POLICY PAPER

WHAT CAN BE DONE TO ADDRESS THE NEEDS OF 93% OF ENTERPRISES IN EU?

POLICY PAPER ON MICROFINANCE NEEDS, PROBLEMS AND SOLUTIONS IN A NUTSHELL BY MICROFINANCE CENTRE

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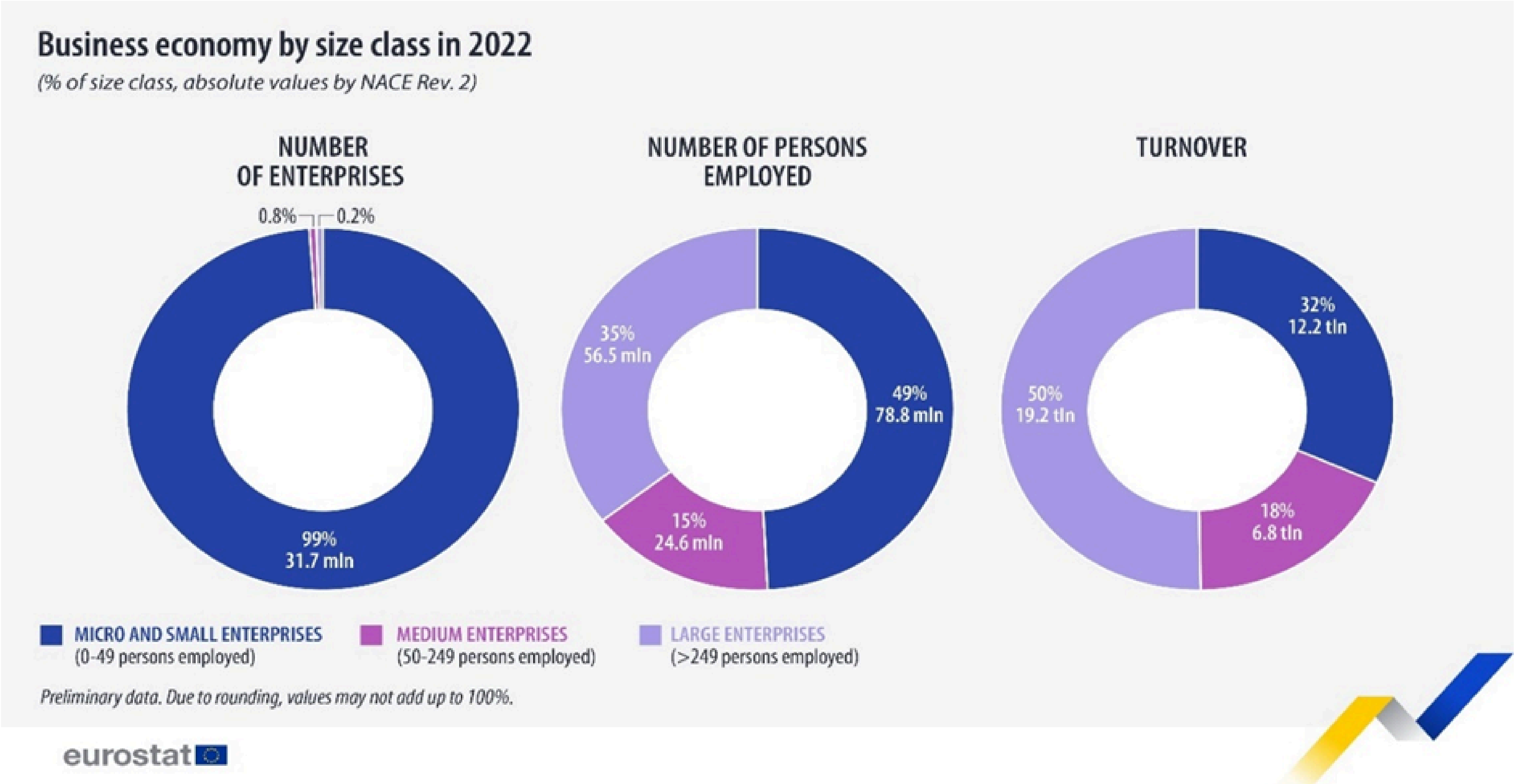
INTRODUCTION

In the light of the evolving economic landscape and the imperative to foster inclusive growth, it is crucial for the European Parliament and Commission to shift its focus towards social finance. Towards the end of its current term, the focus has been on green and digital transition with 30% of all EU expenditure until 2027 to go to climate-related projects [1]. The current policy proposal advocates for a strategic pivot for the next stage of ESG, namely from “E” towards “S” including social finance, particularly emphasizing financial inclusion and focus on vulnerable part of the society, so important in current geopolitical crisis.

