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Financing SMEs in Africa: Rethinking the Role of Development Finance Institutions

Florian Léon

Florian Léon, Research Officer, FERDI

In Africa, small and medium-sized enterprises (SMEs) face a chronic financing gap that hinders their growth and the continent's economic development. Development Finance Institutions (DFIs) are often seen as a solution to bridge this gap, particularly through indirect support to local banks. However, an in-depth analysis of their impact reveals mixed results. While targeted beneficiaries benefit from these programs, it is at the expense of other borrowers. There is a need to rethink the support for these DFI-intermediated financing schemes aimed at supporting the SME sector.

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Introduction

The private sector, especially SMEs, is essential to ensuring sustainable development in Africa. SMEs play a central role in wealth creation and sustainable employment, which is critical to addressing the continent's demographic challenges. In addition, a vibrant private sector reduces economic dependence on a few exported resources and promotes innovation tailored to local needs. Yet Africa's productive sector remains largely informal, and formal firms, which are often small, suffer from low productivity (Baraton *et al.*, 2021).

To sustainably strengthen African economies, there is an urgent need to overcome the barriers faced by entrepreneurs. One approach is to focus solely on improving the business climate. The logic is to provide a harmonious framework to encourage business development without directly interfering with their activities. Numerous programs, often supported by international organizations, have been implemented to this end. However, improving the business environment has not always had the expected impact (Hallward-Driemeier and Pritchett, 2015) and has not alone overcome the obstacles faced by businesses in low- and middle-income countries.

A second approach is to provide direct support to firms to help them overcome their difficulties, particularly financial ones. Because of the importance of financial constraints for firms (see **Figure 1**), **several programs have been developed to facilitate access to finance, particularly through the actions of development finance institutions (DFIs).** The role of DFIs is to stimulate private sector development in developing countries by investing directly in private enterprises. Public capital aims to rebalance the risk-return ratio by reducing costs (and thus increasing profitability) and/or risks.

Development finance institutions stimulate private sector financing, in particular by supporting financial intermediaries (banks, microfinance institutions, investment funds, etc.) to channel these funds to financially constrained enterprises. Despite the growing importance of these intermediation programs, there are few evaluations of their actual impact on stimulating private sector financing. **A recent study by Ferdi (Léon, 2025) has highlighted the limitations of these programs in Africa.**

This note presents the main findings of this study, after first describing the role and functioning of development finance institutions. It concludes with recommendations for improving existing private sector support programs in Africa.

Development Finance Institutions at the Heart of Private Sector Support

Financial intermediation programs in Africa are primarily the work of development finance institutions (DFIs). DFIs are financial institutions with predominantly public capital that finance private projects in developing countries. Some DFIs are part of large multilateral development banks, such as the International Finance Corporation (IFC) of the World Bank Group. Other DFIs originate from individual countries, such as US-DFC (United States), BII (United Kingdom), FMO (Netherlands), DEG-KfW (Germany), or Proparco (France). While some DFIs are legally independent, most multilateral DFIs have only a private sector division, with a few exceptions such as the IFC (for the World Bank) and IDB Invest (for the Inter-American Development Bank).

Despite their limited number, DFIs have played an increasingly important role in development finance, particularly for the private sector. According to several evaluations using different methodologies, DFI investments account for about 15 to 20 percent of foreign direct investment in Africa (Massa, 2016; Léon, 2025).

