

## European Fund for Sustainable Development (EFSD) Guarantee

**Title:** Investment Window - 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”, SDG #12 “Ensure sustainable consumption and production patterns”, SDG #13 “Take urgent action to combat climate change and its impacts”, 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 sized Enterprises (MSMEs) are the main providers of employment across developing and transition countries, contributing to 66% of the job market<sup>1</sup>. 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 clients, trying to reduce their transaction costs and seeking for rather extensive collateral. 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. This sector is also highly vulnerable to the impacts of climate change.

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<sup>1</sup> Financial Inclusion in Africa, AfDB, 2013

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 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<sup>2</sup>, start-ups, climate-smart and green investments, early stage support (e.g. incubators), as well as digital entrepreneurs, social entrepreneurs, agribusiness and the integration of MSMEs into value-chains. Similar sectors will 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<sup>3</sup>, the Communication on private sector's role in development in developing countries<sup>4</sup>, the Joint Communication for a renewed impetus of the Africa-EU Partnership<sup>5</sup>, the revised European Neighbourhood Policy<sup>6</sup> and the New European Consensus on Development<sup>7</sup>, 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.

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

<sup>3</sup> [https://eeas.europa.eu/diplomatic-network/africa\\_en](https://eeas.europa.eu/diplomatic-network/africa_en)

<sup>4</sup> [https://ec.europa.eu/europeaid/european-commission-communication-com2014263-stronger-role-private-sector-achieving-inclusive-and\\_en](https://ec.europa.eu/europeaid/european-commission-communication-com2014263-stronger-role-private-sector-achieving-inclusive-and_en)

<sup>5</sup> [https://eeas.europa.eu/headquarters/headquarters-homepage/25565/joint-communication-renewed-impetus-africa-eu-partnership\\_en](https://eeas.europa.eu/headquarters/headquarters-homepage/25565/joint-communication-renewed-impetus-africa-eu-partnership_en)

<sup>6</sup> [https://eeas.europa.eu/headquarters/headquarters-homepage/330/european-neighbourhood-policy-enp\\_en](https://eeas.europa.eu/headquarters/headquarters-homepage/330/european-neighbourhood-policy-enp_en)

<sup>7</sup> COM(2017) New European Consensus on Development

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

**Geographic area:** Sub-Saharan Africa and the Eastern and Southern Neighbourhood regions. The inclusion of LDCs/landlocked/fragile and conflict affected countries within proposals will be positively viewed.

**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, micro enterprises (to a large extent household and micro enterprises in the informal sector) and secondly, formal SMEs which have none or very limited access to finance at reasonable terms and conditions. The financing gap is larger for women owned MSMEs and young entrepreneurs, and hence a special attention should be given to financial institutions/proposals targeting this sector with appropriate financial products. 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 sustainable agriculture and agri-business, circular economy, resource efficient and low-carbon climate-resilient technologies, social and digital entrepreneurs. Impact investments<sup>8</sup> 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. The proposed operations should be combined with appropriate policy and reform programs, as well as Technical Assistance targeted to financial institutions and enterprises.

Investments should respond to the specific situation and needs of a given country or region, they should respect social, fiscal, ethical and environmental principles and standards, including gender equality, and ensure sustainability and efficient maintenance of investments.

**Type of operations:** The EFSD Guarantee may be used to cover the risks for loans, guarantees, counter-guaranties, capital market instruments, and any other form of funding or

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<sup>8</sup> 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

credit enhancement, insurance, and equity or quasi-equity participations. Different types of eligible operations may be included, such as:

- Guarantees targeted to 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). This type of guarantee will cover the default risk of the loans in a certain eligible portfolio. The eligible portfolio should be additional to the financial institutions operation, for example target a new client group, developing a new type of product, leading to increased inclusion in the financial market.
- Guarantees covering part of the portfolio risk of an investor or group of investors promoting comprehensive national and regional MSMEs schemes. For example this could be a global fund based in Europe, with the intention to mobilise private financing in order to invest/lend to banks and microfinance institutions that demonstrate high social impact.
- Guarantees to Seed Capital, Venture Capital, Impact Investment Funds and Innovative SME Equity Funds in the areas of Innovation and/or Social Business, and to promote start-ups, in order to catalyse value-additive equity financing to innovative enterprises and small entrepreneurs and ensure a smooth transition to the commercial credit market.
- Counter-guarantees to regional and national guarantee schemes supporting MSME development.

