European Commission

Study on imperfections in the area of microfinance and options how to address them through an EU financial instrument

Final Progress Report

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1. Introduction

This Report documents the results of the project "Study on imperfections in the area of microfinance and options how to address them through an EU financial instrument" commissioned by the European Commission, DG Employment.

This project addressed the following central issues connected with an ex-ante assessment of the planned EU financial instrument on microfinance under the EaSI programme:

- The market situation for micro credit provision throughout Europe and how it translates into sub optimal investment situations for MFIs to be addressed through an EU financial instrument

- The variety of possible financial instruments in microfinance and how they may be used by the new EU facility to support micro credit portfolios and institutions

- The lessons to be learned from Progress Microfinance and how they can be used to fine tune the new EU instrument/facility

- The existing public activities to support micro credit provision in Europe and how they can be integrated with the new EU instrument/facility

The methodology that was chosen to analyse these issues of the study is explained in the first chapter of this report. After that the report documents the results of the project along its three analytical strands and provides detailed recommendations for setting up the new EU financial instrument/facility in the framework provided by the Employment and Social Innovation programme (EaSI) that was endorsed by the legislators of the European Union in December 2013.

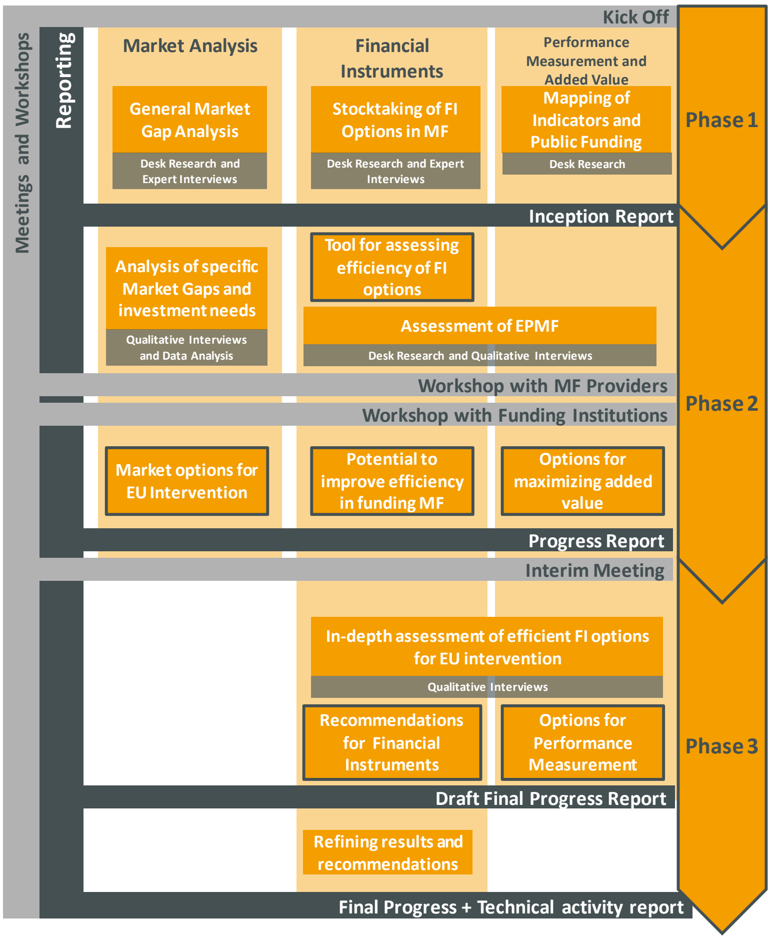
2. Methodological approach

The methodological approach chosen for this ex-ante assessment was based on the Terms of Reference (ToR) that was provided by the Commission in their call for tenders for this study. The ToR reflected the need for a comprehensive analysis on:

a) the prevalence of market gaps/market imperfections in the market for microloans in Europe and
b) options for the design of financial instruments to support the microfinance sector in Europe in addressing those gaps/imperfections

Since the Commission also made it clear in the ToR that it wants to set up the new financial instruments as a follow up to the existing Progress Microfinance facility, the analysis also assessed how to integrate financial instruments into a facility structure that produces an added value to existing funding instruments and programmes available in the sector. Additionally, the Commission wanted the analysis to look at ways to improve the performance measurement of such a facility.
Based on these objectives the study was organized in three main analytical strands (see following overview).

Figure 1: Overview structure of the study



In detail the three analytical strands are:

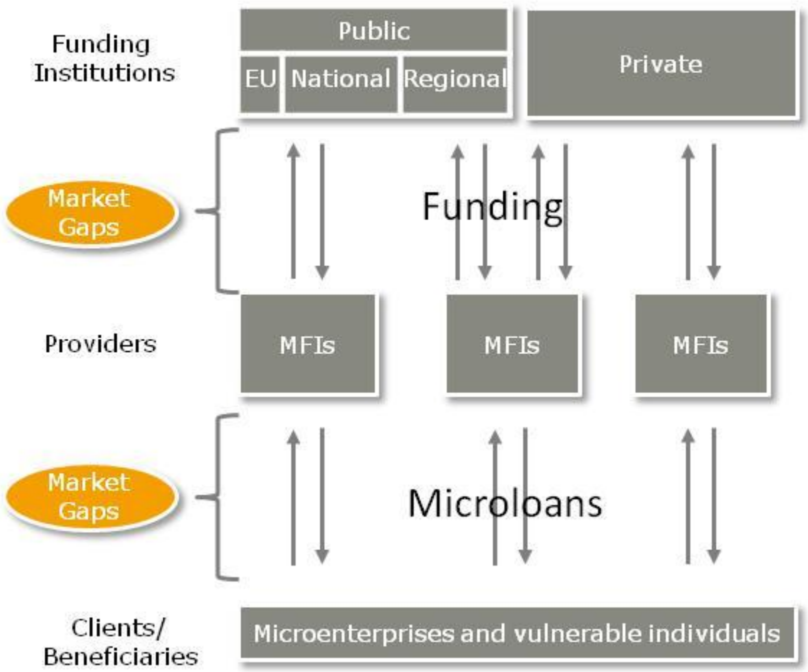
- Strand 1: Analysis of market imperfection and investments needs in the EU microfinance sector
- Strand 2: Assessment of options for financial instruments in microfinance at EU level
- Strand 3: Assessment of options to measure the performance and safeguard the added value of an EU microfinance facility

The specific methodological approaches and analytical frameworks that these three strands rely on are introduced in the following subchapters.

2.1 Analysing market imperfections and investment needs in the EU microfinance sector

A suitable approach towards the identification of market imperfections and failures as well as the assessment of the investment needs in the European microfinance sector has to be based on an **understanding of the structure of markets and actors** in place. The following illustration provides an overview of this.

Figure 2: Overview: Markets and Actors



For a comprehensive gap analysis the supply and demand relationships between the three relevant groups of actors – funding institutions, providers, and beneficiaries (see figure 1) - have to be taken into consideration.

Hence, the analysis starts with the demand and supply side of the microloan market in Europe. The depth of the demand analysis is limited as the availability of data on the demand of microloans remains sketchy throughout Europe and should be subject of more detailed analyses in the future. Therefore we use a fallback solution estimating the respective demand in the form of proxies deducted from available data on target groups and common procedures to calculate estimates for the potential demand of microloans. The analysis of the supply side of the market is based on the recent results of the EMN survey for microcredit provision in Europe (2010-2011), which was conducted by evers & jung as well. This first step of the analysis provides insights on the existence of a market gap in delivering microloans to the target groups of microfinance in Europe. Furthermore, options of policy measures are discussed based on the market gaps findings, which are able to adapt the prevalence or magnitude of possible market gaps. Financing instruments are one

of the major policy measures, as previous studies have shown that lacking access to funding is the primary bottleneck for microfinance providers to close this market gap.
The second step therefore covers the demand and supply side of the funding market for microcredit provision in Europe. For this the most pressing funding needs on the MFI level for the next five to six years are collected and aggregated. This is followed by an assessment of the private and public funding sources available for microfinance providers at national and international level. In this step we also look for the prevalence of bottlenecks in the access of MFIs to those funding sources. Based on the findings on the demand and supply side analysis an estimation of market gaps in the funding market for microfinance in Europe is provided. Those market gaps are then controlled for their impact on the market situation for microloans.

2.2 Assessment of options for financial instruments in microfinance at EU level

In this analytical strand the available options for financial instruments in microfinance at EU level are being analysed and assessed regarding their fit to the investments needs identified in the market gap analysis.
For the past, financial instruments in European microfinance can be organised in three groups: Guarantee instruments, refinancing instruments and funding for non-financial services. The main sources of funding were EU Structural and Investment Funds resources, European Commission's resources and resources of public institutions at national level.
Starting with the microfinance window in the SME guarantee scheme of the Competiveness and Innovation Programme (CIP), the European Commission has subsequently widened the scope of centrally managed instruments to supply funding for European microfinance providers. With the Progress Microfinance facility that was introduced 2010, the EU now offers via EIF, as the central managing institution, a broad range of financial instruments for microfinance under one facility, including debt and equity instruments as well as risk sharing instruments. Although not all of these instruments were successful in attracting a high amount of demand by microfinance providers.
In a first step the available financial instruments under Progress Microfinance as well as financial instruments offered by Microfinance Investment Vehicles (MIVs), other EU programmes including Structural and Investments Funds are analysed regarding their fit to the demands of the sector. In the analysis the identified imperfections in the funding market for microfinance therefore are linked to the assessments of the options for financial instruments. Also it is important to assess the different options for financial instruments to a set of criteria that effective EU based financial instruments in microfinance have to fulfill. Based on the ToR these are mainly:

- Producing a significant **leverage effect** via attracting co-investors. Possible indicators for this are: available routes of co-financing, conditions for co-financing, risk sharing and mitigation
- Safeguarding the **outreach of the intervention** both socially (investments that reach target groups at the level of final beneficiaries) as well as geographically (covering EU member states)
- Influencing **provision standards in microfinance** with regard to lending conditions, gender equality, anti-discrimination and green microfinance principles.
- Allowing a certain **flexibility of terms** to reach the **target group of non-bank MFIs** with high social outreach.

All the assessed financial instruments are rated in a scoreboard along these criteria to identify the options with the best fit to the requirements of the Commission and the policy objectives of EaSI.
Additional to that the assessment has to take into account if there are effective ways to combine the different financial instruments with support instruments for capacity building

and technical assistance to ensure the investment readiness of beneficiaries. In this regard the question of a possible conditionality of technical assistance and connection of the instrument with code of good conduct is covered. Also the different possible set-ups of a financial instrument as part of a larger facility structure regarding its delivery structures, its product conditions, the selection criteria and conditionality and the overall risk structure of the facility needs to be covered.

2.3 Assessment of options to measure the performance and safeguard the added value of an EU microfinance facility

As an EU intervention, the performance of the financial instruments chosen for the new facility under EaSI needs to be measured on a regular basis. This exercise should reflect the specific nature of a centrally managed EU facility that offers financial instruments to support MFIs and their lending activity in the European context. It also needs to meet the requirements for measuring the performance of EU interventions in the framework of EaSI.

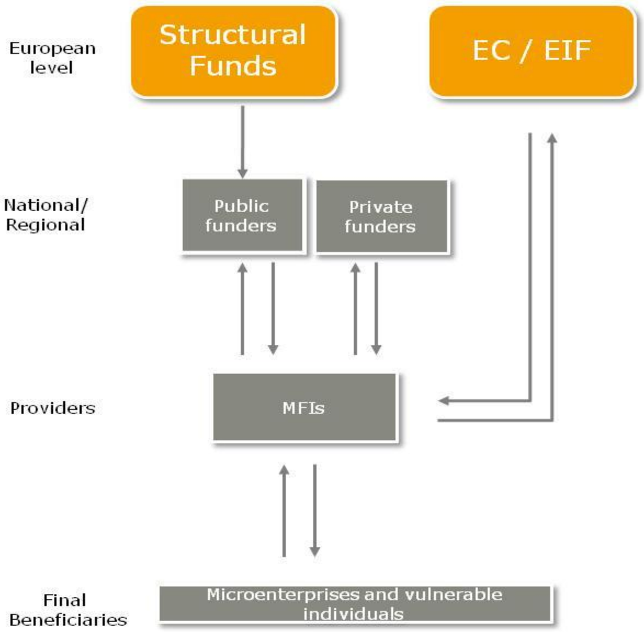
Past discussions in the sector showed that reporting requirements involved in using EU funds can deter microfinance providers from using such a facility. Therefore the assessment strives to identify options for performance measurement that on the one hand take up reporting standards that MFIs in Europe already use in their standard monitoring activity and on the other hand provide a sound performance measurement that is necessary to give the Commission the possibility to get a good overview about the impact of their intervention in the market and the areas in which additional activity may be required.

The assessment is based on an analysis of the performance measurement activities in place to monitor the performance of Progress Microfinance and look into options to find a middle ground between the Commission's reporting requirements and an efficient and light-touch performance measurement for the new facility.

The global microfinance industry has developed standards for efficiently measuring the performance of MFIs and also the impact and return of (semi-) public investments in those MFIs. These standards are often portfolio based and not fully compatible with reporting standards used by the Commission to measure the impact of public interventions delivered in the form of grants or direct investments to final beneficiaries.

The analysis also addresses the question of the added value of a centrally managed funding facility for microfinance in Europe and the financial instruments to be included in such a facility. For this it is important to acknowledge that EU-based funding in microfinance can be delivered in two different ways. Either initialized by national or regional public institutions in the form of co-financing financial instruments with structural funds resources, or as direct intervention by the European Commission in the form of centrally managed instruments facilitated by a dedicated fund manager (see figure 3).

Figure 3: Schematic overview of delivery modes for EU-based funding for MF providers



Therefore, the options for a functional delineation and cooperation with existing public funding structures at the national/regional level are analysed in this strand. The analysis is guided by the notion that on the one hand, EU funded instruments should not replace existent public funding at national or regional level. On the other hand there is the need for a better cooperation with publicly funded instruments to make more efficient use of the resources used to fund these instruments. In the past, the development of intelligent interactions between the centrally managed facilities and Structural funds based offers that had the potential for increasing the added value were discussed but never realized, e.g. equity funding by EPMF for the beneficiaries of the ESF funded national guarantee fund for MFIs in Germany (Deutscher Mikrokreditfonds). To develop such cooperation in the future there is also a need of intelligent ways to **distribute policy learnings and good practices** in financial engineering for microfinance and inclusive entrepreneurship, e.g. in the framework of the upcoming EU platform for TA-support on financial instruments.

3. Market Analysis

The objective of the market analysis is to identify market imperfections and failures as well as to assess investment needs in the area of microfinance, which could be addressed by an EU level financial instrument. The results will be used to develop and validate the recommendations of the study regarding the financial engineering options for the new microfinance facility under EaSI.

Based on the established understanding regarding the structure of markets and actors in the microfinance sector (see chapter 2) the analysis is organised as a two-steps procedure.

The analysis starts with the demand and supply side of the microloan market in Europe. The second step covers the demand and supply side of the funding market for microcredit provision in Europe.

The market gap analysis for both the microloan and funding market is prepared at the level of these five country clusters, including EU member States and EFTA countries[1]:

- **Western Europe:** Austria, Belgium, France, Germany, Luxembourg, the Netherlands and Switzerland
- **United Kingdom and Ireland**
- **Scandinavia:** Denmark, Finland, (Iceland, Norway)[2] and Sweden
- **Southern Europe:** Cyprus, Greece, Italy, Malta, Portugal, and Spain
- **Central and Eastern Europe:** Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania Slovakia and Slovenia.

For the relevant market gaps that can be addressed by a financial instrument at EU level the most important investment needs will be deducted.

3.1 Demand and supply at microloan level

According to classical financial theory[3] all enterprises, irrespective of their size, have the same access to capital markets. However, there are clear indications that smaller enterprises have considerably more difficulties to attract external funding. Numerous factors on the supply side of external funding present major challenges, such as the availability of information, principal-agent issues, i.e. information asymmetries such as moral hazard and adverse selection. [4] As a result SMEs, especially start-ups, microenterprises and solo-entrepreneurs, are particularly facing high credit rationing. Moral hazard emerges in the lending market for SMEs and microenterprises, when the financial institution or bank cannot observe whether the customers are making the full effort for a successful investment of the loan amount or engaging in risky behavior which increases the risk of default[5]. Adverse selection appears, when banks cannot determine whether the borrower's project is low or high risk or whether one borrower is riskier than others[6].

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[1] This approach is based on the methodology of peer-group analysis, which uses data from countries with more complete market data to control the situation in countries with incomplete market data. Only countries where MF activity is known are accounted for. The situation in countries with high microfinance activity outside EU and EFTA (especially on the Balkan) will be addressed only cursory as intermediaries in these countries can only participate in EaSI, if national funds for co-financing are included.

[2] Iceland and Norway, as EU non-members, were covered, but the analysis of these countries provides no additional information due to missing data.

[3] Ang, J. (1992): On the Theory of Finance for the Privately Held Firms. The Journal of Small Business Finance, Vol. 1(3), S. 185-203

[4] Akerlof, G. A. (1970): The Market for "Lemons": Quality Uncertainty and the Market Mechanism, Quarterly Journal of Economics 84 (3), pp. 488-500.

[5] Michael and Joseph E. Stiglitz (1976): Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information, Quarterly Journal of Economics, 90, pp. 630-49; Armendáriz, Beatriz and Jonathan Morduch (2010): The Economics of Microfinance, 2nd Edition, Cambridge, Mass. and London.

[6] Akerlof, G. A. (1970): The Market for "Lemons": Quality Uncertainty and the Market Mechanism, Quarterly Journal of Economics 84 (3), pp. 488-500; Rothschild, Michael and Joseph E. Stiglitz (1976): Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information, Quarterly Journal of

Moreover, small and microenterprises mostly lack the performance measurement systems and consequently the standardized processes that would allow proper risk assessment. As the requested loan volumes are relatively small the required effort for risk assessment is simply disproportionate.

Thus, banks do not see microfinance as a profitable product and due to the ongoing economic crisis are even more risk averse. The insufficient supply of commercial funding for small and microenterprises can be understood as discriminatory credit rationing, which constitutes a market imperfection that can justify a political intervention. In the following the resulting market gap or mismatch between demand and supply of microloans will be determined to provide an as exact and up-to-date picture as possible.

3.1.1 Demand at final beneficiaries' level

The economic crisis led to a strong negative impact on the financial situation of SMEs. In most industrialized countries the recession caused a considerable decline in loans, as loan approval rates decreased significantly, due to more strict credit standards and negative prospects. In 2009 the rejection rates in the Euro zone rose from 12% to 18%.[7] Compared to large enterprises, SMEs faced severe credit rationing with poor conditions, i.e. higher interest rates, shortened maturities and increased requests for collateral.

According to the Organisation for Economic Co-operation and Development (OECD) during a recession the share of short-term loans can be expected to increase relatively to investments or long term loans, since short-term borrowing is needed to solve cash flow problems.[8] Although this trend was not consistent across European countries it could be observed by trend that the share of short-term loans decreased in 2009 and 2010.

The on-going crisis has hit the micro-enterprise sector particularly hard. According to the EU Craft and SME barometer micro-enterprises estimated their overall situation in the second half of 2012 still less favorable than other SMEs[9]. The share of enterprises which perceive access to finance as their most pressing problem is larger among micro-enterprises than among other SMEs[10].For these potential microfinance clients it is especially difficult to obtain capital during times of recession. This is even more significant in the case of vulnerable groups such as ethnic minorities or female entrepreneurs. Due to a more difficult access to finance, it is not surprising that the investment shares which micro-enterprises finance by bank loans or leasing are in general much smaller than for other SME size classes. However, in recent years commercial banks reduced their lending to micro-enterprises significantly.[11]

For non-bank MFIs this development must be considered an opportunity to strengthen and expand their market positions, as increased unemployment in many European countries is likely to raise the demand for microfinance products. It can be expected that especially many young people will use self-employment as a mean to escape impeding poverty.[12]

The availability of data on the potential demand and target groups for microloans in Europe is very limited. One of the most cited source on the European level is an estimation of the European Commission from 2007, prior to the start of the above described crisis. It estimated a demand for microloans in the European Union (EU27) at around 700,000 worth

Economics, 90, pp. 630-49; Armendáriz, Beatriz and Jonathan Morduch (2010): The Economics of Microfinance, 2nd Edition, Cambridge, Mass. and London.

[7] Except for France, where rejection rates decreased from 12% to 7% (OECD, 2013)

[8] OECD (2013): Financing SMEs and Entrepreneurs.

[9] Kraemer-Eis et al. (2013): European Small Business Finance Outlook.

[10] European Commission (2013): Long-term financing of the European economy. Commission Staff Working Document. SWD(2013) 76 March 2013.

[11] Kraemer-Eis et al. (2012): European Small Business Finance Outlook.

[12] Bendig et al. (2013): Overview of the Microcredit Sector in the European Union for the Period 2010 - 2011, on behalf of the European Microfinance Network (EMN). For an assessment of self-employment schemes as policy measures to tackle youth unemployment, see O'Higgins (2001): Youth unemployment and employment policy: a global perspective

EUR 6.2 bn.[13] This analysis was conducted by the European Investment Fund in the framework of JEREMIE[14] evaluations.

In the analysis the basis of the calculation is the working population aged 15 up to 64 years, which is multiplied by the share of people at the risk of poverty (in this case 0.16) in the EU. Out of these, the amount of potential entrepreneurs (in this case 0.45[15]) is calculated, which is finally multiplied by the share of the potential target group (0.03), i.e. the share of actual micro-startups and enterprises with need for external finance, based on the findings of the study by ILO (2002)[16].

The advantage of this model for estimating the demand of microloans is that it is adaptable at the European as well as at country level due to the availability of the data used. The disadvantage is that the data or respectively the calculated demand for external finance cannot be assigned to a certain period of time, e.g. for a specific year or per year, as the basic data used, the population size, is a static variable and non-dynamic, i.e. dynamic variables, such as yearly in- or outflows ,are not available. Furthermore, the data used allows only an estimation of the potential demand for microloans in an important target group of microfinance (start-ups by people at the risk of poverty). It does not include the potential demand of micro start-ups by people that are financially excluded, but not at the risk of poverty and by existing micro-enterprises. Therefore, the estimation can only be a proxy for the 'real' potential demand for microloans in Europe.

Another quantitative source on the European level is an evaluation based on a sample of European MFIs from ten EU member states[17]. The potential demand during the next three years could reach as much as 2,935,000 microcredit users in these countries (see table below). The highest demand was expected from unemployed people wishing to start a business (20%), followed by people who are long-term unemployed or living on social welfare (12%) or people who are excluded both from the market and welfare support (4%) and other disadvantaged groups such as single parents, the young, and migrants (4%).[18] According to this study the economic crisis has doubled the potential demand for microfinance in Europe.

Table 1: Practitioner-based evaluation of microloan demand in 10 EU member states

Selective Member States	**Average evaluation of potential demand** (numbers of users)
Poland	675,000
Bulgaria	110,000
Latvia	30,000
Spain	500,000
Romania	230,000
Italy	475,000
France	375,000
United Kingdom	325,000
Germany	210,000
Netherlands, the	5,000
Total	**2,935,000**

The finding of this evaluation functions as well as a proxy for the potential demand.
Nevertheless, it is important to note that the data is not extrapolated for the member states

[13] European Commission (2007): A European initiative for the development of micro-credit in support of growth and employment, COM (2007) 708 final.

[14] Joint European Resources for Micro to Medium Enterprises.

[15] Based and using the results of Euro barometer Nr. 149

[16] ILO (2002): Micro-finance in industrialized countries: helping the unemployed to start a business, p. 4.

[17] I.e. Poland (PL), Bulgaria (BG), Latvia (LV), Spain (ES), Romania (RO), Italy (IT), France (F), United Kingdom (UK), Germany (DE) and the Netherlands (NL).

[18] European Parliament (2010): Directorate-General for internal policies, Microcredit networks and existing national legislations with a view to the implementation of the microfinance instrument, November 2010.

of EU-28. Thereafter, the total potential demand based on this calculation has to be underestimated.

The two estimations show very different outcomes. The first one by the European Commission (around 700,000 microloans) seems to be rather conservative and the latter one that is based on the views of microfinance organisations (2.94 m microloans) rather seems like an overestimation.