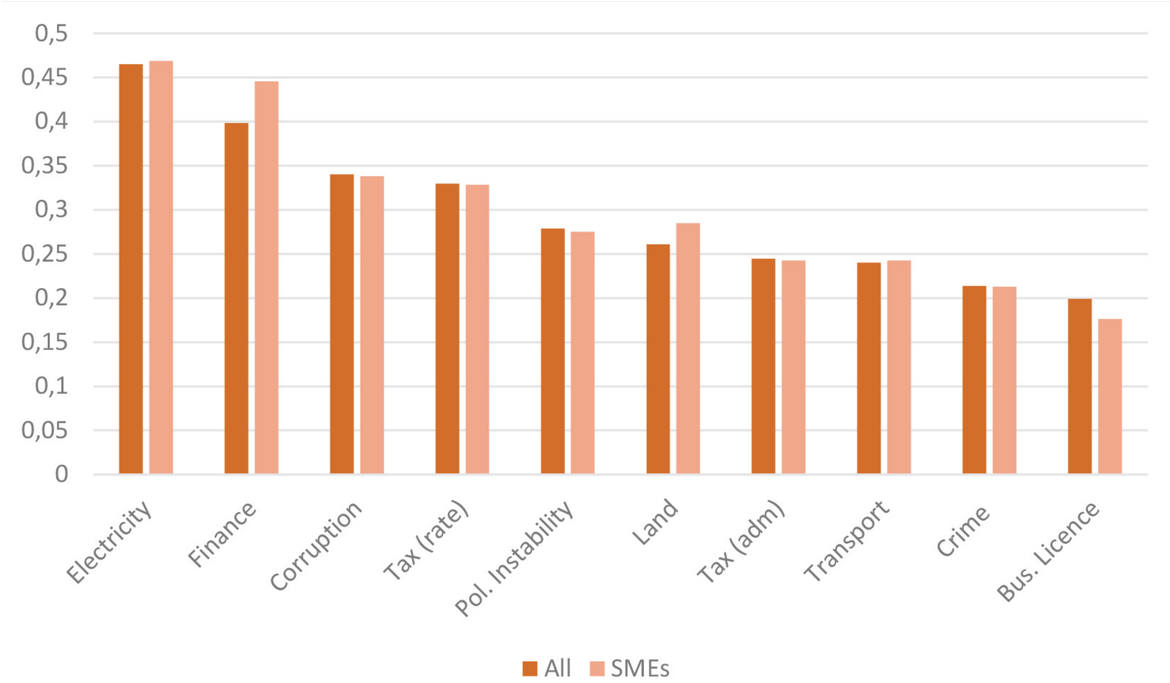
DFIs differ from other investors in developing countries because of their development mandate and the public support they receive. DFIs operate under market conditions. Additionality to the private sector is essential to the legitimacy of their actions (Carter *et al.*, 2021). They should not compete directly with other investors. This additionality can be transitional if they aim to demonstrate that investing in certain low-income countries is profitable under classical market conditions. They must then play a pioneering role and demonstrate that they will eventually be followed by traditional commercial investors. They may also have a mandate to target high-impact projects that are less profitable and/or riskier. Their additionality is then sustainable.

Schematically, DFIs provide financial support to private enterprises in two ways (**Figure 2**):

1. Direct financing: They invest directly, through debt or equity, in private projects or companies through loans or equity. This channel is limited to a small number of large projects because it is difficult for DFIs to absorb the costs of small amounts of financing. This direct financing is therefore useful for supporting large infrastructure projects or large enterprises but ineffective for targeting SMEs with financing needs in the tens or hundreds of thousands of euros.

2. Intermediated financing: Through this method, DFIs finance banks, investment funds, or microfinance institutions through credit lines, equity, and risk-sharing instruments (e.g., guarantees). The supported structures then use these additional resources to provide financing to projects defined in the contract signed with the DFI.

Figure 1. Main obstacles reported by African entrepreneurs



Sources: WBES (latest wave for each country), author's calculations. The survey was conducted with 35,000 companies in 42 sub-Saharan African countries. Each bar reports the percentage of companies stating that the obstacle is a major barrier to their business development. "All" refers to all surveyed companies. "SMEs" groups companies with 0 to 19 employees.