The operations listed above are indicative and non-prescriptive/exhaustive. Priority will be given to inclusive initiatives offering high sustainable development impact (including job creation, youth and women empowerment), fostering a transition towards inclusive low-carbon climate-resilient economies, optimising leverage and cost efficiency, and mobilising funding from multiple sources in fragile countries.

Measures for aligning the interests of the different stakeholders - including fund managers and investors - should be considered in line with relevant market practice. Such measures shall be transparent and will take into account the policy and financial objectives of the relevant instrument.

**Type of risks:** Risks to be mitigated may include: i) Commercial risks (losses due to a borrower or counterparty failing to meet its obligations in accordance with agreed terms, for example payment risk, performance risk, etc.); ii) Political and country risk (all risks that are related to actions of a state or a government, over which the investors do not have any influence, for example expropriation, coup d'état, civil war, or legal and regulatory risk ); iii) Currency risks (potential losses due to fluctuations, convertibility, and transferability international currency exchange rate); iv) 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 to geographical focus, targeted sectors, the terms of the guarantee instrument, and the holistic approach linking all pillars under the EIP.

As for sectors, special attention will be given to underserved market segments, such as women owned business and young entrepreneurs, as well as innovation, early stage support, climate-smart activities and start-ups. The additionality will also lie in ensuring support for proposals promoting the sustainable use of natural resources and transition to a low-emissions climate-resilient economy, in line with the Paris Agreement and its binding commitments.

Moreover, additionality of this window will also be linked to the type of risks the guarantee will cover, for example provision of coverage of foreign exchange (FX) exposure which is one of key problems in lending to MSMEs as well as on the provision of new financial instruments or facilities which are not already covered by existing EU blending operations. The guarantee will also be additional in bringing in private capital, and complement other risk-mitigation instruments on the market, enabling a sustainable financial market.

The holistic approach of the EIP, linking all the pillars, will also be an additionality, taking a market system approach on the development of the financial system.

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:** A growing MSME sector will lead to positive impact on financial inclusion and overall inclusive and sustainable economic growth and decent job creation. Specific outcomes for the proposed interventions would be: i) Increased mobilisation of private sector capital invested in MSMEs; ii) Increased the availability of appropriate products and financial services for MSMEs; iii) Increased access and use of financial services for MSMEs including for remote regions and in particular for women and youth entrepreneurs (e.g. access to medium or long term credit for investments by MSMEs; access to credit, savings, insurance and transfers by micro and small enterprises ; increase use of digital payments); iv) Increased use of resource efficient and climate-smart technologies and processes limiting the effects of climate change and increasing resilience (e.g. reduce health and environmental impacts); v) Innovative and more inclusive business models are scaled up (including social enterprises and cooperatives); vi) Women and youth entrepreneurship is increased; vii) MSMEs are more integrated into global and regional value chains. A results framework will be developed to monitor the impacts achieved.

The overall goal is that the financial institutions benefitting from the guarantee will continue to serve the MSME sector with appropriate financial services, when the guarantee term is over.

When relevant, indicators as approved in the context of EUBEC Platform and included in the list in Annex 2 will apply; additional indicators will be agreed at the level of specific proposals. Disaggregation by gender (when applicable and feasible) shall be pursued.

**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, Sustainable Cities 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.

**Expected minimum Private Sector involvement:** at least 50% of final investment volumes, on a portfolio (PIP) basis, are expected to be financed by the private sector (including commercial banks).

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

For a systematic change in the financial market that will lead to improved access to finance for MSMEs, the full range of the EIP Pillars shall be pursued. Links should be established to adequately coordinate 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, including climate finance
- Economic and trade prospects, Economic efficiency
- Investment incentives
- Climate-related and environmental risks

The Technical Assistance, Pillar 2, can play a crucial role to ensure long term impact of the guarantee schemes by promoting sustainable financial market ecosystems. Provided the

necessary alignment and avoidance of overlaps with existing operations, technical assistance schemes may support in this sense capacity building to different actors at the various levels of the financial ecosystem: i.e. regulators, policymakers, regulators, policymakers, business development services, credit bureaus, etc.

