ADDRESSING MARKET FAILURE THROUGH MICRO AND SOCIAL FINANCE:

RECOMMENDATIONS FOR THE EU MANAGING AUTHORITIES.

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This document, prepared jointly by Microfinance Centre (MFC), European Microfinance Network (EMN) and European Federation of Ethical and Alternative Banks and Financiers (FEBEA), discusses the role of micro and social finance in addressing market failures. Despite the positive economic impacts that micro and social enterprises have, they are often overlooked by private markets. The EU recognizes the potential of micro and social finance in achieving its objectives of growth, employment, and inclusion, and has supported it through funding, capacity building, and raising awareness. The document suggests that public sector support in each member state can effectively address these market failures. It emphasizes the need for clear and less restrictive national legal and regulatory frameworks for micro and social finance providers as well as for micro and social enterprises. In order to reach more microentrepreneurs and social enterprises, it is essential to develop complementary funding mechanisms for the micro and social finance sector. These mechanisms could include BDS grants, risk sharing loans, equity or other forms of financial support that can supplement EU level instruments in support of micro and social finance. By reducing the regulatory barriers and diversifying the sources of funding, we can ensure a more robust and resilient financial ecosystem that can better serve the needs of microentrepreneurs and social enterprises.

1. Introduction

Market failure in the context of public sector support to micro and social finance refers to situations where the market does not provide adequate access to financial services for micro and social enterprises. This can be due to a number of factors, but most commonly micro and social enterprises have difficulty obtaining loans from commercial banks because they are perceived as being riskier borrowers. This is because they often have less or no collateral and less established financial records. In fact, micro and social enterprises generate positive economic outcomes, such as job creation and economic growth. However, private markets rarely take these beneficial impacts into account. Additionally, access to finance for social enterprises is closely linked to the fact that the national legal and regulatory frameworks are either not very clear or too restrictive. As a result, social enterprises are not properly recognized which makes it difficult for them to access finance.

Microfinance is an important innovation in the provision of financial services that addresses market failure by providing access to financial and non-financial services to micro and social entrepreneurs and, as a result, helping them in starting or expanding micro and social businesses, improving people's living conditions, supporting them in coping with shocks and risks, and accessing opportunities and rights. Public sector support to micro and social finance can help to address these market failures more effectively.

The European Union (EU) recognizes the importance and potential of micro and social finance for addressing market failure as well as achieving EU objectives of growth, employment and inclusion. The EU has supported microfinance in various ways, such as providing funding, building capacity and quality of microfinance providers, raising awareness and visibility of microfinance, and promoting social and environmental standards. However, the microfinance sector in the EU is still facing many challenges and gaps that limit its development and impact. These include regulatory barriers, low visibility and awareness by public officials, limited and costly funding, market fragmentation, etc.

At the Member States level, the support to micro and social finance is much more limited and fragmented and requires a more strategic approach to micro and social finance development in each EU country.

The main objective of this document is to provide recommendations to the EU Managing Authorities on how to address market failure through the recognition and support extended to microfinance and other types of social finance institutions in the EU countries. The document aims to help the MAs to design and implement effective and efficient strategies and actions to enhance the microfinance and social finance sector and its contribution to the EU's goals.

The document is based on a comprehensive analysis of the current situation and challenges of microfinance provision in the EU, as well as the best practices and lessons learned from existing initiatives and instruments at the EU level and beyond.

The document is structured as follows: Section 2 presents the current situation and challenges of microfinance provision in the EU; Section 3 reviews the best practices and lessons learned from existing initiatives and instruments at the EU level; Section 4 provides concrete and actionable recommendations to the EU Managing Authorities on how to support and develop microfinance in their countries; Section 5 concludes the document with some suggestions for further research and analysis on microfinance in the EU.

2. Current situation and challenges

Microfinance is a diverse and dynamic sector in the EU, with a variety of providers, products, beneficiaries and markets. EC Market Study: Microfinance in Europe: Market Analysis and Recommendations for Delivery Options in 2021-2027 estimates that 450 institutions offer or facilitate disbursement of microloans in the EU. The 2022 edition of the Microfinance Survey in Europe, conducted by the European Microfinance Network (EMN) and the Microfinance Centre (MFC), the sector reached more than 1.2 million micro and social businesses and disbursed over 4.5 billion euros in loans in 2020-2021. The microfinance sector in the EU serves mainly microentrepreneurs, especially those who are self-employed, women, young, migrants or from rural areas. The sector also offers other financial services, such as savings, insurance, leasing and money transfers, as well as non-financial services, such as business development, financial education, mentoring and coaching.