Because of its importance in channeling capital to a large number of start-ups and SMEs, intermediated financing is widely used by DFIs, accounting for between one-third and one-half of their portfolio. The advantage of this approach is to contract with a single counterparty (e.g., a bank) for a large project (several million), which reduces costs while making it possible to finance a large number of SMEs. The supported financial institution uses these resources to focus on new projects. It is therefore a relatively effective approach for mobilizing private finance in general and private finance for SMEs in particular.

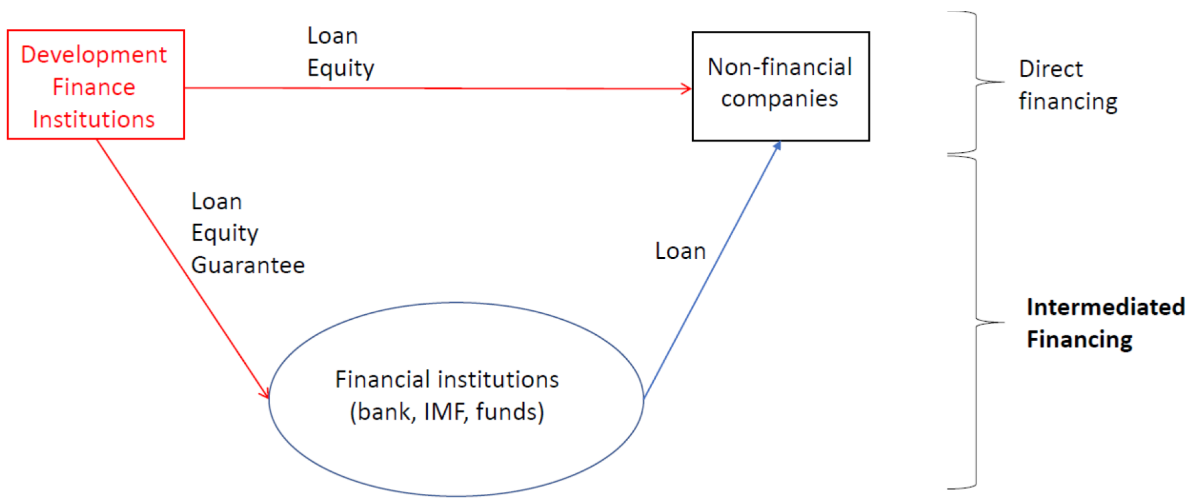
The Unintended Effects of DFI Support to African Banks

Despite the importance of intermediated finance programs in supporting SMEs, there is little evidence on their effectiveness. Existing studies (Cassano *et al.*, 2013; Amamou *et al.*, 2023; Aydin *et al.*, 2024), as well as internal evaluations by DFIs, mainly seek to determine whether the target population benefits from these instruments. They generally highlight positive impacts for beneficiaries. However, these analyses ignore what happens to non-beneficiary clients (within the bank) or to other unsupported banks.

A recent study by FERDI (Léon, 2025) examines whether DFI support programs stimulate the lending of supported banks in Africa and whether other banks suffer from possible competitive distortions. In contrast to previous studies, the analysis is not limited to the targeted borrowers, but takes a broader view of banks' lending activities. It is expected that DFI support will lead to an increase in lending by the supported bank, other things being equal. In addition, other banks operating in the same market should not see their activities change in the absence of competitive distortions.

This analysis is based on an original database containing information on 900 projects for African financial intermediaries financed by 17 DFIs (5 multilateral and 12 bilateral) over the period 2010-2021. For each project, the database provides the year of program signature, the name of the beneficiary, the total amount, and the financial instrument used. Descriptive statistics

Figure 2. Operating modalities of DFIs



show that banks are the main beneficiaries of these programs, as two-thirds of the programs are dedicated to them.

The study examines whether the supported banks increase their lending activities after receiving a program. It is expected that these banks will use these additional resources to target new clients or offer better financing terms to existing clients. To this end, the data collected are merged with information on African banks. The database on DFI programs allows the identification of banks that have received support. The total sample considered for the study includes 956 African banks, of which 156 received DFI funding between 2010 and 2021 and 798 did not. The empirical analysis thus compares the evolution of the lending activity of supported banks before and after the treatment with that of a group of similar banks.

