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MENA-OECD INVESTMENT PROGRAMME

OECD

Lebanon National Investment Reform Agenda Workshop

Background paper for session IV

Improving the entrepreneurial finance: Venture Capital and access to credit for SMEs

- Draft for Comments -

Prepared by: Alissa Koldertsova, Financial Sector Policy Analyst (Alissa.koldertsova@oecd.org, +33 1 45 24 83 05).

I. Introduction

1. Many commentators have suggested the existence of a 'financing gap' for small and medium-sized enterprises (SMEs), meaning that there are significant numbers of SMEs that could use funds productively if they were available, but cannot obtain finance them from the formal financial system. The concept of a financing gap not an undisputed one, but one that has been reinforced on many occasions, including in 1980s by an important study by Stiglitz and Weiss who argued that the imperfections that are commonly found in financial markets, could cause banks to engage in 'credit rationing'. The core of this argument is that agency problems, asymmetric information, adverse credit selection and monitoring problems may force suppliers of finance to offer interest rates that would leave potential borrowers without access to credit.

2. In order to determine the presence and features of such a financing gap, the OECD Secretariat has designed and circulated a questionnaire to officials in 100 member and non member countries in 2006, which led to the compilation of a recent OECD report *SME Financing Gap – Theory and Evidence* [1]. A key conclusion of this report was in fact that OECD countries do not report a generalised SME financing gap and that most SMEs in OECD countries are able to obtain sufficient credit from banks and other credit institutions, supplemented in some cases by official guarantees. On the other hand, the report authors observed not a single gap, but several gaps in financing, particularly at early stages of enterprise formation and in innovative SMEs.

3. In the non-OECD economies on the other hand, a widespread shortage of SME finance was discovered. This development was attributed to the "informality" of emerging markets in which many SMEs operate outside the formal market which in turn is a consequence of few positive incentives for SMEs to enter formal markets (taxation rates, lack of official credit, stringent administrative regulation). This observation applies equally to SMEs operating in Middle East and North Africa (MENA) countries. The importance of financing for SMEs in the region is in fact all the more important given their prominent contribution to regional economies[2], given the high need for employment creation which the public sector in most countries can no longer support, and which cannot be satisfied through employment creation by large enterprises only.

4. If one were to accept the validity and usefulness of the concept of the "financing gap", the actual measures that should be used to gauge this gap are far from evident. As Claessens and Tzioumis note in their 2006 paper on *Measuring Access to Finance,* measurement of access to finance is influenced by the definition and priority of its various dimensions (reliability, convenience, continuity, flexibility). An associated problem is therefore the absence of an agreed conceptual framework for data collection – an issue that will be discussed later in this paper. Noting these empirical debates and obstacles, for the purposes of this paper access to finance will be defined as availability of financial services at a reasonable cost.

II. SMEs in Lebanon

5. In Lebanon, the precise contribution of SMEs to the GDP and employment is difficult to estimate exactly, in part due to the lack of a clear and accepted definition of what constitutes an SME. The EU Commission defines SMEs as enterprises engaged in economic activity, regardless of its legal form, which employs less than 250 employees and whose yearly turnover and/or total assets do not exceed 50 million euros and 43 million euros, respectively (EU Commission, 2006). The EU Commission, and some MENA and OECD governments provide a further refinement of this definition, setting out conditions for revenue and employment of micro, small and medium size enterprises separately. For example, the Commission defines small enterprises as those with less than 50 persons and whose yearly turnover and/or total assets do not exceed 10 million euros. This definition is normally different in many MENA economies given the small size of domestic firms. In Egypt, a small enterprise is defined as that employing between 5-14 employees (MSME

[1] The full report SME Financing Gap: Theory and Evidence, 2006 is available from the OECD website.

[2] In the MENA region, SMEs are estimated to account for 99% of companies, 2/3 of jobs and a significant share of value added (EU Report, 2006).

database, Word Bank, 2006). The approach taken by the OECD is to work with both the national, regional and Community definitions and to attempt to achieve some degree of international comparability.

6. It has been estimated that SMEs constitute the dominant form of business organisation in all countries world-wide, accounting for over 95% and up to 99% of the business population depending on the country. In 2003, 99.8% of enterprises in the enlarged EU were SMEs (< 250 employees). Small enterprises (< 50 employees) make up at least 95% of manufacturing enterprises in most economies (OECD SME and Entrepreneurship Outlook, 2005). In Jordan, MSMEs are estimated to account for 54% of employment as of 2003, whereas in the UAE this percentage was estimated at 86% (World Bank MSME Database, 2006). These estimations of course depend, once again, on the definition of micro, small and medium enterprises, which (to the extent available) are observed to be relatively similar in the region, except in the case of medium enterprises.

7. As mentioned, a variety of definitions are adopted in Lebanon. Kafalat, a Lebanese financial company with a public concern that assists SMEs to access commercial bank funding, uses a threshold of 40 employees to define an SME and no financial criteria.[3] A recent report prepared by GA Consult for Kafalat, suggests that if one were to apply EU definition of SMEs in Lebanon, one could infer that Lebanese SMEs account for 95% of the industrial tissue. According to the last census, 90.2% of companies in Lebanon have less than 5 employees and only 1% of companies over 1000 employees (2004).The World Bank's MSME Database estimates that before the last war, approximately 192,569 SMEs were operating in Lebanon, which effectively translates into a rate of 47.2 MSME per 1000 people (MSME database, World Bank, 2006). These figures, even if they were to vary as a result of application of different criteria, underscore the importance of assuring adequate SME financing in Lebanon, and suggest that the conventional definition of an SME might need to be reviewed and tailored to the specificities of the Lebanese economy.