The microfinance sector in the EU is characterized by a high degree of heterogeneity and fragmentation, reflecting the different legal, regulatory, economic and social contexts of each country. The Survey identified four main types of microfinance providers in the EU: non-bank financial institutions (NBFIs), banks, non-governmental organizations (NGOs) and financial cooperatives. The NBFIs accounted for 58% of the total loan portfolio and 49% of the total number of clients, followed by banks with 32% and 40%, respectively. The NGOs and financial cooperatives had smaller shares of the market, with 6% and 4% of the portfolio and 7% and 4% of the clients, respectively.

The microfinance sector in the EU faces many challenges and gaps that limit its development and impact. Some of these challenges include:

- **Regulatory barriers:** the lack of a common legal and regulatory framework for microfinance in the EU creates obstacles for the registration, licensing, supervision and reporting of microfinance providers, especially for NBFIs and NGOs in many EU countries. The different national regulations also affect the access to funding, taxation, consumer protection and cross-border operations of microfinance providers. Additionally, EU member states' harsh regulatory regimes concerning setting up microenterprises (i.e., by migrants or refugees) may limit the opportunities to provide finance to entrepreneurial people.

- **Lack of affordable and diversified sources of funding**: The access to adequate and affordable funding is a major challenge for microfinance providers in the EU, especially for NBFIs and NGOs. The main sources of funding are grants (predominantly for business development services), loans, guarantees and equity from public or private investors such as EIF, EBRD, CEB national or regional authorities, banks and social investors. However, these sources are often insufficient, while some of them costly or difficult to access for microfinance providers.
- **Market fragmentation:** The microfinance market in the EU is highly fragmented and unevenly distributed across countries and regions. Some countries have a well-developed and mature microfinance sector (examples include France, Romania or the Netherlands), while others have a nascent or emerging one. The market penetration and outreach of microfinance providers also vary significantly depending on the size, density and demand of their target groups and markets.
- **Lack of funding for Innovation and digitalization:** The innovation and digitalization of microfinance services is still limited in the EU compared to other regions in the world. The use of new technologies, such as mobile banking, online platforms or biometric identification systems can improve the efficiency, quality and outreach of microfinance services. However, they also pose challenges that microfinance institutions take into consideration, they include cybersecurity risks or digital exclusion.
- **Low awareness:** the awareness and visibility of microfinance as a tool for financial inclusion, social impact and economic development is still low among various stakeholders in the EU, such as policy makers, regulators, investors, media or potential clients. This may affect the recognition, support and demand for microfinance services in the EU Member States.

These challenges require concerted efforts from various stakeholders in the microfinance sector to overcome them and enhance its potential for achieving the EU's objectives of growth, employment and inclusion.

3. Good practices and lessons learned from the EU initiatives to support micro and social finance

The EU has supported microfinance in various ways, such as providing funding, building capacity and quality of microfinance providers, raising awareness and visibility of microfinance, fostering innovation and digitalization, promoting social and environmental standards and supporting international financial inclusion networks. The main EU level initiatives and instruments that support microfinance are covered by **Annex 1.**

Some of the good practices and lessons learned from the EU initiatives and instruments to support micro and social finance include:

- **Providing initial capital to start-up and existing micro and social finance providers:** there is a strong need to support start-up and some of the existing micro and social finance providers with capital, as they often face challenges in raising capital from traditional sources, such as commercial banks and venture capital firms. The evidence suggests that providing initial capital to start-up MFIs is a cost-effective way to promote financial inclusion. The evidence also shows that only the MFIs that had an opportunity to receive initial capital (after fulfilling certain financial and programmatic targets) have become well established, and in some cases robust institutions serving a significant number of clients excluded from banking services. However, it is important to carefully select MFIs to receive initial capital and to ensure that they meet certain financial and programmatic targets before receiving funding. Existing, well-established MFIs can also benefit from public capital injection to develop their digital and physical infrastructure and expand their portfolios.

