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Progress for Microfinance in Europe

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EIF Research & Market Analysis

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Abstract

In November 2009, EIF issued a working paper on the European microfinance market. In this study, we found that there are wide spectra of final beneficiaries and intermediaries and concluded that there is no common microfinance business model in Europe. While our findings suggested that the microfinance market is immature and fragmented, they also pointed to its growing importance as a market segment with a potential to counter poverty and unemployment while fostering financial and social inclusion. The main findings of our initial research with regard to the structure of the European microfinance market are still valid.

This new report provides updated and additional information about the European microfinance market and current developments in the microfinance area. Moreover, it gives insights into the intervention logic, rationale for EU support, and mandate development considerations of the EIF in this field.

More precisely, following a short introduction, we provide in the second section (general market overview) updated information for selected aspects of microfinance in Europe. The third part explains the rationale for public support in the microfinance area and focuses on the chosen approach for the current Progress Microfinance mandate. This intervention logic is based on the market structure and its significant diversity. It seeks to maximise outreach through a flexible investment approach in terms of eligible types of investments and types of financial intermediaries. Hence, in a fourth part, we provide classifications of various intermediary business models and relate suitable financial product designs to their heterogeneous financing needs.

Based on the experience gained during the first implementation phase of the Progress Microfinance mandate section five points out possible opportunities for further market developments. Section six finally provides some concluding remarks.[1]

[1] This paper benefited from comments by/contributions from Saiyi Suzuki Navarro and Frank Lang. All errors are of the authors.

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1 Introduction

In November 2009, EIF issued a working paper on the European microfinance market (see Kraemer-Eis and Conforti, 2009). In this study, we found that there are wide spectra of final beneficiaries and intermediaries and concluded that there is no common microfinance business model in Europe. While our findings suggested that the microfinance market is immature and fragmented, they also pointed to its growing importance as a market segment with a potential to counter poverty and unemployment while fostering financial and social inclusion.

In our initial study, we also considered the proposal by the European Commission for the Progress Microfinance Facility ("Progress Microfinance"), which aimed to address the microfinance market gap in the EU. At the time of our study, neither the structural nor the implementation details of the facility were finalised and it remained unclear how Progress Microfinance could be designed in order to address the highly fragmented and diverse market.

What our initial study did contemplate, however, was that support measures need to be flexible to fulfill the markets' needs. A wide spectrum of financial intermediaries, active in microfinance in the EU (microfinance institutions, "MFIs"), has been developing, and the product range offered to them has to be sufficiently wide in order to meet their diverse needs and to enable them to provide efficient support to the final beneficiaries.

Microfinance is the provision of basic financial services to poor (low-income) people (who traditionally lack access to banking and related services) (CGAP Definition, Consultative Group to Assist the Poor).

Now, the roll-out of Progress Microfinance is well under way since end of 2010. Progress Microfinance, jointly funded by the European Commission and the EIB aims at promoting microfinance in Europe and provides access to financial services needed by small scale entrepreneurs to start and expand business ideas and enterprises.

The first concrete Progress Microfinance transactions have now already been signed across a variety of countries, and a dedicated team is actively originating new opportunities to maximise outreach across the EU. This report provides updated and additional information about the European microfinance market based on the first implementation year of the mandate.

2 Microfinance market environment

Current market environment

Standardised, regularly available indicators to explain market developments for microfinance in Europe do not yet exist, or refer to Eastern Europe. Thus, we will focus in this section on the framework conditions for microfinance which are covered by the regularly updated Eurostat indicators for poverty and social inclusion, and by data on micro-enterprises. Specific aspects of the current crisis will be discussed later in this paper.

In order to assess the achievement of the Europe 2020 poverty/social inclusion target, Eurostat measures the indicator "people at risk of poverty or social exclusion" as a union of the three sub-indicators "People living in households with very low work intensity", "People at-risk-of-poverty after social transfers", "Severely materially deprived people".[2] Figure 1 depicts the headline indicator, corresponding to the sum of persons who are at risk of poverty or severely materially deprived or living in households with very low work intensity (i.e. a combination of the three sub-indicators).[3]

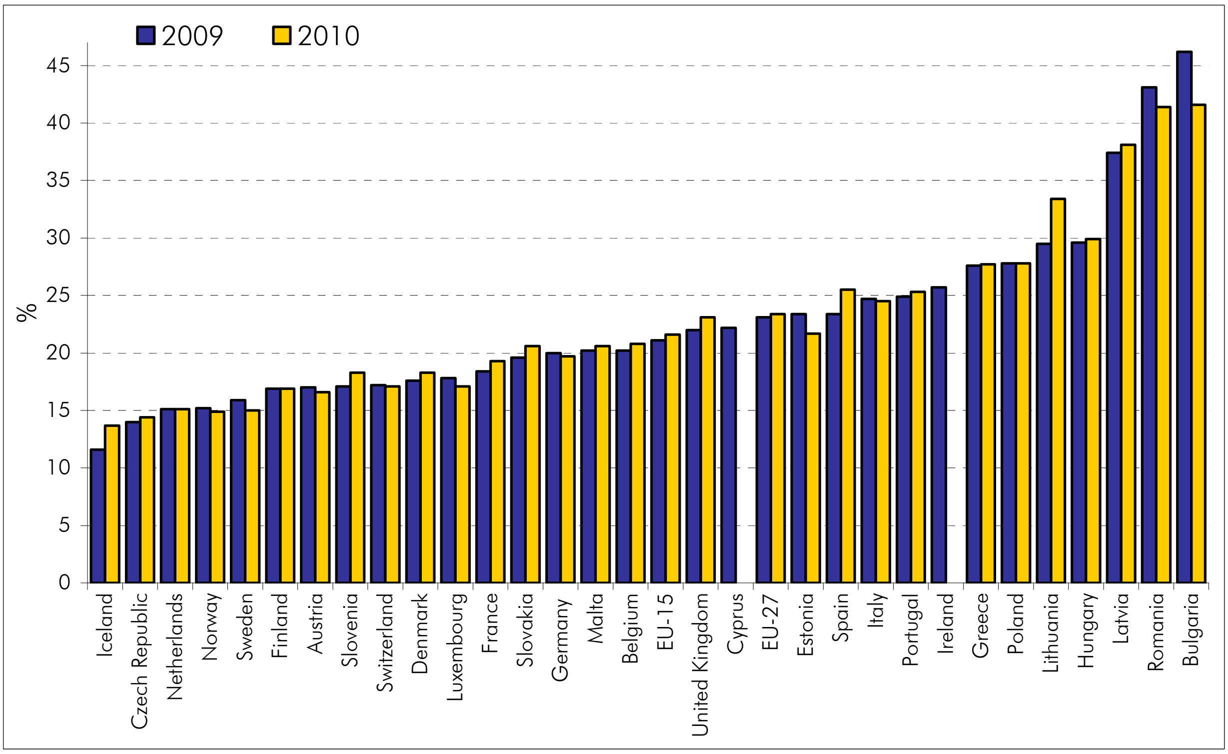
In Eastern Europe, the incidence of poverty or social exclusion is greatest, although the difference between the EU-15 and EU-27 figure is relatively small. When comparing 2009 to 2010, the situation became worse in most of the countries for which 2010 figures are available. Within the EU, the largest aggravation was observed in Lithuania and Spain. Noteable improvements were recorded for Bulgaria, Romania and Estonia, however, they can still be found on the right-hand side of the diagram (meaning higher risk of poverty or social exclusion) which is the case for most parts of Eastern Europe as well as for those West and South European countries which are suffering most from the impacts of the current sovereign debt crises (Greece, Ireland, Portugal, Spain, and Italy).

Micro-credit is defined by the European Commission as a loan or lease under EUR 25,000 to support the development of self-employment and micro-enterprises. It has a double impact (sometimes also referred to as 'the two sides of the microfinance coin'): an economic impact as it allows the creation of income generating activities and a social impact as it contributes to financial inclusion and therefore to the social inclusion of individuals.

[2] See the Eurostat internet site on the Europe 2020 indicators at: http://epp.eurostat.ec.europa.eu/portal/page/portal/europe_2020_indicators/headline_indicators

[3] Persons are only counted once even if they are present in several sub-indicators. At risk-of-poverty are persons with an equivalised disposable income below the risk-of-poverty threshold, which is set at 60 % of the national median equivalised disposable income (after social transfers). Material deprivation covers indicators relating to economic strain and durables. Severely materially deprived persons have living conditions severely constrained by a lack of resources. People living in households with very low work intensity are those aged 0-59 living in households where the adults (aged 18-59) work less than 20% of their total work potential during the past year. For more information please see: http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=t2020_50

