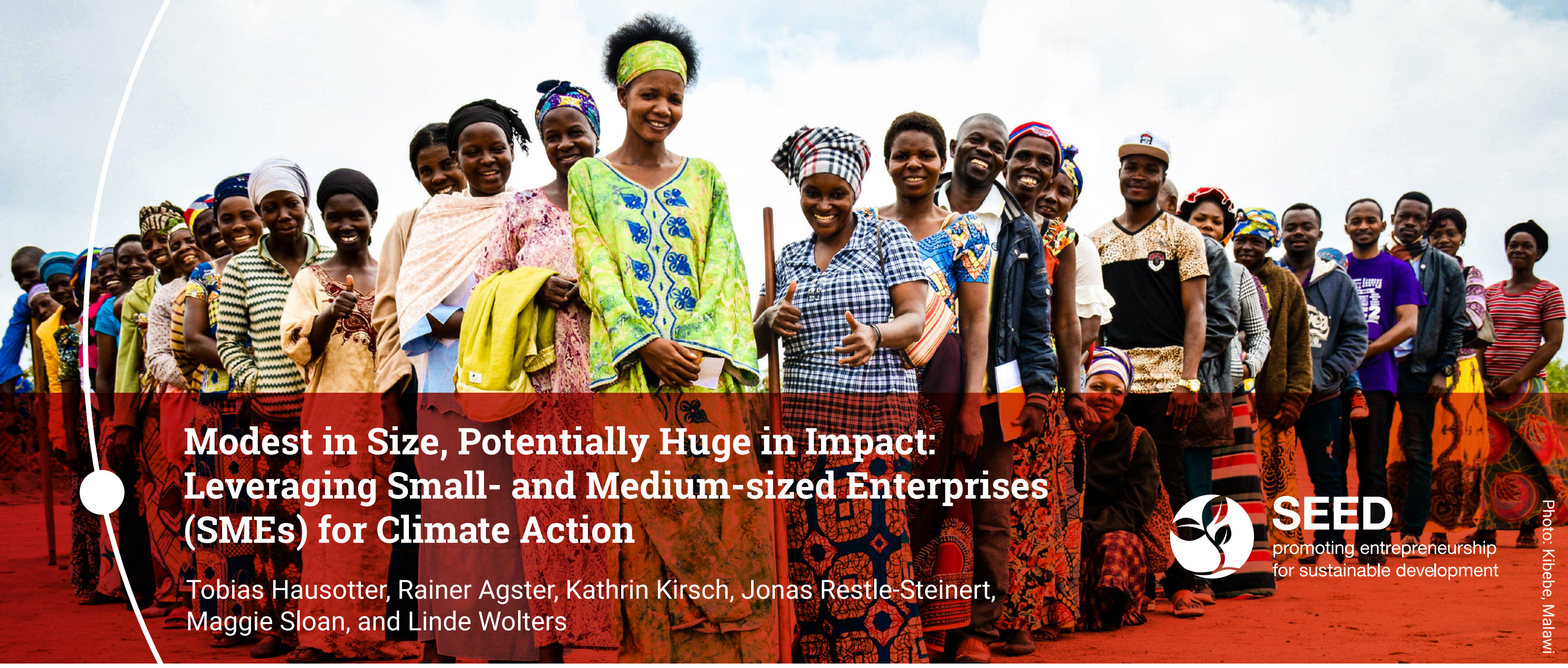

Photo: Kibebe, Malawi

Modest in Size, Potentially Huge in Impact: Leveraging Small- and Medium-sized Enterprises (SMEs) for Climate Action

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SEED
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Key Messages

- SMEs have been recognised as key players for economic development and major contributors to the SDGs. Yet, they have only received limited attention regarding their potential role in attaining the goals of the Paris Agreement.
- The contribution of SMEs to climate change and the role that they might play for climate action are poorly understood and warrant increased attention. As countries prepare to step up their climate commitments by the end of 2020, this provides for an opportunity to better consider how SMEs could help facilitate and improve the implementation of NDCs on the ground.
- Access to finance is among the major challenges that SMEs face, an issue that is even more pronounced for green and climate-friendly SMEs. As locally embedded entities, SMEs need tailored financing products in order to leverage in their potential contribution to NDC implementation.