Beside the above described disadvantages, it seems more transparent to stick with the methodology introduced by the European Commission to calculate the demand side of the market situation for microloans in the EU. This is also in line with the focus of DG Employment on the provision of microloans primarily by non-banking financial institutions (loan funds, microfinance institutions, credit unions, etc.) to the disadvantaged group of people at risk of poverty. Therefore, to verify and to calculate a proxy number of loans demanded in 2012, we updated the estimation using as a starting point the population aged 15 to 64 years in the EU-28 (including Croatia, even though it joined the EU in 2013) and updated the shares for population at risk of poverty, potential entrepreneurs and target group. The analysis revealed a current potential demand of 1,214,000 business loans worth EUR 8.66bn (compared to 700,000 loans worth EUR 6.2bn prior to the start of the crisis). A breakdown of the steps in the calculation can be seen in table 2.

Table 2: Potential demand for microloans for EU28

Population EU28 (2012): 506,820,764
→ 66.9% working population (aged 16-64):339,063,091
→ 24.2% at risk of poverty[19]: 82,053,268
→ 37% potential entrepreneurs[20]: 30,359,709
→ 4% target group[21]: 1,214,388 potential loans
** Average loan size[22]: 7,129 EUR/loan*
→ Potential loan volume: 8,657,374,669 EUR

Since the calculation at EU-28 level is based on unweighted average numbers for the share of people at the risk of poverty and the share of potential entrepreneurs, the total number of loans calculated gives only a very overall picture - related to the included potential target groups, but as well aggregated only on the EU- and not country-level. That is why a more detailed calculation is required for the different member states separately. This is done along the selected country clusters in table 3 in the section on market gaps (chapter 3.1.3). The available estimations of potential demand for microloans at national levels show that the calculation with the model chosen is a good, but still an approximation for the situation in individual member states.

For example, for 2008 in France alone the potential annual demand in the non-bankable segment was estimated at 48,000 microloans for startups (low hypothesis; up to 98,000 loans at a maximum), and 42,000 loans to microenterprises.[23]

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[19] Group in relative income poverty, i.e. individuals living in households where equivalised income is below the threshold of 60% of the national equivalised median income (see definition of Eurostat). The share of population at risk of poverty has increased compared to the estimation in 2007 due to the impact of the financial and economic crisis in the EU.

[20] Potential entrepreneurs are the group of people of productive age (16-64) facing the risk of poverty; it is assumed that on average only 37% of this group would be willing to set up micro-enterprises (see Eurobarometer 2012), i.e. the share of potential entrepreneurs has decreased compared to the number used in the previous estimation.

[21] Number of potential entrepreneurs who have set up micro businesses; it is assumed that this group represents at most 4% of potential entrepreneurs (see International Labour Office study 2002 on micro-finance in industrialized countries.

[22] Bendig et al. (2013): Overview of the Microcredit Sector in the European Union for the Period 2010 - 2011, on behalf of the European Microfinance Network (EMN).

[23] See Adie/EMN (2008): Microfinance Market Study in France, by Audrey Raabe and Vincent Lagalaye, Paris, http://www.european-microfinance.org/data/file/Microfinance%20Market%20Study%20in%20France%20EIF.pdf and Adie (2008): 20 years of microcredit in France, the knowledge gained through Adie’s experience, Paris, http://www.european-microfinance.org/data/file/Librairy/adie-fiche-anglais.pdf.

For Germany, a country with a traditionally strong savings bank sector and semi-public promotional banks that tend to the needs of small enterprises and start-ups the potential demand for microloans disbursed by non-bank MFIs was estimated at least 11.000 business loans annually worth EUR 70m by a study conducted on behalf of the German Federal Ministry of Labour and Social Affairs in 2009. [24] Although this number is much lower than the demand calculated with the model introduced above (around 70.000 loans for 2010-12) mostly due to a different base for calculation[25], it emphasizes that microfinance is of high relevance for start-ups and existing small enterprises in Germany.

In the UK, Community Development Financial Institutions (CDFIs)[26] received nearly 13,000 microloan- inquiries from businesses with a total of EUR 270.5 m in 2012. EUR 35 m in finance was actually provided to 2,600 businesses with nearly half of it provided to unemployed people moving into self-employment[27]. According to the Community Development Finance Institution (CDFA) this reflects a substantial increase in inquiries, which in general could be observed in recent years. The trend is expected to continue as the underserved market in UK is reported to be immense. The CDFA estimates the current potential annual demand for microloans to businesses in the order of about EUR 1.5bn. [28] The total potential annual number of business clients is estimated to be about 103,000.[29]

Although the presented figures have to be interpreted with caution, it can be stated that there exists a considerable demand for business microloans in the European Union, which is expected to further increase, due to adverse economic conditions. Taking into consideration the development of the potential demand of business microloans in UK, Germany, and especially France, as one of the most established markets in Western Europe, we assume that a considerable share of the calculated demand for microloans in Europe is yet unmet, i.e. the provision of microloans is so far not sufficient to meet the potential demand, resulting in unrealized opportunities for realizing entrepreneurship options as a way out of social exclusion and for the creation of jobs in the micro-enterprise sector. In the following part of the study, the analysis focuses on the current supply of microloans by MFIs in the EU to justify the assumptions about a market gap in the provision of microloans to micro-enterprises and start-ups out of social and financial exclusion. The comparison of the estimations for the demand and supply of microloans in Europe and its interpretation will subsequently allow statements regarding the actual market gap at microloan level in Europe to be targeted by policy measures,

3.1.2 Supply at microloan level

As the economic and financial crisis hit Europe, policy-makers looked for solutions to ease access to finance small businesses, to secure and create jobs. Especially in Western Europe microfinance had been seen by policy-makers as an important tool to counteract the effects of the recession. Some of the most ambitious national schemes in the history of European microfinance were initiated during the last years.[30] In addition, the initiative of the European Commission to establish a facility for funding providers of microloans (the European Progress Microfinance Facility) in 2010 provided the sector with further resources, especially

[24] Meißner et al. (2009): Mikrofinanzierung und Mezzanine-Kapital für Gründungen und KMU. Studie für das Bundesministerium für Arbeit und Soziales.

[25] See Meißner et al. (2009): Mikrofinanzierung und Mezzanine-Kapital für Gründungen und KMU. Studie für das Bundesministerium für Arbeit und Soziales. The study estimates the demand by matching results from the national statistics of the existing numbers of self-employment people and results about the financing constraints of SMEs in Germany. That is why that the hereby calculated is based on a more narrow definition of potential clients based more on SMEs and self-employed people with credit constraints and did not take people at risk, etc. into account. Therefore, it seems to be an underestimation of the real demand.

[26] In UK, the CDFIs are mostly the counterpart of the MFIs in the rest of Europe, even though that several CDFIs are offering other products like for e.g. housing loans or community services, as well.

[27] Nearly 90% had been denied by commercial banks and 7% were assessed as being very likely to be denied bank finance.

[28] CDFA (2012): Inside Community Finance.

[29] These figures have to be interpreted carefully, since CDFIs also disburse loans beyond EUR 25,000, which in the framework of the EU definition of microfinance cannot be considered microloans.

[30] E.g. in Germany, the Netherlands and Poland.

funding, for microlending. The effects of these developments as well as the maturing of already established microfinance organisations are reflected in the development of the activity of MFIs analyzed in the latest EMN overview report that covers the provision of microloans in 19 EU countries in 2010 and 2011[31].

The organisations based in EU member states reported 122,370 microloans with a total volume of 872 million EUR.[32] Compared to the results of the survey for the years 2008 and 2009 this marks a rise of 45 percent in the number of loans and 5 percent in the total volume (compared to 2009)[33]. The average volume of the loans disbursed in 2011 was 5,135 EUR. In the covered EU member states the average volume was 7,129 EUR which is a decrease compared to the result from the previous edition (2009: 9,641 EUR). Estimations for the supply of microloans are calculated for the country clusters, which are presented in detail in the following section discussing the gaps of the microloan market.

Important to note is that the European microfinance sector is still characterized by a wide range and diversity of institutions active in the market. The highest shares of institutional types prevalent are NGOs or foundations, as well as the microfinance associations. Furthermore, only around 54 percent of the MFIs surveyed issued more than 100 microloans in 2011, i.e. the majority of MFIs are still very small organisations with limited outreach[34]. This outcome makes clear that the institutional capacities to grow and serve a higher number of clients differ among the diverse landscape of the prevalent MFIs.

Recent numbers from the UK and France on the estimated current and future demand for microloans illustrate that the supply remains beneath existing potential and needs to be expanded in the years to come. In UK, Community Development Financial Institutions (CDFIs)[35] received nearly 13,000 microloan- inquiries from businesses with a total of GBP 231m. GBP 30m in finance was actually provided to 2,600 businesses with nearly half of it provided to unemployed people moving into self-employment[36]. According to the Community Development Finance Association (CDFA), the network and member organisation of the CDFIs in UK, this reflects a substantial increase in inquiries, which in general could be observed in recent years. The trend is expected to continue as the underserved market in UK is immense. The cdfa estimates the current potential annual demand for microloans to businesses in the amount of about GBP 1.3bn. [37] The total potential annual number of business clients is estimated to be about 103,000.[38]

In France the nonbank segment is essentially accounted for by Adie, which is the country's principal MFI. In 2011, Adie alone disbursed 23,000 microloans, around 80% of the total number of loans reported for France by the EMN Overview survey[39]. Compared to 2007 the number of loans disbursed increased by 230%, which underlines the persistent trend of rising demand for microloans in France. The identified market gap was between 80,000 and 130,000 business loans per year.

The presented figures refer mostly to the microloan provision by non-bank MFIs. The EMN overview report (2010-2011) included several microfinance or public promotion banks[40]. However, in most European countries micro-lending activities take place in a market with more or less developed banking sectors that partly also serve the microfinance volume range of below EUR 25,000 as part of their general loan activity targeted to SMEs (e.g. by overdraft facilities). The scale of microcredit provision by commercial banks cannot be

[31] Bendig et al. (2013): Overview of the Microcredit Sector in the European Union for the Period 2010 - 2011, on behalf of the European Microfinance Network (EMN). The overview focuses mainly on non-bank MFIs including some microfinance banks, but excluded microloans disbursed by commercial or savings banks.
[32] Bendig et al. (2013).
[33] Bendig et al. (2013).
[34] Bendig et al. (2013).
[35] In UK, the CDFIs are mostly the counterpart of the MFIs in the rest of Europe, even though that several CDFIs are offering other products like for e.g. housing loans or community services, as well.
[36] Nearly 90% had been denied by commercial banks and 7% were assessed as being very likely to be denied bank finance.
[37] cdfa (2012): Inside Community Finance.
[38] These figures have to be interpreted carefully, since CDFIs also disburse loans beyond EUR 25,000, which per definition cannot be considered microloans.
[39] Bendig et al. (2013).
[40] Bendig et al. (2013).

determined exactly, since these institutions serve microcredit clients as a mere subset of their regular clients. The European Savings Banks Group provided data about the microloan disbursement for a few selected countries and institutions. The Spanish savings bank, for instance, disbursed 34,710 microloans for personal and business purpose, worth EUR 223 million in 2011. Data on the activity of credit unions are only available for Romania. Here the national association of credit unions in Romania, UNCAR, reported an estimated number of 96,000 loans for business purposes in 2011. At the level of general supply of microfinance in Europe, commercial banks are expected to continue reducing their lending to small start-ups and microenterprises. MFIs perceive this development as an opportunity to strengthen their outreach and to position microfinance as a complementary offer to commercial bank lending in European countries.

3.1.3 Market gap at the microloan level

Although the presented proxies for demand and supply at the microloan level in Europe have to be interpreted with caution, the existence of a market gap in the provision of microloans to micro-enterprises and start-ups out of social and financial exclusion can be stated. The actual volume of that market gap is difficult to assess but the presented estimations indicate that there was in the latest years (2010-2012) and still is a significant demand for microloans at the final beneficiary level, which is untapped by microcredit providers in the European Union. The demand (as pointed out in section 3.1.1) for microloans is estimated up to 1,214,388 loans or up to 8.66bn EUR total value of loans when calculated with unweighted averages for the aggregated EU-28[41]. For a more detailed analysis the calculation was made on actual national data regarding the size of the population at the risk of poverty, the shares of entrepreneurial persons and the average volume of microloans provided between 2010 and 2011. The total potential demand calculated along the country clusters of this study sums up to **5.1bn EUR**. The supply was calculated based on the data available from the EMN overview report for the number and value of loans provided in the years 2010 and 2011 in combination with an estimation for 2012[42].

The following table shows the comparison of the demand and supply of microloans.

[41] We take this as a basis, especially as a benchmark for future estimations and results, even though Croatia joined the EU as a member state in 2013.

[42] For the data for 2010 and 2011 see Bendig et al. (2013). We calculated a growth rate for 2012 based on the average of value growth of the covered countries from 2010-2011. This average growth rate was 7%. This growth rate is used for the extrapolation for 2012. It is important to note that the data only included 18 of the 28 possibly covered countries due to not included data in the survey. Therefore, this number can be seen as an underestimation somehow, even though the missing countries are more the underdeveloped microfinance markets.

Table 3: Estimated demand and supply for microloans in the EU

Country Cluster/Countries	**Demand for microloans**[43]	**Supply of microloans**[44]
Central and Eastern Europe		
Bulgaria	69.6 m EUR	10.9 m EUR
Croatia	36.4 m EUR	2.3 m EUR
Czech Republic	40.9 m EUR	N/A
Estonia	8.3 m EUR	N/A
Hungary	232.8 m EUR	17.7 m EUR
Latvia	31.8 m EUR	2.9 m EUR
Lithuania	169.7 m EUR	60.6 m EUR
Poland	275.5 m EUR	256.5 m EUR
Romania	300.7 m EUR	159.3 m EUR
Slovakia	27.7 m EUR	N/A
Slovenia	8.2 m EUR	N/A
Total in EUR	1.2 bn EUR	510.2 m EUR
Market gap in EUR	691.5 m EUR	
Western Europe		
Austria	87.0 m EUR	1.9 m EUR
Belgium	176.1 m EUR	32.8 m EUR
France	376.07 m EUR	505.3 m EUR
Germany	1.2 bn EUR	399.1 m EUR
Luxembourg	3.9 m EUR	N/A
Netherlands, the	201.2 m EUR	42.1 m EUR
Switzerland	8.2 m EUR	N/A
Total in EUR	2.1 bn EUR	981.3 m EUR
Market gap in EUR	1.1 bn EUR	
UK and Ireland		
UK	261.8 m EUR	33.9 m EUR
Ireland	117.9 m EUR	4.1 m EUR
Total in EUR	379.6 m EUR	37.9 m EUR
Market gap in EUR	341.7 m EUR	
Southern Europe		
Cyprus	8.9 m EUR	N/A
Greece	145.6 m EUR	N/A
Italy	481.5 m EUR	14.3 m EUR
Malta	2.5 m EUR	N/A
Portugal	142.1 m EUR	3.6 m EUR
Spain	417.9 m EUR	693.9 m EUR
Total in EUR	1.2 bn EUR	711.8 m EUR
Market gap in EUR	486.7 m	
Scandinavia		
Denmark	83.1 m EUR	N/A
Finland	62.1 m EUR	161.9 m EUR
Iceland	5.7 m EUR	N/A
Norway	46.9 m EUR	N/A
Sweden	33.8 m EUR	N/A
Total in EUR	231.5 m EUR	161.9 m EUR
Market gap in EUR	69.6 m EUR	

In three countries (France, Spain, Finland) the calculation at national level shows the result that the supply of microloans is above the estimated demand, i.e. there is no market gap, but a more glutted market. An explanation for this outcome is connected to different factors for each country. In France, the supply of microloans and the monitoring of its provision by the EMN Overview Survey are better developed than in other countries. Besides ADIE

[43] The estimation of the demand for microloans per country cluster is the sum of the demand per country using the formula described for the EU on Page 14ff. which is based on European Parliament (2010): Directorate-General for internal policies, Microcredit networks and existing national legislations with a view to the implementation of the microfinance instrument, November 2010.

[44] The estimation is based on the collected information of the value of microloans disbursed per country for 2010 and 2011. The value of disbursed loans for 2012 is calculated using the value of microloans disbursed in 2011 multiplied with a growth rate of the value of microloans in the EU-27 in the year 2011, which was 7%. The estimation per country cluster is the sum of the value per country for 2010 to 2012.

several other microloan providing bodies exist, that target small enterprises rather than self-employment activities of socially excluded persons. The demand of these businesses is not covered by the chosen demand estimation methodology. Nevertheless, it seems important to notice that in France the demand for microloans is better addressed than in any other country of Europe. In Spain, the supply of microloans monitored by the EMN Overview survey includes a big share of personal loans provided by one MFI organised as a bank that are given to excluded persons without an entrepreneurial activity. If these loans are taken out of the calculation, the supply decreases by around 120 m EUR. In Finland the supply of microloans is dominated by a promotional bank that issues high volume microloans (average volume of around 18,000) mainly to small enterprises, whose demand is not covered by the demand calculated here.

Added up, the national results show that a total volume of **2.4 bn EUR** was issued in the form of microloans in the EU-28 plus Switzerland, Norway and Iceland between 2010 and 2012. Based on this calculation a gap of around **2.7 bn EUR** in total loan volume can be deducted for the total of the country clusters.

If commercial banks continue to reduce their already limited exposure to risky small scale loan operations over the next years this gap can even be expected to widen. The need to safeguard the provision of inclusive financial services for vulnerable target groups will continue to be a pressing challenge for national governments and the EU, even if the economies of member states will recover from the crisis.

Different policy options can be considered to support the further growth in the supply of microloans and close the identified market gap in the microloan market throughout Europe.[45] At the level of direct support for the sector they are connected to the needs of existent microcredit providers in developing their lending operations and to the needs of new microcredit providers entering the sector. At the level of indirect support for the sector they are connected with the need for enabling legal and regulatory frameworks for microlending and micro-enterprises throughout Europe.

According to several studies on the performance of microfinance providers in Europe[46], the most pressing needs of MFIs that want to grow their lending portfolios are:

- to build and maintain adequate funding models that combine funding for institutional capacity building as well as funding for refinancing loan portfolios,
- improve systems for performance management and analysis,
- improve capacity levels regarding HR management,
- the access to long-term funding for on-lending to high risk target groups.

For MFIs that want to enter the sector the need for funding to cover start-up costs is most crucial.

Available policy measures for direct support:

- Financial engineering instruments for funding microcredit providers and their portfolios
- Technical assistance schemes to improve the capacity building of new and existent microcredit providers
- Tax exemptions to improve private funding in microcredit providers
- Building up (semi-)public microlending organisations

The connection between the supply of microloans and the regulatory framework for microcredit provision and micro-enterprises was established in different studies on the European microfinance sector, e.g. the report of ADIE about their experiences gained in 20 years practice.[47]

Available policy measures for indirect support include:

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[45] FACET, evers & jung and nef (the new economics foundation) (2004): Policy Measures to Promote the Use of Micro-Credit for Social Inclusion, , on behalf of the European Commission DG Employment, Social Affairs and Equal Opportunities.

[46] Jung, Martin, Stefanie Lahn und Michael Unterberg (2009): EMN-Studie: EIF Market studies on Micro Lending in the European Union = Capacity Building and Policy Recommendations, vom 27.03.2009.

[47] Adie (2008): 20 years of microcredit in France - the knowledge gained through Adie’s experience, Paris.

- Microfinance windows in banking regulations
- Support of marketing for microcredit provision
- Improve integration of microfinance sector with welfare bridge schemes
- Improve legal status of solo-entrepreneurs and micro-enterprises

Since the main growth barriers for a widening of the supply of microloans in Europe are related to the access to suitable funding for capacity building and on-lending, policy measures at national and European level need to be in place to improve the availability of funding for microcredit providers to close the gap in the supply of microloans. If, in the following section, a persistent market gap can be identified at the level of funding for microloans in Europe, a rationale for a central EU-intervention to improve the funding situation for microcredit providers is given. Therefore, we analyse the demand and supply of the funding market for microloan activities.

3.2 Demand & Supply at the level of funding for microfinance

The market of funding for microfinance in Europe has developed considerably over the past years. Since MFIs have established their operations in many European countries, the overall demand for external funding is rising throughout Europe. This is also connected to the fact that most microcredit providers in Europe are non-banking institutions and therefore not allowed to take deposits to refinance their lending operations.

MFIs in Europe not only need to secure external funds to refinance their portfolios, they also state a growing demand for risk-sharing instruments and funds for institutional development.

In Europe, funding is supplied both by public and private actors. Public funding at regional, national or international level is still important for many providers since the profitability and therefore the operational sustainability of MFIs as an organisation, but as well of their microlending operations, in Europe is still somewhat limited, especially in the start-up and growth phase of organisations in Western Europe. Private funders like commercial banks or investment funds therefore supply funding in Western Europe mainly in the framework of their Corporate Social Responsibility (CSR) activities or in cooperation with public funders.

The picture in Central and Eastern Europe is different due to the maturity of the sector and the prevalence of more commercial models of microcredit provision. Here international donor organisations are active, providing funding for on-lending at commercial rates, while public funders are less active at national or regional level.

The market analyses confirmed that market gaps are prevalent in the funding market for microlending activities. These gaps can be demand or supply driven. Hereby, market imperfections emerge typically due to

- a lack of supply of funding, both in terms of volume and/or suitable types of funding,
- a lack of affordable funding or funding with a fair market value,
- a lack of access to available funding due to information asymmetries in the market,
- lacking institutional capacities to manage external funds or growth of the microlending activities,
- a lack of investment readiness (e.g. valid financial or social performance measurement) of the microcredit providers[48] due to the suitable and efficient use of external funds.

[48] See for more information: Jung, Martin, Stefanie Lahn and Michael Unterberg (2009): EMN- EIF Market studies on Micro Lending in the European Union - Capacity Building and Policy Recommendations (on behalf of the EMN).

3.2.1 Funding needs of MFI

The analysis of the demand for funding by microcredit providers in Europe is organised in the following methodological steps:

- analysis of general funding needs of MFIs in Europe,
- estimation of actual funding needs based on current use of funding and
- outlook on future needs for funding

The general funding needs are analysed on the basis of a desk research including the main literature sources for identifying the general funding needs of MFIs. The results of this desk research are also used as the basis for the further steps of the analysis e.g. to develop proxies for the actual funding needs of microcredit providers in Europe based on information on their current use of funding. Finally, the findings are complemented by a qualitative survey of the future funding demand among MFIs in Europe.

This qualitative survey is based on face-to-face interviews with MFIs (see table 1) that were conducted during and in the wake of the EMN Conference in Stockholm (25/26th of June). The interviews included MFIs which have already benefited from EPMF, MFIs that are interested to apply for it in the future and MFIs which have applied in the past, but did not received it. The interview guideline, which was used for these interviews, focuses on the use of Progress Microfinance and other funding sources, future needs for funding and experienced funding bottlenecks.

Table 4: List of interviewed MFIs

Name	**Country**	**Size/ Maturity[49]**	**Usage of EPMF**
ADIE	France	Large	Beneficiary
Community Development Finance Association (cdfa)	United Kingdom	Large	Interested in the future
Qredits	Netherlands	Large	Beneficiary
Crédal	Belgium	Small	Beneficiary
FAER	Romania	Small	Beneficiary
Fair Finance	United Kingdom	Large	Beneficiary
Fejér Enterprise (FEA)	Hungary	Small	Interested in the future
Hefboom	Belgium	Small	Interested in the future
Microstart	Belgium	Small	Beneficiary
Micro Development	Serbia	Large	Interested in the future
Nachala	Bulgaria	Large	Interested in the future
Neem	Sweden	Small	Rejection of Application
Rocredit	Romania	Large	Interested in the future
Romcom	Romania	Small	Not interested

[49] We introduced two types of categories for MFIs: small and large in size and maturity. For the categorization, we value the current number of loans issued in combination with the existence in the microloan market.

Furthermore, a workshop was organised at the EMN conference (26th of June) to discuss the funding needs of MFIs in Europe with microcredit practitioners. It was entitled "Progress Microfinance Reloaded: How can it work for you?", and introduced the preliminary findings of the analysis on funding needs of MFIs into a panel discussion with two panellists (one MFI benefiting from Progress from Eastern Europe, and one from Western Europe) and the workshop audience.

