7 Pillar C – Access to Finance

One of the key challenges to SMEs' growth and competitiveness remains access to financial resources. This chapter elaborates on the latter and is structured around six components: 1) the legal and regulatory framework for bank financing, which addresses the protection of creditor rights, the use of a register and a credit information bureau, banking and stock market regulations; 2) bank financing, which essentially covers credit guarantee schemes; 3) non-bank financing, which looks into the use of microfinance, leasing and factoring; 4) the venture capital ecosystem, which analyses the enabling framework and the presence of business angel networks; 5) financial literacy, i.e. governmental efforts to disseminate financial know-how to businesses and citizens; and 6) digital financial services and the relevant regulatory and supervisory frameworks. Policy recommendations on how to further facilitate access to finance for SMEs are formulated at the end of this chapter.

Introduction

Access to finance is a crucial pillar of SME growth and development. Being able to access external finance can allow a company to invest in new assets that will support its growth, develop new products and processes, and manage its finances more efficiently to enable it to become more competitive. As a result, access to finance can accelerate economic growth in an economy.

However, access to finance remains a challenge for SMEs across the globe, including in the Eastern Partner (EaP) region. A pre-COVID assessment of the global SME finance gap estimates that 41% of formal MSMEs in developing countries have unmet financing needs (SME Finance Forum, 2023[1]). In the EaP region, the financing gap is estimated to be around USD 44 billion (EUR ~41 billion, the equivalent of an average of 18% of the countries' GDP), meaning that for SMEs' needs to be fully served, current lending would need to increase by 200%. Given the COVID pandemic, war and economic challenges, these figures have likely not improved.

Obtaining credit can be challenging for many SMEs. Being small and having a wide range of differing needs, SMEs tend to be more difficult to reach and serve than larger companies. They carry a higher perceived risk of default, and their loans are more costly to manage given the fixed costs involved in providing a loan of any size. In many countries, especially those where financial sectors are not particularly deep, banks rely heavily on collateral, preferably immovable assets such as land or buildings. However, many small businesses lack sufficient immovable assets to use as security for loans. In addition, many small business owners possess only limited financial literacy, meaning that identifying the right financial product, preparing adequate accounts and presenting a convincing business case for a new investment can be challenging.

While some of these challenges are related to SMEs' inherent characteristics, many stem from deficient framework conditions and can be addressed or alleviated through government action. A robust legal framework for secured transactions can reduce the lender's risk, an adequate regulatory framework can ensure the sustainable development of the financial sector, and a legal framework supportive of the development of non-bank financing instruments can broaden the options SMEs have available for external finance. In addition, government policies such as credit guarantees can help borrowers with little collateral access funding, and programmes to boost investment in early-stage companies can help start-ups develop and grow. Measures to improve financial literacy can help entrepreneurs make better financial choices and submit loan applications with a higher prospect of approval. Finally, the development of digital financial services can help address some of the issues around scale when it comes to SME access to finance, thus opening up new and more affordable funding opportunities that are more tailored to the needs of small businesses.

Creating the right conditions for the development of a financial sector capable of responding to SMEs' needs is therefore fundamental – a necessity that the Small Business Act for Europe recognises. This chapter analyses different aspects of access to finance and the policies that support it and looks at both the supply and demand sides when it comes to credit provision.

Table 7.1. Pillar C, country scores by sub-dimension (2024)

	Armenia	Azerbaijan	Georgia	Moldova	Ukraine	EaP average	*EaP average 2024 (CM)*	*EaP average 2020 (CM)*
Access to finance	**3.54**	**3.31**	**4.07**	**3.48**	**3.40**	**3.56**	***3.90***	***3.67***
Legal and regulatory framework	4.03	4.13	4.31	4.33	3.70	4.10	*4.32*	*4.29*
Bank financing	2.30	2.34	3.74	2.67	2.54	2.72	*2.93*	*2.33*
Non-bank financing	4.56	3.61	3.71	4.04	4.22	4.03	*3.98*	*3.60*

	Armenia	Azerbaijan	Georgia	Moldova	Ukraine	EaP average	*EaP average 2024 (CM)*	*EaP average 2020 (CM)*
Venture capital	3.34	2.04	3.56	2.32	2.52	2.75	*2.65*	*2.00*
Financial literacy	4.53	3.27	4.80	2.94	3.94	3.90	*3.80*	*3.38*
Digital financial services	3.52	3.05	3.94	3.02	3.81	3.47	-	-
Outcome-oriented indicators	3.00	3.22	4.56	2.78	3.22	3.36	-	-

Note: See the “Policy framework, structure of the report and assessment process” chapter and Annex A for information on the assessment methodology.

Access to finance

Assessment framework

This pillar covers six dimensions relevant to access to finance: i) the legal and regulatory framework for bank financing; ii) the provision of bank financing; iii) the conditions for non-bank financing; iv) the ecosystem for venture capital; v) financial literacy; and vi) digital financial services.

Some important methodological changes have been implemented for this pillar since the last assessment. Most prominently, a new dimension on digital financial services has been added. Given the importance of digital finance for SME credit and the new avenues it opens up to provide more affordable and accessible funding to small businesses, it seemed necessary to expand the assessment framework under this pillar. In addition, outcome indicators have been grouped into one scoring dimension rather than being distributed across thematic sub-dimensions. This change intends to put emphasis on the availability of data points and highlight the importance of data collection as a basis for informed policy decisions.

There have also been some smaller changes to the remaining dimensions, but these are mostly focused on clarifying certain questions to improve the ability to answer and score them. Some new questions have been added. For instance, the inclusion of environmental, social and governance (ESG) aspects in the banking regulatory framework is now being considered given the rising importance of such matters for the finance world, as well as the impact climate change may have on banks’ portfolios. In the non-bank financing sub-dimension, new questions around the regulation of microfinance have been introduced where previously only availability and supervisory aspects were covered. Governments were also asked to provide information about policies put in place during the COVID pandemic to support SMEs’ access to funding when sales dried up due to lockdowns (Box 7.1).

Box 7.1. Government measures to support SME access to finance during the COVID-19 pandemic

During the pandemic, governments across the EaP region introduced measures with a view to stabilising their economies. Among these were measures that focused on providing funding to ensure business continuity and facilitating the management of payment defaults by commercial banks. These included support programmes as well as regulatory adjustments. The aim was to keep businesses afloat, to maintain employment, and to avoid a rapid rise in non-performing loans in the banking sector.

