

Introduction

IN1. IFC is committed to developing local markets through institution building, use of innovative financial products and mobilization, with a special focus on small and medium size enterprises. IFC investments through financial intermediaries (FIs) constitute the most important approach for supporting Small and Medium Enterprises (SMEs). This approach is accompanied by Advisory Services focused on improving the investment climate, connecting SMEs with potential buyers and trading partners, strengthening financial infrastructure and providing resources for building management skills. IFC uses a risk based approach to determine the scope of the environmental and social (E&S) performance requirements for its clients.

IN2. The purpose of this Interpretation Note (IN) is to present IFC’s range of investment products aimed at supporting the development of SMEs and to clarify the different approaches used for managing the E&S risk of SME operations. References to additional resources and guidance are provided as footnotes throughout the IN.

IN3. This IN includes three sections. Section I provides an overview of the SME sector including the role of SMEs in economic development, financial challenges faced by SMEs and E&S issues associated with SME operations. Section II presents IFC’s role in supporting the development of the SME market sector. Section III explains IFC’s approach for managing E&S risk in different investment products to support SMEs.

Section I. Small and Medium Enterprises

IN4. The SME market sector consists of a range of enterprises of various sizes (as defined by number of employees, working capital, and/or annual revenue) and operating in a variety of sectors. At one end of the range, companies can be slightly larger than microenterprises and at the other, companies can be almost the size of large corporations (see Table 1). IFC defines SMEs as registered businesses with less than 300 employees. This category can be further narrowed by distinguishing SMEs from microenterprises by having a minimum number of employees. SMEs can be further divided into small enterprises (SEs) and medium enterprises (MEs). Alternative criteria for defining the sector include annual sales, assets, and size of loan or investment.

IN5. The monetary cut-off for classifying a company as an SME generally varies by country, by market, and financial institution (see Table 1 for IFC’s definition).

Table 1. IFC’s Working Definition for SMEs

NOTE ON ENTERPRISE DEFINITIONS FOR MICRO, SMALL AND MEDIUM FIRMS			
Global Financial Markets categorizes its clients’ sub-borrowers according to the following definitions:			
<ul style="list-style-type: none"> (1) Microenterprise if loan < US\$10,000 at origination (2) Small Business if loan < US\$100,000 at origination (3) Medium Business if loan <US\$ 1 million at origination (US\$2 million for more advanced countries) 			
Technically, the above definitions are a proxy for the official IFC definition, based on an enterprise qualifying under two of the following three indicators, as follows:			
Indicator	Micro Enterprise	Small Enterprise	Medium Enterprise
Employees	<10	10<50	50<300
Total Assets	<\$100,000	\$100,000<\$3 million	\$3 million < \$15 million
Total Annual Sales	<\$100 000	\$100,000<\$3 million	\$3 million < \$15 million

IN6. SMEs play a critical role in the economic and social development of emerging markets^{IN1} by creating jobs and generating income for low-income groups. This fosters economic growth and social stability, and also contributes to the development of a dynamic private sector.

IN7. According to a recent study by the IFC and McKinsey and Company (McKinsey), there are almost 365 to 445 million micro, small, and medium enterprises in emerging markets, of which 25 to 30 million are formally classified as SMEs.

Financial Challenges for SMEs

IN8. Small firms rely on internal financing much more than large firms. 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 that of a larger firm. The availability of other types of SME finance, such as leasing and factoring, is also lower in emerging economies.^{IN2}

IN9. SMEs require access to bank services because they often lack the necessary cash flow to make investments. Access to short-term and working capital loans is essential to help SMEs grow in increments. Such loans enable SMEs to purchase supplies, pay employees, and meet obligations to clients. Long-term financing products, such as term loans with longer maturities and fewer restrictions on usage, provide SMEs with needed investment capital for strategic business expansion (for example, for research and development, or to purchase property/assets and equipment). Financial services can enable SMEs to take on more and larger orders/contracts and to extend their reach across borders (for example, through trade finance^{IN3}).

IN10. Evidence indicates that SMEs continue to be undersupplied with the financial products and services that are critical to their growth. According to the IFC and McKinsey study,^{IN4} almost 45 to 55 percent (11 to 17 million) of the formally classified SMEs in emerging markets do not have access to formal institutional loans or other financial products that could help them grow or become more financially stable.

IN11. Banks and financial institutions in general have hesitated to target the SME sector. Banks, which traditionally have served the corporate and large segments of the market, view working with SMEs as a challenge because of lack of adequate information on which to base credit decisions, lack of collateral,^{IN5} and higher costs of processing smaller transactions. SMEs also often lack qualified staff to perform essential financial functions.