For example, TA could support sound legal and regulatory systems and enabling SMEs policies at country level, as well as inclusive financial systems

## **ANNEX 1: Examples**

### ***SME Finance Facility***

The SME Finance Facility (EUR 15M) combines the EBRD and KfW loans or guarantees to participating financial intermediaries (“PFIs”) in the Eastern Partnership countries, for on-lending to eligible SMEs, including micro-enterprises, with EU grant resources to support SME lending during the crisis period and beyond.

Under the EBRD / KfW window, the credit enhancement support offered takes the form of loss risk sharing cushion for PFIs, to be provided for the portfolio of sub-loans funded under the EBRD and KfW credit lines. Under the proposed scheme, PFIs are able to obtain up to a 50% recovery, capped at the limit of 10% of the disbursed amount of their respective credit lines, during a three-year period from signing of the loan agreement with the EBRD and/or KfW, of Losses which arise on the portfolio of sub-loans funded from the credit lines.



## ANNEX 2: Indicators

MSME Financing		
OUTPUT INDICATORS	UNIT	DEFINITION
<i>For direct operations:</i> Access to finance: number of units served among relevant target group	Nr.	Number of outstanding loans/investments at the end of their fiscal year and annual number of new loans/investments disbursed/made during the year.
<i>For direct operations:</i> Access to finance: Amount of outstanding loans to relevant target group	Currency	Amount of outstanding loans/investments at the end of their fiscal year and annual volume of new loans/investments disbursed/made during the year
<i>For indirect operations:</i> Access to liquidity/capital: volume of new loans made available to financial intermediaries (e.g. banks, microfinance institutions, funds)	Currency	Volume of credit lines/guarantees / capital investment extended to financial intermediaries for on lending to target groups (target groups being understood as Microfinance/MSME/Agribusiness/Energy Efficiency/Renewable Energy/Student Loans/Housing Finance/Retail Finance/Total Portfolio/Other to be specified in each instance) .
OUTCOME INDICATORS	UNIT	DEFINITION
<i>For indirect operations:</i> Access to finance: number of units served among relevant target group	Nr.	Number of outstanding loans/investments in the portfolio of relevant financial intermediaries at the end of their fiscal year and annual number of new loans/investments disbursed/made during the year.
<i>For indirect operations:</i> Access to finance: Amount of Outstanding Loans to relevant target group	Currency	Amount of outstanding loans/investments in the portfolio of relevant financial intermediaries at the end of their fiscal year and annual volume of new loans/investments disbursed/made during the year
<i>For direct operations:</i> Number of MSMEs reporting increased turnover (as a result of direct support received from the FIs)	Nr.	number of MSMEs receiving direct assistance from FI that have increased the volume of their turnover.
<i>For both direct and, where feasible, indirect operations:</i> Number of jobs sustained (resulting from the project)	FTE	Number of full-time equivalent employees at the end of the reporting period. Includes full-time equivalent worked by seasonal, contractual and part time employees. Part-time jobs are converted to full-time equivalent jobs on a pro rata basis.

<b>CROSS SECTOR INDICATORS</b> (Application subject to current practices and methodologies by Financial Institutions)		
<b>INDICATORS</b>	<b>UNIT</b>	<b>DEFINITION</b>
Jobs sustained / created	Number (FTE)	Jobs sustained / created as a result of the project (methodology used to be made transparent)
Total number of beneficiaries	Nr.	Estimated number of people with improved access to services (financial services, social and economic infrastructure, etc.)
Number of beneficiaries living below the poverty line (whose living conditions are improved by the project)	Number (and/or %)	Sub-group of the above (if applicable), (to be made transparent which reference point has been used, e.g. national or international definitions of poverty)
Variation CO2 / Greenhouse gases	CO2 ktons equivalent / year	Amount of CO2 / GHG emissions generated for a typical year of operation by a project compared with the baseline scenario.