European Investment Bank

The EU bank

Neighbourhood SME financing

Synthesis Report

February 2016

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Lead author

Geoff Frewer, Deputy Head of Division, European Investment Bank

Economics editor

Debora Revoltella, Director, Economics Department, European Investment Bank

Editorial, linguistic and statistical support

Tamar Baiashvili, Economist, European Investment Bank and National Bank of Georgia
Polyxeni Kanelliadou, European Investment Bank

This report is based on a survey of the intermediaries conducted by the Economics Department of the European Investment Bank. Information about the market context draws on the EIB/EBRD/WB Enterprise Survey and the World Bank's Doing Business as well as national sources. The synthesis report is based on country papers prepared in the second half of 2015 on Ukraine, Georgia, Egypt, Jordan and Tunisia and in the first quarter of 2016 Morocco.

About the Economics Department of the EIB

The mission of the EIB Economics Department is to provide economic analyses and studies to support the Bank in its operations and in its positioning, strategy and policy. The Department, a team of 35 economists and assistants, is headed by Debora Revoltella, Director of Economics.

Disclaimer

The views expressed in this document are those of the authors and do not necessarily reflect the position of the EIB.

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Summary

This report provides an assessment of the needs of the SME sector of the DCFTA countries[1] from the point of view of the intermediaries. There are many constraints on the development of the SME sector – macroeconomic, institutional, information problems, etc. – but the objective of this paper is to assess the constraints on the intermediaries taking as given the existing market failures and distortions. The report is based on a survey of the intermediaries conducted by ECON[2], and information about the market context draws on the EIB/EBRD/WB Enterprise Survey and the World Bank's Doing Business as well as national sources.

SME risk is an important constraint for the intermediaries everywhere. All banks indicate some degree of difficulty for SMEs to post the necessary collateral, and provide business plans and transparent accounts. Guarantee schemes which have been established in many countries have financial and administrative limitations and only partially address the problem.

EAST

- In Ukraine SMEs are not investing in the current economic conditions and the capacity of the banking sector to supply credit has been undermined. As a result, intermediation in Ukraine faces significant constraints on both the demand and supply side. In Moldova the functioning of the banking sector itself is the primary concern. In Georgia where banks can provide effective intermediation there is a combination of supply and demand side constraints.
- Credit products and trade finance are widely available but private equity and venture capital are practically non-existent. There are gaps in long term investment finance everywhere, in local currency finance in Georgia, and in foreign currency in Ukraine.
- Lack of risk-bearing capacity is a constraint for the intermediaries. Existing guarantee schemes are limited by costs, administrative barriers and lack of transparency.
- Funding in foreign currency is a constrained in Ukraine and Moldova whereas the limitations of the local deposit base are binding in Georgia.

SOUTH

- Despite the wide availability of credit products and trade finance there is still a significant financing gap. Many SMEs, particularly young and innovative enterprises, are credit constrained and in Egypt in particular many SMEs are disconnected from the banking system.
- There are gaps in longer term finance everywhere, particularly for local currency loans that are constrained by short term deposit funding. Constraints on foreign currency lending are exacerbated by macroeconomic factors in Egypt and the overall funding deficit in Tunisia. Funding surpluses in Egypt and Jordan are to some degree absorbed by government budget deficits and some of the challenger banks that are more aggressive in the SME sector do not have access to deposits.
- There are gaps in the leasing market everywhere. In particular, leasing in Tunisia is constrained by lack of long term financing and in Egypt by failures in the business environment.

- Gaps in equity finance are a particular problem for start-ups that do not have access to debt financing. Nascent private equity markets focus on niche segments and their impact on the SME sector in general remains limited.
- The profitability and risks of SME lending are important constraints. In Egypt, for example, banks are profitable but SME lending is tightly controlled, whereas in Tunisia the poor financial performance of the

[1] The seven European Neighbourhood counties that have DCFTA agreements with the EU: Ukraine, Georgia and Moldova in the East, and Egypt, Jordan, Tunisia and Morocco in the South.
[2] This report is based on the following ECON country papers prepared in the second half of 2015: Ukraine (Baiashvili, Frewer), Georgia (Baiashvili, Gattini), Jordan (Betz, Frewer) and Tunisia (Stolting); and forthcoming Egypt (Betz, Frewer) and Morocco (Stolting). The reports are available at https://ged.beilux.eib.org/ged/ged.dll/open/64532812.

public sector banks is an important constraint on credit growth. Interest rate regulation in Tunisia also limits banks' ability to charge for risk.

Part I – EAST

Economic and financial situation

The slowdown in economic activity in the East was largely the result of the impact of lower oil prices, spillovers from Russia and conflict in Ukraine.

The Russian economy, which has traditionally been a major trading partner and driver of economic activity in the region, has been in recession since late 2014. The combination of low oil revenues, restricted access to international capital, and resident capital outflows undermined confidence and led to lower demand for consumption and investment. Economic decline in Russia combined with geopolitical tensions spilt over to neighouring countries.

