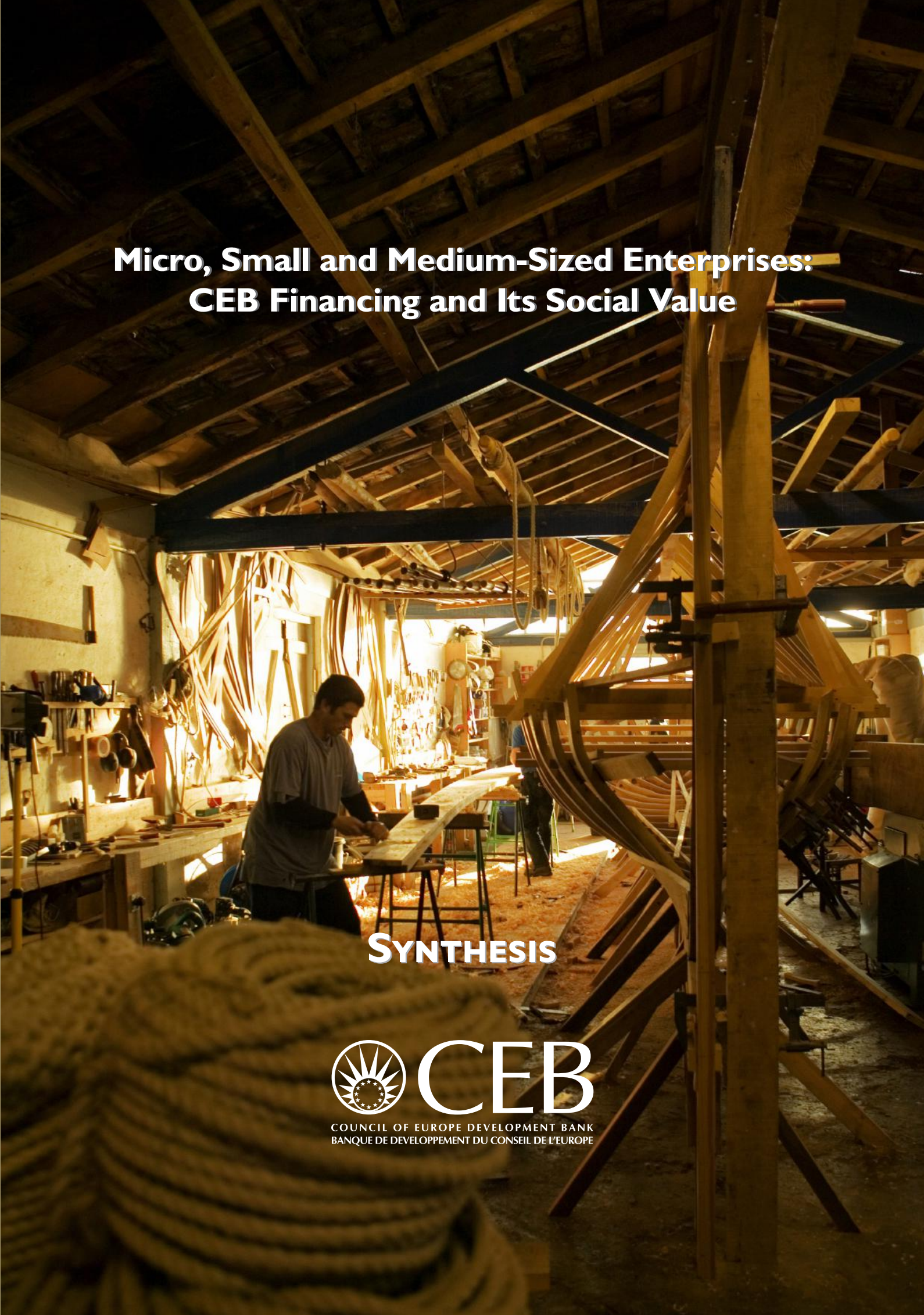


Micro, Small and Medium-Sized Enterprises: CEB Financing and Its Social Value

Synthesis

CEB

COUNCIL OF EUROPE DEVELOPMENT BANK
BANQUE DE DEVELOPPEMENT DU CONSEIL DE L'EUROPE

ACKNOWLEDGEMENTS

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FOREWORD

Employment has long been identified as a significant pillar of social inclusion. It helps lift people out of poverty, (re-)integrates marginalised or socially excluded populations, and contributes to the development of social identities of individuals and to social cohesion of communities.

Net job creation and economic growth have increasingly been linked, especially in the past decades, to the growth of micro, small and medium-sized enterprises (MSMEs). Nevertheless, it is smaller companies, as opposed to large firms, that report higher financing obstacles which impede their growth.

The Council of Europe Development Bank (CEB) works with governments and financial institutions to promote the creation and preservation of viable jobs in its Member States. It provides small companies with medium- and long-term financing through intermediaries. The primary financing instrument for this is the "programme loan", a lending instrument widely used in the development community.

From 1956 to end-2012, the Bank approved close to € 9 billion in loans to this effect. This activity has gradually evolved, becoming a major expression of the CEB's social mandate since 1995. From 1995 to 2012, the CEB's financing in favour of job creation and preservation amounted close to € 8 billion, representing a fifth of its total lending activities.

The purpose of this study, entitled "Micro, Small and Medium-Sized Enterprises: CEB Financing and Its Social Value", is to establish a historical overview of the Bank's activities in favour of creation and preservation of jobs from the CEB's establishment to 2012. The study also analyses the socio-economic rationale for the CEB's support to MSMEs.

The key references are additionality, i.e. value beyond the contributions of the private sector, and social added value of the CEB's support in this sector: creation and preservation of viable jobs. The report explains that this final social objective has been achieved through the role of the CEB: *(i)* in promoting financial inclusion of disadvantaged and socially marginalised populations and regions in the Bank's Member States and *(ii)* in providing a particular degree of additionality and producing catalytic effects in the financial sectors of the Bank's so called "target countries" in Central, Eastern and South-Eastern Europe.

I believe that the report is especially pertinent in the context of the socio-economic consequences of the crisis which erupted in 2007. I would also like to underline the Bank's effort to present options to be further explored in order to enhance its existing operating model of MSME financing and to increase the social added value of its operations in this sector.

This study comes as a natural reflection following over four decades of activities in favour of job creation and preservation and is largely based on the input from the operations, technical assistance and monitoring, and evaluation departments. It makes reference, inter alia, to the findings of the recent Evaluation Synthesis Report on the activities of the Bank in favour of MSME financing.

I would hope that this publication will raise awareness of this major sector of the CEB's lending as an integral part of the Bank's contribution to fostering social cohesion in its Member States.



Rolf Wenzel
Governor
Council of Europe Development Bank

ABOUT THE CEB

Set up in 1956, the CEB (Council of Europe Development Bank) has 40 Member States. Twenty-one Central, Eastern, and South-Eastern European countries, forming the Bank's target countries, are listed among the Member States.

As a major instrument of the policy of solidarity in Europe, the Bank finances social projects by making available resources raised in conditions reflecting the quality of its rating. It thus grants loans to its Member States, to financial institutions and to local authorities for the financing of projects in the social sector, in accordance with its Articles of Agreement.

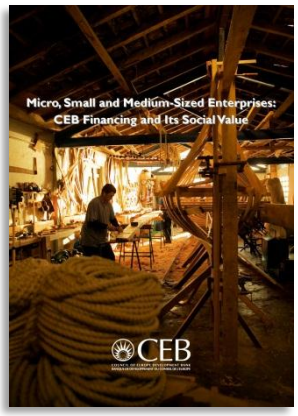
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EXECUTIVE SUMMARY

1. The Council of Europe Development Bank (CEB) is a multilateral bank with an exclusively social mandate. Since its establishment in 1956, the CEB has been committed to supporting social investment projects while giving priority to its historical mission to help in solving social problems of refugees, displaced persons and migrants.

