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FEMIP

The Potential of Mesofinance for Job Creation
in Mediterranean Partner Countries

European Investment Bank
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EIB

The Potential of Mesofinance for Job Creation in Mediterranean Partner Countries

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Final Report

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The study is financed under the FEMIP Trust Fund. This Fund, which was established in 2004 and has been financed – to date – by 16 EU Member States and the European Commission, is intended to support the development of the private sector via the financing of studies and technical assistance measures and the provision of private equity.

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Abbreviations

AFD	Agence Française de Développement
ANPME	Agence Nationale pour la Promotion des PME
ATM	Automated Teller Machine
BDS	Business Development Services
CAPMAS	Central Agency for Public Mobilization and Statistics
DZD	Algerian Dinars
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
EPCGF	European Palestinian Credit Guarantee Fund
EU	European Union
EUR	Euro
FI	Financial Institution
Frankfurt School	Frankfurt School of Finance & Management
FTF	FEMIP Trust Fund
GDP	Gross Domestic Product
ICT	Information and Communications Technology
IFC	International Finance Corporation
IFI	International Finance Institution
ILO	International Labour Organization
IMF	International Monetary Fund
LYD	Libyan Dinar
MAD	Moroccan Dirham
MENA	Middle East North Africa
MFI	Microfinance Institution
MPC	Mediterranean Partner Countries
MSME	Micro, Small and Medium-Sized Enterprise
OECD	Organization of Economic Cooperation and Development
OVI	Objectively Measurable Indicator
PCB	Public Credit Bureau
PCR	Private Credit Registry
POS	Point of Sale
R&D	Research and Development
SME	Small and Medium-Sizes Enterprise
SOE	State-Owned Enterprise
TA	Technical Assistance
TC	Technical Cooperation
ToR	Terms of Reference
USAID	United States Development Agency
USD	United States Dollars
VC	Venture Capital

1 Executive Summary

Background

The European Investment Bank (EIB) has been cooperating with the Mediterranean Partner Countries (MPC) under the Facility for Euro-Mediterranean Investment and Partnership (FEMIP) for over 10 years. In this context the FEMIP Trust Fund (FTF) supports private sector development with a special focus on the financial sector[1]. The predominant actors in the private sector are small and medium enterprises. They happen to face particular challenges in the access to finance.

Against this background the FTF initiated a study to assess "*The Potential of Mesofinance for Job Creation in Mediterranean Partner Countries*". Mesofinance is defined here as: the provision of a package of financial services to clients that are too big to be served by most MFIs, but too small or opaque to be fully bankable. Mesofinance could be of interest to banks – provided they downscale – to MFIs – provided they upscale – and other regulated financial institutions – provided they adapt their delivery techniques.

The study is based on a literature review, surveys of small entrepreneurs and consultations with government officials, staff of supervisory institutions, international donors as well as financial institutions in Egypt, Jordan and Tunisia[2]. It is the basis for pilot actions to test innovative approaches in enhancing access to finance for SMEs in the Mediterranean partner countries.

Mesofinance in FEMIP region

The number of enterprises in the MENA region is generally lower than in other emerging economies and is skewed towards nascent and mature firms i.e. there are more younger and older enterprises than mid-age firms: there are more than 3 nascent ventures and almost 4 mature firms for each 100 adults (age range 18-64), compared to only 2 infant firms and young firms[3]. This implies that there is a high rate of enterprise mortality between the 4th month and the first 5.5 years of the life of the business, and smaller mortality rates afterwards.

From these numbers, it can be assumed that firms in the MENA region find it difficult to survive in the first 3 months of their life, which would explain why there are relatively less firms in operation in the region compared to other emerging economies. Fewer firms being created and growing translates to a smaller total firm population.

SMEs in the MPCs' economies constitute over 85% of all registered companies, and contribute over two-thirds of total formal employment[4]. The SME sector has a significant share of GDP

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[1] *a) Capital North Africa Venture Fund II (CNAV II) (participation à euro 20 millions), Maghreb, PME établies, géré par Capital Invest (Casablanca). b) Enda Inter Arabe, prêt à hauteur d'euro 4 millions pour financer son expansion (mai 2013)*
c) PG VI Tunisie ligne de crédit aux intermédiaires financiers Tunisiens sélectionnés: euro 100 millions ; d) financements long terme pour de nouveaux investissements et pour l'extension, la modernisation ou réhabilitation de projets portés par des entreprises privées opérant dans l'ensemble des secteurs industriels et des services, avec un appui particulier aux petites et moyennes entreprises (PME) » ; e) Bond initiative (senior debt), MENA, euro 4,6 billion pour renforcer le financement de ces projets en appui du développement des PME ".

[2] *Using a financial diary approach, organized by a global market research company with a local office and professional research staff in Amman, Cairo and Tunis.*

[3] *New Entrepreneurs and High Growth Enterprises in the Middle East and North Africa, OECD, February 2013*

[4] *In Egypt, there are between 2.25 and 2.5 million micro enterprises and 200,000 to 300,000 small and medium sized enterprises. In comparison, Jordan has 146,443 micro and small enterprises and Tunisia 602,222 micro and SMEs.*

(approximately 60%). The majority of SMEs are still informal in some respects. They are also largely opaque – often deliberately so – hence difficult to evaluate by banks.

In the MENA region 63% of small firms do not have access to formal finance[5], which is high compared to countries of similar GDP levels[6]. Only 8% of total bank lending in the MENA region goes to SMEs[7]. SMEs rely on internal and self-generated funds[8]. The MENA countries generated approximately 1.2 million new jobs, annually; however, 1.8 million new job applicants currently come into the labour market each year. Youth employment in the region is the highest in the world[9]. In addition to a growing population, the MPCs received some five million (net) refugees. Labour market rigidity is another factor that explains the high unemployment rates in the region. The skills of new entrants on the labour market often do not match those needed by the employers. Entrepreneurial activity is perceived by graduates as inferior compared to employment in the public sector. With the limited labour absorption capacity in the formal public and private sectors, employment in the informal economy becomes an ultimate alternative for many young and female job seekers.

Governments continue to influence economic affairs substantially. The public sector employs a disproportionate share of the labour force. With an average "Ease of Doing Business ranking"[10] of 98.2, the MENA region finds itself in mid-range internationally[11]. This has not changed much since the Arab spring; to the contrary, due to the upheaval reforms long overdue could not yet be tackled. This also affects market conditions for SME, especially with regard to finance. Labour market reforms have also not yet been implemented affecting labour costs in SMEs and the ease of recruitment and termination of employment.

Mesofinance in the context of the financial sectors of MPCs

On the supply side state banks still play an important role in SME lending. Private banks continue to be reluctant to engage in this sector. As a result SME lending represents only a small share of total bank lending to the private sector: 13% on average in the MENA region, much less than what would be socially desirable and commercially viable[12]. The causes are various: banks prefer collateral-based lending, all the more so that they do not have risk assessment tools tailored to the specificities of the SME sector. The volatile economic environment is also to be blamed. The financial infrastructure is little developed considering the middle income status of MENA countries. Credit bureaus are in a nascent stage of development[13]. The legal system does not always provide adequate protection for the rights of creditors. There are significant problems in the registration, enforcement and selling of collateral, in particular movable collateral. Enforcement of collateral is an even greater problem.

Despite these constraints there are also positive developments in bank perceptions and attitudes as of lately. The survey by the Frankfurt School shows that banks start to recognize the potential profitability of the SME segment. This perception is also inspired by the fact that the market for large corporate lending and consumer lending start to get saturated. Banks need to diversify their portfolios. Finally, many banks see in the SME segment scope for cross-selling.

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[5] *Saleem, Qamar, op.cit., p2*

[6] *Pearce, Douglas, Financial Inclusion in the Middle East and North Africa, WB Policy Research WP 5610, March 2011, p.6*

[7] *Idem, p.2*

[8] *69% of Tunisian entrepreneurs start their business with own funds, 94% in Egypt and Jordan. Bank loans for start-ups are used by 23% of respondents in Tunisia, 7% in Jordan and 1 % in Egypt.*

[9] *Saleem, Qamar, Overcoming constraints…, p.1*

[10] *In terms of venture capital availability, taxation, business sophistication, getting credit, starting a business, registration property, strength of auditing and reporting*

[11] *Tunisia ranked 50, Morocco 97, Jordan 106 and Egypt 109.*

[12] *Egypt: less than 10%, Jordan: between 10-15% and Tunisia: between 15% and24% of total loans.*

[13] *Only Egypt and Morocco have developed public credit bureaus in the past five years.*

In contrast to other regions MFIs in the MPCs cannot take deposits from the public which continues to affect portfolio growth, composition and product innovation. In particular compared to other regions few MFIs have found ways to tap into the SME market.

Equity finance is largely tailored to large firms and high tech start-ups, not to the bulk of SMEs.

