

CDKN policy brief:
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Increasing MSME access to climate finance

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Dalberg

Key Messages

- Micro, small and medium-sized enterprises (MSMEs) have an important role to play in climate action as they account for 90% of enterprises in developing countries.
- Three key areas require attention to increase access to climate finance for MSMEs: improving the enabling environment; increasing knowledge and awareness of MSME climate finance opportunities; and providing tailored financial products.
- High transaction costs are a fundamental barrier to MSME investing – finance providers should work through local FIs and MSME aggregators to maximise reach and efficiency.
- The vast majority of MSMEs in developing countries are in the informal sector - finance providers should test and expand use of alternative credit worthiness assessments and alternative collateral approaches to reach informal businesses.
- The trade, agriculture, and manufacturing sectors contain the highest number of MSMEs in developing countries, and so opportunities to green the operations of businesses in these sectors could have considerable impact.
- Based on market projections for MSME climate technology sectors in developing countries, wastewater, small hydropower, and water technologies will support the highest number of MSMEs, so support to these businesses will be crucial.
- The pilot phase of the Green Climate Fund's (GCF) MSME Program is an important opportunity to i) identify specific investment opportunities in these sectors, ii) test new approaches to reach MSMEs efficiently, and in particular, iii) test approaches to reach informal MSMEs.

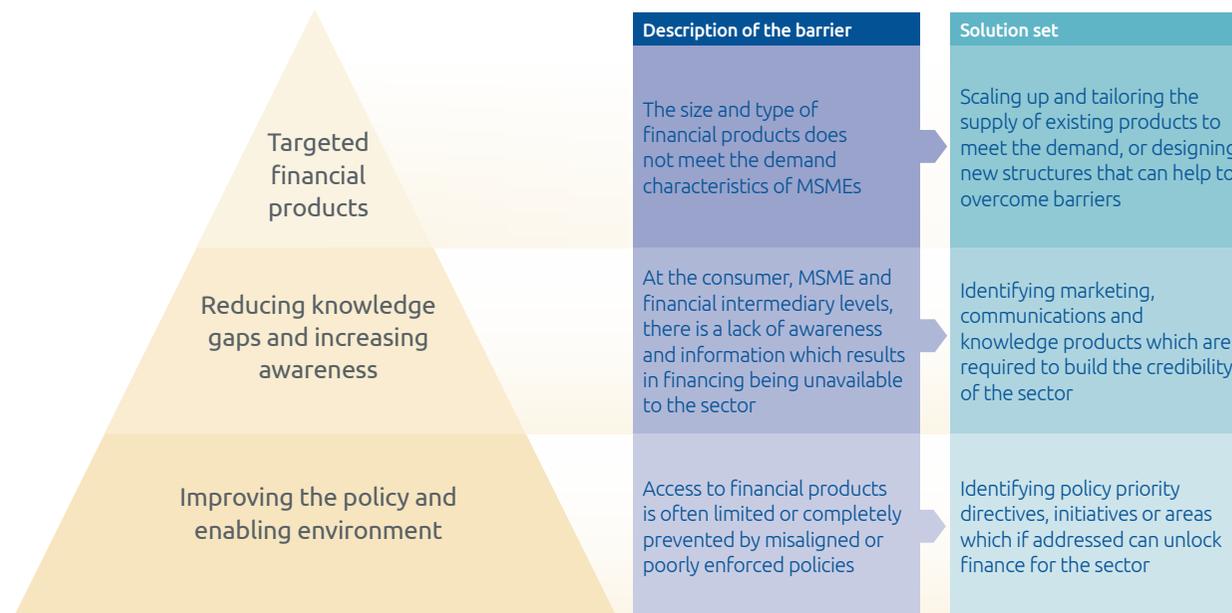
Context

An adequate response to the growing threat of climate change in developing countries requires greater involvement of the private sector, and micro, small and medium-sized enterprises (MSMEs) in particular. MSMEs account for 90% of businesses in developing countries¹ and so greening MSMEs could be essential to help move the private sector to a low-emission, climate resilient development pathway. Furthermore, MSMEs play an essential role in several climate technology sectors and help provide related goods and services to the base of the pyramid.