2. In the mid-1960s, the CEB started to support the creation and preservation of jobs in its Member States. To this effect, as of end-2012, it approved € 8.7 billion in loans. Activity in this sector has gradually evolved, becoming a significant pillar of the CEB's lending since 1995. From 1995 to 2012, the CEB approved € 7.6 billion and disbursed € 5.5 billion in loans in favour of job creation and preservation. During this period, this sector represented on average one-fifth of the total CEB lending, with peaks of more than 40% in 2008 and 2012 in the context of the socio-economic consequences of the crisis.

3. In the CEB's so-called "target countries" in Central, Eastern and South-Eastern Europe[i], job creation and preservation was the most significant sector of CEB activities between 1995 and 2012, accounting for 31% of approvals or € 5.0 billion. In the Bank's Western European Member States during the same period, it was the second most important sector, representing 13% of approvals or € 2.6 billion.

4. CEB loans in favour of job creation and preservation have consistently targeted micro, small, and medium-sized enterprises (MSMEs)[ii]. Responding directly to the pressing concern of smaller companies, limited access to finance, the Bank provides them with medium- and long-term financing. The rationale for supporting MSMEs is the recognition of their potential as drivers of economic growth, net employment generators, and promoters of social cohesion.

5. The typical CEB's lending instrument in favour of job creation and preservation is the "programme loan", i.e. a loan financed by the CEB through intermediaries disbursed according to their absorption capacity, and, consequently, demand from beneficiary MSMEs. The CEB has partnered with sovereigns as well as with public and private financial institutions to reach MSMEs in its Member States. In its target countries, where leasing tends to be a source of medium- and long-term financing, the CEB has worked with leasing companies in addition to traditional banks.

6. The CEB's activities, including those in favour of job creation and preservation, involve additionality i.e. value beyond the contributions of the private sector, and social added value. The CEB promotes financial inclusion of MSMEs in all Member States and contributes to deepening local financial systems and strengthening MSME lending markets in its target countries[iii]. The final objective of the CEB's MSME financing is to create and preserve viable jobs. In 1995-2011, following the projections obtained for 60% of loans in favour of MSME financing, the CEB's social impact could be estimated at around 137 000 of jobs created and another 1.6 million of jobs preserved[iv].

7. Financial inclusion reflects widespread access to financial systems and use of financial products. It equalises opportunities for all populations and thus fosters social cohesion. In its target countries, characterised by generally less inclusive banking systems, the CEB aims to reach a broad spectrum of MSMEs that tend to be underserved and/or credit rationed. In its non-target countries, the CEB addresses disadvantaged regions at the sub-national level, registering unemployment rates above the EU average[v], micro-firms, and socially excluded or marginalised populations, such as immigrants and women[vi].

8. The depth of financial sectors is characterised by the level of availability of credit. In shallow financial systems, credit to the private sector is limited, medium- and long-term financing is scarce, and MSME lending sectors are usually "embryonic". In its target countries, where the financial sectors, in addition to being less inclusive, are relatively shallow than in Western European countries, the CEB provides a particular degree of additionality. It also produces more pronounced catalytic effects, i.e. working with local financial intermediaries and contributing to mobilising resources from other IFIs for MSMEs.

9. Based on the Bank's experience following over four decades of operations, monitoring, and evaluations, the study presents several options to be explored by the CEB. The non-exhaustive list of alternatives is considered to further enhance the existing operating model of MSME financing and to increase the social added value of the Bank's operations in this sector. These options include: (i) targeting the lower-end of the MSME size spectrum, (ii) complementing the financing instrument (programme loan) with other instruments (e.g. technical assistance), (iii) adding to or replacing the headcount-based approach to impact assessment with more relevant and suitable indicators (e.g. financial inclusion), and (iv) adapting the eligibility criteria to take into account the role and needs of MSMEs.

Executive Summary Endnotes:

[i] Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Georgia, Hungary, Latvia, Lithuania, "the former Yugoslav Republic of Macedonia", Malta, Republic of Moldova, Montenegro, Poland, Romania, Serbia, Slovak Republic, Slovenia, Turkey.

[ii] Throughout the study, the acronym "MSMEs" refers to micro, small, and medium-sized enterprises. In the context of CEB MSME financing, support to micro-firms has not been normally identical to micro-crediting. While both activities refer to supporting individuals or enterprises with fewer than ten employees, micro-crediting is a particular support to the most socially excluded, e.g. low-income individuals, usually with small-value loans, although the array of products has increasingly broadened. The CEB has only occasionally channelled its lending to microfinance providers with the objective to support marginalised populations, such as immigrants and women.

[iii] Although CEB MSME financing may have such potential effects, they are not specified as objectives in the design documents, and there are no appropriate monitoring indicators on which final performance could be evaluated.

[iv] The headcount reflects projected figures provided by implementing partners, which are based on self-declarations by the financed MSMEs. At the time of writing, projections were available for 60% of loans in favour of job creation and preservation. The CEB's Evaluation Department (EVD) has highlighted the low information content of, and methodological difficulties associated with the headcount-based approach focused exclusively on number of jobs created and/or preserved. The issues regarding this development impact indicator are a matter of debate, specific not only to the CEB, but also to the IFI community as a whole.

[v] "Disadvantaged regions" in non-target countries were referenced to the EU average in the CEB's Overall Policy Framework for Loan and Project Financing following CEB Administrative Council Resolution 1495 in 2006.

[vi] Conclusions based on the Case Studies presented in Part VI of the complete version of the study, selected by purposive sampling to cover a range of financing modalities, countries, and final beneficiaries.

INTRODUCTION

The purpose of this synthesis is to summarise the main messages of the CEB's study entitled **"Micro, Small and Medium-Sized Enterprises: CEB Financing and Its Social Value"** (February 2013). The publication builds upon over four decades of operations, monitoring and evaluations in the sector of action "creation and preservation of viable jobs"[1].

Box 1. CEB Sectoral Lines of Action

Sectoral lines of action	Sectors of action
Strengthening social integration	• Aid to refugees, migrants and displaced persons • Housing for low-income persons • Creation and preservation of viable jobs • Improvement of living conditions in urban and rural areas
Managing the environment	• Natural or ecological disasters • Protection of the environment • Protection and rehabilitation of historic and cultural heritage
Supporting public infrastructure with a social vocation	• Health • Education and vocational training • Infrastructure of administrative and judicial public services

This synthesis concentrates on the following messages:

The Rationale for the CEB's Activities in Favour of MSME Financing

1. The MSME sector is a driver of social cohesion across CEB Member States.
2. "Access to finance" is identified by MSMEs as a pressing problem and represents an obstacle in fulfilling their socio-economic potential.

CEB Operations under "Creation and Preservation of Viable Jobs"

3. The description of the € 8.7 billion portfolio in MSME financing from the Bank's establishment in 1956.
4. The CEB's commitment to its target countries as of the mid-1990s, where, in the context of more shallow financial sectors than in Western European Member States, this sector of action was the most significant activity of CEB operations.
5. Social added value of CEB MSME financing based on five case studies selected by purposive sampling.
6. Key lessons learned and non-exhaustive options ahead to further enhance the CEB's operating model of MSME financing.

The complete version of the study can be accessed on the CEB's website under the heading "Brochures and Studies", sub-heading "Technical Studies".

[1] Throughout the history of the CEB, the sector of action in favour of MSME financing had different headings. Under Resolution CA 1495 in 2006, which brought the approval of the Bank's Overall Policy Framework for Loan and Project Financing, it was re-named "creation and preservation of viable jobs". Please refer to the full version of the study (**Chapter 1**), available on the CEB's website, for the historical overview and evolution of the CEB's activities in job creation.