General findings on funding needs of MFIs in Europe

The main challenge for MFIs in the EU is to develop and maintain a flexible and sustainable funding model for microfinance operations that allows them to realise their individual approach towards providing microloans (target groups, objectives) as well as to enlarge their portfolio and develop their institutional capacity.

In this regard it is essential to differentiate between different types of funding instruments for specific needs of MFIs. Funding is needed for equity and the refinancing of the loan portfolio.

As many MFIs do provide financial and non-financial services, it is important to differentiate the funding of these two types of services.

The whole continuum of funding needs for microfinance operations in the EU can be structured as follows:

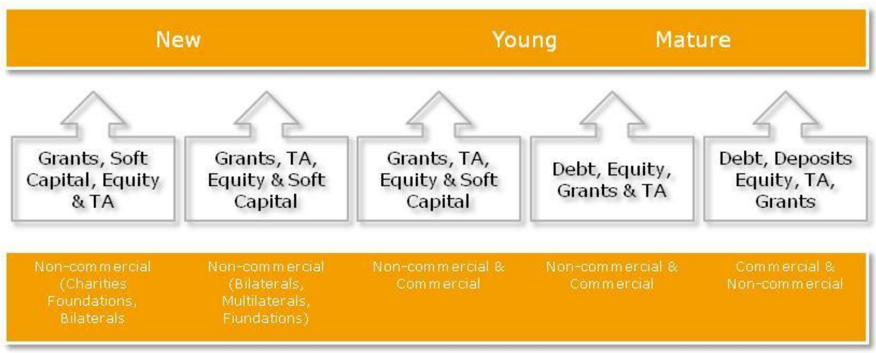
Table 5: General funding needs of MFIs in Europe

Funding Needs	**Description**
Start-up costs/institutional development	Any cost connected to the creation or substantial expansion of a MFI. This is mostly financed by a **grant** or a **donation**.
Long term investment/patient capital	Investments to build up the equity base of a MFI and provide security or financial buffer to cover loan defaults. This can be realized in the form of direct **equity investments** or **indirect quasi-equity finance**.
Refinancing loan capital´	In the absence of deposits many non-bank MFIs need to refinance the loan capital via **debt finance** to reach scale. Banks offering microlending might need additional debt finance to grow their portfolios.
Operational costs of lending operations	Funding need arises due to a mismatch between operational income and transaction costs connected to the provision of microloans on the one hand and risk costs to hedge the default of loans on the other hand. Part of these costs be covered by **grants/donations** and risk-sharing instruments like **guarantees.**
Operational costs of non-	Additional non-financial services

financial services provided	to microenterprises can be provided in-house or by specialized service providers. Mostly, a part of the costs needs to be covered by additional funds in the form of **grants,** e.g. in the framework of ESF-programmes or national funding.

The funding needs of MFIs in Europe can be further detailed depending on the life cycle stage of their development. The institutional life cycle theory has been used to describe the development of non-bank MFIs in developing countries[50]. It was mainly used to analyse their funding needs and patterns. According to this framework of analysis, most MFIs start out as NGOs with a social vision, funding their operations with grants and concessional loans from donors and international financial institutions that effectively serve as the primary sources of risk capital for the microfinance sector. Donor grants and "soft loans" are the main sources of funding in the formative stages of the organisation. As the MFI matures, private debt capital becomes available but the debt structures have restrictive covenants and/or guarantees. In the last stage of MFI evolution, traditional equity financing becomes available, because it is a profitable investment.[51]

Figure 4: MFIs Lifecycle Stages and typical funding patterns



Source: de Sousa-Shields, M., & Frankiewicz, C. (2004): Financing Microfinance Institutions: The Context for Transitions to Private Capital. (USAID Micro Report No. 8 - Accelerated Microenterprise Advancement Project - USAID), p. 3

The diversity of institutional models to deliver microfinance is higher or at a similar level in the EU than in developing countries, where a higher share of MFIs strives for full financial sustainability than in the EU. Nonetheless, the following major development stages can be used to describe and analyse the life cycle of non-bank MFIs in the EU.

Table 6: Major development stages of non-bank MFIs in Europe

Youth	Initialisation and start-up phase
Growth	Institutional Capacity Building and Expansion
Maturity	Performance (Triple Bottom Line) and Diversification (e.g. insurance products, support services)
Optional: **Transformation**	From non-bank MFI into a Bank, or set-up a joint venture with Banks

[50] e.g. de Sousa-Shields, M., & Frankiewicz, C. (2004): Financing Microfinance Institutions: The Context for Transitions to Private Capital. (USAID Micro Report No. 8 - Accelerated Microenterprise Advancement Project - USAID)
[51] Vicki Bogan (2008): Microfinance Institutions: Does Capital Structure Matter? (May 2008).

MFIs that are organised as a banks follow the same life cycle if they are set up as a greenfield initiative, i.e. they are set-up in a first step as a non-banking MFIs, e.g. as an NGO, as most of the the microfinance banks were established during the last ten years in Eastern Europe. In some cases, these organisations are set-up with the clear objective to build a bank for microfinance out of it, e.g. the ProCredit Banks in Eastern Europe. That is why these institutions normally start at a more mature institutional level compared to non-bank MFIs. This is connected to the requirements of banking regulations throughout the EU. In some cases bank MFIs start their operations as spin-offs of commercial or saving banks, transferring institutional know-how and resources in the process. Although the general funding needs of bank MFIs are similar compared to their non-bank counterparts, the need of debt finance and equity is lower due to the availability of deposits and a higher equity base during start-up phase. Internal funds for institutional development and expansion may be available from revenues of activities besides microloan provision.

Estimation of actual funding needs based on current use of funding by MFIs in Europe

Currently, MFIs in Europe use several types of funding to finance their operations and growth. The most common are: debt finance, guarantees, equity and grants. The use of deposits is not so widespread in the European microfinance sector, only credit unions and some bank MFIs in Eastern, Central and Southern Europe offer such products. Therefore, they are able to use this capital for refinancing their loan portfolio[52].

A quantification of the funding needs of European MFIs over the different types of funding can only be provided in the form of proxies based on the estimated demand situation at the microloan level (see chapter 3.1). How exactly this estimated demand for microloans in a country translates into funding needs for MFIs that provide the matching supply can only be approximated, since no standard methodology is available to calculate this. The analysis showed that even the MFIs themselves have no clear picture of how their external funding needs regarding coverage of operational costs and institutional development are connected to the estimated demand they are facing.

For the refinancing of loan capital, the situation is clearer. Most non-bank MFIs in Europe refinance their loan portfolio completely via external debt. The estimated demand for microloans in a country can therefore be translated 1:1 into funding needs for on-lending[53].

Based on the results of studies on the institutional capacity of non-bank MFIs in Europe[54] it can be assumed that risk costs are in most cases not covered by operational income, and therefore need to be refinanced by external funding. This can take the form of guarantees or equity investments. In most cases, microfinance portfolios need to cover a default rate of around 5% in Europe. For MFIs with high risk target groups the rate can go up to 15-20%. This means that MFIs need to cover up to 20% of each EUR of loan volume provided in the form of risk costs. For the development of an institution, the amount of funding needed is only loosely connected to the volume of loans provided, as the operational income increases with bigger portfolios while efficiency effects kick in. It can be argued that smaller and younger MFIs need higher amounts of funding to develop their business than bigger established MFIs that scale up their portfolio. Since there is no reliable and coherent source of data on the volume and types of funding used by European MFIs over the past years, the analysis has to rely on information that is drawn from different available sources of data for MFIs in the different country clusters.

For some Eastern European countries the Mixmarket database[55] offers aggregated data on the debt funding volumes of national MFIs. European and national networks of microcredit providers, like the European Microfinance Network (EMN), Microfinance Center (MFC) or

[52] In Germany, the national microlending model "Deutscher Mikrokreditfonds" includes a bank (GLS Bank) as central back-office, which uses their own deposits for refinancing the loans provided by the MFIs, which functions as the front-office in the model. The loans are backed by a guarantee fund that includes ESF resources co-financed by national public funds.

[53] Deposits are included in these funding needs.

[54] See for more information: Jung, Martin, Stefanie Lahn and Michael Unterberg (2009): EMN- EIF Market studies on Micro Lending in the European Union - Capacity Building and Policy Recommendations (on behalf of the EMN).

[55] See www.mixmarket.org

national networks, such as cdfa in UK, also offer information on funding used by their members.

Another data source is annual reports issued by larger MFIs, which include information about the funding used to refinance their loan operations in that year. And finally the volume of EPMF backed funding per country is available.

Those sources were analysed for the time period of 2010 to 2012 to provide an estimation of the funding used to produce the supply of microloans that was calculated in the chapter on supply at the microloan level. An estimation of the total volume of funds used for building up the equity base and/or for capacity building was not possible.

	Central and Eastern Europe	Western Europe	UK and Ireland	Southern Europe	Scandinavia (Finland)
Estimated supply of microloans 2010-2012[I]	510,239,030 m EUR[II]	981,299,021 m EUR[III]	37,979,349 m EUR	711,828,299 m EUR[IV]	161,878,903 m EUR[V]
Country level information on debt funding used 2010-2012	Bulgaria: ~150 m EUR for 9 MFIs (Mixmarket data) Romania: ~100 m EUR for 10 MFIs (Mixmarket data) Poland: 150 m EUR (one MFI, including deposits)	Germany: 80 m EUR (60 MFIs, including deposits) Netherlands: 45 m EUR (one MFI) France: 75 m EUR (one MFI)	UK: 20 m EUR (cdfa members)	Spain: 592 m EUR (one MFI, including funding for personal loans) Italy: 10m EUR (one MFI) Portugal: 15m EUR (one MFI)	-
Estimated total volume of funding used for refinancing loan capital[VI]	510,239,030 m EUR	981,299,021 m EUR	37,979,349 m EUR	711,828,299 m EUR	161,878,903 m EUR
Country level information on external risk-sharing funding used 2010-2012	Romania: 0.90 EUR Poland: 1.9 m EUR	Austria: 0.5 m EUR Belgium: 0.4 m EUR France: 6 m EUR Netherlands: 5 m EUR Germany: 20 m EUR	Ireland: 1.6 m EUR	Greece: 0.8 m EUR Spain: 30 m EUR Portugal: 0.3m EUR	-
Estimated total volume of risk-covering funding used[VII]	102,047,806 m EUR	196,259,804 m EUR	7,595,869 m EUR	142,365,659 m EUR	32,375,781 m EUR
Country information on equity/grant funding used 2010-2012	Poland: 15.7 m EUR	Belgium: 2m EUR Netherlands: 2 m EUR Germany: 5 m EUR	-	Italy: 8 m EUR	-

Table 7: Overview of funding levels in Country Clusters

[I] The estimation is based on the collected information of the value of microloans disbursed per country for 2010 and 2011. The value of disbursed loans for 2012 is calculated using the value of microloans disbursed in 2011 multiplied with a growth rate of the value of microloans in the EU-27 in the year 2011, which was 7%. The estimation per country cluster is the sum of the value per country for 2010 to 2012.

[II] Information on supply for Czech Republic, Estonia, Slovakia and Slovenia are missing.

[III] Information on supply for Luxembourg and Switzerland are missing.

[IV] Information on supply for Cyprus, Greece and Malta are missing.

[V] Information on supply for Denmark, Iceland, Norway and Sweden are missing.

[VI] For the estimation of the funding used to refinance the supplied loan capital for 2010-2012, we used the volume of the estimated supply of loans mentioned above in the table, as the leverage of the refinancing volume is just the factor 1. That means the needed external debt or refinancing funding equals for this calcuation the supply of the loans. It is important to state that the real need for funding might be higher especially due yet unmet demand for microloans and the funding need involved in satisfying this demand.

[VII] For the estimation of funding used for covering default risk in microloan provision for 2010-2012, we take the total volume of estimated microloan supply in a country and multiply this with the factor 0.2, as this is the typical cap rate for first lost coverage of guarantee instruments in microfinance, e.g. for the micro-credit guarantee instrument of the current Progress Microfinance Facility.

Outlook on the development of the demand for funding of MFIs in the EU

The specific type and volume of funding demanded by individual MFIs can change over time due to developments that are internal (e.g. growing institutional maturity, prevalence of new business models) and/or external (e.g. increasing legal banking regulation, changes in economic development) to the sector. Therefore it is important to complement the findings on funding needs at the aggregated level of country clusters with insights gathered at the level of individual MFIs.

The following findings are based on a qualitative survey, conducted as face-to-face interviews with representatives of MFIs from 9 different European countries (see table 1 for an overview of the interviewees). The half-standardized interviews focused on an assessment of the MFIs' experiences in using the Progress Microfinance Facility and other funding sources for funding. They provide insights into the expectations of MFIs regarding volume[56], types, design and conditions of external funding offers. The MFIs were also asked to report on difficulties in accessing available funding.

Overall the survey included 14 MFIs, which differ widely in their size (in number of microloans issued per year) and level of maturity (see table 1). Among these were six MFIs which have already benefited from the Progress Microfinance Facility and six MFIs that have not applied for EU funding in the past but are interested to apply in the future. One MFI had applied in the past, but did not manage to close a deal with EIF, and one MFI stated that it was not interested in EU funding.

General findings:

During the survey, it became apparent that most MFIs in Europe are looking for long-term funding options at a pricing that reflects their limited ability to charge their clients high interest rates and additional costs of lending. Furthermore, the MFIs stated that it is important for them that the conditions of external funding offers are flexible enough to be aligned with that of funding instruments already in use. They should also take into account the MFIs' developmental stage as an institution and its business activities. The interviewees pointed out clearly that the needs for funding of start-up MFIs are very different from those of established MFIs. A general problem is that funds for offering BDS and coaching to their clients are not available for most of the MFIs.

In general all surveyed MFIs (regardless of their location, size and maturity) reported a continuous demand for the three basic types of external funding described in the chapter on general funding needs of MFIs: Debt finance for on-lending, guarantees for risk sharing and long term investments for building up the equity base of the organisation. Additionally the MFIs reported that they have needs for specific funding to support their institutional development. The following summary of the MFI statements are matched along those different types of funding. Furthermore, a distinction is made between Western and Eastern European MFIs as well as between young and well-established MFIs[57].

Debt finance for on-lending

The mature MFIs from Western Europe reported a significant demand for debt finance in the upcoming five years with a total volume of EUR 120m. These two organisations are especially looking for or preferring debt finance with capped or fixed interest at quasi commercial or even CSR rates with long maturities (longer than three years). Yet, they can also work with short-term debt. In addition, one MFI is urgently looking for possibilities to expand its overdraft loan facility with a commercial bank, which is limited due to the MFI's low equity base.

The same is true for the smaller and less established MFIs from Western Europe, which have also stated a future need for debt finance. While the specific amounts of the required

[56] Only few MFIs were able to provide specific information about the funding, i.e. volume of funding, which they need in the near future (the next five to seven years).

[57] These distinctions were made to distinguish and especially

funding remain sketchy, it became clear that these MFIs cannot afford to pay annual interest rates beyond 6% due to their organisational size or level of maturity respectively. They are especially interested in senior loans with a long maturity (up to five years) to become able to attract short term debt from private sector sources.

Among well-established MFIs from Eastern Europe, the future demand for debt funding is significant in the upcoming years, as the situation is very similar to that of Western European MFIs. With regards to the need for senior debt for on-lending it can be stated that in Eastern European countries MFIs are looking for similar conditions concerning the period and costs of available funding instruments. The maturity should not undercut 5 years in order to allow long-term portfolio planning. Furthermore, annual interest rates of 3-5% are deemed appropriate and anything beyond 6% is simply not affordable.

Smaller MFIs from Eastern Europe reported plans to extend the provision of microloans in their countries, which goes in line with an increasing need for external debt funding in the upcoming years. They were not able to quantify this need further, but stated that given that they have access to affordable debt funding they could manage to increase their microloan provision by up to 20% a year. As commercial debt funding offers in these countries are very expensive, the smaller Eastern European MFIs are generally very interested in public funding options. The interviewees are looking for instruments with a maximum annual interest rate of 5% and maturity of five up to six years. Flexibility in the conditions is seen to be helpful to adapt to unforeseeable market changes.

Guarantees for risk sharing

The two mature MFIs from Western Europe both use EU guarantees at the moment and reported a further demand for direct guarantees to reduce the risk exposure of their loan portfolios. The total portfolio volume that needs to be secured is about EUR 100m for the upcoming five to seven years. Besides the actual coverage of loan losses the public guarantees are mainly used to attract additional private funding for their portfolios. Therefore, those MFIs are looking for conditions that are most attractive for private co-funding, e.g. first-loss coverage, long inclusion periods (up to five years), high or no caps and coverage in the case of bankruptcy of the MFI.

Guarantees for risk sharing are also an important funding option for the younger MFIs from Western Europe. Most of them are in the process of building up their portfolios and encounter higher risk rates than their more mature counter-parts. Due to their low level of maturity, they require guarantees that are easy to use and cover higher amounts of losses. The interviewed MFIs reported that the effort to apply for the microcredit guarantee instrument from the Progress Facility is comparably high for small MFIs. The interviewees also suggested that guarantees are especially helpful for their organisations if they can be combined with other forms of public funding in the form of equity investments, grants or loans. One MFI reported that they were able to secure a set of funding instruments from different public sources that worked very well together to enable their start of lending operations. Such combinations should be available as standard package deals for young MFIs, as they needed to invest a lot of time and resources to make it happen.

Among the well-established MFIs in Eastern Europe a future demand for direct guarantees was also presented. Although their portfolios are on average larger and more established than those of their Western counterparts they also look for cost free guarantees with guarantee rates of up to 80% and first loss caps of up to 20%. Additional some MFIs reported a strong interest in microcredit counter guarantees and national guarantee funds.

In relation to the demand for guarantees for risk sharing the situation regarding the smaller MFIs in Eastern Europe is more diverse. While the prevalence of some MFIs literally depends on the provision of (public) guarantees, as the risks would otherwise be too high, others reported to not need it at all, as they have a proper risk control management in place, which allows realizing a very low write-off rate.

Long term investments in equity base:

With regards to long-term investments the established MFIs from Western Europe stated a significant demand within the next five to seven years. Altogether the two MFIs expect to require about EUR 13m in equity investments. They are especially interested in investments with a focus on social impact rather than financial return (patient capital with no quantified exit goals). The MFIs would favor if these investments could be realized in the form of subordinated debt finance with bullet repayment since it is quite difficult for these organsiations to effectively use standard equity instruments due to their legal status and owner structure, which prohibits issuing shares and limits the possible payment of returns on raised equity.
None of the smaller Western European MFIs reported an urgent demand for long-term investments, which is not surprising, since those organisations have not (yet) reached the life cycle stage of their development in which equity investments are needed or even feasible for the MFI and possible investors. Although one MFI was successful in attracting equity investments in the past, using the EPPA initiative.
All the Eastern European MFIs reported that there is and will be a need for long-term investments in their equity base over the next years. However, they were not able to specify the volume and conditions of the needed investments. More matured MFIs tend to be better prepared to attract and use equity investments from private sector sources. Nevertheless, some MFIs are looking for public alternatives especially for long term equity investments to fund the growth of their operations.

Funds for Technical Assistance and Capacity Building:

Based on the interviews it can be stated that there also is a great demand for funding to access direct Technical Assistance (TA) support and capacity building among Western as well as Eastern European MFIs. This demand will increase over the next years as especially MFIs that intend to grow urgently need funding to finance the training of new staff (skill development) and the implementation of proper IT-infrastructure (technical development). The economic crisis often led to a turndown in operations of MFIs. Meanwhile many MFIs are recovering and now intend to increase the number of staff if suitable funding can be secured.
The JASMINE initiative by the Commission (DG Regio) offered TA support for MFIs over the past years, often combined with an endorsement of the Code of Good Conduct. Those MFIs which successfully applied for JASIMINE TA are reasonably satisfied with the support offered by the consultants of the initiative. However some Western European MFIs reported a lack of consultants that are experienced in Western European microfinance operations. A voucher system for subsidizing TA-support by consultants that are chosen by the MFIs would be a better solution for them. Some MFIs stated that JASMINE and the implementation of the Code of Good Conduct requires a proper social performance measurement system, but does not offer the funding to finance it. Moreover, it was criticized that there are no funds for additional rating exercises (e.g. smart campaign) available. Furthermore, it was suggested that capacity building measures like JASMINE should in general be linked to suitable funding to implement the ideas and strategies developed with the consultants.

3.2.2 Supply of and access to fundings instruments for Microfinance in the EU

For a long time the provision of funding for European MFIs had been confined to public actors, namely governments in the form of Development Finance Institutions (DFIs), public programs with a local development agenda, administration departments or public agencies with the goal to support employment or entrepreneurship. In the past years the availability of private funding for microfinance in Europe has increased due to the rise of social investors, Microfinance Investment Vehicles (MIVs), corporate social responsibility (CSR) programs of commercial banks and public-private co-operations in the aftermath of the financial crisis. This follows the development in international microfinance, where the microfinance industry increasingly attracts private funding as well, which is illustrated in double-digit growth rates. Private actors here are mainly made up of financial institutions (commercial banks, public banks, and cooperative societies), funds (collective investment schemes that pool money from many investors) and other agents like foundations or individuals. Many public as well as private actors, predominantly public donors and private investors, are operating internationally. In some countries this cross-border funding represents the major share of MFIs' funding base. Over the past decades especially the number of private cross-border activities in microfinance has increased substantially and is expected to continue growing, with investors increasingly looking for sustainable and socially responsible investment (SRI) opportunities. However, in countries where proper local capital markets are in place and/ or MFIs are allowed to mobilize deposits, cross-border funding only represents a small share of overall funding.[58]

In Europe this development has diversified the supply of funding for MFIs. Therefore, a stock-taking of funding offers that are available to European MFIs was undertaken, including public sources as well as private ones. The following table aligns the typical funding needs of MFIs identified in chapter 3.1 with the sources of funding that put funding offers on the market.

Table 8: Funding offers available to European MFIs

Funding Needs	**Sources of funding**	**Types of funding offers**
Start-up costs/ institutional development	Private: Donors	Donations
	Public: National/regional governments,	Grants, subsidies for TA
Long term investment / patient capital	Private: Social investors, Commercial banks	Equity and quasi-equity investments
	Private/Public: International Microfinance Investment Vehicles	Equity and quasi-equity investments
	Public: Revolving funds at European/National/ Regional level, set up by public actors	Equity and quasi-equity investments, interest free loans

[58] El-Zoghbi et al. (2011): CGAP Microfinance Funder Survey – Cross-border funding of microfinance (April 2011).

Refinancing loan capital	Private: Commercial banks, Private Investment Funds	Senior loans
	Private/Public: International Microfinance Investment Vehicles	Senior loans, junior debt instruments
	Public: Revolving funds at European/National/Regional level, set up by public actors	Senior loans,
Operational costs of lending operations	Private/Public: International Microfinance Investment Vehicles	Guarantees
	Public: European/National/Regional Guarantee schemes	Guarantees
Operational costs of non-financial services provided	Public: National/regional Structural funds programmes	Grants, Subsidies

A quantification of the funding offers that are available from these diverse sources throughout Europe is not available. Besides lacking data on funding activities this is connected to the very flexible nature of the mobilisation of funds from both private and public sources. In the case of private sources the volume of available funding may be very high, but only for very mature MFIs with established and risk controlled portfolios. For small and young MFIs with risky target groups the amount of available funding is much lower. In the case of public sources the total amount of funding available for European MFIs depends either on investment intensities in other regions of the world (cross-border funding) or on domestic policy initiatives that may change over time.

Based on the, albeit limited, information available regarding the use of funding by European MFIs in the years between 2010 and 2012 (see chapter 3.1) and the results of overview studies like the past surveys of EMN it can be concluded that the availability of suitable and accessible funding is the main hindrance for most European MFIs to scale up their provision of microloans. This does not necessarily mean that the overall volume of available funding for microfinance in Europe is too low, but that the majority of European MFIs do not have access to enough funding of the right type to finance their growth and development strategies.

