European Fund for Sustainable Development (EFSD) Guarantee

Investment Window

Title:	MSME Financing

1. Policy Rationale

Background analysis: The window will contribute to achieving the United Nations Sustainable Development Goals (SDGs) #8 “Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all”, SDG #9 “Build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation” and SDG #1 “End poverty in all its forms everywhere”.

Complementarity and synergies with international initiatives such as G20 Compacts with Africa will also be ensured.

Micro, Small and Medium Enterprises (MSMEs) are the main providers of employment across developing and transition countries, contributing to 66% of the job market[1]. MSMEs are an essential component of local ecosystems in developing countries and they often represent the vast majority of businesses operating in African and in the EU Neighbourhood countries; nevertheless their growth is constrained by limited possibilities of accessing affordable sources of financing, the lack of adequate technical, professional, financial and managerial skills as well as non-conducive legal and regulatory framework and good governance.

On the financial services supply side, the financial institutions in African and the EU Neighbourhood countries are relatively scarce and concentrated in urban areas. They often face challenges regarding asymmetry of information and lack of valid collaterals. Credit bureaus are rare, property or land registration is uneven and the legal system is not strong enough to support claims in due time. Financial institutions tend to focus on larger and richer clients. The supply of financial services is thus scattered and limited excluding longer term lending and leasing solutions. Interest rates are high. On the demand side, MSMEs in African and in the EU Neighbourhood countries face similar challenges. Their access to finance is limited by the size of their balance sheet, with little or no collateral available. They often lack human and technical skills which increase the risk and limit even more their growth. Finally they are highly vulnerable to market swings or to large-firm competition. In Sub-Saharan Africa, the private sector is often characterised by small firms, mostly operated in the informal sector and ran by women. The gap also disproportionately affects fragile states.

The proposed window shall specifically address the main constraints hampering MSMEs development in Sub-Saharan Africa as well as in the EU Neighbourhood, by adopting a differentiated approach. This will result in increased jobs opportunities, especially in

[1] Financial Inclusion in Africa, AfDB, 2013

countries affected by conditions of fragility, whilst promoting the progressive graduation of businesses from the informal economy.

The risk of funding MSMEs varies according to the economic and legal and regulatory environment, but it is perceived as high, limiting the financing options, when on the other hand, MSMEs form the main part of many countries' economic activity and job creation. The investment window intends to reconcile demand and supply of financial products by covering a wide spectrum of services for different unserved or underserved clients in risky markets. It will thereby unlock opportunities to attract non-ODA investments into MSMEs in Sub-Saharan Africa as well as in the EU Neighbourhood as well as potentially mobilise already existing domestic savings and deposits into investments, which is one of the key objectives of the EIP.

Considering that for the EU Neighbourhood a comprehensive range of instruments for general SME finance is already available under the Neighbourhood Investment Facility (NIF), the investment window shall promote instruments and facilities addressing unserved sub-sectors in the region in particular in the field of innovation[2], start-ups as well as digital entrepreneurs, social entrepreneurs, agri-business and the integration of MSMEs into value-chains. Similar sectors can possibly be supported in Sub Saharan Africa countries.

Efforts will also be made to partner with EU MS export credit agencies and to scale-up the collaboration with EDFIs in order to boost joint ventures between MSMEs. Additional financing from private foundations as well as channelling remittances into productive sectors of the economy are additional aspects that are eligible.

EU Policy objectives: In line with the Cotonou Agreement with African, Caribbean and Pacific (ACP) countries[3], the Communication on private sector's role in development in developing countries[4], the Joint Communication for a renewed impetus of the Africa-EU Partnership[5], the revised European Neighbourhood Policy[6] and the New European Consensus on Development[7], the Investment window shall be aimed at improving access to finance for MSMEs with particular emphasis on promoting financial inclusion, as a way to stimulate decent employment , inclusive and low-emissions climate-resilient growth and to address root causes of migration.

This window could possibly group several instruments (proposed under separate PIPs), targeting different sectors of intervention including those indicatively listed in the next section.

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[2] The term "innovation" covers all possible sectors and not exclusively tech & IT (e.g. social innovation, creative industries, innovative circular economy models, etc…)

[3] https://eeas.europa.eu/diplomatic-network/africa_en

[4] https://ec.europa.eu/europeaid/european-commission-communication-com2014263-stronger-role-private-sector-achieving-inclusive-and_en

[5] https://eeas.europa.eu/headquarters/headquarters-homepage/25565/joint-communication-renewed-impetus-africa-eu-partnership_en

[6] https://eeas.europa.eu/headquarters/headquarters-homepage/330/european-neighbourhood-policy-enp_en

[7] COM(2017) New European Consensus on Development

Geographic area: Sub-Saharan Africa and the Eastern and Southern Neighbourhood regions.

Domain: MSME financing.