1. MSME SECTOR – DRIVER OF SOCIAL COHESION

Across CEB Member States, there is a robust, positive relationship between the relative size of the formal **MSME sector** and **economic growth.**

In European economies, **MSMEs** are the key engine of **job growth in the private sector.** During 2002-2010, they accounted for **85% of net new jobs created.**

A typical EU firm is a **micro-company.**

Micro-enterprises contribute the most to **total net employment growth (58%).**

In European economies in 2008, MSMEs accounted for **59% of GDP** and **more than two-thirds of the total employment** in the non-financial business economy.

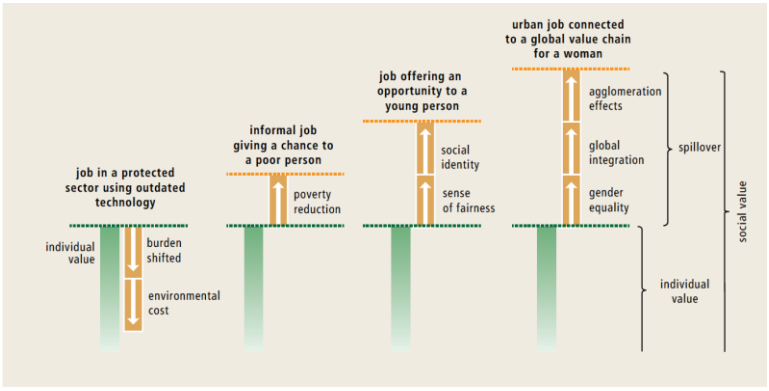
Table 1.1. MSME Sector in the EU-27

2008	Number of enterprises	Persons employed	Value added
	Share in total (%)		
All enterprises	100.0	100.0	100.0
All SMEs	99.8	66.7	58.6
Micro	92.0	29.0	21.8
Small	6.7	20.5	18.6
Medium-sized	1.1	17.2	18.2
Large	0.2	33.3	41.4

Source: Eurostat Pocketbooks (2011), *Key figures on European business with a special feature on SMEs,* Eurostat and European Commission

The expansion of the MSME sector is closely linked to economic growth and job creation, which, in their turn, contribute to **social cohesion**.

Figure 1.1. Social Value of Jobs



Source: The World Bank (2012), *World Development Report 2013: Jobs,* International Bank for Reconstruction and Development/The World Bank

Poor people identify **employment** – whether through self-employment or from receiving a salary – as "their **best prospect for escaping poverty**" (IFC, 2011).

A successful private sector, [notably MSME sector], expands the **variety and reduces the costs of goods and services**, including those consumed by poor people" (IFC, 2011).

Micro-enterprises engage the highest percentage of **long-term unemployed** and **people aged 50+** (EC, 2012), social groups badly affected by the crisis and demographic contraction in Europe.

In the EU, employees in MSMEs report **higher job satisfaction in terms of the "soft" side of work relationships**, such as work climate, working time arrangement, or work-life balance (EC, 2012).

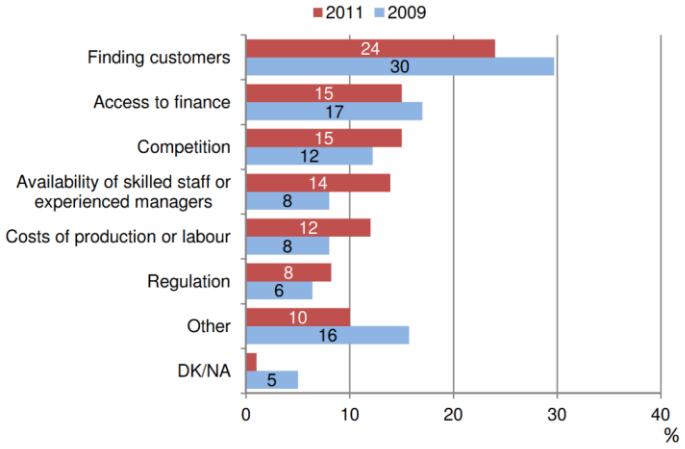
2. OBSTACLES FACING MSMEs IN FULFILLING THEIR SOCIO-ECONOMIC POTENTIAL

The dominant concern for MSMEs represents "finding customers", being cited by 30% of MSMEs in 2009 and 24% in 2011 (see **Figure 2.1.**).

In the EU-27, MSMEs perceive "access to finance", along with "competition", as their second most pressing problem. In 2011, 15% of MSMEs reported "access to finance" among the top concerns, a slight drop from the 2009 level of 17%.

According to the 2011 Survey on SMEs' Access to Finance (SAFE), in the EU banks are the most common provider of loans to MSMEs, with 87% of MSMEs that got a loan obtaining the loans from banks. Bank loans are also the most favoured source of external financing, cited by 63% of MSMEs that expect to grow in the coming years[2].

Figure 2.1. The Most Pressing Problems of MSMEs in the EU-27



Q0. What is currently the most pressing problem your firm is facing?: All SMEs, % EU-27

Source: *Ipsos Mori (2011), SMEs' Access to Finance Survey. Analytical Report,* European Commission, Enterprise and Industry.

Nevertheless, MSMEs are underserved and it is the larger and mature enterprises that are more likely to obtain the requested external financing. About one third of MSMEs did not obtain the finance they had planned for – only 63% of MSMEs that applied for a bank loan obtained the full loan, as opposed to 77% of large enterprises[2].

Market Imperfections as Explanations of the Supply Side Constraints

In a perfect financial market, the differences between large and smaller enterprises such as profitability, growth, and probability of survival would be reflected in higher interest rates or less favourable terms of debt financing for smaller entities. In reality, there are market imperfections that limit the willingness of banks to engage in MSME financing and/or increase further the cost of financing:

- Asymmetric information leads to higher transaction costs relative to the small size of MSME operations, translated into higher interest rates.

  Theoretically, there are two solutions to manage the asymmetric information:

  - Provision of collateral, i.e. signalling of creditworthiness, that "may [however] lead to situations in which lending is not based on expected return but rather on access to collateral" [3].
  - Pursuit of long-term relationship with clients, i.e. screening, practised mainly by micro-finance providers.

- Immature financial markets, such is the case in most CEB target countries (see **Table 2.1.**) where financial sectors are shallower and less inclusive in comparison to the Western European countries, as referenced to the EU average:

  - Banks in countries with immature (shallow) financial systems usually face little competition, and thus little incentives, to take additional risks and to operate actively in the MSME market. In these countries, the MSME lending markets thus tend to be "embryonic".

[2] Ipsos Mori (2011), *SMEs' Access to Finance Survey. Analytical Report,* European Commission, Enterprise and Industry.
[3] OECD, SMEs and Entrepreneurship, "*Small Businesses, Job Creation and Growth: Facts, Obstacles and Best Practices*".

- Banks in developing countries are often reliant on short-term liabilities, such as deposits. They are thus challenged to avoid the mismatch in the maturities of assets and liabilities and tend not to provide longer term financing, terms most preferred by MSMEs.

These market imperfections and the inherent characteristics of smaller entities create an environment in which MSMEs are more likely to be either (i) credit rationed/unserved, or (ii) underserved, i.e. have a certain access to external financing, but it is not sufficient.

* * *

MSMEs face disproportionate barriers to accessing finance that create an unequal playing field with large enterprises. This inequality, in its turn, undermines the socio-economic potential of MSMEs as drivers of economic growth and net employment generators, and disrupts social cohesion. In line with the practice of the international community, the CEB assists MSMEs in its member countries and provides them with medium- and long-term financing. The CEB acts directly upon market imperfections and:

- Supports with medium- and long-term financing not only traditional banks, but also micro-finance providers and leasing companies.