- **Leveraging partnerships with micro and social finance providers:** EU Member States can achieve many of their socio-economic development goals by partnering with micro and social finance providers and by providing them with long-term and affordable funding, that should include risk-sharing financial products such as guarantees, loans or equity that allow them to reach out to various marginalized and risky groups of potential entrepreneurs.
- **Providing a mix of financial and non-financial support:** Micro and social finance providers need not only funding but also technical assistance, capacity building, networking opportunities, innovation support, etc. to improve their performance, quality and outreach.
- **Providing grant support for the development of Business Support Services (BDS):** subsidy should be applied to enhance micro and social finance providers capacity to provide BDS in the form of financial education, training and mentoring of the final beneficiaries. Many micro and social finance providers offer BDS services either independently or in collaboration with other organizations. However, the scope of these services may be limited due to a lack of funding. These providers often struggle to cover their operational expenses with the interest earned on loans, making it difficult for them to finance BDS services. Public funding is therefore crucial for expanding BDS services, particularly for the most vulnerable groups such as low-income individuals, migrants, and those living in rural areas. By investing in these services, we can empower these individuals with the knowledge and skills they need to succeed, fostering economic growth and reducing inequality.
- **Promoting social and environmental standards:** Microfinance institutions were among the first world-wide adopters of social and environmental standards that reflect their mission and values. Social and environmental standards help microfinance providers to measure and report their impact, improve their governance and transparency, enhance their reputation and trustworthiness, attract new clients and investors, etc.
- **Fostering innovation and digitalization:** Micro and social finance providers can embrace innovation and digitalization as a way to improve their efficiency, quality and outreach. Innovation and digitalization can help microfinance providers to reduce costs of both financial and non-financial services they provide, increase revenues, diversify products and services, expand markets, reach new clients segments, etc. However, owing to funding shortages, most of the EU micro and social finance providers require additional financial support to develop and implement digital transformation strategies. One effective way to ensure that micro and social finance providers adhere to these standards is by promoting the endorsement and certification of the EU Code of Good Conduct for Microcredit Provision. This can serve as a benchmark for best practices, encouraging providers to strive for excellence in their operations

4. Recommendations

The Managing Authorities have a crucial role to play in developing support instruments for micro and social finance in their countries. In considering support for micro and social finance, MAs should seek to understand the various barriers that micro and social finance institutions face and facilitate the process of removing the barriers to enable growth and development of the social finance sector. While designing new support instruments, MAs should also investigate the current InvestEU offer to ensure complementarity and avoid duplication of efforts. It is also critical to understand if the micro and social finance providers have access to the InvestEU financial instruments, and the reasons for not being able access them. Understanding the specifics of the InvestEU offer is crucial for MAs to design a complementary support system that can effectively address the InvestEU gaps and limitations (including the budgetary ones) and respond to the needs of the micro and social finance providers in their countries. Specific recommendations for various support measures include:

Reduce legal and regulatory barriers for micro and social finance providers

We strongly recommend that the Managing Authorities undertake a comprehensive mapping of the legal and regulatory barriers faced by micro and social finance providers that may include issues related to registration, licensing, supervision and reporting requirements. Such initiative will help identify the challenges that these entities encounter, thereby paving the way for the development of effective strategies to mitigate them. Furthermore, it is crucial to promote initiatives aimed at reducing and/or eliminating these barriers, as they can significantly hinder the growth and impact of micro and social finance providers.

Similarly, it is equally important to map out the legal and regulatory barriers faced by micro and social enterprises. By identifying these barriers, we can work towards creating a more conducive environment for these enterprises to thrive and contribute to our collective goal of building a more inclusive and sustainable economy.

Develop new funding opportunities

Design liquidity instruments

Risk sharing loans are a good example of financial instruments that allow micro and social finance providers to offer loans to vulnerable groups at favourable terms, such as lower interest rates, longer repayment periods, grace periods, etc. This reduces the financial burden and risk for such groups and increases their repayment capacity and performance. A typical risk sharing loan works by having a third party, such as a public institution or a development bank, provide a partial guarantee to a lender to cover a portion of the losses in case of default by the borrower, such as a migrant entrepreneur. This reduces the risk for the lender and allows them to offer more favourable terms and conditions to the borrower. Risk sharing loans can be designed and managed by MAs alongside the existing guarantee schemes such as the InvestEU Microfinance & Social Entrepreneurship Guarantee or other country or regional level MSME guarantee systems. It is important to stress that not all of the financial intermediaries, in particular if they are non-banks (such as micro and social finance providers or regional MSME funds) can access the InvestEU guarantees owing to shortages of their own capital, while they may have an excellent track record of lending to microenterprises and SMEs from the external sources of funding. Risk sharing loans could help such intermediaries overcome this obstacle and allow them to reach out to various marginalized groups of potential entrepreneurs despite their own capital and liquidity limitations. A significant advantage would be to provide the risk sharing loans in combination with interest rate subsidy and grants that could support the development of technical skills of entrepreneurial migrants and other vulnerable groups of people. A typical public investor risk sharing rate is at the level of 70-80%. Consequently, the ultimate beneficiary, whether a start-up from a vulnerable group or a social enterprise, will receive a loan with a low-interest rate, accompanied by a significant grace period and extended repayment terms. On the other hand, micro and social finance providers can support riskier segments without the need for collateral.

