Chapter 4. Pillar C – Access to finance

Access to finance remains a major obstacle for SMEs across the Eastern Partnership region, and features prominently in the Small Business Act as key to SME development. This chapter assesses the policies in the region that support SMEs' access to external sources of finance, assessing progress in establishing a comprehensive legal and regulatory framework to support external financing, the availability of bank and non-bank finance, venture capital and financial literacy.

Overall, the region has made some progress, but the lending environment remains difficult and financial inclusion remains low, particularly in countries that have suffered from difficulties in their banking sectors in recent years. All countries have a robust legal and regulatory framework in place to support lending, though the need for enforcement remains critical. Financial sector supervision has strengthened, and the availability and accessibility of credit information has improved. Bank lending remains the single most commonly used type of finance, and many countries have or are working towards putting credit guarantee schemes in place to support lending expansion. In contrast, non-bank financial instruments such as microfinance, leasing and factoring, and equity financing remain largely underutilised. Some countries are currently undertaking reforms to better regulate leasing and factoring, which is expected to increase uptake in the medium term. Lastly, notable improvements have been made in the area of financial literacy. All countries now have a financial literacy strategy in place, although thorough implementation and monitoring will be essential to gauge long-term and systemic impact.

Introduction

Access to finance is critical to companies' survival and growth, allowing them to expand operations, modernise equipment or move into new undertakings. Lack of capital presents a particular problem for SMEs, as ease of access to finance is typically correlated with firm size. The smaller the company, the more difficult it is to tap external financing options. This reflects such diverse factors as higher rates of informality among the smallest firms, a higher perceived risk profile, fewer collateral options, and lower accounting and financial management capacities. As a result, lenders and investors may see SMEs as higher-risk prospects, but some of these challenges reflect market failures that sound policies can remedy, thus reducing the gap in cost of finance between smaller and larger firms.

According to EU data, access to finance is perceived to be the single most important obstacle faced by 1 in 11 SMEs (down from 1 in 6 in 2009). Smaller businesses also tend to be particularly exposed to downturns in the supply of finance due to their higher risk profile and commonly limited collateral options; access to finance is a particular hindrance for young and fast-growing SMEs (EC, 2017[1]).

Governments can play an important role in improving access to credit by creating a legal environment that provides flexible collateral options as well as transparent and reliable legal processes in cases of default, and by establishing support schemes to ease SME access to finance. While they cannot *eliminate* differences in access to finance (some of which reflect genuine economies of scope and scale that benefit large firms), they can *reduce* the financing gap, sometimes substantially. The Small Business Act for Europe recognises that governments "should facilitate SMEs' access to finance, in particular to risk capital, microcredit and mezzanine finance, and develop a legal and business environment supportive to timely payment in commercial transactions" (EC, 2008[2]).

For instance, an efficient legal framework that supports the enforcement of creditor rights helps to increase financing opportunities from banks by reducing perceived credit risk. A comprehensive cadastre and a system to register security interests over movable assets increases SMEs' collateral options while reducing risks for lenders. Comprehensive, reliable and easily accessible credit information systems can reduce information asymmetries between creditors and borrowers. When it comes to bank financing, credit guarantee schemes can stimulate SME lending by addressing banks' concerns over the risks presented by SMEs. Well-regulated alternative sources of finance – such as microfinance, leasing and factoring and crowdfunding – are important tools for increasing financial inclusion. Finally, supporting SMEs' financial literacy through formalised programmes helps them develop their business planning and financial management skills, making them more attractive clients to financial service providers.

Governments can resort to a range of mechanisms to facilitate SME access to finance. A critical aspect of any support scheme is its additionality: the aim should be to support the private provision of financial services without crowding it out. Ill-designed interventions can risk making businesses dependent on continued public support rather than leveraging private funding, which in turn affects the sustainability of support schemes. In addition, any support programme should be systemically monitored against performance indicators and evaluated to make sure that it reaches those most in need of support, and adjusted as needed.

Improved access to finance can give SMEs the resources necessary to invest in innovation inputs such as new technologies, research and development (R&D), and human capital. Those inputs can enable them to increase productivity and introduce innovation-oriented practices, which, in turn, are crucial to competitiveness, entry into new foreign and domestic markets, and growth.

Figure 4.1. SME Policy Index scores for Pillar C: Access to finance

Regional scores, 2020 vs. 2016

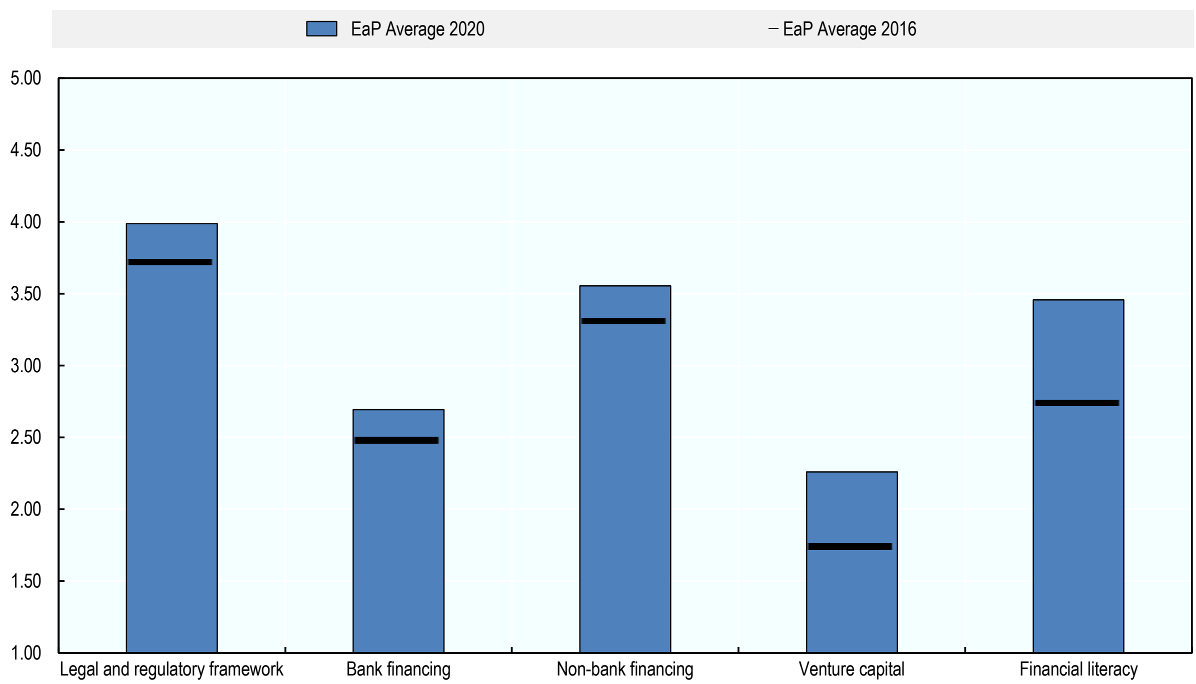

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Table 4.1. Country scores by dimension and sub-dimensions, 2020

	ARM	AZE	BLR	GEO	MDA	UKR	EaP average 2020	*EaP average 2016*
Access to finance for SMEs	**3.81**	**3.12**	**3.57**	**4.02**	**3.61**	**3.31**	**3.57**	**3.28**
Legal and regulatory framework	4.18	3.63	3.74	4.42	4.10	3.85	3.99	*3.72*
Bank financing	2.89	2.21	3.05	3.42	2.79	1.79	2.69	*2.48*
Non-bank financing	3.66	2.45	4.38	3.01	3.79	4.02	3.55	*3.31*
Venture capital	3.37	1.81	2.27	2.92	1.53	1.66	2.26	*1.74*
Financial literacy	3.82	3.29	3.25	4.66	2.67	3.06	3.46	*2.74*

Note: The dimension score is the weighted average of the sub-dimension scores. The following methodological changes have been introduced in the 2020 assessment (and should be taken into account when observing trends in SME Policy Index scores): 1) references to savings and loan associations have been excluded from the analysis, as these are typically already captured under microfinance or bank finance; and 2) more emphasis has been placed on quality of leasing and factoring legal frameworks and higher weights given for their penetration data.