Key E&S Concerns in SME Operations

IN12. Business activities of SMEs can potentially generate impacts^{IN6} on the environment, present a hazard to human health or negatively affect local communities as a result of improper planning or management. The extent of this depends on the complexity of business operations, in particular the

^{IN1} Studies indicate that formal SMEs contribute up to 45 percent of employment and up to 33 percent of GDP in developing economies.

^{IN2} See the G-20 Stocktaking Report on "Scaling-Up SME Access to Financial Services in the Developing World."

^{IN3} For example, with a letter of credit, exporting SMEs can offer customers better payment terms because a bank pays the enterprise based upon documentation of the sale and extends credit to the customer of the enterprise.

^{IN4} http://www.mckinsey.com/client/service/Social_Sector/our_practices/Economic_Development/Knowledge_Highlights/~/_media/Reports/SSO/Two_trillion_and_counting.ashx.

^{IN5} Some banks offer unsecured loans to SMEs, based on cash flow rather than collateral, these loans often come with shorter maturities; in general, collateral requirements have been the norm.

^{IN6} Additional guidance for understanding E&S issues in business activities is available at FIRST for Sustainability (<http://firstforsustainability.org/risk-management/understanding-environmental-and-social-risk.php>).

sector and the geographic context. E&S concerns for SMEs are typically associated with production processes or other activities that generate emissions and byproducts that are potentially harmful to the environment, employees and communities.

IN13. The E&S risks associated with the operations of an individual SME are generally limited but aggregated across all SMEs these risks can be significant and need proper management/mitigation starting with individual companies.

IN14. Mitigation measures to address E&S risk will vary as a function of the complexity of the SME's operations. In most cases, management of these issues will not interfere with the SME's economic growth potential and over time those measures should improve the bottom line of the company.

IN15. Banks, investors, insurance companies and buyers typically base their financial decision-making process on risk assessment. The higher the risk, the less likely that a bank will lend or investors are less likely to invest and insurance premiums are likely to be higher as well. Effective E&S risk management by an SME would reduce the overall risk of the company's operations, putting an SME in a better position to obtain loans and insurance cover as well as to attract investment.

IN16. SMEs which do not consider, or effectively manage, the E&S issues associated with their operations could expose themselves to various operational and reputational risks that can ultimately threaten the viability of their operations. Risks for SMEs include:

- **Regulatory issues.** An SME's operations may be impacted directly by E&S regulations, such as operating license requirements, occupational health and safety standards, and emission/discharge permits. If an SME fails to comply with these requirements, this will result in fines and penalties or even indefinite suspension of operations if operating permits are revoked by authorities.
- **Loss of market share.** Due to new or more stringent E&S standards and market demands (such as demands for socially responsible or environmentally preferable products and services) from both local and international buyers, an SME can lose market share if it cannot meet these requirements.
- **Disruption of operations.** An SME's operations may be impacted directly by changing social conditions, such as high staff turnover or changing environmental conditions, such as deterioration of resources on which the operation depends.
- **Liabilities and market devaluation.** SMEs may face E&S liabilities due to E&S damages caused by its operations. Remediation actions for land and/or groundwater contamination (as required under environmental regulations) and claims for payment/compensation for damages or injuries to third parties can be extremely costly, which represents a significant financial burden to SME and typically results in market devaluation of its assets.

Section II. IFC's Role in Supporting SMEs

IN17. IFC provides financial products and advisory services designed to reduce the gap in financing options available to SMEs, enable institution building and disseminate best practices to promote the development of the SME market sector.

Investments Through Financial Intermediaries

IN18. IFC investments through FIs constitute the most important approach for supporting SMEs. For IFC, investing through FIs is a more efficient and effective approach for reaching a larger group of SMEs than providing direct financing to individual SMEs.

IN19. IFC provides debt, equity and guarantee facilities to FIs in emerging markets, which in turn provide financial support to SMEs. Banks provide working capital and other types of short term finance (such as short-term loans, overdraft facilities, trade finance,^{IN7} warehouse finance,^{IN8} and factoring) to SMEs. Private equity funds^{IN9} invest in local companies, which are for the most part SMEs. IFC also supports the insurance sector, which is critical for the development of SME markets.

Direct Investments in SMEs

IN20. Since 2000, IFC has mostly shifted away from making direct investments in SMEs. Nowadays, this type of investment is infrequent and typically limited to providing long-term venture capital to SMEs involved with information technology, telecommunication or mining exploration.

Advisory Services

IN21. IFC's Advisory Services support SMEs by improving the investment climate, connecting SMEs with potential buyers and trading partners, strengthening financial infrastructure (such as credit bureaus, collateral registers, and payment systems) and providing resources for building management skills.

