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Private Sector Financing In The Eastern Partnership Countries And The Role Of Risk-bearing Instruments

Synthesis Report

November 2013

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Business & Finance Consulting

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EPTATF VISIBILITY

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DISCLAIMER

"The authors take full responsibility for the contents of this report. The opinions expressed do not necessarily reflect the view of the European Investment Bank. "

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List of acronyms used in this report

ADB	Asian Development Bank
AIC	Azerbaijan Investment Company
BFC	Business & Finance Consulting
BSTDB	Black Sea Trade and Development Bank
BY	Belorussia
CAR	Capital adequacy ratio
CGF	Caucasus Growth Fund
CIIC	Caspian International Investment Company
CIS	Commonwealth of Independent States
CPI	Consumer price index
DFI	Development Finance Institution
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
EE	Eastern Europe
EP	Eastern Partnership
ENCA	Eastern Neighbours and Central Asia
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
HQ	Headquarters
IFC	International Finance Corporation
IT	Information technology
KfW	Kreditanstalt fur Wiederaufbau
LC	Letter of credit
MAIB	Moldova Agroindbank
MD	Moldova
MFI	Microfinance Institution
MIS	Management information system
MSE	Micro and small enterprise
MSME	Micro, Small and Medium Enterprise
NPL	Non-performing loan
PE	Private equity
PPP	Purchasing power parity
SEAF	Small Enterprise Assistance Funds
SME	Small and Medium Enterprise
TA	Technical assistance
UA	Ukraine
VAT	Value added tax
VC	Venture capital
WB	World Bank

ABOUT THIS REPORT

This report is one of a series of reports produced by Business & Finance Consulting GmbH (BFC) for European Investment Bank (EIB) as part of the project "Private Sector Financing In The Eastern Partnership Countries And The Role Of Risk-bearing Instruments." The series of reports includes individual country reports on Armenia, Azerbaijan, Georgia, Moldova, and Ukraine, as well as a synthesis report which considers the results from all five countries. The purpose of the project is to assess the financing needs of SMEs in the Eastern Partnership countries and identify market failures that prevent the development of the SME sector.

The project was carried out from June 3, 2013 to November 1, 2013 by a team of four experts from BFC. Onsite visits were conducted for each country in order to meet with representatives from financial institutions, development institutions, the government, and other relevant actors who can comment on the SME sector and its access to finance.

1. DEMAND ANALYSIS

Conclusion:
SME demand conditions are generally favourable in the Eastern Partnership countries, although economic slowdowns in Ukraine, Georgia, and Moldova are currently negatively affecting demand, particularly in Ukraine.

Key findings:
- *The number of MSMEs according to official statistics are 132,923 in Armenia, 224,830 in Azerbaijan, 48,100 in Georgia, 49,444 in Moldova, and 364,237 in Ukraine.*
- *Wide differences in the definitions of SMEs and in the methodology for gathering official data complicate the process of statistical analysis.*
- *Trade is the dominant sector, accounting for the greatest proportion of enterprises in all five countries.*
- *All countries demonstrate a high concentration of MSME activity in the capital city except Ukraine, where there is a greater distribution throughout the regions.*
- *With the exception of Georgia, all countries tend to rank poorly in terms of trading across borders, paying taxes, and getting electricity. All five countries need further improvement in terms of resolving insolvency.*
- *Loans account for the vast majority of demand for finance among SMEs in all five countries. Demand for leases, unfunded trade finance products such as letters of credit and guarantees, and risk capital is low by comparison.*

1.1 Number of MSMEs

The number of MSMEs according to official statistics range from a low of 48,100 in Georgia to a high of 364,237 in Ukraine. Relative to the total population, there is a very wide discrepancy between countries. Armenia has the highest "density" of MSMEs, at 44.3 per 1,000 population, while Ukraine has the lowest, at 8.0.

Number of MSMEs and SMEs

	Armenia	**Azerbaijan** (MSE only)	**Georgia**	**Moldova**	**Ukraine**
MSMEs	132,923	224,830	48,100	49,444	364,237
SMEs	33,990	n/a	n/a	11,108	77,776
Population (millions)	3.0	9.4	4.5	3.6	45.6
MSMEs per 1,000 pop.	44.3	23.9	11.4	13.7	8.0
Data year	2009	2011	June 2013	2012	2012

Azerbaijan does not count the number of medium enterprises, so only the number of MSEs is shown. For Georgia and Moldova, the number of active enterprises is shown, while for Armenia, Azerbaijan, and Ukraine, the number of registered enterprises is shown. The number of registered enterprises can be much higher than the number of active enterprises. The data for Moldova only counts active legal enterprises which submit financial reports. There are also 65,381 registered sole proprietorships which are not required to submit financial statements.

1.2 Definition

There is a wide variety of definitions of SMEs applied among the countries and even within each country. The upper limit for SMEs – that is, the boundary between medium and large enterprises –

used by the government statistical agencies which track SME activity are shown in the table below. Azerbaijan has no official definition of medium enterprises, so the upper limit for small enterprises is shown.

Government definition of SME – upper limit

	Armenia	Azerbaijan (small)	Georgia	Moldova	Ukraine	European Union
Employees	250[1]	Industry: 50 Agriculture: 25 Trade: 15 Other: 10	100	250	50	250
Turnover (EUR)	3 million	Industry: 490k Agriculture: 245k Trade: 980k Other: 245k	690,000	3 million	50 million	50 million
Assets	2 million	n/a	n/a	3 million	n/a	43 million

In terms of the number of employees, the upper boundary for SMEs ranges from a low of 50 in Ukraine to a high of 250 in Armenia and Moldova. By turnover, there is a wide range from a low of EUR 685,000 in Georgia to a high of EUR 50 million in Ukraine. Only Armenia and Moldova use total assets as a criterion in the definition.

The differences in the upper limits probably do not make a large difference in the calculation of the number of MSMEs, since there are relatively few institutions near the upper limit (by number, most are microenterprises). However, there are differences in the way that microenterprises are counted, which do significantly affect the calculation of the number of MSMEs. Naturally, unregistered enterprises are not included in the statistics, so the figures are greatly affected by the size of the informal sector in each country. Small farming households, even if they are registered in some way, are also usually excluded, since many of them may be engaged primarily in subsistence farming.

In all five countries, financial institutions do not use the government definition to segment their customers. Most financial institutions use loan amount to segment the market, although some use employees, turnover or assets.

1.3 Contribution to the economy

According to government statistics, the contribution of MSMEs to employment ranges from 40.9% in Georgia to 67.6% in Ukraine. By contribution to GDP or turnover, Georgia is likewise the lowest (at 17.4%), and Ukraine remains the highest at 57.9%. For three of the five countries (Georgia, Moldova and Ukraine), the contribution to output/turnover is noticeably lower than the contribution to employment, whereas for Armenia and Azerbaijan the contribution is at a comparable level.

