



SME Financing in the Mediterranean: Meeting the Challenges Ahead

Declaration of High-Level CEPS-IEMED Working Group¹

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Background

Micro, small and medium-sized enterprises (MSMEs) are the driving force behind economic development in the Mediterranean. They perform an essential role as providers of employment and innovation opportunities and act as key players for regional and local development and social cohesion.

Aware of their importance, several Euro-Mediterranean initiatives, such as the Euro-Mediterranean Charter for Enterprise, adopted at the Caserta Ministerial Conference³ in 2004, strive to operationalise key principles for creating a business environment conducive to investment and private sector development in the region. The Union for Mediterranean (UfM)⁴, a French-led initiative launched on in July 2008 in Paris, is also expected to foster business development and financing opportunities in several sectors and involving a multitude of actors.

Among the key areas emphasised in the 2004 Charter and the UfM under the Mediterranean Business Development Initiative (MDBI), MSME access to finance is given high priority. The discussions focused on general issues such as the definition of an MSME, the importance of a Euro-Med joint policy effort to set targets in order foster MSME inclusive

¹ Jointly established by the Centre for European Policy Studies (CEPS) and the European Institute of the Mediterranean (IEMED), the High-Level Working Group is composed of experts drawn from throughout the Mediterranean. In a first meeting on 7 May 2010 in Barcelona, the group examined practical avenues to improve access by micro, small and medium-sized enterprises (MSMEs) to financing in the region. This Declaration is the result of their deliberations. A list of the experts participating in the Working Group appears at the end of this document. The group will produce a comprehensive report by October 2010, co-authored by Rym Ayadi (Senior Research Fellow, CEPS), Annie Cordet-Dupouy (Senior Partner, Sabaudia Consulting) and Emrah Arbak (Researcher, CEPS). For more information on CEPS and IEMED, see www.ceps.eu and www.iemed.org.

² Dr. Rym Ayadi is managing a new Mediterranean consortium funded by the European Commission's seventh Framework Programme that aims at building scenarios for the political, economic and social future of the region until 2030. More information is available on www.medpro-foresight.eu.

³ http://ec.europa.eu/enterprise/policies/international/files/f1960quar_en.pdf

⁴ http://ec.europa.eu/enterprise/policies/international/files/barcprocesscom08_319_en.pdf

growth and sustainable development in the region; the recommendations of MBDI Feasibility Study commissioned by the European Investment Bank (EIB); and more specific issues such as the effectiveness of credit guarantee schemes, the role of banks (domestic and foreign), micro-credit and private equity and venture capital.

The Group concluded its discussions with the following recommendations which aim at contributing to the ongoing policy debate under the UfM and the potential re-evaluation of the 2004 Euro-Mediterranean Charter for Enterprise.

Policy Recommendations

1- Need for a tailored definition of MSME in the South Mediterranean

There is no uniform definition of an MSME that can be applied to the South Mediterranean countries. Moreover, the largest percentage of MSMEs in these countries may not be considered in the SME definition in the EU, which is a key technical challenge for some of the EU-based initiatives. One relevant criterion for assessment is the turnover (alone or combined with other indicators (such as the number of employees)). The definition must be simple, able to be implemented legally and must cover the majority of the MSME population in the South Mediterranean countries. It is therefore recommended to run a comprehensive survey in the region in order to ensure that a revised definition captures the largest population of MSME. This survey should also be the tool to collect better statistical data of the MSME in order to provide a sound basis for the preparation of future strategies in the region.

2- Need for a coherent Mediterranean long-term strategy for inclusive growth and sustainable development

It is crucial to define a comprehensive long-term growth and sustainable development strategy in the region emphasising the role of MSMEs as the chief driver for innovation and growth. This strategy will also ensure coordination and continuity of the wide-ranging EU-funded initiatives as well as the various donors programmes (KfW, AFD etc ...) in the region targeting MSMEs to maximise benefits and avoid duplication. This strategy may be implemented by the services of the European Commission in close cooperation with the secretariat and Member States of the UfM. If approved by policy-makers in the UfM Member States, this strategy will define a clear road-map with realistic targets, means and impact assessment. The 2004 Euro-Med Charter for Enterprise would be part of this strategy and progress can be monitored in close cooperation with the MBDI under the UfM. Two key dimensions will be introduced: think small first and allow for a second chance.

3- Need for better and more organised involvement of the private sector in future Euro-Med policy initiatives

The private sector is instrumental to ensure that policy initiatives are meeting the reality and needs of companies in the region, which are the driving force of innovation and growth. In the region and up till today, the fate of the private sector is decided by policy-makers behind closed doors. The UfM's new philosophy of co-development is to build the Union on the basis of projects and private-public successful partnerships, therefore involving the private sector in the future of the region and ensuring that concerted and coordinated public-private partnerships are critical.

4- Given the realities of the MSMEs in the Mediterranean region, a one-size-fits-all financing solution is not always the way forward. Rather, a multi-dimensional pragmatic solution that chiefly meets the MSMEs' different needs is highly welcomed.

It is expected to produce a more targeted and positive outcome than when MSME financing is part of wider financing programmes and hence more likely to be diluted.

The Group supports the findings and actions to be taken proposed by the MBDI Feasibility Study commissioned by the EIB. These actions and their future implementation shall meet the specific requirements of the countries in the region. In particular, the Group welcomes the proposals:

- a. To finance micro-entrepreneurs through the development of microfinance institutions and new microfinance products;
- b. To improve the equity base of SMEs through support to investment funds/risk capital and to pilot funds for small enterprises;
- c. To increase the access to finance for SMEs through a support to guarantee institutions and the creation of a counter-guarantee fund;
- d. To support specific segments, such as start-ups through start-up funds, industrial/technological parks and clusters and women-owned enterprises and increasing the volume and outreach of financing instruments such as leasing and factoring; and
- e. Support training and finance professionals.