Contrary to expectations, the empirical results show an 8% slowdown in the lending activity of supported banks compared to a group of similar banks. This negative effect appears two years after the signing of the agreement and tends to persist in the following years. The time lag is explained by the implementation period of the project.

Several possible explanations are put forward and tested to explain this unexpected result. Further analysis suggests that this reduction in activity is not due to DFIs targeting certain banks for political reasons or because the supported banks are in difficulty. Similarly, the slowdown in the lending activity of the supported banks does not seem to be related to the relatively strict intervention conditions of the DFIs. The latter, due to a mandate focused on financing high-impact enterprises, may induce banks to reduce their investments in polluting sectors. This could explain a slowdown in lending. However, additional analyses do not confirm this hypothesis and tend to refute it.

The data suggest that assisted banks may struggle to cope with the costs of these programs. They may be forced to reallocate some of their resources at the expense of traditional customers. DFI support imposes additional costs on recipient banks, whether in terms of implementation costs (identifying new projects to finance, supporting enterprises) or monitoring costs. Supported banks will therefore need to reallocate some of their resources (especially human resources) to target new clients and meet DFI requirements. If their capacity is limited in the short term, they are thus forced to make a choice by prioritizing the beneficiaries targeted by the program at the expense of other borrowers. Due to the composition effect (new loans are smaller than old ones and take longer to materialize), the bank's lending activity slows down. To validate this explanation, it is hypothesized that small banks or those that are initially less efficient have higher adjustment costs and experience a greater reduction in their activity, which is supported by the data.

The second part of the study focuses on banks that are not supported by DFIs. The results show that the level of financing provided by DFIs has no effect on these banks. In other words, financial intermediation programs have no effect on unsupported banks, either negative (distortion of competition) or positive (recovery of unserved clients relative to the previous result).

Recommendations to Make Intermediated Financing More Effective

Existing studies have highlighted the positive effects of financial intermediation programs for targeted segments (Amamou *et al.*, 2023; Aydin *et al.*, 2024), although not all studies agree (Cassano *et al.*, 2013). **The FERDI study (Léon, 2025) suggests that these positive effects come at**

a cost for clients not targeted by these programs. The slowdown in lending is explained by a reallocation of the portfolio in favor of companies and sectors targeted by the program. Conversely, the bank's traditional clients no longer benefit from the same financing opportunities as before.

The impact on access to credit for SMEs is ambiguous and depends on the nature of the clients not targeted by the program, who therefore bear the costs. If banks decide to reduce their support to well-established firms with easy access to other sources of finance, the results are not worrying. However, it is possible that banks may reallocate some of their resources to the detriment of clients with difficult access to credit, such as SMEs operating in sectors not targeted by the scheme. This possibility is more likely if these small loans generate low margins for the bank. In this case, the impact on credit access is more questionable. There is a risk of facilitating access to credit for certain targeted enterprises while increasing the financial constraint for other potential borrowers.

This problem could be exacerbated if projects target areas where banks have less expertise, such as climate or agriculture. Unlike more traditional projects supporting SMEs or exports, banks often lack the internal skills to select companies or projects to finance in these emerging sectors. In addition, monitoring projects and indicators requires specific knowledge that banks do not always have.

Misguided Solutions

A misinterpretation of the results of the Ferdi study would be to conclude that DFIs should abandon intermediated finance, limit it to banks with the best absorption capacity, or target only low-cost (often less innovative) projects.

First, intermediated finance is the main channel through which DFIs can support SMEs and start-ups in developing countries. As explained above, direct financing is only possible for projects costing millions of dollars, which excludes the majority of enterprises in low- and middle-income countries. In addition, this segment is of significant financial importance to DFIs.