Figure 1: People at risk of poverty or social exclusion



Source: Based on data from Eurostat

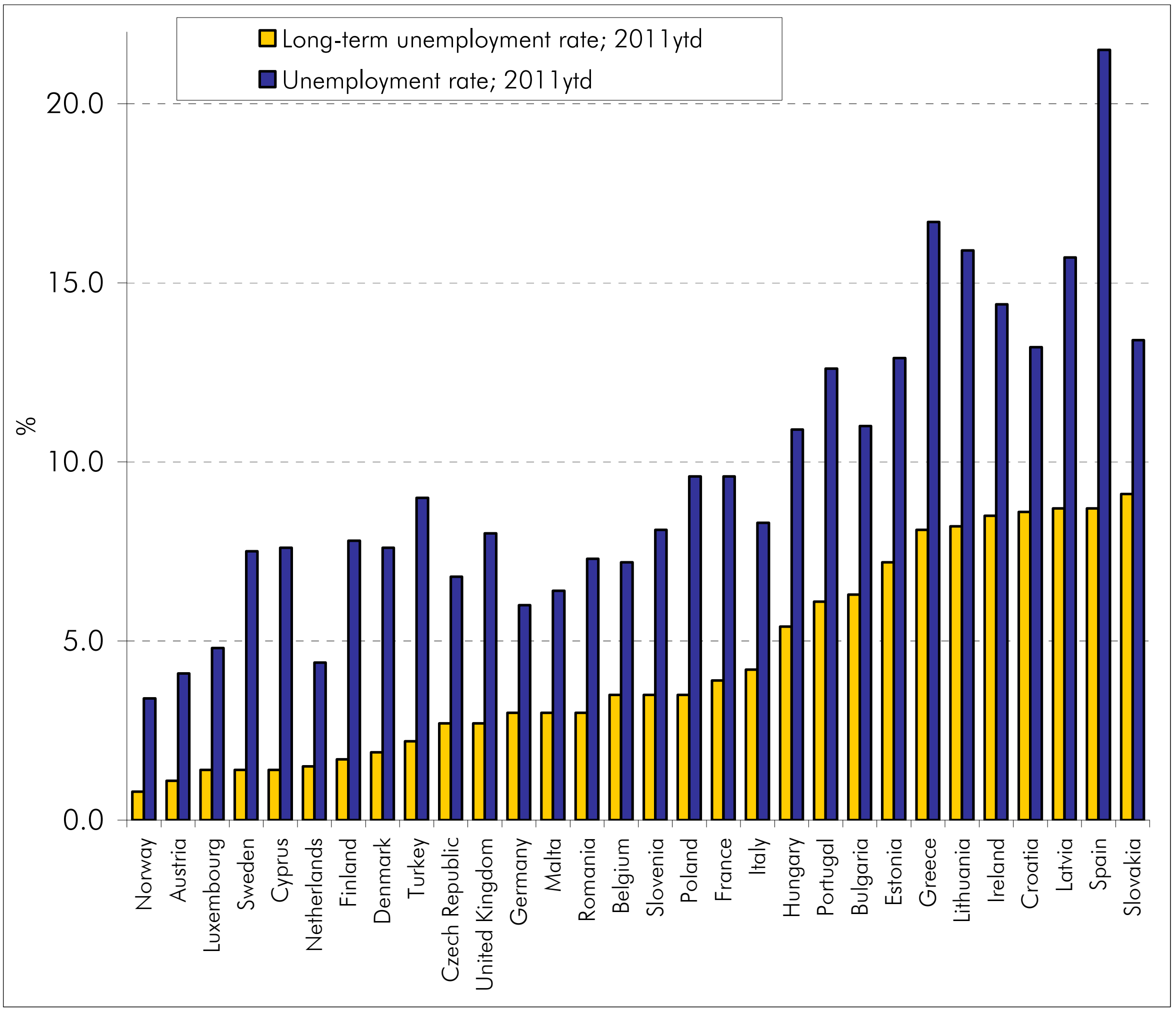
Figure 2 below shows another indicator of social welfare, the unemployment rate and the long term unemployment rate. Again, most Eastern European countries are placed at the right hand side of the chart (meaning higher long term unemployment).

> *A* Micro-enterprise *is any enterprise with fewer than 10 employees and a turnover under EUR 2m (as defined in the Commission Recommendation 2003/361/EC of 6 May 2003, as amended).*

The relatively weak performance of Eastern European EU member states in social welfare indicators, combined with low bank penetration rates, is one reason for the significant market for commercial microfinance in this region.

With regard to unemployment rates, in certain countries low rates are likely to be biased due to the generally larger size of the informal economy, and the less widespread incidence of benefits, making people less likely to register as unemployed.

Figure 2: Unemployment rate (long term and annual average)[4]



Source: Based on data from Eurostat

Specific microfinance landscape

The main findings of our initial research with regard to the structure of the European microfinance market are still valid. We are not going to repeat the analysis here but refer the interested reader to the details of the original paper (see Kraemer-Eis and Conforti, 2009). We can summarise our findings at the time in the following way:

- SMEs constitute the backbone of entrepreneurship in the EU, irrespective of national boundaries. The majority of these companies are micro-enterprises; in the EU-27, 92% of the companies have fewer than 10 employees. The ability of a financial system to reach these small entities is crucial for the achievement of general socio-economic improvement.
- The EU microfinance market is immature and fragmented, but of growing importance as a market segment with a potential to counter poverty and unemployment while fostering financial and social inclusion. One reason for the fragmentation is the diversity of underlying regulatory frameworks (see also box 1 below).

[4] At the time of finalisation of this report the available 2011 data for the unemployement rate covered the period January to November and for the longterm unemployment rate the period January to September.

Box 1: Relevance of the regulatory framework for the development of microfinance

The European microfinance market is characterized by varying legal and regulatory frameworks, different economic realities, differing political philosophies towards socio-economic activity, and different financial sector structures (and history).[5] Banks are subject to comprehensive regulation, even though local differences exist given that EU directives may not have been fully transposed into national law. In some European countries, only regulated banks may engage in micro-lending. Non-banks are typically not subject to banking regulation. However, specific regulations exist in some countries for MFIs (i.e. as EU jurisdictions: Romania, France, Hungary, Italy, Latvia, Lithuania, Slovenia) or in relation to certain legal forms, e.g. the cooperative banks in Italy, or e.g. the community development finance institutions in the UK. Also, the existence of certain legal exemptions may create a specific niche for micro-lenders (such as in France).

Apart from banking regulation, more general legislative aspects, both in relation to micro-lenders and micro-borrowers, have a bearing on the development of microfinance in a given country. This is the case with tax laws, legal provisions in relation to self-entrepreneurship, interest rate ceilings, usury rates, etc. The different frameworks are key determinants and have led to a broad variety of institutional forms and business models for microfinance lending in Europe.[6] As a result, there is noticeable diversity in the various types of microfinance providers, like development agencies, micro-banks, banks (incl. savings banks, and cooperative banks), and non-bank financial institutions (we provide more information on intermediary business models in chapter 4).

- The European microfinance market presents a dichotomy between Western Europe and Central/Eastern Europe in terms of intermediary profile, target beneficiaries, loan size, etc. In general, there is no common microfinance business model in Europe.
- Lenders which focus on SME support and job creation tend to lend larger sums, whilst those focusing on social and financial inclusion tend to issue smaller micro-loans.
- Ratings of MFIs are gaining importance in the microfinance arena but, so far, with a focus on developing countries.
- Often, MFIs follow a transformation process: they start as NGOs and finance their business via donations and/or public money; over time they "grow" towards formal financial institutions and regulated entities. Social performance assessments and ratings are also developing, reflecting the growing need (and wish) for accountability of institutions in this field.[7]

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[5] An early research piece in that area that investigated the legal situation of micro-lending in seven EU member states (Germany, Belgium, France, Italy, The Netherlands and the UK) and put them into an economic, social and political context, distinguishes the following three approaches: (i) the "market approach" (e.g. UK), (ii) the "welfare state approach" (e.g. Germany and the Netherlands) and (iii) the "social lending approach" (e.g. France and, in some respects, Italy). See Reifner (2001). A wider overview of legal and regulatory frameworks of micro-enterprises and micro-credit in Europe has recently been published by Thomson Reuters sponsored by ADIE in a move to identify barriers for development of the sector and reveal good practices for removing them. See: Thomson Reuters Foundation (2011).

[6] For example, in Germany MFIs have to cooperate with banks which provide the loans. This business model is based on restrictions given by the regulatory environment.

[7] In the frame of the JASMINE Technical Assistance programme financed by the European Union and managed by the EIF, financial ratings and assessments of European non-bank MFIs have been actively promoted since 2009. On the basis of its success, the programme will be extended until 2013.

- Not only the financial support of microfinance in Europe is crucial – non-financial support measures for MFIs and final beneficiaries are important for the sector as well (i.e. mentoring, training, and counselling for final beneficiaries; technical assistance and capacity building for MFIs).
- The main challenge for MFIs in the EU is to develop and maintain a flexible and sustainable funding model for microfinance operations that allows them to realise their individual approach.

Market pulse

The results of the most recent EMN survey amongst the microfinance actors provide a picture of the heterogeneous market (Jayo et al, 2010):

- Sixty percent of their respondents are not-for profit organisations (17% less than in the previous survey).
- Typically, microfinance is provided by either small organisations or bigger institutions (where microfinance represents only a small part of the overall activities). The EMN survey reports that 24% of the responding lenders focus only on microfinance; for almost half of the respondents the activity represents only a small portion of the overall activities. In terms of numbers of employees, the biggest organisations are in France, Romania, and Hungary.
- 57% of the microfinance organisations provided fewer than 50 loans in 2009 (typically in France, Germany, Spain); only 13% provided more than 400 loans (largely in Eastern Europe, i.e. Bulgaria, Hungary, Romania, Poland).
- Micro-loan sizes vary between EUR 220 and EUR 37k[8] with banks, non-bank financial institutions and government bodies offering larger loans than credit unions, NGOs, savings banks, and foundations. The average loan size across the sample in 2009 was EUR 9.6k.
- 59% of respondent lenders do not require guarantees; the remainder require either collateral or participation in a guarantee programme.
- There is a tendency of cross-selling as around 50% of respondents offer other financial services to their microfinance clients (debt counselling, savings, insurance, mortgages, money transfer).