Despite the goals put forward in the Paris Agreement and commitments by countries in their nationally determined contributions (NDCs) the concentration of greenhouse gases in the atmosphere is rising (WMO 2019). It is therefore more important than ever for countries to step up their ambition and NDC commitments in 2020. The COP25 climate negotiations will pave the way for the next year and the NDC update processes. These open up the opportunity to acknowledge a modest yet potentially impactful group of players for ambitious climate action: small- and medium-sized enterprises (SMEs).

SMEs are key players for economic development

Small- and medium-sized enterprises (SMEs) have received considerable attention at the international policy level over the last couple of years. The G20 has put SMEs on the agenda in 2015, and since has made the issue of how to best support SMEs for economic development one of its highest priorities. Other organisations such as the OECD, the World Bank and the World Economic Forum (WEF) have conducted considerable work on the importance of SMEs for the world economy and how they can be strengthened.

This attention is not surprising. SMEs are regularly described as the "economic backbone" of countries around the world and considered indispensable for their development, mainly because of the significant role they play for employment. They account for 95% of registered firms worldwide, provide 50% of jobs, and contribute well over 35% of GDP across emerging economies (WBG 2017). In developing and emerging economies specifically, SMEs contribute to social cohesion and poverty reduction, engage with the bottom of the social pyramid through the delivery of goods and services, and help integrate socially disadvantaged groups such as women and the youth into economic activities (IIED 2016, WBG 2017). Accordingly, recent research indicates that can significantly contribute to achieving the Sustainable Development Goals (SDGs) (ITC 2019).

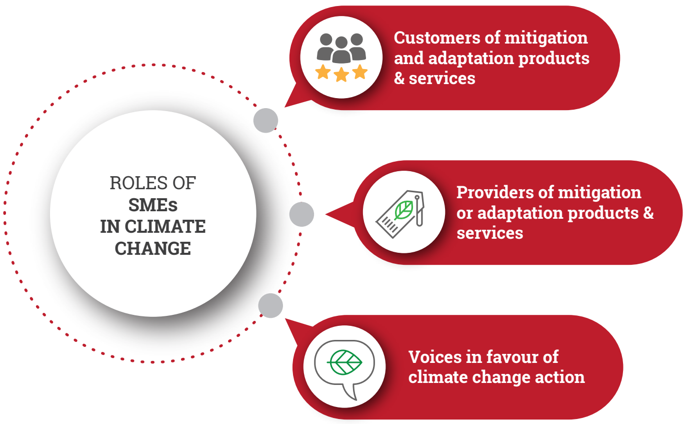
Exploring the role of SMEs for climate action

Given the importance of small businesses for sustainable economic development at the global level, it is surprising that SMEs have not received more attention in the area of climate change. A first step would be to undertake efforts to better understand their climate footprint. Their contribution to greenhouse gas emission remains largely unclear as emission estimates for SMEs do not seem to exist neither globally nor at the country level. At the same time, given the local nature of climate change impacts and the according need to develop specific responses, SMEs can be considered driving forces for climate change adaptation and resilience building (adelphi 2019b).

The potential contribution of SMEs for attaining the international community's climate goals is also largely unclear. While the private sector has emerged as a key stakeholder group for the transition to a low-carbon and climate-resilient economic model, the part that specifically SMEs can play in the development and implementation of climate actions have yet to be better understood, recognised and addressed. As many countries seek to align their national development priorities with their response to climate change as expressed through their NDCs, the updating and implementation of NDCs represents a major opportunity for increased engagement of SMEs in the area of climate change.

In this context, SMEs can assume three different roles. First, they can be customers of products and services for climate change mitigation and adaptation. Second, they can be providers of technologies, products and/or services for mitigation and adaptation. Finally, they can act as voices in favour of taking climate change action and raising awareness about the consequences of climate change (Dalberg 2016). While their focus should be to protect their operations and assets from the impacts of climate change through their own adaptation, they may also benefit from new and emerging business opportunities around climate friendly products and services (adelphi 2019a).

Figure 1: Roles of SMEs in Climate Change



Source: Based on Dalberg 2016.