Ukraine experienced deterioration towards the end of 2014. In 2015, GDP is expected to decline in excess of 5 per cent and the situation remains critical. Cumulatively, Hryvnia lost approximately two thirds of its value (from 7.99 to 24.00 UAH/USD) against the US dollar during 2014-2015.

GDP and industrial production fell sharply with the only positive contribution coming from the agricultural sector due to the recovery from the adverse impact of weather on the previous year's harvest. The government deficit increased to over 10% of GDP due to the economic downturn and further deterioration in the position of Naftogas. Inflation reached over 60 per cent as exchange rate depreciation passed through to administered prices and the central bank maintained liquidity in the system. The banking sector has been adversely affected by the economic downturn, loss of confidence and exchange depreciation.

In contrast, the situation in Georgia is more positive following progress with the Deep and Comprehensive Free Trade Agreements with the EU, progress with reforms and economic growth. Negative spillovers from the regional crisis decreased external demand, remittances and tourism revenues and led to economic slowdown since the second half of 2014. However, these indicators seem to have bottomed out and expectations of positive externalities derived from the DCFTA imply a positive outlook.

The situation in Moldova deteriorated towards the end of 2015 and the exchange rate depreciated sharply. The causes for depreciation are: 1) a decrease in remittances (which account for 25% of Moldovan GDP) linked to the economic crisis in Russia; 2) a decline in exports to two important trading partners: Russia and Ukraine; 3) the crisis in the banking sector (and in particular the diversion of large amounts of foreign currency from the Moldovan market). The National Bank made some steps to stabilize the situation, by intervening on the market with USD 420 million, imposing requirements on banks to increase their reserves in MDL, and increasing the refinancing rate from 3.5 to 19.5% between December 2014 and October 2015.

Banking sector

Banking sectors were opened to international competition following independence from the Soviet Union and the entry of foreign banks with access to funding from abroad led combined with credit growth led to structural funding deficits. In Ukraine 38 out of a total of 126 banks are foreign-owned. However the market share of Western banks declined in recent years while Russian banks increased their presence. West European banks withdrew from the country due to their deleveraging strategies, more risk-averse approaches and weak growth prospects on the Ukrainian market. Funding of the Georgian banking system also depends on foreign capital. While the saving rate in Georgia is quite low, which results in deposits-to-GDP ratio of around 42%, banks have been efficient in mobilizing funding from foreign sources

Banking sectors with a large presence of foreign banks and dependence on international funding were exposed to external shocks which reduced their capacity to extend credit.

Foreign currency exposure is an important element in the risk profile of the banking sectors. Georgia remains exposed to exchange rate risk through unhedged borrowers. While more than 65% of deposits and loans are in FX (USD), over 90% of foreign currency borrowers rely on income in local currency[3]. In Ukraine the impact of exchange rate depreciation was more severe and was one of the key factors contributing to the pressure on the financial sector. Turbulence on FX market adversely affected banks with open foreign exchange positions and the ability of borrowers to service FX debt. In addition, deposit withdrawals in 2014 and early 2015 led to liquidity shortages and increased need for NBU liquidity provisions.

In Ukraine the capital adequacy of the banking system deteriorated significantly during 2015 driven by the impact of currency depreciation on open positions coupled with rising NPLs and increased provisioning. As of May 2015, the official statistics for regulatory capital to risk-weighted assets stood at 7.7% and recapitalization is on-going. At the initial stage the banks will be required to restore the capital adequacy ratios to 5% and then during the three-year period up to end-2018, they will be expected to restore the adequacy level to 10%.

Moldova was hit by a large banking sector scandal, as large suspicious transactions between three banks (Banca de Economii, Banca Sociala and Unibank) occurred in late 2014. The transactions involved unsecured loans worth some USD 1.2 bn issued by the three banks with the recipients of money unidentified; this represents about 30% of total banking assets, and is equivalent to about 15% of Moldova's 2014 nominal GDP. In October 2015, former Moldovan Prime Minister (serving during 2009-2013), Vlad Filat, was detained and charged with being involved in this bank fraud. The macroeconomic and financial implications of this crisis are potentially considerable including adverse implications for the for bank lending.

Georgia has maintained a well-capitalized and soundly managed banking sector despite the recent slowdown in economic activity and weaker credit growth. Sector-wide capital adequacy ratio stands at 19% (in Basel standards), higher than the regulatory minimum of 12%. The NPL ratio, defined according to the international standards (loans in arrears over 90 days), is one of the lowest among the peer countries and it stands at 3.4%.

Underlying problems of transparency and governance, which have been pervasive across some of the economies of the East, were also present in the banking sectors. In Ukraine, distress in financial system highlighted the need for strengthening banking sector governance and adoption of best practices in regulation. The National Bank of Ukraine has started to implement the program for the Development of Ukraine's Financial Sector till 2020. In Moldova, the situation urgently requires the

[3] In addition to imposing risks of ability to service FX debts and increasing spending on FX loan servicing, depreciation imposes inflationary pressure. However, inflation remains close to the Georgian central bank's target.

