A Unified Regulatory Framework for SMEs to Access Capital

WORLD ECONOMIC FORUM

An Actionable Idea by Lulu Financial Group, a member of the Regional Action Group for the Middle East and North Africa

Call to action

This actionable idea contributes to:

Action 1: Fulfilling the pledge of the Principles of Stakeholder Capitalism for the Middle East and North Africa

Principle 4: Harnessing the Fourth Industrial Revolution

Action 2: Contributing to the United Nations Sustainable Development Goals

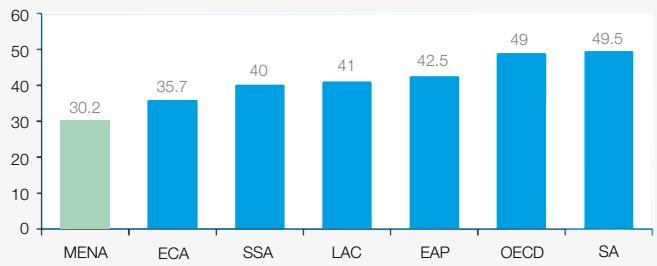
- **UN SDG 8: Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all.**
- **UN SDG 9: Build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation.**

The actionable idea

The idea is to establish a uniform regulatory framework for small and medium-sized enterprises (SMEs) based in the Middle East and North Africa (MENA) region to be part of a singular credit readiness system. Through a region-wide coalition, stakeholders such as GREs, auditors, financial institutions and private investors will be able to standardize the regulatory framework for SMEs to become credit worthy. Rooted in internationally accepted audit and compliance modalities, such a framework aims to allow SMEs to formalize their bookkeeping process, raise their profile among investors, consumers and other stakeholders, and adhere to the financial readiness expected by formal banking systems for better access to capital expenditure and supply chain finance.

SMEs in the MENA region

Despite being built on the foundation of enterprising individuals and startups, the MENA region faces one of the largest unemployment ratios in Asia. SMEs, which form the backbone of the region's economies, are among the worst-funded globally, with only 3% having access to funding.



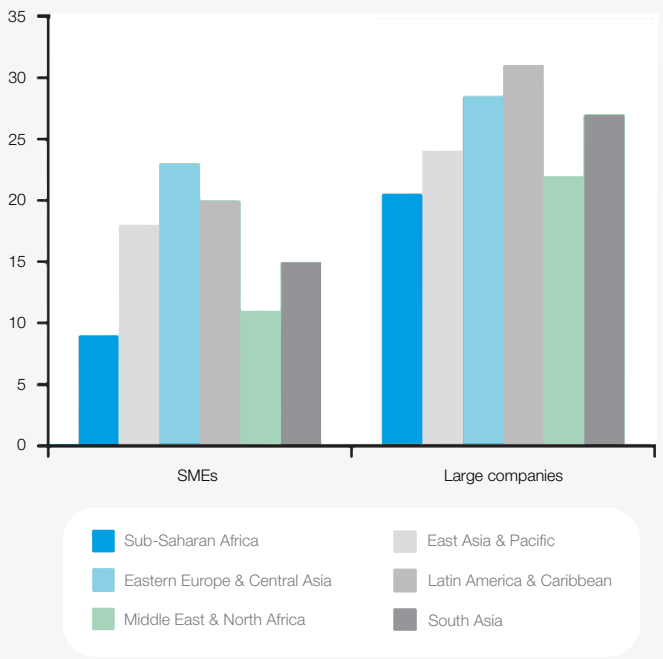
Source: World Bank Enterprise Surveys (2006-2009)

Despite SMEs representing 96% of registered companies, the MENA region's SME employment as a percentage of total private employment is among the lowest in the world. Meanwhile, SMEs in the region count among the lowest levels of bank loans usage globally, at 8% of total bank lending.

Not only lending for operations, but lending for capital expenditures (capex) is also severely re-stricted in this matter. For example, a mall operator may need to install an escalator, for which the operator may approach a bank. The bank can simply open a line of credit (LC) and secure a medium-term repayment from the SME, but instead the bank gives a personal

loan to the mall owner at exorbitant rates.

This situation can be attributed to the lack of an organized audit or regulatory framework for most SMEs, due to which there is no set mechanism to gauge credit worthiness and risk



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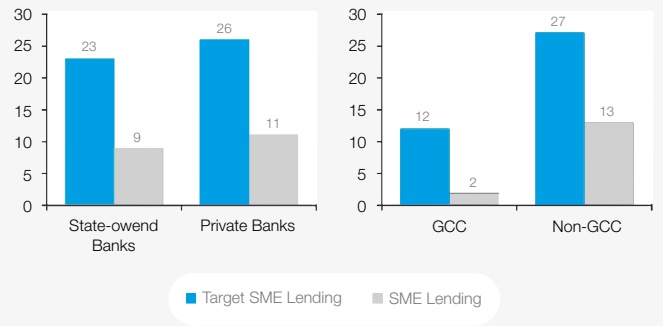
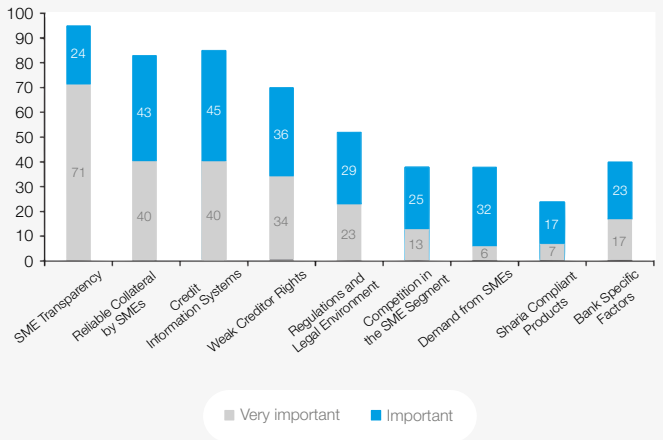