On the demand side SME operators continue to find it overwhelmingly difficult to get a bank loan: in Egypt, 47% of respondents find it difficult and 17% very difficult to get a bank loan because procedures are too long and complicated (59%), interest rates are too high (59%), lack of guarantees (41%), fear of corruption (39%). Similarly, in Tunisia, 58% of SMEs interviewed consider it not easy to get access to credit from banks. The main challenges identified by Tunisian entrepreneurs are lack of guarantee and high interest rates (53%), procedures too long and complicated (44%) and bureaucracy (30%).

SME owners feel that banks do not understand their businesses. This shows, notably, in their failure to consider their particular cash flows that do not permit a monthly amortization and interest payment in equal instalments. SME owners also have difficulties to see the justification for the high interest rates charged. The surveys carried out in the context of the study show that SME owners wish to have a more active funding partner on their side that assists in financial engineering of the small enterprise and is willing to be involved in strategy considerations.

Whether on balance there is a mesofinance gap is a matter of circumstantial evidence, for example the pick-up of SME demand for innovative financial products that show a way around strict collateral requirements. This would suggest the existence of a gap. A significant number of small businesses could use external funds productively if available. Whether or not it can be safely quantified is another matter[14].

Options for more sustainable mesofinance

State banks with a promotional mandate (like BFPME or BTS in Tunisia) may have contributed to improving SME finance access to some limited extent, but without acquiring the capacity to manage specific SME related risks as shown by below average portfolio quality. As a result the emulation by private commercial banks was less than what was hoped for.

Access to financial services in Tunisia is also largely a matter of geography. For instance in leasing services, a sector particularly attractive for SMEs as it bypasses traditional collateral requirements, most branches are concentrated in the capital city and the coastal regions, while inside the country it is almost impossible for SMEs to find a leasing company.

The time for establishing new types of financial institutions in Tunisia is over. There is literally no room left for new institutions. What seems to be missing is a change of attitude and a greater innovation readiness. Public procurement and consumer credit seem to have reached the saturation point, a fact that this arguing in favor of shifting to SME finance. "Relationship lending" and other approaches easing collateral requirements as they are practiced elsewhere could serve as an example for Tunisian banks on available options.

At the same time, one should not only rely on banks. Microfinance institutions have demonstrated ability to innovate. Although their traditional target market differs in many aspects from that of SMEs, their proximity to clients and their thorough understanding of clients' needs shouldn't be underestimated. An alliance with postal offices is a particularly promising option in that regard.

[14] *The IFC estimates the SME funding gap in the MENA region to be between USD 160 and 170 billion.*

2 Introduction and Background of the Study

2.1 Background

The European Investment Bank (EIB) has been cooperating with the Mediterranean Partner Countries (MPC) under the Facility for Euro-Mediterranean Investment and Partnership (FEMIP) for more than 10 years. The FEMIP Trust Fund (FTF), in this context, supports the private sector developments in these countries, with a particular focus on financial sector development.

This study is financed under the FEMIP Trust Fund. The Fund, which was established in 2004 and has been financed – to date – by 16 EU Member States and by the European Commission, is intended to support the development of the private sector via the financing of studies and technical assistance measures, as well as the provision of private equity.

Based on the assumption that access to financial services is a crucial aspect in supporting entrepreneurial activity, and helps significantly increase the standard of living of poor people, the FTF has launched this study to assess the "*Potential of Mesofinance for Job Creation in Mediterranean Partner Countries*".

2.2 Study Objectives

Currently, the greater issue facing governments and international donors is how to efficiently support SMEs in order to fully capture their potential to create an added value to the economy. To date, a large number of SMEs have financing needs that far exceed the amounts typically offered by Microfinance Institutions (MFIs), but which are still too small for the traditional banking sector. These enterprises constitute the "*missing middle*" in the FEMIP countries, and their growth is considerably hampered by the lack of access to adequate finance.

It is assumed that filling this financing gap will lead to a significant growth in the SME sector and, as a consequence, substantially add to the creation of employment in these countries. This study is, therefore, expected to identify the Mesofinancing gap in the Mediterranean Partner Countries, and evaluate the potential for job creation.

Study Objective

Overall Objective

The overall objective of the study is to contribute to job creation by proposing specific actions directed at enhancing access to financing for SME clients in the Mediterranean Partner Countries. As such, the study aims to:

- Assess the existing access levels to Mesofinance services in MPC;
- Identify and assess the market gaps affecting each MPC in the Mesofinance segment in the market for financial services;
- Based on the analysis of the existing access levels and the identified gaps, design three country specific pilot action plans, for selected countries, aimed at promoting a national strategy for Mesofinance, including concrete recommended actions for national governments, international financial institutions, and the local banking industry.

This final report is a compilation of the information gathered during the course of the study, and draws on economic analysis of quantitative data from MPCs, qualitative research, and other international evidence to analyse Mesofinance challenges and identify the priority areas for policy action to promote Mesofinance for job creation in the region. In Section 3, a general overview is presented, of the 10 FEMIP countries, including economic and social indicators. In Section 4, the supply and demand for Mesofinance is analysed. Sections 5 and 6 consider key regulatory constraints for both microfinance institutions and commercial banks and provide a comparative analysis of key features for the "*missing middle*" and section 7 present recommendations for developing or enhancing Mesofinance services.

2.3 Research Methodology

The study started with a kick off meeting in November 2012 with the EIB team in Luxemburg. Thereafter, the consultants made final arrangements for cooperation among team members, and began the literature review. The team leader and project team members undertook three field visits, to Egypt, Jordan and Tunisia, to conduct the review of the Mesofinance activities and identify market failures. All relevant stakeholders – banks, microfinance institutions, business support organizations, ministries, central banks and other regulators – were interviewed in order to understand existing business models and identify lessons learned for the support of Mesofinance in the FEMIP countries. In addition, 100 interviews were conducted with Mesofinance clients or potential clients in Egypt, Jordan and Tunisia.

The information collected, and analysis conducted were used to prepare the country specific action plans to improve SME access to finance in Egypt, Jordan and Tunisia. The purpose of this final report is to synthetize the findings of the desk research and field visits to formulate recommendations for developing or enhancing Mesofinance activities for MPC.

2.4 Defining the Mesofinance Concept

Mesofinance is a term that has been increasingly used to refer to the financial needs of small and medium-sized enterprises (SMEs) in developing countries. Since SMEs are defined differently from one country to another, there are some variations in the definition of Mesofinance, as well. Nonetheless, there is a consensus that the term refers to the missing middle -- enterprises whose financial needs are too big to be adequately serviced by MFIs, but are too small to be eligible for commercial bank loans or subsidized international finance.

Below is the discussion that leads to the definition of Mesofinance used for this study. Sanders and Wegener[15] describe Mesofinance as "*an unofficial term for financial needs of small businesses ranging between EUR 5,000 and EUR 500,000. That is roughly the financial needs above the microfinance level and below the commercial and subsidized international finance level*". They further explain, "*this is the segment above microfinance (loans to enterprising individuals, sometimes to 'businesses') and below large companies with more than 250 employees*", and describe the size of the SME businesses in terms of employment, which is anywhere between 2 and 250 employees.

In their article "Putting Paid to Poverty", A. Hammond and B. Kramer draw attention to the fact that in developing countries, micro-enterprises and large companies tend to have a number of financial services and products that are tailored to their needs, while SMEs have very few financial options[16].

Box 1: **The microfinance market**

While microfinance is increasingly well provided for (though there is still a huge unmet demand), loans top out at about a few thousand dollars. Above that is a vast gap – between a few thousand and USD 500,000 – where financing options are almost non-existent. It is precisely in