Sectors of intervention: As far as Sub-Saharan Africa is concerned, the investment window will target two main types of beneficiaries that have differentiated needs: on the one hand households, micro and informal enterprises with a specific focus on most excluded population comprising women, entrepreneurs, youth; and, secondly, formal SMEs which have none or very limited access to finance at reasonable terms and conditions. Interventions under this window should be complementary to the operations proposed in other windows. Specific financial vehicles for the Neighbourhood (and for Africa, when applicable) shall address investments to tap financial gaps in the different unserved sub-sectors, including targeted finance in the field of innovation, start-ups as well as MSMEs working in agriculture and agro-business , green technologies, social and digital entrepreneurs. Impact investments[8] shall also represent an interesting model to look at for both regions, to complement existing instruments, possibly addressing investment sizes which are smaller than what is usually covered by partner IFIs.

2. Operational Concept

The EFSD Guarantee will be structured in such a way to mitigate the risks associated to investments, improve MSMEs financing and bring in the private sector with its skills and funds.

Type of operations: Different types of eligible operations may be included, such as:

- Guarantees for commercial banks and non-banking financial institutions for medium-long term lending towards MSMEs primarily for capital expenditure, potentially covering the various types of risk (counterparty default, interest rate fluctuation, foreign exchange rate fluctuation)
- Guarantees covering part of the portfolio risk of an investor or group of investors promoting comprehensive MSMEs schemes, combining Technical Assistance for skill development and financing mechanisms.
- Guarantees to promote start-ups in the areas of Innovation and/or Social Business, benefitting Seed Capital, Venture Capital, Impact Investment Funds and Innovative SME Equity Funds in order to catalyse value-additive equity financing to young innovative enterprises and entrepreneurs and ensure a smooth transition to the commercial credit market.

The operations listed above are indicative and non-prescriptive/exhaustive. Priority will be given to inclusive initiatives offering high sustainable development impact (including

[8] Impact Investments are defined as investments made into companies, organisations and funds with the intention to generate measurable social and environmental impact alongside financial return - **Global Impact Investing Network (GIIN)**, *Impact Investing Trends*, December 2016

job creation, youth and women empowerment), optimising leverage and cost efficiency, and mobilising funding from multiple sources in fragile countries.

Type of risks: Risks to be mitigated may include: i) Commercial risks (payment risk, performance risk, etc.), ii) Political and country risk (expropriation, coup d'état, civil war, etc.), iii) Legal and regulatory risk (change in law and regulatory framework, etc.), iv) Currency risks (e.g. exchange rate fluctuation, convertibility, transferability, etc.), v) Climate change and environmental risks (e.g. droughts, flooding, extreme weather events, temperature rises, etc.)

Expected Additionality: The additionality of the EU intervention, including compared with the standard blending operations, will be linked, among others, to the operations: in fragile/conflict affected states/regions and other high risk situations; in underserved market sectors and segments; promoting MSMEs, social business and cooperatives; aiming at youth and women empowerment; and promoting small investment size. The value added, , will also lie in ensuring support for proposals promoting the sustainable use of natural resources and transition to a low-emissions climate-resilient green economy and investments in the blue economy. Moreover, added value of this window will also be linked to the provision of coverage of foreign exchange (FX) exposure which is one of key problems in lending to MSMEs. The additionality of operations will be measured in terms of actual capacity to mobilise both local and international private sector investors. Furthermore, a development of specific new financial products and vehicles for example for companies and early stage MSME graduating from the start-up phase shall contribute to the additionality of EU intervention. The value-added of the guarantee will be passed on to the final beneficiaries.

Envisaged Impact: i) Expected positive impact on overall inclusive and sustainable economic growth and decent job creation for youth and women; ii) Increased number of MSMEs accessing medium or long term credit for investments; iii) Improved financial inclusion (e.g. number of micro and small enterprises taking credit for the first time; number of adults using digital payments; women entrepreneurs/young entrepreneurs; enterprises served in different regions/outside capital etc.); iv) Increased number of available products and financial services for MSMEs. v) Increased contribution of MSMEs in given markets to economic growth and employment creation; vi) MSMEs are more integrated into global value chains; vii) Women and youth entrepreneurship is increased; viii) Innovative and more inclusive business models are scaled up (including social enterprises and cooperatives; ix) Increase the use of technologies and processes limiting the impact on the environment; x) Increased mobilisation of private sector capital invested in MSMEs.

Complementarity/Risk of potential overlapping with other Investment Windows: The interventions under this window should be complementary to the operations proposed in other windows, namely: Agriculture, Digitalisation and Sustainable Energy and Connectivity Investment Windows. The main focus of operations to be supported through the Guarantee shall be on MSMEs and their investment projects, addressing a wide range of different sectors according to their expected impact in terms of economic growth and job creation.

3. Supporting Policy Actions (links to pillars 2 and 3)

Links will be established between the investment pillar (pillar 1) and enabling policies (pillar 3) to foster a conducive business environment and investment climate as well as technical assistance (pillar 2).

The risk associated to the operations supported via (or with) the Guarantees will therefore be further mitigated through business environment reforms and improvements to investment climate. Priority areas of reform can be grouped in the following 10 key elements:

- Political stability
- Macroeconomic framework
- Governance, rule of law, judicial security, public finance management
- Business enabling environment – legal and regulatory system
- Infrastructure and logistics
- Human resources/skills
- Financial markets & access to finance
- Economic and trade prospects, Economic efficiency
- Investment incentives
- Climate-related risks