Government's response to establish of a strong regulatory framework in line with best banking practice as well as concrete remedy actions. The last government, appointed in mid-February 2015, was proposing the alignment of financial legislation with the best EU practice, to ensure the independence and effectiveness of the National Bank of Moldova, as well as minimum standards of integrity and transparency for bank shareholders.

The SME sector

SME activity

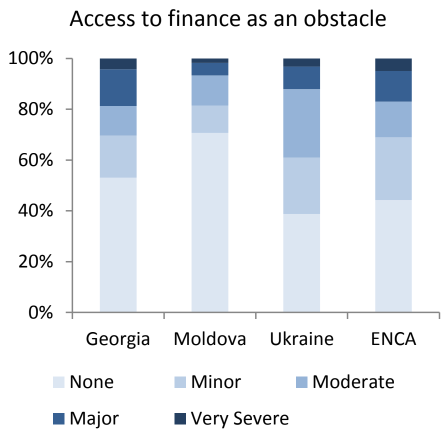
The SME sector has a special role to play in the process of transition of the economies of the EAST. Each country has its specific circumstances, however one factor that they share in common is the transformation from an economic model based large enterprises specializing in commodity transformation and intermediary outputs to a more diversified economic structure. The SME sector can facilitate this process of transformation because SMEs are market-oriented and offer more flexibility in responding to changing demand.

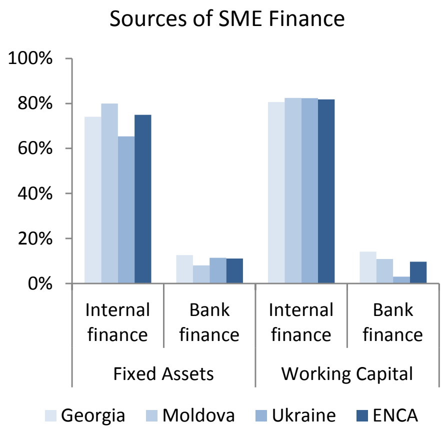
However, although SMEs make up the large majority of firms in the EAST many are still restricted to niche markets with little growth potential. SMEs account for 94% of enterprises in Georgia, 97% in Moldova and 95% in Ukraine. However, with their concentration in the micro segment and subsistence activities, their contributions to employment and turnover are much lower. The employment contribution, for example, is only 43% in Georgia, 47% in Moldova and 67% in Ukraine[4].

Access to finance is one of the main obstacles to doing business as perceived by SMEs (see chart). Other factors highlighted by the Enterprise Survey[5] include political instability, corruption, and tax rates. The survey for Ukraine was conducted in 2012-2013 and political stability would likely be higher among concerns today. In Georgia the survey was conducted in 2012 when the country was going through a democratic process of change in government and political concerns may weigh less heavily today than access to finance.

With limited access to external funding, SMEs rely heavily on internal sources of funding and retained earnings. In Ukraine about 65% of investments in fixed assets and 80% of working capital are financed with internal resources. In Georgia over 70% of investments in fixed assets and 80% of working capital are financed with internal resources. Bank lending makes a small contribution to total financing needs which for both fixed assets and working capital are predominantly met by internal finance.

[4] OECD Small Business Act.
[5] http://ebrd-beeps.com/reports/beeps_v_report/





Source: Enterprise Survey

Business environment

The quality of the business environment is highly diverse in the East. Based on the World Bank's Doing Business 2015 report, Georgia has the highest ease of doing business rank, at 15, while Ukraine has the lowest, at 96. Moldova is in between the other two with a rank of 63.

Getting credit is not the most serious problem facing businesses in any of the countries. For Georgia, doing business indicates that closing a business and getting electricity are the most important concerns. Other aspects of the business environment in Georgia are generally positive and the country scores particularly well for dealing with licenses, registering property and starting a business. In Moldova the scores for enforcing contracts, registering property and starting a business are relatively good but the report highlights serious problems with dealing with licenses, getting electricity and trading across borders. In Ukraine overall business environment is less favorable, and with the exception of enforcing contracts and getting credit there are constraints in all other aspects of the business environment. In particular, 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 informal economy and some even shut down as a result.

Corruption is a barrier to SME development in all three countries, although less so in Georgia, which has benefited from an effective anti-corruption campaign initiated by the Saakashvili administration. According to Transparency International, Ukraine is one of the worst offenders, ranking 144th out of 176 countries in the index[6].

[6] Corruption perceptions index: Armenia 105; Azerbaijan 139; Georgia 51; Moldova 91; Ukraine 144. Rank out of 176 countries. Source: Transparency international.