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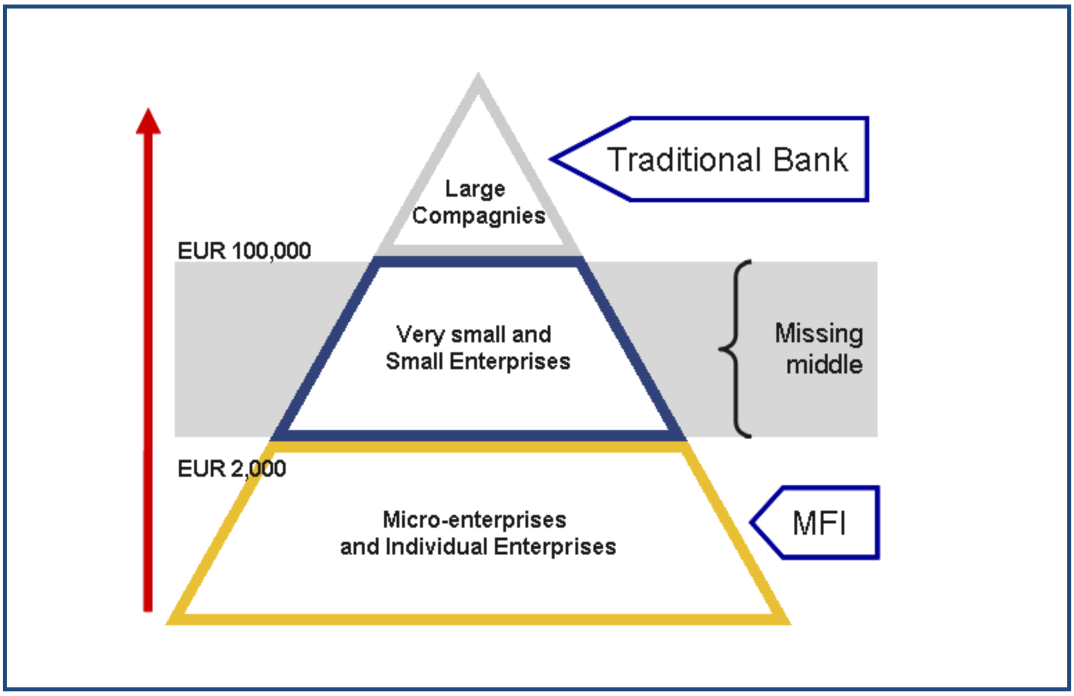
[15] *"Mesofinance: Filling the Financial Service Gap for Small Businesses in Developing Countries". T. Sanders and C. Wegener September 2006.*
[16] *http://www.valuenewsnetwork.com/read-the-magazine/putting-paid-poverty*

this range – Mesofinance – those successful small and medium-sized businesses in developing countries, seeking to expand, need investment capital, equipment financing, or loans. The gap is important, as it is these businesses that provide most of the jobs and generate the majority of new employment in every economy.

Agence Française de Développement (AFD) follows a similar approach as indicated above, defining Mesofinance as any loan that is between EUR 2,000 and EUR 100,000. The AFD takes the definition further by incorporating criteria relating to the size of the enterprise. Hence, a Meso-enterprise is defined as a business with an asset size of USD 20,000 and higher, having between 3 and 30 employees and a monthly turnover that fluctuates between USD 6,500 and USD 40,000[17].

Graph 1: **AFD definition of Mesofinance**



Based on the literature review, it became clear to the authors of this study that in order to define Mesofinance, it is necessary to identify a set of indicators that define an SME. The term SME encompasses a broad spectrum of definitions across countries and regions. Typically, in the Middle East and North Africa (MENA) region, the cut-off between small and medium-sized enterprises ranges from 5 to 50 employees, and the cut-off between medium and large firms ranges from 15 to 100 employees[18].

Defining Mesofinance in terms of the SMEs poses a challenge in that no two countries, organizations or institutions have the same definition for it. Table 1 below, shows the differences in SME definitions in the FEMIP region.

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[17] *http://www.afd.fr/home/projets_afd/appui-secteur-prive/accessibilite-financiere2/Mesofinance*

[18] *Rocha, R., S. Farazi, R. Khouri, and D. Pearce. 2011. "Banks Financing for SMEs in the MENA Region: Evidence from a Joint Survey of the World Bank and the Union of Arab Banks". World Bank.*

Table 1: Overview of SME definitions in FEMIP countries[19]

Country	Firm size	Employees	Annual sales	Assets/Capital	Definition source
Algeria	Micro	1-9	< 20 million DZD	Assets < DZD 10 million	Ministry of Industry
	Small	10-49	< 200 million DZD	< 100 million DZD	
	Medium	50-250	200 million – 2 billion DZD	DZD 100 million – DZD 500 million	
Egypt	Micro	1-5	< 100,000 EGP		Central Agency for Public Mobilization and Statistics (CAPMAS) & Egyptian Banking Institute
	Small	6-10	100,000 -< 1 million EGP	Capital: EGP 50,000 – EGP 1 million	
	Medium	11-100	1 million -<10 million EGP	Capital: EGP 1 million - EGP 5 million	
Gaza/West Bank	Micro	2-4	--	--	The Small Enterprise Centre (SEC)
	Small	5-9	--	--	
	Medium	10-25	--	--	
Israel	Micro	1-9	--	--	Central Bureau of Statistics
	Small	10-49	--	--	
	Medium	50–100	--	--	
Jordan	Micro	1-4	--	--	Department of Statistics (DOS) & Central Bank of Jordan
	Small	5-19	< 1 million JD	--	
	Medium	20-99	1 million JD - < 3 million JD	--	
Lebanon	No definition breakdown between Micro, Small and Medium enterprises	< 200	< USD 5 million	--	Ministry of Economy and Trade
Libya	Micro	-	-	--	General People's Committee
	Small	< 25	-	LYD 2.5 million	
	Medium	< 50	-	LYD 5 million	
Morocco	Micro	< 200	< MAD 3 million	--	ANPME, Central Bank of Morocco
	Small	< 200	< MAD 10 million	--	
	Medium	< 200	< MAD 75 million	--	
Syria	Micro	< 10	< SYP 3 million	--	Syrian Enterprise and Business Centre (SEBC)
	Small	< 50	< SYP 50 million	< SYP 50 million	
	Medium	< 250	< SYP 250 million	< SYP 250 million	
Tunisia	Micro	0-5			National Institute of Statistics
	Small	6-49			
	Medium	50-199	--		

[19] *IFC Companion Note for the MSME Country Indicators.*

A third approach, adopted by UNIDO, includes additional qualitative terms to define SMEs. Below is a table of the main criteria established for SMEs, in comparison with larger companies.

Table 2: Qualitative indicators for defining SMEs[20]

Category	SMEs	Large companies
Management	Proprietor-entrepreneurship and functions linked to personalities	Manager-entrepreneurship; division of labour by subject matters
Personnel	Have all-round knowledge but are not university graduates	Dominance of university graduates and specialization
Organization	Highly personalized contacts	Highly formulized communications
Sales	Competitive positions not defined and uncertain	Strong competitive positions
Buyers' relationship	Unstable	Based on long-term contracts
Production	Labour intensive	Capital intensive; economies of scale
Research development	Following the market intuitive approach	Institutionalized
Finance	Role of family funds, self-financing	Diversified ownership structure; access to anonymous capital market

While, for practical reasons, qualitative indicators will not be used for defining the SME sample within the scope of this study, it is important to keep these in mind when analysing the causes of the Mesofinance gap, and formulating concrete proposals for increasing the missing middle's access to finance. Indeed, one of the factors hindering SME access to finance is that many of them suffer from the same shortcomings as micro-enterprises (lack of strong accounting and financial procedures, weak management, unqualified personnel, low collateral, weak credit history, etc.), making them less attractive for commercial banks.

In conclusion, it can be observed that although the value/brackets of the indicators differ from one country to another, there are strong similarities in the type of indicator. The table below gives an overview of the most commonly used indicators for defining SMEs, as well as their relevance.

Table 3: Indicators and relevance for defining Mesofinance

Indicator	Relevance	Explanation
Number of employees	High	It is a recurring indicator in many definitions and is relatively easy to obtain.
Annual sales	Medium to High	Particularly relevant for enterprises in the trade and distribution sectors. However, accurate data may be hard to acquire at national level.
Total assets	Medium to High	Particularly relevant to asset-based industries such as manufacturing. However, accurate data may be hard to acquire at national level.
Registered capital	Low	Registered capital does not necessarily reflect the real size of the enterprise.

[20] *UNIDO.*

Indicator	Relevance	Explanation
Total credit facilities	Low	The size of a credit facility does not necessarily reflect the size of the enterprise, therefore, it is not an accurate representation of what constitutes an SME.
Qualitative indicators	Medium	Due to the difficulty of measuring qualitative indicators, their use is not widespread.

Within the scope of this study, Mesofinance is generically defined in the following terms:

- Mesofinance targets clients that are too big to be served by MFIs (especially donor supported MFIs), but too small to have access to regular banking services (or are simply not serviced by MFIs and banks for any reason);
- Mesofinance includes a variety of financial products.

The thresholds for the proposed indicators are as follows:

Number of Employees: In the majority of the FEMIP countries, the number of employees for a medium-sized company is approximately 200 (Algeria is the only country that has a higher limit set at 250 employees). Moreover, a number of international studies and institutions set the cut-off limit for SMEs at less than 250 employees. Therefore, it is proposed that the upper limit for defining **Meso-enterprises be set at 250 employees.**

Annual Sales: The upper limit for turnover varies from approximately USD 5 million (Lebanon and Morocco) to USD 25 million (Algeria). On an international level, IFC defines a medium enterprise as a business with annual sales of less than USD 15 million, whereas the EU sets the upper limit at USD 67 million. The study follows the IFC definition, and fixes the upper limit for Mesofinance annual sales at USD 15 million. This criterion is believed to help capture most of the Mesofinance activities; among the target countries, only Tunisia has an upper limit for annual sales, which is substantially below this threshold (i.e. fixed at TND 5 million, equivalent to approximately USD 3.3 million).