Assessment framework

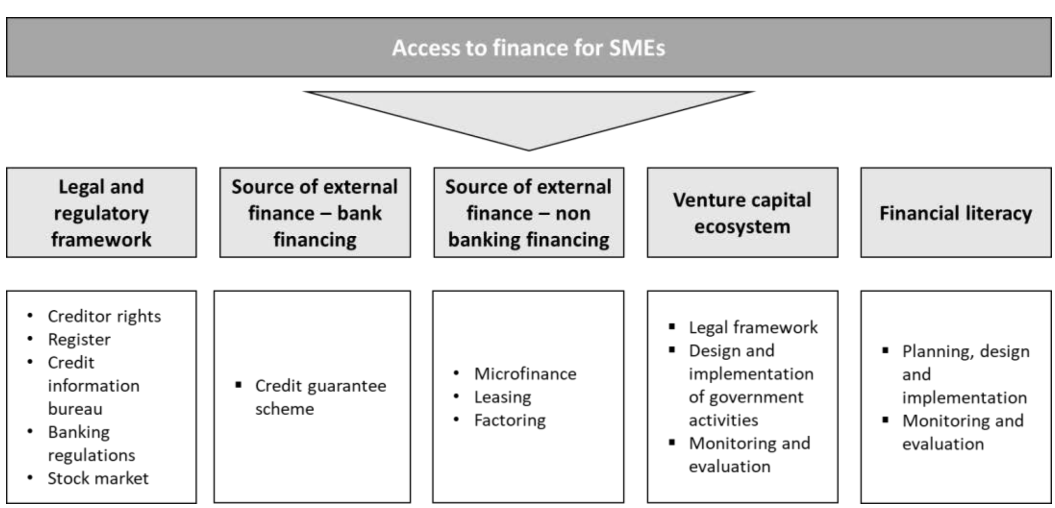
Access to finance for SMEs is assessed through the following five sub-dimensions:

- **Legal and regulatory framework**, which focuses on the legislation facilitating access to finance, including protection of creditor rights, facilitating the use of collateral and credit information, and banking and stock market regulations;
- **Bank financing**, including the lending practices of local banking markets and the availability of credit guarantees;
- **Non-bank financing**, reviewing the legal framework and usage of microfinance, leasing and factoring;
- **Venture capital**, assessing the legal framework enabling venture capital and the existence of business angel networks; and
- **Financial literacy**, analysing government efforts to promote financial know-how among the business community and wider population.

The assessment framework puts particular emphasis on the legal and regulatory framework for facilitating access to finance for SMEs. However, access to finance is the result of a complex interaction of a variety of determinants, including the macroeconomic environment, the health of local financial markets and the overall creditworthiness of enterprises. The assessment framework cannot capture all these factors; rather, it focuses on a set of specific themes and indicators that are deemed disproportionately important for SMEs as opposed to larger firms.

Figure 4.2 illustrates how the sub-dimensions and their constituent indicators make up the assessment framework for this dimension.

Figure 4.2. Assessment framework for Pillar C: Access to finance for SMEs



In contrast to the previous assessment, references to savings and loan associations have been excluded from the analysis, as these are typically already captured under microfinance or bank finance. In addition, more emphasis has been placed on the quality of legal frameworks for leasing and factoring and higher weights given for their penetration.

Data from the World Bank's *Doing Business* report were used to supplement the assessment of the legal framework for secured transactions (World Bank, 2018[3]). These include indicators (such as the coverage of credit information systems and recovery rates in cases of insolvency) that facilitate the drawing of cross-country and over-time comparisons. Data from the *Business Environment and Enterprise Performance Survey* V (BEEPS V) (EBRD, 2014[4]) are used to provide information on the extent of credit constraints. Reports – mainly by national or international associations on the use of certain instruments such as factoring, leasing or capital markets – were also used to provide context for the relevant sections. The World Bank's *Global Financial Development* database (World Bank, 2018[5]) provided credit data for the Eastern Partner countries and comparator economies.

Overall, the data available for this chapter were relatively limited (particularly data disaggregated by firm size and data on non-bank financing instruments), and it was not always possible to use the same reporting year. However, in all cases the latest available data were used.

Analysis

Access to finance is critical to companies' survival and growth. Due to their smaller size, SMEs often face barriers in accessing external financing. Pillar C assesses government's efforts to facilitate SMEs access to financial resources.

In order to encourage lending to SMEs, it is important to develop a well-designed legal and regulatory framework that reduces lending risk. Some progress in developing such a robust legal framework has been achieved: Armenia, Azerbaijan and Belarus have passed laws to establish modern and unified registers to facilitate the use of movable assets as collateral, and banking regulations in most countries have been aligned with Basel III requirements.

The lending environment still suffers the effects of the banking crisis experienced in recent years by Azerbaijan, Moldova, and Ukraine. Almost all EaP countries have made efforts to establish credit guarantee funds to support SME lending.

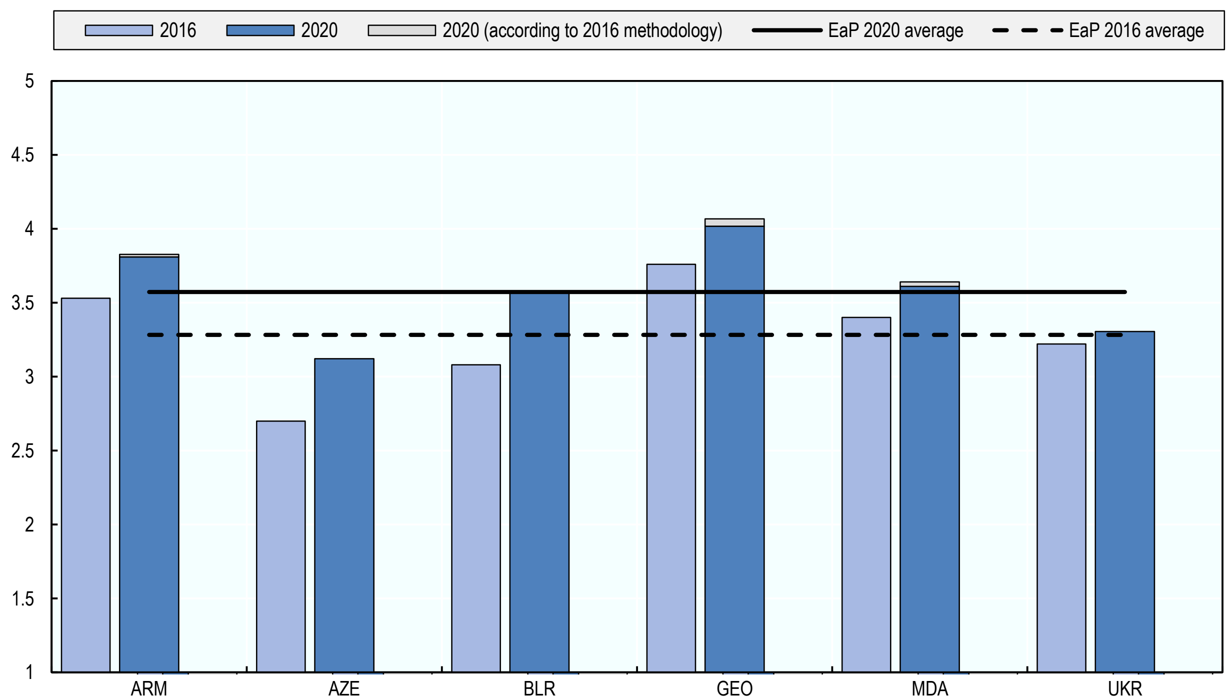
Little progress has been made in recent years in fostering the development of non-bank financial instruments, such as leasing and factoring. However, many countries have undertaken (Belarus and Moldova) or are undertaking (Azerbaijan and Georgia) reforms to their legal frameworks to support the development of both types of alternative financial instruments.