8. In Lebanon, the consensus seems to point that the environment for enterprise financing more generally and SME financing more specifically, is not ideal. This echoes the situation in other MENA countries working on this issue with the MENA-OECD Investment Programme. For instance, in Morocco, the government has been paying significant attention to the issue and has established in 2002 an agency designated to deal with issues concerning SME support policy, including in the area of financing.[4] Jordan has also sought the advice of the Programme on improving the conditions for venture capital in the region. Lebanon is thus not unique in facing SME financing challenges, despite the current increased liquidity in the region.

9. In most MENA countries then, the presence of a 'financing gap' is widely acknowledged and accepted as a key obstacle to full employment and as a social issue. This financing gap is difficult to quantify and varies largely based on perceptions of entrepreneurs and financiers. Asymmetric information, lack of transparency and governance practices are typically cited as the principal causes of the gap in the region, which like in OECD countries, is likely be composed of gaps to SMEs operating in certain sectors and at certain stage of financing. In fact, a particular subset of SMEs which operate in the innovation and technology industries are at a particular risk of inadequate financing since their assets are often intellectual in nature and therefore do not lend themselves to being easily provided as collateral.

10. Lebanon finds itself in a relatively advantageous position vis-à-vis other MENA countries in terms of access to financing generally, and access to credit in particular. Lebanon scores ahead of the region in all dimensions of the Getting Credit in Doing Business Database and on par with OECD member countries along some dimensions, with the notable exception of private bureau credit coverage (2007). Lebanon rates 50th out of 95 countries ranked in terms of banking sector, equity markets and bond markets development in a 2006 study conducted by Claessens and Tzioumis of World Bank (2006). This is a direct result of the emphasis placed by the Lebanese government on developing its financial sector, and more specifically the banking

[3] Kafalat is currently considering introducing more granularity in its definition of an SME.

[4] For more information, refer to the website of the agency at http://www.anpme.ma.

sector. Using the traditional ratios of banking sector development - the ratio of currency to deposits, the ratio of M2 to GDP and the ratio of M1 to M2, Lebanon stands out positively in the MENA region. The currency to deposit ratios are lowest in Lebanon, as well as Egypt, Tunisia, Jordan, indicating fairly sophisticated financial markets and public confidence in the banks. The monetization ratio, M2/GDP, is higher in Lebanon (and Jordan) than in many other developing countries. The development of the Lebanese banking system is a reflection, at least to some extent, of the liberal exchange and currency standards in the country. There is no restriction on the movement of currency and capital, no exchange controls, and the currency is totally convertible.

11. The aggregate measures of financial sector development permit an assessment of the supply of financial services, although such assessment does not help with understanding of the distribution of financing among enterprises. A number of studies shows that financial liberalisation (Laeven, 2003), developed capital markets (Rajan and Zingales, 1998) and increased foreign bank penetration (Clarke et al., 2001) have a positive impact on financing conditions for firms. In the absence of more detailed data, these provide an avenue for bridging the theoretical gap between financial sector development and condition for financing. In this regard, a number of comparative regional studies and Financial Sector Assessment Programme (FSAPs) and the Financial Sector Development Indicators Project launched in 2006 by the World Bank provide a useful means to measure quantitatively the various aspects of financial sector development in the MENA region and beyond. The OECD in its Financial Markets Committee is also looking at launching a project to gather data on a set of indicators on financial sector regulation, including information on the main institutional sectors of the financial systems, and information organised around the key regulatory areas which together form the legal infrastructure that underpins transactions in debt and equity markets.

III. Specific Financing Instruments and Programmes in Lebanon

a. Debt instruments

12. While banking intermediation is relatively weak in the MENA region (35-90% of GDP according the estimates by the EU), the Lebanese financial sector has been traditionally and remains one of the most developed in the region, with 54 active commercial banks and 10 specialized medium and long term credit banks currently operating. The Lebanese banking sector is spread throughout the country, and manages the equivalent of USD 71 billion in assets nation-wide (Association of Lebanese Banks, 2006). A large foreign presence by international banks, including Societe Generale, BNP Paribas, etc. can be also witnessed. Despite the high level of financial sector development, Lebanese banks have a limited size compared with other banks in the region. The Bank of Lebanon encourages groupings so as to enable banks to better face competition, although nothing of the like of the Egyptian Asset Management Programme has taken place in terms of bank consolidation and privatization.

13. Nonetheless, this high level of banking sector development has translated into better conditions for access to credit for Lebanese enterprises than for their regional counterparts as demonstrated in the Table 1 below.

