advancing with ESIF financial instruments

Financial instruments working with microfinance

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Introduction

Microfinance is the provision of basic financial services and products such as microcredit, micro-savings, micro-insurance and micro-leasing. These types of financial instruments can be supported by the European Union (EU) Member States through the European Structural and Investment Funds (ESIF)[1]. After the financial crisis and the ensuing economic recession, debt financing became more expensive and difficult to obtain for both individuals and microenterprises. Addressing this market gap through microfinance has become a high priority across the EU's internal, regional, enterprise and employment policies. Under the European Social Fund (ESF)[2], microfinance is particularly relevant to support microenterprises as well as low income and other disadvantaged people who have been excluded from access to traditional banking and related services, such as the unemployed, migrants, women, people with disabilities and students. Self-employment through small scale entrepreneurship supported by microcredit can address employment challenges in Member States and contribute to the 75% employment target set by the Europe 2020 strategy.

This *factsheet* provides information on the opportunities available in the 2014-2020 programming period[3] where financial instruments are a sustainable complement to traditional grant-based financing[4]. Primarily intended for ESF managing authorities and other stakeholders, this document raises awareness and builds a deeper understanding of the role of ESF programmes in supporting microfinance instruments.

Important microfinance concepts include: the trade-off between financial performance and social results; the contribution to social impact investment; the manner in which they are implemented; and the importance of business development services to increase the effectiveness of microfinance. This factsheet

1 The EU definition of 'microcredit' is twofold: a business microcredit is a loan under EUR 25 000 to support the development of self-employment and microenterprises; a personal microcredit is a loan under EUR 25 000 for personal necessities such as rent, medical emergencies, or education (see European Investment Fund, 2009, '*Microfinance in Europe – A market overview*'; see also Art.2 of Reg. 1296/2013). Microenterprises are enterprises employing less than 10 people with an annual turnover and balance sheet of less than EUR 2 million (Commission Recommendation 2003/361/EC of 6 May 2003).

2 Microfinance is also used in other ESI Funds but with a focus on SMEs.

3 See pages 2-3 of the European Commission's, '*Financial instruments in ESIF programmes 2014-2020 – A short reference guide for Managing Authorities*', (2014) for a review of key differences for ESI Funds between the 2014-2020 and 2007-2013 programming period.

4 European Commission (2014), '*Financial instruments in Cohesion Policy 2014-2020*'.

highlights the long-term vision of microfinance as a tool and explains the concept of sustainable microfinance.

Microfinance instruments co-financed by the ESF can play an important role by supporting public policies and efficiently complementing traditional grant-based financing, covering shortages in public resources and generating savings. Each of these aspects is discussed as follows:

1 Why Microfinance Instruments? → 2 The Microfinance Ecosystem → 3 Financial Intermediaries in Microfinance → 4 Microfinance Products → 5 Business Development Services → 6 Combination of Support

This factsheet contains topics that closely relate to other *fi-compass* products, such as the use of ESF financial instruments or the implementation of funds to address individual needs and social enterprise goals. Concepts that are common to all financial instruments, such as their life cycle, implementation options and governance, are described in further detail in other *fi-compass* advisory products.

***fi-compass* product**	**Content relevant for microfinance**
■ Introducing financial instruments in the ESF context	Why use financial instruments in the ESF programme; social impact investment; final recipients and financial intermediaries; how to manage and implement financial instruments; financial products.
■ Financial instruments working with social entrepreneurship	Characteristics of social enterprises; financial instruments for social entrepreneurship and financial intermediaries; financial products.
■ Financial instruments working with personal loans	Targeted final recipients; financial intermediaries for personal loans; financial products.
■ Case studies	Insights from past and current experience in implementing financial instruments under ESF programmes.
■ Developing an action plan – design, set-up, implementation and winding-up of financial instruments	Phases of the financial instruments life cycle; regulatory provisions; how to develop an action plan.
■ Financial instruments products – loans, guarantees, equity and quasi-equity	Key features and differences of the main financial products.

Note: ■ ESF related product; ■ ESIF related product.

1. Why Microfinance Instruments?

The social and financial dimensions of standard credit have often been perceived as conflicting if not as direct opposites. Investments with positive social impact are expected to have negative financial returns while investment creating financial value would not take the social dimension into consideration[5]. This trade-off is well known among ESF programme stakeholders. Microfinance instruments, however, offer powerful possibilities to make a real difference in the lives of those supported, by fostering financial inclusion and by fighting poverty and social exclusion.

