

# Crossfire: SME lending vs. microfinance

THOMAS GIBSON and MARC DE SOUSA-SHIELDS

*In our regular debate between two experts, Crossfire invites Tom Gibson and Marc D'Souza to argue the case surrounding: 'The popularity of microfinance in the development community has diverted attention from small enterprise lending'.*

*Dear Marc,*

My 20 years of working exclusively with small and medium enterprises (SMEs) (if I can use that term) is proof enough for me of this statement. In forums ranging from congressional testimony to cocktail chat, microenterprise has stolen my SME thunder with frustrating regularity. Few would dispute that microfinance is more personally and politically attractive than SME finance. Given a choice, most decision makers would rather be associated with the former than the latter.

There are two things I confess I cannot do in this debate: First, I cannot engage in debating the developmental contribution of microenterprises vs. that of SMEs. That is not the issue here.

Second, I am unable to provide any incontrovertible, quantitative data to support claims of a negative influence of microfinance programmes on SME finance. As a field, microenterprise is far better organized, documented and defined than SME development. The literature on SMEs, by contrast, is appallingly inconclusive. I have come across no research that sheds any definitive light on this debate. I will try, then, to make my case by mustering compelling anecdotes and a persuasive line of reasoning.

I see two principal ways in which the popularity of microfinance undermines interest in SME finance:

First, microfinance is *assumed* to alleviate poverty while the claim of poverty alleviation by larger enterprises requires more robust proof. I learned this yet again recently from an officer of one of the world's largest private foundations, one that has embraced microenterprise and that recently considered SME development as an additional

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If the data fail to find a positive contribution of SMEs, what about microenterprise?

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area of intervention. Regrettably, the foundation was referred by the World Bank to the celebrated recent work by its economists Thorsten Beck et al., entitled 'SMEs, Growth and Poverty: Cross-Country Evidence', the abstract of which says the following: 'Thus, while a large SME sector is characteristic of successful economies, the data fail to support the hypothesis that SMEs exert any positive impact on growth. Furthermore, we find no evidence that SMEs reduce poverty'. Which brings me to ask, if the data fail to find a positive contribution of SMEs to economic development, what would a similar study say about microenterprise?

However laughable the Beck study assertion may be for people who live in poor countries – many have told me they find it so – the Beck paper certainly makes it easier for anyone finding microenterprise more attractive to write-off the SME sector. Having to prove one's case robustly will always be less attractive than not having to prove one's case at all. I am not saying that microfinance fails to alleviate poverty. However, in the search for sources of systemic economic growth, it would be hard to argue that microfinance has been subjected to the degree of testing for causality, as has the SME sector. It is simply easier to claim victory in microfinance than SME finance.

The second way in which the popularity of microfinance

undermines SME finance is with its capacity to generate returns on loans, which are so high, and default rates, which are so low. By comparison, SME finance appears far less financially sustainable and of significantly higher risk. It is difficult in any country for a small manufacturing or food processing business employing, say, 50 people, to survive on short-term debt with interest equivalent to 30 per cent per annum. It is also much tougher for a business needing US\$250,000 for expansion to come up with 100 per cent of that amount in collateral, than for a micro-borrower to find five coguarantors for a US\$500 loan. This, I believe, is one prominent reason why so many more investors seem to be hunting for microfinance institutions than for intermediaries exclusively targeting SMEs.

In 1998 I was in Bolivia putting together a risk capital fund for SMEs. I had the pleasure of spending most of a morning with Hermann Krutzfeldt, then the CEO of BancoSol. I asked him after a tour of the bank how many of his 200,000 micro-borrowers had grown to the point where they were could productively absorb financing of at least US\$100,000, the minimum for our fund. His reply: 'maybe one, maybe two'. He also pointed out that in the previous year, BancoSol had achieved a return on equity (ROE) for its investors of 29.6 per cent.

I asked myself then, and I ask myself now, why anyone who

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How do you put more competitive local goods on the supermarket shelf?