Doing Business rank out of 189 countries

	ENCA excl Russia	Georgia	Moldova	Ukraine
Closing a Business	90	122	58	142
Dealing with Licenses	116	3	175	70
Ease of Doing Business Rank	85	15	63	96
Enforcing Contracts	32	23	42	43
Getting Credit	68	7	23	17
Getting Electricity	n.a.	80	106	121
Paying Taxes	60	38	70	108
Protecting Investors	65	43	56	109
Registering Property	36	1	22	59
Starting a Business	51	5	35	76
Trading Across Borders	166	33	152	154

Source: World Bank 2015

The quality of the business environment to a large degree reflects the underlying institutional framework for SMEs. Assessment and recommendations for the institutional framework has been made under the OECD's initiative on the small business act.

In Georgia the legal framework has been improved, particularly with regards to private credit bureau information. Bank lending is constrained by high interest rates and collateral requirements. Microfinance institutions are widespread but lack capital, while other non-bank financial institutions are less developed. The legal framework for venture capital is in place but activity remains low. Looking forward, Georgia has formulated an SME strategy for implementation over 2016-2020.

In Moldova creditor rights have been strengthened but there are remaining regulatory gaps. Bank lending is constrained by structural deficiencies because SMEs are seen as risky and costly by banks. The microfinance sector has grown but oversight is limited and other non-bank segments are lacking. Venture capital legislation is in place but activity is low and limited investment and exit opportunities restrict the appetite of investors. There are multiple financial literacy initiatives but no overall coordinate approach.

SME Policy Index Scores

	Georgia	Moldova	Ukraine
Regulatory framework	3.5	3.5	2.5
Operatinal environment	4.3	3.6	3.8
Bankruptcy and second chances	2.9	2.7	2.1
Access to Finance	3.8	3.4	3.2
Legal and regulatory framework	*4.3*	*3.7*	*3.7*
Bank Financing	*3.3*	*2.7*	*2.1*
Non-bank financing	*3.7*	*3.5*	*3.5*
Venture capital	*1.7*	*1.5*	*1.4*
Enterprise skills	3.0	2.5	2.6
Support measures for SME start-ups	3.7	3.4	1.8
Public procurement	4.0	2.9	2.7
Innovation policy for SMEs	2.9	2.4	1.5
Standards and technical regulations	4.2	4.1	4.3

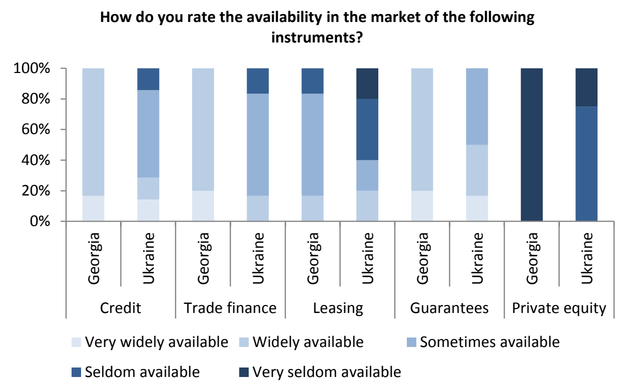
Source: OECD Small Business Act
Note: scores on a scale of 1 to 5 with 1 the weakest

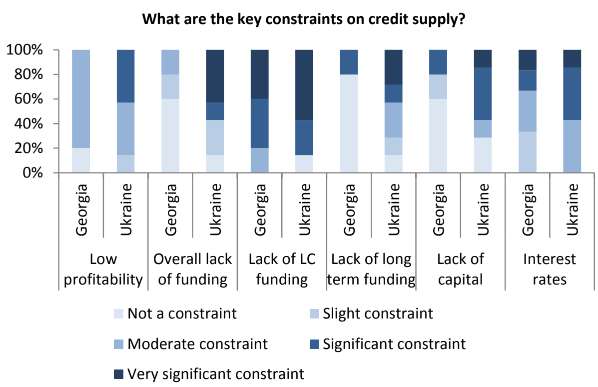
In Ukraine banking regulations have had significant shortcomings that are now being addressed by reforms under the bail-out program. Bank lending has decreased in the adverse macroeconomic environment and government support programs for the SME sector have limited reach. Venture capital legislation is limited and the level of activity is low. Financial literacy programs have expanded but lack central oversight and evaluation.

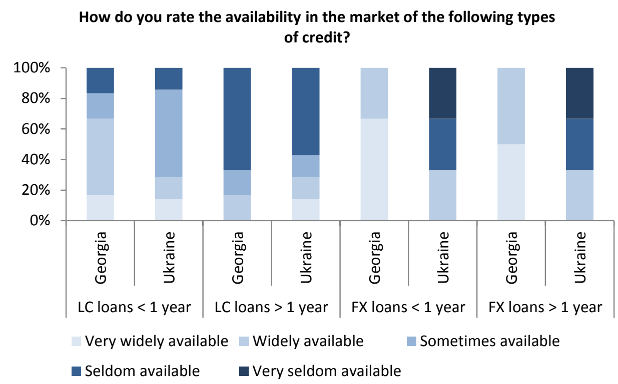
Gaps in private sector financing

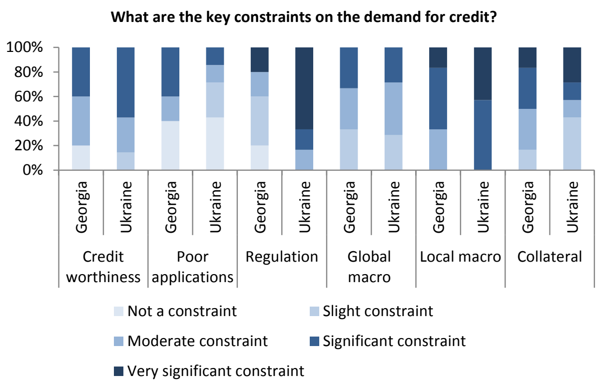
Gaps in the availability of financial products:

- Credit is widely available, and SMEs generally have better access to short term working capital loans than long term investment finance.
- There are differences across the region in terms of availability of foreign currency. In Georgia it is easier for SME to access foreign currency than local currency but in Ukraine the reverse is true and foreign currency loans are more restricted.
- Trade finance is generally available and benefits from the support of IFI credit enhancement programs both in Georgia and Ukraine. However it is constrained in Ukraine by the sovereign credit rating and the limitations of export credit agencies. Trade finance market is less developed in Georgia and the main players are larger companies, mostly using credit, letters of credit and guarantees. On the demand side, low market customer awareness is a limiting factor, while on the supply side high costs of financial intermediaries translate into unattractive pricing. Leasing is small but active in Ukraine with 20% of SMEs using finance leases primarily in transport and agriculture. It is less developed in Georgia.
- SME guarantee schemes are used by three quarters of banks surveyed in Ukraine and half of those in Georgia. Banks in Ukraine report administrative barriers and issues with transparency in relation to guarantee schemes, while in Georgia cost is the main issue.
- Private equity and venture capital are very rarely available. In Ukraine the nascent market was stalled by the economic downturn and in Georgia these financial products remain practically non-existent.









Source: EIB Survey of Intermediary banks[7]

Constraints on the growth of SME finance

[7] Based on responses from 13 banks, 6 in Georgia and 7 in Ukraine. Not all banks responded to every question.

- SME credit growth in Ukraine is constrained by both demand and supply-side factors. SMEs are not investing in the current economic conditions, and agriculture is the only bright spot. Demand constraints are important in Georgia as well, but half of the banks also report supply side constraints.
- Funding constraints vary across banks, but in general funding constraints are tighter in Ukraine than Georgia. Georgia has good access to foreign currency funding but the local deposit base is a constraint on lending in local currency. In Ukraine some banks have good access to deposits while others don't, and there is a systemic constraint on access to foreign capital resulting from macroeconomic conditions and country risk.
- Capital constraints and tightening regulations are clearly a problem for many banks in Ukraine that are required to raise additional capital under the recapitalization program. Lack of capital is less of a concern for the Georgian banking sector.
- Low banking sector profitability for a number of years has constrained the ability and incentive for Ukrainian banks to lend. This is not such a major concern in Georgia.
- SME risk is an important constraint for the intermediaries across the region. All banks indicate some degree of difficulty for SMEs to post the necessary collateral, and provide business plans and transparent accounts. SME risk is further exacerbated by problems with the business environment in Ukraine.
- Financial literacy is another constraining factor for SMEs to make better use of financial products other than loans and to increase their overall bankability.

Part II – SOUTH

Economic and financial situation

In the aftermath of the Arab Spring, the south neighbourhood countries are still struggling to enter a path of solid recovery. Continued political instability and security concerns have affected most countries in the region.

Almost all countries in the south have seen their fiscal and current account deficits ballooning over the last years, but first improvements are now visible. Despite progress towards consolidation, fiscal developments give rise for concern as debt to GDP ratios are high relative to income levels and kept rising also in 2015. The reduction of external imbalances is expected to be most pronounced in the oil importing countries in the region reflecting recent favourable developments in commodity prices. Foreign exchange reserves have increased albeit from precariously low levels. Structural problems remain deep in the southern Neighbourhood.

Weak institutional structures, heavy regulations, large public sectors as well as weak business environments have led to economies operating below their potential. Lack of employment opportunities, as well as unequal access to economic opportunities, are results of these structural deficiencies. Important reform programs are under way in most countries in the region, but progress is uneven and partly very slow. Reforms of generalized energy subsidies are being implemented across the region, and solutions for better targeted social protection are being put in place. However, problems touching upon the inefficiency and size of public sectors have so far not been resolved, and reform progress regarding tax systems or labour markets remains slow.

Banking sector

Banking sectors differ considerably in terms of depth. On the one hand, Morocco, Tunisia and Jordan have relatively high ratios of private credit to GDP when compared to countries at a similar income level. On the other hand, Egypt has a level of financial depth similar to income peers like Djibouti and Gaza West Bank. Firm-level access to credit outcomes exhibit a similar picture with banks in Morocco, and to a lesser extent Tunisia, providing relatively high levels of SME financing whereas banks in Egypt are clearly lagging behind. In Jordan, and also Egypt, supplier credit plays an important part alongside bank lending.