Contribution of MSMEs and SMEs to employment and GDP (or turnover or value added)

		Armenia	Azerbaijan (MSE only)	Georgia	Moldova	Ukraine	EU[2]
Employment	MSME	42.2%	7.4%	40.9%	57.7%	67.6%	67.4%
	SME	32.6%	n/a	n/a	40.3%	57.3%	37.8%
GDP, turnover, or value added	MSME	42.5%	8.7%	17.4%	34.5%	57.9%	58.1%
	SME	32.1%	n/a	n/a	29.9%	52.9%	36.9%

[1] Until 2011 the limit in Armenia was 100 for production, 50 for construction, engineering, science, and education, and 30 for transport, trade and services. The statistics on number of SMEs is based on this older definition – an SME census based on the new definition has not been completed.

[2] Source: ECORYS and European Commission. *EU SMEs in 2012: At the Crossroads*. September 2012.

The results are difficult to compare, since each country applies different definitions of MSMEs. The higher ratio in Ukraine, for example, may be explained by the fact that the upper boundary for turnover of SMEs, at EUR 50 million, is many times higher than the upper boundary in other countries. Similarly, the fact that Georgia ranks last by contribution to employment and turnover may be explained by the fact that Georgia's SME definition has the lowest number of employees and turnover.

Ukraine is noteworthy for the extremely high contribution of medium enterprises, which alone account for 41.0% of employment and 42.0% of turnover. The micro and small enterprise sector in Ukraine is quite limited by comparison. This may be partly explained by the new tax law in Ukraine, which is particularly burdensome for the smallest enterprises and has caused many MSEs to move to the informal sector or shut down entirely.

Azerbaijan is a special case, since the government does not track the share of medium enterprises. Nevertheless, the contribution of micro and small enterprises is quite low, and it can be assumed that, if data for medium enterprises were available and added, Azerbaijan would still have the lowest ratios among the five countries. If correct, this result would be logical, since Azerbaijan's economy is dominated by the oil sector, in which nearly all the participants are large enterprises.

1.4 Characteristics of MSMEs

1.4.1 Sector

Trade is the dominant sector among MSMEs, both in terms of the number of enterprises and total output or turnover. The share of trading enterprises in the total number of MSMEs ranges from a low of 28.2% in Ukraine to a high of 69.8% in Azerbaijan.

Sector analysis: number of MSMEs and output (or turnover) by sector

	Armenia	Azerbaijan (MSE only)		Georgia		Moldova		Ukraine	
		#	Output	#	Output	#	Output	#	Output
Trade[3]	n/a	69.8%	38.2%	37.8%	n/a	40.5%	49.7%	28.2%	49.2%
Manufacturing	n/a	2.0%	9.6%	9.8%	n/a	9.8%	13.0%	13.0%	22.1%
Agriculture	n/a	1.7%	1.8%	1.0%	n/a	5.0%	6.7%	13.1%	5.9%
Other	n/a	26.5%	50.4%	51.4%	n/a	44.7%	30.6%	45.7%	22.8%

Manufacturing accounts for no more than 13.0% of the number of MSMEs in any one country. The share of manufacturing to output or turnover is disproportionately high in comparison to the number of enterprises in all three countries reporting data, suggesting that manufacturing enterprises tend to be larger in size than other MSMEs. The very low proportion of manufacturing MSEs in Azerbaijan is related both to the fact that medium enterprises are not counted and that manufacturing is dominated by large enterprises, particularly in the oil sector.

Agriculture contributes relatively little to both the number of MSMEs and their output, according to government data. However, these statistics probably greatly underestimate the number and output of MSMEs, since small farming households generally do not register as businesses and are thus excluded from the calculation.

[3] For several countries, the trade category includes enterprises engaged in repairs of vehicles and equipment

1.4.2 Regional distribution

Four countries – Armenia, Azerbaijan, Georgia, and Moldova – demonstrate a very high concentration of MSME activity in the capital city, with the proportion of MSMEs in the capital and their output approaching or exceeding 50% of the total. Only Ukraine demonstrates a more even distribution of MSME activity, with the capital city contributing a more moderate 25.0% of turnover[4], thanks to the presence of major secondary cities such as Kharkiv, Odessa, and Donetsk, among others.

Contribution of capital city

	Armenia	Azerbaijan	Georgia	Moldova	Ukraine
# of enterprises	46.5%	36.0%	54.4%	66%	n/a
Output/ turnover	n/a	63.6%	n/a	65%	25.0%

In all five countries, informal, unregistered enterprises are more likely to be located outside the capital, so these statistics understate the contribution of other regions to some degree.

1.5 Regulatory and institutional issues

Based on the World Bank's *Doing Business 2013* report, Georgia has the highest ease of doing business rank, at 9, while Ukraine has the lowest, at 137. Armenia's overall rank of 32 is good, while Azerbaijan and Moldova have mediocre ranks at 67 and 83, respectively. The Caucasus countries all rank very high in terms of starting a business, registering property, and protecting investors. With the exception of Georgia, all countries tend to rank poorly in terms of trading across borders, paying taxes, and getting electricity. All five countries need further improvement in terms of resolving insolvency, with no country ranking higher than 63.

Doing business rankings

Indicator	Armenia	Azerbaijan	Georgia	Moldova	Ukraine
Ease of doing business 2013	**32**	**67**	**9**	**83**	**137**
Starting a business	11	18	7	92	50
Dealing with construction permits	46	177	3	168	183
Getting electricity	101	175	50	161	166
Registering property	4	9	1	16	149
Getting credit	40	53	4	40	23
Protecting investors	25	25	19	82	117
Paying taxes	108	76	33	109	165
Trading across borders	107	169	38	142	145
Enforcing contracts	91	25	30	26	42
Resolving insolvency	63	95	81	91	157
2007 Doing Business rank	*34*	*99*	*37*	*103*	*128*

Source: World Bank, Doing Business 2013; Green = Top 25 rank; Red = 100 or below rank

All countries have shown improvement since 2007 with the exception of Ukraine, which fell from 128th to 137th place. Ukraine's business environment for SMEs has deteriorated partly as a result of a new tax code adopted in 2011, which increased the effective tax rate and administrative burden on SMEs. Many SMEs moved into the formal economy and some even shut down as a result.

Corruption is a barrier to SME development in all five countries, although less so in Georgia, which benefited from an effective anti-corruption campaign initiated by the Saakashvili administration.

[4] The data on Ukraine is from 2009, the most recent period available.

According to Transparency International, Azerbaijan and Ukraine are the worst offenders, ranking 139 and 144 respectively.