The capacity for MSMEs to realise their potential role in climate action is restricted by a lack of access to climate finance. This is primarily due to weak enabling environments; limited knowledge and awareness of finance opportunities, and; inadequate financial products (Figure 1.).

The GCF Board recognized the importance of supporting MSMEs and approved the creation of a MSME Program within its Private Sector Facility. This policy brief aims to outline the options available to the MSME Program to help it tackle the barriers mentioned above. This document also provides suggestions for the program’s strategic objectives, in particular during its pilot phase.

Figure 1:
Barriers and solutions to improving access to finance for MSMEs



¹ The SME Banking Knowledge Guide, IFC

² Building Competitive Green Industries: The Climate and Clean Technology Opportunity for Developing Countries, infoDev Climate

Methodology

This policy brief was written by Dalberg Global Development Advisors, and provides a synopsis of a longer report on “Increasing MSME access to climate finance”. The project team used a combination of quantitative and qualitative analysis to develop the findings in the report. The data and information used to formulate these findings came from a wide variety of sources, including existing literature, analysis, and a large number of expert interviews.

For each solution, the team identified and outlined a relevant case study to highlight where the solution has been successfully implemented.

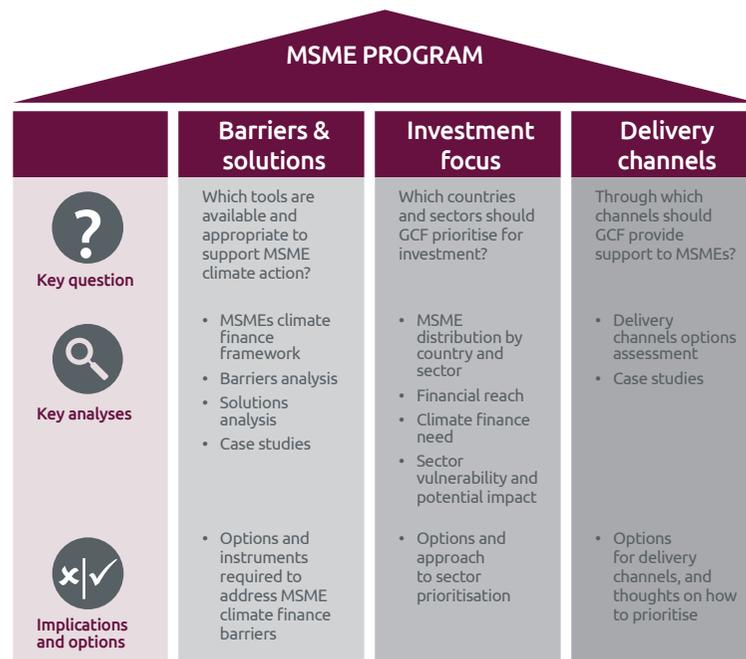
To assess which countries and sectors the GCF should prioritise, the team split the analysis into two sections i) prioritising support to MSMEs in all sectors for greening existing operations, and ii) prioritising support to MSMEs working in climate technology sectors. The team used the IFC MSME database (among other sources) to estimate the number of MSMEs across sectors and the corresponding credit gap. The climate technology prioritisation approach used estimates from a recent Infodev report² to estimate the MSME clean technology market size opportunity. The scope of this analysis was limited to using existing data to form a high-level view of prioritisation, and the project team did not undertake in-country analysis or validation.

The project team aimed to answer three key questions: what are the barriers and solutions for increasing MSME access to climate finance, which countries and sectors should the GCF prioritise for investment, and which delivery channels should the GCF use to support MSMEs.

When assessing the barriers and solutions, the team conducted extensive desk research. A large amount of literature exists around how to address access-to-finance barriers for MSMEs, but there has been very little focus on climate finance, specifically for MSMEs. Therefore, the team conducted over 30 interviews with multilateral organisations, NGOs, corporations and government actors to build our understanding of which barriers and solutions are most applicable to climate finance for MSMEs.

Finally, the team conducted desk research to identify the possible delivery channels the GCF could use to support MSMEs. Using expert interviews and case studies, they assessed each delivery option and outlined its suitability for the MSME program. Figure 2 adjacent illustrates the team’s methodology.