Large-scale lending to governments and state-owned enterprises is a characteristic feature of all of the banking sectors in the region. Government deficits absorb a large proportion of the funding surplus in Egypt, Jordan and Morocco as banks channel the excess of domestic deposits over lending into government securities. Tunisia, on the other hand, has an overall funding deficit and relies to some degree on external sources of funding.

Strict regulation and supervision has maintained relatively high levels of bank capitalization in Egypt and Jordan. This has maintained financial stability but SMEs in these countries are less likely to have a bank loan. High capital ratios may therefore be an indication of risk-aversion over and above the risks inherent in the operating environment. Banks with lower capital ratios in Tunisia, for example, are more fragile, but there is a trade-off between financial stability and access to bank credit.

Net interest margins and profitability also tend to be negatively correlated with SME lending. High margins to some extent reflect operating risks. However, they may also be driven by high operating costs and inefficiencies in the context of high concentration ratios and limited competition between lenders.

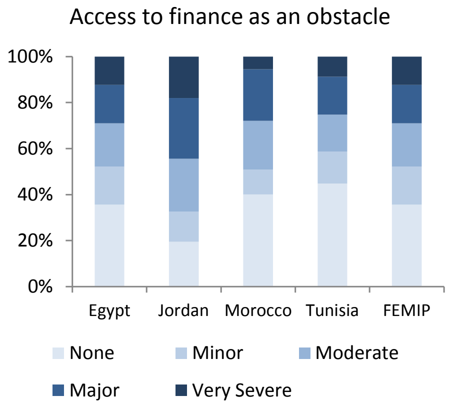
The SME sector

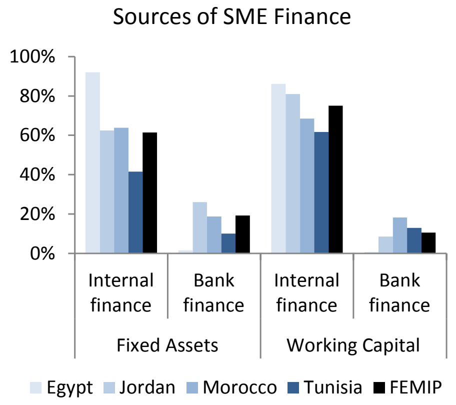
SME activity

In comparison with other regions of the world, the SME sectors of the SOUTH have an unusually high proportion of enterprises that are “disconnected” from the banking system. In the Enterprise Survey these disconnected firms appear as non-credit constrained firms which report either that they don’t need a loan or that they are discouraged from applying because they believe that their loan application would be unsuccessful.

The occurrence of disconnected firms is particularly high in Egypt where it applies to more than 71% of enterprises. Corresponding figures are 50% in Jordan and 37% in Tunisia. Firms report high interest rates, high collateral requirement and complex loan application procedures as the main reasons why they are discouraged from applying. As a consequence of these difficulties SMEs have adopted cash-based strategies to operate their businesses without bank services. Moreover, the survey statistics cover only registered businesses that operate in the formal economy and bank penetration rates would be expected to be much lower for informal and micro-enterprises.

The presence of the large informal sector puts a further brake on the development of formal SMEs. A large proportion of respondents indicate that competition against informal firms places them at a competitive disadvantage. In Egypt in particular the informal sector developed over a period of years in response to complex and bureaucratic rules with unclear enforcement and insufficient legal protection which raised the cost and acted as a disincentive for SMEs to register as formal enterprises.





Source: Enterprise Survey

Young firms and smaller firms are less likely to have access to bank credit than older and larger firms. Uncollateralized is not as widespread as in high income OECD countries and the ratio of collateral value to loan value is higher.

As a consequence, retained earnings and own funds are much more important than bank loans for financing both working capital and fixed assets. For FEMIP as a whole, credit contributes 11% of working capital and 19% of investment finance, and in Egypt the contributions are particularly low at 1% and 2%.

These constraints have implications for economic performance. Young firms have an important role in job creation and external finance is often necessary for firms to implement their expansion plans. Therefore disconnection and the related constraints on young and small enterprises are associated with lower employment and growth[8].

Business environment

Shortcomings of the business environment are a major constraint on the development of the SME sector and the potential demand of SMEs for credit. SMEs suffer more than large firms from institutional constraints and imperfect markets. Small firms in particular are more likely to report regulatory policy uncertainty, corruption, access to land, taxation, access to finance, and electricity as serious constraints. Managers of SMEs spend a higher percentage of their time dealing with bureaucracy and are more likely to report that informal payments to officials are needed to get things done.

The overall ease of doing business is relatively good business in Morocco and Tunisia but more challenging in Egypt and Jordan. The World Bank Doing Business indicators (see table) show Morocco and Tunisia with rankings of 71 and 60 out of 189 countries, while Egypt and Jordan are much lower down the rankings at 112 and 117.