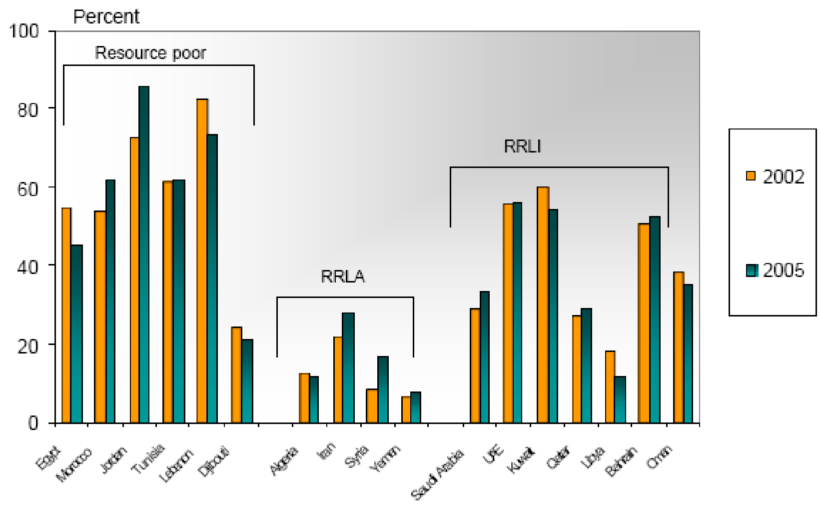
Table 1: Domestic credit to private sector and non financial public enterprises (% of GDP)

Country[7]	1999	2000	2001	2002	2003	2004
Algeria[8]	61.5	40.8	38.8	41.4	35	
Egypt		52	54.9	54.7	53.9	49.3
Israel	86	83	91.8	97.3	92.2	92.2
Jordan[9]	75.6	75.5	78.3	75.4	73.5	
Lebanon	86	88.9	86.9	82.7	76.1	73.2
Morocco	54	56.6	54.5	54.4	55.9	56.7
Tunisia[10]	66	66	68	69.5	67.4	

Source: EU Experts Group Report, 2006.

14. Credit to private sector has over the years fluctuated between 70-80 % (refer to Figure 1 below) but points still to the impact of crowding out of the private sector by the public sector despite the well developed banking sector and the liberalization of credit policies (M. Nagy Eltony, 2004). Lending of all banks to private sector at the end of 2006 was estimated at 17.2 billion USD, or 77% of GDP. The claims of banks and financial corporations on the private sector as of January 2007 stood at 26050 billion LBP (Central Bank statistics, 2007).

Figure 1: Private sector credit to GDP, 2002- 2005



-Or closest year available. Claims on the private sector by deposit money banks as a percentage of GDP.
Sources: IMF IFS; World Bank country data.

Source: World Bank, 2006.

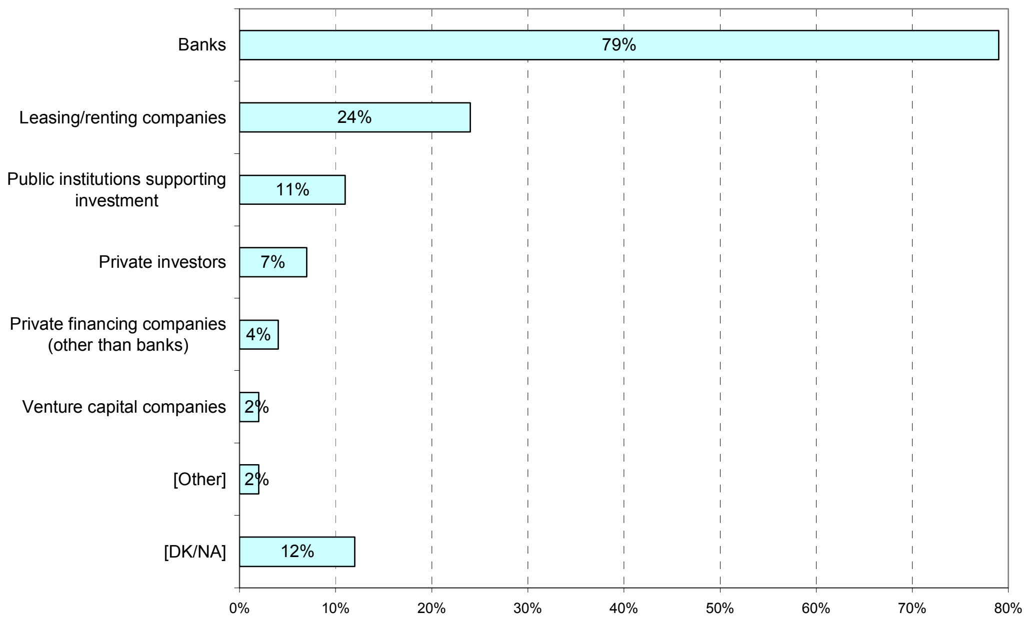
15. While the measure of private sector credit to GDP demonstrates the high level of development of the Lebanese banking sector, it is important to note that only 3% of beneficiaries account for 75% of total private sector credit, which demonstrates that larger firms have a much better access to credit in Lebanon (Nassib Ghobril, interview). Furthermore, according to some studies, the bulk of credits extended to SMEs are channeled to trade and services, the major cause of this being that services and trade companies are able to generate profit and cash flows to service the debt in the short term (Chamas, 2006). Furthermore, in Lebanon, the private sector suffers from bias to short terms, trade related and relationship based lending. Even in EU

member countries, 18-35% of SMEs had their credit refused and this figure is expected to be higher in the MENA region (EU, 2006). Furthermore, collateral requirements can be high, reaching 200-300%, in part due to the prudential rules imposed by monetary authorities.[5]

16. A recent study in the *Development Policy Review* attempts to explain the reluctance of banks in developing countries to provide credit. It concludes that "the financial systems in developing countries fail to mobilise domestic savings adequately and to allocate them to firms and individuals that can use the funds most productively. Banks hold substantial liquid assets while providing only modest or minimal lending to private sector firms (Freeman and Click, 2006). The primary reasons for the lack of private sector credit in developing countries include: (i) high reserve requirements, (ii) deficiencies in the legal and regulatory environment, particularly with respect to contract enforcement, (iii) crowding-out from fiscal deficits, (iv) substantial asymmetric information and (v) the inadequate skills of financial intermediaries. (ibid) These general conclusions seem to apply to the current situation in Lebanon.