The suitability of available funding sources for MFIs mainly depends on the legal form of the MFI, its development stage, and its area of operation. Credit unions, cooperatives and bank MFIs refinance most of their loan capital out of deposits and use public funding to cover risk costs and additional services for their clients. NGOs and foundations often use a mix of public and private sources for refinancing their loan portfolio and risk costs. Often a transformation process can be observed, with an MFI starting as NGO that finances itself via donations and/ or public subsidies and over time grows towards a formal financial institution or regulated entity capable of attracting private investments and, in an ideal case, finally reaching self-sustainability[59].

The accessibility of suitable funding sources is connected with the capacity of MFIs to attract and manage the funds that are available in the market for funding. The majority of MFIs in Europe is still characterized by low capacity levels regarding their funding models and fund-

[59] See Kraemer-Eis and Conforti 2009.

raising strategies[60]. The terms of the funding they manage to attract are often not suited to their model of operation and/or state of organisational development. Therefore a lack of investment readiness can be observed among many European MFIs, which seems to be a serious barrier to tapping existing funding sources in the market. Furthermore, regulatory issues in the respective countries may also serve as an explanation for limited use of available funding.

In many cases the lack of investment readiness is directly connected to missing or poorly implemented systems of performance measurement[61]. Often MFIs are either not aware of the importance of proper performance measurement and analysis or show a lack of capacity to implement and maintain proper Management Information Systems (MIS) for these ends. Many MFIs only produce financial data (e.g. number and value of loans disbursed) with basic MIS limited to the reporting requirements implied by the respective funder. Hence, quantity and quality of available data on organisational performance often remain insufficient. In general there still seems to be little awareness (especially among smaller MFIs in Western Europe) regarding the distinction between measuring long-term outcomes, as opposed to outputs, and of the power of performance indicators in securing new funding. It can be noted that, despite marginal improvements, there still seems to be a lack of culture among MFIs regarding the evaluation of results based on performance and numbers. Again this especially applies for Western European MFIs. The Eastern European microfinance market is more mature and has greater proximity to the traditional banking sector. Institutional and operational relationships between the commercial banking sector and the non-banking microfinance sector are often well-established, which results in better developed reporting standards. However, even in this more favorable microfinance environment, performance measurement of MFIs lags behind possibilities. A major issue here is the shortage of professional technological infrastructure (MIS and scoring systems), which would allow proper analysis of institutional capacity and progress.

Regulatory issues are another major hindrance to using existing funding options. In many EU countries specific legislation concerning microfinance is not in place. Often MFIs are not regulated, as there are no common laws on reporting at national level, resulting in issues like, e.g. uncertainty among MFIs regarding reporting/ measurement standards, no access to existing debt registers, management positions are held by persons without suitable education, etc.

The lack of investment readiness and the regulatory issues can be understood as central bottlenecks that hamper the use of available funding. Especially the underdeveloped performance measurement can be perceived as serious barrier to existing funding opportunities. It is said that this underdevelopment often stems from a missing long-term orientation, more specifically, missing strategies and models in building and maintaining comprehensive funding models and funding terms (EIF Market Study Microlending 2009).Yet, this is only half of the picture. Access to existing funding partly depends on the presence of proper performance management (systems), but what hinders most MFIs from developing and implementing strategy-driven performance measurement is the availability of suitable funding to establish such measures besides day-to-day work. Qualitative research reveals that many MFIs are trapped in a vicious circle: no funding without proper performance measurement and no proper performance measurement without funding. These circumstances will be covered in more detail below.

Role of EU-backed funding offers

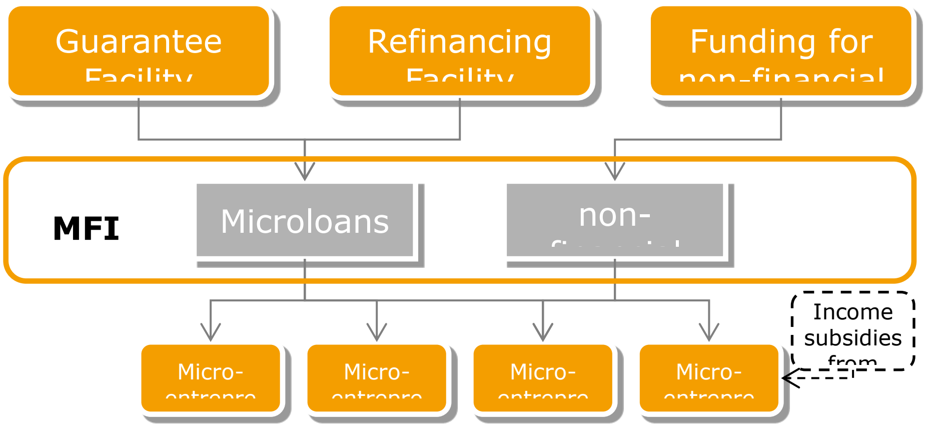
Over the last years, various EU-backed funding offers were made available for European MFIs as the sector continued to grow and the provision of microloans was positioned as a central instrument to fight the negative labour market effects of the financial and economic

60 See EIF Market studies.

61 This is also covered in the Code of Good Conduct for microloan providers in the EU.

crisis in Europe. Some of these offers are backed by resources of the European Commission and are managed centrally by EIF as managing organisation. Others are only available at national/regional level, backed by nationally/regionally co-financed EU Structural Funds resources (ERDF or ESF) and managed by Managing Authorities (national/regional authorities responsible for the implementation of Structural Funds)[62]. While most of these funding offers cover the central funding needs of MFIs involved in providing microloans, some ESF-based funding offers also provide funding for the supply of non-financial services to microloan clients (see Figure 5). The specific design of these funding offers and their instruments will be described in more detail in chapter 4 on financial engineering options in the field of microfinance.

Figure 5: Role of EU-backed funding offers in refinancing MFIs' services



To assess the role of EU-backed funding in the overall supply of funding for MFIs it is necessary to compare the amount of funding provided by EU-backed funding offers to the overall funding used by MFIs. For the years 2010 to 2012 this is possible for the centrally managed instruments like the Progress Microfinance Facility, as data on the volume of funding provided is available from EIF.
In the case of national/regional funding offers that use EU Structural Funds resources, i.e. ESF- or EFRE-funds, the picture is more diverse. Direct funding of microlending activities under ESF was piloted during the funding period of 2000 – 2006 in some countries in the framework of the Community Initiative EQUAL[63]. In the funding period of 2007-2013, there are several dedicated national and regional microcredit schemes or funds financed by structural funds[64] Most of the ERDF-funded schemes are realised in the framework of JEREMIE (see chapter 4 for more details). ESF-funded schemes can take the form of direct funding for microfinance like in the case of Germany where a national guarantee fund was set up ("Deutscher Mikrokreditfonds") or programmes that fund support services for the clients of microfinance, e.g. coaching or business development services (BDS). A good overview on the options for National/Regional Managing Authorities to set up microfinance schemes can be found in the manual developed by the working group "Access to Finance" in the framework of the Community of Practice on Inclusive Entrepreneurship (COPIE), a learning network of ESF Managing Authorities and Implementing Bodies at national and regional level in Europe.[65] Because of the diversity of the realised approaches in funding microfinance with Structural Funds resources a summary of the total supply of these schemes for microcredit providers in the different country clusters cannot be provided in this analysis, although the amount of funding supplied by funding offers that are backed by EU Structural Funds resources is substantial in all country clusters.

62 In the case of some JEREMIE holding funds, the funds are also managed by EIF as Holding Fund manager.
63 See http://ec.europa.eu/employment_social/equal_consolidated/
64 See Lopriore, Marco and Diana Pati (2012): Microcredit and EU Cohesion Policy, EIPA Maastricht.
65 See http://www.cop-ie.eu/sites/default/files/COPIE_ESFManual_Access_to_Finance_print.pdf

Therefore, the overview in table 6 only displays the amount of centrally managed EU funds supplied to MFIs in the different country clusters. This includes the Progress Microfinance Facility, the Microfinance window under SMEG (CIP) and the EPPA initiative. The volume of TA support under JASMINE could not be assessed based on the information available

The overview shows that in most EU countries centrally managed EU- funding offers only play a minor role in funding MFIs. The share of EU-funding is especially low in Scandinavia where no funding deal with centrally managed EU-resources was realised between 2010 and 2012 and UK /Ireland where only one guarantee deal was reported. In Western Europe the amount of EU-backed guarantee funding is markedly higher than the amount of debt finance. This could be connected to difficulties in accessing the EU funding offers for loan refinancing and a good availability of low-cost debt funding offers from domestic public sources, including EU-Structural fund resources, or cooperating banks. In the more mature microfinance sectors in Eastern Europe the use of EU-backed debt funding offers is more widespread, since these MFIs operate bigger portfolios and are used to manage with higher costs of external debt finance. In Southern Europe the use of centrally managed EU-funding is rising, partly due to the retreatment of bank funding in the wake of the financial crisis that hit the financial markets in these countries very hard. Like in Western Europe, the use of EU guarantee funding is more widespread than the use of EU debt finance.

Table 9: Amount and share of centrally managed EU- funding in Country Clusters

	Amount of EU-backed debt funding used[I]	**Amount of EU-backed guarantee funding used**[II]	**Amount of EU-backed equity funding used**[III]	**Percantage of estimated total funding**[IV]
Central and Eastern Europe	15.9m EUR	7m EUR	-	~4%
Western Europe	1m EUR	16.5m EUR	5m EUR	~2%
UK and Ireland	-	1.7m EUR	-	~3%
Southern Europe	2.4m EUR	21.1m EUR	1.5m EUR	~3%
Scandinavia	-	-	-	0%

[I] Including utilisation of debt finance deals with EPMF until Sept 2012.
[II] Including cap amounts of EIF guarantee deals under Progress Microfinance and micro-credit window of SMEG.
[III] Including utilisation of equity deals under EPMF and investments via EPPA.
[IV] Share of total estimated funding used based on methodology described on page 23.

A **crowding out** of private funding cannot be observed for the years 2010 to 2012. On the contrary, EU-backed funding offers often acted as a catalyst for bringing private funding into the sector, especially in the case of guarantees and long-term investments to non-bank MFIs. EU-backed debt funding that is provided to bank and non-bank MFIs does not leverage as much private co-funding in to the sector but is seen by most MFIs and private investors as an important long-term addition to the existent debt funding supply for European MFIs. This role will become most probably even more important with regard to the future developments of the funding supply for microfinance in some regions of the EU (see below).

The **accessibility** of EU-backed funding offered to European MFIs, especially non-bank MFIs, is a source of constant discussion between the Commission, EIF and practitioners from the sector.

Some insights on this matter can be deducted from the results of the qualitative interviews with Non-Bank MFIs held in the context of this analysis. Most of the accessibility issues encountered by these MFIs are connected to the design of the instruments offered, the leverage requirements and regional restrictions. Especially small MFIs see EU-backed guarantees as very suitable funding options but lack the understanding and know-how on how to make them work for their organisation. The information available on websites and in brochures does not help them to overcome this barrier. Most MFIs report that the access to the instruments becomes easier, once a direct contact with EIF is established and negotiations about the funding deals are under way. Nevertheless, the application process

can be burdensome for small MFIs with no experience in financial engineering instruments. The simplification of the design of EU-backed guarantees could improve the access to this kind of instruments by small Non-Bank MFIs. More mature MFIs already report good accessibility of these instruments. In the case of debt instruments a simplification and mainstreaming of the design of the funded instruments offered by the Progress Microfinance Facility might help to improve the access to these instruments for Non-bank MFIs. Bank MFIs could also benefit from more mainstreamed instruments e.g. in the case of junior debt loans.
Some young MFIs experienced that funding deals with EIF could not be realised because either the leverage provided by them was rated as too low or the risk associated with the investment was seen as too high. Although leverage requirements of EU-backed funding are important with regard of the market impact that can be realised with the available EU resources, these could be lowered for start-up MFIs to improve access to debt and guarantee funding. The risk taking that is possible by an EU backed funding facility is limited in those instruments that are based on a fund structure which includes co-funding at fund level by market oriented actors, e.g. the European Investment Bank in the case of the funded instruments of the Progress Microfinance Facility. Instruments that are purely backed by the EU Commission’s funds, like guarantees or the EPPA investments can take higher risks and are therefore more accessible for young non-Bank MFIs with risky target groups. MFIs from some countries reported that they cannot access some of the funding offers because they do not operate in an EU member state or because of volume limits for EU-backed funding in the country they operate in. This could be improved by opening up the centrally managed funding offers to Non-EU member states and limits for individual deal volumes in countries with many MFIs (see chapter 6 for detailed recommendation). Taken together the accessibility of the centrally managed EU-backed funding offers can be rated as good, although the access for small and young Non-Bank MFIs could be improved.

In the case of national/regional funding offers that are backed by EU-Structural Funds the accessibility strongly depends on the initiative and know-how of national/regional Managing Authorities in implementing financial instruments for supporting the provision of microloans. Hence, many MFIs do not have access to EU Structural Fund based programmes in their country, because they are not seen as a target group of these programmes. This is especially true for national/regional ESF-Programmes to fund the costs of BDS provision. MFIs and their lobbying organisations (especially networks) therefore need to be more active in addressing this issue at the national/ regional level. An example for successful lobbying of national Managing Authorities into establishing an ESF-based funding program for microfinance is the “Deutscher Mikrokreditfonds” that made EUR 100M available for risk-sharing and capacity building for microloan provision in Germany. Since the setup of dedicated funding schemes for microfinance as part of national/regional EU Structural Funds strategies is a demanding task on the part of the Managing Authorities, there is also a need for more exchange and support on how to do this properly. The planned TA initiative of DG Regio for the new funding period, including off-the-shelf blueprints for revolving financial instruments and the development of an accessible and well-designed TA-platform could better this situation markedly, if it includes appropriate specifications. Also, feasible ways to combine centrally managed EU funding offers and national/regional EU Structural Funds programmes in a coherent funding strategy for MFIs need to be explored in more detail and forwarded to interested MFIs and Managing Authorities to better the access to both types of offers.

Outlook on development of funding supply for microfinance in Europe

The future development of the funding supply for MFIs in Europe was assessed based on desk research, interviews with MFIs and representatives from funding actors that are active in Europe. The assessment also included a workshop on the issue of financial engineering that was held in Brussels with participants of public and private institutions involved in funding microfinance in Europe.

One of the most obvious trends in this regard is a decline of cross-border funding available for MFIs in the country cluster of Central and Eastern Europe, as Development Financial Institutions (DFIs) and private investors are expected to retreat from these countries due to developing financial sectors, stricter regulation and high losses on microfinance investments in the South-East part of Europe, especially in the Balkan countries, e.g. Bosnia. Domestic funding offers from the banking sector or from public sources are not that well developed in countries from the Central and Eastern European country cluster and will most probably not be able to fill this gap.

In Western Europe, the UK and Ireland, Southern Europe and Scandinavia the availability of cross-border funding for MF will remain restricted due to lower profit margins and more risky target groups of microloan providers. Domestic public funding for MFIs is expected to decline, due to budget restrictions and high deficits at national and regional levels. The activity of domestic private funders may develop more positively, as social investors, impact investment vehicles and CSR programmes of banks are looking for interesting investment opportunities that combine social impact with a moderate financial return. Also new forms of raising funds for social initiatives, like crowd funding and peer-to-peer lending might increase the inflow of private funds into the microfinance sector. Nevertheless, MFIs and investors alike see an important role of EU-backed funding offers over the next years to provide a backbone of long-term investments in MFIs to support the building of sustainable funding models for MFIs that combine private with public funding. A crowding out effect is not expected if EU-backed offers will continue to provide instruments that offer tailor made funding with long maturities and high levels of risk taking in a market that is still affected by the insecurities of global financial markets. Also strict additionality[66] rules should be in place to prevent market distortions and private sector crowding-out from occurring.

3.2.3 Identification of market imperfections at the level of funding market

The analysis of the funding market for European MFIs shows that some persistent funding bottlenecks exists for specific forms of microcredit (e.g. loans to high risk target groups) and non-financial service provision (e.g. BDS for self-employment out of social exclusion), especially if the MFIs are very small and organisationally underdeveloped.

Additional to this, more general market gaps may arise in the future due to contrary developments at the demand and the supply side in most member states.

1) The funding need of European MFIs is expected to grow further in volume due to a general expansion of microloan portfolios in most member states. In Western and Central Europe non-bank MFIs are maturing gradually and in the process strengthen their ability to absorb higher levels of funding. In Eastern Europe the markets for microloan provision are developing further with established MFI actors reducing their activity and new actors looking for growth in their lending activities.

2) The funding supply for MFIs is expected to decrease due to

- shifting policy objectives at European, national and regional level giving priority to direct labour market activities over measures to foster entrepreneurship.At the European level this is connected with the priorities of the new ESF funding period.
- Changes in the global investment patterns of Development Finance Institutions. Especially in Central and Eastern Europe the availability of cross-border debt financing is expected to reduce markedly over the next years.
- Reduction in the availability of affordable debt finance by commercial banks for microfinance due to more strict regulative restrictions for the financial sector (e.g. BASEL II/III)

[66] Additionality is a legally binding concept and refers to the difference in the volume that could be achievable without the EU-backed support against that achieved with the EU-backed support during a given period. Additionality rules prevent intermediaries from substituting their own lending with European funds and encourage them to lend to segments not covered by the private sector. EU backed instruments like the SMEG Facility of CIP thus allow for quantitative additionality" by guaranteeing larger volumes of loans; and „qualitative additionality" by reducing collateral requirements and acceptance of higher risk (in SME lending) by the banking sector.

Based on the market analysis the following can be deducted for the five Country Clusters.

Table 10: Market gaps in funding market for MFIs

	Identified Market gap at microloan level	**Additional funding needed to close market gap at microloan level***	**Anticipated development non EU-backed funding supply**
Central and Eastern Europe	691.5 m EUR	829.8 m EUR	↓
Western Europe	1.1 bn EUR	1.3 bn EUR	↘
UK and Ireland	341.7 m EUR	410 m EUR	↘
Southern Europe	486.7 m EUR	584 m EUR	→
Scandinavia	69.6 m EUR	83.5 m EUR	→

*calculated with the proxy methodology introduced in chapter 3.2.1, only including funding for refinancing loan capital (x1) and covering risk costs (x0.2)

3.3 Investment situations for an EU level facility

The identified market gaps at funding level are closely connected to the development on the market for microloan provision (microloan level). Market gaps in debt finance limit the growth potential in the supply of microcredit with negative implications for the outreach of the microcredit providers. High cost debt finance and lacking availability of affordable risk-sharing options for MFIs have a negative impact on the lending conditions and therefore the social outreach of the MFIs. Lacking equity capital for MFIs can also increase their risk adversity and reduce the supply of microcredit for socially excluded target groups. Additionally, market gaps in funding for non-financial support services can also reduce the supply of microloans for these target groups.

The introduction of a coherent strategy at EU level to foster the provision of microloans as a tool to fight social exclusion and unemployment improved the funding situation for MFIs markedly and supported a growth in the supply of microloans to those economically vulnerable groups. The market analysis showed that public funding support for MFIs is needed to enable these organisations to further widen the supply of microloans throughout Europe. With the European Progress Facility ending its activity end of 2016 there is a need for a follow up that offers funding instruments that meet the needs of non-bank and bank MFIs alike and further support the development of sustainable funding models for European MFIs that combine private with public funding.

Based on the identified market gaps the following general investment situations for a new centrally managed EU funding facility can be deducted:

- Need for additional supply of affordable debt finance for non-bank and bank MFIs
- Need for long-term investments into non-bank MFIs to strengthen their capital base and allow for organisational development.
- Need for risk-sharing funding to reduce risk exposure of non-bank and bank MFIs and to attract additional private funding into the sector
- Need for flexible start-up investments in greenfield microfinance initiatives with potential to grow.
- Need tailor-made TA support to develop sustainable funding models and strategies for institutional capacity building
- Need for integration with national/regional level funding for non-financial support services for microcredit clients, e.g. BDS

Across the EU member states the priorities of these investment needs may vary, since the supply of funding differs in regard of the availability of cross-border funding and national/regional public funding. Also the organisational models and maturity of the MFIs that are active throughout Europe varies regionally.

4. Assessment of options for financial instruments

In this part of the assessment we are looking at available options for financial instruments to support microcredit providers and compare their profile with the identified investment needs in the European microfinance sector. Based on the findings of the market analysis, investment needs can be identified for certain sectors of the market for MF funding, especially funding for risk-sharing and long-term investments in the equity base of MFIs and for capacity building of non-bank MFIs. EU-backed funding both at EU and national or regional level can also serve as an important source of funding for greenfield investments in nascent MFIs, as this type of funding is not yet widely available in the funding market. The market analysis showed that these investments needs are difficult to quantify. The estimations of the market gaps for funding that were based on proxies for market gaps at the level of the microloan market and the supply side of the funding market for microcredit provider show that these needs easily surpass the budgets available for policy interventions into microfinance at EU level. The role of centrally managed EU-backed funding offers can therefore only be the provision of scalable and consistent funding offers that help to attract additional funding from public and private sources into the sector and allow European microcredit providers to strengthen the supply of loans for their target groups. Especially the integration with EU Structural Funds based funding schemes at the national or regional level can help to mobilise much of the needed funding for microcredit providers throughout Europe.
The chosen approach in the design of the specific financial instruments for the planned facility in the framework of the EaSI needs to acknowledge this activating role of EU-backed funding in the European funding market. It should reflect the need to safeguard the market impact of the planned EU intervention and to reduce potential market distortions. To identify financial engineering options that fit to the identified market needs and the strategic goals of the Commission, the following analytical steps are taken:

- In a first step we clarify the **framework conditions for the new facility** at the level of EU programming and the estimated availability of funds. The Progress Microfinance Facility as the predecessor of the new facility is being examined as well as the EaSI programme under which the new facility will be set up and run during the new funding period.

- In the next step we summarize the **strategic goals of the Commission in regard of the new facility**. This is informed by the general strategy of the Commission towards microfinance, the statements in the ToR for this ex-ante evaluation, the lessons learnt from the implementation of Progress Microfinance[67], documented in the yearly reports on the implementation of Progress Microfinance[68] and discussions with DG Employment throughout the project.

- A **stocktaking of FE options for MF in Europe** is undertaken to inform the assessment of suitable financial instruments to address the identified investment needs. As a part of this the **financial instruments under EPMF** are scrutinized in more detail.

- Based on the results of the stocktaking of FE options an analytical scoreboard is built to **assess the fit of the available financial engineering options** to the identified investments needs in the market and the strategic goals of the commission.

[67] The interim evaluation of Progress Microfinance was still ongoing at the time of the finalization of this report.
[68] See COM (2011) 195 final, COM (2012) 391 final, and COM (2013) 562 final.

- The results of this analytical assessment will be used to deduct **recommendations for setting up the financial instruments** for the new facility.

4.1 Framework conditions for the new Microfinance facility

Progress Microfinance

In March 2010 the EU established a dedicated Microfinance Facility for employment and social inclusion in the framework of the PROGRESS programme. Public and private intermediaries, both banks and non-banks, can apply for support from this facility in the form of different financial instruments for risk-sharing, on-lending and equity.
The aims of Progress Microfinance, which was set up as a response to the economic crisis in Europe, were twofold: on the one hand, it should contribute to make microfinance within the EU more readily available and accessible to persons who wish to become self-employed, start-up a micro-enterprise or develop existing micro-enterprises further; so that microcredit providers in the EU are able to increase their lending to these final beneficiaries. On the other hand, it improves access to microfinance by reducing the risk borne by microfinance institutions. This allows providers to reach out to groups who could not normally be served, for instance, because they could not put up sufficient collateral or because the interest rates would have to be very high if they were to reflect the real credit risk.
Progress Microfinance is the first full-fletched financial engineering facility for microfinance that is available for all microcredit providers that operate in EU member states. The Project Signing Period of the facility will end at the 7th of April 2016. The remaining funds in the trust account for the micro credit guarantees and the revolved commission-based funds from the funded instruments under the European Progress Microfinance Fund (EPMF) will then be paid back to the Commission. The co-legislators have agreed to use these funds for the new facility that is planned under the Programme for Employment and Social Innovation (EaSI). The Commission estimates that a total sum of nearly 70 m EUR will be available from the EPMF, once the maturity of the signed loan deal and guarantee deals is reached. The reflow of these funds will most probably start in 2016 and be continued on a yearly basis.