After years of economic crisis, which put pressure on public budgets, the need to improve the efficiency and effectiveness of public policies is more evident across the EU. In addition, difficulty in accessing finance is greater for microenterprises than for other small and medium-sized enterprises (SMEs) and large enterprises. Among individuals, access to finance can be more difficult for vulnerable and underrepresented groups such as ethnic minorities, migrants or female entrepreneurs.

Traditional banks are generally reluctant to lend small amounts without much higher interest rates, due to the fixed costs of managing loans coupled with a higher credit risk for these loans.

However, microcredit is steadily increasing across Europe. In 24 EU countries nearly 390 000 microcredits were disbursed worth EUR 1.53 billion in 2013 (+45% in two years), with a slight shift towards loans for businesses[6]. More financial needs are therefore being met for both enterprises and individuals, showing the growing potential for the use of microcredit under ESF.

Microfinance instruments may represent an additional opportunity for public actors to increase resources available and their capacity to address new social challenges. Microcredit can therefore improve social inclusion, help establish microenterprises, increase job opportunities and enhance human capital.

5 Jed Emerson (2000), '*The Nature of Returns: A Social Capital Markets Inquiry into Elements of Investment and The Blended Value Proposition*', Social Enterprise Series1, No. 17.

6 European Microfinance Network (2014), *'Overview of the microcredit sector in the European Union 2012-2013'.*

While addressing specific ESF thematic objective goals (see the figure below), microfinance also assures:

- Focus on clients demand, their needs and expectations;
- **Increased capacity** in the financial ecosystem to provide finance;
- A **closer relationship** between lender and borrower compared to traditional financial instruments;
- Efficiency and effectiveness of EU programmes with funds **revolving** and with **leverage**;
- **Attracting co-investment** from other sources, including private investment, to increase the funds available in particular sectors.

Figure 1.1: The added value of microfinance to ESF thematic objectives

Thematic Objective 8

Promoting employment and supporting labour mobility

- Economic returns in addition to social value especially when initiatives are tailored to creating microenterprises.
- Tailored support to reduce unemployment through creating microenterprises with direct and tangible spillover in the local economic context.
- When microfinance is tailored to business creation, with financial returns, there may be more co-investment.
- Microfinance can cover the gap between entrepreneurs in the social economy and unemployed people in those countries where there is insufficient institutional support from the government.

Thematic Objective 9

Promoting social inclusion and combating poverty

- Microfinance can help local financial intermediaries to address the needs of social inclusion.
- Microfinance can integrate institutional support for social inclusion which is low in most Member States.
- Microfinance is an important instrument for combating poverty in times of financial and economic crisis.
- Providing microfinance to disadvantaged groups reduces public spending for social services. Added value in terms of making the borrowers more responsible.

Thematic Objective 10

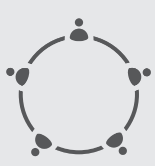
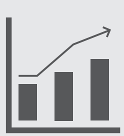
Investing in education, skills and lifelong learning

- Increased amounts available for students with a reduced cost of financing education.
- Since returns on investing in education affects qualifications, microfinance may encourage people – especially from socio-economically disadvantaged backgrounds – to keep on studying.
- Investing in education and lifelong training raises the potential for finding better jobs.

2. The Microfinance Ecosystem

The microfinance ecosystem may involve a wide range of actors. These include final recipients with different financial and social needs, as well as social investors, financial intermediaries, policy makers, and social services providers. A good way to understand the ecosystem is through a 'social impact investment' framework. Supported by a growing number of national governments, especially in the EU, and increasingly important in recent years, social impact investment is defined as "*the provision of finance to organisations addressing social needs with the explicit expectation of a measurable social, as well as financial return*[7]".

Social impact investment can be a framework to drive the implementation of microfinance instruments.

	***Social:*** social impact investment's primary objective and starting point is to tackle social needs which include ageing, disability, health, families, affordable housing and unemployment. Microfinance may represent a more flexible and sustainable alternative to grants, reaching a **wider range of final recipients**.
	***Impact:*** social impact investment looks to produce social change and an improvement in final recipients' lives. To continue to improve its effectiveness, and gain visibility to attract investors, the impact of microfinance has to be **measurable and monitored** during the financial instrument's entire life cycle.
	Investment: while addressing social goals, the recipient is expected to **return the money invested**.