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SME development is an incredibly complex development challenge

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stood to make a 30 per cent ROE on loans to 200,000 poor people would take the trouble to find and finance a few complicated entrepreneurs, any one of whose failures might lose a quarter of a million dollars. The answer, I think, lies in another set of questions: Where do big businesses come from? Who really effectively understands and wants reform? How do you put more competitive local goods on the supermarket shelf? These are questions that decision makers should be asking, but the easy victory that microenterprise provides gives them little reason to look beyond the individual beneficiary to the economy as a whole.

*Yours,  
Tom*

*Dear Tom,*

Microfinance is not the development tool that has stolen the thunder of SME, rather it is lighting illuminating the sins of poorly managed SME development practice and missed opportunities to better understand and brand the myriad possibility of SME.

Let us not be misled by any macroeconomic tomfoolery. SMEs are important to any economy. SMEs invariably contribute over 50 per cent of developing country GDPs and over 90 per cent of formal employment. Personally, I am not fussy about causality, that is, whether SMEs cause economic growth or are an outcome of it.

Either way, try to have a efficient economy without them.

Unconvinced? Just ask Nike, CEMEX, WalMart or any other large national or multinational company if they need SMEs (conversely, ask them if they can live without microenterprise).

Further, as we well know, there are many thousands of SMEs with millions of stakeholders better off as a result of reforms and interventions by development agents. I alone can count dozens of companies my own firm has had a hand in supporting. Why then, if SMEs are so important and interventions are not entirely unsuccessful, does SME not garner the same attention as microfinance?

At the broadest level, the answer is simple: complexity versus simplicity.

SME development is an incredibly complex development challenge. SMEs come from various sectors, face numerous and different problems, are harder to finance, and face multiple regulatory issues. Supporting microfinance institutions (MFIs), in contrast, is not without its challenges, but simple, proven, codified best practice exists for most types of MFIs in any part of the world. As you note too, it seems alarmingly simple – perhaps unbelievably so – to count and communicate the success of microfinance.

SME complexity has, by contrast, led to the myopic perception (among some) that SME intervention success is dramatically outpaced by failure.

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SME's diversity of approaches have led to poorly thought out interventions

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Complexity has led to a diversity of approaches that have unfortunately produced a great deal of uncoordinated, misplaced and poorly thought out interventions. As an SME owner (one successful, one failed), I can attest to the challenges of SME development, so we cannot place the entire blame on practitioners for SME being pushed aside by micro-finance. But neither can SME practitioners be excused for our 'appalling lack of research' and the many things we should have done when SME funding was much easier to get than it is now.

There are three original and very much related sins that I see as having caused great weakness in the SME movement past and present.

*Sin 1. Many gods, many voices.* If microfinance were a religion it would have a single deity. SME has many. It has venture capital, business development services, supply chain, value chain, export development etc. Diversity is good, but each having its own adherents leaves SME without a singular and coherent voice.

Competing specializations also leave SME without a unified theory of development, one that brings together its many approaches, tools and points of leverage. The result is that the SME message is weak in the face of a rather less complex theology of microfinance. An honest assessment of what each type of SME intervention can accomplish and how it can contribute in concert with other approaches to

dynamic SMEs is essential and long overdue.

*Sin 2. Intellectual sloth.* It will not be easy to codify best practice for SME interventions, particularly if they are to be linked to or part of a unifying theory of SME development. But without this work, SMEs will not enjoy the renaissance developing countries deserve.

Small initiatives are on the horizon but the great energy required to bring together disparate threads of thought and activity has been avoided to date by both practitioners and donors alike. Unlike microfinance, where research, development and training focus on similar types of businesses (i.e. small financial institutions), SME success demands a great deal of hard intellectual work given the many different types of businesses, sectors of the economy and types of interventions employed. Because this work has been left undone for so long, there is little intellectual fire power to counter the simplicity and accomplishments of microfinance (not to mention the negative prognostications of SME importance to development). Having let the moment slip in the late 1980s and early 1990s, the effort required to put SME back on the stage now not only faces the complex challenge of SME but fierce funding competition. Worse, we must also now swim against the tides of current economic thought (though we may find some solace if not delight knowing that most economists only know tomorrow why

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An honest assessment of what SME interventions can accomplish is overdue

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the things they predicted yesterday didn't happen today).