IN22. Advisory Services developed two on-line capacity building tools: the SME Toolkit^{IN10} and Business Edge.^{IN11} The SME Toolkit^{IN12} provides SMEs with a comprehensive set of guidance on accounting and finance, business planning, human resources, exports legal and insurance, marketing and sales, operations, etc. needed for establishing and running a company. Business Edge is a training system that provides practical solutions for SMEs. It aims at improving the business performance and competitiveness of firms and creating jobs in developing countries.

Section III. IFC's Approach to Managing Environmental and Social Risk

IN23. In accordance with the IFC Policy on E&S Sustainability (Sustainability Policy), IFC categorizes its investments using a system based on the relative magnitude of E&S risks and impacts. Investments involving FIs or delivery mechanisms involving financial intermediation are classified, from high to low E&S risk, as Category FI-1, FI-2 and FI-3; direct investments are classified as A, B or C.

IN24. All IFC clients and projects financed by IFC are expected to manage the E&S risks associated with their operations or activities. As a result of the E&S review process, IFC determines the scope of the E&S performance requirements for IFC clients (both in direct investments to SMEs and through FIs) based on

^{IN7} IFC's Global Trade Finance Program (GTFP) was conceived as a vehicle to facilitate the provision of trade finance to banks in the emerging markets, with particular emphasis on IDA countries and smaller institutions which serve SME clients. The GTFP has now been operational for over five years, with a strong track record of development results. 83% of underlying trade transactions are considered SME; overall over 8,400 guarantees with a median value of \$164,000 have been issued without loss. Approximately 75% (\$8 billion) of the total dollar volume of guarantees issued has been in support of imports and 25% (\$2.6 billion) has been in support of exports in the form of pre-export finance.

^{IN8} The Global Trade Supplier Finance (GTSF) program will, through reverse factoring, provide better access to working capital finance at competitive terms to suppliers in developing countries, many of which are SMEs. In addition, a Global Warehouse Finance Program (GWFP) supports access to finance for players in the agriculture sector, including SME and farmer producers, against warehouse receipts as collateral.

^{IN9} For instance, the IFC SME Ventures Program launched private equity funds, which target smaller SMEs in five IDA countries, four of which are Fragile States.

^{IN10} <http://www.smetoolkit.org/smetoolkit/en>.

^{IN11} http://www.businessedge-me.com/cms.php?id=landing_page.

^{IN12} To date, the Toolkit has been translated into 15 languages (Arabic, Bengali, English, French, Hindi, Indonesian, Macedonian, Mongolian, Nepali, Portuguese, Russian, Spanish, Ukrainian, Urdu, and Vietnamese) and has almost 30 regional and sector sites.

the IFC investment type, use of proceeds from the IFC investment, and level of E&S risk associated with client operations.

Through Financial Intermediaries

IN25. The Policy on Environmental and Social Sustainability requires IFC FI clients to develop and operate an Environmental and Social Management System (ESMS)^{IN13} commensurate with the level of E&S risk in their portfolio and prospective business activities.

IN26. As part of the ESMS, IFC FI clients are required to identify the E&S risks and impacts associated with their lending/investment activities by conducting environmental and social due diligence (ESDD)^{IN14} at the transaction level to identify the risks and impacts associated with environmental, social, labor, occupational health and safety, and security aspects of borrower/investee operations (see Figure 1).

Figure 1. Sample Checklist for Reviewing E&S Issues in SMEs by Financial Intermediaries^{IN15}

<p>1. Nature of the client's business:</p> <ul style="list-style-type: none"> • name, location (region, city/town and type of neighborhood - commercial or residential) • industry sector, product manufactured, capacity, no of employees • main markets (domestic/export (specify countries)) <p>2. Key indicators of problems</p> <p>House keeping in the work areas</p> <ul style="list-style-type: none"> • Evidence of liquid and solid wastes in the workplace • High levels of noise (intermittent or continuous) • Strong smell's/irritants • Access, fire risk <p>Handling of wastes</p> <ul style="list-style-type: none"> • Whether hazardous or not (check with client) • Disposal mechanism • Waste water and effluents • Treatment • Presence of toxic/hazardous materials • Disposal • Air emissions from stacks (chimneys) <p>Social and labor issues</p> <ul style="list-style-type: none"> • Labor and working conditions and ability to have representation • Relations with local communities, disclosure and transparency • Records of problems, complaints and protests from local communities <p>3. Environmental Regulatory Compliance and Liability</p> <p>Is the Company in possession of all required HSE permits and approvals?; Has the Company paid excess charges or fines/penalties for non-compliance with HSE regulations and standards in the last two years? ; Is the Company exposed to potentially significant HSE liabilities, such as those arising from land / groundwater contamination, related to the Company's past or ongoing operations? If yes, specify magnitude?; Has the Company had any significant accidents or incidents in the last two years (e.g., oil spills, fires) involving deaths or multiple serious injuries and/or significant environmental damage? Was the company inspected by relevant government/municipal authorities in last 2 years? If yes, provide results.</p> <p>4. Social issues and community relations</p> <p>5. In the event that the Company is not materially in compliance with HSE regulations and standards, or if there are potentially significant HSE liabilities, please describe further actions required by the authorities and/or planned by the Company to address these issues satisfactorily, and to achieve regulatory compliance.</p>

^{IN13} Additional guidance for FIs for developing an ESMS is available at FIRST for Sustainability (http://firstforsustainability.org/risk-management/managing-environmental-and-social-risk-2_2.php).