Corruption perceptions index

	Armenia	Azerbaijan	Georgia	Moldova	Ukraine
Rank (out of 176 countries)	105	139	51	94	144

Source: Transparency international

In terms of the institutional framework for SMEs, all countries except Georgia have a law on state support for SMEs in place. Armenia, Moldova and Ukraine also have written SME development policy documents. For Azerbaijan and Georgia, SME development policies are generally addressed as part of broader economic policy documents. Armenia and Moldova both have government bodies specifically created to deal with SME development issues. In Azerbaijan and Georgia, the Ministry of Economy is the relevant government body, while in Ukraine, the Cabinet of Ministers develops policies, which are then implemented by the State Service for Regulatory Policy and Entrepreneurship. The following table summarizes these features of the institutional framework.

Regulatory and institutional characteristics

	Law on State Support for SMEs	Responsible government body	SME Development Policy
Armenia	Yes	SME Development National Center and Ministry of Economy	Concept for SME Development Policy and Strategy
Azerbaijan	Yes	Ministry of Economic Development	n/a
Georgia	No	Ministry of Economy and Sustainable Development	n/a
Moldova	Yes	Organization for SME Sector Development	State Programme for Supporting SME Development
Ukraine	Yes	Cabinet of Ministers and State Service for Regulatory Policy and Entrepreneurship	National Programme for Small Entrepreneurship Development

1.6 Demand for finance

1.6.1 Demand by type of instrument

Loans account for the vast majority of demand for finance among SMEs in all five countries. Demand for leases, unfunded trade finance products such as letters of credit and guarantees, and risk capital is low by comparison. The preference for loan funding is mainly a function of the familiarity of SMEs with loan products and the financial institutions which offer them. Most entrepreneurs are familiar with the content of a loan contract and the average interest rates and maturities which are being offered to similar businesses, so there is less risk that they will be taken advantage of. Furthermore, entrepreneurs generally know which lending institutions are the most reputable, at least based on word of mouth. By contrast, they usually have less information about leasing companies or private equity firms and less information about the contractual conditions on such products. The fact that loan products and lending institutions tend to be more strictly regulated and supervised than other types of products and institutions may also provide additional incentive for SMEs to prefer loans.

Within the category of trade finance, loans are by far the preferred instrument for SMEs despite the fact that many banks offer unfunded products such as guarantees and letters of credit. When unfunded trade finance products are demanded, it is most commonly guarantees that are requested, rather than letters of credit. According to experts interviewed for this study, the fact that

LC financing is document-driven may be perceived as undesirable; entrepreneurs may fear that small errors in documentation will cause delays or difficulties in obtaining their goods.

Demand for equity and quasi-equity from formal institutions is particularly low in the EP countries. Cultural factors may play a role, as businesspeople may be averse to cooperating with outsiders and sharing a part of their business with strangers. Lack of awareness of the availability of equity products, and lack of familiarity with the products themselves (such as a standard term sheet) also negatively affect demand. Without an appropriate venture capital ecosystem in place, including incubators, angel investor networks, and academic conferences, potential investees have limited opportunities to learn about these products. In fact, many SMEs are not even aware that there are companies offering risk capital in their country.

1.6.2 Demand by type of SME

Based on the World Bank Enterprise Surveys conducted in 2008 and 2009, the proportion of enterprises which need a loan ranges from about 50% to 75% depending on the country and the enterprise size. Overall, Armenia and Azerbaijan demonstrated the lowest level of demand, while enterprises in Moldova demonstrated the highest. In Armenia, Moldova, and Ukraine, medium enterprises were more likely to need a loan than small enterprises, while in Azerbaijan and Georgia, medium enterprises were less likely.

Proportion of enterprises not needing a loan at time of survey

	Armenia	Azerbaijan	Georgia	Moldova	Ukraine	All countries
Overall	43.1%	46.8%	38.3%	30.3%	38.9%	39.6%
By enterprise size:						
Small (5-19 employees)	48.6%	45.1%	38.5%	33.0%	45.0%	40.3%
Medium (20-99 empl.)	42.2%	46.8%	44.4%	25.5%	31.6%	39.1%
Large (100+ employees)	20.9%	57.5%	14.4%	28.0%	28.2%	40.4%

Source: World Bank Enterprise Surveys

By sector, demand for funding in absolute terms is generally consistent with the proportion of enterprises in each country. Trading enterprises, therefore, account for the highest proportion of demand. The demand for agricultural financing is generally disproportionately higher than the number of registered agricultural enterprises, since agricultural enterprises are more likely than others to be unregistered, particularly at the micro end of the MSME scale.

2. SUPPLY ANALYSIS

Conclusion:
Bank loans dominate the supply of SME finance in all five countries, with leasing companies, MFIs, and private equity firms making relatively small, but growing, contributions.

Key findings:

- *The highest share of MSME loans are granted to trading enterprises in all five countries, and lending to MSMEs is highly concentrated in the capital cities of each country, although less so in Ukraine.*
- *In terms of product conditions, strict collateral requirements and limited availability of local currency lending, especially for longer terms, represent key constraints to SME lending.*
- *The largest banks and MFIs in all five countries generally have sufficient access to funding to meet demand. However, smaller banks and MFIs are more likely to experience funding constraints. Leasing companies also have difficulty attracting a sufficient amount of funding.*
- *Regulatory and institutional constraints which can be observed for several countries are weak bankruptcy resolution regimes, inadequate credit bureaus and collateral registries, and tax disadvantages for leases compared to loans.*

2.1 Type of intermediary

The table below shows the total number of relevant intermediaries in each country. Not all of these intermediaries offer SME financing; these figures establish the upper limit for the number of institutions which could potentially offer SME funding.

Number of financial intermediaries

	Armenia	Azerbaijan	Georgia	Moldova	Ukraine
Banks	22	43	19	14	184
MFIs	12	30	63	60	1
Leasing companies	3	8[5]	3	25	21
PE/VC firms	2[6]	2	2	5	13[7]

Banks are by far the main source of SME funding in all five countries. This is consistent with their high share of financial sector assets, which exceeds 90% in all countries except Ukraine, where the share of banks is 67.7%. Key banking sector indicators for all five countries are provided in Annex 2. The majority of banks in each country offer loans to SMEs, although for many banks SME loans comprise only a small portion of the total portfolio.

MFIs are a significant source of funding for microenterprises, but tend to be less active in lending to SMEs. Many MFIs do not offer SME loans at all, and of the MFIs which are engaged in SME lending, SME loans tend to make up a small portion of their portfolios. Some MFIs only work with SMEs which were previously micro clients and have scaled up to reach small enterprise size.