Offer BDS grants

Business Development Services grants will allow micro and social finance providers to develop or expand their existing BDS programmes either through developing their own capacity for BDS provision (i.e. by investing in BDS delivery digitalisation, staff capacity, design of new training modules etc), or creating new linkages with other organisations that specialise in entrepreneurial training and coaching to create more sustainable support systems that include both financial and non-financial

support. Calls for proposals for BDS grants to MFIs (and other BDS providers) can be provided in annual calls for proposals or organized every 2-3 years depending on the number of BDS providers and quality of BDS delivered. Grant contracts should include income and outcome indicators to measure the impact of the subsidy on beneficiaries and the ecosystem effects.

Design complementary guarantee schemes

Such schemes could provide additional security to MFIs, reducing their risk and encouraging them to lend to more low-income individuals and small businesses. By doing so, these complementary support instruments could help to address the market failures in microfinance and promote financial inclusion. It is important that the new schemes are not just limited to entrepreneurs and businesses. They should also cover personal guarantees for low-income individuals, addressing various needs from employability to housing and health. This would ensure a more comprehensive approach to financial inclusion and economic growth.

Provide equity to micro and social finance providers.

Public sector equity can help to reduce the risk for private investors and make it easier for start-up and existing micro and social finance providers to raise additional capital. It can also provide start-up providers with access to technical assistance and other resources that can help them to succeed. Obviously, there are also some potential risks associated with public sector equity in start-up micro and social finance providers. One risk is that the government could lose money on its investment if the providers fail. However, these risks can be mitigated by carefully designing and implementing public sector equity programs. For example, the government could provide equity to start-up providers through a competitive bidding process. The government could also require start-up providers to meet certain performance criteria in order to receive equity funding. Overall, the potential benefits of public sector equity in start-up micro and social finance providers outweigh the risks. Public sector equity can help to increase access to financial services for underserved populations, promote financial inclusion, and create jobs and boost economic growth.

Promote micro and social finance

Raise awareness and visibility of microfinance as a tool for financial inclusion, social impact and economic development among various stakeholders in the EU, such as policy makers, regulators, investors, media or potential clients. This would increase the recognition, support and demand for microfinance services in the EU, as well as reduce the social stigma associated with microfinance.

Allocate appropriate budget to support micro and social finance

It is important to allocate a significant share of the EU shared management funds available to microfinance and social economy finance, especially the funds available through ESF+. This would provide microfinance providers with access to long-term and affordable funding, as well as risk-sharing mechanisms such as guarantees, loans or equity as well as BDS grants. We recommend that MAs consider the Social Return on Investment (SROI) when making budget allocation decisions. By incorporating SROI into their decision-making process, MAs can ensure that their investments are not only financially sound but also contribute to societal benefits. This approach could make the case for investment in micro and social finance more compelling, underlining the importance of these sectors in achieving broader economic and social objectives.

Use the fi-compass platform

Using the fi-compass platform for advisory services on EU shared management financial instruments can be particularly beneficial for Managing Authorities (MAs) that have limited experience in designing new financial instruments. Fi-compass is a platform provided by the European Commission in partnership with the European Investment Bank that offers various information and learning resources on financial instruments under the European Structural and Investment Funds (ESIF). Fi-compass can help managing authorities to design and implement effective and efficient financial instruments to support microfinance and social economy finance. Fi-compass provides case studies, factsheets, manuals, videos, news, events and other resources that showcase best practices and lessons learned from existing financial instruments in different sectors and countries. Fi-compass also provides technical assistance and advisory services for managing authorities who nee specific guidance or support while designing their financial instruments.

Contribute funding to the InvestEU Member State compartment

Using the mechanism of the InvestEU Member State compartment to increase the InvestEU resources available for guarantees to micro and social enterprises is an effective way to use the InvestEU instruments for national or regional priorities. EU countries have the possibility to contribute a part of their shared management funds to the InvestEU Fund, when setting up a "Member State compartment". This would allow them to benefit from the EU guarantee's high credit rating, giving national and regional investments more power, while cutting red tape. Under the Member State compartment, guarantees can be offered as a complement to other public and private investments, with a focus on specific national priorities. This would enable microfinance providers to offer loans to micro and social enterprises at favourable terms, such as lower interest rates or longer grace periods.