While there is variation across countries in terms of specific measures, some commonalities exist. The majority of measures were introduced in the first quarter of 2020 (and updated thereafter), and most were phased out in the course of 2021, with only a few exceptions. The most commonly used measures include the following:

- **Interest rate subsidies**: several governments introduced interest rate subsidies in order to help keep businesses alive. Some of these loans benefitted from interest-free periods (e.g. Armenia) or reduced rates (e.g. Georgia, Ukraine), and eligible loan purposes were defined relatively widely so that loans could be used for salaries, utility payments, rent, working capital and even refinancing of existing debt (e.g. in Ukraine).
- **Grants**: One-off payments, especially to small and micro businesses, were also quite common, for example in Armenia, Azerbaijan and Ukraine. Some grants also targeted specific sectors such as tourism or agriculture.
- **Credit guarantee schemes**: In all EaP countries, credit guarantees were either introduced or expanded in order to help businesses cope with the strain from lockdown measures. Typically, measures included the increase in the guaranteed amount (to 80-90% for individual exposures), reduction in guarantee fee payments (to 0% in certain cases), and expansion of eligible loans (in terms of minimum or maximum amounts or eligible use of proceeds).
- **Payment deferrals and management of loan portfolios**: Central banks in all EaP countries encouraged commercial banks to apply more flexibility in terms of repayment schedules for borrowers that were struggling. In some countries (e.g. Azerbaijan, Moldova and Ukraine) these were also accompanied by changes in macroprudential measures, such as capital and liquidity requirements or loan classification and provisioning obligations, i.e. being able to maintain a certain loan classification even in case of repayment holidays. The National Bank of Georgia introduced a liquidity support instrument to support SME lending by allowing banks to use their SME loan portfolios as collateral. Under the programme, it was also possible to defer principal and interest payments for SME clients, and 50% of SME borrowers benefitted from this measure.

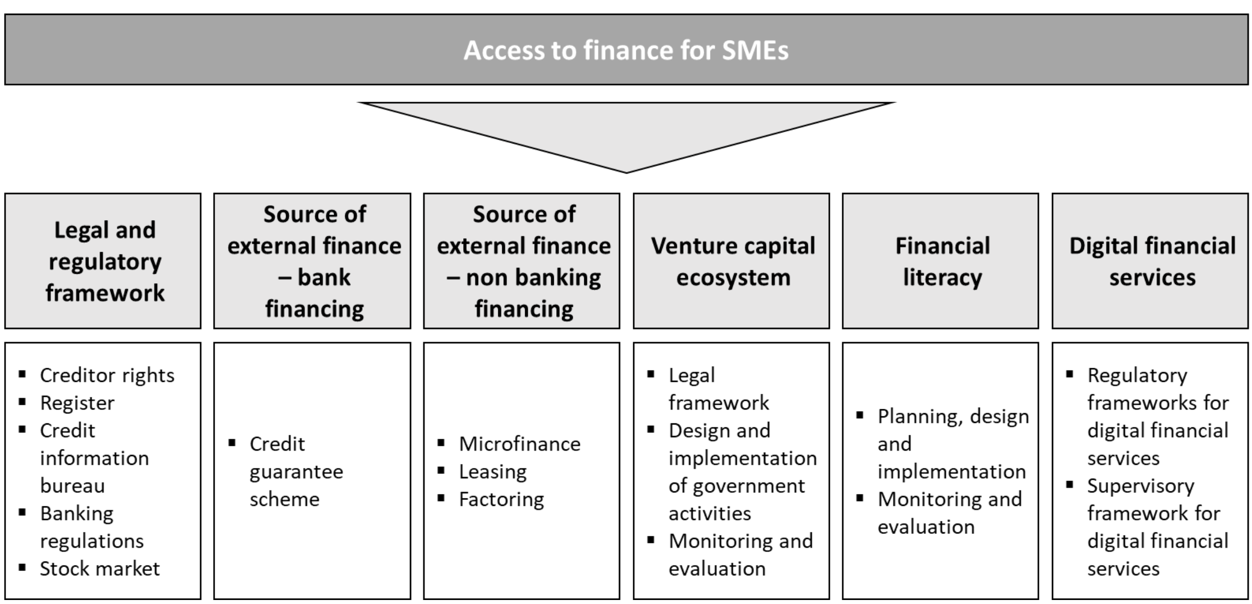
Although credit levels in some cases are still below crisis levels, these measures supported the continued functioning of both the banking sector as well as the real sector, laying the foundations for positive credit growth going forward.

Source: (IMF, 2021[2]); EaP government accounts.

Overall, access to finance is the result of a complex interaction of different determinants, including the macroeconomic environment, monetary policy, the health and breadth of local financial markets, and the creditworthiness of enterprises. The assessment framework cannot capture all these factors, but instead focuses on a set of topics which are deemed disproportionately important for SME access to finance:

- **Legal and regulatory framework**: this sub-dimension focuses on the legislation facilitating access to finance, including protecting creditor rights, facilitating the use of collateral and credit information, and banking and stock market regulations.
- **Bank financing**: this sub-dimension covers bank lending practices and the availability of credit guarantees.
- **Non-bank financing**: this sub-dimension reviews the legal framework and use of microfinance, leasing and factoring.
- **Venture capital**: this sub-dimension assesses the legal framework enabling venture capital (VC) and the existence of business angel networks.
- **Financial literacy**: this fourth sub-dimension analyses government efforts to promote financial know-how among the business community and wider population.
- **Digital financial services**: the last sub-dimension covers the existence of a regulatory and supervisory framework for a range of digital financial services.
- The section on **outcome indicators** considers countries' ability to regularly collect statistical information about the following indicators: outstanding business loans (SMEs and total); new business lending (SMEs and total); short-term loans (SMEs, initial maturity < 1 year); long-term loans (SMEs, initial maturity > 1 year); government loan guarantees (SMEs); government guaranteed loans (SMEs); interest rates for new business loans (SMEs and large firms); collateral requirements (SMEs); VC investments; leasing and hire purchases; factoring and invoice discounting; microfinance loans; non-performing loans (SMEs and total); and payment delays (business-to-business).