The leasing sectors of all five countries are relatively under-developed, so the total supply of funding from specialized leasing companies is not large, even though a relatively high percentage of the clients of leasing companies are SMEs. Most leasing companies work with SMEs to offer equipment

[5] BFC estimate
[6] One of these was still in the process of registering at the time of the onsite visit.
[7] BFC estimate

and vehicle leasing, with the exception of several leasing companies which are entirely engaged in consumer leasing of vehicles and household equipment.

There are a number of private equity firms active in the region, including both local and international companies. Among the more prominent companies are Horizon Capital, SEAF, Dragon Capital, and Euroventures management. The number of PE firms is higher in Ukraine and Moldova than in the Caucasus region. The firms active in Ukraine and Moldova are usually regional and include other markets in Eastern Europe. By contrast, funds in the Caucasus countries tend to be Caucasus-specific. Several PE firms are working in multiple countries and are counted more than once in the table above, so the number of unique firms is less. The number excludes development institutions which make direct equity investments in SMEs, such as EBRD and IFC. Annex 5 provides basic data on the PE firms and funds active in the region.
There are fewer venture capital firms focusing on smaller, early-stage enterprises than private equity deals involving larger, more mature companies. This is particularly true for the Caucasus countries, where only one venture capital fund was identified, focusing only on Armenia. Partly as a result of the strength of the IT sectors in Moldova and Ukraine, there are more specialized VC firms there than in the Caucasus. The venture capital industry in all countries was particularly negatively impacted by the economic downturn of 2008-2009, and investment activity virtually ceased for a period of several years. However, investors and fund managers are starting to take a greater interest in the sector recently, so venture capital activity may be poised for significant growth.

Government lending directly to SMEs is generally not practiced on a national scale, although several countries provide state financial support to SMEs by means of guarantee funds. Azerbaijan and Georgia do not have guarantee funds at present. The Ukrainian Fund for Entrepreneurship Support can issue guarantees on behalf of SMEs, but reportedly has not done so yet. The two active funds are:

- **Armenia**: The SME Development National Center of Armenia (SME DNC) issues loan guarantees which provide up to 70% coverage on the principal of loans for SMEs in the manufacturing, services and trade sectors. Eligible loans can have a maturity of up to five years and a loan amount up to AMD 15.0 million (EUR 27,600). Through this program, loans are extended through SME DNC's eight partner banks. In addition, as a temporary measure following the financial crisis in 2009, the government provided about AMD 60 billion (EUR 111.7 million) in guarantees for lending to SMEs oriented towards exports or production for the domestic market.
- **Moldova**: A loan guarantee fund for SMEs was set up by the Ministry of Economy, which is managed by the Organization for SME Development (ODIMM). The guarantees are intended for enterprises lacking sufficient collateral to receive a bank loan. Mature enterprises can obtain a guarantee for up to 50% of the loan amount, with a maximum limit of about EUR 43,000. For newly established enterprises the guarantee can cover up to 70% of the loan amount up to a maximum of about EUR 18,000. This fund is open to banks only.

2.2 Type of funding instruments

Loans are by far the primary source of funding for SMEs. Leasing is estimated to take second place, although leasing volume constitutes only a small fraction of total lending volume. After leasing, guarantees, letters of credit, factoring and risk capital each make small contributions to total SME funding. The following table shows the total loan and lease portfolios in each country.

Gross loan and lease portfolios (EUR millions at December 31, 2012)

	Armenia	Azerbaijan	Georgia	Moldova	Ukraine
Total loans	3,224	11,773	4,239	2,388	77,611

- Bank loans	3,011	11,464	4,002	2,272	77,376
- Other loans	213	309	238	117	235
Gross loans to GDP (%)	*43%*	*23%*	*35%*	*44%*	*43%*
Leases	17[8]	n/a	<45[9]	51	1,287[10]

Based on surveys of banks conducted for this study, the share of MSME and SME loans in the portfolios of banks ranged from a low of 14.7% (MSME) and 12.2% (SME) in Ukraine to a high of 41.7% and 27.4% in Moldova at year-end 2012.[11] The following table presents the results for each country. The low result in Ukraine is consistent with the comments of financial institutions interviewed, many of which expressed a negative outlook for the segment. The surveyed institutions generally included the most active MSME lenders in the country, so it is likely that these proportions somewhat overstate the share of MSME loans in the banking system as a whole.

Share of MSME loans in surveyed banks' total loan portfolios (year-end 2012)

	Armenia	Azerbaijan	Georgia	Moldova	Ukraine
MSME (%)	34.2%	38.8%	24.2%	41.7%	14.7%
SME (%)	25.8%	23.2%	17.9%	27.4%	12.2%

Based on the above percentages, the total MSME portfolios of banks are shown in the next table. Like the percentages, these figures may somewhat overstate the actual portfolios.

Estimated MSME loan portfolio of banks (year-end 2012)

	Armenia	Azerbaijan	Georgia	Moldova	Ukraine
MSME portfolio	1,030	4,448	968	947	11,374
SME portfolio	777	2,660	716	623	9,440

For MFIs, the share of SME loans is generally lower than in banks, since many MFIs do not engage in SME lending at all or have only started to do so recently. MSME loans, by contrast, make up nearly 100% of the portfolios of MFIs, although some MFIs are also engaged in consumer lending.

Since loan sizes on SME loans can range from a low of EUR 10,000 or 20,000 to a high of up to EUR 1 million or more, it is difficult to characterize average funding conditions, such as interest rates and maturities, which vary widely based on the size of the loan and the characteristics of the borrower and lender. For collateral, however, the five countries are generally consistent in terms of requiring a high ratio of collateral to loan amount (150% and above is common) and often demanding real estate collateral. The five countries are also relatively consistent in terms of issuing a high proportion of foreign currency loans, since most of their borrowings are in foreign currency. When local currency is available, it is usually sourced from short-term deposits and thus can only be lent out at relatively short maturities. The strict collateral requirements and limited availability of local currency, especially for longer terms, represent the main constraints to SME lending.

[8] At March 31, 2013

[9] For Georgia, since data on the lease portfolios are not available, the total assets of leasing companies are shown, which establishes an upper boundary for the lease portfolios.

[10] At June 30, 2012

[11] The MSME definition is based on the banks' internal definition, as thus varies from bank to bank, even within a given country.

Based on a survey of financial institutions in each country, only in Armenia do MSME loans appear to be unequivocally less risky than other loans. In the other countries, either the average NPL ratio for MSME loans is above average (Azerbaijan, Georgia, and Ukraine) or the majority of respondents have a higher NPL ratio on MSME loans than other loans (Azerbaijan, Moldova, and Ukraine).

NPL ratios for MSME loans (data for year-end 2012)

	Armenia	Azerbaijan	Georgia	Moldova	Ukraine
NPL ratio - MSME	1.4%	5.2%	4.5%	10.7%	17.8%
NPL ratio - all loans	2.4%	2.5%	4.0%	11.1%	14.4%
MSME NPL ratio ≤ Overall NPL ratio[12]	67%	29%	57%	22%	40%

For leasing companies, the share of SME leases to total leases is probably higher than the shares observed for loans, since SMEs often do not have sufficient collateral to get a loan to fund equipment purchases.