- Increases the availability and affordability of external financing for MSMEs and fosters the development of deeper and more inclusive financial sectors, most needed in CEB target countries. The geographic focus on these Member States is also in line with the Bank's strategic commitment to the Central, Eastern and South-Eastern European (CEE) countries. The institutional commitment to this region was officially declared in the Medium-Term Development Plans 1997-2001 and 1999-2004. The Development Plan 2005-2009 introduced the concept of "target countries", which comprises 21 countries (see **Table 2.1.**).

Table 2.1. CEB Member States (Year of Accession & Target/Non-target Countries)

CEB TARGET COUNTRIES	YEAR OF ACCESSION	CEB NON-TARGET COUNTRIES	YEAR OF ACCESSION
Turkey	1956	Belgium	1956
Cyprus	1962	France	1956
Malta	1973	Germany	1956
Bulgaria	1994	Greece	1956
Slovenia	1994	Iceland	1956
Lithuania	1996	Italy	1956
Romania	1996	Luxembourg	1956
Croatia	1997	Holy See	1973
"The former Yugoslav Republic of Macedonia"	1997	Switzerland	1974
Estonia	1998	Liechtenstein	1976
Hungary	1998	Portugal	1976
Latvia	1998	Sweden	1977
Republic of Moldova	1998	Denmark	1978
Poland	1998	Netherlands	1978
Slovak Republic	1998	Norway	1978
Albania	1999	Spain	1978
Czech Republic	1999	San Marino	1989
Bosnia and Herzegovina	2003	Finland	1991
Serbia	2004	Ireland	2004
Georgia	2007		
Montenegro	2007		

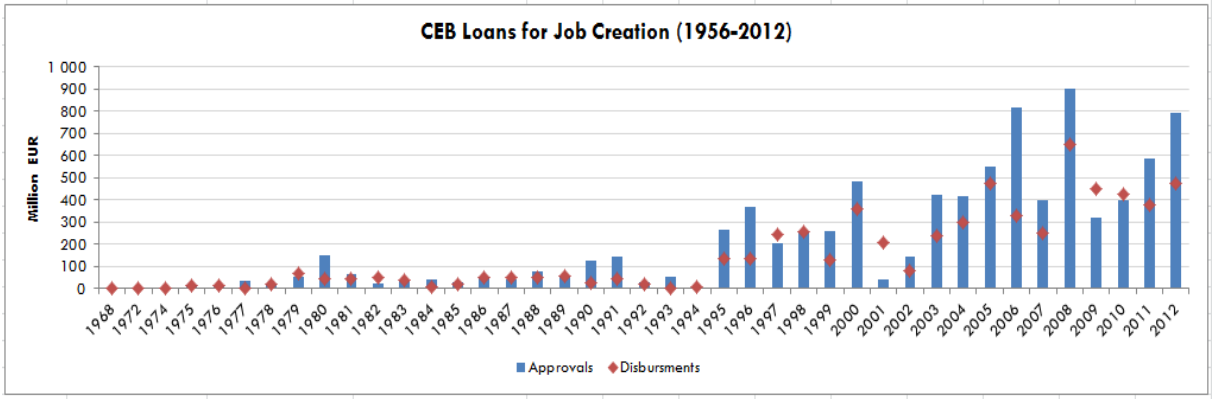
3. CEB PORTFOLIO IN JOB CREATION AND PRESERVATION SINCE ITS ESTABLISHMENT IN 1956

The CEB started its financing in favour of job creation in the mid-1960s. From the mid-1990s, this sector of action became a significant activity (see **Graph 3.1**):

- Between 1956 and 1994 the CEB approved loans in value of € 1.1 billion and disbursed € 0.6 billion.
- Between 1995 and 2012 the CEB approved loans in value of € 7.6 billion and disbursed € 5.5 billion.

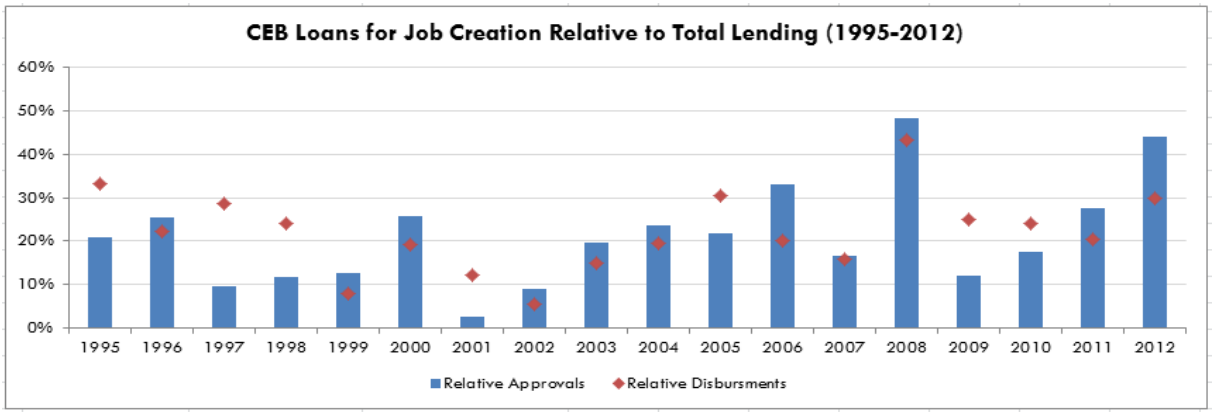
The increase in activities is related to the evolution of the role of the Bank in job creation as part of the social mandate of fostering social cohesion; geographic expansion as of 1994 into CEE countries; progressive development of the banking sectors in the new member countries; use of "transit loans" [4]; and a gradual increase in demand for CEB lending.

Graph 3.1



Relative to its total lending, between 1995 and 2012, the allocation of CEB loans to job creation averaged 21%. This ratio also holds when excluding the years of lowest (2001 and 2002) and highest activity (2008 and 2012) in this sector (see **Graph 3.2**).

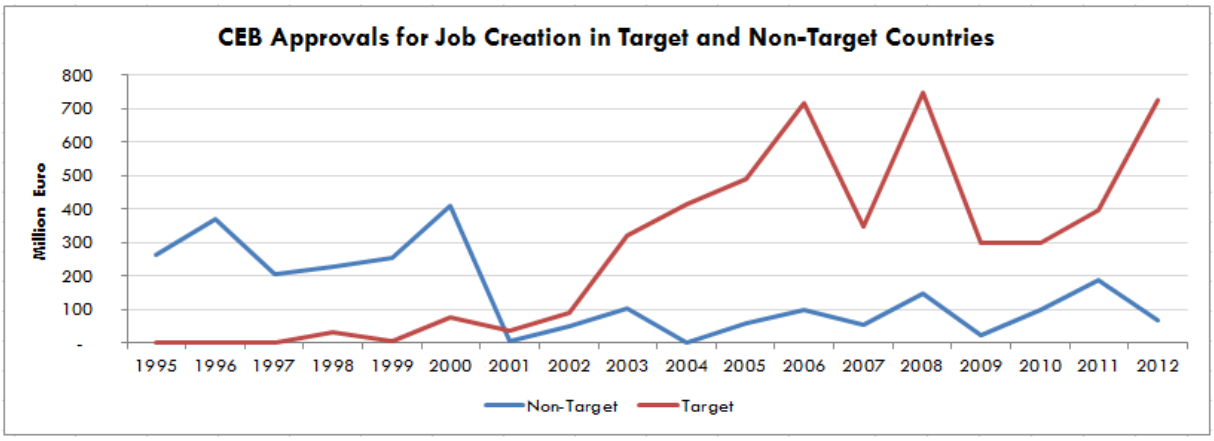
Graph 3.2



[4] Loans granted to borrowers in non-target countries with the final objective of benefiting projects in target countries.