7 OECD (2015), '*Social impact investment – Building the evidence base*'.

Dimensions of social impact investment are described below and illustrated in Figure 2.1.

Social needs	Under ESF the needs of social impact investment are similar to the needs in the programme strategy, the priority axis and the specific objectives.
Demand side	The demand for microfinance comes from the same final recipients as in the ESF investment priorities: the unemployed, women, students, the disadvantaged people, migrants, and microenterprises.
Supply side	Social impact investors include government and public institutions, banks, foundations, 'high net worth individuals' and philanthropists. Resources provided through the programme can complement other measures under the ESF, or other EU programmes, as well as national and regional resources.
Financial intermediaries	Under ESF, financial intermediaries can be either banks including commercial banks, cooperative banks, and saving banks, or non-bank intermediaries such as NGOs, social equity funds, specialised microfinance intermediaries, and government bodies. Financial intermediaries can also provide business development services.
Enabling environment	Includes social systems, tax and regulations, administrative capabilities, and administrative burdens where the programme is implemented.

Figure 2.1: The microfinance ecosystem and main actors in Social Impact Investment

SOCIAL NEEDS

The social needs are the same as those in the ESF Programme strategy, priority axis and specific objectives

DEMAND SIDE

Microfinance for...

Unemployed people
- reduces the unemployment rate and household poverty
- generates positive local economic spillovers in terms of labour productivity and growth
- reduces welfare dependency

Women
- improves the recipients' skills
- creates better job opportunities and entrepreneurial activities
- generates positive spillovers in the local economy
- sustains gender equality

Students
- increases local human capital
- encourages investment in the local economy by enhancing human capital
- reduces emigration and "brain drain"

Disadvantaged people
- favours social inclusion and increases the chances of finding a job
- generates positive spillovers for the local welfare system
- improves access to services such as social protection

Migrants
- favours social inclusion
- increases the active population
- reduces welfare dependency
- diminishes social tension

Microenterprises
- stimulates start-ups and self-employment and creates new job opportunities
- improves sustainability
- contributes to expansion of the local economy

INTERMEDIARIES

Bank intermediaries
- Commercial banks, cooperative banks, savings banks

Non-bank intermediaries
- NGOs, foundations, social equity funds, specialised microfinance intermediaries, government bodies, community development, financial institutions

SUPPLY SIDE

ESF Programme priority axis in combination with additional resources from public institutions, foundations, banks and microfinance institutions

BUSINESS DEVELOPMENT SERVICES

ENABLING ENVIRONMENT

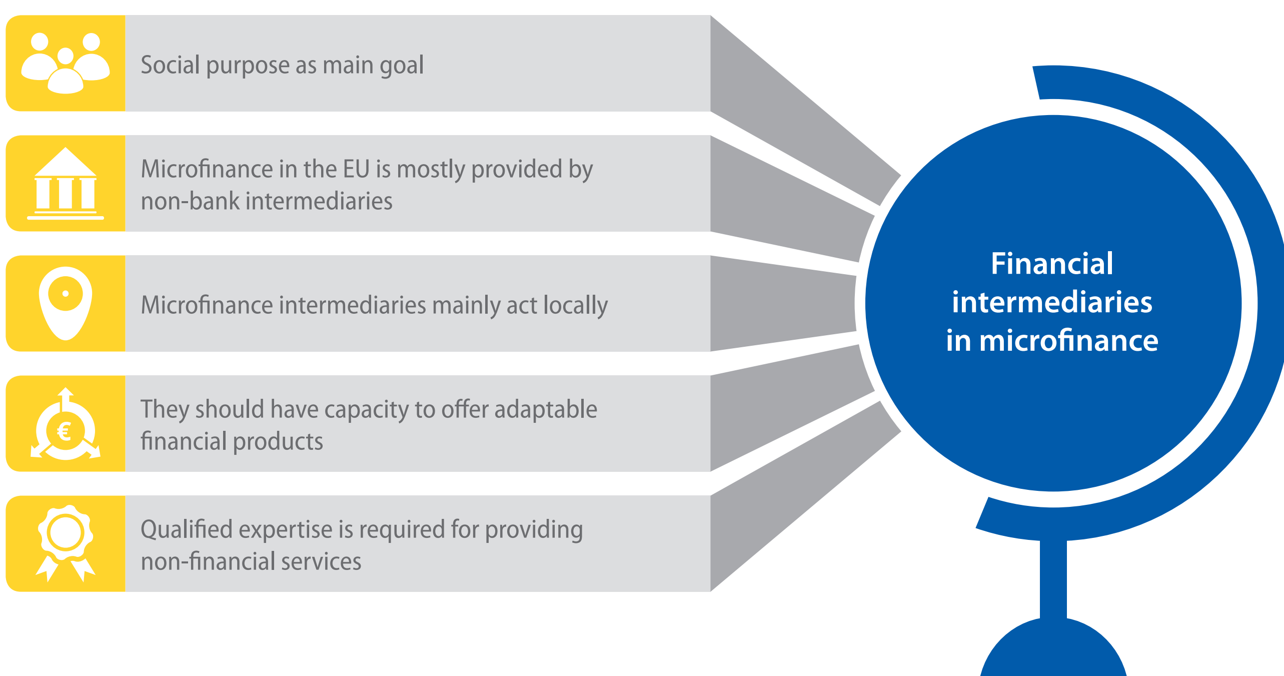
In the context of ESF, the key enabling conditions are included in the ex-ante conditionality (administrative capability, administrative burdens, sector planning etc.)