17. This importance of addressing the reluctance of banks to lend is all the more important, given that bank credit constitutes the primary source of financing for SMEs in Lebanon, as in other MENA and OECD member countries. A recent survey of sources of financing for EU-based SMEs revealed that 79% of financing was provided in the form of bank credit (refer to Figure 2 below). In non-bank dominated financial systems which are prevalent in North America, equity financing is purported to play a more important role.

Figure 2: Sources of Financing for EU-based SMEs



Source : EOS Gallup Europe (2005), "SME Access to Finance", Flash Eurobarometer 174, October, upon the request of the European Commission (Directorate-General "Enterprise and Industry").

18. The difficulty of obtaining access to credit by Lebanese enterprises further exacerbated by the lack of transparency of financial records of SMEs (GA Consult, 2005). Although a corporate governance code covering SMEs as a category of enterprises does exist, it remains a voluntary code which implied that enterprises do not have to provide disclosure concerning their financial situation.

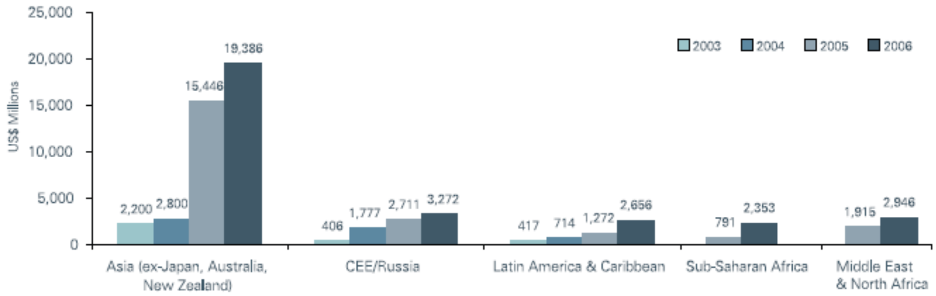
[5] Collateral consists of 30% overdraft accounts, 28% real estate, 18% personal guarantees, 17% cash collateral and government securities.

On the other hand, difficulties put forward by banks include the following: access to longer term resources through international institutions, high debt/equity ratios of Lebanese firms, lack of transparency in firms' financial statements, lack of scientific business plans, lack of scientific business plans and slowness of the judicial system in terms of resolving non-performing loans (MED Best Report, 2005).

b. Equity financing

19. According to Emerging Markets' Private Equity Association, $33.2 billion USD of equity was raised in emerging markets in 2006. This figure reflects the boom in financing in the industry over the last two years in emerging markets, including the MENA region. On the supply side, the industry has most certainly benefited from a greater liquidity in the Middle East and North Africa (MENA) region following the repatriation of capital by Arab investors from world markets in 2001, greater intra-regional investment which followed, as well as the recent oil boom. While the Middle East experienced a 198% increase of year-to-year growth in total funds raised, other emerging markets, notably Asia, are still leading (refer to Figure 3 below).

Figure 3: Emerging Markets Private Equity Financing by Region, 2003-2006

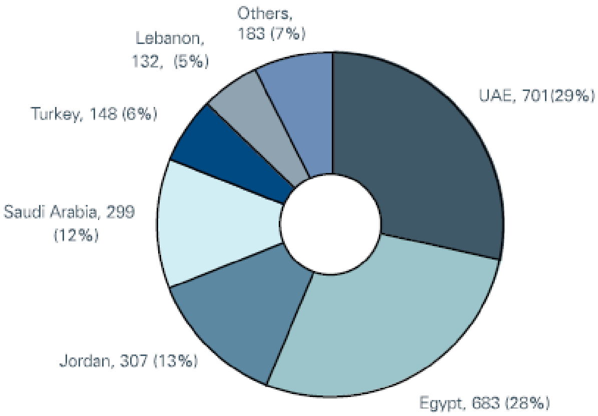


Source: EMPEA estimates, 2006, taken from the EMPEA Newsletter, vol. 3, issue 1, 2007.

20. KPMG estimates that 90% of the estimated $13 billion in private equity capital currently under management in the region has been raised in the last 2 years. Along in growth in fundraising, the size of funds has also increased, and some over $1 billion funds managed by Abraaj Capital and Global Investment House are already investing across multiple emerging markets. There are currently approximately 30 private equity firms investing in the MENA region, many of them belonging to the traditional financial houses or family-owned enterprises. For several of the newly-launched funds focused on the Middle East, fund managers are not simply interested by prospects offered by the GCC countries. The Levant Region is also an area of focus. Argent Financial's Lebanon Recovery Investment Fund and a new fund from Levant Capital are specifically focused on Lebanon (EMPEA Newsletter, vol.3, issue 1, 2007). A $20 million fund focusing on Lebanon and Jordan was launched in January 2007 by Byblos bank.

21. Of the total investments made in the MENA region, 5% was made in Lebanon, with Egypt and UAE leading with 28 and 29%, respectively (refer to Figure 4).

Figure 4: Private Equity Investments in the MENA region, 1998-3Q2006, Cumulative (US millions)



Source: Zawya/KPMG, taken from the EMPEA Newsletter, vol. 3, issue 1, 2007.