The Programme for Employment and Social Innovation (EaSI)

The European Parliament and the Council reached a political agreement on the EU programme for Employment and Social Innovation (EaSI)[69] with a proposed budget of 919.469 m EUR[70] for the 2014-20 period.
Together with the European Social Fund, the Fund for the European Aid for the most Deprived and the European Globalisation Adjustment Fund, EaSI forms the fourth pillar of the EU Initiative for Employment and Social Inclusion 2014-2020.
EaSI will support Member States efforts in the design and implementation of employment and social reforms at European, national as well as regional and local levels by means of policy coordination, the identification, analysis and sharing of best practice.
EaSI integrates and extends the coverage of three existing programmes:

- Progress (Programme for Employment and Social Solidarity),
- EURES (European Employment Services)
- and the European Progress Microfinance Facility,

which will be allocated respectively 61%, 18% and 21% of the budget.

[69] The following details of EaSI are based the finalized version of REGULATION (EU) No 1296/2013, see http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:347:0238:0252:EN:PDF
[70] This is the amount available in current prices.

The political agreement followed the ordinary procedure and was endorsed by the European Parliament and Council at the end of 2013. This allows the launching of EaSI in early 2014.

For Financial Instruments for microfinance the following two program axes are relevant:

1) Progress axis

For the period 2014-2020 the 'Progress' element of EaSI will continue its current activities (analysis, mutual learning and grants) and will have a specific budget for social innovation and social policy experimentation.
The Commission communicated that around 8-9m EUR of this specific budget could be used to support microcredit providers, based on Article 16 (3b) of the proposed regulation of EaSI, which provides "support with regard to capacity-building of national administrations […] and microcredit providers;" [71].

2) Microfinance facility and Social Entrepreneurship

Under this axis EaSI will:

- extend the support given to microcredit providers under the current European Progress Microfinance Facility
- provide funding for capacity building of microfinance institutions
- support the development of the social investment market and facilitate access to finance for social enterprises.

The total proposed budget for the microfinance and social entrepreneurship axis is around 193m EUR for the period 2014-2020. Access to microfinance would receive 87,5m EUR. Institutional capacity building would receive almost 9m EUR and 96.5m EUR would be dedicated to support social entrepreneurship.
The specific objectives of the Microfinance and Social Entrepreneurship axis are:

- increasing access to, and the availability of, microfinance for vulnerable groups who are in a disadvantaged position with regard to access to the conventional credit market and who wish to start-up or develop their own microenterprises and micro-enterprises.
- building up the institutional capacity of microcredit providers;
- supporting the development of social enterprises, in particular by facilitating access to finance

4.2 Strategic goals of the Commission

The general strategy of the Commission towards the support of microcredit lending developed markedly over the past ten years from individual activities and programs by different DGs toward a streamlining approach for more integrated activities.
The first landmark in this regard was the Communication on microcredit adopted by the Commission on 17th November 2007: "A European initiative for the development of micro credit in support of growth and employment"[72]. In this communication the Commission summed up the needs of public support for microcredit in the EU in four central strands:

- Improving the legal and institutional environment in the Member States
- Further changing the climate in favour of entrepreneurship;
- Promoting the spread of best practices, including training
- Providing additional financial capital for micro credit institutions

The communication led to the establishing of JASMINE (Joint Action to Support Micro-finance Institutions in Europe), a joint initiative of the Commission, the European Investment Bank (EIB) and European Investment Fund (EIF), developed in the framework

[71] See REGULATION (EU) No 1296/2013.
[72] See COM (2007) 708 final.

of JEREMIE. Originally the JASMINE Facility provided various financial and non-financial services to MFIs, but the concept has evolved over the years. As it stands now, the JASMINE TA Facility concentrates on delivering Technical Assistance (TA) to microcredit providers, while financing is made available to microcredit-providers through the European Progress Microfinance Facility (EPMF) managed by the EIF. Some Member states and regions have established financial instruments for microcredit support in the framework of their Structural Funds strategies (e.g. in the form of JEREMIE funds) and allocated part of their structural funds appropriations to these instruments.
The European Parliament in its resolution of 24th March 2009 with recommendations to the Commission on a European initiative for the development of microcredits in support of growth and employment requested that the Commission strengthen its efforts to develop microcredits in support of growth and employment.
Furthermore, the European Parliament approved an additional 4m EUR of support for a pilot action to be implemented in the context of the JASMINE framework, the European Parliament Preparatory Action (EPPA).

The Commission's communication of 3rd June 2009, entitled 'A shared commitment for employment', underlined the need to offer a new chance to unemployed persons and open the road to entrepreneurship for some of Europe's most disadvantaged groups who have difficulty in accessing the conventional credit market. In addition to existing instruments, specific action is needed to further strengthen economic and social cohesion by reinforcing activities undertaken by the EIB and the European Investment Fund (EIF) and other international financial institutions without prejudice to the activities of the Member States. The Commission therefore announced a proposal for a new EU-wide microfinance facility to "extend the outreach of microfinance to particular at-risk groups and to further support the development of entrepreneurship, the social economy and micro-enterprises." With the establishing of the Progress Microfinance Facility in 2010 the European Commission committed 100 m EUR to a central investment facility. The facility consists of a strand for guarantees and a fund for funded instruments that is co-financed by the EIB with additional 100 m EUR. The facility is managed by the EIF and will be active until the 7th of April 2016 (end of Project Signing Period).

The Commission has proposed to continue supporting microcredit development from 2014 onwards throughout the EU under the new Programme for Employment and Social innovation (EaSI), by establishing a new facility that would build on the successful intermediary model of EPMF and by offering a similarly wide range of products, disseminating best practice and pioneering financial inclusion by strengthening underserved market segments. With the new facility the Commission plans to react on the criticisms that during the current financial period EU microfinance support is scattered among several separate, though complementary, programmes. Therefore it attempts to create a one-stop-shop for microfinance support, including funding for capacity building of microcredit providers based on experience gained from the EPPA initiative and allow the financing of technical assistance for microcredit providers. The financing of microfinance schemes, capacity-building actions and entrepreneurship support services will still be possible across the EU under the structural funds (the ERDF and the ESF), operated through shared management between the Commission and Member State authorities. The new facility should be designed to provide an added value to these activities. The new facility will be available for intermediaries that operate in the EU member states. Intermediaries that operate in EFTA and candidate countries can access the facility on the basis of the respective agreements on participation in Union programmes.

With the new facility the Commissions plans to enhance the coherence, transparency and effectiveness/efficiency of the financial support for the microcredit sector. In detail this implicates that:

- The facility should **address clear market gaps** that cannot be addressed sufficiently by national/regional funding offers
- The facility should be **alligned with existent EU initiatives on microcredit**, especially the follow-up of the JASMINE pilot initiative and the ongoing dissemination of the Code of Good Conduct. Ideally this coordination should also include activities under control of the member states (e.g. EU Structural Funds programming).
- The facility should be organised in **a clear and consistent structure** that can be positioned in the market as the only centrally managed EU funding offer for microcredit providers.
- The facility should **combine the funding of portfolios and investments in organisations** in order to increase the institutional capacities of the sector, and hence address market gaps in the microloan provision to final beneficiaries.
- Access to funding by the facility should be connected to the adherence to **standards for social performance measurements** and other institutional standards of the Code of Good Conduct to safeguard the highest possible impact on the final beneficiaries.
- The **financial instruments** of the facility should be based on the experience of Progress Microfinance and improved with regard of their **fit to market needs** and their **role in fostering sustainable funding models of MFIs**.
- The facility should offer different types of financial instruments that are suitable for **specific needs in different stages of the life-cycle of a MFI**.
- The **accessibility of the financial instruments for small non-bank MFIs** should be enhanced. The instruments need to be simple and flexible to be understandable by MFIs that are not experienced in financial engineering/funding.
- The **leverage effect** of the instruments should reflect their expected social impact, their usage of COM-resources (revolving vs. lost funds) and their function in the funding structure of MFIs (refinancing portfolios vs. investments in organisations).

4.3 Stocktaking of FE options in European Microfinance

In its Communication "A budget for Europe 2020", the Commission highlighted the intention to increase the use of innovative financial instruments for magnifying the impact of the EU budget. Financial instruments, such as guarantees, equity or quasi-equity investments or other risk-sharing instruments, can also be combined with grants if appropriate. They are used to address market failures or sub-optimal investment situations. Their use at EU level has to respect the principle of additionality, meaning that they shall not replace existing funding, they shall not distort competition in the internal market and they have to create a leverage effect, i.e. the contribution from the EU budget shall mobilise investment exceeding the size of the Union contribution.

Generally there are two routes of using EU budget for financial engineering in European Microfinance: 1) centrally managed financial instruments that use resources of the EU Commission and 2) initiatives at national or regional level that use EU Structural Funds' resources to budget financial instruments. In the following chapter only options for centrally managed instruments will be discussed. National or regional options for providing EU backed

funding for microfinance activities will be analysed in more detail in the chapter on performance measurement and added value (chapter 5).
Based on the past ten years of public support at EU level for microcredit provision in Europe the following financial engineering options for centrally managed financial instruments can be distinguished:

- Microfinance Investment Vehicles for
    - Guarantee facilities
    - Equity/Grant schemes (mostly for investments in capacity building)
- Programmes for direct financing of technical assistance (TA) support by third parties

These financial engineering options offer different types of financial instruments and serve different functions in addressing the sector's need for funding (see chapter 3.1 and 3.2 for a more detailed overview). For the new facility it is not only important to select a mix of instruments that fits the identified market needs but also to choose the most efficient mode of delivering the products that these financial instruments offer. In this regard the stocktaking of available financial instruments needs also to look at delivery structures and product conditions.

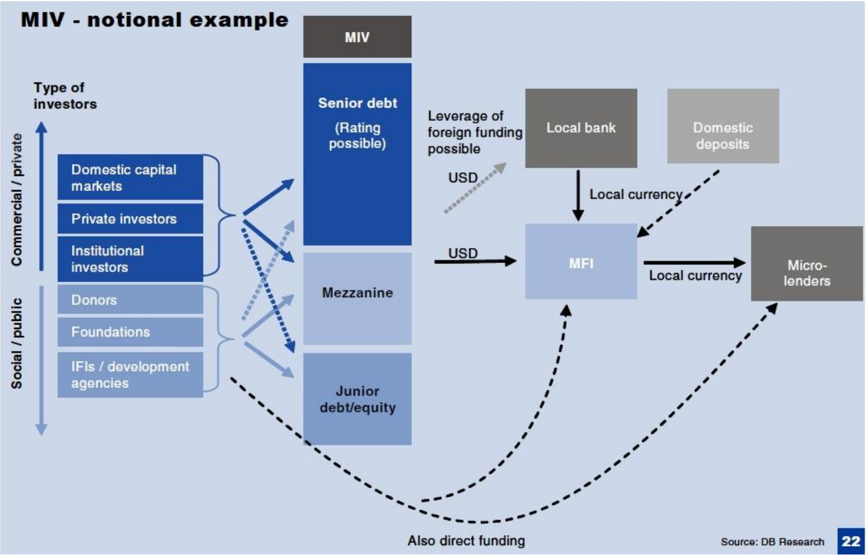
4.3.1 Financial instruments for MF in Europe

The instruments and products offered under EPMF are analyzed separately under 4.3.2.

Microfinance Investment Vehicles

The past years have seen a surge in the set-up of structured funds that offer financing products to microcredit providers, including bank and non-bank MFIs. Most of these funds are classified as Microfinance Investment Vehicles (MIV) and include funding by public sources or semi-public bodies like International Financial Institutions (IFIs).
Leverage effects by private co-funding are mostly realized at fund level, by including the investments of private investors directly into the fund's total budget. Co-funding at the level of individual deals with MFIs e.g. by including resources of local banks is not that widespread.

Figure 6: Structure and function of MIVs



The most prominent case of a MIV that is active in the European sector is the European Fund for Southeast Europe, known as EFSE, that was launched on 15th December 2005 and represents the first public-private partnership of its kind. Led by KfW, EFSE is among the three largest microfinance investment vehicles in the world. The fund manager is Oppenheim Asset Management Services in Luxembourg and fund advisor is Finance in Motion, based in Frankfurt am Main. Citibank Luxembourg acts as fund administrator and custodian.

EFSE offers various financial instruments for providers (commercial banks as well as MFIs and non-bank financial institutions (NBFIs)) of micro and small enterprise loans, rural loans for micro and small enterprises located in rural areas or those engaged in agricultural activities and housing loans to low-income private households:

- medium to long-term senior loans,
- subordinated loans,
- term deposits,
- subscriptions to bond issues,
- co-investments (syndicated loans),
- standby letters of credit,
- guarantees, and
- equity and quasi-equity participations.

End of March 2013, EFSE had an outstanding amount of EUR 766,1m invested in its partner lending institutions. To attract private investors at the fund level, EFSE needs to provide a suitable ROI. The pricing of the offered products are therefore market oriented, allowing a margin of up to 400 interest points on the investments[73].
As a result, the portfolio of partner lending institutions of EFSE is clearly dominated by established bank institutions with big loan portfolios, like ProKredit Banks and Raiffeisen Banks.
Additional to the EFSE the EFSE Development Facility was set up. It operates in tandem with the Fund and complements it with non-financial services – such as technical assistance, consulting and training – tailored to the specific needs of EFSE's partner lending institutions. Its aim is to help them strengthen their internal capacities and operations and thereby enhancing the long-term development impact of EFSE's investments and increasing the outreach of the partner lending institutions towards the Fund's target groups: micro and small enterprises and low-income private households.

Guarantee facilities

Guarantee facilities for intermediaries that provide microcredit to their clients are the most established form of EU backed financial instruments for microfinance in Europe. At the moment they are offered by the Progress Microfinance Facility (see chapter 4.3.2) and under the SMEG of CIP.
The first iteration of a guarantee facility for micro credit was the establishment of a micro credit window in the guarantee facility of the Multi-Annual Programme (2000-2006) 'MAP'. It was continued under the Entrepreneurship and Innovation Programme (2007 -2013) 'EIP', which is one of the three 'pillars' of the Competitiveness and Innovation Framework Programme (CIP). The CIP's overarching aim is 'to contribute to the enhancement of competitiveness and innovation capacity in the EU, the advancement of the knowledge society, and sustainable development based on balanced economic growth'. A significant part of the CIP consists of encouraging the competitiveness of European enterprises, especially SMEs.

The EIP objective of increasing access to finance for the start-up and growth of SMEs is served primarily by one measure (Financial Instruments for SMEs) that includes two

[73] In interviews on behalf of this study, EIF reported that debt finance investments in the framework of EPMF allowed a maximal margin of around 200 percent points.

instruments – the GIF (High Growth and Innovative SME facility) and the SMEG (SME Guarantee facility). The SME Guarantee Facility provides counter- or co-guarantees for schemes operating in eligible countries, and direct guarantees to financial intermediaries, in order to increase the supply of debt finance to SMEs. SMEG has been operational since September 2007, features a total budget of €506 million and is implemented by the EIF on behalf of the Commission. There are four windows under SMEG:

1. Guarantees for debt financing via loans or leasing: the aim is to reduce SMEs' difficulties in accessing finance either due to the perceived higher risk or to the lack of sufficient collateral.
2. Guarantees for micro loans: guarantees for loans of up to €25 000 to micro-enterprises with up to 9 employees, particularly for entrepreneurs starting a business. Financial intermediaries may also receive some support to partially offset the high administrative costs of micro loans.
3. Guarantees to cover equity and quasi-equity investments in SMEs.
4. Guarantees to support securitisation structures.

Of the 52 transactions with 46 financial intermediaries from 23 countries that had been approved by the end of 2012, 12 deals were done under the Microcredit Window (in France, Ireland, Spain, Norway, Poland, Serbia, Montenegro, Croatia, Slovakia and 3 deals in Turkey). The expected volume of debt finance to be supported by these deals is 1.053 bn EUR (1 billion). Most of the guarantees are direct guarantees to intermediaries who typically provide loans directly to the micro-enterprises. In addition there is a focus on high-risk SMEs for micro-loans, resulting in higher cap rates. Leverage in the micro credit window is therefore generally lower than for loan guarantees.
The micro credit Window under CIP/SMEG will be available for signatures until the end of 2013. The follow up programme of CIP, called COSME, will feature no separate micro credit window in its guarantee facility. This follows the recommendations of the evaluation of the EIP to re-assess the rationale for continuing the micro credit window in future Commission programmes on competitiveness and innovation as it is more geared towards social objectives. In principle, the micro loan segment can be served by the guarantee facility of COSME, as the main target of COSME programme are loans under 150,000 EUR, i.e. from 0 to 150k EUR. The cap rates of the guarantee deals will have to occur to the standard limits of the guarantee facility.

Equity/Grant schemes

The use of equity instruments to address market gaps in SME finance as a financial engineering option for using EU budget is a cornerstone of the Commission's strategy to achieve the Europe 2020 Strategy's objectives of smart, sustainable and inclusive growth. The Commission Communication of 19th October 2011 on "A new framework for the next generation of innovative financial instruments – the EU equity and debt platforms" (COM(2011)622 final) describes the Commission's view on how to realize these objectives via equity and debt (loans, guarantees, risk sharing) instruments. The described equity and debt platforms are common rules and guidance for innovative financial instruments. Most of these instruments are designed to be realized in the framework of EU cohesion policy and but there are also some examples for centrally managed equity instruments in the ongoing funding period.
Under CIP (EIP) the High Growth and Innovative SME Facility (GIF) offers early-stage (seed and start-up) investments and expansion-stage investments to innovative SMEs with high-growth potential. The activity is managed as a "Funds of Funds" by EIF who invests in specialised venture capital and risk capital funds. The evaluation report on the EIP rated the equity investments as a successful way to foster the development of innovative SMEs with high growth potential. The transferability of these options to the funding of microcredit providers is limited because investments into high growth SMEs differ from equity funding for financial intermediaries that need equity capital for activating private funding from the capital market.

Equity investments in microcredit providers are realized as part of the funded instruments of the EPMF (see chapter 4.3.2) and as part of the JASMINE pilot initiative of the European Commission in the framework of a preparatory action of the European Parliament (EPPA). In 2010, the European Parliament made available 4.25m EUR of funding to support the development of microfinance institutions in the EU. The Commission used these funds to provide seed funding to non-bank microcredit providers. EIF managed the budget and allocated the funding if possible complementary to EPMF.
The type of investments that could be realized by EIF under EPPA were very flexible and could take the form of

- Debt instruments (senior and subordinated loans, subscription of bonds, etc.)
- Equity instruments
- Funded and unfunded risk sharing arrangements

In the case of debt instruments or funded and unfunded risk sharing arrangements, investments could have a maximum maturity of five years. In the case of equity instruments adequate exit strategies needed to be in place prior to the end date of the facility. No restrictions regarding the risk taking of EIF as managing organisation were in place as the budget was made available by the Commission in the form of a grant to EIF.

Five deals with four MFI were realized between 2010 and 2013. Three direct equity deals with two MFI and two loans. In two cases the investment/loan was given to microfinance providers that had also benefitted from a EPMF guarantee. In one case a loan for capacity building was given to a MFI that benefitted from a senior loan from EPMF. In total 3.5m EUR were allocated.
In an interview, representatives from EIF pointed out that other tahn the equity instruments under EPMF the EPPA investments were a very flexible funding option that allowed first round investments in young non-bank MFIs with growth potential. The financial return perspective on the investments was not that important since the activity was originally designed as a pilot action and the allocated funds were seen as "lost funds" by the Commission. In this regard the EPPA equity instrument proved to be better suited to the specific investment needs of non-bank MFIs than the equity instruments under EPMF.

Programmes for direct financing of technical assistance (TA) support by third parties

The supply of TA for financial intermediaries to enhance the institutional capacity of those organisations to allocate EU budgets is a financial engineering option that was established in EU cohesion policy in the past two funding periods. For microcredit providers direct EU financing of TA support was piloted via JASMINE, a joint initiative of the Commission, the European Investment Bank (EIB) and European Investment Fund (EIF). This action is being developed in the framework of JEREMIE and the Communication on microcredit adopted by the Commission on 17 November 2007: "A European initiative for the development of micro credit in support of growth and employment" (COM (2007)0807)

Its objective is to[74]:

- Disseminate good practice in the EU as regards microcredit lending.
- Support the development of microcredit providers active in the European Union in various fields such as institutional governance, information systems, risk management and strategic planning (capacity building).
- Help these intermediaries become sustainable and viable operators on commercial terms.

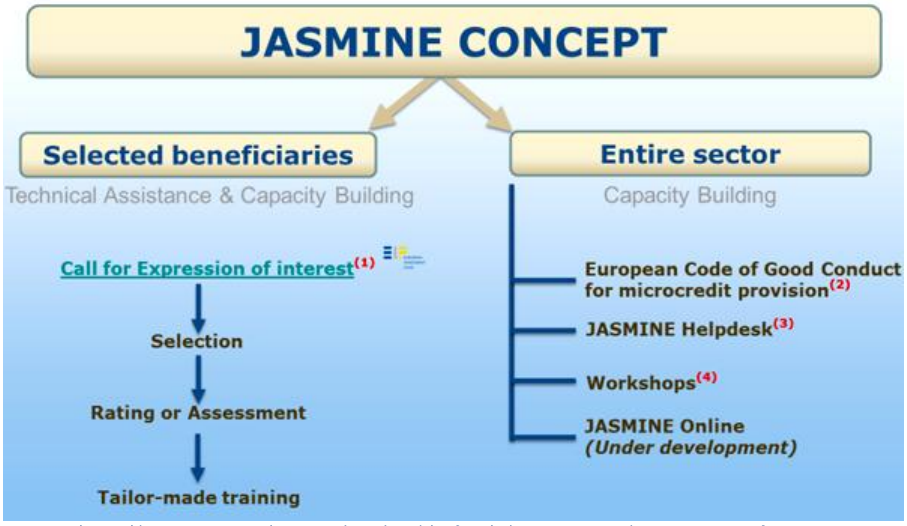
[74] The following information on the JASMINE programme is taken from the EC website http://ec.europa.eu/regional_policy/thefunds/instruments/jasmine_en.cfm#1.

Originally the JASMINE TA Facility provided various financial and non-financial services to MFIs, including the EPPA initiative described above, but the concept has evolved over the years. As it stands now, the JASMINE TA Facility concentrates on delivering TA to microcredit providers.

A range of services are offered, that focus on improving the quality of microcredit providers and establish good practice in this sector. Two types of services are made available:

- Capacity building aimed at beneficiaries selected via Calls for Expression of Interest, managed by the EIF
- Microfinance Development tools and services for the entire microfinance sector

Figure 7: The JASMINE concept



Source: http://ec.europa.eu/regional_policy/thefunds/instruments/jasmine_en.cfm#1.

The EIF was appointed by the Commission to setup and manage the JASMINE Technical Assistance Facility for selected beneficiaries active in the European Union. The selection of the beneficiaries results from a due diligence conducted at the end of a "Call for Expression of Interest" process launched by the EIF once or twice a year.

The JASMINE Technical Assistance targets the following types of Microcredit Providers, active in the European Union:

- Non-bank financial institutions
  - Greenfield MFIs willing to improve their internal processes through (i) an independent assessment of their institution and (ii) tailored trainings to the staff;
  - mature MFIs willing to increase the quality of their operations through (i) an assessment report or a rating report likely to facilitate fundraising and (ii) tailored consulting services to the staff and the management team;

- Licensed banks never rated by specialised microfinance rating agencies, providing microcredit products and willing to receive (i) an independent opinion on their microcredit operations by specialized European microcredit rating agencies as well as (ii) tailored coaching to increase the staff knowledge in microfinance.

The micro credit providers / micro-finance institutions selected by the EIF benefit from a range of services made available free of charge. These services include:

- either an evaluation / diagnosis of the structure, organisation and operating mode of the selected micro credit providers/MFI or an institutional rating performed by a specialised rating agency (Planet Rating or MicroFinanza);
- tailor-made training for the staff and the management of the selected MFIs provided by expert consultants (Microfinance Center) following the evaluation / rating exercise;

Since the launch of the JASMINE offer in 2010 a total of 81 organisations in 15 countries benefited from the support, which is werdistributed over the country clusters in the following way:

Table 11: Geographical distribution of beneficiaries of JASMINE

Country Cluster	No. of beneficiaries	Countries with highest amount of beneficiaries
Central and Eastern Europe	39	Romania (19 organisations) Bulgaria (9 benefiaciaries)
Western Europe	21	Germany (17 organisations)
UK and Ireland	5	UK (5 organisations)
Southern Europe	15	Italy (10 organsiations)
Scandinavia	1	Sweden (1 organisation)

Source: http://ec.europa.eu/regional_policy/thefunds/instruments/jasmine_en.cfm?showbenef=1#2.