3. Financial intermediaries in Microfinance

Financial intermediaries in the social area have a dual aim covering both **social purpose** as well as **financial sustainability**. The social purpose refers to providing support for people and groups that may be excluded by the traditional banking sector. Balancing social purpose and financial sustainability can be much more challenging in microfinance. In general, microfinance involves a higher proportion of management costs and higher risk so interest rates are higher.

Financial intermediaries providing microfinance are typically designed to better meet social needs and to promote financial operations that generate social impact. Mainstream commercial lenders commonly find it unprofitable to provide small loans to individuals with low income and little or no collateral, or to projects with limited financial sustainability.

Figure 3.1: Characteristics of financial intermediaries working with microfinance



Among financial intermediaries, **non-bank intermediaries**[8] generally operate more in markets with low financial service penetration and limited public or third party support, developing commercial activities and also providing microfinance to the socially excluded[9]. These include NGOs, foundations, specialised microfinance intermediaries (non-bank financial institutions) government bodies or agencies, and community development financial institutions. Commercial banks, cooperative banks and saving banks normally provide finance to non-bankable or socially excluded target groups as a small part of their usual commercial activities.

In microfinance, it is important to understand the specific financial needs of the target group and the local area. Therefore financial intermediaries that **operate locally** can establish closer relationships with borrowers, their customers and suppliers, as well as with local business. This ensures face-to-face contact with both local microenterprises and individuals[10]. However, smaller local intermediaries may not be self-financing, relying on subsidies or shareholder contributions and may have a tendency to finance projects with low economic returns.

Finally microfinance products should be **adaptable** to different social needs and the changing social environment. So financial intermediaries should be able to offer medium and long-term finance for projects that may carry higher risks. In addition, microcredit can be more effective and efficient when accompanied by non-financial services such as **business development services**. Therefore, in addition to offering support through the microfinance instrument, financial intermediaries may need to provide supplementary advice and training.

8 Unlike banks, non-bank intermediaries do not normally accept deposits. According to the 2014 survey on microfinance provided by the European Microfinance Network, NGOs and non-bank financial institutions provide more than 50% of microfinance in Europe. Among bank intermediaries, cooperative banks support social investment more than commercial banks do.

9 European Investment Fund (2012), *'Progress for Microfinance in Europe'* Working Paper 2012/13, EIF Research & Market Analysis.

10 In addition, financial intermediaries operating locally have an advantage in processing soft information because of the proximity of the management that must approve the credits to the recipient (European Microfinance Network, 2014, '*Overview of the microcredit sector in the European Union 2012-2013*').