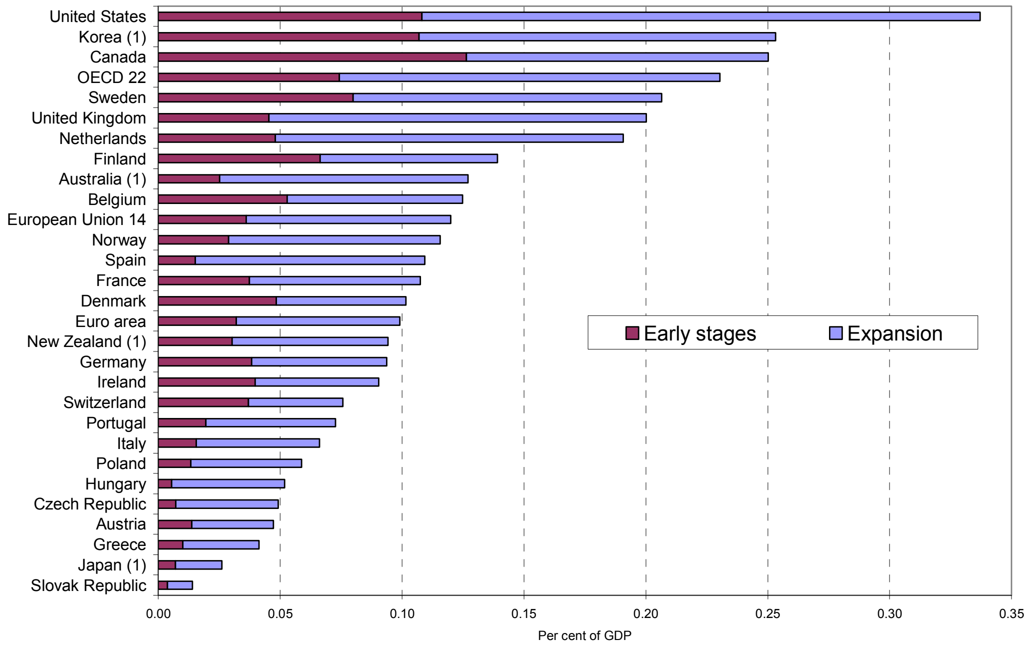
22. These figures seem to point that the equity culture remains rather weak in Lebanon, with most equity provided through family resources. Venture capital is practiced at the private level, and most funds target specific industries such as tourism and real estate. Moreover, Lebanese firms' owners, similarly to other MENA countries, are not usually keen on accepting external control. Presently, it is estimated that in Lebanon, the majority of SMEs continue to rely on internally generated funds or other non-arms length sources of income (Ghobril, 2007). Further interviews and analysis on the activities of foreign and local venture capital funds is necessary in order to identify the strengths and weaknesses of the sector and the measures which would be necessary in order to make venture capital a more prominent means of financing in Lebanon.

23. Certain characteristics of the industry and points for future action are already evident. Presently, there is no regional level association bringing together venture capital and private equity actors as it exists in Morocco and Tunisia, for instance. The region has witnessed a high level of interest in such associations, with the creation of the Gulf Venture Capital Association in 2006 and an interest in creating a national level association in Egypt. Setting up such an association may be of interest in Lebanon as the sector matures and develops. An association can have an important role to play in organising training events, gathering statistics and voicing the industry's concerns.

24. Secondly, the issue of exit possibilities for venture capitalists is a subject which ought to be paid attention to, with a particular emphasis on exits via IPOs. Some MENA governments, such as Morocco, have second tier markets and have reviewed the conditions for listing in order to increase the liquidity in local markets in order to provide greater incentives for venture capitalists. In Lebanon, like in other MENA countries, it remains to be seen whether fund managers will be able to develop deal flow and exit opportunities in line with their success in fundraising. This will likely be a key issue determining the interest of the potential equity financiers in this industry in Lebanon.

25. While further recommendations can be made on the status of venture capital financing in Lebanon, its limitations need to be also stated upfront. This method of financing is normally more applicable to enterprises at later stages of development (expansion) as the Figure 5 below demonstrates. The availability of venture capital in Lebanon is therefore not likely to relieve the pressure on those entrepreneurs wishing to establish new ventures or embark on new projects. Access to venture capital or financing by business angels is particularly desirable at the start-up stage, since micro financing does not have wide exposure in Lebanon (20 micro financing programmes provided through NGOs with the size of loans ranging from 200-5000 USD) and since established banks are more reluctant to get engaged in early stages of enterprise financing. Other, possible government schemes will be required to provide finance to new enterprises, through Kafalat or other institutions.

Figure 5: Venture Capital Investments by Stage as a % of GDP in OECD member countries



Source: OECD, 2006.

26. In addition to private equity and venture capital, Lebanese companies can raise capital through IPOs and issuance of shares on the Beirut Stock Exchange or other exchanges; however, given the focus of this paper on SMEs, this financing method will not be discussed in this paper.

c. Government supported schemes and initiatives

27. In the MENA region, as in OECD member countries, the governments have a number of direct and indirect support schemes and guarantees programmes for SME lending. These range from SME promotional banks, to guarantee funds to guarantee programmes administered by a Ministry or a body responsible for SME policy. In Lebanon, there the main government body charged with coordination of SME related policies, the SME Support Programme created in 2004, lies with the Ministry of Economy and Trade and is coordinated jointly with the Ministry of Finance. The Programme objective is to assist the government in developing and implementing an integrated approach to SME development combining national policy formation, enhancing business development services, and accessing appropriate financial support instruments. It has the following main components:

- An SME Support Unit in the Ministry of Economy and Trade as the driver of government support and policies over the coming decade.
- Policy, legislation and regulation are being formulated and amended that positively enables and stimulate the development of business.
- The establishment of four Business Development Centres with an emphasis on incubation of innovative business funded directly by the programme. This component includes also the creation of national SME support services with a network of professional and accredited service providers.