None of the EaP countries has progressed significantly in developing dedicated legal frameworks to facilitate venture capital (VC) investments, and VC financing is unlikely to play a major role in the EaP region any time soon.

EaP countries usually underperform in the context of financial literacy promotion. However, there are some encouraging initiatives taking place: Armenia, Azerbaijan and Georgia now have a national strategy on financial education in place, while Ukraine has incorporated financial literacy into its SME strategy for 2020. Georgia is the leading economy in this regard, and a dedicated financial education programme targeting SMEs was started there in 2018. Georgia is also gradually introducing mandatory compliance with International Financial Reporting Standards (IFRS) for SMEs, which will lead to more-accurate financial management and reporting amongst the business community in the medium term.

Figure 4.3 shows EaP country scores for the *Access to finance* dimension compared to 2016. Even though the 2020 scores are not directly comparable with those from 2016, some improvements in policies to support SME access to finance can be observed across all countries, albeit to a varying extent. All countries have made progress in a number of sub-dimensions of the legal framework underpinning access to finance, resulting in an overall increase in the average score for the Eastern Partnership region from 3.28 in 2016 to 3.57. Georgia continues to outperform the region in the area of access to finance for SMEs, followed by Armenia. Azerbaijan and Belarus are the strongest overall reformers, with scores improving significantly, albeit from low levels.

Figure 4.3. Scores for the *Access to finance* dimension compared to 2016



Note: Methodological changes have been introduced to the 2020 assessment and should be taken into account when observing trends in SME Policy Index scores.

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Progress is particularly apparent in developing registers for security interests over movable assets, aligning banking regulations with Basel III requirements, and expanding the coverage of credit information systems.

The lending environment for SMEs continues to be difficult, however, in much of the region. Azerbaijan, Moldova and Ukraine have gone through a major restructuring of their banking sector in recent years and credit growth has been negative in these countries as a consequence, affecting SMEs' access to finance. In Armenia and Belarus private sector credit as a share of gross domestic product (GDP) has slightly expanded, while Georgia has experienced a significant upward shift between 2014 and 2018 (see Table 4.2). On average, private credit stands at around 38% of GDP in the EaP region. This compares to private credit levels of 94% of GDP in the EU-28, which suggests that the level of financial intermediation is still low in most economies in the region. Even though recovery is underway, credit is still below levels seen in 2014 for Azerbaijan, Moldova and Ukraine. Governments are, however, making efforts to support access to loans for small businesses. Many, such as Azerbaijan, Georgia and Moldova, have chosen to establish or reform credit guarantee schemes, which should help SMEs deal with collateral requirements and reduce lenders' risks. Their effectiveness remains to be tested, however.

Table 4.2. Key banking sector indicators (2008-18)

	Private sector credit, as a % of GDP			Credit constrained firms, as a % of firms needing a loan		NPLs, as a % of total gross loans		
EaP Country	2011	2014	2018	2008	2012	2011	2014	2019
Armenia	35.4	48.9	55.6	34.7	38.1	3.4	7.0	5.4
Azerbaijan	17.3	30.6	20.8	78.3	75.5	6.0	12.7	11.0
Belarus	39.2	23.6	27.8	33.7	41.3	4.2	4.4	5.8
Georgia	32.7	48.9	68.0	36.2	35.0	4.5	3.0	2.9
Moldova	35.9	31.0	23.5	41.2	52.5	10.7	11.7	10.6
Ukraine	71.1	75.2	34.1	50.5	75.7	14.7	19.0	50.8

Note: NPL ratios: latest data for Q2 2019. Figures for Azerbaijan based on overdue loans reported by the Central Bank of Azerbaijan, for all other countries based on IMF data.
Source: World Bank, (2019[6]), *World Bank Development Indicators*; EBRD, *Business Environment and Enterprise Performance Survey*, (2014[4]); IMF, (2019[7]), Financial Soundness Indicators ; Central Bank of Azerbaijan, 2019.

Non-bank financing alternatives remain underdeveloped and little progress has been made over recent years to improve accessibility and uptake. This can reflect the failure of legal frameworks to provide sufficient certainty when entering into e.g., leasing or factoring transactions, for example. Often, limited awareness by potential users is also a key obstacle to uptake, as business owners rely on bank credit and overdrafts in order to manage their finances. Some countries have either undertaken, or committed to, reforms of the legal frameworks for leasing and/or factoring, which should help develop these activities in the medium term. Equity investments in general and venture capital in particular remain in their infancy across the region. Governments are putting in place initiatives to support these types of financing, however; these include government-sponsored equity funds, support programmes for start-ups and innovative businesses, and creating crowdfunding platforms.

Progress, in some cases significant, has also been observed in the area of financial literacy, though financial literacy across the region remains low by international standards. All economies now have financial literacy programmes in place, but these tend to focus on personal finance, with entrepreneur-focused initiatives and training being provided more on an ad hoc basis without centralised co-ordination. There is an increasing awareness, however, that more-focused training could go a long way in improving small business owners' capacity to manage their finances – and thus improve their ability to access different sources of external funding.

Legal and regulatory framework

The legal and regulatory framework surrounding secured transactions should be designed so as to encourage banks to lend to SMEs, especially as small firms are seen as riskier borrowers. It is important to have a framework that reduces lending risk, for example by tackling information asymmetries and by creating systems that allow security interests to be established and enforced in case of default. Therefore, creditor rights, functioning systems for registering security interests, comprehensive credit information systems and adequate banking regulations are important ingredients of a legal framework that supports, rather than impedes, lending to SMEs.

This section looks at these different aspects of the legal and regulatory framework that supports bank lending to SMEs.

All EaP countries have made progress in a number of sub-dimensions of the legal framework underpinning access to finance, although score improvements are mostly moderate (Table 4.3). Two areas with major improvements are banking regulations and registers for securities over immovable and movable assets. The coverage of credit information systems has also expanded, albeit from a low base in most countries.

Table 4.3. Scores for the *Legal and regulatory framework* sub-dimension

	ARM	AZE	BLR	GEO	MDA	UKR	EaP average
Creditor rights	4.22	4.56	2.78	3.89	5.00	4.22	4.11
Register	4.05	4.12	4.12	4.83	4.47	4.28	4.31
Credit information bureau	4.73	4.22	4.32	5.00	3.88	4.28	4.40
Banking regulations	4.50	1.50	4.50	5.00	4.00	2.50	3.67
Stock market	3.04	2.33	3.00	3.08	2.43	3.07	2.83
Weighted average	**4.18**	**3.63**	**3.74**	**4.42**	**4.10**	**3.85**	**3.99**

Note: see Annex A for information on the assessment methodology.