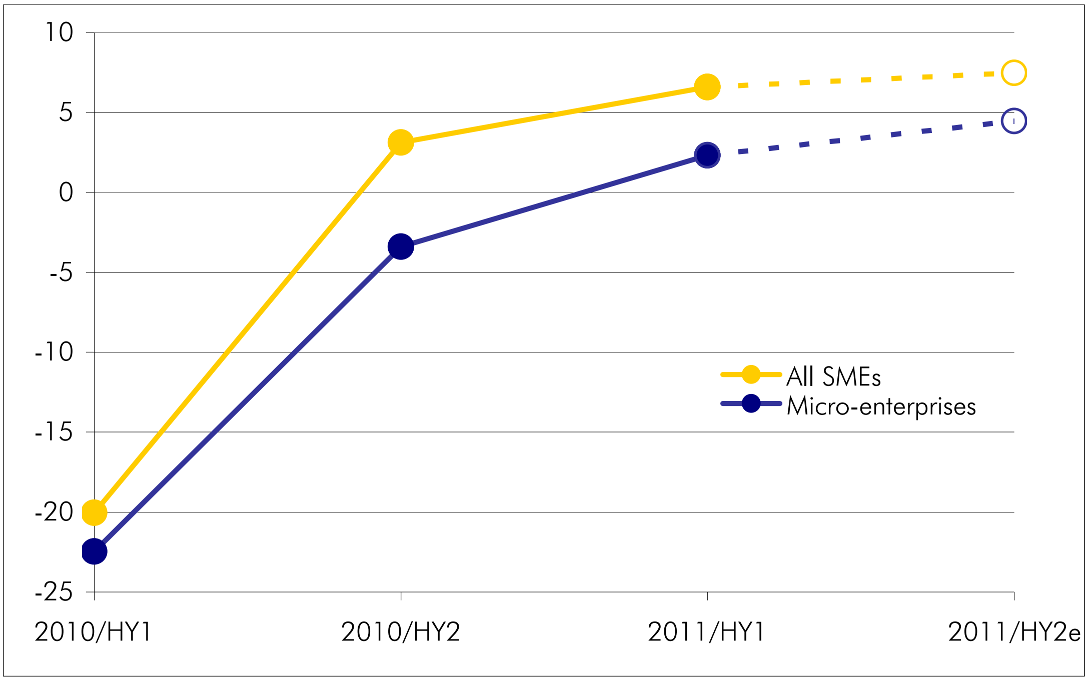
> *"In 2010, there were over 20.8 million enterprises active in the non-financial business sector in the European Union, of which 99.8% were SMEs. About 92% of the total business sector consists of micro enterprises, which employ fewer than 10 persons. The typical European firm is a micro firm" (EIM, 2011).*

- The most pressing problem for the microfinance providers is the lack of access to long-term funding.

[8] Although strictly speaking the latter is no longer considered a micro-loan under the EU definition.

When looking at the business climate of micro-enterprises, the EU Craft and SME barometer (UEAPME, 2011) shows that micro-enterprises on balance estimated their overall situation somewhat less favourable than all SMEs in the first half of this year (see figure 3).[9] Nevertheless, the weighted difference between positive and negative answers increased, and the outlook for the second half of the year was even a bit better. Similar results were reported for the survey questions on turnover, prices, and orders. However, expectations for investments were on balance lower than their actual situation, and employment expectations resulted largely in balance with the current situation. All in all, the figures reveal more difficulties for micro-enterprises than for other SMEs.

Figure 3: Overall situation of European micro-enterprises

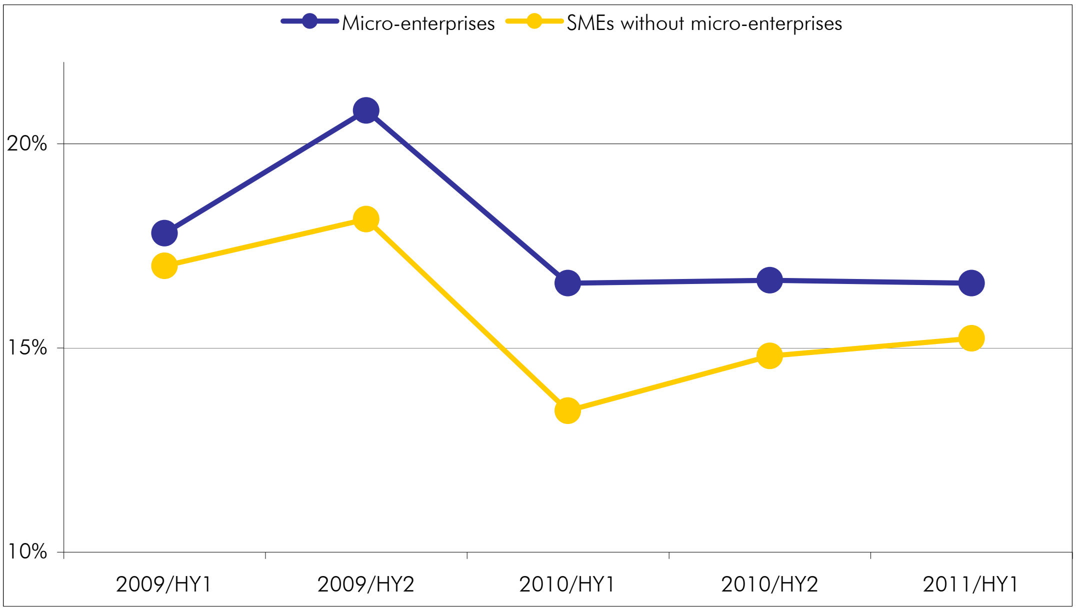


Source: UEAPME Study Unit (2011)

According to the latest ECB survey on the access to finance of SMEs in the Euro area (ECB, 2011), access to finance remained a more pressing problem for Euro area SMEs than for large firms, and the share of enterprises which see access to finance as their most pressing problem is larger among micro-enterprises than among other SMEs (see figure 4).

[9] The EU Craft and SME barometer builds on surveys that are conducted by UEAPME member organisations. The 2011HY1 results are based on about 30,000 answers collected between May and July 2011. The balanced figures mentioned in the text show the difference between positive and negative answers, with national results weighted by employment figures. The surveyed categories include overall situation, turnover, employment, prices, investment, and orders. For details see http://www.ueapme.com/IMG/pdf/111011_Barometer_2011H2_final.pdf

Figure 4: Share of enterprises reporting access to finance as their most pressing problem



Source: European Central Bank[10] and own calculations.

Final beneficiary profile

There is also diversity with regard to final beneficiaries: many providers target people excluded from mainstream financial services (47% of respondents of the latest EMN survey) and women (44%); moreover, ethnic minorities and/or immigrants (41%), young (29%) and disabled people (21%) are amongst the top ranks (see Jayo et al, 2010).

Priority outreach to these specific target groups show the high social focus of microfinance in Europe. The causes and consequences of financial exclusion can also contribute to social exclusion: Those unable to access finance for enterprise creation/development, have greater difficulty in integrating into the financial system; this reality can also affect their participation in mainstream social activities and events specific to their cultural reference group.

On the other hand, those who are socially excluded - particularly with respect to networks, decision making, and an adequate standard of living may also become excluded from mainstream financial services in so much as they are unable to provide the types of professional and personal references needed to access finance. In times of personal hardship, socially excluded persons may rely on predatory "door step" lenders, further exacerbating their vulnerability and exclusion.

[10] Statistical Data Warehouse. Survey on the access to finance of SMEs in the Euro area.

3 Rationale for public intervention

3.1 Market failure

Economic literature often discusses that in the area of access to finance for SMEs, a market imperfection/failure is not only present during a deep recession but also on an ongoing basis as a fundamental structural issue. The reasons for the market failure relate to insufficient supply of capital (debt or equity) and inadequacies on the demand side. This market failure is mainly based on asymmetric information (in the case of debt: information gap between lender and borrower), combined with uncertainty, which causes agency problems that affect debt providers´ behaviour (see Akerlof, 1970 and Arrow, 1985).[11]

Information asymmetry can be reduced via three ways: a firm's ability to signal its credit worthiness (incl. an institutional assessment or rating by an independent agency and the provision of collateral), a strong relationship between lender and borrower, and through due diligence/lenders' examination (screening). However, this means on the other hand that new or young firms, with a lack of collateral and by definition without track record are the ones with the greatest degree of difficulty accessing debt capital (Equinox, 2002). Micro-enterprises, young companies or start-ups by definition have no track record, often only limited collateral, and no long standing relationship with lenders. One could even generalise or simplify that: the smaller the company, the bigger the information asymmetry and thus the higher the transaction costs in relative terms.

Microfinance institutions have been affected by the adverse macro-economic conditions during the global financial and economic crisis, generally through significantly higher bad debt rates among their clients and in some cases through increased difficulties in accessing external sources of funding. With ongoing problems in the banking sector, the target group for microfinance, namely the financially excluded but economically active, might be faced with tightening credit supply by mainstream banks due to their higher risk aversion and increasing need to de-leverage their balance sheets.

This reluctance on the part of mainstream lenders creates an opportunity for microfinance but also underlines the paramount importance of credit risk management in an industry that, in Western Europe at least, continues to be driven by socially motivated investors and entities supporting microfinance as part of their social responsibility initiatives. This realisation has a significant impact on the pricing of financing instruments to such types of entities and has arguably served to undermine the development of viable microfinance models in terms of self-sustainability. Self-sustainability of microfinance models is critical for the industry to ensure long term availability of microfinance products for microfinance clients. The economic sustainability of microfinance intermediaries comes as a result of the balance between the income and the costs, which in turn are a function of the pricing policy (interest and fees), cost management (operational and financial costs and provisions), economies of scale and level of available subsidies of a particular institution.

[11] Agency theory/the principal-agent approach is often applied in economics literature for the analysis of relationships between lenders and borrowers (e.g. contract design, selection processes, credit constraints, etc.).

The impact of the crisis further increases the market failure – also driven by increased risk aversion on the supply side of microfinance - and underlines the need for public support for this emerging sector in Europe.

In addition to the fundamental structural problems of the microfinance sector in Europe, public intervention has largely been justified and substantiated with positive externalities, i.e. that social and financial inclusion generates attractive economic and social returns. From an EU policy standpoint, public intervention has traditionally been made conditional upon ensuring "additionality", i.e. not crowding out private activities, but rather serving as a catalyst for the entry of private capital in order to create a self-sustainable market in the long run.