Understanding barriers and challenges for SME financing

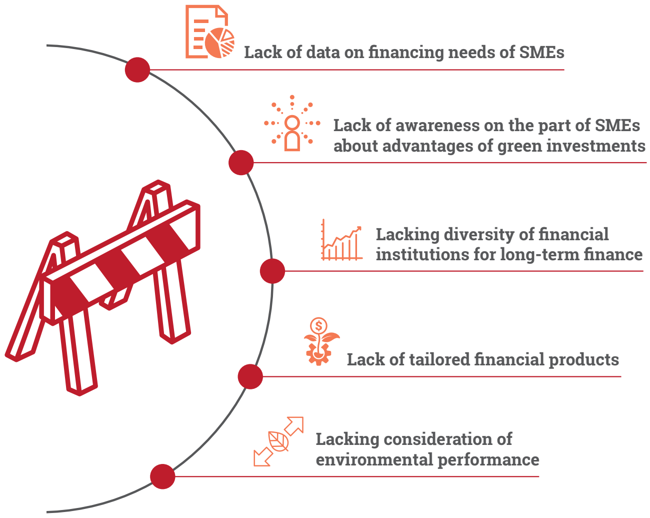
SMEs are substantially underserved by financial institutions. Recent estimates assume that 55-70% of formal SMEs in emerging economies are not or underserved by financial institutions (WBG 2017). The so-called SME finance gap has been calculated at about USD 1 trillion and widens to USD 2.6 trillion if informal SMEs are also considered (WBG 2017). The shortage of finance for SMEs especially in developing countries is reflected by another statistic: Less than 1% of the finance of global asset managers is currently invested in SMEs from developing countries (ITC 2019).

In most developing countries, a well-functioning SME lending market does not exist due to two broader types of challenges (Dalberg 2011, OECD 2019, adelphi 2019b):

- The most significant barrier is **access to finance**. Serving SMEs is often considered very risky by commercial finance, partly because of the comparatively small amounts of finance that are required by SMEs and the relatively high expenses involved in funding them. A lack of experience of financial institutions in dealing with SMEs may be another reason. Investors may also not understand innovative climate technologies or adaptation measures and their impact. The high-risk perception, in turn, leads to higher requirements for collateral, which further impede SME access to finance.
- Another group of barriers concerns SME **knowledge and awareness** of finance opportunities, including climate finance. This may comprise lacking skills for marketing and strategic management as well as a lack of capacities or knowledge for business development and financial literacy.

Figure 2 depicts specific barriers of SMEs accessing green and climate finance.

Figure 2: Barriers for SMEs to access climate finance



Source: Based on OECD 2018.

Case study on potential SME contribution to NDC implementation: Uganda

In its NDC, Uganda has committed to a 22% reduction of GHG emissions in 2030 compared to a business-as-usual (BAU) scenario. These reductions are intended to be achieved by policies and measures in the energy supply, forestry and wetland sectors. Adaptation is of key importance for the country, focusing on activities such as expanding climate smart agriculture (CSA), diversification of crops and livestock, and small-scale water infrastructure. The financing needs for adaptation are estimated to amount to USD 2.9 billion until 2030, while for mitigation, USD 5.4 billion are estimated to be required until 2025.

SMEs may play an important role in mobilising these investments. The Ugandan Investment Authority recognises SMEs as "the engine of growth for the economic development, innovation, wealth creation of Uganda". The sector employs 2.5 million people or 90% of the private sector workforce. SMEs generate over 80% of manufacturing outputs and contribute 20% to Uganda's GDP (UIA 2016).

As part of the SEED Practitioner Labs Climate Finance (PLCF) Uganda in 2018, a financing approach on "Irrigation System Microleasing for High-Value Crops" was developed. The approach aims to direct deal flow to climate-smart irrigation systems to improve productivity and climate adaptation capacities of small-scale agribusinesses. The product provides low-risk microleasing with buy-back options, payments adjusted to crop cycles, decentralised delivery via technology suppliers, and awareness raising and training.

This innovative financing approach directly addresses several adaptation priorities mentioned in the NDC while specifically targeting SMEs, the country's engine of growth. It is a valuable example of how tailored financing instruments developed with the participation of the potential financing recipients can leverage SMEs for climate action.