Figure 7.1. Assessment framework – Access to finance



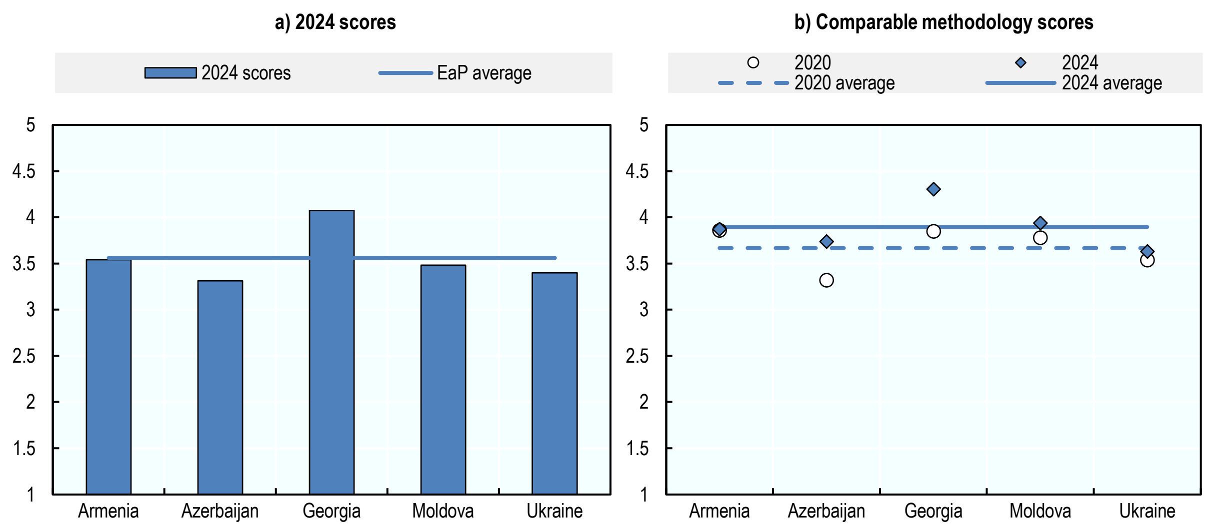
Analysis

Regional trend and comparison with 2020 assessment scores

Due to the methodological changes and new dimensions that have been introduced, the 2020 and 2024 scores are not directly comparable; however, much of the movement and variation across countries and sub-dimensions can be noted and certain trends can be discerned. For instance, policies across almost all sub-dimensions have improved, with many governments putting in place new or larger support schemes for access to finance, introducing legal reforms to improve the framework conditions for non-bank financing solutions and conducting more regular financial literacy assessments. Another aspect that has led to improvements in the scores for this sub-dimension is the removal and grouping of outcome indicators that used to suppress scores. As is common in the policy world, changes on paper do not necessarily translate into immediate improvements in outcomes for a variety of reasons: time lags in legal or policy changes feeding through to actual outcomes, deteriorations in the macro environment that counterbalance positive policy changes, and other influencing factors.

On the other hand, methodological changes that led to the addition of more ambitious objectives, such as the consideration of ESG aspects in the regulatory framework, meant that scores were lower than if these additional elements had not been introduced. This affected scores in the opposite direction, leading to an overall score that suggests very little has changed when in fact quite a lot has happened in this pillar, as will be explained in more detail in the following sections.

Figure 7.2. Access to finance, dimension scores



Note: See the “Policy framework, structure of the report and assessment process” chapter and Annex A for information on the assessment methodology.

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Legal and regulatory framework

Having an adequate legal and regulatory framework for SME access to finance is a fundamental prerequisite for bank lending to SMEs, especially since small firms are typically seen as riskier borrowers. Therefore, much of the legal framework for secured transactions focuses on reducing lending risk. For instance, having registers in place allowing security interests to be established facilitates the use of collateral, which means that the bank has a chance of recovering at least part of its money if the borrower defaults. However, such registers need to be accompanied by fair and efficient enforcement processes so that lenders can get quick access to the collateral if enforcement is necessary. Similarly, credit information systems can help reduce information asymmetries and therefore decrease the perceived riskiness of a borrower.

Having adequate prudential measures in place is important to ensure that the banking sector remains healthy and able to lend, and provisions to encourage local currency lending are useful from both a financial stability and consumer protection perspective, as unhedged borrowers may be at a higher risk of default if taking out a foreign currency loan when exchange rate movements are a realistic possibility.

Table 7.2. Legal and regulatory framework, sub-dimension scores

	Armenia	Azerbaijan	Georgia	Moldova	Ukraine	EaP average
Sub-dimension score	**4.03**	**4.13**	**4.31**	**4.33**	**3.70**	**4.10**
Creditor rights	3.20	4.10	4.10	5.00	3.20	3.92
Register	4.86	4.91	5.00	4.81	4.90	4.90
Credit information bureau	4.32	4.32	4.32	4.32	4.32	4.32
Banking regulations	3.40	2.90	4.09	3.00	1.26	2.93
Capital market	4.16	3.71	3.71	3.71	3.89	3.84

Note: See the “Policy framework, structure of the report and assessment process” chapter and Annex A for information on the assessment methodology.

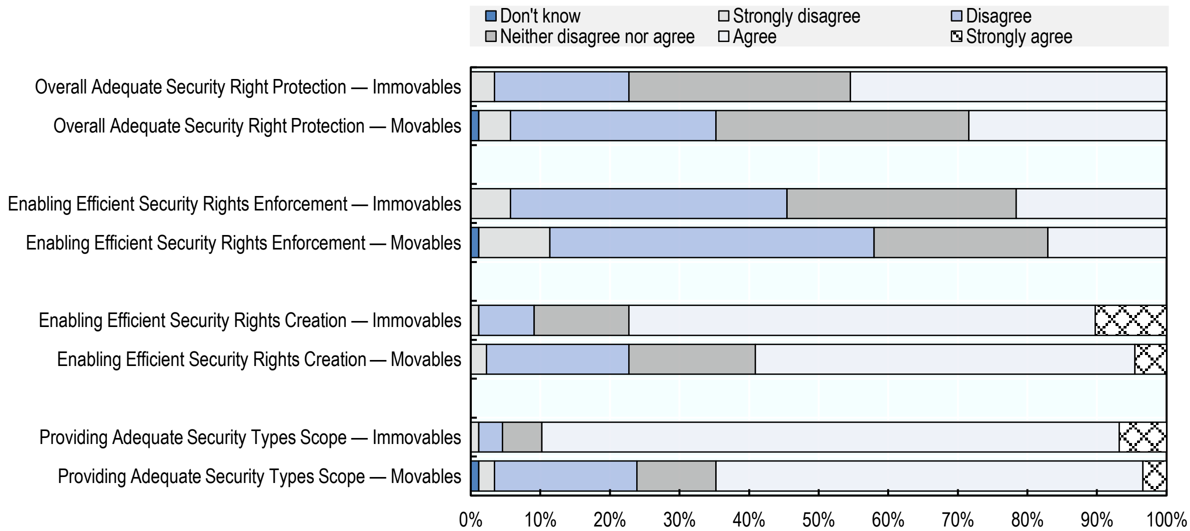
Creditor rights: Legal frameworks for secured transactions are in place but enforcement remains an issue across the region

All economies in the region have a reasonably developed legal framework for secured transactions in place and scores have only changed marginally in this sub-dimension. Enforcement continues to be of concern, however. This issue has been consistently flagged throughout the assessments, but progress to address it has been slow. If enforcement is inadequate, this impacts the entire framework, as creditors will not be able to make use of collateral and take steps to recover their funds if a borrower defaults, even if the process of defining and registering an asset as security was straightforward.