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

A well-designed legal framework for secured transactions can reduce lending risks and therefore lending costs, encouraging bank lending at acceptable terms. Most economies in the EaP region have robust legal frameworks for secured transactions in place and scores have only changed marginally in most cases. One exception is Azerbaijan, where secured creditors were provided with grounds for relief and time limits during an automatic stay. However, enforcement remains an issue, with lengthy procedures and sub-optimal outcomes. For instance, according to the World Bank's *Doing Business*, insolvency proceedings take an average of 2.1 years compared to 1.78 years in OECD member countries. Similarly, secured creditors in the region on average recover less than half of the amounts collected in OECD members: 33.45 cents on the dollar compared to 67.87 (World Bank, 2019[8]). Further details can be found in the section on Bankruptcy and Second Chance in Pillar A.

Registers for security over movable assets are being developed

Having reliable and accessible registers that facilitate the use of immovable and movable assets as collateral is important in the context of a legal framework for secured transactions. Up-to-date information and accessibility are crucial to ensuring that lenders can check whether a certain asset is already pledged and register their own security interest. Together with a legal framework that allows for a straightforward repossession process, such systems can facilitate collateralised lending and bring down interest rates by increasing the chances of recovery in cases of default.

It is therefore important to have a cadastre that allows for the registration of land and real estate, including information on their value, ownership and existing pledges over the asset. Online availability and broad access (within the limits of privacy laws) are important to improve ease of use and reduce costs. In addition, registers for security interests over movable assets can widen the range of assets that companies can use as collateral. This is particularly important for SMEs, as they often lack access to sufficient land or real estate to use as a security. Such registers should be centralised and unified in order to avoid multiple use of the same asset. As with a cadastre, accessibility is important with respect to lowering costs and increasing usage.

In particular, in the area of putting in place registers for security interests over movable assets, progress has been made in all EaP economies by improving legal frameworks and online availability. Notably, Armenia, Azerbaijan and Belarus have launched modern and unified registers to facilitate the use of movable assets as collateral. Georgia, Moldova and Ukraine, on the other hand, have undertaken measures to expand and further improve the operability of their already existing online registers for security over movable assets. In many economies, movable assets are accepted as collateral by banks, but mostly used to top up collateral requirements that are insufficiently covered by immovable assets.

The coverage of credit information systems has expanded but is still relatively low

Credit information systems can help reduce information asymmetries between lenders and borrowers by giving potential lenders access to the credit history of a borrower. While public registries are usually managed by the central bank (which is collecting lending data mainly for supervisory purposes), private credit bureaus often collect a broader range of information which can include data from a wider range of financing providers as well as utilities or telecommunication companies. Collecting information from a broader range of (non-bank) sources can be particularly helpful for first-time borrowers who have not yet established a credit history with a bank or other financial institution.

All economies in the region have either a public credit registry or a private bureau, with the coverage of the population varying (Table 4.4). The coverage has generally improved in recent years; in the case of Georgia it even reached 100% of the population, giving the country the best possible score in this thematic block (see Table 4.3). However, in Azerbaijan and Moldova, coverage remains below 50%. In a number of economies, information from non-bank finance providers such as credit unions or microfinance institutions is missing, and records from utilities are only collected in Armenia, Azerbaijan and Georgia.

Table 4.4. Credit information coverage in the EaP economies (2008-19)

	Public credit registry coverage (% of adults)			Private credit bureau coverage (% of adults)		
EaP country	2007	2014	2019	2007	2014	2019
Armenia	2.8	23.5	n/a	13.5	65.8	82.5
Azerbaijan	1.4	28.7	n/a	n/a	n/a	44.6
Belarus	1.1	64.5	53.0	n/a	n/a	n/a
Georgia	n/a	n/a	n/a	0.2	56.8	100
Moldova	n/a	n/a	n/a	n/a	8.8	18.2
Ukraine	n/a	n/a	2.4	n/a	48	56.9

Note: 'n/a' means institution does not exist in the economy.
Source: World Bank, (2019[8]), *Doing Business 2020*.

Banking regulatory frameworks have started to align with Basel III

The consistent implementation of banking regulations across credit institutions functions as an important safeguard against financial and operational risks, faced by banks and the banking system. The strength of banking regulatory frameworks varies across the region. Over the last few years, most central banks have either completed or advanced the adoption of Basel III requirements, thus strengthening the oversight and stability of the banking sector more generally. This is particularly important in a region where a number of countries have seen major banking crises in the past years.

Many of the economies in the region are highly dollarized, however. Foreign exchange (FX) denominated loans average 49%, ranging from 41% in Azerbaijan to 63% in Armenia (as of December 2017). Such loans can expose small businesses to exchange rate risks when borrowing. SMEs in particular tend to lack a natural hedge because most are not exporters but rather have income in local currency. In such a context, it is important that banks disclose such exchange rate risks to prospective borrowers and make sure they understand them. This is particularly important because smaller-scale entrepreneurs tend to be less-sophisticated borrowers and financial literacy remains an issue across the region. However, such a regulatory requirement exists only in Armenia, Azerbaijan, Belarus and Moldova. For example, in Moldova regulation was put in place in 2015, which requires lenders to inform prospective borrowers of the additional risks associated with foreign currency loans. Moreover, only SMEs, which sell to international markets (and thus have a natural hedge) are legally permitted to access FX loans.

Capital markets require significant development before SME segments could be considered

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 for some more mature companies to access (long-term) financing, either in the form of an initial public offering (IPO) or corporate bonds. Attempts to adapt capital market instruments to SME needs have been made in both developed and emerging markets in recent years – albeit with mixed results.

Capital markets remain underdeveloped across the region. Even though a stock exchange nominally exists in all countries, the majority are not effectively working and market capitalisation as a percentage of GDP is ten times less than that of economies in the EU or OECD. As such, the establishment of SME or low-capitalisation segments seems like a rather distant objective.

Bank financing

Across the globe, bank finance remains the most important source of external financing for SMEs. Many factors influence the availability of bank financing for SMEs, including the competitive environment in the banking system, the legal framework for bank lending, and the financial readiness of borrowers. Governments can put in place policies to target the "enabling environment", such as the legal framework or financial literacy, and they can run support schemes that target an increase in bank lending.