Limiting support to well-established banks is also not a sustainable solution. The beneficiaries of DFI financing are already well-established financial institutions belonging to large banking groups (Gajigo *et al.*, 2022; Léon, 2025). However, there are several arguments in favor of broadening the range of eligible institutions. Local institutions have in-depth knowledge of the terrain and are better equipped to collect and process qualitative information, which is essential for financing SMEs (Stein, 2002; Liberti and Mian, 2009). Moreover, the principle of additionality (Carter *et al.*, 2021) implies supporting institutions that have difficulty accessing external capital, unlike large international financial groups that can raise funds on the markets. Sustainable development of the financial system requires support for a variety of actors that provide complementary services. It is therefore crucial not to limit support to banks, but to include microfinance institutions (MFIs), insurers, leasing companies and investment funds.

Finally, DFIs may be tempted to target projects with the lowest implementation costs. However, a significant portion of these costs are difficult to compress because they relate to the procedures that financial institutions must follow in order to work with DFIs. These procedures are designed to ensure that funding goes to safe institutions and that funds are not diverted. A simple solution would be to streamline and simplify procedures, but even if there is room for improvement, it is unlikely that DFIs can drastically reduce their requirements, some of which are regulatory. Another approach is to address the cost of implementing programs, particularly by targeting areas where banks have expertise.

However, focusing on less ambitious programs with limited implementation costs would be contrary to their mandate. Financing the expansion of an existing program is certainly useful and less costly, but it will not have the same impact as a program aimed at structuring a new market, whether it is developing an innovation, exploring a new geography, or exploring new issues such as climate or biodiversity.

Better Supporting Supported Financial Intermediaries

To make intermediated finance more effective, DFIs need to play an active role in supporting the financial intermediaries they support, particularly in implementing innovative programs. These programs, such as those related to climate or agriculture, present unique challenges and require specific expertise. The cost of implementing innovative programs is often high. Financial intermediaries must not only absorb the costs of monitoring, but also develop expertise in new market segments. Traditional risk assessment tools need to be adapted to take into account sector or geographic specificities. Case studies are lengthy and costly, and loss ratios can be significant. To address these challenges, DFIs can apply several levers.

Adjust overhead costs: DFIs should fund overhead costs that reflect the real costs of the supported banks, MFIs, and funds.

Provide technical assistance: DFIs could increase technical assistance. This assistance could include training of intermediary staff, development of new risk assessment tools, and sharing of best practices. By supporting banks in these areas, DFIs can reduce start-up costs and improve program efficiency.

Experimentation and lessons learned: Small-scale experimentation and lessons learned are also effective ways to limit implementation costs. By building on lessons learned from previous projects (both successful and unsuccessful), financial intermediaries can avoid costly mistakes and optimize their processes. DFIs can facilitate this experience sharing by creating collaboration platforms and organizing training workshops.

Concessional financing: DFIs also have a key role to play in providing concessional loans to improve project viability and cover some of the invisible costs of implementation. It is sometimes necessary to accept that short-term costs are higher than expected, especially for innovative projects. Financial returns may take a long time to materialize, and financial instruments need to be adapted accordingly. Partially concessional financing can be a solution, allowing projects to be supported until they reach sustainable profitability.

Conclusion

Intermediated financing is a powerful tool for DFIs to promote the development of the dynamic economic system. Although its effectiveness is limited by implementation and monitoring costs, there are solutions to improve this financing method. Technical assistance and subsidized loans are two key levers to overcome these challenges.

Beyond operational solutions, however, **this discussion raises the question of the role of subsidies and concessional financing by DFIs.** The assumption is that DFIs make only limited use of public financial support and operate at market rates. Nevertheless, the question arises as to the interest of using concessional funds when their investments are directed to riskier regions and actors, and thus entail higher risks and costs, but a stronger economic, social and/or environmental impact.

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Contact
www.ferdi.fr
contact@ferdi.fr
+33 (0)4 43 97 64 60

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