- Facilitation of access by SMEs to risk accepting capital sources including the creation of a joint Guarantee Scheme with Kafalat. (Ministry of Economy and Trade, 2007).

28. Kafalat is a guarantee society that helps SMEs by providing loan guarantees based on business plans and feasibility studies that show the viability of the proposed business activity. As a guarantee society plays 2 roles: one with regard to SMEs, the other with regard to the credit institution. It processes guarantee applications for loans that are to be provided by Lebanese banks to SMEs operating throughout Lebanon. Guarantees are made in favor of the lending bank, and in some instances, borrowers have to provide the bank with additional collateral, which makes the loan safer for the bank. (refer to Table 2 below). Kafalat's loans have been concentrated in the following sectors: traditional crafts, high technology, agriculture, tourism and industry, with the large majority being concentrated in agriculture and industry.

Table 2: Kafalat Loan Guarantee Schemes

Type of scheme	Amount (USD)	Guarantee Provided	Period	Comments
Kafalat Basic	200,000	75% of the loan and interest	7 years plus grace period of 6-12 months	Any individual or corporate entity can apply. The bank can ask for additional guarantees. Interest payments up to 7% subsidized by the Central Bank.
Kafalat Plus	400,000	85% of the loan and interest	7 years plus grace period of 6-12 months	Restricted to joint stock companies only. Bank cannot ask for additional guarantees. The client has to provide 20% equity participation (in cash or in kind).
Kafalat Innovative	400,000	85% of the loan and interest	Up to 5 years	Restricted to joint stock companies only. Client has to provide 10% in equity participation.

Source: author, based on interviews.

29. Kafalat guarantees are available to all Lebanese banks and in fact, they have a strong incentive to apply for a guarantee, although not all of them do.[6] Kafalat does not employ overly stringent selective criteria, with the rejection rate of less than 5% in 1st quarter 2007, since the clients apply for credit to banks who apply the appropriate screening criteria to determine whether the individual or company should be eligible for financing (authors' interview, 2007). The banks have an additional incentive to apply for Kafalat guarantees since the Central Bank exempts 60% of the loan face value from the legal, non-interest bearing reserve.

30. Although the structure of Kafalat is relatively unique in that it is owned by the National Institute for the Guarantee of Deposits and Lebanese banks, similar guarantee Programmes exist in OECD Member countries as well as in MENA countries. The Jordan Loan Guarantee Corp. and the Société Tunisienne de Garantie (SOTUGAR) are both examples of guarantee companies in the region, which are both publicly funded. The Jordan Guarantee Corp. operates in a similar fashion as Kafalat whereby the participating banks set up the criteria for the issuance of the guarantees. As of middle 2005, the JLGC offered 14 services tailored to the various needs and sectors of SMEs up to half a million euros. In Tunisia for instance, in addition to the Société Tunisienne de Garantie, the state has also established in a bank dedicated to financing of SMEs (Banque de Financement des Petites and Moyennes Enterprises- BFPME) which finances businesses by granting medium and long term loans and contributing to hedge part of the risk incurred though the SOTUGAR.

[6] Some banks do not participate in the Kafalat programmes since they do not engage in lending to SMEs.

31. In addition to Kafalat loans, subsidized interest rate loans are also available under the protocol signed by the European bank for Investment for the same set of industries covered by the Kafalat, in addition to the subsidized interest loans granted by leasing companies. Unlike Kafalat loans which are somewhat distributed across sectors, the loans subsidized by the EU Programme and by the leasing companies are heavily targeted to the industrial sector. According to the latest available statistics, a total of 385 billion LBP of loans were issued where the interest was subsidized (Central Bank, Quarterly Bulletin, 1st quarter 2006).

32. Although no impact analysis of these guarantee schemes on access to finance in Lebanon has been conducted for empirical reasons mentioned above, since the launch of the scheme banks have a greater incentive to provide loans not only to companies in tourism and real estate sectors, but also in other sectors covered by Kafalat such as agriculture and technology. In fact, the Kafalat Innovative guarantee is used primarily by companies in the technology and innovation intensive sectors. Nonetheless, a very small percentage of total guarantees provided were made to high technology enterprises.

33. In addition to the existing schemes, a number of new initiatives are under consideration of the Ministry of Economy and the Ministry of Finance as part of the post-war reconstruction. The Ministry of Finance of Lebanon is currently considering measures to improve the financing facilities for the private sector, including Physical Disaster Loans for enterprises that have suffered direct damages (to be provided by commercial banks and overseen by the Central Bank and Kafalat), Economic Injury Loans for enterprises that have suffered partial or indirect damages (to be provided by commercial banks and overseen by the Central Bank and Kafalat), Re-launching loans to respond to short term financing needs (to be provided by commercial banks). The Ministry of Finance is currently considering a scheme whereby loans less than 10,000 USD would be provided to enterprises in need on preferential terms.