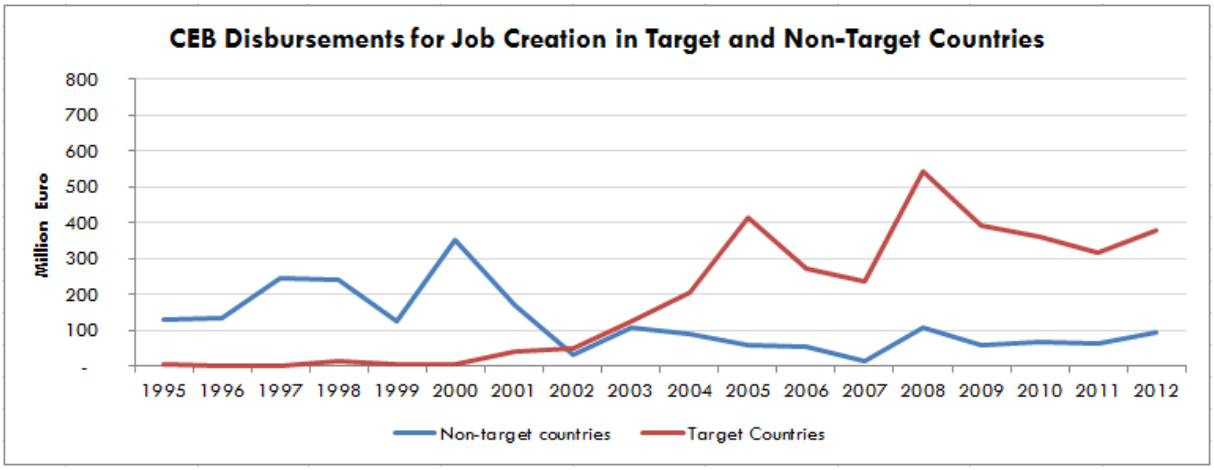
From the Bank's establishment to end-2012, job creation and preservation in target countries accounted for 61% of CEB MSME lending or € 5.3 billion. From 1995 to 2012, it was the most significant sector of CEB activities in target countries. During this period, as a share of CEB lending in target countries for all sectoral lines of action, it represented 31% of approvals or € 5 billion, and 30% of disbursements or € 3.4 billion.

Graph 3.3



From the Bank's establishment to end-2012, job creation and preservation in non-target countries in Western Europe accounted for 39% of CEB MSME lending or € 3.4 billion. From 1995 to 2012, it was the second most significant sector of CEB activities in non-target countries. During this period, as a share of CEB lending in non-target countries for all sectoral lines of action, it represented 13% of approvals or € 2.6 billion, and 14% of disbursements or € 2.2 billion.

Graph 3.4



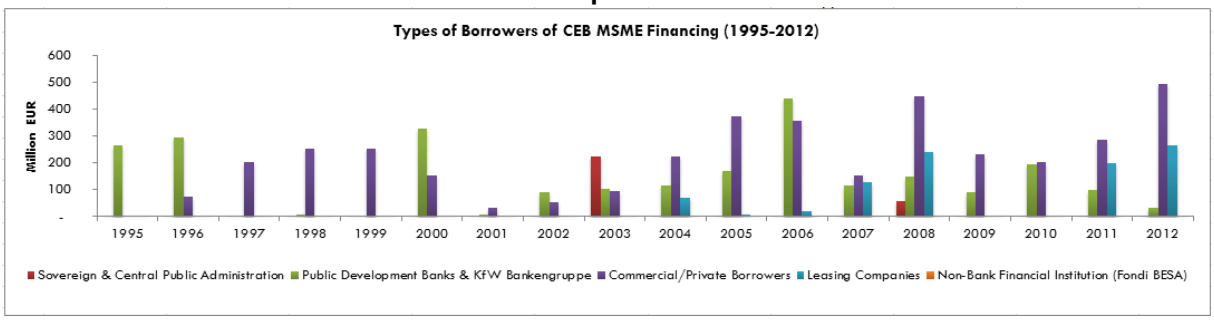
As a result of the crisis that erupted in 2007, in the context of more fragile European sovereigns, unresolved structural problems in the financial sectors, and tighter credit supply and standards, the role of IFIs support to the private sector in CEE economies, including MSMEs, has strengthened. The CEB has also continued its financing in favour of the MSME sector, with a focus on its target countries:

- In 2008, the CEB provided the largest share of MSME financing from its establishment in 1956 in both absolute, € 0.9 billion, and relative terms, 48% of total approvals. 83% of the loans in favour of MSMEs benefited CEB target countries.

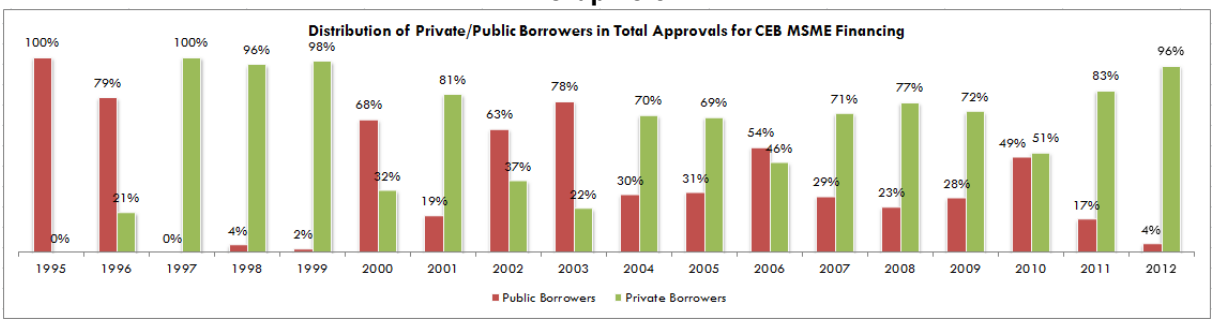
- In 2012, the second largest share of financing, € 0.8 billion or 44% of total approvals, was in favour of job creation and preservation. 92% of the loans in favour of MSMEs benefited CEB target countries.

The CEB does not have branches in its Member States and operates via intermediaries – sovereigns and public or private financial institutions – to reach the intended MSME beneficiaries. **Graphs 3.5** and **3.6** present the diversification of the distribution channels for CEB MSME financing during 1995-2012. During this period, 37% of borrowers of the CEB MSME financing were public (sovereigns, central or local public administration, and public development banks), while the remaining 63% were private borrowers (commercial borrowers, leasing companies, and non-bank financial institutions).

Graph 3.5



Graph 3.6



Note: The category "Public Borrowers" includes sovereign & public administration (central and regional), and public development banks such as KfW Bankengruppe. The category "Private Borrowers" consists of commercial borrowers, leasing companies, and non-bank financial institution (Fondi BESA).

Between 1995 and 2012, the largest borrower was KfW Bankengruppe with € 1.24 billion in loans approved and € 1.18 billion in loans disbursed. It was followed by UniCredito Italiano (€ 500M approved and disbursed) and Magyar Fejlesztési Bank (€ 320M approved and disbursed).

The CEB's financing instrument in favour of MSMEs is the loan passed on through intermediaries: during 1995-2012, 63% of MSME lending was done through programme loans and 37% via project loans (see **Box 3.1.**). During the same period, the average size of a loan in favour of MSMEs approved was € 40 million (189 loans). The lowest size was € 500,000 (two loans) and the highest was ≈ € 260 million (three loans). CEB lending is generally characterised by its favourable terms regarding interest rates, tenors and grace periods.