In addition to the technical assistance provided to selected beneficiaries JASMINE also provides tools and services available for the entire microcredit sector of the European Union. One of the most relevant tools for microcredit providers is the JASMINE - European Code of Good Conduct for Microcredit Provision, which was developed by a contractor on behalf of DG Regio between 2011 and 2012 and is now disseminated throughout the sector. This Code was developed in close collaboration with a large number of stakeholders including representatives of the European banking and non-banking microfinance sector. Via the provision of recommendations and standards the Code aims to foster best practice in the European microcredit sector and to provide guidance for microcredit providers from the different points of view, including consumers, investors, funders and regulators. As a practical approach, this so far voluntary CoGC contains five different sections addressing customer and investor relations, governance, common reporting standards, management information systems and risk management. In the pilot implementation phase from 2010-2011 nine organisations took part.[75]

JASMINE was successful to establish a platform for TA support services to bank and non-bank MFIs throughout the European microcredit sector. All criticism that is voiced by MFIs and stakeholders (e.g. the lacking availability of consultants and experts experienced in Western European models of microlending) is connected with the implementation and provision of the services offered, not the offer itself. With the future of the JASMINE initiative being unclear there was a strong case made by MFIs and funding institutions in the interviews for this analysis to continue the offer of EU-backed TA services for the sector. MFIs that benefitted from JASMINE's TA services also reported that they missed financial

[75] See here http://ec.europa.eu/regional_policy/thefunds/ instruments/jasmine_cgc_en.cfm#6.

instruments that allowed them to realise the investments needed to implement the capacity building initiatives that were triggered by the TA services and the implementation of the Code of Good Conduct. Therefore a better integration with EU financial instruments for funding capacity building of microcredit provider e.g. equity investments is needed to enhance the impact of such an offer.

Preliminary Results of Stocktaking of FE options

- General growth in availability and diversity of financial engineering options for centrally managed financial instruments to allocate EU budgets for microcredit provision
- Different financial instruments, products and delivery options exist for different policy goals, e.g. general support for growth of microloan supply vs. specific support for capacity building of non-bank MFIs to reach the most vulnerable target groups
- Microfinance Investment Vehicles are a good financial structure to attract co-funding at the fund level and to provide standardized financial instruments for banks and more mature non-bank MFIs
- Institutional diversity and lacking "investment-readiness" of non-bank MF providers in Europe limit the use of sophisticated financial engineering options that are based on the capital and refinancing structures of full-fletched banks.
- EU-backed micro credit guarantees have proved to be successful instruments to foster risk-sharing in microcredit provision in Europe and to allow European microcredit providers to build up their portfolios.
- Equity or quasi equity instruments for non-bank MFI in Europe are an important financial engineering option but need to be implemented in the right way to function. The EPPA experiences show that flexibility is a key to be able to provide different types of non-bank MFIs with long-term investments for capacity building.
- Start-up investments in greenfield microfinance initiatives are especially risky and need a combination of different financial instruments to be successful.

4.3.2 Progress Microfinance[76]

As the predecessor of the new facility the setup and mix of products of the current Progress Microfinance Facility is assessed in more detail in terms of efficiency and effectiveness with regard to its policy objectives (see chapter 4.1).

Structure of the facility

Structurally, the facility consists of two funds with seperate budgets. In total, the budget provided by the European Commission for Progress Microfinance accounts for 100 m EUR for both guarantees and funded instruments.
The European Investment Fund (EIF) issues the guarantees and manages the funded instruments on behalf of the Commission and the EIB. Entities selected for participation become financial intermediaries, providing microloans of up to 25 000 EUR to the final beneficiaries, financially excluded individuals and microenterprises.

a) Micro credit guarantee instrument: based on a Fiduciary and Management Agreement (FMA) between EU and EIF signed on 01.07.2010.

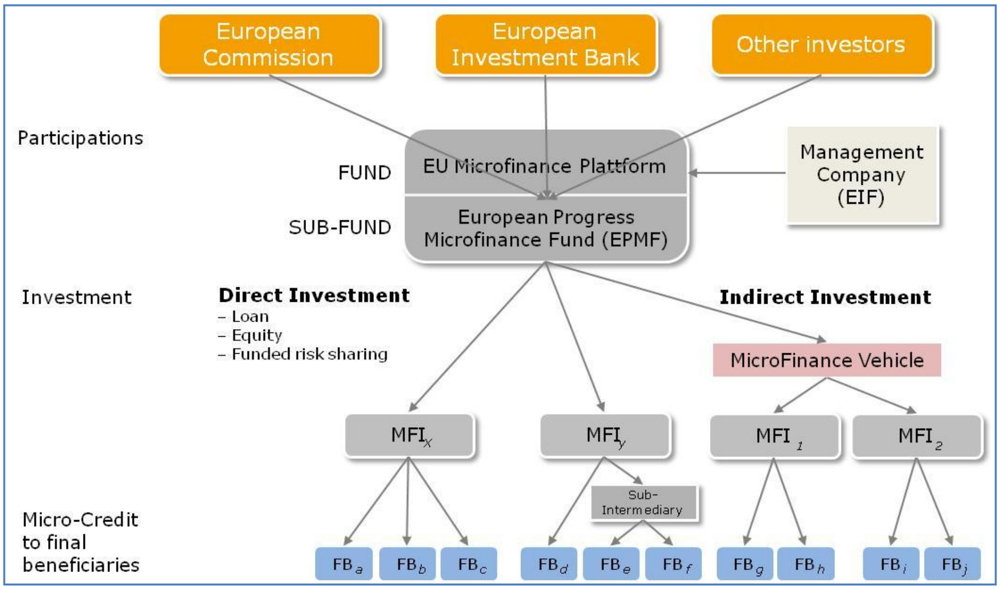
Budget:
25m EUR out of the overall budget from the Commission has been allocated for micro credit guarantees and transferred in a trust account managed by EIF to provide micro credit guarantees to financial intermediaries up to 4m EUR (cap amount).

[76] All data on performance of the facility are of March 2013.

b) EU Microfinance Platform for funded instruments: Established as a *Fonds Commun de Placement-Fonds d'investissement spécialisé* (FCP-FIS) with a dedicated sub-fund (European Progress Microfinance Fund) for delivering funded instruments to microcredit providers (see figure 7).

Budget:
The budget available for funded instruments is composed of EUR 75m from the Commission and EUR 100m from the European Investment Bank (EIB), which agreed to match the Commission's contribution. To the initial budget of EUR 75m additional EUR 3m have been added in 2010 from a European Parliamentary Preparatory Action[77] and EUR 2m in 2013 from the previous year Global transfer procedure. This results in a leverage effect of 2.25 at fund level.

Figure 8: Overview Structure FCP-FIS (EU Microfinance Platform)



Instruments of the facility

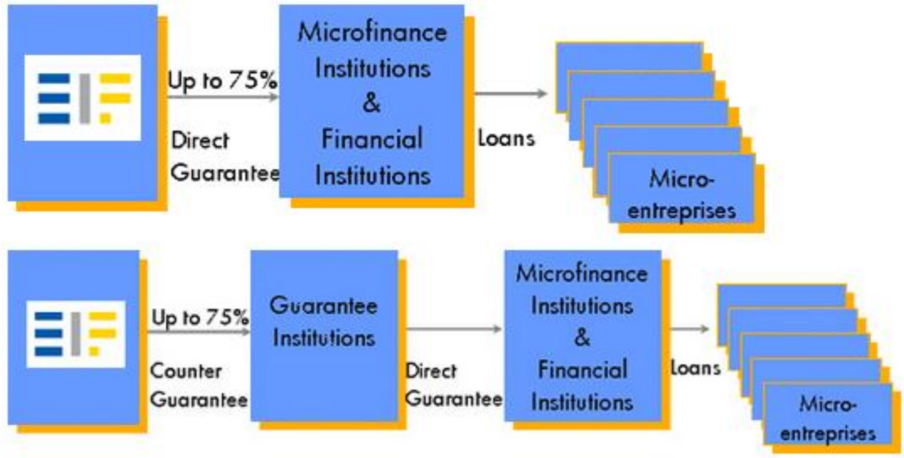
The financial instruments that are offered by EIF via the facility to microcredit providers are guarantees and funded instruments.

a) Micro credit Guarantees

The Micro credit Guarantees that are offered by Progress Microfinance can be used by a microcredit provider as a direct guarantee or by a guarantee institution as a counter guarantee (see figure 8).

[77] European Parliament Preparatory Action — 'Promoting a more favourable environment for microcredit in Europe'.

Figure 9: Direct and Counter-Guarantees under EPMF



Source: http://www.eif.org/what_we_do/microfinance/progress/Progress_Microcredit_Guarantees_1.htm.

Conditions:

- Other than a commitment fee, no guarantee fee is charged. The commitment fee is charged to the intermediary in case the portfolio does not reach at least 90% of the agreed volume within the availability period (up to 24 months)
- Covers defaults occurred within six years from signature of the guaranteed loan agreement
- Guarantee rate is up to 75% of the underlying micro-loan or micro-loan guarantee, with the intermediary retaining a minimum of 20% of the credit risk of such underlying micro-loan or micro-loan guarantee
- The cap rate of the losses covered by EPMF is up to 20% of the guaranteed amount. The Cap Rate is fixed by EIF individually for each EPMF guarantee agreement having regard to the risk profile of the micro-loan portfolio or micro-loan guarantee portfolio to be guaranteed

More generally, direct guarantees allow microcredit providers to extend their lending activities to riskier groups and to grow their portfolios. Millennium bcp, for example, does not apply its scoring system to clients of guaranteed microloans, as these are clients who would most likely not have been able to pass banks' standard criteria. Alternatively, a guarantee could be, and is, used to ease standard loan conditions by reducing interest rates or collateral requirements, or extending microloan maturities. Also, many MFIs that use Micro credit guarantees under Progress reported in the interviews that they use the guarantee to attract private funders to invest in their portfolios. The counter guarantee was modeled on the successful counter-guarantee instrument of the SMEG facility of the EIP program.

b) Funded instruments

- Senior Loan
  Standard debt financing of loan portfolios. The Senior loan is offered as long-term financing in the range of 5-7 years, depending on the intermediaries' debt servicing capacity

- Subordinated Loan
  An instrument to enhance the capital base (Tier 2) of bank MFIs. The debt is subordinated to senior creditors of the intermediary and typically paid back at the end of the term to maturity (bullet loan).

- Risk-Sharing Loan
  An instrument for funded risk-sharing. A Senior Loan is combined with a risk participation of EPMF in the micro credits provided by the intermediaries.

- Equity Participations
  Investments in the equity base of bank and non-bank MFIs. This can be done through ordinary or preferred shares, typically with an investment horizon of six up to eight years.

The funded instruments are designed as revolving instruments with only a limited level of risk taking on the side of the fund. There are targets in place for the volume of the deals to be realised until the end of the signing period of the facility. The Senior Loan instrument works a straightforward debt instrument that can be used by MFIs as an alternative to existing debt offers in the market. The pricing is benchmarked on the CSR rates of commercial banks and normally does not exceed Euribor+4%. Although co-funding is not mandatory at the level of individual deals, EIF representatives reported that EIF motivates signees to attract additional debt finance over the maturity period of the loans to provide additional leverage for this instrument. Normally additional co-funding has shorter maturities than the EPMF loans. The subordinated loans are a very interesting instrument for bank MFIs but suffer from limits regarding the maximum term to maturity and national regulation for this kind of investments in financial intermediaries. In the market standard maturities for subordinated loans are ten years. The risk-sharing loan is very sophisticated instrument targeting mature bank MFIs. EIF representatives reported that the realisation of deals with this instrument is very complicated and costly. The equity instruments under EPMF proved to be not feasible due to restrictions in risk taking by the management rules of the EPMF and EIB's risk control standards. Especially the settlement of exit strategies and the issuing of shares were difficult issues in the negotiating with MFIs. In the case of PerMicro this led to the decision to use EPPA instead of EPMF's equity instruments.

Performance of the facility:

The geographical coverage of the deals realised by EIF under Progress Microfinance is illustrated in figure 9.

Figure 10: Geographical distribution of Progress Microfinance by March 2013

Source: Annual Progress Microfinance report, COM (2013).

By March 2013, intermediaries from nine Member States had acquired guarantees (BE, IE, EL, FR, NL, AT, PL, PT and RO) as opposed to only six in the previous period. Funded instruments were being applied in ten countries (BG, ES, FR, IT, CY, LT, PL, PT, RO, and

SI), one more than last year. The highest activity was in Italy and Poland (each 4 deals), followed by Bulgaria and Romania (each 3 deals). The Commission set country limits for the allocation of the resources of the facility. Until March of 2013 only one country reached this limit (Romania), resulting in the denial of funding for further intermediaries from that country.

a) Guarantees

All providers so far benefit from the highest possible coverage in terms of guarantee rate (75%). Until now, the cap rate has been in the range of 5.5% to 20%. No counter-guarantee deal was signed.
The 2011 Implementation Report indicated the need to extend the maximum term to maturity of loans to be included in the guarantees from three to six years, as intermediaries were unable to deliver the agreed multiplier volumes with the shorter maturity limit. This was done by way of an amendment in October 2011. Empirical evidence shows that this change has resulted in a significant rise in demand for the guarantees, with the overall volume more than doubling since last year.

- **Dealflow:**
  Nearly 50% of the available funds for guarantees were used until March 2013. 11 individual deals (10 providers) were realised with a total volume (cap amount) of 11.6m EUR.

- **Leverage:**
  The average leverage of the guarantees deals is 11.5 (total agreed micro-loan multiplier volumes versus signed cap amounts).

- **Market impact:**
  Total loan volume mobilised (Agreed multiplier volume): 134m EUR. Absorption levels of providers (total micro-loan volumen commited versus agreed multiplier volume): 22%

b) Funded Instruments

Demand for funded instruments is even higher than for guarantees. This justifies the distribution of funds within Progress Microfinance, where EUR 180 m of the budget is earmarked for them. Over the whole range of instruments, it is senior loans that keep attracting most interest. One subordinated loan was issued in 2012 (Sberbank banka). A first risk-sharing loan deal has also been signed with Banca Popolare di Milano, for an amount of EUR 8.8 m. While no equity participation contracts have been signed yet, negotiations on a direct equity investment with a potential Italian non-bank provider are currently ongoing.
In order to increase the leverage effect of senior loans, EIF began to issue senior loans with a multiplier requirement of 1.5 to 2.0, particularly for senior loans with banks and in repeat transactions with intermediaries which have secured co-financing from third parties. When EPMF is refinancing a part of a portfolio it provides in most cases the senior loans with the longest maturity. The additional re-financing loans by banks are more short-term oriented. In recent deals EIF always realised ratios that exceeded 1:1 re-financing of portfolios. With bank MFIs, leverage in terms of volume is better/easier but it is harder to realise leverage that is connected to specific outreach to target groups. Co-financing at the level of senior debt almost never happens to the same time as the agreement with EPMF. It is counter-productive to ask the managing institution of the new facility to provide detailed information on the co-financing. The MFI should confirm that they will include other re-financing sources at some point in the future.
The overall leverage effect of the funded instruments was reduced by the limited success of EIF to attract co-investors at fund level. EIF reported unsuccessful talks with KfW, CEDB, BNP Bank, ING Bank and APS Bank.to secure a co-funding deal besides the EIB investment. EIF representatives reported that this was primarily connected to the unfavourable risk-

return ratio of investments in MFIs from EU countries, compared to investments in MFIs from development or transition countries like the Balkan countries. The profit margin that can be realised by MIVs like EFSE, that invest in South Eastern Europe (around 400 percentage points per invested Euro) is not possible in Western and Central Europe. Also, the amounts of co-funding that were offered by funding institutions that were interested to act as co-investor at fund level were much lower (less than 5m EUR) than the amounts needed to balance the co-funding of the EIB. The governance rules of the FCP fund structure impede the management of such minority co-funding. Finally, EIF representatives reported a holding tax issue for investments in FCP-FIS funds, if the investing organisation is not an international financing institution.

- **Dealflow:**
  Good Placement of senior loans (12 individual deals with total volume of 89m EUR). No equity deals, only one subordinated loan deal and one risk-sharing loan deal.

- **Leverage:**
  Average leverage effect at level of individual deals is 1.77 (total agreed micro-loan multiplier volumes versus signed amounts). Total leverage effect is 3,465 (average leverage effect of funded instruments x leverage effect of Commission's funds at fund level (=2.25)).

- **Market impact:**
  Total loan volume mobilised (Agreed multiplier volume):158m EUR. Absorption levels of providers (total micro-loan volumen commited versus agreed multiplier volume): 18%.

Accessibility of the facility for non-bank MFIs

Since the introduction of Progress Microfinance, the EIF has been in contact with over 180 microcredit providers. With 27 intermediaries[78] having signed a transaction by March 2013, the successful deal origination rate is 15%, partly a result of national schemes and other available funding being already in place, most notably in the Nordic countries and in Germany. Other reasons for the low deal origination rate might be the EIF's focus on larger amounts due to volume targets set by the Commission, high transaction costs or strict credit assessment.
The balance between banks and non-bank MFIs regarding the screening activity is 100 to 82. 14 transactions were signed with bank MFIs and 15 transactions with non-bank MFIs. The total signed amount of transactions with bank MFIs accounts for twice the volume of the signed amount of transactions with Non-bank MFIs. This is connected to the fact that transactions with non-bank MFIs were more often guarantee deals (11 out of 15 deals) that feature a lower signed amount than funded instruments, which were allocated more often to bank MFIs (10 out of 14 deals). The actual disbursement of the signed amount is higher in the deals with non-bank MFIs.

Representatives of EIF supported the view that non-bank MFIs may have a harder time accessing the more sophisticated EPMF instruments, e.g. guarantees or risk sharing and subordinated loans due to less experience with financial engineering instruments. Most of them also have a less diversified funding base than bank MFIs which makes senior loan deals with leverage requirements more difficult to realise. Also the direct combination of guarantees and senior loans for the same portfolio is not allowed under Progress Microfinance[79] restricting the access for Greenfield non-bank MFIs that are looking for both types of funding (debt finance and risk-sharing) to set-up their portfolio.

[78] Including the contract signed with First Step from Ireland.
[79] In the case of Patria Credit, the organization used a senior loan for refinancing its general microloan portfolio and a Progress guarantee for a specific loan programme.

4.4 Structured assessment of financial engineering options

For a structured assessment of the financial engineering options for a centrally managed EU to address the identified investment needs in the European microfinance sector the following aspects were analysed:

- The **investment needs** that the instruments address and the **investment level** on which the instruments operate (e.g. level of portfolios or level of institutions)
- The central **target group** of the instruments (e.g. bank or non-bank MFIs)
- The **uptake** of the instruments **in the ongoing funding period** (e.g. under Progress Microfinance, SMEGF of EIP, JAMSINE/EPPA)
- The **future market demand** for the instruments, both in terms of **number of intermediaries** that are interested in this type of instrument and the **average volume of funding** needed for each deal of the instrument
- The way in which the instruments **use EU resources** (e.g. revolving use or lost funds)
- The potential of the instruments to produce a significant **leverage effect** via attracting co-investors and mobilising additional financial resources in the MFIs and the microfinance sector as a whole.
- The **social impact** of the instruments, with regard to the enhancing of MFIs to reach vulnerable targets groups at the level of final beneficiaries.
- The **influence** of the instruments **on lending conditions** for microloan provision (e.g. interest rate, collateral requirements) [80].
- The **flexibility of terms** of the instruments to make them more accessible for non-bank MFIs with lacking investment readiness.
- The **fit** of the instruments **to the EU Commissions' policy goals** in the field of microfinance

The different aspects need to be analysed in an integrated form to provide a better picture on the different financial engineering options e.g. there may be a trade-off between a high leverage effect and social impact, since bank MFIs with big portfolios offer the highest leverage in terms of investments activated, but provide less social impact as specialized non-bank MFIs that have a limited leverage factor due to their smaller portfolios. The results of the assessment are therefore transferred in a balanced scorecard to deduct recommendations for financial engineering options that are most suited to be included in the new facility (see table 12).

[80] This influence need to be realized without disturbing the market. It is important to acknowledge that a lowering of the interest rates of European MFIs would probably limit the sustainability perspective of these organisations. The latest EMN Overview of the Microfinance Sector showed that the average interest rates of European MFIs are much lower than the levels that are in place in transition or development countries. In the case of collateral requirements for microloans, the situation is different. In some European countries like Poland and Romania commercial banks and also MFIs require high amounts of collateral even for small loan volumes due to regulation issues and general risk management procedures of financial institutions.

Financial instruments for debt funding

Senior loans

Senior loans are addressing the investment need of debt finance for refinancing loan capital. They are investing at the portfolio level of microcredit providers and are accessible for both banks and non-banks MFIs. Senior loans are a standard debt finance instrument that is easy to manage, even for less experienced non-bank MFIs. The placement of senior loans under EPMF was successful, indicating a good fit to market needs. The identified future market demand for this type of instrument is substantial throughout the EU, although there are several alternative options for debt finance available for bank and non-bank MFIs. The average volume of funding needed for this instrument is high, as the portfolios of MFIs are growing throughout Europe, and the leverage effect of senior loans is lower than other more sophisticated financial instruments for investments in portfolios like subordinated loans or risk sharing instruments. The use of EU resources is revolving resulting in ongoing reflows into the originating fund. The social impact of senior loans is limited as the instrument only influences the general on-lending volume of MFIs and not directly supports the outreach to more vulnerable groups of final beneficiaries. The results of the social reporting of the beneficiaries of senior loans under EPMF showed a mixed result. Therefore a low social impact of this instrument can be assessed. The influence of the instrument on the lending conditions to the final beneficiaries must also be rated as low. The conditions of the senior loans under EPMF were market oriented and therefore have no impact on a lowering the interest rates for final beneficiaries or the reduction of the collateral required by the funded MFIs. To improve the social impact of senior loans and their influence on lending conditions stricter eligibility criteria and reporting requirements for the intermediaries have to be in place. This may however limit the uptake of this instrument. The flexibility of terms of senior loans is limited as this is a very straightforward instrument. Taken together a fit to the policy goals of the EU Commission can be stated for this instrument. The leverage effect should be enhanced by flexible management rules for securing additional co-funding at the level of individual deals. As an easy to use instrument that allow a revolving use of EU resources, senior loans can produce a high turnover of deals to support the refinancing of loan capital for microcredit providers on a bigger scale than other instruments.

Subordinated loans/Junior Loans

Subordinated loans are addressing the investment need of debt finance for capital relief to enhance the intermediaries' capital structure and therefore better the conditions for refinancing loan capital. They are investing are targeted at bank MFIs and very mature non-banks MFIs, that need to strengthen their capital base to be able to reach out to microloan costumers. Subordinated loans are a sophisticated financial instrument that demand well developed capital structures on the side of MFIs.

The placement of subordinated loans under EPMF was very limited (only one deal), indicating a missing fit to market needs. From the perspective of the EIF representatives this low number of deals is connected with the unfavorable terms of the subordinated loans under EPMF compared to market standards. In the market, sub-ordinated loans are offered with terms to maturity of 10 years and more to function as an equity capital relief instrument. This is much longer than the terms that can be offered under EPMF. Also the national regulation of subordinated debt in most member states made the allocation of this instrument difficult. National regulators are used to fairly straightforward products and the sub-ordinated loans under EPMF have a lot of clauses they do not understand at first.