Provide funding for innovation, digitalization and green transformation

MAs can provide funding to support innovative projects in the microfinance sector. This could include funding for research and development projects, facilitating green transition or for pilot projects that test new digital solutions. Specific examples of how MAs can provide appropriately designed funding to support innovation and digitalization in micro and social finance include:

- Providing grants to micro and social finance providers to develop and implement new technologies and green products.
- Providing loans to invest in new technologies and infrastructure.
- Providing equity financing to MFIs to support their growth and expansion.
- Providing technical assistance to MFIs to help them build their capacity to use new technologies.

By providing appropriately designed funding and support, EU managing authorities can play a leading role in promoting innovation and digitalization in micro and social finance. On top of the core structural funds that remain under the shared management, the MAs can consider using the Just Transition or the Social Climate Funds to support the green transition and digitalization of the micro and social finance sectors.

5. Conclusions

The document aims to help the EU Managing Authorities to design and implement effective and efficient strategies and actions to enhance the micro and social finance sector and its contribution to the EU's objectives of growth, employment and inclusion. The document also aims to encourage more dialogue and cooperation of the public, micro and social finance sectors. By engaging in more dialogue and cooperation, public sector can identify needs, address challenges, explore opportunities and create synergies for the development and impact of micro and social finance in their countries.

MAs should consider designing support instruments that are cost-effective yet impactful. This could include low-interest, risk-sharing loans that can provide much-needed liquidity to micro and social finance providers and would enable them to reach specific target groups. Another important way to support micro and social finance providers would be to provide grants for the development of BDS services or supporting early-stage and well-established social finance providers with capital to help them establish and grow their operations. MAs should also consider supporting innovation and green transition facilitated by micro and social finance providers as well their digital transformation.

Moreover, MAs should seriously take into account various barriers faced by MFIs in their countries This could involve conducting a thorough assessment to understand these barriers and designing the support plans and instruments in a way that makes it easier for micro and social finance providers to use their full potential.

ANNEX 1

Overview of the selected European Commission initiatives in support of microfinance

- **The European Progress Microfinance Facility (EPMF),** launched in 2010, was a €200 million initiative that aimed to increase the availability and accessibility of microcredit for vulnerable groups and micro-enterprises. The EPMF provided guarantees and funding to microfinance intermediaries, such as banks, non-bank financial institutions or NGOs, through the European Investment Fund (EIF). The EPMF also supported capacity building and technical assistance for microfinance intermediaries through the European Investment Bank (EIB) and other partners. The EPMF reached over 100,000 borrowers in 23 EU countries.
- **The Microfinance and Social Entrepreneurship axis of the Employment and Social Innovation (EaSI) Programme**, launched in 2014, was a €193 million initiative that continued and expanded the activities of the EPMF. The EaSI Programme aimed to increase access to finance for social enterprises and micro-enterprises, especially those facing difficulties in accessing credit. The EaSI Programme provided guarantees and funding to microfinance intermediaries through the EIF, as well as grants for capacity building, innovation, research and networking activities through the European Commission. The EaSI Programme reached more than 230,000 micro-borrowers and 1,200 social enterprises in 28 EU countries.
- **The InvestEU Programme** provides an EU budget guarantee to public and private investors who finance projects that contribute to the EU's objectives of growth, employment and inclusion. The InvestEU Programme is structured around four policy windows: sustainable infrastructure; research, innovation and digitisation; SMEs; and social investment and skills. Microfinance and social economy finance are supported under the SME window and the Social Investment and Skills window.
- **JASMINE, EaSI TA** and **SIFTA** are examples of the EU designed dedicated technical assistance and advisory services for microfinance and social finance providers that have been implemented over almost 20 years (SIFTA is the current complementary technical assistance and peer visit program) and that have offered considerable opportunities to develop institutional capacity and resulted in the increased outreach of the EU microfinance institutions.
- **The EU Code of Good Conduct for Microcredit Provision** is a voluntary code of conduct that sets out best practices for microcredit providers in the European Union. The Code was developed by the European Commission in consultation with key stakeholders. It plays an important role in promoting responsible and ethical lending practices in the European microfinance sector. The Code helps to ensure that microcredit borrowers are treated fairly and that they have access to affordable and accessible financial services. The EU Code of Good Conduct is a condition for microcredit providers to access EU funding under the EaSI financial instruments and the InvestEU Social Investment and Skills window.
- For many years, the European Commission have been providing grant support for the **international financial inclusion and social finance networks** to promote the development of a more inclusive and sustainable financial system.