34. Besides programmes which are targeting specifically the conditions for financing, other initiatives targeted towards the overall institutional framework for SMEs/young enterprises are being pursued. For instance, four Business development centers are established in Lebanon to support SMEs, with the support of the Ministry of Economy and Trade and a number of local partners, in the framework of the Integrated SME Support Programme, funded by the European Union. Another reform which is being implemented by the Ministry of Finance in 2007 is the setting up for a one-stop-shop for SMEs.[7]

d. alternative/emerging instruments

- Micro financing

35. In additional to traditional equity and debt finance, SMEs in Lebanon have some access to newer instruments such as micro-financing and financing through Islamic compliant instruments. In terms of micro-finance, this method of financing is not prevalent in Lebanon, and in fact the demand for micro-finance in Lebanon is not quantified. One researcher estimates that if micro finance were to be institutionalized, the volume would be approximately $500 mil in the coming 5 years (Chamas, 2006). Some researchers have noted the proliferation of the informal market for credit and informal micro-finance by money lenders, as is the case in other countries in the MENA region.

36. The most widely known companies offering micro-financing in Lebanon are Al Majmoua and AMEEN. AMEEN is a for-profit organisation established in 1999 that is working in partnership with three commercial banks to provide microfinance products and services for small- and medium-sized enterprises (SMEs). The banks provide 50-75% of the loan capital— depending on the match and profit sharing arrangements. AMEEN has disbursed over US$40 million in loans and currently has more than 7,800 active clients (AMEEN, 2007). Ameen works in partnerships with commercial banks to provide micro-finance

[7] A similar initiative is currently underway in Bahrain, where the Ministry of Industry and Commerce has launched a new initiative to provide a one stop shop for SMEs (B-OnLine Initiative).

products and services for SMES, where the banks provide 50-75% of the loan depending on the profit sharing arrangement. Al Majmoua, the other major micro-credit provider in Lebanon, had a credit portfolio of 5150,000 USD at the end of 2004, distributed among 6000 clients.

- Islamic financing instruments

37. Although Lebanon's offerings of Islamic Financing instruments cannot compete with established Islamic Financial Centers such as Bahrain, UAE or Qatar, the market has witnessed the creation of several Islamic banks and finance houses such as the Arab Finance Investment House, the Lebanese Islamic Bank and the BLOM Development Bank. The Islamic Financing Industry in Lebanon is regulated by the Central Bank through law 575 on establishment of Islamic Banks and a variety of circulations of operations of such institutions. The amount of financing that could be provided to SMEs through Islamic Finance cannot be presently quantified, however given sufficient demand, Islamic financing houses from the Gulf could enter the Lebanese market if it were to be judged as profitable.

- International credit lines and other

38. In addition to the mentioned instruments, following the reconstruction effort, a number of international creditors and organisations have established additional lines of credit to the Lebanese government more generally and for the purpose of SME financing more specifically. The IFC has launched a $50 million project in March 2007 with The Fransabank to establish an SME risk sharing and corporate credit line in Lebanon. The project involves IFC providing a senior corporate credit line and SME risk sharing facility to Fransabank to be lent to the Bank's existing and new clients as a response to post conflict needs in Lebanon. An earlier 25 million programme with Blom Bank, Lebanon's largest bank and with Kafalat was also initiated by the IFC.

39. The EU has also contributed $3.7 million USD investment in SMEs in Lebanon through the business development centers situated in four locations throughout Lebanon to assist SMEs. Each of the centers can support 15-20 businesses on its premises and provide assistance to 100 companies annually (Euromed News, March 2007). Likewise, a part of the European Investment Bank, the Facility for Euro-Mediterranean Investment and Partnership (FEMIP) provides for opportunities in the areas of risk capital and mezzanine finance in Lebanon and has helped to create a new investment company, dedicated to primarily SMEs (EIB press release, 11 January 2007).

IV. MENA-OECD Initiatives and Work in the area of Entrepreneurship and Financing

a. Potential Contribution of the Enterprise Financing Network

40. The MENA-OECD Enterprise Financing Network (EFN) launched in May 2006 is an important private sector activity of the MENA-OECD Investment Programme dedicated to enhancing growth and job creation in the MENA region. The EFN aims to improve the conditions for innovative entrepreneurship by creating a platform to connect entrepreneurs, financiers, research bodies and policymakers. The uniqueness of this Network lies in the fact that it is a regional initiative, inclusive of private and public sectors, which seeks practical solutions to the financing gap through dialogue with financial institutions in parallel with dialogue with the public sector bodies.

41. The Dubai Declaration adopted by the EFN in March 2006 makes recommendations to financial sector representatives and governments on improving access to financing for enterprises, including SMEs. The Declaration urges private and private sector participants to share responsibility and facilitate information exchange between government action and private sector initiatives on innovative entrepreneurship and enhancement of financing conditions. It also highlights the need to improve the collection and dissemination

of data related to enterprise financing through various instruments (bank credit, fixed income instruments, capital markets, venture capital, private equity, etc.). [8] The Lebanese banks, business incubators, research institutions and government representatives are welcome to participate in the activities of this Network. In particular, the Network has already agreed to conduct a quantitative study on SME financing in the MENA region. Participation of Lebanese representatives in this effort would be welcome.

b. The SME Policy Index

42. The MENA-OECD Investment Programme is currently in discussions with the EU Commission on the implementation of SME Policy Index in a number of MENA countries. Morocco has already agreed to use this tool in the assessment of its framework for SMEs. The SME Policy Index is structured around the ten policy dimensions, including education and training for entrepreneurship, cheaper and faster start-up; better legislation and regulation; availability of skills; improving on-line access, etc. Each policy dimension is further divided into sub-dimensions that capture the critical feature of policy development in each specific area. For example, the sub-dimensions included in dimension 3 (Better legislation and regulation) are: 1. Regulatory impact assessment for new SME-regulation; 2. Simplification of rules; 3. Institutional framework. Sub-dimensions are broken down into indicators. For example, the sub-dimension 'Institutional framework' contains the following indicators: inter-governmental co-ordination in policy elaboration; SME development strategy; SME policy implementation agency or equivalent. The indicators are structured around five levels of policy development, with 1 the weakest and 5 the strongest. A presentation on the Policy Index will be made by during the NIRA workshop.