Loan Size: For the size of the loan, it is proposed to retain AFD's definition of loans between EUR 2,000 and EUR 100,000 (or USD 2,500 to USD 130,000). Including this criterion will allow for a dialogue with bankers and microfinance practitioners alike.

Table 4: Mesofinance definition for the purposes of the study

Criteria	Employees	Annual sales	Loan size
Mesofinance	< 250	< USD 15 million	> EUR 2,000 and < EUR 100,000

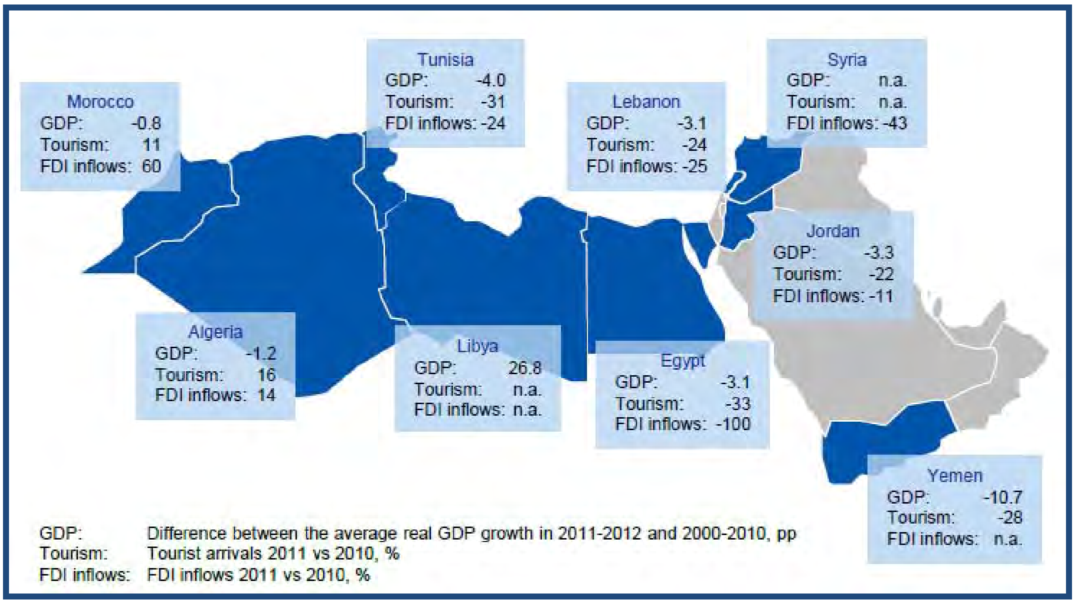
3 Landscape for Mesofinance in the FEMIP Region

3.1 General Overview of the MENA Region

Widespread political and social instability following the Arab Spring.

The economic performance, in terms of GDP growth, in the MENA region has been mostly moderate, although volatile, during the last decade. Between 2000 and 2010, the GDP of countries in the region grew at an average yearly rate of 4.8%. The widespread political and social instability following the Arab Spring disrupted the economic growth, and had a direct negative economic impact, especially in those countries most affected by the turmoil. Egypt and Tunisia, for instance, registered a negative economic growth in 2011 due to the cancelation or postponement of investment and consumption decisions, and the temporary closing of banks and other businesses. However, the economic fundamentals of these two countries are not significantly affected, and economic growth can be expected to resume if a successful political transition is achieved and economic reforms are adequately implemented. This can already be seen in the modest return to growth in 2012. By contrast, Morocco and Jordan have experienced limited social tensions, in comparison to most other MENA countries. Nevertheless, their economies have suffered from negative spill over effects from the instability of neighbouring countries. Other countries registering higher levels of violence and instability, such as Libya and Syria, suffer more in the short and medium terms, given the likely dents in their infrastructure and economic fundamentals.

Graph 2: Overview of the economic impact of the Arab Spring



Source: DB Research.

The rising consumer price index is a major challenge for some MENA countries. In particular, countries that import significant amounts of food and fuel see inflation peaking as a result of high and rising world commodity prices for these imports. Consumer price inflation has remained high since the oil and fuel price spikes of 2007/8, and most countries registered higher inflation rates during the period of 2006 to 2010 than during 1996 to 2005. This is particularly the case in Egypt, which registered an inflation rate of 5% during 1996 to 2005, and a significantly higher rate of 11% during the period of 2006 to 2010. A notable exception to high inflation has been Morocco, which has kept consumer price increases below 3%. Most affected by inflation have been low and middle-income population segments, which devote large shares of their revenues to food and energy items, as compared to wealthier segments of society.

Table 5: Selective economic indicators for the MENA region

Indicator	Algeria	Egypt	Gaza/West Bank	Jordan	Lebanon	Libya	Morocco	Syria	Tunisia
GDP growth rate (2012)	2.6%	2.0%	5.7%	3.0%	2.0%	121.9%	2.9%	-2.0%	
GDP per capita in USD	4,470	2,600	1,610	4,380	9,110	12,320	2,970	2,803	4,070
Inflation rate (2006-2010)	8.5%	11.0%	N/A	5.8%	5.2%	4.7%	2.2%	33.7%	4.1%
% of SME as part of all enterprises			99.9%			-	98.8%		
Human Development Index ranking	93	112	110	100	72	64	130	116	94
% of people living below poverty line (2 USD a day)	23.6%	15.4%	25.8%	1.6%		-	14.0%	16.9%	8.1%
Unemployment rate	10.0%	13.2%	N/A	12.8%	5.8%	19.5%-	9.4%	14.9%	16.5%

Source: World Development Indicators, The World Bank

The GDP growth rates since 2000 have not been reflected in GDP per capita growth, which indicates that economic growth has not kept pace with population growth. Economic growth in the MENA region between 2000 and 2010 averaged 4.8%, whereas average GDP per capita growth for approximately the same period (2000 to 2009) was only 2.5%. This gap between GDP and GDP per capita growth is one of the highest in the world. However, the performance among countries differs, with Tunisia, Morocco, and Lebanon registering the lowest gaps between GDP and GDP per capita growth.

Table 6: Population statistics for countries in the MENA region

Indicator	Algeria	Egypt	Gaza/West Bank	Jordan	Lebanon	Libya	Morocco	Syria	Tunisia
Total population (million)	36.5	83.9	4.2	6.5	4.3	6.5-	32.6	21.1	10.7
% of population < 15 years	28.1%	21%	19%	20%	18%	23%-	18%	23%	21%
Population growth (2008-2012)	1.9%	1.7%	3.0%	2.2%	0.7%	1.1%	1.0%	1.8%	1.2%

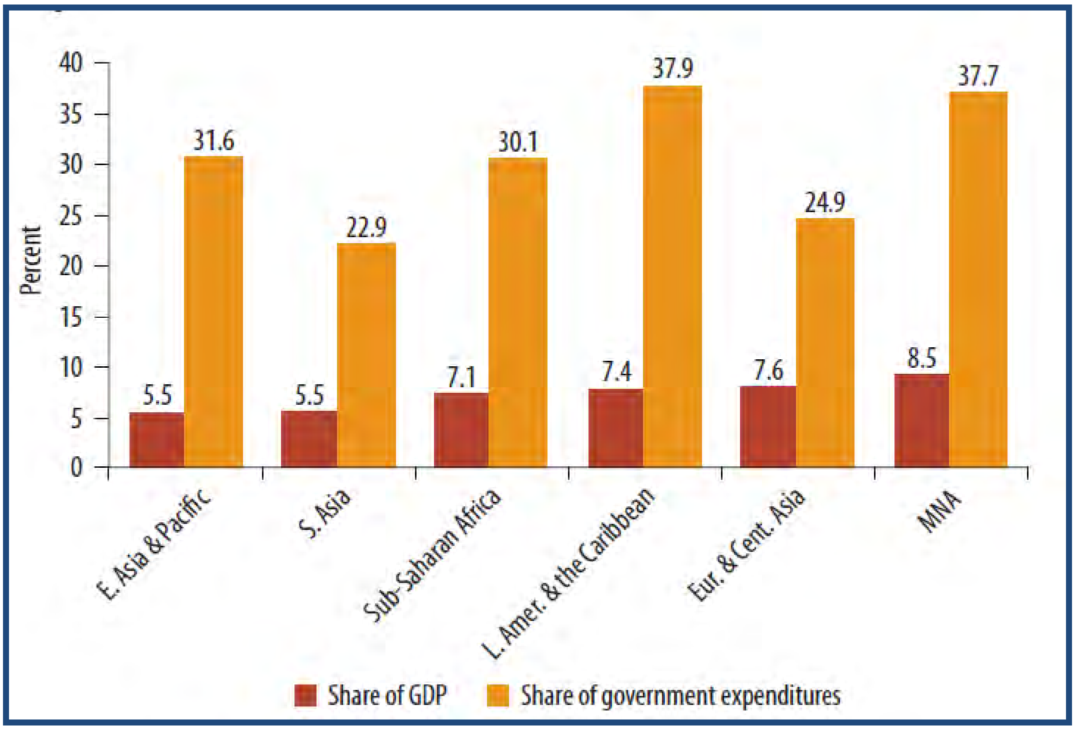
Source: World Development Indicators, The World Bank

The MENA region's unemployment rate has been much higher than those of the successful economies of South and Southeast Asia, and good quality jobs in MENA's private sector have been scarce.