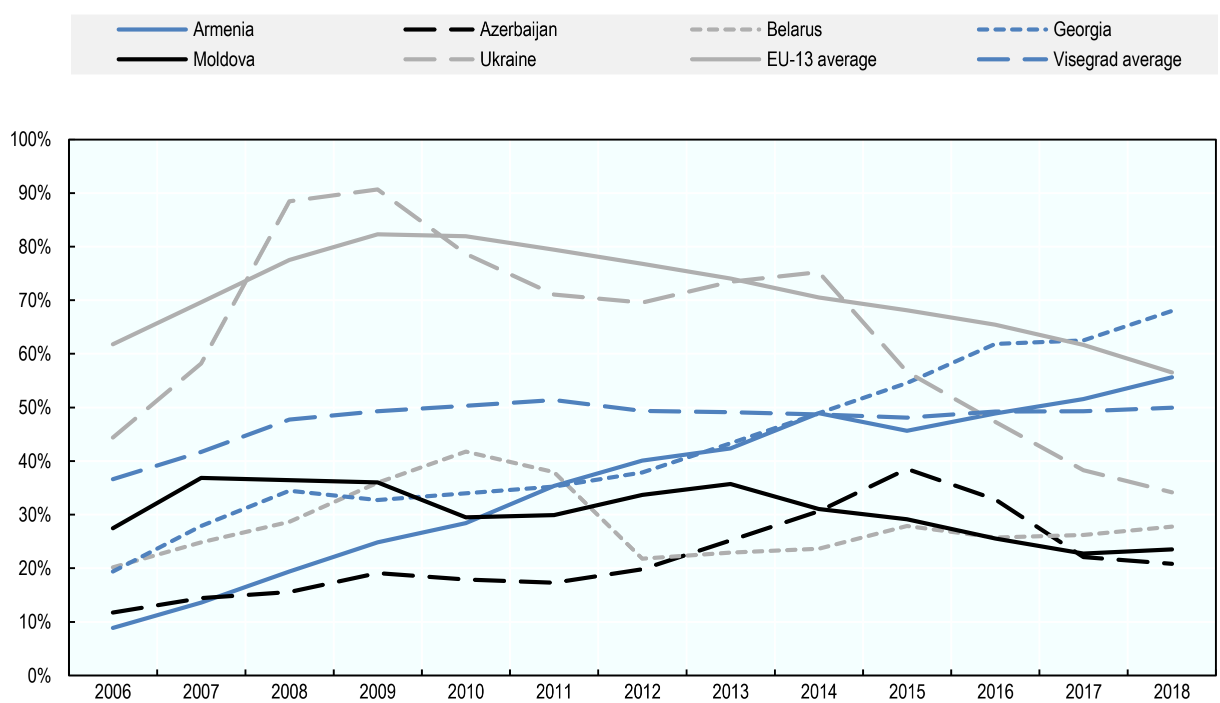
Support schemes can take many different forms: interest-rate subsidies or caps, guarantees and other instruments. While the choice of instruments can depend on a variety of factors, it is important to align instruments as much as possible with market decision making in order to have a more sustainable instrument that minimises market distortions. For example, providing guarantees is more closely aligned with banks' commercial lending decisions than interest-rate caps dictated by policy makers with no consideration for risk profiles and cost of funding.

This section looks at the availability of bank financing more generally and then discusses support schemes that could facilitate lending to SMEs.

Bank lending is well below levels seen in OECD economies

In recent years, Azerbaijan, Moldova and Ukraine have gone through a difficult period in the banking sector that led to drops in lending levels and required significant restructuring to resolve. Much has been done by regulatory bodies to support the clean-up and recovery is underway. However, lending levels remain subdued and have not returned to pre-crisis levels (Figure 4.4). Armenia and Georgia have seen steady credit growth, which is likely to have made lending conditions for SMEs easier as well. The domestic credit provided in the Eastern Partnership region equals on average 38% of GDP compared to around 98% of GDP for OECD members – although the regional average conceals wide variation, from around 22% (Azerbaijan) to 62% (Georgia).

Figure 4.4. Domestic credit to private sector as percentage of GDP



Source: World Bank, (2019[6]), *World Development Indicators*.

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Many governments have put in place new credit guarantee schemes but their effectiveness remains to be tested

Governments can support SME access to finance through a range of tools, such as credit on more favourable terms, interest-rate subsidies, or credit guarantees. Credit guarantee schemes (CGSs) can be an effective tool for supporting SME lending. They can provide important security for lenders in light of existing information asymmetries and the perceived risk of lending to small businesses. Therefore, they can help alleviate financing constraints for SMEs. In addition, credit guarantees tend to be more aligned with commercial lending practices than measures such as interest rate subsidies. If well designed and monitored, they are also less onerous on public budgets.

A number of economies in the EaP region have made efforts over the last few years to establish credit guarantee funds to support SME lending. Azerbaijan, Belarus and Georgia are making efforts in this direction and Moldova expanded its Credit Guarantee Fund in 2018. Armenia continues to provide guarantees through its SME agency (the SME DNC) but there is room to increase its scope and reach. Ukraine has certain regional support programmes in place and is considering setting up a public guarantee scheme, but for now there is no such scheme in place, which is reflected in the score of 1.0 in this thematic block (see Table 4.5). Many of the above-mentioned initiatives are relatively recent and little is yet known about their operationalisation and, ultimately, effectiveness. Private sector participation in the management or ownership of these schemes is still rare. This can result in a limited feedback loop between guarantee schemes and the commercial banks that are supposed to use them. It will be important to monitor uptake and calibrate new and existing schemes as necessary to maximise their impact. Box 4.1 provides an overview of credit guarantee schemes and their key design features.

Table 4.5. Scores for the *Bank financing* sub-dimension

	ARM	AZE	BLR	GEO	MDA	UKR	EaP average
Statistics	2.82	2.12	3.53	4.04	2.70	2.32	2.92
Credit guarantee schemes	3.00	2.33	2.33	2.48	2.92	1.00	2.35
Weighted average	**2.89**	**2.21**	**3.05**	**3.42**	**2.79**	**1.79**	**2.69**

Note: see Annex A for information on the assessment methodology.

Box 4.1. Credit guarantee schemes and their key design features

Credit guarantee schemes (CGSs) can help alleviate financing constraints for SMEs by allowing banks to absorb more risk and thus encourage more lending to the SME segment. However, if poorly designed or implemented, they add only limited value and can prove to be costly.

CGSs provide guarantees on loans by covering a share of the default risk of the loan. In case of default, the lender recovers the value of the guarantee. Guarantee schemes can be designed in many different ways. They can have differing coverage ratios, risk-sharing arrangements, and pricing structures; can cover individual loans or loan portfolios; and may have private sector participation. While the ultimate design of any scheme depends on the circumstances of its inception and specific objectives, there are certain aspects that should be taken into account when setting up or reforming a CGS.

One key component is the setting up of the risk-sharing and coverage structure. For example, a high coverage ratio (i.e. the guarantor bears most or all of the losses in case of default) or imbalanced risk-sharing arrangement can increase moral hazard and may incentivise borrowers to default prematurely, or relieve banks of their responsibility to assess loan risk adequately at origination. An interesting example of how to establish the guarantee rate and reduce moral hazard is FOGAPE in Chile, where the coverage ratio is determined through an auction. Pricing should adequately reflect risk-taking by the guarantor in order not to overly subsidise private market participants. While this should keep losses to a minimum, credit guarantee schemes should not pursue a profit-maximising objective as this would defeat the purpose of the scheme, which is to provide affordable financing to SMEs. Therefore, the structure should reflect policy priorities in terms of balancing loan incrementality and cost recovery.

Providing guarantees for individual loans gives more control to the guarantee scheme as it can evaluate each loan application. However, it may be cumbersome to implement for commercial banks, which must fill in documentation for each loan and wait for a decision by the CGS. This can significantly lengthen the application and decision-making process by the commercial bank and make the loan more costly. Portfolio guarantees may be easier to implement but can be more difficult to design in order to minimise moral hazard.

While many guarantee schemes are originated and funded by the public sector, private sector participation should be considered and even encouraged. Having commercial banks participate in the scheme's capital can not only provide additional financing but enables an important feedback loop between commercial banks and the credit guarantee scheme to ensure that the products offered are tailored to market needs, thus increasing effectiveness.

Finally, some schemes provide additional services to end-borrowers, beyond just the guarantee. These include technical assistance (which can also be provided through referral to other state agencies), advisory services and training. For example, the Korea Technology Finance Corporation (KOTEC) provides services beyond guarantees that have had a positive effect on the recipients' performance.