3.2 History of EU support for microfinance

Early initiatives

Microfinance has long been recognised by European policy-makers as an instrument to support entrepreneurship and competitiveness on the one hand, but also social inclusion on the other. However, in view of the specific local legal and political environments, the development of the European microfinance sector is still in an early stage with regard to scale and broader impact, and faces a continuing gap between supply and demand.[12]

Over the past decade, the EU has promoted a series of actions in support of microfinance, among which the following can be highlighted:

- Risk protection to financial institutions (including banks, guarantee institutions and counter-guarantee institutions) for new micro-credit portfolios, under the Growth and Employment initiative (1998-2000), the Multi-Annual Programme for the promotion of enterprise and entrepreneurship ("MAP", 2001-2005) and, currently, the Competitiveness and Innovation Framework Programme ("CIP", 2007-2013), all managed by the EIF.[13]
- The Joint European Resources for Micro and Medium Enterprises ("JEREMIE") scheme, managed by the EIF on behalf of the European Union for the period 2007-2013, aims at improving access to finance, including micro-credit using European Structural Funds.

A broader EU policy move to use public funds to contribute to the development and long-term sustainability of the sector was initiated with the European Commission Communication, in November 2007, on a "European initiative for the development of micro-credit in support of growth and employment".[14]

[12] See Kraemer-Eis and Conforti (2009) with regard to market gap estimations (p. 26f).

[13] More information can be found in: Council Decision (98/347/EC) of May 1998 on measures of financial assistance for innovative and job-creating small and medium-sized enterprises – the growth and employment initiative. OJ L155, 29.05.1998. Council Decision (2000/819/EC) of 20 December 2000 on a multiannual programme for enterprise and entrepreneurship, and in particular for small and medium-sized enterprises (2001-2005). OJ L333, 29.12.2000, and Decision No 1639/2006/EC of the European Parliament and of the Council of 24.10.2006 establishing a Competitiveness and Innovation Framework Programme (2007-2013). OJ L310, 09.11.2006.

[14] Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions: a European Initiative for the development of micro-credit in support of growth and employment - COM (2007)708 final.

Its objective was to promote the development of micro-credit in the European Union through actions along the following strands:

- Improving the legal and institutional environment in the Member States;
- Further changing the climate in favour of entrepreneurship;
- Promoting the spread of best practices;
- Providing additional capital for micro-credit institutions.

The Communication highlighted the role played by microfinance institutions/micro-credit providers in developing the provision of micro-credit in Europe and stressed that adequate technical support is necessary to help these operators release their potential. In this context, the Commission and the European Investment Bank agreed on the "Joint action to support microfinance institutions in Europe" ("JASMINE"), an initiative launched in September 2008 and aimed at helping MFIs/ micro-credit providers to improve the quality of their operations, to expand and to become self-sustainable.

The initiative comprised a technical assistance facility ("JASMINE Technical Assistance") through which the EIF has arranged, on behalf of the EC's Directorate General for Regional Policy, ratings, institutional assessments and trainings for non-bank microfinance institutions. As accompanying financial measure, in January 2009 the EIB entered into an agreement with the EIF for the implementation of a pilot microfinance investment window ("RCM Micro") under the existing Risk Capital Mandate ("RCM").[15]

Another early-stage mandate in support of the European microfinance sector was the European Parliament Preparatory Action ("EPPA"), a EUR 4m envelope under which the EIF has, since April 2010, made four risk capital investments and loans to non bank MFIs.

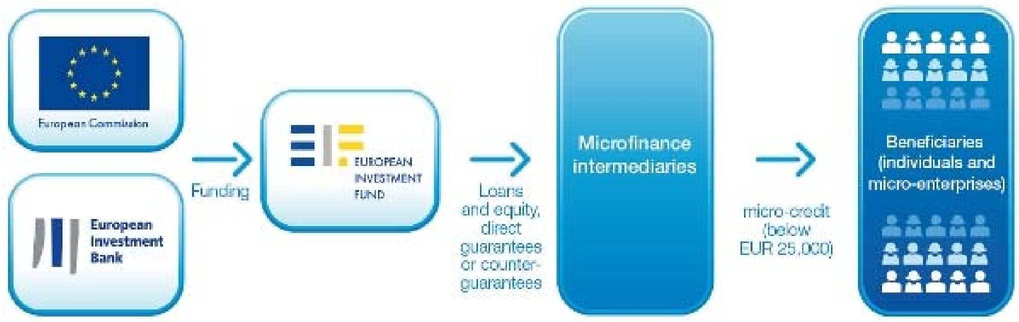
While these windows served as an opportunity for market testing, their pilot nature and limited scale and scope represented a constraint on the market impact that these EU initiatives could deliver. Instead, the potential for EU-funded microfinance initiatives to effect more sizeable market impact in the EU-27 came with the launch of the Progress Microfinance initiative in 2010.

Progress Microfinance

Motivated by the adverse effects of the financial crisis, in 2010 the Commission Directorate General for Employment, Social Affairs and Inclusion and the EIB made each available EUR 100m to the benefit of micro-enterprises and self-employment, with a particular emphasis on social inclusion and groups with limited access to the traditional banking system. Progress Microfinance represents the first ever EU-wide dedicated financing programme for the European microfinance sector, and in addition to financing capacity it also provided for the structural framework needed to absorb the various smaller microfinance pilot predecessors and evolve towards a much-called for ´one-stop-shop´ for EU supported finance measures (see figure 5).

[15] The RCM is a EUR 5bn Venture Capital mandate from EIB to EIF.

Figure 5: Simplified structure of Progress Microfinance



Source: EIF

Progress Microfinance has been implemented through two actions, both of which are managed by EIF. They are: 1) a guarantee instrument to providers of micro-credit (funded entirely by the European Commission); and 2) a structured investment vehicle set up under Luxembourg law, the European Progress Microfinance Fund, funded by the European Commission and the EIB. This Fund offers senior loans, subordinated loans (financing subordinated to senior creditors), risk-sharing loans (senior loans combined with risk participation in the micro-credit portfolio) and equity participation to micro-credit providers. The EU´s target commitment in the Fund is EUR 78m, matched by EUR 100m target commitment by the EIB (and possible further funds of other investors of up to EUR 47m).[16] An indicative EU budget of EUR 25 million has been allocated to the guarantee instrument.

The Progress Microfinance investment by the EIB is part of EIB Group's long term financing role seeking to increase value added and catalyse funds in support of small companies. Progress Microfinance illustrates the enhanced cooperation between the EU and the EIB Group through innovative risk sharing structures with subordinated capital from the European Union, allowing higher leverage on the Community budget and subsequently greater market impact and providing value added to a still emerging market through more effective and efficient use of scarce budgetary funds.[17]

Because of the highly diverse needs of beneficiaries and heterogeneity of micro-credit providers in the EU, Progress Microfinance has been specifically designed to respond this demand through a number of tailored instruments. Until the end of 2011, EIF had already entered into contracts with 14 intermediaries in 12 countries and will continue to provide financial instruments to MFIs located within the EU Member States until 2016, for on-lending to local micro-entrepreneurs and micro-enterprises.[18]

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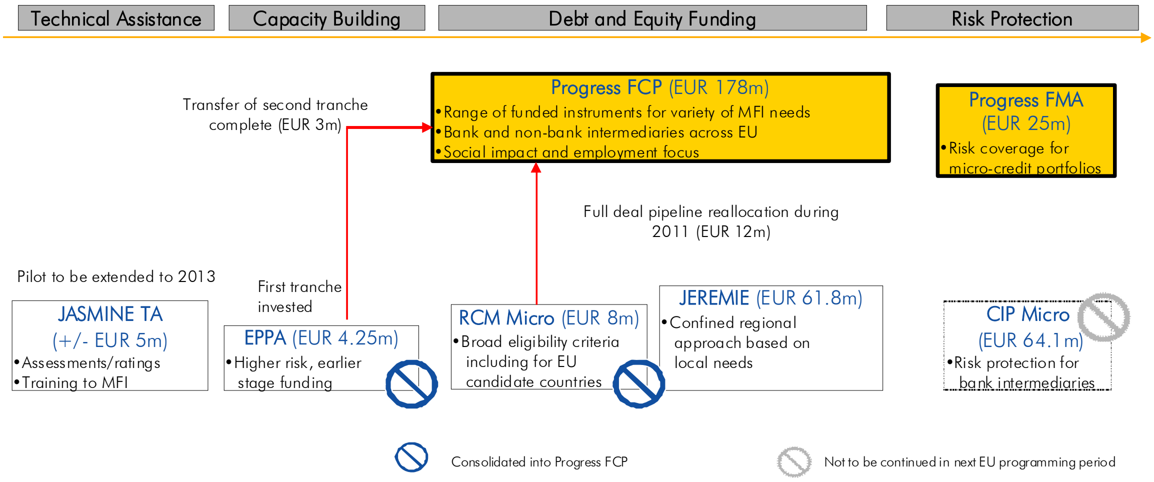
[16] The European Progress Microfinance Fund is managed by the EIF acting as Management Company. The EU holds the junior units, which means that it bears the first net losses affecting the Fund's assets, within the agreed commitment cap, while the EIB as holder of the senior units is protected against the losses borne by the junior units.

[17] The Progress Microfinance initiative integrates well into this strategy, in particular since it addresses already the Europe 2020 dimension of inclusive growth. See chapter 3.3 for more information about Europe 2020.

[18] For more details see: http://www.eif.org/what_we_do/microfinance/progress/index.htm.

An overview of the development of the EIF-managed programmes and pilot initiatives under a financial product perspective is shown in figure 6:

Figure 6: Development of EIF-managed microfinance programmes[19]



Source: EIF

Progress Microfinance has become the central platform for pan European EU supported microfinance programmes. Deeper regional support to microfinance is provided under Structural Funds through the JEREMIE mandates to certain Member States or Regions.

Non financial support is offered through JASMINE Technical Assistance, which has started as a two-year pilot initiative in 2009 and is now extended for two further years. The EPPA initiative bridges the development gap of in particular younger, riskier non-bank MFIs with financing aimed at the institutional capacity building of these institutions. A second EU budgetary tranche initially foreseen to top up the first EUR 4m has been consolidated into the Progress Microfinance Fund ("Progress FCP" in figure 6). The same was done with the unused EIB resources under the EUR 20m RCM Micro window in order to streamline with the interventions in support of microfinance and thus avoid overlaps or confusion.