Source: World Bank and UAN Banks' Survey (2010)



Source: World Bank and UAN Banks' Survey (2010)

A uniform regulatory framework for SMEs

Setting this right is crucial, as the growth of SMEs is critical in creating more job opportunities and building a resilient economy. A unified regulatory framework for SMEs will provide citizens with improved livelihood and greater levels of financial inclusion. For SMEs to grow and create jobs, an ecosystem needs to be put in place that assures confidence in the financial health of private sector companies.

This ecosystem exemplifies the benefits of growing the private sector towards the greater good for the economy. Understanding SMEs' contribution to the economy, the wider economic competition and availability of quality credit information are valuable pre-requisites in order to facilitate access to finance.

Measuring success by 2025

Increasing the 3% of SMEs with access to funding to 20% by 2025 will impact job creation and stakeholder value creation, while yielding substantial macro-financial benefits and boosting annual growth rates by up to 1% over the medium term. Success by 2025 will be measured as follows:

- Onboarding of 1,000 companies and making them credit-ready in each country of the MENA region.
- Enabling an ecosystem where at least 20% of the companies on this list are able to get easier and faster access to funding.
- Creating 15 million jobs through SME growth.

The establishment of such a framework allows companies to adhere to a singular credit worthiness system, opening markets to fintech players and alternate financial agents (such as supply chain finance providers), who plug and play into this network to assess the resilience of SMEs and provide adequate funding.

The framework builds on previously identified conditions, such as strong legal and property rights, contract enforcement, and collateral and insolvency regimes. This allows banks to offer loans with reasonable terms and conditions and, once the right checks are in place, are more confident of companies' transaction and repayment histories, and credit worthiness. This will open up a line of capex and operating expense (opex) funding for growth and business development. Estimates of gains in employment and labour productivity growth using firm-level data point to potentially higher GDP growth gains. This in turn could potentially create 15 million new jobs by 2025, as outlined in a report by the IMF's Middle East and Central Asia Department.

Pilot stage

The actionable idea can be piloted in the United Arab Emirates (UAE) before expanding to other markets. Thanks to its advanced IT infrastructure and high levels of mobile and internet penetration, the UAE traditionally encouraged path-breaking and innovative frameworks. The pace of digital transformation being undertaken in various sectors, both in the government and private sectors, are second to none globally. The UAE is also home to fintech hubs such as DIFC and ADGM. It has a ready number of SMEs and investors that are well placed to set up the framework through a pilot exercise.

Improved macroeconomic policies

Greater SME financial inclusion will improve the effectiveness of macroeconomic policies, including tax collection efficiency and monetary policy transmission – two areas where the MENA region could benefit from. This will lead to more holistic policy strategies that will ultimately create meaningful, safe and sustainable SME financial inclusion. Having a robust financial inclusion policy for the region's largest employment generator will also lead to better political and social stability, thus projecting the inherent business potential of the regional economy among foreign investors and financial institutions.

Recently, the UAE adopted a series of world-class regulatory reforms to streamline processes and give greater control to companies operating at the intersection of finance, technology and consumer behaviour. Such a favourable entrepreneurial ecosystem makes it an ideal destination to pilot the actionable idea.

To gain momentum and acceptability, the pilot programme should be industry agnostic. Many previously adopted programmes have failed in this respect, as they were solely focused on certain industry segments, or companies of a certain size. Taking a holistic approach would allow private investors and government-led investment vehicles, along with PEs, to have a tangible impact.

The following factors should be particularly considered:

- The regulatory framework needs to be established by considering the inputs from various interconnected government entities, established SMEs (and MSMEs) and banks.
- In association with the Chamber of Commerce and the Ministry of Industries, 1,000 companies can be selected and aided in scaling up their back-end IT infrastructure, accounting processes, marketing, and governance to comply with the regulatory framework.
- Over a period of six months, the selected companies should be regularly audited and provided support to align with the framework.
- At the end of the pilot, their readiness for accessing funds should be tested in a real world or demo-day type environment, connecting them to potential financial institutions, including global and regional banks.
- These funds can be for capex or opex, with banks and other alternative lenders given access to the framework-led data for making a sound decision regarding lending.