*Sin 3. Poor brand management.*

Is there a bigger sin in business today than poor brand management? Like one of those famous older lines of branded products, SME has somehow lost its way and now takes a distant backseat to emergent brands, sitting dusty on the donor supermarket shelves. We need to shake loose the negative image that some interventions such as business development services have, rightly or wrongly, painted the SME image.

Tom, we both know that SMEs are just as vital to an economy today as they were 20 years ago. We also know that many interventions make the SME sector more vital and even if they may not cause economic growth, SME fine tuning will certainly add greatly to economic productivity.

I concede that microfinance has exacerbated SMEs' fall from grace. But we need to keep the faith. Admission of sins is a first step. Recognizing the need for a change is the second. Best practice codes supporting successful interventions tied to specific SME market and economic ecologies may be a good place to start and a means to gain parity with microfinance.

*Yours,  
Marc*

*Dear Marc,*

So, I take it: 'We have met the enemy and he is us'. I'll give you partial credit for that one. The

SME constituency has, indeed, done a poor job of making its case. Weak 'brand management' is a good way to describe it and it is a 'sin', for which I and others ought to atone. But there is nothing shameful in 'complexity' and I think there are many politicians, both vocational and avocational, who have taken advantage of the simplicity with which microfinance creates its appeal.

Picking up on brand management and complexity, let me make a point and a couple of recommendations.

I submit that the weak branding of SME development is the product of a more insidious misbranding of the developing world. I suppose that if I were a parliamentarian or a movie star, I would rather be photographed with my arm around a smiling farmer holding a home-made hoe than around the eight-foot tyre of a combine harvester. I'll be saying to my audience that I care about people, their health, their shelter, their quality of life. Good for me. But I am also reinforcing a sadly simplistic, stereotypical view of development and developing countries. Underlying this 'brand' is the truly damaging notion that poverty alleviation and the routing out of its many causes can be accomplished by one person, one family, or one village at a time. That's a lot of weight for the poor smiling fellow with the hoe, his family, or his village to bear.

Now here's what we should be saying with the picture of the

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SME now takes a distant backseat to 'emergent brands'

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We are reinforcing a sadly simplistic, stereotypical view of development

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Let's stop holding  
conferences that  
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SME finance

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We should ban the  
term 'MSME'

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combine harvester: First, that less scarce foreign exchange is being spent to import wheat into a country that can produce more than it consumes. Then that permanent jobs are being created down the value chain in the harvesting, milling, processing, packaging, distribution and sales of that wheat. And that at each point along the chain, there is likely to be an SME hiring and training unskilled workers, in most cases paying them more than they could possibly make while self-employed and even paying them when they are off sick for a week.

The first picture says a thousand words that people want to hear. The second needs a thousand words to explain why anyone would have her picture taken with a combine harvester. We in the development community have firmly branded the developing world as a collection of needy individuals waiting for our rescue. We have kept notions of complexity within our own walls and we are evermore pressed to respond to the simplistic view we have promoted. Microfinance, in harmonious concert, has contributed to this condition as much as it has benefited from it. By contrast, those of us in the SME sub-set of development have scattered, each to his own corner, without making a persistent, common effort to be more popularly understood.