Under the CIP mandate, a dedicated window exists for micro-credit portfolio guarantees, similar to the ones offered under the guarantee leg of Progress Microfinance ("Progress FMA" in figure 6). While the CIP programme also extends to countries outside EU-27 and is capable of offering larger guarantees to intermediaries than Progress Microfinance, the proposals made by the European Commission in relation to the next EU budgetary programming period from 2014-2020 for Competitiveness and SMEs ("COSME") do currently not foresee a continuation of such dedicated window, so that the overlap between the two programmes (albeit limited in practice) is avoided (European Commission, 2011e).

[19] Indicated volumes are target programme amounts except for JEREMIE and CIP Micro. For JEREMIE we show amounts signed and tendered (microfinance and social finance); for more information about JEREMIE see:
http://www.eif.org/what_we_do/jeremie/index.htm
For CIP Micro we show the actual cap amount; this corresponds to total commitments by financial intermediaries of EUR 666m. Please note that also in other CIP windows micro-enterprises can receive micro-loans; only the amounts for the specific CIP Micro window are shown here. For more details about CIP Micro see:
http://www.eif.org/what_we_do/guarantees/cip_portfolio_guarantees/micro_credit_guarantees/index.htm

3.3 Rationale of central EU intervention ("European Added Value")

The Europe 2020 strategy provides the overarching policy framework in which EIF's microfinance strategy is determined for the coming years. Formally adopted at the European Council in June 2010 (European Council, 2011), the political and economic objective of Europe 2020 is to deliver "smart, sustainable and inclusive growth" for the EU as a response to the crisis and as a means to maintain and strengthen Europe's competitive position in the global economic order. In so much as microfinance has proven a useful policy tool to support inclusive growth, the ongoing implementation of Progress Microfinance and development of its successor can serve as cornerstones in delivering measurable results in the area of inclusive growth under Europe 2020, i.e. in the target areas "employment" and "social inclusion" (European Commission, 2011c).

The central EU-sponsored interventions in support of the microfinance sector are firmly grounded on the idea of European Added Value, i.e. justification of the subsidiarity. The following aspects substantiate the strong European Added Value of a central support measure for the European microfinance sector, based on better efficiency, effectiveness and synergies:[20]

Critical mass and effectiveness

Progress Microfinance has brought a financing programme in Europe with critical mass previously missing under the disparate small-ticket EU mandates. In general, microfinance is an emerging market segment where a minimum scale needs to be reached in order to start attracting private sector capital. It is through this critical mass then that a more forceful market impact characterised by stronger outreach across a broader range of microfinance intermediaries can be achieved. At this stage of operation it is already visible that Progress Microfinance is an effective way to address the current fragmentation of the market and to incubate a segment that has no sufficiently viable infrastructure in place yet to foster a generally sustainable sector in Europe.

Complementarity

Progress Microfinance has marked the first instance in which a single EU-managed microfinance programme has offered a comprehensive set of microfinance tools to match the varying risk coverage and funding needs of intermediaries across EU-27 countries. In addition to guarantees and counter-guarantees on portfolios of micro-credits, Progress Microfinance also involves deployment of a series of newly developed funded instruments including various types of loans and also including the possibility of equity participations. This diversity of products is based on the heterogeneity of the intermediary business models that will be explained later in this paper.

Through its horizontal investment approach, Progress Microfinance broadly seeks to serve market needs of the microfinance sector across EU-27 geographies. As a complement to the widening effect underpinning the Progress Microfinance strategy, more targeted regional support can still be made available through the JEREMIE framework in line with national policy priorities under Structural Funds.

Against the backdrop of widely differing national and regional microfinance markets across the EU, central EU support to microfinance can help to build up specific competencies locally which, in turn, are instrumental for further development of a more coherent market. Furthermore, the

[20] See European Commission (2011f).

Progress Microfinance support measures are expected to have a positive influence on measures adopted at the national or regional levels.

Risk Diversification and Catalytic Effect

At the same time, creating a Europe-wide portfolio of microfinance assets at the level of Progress Microfinance allows for a degree of risk diversification that would otherwise not be possible at a national level only. This is of particular advantage in a sector where the bulk of MFI counterparts display sub-investment grade quality. In addition, in the chosen Microfinance Fund structure, the EU investment serves as a risk buffer for other investors at a more senior level. This structure allows to multiply limited EU budgetary resources at both the Fund and product levels and thereby to enhance the impact on targeted final beneficiaries.

Efficiencies

Progress Microfinance has had an important effect through the chosen implementation structure: The FCP-SIF (fonds commun de placement – fonds d'investissement spécialisé) structure is an example of how EU policy outreach can be enhanced through delegated, cost-efficient management drawing on market-based instruments and practices. Given that the platform has been designed to accommodate integration of further bespoke investment compartments, future EU microfinance initiatives can be effectively housed under the existing structure in a ´one-stop-shop´ perspective.

As indicated above, the establishment of the Progress Microfinance platform has already had a clear efficiency effect by absorbing some of the prior small pilot financing initiatives. Furthermore, integrated management of the variety of products under the pooled expertise of an experienced and professional manager allows for more efficient coordination, quality standards and enhanced impact potential. Centralised reporting, also on social impact, allows for better monitoring of the achievement of objectives.

Demonstration and Signalling Effects

Centralised management under defined objectives and high quality standards spurs demonstration and signalling effects, i.e. typically the consistent application and promotion of best market practices (or in view of the non-existence of a business model - consistent practice to build market standards). This fosters the qualitative development of a market and increases intermediary sophistication over time. With regard to microfinance, this demonstration and signalling effect can be enhanced by providing support to MFIs in the form of non-financial technical assistance and capacity building financing (e.g. for branch expansion, build up of IT and other infrastructure etc.). A centrally managed programme, combined with special expertise (in this case for a diverse product offering: microfinance, loan instruments, equity instruments, guarantees) and the ability to implement innovative financing solutions can provide the necessary visibility, integration, and quality to spearhead a harmonised and scaleable model.

4 Intermediary business models and respective financing needs

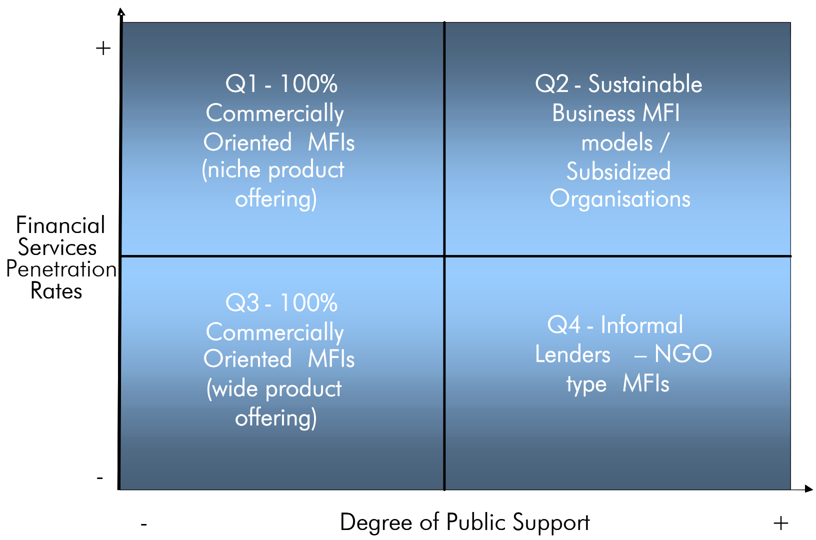
So far we analysed the market environment and the validity of central EU support measures for microfinance. We now turn to the financial intermediaries and their business models. A categorisation of these models can either be done according to the "legal" classification - MFI with/without banking license - or with regard to the "nature" of the MFI. We present both options below. The diversity of these business models forms the basis for the product portfolio of Progress Microfinance.

4.1 Categorisation I: Non-bank versus Bank MFIs

Non-bank MFIs

In the illustration below (figure 7), a non-bank MFI business model matrix has been defined as a function of financial services penetration rates in a given country and the degree of public/third party support to non-bank MFIs in a given country. In general, it is assumed that low financial services penetration rates combined with limited public / third party support (e.g. in most of the Eastern part of the EU) to individual MFIs create an environment where non-bank MFIs can deploy a commercially oriented microfinance business with relatively wide product offering alongside banks. Commercially oriented MFIs can also operate in environments with high financial services penetration rates (e.g. in most of the Western part of the EU) even though such examples are rare and it is too early in many cases to say whether they can survive in the long run. Such MFIs often have a niche product offering. Where the regulatory framework prevents non-bank MFIs to enter into lending activity themselves, institutions explore ways through cooperation with banks to build a business model for microfinance. One example is Germany, where MFIs accredited by the German Microfinance Institute operate as consultants to facilitate micro-lending via GLS bank under the publicly financed Microcredit Fund Germany.

Figure 7: Non-bank MFI business model matrix



Source: EIF

Public or third party support takes different forms and shapes including e.g. MFIs being set up or sponsored in the context of corporate social responsibility ("CSR") projects of major banks or donors, subsidising MFIs with full operating cost coverage. Most of such examples can be found in the Western part of the EU where micro-loan pricing often is below the level required to cover all costs associated with the micro-credit activity, in particular operating costs. In the Eastern part of the EU there are examples of non-bank MFIs set up as subsidiaries of national development agencies.

Unlike bank MFIs, non-bank MFIs do not have access to deposits as a source of funding. Non-bank MFIs typically have a modest financial leverage and commercially oriented ones rely on a small number of wholesale funding providers. Also highly subsidized non-bank MFIs can secure whole sale funding although additional comfort in the debt structuring is required to mitigate the event risk of third party sponsors discontinuing their support of such MFIs. Such additional comfort could e.g. take the form of guarantee coverage for the micro-loans on the MFI's asset side, reduced financial leverage or tranching of the whole sale funding tied to ongoing donor payments.