[1] Climate change: what the EU is doing - Consilium (europa.eu) (accessed on 11 March 2024)

WHY MICRO AND SOCIAL FINANCE?

In 2022, in EU, there were 32 million enterprises, employing 160 million people generating 38 trillion EUR net turnover. Out of this 99% enterprises were micro and small employing 49 % of people in EU. Yet they generate only 32% of net turnover. [2]



Microenterprises alone represent 93% of all companies from European non – financial business sector [3]

[2] Large businesses generated half of EU's net turnover - Eurostat (europa.eu)

[3] EIF, Financing Micro Firms in Europe: An Empirical Analysis, EIM Research & Analysis, Working Paper 2017/44

WHAT HINDERS THE DEVELOPMENT OF MICRO AND SOCIAL ENTERPRISES?

Businesses to develop need stable and affordable access to funding. For medium and large enterprises such access provide e.g. banks and various investors. Also well developed, though still within the category of “small” [4] enterprises could be also accepted by banks.

....and what about micro and social enterprises [5]?

Micro and social enterprises are fundamentally underserved in the market. The best of them will be able to get some banking funding but for the majority of them it will be very difficult due to many reasons. They are too small and have little needs, which makes them uninteresting for the banks, although the banks are encouraged to finance microenterprises.

For banks financing enterprises which take a loan without real estate collateral means that the banks need to have much bigger capital risk weights. If e.g. microbusinesses take 20 thousand EUR loan they do not provide real estate collateral, as the loan is too small. In this way, substantial majority of microloans for businesses go without any real estate collateral. As a result, financing microbusinesses means much more complex process and also much higher capital allocation and all that for small amounts. Therefore banks, although encourage, often do not lend much to microbusinesses.

[4] According to Commission Recommendation of 6th May 2003 (2003/361/EC) small enterprises employs than 50 persons and either annual turnover of balance sheet total does not exceed EUR 10 m EUR LexUriServ.do (europa.eu)
[5] Microenterprise employes fewer than 10 persons and either annual turnover of balance sheet total does not exceed EUR 2 m EUR, Ibid.

Who will finance microbusinesses, then?

Microbusinesses are socially very sensitive segment and very big one, too. Non-bank lenders already proved that they are one of most active lenders in this segment who are providing rate available and affordable for those businesses. But to do this, there is a need for public money participation to address the issue of financial inclusion.

Why public money is needed?

Non-bank lenders are not entitled to accepts deposits which is in turn low-cost source of money for the banks. So, they need to turn to much more expensive sources, for example issuing bonds on capital market or attracting funding from investment funds where they compete with real estate developers.

There is also option for turning to impact investment funds but here part of the rate is e.g. EURIBOR. If 6-month Euribor rate is at about 4% with additional margin of e.g. 4%, it ends up with 8% - much more expensive than interest rates given by banks on deposits. This also translates to the rates available to end beneficiaries of microloans.

The solution is thus to enter into partnership with institutional investors (governmental banks or state agencies interested in positive social impact seen in micro and social enterprises).

Yet, the solution should be comprehensive addressing also the weaknesses of the current system.

MFC PROPOSITION OF THE SOLUTIONS

1. Securing adequate funding for microfinance sector both at EC and national level

Funds filling the gap, available in local currency

First of all, there is a need for allocated public funds of adequate amount as this is crucial to make the microloans affordable and accessible. We highly appreciate up to date EC efforts to provide funds under InvestEU and previously EaSI and Progress. Yet, with the development of the sector and broadening of the scope from EaSI to InvestEU the demand for funds much exceeds the funds available. In 2019 the gap only for microfinance products was estimated at EUR 12.9 billion p.a. for EU Member States and was forecast to grow to EUR 15.0 - 16.7 billion in 2027 [6] Moreover the continuity of the funds is of essence not to loose up to data achievements and continue to provide finance for micro and social enterprises.

Yet, the issue is not only with the funds but also with the currency. MFIs need funding in local currency as currency hedging costs can be quite high (e.g. in Poland and Romania).

2. Solving current problems with public money instruments

PROBLEM: Public money programs often look for a leverage at the central level, that is, they look how to give 1 EUR and attract e.g. additional 5 EUR of private money. This way of working is reflected e.g. in capped guarantees. Yet, in funding, it is difficult to get that kind of leverage. On the other hand, cheap governmental money could be blended at MFIs level with regular money, and thus providing leverage though not at central level but instead at that of MFIs.