Box 3.1: European Code of Good Conduct for Microcredit Provision

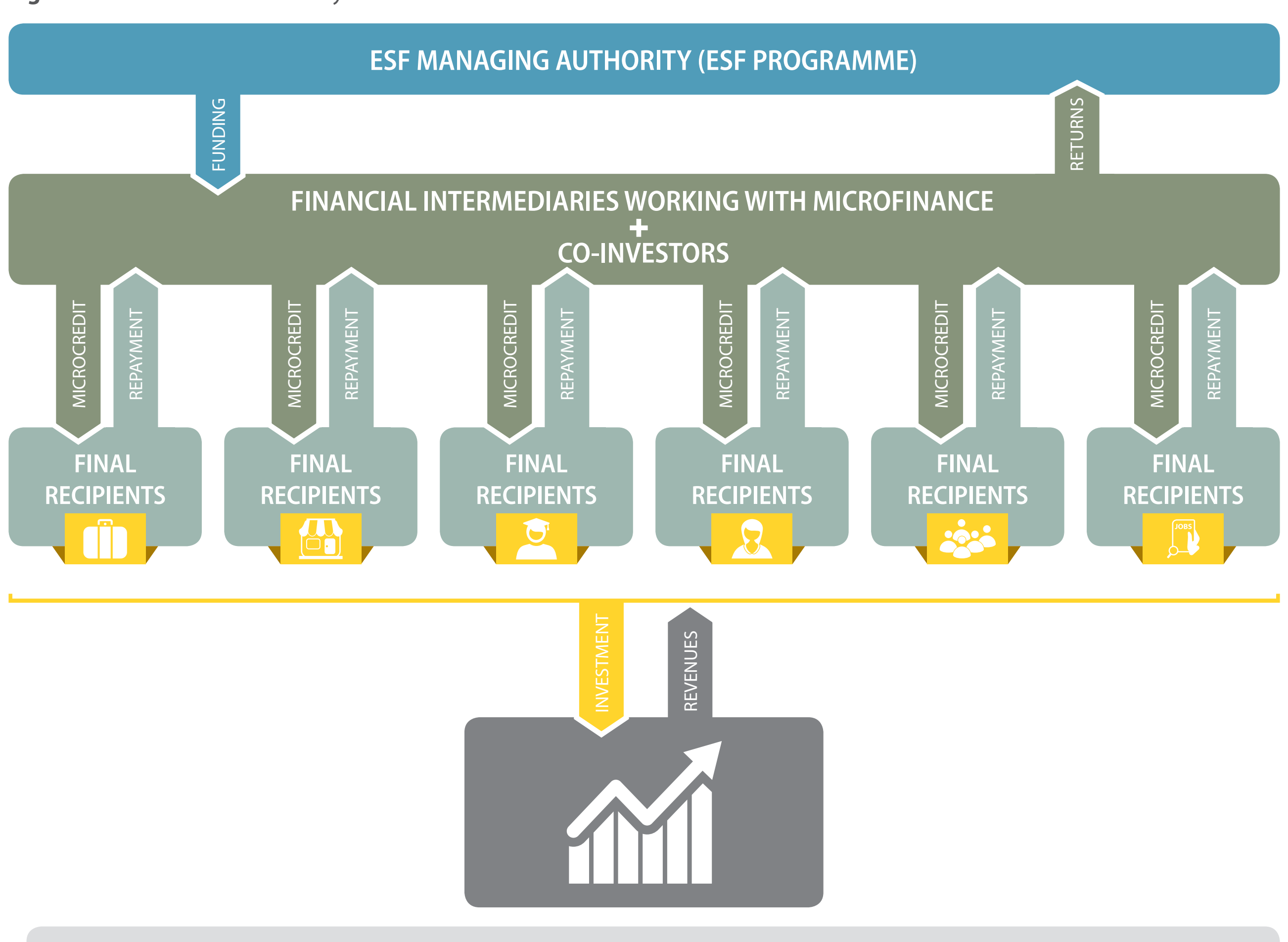
In 2011 the European Commission launched the European Code of Good Conduct for Microcredit Provision, which was updated in 2013 following the phase of testing. Built on recognised good practice in the microfinance sector, the Code establishes standard terms for management, governance, risk management, reporting, and consumer and investor relations that are common to the microcredit sector in the EU. These standards are for the benefit of customers, investors, funders, owners, regulators and partner organisations. The Code is addressed to non-bank microcredit providers which make loans of up to EUR 25 000 available to micro entrepreneurs or self-employed people. According to the Code, microcredit providers should:

- *Ensure constant and clear relations with final recipients and investors* by guaranteeing sufficient information, avoiding over-indebtedness of customers, ensuring costumer care, guaranteeing staff and institutional behaviour, ensuring final recipient data protection, and guaranteeing investor relations;
- *Have an efficient governance structure,* by providing, for example, a business plan, management and external boards, a risk management framework and internal audit;
- *Adopt common reporting standards*;
- *Implement a management information system,* guaranteeing functionality and expandability.

4. Microfinance Products

In the EU, microfinance is mainly based on microcredit. **Microcredits**, which are **loans**[11] of up to EUR 25 000, provide borrowers with funding in exchange for repayment of this 'principal' along with interest, based on pre-determined timeframes and interest rates. The following scheme illustrates how microcredits work and their key advantages.