A survey of banks across the region shows that they are generally satisfied with the scope of the types of security that can be used, as well as with the process of creating security rights. There is some difference between types of assets, with immovable assets being assessed as more favourable. However, 46% of respondent banks disagree or strongly disagree with the statement that “the existing framework enables the efficient enforcement of security rights over immovable assets”, and this share increases to 57% for movable assets. This points to widespread dissatisfaction when it comes to enforcement mechanisms thus compromising the willingness of lenders to provide credit to smaller firms.

Further information related to this topic can be found in the Pillar A chapter under “Bankruptcy and second chance”.

Figure 7.3. Bank responses: assessment of the law and its implementation related to immovable and movable assets, EaP total



Source: (EBRD, 2020[3]).

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Register: Collateral registers are available in all countries but accessibility could be improved in some cases

Having reliable and accessible registers that facilitate the use of immovable and movable assets as collateral is important for a legal framework for secured transactions. Up-to-date information and accessibility are crucial to ensure that lenders can check whether a certain asset is already pledged and register their own security interest.

There have not been any major changes to how the existing registers are operating since the last assessment. Cadastres exist in all countries and are available online and to all stakeholders. In Azerbaijan, access used to be restricted but has been broadened to the general public. Registers for movable assets are also in place across the region and all financial institutions can access them. They are fully available online in Armenia, Azerbaijan and Georgia, but only partially available online in Moldova and Ukraine. In Ukraine, online access was restricted after Russia's invasion and access has to be specifically requested.

When it comes to practical application, a recent banking survey suggests that cash-flow analysis, knowledge of the client, personal collateral and immovable assets are the most important factors that lending decisions are based on. Guarantees (by governments and individuals), automated credit scoring, and movable collateral seem to play less of a role in bank's lending decisions (EBRD, 2020[3]).

Credit information

Credit information systems can be useful in reducing information asymmetries between lenders and borrowers and facilitating the creditworthiness assessment of an SME asking for finance. There are generally two types of credit information system: 1) a public register, usually run by the central bank or financial authority; and 2) a private credit bureau, a company that collects credit information and makes it available to financial service providers for their credit assessments. Public credit registers tend to only take information into account that the central bank collects from the banks and other financial institutions it supervises. A private credit bureau can collect information from a wider range of sources, such as financial service providers that do not fall under the supervisory authority of the central bank, utilities, telecommunications companies, insurance companies and others. This usually allows them to build a fuller picture of a potential borrower, especially if that borrower lacks a history of borrowing and repaying.

In some markets, credit information providers are increasingly trying to use digital technologies to assess the risk of a borrower's default based on a wider range of data, such as behavioural and social information. These types of credit scoring mechanisms are particularly relevant in the context of digital financial services (see under "Digital financial services" later in this chapter) but can also supplement more traditional credit scoring.

All central banks in the region have a credit register, and each country has at least one (if not more) private credit bureau, with a private credit agency opening up in Azerbaijan for the first time since the last assessment. Borrowers in all EaP countries have a legal right to access their credit information. In terms of coverage, most credit bureaus go beyond collecting information from financial institutions, but sources of credit information could be further expanded in some countries, such as Moldova and Ukraine. Since the discontinuation of the World Bank's Doing Business data collection, new comparable data on population coverage of credit information are not available, but data up to 2020 suggest that credit coverage was less than 60% of the population in Azerbaijan, Moldova and Ukraine, whereas it was relatively high (above 80%) in Armenia and Georgia.

Banking regulations

A robust supervisory framework is important for maintaining a healthy banking sector capable of extending credit to companies and households. Many of the measures that are examined in the context of this assessment are about reducing risks within the system. For instance, the adoption of Basel III principles puts in place prudential measures that ensure banks manage portfolio risks well and have sufficient buffers to withstand more difficult times. Regulation to encourage local currency lending aims to reduce defaults due to exchange rate shifts and also has an element of consumer protection. In all of the Eastern Partner economies, foreign currency loans tend to be cheaper than local currency loans, making them an attractive, albeit higher-risk, option for unhedged borrowers. Ensuring that banks recognise and manage this risk, and that clients are aware of the potential ramifications of taking out a foreign currency loan, is particularly important in this type of environment.

Countries have made progress with the implementation of Basel III requirements. Where only Georgia had fully implemented them in the last assessment, Moldova has now followed suit, and Armenia, Azerbaijan and Ukraine have made progress on implementation. Ukraine, in particular, relaxed some prudential requirements after the full-scale invasion and, consequently, Basel III implementation is delayed. Expectations are, however, that they will progress in 2024 if the situation allows.

Loan dollarisation levels have decreased since the last assessment, with between 55% and 80% of loan portfolios now denominated in local currency. Except in Ukraine, all central banks have put in place certain requirements to encourage local currency lending, such as higher risk weights and mandatory disclosure of foreign exchange risk to borrowers.

Finally, it is increasingly important to take ESG (environment, social & governance) considerations into account in regulatory frameworks. Climate change can have a significant impact on banks' portfolios. For example, extreme weather events can damage companies' and households' assets, or impact the revenue generation of agricultural companies, which in turn can affect a borrower's repayment capacity.

The inclusion of ESG-related indicators in banks' reporting obligations is not yet widespread, however. Georgia is the only country where banks need to systematically report on these aspects, and the National Bank of Georgia is the only financial authority in the region that has already developed a green taxonomy to facilitate the correct classification of green financing instruments. The central bank is also working on introducing climate-related stress testing. In all other countries, these developments are still at an early stage. In some instances, governance-related issues are being monitored, albeit at the bank level rather than the borrower level. Environmental or social aspects do not form part of any disclosure requirements, however. There is still a long way to go for these considerations to become a firm part of the central bank's supervisory framework, but work has begun and should lead to further improvement in the next assessment.

Capital markets

The notion of financing SMEs through capital market instruments has gained traction in recent years. If tailored to SME needs, capital markets can provide a viable alternative financing option for companies at the higher end of the SME size spectrum. Companies can use capital markets to access more long-term financing, in the form of either an initial public offering (IPO) or corporate bonds. In both developed and emerging markets, attempts have been made to make capital market instruments more accessible for SMEs, albeit with mixed results. One common constraint involves the fixed costs associated with capital market instruments, which make smaller amounts of financing less worthwhile. But fundamentally, ESG - oriented instruments need to be developed and liquid enough to provide a viable financing option for corporates in the first place before moving on to SMEs.

None of the markets in the region are sufficiently developed to be seen as a realistic funding option. Although each country has a stock exchange, they tend to be characterised by issuances of government or bank bonds with a limited investor base. Market capitalisation as a percentage of GDP is low, with an illiquid secondary market. In some instances, restrictions on institutional investors restrict the investor pool, which contributes to limited liquidity.