Non-bank MFIs have different forms of equity. Some are set up in the form of foundations where equity only can take the form of charitable contributions and grants.[21] Other MFIs have a more traditional corporate form and are set up with issued share capital as equity base. Even in this category though, the motives by the equity investors differ a lot. Some strive for a stable ownership structure with modest growth and limited upside potential, some are more inspired by private equity prospects with aggressive growth over a relatively short investment horizon. In the latter case, it is of the essence to assess whether such shareholding base will remain committed to micro-credit over time.

Bank MFIs

These are banks for which microfinance is a small part of their overall operations. Microfinance may be offered either

(i) as part of the financial intermediaries' social responsibility programme, or

(ii) as part of the financial intermediaries' commercial activities.

In the former case, micro-loans are usually offered with a special focus on social inclusion. Often, the interest rates on such micro-loans are not priced reflecting all costs and credit risk, and the underlying micro-businesses are not always profitable or viable in a commercial context. This allows the banks to clearly segment their activities and avoid any potential conflicts with its mainstream private banking business (e.g. negative reputational effects by pricing micro-credits high, which may taint the perception of the mainstream customer in relation to the banks' price competitiveness).

In the latter case, micro-loans are offered by way of extension of the financial intermediaries' SME lending activities (i.e. down-scaling); this is also true e.g. for some public/cooperative bank networks, some local/regional banks in the Western part of EU and some smaller domestic banks in the Eastern part of EU. Smaller and niche oriented Bank MFIs often have an outreach that partially overlaps with larger non-bank MFIs.

[21] Progress Microfinance cannot provide equity capital to such type of MFIs.

Interest rates on micro-loans of this type usually reflect the risk profile and cost structure of the financial intermediary, and there is more focus on the commercial aspects, aiming to make micro-lending an integral part of the products offered by the financial intermediary. In each case, such institutions usually finance their microfinance activities through their balance sheet, hence at relatively low margins.

The typical Bank MFI operational models are the same as standard banking business models – the only difference is the borrower (micro-enterprise); and sometimes the banks' microfinance activities include business support services to the micro-borrowers.

4.2 Categorisation II: "nature" of the MFIs

An alternative classification of financial intermediaries can be done according to the following basic categories:

(i) For-profit Small / Mid-sized microfinance institutions ('Small / Mid-sized MFIs')

These intermediaries are privately owned financial intermediaries offering exclusively or mostly microfinance services (typically micro-loans). If the financial intermediary offers products other than microfinance, such would usually be SME lending products (i.e. up-scaling).

Such institutions usually have a balance sheet of less than EUR 100m (often no more than EUR 10 to 15m; although in exceptional cases it can be up to EUR 500m). Micro-loans are usually targeted at borrowers that operate profitable micro-enterprises, hence the micro-loans can be offered at commercial terms. Consequently, the micro-loan interest rates cover the cost structure of the financial intermediary fully. Such financial intermediaries usually refinance their activities through equity and debt (on a low leverage basis) usually in form of bilateral loans by microfinance investment funds and/or IFIs. Due to the limited refinancing options (no deposits, as often no full banking licence) and the relatively high micro-loan interest rates, the refinancing conditions of such financial institutions are typically high.

(ii) Mainstream banks operating microfinance windows ('Mainstream Banks' or 'Bank MFIs')

See Bank MFIs in the previous section.

(iii) Public entities operating microfinance windows ('Public Entities')

These are entities that consider microfinance as part of their public enterprise promotion or social inclusion mandate, in a similar logic as that described in the section 'Bank MFIs'. Such institutions typically finance these activities with public funds, usually at relatively low margins (particularly if they are government guaranteed).

(iv) Greenfield entities ('Greenfield Entities')

Start-up MFIs or MFIs with little or no track record, sponsored by private individuals or other investors.

(v) Dedicated microfinance vehicles

Funds or vehicles, often set up for a limited period of time, that invest in (usually Small/Mid-sized) MFIs or provide micro loans directly.

In terms of business model and client targeting, the above mentioned types of financial intermediaries can be summarised as follows (see table 1):

Table 1: Types of intermediaries

Type	Role of microfinance in business model	Target clients	Main products
Small/ Mid-sized MFIs	Main (only) part of business model, possibly complemented by SME lending (i.e. up-scaling)	Profitable micro-enterprises, with no or limited alternative access to funding	Commercially priced micro-loans
Mainstream Banks/Bank MFIs	Small (non-core) part of business model, either (i) as part of its social responsibility programme, or (ii) as an extension of its commercial SME lending (i.e. down-scaling)	Depending on business model, either (i) individuals and micro-enterprises with certain socioeconomic attributes, may or may not be profitable micro-enterprises; or (ii) profitable micro-enterprises, with no or limited access to funding	Depending on business model, either (i) soft-priced micro-loans; or (ii) commercially priced micro-loans
Public Entities	Varies	Depending on mandate, usually as above (Mainstream Banks)	Soft-priced micro-loans
Greenfield Entities	Main (only) part of business model	Varies	Commercially / soft-priced micro-loans
Funds and vehicles	Main (only) part of business model	Allows to access intermediaries and hence final beneficiaries, which otherwise could not be included in the fund	Varies, depending on business model of intermediaries pooled in the Indirect Investment

Source: EIF

4.3 Product design for a heterogeneous market

The Progress Microfinance product portfolio has been designed to fit in a heterogeneous market environment with a wide range of different financial intermediaries applying different microfinance models and going through different stages of development. The products offered to the financial intermediaries are: senior loans, subordinated loans, portfolio risk sharing loans, equity and quasi-equity participations and portfolio guarantees (direct and counter-guarantees). The main features of these products and their catalytic effect will be explained below.

Senior loans are provided to well established non-bank MFIs and in general to smaller banks active in the field of microfinance. The purpose of the senior loan is to grow the micro-credit portfolios of the financial intermediaries over a predefined period of around 2 to 3 years. The growth target of the micro-credit portfolios is set as function of the nominal amount of the senior loan granted. It typically results in a multiplier effect of 1x to 2x.[22] The senior loans are normally provided with a maturity of 5 to 7 years, subject to the credit profile of the institution. The specific

[22] The "multiplier effect" is a parameter that expresses the catalytic effect at the final beneficiary level; it specifies how much additional money will be "incentivised" based on the public support.

repayment modalities under the loans are set in view of the debt service capacity of the MFIs and the actual compliance with the agreed growth targets.

Subordinated loans are structured as Tier-2 capital instruments and therefore do not only provide long-term funding but also strengthen the capital base of the financial intermediaries. Such product is only offered to regulated banks active in the field of micro-lending, either as part of their normal SME lending or through a dedicated microfinance down-scaling model. The growth target for the micro-credit portfolios is set higher for the subordinated loan than for the senior loans, based on the stronger growth potential inherent in Tier-2 capital instruments. The minimum multiplier effect is 2x. The subordinated loan contracts include features to incentivise the achievement of the agreed growth targets. Subordinated loans are provided with a maturity of up to 8 years.

Portfolio risk sharing loans are hybrid instruments that combine the funding component of senior loans with the credit loss protection of guarantees. Such product is offered to good quality banks in the context of micro-credit pilot projects. The risk sharing loans provide co-financing and risk sharing of up to 50% of new micro-credit portfolios to be originated over a period of 2 to 3 years. For this product, the target multiplier effect is 2x. Its achievement is guided by specific contractual features, including in relation to repayment and scope of credit loss protection. Risk sharing loans are offered with maturities in the range of 5 to 8 years depending upon the expected maturity profile of the micro-credit portfolio on which credit loss protection is provided as well as the counterparty risk of the intermediary.

Equity and quasi-equity, through ordinary or preferred shares, is provided to start-up non-bank MFIs to strengthen their capital base. Equity investments are undertaken alongside other investors, so that a minority stake in the investee company can be achieved. The planned investment horizon is in the range of 7 to 9 years and exits could take the form of trade sale, possibly following the exercise of a put option vis-à-vis a third party identified at the time of the original investment or through a share buy-back by the investee company itself. The product multiplier target for equity investments is minimum 3x since it is assumed that the MFI will manage to secure also loan financing over the investment horizon of the equity investments. Through its influential rights, equity investors, can - to a certain extent - influence the activities of the investee company through board presentation or achieve early exit through trade sale as long as lock up periods for equity investments are kept short. This supports also the compliance with set growth targets.