Figure 4.1: The microcredit ecosystem



MAIN ADVANTAGES

1. Not particularly difficult to administer (so there are limited management costs/fees).
2. A defined repayment schedule makes budgeting easier.
3. The lending mechanism is well understood, reducing the need for capacity building and the risk of misunderstanding.
4. Microcredit preserves the equity of the final recipient as there is no claim on the ownership of the microenterprise.

11 According to the '*Guidance for Member States on Financial Instruments – Glossary*' (European Commission, 2015), a loan is "an agreement which obliges the lender to make available to the borrower an agreed sum of money for an agreed period of time and under which the borrower is obliged to repay that amount within the agreed time" (Article 2(k) FR).

Specifically, microcredit can contribute to the following investment priorities addressing thematic objectives 8, 9 and 10:

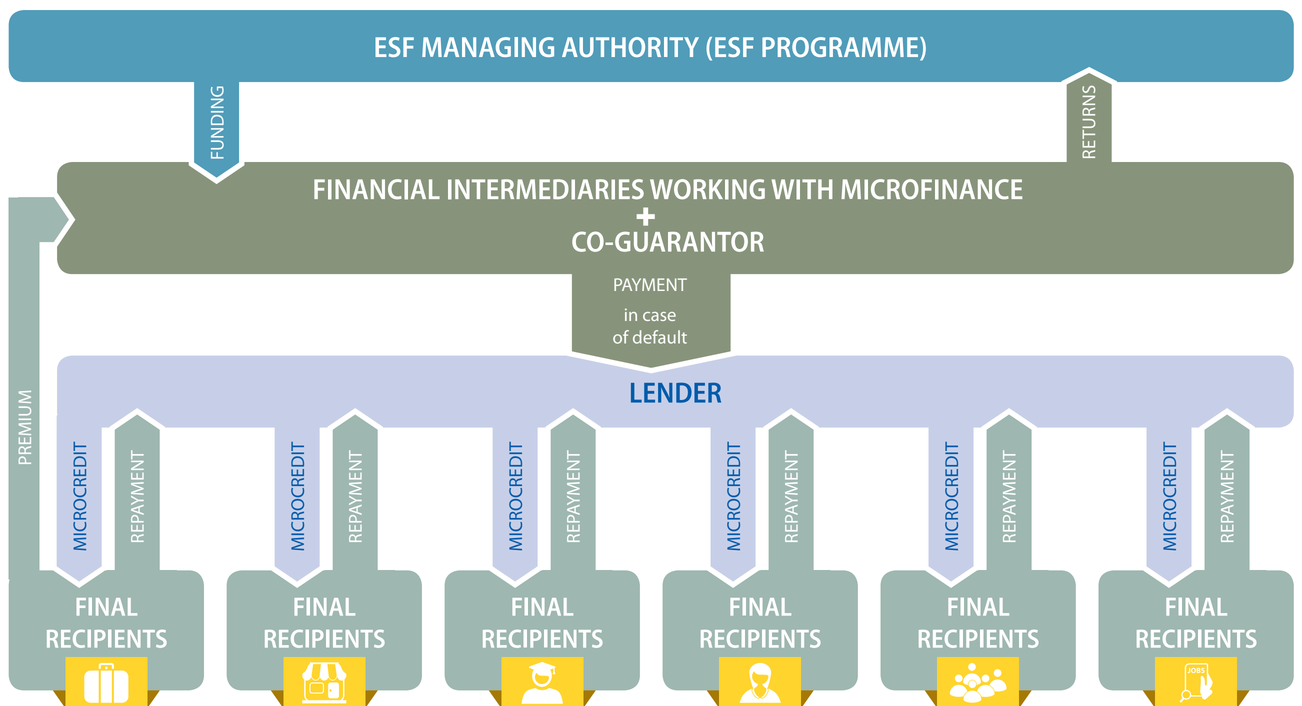
	TO 8 – Self-employment, entrepreneurship and business creation; Adaptation of workers, enterprises and entrepreneurs to change; Access to employment for job seekers and inactive people.
	TO 9 – Promotion of social entrepreneurship and vocational integration in social enterprises; Active inclusion and improving employability; Integration of marginalised groups.
	TO 10 – Enhancing equal access to education and lifelong learning; Improving the labour market relevance of education and training systems; Facilitating the transition from education to work.
Example[12]	**Mikrokreditfonds, Germany:** loans of up to EUR 20 000 to start-ups and microenterprises, targeting migrants, women entrepreneurs and companies offering apprenticeships. Migrants received 41% of loans and women 22%. Set up in January 2010 with EUR 60 million from the ESF and EUR 40 million from the Federal Ministry of Employment and Social Affairs, the goal of the fund was to disburse EUR 100 million through 15 000 loans by 31 December 2015. As at August 2015, the total lending was EUR 113 million through 18 800 loans with an average maturity of two years.