Facilitating investments in SMEs through tailored financial products

Credit lines are generally the main vehicle for SME financing, typically channelled through on-lending schemes involving commercial banks as intermediaries (WBG 2017). Local financial intermediaries or institutions are important for connecting international (climate) finance with local SMEs, given their knowledge about the local context and the country-specific financing landscape (ITC 2019). They also have the potential to bridge the gap between the small sums that SMEs require and the large sums that investors are interested in investing by bundling small loans into larger amounts (ITC 2019).

In the area of climate change, many countries still have difficulties making tangible progress in the implementation of their NDCs. A shortage of tailored financial products besides credit lines for players with smaller financing needs such as SMEs might be one reason for this. A lot of international attention is devoted to discussing and calculating available amounts of climate finance, and dedicating finance for specific climate purposes. Less attention is paid to how to best distribute the finance to maximise positive climate-related impacts.

Case study on potential SME contribution to NDC implementation: India

India's NDC stipulates the goal of a 33-35% carbon intensity reduction by 2030 compared to 2005 levels. In addition, the country wants to increase the share of non-fossil fuel based energy resources to 40%, and substantially expand forest and tree cover. With regard to adaptation, agriculture, water, forestry and the Himalayan ecosystem feature prominently as National Missions on Climate Change. A preliminary estimate indicates that at least USD 2.5 trillion are required for meeting India's climate change actions until 2030.

The Indian economy is strongly characterised by micro, small and medium-sized enterprises (MSMEs), which therefore may be key actors for mobilising some of the required financing. According to the Indian Ministry of MSME, there are approximately 63 million MSMEs which contribute nearly 30% to the GDP (M/o MSME 2019).

During the SEED Practitioner Labs Climate Finance India in 2018, a financing approach titled "Green MSME Finance Tool" was developed that offers a knowledge platform for providing data and frameworks to banks to understand green technology-based enterprises and evaluate them for financing. The tool addresses the information gap in banks on green finance, green technologies, and high transaction costs in assessing green enterprises.

Such an approach has the potential to unlock the large SME base of the country for low carbon and climate-resilient development. By addressing knowledge and information gaps on the side of banks, the approach could facilitate financing to climate-friendly SMEs from a broad range of sectors, promoting a comprehensive contribution to the country's NDC targets and priorities.

SMEs are strongly rooted in their local environment, which provides for their knowledge, skills, business opportunities and finance (OECD 2017). This specific nature of SMEs should be reflected in tailored financial products and services in order to support their development and financing, also for the benefit of NDC implementation. One approach is to involve eco-entrepreneurs and other local actors in the bottom-up development of according financing approaches. The SEED Practitioner Labs Climate Finance engage local stakeholders for developing innovative, tangible and robust climate finance products. They also strengthen the product implementation capacity of lab participants and build a network of partners to launch the climate finance products.

Building knowledge and skills through technical assistance programmes

Access to skills is the second major element for supporting SME finance (OECD 2018). Targeted technical assistance and capacity building programmes enable SMEs to develop the technical skills and managerial knowhow to pursue eco-innovations and implement climate-friendly measures. This also helps make small businesses investment-ready, which can then be further supported by matching investment-seeking SMEs with potential financiers. SEED, for example, through various programmes, directly assists individual enterprises at different levels of business development – from the early stages of inspiration and concept-building to scaling up or the replication of proven, successful eco-inclusive business models in other geographical locations. It also cultivates networks of collaborators, finance and policy instruments to support eco-inclusive entrepreneurship through a range of additional ecosystem building activities.

Outlook

The potential for a positive contribution of SMEs to sustainable development is significant and has been widely recognised. At the same time, the role they might play in low-carbon and climate-resilient development has so far received limited attention and is not well understood. As the concept of a just transition is emerging as a framework that can simultaneously address climate change and achieve sustainable development (IOE 2019), the role that SMEs might play in linking these two areas deserves further attention.

Many countries intend to enhance their NDC ambition or actions by the end of 2020. This provides for an opportunity to more closely involve the private sector – and thereby the SME sector – in the elaboration of targets and identification of measures while better specifying their role and commitments (GRI and CDP 2019).

At the same time, efforts should continue at international climate funds and finance institutions to explore better ways and mechanisms to channel climate finance to SMEs. As they operate at the local level where climate change is felt most and where emission reductions have to materialise, they hold considerable potential for impactful investments. A more widespread adoption of bottom-up approaches to the development of SME financing instruments may help in leveraging the potential contribution of SMEs to NDC implementation.

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