In addition, the Group emphasises the need for more capacity-building for micro-and small start-ups and technology/innovative ventures and entrepreneurs. Technical assistance and support may also target local entities providing technical, business and financial support services to micro and small enterprises to enable them to build a credible business plan and balance sheet and reliable credit information essential to be granted a loan. These capacity-building programmes should be complemented and coordinated with existing and potential new programmes extended to governments and public authorities under the Euro-Med bilateral partnership to reinforce R&D and innovation in the region through the exchange of best practices, the organisation of pilot projects and sharing of methods for evaluation of outcomes.

The Group urges prompt implementation of the proposed actions under the MBDI within a comprehensive outreach and friendly-user strategy to ensure a wide local public awareness in the Mediterranean countries. Obviously, national campaigns, regular media coverage (newspapers, television and others) and publicity in local languages are instrumental for an effective outreach policy.

To be successful, the institutional setting of the MBDI is crucial. The Group is sympathetic to the option of creating an autonomous unit within the EIB with decentralised local operations. At this stage, this option may be the optimal way in terms of costs, functionalities and avoiding delays. To assess its effectiveness, an impact assessment should be conducted two years following the start of operations of MBDI.

5- There is large evidence supporting the role of credit guarantee schemes (CGSs) in expanding the availability of debt to SMEs. However, the effectiveness of these schemes in the majority of Mediterranean countries where they operate falls short of expectations. The Group supports the MBDI Feasibility Study proposal to create a counter-guarantee fund to increase leverage; however, the Group recommends a prompt comprehensive assessment of the existing schemes in the UfM Member States that will take into consideration the following recommendations:

- a. CGSs should be seen as the driving force to motivate banks to finance SMEs. Therefore the bank-CGS relationship must be built on risk-sharing rather than

- risk transfer to ensure that banks and schemes jointly screen and monitor borrowers effectively;
- b. CGSs must be well designed in order to minimise moral hazard;
- c. CGSs must be properly governed and monitored (subject to regular and independent audits and peer reviews) to ensure that political interference remains limited;
- d. CGSs must have the technical capacity to understand SME risk and be selective;
- e. CGSs must have the appropriate resources (work force and skills) to be credible and persuasive and thus offer an adequate credit mitigation instrument to banks;
- f. CGS procedures should be simple, not excessively time consuming and should serve the SME to understand and improve its business plan;
- g. the CGS cost must be affordable to SMEs; and
- h. CGSs must be visible to the public; a budget should be allocated for raising public awareness.

The assessment of existing schemes will permit us to identify weaknesses and capacity-building needs and to propose actions to fill-in the gaps to take better advantage of the proposed counter-guarantee fund under the MBDI or any other mechanisms, such as re-insurance schemes and stop-loss support by international donors. Coordination and good practices exchanges should also be encouraged through networking. In the future the conditions for a cross-border CGS solution can be sought if needed for example in case of SME cross-border expansion in the region.

6- Banks and other credit providers are bound to their conservative risk assessment strategy. In the Mediterranean region, the lack of a widely accepted definition of MSME, the lack of reliable accounting data on companies, the lack of collaterals and the low level of equity make MSMEs unlikely candidates for banking credit. The situation is worsened by the strong political interference in some instances that ultimately leads to high non-performing loans and therefore exhausts the lending capacity of banks. Several mechanisms could help MSMEs to access bank lending including loan guarantees, coaching, long-term advice, monitoring and targeted regulatory actions. As was rightly mentioned in the MBDI Feasibility Study, banks are liquid but allocate much of their resources to finance government debt. Therefore, the problem is not liquidity but the capacity to take sufficient risk to finance the real economy. The feasibility of the following mechanisms must be explored.

- a. UfM Member States should act jointly to motivate banks to extend credit to MSMEs though targeted regulatory actions and fiscal incentives;
- b. Domestic banks should be coached to implement down-scaled strategies to grant loans to MSMEs. Risk assessment is a key but also expert judgment on MSME risk (per profile, sector, business cycle....) must be developed by dedicated teams;
- c. Banks should work in close cooperation with domestic guarantee schemes or private credit insurance companies to ensure a maximum recuperation rate and improved risk mitigation through joint risk assessment of projects; and
- d. Banks (foreign and domestic) should reinforce cooperation to better channel remittances into productive investments projects into the recipient country.

7- Microfinance institutions operate and are successful in a number of countries in the Mediterranean. Building on successful experiences in countries where existing and potential micro-entrepreneurs (men and women) may struggle to get financing from mainstream financial institutions is the way forward to further develop microfinance

institutions to fulfil this potential need. **Traditional concepts of micro-credit shall be overcome and be complemented by up-scaling strategies to cover all segments of micro and also very small enterprises and artisans. The potential success of this endeavour is highly correlated with the willingness of international donors and existing players such as credit guarantee schemes to implement new and innovative strategies to reach this purpose.**

- 8- Until today, private equity institutions target relatively medium to large enterprises in the region. The future development of small enterprises' targeted funds will continue facing obstacles such as difficult exits, illiquidity, valuation, management competence and commitment etc. **It therefore calls for innovative investment approaches and strategies, which are highly dependent on the involvement of international institutions and donors to reduce investor's risk in this segment while supported by adequate domestic or multi-lateral guarantee schemes for investment. Due diligence cost for small investments, usually dissuasive, should also be compensated by appropriate support.**

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Members of the High-Level CEPS-IEMED Working Group
Barcelona, 7 May 2010

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