* http://www.fogape.cl/sitio/

Source: Industry Canada (2014[9]), *Evaluation of the Canada Small Business Financing Program Final Report*; EBCI Vienna Initiative (2014[10]), *Credit Guarantee Schemes for SME lending in Central, Eastern and South-Eastern Europe*; OECD (2010[11]), *Facilitating Access to Finance: Discussion Paper on Credit Guarantee Schemes*

Non-bank financing

Diversifying access to finance for SMEs has been recognised as a key policy instrument for increasing financial inclusion. According to the G20/OECD High-level Principles for SME Finance (G20, OECD, 2015[12]), economies need to develop more comprehensive options for SME financing to support sustainable economic growth and boost the resilience of the financial sector, particularly targeting enterprises more likely to be under-served by the banking sector.

One such instrument is microfinance, which is a common tool to increase financial intermediation among smaller enterprises that are typically not yet covered by commercial banks. In a development context, microfinance is traditionally used as a way to alleviate poverty, focussing on consumer lending. However, recent research has shown that microfinance achieves the biggest impact for existing entrepreneurs. If well designed and sufficiently tailored to individual borrowers, microfinance therefore can be an important tool for ensuring the continuation of borrowers' growth trajectory and transition to SME status. Integrating information from microfinance institutions into the credit information system can further help borrowers build a credit history and increase their creditworthy in the long run. The literature addressing microfinance's impact on entrepreneurship and poverty alleviation is discussed in Box 4.2

Box 4.2. A literature review: The impact of microfinance on entrepreneurship and poverty alleviation

Microfinance has long been considered a key tool for alleviating poverty by allowing poor people to set up or expand small-scale enterprises. However, recent rigorous studies, using randomised controlled trials, have found that access to microfinance does not systematically lift people out of poverty. One reason is that many households are simply not interested in taking up microfinance when it is offered to them. In addition, conditional on loan take-up, households often use microfinance for consumption purposes rather than for investments in new or existing businesses. While this may enhance household wellbeing, for instance by smoothing their consumption patterns over time, it does little to systematically boost incomes in the longer run. Yet, even where the borrowed money is used for entrepreneurial purposes, microfinance typically does not translate into higher incomes. As such, the evidence suggests that microfinance has not proven to be an effective poverty-alleviation tool.

Having said that, recent evidence also indicates that specific groups of borrowers may benefit from improved access to small loans. For instance, evidence from Mongolia suggests that under certain circumstances, joint-liability (group) lending may help entrepreneurs to diversify risk, especially in volatile environments. This may explain why, at least in the Mongolian context, joint-liability loans can have slightly more positive (though still small) impacts on consumption.

Recent evidence also shows that microfinance can be an important factor in supporting *existing* micro-businesses on their growth trajectory. Findings from India indicate that improved access to microfinance has led to more business investments and higher profits for those borrowers that already had a small enterprise when they started to borrow. That is, while microfinance in and of itself does not seem to enable poor borrowers to turn into successful entrepreneurs, it does seem to help at least some more-experienced entrepreneurs to further scale up their businesses.

These findings suggest a number of important insights for policy makers and financial sector players alike. First, the purpose of microfinance lending needs to be clearly defined and the structure has to be tailored to local needs and circumstances. Microfinance institutions (MFIs) should move away from offering standardised products that do not sufficiently consider the borrower's needs and prospects of success. For instance, micro-businesses that are very likely to succeed could be provided with larger and more flexible microloans to enable them to reach their full potential and ultimately attain SME status.

Second, research has shown that more-flexible repayment arrangements, such as granting longer grace periods, gives businesses time to grow and positively affects long-run profits. Indeed, in a similar vein, some MFIs already offer the option to adjust repayment schedules to their borrowers' predicted cash flows.

Lastly, MFIs should especially concentrate their efforts on high-performing micro-businesses and help them to gain access to SME lending once they have outgrown the microfinance sector. For this purpose, MFIs could design a mechanism to refer these successful enterprises to local commercial banks in exchange for a fee.

As a result, recent research cautions against too-generic microloan programmes and advocates instead for products that are tailored to the specific needs, risk level and stage of development of a given microenterprise.

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Other non-bank financial instruments include asset-based financing tools such as leasing and factoring, which can provide credit to enterprises without sufficient collateral or credit history. Leasing can help SMEs modernise equipment and implement expansion plans in the absence of bank loans or financial resources of their own. In contrast, factoring is an instrument based on the sale of accounts receivable from a firm with good credit performance; the firm can increase its cash flow by selling its invoices to a third party (a factor, or factoring company) at a discount. Factoring, in particular, can alleviate liquidity constraints for SMEs (especially those in supply chains), and enable them to have off-balance sheet access to working capital, which is priced against the credit risk of the enterprise's customers rather than that of the company itself.

Overall, the region has made little progress in this sub-dimension; in particular, the potential of leasing and factoring to bolster financial inclusion remains untapped (Table 4.6). However, due to limited availability of comprehensive statistical data on non-bank financing, the analysis of this sector is limited.

Table 4.6. Scores for the *Non-bank financing* sub-dimension

	ARM	AZE	BLR	GEO	MDA	UKR	EaP average
Microfinance	4.00	2.67	4.33	5.00	5.00	4.33	4.22
Leasing	3.44	3.00	5.00	3.00	3.67	4.33	3.74
Factoring	3.55	1.70	3.83	1.02	2.73	3.41	2.71
Weighted average	**3.66**	**2.45**	**4.38**	**3.01**	**3.79**	**4.02**	**3.55**

Note: see Annex A for information on the assessment methodology.

Microfinance is commonly available in most countries, but primarily focussed on consumer lending

Microfinance continues to be the most commonly used source of alternative finance across the Eastern Partnership region, although reliable data remains largely unavailable. The availability of microfinance continues to grow in particularly in Belarus and Moldova, where the number and volume of MFIs have increased substantially since the last assessment, and where MFIs often operate at commercially viable levels. Georgia and Moldova do particularly well in this thematic block, reaching the maximum possible score (see Table 4.6 above). In other countries, volumes of microfinance have decreased. This is particularly true for Azerbaijan, where microfinance operations were hit hard by the deterioration of the financial industry between 2015 and 2017 and the number of customers more than halved. In Ukraine, even though microfinance is available through credit unions and banks, dedicated MFIs are not at all active due to the lack of a legal framework for their establishment. Similarly, in the absence of a dedicated framework, microfinance remains subdued in Armenia.

Despite their broad presence, however, the majority of MFIs across all countries in the EaP region continue to focus on lending to households. Especially in Belarus, where a dedicated regulatory framework is in place, this is due to legal limitations: MFIs are structured as "consumer co-operatives". In the rest of the region, microfinance is regulated by more-general legislation on non-bank finance institutions or credit organisations, with little or no dedicated legislation.

Leasing and factoring has gained momentum as legal reforms are being implemented in some countries, but market penetration remains low

Statistical data on leasing and factoring is scarce across the region, with available data suggesting that outreach and size of operations remains very limited, offering significant development potential. Leasing is available in all countries, but levels are relatively low. In most countries, leasing activities tend to focus on vehicle leasing rather than other assets such as, for example, equipment. Similarly, factoring penetration remains negligible and below 1% of GDP across all countries, compared to an average of 6.3% in OECD countries (World Bank, 2019[6]). Demand-side limitations play a role here, such as low awareness of the opportunities and benefits of such financial instruments, but also lack of adequate legislation supporting these operations.

Both types of financial instruments require a supporting legal framework, either incorporated into the general legal framework or, preferably, supported through dedicated factoring and leasing laws. Factoring often includes complex contracting procedures and requires more sophisticated legislation. In addition, policy makers and regulators can encourage the development of leasing and factoring by maximising stability and legitimacy of the industry, ensuring that market players are well established and increasing the legal certainty of transactions.

