions lending technologies used by financial institutions.

2) *Risk Assessment:* Data opacity also results in harder and expensive risk assessment for financial intermediaries. Higher risk tied to SME lending results in higher interest rate loans.

3) *Collateral requirements:* At the small stage, SME usually lack immovable collateral. Banks in developing countries like usually prefer immovable to movable collateral for their loans. Due to the lack of collateral registries, which ties back to the financial infrastructure of the country, collecting immovable collateral such as machinery and inventory.

[23] IFC, 2010

V. Recommendations and Action Plan

Drawing from the work and experience of the Inter-American Development Bank and the International Finance Corporation, background research, existing models, and the characteristics of the Honduran market, an action plan is presented as the first step of a country initiative to expand access to finance for SMEs in Honduras.

Overview: Access to credit under traditional lending models is usually a challenge for SMEs due to their lack of credit histories, collateral, low education levels. It is clear that the government plays a fundamental role in providing the enabling environment needed for financial intermediaries to expand credit to SMEs; however, these recommendations will mainly focus on what can be done through financial institutions.

Purpose: The goal of this initiative is to bring regional experiences, models from other regions, and knowledge to interested financial intermediaries in Honduras, hereby connecting them to the untapped, yet critical economic players SMEs represent in the economic system. Interested and qualifying financial institutions will get funding support from IFC and IDB to implement strong models as well as sharing of the initial risk.

Action Plan

1. Assess SME Credit Gap: Develop a country diagnostic on the current financial infrastructure in Honduras, and quantify the existing SME finance gap. This diagnostic will serve as the base of the SME finance strategy, measure the SME finance gap, and will clearly outline the strengths and weaknesses in the financial infrastructure.

2. Perform an internal assessment for interested financial institutions: Banks should develop the SME business through a clear strategy that optimizes the balance between risk, rewards, and costs. Once this strategy has been defined, financial intermediaries can proceed to analyze intervention alternatives based on SME lending best practices.

3. Expand financing options and strengthen the financial infrastructure in the country.

A) Promote SME lending and demonstrate the viability of the segment: While some financial institutions in Honduras like Banco Ficohsa have already been able to develop SME lending models (See Appendix 2), the SME segment still faces a significant financing gap. Promoting SME lending and demonstrating the viability of the segment will involve developing cost-effective models for risk assessment and customer management, risk sharing, and mobilization of critical players.[24] It is important to note that “there is no one size fits all” when it comes to recommending lending models. Variations and differences among countries and financial intermediaries start from how they define an SME. SME lending should be promoted through commercial banks, microfinance institutions (MFIs), and other financial intermediaries.

[24] IDB, 2012

B) With the assistance of International Finance Institutions, support financial intermediaries in implementing lending models. The assistance of international finance institutions is crucial not only for their financial support, but also their strong knowledge base and expertise. A study done by the Independent Evaluation Group of the World Bank Group has demonstrated that a mix of advisory and investment services yield higher success rate.[25] Therefore, a combination of capacity building, knowledge, and capital is necessary for success of this initiative and to help financial institutions reach creditworthy SMEs. Investment and advisory services must be tailored to the needs of a specific financial institution.

- Provide loans, risk-sharing facilities and partial credit guarantees.
- Provide grants to transfer knowledge of effective lending models for SMEs, and train credit managers and loan officers in these products and services.
- *Institutional Capacity Building*- Building the capacity of financial institutions is important to help them better serve the SME segment as well as incorporate sustainable finance practices into their operations. Capacity building will help train management and personnel, increase and standardize product offerings, and streamline credit processing among other things.

C) Financial Infrastructure: Develop and expand sources of finance best suited to meet the financial services needs of SMEs.

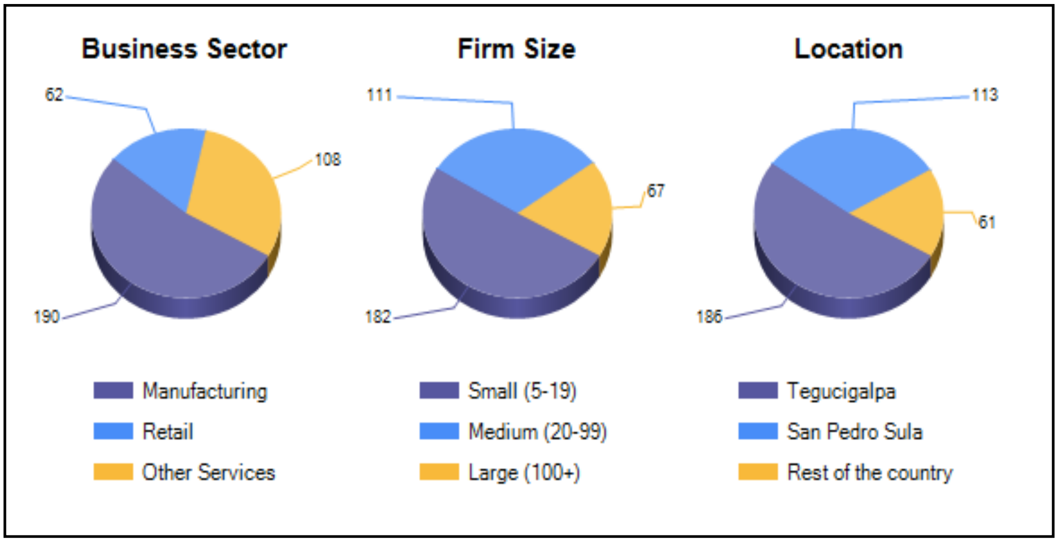
- *Develop internal lending technologies-* Considering the weaknesses in the enabling environment and financial infrastructure of Honduras, financial providers should develop internal lending technologies that reduce information asymmetries such as traditional relationship lending.