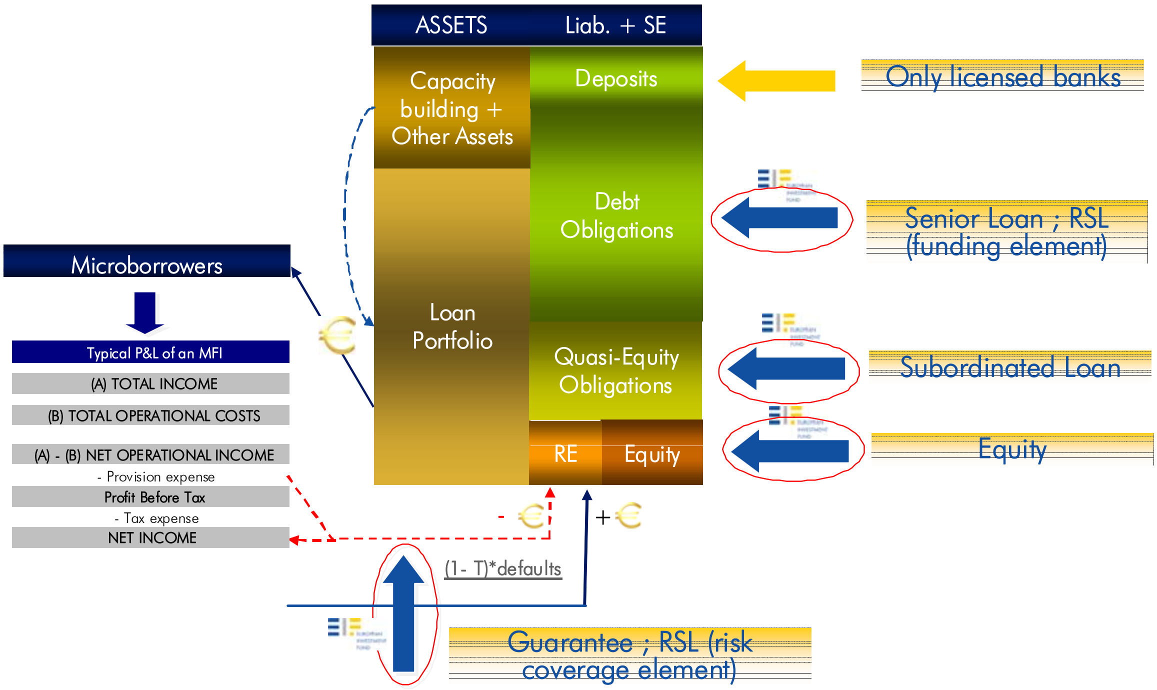
A special form of equity is provided to special purpose vehicles or funds set up to finance non-bank MFIs and/or micro-borrowers directly. This could take the form of investments e.g. in subordinated asset-backed securities or redeemable preference shares. Such equity investments often have exit strategies, (ex ante) defined in intercreditor arrangements agreed among investors of all seniority rankings. A peculiarity of this type of equity investments is that micro-credit origination is performed by a third party investment manager.

Guarantees are provided to bank as well as non-bank MFIs. They grant up to 6 years of credit loss protection for new micro-credit portfolios to be originated over a period of up to 24 months. Under such guarantees, Progress Microfinance shares the risk in each individual underlying micro-loan at a guarantee rate of up to 75%. At a portfolio level, the aggregate amount of guarantees is capped at 20% maximum loss cover. As a result of these features, the minimum multiplier effect of this product is significantly higher than for debt and equity instruments (6.67x, or 1 divided by the product of the 75% guarantee rate and 20% guarantee loss cover).

This product is only offered to financial intermediaries which have already funding readily available for its new micro-credit lending from other sources than Progress Microfinance.

Figure 8 shows how these different products address the profit and loss and balance sheet needs of intermediaries:

Figure 8: MFI – product fit[23]



Source: EIF

A **mid to long term senior loan** helps balance sheet expansion of a growing intermediary that has already established a certain track record and creditworthiness. The smaller and/or younger institutions lack deposit funding but also do not yet have access to longer term debt financing, hence require a strengthening of their **equity** base first to grow to a size that allows for debt financing in the future. Under the EPPA mandate, EIF has extended **capacity building** financing through **equity investments or loans**. This allows younger, more risky institutions e.g. to expand their branch network, hire professional staff or upgrade their other infrastructure. This increased capacity lays the base for further growth in the loan portfolio. Such institutions may then be eligible for continued and longer term debt finance in the future. The **subordinated loan** aims at bolstering the capital of regulated institutions through quasi equity. This instrument requires careful structuring based on local regulatory frameworks. A **guarantee** provides Profit & Loss protection for institutions that have sufficient funding sources available, but would benefit from credit risk mitigation in relation to new micro-loan portfolios to be built up in order to facilitate further growth in this area (or new entry into this segment, respectively). Finally, a **risk sharing loan ("RSL")** combines a risk coverage element in the form of a portfolio guarantee with funding in the form of a senior loan, hence it addresses both the Profit & Loss account and Balance Sheet.

[23] Acronyms: SE: shareholders' equity; RE: retained earnings; RSL: risk sharing loan.

4.4 Profit versus social impact objectives

The fear of mission drift and consumer abuse

The development of microfinance outside Europe has brought certain excesses once microfinance had witnessed high growth rates and gained access to the equity capital markets. Shareholder and investor expectations led managers to follow a profit oriented path and lose sight of the initial focus on supporting the poor. This development has also influenced stakeholder discussions in Europe, even more so since the microfinance model in particular in Western Europe is generally more geared towards outreach to disadvantaged groups and fight against social and economic discrimination. As of now, the European market has not yet reached a stage where significant investment in microfinance vehicles has taken place, and the current strained capital markets do also not predicate such marked development in the near future.[24]

As the market develops, with availability of commercial financial products and growing interest from (profit oriented) investors, the question might arise at some stage for the European market. The concern about ´mission drift´ arises if the evolution of primarily commercially driven investment and lending models takes place on the back of the borrowers to whom high interest rates are charged and selection of borrowers takes place under a purely financial perspective whilst losing the social mission out of sight. Press articles on usury practices are published from time to time, but relate to the developing countries. However, stakeholders in Europe have also become concerned about the incidence of high interest rates to micro-borrowers.

Diverse interest rate landscape

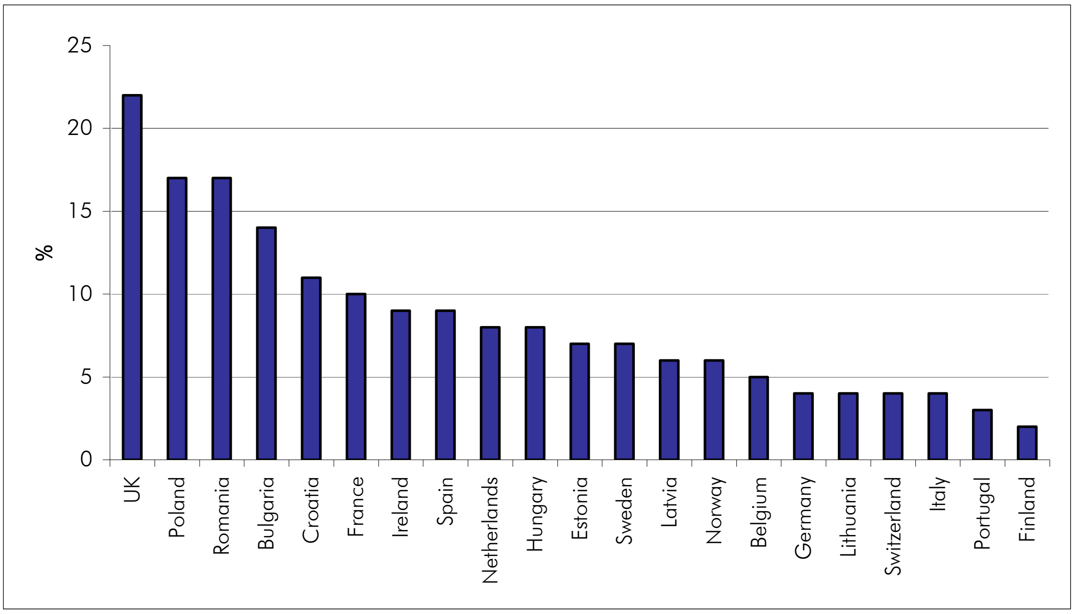
The level of interest rates charged by microfinance lenders in Europe varies widely from country to country, due to varying business models (product range and pricing policy, level of subsidies, institutional mission, collateralisation practices etc.), differences in refinancing costs, and different local laws regarding usury and consumer protection. Currently, 10 member states of the EU-27 have usury rules: Austria, Denmark, Finland, Germany, Hungary, Italy, Poland, Romania, Spain and Sweden (Thomson Reuters Foundation, 2011).

Experience has shown that micro-borrowers value primarily the access to funding and are ready to pay the required interest rates set by microfinance institutions.[25] In developing countries and emerging markets, where most of the microfinance institutions operate and receive funding from social investors and IFIs, the level of interest rates charged on micro-loans is often significantly higher than in Europe, e.g. in the range of 25% to 30% for South Asia and Latin America (according to the Mixmarket database). This is due to the fact that average loan amounts are even smaller (around EUR 3,000 and below) and the servicing costs higher due to lack of infrastructure. Figure 9 shows results based on an EMN survey (Jayo et al, 2010).

[24] In this context the European Fund for South East Europe (EFSE) and CoopEst can be mentioned.

[25] Often the only alternative is to turn to so called ´loan-sharks´ who charge a multiple of the interest rates charged by microfinance institutions (80% per annum and above).

Figure 9: Average micro-loan interest rates for selected countries[26]



Source: based on Jayo et al, 2010.

There is an important difference in pricing between some countries in the Eastern part of the EU (Bulgaria, Romania and Poland in particular) with non-subsidised, cost covering business models of MFIs, and the Western part of the EU with higher prevalence of social microfinance, corporate social responsibility initiatives and MFIs with subsidised, partly grant dependent business models. In countries without interest rate caps, higher interest rates can be observed, but even within the respective countries a wide range of interest rates can be observed. For UK, e.g., a country without restrictions on the interest rates, the highest reported interest rate was 36%, the lowest 5%. However, the absence of interest rate caps does not necessarily result in usury, as we can see in the case of France (see: Jayo et al, 2010).

Typically, for-profit-institutions charge higher interest rates (cost coverage) and grant larger loans (economies of scale). However, it is important to note that a profit orientation is not inconsistent with a socially oriented investment strategy. In fact, the micro-loan business model, if operated on sustainable terms in the long run, inherently requires relatively high interest rates on the micro-loans ("high" compared to "standard" lending business). Microfinance institutions have to earn the credit risk, refinancing cost, servicing, transaction, monitoring and administration costs related to the micro-loans. The cost structure of micro-lending is usually high, because of small loan amounts, often very short maturities and high monitoring costs related to lending without collateral. An adequate profit should also be allowed for, so that MFIs can reinvest in the business and thereby grow to an institutional scale that is capable of being financially sustainable in the long term for the purpose of pursuing the desired social impact. This involves achieving a minimum portfolio size to reach a diversification that in turn reduces risks, and to achieve efficiencies through scale effects and experience.