Encouragingly, many countries have made progress in strengthening their legal frameworks since the last assessment. Belarus (which achieved the highest possible score in the *Leasing* thematic block – see Table 4.6) and Moldova have undertaken reforms to strengthen leasing and factoring legislation, while in Azerbaijan (leasing only) and Georgia, reform is currently underway. In Ukraine, the SME Strategy mentions a reform of the factoring legal framework, but no concrete steps have yet been taken. If co-ordinated well with the needs of the private sector and linked to awareness raising, these measures are expected to help increase uptake in the medium term.

Venture capital

Conventional debt financing is particularly ill-suited for high-growth and innovative early-stage firms – which, in addition to lacking of credit history and collateral, operate in a rapidly changing environment. For these types of enterprises, venture capital, which is a more equity-based financial instrument, is more relevant. Venture capitalists – ranging from business angels and accelerators to specialised VC funds – complement investments with business expertise and advice, and typically invest in enterprises at the pre-launch,

launch, or early development phases (Table 4.7). In return for the higher risk of investing in early phase enterprises, VC funds usually envisage higher-than-average returns on investment.

Business angel networks have a similar approach to VC, though the size of investment is usually much smaller and driven by high-net-worth individuals or successfully established entrepreneurs.

Accelerators are cohort-based programmes that, while offering seed finance, also offer mentoring and support for the beneficiary companies in developing business connections.

Table 4.7. Venture capital by stage

Stages	Definition
Pre-seed/ seed	Financing provided to research, assess and develop an initial concept before a business has reached the start-up phase.
Start-up/ other early stage	Financing for product development and initial marketing. The company has not sold its product commercially and is in the process of being set up.
Later stage venture	Financing for the expansion of an operating company.

Source: OECD (2015[19]), *New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments*, https://doi.org/10.1787/9789264240957-en.

Crowdfunding, though currently not part of this assessment, is another emerging type of equity-based, non-bank financial instrument particularly relevant to start-up companies. Crowdfunding allows businesses to draw on a multitude of investors without having to meet excessive reporting requirements and due diligence. The downside, however, is that it usually does not offer adequate investor protection, unless embedded in a dedicated legal framework.

Venture capital remains in its infancy across the region, with efforts focussing on building a conducive ecosystem

Venture capital, like equity investments in general, is scarce across the Eastern Partner region and is unlikely to play a major role in the region for some time to come. Venture capitalists require a substantial deal flow in order for the model to work – they finance large numbers of firms, most of which fail or succeed very modestly, but reap the greater rewards that come from the minority of ventures that really take off. However, the outreach and success of VC is heavily influenced by a number of factors, including the availability of innovative and high-growth potential enterprises, the investment readiness of companies, and a policy framework conducive to equity investment.

As reflected in the country scores for this sub-dimension (Table 4.8), none of the Eastern Partner countries has progressed significantly in developing dedicated legal frameworks to facilitate VC investments, thereby limiting investors' appetite and opportunities. With the support of international donors, Belarus has undertaken a review of existing legislation, but no further steps have been taken to date. Similarly, in Azerbaijan, a working group has been established to identify impediments to VC in existing legislation. In Ukraine, some preliminary work is also being conducted. In Moldova, plans for introducing a dedicated legal framework to support VC have existed for years but have not resulted in any actions.

Table 4.8. Scores for the *Venture capital* sub-dimension

	ARM	AZE	BLR	GEO	MDA	UKR	EaP average
Legal framework	3.00	1.45	2.78	2.78	1.22	1.45	2.11
Design and implementation	4.11	2.45	2.45	3.89	2.00	2.11	2.83
Monitoring & evaluation	2.33	1.00	1.00	1.00	1.00	1.00	1.22
Weighted average	**3.37**	**1.81**	**2.27**	**2.92**	**1.53**	**1.66**	**2.26**

Note: see Annex A for information on the assessment methodology.

Innovation financing for enterprises is predominately public sector- or donor-funded, and much focus is placed on establishing a business environment supportive of innovation, which is expected to lead to more investments in the medium term. Granatus Venture in Armenia and the "Start-up" project in Azerbaijan continue to invest in a selective number of local companies, although as yet there is little evidence of successful exits. In Georgia, the Innovation and Technology Agency (GITA) offers a range of financial support schemes to innovative companies.

However, some private-sector led initiatives have emerged recently. In 2017, the Investors Club of Armenia was established to support international investments into Armenia, and the EBRD/EU-supported SME Equity Fund became operational in 2019; it is expected to invest up to EUR 70 million into Armenian SMEs in the coming years. In Ukraine, VC activities have also increased in recent years, reaching a volume of almost USD 337 million in 2018 (UVCA, 2018[20]); however, the investments have focused on the seed stage. In Armenia, Belarus and Ukraine, Business Angel networks have also been established, but these remain largely inactive.

Recognising the increasing opportunities offered through crowdfunding, Georgia established a crowdfunding platform in 2015, and legislation to regulate activities is currently under preparation. Similarly, in Armenia, introduction of a dedicated legal framework for crowdfunding is under consideration.

Financial literacy

Supporting financial literacy is a key tool employed by policy makers to help increase the demand side of access to finance and bridge gaps in financial inclusion. From a macroeconomic perspective, research has shown that higher levels of financial education among a population lead to lower rates of loan defaults and higher retirement saving rates (Lusardi and Mitchell, 2014[21]). This is particularly pertinent in the Eastern Partnership region, where market economies are relatively young and surveys have shown only 32% of the population to have a general level of financial literacy, compared to 52% in the EU countries (Klapper, Lusardi and Van Oudheusden, 2015[22]).

Comprehensive policy frameworks in support of enhancing financial literacy levels should incorporate basic financial education into the education curriculum, ranging from the basics of personal finance and the financial system in the general secondary educational track to more specific subjects in vocational secondary education. As for the adult population, any policy measures should be built on a comprehensive financial literacy survey that allows policy makers to fully understand existing financial literacy levels; such a survey should be demographically disaggregated so as to better target individual sub-groups (e.g. younger people may require more targeted support on budgeting and retirement). In particular, the analysis should distinguish business owners to enable a closer assessment of the level of financial literacy of entrepreneurs. (For an example of targeted financial literacy measures, see Box 4.3).

Box 4.3. Money Wise Action Plan for financial literacy in the Netherlands

The **Netherlands** has a long tradition of financial education that has been consolidated into a national education strategy targeting young people. Indeed, Dutch students repeatedly score above the average of the OECD countries assessed for financial literacy by PISA (OECD, 2015[23])

Since 2008, the Ministry of Finance has chaired a Steering Group that leads the National Strategy for Financial Education. The group includes the Central Bank, the Authority for Financial Markets, the Banking Association, the Insurers' Association, the Pension Federation and the National Institute for Family Finance Information (Nibud). The programme board includes the ministries of Education and Social Affairs, the Consumer Authority, the Association of Financial Advisors and Tilburg University. The strategy was launched as the Money Wise Action Plan, which involves a plethora of stakeholders from both the public and the private sectors: more than 40 partners from the financial sector, government, public information, academia, and consumer organisations that are involved in the implementation of the national strategy.

The initiative targets students and young people, as well as working-age adults, SMEs and potential entrepreneurs.