Box. 3.1. CEB Lending Instruments: Programme Loans and Project Loans

The traditional lending instruments, which are also the main tools for the CEB's activities in its Member States, are project loans and programme loans:

- **Project loans** refer to individual projects directly financed by the CEB, which usually relate to financing capital goods representing the "hardware" foundation of a community, such as rural and urban infrastructure, housing for low-income people or administrative and judicial infrastructure. Project loans are disbursed based on work progress.
- **Programme loans** refer to loans financed by the CEB through intermediaries, disbursed based on the absorption capacity of the borrower.

The typical CEB MSME financing loan is a programme loan, and is referred to as such throughout the study.

4. CEB MSME FINANCING IN ITS "TARGET COUNTRIES": SUPPORT UNDER "TRANSIT LOANS" AND LEASING OPERATIONS

Despite the gradual financial integration and increased foreign presence in their financial sectors since mid-1990s, CEB target countries have relatively shallow and less inclusive financial sectors than non-target countries. In order to reach the intended beneficiary MSMEs in these Member States, the CEB started to operate, as of 2000, under "transit loans" and, as of 2004, under leasing operations.

CEB Support under "Transit Loans"

Given the strong presence and profiles of Western European banks in target countries, since 2000 the CEB has started to support these banks via a CEB mechanism labelled "**transit loans**", i.e. loans granted to financial intermediaries in non-target countries to finance projects in target countries (see **Box 4.1.**). This mechanism contributed to mitigating the CEB's credit risk, as the risk borne by the CEB is that related to financial intermediaries, which have stronger risk management and financial solidity, and not that of final beneficiaries.

Furthermore, "transit loans" allowed the CEB to reach local beneficiaries it would not otherwise have access to.

In terms of the overall CEB activities, "transit loans" have mainly been used to reach MSMEs for preservation and creation of viable jobs; fund housing for lower income groups; and invest in small municipal infrastructure projects, sectors that are naturally suited to the use of intermediaries.

Box 4.1. "Transit Loans"

CEB loans are said to be "intermediated" when borrowers from the CEB provide funding for legally separate third parties responsible for implementing one or more projects. The relevant intermediaries must:

- Assume operational responsibility for identifying final beneficiaries;
- Transfer the funds to the final beneficiaries;
- Effect the repayment to the CEB of the loans granted to the final beneficiaries, the CEB's credit risk being that of the intermediaries;
- Assume responsibility for reporting to the CEB on the operations carried out.

Source: Excerpt from the CEB (2012), *Financing Social Projects in CEB Target Countries: Achievements and Challenges*.

During 2000-2009, a total of € 1.4 billion of "transit loans" were approved in favour of job creation and preservation, via financial institutions in Italy (€ 777 million), Germany (€ 493 million) and Sweden (€ 100 million) (see **Table 4.1.**). This represents slightly more than two-thirds (69%) of the value of "transit loans" approved for all CEB sectors of actions during the period 2000/2009.

Table 4.1. CEB MSME Financing through "Transit Loans". Amounts Approved (2000-2009).

Million EUR	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Grand Total
"Transit Loans" / GERMANY	**60**	**30**	**75**	**50**	**48**	**50**	**80**	**100**			**493**
IKB Deutsche Industriebank AG		30									
KfW Bankengruppe	60		75	50	48	50	80	100			
"Transit Loans" / ITALY				**20**	**30**	**120**	**405**	**2**	**200**		**777**
Intesa Sanpaolo S.p.A.				20	30	20	55	2			
Società Italiana per le Imprese all'Estero (SIMEST)							150				
UniCredito Italiano						100	200		200		
"Transit Loans" / SWEDEN							**40**			**60**	**100**
Skandinaviska Enskilda Banken (SEB)							40			60	
Grand Total	**60**	**30**	**75**	**70**	**78**	**170**	**525**	**102**	**200**	**60**	**1 370**

In 2010-2012, "transit loans" were not approved in favour of MSME financing. This phenomenon could be explained, inter alia, by the deleveraging process of Western European Banks as a consequence of the crisis. It also reflects the increased demand for CEB lending from state development banks in target countries.

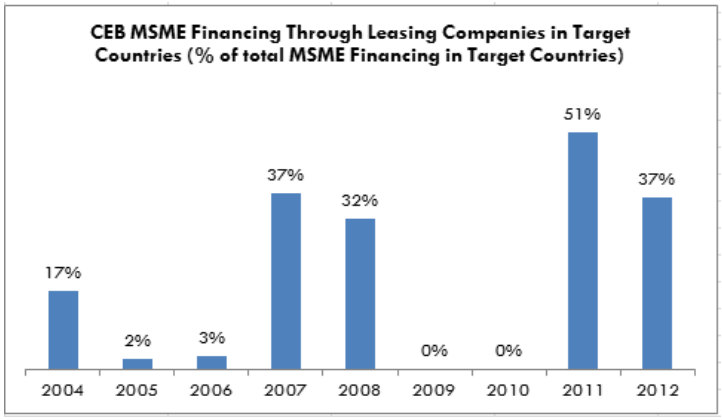
CEB Financing of Leasing Operations

In the context of market imperfections and the consequences of the crisis, such as Basel III regulations and deleveraging of Western European banks, leasing and factoring have become important alternative sources of MSME financing to bank loans and overdrafts, especially in CEB target countries. Compared to traditional lending, which makes cash available to MSMEs, leasing provides with tangible asset with no additional collateral required, as the asset itself is the collateral for the transaction[5]. It is often seen as a source of medium- and long-term financing and it is considered "last financing resort"[5].

From 2004, the CEB started to use leasing as an MSME financing instrument in its target countries by providing medium- to long-term financing to leasing companies. During 2004-2012, 21% of CEB MSME financing in target countries, or € 1 billion, was done through leasing. 2011 was the year which registered the highest share of leasing operations of 51%, 2005 and 2006 had low shares of 2% and 3%, respectively, and 2009 and 2010 being the years when leasing was not used (see **Graph 4.2**).

The CEB's 2011 Annual Report on Project Preparation and Follow-Up concluded that leasing was particularly effective in reaching small firms. The Bank's on-site visits to sub-projects financed by leasing companies systematically reported that the lease instrument allowed small firms to obtain needed capital equipment even when they had limited or no access to bank funding[6].

Graph 4.2



[5] Kraemer-Eis, H., *et al.* (2012), *The Importance of Leasing for SME Finance*, European Investment Fund (EIF), Research and Market Analysis.
[6] The CEB's Annual Report on Project Preparation and Follow-Up 2011.

5. SOCIAL ADDED VALUE OF CEB MSME FINANCING

The social added value of CEB MSME financing, based on established in-house methods, is creation and preservation of viable jobs. In 1995-2011, following the projections obtained for 60% of loans in favour of MSME financing, the CEB's social impact could be estimated at around 137 000 of jobs created and another 1.6 million of jobs preserved[7].

In order to analyse the CEB's additionality and social added value, the study presents five case studies as at 31.12.2011. The selection of the case studies is based on purposive sampling to cover a range of financing modalities (loans and leasing), countries (target and non-target), and final beneficiaries.

Table 5.1 Cases – Examples of CEB MSME Financing Programmes

Case	Country	Borrower	Final Beneficiaries
1	Finland	FINNVERA	Finnish SMEs located in disadvantaged regions of Finland
2	Spain	MICROBANK[8]	Micro-firms and individuals, such as immigrants and women, with limited access to credit
3	Poland	EUROPEJSKI FUNDUSZ LEASINGOWY (EFL)	Polish SMEs
4	Turkey	TURKIYE SINAI KALKINMA BANKASI A.S. (TSKB)	SMEs located throughout Turkey
5	Bulgaria	PROCREDIT BANK	SMEs on the micro- or lower end of the market
	"The former Yugoslav Republic of Macedonia"		

Please refer to the full study accessible of the CEB's website for a detailed description of the cases.