Figure 2: *Dalberg approach focuses on core elements of MSME Program design*



² Building Competitive Green Industries: The Climate and Clean Technology Opportunity for Developing Countries, infoDev Climate Technology Program

Solutions to increasing access to climate finance for MSMEs

In order to successfully catalyse climate action among MSMEs, the GCF can support interventions across three key areas (Figure 1):

- **Improvements to the enabling environment.** Many options exist to support policies that can encourage and enable the flow of climate finance to MSMEs. For example, at the national level, the GCF could support the development of clear and stable climate change strategies, strengthened financial infrastructure, and pro-MSME and pro-green investment policies. It could also support the development of green incentives for MSMEs, as well as national standards for climate technologies. At the international level, stakeholders could support free trade in green technologies and the reduction of counterproductive fossil-fuel subsidies³.
- **Increasing knowledge and awareness.** The GCF could support the provision of climate finance by focusing on improving knowledge and awareness of the opportunities. For example, it could support matchmaking platforms to link investors with investees. It could also support technical assistance programs for investors, intermediaries, or MSMEs to improve understanding of the opportunities and how to access them.
- **Providing tailored financial products.** The opportunities for support in this area are multifaceted. The MSME Program could encourage intermediaries to provide finance to MSMEs by earmarking funding and by using simplified applications and reporting requirements. It could finance risk-sharing instruments such as concessional finance, grants and first-loss investments to reduce the cost and risk of MSME investments. It could also invest through MSME aggregation points to maximise efficiency of working with small organisations, and it could test alternative credit worthiness methodologies to lend to informal businesses. Finally, the MSME Program could provide financial products based on the growth stage of MSMEs, such as focusing on providing seed funding to new MSMEs or working capital to rapidly expanding businesses.

³ It should be noted that the GCF may potentially undertake policy interventions through its readiness window, in which case the options here could be incorporated into that support

Implications for the GCF's MSME Program

Beyond the willingness and ability to support the range of interventions mentioned above, the MSME Program will have to face additional challenges:

The MSME Program should find ways to maximise efficiency of MSME investing. There are more than 350 million MSMEs in developing countries. The transaction cost of interacting with large numbers of entities, with small ticket sizes, means the MSME Program will need to find ways to maximise efficiency of lending and investing. Practically speaking,

this means prioritising investments through those intermediaries that have demonstrable efficiency advantages and/or targeting investment aggregators as an entry point to the MSME market.

The MSME Program should look for ways to invest in the informal sector. The majority of MSMEs in developing countries, almost 300 million, are in the informal sector. Therefore access to climate finance will remain limited unless providers find a way of investing in informal businesses that goes beyond

traditional financial products. The MSME Program could therefore support solutions such as alternative sources of collateral or alternative credit worthiness assessments.

Country and sector-level analysis should determine specific programs within the MSME Program. Analysis shows that the sectors in developing countries with most MSMEs are trade, agriculture, and manufacturing. Providing greening support to these businesses could have a significant impact on emissions and resilience. Among climate technology sectors in developing countries, it is estimated that wastewater, small hydropower, and water technologies will support large numbers of MSMEs in the coming decade. The MSME Program should conduct analysis into each of these sectors, across multiple countries, to identify specific investment opportunities.

The MSME Pilot Program could test approaches to tackle the challenges mentioned above, whilst maximising learning before scale-up. The overarching objective of the pilot should be to test and refine the MSME Program's approach in preparation for full-scale implementation, and in doing so reduce uncertainties around potential challenges. There are two

components to this. First, the pilot program should test new approaches whilst at small-scale to reduce risks of failure. Second, it should maximise learning to ensure that efficiency gains can be found early on during scale-up. Practically, this means that the MSME Pilot Program should identify investments that can maximise MSME reach whilst reaching informal MSMEs. These investments should be made within the bounds of a strong M&E framework to ensure all key lessons can be extracted and used in future investments.

The pilot program would be a good opportunity to undertake more detailed sector analyses at the country level to uncover specific investment opportunities. For example, in-depth sector analysis may suggest that a high priority opportunity exists in financing for off-grid mini-solar power units for MSMEs in the manufacturing sector. Given this information, the efforts of the pilot program could focus around a coordinated approach to support a stronger enabling environment, increased knowledge and awareness, and the provision of tailor financing products specifically for this opportunity.

More information can be found in the full report, **“Increasing MSME access to climate finance”**.

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