Money Wise performs financial literacy activities both online and offline. Online, the Money Wise website offers tested teaching material that can be employed in classes of primary and secondary education. It launched a tool called "What does it mean for me?" that screens the personal information of the users and gives them an overview of the impact of government measures that are relevant for them. For outreach to the public, and young people in particular, it uses social media too. Offline, Money Wise hosts two events every year: National Money Week and Pension3Day. The former targets primary school pupils and their parents, focuses on basic financial literacy and takes place in the classroom at school, with around half of Dutch schools participating in the last edition alone. The latter delves into pension issues and collaborates with over 250 organisations to raise awareness among employers, employees, and SMEs.

Source: Money Wise, (2019), https://www.wijzeringeldzaken.nl/english/press_releases/money-wise-platform-committed-to-responsible-financial-behaviour/; OECD (2015), *The Netherlands – Country Note – Results From Pisa 2015 Financial Literacy,* https://www.oecd.org/pisa/PISA-2105-Financial-Literacy-Netherlands.pdf; OECD (2012), *Financial Literacy in Dutch schools: A platform approach*, http://www.oecd.org/daf/fin/financial-education/50346929.pdf.

Off the back of such an assessment and a subsequent framework or strategy, policy makers can draw on a variety of tools to alleviate the issues identified – from online information portals and awareness-raising campaigns to classroom training. Crucially, all such support mechanisms must be implemented alongside stringent monitoring and evaluation mechanisms – with specific targets (and measurements thereof) for efficiency and impact – and should be implemented in close co-ordination with private sector participants.

Within this context, the Eastern Partnership region generally underperforms. While virtually all six countries implement some form of financial literacy support, they tend to be focused on personal finance and centred on ad hoc training, without centralised co-ordination or evaluation. Georgia is leading the way, especially regarding the *Design and implementation* thematic block. By contrast, Azerbaijan, Moldova, and Ukraine are still lagging behind in the *Monitoring and evaluation* building block, as their scores of “1” indicate (see Table 4.9).

Table 4.9. Scores for the *Financial literacy* sub-dimension

	ARM	AZE	BLR	GEO	MDA	UKR	EaP average
Design and implementation	3.86	3.86	3.48	4.90	3.09	3.57	3.79
Monitoring & evaluation	3.67	1.00	2.33	3.67	1.00	1.00	2.11
Weighted average	**3.82**	**3.29**	**3.25**	**4.66**	**2.67**	**3.06**	**3.46**

Note: see Annex A for information on the assessment methodology.

There are encouraging signs across the region, with all countries adopting elements of the best practices outlined above. Armenia, Azerbaijan and Georgia all now have a national strategy on financial education in place, while Ukraine has incorporated financial literacy into its SME strategy for 2020. However, rarely are these efforts based on a comprehensive government assessment of the population, and monitoring and evaluation frameworks remain entirely absent.

Most comprehensively within the region, Georgia has followed the initially described outline: an assessment of the population, followed by a national strategy and most recently, in 2018, a dedicated financial education programme targeting SMEs and specifying various forms of financing. This is accompanied by financial education in secondary schools and a National Bank certification for education providers. While this strategy would also benefit from a stronger focus on financial products and entrepreneurship (the strategy explicitly targets the broader population), it is an encouraging move for the region given its breadth.

As the first country in the region, Georgia is also gradually introducing mandatory compliance with IFRS for SMEs for most businesses (more information is available in the Georgia country chapter), which will lead to more accurate financial reporting among the business community in the medium term.

The way forward

As highlighted above, SMEs’ access to finance remains limited in the EaP region, and governments could intensify their efforts to address the issues at the core of this problem by considering the following policies and initiatives:

- **Collect payment information from a wider range of actors**. The credit information system coverage is relatively low, meaning that only a limited share of the population is able to build a credit history, which is important to access a loan. Collecting such information from a wider range of sources would make it possible to expand credit information coverage. This can include microfinance institutions and credit unions, credit card issuers, retailers and utilities.
- **Set up (or reform, if the circumstances require it) credit guarantee schemes**. Small businesses often face high collateral requirements while at the same time lacking access to assets they could pledge. Credit guarantees can help SMEs that struggle with collateral requirements and encourage the supply of credit by reducing lending risk. Governments should continue their efforts to set up credit guarantee schemes where appropriate. Where schemes exist but are ineffective, reforms should be considered. The design of these schemes should be mindful of

questions of sustainability, scale and private sector participation in order to ensure that they are meaningful and result in appropriate uptake.

- **Improve the availability and collection of statistics on the financial industry.** Improve the availability and collection of more granular statistics on the financial industry, segregating sub-borrowers by type and size and broadening data from non-bank financial institutions. Doing this would address the poor record of statistical information on the financial sector.
- **Complete and review the ongoing reform of legislation on leasing and factoring.** The low coverage of comprehensive and up-to-date statistical information on the financial sector limits the assessment needed to develop tailored products and provide adequate policy support to enhance financial inclusion. Governments should complete ongoing reform of legislation on leasing and factoring, where applicable, and link to awareness-raising efforts to ensure uptake. They should also review existing legislation to identify regulatory impediments to the development of leasing and factoring in particular, and – in co-operation with the financial sector – amend legislation.
- **Co-ordinate and formalise financial literacy efforts.** Central co-ordination of financial literacy efforts, including targeted training for entrepreneurs and a centralised monitoring and evaluation framework, would strongly improve the effectiveness of support mechanisms.

Policy instruments – Access to finance

Table 4.10. Dimension challenges and policy instruments – Pillar C

Dimension	Challenges / Opportunities	Policy instruments
Legal and regulatory framework	**Low credit information system coverage**. Limited credit information system coverage means that for many it is nearly impossible to build a credit history, which is crucial for accessing loans.	**Collect payment information from a wider range of actors.** Collecting payment information from multiple sources (e.g. microfinance institutions and credit unions, utilities or retailers) allows for a wider coverage of the credit information system and allows more people to build a credit history.
Bank finance	**Lack of well-designed credit guarantee schemes.** Small businesses in particular typically face high collateral requirements while at the same time having restricted access to assets they could pledge.	**Set up and/or reform credit guarantee schemes.** Focus on sustainability, scale and private sector participation to ensure the schemes are relevant for SMEs and to encourage the supply of credit with reduced lending risk.
	Poor information on financial sector. Lack of comprehensive and up-to-date statistical information of the financial sector limits the detail and efficacy of needs assessments and policy making.	**Enhance the availability and collection of statistics.** Improve the availability and collection of statistics on the financial industry, segregating sub-borrowers by type and size and broadening the reach to non-bank financial institutions.
Non-banking finance	**Low market penetration of factoring and leasing**. Lack of comprehensive and specific legislation, which reduces uncertainty around such transactions limits take-up of alternative financing methods.	**Enhance the legislative framework.** Complete ongoing reform of legislation on leasing and factoring, in concert with awareness-raising efforts. Review existing legislation to identify regulatory impediments to the development of leasing and factoring.
Financial literacy	**Existing support schemes are disparate and rarely formalised.** A lack of centralised oversight	**Formalise financial literacy support**. Introduce centralised coordination of financial literacy efforts with a stringent monitoring and evaluation framework of

Dimension	Challenges / Opportunities	Policy instruments
	means that support measures cannot be targeted effectively.	support mechanisms, including disaggregated support for different demographic groups, such as existing or potential entrepreneurs.

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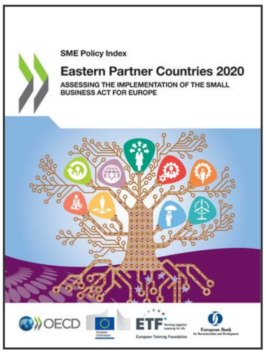

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