Intermediaries: Strong Profiles and Alignment of Mandates/Incentives

MSMEs benefitting from CEB-financed programmes are generally those within the existing pipeline of intermediaries. Under this operating model, the social added value of the CEB's operations is highly correlated with the choice of the intermediaries.

Cases 1 to **5** evidence that the implementing partners of the CEB-financed programmes were important players in the local markets; and had the relevant mandate, expertise, willingness and institutional capacity to reach effectively MSME beneficiaries at the moment of loan approval and subsequent disbursements.

[7] The headcount reflects projected figures provided by implementing partners, based on self-declarations by the financed MSMEs. At the time of writing, estimations were available for 60% of loans in favour of MSME financing. The CEB's Evaluation Department (EVD) has highlighted the low information content of, and methodological difficulties associated with the headcount-based approach focused exclusively on number of jobs created and/or preserved. The issues regarding this development impact indicator are a matter of debate, specific not only to the CEB, but also to the IFI community as a whole.

[8] The entity was renamed "Nuevo Micro Bank, S.A.U" following the re-organisation of the La Caixa Group in 2011. As the name "MicroBank" is used for commercial purposes, it is referred to as such throughout the study for the purpose of simplicity.

Favourable Lending Conditions: Additionality of CEB Financing

"CEB raises funds on the best terms available on capital markets, and passes these terms to the borrower, applying the lowest possible margin which takes into account the need to cover its operating costs"[9]. CEB lending is generally characterised by its favourable terms, regarding interest rates, tenor and grace periods:

- The level of interest rates is established for each disbursed tranche of a loan. The interest rates are generally more competitive than those provided by commercial loans, without distorting the local markets. In **Cases 1-5**, the borrowers received an interest rate advantage ranging roughly between 0.05% and 2% compared to the levels they would have otherwise been charged on the market (pertinent for borrowers that had direct access to the market)[10]. The borrowers have a choice between fixed and variable interest rates, but the customary CEB financing is through floating rates. The CEB's reference currency is EURO, which does not exclude recourse to other currencies.
- The tenor is medium- to long-term. During 1995-2011 the customary tenor for MSME lending was 10 years applied to more than two-fifths, or € 2.1 billion, of disbursements under MSME financing, with the shortest tenor being 3 years (€ 0.3 billion) and the longest, 15 years (€ 0.3 billion).
- Grace period may be granted, if estimated appropriate, for loan repayments, not for interest repayments. Almost 30% of disbursements during 1995-2011 contained a grace period. For those loans the customary grace period was 5 years applied to almost two-fifths, or € 0.5 billion, of loans disbursed with grace period. The tenor and grace periods reflect the nature of the underlying investment.

The CEB, similar to other IFIs, strives not to crowd-out private sector players: it aims at providing lending to final beneficiaries that tend to be underserved and/or credit rationed by the private sector.

Eligible Costs

The CEB applies the EU definition of MSMEs as eligibility criterion for MSME financing.

- In the case of CEB non-target countries (see **Table 2.1**), SMEs must also be situated in regions with an unemployment rate equal to or higher than the average unemployment rate within the EU. Non-target countries not members of the EU are assimilated to the EU regions.
- The unemployment rate criterion for SMEs is not applicable to target countries.
- Micro-credit programmes in favour of micro-enterprises are considered for financing irrespective of the location.

The CEB's share of financing may represent up to 50% of the total eligible cost of the sub-project[11]. During 1995-2012, the average size of an MSME programme loan approved for intermediaries was € 40 million (189 loans). The lowest size was € 500,000 (two loans) and the highest was ≈ € 260 million (three loans).

CEB MSME financing must involve fixed investments or investments in productive equipment[12], including in the form of leasing, aimed to create and/or preserve permanent and/or seasonal jobs.

CEB can also cover working capital financing when it de facto fulfils the criteria of an investment financing, rather than ordinary working capital financing. The financing of working capital is limited to the level of small enterprises as defined by the EU and up to € 50 000 by sub-project[9].

[9] The CEB's Policy for Loan and Project Financing 2009. http://www.coebank.org/Upload/legal/en/ppfp_english.pdf
[10] Approximations are provided by the CEB's General Directorate for Loans and Social Development for borrowers which had direct access to market financing at the moment of tranche disbursement.
[11] The share may be higher, but not exceeding 90%, in case of (1) projects in favour of refugee populations, migrants and displaced persons; (2) reconstruction and or/rehabilitation of destroyed or damaged infrastructure in the wake of a natural or ecological disaster; and (3) projects implemented in the CEB target countries. Source: CEB Policy for Loan and Project Financing 2009.
[12] Eligibility is excluded for investments in the primary agricultural sector, weapons, nuclear energy, tobacco, production of spirits, gambling, pornography, and products considered by EU regulations to be harmful to health and to the environment

CEB Social Value: Promoting Financial Inclusion in CEB Target and Non-Target Countries[13]

Given the judicious choice of intermediaries, the CEB is able to reach MSMEs that tend to be underserved and/or credit rationed, disadvantaged regions and socially excluded populations in its target and non-target countries:

- The CEB MSME support in target countries in **Cases 3-5 (Poland, Turkey, Bulgaria,** and **"the former Yugoslav Republic of Macedonia")** reached a broad spectrum of MSMEs that tended to be underserved and/or credit rationed in the context of generally less inclusive banking systems. It also supported specialised leasing companies, which are often the preferred alternative to external banking financing, such as EFL, the leader in the Polish leasing market.

- The Bank's MSME support in non-target countries addresses disadvantaged regions at the sub-national level, registering unemployment rates higher than the EU average[14][15], socially excluded or marginalised populations, such as immigrants and women, and micro-firms. Under **Case 1 (Finland)** the programme loans to Finnvera, the only full state-owned financial institution in Finland, targeted MSMEs located in pre-defined disadvantaged regions with predominantly high unemployment rates. Under **Case 2 (Spain)**, the support to MicroBank, the MFI of La Caixa, aimed at reaching socially disadvantaged populations that risked marginalisation and/or social exclusion, such as women and immigrants.

CEB support to the lower-end of the MSME size spectrum has generally had a broader scope than micro-financing or micro-crediting. Nevertheless, the CEB has occasionally channelled its lending through microfinance providers, such as MicroBank in Spain (**Case 2**) with the objective to support marginalised populations, such as immigrants and women.

CEB Social Value: Contributing to Deepening Financial sectors in CEB Target Countries

In its target countries in CEE, the CEB fosters social cohesion through creation and preservation of employment not only by promoting financial inclusion of MSMEs, but also by contributing to deepening the financial sectors and strengthening the MSME lending market [16].

CEB activities provide a particular degree of additionality, as the private sector tends not to provide medium- and long-term financing in shallow banking sectors. The CEB also plays a catalytic role, i.e. working with local financial intermediaries and contributing to mobilising resources from other IFIs to increase their lending to MSMEs. Also, since the CEB supports both local and foreign intermediaries, it may contribute to introducing competition and expertise and to increasing efficiency in the local financial sectors.

- For example, **Case 5** presents CEB MSME financing in "the former Yugoslav Republic of Macedonia", where the banking sector is highly concentrated. The CEB partnered with ProCredit Bank, established as a local reference bank for micro-credits, to increase the availability of medium to long-term financing and to potentially contribute to mobilising other IFIs to increase their lending to MSMEs.

[13] Although financial inclusion may be another potential effect of CEB MSME financing, it is not specified as an objective in the design documents, and there are no appropriate monitoring indicators on which final performance could be evaluated.
[14] "Disadvantaged regions" in non-target countries were referenced to the EU average in the CEB Overall Policy Framework for Loan and Project Financing following the CEB Administrative Council (AC) Resolution 1495 in 2006. The previous CEB definitions can be found under AC Resolution 1313 (1993), 1313 Revised 2 (1995), and 1424 (1997).
[15] Non-target countries not members of the EU are assimilated to the EU regions. Source: The CEB's Overall Policy Framework for Loan and Project Financing.
[16] Although deepening financial sectors and/or strengthening the MSME lending markets may be other potential effects of CEB MSME financing, they are not specified as objectives in the design documents, and there are no appropriate monitoring indicators on which final performance could be evaluated.