Bloated public sectors

Another key challenge facing the region is the bloated public sectors, including both government agencies and state-owned enterprises (SOEs) that employ significant shares of the labour force. Employment in the public sector ranges from 22% in Tunisia to about 33 to 35% in Syria, Jordan, and Egypt. Further, if only non-agricultural employment were to be considered, the share of the public sector reaches 42% in Jordan and 70% in Egypt. **The public sector in the Mediterranean Partner Countries acts as a magnet for young graduates attracted by high salaries, employment protection, and a special social status.** The average public sector wage bill relative to GDP and total government spending in MENA is the highest in the developing world (graph 3). Here also, countries in the region vary significantly. For instance, in 2008, Jordan's wage bill amounted to nearly 18% of the GDP. Conversely, in the same year, the wage bill made up 47% of total spending in Morocco, but only 23% of total spending in Egypt. Public sector jobs are substantially better remunerated than private sector jobs. Graph 3 shows the public sector wage gap in monetary earnings for four countries in the region. The differences in pay rates, especially for women, between the public and private sectors are striking. A part of these differences reflect the nature of the jobs in each sector. On average, the public sector requires higher levels of education and employs more workers in urban areas than the private sector. Nonetheless, even after verifying the differences in education and other characteristics, public sector jobs are more lucrative than those in the private sector. The gaps increase with the level of education.

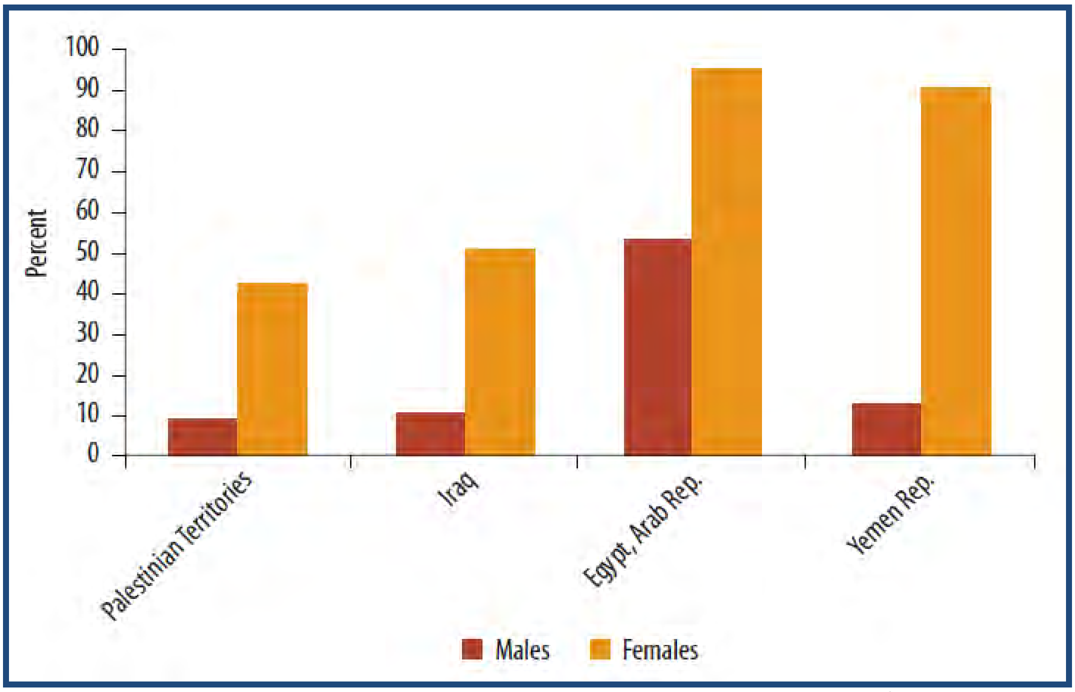
Graph 3: Public Sector Wage Bill as a Per cent of GDP and Total Expenditure, 2008



Source: Opening Doors: Gender Equality and Development in the Middle East and North Africa (2013). World Bank.

Furthermore, non-monetary benefits are much higher in the public sector. These benefits include social security, health insurance, greater job security, and paid sick leave. Once these factors are taken into account, it is no surprise that educated young people, especially women, are attracted to the public sector. The higher public sector benefits have economy-wide effects on productivity and growth because they distort the market incentives to efficiently allocate skills to their most productive use. Public sector jobs are distinctly better compensated than equivalent private sector positions, particularly for the highly educated. However, as young people graduate from high school and university, the creation of new positions in the public sector has not kept pace. As a result of the compensation gap, many young people are prepared to remain unemployed in the hope of eventually finding a job in the public sector, leading to a phenomenon called "wait unemployment." This pattern is partly responsible for the extremely high unemployment rates in MENA countries -- rates that are most pronounced among youth and more educated individuals, particularly women.

Graph 4: Public Sector Wage Gap: Difference in Average Hourly Earnings for Salaried Workers in Public and Private Sectors



Source: Opening Doors: Gender Equality and Development in the Middle East and North Africa (2013). World Bank.

Although this situation is gradually changing, the position of the public sector as a prime target for employment creates incentives for individuals to acquire knowledge and skills in areas demanded by the government sectors, and reduces the pool of qualified candidates for the private sector.

Box 2: Absence of an SME enabling environment

The large public sector has also bred a lack of economic dynamism in the region, further setting back employment gains. A World Bank study from 2010 found that the MENA region had some of the lowest firm entry density rates in the world, with a rate almost four times lower than that of Europe and Central Asia[21]. According to the World Bank's 2013 Doing Business report, investors in the MENA region have to deal with insufficient protection of investor and property rights. The survey also finds that business managers are particularly concerned about corruption, anti-competitiveness and uncertainty regarding regulations. With an average "Ease of Doing Business ranking" of 98.2, the MENA region, as a whole, finds itself in mid-range internationally. However, apart from Tunisia and Morocco to some extent, most of the MPCs in this study score relatively poorly. While in the past some governments have put bold efforts into reforming their countries' business environment, the report states that since the beginning of the Arab Spring in 2011 the region's reform process has lost some momentum, hampered by the problems and uncertainties that accompany the political transition processes. The combination of these factors is a formidable obstacle to boosting employment in the region.

[21] On average, in high-income countries about four new limited liability firms register annually per 1,000 working-age people in low- and middle-income countries, less than one. Among developing regions, Europe and Central Asia have the highest average entry density (2.26), and Sub-Saharan Africa, the Middle East and North Africa have the lowest (0.58 and 0.63). Source: Klapper, Leora and Inessa Love (2010). "New Firm Creation: What has been the effect of the financial crisis?" Viewpoint September 2010. World Bank Group.

Already before the Arab Spring, the Commission on Growth and Development of the World Bank[22] reviewed the experiences of some MENA economies and assessed the extent to which economic growth also meant inclusive growth. Inclusive growth is defined as high and sustained economic growth that leads to poverty reduction by lifting wages and creating jobs for millions of people. In areas with similar economic growth figures, the MENA region scored much lower than countries elsewhere.

The Commission concluded that governments in the MENA region chose to redistribute instead of creating conditions for inclusive growth and development. Redistribution occurred via subsidies, government sector employment and public investment. Policy distortions prevented the efficient allocation of resources. Energy subsidies, in particular, biased production towards capital-intensive industries. In addition, these governments created labour market distortions that discouraged private sector growth and acquisition of skills demanded by the market (also see next paragraph). Rent seeking discouraged competition and technology upgrading, and access to finance was limited, especially for small and medium enterprises. Notably, government institutions remained relatively weak with regulations applied in an uneven and preferential way, which further discouraged private investments, as these remained relatively low and reduced the efficiency of public investments.

Pervasive corruption, cronyism, and the absence of democratic representation have significant effects on (privately initiated) economic activities, investment decisions and the development of small and medium-sized enterprises. Weak governance and corruption, for instance, hinder a level playing field for businesses and obstruct transparency and clarity in business environments. Similarly, cronyism, or the granting of special privileges based on relationships, distorts markets and competition (e.g. by granting business contracts to the privileged few), and prevents government efficiency (e.g. by appointing government officials based on relationships instead of credentials and suitable experience). The World Economic Forum (2011) has stressed that corruption and misuse of political power are problematic factors for doing business in the Middle East and North Africa regions. According to Transparency International's Corruption Perceptions Index (2010), the MENA region is widely perceived as very corrupt, with an average score of 3.1 (see Table 7)[23].