The identified future market demand for this type of instrument is growing throughout the EU, as bank MFIs are confronted with rising capital requirements of banking regulations. Additionally, mature non-bank MFIs that are planning to transform into banks will also need this type of investments to secure their lending activities. The average volume of funding needed for this instrument is lower than for senior loans, but higher than other instruments. The leverage effect of subordinated loans is markedly higher than senior loans, but lower

than risk-sharing instruments. The use of EU resources is revolving, although the term to maturity is longer than senior loans and repayment is in most cases designed as a bullet payment at the end of the term.
The social impact of subordinated loans is difficult to assess as the instrument mainly influences the refinancing ability of MFIs. MFIs with a clear focus on microlending can use this for better outreach to micro credit clients. Bank MFIs with a broader range of lending activities may use the instrument for a general improvement of refinancing loan portfolios. The enhancement of the capital base of MFIs can lead to more favorable collateral requirements for final beneficiaries. The flexibility of terms of this instrument is limited as it needs to be designed as a standard instrument to be able to be used by the target group. Given that the design of the instrument is adapted to the needs of MFIs with a clear focus on micro credit provision subordinated loans can be an instrument with a good fit to the goals of the policy goals of the EU Commission.

Financial instruments for risk-sharing

Risk-sharing loans

Risk-sharing loans are an instrument that addresses the investment need of debt funding for refinancing loan capital at the level of portfolios, but combines it with an element of risk-sharing, also at the level of portfolios. Risk-sharing loans target bank MFIs. Risk sharing loans are a sophisticated financial instrument that includes both a senior and a junior position and is only manageable for banks with advanced capacity for handling structured refinancing products. The uptake of risk-sharing loans in the ongoing funding period was low, with only one deal under Progress Microfinance. The future market demands for risk sharing loans is low as advanced banks can use other funding and risk-sharing instruments to engage in microlending activities. The volume of funding that is needed for individual deals is higher than for pure risk-sharing instruments like direct guarantees, due to the funding element of the loans. The instrument has a higher leverage effect as senior loans as the intermediaries need to co-fund up to 50% of the volume of the financed portfolio. The use of EU resources is revolving but some funds are lost, due to the risk element that covers losses that exceed the agreed Subordination Threshold. The social impact of risk sharing loans is higher than that of senior loans, as they include a risk-sharing element to limit losses when riskier groups of final beneficiaries are targeted by the intermediary. The social impact is not as high as that of guarantees which cover first-loss defaults in a portfolio. The influence on lending conditions is also lower, because the risk-sharing element only kicks in if a certain threshold of losses is reached. The flexibility of terms of the loans is very limited due to the sophisticated nature of the instrument. Taken together the instrument of risk sharing loans has a low fit to the goals of the EU Commission in the field of microfinance.

Guarantees (Direct and Counter-Guarantees)

Guarantees for micro credits are an instrument that addresses the investment need for risk-sharing at the level of portfolios. Direct guarantees target as well bank MFIs as non-bank MFIs. Counter guarantees target guarantee institutions. The focus on risk-sharing without a funding element makes the direct guarantees especially useful for MFIs with a strong social focus, but it is also an instrument for more upmarket microcredit providers that want to control the risk involved in enlarging their portfolios. Direct EU backed guarantees are a sophisticated financial instrument that was streamlined by EIF over the past years. It is manageable even for non-bank MFIs with smaller portfolios, although the central mechanisms (esp. the cap amount) need explanation and good communication to be understood. Counter-guarantees are more complicated and rely on the know-how of guarantee institutions. The uptake of micro credit guarantees in the ongoing funding period was very good, with the guarantees under Progress Microfinance being more successful than the guarantees under CIP. Counter-guarantees in the field of microfinance were not placed, mostly due to the lack of guarantee institutions with a focus on microcredit providers. The future market demands for direct guarantees is high with regard to the number of MFIs that need these instruments to share the risk of their portfolios and/or to attract additional funders based on the access to a public guarantee Some MFIs reported that they were successful in attracting funding based on the EPMF guarantee. The market need for counter-guarantees is lower but should be rising as national or regional guarantee institutions engage more in microfinance activities. The volume of funding that is needed for individual deals is lower than for debt instruments or equity instruments, due to the definition of cap amounts. Direct guarantee instruments have a higher leverage effect than debt finance or equity instruments. Counter-guarantees can provide the highest leverage of all instruments assessed. The use of EU resources is not revolving as the funds that are used for the first-loss cap amount of the guarantees are lost if the defaults of the guaranteed portfolio reach the cap rate. The social impact of direct guarantees is high, as they allow MFIs more outreach to vulnerable target groups. The influence on lending conditions is also higher than that of the other instruments assessed as the guarantees allows MFIs to reduce their collateral requirements. The additionality rules of the EU backed guarantee instruments in the ongoing funding period support these effects. For Counter-guarantees these effects are less strong as the additionality takes place at the level of the guarantee institution. The flexibility of terms of guarantee instruments is limited as the main mechanisms of the instrument that allow to control the usage of the Commission's resources (e.g. cap amount, limited inclusion period) needs to be in place to safeguard the positive effects on leverage and social impact. Some flexibility in the conditions could be realized for the new funding period, e.g. the length of the inclusion period. Taken together the instrument of direct guarantees has a high fit to the EU Commission’s goals in the field of microfinance. The Counter-guarantees also fit to the goals but have less direct impact on the microcredit provision of MFIs.

Financial instruments for equity investments in and long-term investments for institutional capacity

Equity investments

Equity investments in the form of direct and indirect equity investments are an instrument that addresses the investment need of long term investments in the equity base of microcredit providers at the level of institutions. Equity investments target bank MFIs as well as non-bank MFIs that are able to issue shares. Direct equity investments are a straightforward instrument if the intermediary has a legal form that allows such investments and is able to provide a forecast of the development of the organisation that can serve as the basis for an exit strategy. In the case of indirect equity investments the requirements on the part of the intermediaries are lower e.g. if they are implemented as convertible loans[81]. The uptake of equity investments in the ongoing funding period was low, with only three equity deals realised in the framework of EPPA. Under EPMF no equity deal was realised. EIF representatives reported that this was and is partly due to the lacking flexibility of the equity instruments under EPMF and the general limits on risk taking in the framework of the market oriented management rules of the funded instruments under EPMF. The future market demands for equity investments in microcredit providers is high as bank and non-bank MFIs are looking for ways to strengthen their equity base to attract additional private funding and to develop their institutional capacity. The volume of funding that is needed for individual deals is higher than for risk-sharing instruments but lower than for debt finance instruments. The funds need to be available on a long-term basis (6 to 8 years). The instrument has a high leverage effect as the investments are always done as a co-investment with other long-term investors. The use of EU resources is revolving in a long-term perspective but some funds may be lost, due to the risk of bankruptcy of the

[81] These are loans that include the option to convert all or a portion of the outstanding principal of the loan into some form of an equity position (at an agreed conversion price) in the borrower's organisation.

institutions. The social impact of equity investments in microcredit providers is difficult to assess because they work at the level of institutions and not of portfolios. It can be expected that they do foster social outreach of the institutions because this instrument provides funds to enhance the resources for capacity building. However, this needs to be safeguarded by additional TA-support/rating and a transparent adherence of the beneficiaries to the Code of Good Conduct. This is also the case regarding the influence on lending conditions. The flexibility of terms of equity investments is higher than for loans or guarantees. This flexibility needs to be used to make this instrument work for a range of MFI types. If this is realised, the instruments have a good fit to the EU Commission's goals in the field of microfinance.

Repayable grants/soft loans

Repayable grants are an instrument that addresses the investment need of long term investments for capacity building at the level of institutions. The instrument targets non-bank MFIs that are not able to issue shares. Repayable grants are a very simple instrument to fund the capacity building strategies of small organisations. These are grants that need to be paid back if the revenues out of the investment funded reach a certain limit. Another instrument that is often used to fund investments in capacity building are soft loans with very low interest rates and long repayment periods. In the ongoing funding period repayable grants or soft loans were not available, although the two loan deals under EPPA were similar. The future market demands for repayable grants is high as MFIs are looking for funding to implement the capacity building activities that were initiated by TA support received under JASMINE and the implementation of the Code of Good Conduct. The volume of funding that is needed for individual deals is lower than for equity investments. The instrument has a low leverage effect as the investments are used for specific capacity building purposes and co-funding is not involved. The used EU funds are lost but some reflows are generated based on the individual deal. The social impact of this instrument is higher than that of equity investments as there is a close integration with capacity building strategies for better social outreach. The influence of lending conditions should be in the lines of the clauses in the Code of Good Conduct. The flexibility of terms of this instrument is very high as they can be tailor-made for each deal. As a complementation to the TA support of the Commission this instrument has a very good fit to the EU Commission's goals in the field of microfinance.

Financial instruments for funding TA support

TA services/Vouchers for TA support by third parties

Financing TA services by third parties for microcredit providers is an instrument to address the investment need for funding TA support at the level of institutions and TA service providers. It targets bank MFIs as well as non-bank MFIs. The uptake in the ongoing funding period was very high with the JASMINE initiative facilitating TA services to X beneficiaries. The future market demand for this instrument will continue to be high in terms of numbers of MFIs, with the sector developing further towards professionalization in Western Europe and transformative developments in the sector in Eastern Europe. The volume of the funding needed in individual deals is very low compared to the other instruments assessed. The instrument does not produce a leverage effect if it is delivered as direct financing of TA services by a third party service provider as in the JASMINE initiative. If it is delivered as a voucher scheme for TA support that require co-financing by the microcredit provider an albeit limited leverage effect is realised. The used EU funds are lost. The social impact of the instrument is high, if the TA support is used to enhance the social outreach of the beneficiary. The same is true for the influence on lending conditions. The fit to the EU Commission's policy goals is high as the funding of TA support is an important instrument to be combined with financial engineering options for capacity building to safeguard the sustainability of the investments made.

Table 12: Assessment of financial engineering options for financial interventions in the European microfinance sector

Addressed investment need	**Level of funding**	**Instrument**	**Target group**	**Uptake in ongoing funding period**	**Future Market demand (number of MFIs)**	**Future Market demand (Volume per deal)**	**Leverage effect**	**Use of resources**	**Social impact**	**Influence on lending conditions**	**Flexibility of terms**	**Fit to EU policy goals**
Debt finance	Portfolios	Senior loan	Bank and Non-bank MFI	High	medium	High	Low	revolving	low	low	Medium	medium
	Institutions	Subordinated loan	Bank and Non-Bank MFIs	Low	medium to high	Medium	medium	revolving	low	Low to medium	low	medium
Funding for risk sharing	Portfolios	Risk sharing loan	Bank MFIs	Low	low	Medium	Low	Revolving/ some losses	Medium	Medium	Low	Low
		Direct guarantee	Bank and Non-bank MFI	High	high	Low to Medium	high	lost	high	high	medium	high
		Counter guarantee	Guarantee Institutions	Low	low to medium	Low	high	lost	medium	medium	Medium	medium
Equity investments and long-term investment capacity building	Institutions	Direct Equity	Bank and Non-bank MFIs	Low	Medium to High	Medium	medium	revolving/ some losses	medium	low	Medium	Medium
		Indirect equity	Bank and Non-bank MFIs	Low	Medium to High	Medium	Low	revolving/ some losses	medium	low	Medium	Medium
		Repayable grant/soft loan	Non-bank MFI	Not available	Medium to High	Low	Low	Lost/some reflow	medium	medium	High	High
Funding for TA support	Institutions/ TA service provider	TA services/ Vouchers	Bank and Non-bank MFIs	High	High	Low	Low	lost	medium	low	/	High

5. Performance measurement & added value

5.1 Performance measurement options

To assess the fit of the financial instruments of a centrally managed funding facility for microfinance in Europe, a suitable system for performance measurement needs to be in place. This system and its implementation have to be in line with the regulation for measuring and evaluating the performance and impact of financial instruments in the framework of EaSI. But it should also reflect and take into consideration the capacity of microcredit providers to report about their lending activity and its social impact on a regular basis.

The standard for performance measurement of Community Funding Programmes like EaSI is to implement a system for results-based management (RBM). A Strategic Framework, developed in collaboration with the Member States and stakeholders, sets out the intervention logic for programme-related expenditure and defines the programme's mandate and its long-term and immediate outcomes. It is supplemented by performance measures which serve to determine the extent to which the programme has delivered the expected results. The Commission then regularly monitors the effect of initiatives that were supported by the programme and considers how they contribute to programme outcomes as defined in the Strategic Framework. The performance measures for the Microcredit and Social Entrepreneurship strand of EaSI will be based on the objectives defined in the most recent proposal for the programme. They include the promotion of employment and social inclusion by increasing the availability of microfinance to vulnerable groups, and micro-enterprises, especially micro-enterprises which employ vulnerable persons. The output of the programme should also reflect an emphasis on gender equality, anti-discrimination and green microfinance (microloans to businesses/start-ups in the green economy). The commissions also defined the build-up of the institutional capacity of microcredit providers as an objective of the programme. Performance indicators to measure this should be based on data at the level of MFIs and how they adhere to the Code of Good Conduct.

Microcredit providers generally need to provide substantial reporting for attracting funding from public and semi-public sources. The global microfinance industry has therefore developed standards for efficient systems to measure the performance of MFIs and also the social impact and return of (semi-) public investments in those MFIs[82]. These standards are often portfolio-oriented and therefore not fully compatible with reporting standards required by the European Commission to measure the impact of EU-backed interventions at the level of each final beneficiary that has benefitted from the intervention. The relevant information on the clients is entered by most MFIs in some form into their MIS in the process of the loan application, but it is difficult for them to produce the detailed reports the Commission requires on a regular basis as they do not need such reports for other purposes.

The performance measurement of the current Progress Facility includes reporting requirements for the intermediaries at the level of financial reporting and social reporting. The financial reporting is in line with standard procedures implemented in many centrally managed financial instruments, including several indicators at portfolio level, e.g. the numbers of loans provided, the portfolio at risk, the default rate. Although it is based on reporting standards for bank intermediaries it is manageable by non-bank MFIs. The social reporting under Progress Microfinance was developed by the Commission and EIF in line with the reporting standards used in the provision of the microfinance window of the SMEG facility under EIP(CIP). It is organised at two levels:

[82] E.g. there are rating standards to measure financial and social performance that were developed by institutions such as PlanetRating or Microfinanza Rating.

- At the level of final beneficiaries
- At the level of the intermediaries

The social performance measurement of Progress Microfinance is a mixture between reporting at the level of individual loans- or final beneficiaries and aggregated data for the total portfolio supported or financed by the Progress Facility. This allows examining the effects of the provision of micro credits for each final beneficiary as well as monitoring and cross-checking the performance of the intermediaries benefiting from the Progress Facility at an aggregated level. The disadvantages are that the procedure involves considerable effort on the side of the MFIs, since the reporting requirements at the level of individual loans differs from the monitoring standards in the sector in terms of the scope of the data that needs to be gathered. Most European MFIs limit their monitoring systems on financial information about their clients rather than including data on the social performance and employment effects of the loan provided. If social performance reporting systems are in place, it is mostly implemented at the level of the portfolio. For the managing authority - EIF in the case of Progress Microfinance- the two-fold approach to reporting means additional work as the data at final beneficiaries' level needs to be aggregated into reports that bring together information at the level of final beneficiaries for measuring the social impact and information at the portfolio level for measuring the financial performance of the intermediaries and the funding provided by Progress. In the case of inconsistencies the EIF needs to contact the MFI for further data. Representatives from EIF and MFIs alike reported that extensive reporting requirements on a loan-to-loan basis may even deter potential beneficiaries from using EU backed financial instruments.

To sum up, the analysis of the performance measurement system of Progress Microfinance indicates a trade-off between reporting efficiency at the level of intermediaries and the managing institution and the need to have disaggregated data on the final beneficiaries and the effect of the individual loans for the legitimating of the policy intervention to promote the microfinance sector and assignment of funds. It is therefore necessary to look at ways to introduce a performance measurement system for the new facility that on the one hand allows for a certain level of aggregation at portfolio level in the standard reporting of intermediaries/MFIs and on the other hand makes sure that the relevant data at the level of final beneficiaries is collected by the MFIs in a way that allows a retrieval by the Commission if the data is needed for reporting to the parliament or the documentation of the eligibility of the loan deals provided. Such a system should build on the experience of the social and financial reporting in the framework of Progress Microfinance and needs to be in line with the standards of the reporting clauses featured in European European Code of Good Conduct of Microcredit Provision.

The European Code of Good Conduct of Microcredit Provision[83] is now fully in force since the successful conducted pilot phase (until the end of 2012) and the currently introduced implementation methodology, e.g. including a self-assessment tool before the start of the implementation. The Code promises to be the future quality standard of the microcredit sector in Europe.

The Code includes a chapter or respectively several clauses, which has to be fulfilled under the code, on reporting standards (Chapter 4) for non-bank MFIs. The reporting requirements are distinguished by financial, social and disclosure standards. Both, the financial and social standards are portfolio-based indicators, e.g. financial indicators, such as Portfolio at Risk (30 or 45 days) or operational sustainability ratio, and social indicators, such as average disbursed loan size or percentage of ethnic minority or indigenous customers if relevant for target market and mission.

Therefore, we propose for the new Progress Facility that the intermediaries, i.e. the benefiting MFIs, are required to report aggregated data on the social performance of their

[83] See http://ec.europa.eu/regional_policy/thefunds/doc/ code_bonne_conduite_en.pdf.

portfolios on a regular basis. For this they should be required to collect data at the final beneficiaries' level, store it and make it accessible by request to the managing institution of the facility, the European Commission and contracted service providers e.g. evaluators for ex-post evaluations of the program or for selected reports.
Performance indicators should include:

a) Financial performance (at the level of intermediaries/MFIs)
- Number of loans provided
- Average volume of loans provided
- Portfolio at Risk
- Annual default rate

b) Social performance at the level of the client:
- socio-demographic information (age, sex, educational level, ethnicity)
- employment status before loan provision

c) Social performance at the level of the business financed:
- Sector, size and age of business
- Number of jobs that were created (including entrepreneur)
- Number of jobs that were secured (including entrepreneur)
- Employees' share of women, ethnic minorities/migrants, disabled persons

Furthermore, we propose that the social performance indicators are synchronized and adjusted to the requested indicators on the portfolio level under the European Code of Good Conduct of Microcredit Provision. This has two major gains: (1) it supports the standardization of the social performance measurement in the microfinance sector and (2) the data can be added into the JASMINE Online system and published to selected stakeholders, like the Commission, on a permanent basis or in the long run for the wider public, like at the MIX Market.

5.2 Added value of a centrally managed EU backed funding facility

To provide substantial added value in the funding market for microfinance a centrally managed EU funding facility needs to fit into the existing framework(s) for funding microcredit providers in Europe including national/regional schemes. It should be able to employ the comparative strengths of EU funding in microfinance e.g. the level of risk taking or the long-term investment horizon for initiating integrated funding and support packages that allow MFIs to develop sustainable and scalable funding models. On the one hand, EU funded instruments should not replace existent public funding at national or regional level. On the other hand there is the need for a better cooperation with publicly funded instruments to make more efficient use of the resources used to fund these instruments. The facility should also integrate the different strands of centrally managed microfinance support at the EU level to be able to act as a one-stop entry point for MFIs looking for EU support in funding and capacity building/TA. There is a need for integration with activities under EaSI e.g. the new facility for supporting social enterprises under EaSI and with activities that are located in different DGs of the Commission.
For COSME, the follow up programme to CIP, managed by DG Enterprise and for the upcoming TA-Platform, managed by the EIB group some preliminary options for integration are already available[84].

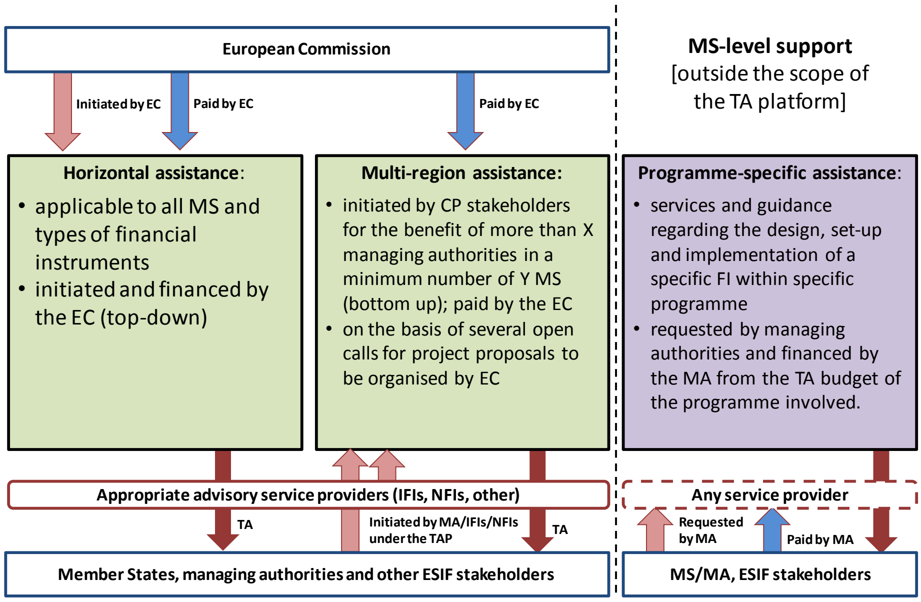
The **COSME** programme will not feature a dedicated microfinance window like CIP. In principle, the guarantees under COSME could be used to cover microloans as the Loan Guarantee Facility will cover loans up to EUR 150 000 and will be available for loans to all types of SMEs. But other than under CIP the available cap rates for the guarantees will be modeled on the needs of financial intermediaries active in SME lending rather than

[84] Detailed information on the design of the social enterprise facility was not available before finalising this report.

microlending. Also it can be suspected that the specific eligibility criteria under COSME will be chosen in a way to differentiate the offer from the microfinance offer under EaSI. DG Enterprise has signaled on some occasions that microfinance operations will not be adressed by them in the future. This might be based on the verdicts of the evaluation reports of the EIP, that the microfinance support under CIP should be revised as it is socially oriented and does not fit to the competitiveness and innovation focus of the programme. For the new facility under EaSI this means that a clear differentiation between the target group of COSME and of the new facility is important, since for financial intermediaries that have a strong focus on SME lending and supporting innovative start-ups the usage of COSME could be better fitted than the new facility for microfinance.

The upcoming **TA Platform** for financial instruments (FIs) under the European Structural and Investment funds (ESIF), managed by DG Regio.
The platform is planned to address TA needs at the level of member states, managing authorities and other ESIF stakeholders for designing, setting-up and implementing FIs in cohesion policy. The support will be delivered as horizontal assistance that is applicable to all member states and types of financial instruments and as multi-regional assistance that include support for the development of FIs targeting development objectives or market failures that are shared by a number of regions. (see graphic)

Figure 11: Overview of the planned TA Platform



Source:http://ec.europa.eu/regional_policy/what/future/pdf/preparation/4_presentation_technical_assistance_platform.pptx

For the horizontal assistance the EIB group was awarded with a single multi-annual service contract to provide activities that would typically include the exchange of best practice and the networking across MS, as well as trainings or guidance on common themes such as ex-ante assessments, public procurement, regulatory aspects concerning cohesion policy, possibly State aid, etc. The EIB group may subcontract service providers for these activities.
The JASMINE activity will most probably be included into the horizontal assistance strand of the new TA platform, although it is yet unclear in which way the specific microfinance activities, including direct TA support to microcredit providers and the implementation of the Code of Good Conduct will be continued.
To safeguard the added value of the new facility it is important to integrate its TA-strand with the offer of DG Regio to provide integrated sector wide support services to microcredit providers and other stakeholders in the European microfinance sector. These should include direct TA services for institutional capacity building in MFIs (based on the Code of Good Conduct) as well as exchange and networking options to distribute policy learnings and

good practices in financial engineering for microfinance and inclusive entrepreneurship. The access to these support activities should be managed by an institution that acts in the framework of the multi-annual service contract of the EIB group. It seems advisable to include the European microfinance networks, EMN and MFC in the provision of the direct TA-support to MFIs and to use JASMINE Online as an online database to facilitate policy exchange on microfinance as a financial instrument under ESIF.