Sustainability of CEB Activities

The Bank aims to achieve sustainability of its activities over the medium- and long-term. Its operating model allows addressing the viability of operations by maximising the quality of projects/programmes. To this end, the CEB is closely involved in the design, preparation and monitoring of projects/programmes. It appraises the financial and institutional capacity of implementing partners, and the adequacy of the financing package.

- For example, the CEB's technical mission deemed the sustainability of the programme with ProCredit in Bulgaria (**Case 5**) as high. This opinion was expressed given the institutional capacity of the implementing partner: "ProCredit is a sound micro-finance institution operating on a best-practice basis, with an ownership that is committed to its development and mission. Its business strategy is sound and it has in place an active business development plan and resource mobilization strategy"[17].

The sustainability of CEB activities also relies on external factors, such as the effectiveness of national and/or sub-national business and economic policies. In this sense, CEB loans tend to address the macroeconomic environment and imbalances at the sub-national level and thus complement national or regional policies and priorities.

- For example, the already mentioned CEB cooperation with Finnvera (**Case 1**) targeted Finnish SMEs located in disadvantaged regions. These regions were also defined as Objective Areas in the context of the EU Structural Funds, which matched with high unemployment regions of Finland.

[17] Excerpt from the mission report of the CEB's Technical Assessment and Monitoring Directorate.

6. CEB MSME FINANCING – LESSONS LEARNED AND OPTIONS AHEAD

Lessons Learned

Following the assistance and monitoring performed by the General Directorate for Loans and Social Development, on-site missions conducted by the Directorate for Technical Assessment and Monitoring, and evaluation findings of the Evaluation Department, several lessons and findings can be summarised regarding the Bank's activities in the sector of action "creation and preservation of viable jobs":

- The CEB has successfully deployed its efforts to prioritise investments in its target countries, including through the use of "transit loans".
- Social impact was mainly associated with the creation and preservation of viable jobs, as explicitly defined in the social objective of CEB financing. Employment generation effects, based on established in-house methods, were generally above expectations, varying with the financial performance of the financed SMEs.
- A multiplier effect was also registered in terms of jobs created in other companies, mainly suppliers. Thus, the indirect job creation impact was also significant.
- Relevance of the Bank's activities depends on the prevailing market conditions, both national and international, and/or on the choice of the implementing partner.
- Relevance is high when access to credit is more difficult. Thus, in the context of the socio-economic consequences of the banking crisis of 2007, CEB financing has a more pronounced financial additionality as opposed to the pre-crisis years. Generally, the CEB's additionality is related to the Bank's provision of medium- and long-term, thus stable, debt to intermediaries and final beneficiaries.
- The judicious choice of intermediaries at appraisal allows for an effective transfer of the CEB's social development objective to the implementing partners. It also determines the capacity of the Bank to reach its intended final beneficiaries, assuming they are well-defined at the design stage. Preference should be given to partners with broad experience and a business strategy focused on support to MSMEs.
- Very broadly defined SME programmes tend to score lower relevance ratings; while more targeted programmes involving smaller lending volumes and narrower social objectives have higher added value. For example, the Evaluation Report on Women Entrepreneurship in the Baltic States in 2002-04 channelled through 5 intermediary banks in target countries (2 in Lithuania, 2 in Latvia and 1 in Estonia) concluded that the programmes performed well and were highly efficient. The programmes aimed to create and preserve jobs in firms owned or managed by women, or which had a project improving women's situation on the labour market[18]. The focus on small credits to small, successful women-led firms provided the CEB with a specific niche and the cooperation with the Nordic Investment Bank (NIB) was valuable, in particular at the start-up phase of the programmes.
- Leasing was an effective measure to reach micro- and small businesses in the CEB's target countries. This instrument allowed smaller firms to obtain needed capital equipment even when they had limited or no access to bank funding.
- Sharing the knowledge gained from prior operations represents another source of the CEB financing's added value. For example, following its cooperation with specialised DFIs, such as Finnvera, which have built the necessary expertise and capacity to reach firms that tend to be underserved and/or credit rationed by commercial banks (e.g. start-ups, firms facing difficulties finding merger partners or selling-out), the CEB brought this experience into the discussions on preparation of activities with other intermediaries that could have benefitted from potential improvement in their targeting mechanisms.

[18] Preparation in Lithuania was supported by a Finnish Trust Account, whereas in Estonia and Latvia existing NIB women entrepreneurship programmes were renewed. The Trust Fund and the cooperation with NIB contributed to an exemplary preparation of the programme. A major added value of the programme was the successful transfer of the CEB social objectives to intermediary banks. Source: EVD Report

Options Ahead

Following the aforementioned findings and four decades of operations, monitoring and evaluation, it would be sensible for the Bank to continue to prioritise MSME financing in its target countries, where the additionality of longer maturities of its loans is most effective and catalytic effects are generally more pronounced given shallow and less inclusive financial systems.

At the same time, the Bank could consider enhancing the existing operating model of CEB MSME financing to better respond to the needs of final MSME beneficiaries and capacities of implementing partners. The suggested options represent a common effort by the in-house directorates to contribute to the enhancement of the social added value of the CEB's operations in this sector[19]. The following list is not to be considered exhaustive or limiting:

- Adopting a more targeted approach, such as focusing on the lower-end of the MSME size spectrum. The CEB applies the EU definition of MSMEs as eligibility criterion for MSME financing, according to which 99.8% of European enterprises could be potential participants in CEB-financed operations in favour of job creation and preservation. To increase its social added value in this sector and contribution to the social cohesion of local communities, the Bank could consider setting additional targeting measures to effectively reach the lower-end of the MSME size spectrum. Under the current operating model of MSME financing, these measures would have to be complemented with a judicious screening of implementing partners, a comprehensive understanding of their effectiveness as resource allocators to sub-projects which are economically, socially and environmentally sustainable[20], and close technical co-operation with them in the design, preparation of operations, and monitoring arrangements[21].

- Complementing the existing financing instrument, programme loans passed on through intermediary banks, with additional instruments, such as technical assistance for programme preparation, to confer a more differentiated and contextualised approach to MSME financing.

- Complementing or replacing the headcount-based impact indicator with more relevant and suitable indicators. This would provide more pertinent information on the actual impact of programmes. For example, when programmes entail financial inclusion adequate monitoring indicators should be assessed. For these purposes, a clearer operational definition of objectives would have to be defined at the design stage.

- Adapting the eligibility criteria[20]. The definition of eligible goods, effectively focusing on hard goods, does not fully take into account the role and needs of MSMEs. For example, MSMEs increasingly require not only machines, but also know-how support for growth. In this sense, the CEB could also consider extending its financing to services, such as consultancy or software development. However, given the nature of CEB loans, only medium- and long-term investments could be appropriate for financing.

* * *

At end 2012, the CEB's support to MSMEs remained a major pillar of its activities. In order to increase the social added value of its operations in this sector, the CEB could further explore these alternatives to enhance its operating model of MSME financing.

If pertinent, these options would be considered in a holistic manner taking into account the Bank's overall strategy and available resources, including donors' contributions, and willingness and institutional capacity of its implementing partners.

[19] The suggestions are based on testimonies and reports of the CEB's General Directorate for Loans and Social Development, Directorate for Technical Assessment and Monitoring, and Evaluation Department.
[20] The CEB's Progress [Monitoring] Report on Projects 2009
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