[22] *The Growth Report. Strategies for Sustained Growth and Inclusive Development, by the Commission on Growth and Development, World Bank, 2008.*

[23] The Corruption Perceptions Index ranks countries/territories based on how corrupt a country's public sector is perceived to be. It is a composite index, drawing on corruption-related data from expert and business surveys carried out by a variety of independent and reputable institutions. Scores range from 0 (highly corrupt) to 100 (very clean). *Source:* Transparency International.

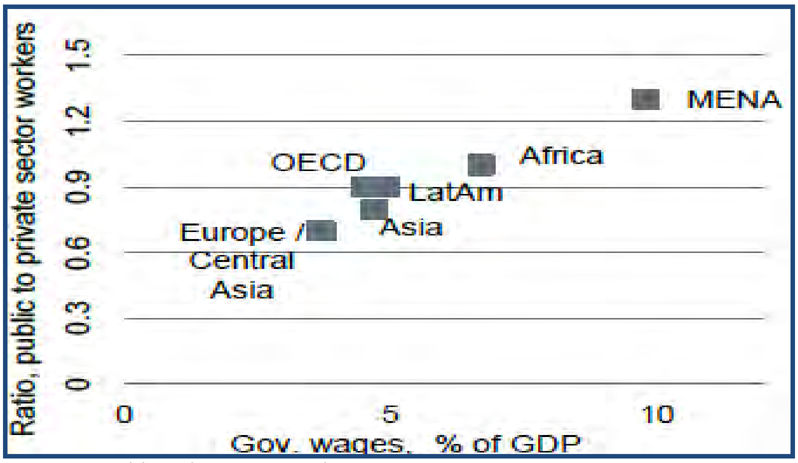
Table 7: Private business climate in the MENA region

Indicator	Algeria	Egypt	Gaza/West Bank	Jordan	Lebanon	Libya	Morocco	Syria	Tunisia	Turkey
Ease of doing business ranking	152	109	135	106	115	Na	97	144	50	71
Getting credit	129	83	159	167	104	Na	104	176	104	83
Registration property	172	95	78	102	108	Na	163	84	70	42
Enforcement contracts	126	152	93	129	121	Na	88	176	78	40
Resolving insolvency	62	139	185	112	131	Na	86	111	39	124
Transparency index ranking	105	118	Na	58	128	160	88	144	75	54
Transparency index score	34	32	Na	48	30	21	37	26	41	49

Source: World Bank and International Finance Corporation (2012). Doing Business 2013: Smarter Regulations for Small and Medium-Sized Enterprises.

The role of governments in the MENA region in direct economic affairs means that the SOEs not only compete with the private sector, but also account for an outsized portion of public employment in the region: 9.8% of the GDP compared to the global average of 5.4%. On average, public sector salaries accounted for 35.5% of government expenses in 2009 for regional governments (for benchmarking, see Graph 3).

Graph 5: Central Government wage bill by region (1990s)



Source: World Bank, DB Research

Limited participation of women in the workforce

The World Bank's 2013 report, *Opening Doors: Gender Equality in the Middle East and North Africa*, focuses on the challenges and reform priorities for gender equality in the region, and argues that the MENA region exhibits a gender equality paradox. While most MPCs have made considerable progress in closing their gender gaps in education and health outcomes, these investments in human development have not yet translated into commensurately higher rates of female participation, economically or politically. Since 1970, countries in the region have recorded the world's fastest progress in human development. During the same period, the average growth rates of key indicators—such as female literacy, infant mortality, and life expectancy—exceeded those of most other developing regions.

Gender gaps remain in some areas of human development—particularly in school completion rates—and gender differences in educational specialization remain significant. Nevertheless, most MENA countries are well on their way to achieving gender parity in key human development indicators. Paradoxically, these considerable investments in human capital have not yet been matched by an increase in women's economic participation. While in all countries in East Asia and the Pacific, Europe and Central Asia, Latin America and Caribbean, and Sub-Saharan Africa, gaps in economic opportunities for women persist, more than 50% of the women aged 15 and over participate in the labour market. By contrast, the corresponding figure in MENA is only 25.2% (see Graph 7 and Box 7 for gender gaps in the MENA labour market).

The high rate of female unemployment observed in the region indicates the influence of significant constraints with respect to women who do want to work. These constraints are also reflected in the wide gap between female and male unemployment rates. Over the last 25 years, this gap nearly doubled from 5.5% (1985) to more than 10.0% (2010).

In many countries in the region, unemployment rates among young women aged 15–24 are as high as 50% (see also Graph 9 Gender gaps in youth unemployment in MPCs and Box 6 Gender gap in the MENA labor market in section 3.3.2. Youth unemployment, page 28), compared to 10–20% for their male counterparts. Furthermore, these high rates of unemployment understate the true degree to which women in the region lack economic opportunities. Finally, opportunities for self-employment are also limited. As in the rest of the world, women entrepreneurs are a minority in MENA. Of the 5,887 firms in 10 MENA countries surveyed by the World Bank between 2003 and 2010, only 15% were female-owned.

The limited development of the SME sector in MENA (vis-à-vis other developing countries) can, thus, be explained by three factors: (1) the high barriers to doing business, particularly for smaller firms (e.g. the aforementioned corruption and consequent unfair competition, as well as complex licenses, rigid labour laws, high taxes, etc.); (2) cultural norms in which entrepreneurial activity is seen by young graduates as inferior compared to employment in the public sector, which offers more job security and esteem in society; (3) the very low participation of women in the labour force and in entrepreneurial activity.

To conclude, the modest economic growth of the last decade has not improved living standards for the majority of the people. Not only is this because the economic growth barely outpaced population growth, but also because the economic growth happened in the absence of a vibrant private sector that would be able to create more and better (i.e. sustainable) jobs. As has already been noted, some factors causing this deficiency are the crowding out of private enterprises by SOEs, high corruption levels, and cronyism. However, there are also other economic and structural factors inherent to small and medium-sized businesses, such as low levels of competitiveness in the manufacturing sector, lack of export-market diversification, and low intra-regional integration. Furthermore, although the Arab Spring provides an important opportunity for economic reform, its immediate effects for SME growth will be negative, especially for those countries most affected by social and political instability.

3.2 First Evidence of Link Between Mesofinance and Job Creation in the SME Sector

The justification for financial support (i.e. credit) to the SME sector is that through credit, small and medium enterprises will create new jobs, which in turn will lower the overall high unemployment levels in the MENA region. It is also believed that the SME has limited access to bank loans and, consequently the motor to create jobs in the region is ineffective and underutilized.

Indeed, several studies indicate that small and medium-sized enterprises not only have the largest share in employment, but also create more jobs than large corporations. According to the World Development Report of 2013 on jobs, it is perhaps not even the small and medium-sized enterprises, but in fact micro and medium-sized enterprises that have the highest share of employment and job creation. Their share seems to increase even further once household and labour force survey data are used, as this is more likely to account for employment in the informal sector, which is usually not captured in enterprise level surveys and censuses. A similar pattern emerges when contributions to job growth are analysed.

This supports the idea of improving access to finance to the mesofinance sector, particularly to the start-ups, where the least investment is required to create new jobs. However, the three surveys carried out by Frankfurt School in Tunisia, Egypt and Jordan only partially support this idea. Except for small entrepreneurs interviewed in Tunisia[24], very few respondents recruited new labourers following the receipt of bank loans. The survey from Tunisia does not provide additional information as to why the situation in this country is different from the other two.

The survey also suggests that most loans are used for working capital. Managing cash flows is, perhaps, the most difficult financial challenge for small entrepreneurs, and the inability to manage cash flows can destroy employment in the SME sector. In such cases, external funding, in combination with technical assistance to improve cash flow management, can help secure existing jobs, which is equally important as creating new jobs.

Although financing start-ups may create more jobs, it is unclear whether these jobs would still exist in the medium run, as it is not certain whether the newly created jobs are stable. In Egypt, the survey indicated that employment in enterprises that existed between four to six years and seven to nine years grew between 2009 and 2012, and that employment in small enterprises operating for more than nine years stabilized, while for the economy, as a whole, unemployment levels went up. Similar developments occurred in Jordan; in Tunisia small enterprises showed an impressive growth in employment creation, with the biggest increase in those enterprises operating between four and six years. While enterprises with little or no track record experienced higher job creation, in the longer run it is uncertain whether these amount to stable jobs.

Although the SME sector is very heterogenic in terms of size, profitability, growth and employment potential, and small firms drive employment growth in the MPCs, they are also much more likely to go out of business. This might be indicative of the various constraints previously mentioned, and that small firms are unable to grow into larger ones.

A recent paper by the OECD discusses the process of enterprise birth and its role in job creation[25]. It is widely accepted that new and small firms can contribute significantly to job creation in the modern economy. The OECD paper challenges our expectations on job creation, focusing on the mortality rates of SMEs, and in particular looking at the distinctions between firm size and age. Although it is often argued that the smallest firms are important for employment, what triggers job creation and economic growth is not the size of composition of the enterprise population but rather its *dynamics*. For instance, Haltiwanger *et al.* (2010)[26] show that, after controlling for firm age, there is no systematic relationship between firm size and job growth.