Bank financing

In all markets, both developed and emerging, bank financing is the most important source of external finance for SMEs. Many factors influence accessibility and affordability: the enabling environment for bank financing (as discussed in the first part of this chapter), the macroeconomic environment, competition in the financial sector and many more. Governments can work on the enabling environment to support the development of a healthy private banking sector that can serve borrowers who are able to take informed financial decisions. They can also run support schemes that target SMEs' access to finance specifically, addressing some of the market failures that SME lending suffers from.

These schemes can take different forms, such as interest-rate subsidies, grants or credit guarantees. While the government's choice of instrument can depend on various factors, it is important that any scheme be designed with several considerations in mind: how it addresses the identified policy issue, what sunset clauses are being introduced to avoid over-dependence, how the support scheme can be designed to minimise the risk of market distortion, and what evaluation mechanisms are put in place to monitor their effectiveness and adjust if necessary. The last point is particularly crucial to ensure that whatever option is chosen addresses the identified policy issue and supports the intended outcomes, therefore minimising the potential waste of public funds.

Table 7.3. Bank financing, sub-dimension scores

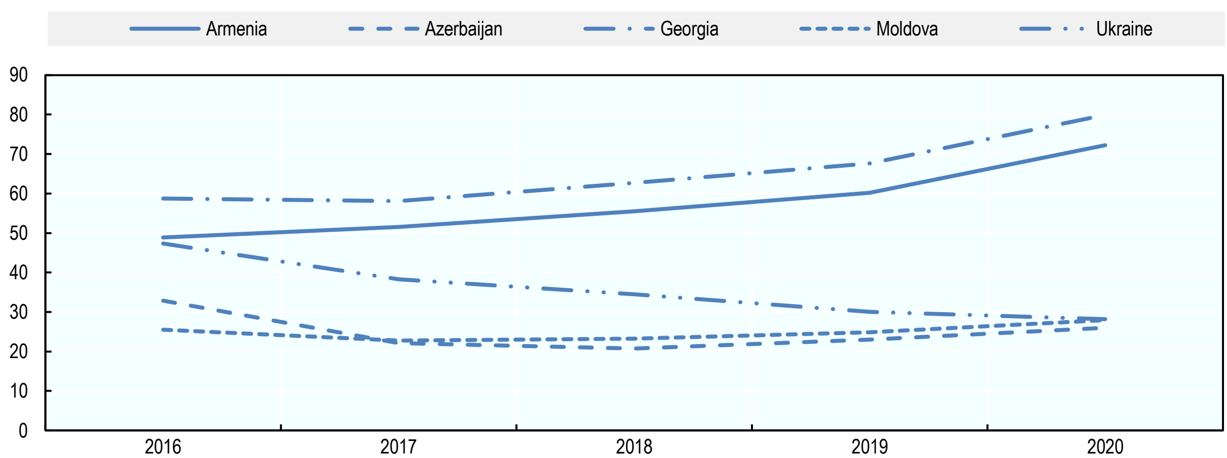
	Armenia	Azerbaijan	Georgia	Moldova	Ukraine	EaP average
Sub-dimension score	**2.30**	**2.34**	**3.74**	**2.67**	**2.54**	**2.72**
Banking lending practices and conditions	2.66	2.32	3.31	2.66	2.50	2.69
Credit guarantee schemes	1.78	2.38	4.38	2.70	2.61	2.77

Note: See the "Policy framework, structure of the report and assessment process" chapter and Annex A for information on the assessment methodology.

Banking lending practices and conditions

A number of countries in the region have recently experienced major upheavals in their banking environments, that have impacted lending conditions in the years since. Azerbaijan, Moldova and Ukraine all experienced difficult periods in the banking sector that required major clean-up and recovery measures by their respective central banks. These activities have helped stabilise sectors, but in the meantime lending has remained subdued (see Figure 7.4) and the COVID pandemic has further delayed recovery. Overall, the ration of domestic credit to GDP ranges from as low as 26% in Azerbaijan to nearly 80% in Georgia. Levels are higher than during the last assessment, but still well below the OECD average (102%).

Figure 7.4. Domestic credit to the private sector as a percentage of GDP (2016-20)



Source: (World Bank[4]).

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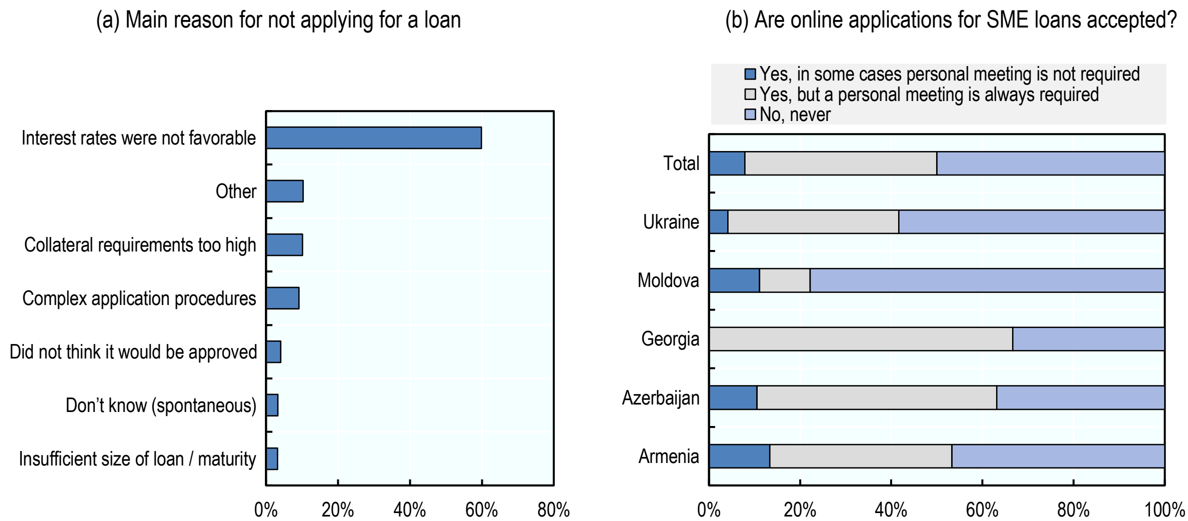
According to some estimates, there is a funding gap equivalent to 18% of GDP across the EaP region, and around a third of SMEs are reportedly credit constrained, meaning they would like a loan but cannot access one (SME Finance Forum, 2023[1]). According to a business survey conducted in 2019, the reasons for not being able to access a loan when needed were mainly linked to high interest rates, but high collateral requirements and complicated application procedures also played an important role (EBRD and World Bank, 2020[5]). While interest rates and collateral requirements are the result of a complex set of factors, easing barriers to loan applications is something that can be remedied more easily. However, when looking at the ease of submitting a loan application, a recent survey of banks shows that online applications that do not require a physical presence are not common and in half of the cases, no online application is possible at all (Figure 7.5) (EBRD, 2020[3]). This chapter also discusses elements that can address the issues of high interest rates (e.g. a robust secured transactions framework for digital financial services) and high collateral requirements (e.g. credit guarantees, which are explored in the following section).