What to do about this is the subject of another occasion but, for starters and examples, I might suggest we do the following:

- Let's stop holding conferences, seminars and workshops combining microfinance and SME finance. Let us work through our complexities without diluting them in deference to our friends in the micro world.
- Let's stop defining SMEs in any way that suits our purpose of the moment. Let's agree to some universal formula for defining SMEs, scalable to their varying environments, but reinforcing common characteristics.
- Let's lobby in concert for SME departments, SME ministries and SME committees. In doing so, let us ban forever the term 'MSME', lumping together 99 per cent of all enterprises as if 99 per cent of anything constituted a category, as if the business of making a US\$250, six-month loan to a two-person dress shop should be swapping notes with the business of making a five-year, US\$ 250,000 convertible preferred loan to a 200-employee garment manufacturer.
- And for heavens sake, let's put together a robust retort to the work of Thorsten Beck and all who say that SMEs 'exert no positive effect' on growth and poverty alleviation.

*Thanks,  
Marc*

*Dear Tom,*

I like your list of suggested actions, and agree with most them. Let me go a step further, however, by suggesting that somewhere in the complexity of SME development there is a mountain top upon which lies a tablet of stone on which four SME commandments are written. If I, most presumptuously, were to write these they may look something like this:

*Know thy neighbour.* While data-poor economies almost always yield loose-fitting economic conclusions, we must heed Mr Beck et al. as much as we need rebut them. Efficient economies and strong SME sectors thrive on certainty. Poor regulation, corruption and ineffective judiciary are just a part of the festivities that makes the SME environment so uncertain in developing economies. Add impossible infrastructure, weak market information, shallow management pools etc. and you have the perfect diet for chronic anaemia. A predictable business environment and strong supporting institutions as Mr Beck suggests, are pillars of SME confidence and growth. This is 'macro level' priority number one.

*Do unto others as we have done unto ourselves.* Behind every entrepreneur there is a host of accountants, human resource experts, marketing professionals, engineers and office managers who turn entrepreneurial water into wine. These educated profes-

sionals are as critical to SME growth and development as is the risk-taking, innovative, entrepreneurial zeal brought by the entrepreneur. Few believe you can teach someone to become an entrepreneur but we can teach the supporting casts to support better. If the thousands of business college advertisements crowding metro lines in the US and Canada are any indication, a photo of the newly minted accountant may be as photogenic as the equally ubiquitous micro-finance-receiving street vendor. The SME infrastructure or 'mesolevel' priority should be to train – as we do in industrial economies – a wealth of SME support professionals.

*Thou shalt cut to the chase.* For too long, SME experts have been unable to appoint a 'lead' substantive 'micro' level, on-the-ground intervention. SME venture capital is seductive; there is great tactical value in supply and value chain work; and there is some promise for highly targeted business development services programmes. But I am willing to forgo their charms for expanded SME commercial bank finance. Just like microfinance, commercial bank finance may not be a panacea, but if I were a betting man, my money is on better and more commercial bank finance as a lead micro-level SME development agent.

Give us credit-scoring technologies à la Wells Fargo, give us combined income- and asset-based lending (yes! the best of

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SME needs a wealth of support professionals

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micro with the best of small business lending), and give us empowered, well-trained SME lenders, and give us bank presidents intent on good SME lending. To wit: a Central American bank recently and successfully increased its SME lending by 17 per cent, bringing its average SME loan size down from US\$70,000 to US\$20,000 simply by deciding to target SMEs and by providing basic training and incentive programmes for loan officers. Imagine if all banks did this.

*Think before you leap.* With microfinance moving inexorably towards private finance and away from donor support, now may be the time to regroup SME theory and practice. SME is important. It is an indispensable variable in sustainable development and, among other things, we need to assert its long-standing and demonstrable potential as a tool for improving the environment,

advancing labour rights, and most of all, reducing poverty.

Great reflection and thought is required to develop analytical models that help us apply interventions to each of the unique SME ecologies we encounter. There is also something to the adage that good strategy is defined not so much by what one does as by what one chooses not to do.

We all need to set out lists as we have done here, Tom, and kick start a long overdue debate about SME priority setting. The fortunate irony of our debate is that there is much to learn from microfinance, led by the likes of CGAP, USAID, UNDP/UNCDF among others, on what makes good sense to do and what does not!

It has been a great pleasure debating with you.

*Yours,  
Marc*