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[24] In Tunisia, 61% of the SME respondents reported that following a loan receipt they recruited additional people.

[25] *New Entrepreneurs and High Growth Enterprises in the Middle East and North Africa, OECD, February 2013*

[26] Haltiwanger, J. C., R. S. Jarmin and J. Miranda (2010), "Who Creates Jobs? Small Vs.Large Vs.Young", NBER Working Paper Series August.

The youngest and smallest enterprises are also the most likely to disappear in the first years of their existence, therefore leading to important job losses. Under these circumstances where are the jobs most likely to come from?

Stangler and Litan (2009) find that only half of start-ups survive the 5th year and around at third of them close as soon as their second year of existence[27]. High rates of job creation by start-ups and young firms are accompanied by similar (although normally lower) rates of job losses[28]. The sum of births and deaths of enterprises is an indicator reflecting the degree of "creative destruction" in an economy and, is of interest for analyzing productivity growth.

A study analyzing enterprise creation and mortality in Jordan, Morocco, Tunisia and Turkey concludes that enterprise entry and exit in all four economies add to productivity since new firms have higher productivity than survivors and survivors have higher productivity than exiting enterprises[29].

The 2009 global turmoil had a negative effect on both enterprise and job creation. It was not possible to collect data on enterprise creation and death during the 2011 events for MPC economies but it is safe to assume that the slowdown in economic activity due to political and social instability has almost certainly led to lower rates of enterprise creation (at least of formal firms). Similarly, enterprise mortality rates are likely to have increased, leading to further job losses.

The number of enterprises in the MENA region is generally lower than in other emerging economies and is skewed towards nascent and mature firms i.e. there are more younger and older enterprises than mid-age firms: there are more than 3 nascent ventures and almost 4 mature firms for each 100 adults (age range 18-64), compared to only 2 infant firms and young firms. This implies that there is a high rate of enterprise mortality between the 4th month and the first 5.5 years of the life of the business, and smaller mortality rates afterwards.

From these numbers, it can be assumed that firms in the MENA region find it difficult to survive in the first 3 months of their life, which would explain why there are relatively less firms in operation in the region compared to other emerging economies. Fewer firms being created and growing translates to a smaller total firm population.

Many countries in the Middle East and North Africa would have a greater ability to generate more stable, quality jobs for (young) people if the barriers to firm entry (e.g. registration requirements) and growth were eased. This prospect is unlikely to materialize, however, as long as political connections remain more important than entrepreneurial capacity to enter into the modern sector.

The validity of the above-mentioned view has recently also been challenged by academic research that suggests it is likely the age of the enterprise and not its size that matters most when a link is suggested between job creation, SME development, and mesofinance[30]. Small enterprises -- especially those with less than 100 employees, and more mature firms that have been in operation for more than 10 years were found to have the largest share of employment, and contributed the

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[27] *Stangler, D., and R. E. Litan (2009), Where Will the Jobs Come From? Ewing Marion Kauffman Foundation, Kansas City, Missouri*

[28] *Kane, T. (2010) "The Importance of Startups in Job Creation and Job Destruction", Kauffman Foundation Research Series: Firm Formation and Economic Growth, July.*

[29] *Sekkat, K. (Ed.) (2009), Market Dynamics and Productivity in Developing Countries: EconomicReforms in the Middle East and North Africa. Springer and IDRC, New York and Ottawa.*

[30] *"Small businesses, job creation and growth: Facts, obstacles and best practices", OECD (2009), and "IFC Job Study: Assessing private sector contribution to job creation and poverty reduction", 2013.*

most in terms of job creation. Even when the country experienced net job losses in the economy, small but mature enterprises recorded net job gains[31].

There is further evidence of a positive connection between productivity and job creation. Though it depends on the economic sector, type of innovation and level of analysis, there is evidence in favour of higher productivity and innovation being positively linked to employment growth. Therefore, jobs that are created due to innovation or linked to higher productivity tend to be stable and more secured than jobs created in a highly competitive environment with little "moat", i.e. in sectors with little competitive advantages.

The OECD-Eurostat Entrepreneurship Indicators Programme shows that enterprise births, exits, overall enterprise and job churn are consistently higher in the services than in the manufacturing sector, reflecting its greater dynamisms. Furthermore, an analysis of firms in the United Kingdom (Disney et al., 2003) showed that between 1980 and 1992, single establishment firms (25% of manufacturing employment) experienced no productivity growth among survivors; all productivity gains for this group came from entry and exit[32].

There is also evidence that in more competitive and open economies, innovative and productive businesses tend to exhibit not only higher job growth, compared to other businesses, but also more inclusive growth -- with an increase in the number of low skilled workers hired.

3.3 Employment Situation in the Region

3.3.1 Employment and Job Creation

The Mediterranean Arab countries in the MENA region need substantial economic growth figures to combat the persistent high unemployment figures. The economy had performed reasonably well, with average annual growth figures of 4.8%, and did create new jobs. The MENA countries generate approximately 1.2 million new jobs annually, however, with 1.8 million new job applicants currently coming into the labour market each year, their economy cannot cope with the demand side. Egypt, alone, must create nearly 700,000 jobs a year for its unemployment rate to remain unchanged, and many more to effectively reduce unemployment. Therefore, the current unemployment figures are likely to remain high for the region. According to ILO statistics, only Algeria has managed to sustain a job creation rate in recent years that outstrips the increasing demand arising from labour force growth. Egypt's employment generation rate is below the growth in new job seekers. The pace of job creation, especially, has fallen well behind demand growth in Morocco, Gaza Strip/West Bank, Syria and Tunisia, which means that these countries are experiencing a structural trend of worsening unemployment.

Most of the MENA countries are experiencing a decline in agricultural, industrial and government jobs. These sectors were formerly the main sources of labour demand. Commerce, services and construction must now create nearly all of the new jobs, but, as has been noted, the pace of job creation (1.2-2.7% per year) remains well below what is needed to ensure that current unemployment levels do not rise.

The advent of the Arab Spring is adding pressure to unemployment rates, which is expected to increase given the slowdown in economic activities in the most affected countries. Furthermore, the economic situation in Europe, the most important trading partner for the majority of the MENA countries, will make it more problematic to lower unemployment levels. For example, Egypt's

[31] *It is important to point out, however, that this analysis was based only on small enterprises that have survived, and given that small enterprises have a higher likelihood of going out of business, the results may overstate the net effect at the economy level.*

[32] *Disney, R., J. Haskel and Y. Heden (2003), "Restructuring and Productivity Growth in UK. Manufacturing", Economic Journal, 113 (489), 666-694.*

Ministry of Finance estimated that, because of the contraction in consumption (the main economic driver in the country) and economic activity, unemployment has increased to 12%, compared to its rate of less than 8.9% in December 2010, and is unlikely to decrease before 2013/14. Similarly, unemployment in Tunisia is estimated by the Ministry of Finance to have increased from 13% in 2010, to close to 17% in 2012.

Table 8: Unemployment rates in the MENA region (2008-2011figures)

Unemployment indicator, 2008-2011	Algeria	Egypt	Gaza/West Bank	Jordan	Lebanon	Libya	Morocco	Syria	Tunisia	MENA
Male, % of male labor force	8%	5%	23%	11%	..	..	8%	6%	..	9%
Female, % of female labor force	19%	23%	27%	21%	..	..	10%	23%	..	19%
Youth male, % of male labor force	19%	15%	37%	26%	..	..	18%	15%	..	..
Youth female, % of male labor force	38%	54%	50%	47%	..	..	17%	40%	..	..

Source: World Development Indictors, The World Bank (http://data.worldbank.org/indicator)

The only positive trend in the labour market appears to be the stronger overall growth of job creation for women. However, the downside is that the new jobs created for women are not always paid employment. A major portion of existing jobs, especially for women, is self-employment or family or unclassified jobs. Moreover, in many of the countries, the share of total employment created is attributed to unskilled labour, in the order of 20%, which is significant.

Even though the rates are established according to the strict ILO definition, which does not differentiate between informal work, precariousness, or unemployment situations, the latest unemployment rates in most of the MPCs are now in double-digit figures, and stand between 9 and 17% of the active population -- and with a continual deterioration. Unemployment primarily affects young people, the new labour market entrants, and women, in proportions that are much more serious than in other regions of the world (unemployment rates for young people 15-25 years are between 16 and 43% – see below for more details).

Box 3: Who is unemployed?