Although most banks reported having a minimal volume of trade-related guarantees or letters of credit extended to SMEs, this appears to be more of a demand issue than a supply issue, with banks generally expressing a willingness to provide such products to SMEs.

Risk capital plays a very small role in the funding of SMEs. As mentioned above, there are relatively few providers of risk capital, and their portfolios are very small in comparison with the loan portfolios of the leading banks in the region. Fund sizes tend to be modest in individual countries, usually less than EUR 50 million and in some cases less than EUR 10 million.

2.3 Characteristics of funding recipients

Based on surveys of MSME lenders conducted for this study, the highest share of MSME loans are granted to trading enterprises in all five countries, comprising between 34% and 46% of total MSME loans. The secondary sector differs by country – in Moldova and Armenia it is manufacturing, in Georgia and Ukraine services, and in Azerbaijan agriculture.

Sector breakdown of MSME loan portfolios of selected institutions

Sector	Armenia	Azerbaijan	Georgia	Moldova	Ukraine
Trade	41.9%	45.5%	34.5%	38.1%	34.0%
Services	10.3%	20.3%	23.3%	15.5%	20.7%
Manufacturing	19.1%	7.0%	11.9%	19.1%	20.5%
Agriculture	11.3%	22.8%	10.6%	10.1%	14.9%
Other	17.5%	4.4%	19.8%	17.2%	9.9%
Total	**100%**	**100%**	**100%**	**100%**	**100%**

Source: BFC survey of 7-9 MSME lenders in each country

Lending to MSMEs is highly concentrated in the capital cities of each country, although less so in Ukraine, where there is a greater regional distribution. This urban-focused, centralized concentration of lending represents a key constraint for the agriculture sector and rural clients. The high share of lending in the capital is a consequence of the high concentration of bank branches there. MFIs tend to have a better regional and rural presence, but their total volume of SME lending is relatively small compared to banks.

[12] The proportion of survey respondents for whom the NPL ratio for MSME loans was less than the NPL ratio for the loan portfolio as a whole.

2.4 Institutional and regulatory issues

For the most part, all five countries have acceptable regulatory frameworks for banks and MFIs in place. The number of key regulatory and institutional constraints to SME funding is not excessive, but there are some key issues to be noted:

- **Bankruptcy**: Resolving bankruptcy is an issue in all five countries, with no country ranking higher than 63rd in World Bank's Doing Business 2013 report for "resolving insolvency." The best performer, Armenia, requires 1.9 years to resolve bankruptcy, with a recovery rate of 41% and a cost of 4% of the business value. The worst performer, Ukraine (ranked 157), requires 2.9 years and has a recovery rate of just 9% and costs 42%.
- **Credit bureau**: In Azerbaijan and Moldova, the credit bureau excludes payment data from utilities, phone provides, and similar non-financial companies. In Moldova, in fact, only bank data is included.
- **Deposit-taking**: Non-bank MFIs are not permitted to accept deposits from the public in all five countries, thus limiting their funding options.
- **Collateral registry**: In Armenia and Azerbaijan, weaknesses in the collateral registry system lead to more conservative collateral policies, which constrains credit to the SME sector.
- **Foreign currency transactions**: Armenia, Georgia, and Ukraine all apply a combination of high risk weights, provisions, and reserve requirements on foreign currency transactions in order to encourage saving and lending in local currency. This discourages institutions from lending in foreign currency, and some institutions have limited access to local currency funding, thus restraining the supply of credit.

These issues are summarized in the table below.

Key regulatory and institutional constraints

	Lending	Leasing
Armenia	• Weak collateral registry system – lacking online functionality • High risk weights, provisions, and reserves on FX assets and liabilities	• VAT treatment makes leasing more expensive than lending
Azerbaijan	• Absence of movable collateral registry • Slow time to resolve bankruptcy and low recovery rates • Credit bureau excludes utilities & phone providers	• VAT treatment makes leasing more expensive than lending
Georgia	• High risk weights and reserves on FX assets and liabilities • Max. loan size for non-bank MFI is EUR 22,900	N/A
Moldova	• Credit bureau only includes bank loans • Slow time to resolve bankruptcy and low recovery rates • Effective interest rates not disclosed	• VAT treatment makes leasing more expensive than lending
Ukraine	• Recovering collateral through court system is slow and expensive • High provisions and reserves on FX assets and liabilities	N/A

2.5 Funding of intermediaries

The degree to which funding of intermediaries is a constraint to financing of SMEs depends significantly on the size of the intermediary. Overall, the largest, most reputable FIs in each country are able to borrow at acceptable terms from a variety of sources in sufficient volumes. Smaller banks and MFIs are much more likely to face funding limitations, given that it is more difficult to attract the attention of foreign lenders in a crowded market. Operationally and financially, it is more advantageous for IFIs to provide large loans to several local institutions than small loans to many. As a result, funding tends to be crowded at the top of the market. Leasing companies also commonly cited lack of funding as a constraint in all countries, which may also be a function of size, since even the largest leasing companies tend to be quite small relative to banks.

Loan-term local currency funding is also a key constraint, even for larger banks and MFIs, particularly in countries where demand for local currency funding is high, such as Armenia, Georgia, and Ukraine. Most local currency funding comes from deposits, which tend to be short-term, therefore banks typically only lend out these funds at short terms, creating a large gap for long-term local currency funding. Several DFIs now offer credit lines in local currency to FIs, but the volume of funding remains relatively small and the cost of funding is very expensive.

For banks, deposits remain the primary source of funding, but borrowings generally also make up a very high proportion of funding, with the exception of Moldova. Consistent with this observation, all of the countries except Moldova have a loan to deposit ratio of well over 100%. The following table shows the funding structure of banks.

Funding structure of banks (% of total liabilities and equity) at year-end 2012

Sector	Armenia[13]	Azerbaijan	Georgia	Moldova	Ukraine
Customer deposits	48.8%	44.6%	53.3%	68.5%*	53.0%
Borrowings	28.0%*	28.7%*	22.8%	12.7%	22.8%*
Other liabilities	7.5%	12.3%	7.3%	1.2%	9.1%
Equity	15.7%	14.4%	16.7%	17.6%	15.1%
Net loans/deposits ratio	*132.7%*	*138.5%*	*114.2%*	*85.6%*	*143.9%*

** Includes deposits from banks*

MFIs cannot accept deposits, but the larger MFIs are generally able to meet their funding needs through borrowing from DFIs and microfinance investment funds. Some smaller MFIs reported experiencing funding constraints.