A **guarantee** for microcredit protects investors from a borrower's failure to repay a debt[13]. It can protect a portion of the investment until maturity. Guarantee schemes support access to finance by assuming risks that financial institutions are not able or willing to take on. The following figure illustrates how guarantees work and their key advantages.

12 Several examples and best practices are reviewed in COPIE (2013), '*Designing microfinance operations in the EU – A manual on how to build and implement microfinance support programmes using the ESF*'. The manual also illustrates how to design microfinance instruments, focusing on the operational setup (not on ESF rules).

13 According to the '*Guidance for Member States on Financial Instruments – Glossary*' (European Commission, 2015), a guarantee is "a written commitment to assume responsibility for all or part of a third party's debt or obligation or for the successful performance by that third party of its obligations if an event occurs which triggers such guarantee, such as a loan default" (Article 2(l) FR).

Figure 4.2: The guarantee ecosystem



MAIN ADVANTAGES

1. They can preserve the equity of final recipients as there is normally no claim on the ownership of the enterprise.
2. Since Programme contributions cover only certain parts of microcredits (appropriate multiplier ratio), there is a high leverage effect.
3. The investment risk for third party lenders is reduced (because they only bear part of the risk of default).
4. They require less initial support than funded products such as microcredits.

Specifically, guarantees can contribute to the following investment priorities addressing thematic objectives 8, 9 and 10:

	TO 8 – Self-employment, entrepreneurship and business creation; Access to employment for job-seekers and inactive people.
	TO 9 – Promotion of social entrepreneurship and vocational integration in social enterprises; Active inclusion and improved employability; Integration of marginalised groups.
	TO 10 – Enhancing equal access to education and lifelong learning; Improving the labour market relevance of education and training systems; Facilitating the transition from education to work.
Example	**Fondo Garanzia FSE Marche, Italy:** ESF guarantees covering up to 50% of any insolvency reduced the risk for financial institutions offering microcredit to promote entrepreneurship. This gave jobless and other disadvantaged individuals the resources and training needed to set up a business. Between 2010 and 2015, a total of 867 microcredits were disbursed backed by a guarantee. The financial instrument helped to establish 691 new microenterprises that created an average of 2.5 jobs per loan.

5. Business Development Services

Business development services could include technical support, training activities, professional assistance and financial education. These can enhance the effectiveness of microfinance instruments. Sometimes microfinance needs to be combined with other policies that improve final recipient capacities to develop sustainable income-generating activities. This may also involve a combination of different microfinance products, or microcredit and grants. The provision of business development services and the complexity of social investments require microfinance providers to have a broader range of skills than traditional commercial providers. The aims and type of business development services vary with the needs of final recipients.

Final recipients	Aims of business development services	Examples of business development services
Unemployed people, migrants, women, students	• Increase **human capital** including **job qualifications** • Favour **social inclusion** • Support **business creation** and **microenterprise** start-ups	• Skill training and capacity building in income generating activities • Functional literacy • Social empowerment • Debt advisory services
Microenterprises	• Guarantee **sustainability** • Creation of **job opportunities** • Decrease **dependence on public resources**	• Business skill development • Mentoring services for start-ups • Enterprise and financial management • Debt advisory services
Disadvantaged people	• Increase **inclusion opportunities** • Increase **human capital** and/ or **job qualifications** • Improve accessibility to **social protection**	• Skill training in income generating activities • Social empowerment • Debt advisory services

Providing services other than finance can be costly for financial intermediaries, especially when they are small or non-banks. They may need to work with another entity to provide business development services, which can be integrated with microfinance in various ways[14]:

The linked model	The financial intermediary does not directly provide business development services but establishes a partnership with another entity. This may be appropriate for schemes including non-financial skills that cannot be found within the financial intermediary. This model highlights the cost of this business development service. The financial intermediary has little control over the quality of its partner's services.
The parallel model	Financial and business development services are offered by the same organisation but managed separately. Specialised staff has direct control over each service, though managing them separately may increase financial and administrative costs.
The unified model	Financial and business development services are embedded in a hybrid product provided by the same staff. If well integrated, this model can be cheaper for financial intermediaries as all services are provided by the same personnel.