Figure 7.5. Barriers to SME bank finance in EaP countries



Source: (EBRD and World Bank, 2020[5]).

Credit guarantee schemes

Credit guarantees can be an effective instrument to support SME access to finance. They can help de-risk loans, especially where collateral is lacking. They also tend to be more aligned with commercial lending practices than, for example, interest rate subsidies. Lending decisions are still based on an assessment of risk, and an interest rate is set to reflect that risk. Credit guarantees also tend to be more cost-effective than subsidies. Money has to be paid only in case of a default, whereas subsidies are a continuous expense that cannot be recovered. Therefore, if well-managed, credit guarantee schemes can be less onerous on public budgets.

All economies in the EaP region have credit guarantee schemes in place. Armenia, however, is currently going through a restructuring, which means that the design and future of its scheme is currently uncertain. Azerbaijan and Georgia put in place credit guarantees during COVID specifically to help businesses in particularly challenging times; those schemes are still in place. Moldova expanded its programme nearly tenfold between 2020 and 2022. Increasingly, these guarantee programmes are supplemented by an offering of consultancy and advisory services to help entrepreneurs with their business development. All schemes still rely on government budget transfer, however, rather than being fee-based, and are therefore more self-sustainable. In addition, it would be good to strengthen private participation in the schemes, especially in Armenia and Azerbaijan. This can be done by inviting business associations or private banks to participate in some form of advisory or even supervisory capacity and even consider commercial banks' participation on the scheme's capital. Except in Georgia, none of the schemes are subject to proper impact evaluations that ascertain whether policy objectives, such as increased access to finance or expanded financial inclusion, are being achieved. All of them are subject to some reporting on basic metrics such as volumes disbursed and the number and characteristics of borrowers.

Non-bank financing

Non-bank financing instruments can play several roles in improving access to finance for SMEs. They can offer financial services that are more tailored to SMEs' needs and circumstances, and they can promote financial inclusion by offering products to borrowers that are not able to access bank funding due to their size, lack of credit history or lack of collateral.

This dimension covers microfinance, leasing and factoring as three of the most prominent non-bank financing instruments that are relevant for SMEs. While microfinance is available at a large scale across the region, leasing and factoring levels are still quite low compared to other economies of a similar size. The reason for the low uptake can be inadequate legal frameworks that introduce legal uncertainty to providers and users of a certain product. Another frequent reason is a lack of awareness, as entrepreneurs do not have knowledge of these financing options or how they could be beneficial. Finally, data on these sectors can be patchy or non-existent, making assessments of their health and prospects rather difficult.

Table 7.4. Non-bank financing, sub-dimension scores

	Armenia	Azerbaijan	Georgia	Moldova	Ukraine	EaP average
Sub-dimension score	**4.56**	**3.61**	**3.71**	**4.04**	**4.22**	**4.03**
Microfinance institutions	4.40	4.08	5.00	4.64	4.60	4.54
Leasing	4.71	3.51	5.00	4.71	5.00	4.59
Factoring	4.70	3.35	1.25	2.90	3.20	3.08

Note: See the “Policy framework, structure of the report and assessment process” chapter and Annex A for information on the assessment methodology.

Microfinance institutions

Microfinance is available throughout the region, through banks, credit unions or specialised microfinance institutions (MFIs). Data are not available for all countries, but statistics from Azerbaijan and Georgia show that microfinance has either increased or been stable since the last assessment, meaning that even during COVID there has not been a significant shrinkage of the sector. This is particularly noteworthy for Azerbaijan, where between 2015 and 2017 the number of customers of MFIs halved due to the more general challenges in the banking sector. In Armenia, microfinance loans have dropped by 30% since 2019 (Central Bank of Armenia, 2023[6]). However, this might be due to the sector consolidating after the introduction of a legal framework for microfinance activities. Ukraine still does not have a dedicated legal framework for microfinance in place.

Across the region, microfinance continues to target mainly households and, consequently, an increasing number of governments are putting in place consumer protection measures to avoid customers from being charged excessive interest rates. One example is Moldova, where the financial regulator sets limits on how much MFIs can charge consumers. Microfinance providers tend to be self-sustainable throughout the region, but most are not allowed to raise deposits, which can hamper the sector’s development, as entrepreneurs cannot bank with MFIs as a one-stop shop for all of their financial needs.

Leasing and factoring

Leasing and factoring are asset-based financing tools that can provide access to credit for enterprises without sufficient collateral or where information asymmetries are particularly high because funding is directly tied to an asset of equal value. Leasing can allow businesses to acquire equipment or vehicles necessary for their operations, modernisation or growth without having to provide additional collateral. Factoring means that a business sells its accounts receivable from a client with good credit standing in order to receive liquidity before payment of the invoice is due. In one permutation of this instrument, reverse factoring, a large buyer of goods and services is involved in setting up a factoring facility that allows select suppliers to get working capital from a bank or specialised finance provider against its invoices. This enables SME suppliers to have access to working capital priced against the credit risk of the larger buyer rather than their own.

Leasing and factoring are available in all economies in the EaP region. In a number of countries, such as Georgia, they are provided through commercial banks. Azerbaijan and Georgia have completed the reforms of their legal framework for these instruments since the last assessment. In Ukraine, however, the reform of the factoring framework has not begun, although it could help alleviate existing uncertainty around this instrument and boost uptake.

Venture capital

Venture capital is nascent in the entire region and the lack of growth capital beyond the seed stage presents a real challenge for start-ups. Most countries have start-up grants and accelerator programmes in place to help with the initial stages of development, but once a business enters the growth phase it is important to attract private investors and not just rely on state funding. While the presence of venture capitalists (individuals or funds) is largely determined by the availability and attractiveness of investment targets, governments can contribute to the development of a venture capital ecosystem. Having a conducive legal framework for equity investments, such as robust minority shareholder protection, is an important prerequisite – which is present in all five countries. Governments can also introduce policies that incentivise VC activities, e.g. through co-financing schemes, investments in VC funds or the establishment of a fund of funds that provides capital to VC funds potentially interested in the country or region. The Armenian government, for example, invested in the country's first venture capital fund in 2013. The fund has gone on to make a number of investments in tech-focused start-ups in the country and has made its first successful exits since. Activities like this can be a good use of public funding to catalyse the sector and leverage public funds for private investment.

Table 7.5. Venture capital, sub-dimension scores

	Armenia	Azerbaijan	Georgia	Moldova	Ukraine	EaP average
Sub-dimension score	**3.34**	**2.04**	**3.56**	**2.32**	**2.52**	**2.75**
Legal framework	3.78	3.44	4.11	3.44	3.44	3.64
Design and implementation of government activities	3.75	1.40	3.67	2.04	2.47	2.66
Monitoring and evaluation	1.67	1.00	2.33	1.00	1.00	1.40

Note: See the "Policy framework, structure of the report and assessment process" chapter and Annex A for information on the assessment methodology.