DFIs are active lenders to the financial sector in all five countries. By volume of credit, the largest funders among DFIs are EBRD, IFC, KfW, FMO, BSTDB, and ADB (in the Caucasus). For large and mid-tier banks, the cost of funding usually ranges from 6-8%, although it can be higher or lower in some circumstances. DFI funding to MFIs can be more expensive and typically ranges from 6-10% annually. Loan maturities are typically from 3-5 years, although

Lending from foreign commercial banks which are not development-oriented is practiced, although this is a much smaller source of funding than DFIs. Deutsche Bank, Citigroup, and Commerzbank are among the foreign commercial banks which have made loans to banks in multiple countries within the region. Interbank lending within a country is likewise a relatively small source of funding.

Subordinated debt is increasingly being used as a funding instrument in all countries except Moldova, both by banks and MFIs, although it is still small as a percentage of total borrowings. In Ukraine, for example, subordinated debt accounts for 3.5% of total liabilities. Many of the key DFIs, such as EBRD, IFC, and KfW, have made subordinated loans to local FIs.

Issuance of debt securities by local banks can be observed in all countries with the exception of Moldova. However, only a few banks use this funding source and the total contribution to bank funding is very low. For example, in Ukraine debt securities issued comprise just 1.2% of total liabilities.

[13] Data for Armenia is as of May 2013

3. CONCLUSION: GAPS IN PRIVATE SECTOR FINANCING

Although the financial sectors in the five EP countries are generally doing an adequate job of providing financing to SMEs, there are a number of gaps which need to be addressed. The most significant gaps are observed for the following groups:

- **Rural Gap**: Rural enterprises, especially in remote areas
- **Agriculture gap**: The agriculture sector, particularly agricultural production
- **Collateral gap**: Enterprises without real estate to offer as collateral
- **Currency gap**: Enterprises demanding medium and long-term local currency funding
- **Literacy gap**: Enterprises whose owners or managers have low financial literacy
- **Accounting gap**: Enterprises with weak or no financial reporting capability

Rural Gap: Rural enterprises are subject to a funding gap because they are on average more expensive for financial institutions to serve, due to their physical distance from branches and offices.

Agriculture gap: The agriculture sector experiences a funding gap for a number of reasons. As with rural enterprises, the location of agricultural enterprises usually makes them more expensive to serve. Financial institutions generally perceive agriculture to be risky, especially agricultural production (as opposed to processing). At the same time, demand is quite high due to the need for productivity and efficiency improvements that could result from the utilization of more modern equipment.

Collateral gap: As a result of strict collateral requirements from lenders, SMEs without real estate to offer as collateral have limited funding options. Leasing is available for the acquisition of equipment and vehicles, but this option does not help SMEs which need working capital. Some leasing companies reportedly require collateral anyway in addition to the leased item itself.

Currency gap: SMEs which need medium and long term local currency financing face constraints due to the limited availability of medium and long term local currency funding of financial intermediaries. Short-term local currency loans are generally available to SMEs from banks, financed by their local currency deposits. But lenders are typically borrowing at medium and long term in foreign currency, thus limiting the supply to SMEs.

Literacy gap: Financial literacy was mentioned by many FIs as a barrier to extending credit. Low financial literacy creates funding gaps in a number of ways. First, it reduces demand, since SMEs with low financial literacy have less familiarity with products available and with the financial institutions, which makes them less likely to apply for funding even when they need it. It also reduces supply, since low financial literacy creates communication barriers between FIs and potential clients, making it more likely that FIs will decline to serve them, even when the SMEs are creditworthy.

Accounting gap: Enterprises which cannot produce standardized financial reports have less access to finance than comparable firms with good accounting systems. FIs are reluctant to work with such SMEs, since it is more difficult for FIs to evaluate their repayment capacity, thus making it more risky to provide funding.

ANNEX 1: MACROECONOMIC INDICATORS

Main macroeconomic indicators

Indicator	Armenia	Azerbaijan	Georgia	Moldova	Ukraine
GDP (nominal, EUR millions)	7,497	51,918	11,977	3,645	133,707
Population (millions)	3.0	9.4	4.5	3.6	45.6
GDP (nominal) per capita (EUR)	2,479	5,523	2,663	1,586	2,932
GDP (PPP) per capita (EUR)	5,029	8,039	4,487	2,558	5,727
Real GDP growth rate	7.2%	2.2%	2.3	-0.8%	0.2%
Inflation rate (CPI, annual average)	2.6%	1.1%	-0.9%	4.7%	-0.2%
Exchange rate (EUR, end of period)	533.3	1.04	2.2	16.0	10.5
Change in exchange rate	6.9%	2.0%	1.0	-4.7%	2.3%
Unemployment rate	17.3%	5.4%[11]	15.0	5.6%	8.1%
Poverty rate (WB, $1.25 per day)	2.5%[10]	0.4%[08]	5.8%[10]	0.4%	0.0%[10]
Current account balance (% of GDP)	-10.7%	27.7%	-5.0%	-9.4%	-8.4%
Trade balance (% of GDP)	-28.7%	41.1%	-34.6%	-40.9%	-8.4%
Capital account balance (% of GDP)	9.6%	-15.0%	-2.0%	6.4%	6.4%[10]
Net FDI (% of GDP)	4.8%	1.5%	5.5%	1.9%	4.4%[10]
International reserves (% of GDP)	18.2%	67%	12.5%	34.7%	13.9%
External government debt (% of GDP)	31.9%	7.5%[11]	32.5%[11]	23.7%[11]	34.7%
Fiscal balance (% of GDP)	-2.2%	0.3%	n/a	-2.1%	-4.5%

Note: Data is from 2012 unless otherwise noted. Other years are indicated by superscript next to the value. For example "7.5%[11]" means that the value was 7.5% in 2011.