As a result, MFIs raise the issue of having guarantees, which are highly appreciated, yet without access to funding (e.g. Lithuania, Greece).

[6] Drexler, B. et al. (2020), Microfinance in the European Union: Market analysis and recommendations for delivery options in 2021-2027, Publications Office of the European Union, Luxembourg.

SOLUTION:

Continuation of the guarantees

- Continuation of the current guarantee instruments as crucial assistance for the development of non-bank lenders and small businesses, though with reporting requirements simplified and reduced (e.g. regarding reporting frequency).

Instruments providing low cost funds

- Provision of new instruments allowing apart form guarantees also access to low-cost funds. This could be e.g. in a form of:
  - provision of low-cost governmental money which could be then, at MFIs level, blended with regular money, and thus providing leverage
  - provision of junior capital absorbing first losses that could strengthen negotiation position of MFIs when looking for senior financing.

PROBLEM:

There is temptation for the public money managers to solves a lot of problems with just one instrument e.g. dedicating a single financial instrument both to microenterprises and regular small companies. Often the focus is on a very wide category of both micro and small size companies which constitute 99% of enterprises in the EU. Then:

- microenterprises which take small loans (e.g. EUR 10,20,30 thousand) need to compete with mid size enterprises which take e.g. EUR 500 thousand or EUR 200 thousand.

- such an instrument addressing the needs from e.g. 1 thousand to 1 m. EUR will lead to the situation when microlenders will compete with other commercial lenders who focus on much bigger loans. The latter will take much bigger amount of dedicated funding and for microlending again remains very small amount.

- mid-size companies which already have some choice to take bank loans, credit union loans, will have one more choice to take governmentally subsidised loans while microenterprises situation is not improved.

Instruments to solve microenterprise problems should be dedicated just to microfinance segment

SOLUTION:

The instruments should be focused on solving a specific problem in a particular segment instead of being a one-stop remedy for all the problems of small and micro enterprises It should be the instrument for that specific segment e.g. loans up to 50 thousand EUR but not go up to 1 m EUR as it is absolutely different kind of a loan. It is very difficult to compete 50 thousand EUR loans with 1m EUR loans. It is advised to create an instrument which is, in case of microlending, addressed to microlenders solving problems for microbusinesses. Then much less money would be needed and much more targeted effects would be.

PROBLEM: Current application and reporting system favours bigger MFIs and other social finance providers, which have capacity to address the complex requirements and which are relatively cheaper to service, which leave smaller MFIs without access to funds. Yet, this does not allow the sector to grow.

The situation is even more aggravated as over recent year or two, various international lenders, MIVs do not lend institutions which have portfolio below 10m EUR. It is easier for medium size MFIs which have established reputation and are on market for long time, but again for smaller MFIs remains not much choice.

Simplification of reporting requirements and application processes for smaller MFIs

SOLUTION:

- The requirements regarding both application and reporting processes should be aligned to the size of the MFIs and adequately simplified for the smaller MFIs.
- Also, within the financial instruments there should be a separate funding pool allocated to the smaller MFIs.

Separate funding pool for smaller MFIs

PROBLEM:

When MFIs cannot find enough funding at one stop finance provider they need to gather funding from various sources with various requirements regarding reporting. That is expensive solution.

SOLUTION:

Standardization of the reporting requirements

Although the problem is not new, no significant solution was found. With the digitalisation transition, we propose to increase efforts to harmonise reporting process which should be gradually implemented, starting from the most-prone to be standardized parts and make it digitalised and accessible to all relevant funding providers.

3. Need for enhanced coordinated efforts at both EC and Member States levels to allow for most effective approach

PROBLEM: Funding available at EC level is highly valued and is also a cost effective option. ”For ERDF and ESF financial instruments, levels of management costs and fees are high compared to the actual financial support to final recipients and also appear to be significantly higher than those of centrally managed instruments or private sector investment funds”. [7]

Yet, the Managing authorities have better national expertise and outreach to direct funds to the most needy and financially excluded regions. This outreach may be at the same time more costly and more time consuming in implementation dealing with e.g. smaller entities on top of more administrative costs.

Additionally, there are complains that EU programs although may be more cost effective, are rather aligned to bigger MFIs/other social finance providers (which is also cheaper) at the expense of smaller ones, which may also need smaller amounts, less complicated procedures due to own capacity constraints etc.