[8] Enterprise Survey

Doing Business rank out of 189 countries

	Egypt	Jordan	Morocco	Tunisia	FEMIP
Ease of Doing Business Rank	112	117	71	60	93
Getting Credit	71	185	104	116	93
Closing a Business	126	145	113	54	88
Dealing with Licenses	142	126	54	85	122
Enforcing Contracts	152	114	81	78	119
Getting Electricity	40	130	120	166	122
Paying Taxes	149	45	66	82	118
Protecting Investors	135	154	122	78	94
Registering Property	84	107	115	71	118
Starting a Business	73	86	54	100	84
Trading Across Borders	99	54	31	50	70

Source: World Bank 2015

Getting credit is one of the main obstacles facing SMEs across the region. Jordan in particular ranks 185th out of 189 countries reflecting deficiencies in both the secured transaction framework and the availability of credit information. Morocco and Tunisia are also both below 100. Egypt's relatively good score for getting credit reflects the large proportion of enterprises that are disconnected from the banking system (described above) which therefore do not regard access to bank finance as an obstacle to business development.

Other aspects of the business environment are diverse across the region. Jordan has particular problems resolving insolvency and protecting investors. On the other hand, Jordan performs relatively well in the areas of paying taxes and trading across borders. Overall, Jordan lags behind the FEMIP average despite its comparatively high income levels. In Tunisia the business climate is relatively attractive regarding electricity provision (38th) and trading across borders (50th), even though the latter has recently weakened due to deterioration in port infrastructure and inadequate terminal space. The biggest challenge after getting credit is starting a business (100th).

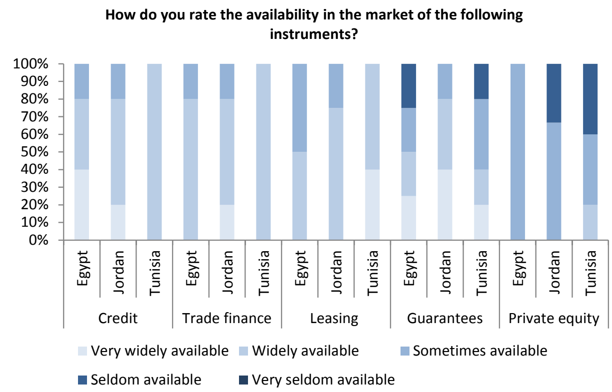
Gaps in private sector financing

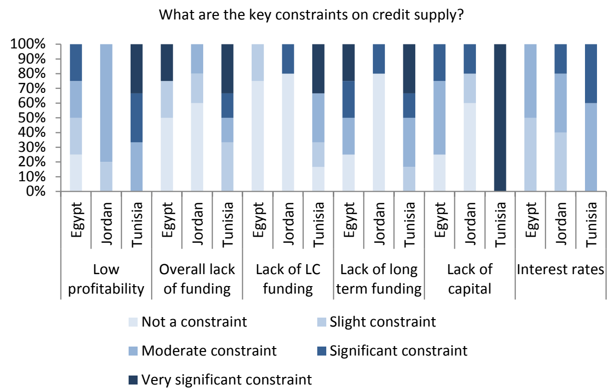
Gaps in the availability of financial products:

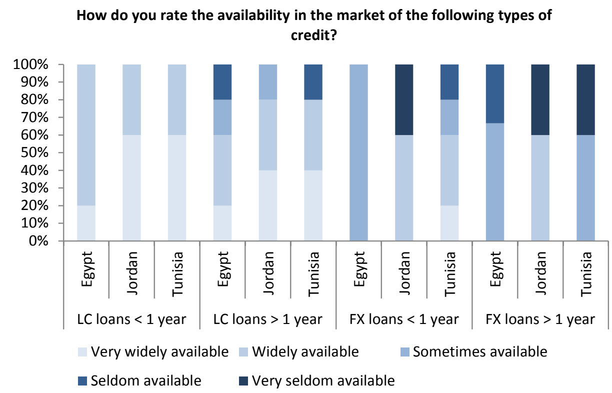
- SME credit is widely available but there are differences across the region in availability of long term credit and loans in foreign currency. In Jordan, long term and short term credit is available in both local and foreign currency. In Egypt availability of local currency is better than foreign currency, especially for longer maturities. In Tunisia also, local currency is more widely available than foreign currency but some banks report a gap in provision of long term local currency loans.
- Trade finance products are widely available but the growth of this type of product is constrained by sovereign ratings.
- Despite the availability of credit there is still a significant financing gap and many SMEs consider themselves credit constrained. In particular, young and innovative SMEs are often cut off from external financing sources due to a lack of acceptable collateral. In the FEMIP region 10% of firms report access to finance as the most important constraint on enterprise development. In Egypt many SMEs, even among those in the formal sector, operate on a largely cash-only basis and have become disconnected from the banking system. In Jordan access to finance is the most important constraint on enterprise development for approximately 30% of Jordanian firms.
- There are active leasing markets in all of the countries but the level of activity remains low. In Tunisia leasing companies need longer term external financing. In Egypt, leasing is constrained by failures in the business environment and leasing companies have moved towards a client-