Contribution of selected sectors to GDP in 2012

	Armenia[14]	Azerbaijan	Georgia	Moldova	Ukraine
Agriculture	20.2%	5.2%	7.2%	10.9%	7.9%
Industry/manufacturing	16.7%	54.1%[15]	9.9%	11.3%	19.2%
Construction	12.8%	9.2%	6.3%	3.5%	2.7%
Trade	13.4%[16]	6.7%	14.3%	15.2%[17]	15.6%[18]
Others	36.9%	24.8%	62.3%	59.1%	54.6%
Total	100%	100%	100%	100%	100%

[14] Data is from 2011
[15] Includes the oil sector
[16] Retail only
[17] Includes hotels and restaurants
[18] Includes repair services

ANNEX 2: BANKING SECTOR INDICATORS (2012)

Banking sector indicators for 2012

Indicator	Armenia	Azerbaijan	Georgia	Moldova	Ukraine
STRUCTURE OF THE BANKING SECTOR					
Number of banks	22	43	19	14	184
Number of state-owned banks	0	1	0	1	2
Assets of SOBs to total bank assets	0	37.3%	0	9.0%	11.4%
5-bank concentration ratio	48.6%	58.3%	92.4%	70.3%	31.6%
Bank branches per 100,000 population	18.9	7.0	18.5	35.5	1.6
FINANCIAL INDICATORS (EUR millions)					
Total assets	4,486	15,895	6,113	3,644	85,311
Total net loans	3,101	10,270	3,722	2,129	68,522
Total deposits	2,840	7,414	3,505	2,486	32,900
Total equity	2,336	2,457	1,037	641	10,987
Total regulatory capital	757	2,474	1,161	438	11,337
Total net profit	738	125	82	39	673
FINANCIAL RATIOS					
Capital adequacy:					
Tier 1 CAR	15.2%	12.9%	13.4%	n/a	n/a
Total CAR	16.8%	16.8%	17.0%	24.3%	14.1
Equity to total assets	16.9%	15.5%	17.0%	17.6%	12.9
Liquidity:					
Net loans to customer deposits	132.7%	138.5%	114.2%	85.6%	143.9%
Growth rate of customer deposits	33.3%	15.5%	13.4%	14.8%	29.6%
Liquid assets to total assets	25.6%	15%	27.3%	32.9%	n/a
Profitability:					
Return on average assets	2.5%	0.9%	1.4%	1.1%	1.0%
Return on average equity	14.7%	5.6%	8.6%	5.6%	8.5%
Net interest margin	5.3%	4.8%	n/a	5.1%	5.3%
Asset quality:					
Growth rate of net loan portfolio	36.6%	20.7%	12.8%	14.9%	63.2%
NPL ratio	3.7%*	6.5%	3.7%*	14.5%*	3.9%
Others:					
Growth rate of total assets	15.8%	18.5%	16.8%	15.2%	54.5%
Bank assets to fin. sector assets (%)	90.2%	≈95%	95.2%	95.0%	67.7%

**Main quantitative criterion is 90 or more days late*

ANNEX 3: FINANCE AS A CONSTRAINT IN WORLD BANK ENTERPRISE SURVEYS

WBES % identifying access to financing as a main constraint

	Armenia	**Azerbaijan**	**Georgia**	**Moldova**	**Ukraine**	**All countries**
Overall	32.6%	23.2%	35.3%	39.1%	34.7%	32.5%
By sector:						
Manufacturing	27.8%	43.1%	42.6%	43.8%	n/a	n/a
Retail	43.0%	16.6%	46.8%	38.4%	28.2%	n/a
Other services	29.6%	15.6%	26.8%	36.8%	32.7%	n/a
By enterprise size:						
Small (5-19 empl.)	37.3%	19.3%	43.7%	38.2%	29.5%	34.0%
Medium (20-99 empl.)	29.5%	28.9%	19.8%	38.6%	40.4%	30.2%
Large (100+ empl.)	19.8%	30.6%	31.5%	49.6%	44.5%	25.3%

ANNEX 4: GUARANTEE FUNDS OF DFIS

Country	Guarantee Activity
Armenia	• KfW previously had a EUR 5.0 million credit guarantee fund that provided a guarantee on loans from Commerzbank to five Armenian banks. • OPIC has issued guarantees on behalf of Armenian FIs to access funding for SME lending. The most recent transactions are a USD 3.5 million guarantee in 2012 on behalf of ACBA Bank to borrow from Citibank for SME lending. In 2009 Ardshininvestbank was granted a USD 10 million guarantee to access funding from Bankworld, Inc. • USAID's Development Credit Authority guarantees up to 50% of loans from local or international financial institutions to local financial institutions on a pari passu basis. Local enterprises have received 53 loans in an amount of USD 6.2 million since inception.
Azerbaijan	• OPIC issued a guarantee in 2013 on behalf of Demirbank, AzerCredit, and TBC Kredit to help them secure funding from MicroVest Short Duration Fund in order to on-lend to MSMEs. Muganbank (USD 10 million in 2011), Rabitabank (USD 5 million in 2010) and Turanbank (USD 7.5 million in 2009) also received guarantees to borrow from foreign lenders for on-lending to SMEs. • Through USAID's Development Credit Authority, local enterprises have received 87 loans in an amount of USD 2.4 million since inception.
Georgia	• Through USAID's Development Credit Authority, AG Leasing and TBC Leasing both have access to guarantees. USAID also provided partial loan guarantees to Crystal MFI to access funding at the wholesale level, and a loan portfolio guarantee to Bank Republic to partially guarantee loans primarily to the agriculture sector. In total, through the Development Credit Authority local enterprises have received 50 loans in an amount of USD 28.8 million since inception. • In 2007-2008, KfW had a EUR 10.0 million credit guarantee fund that covered 90% of the credit risk on loans from Commerzbank to three local banks: BoG, TBC and Bank Republic. • OPIC has provided guarantees to the following institutions to secure funding for on-lending to SMEs: Georgia Leasing Company (USD 7 million in 2013), Bank Constanta (2012), MFO Crystal (2012), BasisBank (USD 5 million in 2011), and ProCredit Bank (USD 30 million in 2010). • The Multilateral Investment Guarantee Agency (MIGA) issued a guarantee of USD 13.5 million to ProCredit Holding for a loan to its own subsidiary in Georgia.
Moldova	• The local company GarantInvest was established by DFID as an inter-bank guarantee society to ease access to finance for those entrepreneurs who lack the necessary collateral, particularly in rural areas. The guarantees are issued directly to the businesses and cost 2.5-3.0% of the guaranteed loan amount per year. Seven banks and one MFO participate in the scheme. • OPIC has issued guarantees on behalf of Microinvest (USD 3.9 million in 2012) and Fincombank (USD 6 million in 2009) to access funding for SME lending. • In 2011 MIGA issued a guarantee of EUR 4.75 million to Raiffeisen Bank of Romania for a loan to its subsidiary Raiffeisen Leasing in Moldova. More than half of the beneficiary lessees are expected to be SMEs. • Through USAID's Development Credit Authority, local enterprises have

	received 1,805 loans in an amount of USD 21.8 million since inception.
Ukraine	• IFC has offered guarantees to local financial institutions in support of SMEs. For example, in 2012 IFC provided a USD 17.5 million guarantee to ACBA Bank which covered 50% of risk on a portfolio of loans to farmers to finance purchases from Bayer Ukraine. • OPIC has issued a guarantee on behalf of Megabank (USD 10 million in 2012) to access funding for SME lending. • Through USAID’s Development Credit Authority, local enterprises have received 272 loans in an amount of USD 3.9 million since inception.