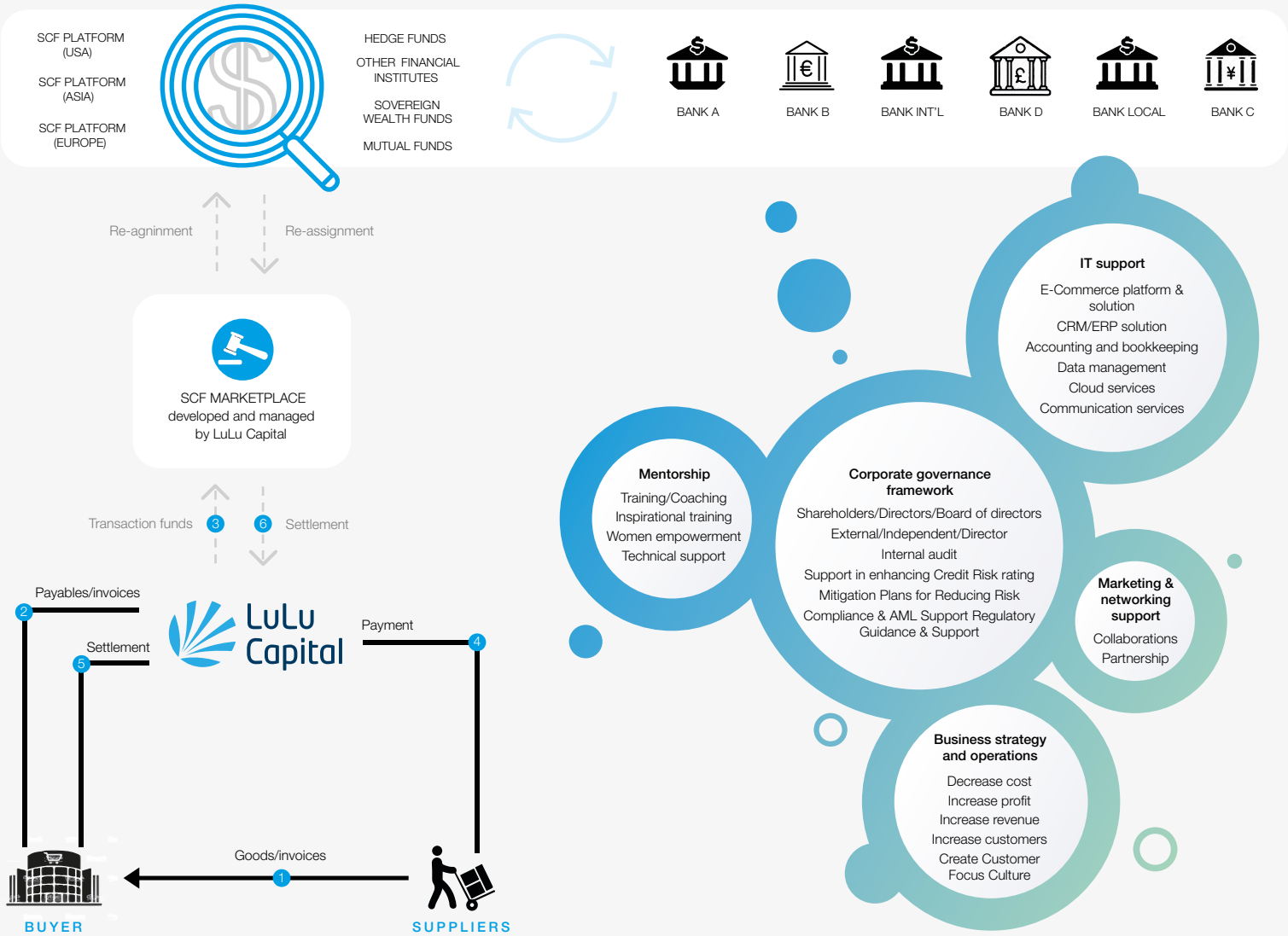
Scalability

Once the pilot is successful, stakeholders should convene to expand it to other major economies of the MENA region in the second phase. Some of the countries to be considered include Saudi Arabia, Bahrain, Qatar, Oman, Kuwait and Egypt. Among them, Saudi Arabia and Bahrain are already on par with the UAE in terms of infrastructure and regulatory readiness, while the others are catching up as well.

To achieve real scalability, it is necessary that the framework is tech-driven, allowing a single plug and play network for SMEs and other participating stakeholders, such as government representatives, banks and other financial institutions, investors, etc. to collaborate seamlessly and ensure adherence to a process-driven lending system.

Such a proposition requires the **tokenization of assets by the application of blockchain technology**.

See the Actionable Idea "**Towards the Token Economy**".



Contribution of Lulu Financial Holdings

LuLu Financial Holdings is willing to play an active role in laying the groundwork for the regulatory framework to be established. Through LuLu Capital, it will provide the much-needed management and IT tools to develop the framework.

LuLu Capital is headquartered in ADGM and can scale support to any country. The company has already developed a proprietary fintech tool for SCF propositions and is well positioned to extend its existing partnerships to pilot the idea in any three emirates of the UAE, and gradually provide technical support in scaling it to other regions of MENA for establishing a future-proofed mechanism bridging the gap between SMEs in the region and their need for easier access to funds.

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