Concluding Comments

43. As demonstrated in this brief policy note, a number of obstacles for entrepreneurial finance in Lebanon exist, most of which relate to the overall economic situation in Lebanon, and some of which have been aggravated by the recent war. Perhaps the most prominent challenges can be highlighted as follows: weak corporate governance practices, lack of specialized financing tools adapted to specific sectors, lack of experience or lack of interest of some banks in managing long term loans, lack of reliable and sophisticated credit information. As a result, Lebanon, like other MENA countries, faces challenges of providing SMEs with longer term sources of finance, of providing credit to smaller firms, of properly evaluating credit risk as opposed to compensating for it with credit guarantees and high collateral requirements.

44. In fact, following the recent war, the climate for SME financing would benefit from an additional review to ensure that there is sufficient capacity to deal with financing requests either through debt or equity instruments. The need for such a review is underscored by an apparent increase in the demand for credit as demonstrated by the increase in the number of SME credit applications which are being received (Kafalat, 2007). The Ministry of Finance and the Ministry of Economy and Trade are already working on programmes to ensure that sufficient support for SMEs is available.

45. The methodology for carrying out such analysis would have to be carefully considered as traditional econometric analysis would be constrained by data limitations existing in Lebanon. Existing literature on financing constraints which uses econometric modeling of firms' financial statements provides a rigorous method for empirical investigations. However, this methodology would have to be adjusted to the context of Lebanon because local SMEs are under no obligation to file detailed financial reports and to disclose the data needed for testing empirically the financial constraints.

46. In Lebanon, SMEs are under no obligation to disclose their financing, and banks do not typically collect data relating to financing of SMEs since borrowing is frequently done by the principal owner of the enterprise, without any reference to the business entity. Although a Corporate Governance code covering

[8] The full text of the Dubai Declaration is available from the website of the MENA-OECD Investment Programme.

SMEs as a category of enterprises does exist, it remains a voluntary code which implies that enterprises do not have to provide disclosure concerning their financial situation. As interviews conducted reveal, this opaqueness with regard to SME borrowing in Lebanon is starting to change as key actors such as Kafalat demand greater transparency in this regard.

47. Such a review could result in recommendations to enhance financing through one of the avenues outlined in the Table 3 below or additional recommendations.

Table 3: Financing and Related Programmes and Initiatives in Lebanon

Type of Scheme	Progress
Enhancing the coverage and accessibility of credit registries	Currently, public credit registry in Lebanon covers approximately 10% of population, and no private credit registry exists. Consideration could be given to introducing measures to increase credit registry coverage.
Establishing a code of corporate governance, applicable to listed and non-listed companies	Corporate governance code for enterprises, including SME is in place, but is not mandatory. Further promotion of the Code may be beneficial in order to increase awareness of this instrument. This effort may be coordinated with local banks.
Providing guarantees for private sector lending	Guarantees for private sector lending are provided by Kafalat. Guarantees are perceived by market participants as sufficient and appear to be working well.
Supporting young enterprises through indirect measures (business incubators, techno parks, etc.)	A number of Programmes are in place. For instance, the Young Entrepreneurship Programme (BADR) established by to promote the entrepreneurial spirit and support young entrepreneurs, seeks to establish new financial tools. In 2007, it will focus on consolidating the equity fund. Other programmes are ongoing as part of the work of the SME Unit of the Ministry of Economy and Trade.
Encouraging the development of a private equity/venture capital industry	No formal government measures in place. Consideration may be given to measures to formally support this industry in Lebanon and to attract funds from the Gulf region.
Encouraging foreign lines of credit	Foreign lines of credit, particularly through various EU Programmes are in place. Raising additional awareness around them may be necessary.
Supporting micro-credit schemes	Micro-credit schemes exist, targeting rural areas and women operated businesses in particular, and lending small amounts which would normally not be lucrative for banks.
Financial education projects	Projects on financial education of SME owners may exist but are dispersed. A coherent framework for educating SME owners on issues such as preparation of financial statements, financial instruments available, may be useful. In this regard, the OECD Financial Education project may be of interest as a model.
Adoption of alternative models such as export credits, leasing and factoring	Alternative financing models such as venture capital and Islamic financing instruments are at early stages of development. A number of recommendations on developing private equity/venture capital financing were proposed above. Furthermore, Bahrain's VC Bank has recently sponsored the MENA SME Fund in partnership with GEM and has already closed 80 million. This model might be of interest in the context of Lebanon.
Encouraging the growth of stock exchanges through privatisation and other means	Equity financing is not developed in Lebanon with 11 firms listed on the Beirut Stock Exchange. Measures to encourage activity on the stock exchange should be considered, including establishing a second-tier exchange to facilitate listings of companies.

Source: author's research and interviews.

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