ANNEX 5: PRIVATE EQUITY FIRMS

Company/Fund name	Manager	Target country	Domicile	Investment size	Fund size (USD mln)
Georgia Regional Development Fund (GRDF)	SEAF	Georgia	USA		30
Caucasus Growth Fund (CGF)	SEAF	Caucasus	Caymans	Up to USD 6 million	75
Azerbaijan Investment Company (AIC)	N/A	Azerbaijan	Azerbaijan		
Caucasus International Investment Company (CIIC)	N/A	Azerbaijan	Azerbaijan		
Granatus Venture Fund I	EV Consulting	Armenia	Armenia	USD 500,000 average	6
SME Invest	N/A	Armenia	Armenia	Up to USD 360,000	17
Emerging Europe Growth Fund II	Horizon Capital	UA, MD, BY		USD 15-40 million	370
Western NIS Enterprise Fund	Horizon Capital	UA, MD	USA	USD 1-10 million	150
Europe Virgin Capital	Dragon Capital	UA, MD, BY	Isle of Man		57
NCH Capital (multiple funds)	N/A	CIS/EE	USA		
Agribusiness Partners International	Agribusiness Management Company	CIS/EE	USA (HQ)	USD 5-25 million	100
Fribourg Capital	N/A	CIS/EE	Romania		
Euroventures Ukraine Fund II	Euroventures Management	Ukraine		USD 5-10 million	76
ACEE IV Fund	Advent International	Central/ Eastern Europe		EUR 35-100 million	1,300

ANNEX 6: TECHNICAL ASSISTANCE

As funding is generally plentiful in the target countries, EIB's main opportunity to add value will be through technical assistance.

EIB should adapt its approach to technical assistance to match the increasing sophistication of local financial institutions. This means that a greater degree of TA specialization is needed. In a typical TA model designed by DFIs, technical assistance is provided to a funding recipient (or multiple funding recipients) on a variety of topics by one consulting firm. For example, a consultant assigned to a partner bank may carry out a variety of functions: hiring and training of loan officers, product development, development and improvement of lending policies and procedures, development and strengthening of risk management systems, design of the marketing plan, and changing the organizational structure, to name a few. Even when some of these functions are handled by different consultants, they come from the same firm and often have a generalist background. The result is "generic" TA which gets the basic principles right, but sometimes fails to deliver on the depth of knowledge and specificity which financial institutions increasingly need. Such generalized TA is appropriate for small, unsophisticated institutions which are new to SME lending, but not for the larger, increasingly sophisticated institutions which now populate these markets. Consequently, EIB technical assistance to funding recipients should be heavily focused on a high degree of specialization, with different types of services providing by different, specialized consulting firms.

Other key principles which should be observed when designing TA programmes for lending institutions are:

- Long term TA projects for FIs which have not participated in DFI-funded projects previously face a higher risk of failure. EIB may wish to test the receptiveness of new FIs to consulting by starting with smaller, short-term projects. However, for FIs which demonstrate an ability to cooperate with consultants, long-term projects are more beneficial.
- Cost-sharing provides an important incentive for funding recipients to implement recommendations of consultants. EIB should require that TA recipients contribute some portion of the total cost of the services to be provided, although it should take a flexible approach to setting the percentages.
- Set low quantitative targets for the first year of TA for a given institution. It is better to focus on quality than quantity in the early stages of TA cooperation.
- Identify "low hanging fruits" among TA topics in terms of impact and risk and start with those. Some types of TA are easier to implement than others, such as training of credit staff, while others are more complex, such as IT-related support.
- Ensure economies of scale for consulting firms by building pipelines of the same types of projects. This creates enough critical volume for the selected firms to invest in their own staff and service quality.

The exact topics and themes of TA should be customized for the individual funding recipient. EIB should be willing to consider a broad spectrum of TA services for local lenders, based on the identified needs of each institution. Some of the main topics mentioned by local financial institutions during the study include:

- Training of loan officers and other credit staff in credit analysis
- Product development
- Risk management
- Internal audit
- Credit scoring
- MIS support

- Implementation of tablet computers for field work of loan officers
- Peer-to-peer workshops with financial institutions in other countries

Training of credit staff in cash flow analysis techniques, along with the design and implementation of credit policies, procedures, and MIS tools to support improved cash flow analysis, is particularly important, as it has the potential to reduce several gaps. Improved cash flow analysis will assist FIs to be less dependent on collateral and will encourage lending to institutions with weak financial reporting, this mitigating the collateral gap and accounting gap (see section 3). Such cash-flow-focused TA should consider not only how to increase the accuracy of financial projections, but also how to make the process of determining cash flows faster and more efficient.

One aspect of TA for financial and cash flow analysis that requires special attention is related to agricultural lending. The methodology for financial analysis of agricultural enterprises is different from the methodology for non-agricultural enterprises and requires special tools, such as what is typically referred to in the region as "technical cards," or templates for determining the profit from individual crops. Such specialized TA for agriculture will help to reduce the agriculture gap.

For lending institutions, TA can be targeted to the individual institution. The regulatory and institutional environment for lending, whether through banks or MFIs, is generally satisfactory in the target countries, so TA can focus on supporting the partner institutions themselves. By contrast, the private equity and leasing sectors face a broader set of challenges, including weak demand and inadequate regulatory and institutional frameworks. Therefore, EIB support for leasing and private equity should take a broader approach to boost demand and improve the regulatory environment. Rather than being specifically targeted to individual institutions, such TA programmes could be stand-alone programmes not directly linked to funding and available to a wide group of beneficiaries.

One of the key elements necessary to boost demand for non-loan products – such as risk capital, leases and letters of credit – is financial literacy training and awareness-building campaigns. Demand for these products is often low due to lack of familiarity with the products and the intermediaries which provide them. Development institutions such as World Bank and IFC are already doing some financial literacy training, so EIB could potentially cooperate and build from existing experiences.

In countries where leasing faces a tax disadvantage relative to lending due to VAT treatment (Armenia, Azerbaijan, and Moldova), EIB should consider providing TA directly to the government for regulatory support, in order to try to influence the relevant tax laws. Funding to the leasing sector would only be granted following changes in the tax regime.

For the private equity sector, the key barrier to development is on the demand side, rather than the supply side. There are a limited number of enterprises which are innovative or have highly scalable business models, and there is limited demand from entrepreneurs for risk capital. EIB should therefore consider a general TA programme not tied to specific funding which is designed to support incubators and raise awareness and financial literacy for risk capital among businesses.

MFIs generally have better reach into rural areas and more remote regions than banks, and they are likewise more comfortable working with the agricultural production sector. However, for a variety of reasons, SME loans comprise a very small portion of their portfolios. TA support from EIB to help MFIs upscale from microfinance to SME finance would be especially beneficial to rural and agricultural SMEs.

European Investment Bank

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