[25] Independent Evaluation Group. http://advisoryservices.ifc.org/uploads/documents/20080702T141309_MSME-Full-Report.pdf

- Create SME units with specializes staff and a set of standardized products that help reduce costs
- Develop internal credit scoring models
- Foster client relationship approach that focuses on cross-selling of a mix of financial services beyond credit.

- *Expand the use of Leasing*- Involves a leased asset, helps with the problem of collateral, focuses on the firm's ability to generate cash flows from business operations to service the leasing payment, rather than on its credit history or ability to pledge collateral.
- *Expand the use of Factoring*- Useful when the financial infrastructure presents gaps, and addresses the problem of SME data opacity and risk. Factoring entails the purchase by the lender of a firm's accounts receivables and the collection of invoices from the parties that owe money.

APPENDIX 1: Characteristics of firms in Enterprise Survey for Honduras



Source: Honduras Enterprise Survey, 2010

APPENDIX 2: Snapshot of Successful Models[26]

1. Banco Ficohsa

Banco Ficohsa stands out as one of the most dedicated banks in Honduras in expanding its SME outreach. It is currently the second largest Honduran bank in terms of credit portfolio, and it offers a wide variety of financial services including SME loans, trade finance, factoring, and secured term finance. In 2008, the International Finance Corporation disbursed a $20 million term loan for housing finance and MSMEs. Additionally, IFC provided advisory services for a new business model for MSMEs. Despite the recent financial crisis, Ficohsa has grown is MSME portfolio by 22% and as of June 2010, the bank had 2,265 MSME clients with a total of US$77 million in loans.

2. Financial Infrastructure: Sin Riesgos (inclusive credit bureau)

Sin Riesgos is a private credit bureau, primarily owned by Nicaragua's microfinance association ASOMIF. It was created as an innovative credit-rating system in Nicaragua that goes beyond banking information and uses non-traditional types of data such as utility bills, opening up the credit information system to MSMEs. The World Bank provided technical assistance and financed some of the initial investment costs.

3. Risk Assessment: Entrepreneurial Finance Lab [27]

The Entrepreneurial Finance Lab offers psychometric test to the entrepreneur that has been able to assess the default probability of the loan based on a psychometric analysis. This model can be used as a complimentary model for risk assessment to help banks with a robust credit base take

[26] *Scaling-Up SME Access to Financial Services in the Developing World.* (2010). International Finance Corporation.
[27] Entrepreneurial Finance Lab (EFL). (2012). http://www.efinlab.com/

the extra step. The model is still in the initial testing stages in two markets in Latin America; however it has yield results Africa.

4. Banking Services: SME Banking Standard Chartered Bank

Standard Chartered Bank model has been recognized as a best practice model. It has created an SME Banking unit as a distinct business dedicated to the SME segment. A differentiated service model, an international network, and full relationship banking beyond just lending have characterized its success.

5. Banking Services: ProCredit Holding, IADB/MIF

The ProCredit business model is a private sector initiative combining an entrepreneurial approach with a development policy orientation. Three specialized, regulated financial institutions within the ProCredit network where established to expand financial services available to MSMEs in Colombia, Honduras, and Mexico. The IADB provided both investment and technical cooperation through staff training for the financial institutions.

6. Banking Services: Wells Fargo Bank

Since 1992, Wells Fargo has become a pioneer with credit scoring for small business lending. The product was an unsecured line of credit up to USD 50,000, and a new business unit was dedicated for this line of credit. The business unit it still is called “Business Direct.”

7. Credit Guarantee: FOGAPE (SME lending guarantee fund)

FOGAPE illustrates a public support scheme in Chile to increase access to finance for SMEs. Credit

Guarantee FOGAPE is an SME guarantee fund and government initiative that providing partial credit guarantees to banks in favor of SMEs who lack the necessary collateral to gain access to credit, or need longer maturities. FOGAPE guarantees are risk- sharing instruments meant to leave some risk with the financial institution. The fund was originally finance by the government of Chile, but it has been successful and profits from its operations now contribute to the fund's capital base.

8. Financial infrastructure: FINPYME Inter-American Investment Corporation- IIC (part of IADB Group)

FINPYME is a credit information registry used in 13 countries in Latin America with the help of the Inter-American Development Bank. It is used as a diagnostic tool to review and analyze SMEs competitive positions and provides a point of reference for financial institutions to determine credit eligibility for SMEs. It has three main phases. The first is the diagnostic phase based on a set of criteria including industry attractiveness, competitive position, innovativeness, owner's commitment to company, and financial position. Local universities, business schools and associations to allow for technology transfer and know-how within the country carry out the diagnostic. Based on the diagnostic, the second phase is technical assistance to help SMEs make the necessary improvements needed. The third phase is FYNPYME training and access to expert evaluations through learning institutions.

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