Financial literacy

All the other dimensions in this pillar look at supply-side issues, but to promote access to finance for SMEs, it is also important to look at obstacles on the demand side. Increasing awareness of the range of financial instruments helps firms evaluate their options and find the best funding solution for their needs rather than always reverting to bank loans as the sole source of external finance. Ensuring that entrepreneurs are capable of preparing accurate accounts is an important factor in reducing information asymmetries for lenders, thus decreasing risk, and consequently the cost of a loan. Greater financial literacy among the population also means that entrepreneurs are more capable of interacting with financial service providers and take informed decisions, especially at the more vulnerable micro end of the spectrum. It is also important to have financial literacy assessments and trainings specifically designed to target entrepreneurs, in addition to the general population. Entrepreneurs have different needs than households when it comes to preparing loan applications and choosing financing instruments, as requirements tend to be more complex and the range of instruments broader.

However, the first step toward building greater financial literacy among the population is an assessment of financial skills within the population (including entrepreneurs). The assessment should cover different aspects of financial literacy, as in the OECD's framework for assessing financial literacy[1]. This helps to disaggregate knowledge, attitudes and behaviours and design policy measures that target the weakest areas. All countries in the region conduct financial literacy assessments, usually led by the financial regulator, and in some cases supported by international donors (e.g. Ukraine).

Trainings and awareness-raising campaigns are important policy tools to improve the population's financial literacy. Armenia and Ukraine also stand out by having introduced centralised platforms that bring together training materials and knowledge products aimed at a range of audiences, such as pupils, teachers, the general public and businesses. Such platforms can be immensely helpful, as they provide impartial information and advice; are easily accessible; and, through their modularity, their offering can be adjusted if needed. Incorporating financial literacy into school curricula can be another effective way to raise the population's understanding of financial concepts. Financial literacy is mandatory for general and vocation tracks in Armenia and Ukraine; in the other countries, it is either optional or mandatory only for some schools.

Table 7.6. Financial literacy, sub-dimension scores

	Armenia	Azerbaijan	Georgia	Moldova	Ukraine	EaP average
Sub-dimension score	**4.53**	**3.27**	**4.80**	**2.94**	**3.94**	**3.90**
Planning, design and implementation	4.75	3.50	4.75	3.10	3.94	4.01
Monitoring and evaluation	3.67	2.33	5.00	2.33	3.93	3.45

Note: See the "Policy framework, structure of the report and assessment process" chapter and Annex A for information on the assessment methodology.

Digital financial services

Digital financial services have developed quite rapidly in recent years. They can enhance existing financing structures, but can also be a way to leapfrog toward greater financial inclusion and better SME access to finance in the face of underdeveloped financial markets. They can also help address some of the common issues around SME finance. Digitising processes can help scale solutions and make decision and management processes around loan provision more efficient. This can help banks scale their SME lending and bring down costs. New sources of data such as data from non-bank sources for credit analysis can provide a more reliable assessment of the borrower's repayment capacity and therefore reduce information asymmetries. A number of fintech-based products can help address a lack of collateral by using asset-based lending techniques, using movable assets or relying on better credit assessment, therefore reducing the need for collateral. In addition, new products are being developed that are better tailored to SMEs' needs, such as mobile digital payment devices.

Digital financial services are typically delivered by new players, such as specialised fintechs, big tech companies or mobile network operators, and challenger banks – although, increasingly, traditional banks are offering them as well. These services often focus on a single product or a limited range of products. The new players coming to the market with their customer-focused solutions can induce competition, which can lead to better or cheaper financing products and a greater desire by finance providers to serve more hard-to-reach segments. Indeed, when fintechs first started to appear on the financing landscape, many banks viewed them as competitors. This has changed, however. Increasingly, banks – and fintechs – realise that they can form mutually beneficial relationships, fintechs becoming service provider not just to consumers, but also to banks. These links can improve banking service provision by introducing new products or processes that make banking easier or cheaper. However, in markets that are not yet very developed, or that have an imbalance in terms of market dominance, the use of digital tools by one bank can lead to more concentration. If other banks in the market are unable to follow suit, an early adopting bank can cement its leading market position. While in and of itself not an issue, regulators need to be vigilant to detect any abuse of market power that could ensue.

Overall, however, digital financial services can open up new avenues to develop financial markets and reach SME clients whose financing needs have not been met by traditional banking models. Therefore, the developments over recent years provide a huge opportunity to improve SME access to finance, and hence the inclusion of this new dimension in the assessment. This dimension covers two main aspects:

- **The regulatory framework** – the institutional set-up for addressing issues related to digital financial services; the relevant authority's regulatory approach; and how operational risks are being managed, including data protection and the outsourcing of certain banking functions.
- **The supervisory framework** – the use of regulatory tools that are aligned with the rapid technological developments in the sector, e.g. the use of "regulatory sandboxes", or supervisory technology ("suptech").

Table 7.7. Digital financial services, sub-dimension scores

	Armenia	Azerbaijan	Georgia	Moldova	Ukraine	EaP average
Sub-dimension score	**3.52**	**3.05**	**3.94**	**3.02**	**3.81**	**3.47**
Regulatory frameworks for digital financial services	3.74	3.60	4.37	3.55	4.11	3.87
Supervisory framework for digital financial services	3.30	2.50	3.50	2.50	3.50	3.06

Note: See the "Policy framework, structure of the report and assessment process" chapter and Annex A for information on the assessment methodology.

Regulatory frameworks for digital financial services

The emergence of digital financial services poses legal and regulatory challenges. In many emerging jurisdictions, the roll-out of digital financial services can be limited by existing legal and regulatory frameworks that need updating for new solutions to work, or their full benefits to be realised. Therefore, adjustments to the regulatory framework are often needed to account for new risks associated with these technologies, but also to allow new solutions to develop and take hold in the market (some of this will be discussed in the next section).

Foundational conditions are also important: the availability of reliable Internet services, digital identities, e-signatures and e-invoicing are all tools that support the development of digital financial services. But new technologies also pose their own risks, such as the emergence of new monopolies, more entrenched financial exclusion, as well as data protection and privacy concerns. For example, the use of new sources of data for credit scoring purposes can help households and SMEs access funding that was underserved by the traditional banking system. At the same time, many of these solutions use algorithms that can be somewhat of a black box when it comes to credit decisions, and that can perpetuate certain discriminatory practices as they learn from existing decision-making processes. Given the interdisciplinary nature of the challenges that digital financial services pose, it is crucial to have a more collaborative approach to regulation, ensuring that different public authorities are involved in developing policies that affect this sector.