14 L. Flores and P. Serres (2009), '*Microfinance and non-financial services: an impossible marriage*', in 'What balance between financial sustainability and social issues in the microfinance sector?', Private Sector & Development, Issue 3, September 2009.

6. Combination of Support

The ESIF legislative framework for the 2014-2020 programming period contains conditions for a combination of financial instruments with other forms of support[15] such as grants or other financial instruments in the same programme, or from other EU programmes. Using microfinance together with other forms of financial support may raise the effectiveness of the support and meet the needs of a wider range of final recipients. Two types of combination can be identified[16]:

a) Combination of support within a financial instrument operation (a single operation)
Other forms of support (including technical support to assist implementation of the instrument, interest rate subsidies and guarantee fee subsidies) and the financial instrument are part of the same operation, co-financed by an ESI Fund under a priority axis of an ESIF programme. The other forms of support are provided either by the fund manager or, in specific cases[17] by the managing authority. Support is for the benefit of final recipients but is not directly paid to the final recipient.

Figure 6.1: Combination of support within a single financial instrument operation

Note: figure adapted from European Commission (2015), '*Guidance for Member States on CPR 37_7_8_9 Combination of support from a financial instrument with other forms of support*', p. 6.

15 CPR Article 37(7), (8), (9), Article 42(1), Article 65(11).

16 European Commission (2015), '*Guidance for Member States on CPR 37_7_8_9 Combination of support from a financial instrument with other forms of support*'.

17 Financial instruments implemented pursuant to Article 38(4)(c).

b) Combination of support at the level of the final recipient (combination of two separate operations)

Support from a financial instrument may be combined at the level of final recipient with support from another ESI Funds priority or programme or another EU financed instrument. In this case the grant or other form of assistance does not constitute part of the financial instrument's operation. The combination of financial instrument support and the grant (or other forms of support) coming from another priority, programme or instrument takes place within two separate operations, each having distinct eligible expenditure.

Figure 6.2: Combination of support at the level of the final recipient (combination of two separate operations)

Note: figure reproduced from European Commission (2015), '*Guidance for Member States on CPR 37_7_8_9 Combination of support from a financial instrument with other forms of support*', p. 11.

Two EU programmes offer microfinance products that address ESF target groups. These may be combined with support from financial instruments under ESF.

EaSI - Microfinance and Social Entrepreneurship	The third axis of the EaSI programme aims to: • Increase access to, and the availability of, microfinance for vulnerable individuals or groups who want to set up or develop businesses and microenterprises. • Build up the institutional capacity of microcredit providers. • Support the development of social enterprises, in particular by facilitating access to finance. Two financial products are tailored to public and private institutions: funded instruments, which include loans and equity and the EaSI Guarantee Financial Instrument, which provides capped guarantees and counter-guarantees covering loan portfolios in the microfinance and social entrepreneurship sector. ESF financial instruments can be enhanced by the Microfinance and Social Entrepreneurship axis of EaSI through: • More financial resources generating new job opportunities with self-employment for unemployed people and non-bankable individuals. • Providing new financial instruments increasing institutional capacity for financial intermediaries providing microfinance that addresses social needs. • More financial resources for social enterprise creation and expansion. Microfinance and Social Entrepreneurship axis of EaSI is therefore particularly appropriate for thematic objectives 8 and 9.

<table>
<tr>
<td>Erasmus+ Master Loan Guarantee Facility
 </td>
<td>Managed by the European Investment Fund, this loan guarantee facility increases access to finance for students, regardless of their social background, to take a Master's Degree in another Erasmus+ country, tackling skills gaps in Europe. The interest rate for the loans is lower than the market rate, because the financial intermediary must pass on the benefit of the EU guarantee. Moreover, the loan has no collateral and repayment terms include a 'grace period' of up to one year following the completion of studies before repayments begin and a further one-year 'payment holiday' which can be taken throughout the duration of the loan.

ESF financial instruments can be enhanced by Erasmus+ programme through:
• More financial resources for higher education students to study abroad for a Master's Degree;
• Improving human capital, with better job opportunities for students.

The Erasmus+ programme is therefore particularly appropriate for thematic objective 10.</td>
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Notes

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