^{IN14} Additional guidance for FIs for conducting ESDD is available at FIRST for Sustainability (<http://firstforsustainability.org/risk-management/environmental-and-social-due-diligence.php>).

^{IN15} This sample checklist is indicative rather than exhaustive and should be further developed, as necessary, to identify the risks and impacts associated with environmental, social, labor, occupational health and safety, and security aspects of SME operations.

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IN27. The majority of IFC FI client transactions to support SME operations constitute short-term financing. For FIs involved with transactions consisting of short-term financing (such as short-term loans, overdraft facilities, trade finance, warehouse finance and factoring), the scope of the ESDD typically includes a review against the IFC Exclusion List,^{IN16} applicable E&S laws and regulations and, as necessary, country-commodity and country-sector specific risk screens, if available.^{IN17} These types of transactions are not subject to review against the requirements of the Performance Standards.

IN28. FIs involved with transactions consisting of long-term financing^{IN18} (such as for medium size companies seeking to expand their operations, potentially resulting in property/asset acquisition/development and increased air/water emissions due to increased production capacity), the ESDD process^{IN19} typically includes a review against the IFC Exclusion List, national E&S laws and regulations, and IFC's Performance Standards 1 through 8.

IN29. As an outcome of the ESDD process, the FI can identify necessary mitigation measures or corrective actions^{IN20} for SME operations. For certain transactions, in particular long-term financing,^{IN21} the E&S action plan should state the mitigation measures necessary to reduce risks and impacts of operations on the SME's workers, communities, and the natural environment. Typically, the scope of issues considered is related to Performance Standard 1 on Assessment and Management of Environmental and Social Risks and Impacts and Performance Standard 2 on Labor and Working Conditions. Depending on the sector of the SME, issues related to Performance Standard 3 on Resource Efficiency and Pollution Prevention and/or Performance Standard 6 on Biodiversity Conservation and Sustainable Management of Living Natural Resources are also included. Issues related to Performance Standards 4, 5, 7 and 8 (such as community health, resettlement, indigenous people and cultural heritage) are not frequently relevant to the activities of most SME operations. However, this should be determined on a case by case basis.

In Direct Investments

IN30. In compliance with IFC's Sustainability Policy, IFC conducts ESDD of all new direct investments that are being considered for IFC support, whether in the design, construction, or operational stage.

IN31. All IFC clients are required to implement an ESMS commensurate with the level of E&S risks and impacts associated with their operations. For direct investments in SMEs, the scope of E&S risk management will vary as a function of the scale and complexity of the SME's operations and the associated E&S risks and impacts.

IN32. For most SMEs, the scope of the ESMS generally addresses monitoring ongoing compliance with applicable E&S regulations as well as issues related to Performance Standard 1 on Assessment and Management of Environmental and Social Risks and Impacts and Performance Standard 2 on Labor and Working Conditions. The other Performance Standards are not frequently relevant to the activities of most SME operations. However, this should be determined on a case by case basis as SMEs' operations have to comply with the IFC's Performance Standards where relevant.

^{IN16} The IFC Exclusion List defines the types of projects that IFC does **not** finance (http://www1.ifc.org/wps/wcm/connect/Topics_ext_content/ifc_external_corporate_site/IFC+Sustainability/Risk+Management/Sustainability+Framework/Sustainability+Framework+-+2006/IFC+Exclusion+List/).

^{IN17} IFC is supporting the development of guidance and tools for FI clients, including country-commodity and country-sector screens and due diligence frameworks to review the risks associated with short-term, revolving facilities offered to SMEs.

^{IN18} Project finance or long term corporate finance.

^{IN19} Additional guidance for FIs on the ESDD process for SMEs is available at FIRST for Sustainability (<http://firstforsustainability.org/risk-management/due-diligence-for-small-and-medium-enterprises.php>).

^{IN20} Additional guidance for FIs on preparing a corrective action plan is available at FIRST for Sustainability (<http://firstforsustainability.org/risk-management/corrective-action-plan.php>).

^{IN21} Project finance or long term corporate finance.