Regulators also need to ensure interoperability of systems and certain standards for data collection and sharing so that new players can access valuable data in order to develop their new funding solutions. And greater access to finance also requires greater financial literacy among the population so that consumers and businesses understand what these new solutions mean for them, especially in an environment where regulation sometimes has to play catch-up.

Regulatory frameworks in the region are only at the beginning of their adjustment to these new challenges. While all financial authorities have a department with a dedicated mandate to cover digital financial services, only Ukraine has a dedicated digital finance strategy in place. In Georgia, aspects of digital finance are covered in the central bank's strategy. In Azerbaijan, a digital payments strategy has been developed, thus covering one important area within the digital finance space.

All countries have regulation in place around data protection and sharing, and all authorities, except for Armenia, require institutions to share data under certain rules and circumstances, according to specific standards. All financial authorities have adopted a technology-neutral approach to digital financial service regulation, and do not have specific provisions for big tech solutions in place. An operational resilience framework for financial service providers is also in place in all of the countries, but only Armenia, Georgia and Moldova have a framework to regulate the outsourcing in the financial service sector, e.g. when a bank contracts a third-party provider to implement certain processes.

Supervisory framework for digital financial services

The emergence of new financial services and associated entities means that regulators need to balance differing objectives that can at times compete with one another: financial innovation, consumer protection and financial stability. In addition, the supervisory framework needs to ensure that new solutions that would bring benefits to the market can actually develop and are not immediately stifled by existing regulation that may or may not be relevant to addressing the risks associated with this specific type of new product or service.

In response, regulators have developed new regulatory tools. One of the more prominent tools is the regulatory "sandbox", a ringfenced space in which new financial products or services can be tested with consumers. The key here is that the scale is small (pilot), that consumers who use the product can easily raise the flag in case of a problem and that the regulator has a very close eye on how things develop. Some regulators also require the financial company to (partially) compensate consumers who test this new product in case things go wrong. Georgia is the only country in the region that has developed such a sandbox approach, which has already been used, mainly by banks, to test new methods of service provision such as digital banking. Setting up regulatory sandboxes requires significant investment in resources, however. Therefore, regulators should consider setting up innovation offices if other instruments are not yet realisable for the time being. An innovation office provides a focal point within the regulator for digital financial service providers to get clarity over regulatory requirements and to inform the regulator of their plans. Such a set-up can be an important tool for two-way communication between digital finance providers and the regulator and can be helpful in determining what the existing regulatory framework means for digital financial services and whether it may need adapting.

Given the complexity of some of the issues these new products and services raise, as well as the novel nature, multi-disciplinary co-operation between authorities is crucial to ensure that all potential risks are covered. Digital finance raises issues related to data protection, consumer protection, competition, ICT regulation, and many more. Ensuring that all of these aspects are taken into account is important to having a functioning and conducive supervisory environment. Currently, none of the countries in the region have a systematically implemented multi-disciplinary approach to digital finance supervision, even though some ad hoc consultations may be conducted. Learning from others is also important across borders. Networks of supervisory authorities focusing on digital finance can be an excellent avenue to learn from international experience and get a glimpse into where the sector might be headed. However, none of the financial authorities are part of such a network.

The way forward

As highlighted above, SME access to finance could be further improved in the EaP region, and governments can help address the identified issues by focusing on the following actions:

- **Improve enforcement frameworks for secured transactions.** Enforcement is a crucial element of a functioning secured transaction legal framework. Without being able to make use of the collateral that has been taken, loan costs will be unnecessarily high to account for the risk or cost involved in the enforcement process. In this context, out-of-court mechanisms should also be considered, especially for smaller loan amounts typically associated with SME lending. Because these mechanisms can be less costly in terms of both time and money, they can benefit both the lender and borrower.

- **Ensure adequate monitoring and evaluation mechanisms for financial support programmes.** All countries in the region have some form of support programme in place to facilitate SME access to finance. In the case of subsidies, these can be quite costly, and evaluations are paramount to determine whether greater financial inclusion has actually been achieved. The monitoring and evaluation framework therefore needs to go beyond the collection of basic usage data, such as number of clients reached or volumes of funds disbursed. In addition, it should involve an analysis of the types of borrowers who benefitted, whether they would have been able to access funding in the absence of the programme, and the programme's economic impact.
- **Improve the availability and collection of statistics in the financial sector**. While data on bank lending are usually available, they could be expanded to obtain more information on the type of borrower. Usually, disaggregation by size is possible, but not necessarily by other metrics, such as gender, type or location. However, such granular statistics are important to identify issues with sub-groups that may require targeted policy intervention. Data collection for non-bank financing sources should also be improved to be better able to pinpoint whether and why certain instruments are not taking hold.
- **Consider the establishment of support mechanisms for developing growth-stage funding for start-ups**. Successful policies to help the sector develop mainly rely on co-financing options, with a focus on catalysing private investment. Examples are government participation in specific VC funds, or the establishment of a fund of funds.
- **Facilitate access to knowledge and learning resources for financial literacy**. Online platforms can be a powerful tool for making information about existing public support and trainings available to different segments of the population. To maximise impact, it is important to tailor these trainings to different target groups: students, business owners, households, etc. The benefit of online platforms is that they are widely accessible; are modular, meaning that they can be adjusted as necessary; and provide neutral financial advice to individuals and business owners. A good example in this regard is the Single Access Point for SMEs (biznis.gov.me) in Montenegro, launched in 2022. The platform brings together useful information for entrepreneurs around access to finance, posts updates on relevant legal and regulatory changes, presents available support programmes and provides an interface for submitting questions to the Ministry of Economy. There are also good examples within the EaP region, including the Diia.Business platform in Ukraine and the abcfinance.com and fininfo.am websites in Armenia.
- **Develop strategic directions for digital financial service regulation and supervision and adopt a multi-disciplinary approach**. A strategy document, whether stand-alone or part of the financial authority's strategy, is important for identifying key challenges, establishing strategic direction and pledging necessary resources. Digital financial services are an emerging field that is complex and fast moving. It is therefore crucial to equip regulators with the human capital and tools necessary to address looming challenges. Part of this process is a new, more open approach to regulation in which both public and private stakeholders are regularly consulted.

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Notes

[1] For more information, see https://www.oecd.org/daf/fin/financial-education/core-competencies-frameworks-for-financial-literacy.htm

From:

SME Policy Index: Eastern Partner Countries 2024

Building Resilience in Challenging Times

Access the complete publication at:

https://doi.org/10.1787/3197420e-en

Please cite this chapter as:

OECD/European Bank for Reconstruction and Development (2024), “Pillar C – Access to Finance”, in *SME Policy Index: Eastern Partner Countries 2024: Building Resilience in Challenging Times*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/927b02ed-en