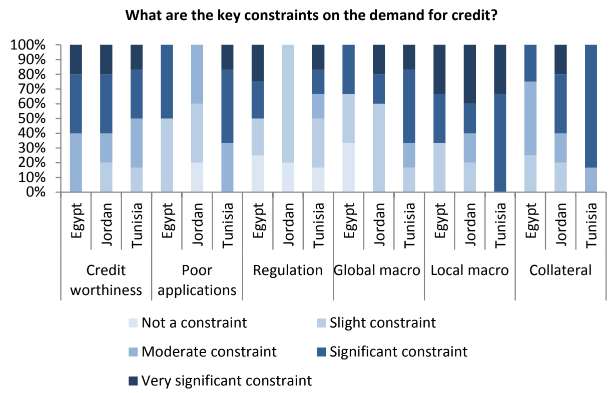
based model where the client's creditworthiness is given more weight than the potential of the asset to generate cash flow. In Jordan leasing activity is relatively low with only 7.5% of firms leasing fixed assets compared to approximately 20% in the FEMIP region.

- Equity finance has limited availability and this is a particular problem for start-ups that do not have access to debt financing. Egypt has an active and growing private equity industry but the volume of transactions is small in view of the potential size of the market. Funds in Jordan tend to focus on specific sectors such as real estate and telecoms, where the investment horizon is relatively short and their impact on the SME sector in general remains limited.
- There are a number of existing SME guarantee schemes but their contribution to SME lending remains relatively small. The Jordanian Loan Guarantee Corporation, for example, has been constrained by the one-by-one approval process and the total guarantee portfolio at the end of 2014 was only some 3,500 guarantees. In order to deepen their SME business, banks are interested in the development of SME portfolio guarantee systems.
- Legal and institutional failures will require government initiatives to improve the business environment and incentives for the private sector, which will run in parallel with measures to improve access to finance.









Source: EIB Survey of Intermediary Banks[9]

Constraints on the growth of SME finance:

- The growth of SME credit is constrained by a combination of supply and demand side factors. In Egypt the constraints are primarily on the demand side due to political unrest and economic disruption. Demand side constraints have also been important in Jordanian where

[9] Based on responses from 16 banks, 5 in Jordan, 6 in Tunisia and 5 in Egypt. Not all banks responded to every question.

the economy has been affected by conflict in neighbouring countries and in Tunisia where local and global shocks have affected both the demand for credit and the lending capacity of the banking sector.

- On the supply side, the major constraint on SME lending is not a lack of liquidity but lack of risk-bearing capacity. The existing SME programs have serious shortcomings and only partially offset the deficiencies in the financial infrastructure (relating to credit information, secured transactions and insolvency) and incentives for intermediaries.
- Funding surpluses in Egypt and Jordan are to some degree absorbed by government budget deficits. However the funding positions of the banks are diverse. Banks with well-established branch networks have good access to deposits, whereas some of the challenger banks that are more aggressive in the SME sector do not. In Tunisia the banking sector in aggregate has a funding deficit and the loan-to-deposit ratio stood at 112.6% at end-2014 and competition between banks for deposits is squeezing margins.
- Funding and capital constraints vary across countries and banks. Banks need longer term funding to provide more long term loans to SMEs, as this helps them to reduce risks from maturity mismatches on their balance sheets. Jordan has plentiful deposits, good access to foreign exchange and adequate capital ratios. Egyptian banks are well capitalized and are tightly controlled with strict capital adequacy regulations. However, in Tunisia, the financial situation of the banks is an important constraint, particularly for the public sector banks where asset quality has deteriorated, and capitalization has fallen below regulatory thresholds.
- For SME lending specifically, banks report that profitability is a significant concern. In Tunisia profitability is depressed, and while Egypt reports better profitability the figures may overstate the true position of the Egyptian banks due to rescheduling and restructuring of loans affected by political turmoil.
- Interest rate regulation in Tunisia limits banks' ability to charge higher interest rates for particular risk profiles and highlights the need for extra provisioning. Interest rate caps have also been a constraint on the development of commercially based microfinance.
- SME risk is an important constraint and all banks indicate some degree of difficulty for SMEs to post the necessary collateral, and provide business plans and transparent accounts. SME risk is further exacerbated by problems with the business environment.
- Capacity building at the enterprise level is needed to fill gaps in business skills and to promote the generation of high-quality investments. These enterprise skills may be supported through capacity-building linked to loans or through independent initiatives.

European
Investment
Bank
The EU bank

Economics Department
economics@eib.org
www.eib.org/economics

Information Desk
+352 4379-22000
+352 4379-62000
info@eib.org

European Investment Bank
98-100, boulevard Konrad Adenauer
L-2950 Luxembourg
+352 4379-1
+352 437704
www.eib.org