The cooperation of the facility with the new TA platform of DG Regio is closely connected to a further integration with existing public funding structures at the national/regional level. Under Progress Microfinance, the integration of EPMF funding and structural funds schemes to increase the added value of the facility was not successful. This is connected to the limited knowledge of the options available for combining financial instruments of a centrally managed facility with national/regional schemes that use EU structural funds for supporting microfinance. Both the managing institution of the facility and the managing authorities responsible for ESIF schemes need to have better insight into the added value that can be generated when the funding offers at EU and national/regional level complement rather than exclude each other. The options for such a complementary use of centrally managed and national/regional funding offers can be based on two general types of ESIF schemes that provide funds for microfinance:

Direct investments into microfinance

Microcredit is not a completely new area of intervention of cohesion policy, including direct funding support, e.g. the Community Initiative of EQUAL. In the period of 2007-2013, there are several direct investment schemes into microfinance that are set up in the national/regional framework of using EU structural funds[85]. Some examples are:

- Hungary, ERDF-Funds under JEREMIE: "Széchenyi Kombinált Mikrohitel" with 85 m EUR loan capital for microcredits up to 17,200 EUR.
- Germany, ESF-Funds: "Mikrokreditfonds Deutschland", 100 m EUR guarantee funds that provides additional funding for capacity building of MFIs.
- Lithuania, ERDF-Funds under JEREMIE: „Entrepreneurship Promotion Fund", 15.5 m EUR loan capital.
- Spain, ERDF-Funds under JEREMIE: "Microcredit Initiative", 10 m EUR loan capital.
- In Italy eight regional microcredit schemes were implemented under ESF for the ongoing funding period 2007-2013 with a total volume of 173.5 m EUR86.

The introduction of JEREMIE in 2007, which facilitates the use of ERDF-funds to promote the use of financial engineering instruments and improve access to finance for SMEs, generally boosted the inflow of EU structural funds into the European microfinance sector. Individual microcredit providers can benefit from these schemes to refinance their loan capital at favourable terms. For example, a regional JEREMIE fund in France, in Languedoc-Roussillon region, includes 7 m EUR for microcredit and is used by Adie. Another case is Poland, where the FM Bank uses 20 m EUR out of a regional JEREMIE fund to issue microloans.
These examples show that Structural Funds schemes play a growing role to directly finance microcredit provider on the national or regional level in different countries. The funding offered is loan capital in most cases to be used instead of debt finance to refinance loan portfolios. This type of funding would benefit from a guarantee for risk sharing by the centrally managed facility or even an equity investment to develop the institutional capacity of the MFIs using the structural funds scheme. The experience of the German ESF based guarantee fund shows that capacity building of MFIs with national resources is a tedious task and difficult to realise if the funds are also used for guaranteeing defaults of the MFIs. To produce investments into microfinance that include centrally managed funds as well as EU structural funds resources, there needs to be a clear communication between managing institution and managing authorities. The planned off-the-shelf blueprints for financial instruments should motivate managing authorities that are interested in implementing a

[85] See Lopriore, Marco and Diana Pati (2012): Microcredit and EU Cohesion Policy, EIPA Maastricht.
[86] See ibid.

direct funding scheme for microcredit provision to contact the new facility and to assess options for cooperation. The fund structure of the new facility should also be open to act as holding fund for MAs that want to implement a revolving fund for microfinance but do not have the know-how and personal resources to do it on their own..

Schemes for funding additional services to microloan clients

Besides direct funding for microfinance there are also schemes to fund additional services to microloan clients with ESF resources. A good example is the CréaJeunes programme in France. It is composed of three elements:

- An upstream assistance from 2 to 6 months to help the youth to prepare their project, primarily set up by voluntary workers, with the support of external partners,
- An 18-month average post-creation assistance,
- The possibility of obtaining financing by:
    - a microcredit by Adie, a banking loan on trust or a refundable advance by the State.
    - a € 1000 maximum allowance if there is no subsidy for company creation for the young at local level;

ESF schemes that offer support services to microentrepreneurs and excluded people that want to start their business can cover an important gap in the funding market for microcredit providers: the access to funding for offering BDS or other supportive services to their clients. Many MFIs need such funding to be able to reach out to very vulnerable persons and develop them into microloan clients. As a centrally managed facility cannot offer such funding it is important that more MA discover how to design their ESF funded BDS schemes in a way that microcredit provider can use them. Although these schemes do not have a revolving character the use of funds has an added value if a microcredit provider uses a financial instrument from the new centrally managed facility to enlarge its lending activity to beneficiaries of the ESF scheme. This could also be facilitated via the new TA platform.

6. Recommendations for a new financial instrument

6.1 General conclusions and recommendations

The analysis of imperfections in the area of microfinance in Europe and of options how to address them through an EU financial instrument has produced the following main results:

- The ongoing crisis in several EU member states with high levels of youth unemployment calls for **ongoing support of inclusive entrepreneurship as an option to (re-) enter the labour market**. Microloan provision is an important tool for this.
- In most European countries a **significant market gap in the provision of microloans** to persons using self-employment as a way out of social and financial exclusion can be identified. Based on estimations the total gap in EU-28 member states and selected EFTA countries amounts to 2,7 bn EUR.
- Microfinance providers in Europe need **additional external funding** to be able to close this gap via an extension of their loan providing activity.
- The **main funding needs** of both bank and non-bank MFIs exist at the level of **debt finance and finance for risk sharing** to develop inclusive portfolios of microloans and, especially for non-bank MFIs, at the level of **equity or equity-like investments** to strengthen and develop the capacity of their organisational models for microlending.
- It seems unlikely that the identified funding needs of microfinance providers will be covered by private sources or public/semi-public sources at the national or regional level. Therefore a rational for **a centrally managed facility for EU backed investments into microfinance portfolios and organisations** exists.

For the set-up of such a facility in the framework of EaSI the following **general conclusions and recommendations** can be deducted from the analysis:

a) A continuation of Progress Microfinance in the framework of EaSI is well advised. The Progress Microfinance facility has established itself in the European microcredit sector, although the efficiency and effectiveness of the individual financing instruments need to be improved for the new facility.

b) There is a need to adapt the established instruments of EU level funding for microcredit providers to the identified needs in the sector. For this the following issues should be taken into account:

- The **funding needs of the sector change** due to a maturing of providers in Western Europe and a change in the funding framework for providers in Eastern Europe.
- There are **different funding needs of MFI** depending on their **life cycle stage**. Greenfield microfinance activities in countries without established microcredit providers need other instruments to reach market impact than mature MFIs that want to turn into a back.
- The level of demand for **debt finance** will increase on a general level. The individual ticket sizes in demand can be expected to increase as well as accessible debt funding is suspected to be in higher demand from the bigger Eastern European MFIs in the future.
- **Risk-sharing instruments** will continue to be in strong demand, especially from greenfield non-bank MFIs . The outreach and leverage of the instruments should be widened via deals with national guarantee schemes for microfinance that have been set up in the past years.
- It is important to improve the usability and outreach of EU backed **equity or equity-like investments**, as they are strongly demanded by non-bank MFIs throughout the

sector. Greenfield non-bank MFIs should be allowed to combine these investments with debt or risk-sharing instruments. More mature MFIs in Eastern Europe will need equity investments that fit to their national regulation.

c) An integration of the different support activities for microfinance by DG Employment, DG Regio and DG Enterprise is necessary. This is connected to the following findings of the analysis:

- With the SMEGF microfinance window closed under COSME and the future of JASMINE still unclear, the sector needs EU backed microfinance support to be mainstreamed.
- The different financial instruments available at EU level each fit a specific demand in direct funding or TA support but need to be integrated to produce the added value that is needed to better the situation for the final beneficiaries.
- In order to fit the new programme to other EU policy measures in microfinance, like regulation and other connected policy fields like (social) entrepreneurship and active labour market policies it needs to be aligned to existing support activities like JASMINE.
- An integrated approach to microfinance should be based on an improved/revised EU definition of micro credit, reflecting the development of the sector since 2003 regarding average volumes, the role of "personal microloans" and the importance of delivery models.

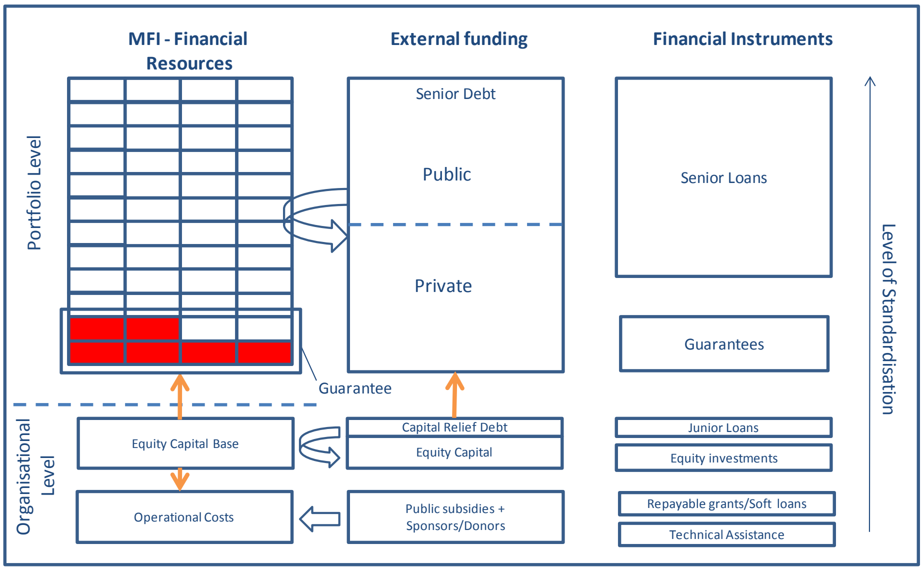
The EaSI programme provides a good framework for a centrally managed programme that is able to address most of the issues raised by this analysis. Based on the findings of the market analysis and the assessment of the available financial engineering options the following **recommendations about the setup of such a programme** are made.

6.2 Proposed structure for a MF programme in the framework of EaSI:

The analysis of financial engineering options showed that a specific set of financial instruments is suited best to realise the Commissions' goals in closing the observed market gaps for external funding for microfinance providers and ultimately widen the supply for microloans throughout Europe. The following overview illustrates how these instruments match the external funding structure of MFIs at the level of their portfolios and their organisational structure[87].

[87] Reading help: The red part of the MFI's portfolio indicates the share of microloans that are defaulting.

Figure 12: Overview of matching of financial instruments to MFI's funding structure



The level of standardisation that can be realised in the different financial instruments is highest in the case of senior loans and lowest in the case of equity investments and repayable grants as the use of these instruments depends on the individual organisational form of the MFI.

To operate the proposed instruments in a straightforward way and fit to the structure of the budget available for microfinance under EaSI, this study proposes to setup a centrally managed funding programme that consists of two integrated elements.

1) A **Financing facility** consisting of three pillars with the following financial instruments.

Pillar 1: Debt finance for supporting loan portfolios

- Senior loan for both bank and non-bank MFIs
- Junior loan for bank MFIs

Pillar 2: Risk sharing for supporting loan portfolios

- Direct guarantee for both bank and non-bank MFIs
- Indirect guarantee for micro credit guarantee institutions

Pillar 3: Equity and equity-like investments for developing microfinance organisations and models

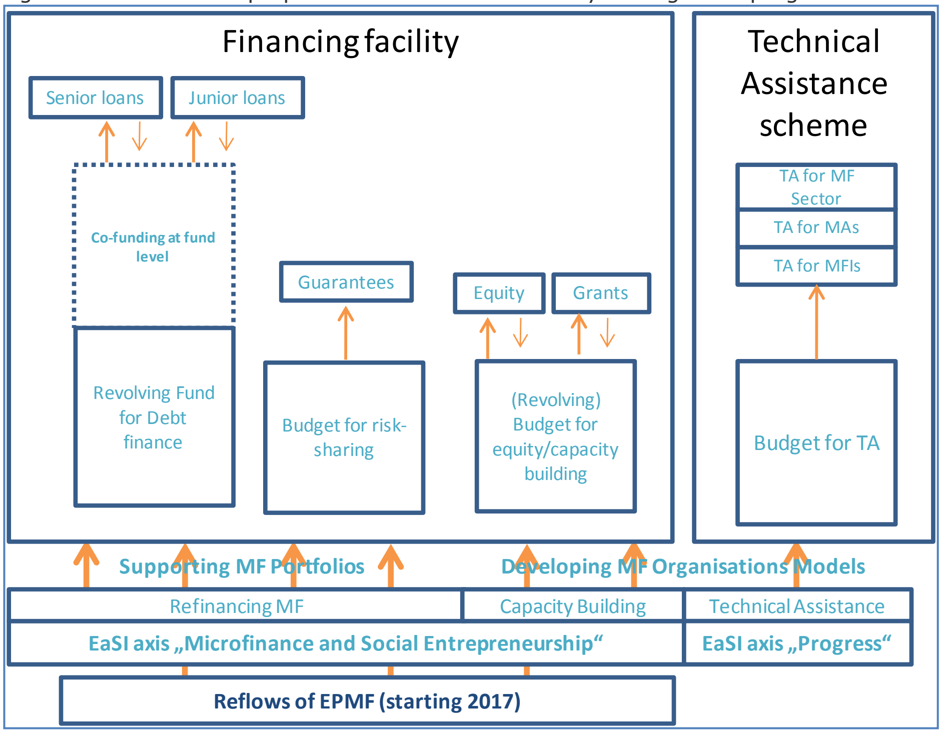
- Direct equity investments for non-bank MFIs
- Indirect equity investments for non-bank MFIs
- Repayable grants for non-bank MFIs

The budget allocation to these pillars should be fitted to the needs in the sector with an emphasis on the possibility to attract additional resources, either at the level of co-funding for a revolving fund or the level of co-financing individual deals. The budget earmarked for capacity building in microfinance under the third axis of EaSI should be used to kick-off the third pillar. If the performance of the equity/equity-like investments call for more budget the reflows from EPMF should be used. The combination of using an instrument from the equity pillar and using an instrument form the debt or the risk-sharing pillar should be allowed.

2) A **Technical Assistance scheme** for developing the capacity building and TA infrastructure of the microfinance sector as part of the upcoming TA-Platform for Financial Instruments. This scheme needs to be integrated closely with the ongoing work of DG Regio in the field of microfinance (JASMINE, Code of Good Conduct) and with national/regional actors and initiatives that use EU Structural Funds.

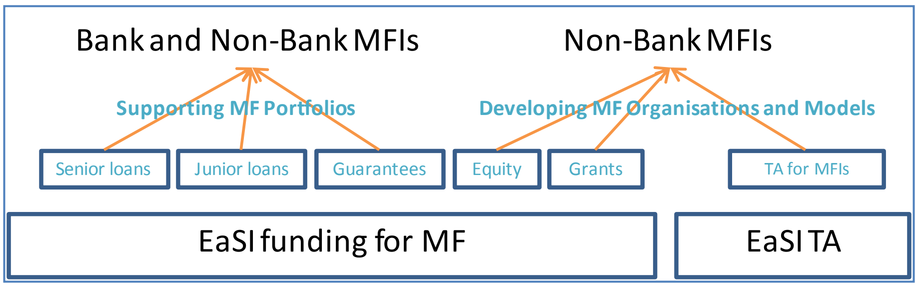
The following overview illustrates the proposed structure of the programme and how it builds on the budgetary structure of EaSI.

Figure 13:Overview of proposed structure of a centrally managed EU programme



The general **target group** of the programme should be MFIs (with the exception of counter-guarantees that target guarantee institutions) which provide microloans to the final beneficiaries. The financial instruments to support microloan portfolios should target bank MFIs as well as non-bank MFIs, while the instruments to develop microfinance organisations and models should target only non-bank MFIs.

Figure 14: Target groups of the financial instruments



All intermediaries must have signed up to the Code of Good Conduct, or in the case of bank MFIs endorse it to be eligible for using the financial instruments of the debt and risk-sharing pillar of the financial facility. In the case of the equity pillar a different regulation should be in place. Non-bank MFIs that have not yet signed up to the Code should be allowed to apply for repayable grants to support their implementation of the Code. Additional TA-support should be available to support them in this regard.

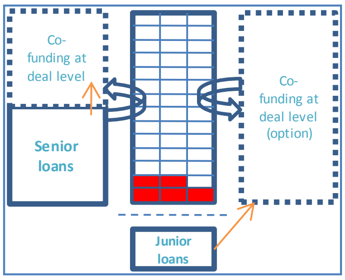
Financing facility

Total budget: Around 90m EUR available under the third axis of EaSI: "Microfinance and Social Entrepreneurship".

The facility should be organised in **three pillars** with separate budgets that offer the financial instruments of the facility. The financial instruments offered in the three pillars differ with regard to their level of standardisation, the level of financial return that can be realised in the market and their target groups.

Debt instruments including senior loans and junior subordinated loans are highly standardised instruments that offer a stable amount of financial return in the form of interest earnings and target as well non-bank as bank MFIs. The use of the assigned EU funds is revolving. The provision of these instruments should be organised as a revolving fund managed by a managing institution that follows straightforward, market oriented managing rules. Co-funding should be involved both at fund and at deal level.

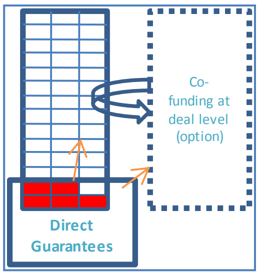
Figure 15: Overview of co-funding options in senior and junior loan deals



The placement of deals should follow a distribution plan with maximum country quotas regarding the volume of debt assigned. If possible, the quotas should reflect on the current market gap for microloans in the countries. In countries with many active micro credit providers a maximum ticket size for loans by bank MFIs should be defined to minimise the risk of using up the available funds in big volume individual deals.

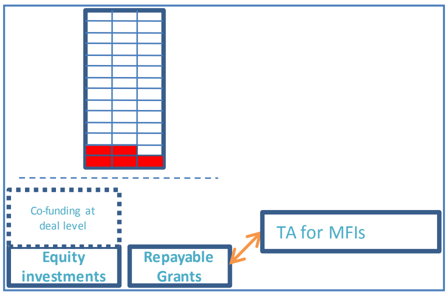
Risk sharing instruments include direct and indirect (counter) guarantees. These instruments are standardised instruments that offer no financial return. Direct guarantees are targeted both at non-bank as well as bank MFIs, indirect (counter) guarantees are targeted on guarantee institutions active in the field of microfinance. The use of the assigned EU funds is not revolving (lost funds). The provision of these instruments needs to be organised by a dedicated managing institution that receives a fixed budget to be spent in a given time period. Guarantees always involve a leverage effect at deal level as they cover only a limited part of an already refinanced portfolio. Co-funding at deal level is an option, if MFIs attract additional debt finance on the basis of the reduced risk exposure of their portfolios. Because of the non-revolving usage of the funds, strict country quotas need to be in place to ensure EU wide coverage.

Figure 16: Overview of co-funding in direct guarantee deals



Equity and equity-like investments for capacity building include equity investments (direct and indirect) and repayable grants. These instruments are less standardised than the other financial instruments offered by the facility and need flexibility on the part of the conditions and in-depth knowledge of the financed MFIs on the part of the managing institution to work properly. Other than debt instruments they can produce some financial return, depending on the specific conditions of each deal but not necessarily so. In the case of direct equity investments the potential return depends on the exit strategy chosen in accordance with additional co-investors. Indirect equity investments can be offered in the form of convertible loans that produce a financial return via interest earnings and optional via exit gains. Repayable grants for capacity building feature conditions that allow some financial return, but focus on enabling the MFI to repay the granted funds. Due to the risk involved in these kinds of investments the use of the EU funds assigned to this pillar is lost but with options for reflows in the longer term. The budget should therefore be organised as a fund but only with limited managing overhead procedures. Investments in this pillar need to be integrated closely with the TA scheme of the programme. This includes direct TA-support for MFIs in preparation or after an equity investment. Repayable grants could be linked to investments in the course of adjusting the organisational capacity to the standards of the Code of Good Conduct. In the case of the equity pillar MFIs that have not yet signed up to the Code should be allowed to apply for repayable grants to support their implementation of the Code. Additional TA-support should be available to support them in this regard.

Figure 17: Co-funding and TA support in equity/equity-like investments



At the start of the programme the funds assigned to the pillar should be limited to the budget available for capacity building under the third axis of EaSI. If the deployment of deals develops well, additional funds should be assigned from the reflows of the EPMF facility. Country quotas need to be in place, but should be handled flexible in the starting phase of the programme (first two years) to allow the managing institution a selection of suitable candidates for good investments.

Overview structure direct funding facility

	Pillar 1: Debt finance for supporting microloan portfolios	**Pillar 2: Risk sharing for supporting microloan portfolios**	**Pillar 3: Equity and equity-like investments for developing microfinance organisations and models**
Organisational form:	Revolving Fund, managed by a managing institution	Fixed Budget, managed by a managing institution	(Revolving) Fund, managed by a managing institutions with experience in equity deals in the field of microfinance
Budget:	• 50m EUR of budget assigned to third axis of EaSI, additional co-funding at funds level. Commission's part is first-loss piece. Additional funds from EPMF reflows 2016+	30m EUR of budget assigned to third axis of EaSI.	9m EUR of budget assigned to third axis of EaSI earmarked for capacity building. Additional funds from EPMF reflows 2016+.
Investment goals:	• Improve the access to debt finance for refinancing microloan portfolios • Leverage additional private co-funding for microloan portfolios	• Risk-sharing for microloan portfolios to widen outreach, especially to vulnerable target groups • Leveraging additional private co-funding based on first-loss risk sharing	• Improving the institutional capacity of individual non-bank MFIs and enhance their 'investment-readiness' • Strengthening the equity base of non-bank MFIs to support their lending activities in the long term
Target group	Bank and Non-bank MFIs	Bank and Non-bank MFIs, Guarantee institutions	Non-Bank MFIs
Financial instruments:	Senior loan, Junior loan	Direct Guarantee, Counter Guarantee	Equity Investments (Direct and Indirect), Repayable Grants
Main changes to instruments compared to EPMF:	**Senior loans** maturities of up to six years **Junior loans** based on subordinated loans under EPMF. Maturities of up to ten years	**Direct Guarantee:** The maximum inclusion period should be prolonged to four years. **Counter Guarantees:** Longer inclusion period and cooperation with national guarantee instrument	**Equity investment:** Flexibilisation of terms of investment, higher risk taken, option to invest in the form of indirect equity (convertible loans, preferred shares) to reach MFIs that cannot issue shares
Descriptions of new instruments:			**Repayable grant:** Modelled on the experience of EPPA instrument. Repayment (bullet or in rates) due if returns on investment reach a defined limit. Close link with TA support

Technical Assistance scheme for sector support

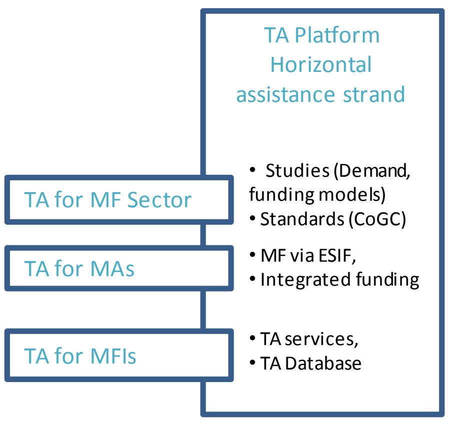
Organisational structure: Scheme managed by a contracted service provider and integrated in existing TA-structures like JASMINE Online, the Code of Good Conduct

Budget: 9m EUR available under the Progress axis of EaSI. These funds should be treated as lost funds.

Investment goals:

- TA for Microfinance Sector: Improving and safeguarding standards of transparency, rating, performance measurement in the sector. e.g. through the further development and implementation of the EU Code of Good Conduct. The sector support activities introduced in the framework of JASMINE, e.g. the online platform JASMINE-Online and the JASMINE Helpdesk should be continued.
- Initiating more and better studies on demand of microloans and best practice exchange on successful funding models of European MFIs
- TA for Managing Authorities (MAs): Developing integrated investment strategies to support microfinance at EU, national and regional level, e.g. through blueprints for integrating EU structural funds schemes with financial instruments of the direct funding facility
- TA for MFIs: Further improving the access of MFIs to high quality TA services, e.g. through the setup of an EU-wide database for consultants/experts that provide TA to MFIs. Consultants can be subsidized through vouchers (covering up to 80% of consultants' fees). Non-bank MFIs should be able to use TA support for the preparation of an application for the instruments of the financial facility.

Figure 18: Overview of the different levels of the TA-Scheme



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