[26] The percentage for France does not consider the so-called prêt d'honneur, zero-interest quasi equity loans that are connected to a bank loan; considering these loans, the average interest rate is reported to be at around 5%.

A critical success factor for a scaleable MFI model is the use of certain banking tools and practices. Technology (front end and back-office related) and standardisation are key factors to improve quality of processes and systems and enhance product offering and outreach. A financially sustainable MFI would over time also channel part of the profits into a reduction of lending rates. Only 40% of the respondents (micro-credit institutions) of the latest EMN survey reported that they are operationally self-sufficient (see: Jayo et al, 2010).

Reputational risk

As a manager of a programme supported by EU budgetary funds, the EIF is particularly sensitive to potential reputational risk resulting from engaging with intermediaries that would not apply sound and transparent lending practices. For this purpose, the due diligence process conducted by EIF on each potential intermediary includes a verification that the micro-loan pricing practices by the intermediaries remain within the scope of the local legal prescriptions, the Consumer Protection Principles (see below), and are also consistent with a business model seeking financial sustainability under a given mission to support micro-entrepreneurs, with a particular focus on disadvantaged groups.

EIF's general approach under Progress Microfinance is (i) to rank pari passu with other investors/lenders, (ii) to seek remuneration broadly in line with that of other funding providers in order to avoid market distortions, and (iii) to delegate to MFIs the decision on risk and pricing parameters at micro-borrower level, while requiring assurances against reckless lending and opaque pricing practices. Since Progress Microfinance seeks a wide geographical outreach within the EU through co-operation with a wide range of financial intermediaries, including bank MFIs, savings banks, co-operative banks, development agencies, microfinance funding vehicles, pricing at micro-borrower level will therefore necessarily differ.

During the market building of the European microfinance market, a number of initiatives and standards have developed in order to promote the adoption of good standards of quality and consumer protection by market intermediaries (e.g. the Client Protection Principles[27], MFTransparency for transparent and fair pricing[28]) and in particular the Code of Good Conduct, recently published by the European Commission, can be expected to become a commonly accepted reference for basic principles of behaviour and operations (European Commission, 2011b).

[27] The Client Protection Principles for microfinance and the accompanying Smart Campaign are part of a collaborative initiative endorsed and led by a broad coalition of MFIs, networks, funders, and practitioners. The purpose of the Campaign and the Principles is to ensure that providers of financial services to low-income populations take concrete steps to protect their clients from potentially harmful financial products and ensure that they are treated fairly. Notably, it focuses on the following six core principles: avoidance of over-indebtedness, transparent and responsible pricing, appropriate collection practices, ethical staff behaviour, mechanisms for redress of grievances and privacy of client data. See: http://www.cgap.org/p/site/c/template.rc/1.26.4943/

[28] MicrofinanceTransparency is a global initiative to promote fair and transparent pricing in the Microfinance industry. See: http://www.mftransparency.org/

5 Lessons learnt and future opportunities

EIF's initial view of the diverse microfinance market prior to launching the Progress Microfinance, has been confirmed through market intelligence gathered as part of active origination efforts during the first year of operations.

However, the incubation of investment activities under Progress Microfinance has also proved essential in providing EIF with deeper market knowledge and a more enhanced understanding of market needs and trends. It is based on evidence gathered during the first year of operating Progress Microfinance and we highlight some trends for further developments. The proposal of the European Commission (European Commission, 2011c) already foresees continuous support with additional budgetary funds also during the next programming period from 2014 to 2020 and on an expanded basis. This includes a wider geographic target zone[29] and support to social enterprise development as new market segment (see box 2).

Based on the developments and insights into the European microfinance market so far, the following four pillars appear essential for a successful further market building:

1. Availability of financial instruments with a balanced focus on social impact objective and financial sustainability of the intermediaries.
2. Non financial technical assistance as well as financial capacity building support to bring the smaller MFIs onto the growth curve, and other MFIs to enhance their standards, upgrade operational models, expand and improve outreach further.
3. Financial education and mentoring of final beneficiaries and entrepreneurs especially in their start-up phase is also key for reducing default rates for MFIs. Such business services are offered by intermediaries, or in cooperation with dedicated service providers and is also supported by the European Commission through the European Social Funds programmes.
4. Spreading of best practices, standards and transparency to create a basis for informed investor decision-making by allowing to filter the profit-only MFIs and, more importantly, predatory lenders from the institutions targeting social impact in a long term sustainability perspective. Part of the market building efforts also come from databases and other initiatives enhancing the transparency of the market and the development of a common language and set of performance metrics (CAF, 2011).

With regard to additional products, peer-to-peer lending, lease receivable financing, and Social Enterprise investments could contribute to the further development of the microfinance market:

There are several peer-to-peer lending models in the micro-credit field, e.g. in Austria, Germany, Italy, Spain and the UK. Some platforms appear to have significant growth potential also for business-related micro-credit and could benefit from capacity building financing (e.g. through equity injections) in a medium to long-term perspective. Some platforms could potentially also seek loan financing for co-financing of the lending activity conducted on the peer-to-peer

[29] Member states, EFTA and EEA member countries (in accordance with the EEA Agreement), as well as candidate countries and potential candidate countries, in accordance with the general principles and the general terms and conditions laid down in the framework agreements concluded with them on their participation in Union programmes (European Commission, 2011c).

platform. This could create a new source of income for such platforms and send a good signal to the other peer lenders. On the other hand, it requires a cautious approach since the risk profile of the peer-to-peer platform provider increases.

Moreover, **leasing** companies, in particular smaller bank independent entities, are often effective channels to reach micro-borrowers in certain countries. The use of small ticket lease assets of standard nature allows for a scalable business with good outreach also in cases where availability of traditional security for bank financing is limited.

In addition, the coverage of **social enterprise investments** provides an opportunity for further development (see box 2).

Box 2: Social Enterprise investments

A segment with similar market characteristics with regard to social impact (employment, social inclusion and sustainable development), but also fragmentation and incubation need is social enterprise investment.

'Social enterprise' means an enterprise whose primary objective is to achieve social impact rather than generate profit for owners and shareholders.[30] It operates in the market through the production of social goods and services in an entrepreneurial and innovative way, and uses surpluses mainly to achieve social goals. It is managed in an accountable and transparent way, in particular by involving workers, customers and stakeholders affected by its business activity (European Commission, 2011c).

Policymakers and, to a growing extent, corporate and financial actors recognise the importance of considering the social and environmental impacts of investment activity. The current economic environment has accelerated the need for policymaking aimed at developing and fostering social entrepreneurship and innovation, given its potential to deliver valuable social goods.

Social enterprises, having at the core of their business clear impact objectives, are used to high standards of accountability and transparency for their business conduct not only towards their direct investors, customers and employees, but to their entire community of stakeholders. Typically, the mission of many social enterprises show a high degree of alignment with the objectives of microfinance, given its focus on disadvantaged communities in the employment market and their resulting marginalisation within society. It is particularly important to note the interdependency between employment issues on one side and other social issues such as lack of education, constraints in access to healthcare and/or housing for marginalised individuals, etc.

[30] There are many definitions of social enterprises and social entrepreneurship extensively catalogued in dedicated literature, e.g. European Federation of Ethical and Alternative Banks (2010), EVPA (2010), EMES (2008), EMES and UNDP (2010), or Nicholls and Pharoah (2008).

6 Final remarks

In the microfinance sector there is a trend towards efficiency, professionalization, and self-sustainability. However, without the access to stable funding, the perspectives of the sector with regard to growth and self-sufficiency are limited

This report has reiterated the diversity and heterogeneity of the microfinance sector as now evidenced through the actual implementation of Progress Microfinance during its first full year of operations. Current experience on the ground suggests - as already concluded in previous research – that support measures need to be flexible to fulfill the markets' needs. While the target groups of intervention measures need to be sufficiently broad in order to provide efficient support, the product range also has to be sufficiently wide in order to meet the target groups' needs.

With regard to this specific mandate, market observers have already begun noting the positive impact of more substantial central EU intervention: "Microfinance in Europe is gradually being consolidated as an essential tool of social policy, for the promotion of self-employment, micro-enterprise support and the fight against social and financial exclusion. This is demonstrated by the initiatives that the European Commission has launched, such as the JASMINE initiative and the European Microfinance Facility for Employment and Social Inclusion (Progress Microfinance Facility), to promote and support the development of this sector." (Jayo et al, 2010).

With regard to micro-credit the European Commission expressed that "there is no "one size fits all" approach "… any policy should respect this diversity" (European Commission, 2010).

List of Acronyms

CGAP: Consultative group to assist the poor
CIP: Competitiveness and Innovation Programme
CoopEst: The Social Economy investment company for Central and Eastern Europe
COSME: Programme for the Competitiveness of Enterprises and SMEs
CSR: Corporate Social Responsibility
EC: European Commission
EEA: European Economic Area
EFSE: European Fund for South East Europe
EFTA: European free trade association
EIB: European Investment Bank
EIF: European Investment Fund
EIU: Economist Intelligence Unit
EMN: European Microfinance Network
EPPA: European Parliament Preparatory Action
ESF: European Social Funds
EU: European Union
EVPA: European Venture Philanthropy Association
FCP-SIF: Fonds commun de placement – fonds d'investissement spécialisé
FMA: Fiduciary Management Agreement
ICT: Information and communications technology
IFI: International Financial Institution
JASMINE: Joint Action to Support Microfinance Institutions in Europe
JEREMIE: Joint European Resources for Micro to Medium Enterprises
MAP: Multiannual Programme
MFI: Microfinance Institution
MSEs: Micro and small enterprises
NGO: non-governmental organisation
P&L: Profit and loss (statement)
PE: Private Equity
RCM: Risk Capital Mandate
SMEs: Small and medium sized enterprises
SRI: Socially responsible investment
TA: technical assistance
VC: Venture Capital

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