Therefore we highly value and see both channels as a complementary solution although with underutilised potential. Yet, only in case where both level efforts are well coordinated it allows for both cost and impact effectiveness (and thus also including the impact in form of the growth opportunity for smaller MFIs and servicing vulnerable part of society, which inherently is more costly). Unfortunately this is not always the case. For example, in Hungary non for profit MFIs do not have access to governmental money, or similarly in Romania NBFI do not have access to governmental money and programs.

Therefore, we highly welcome Recommendation adopted by the Council of the European Union on 27 November 2023 including a framework supporting the design and implementation of social economy strategies by the EU Member States.

[7] Ibid, p. 76.

Reduction of national legal and financial barriers that micro and social finance institutions

Yet, we consider that further steps should be taken by Managing Authorities to encourage to allocate adequate funding to finance social economy, including also microfinance, namely:

SOLUTION: Reduction of national legal and financial barriers that micro and social finance institutions face. This could be done in the following steps:

- Preparation of a comprehensive mapping of legal, regulatory and financial barriers faced by micro and social finance providers.
- Implementation and promotion of initiatives aimed at reduction and/or elimination of these barriers.

Development of new national funding opportunities

SOLUTION: Development of new funding opportunities:

- Preparation of the analysis of the funding needs and gaps not filled by InvestEU instruments.
- Development of national or regional liquidity instruments, such as risk-sharing loans, to offer loans to vulnerable groups at favourable terms (lower interest rates, extended repayment periods, longer grace periods, guarantees, interest rate subsidy, grants for technical assistance (TA) etc.).
- Development of Business Development Services (BDS) grants to micro and social finance providers to develop or expand their existing BDS programs in annual, biennial or triennial calls for proposals.

Promotions of micro and social finance

Encouraging MAs to include microfinance and social finance in their Operational Plans

Allocation of a significant share of EU shared management funds available to microfinance and social economy finance

- Design of complementary guarantee schemes to provide additional security to MFIs and other social finance providers, reducing their risk and encouraging them to lend to low-income individuals and small businesses. Such schemes should include entrepreneurs, businesses, low-income individuals addressing various needs from employability to housing and health.
- Provision of equity (junior shares) to micro and social finance providers as public sector equity can help to reduce the risk for private investors and make it easier for start-ups and existing micro and social finance providers to raise additional capital. The equity for start-ups should be combined with access to technical assistance.

SOLUTION: Promotions of micro and social finance to raise awareness and visibility of this tool for financial inclusion, social impact, job creation and economic development.

SOLUTION: Encouraging Managing Authorities to include microfinance and social finance in their Operational Plans to ensure microfinance institutions and ethical banks have access to resources at the national level.

SOLUTION: Allocation of a significant share of EU shared management funds available to microfinance and social economy finance, especially the funds available through ESF+ to allow for long-term, sustainable and affordable funding utilising e.g. Social Return on Investment (SROI) when making budget allocation decisions.

Usage of the fi-compass platform for advisory services on EU shared management of financial instruments

Provision of funding for innovation, digitalization, and green transformation

Using State Compartment to increase the InvestEU resources available for guarantees to micro and social enterprises

Provision of BDS and TA

SOLUTION: Usage of the fi-compass platform for advisory services on EU shared management of financial instruments, especially for Managing Authorities which have limited experience in designing new financial instruments.

SOLUTION: Provision of funding for innovation, digitalization, and green transformation e.g. grants, loans, equity financing and technical assistance (TA) to implement new technologies, green products etc. and to facilitate twin transition of the micro and social finance sectors. The specific solutions should enable vulnerable consumers and micro/small business beneficiaries to be financially incentivized, by making all grant schemes for these groups enable them to save money the greener and more digitalised they become.

SOLUTION: Contribution of funding to the InvestEU Member State Compartment as a way to increase the InvestEU resources available for guarantees to micro and social enterprises.

SOLUTION: Any solutions should be accompanied with Business Development Services (BDS) for end beneficiaries and TA for MFIs.

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The Microfinance Centre is a social finance network that promotes fairness, inclusion, equality and responsible service. We unite almost 140 organizations across 36 countries of Europe, Central Asia, who together deliver responsible microfinance services to almost 2,000,000 low-income clients.

Together with our members – microfinance, financial cooperative systems, social finance banks, social investors, academic institutions, national and international support organizations and networks – we seek to make financial services work effectively for people, communities and the planet by embracing sustainability good practices and standards, sharing knowledge, advocacy and networking in the region of Europe and Central Asia.

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