ILO definition: The unemployed comprise all persons above a specified age who, during the reference period, were: i) without work, that is, were not in paid employment or self-employment during the reference period; ii) currently available for work, that is, were available for paid employment or self-employment during the reference period; and iii) seeking work, that is, had taken specific steps in a specified recent period to seek paid employment or self-employment. The specific steps may include registration at a public or private employment exchange; application to employers; checking at worksites, farms, factory gates, market or other assembly places; placing or answering newspaper advertisements; seeking assistance of friends or relatives; looking for land, building, machinery or equipment to establish own enterprise; arranging for financial resources; applying for permits and licences, etc.

EUROSTAT definition: Unemployed persons are those who, during the reference week: (a) had no employment, and (b) were available to start work within the next two weeks, and (c) had actively sought employment at some time during the previous four weeks. In addition, unemployed persons include those who had no employment and had already found a job to start later.

Source: International Labour Organization (ILO) Resolutions Concerning Economically Active Population, Employment, Unemployment and Underemployment Adopted by the 13th International Conference of Labour Statisticians, October 1982, para. 10.

Source: Statistics in focus Theme 3 – 11/1999: Labour force survey – Principal results 1999, p.3.

In MPCs the employment challenge is, among other things, shaped by demography. Although their population growth rate has largely declined recently, to less than 2%, the baby boom of the 1970s and 1980s has led to today's massive wave of working age population. Further, due to the deterioration of living conditions, more women are driven by the need to also participate in the labour market. And finally, young people leave the educational system earlier in search of jobs. These, combined, result in a very high growth rate of the active population (between 2.25-3.7% annually) equivalent to 1.8 million people coming into the job market each year. It is not surprising, therefore, that the MPCs have high youth unemployment, with prolonged joblessness and idleness affecting large numbers of young people, resulting in many seeing limited opportunities for the future.

Table 9: Annual growth rate of the economically active population in the MENA region

Country	1985	2008	2020 (projected)
Algeria	4.2%	3.1%	1.5%
Egypt	8.3%	2.4%	1.7%
Jordan	6.2%	3.3%	4.2%
Lebanon	2.9%	2.5%	1.4%
Morocco	4.9%	2.2%	1.9%
Gaza/West Bank	3.8%	3.5%	4.1%
Syria	6.8%	3.7%	3.8%
Tunisia	3.7%	2.6%	1.7%
Total	4.0%	2.7%	1.7%

Source: Employment and Labour Law in the Arab Mediterranean countries and the Euro-Mediterranean Partnership

In addition to demographic trends, the MPCs have received approximately five million (net) refugees, primarily from other Arab countries (Iraqis and Sudanese, in particular), and more recently Syrian and Palestinian refugees. With labour immigration, the stock of immigrants is between 7 and 10 million people. Countries like Jordan and Lebanon, which traditionally export labour, currently receive significant labour migration from Asia.

The security situation in Libya, which hosted about 1.5 million migrant workers in 2010, mostly from Egypt and Tunisia, also has negative effects on employment in these two neighbouring countries. According to the OECD, approximately 100,000 Tunisians have returned to their country following the conflict in Libya. Their repatriation results in higher unemployment rates and adds to social pressures in the short-term.

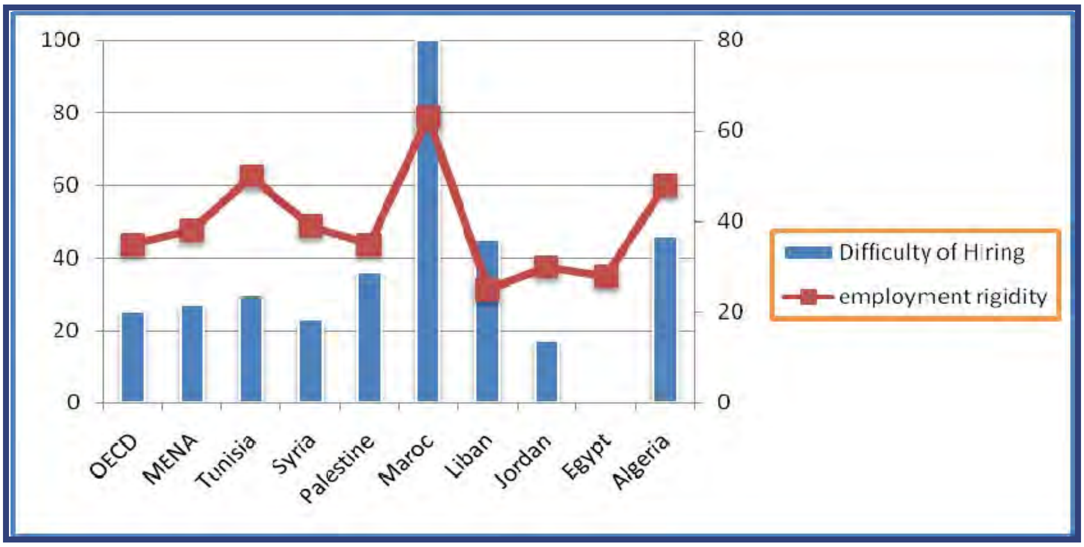
Labour market rigidities are another factor that explain the high unemployment rates in the region. Labour laws discourage firms from expanding employment, even during expansionary economic periods. According to the Global Competitiveness Index 2011, hiring and firing regulations in the MENA region are more restrictive than in other emerging and developing countries. World Bank

Enterprise surveys further indicate that the share of firms identifying labour regulation as a major constraint to business is, on average, higher in MENA countries than elsewhere.

Box 4: Labour rights in the Mediterranean Partner Countries

The labour laws in MPCs stipulate the right to work. Day-to-day realities, however, tell a different story, as work rights (social welfare, rights to free labour unions, rights to strike, etc.) are not positively guaranteed or respected. Moreover, the ILO conventions do not seem to be scrupulously adhered to, despite their ratification; the same can be said of the United Nations Covenant on Economic, Social and Cultural Rights. In particular, the labour rights of immigrants are not properly respected, even of those who have been established for a long time (e.g. Palestinians in Lebanon), despite the relevant international conventions.

Graph 6: Labour market indicators in the MENA region

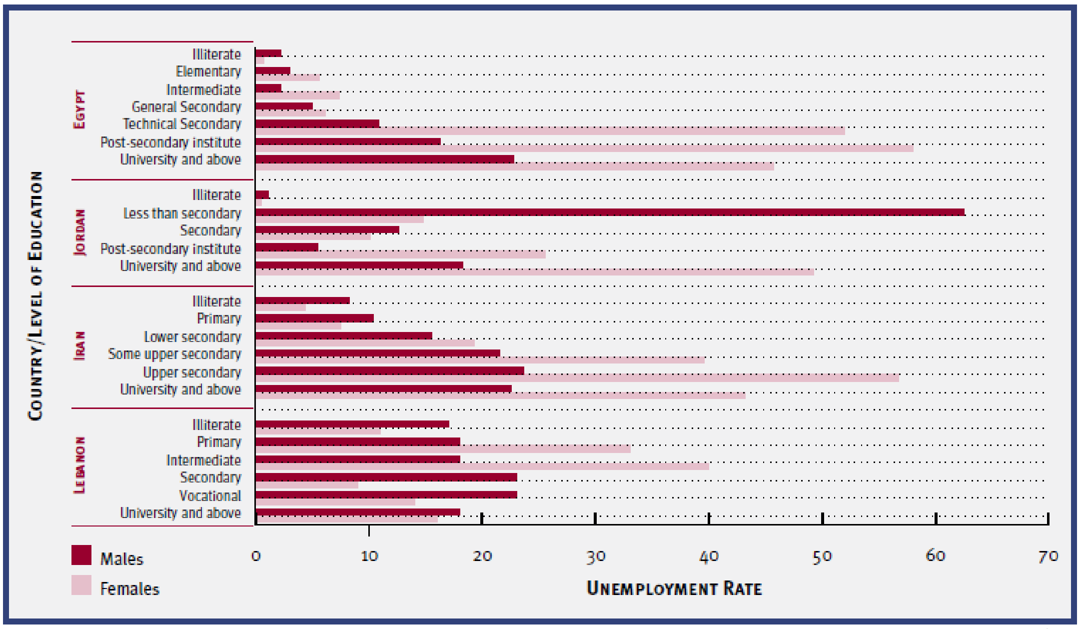


Source: Samir Aita et al. (2008). "Employment and Labor Law in the Mediterranean Countries and the Euromediterranean Partnership." Fundación Paz y Solidaridad Serafín Aliaga de Comisiones Obreras.

Another explanation for the high unemployment levels is that the labour market institutions in the region are widely dysfunctional. The employment agencies, for instance, are ineffective for mediating between supply and demand on the labour market. Lack of information on job seekers and on employment opportunities is one reason why young people face more difficulties than adults in finding jobs. Where private and public agencies and other sources of labour market information are not well developed, personal networks are important for matching people and jobs. The majority of workers in most MPCs have found their jobs through family and friends. Adults tend to have better networks than young people going through the transition from education to employment. If a large percentage of a person's network is unemployed, the chances of that person finding a job are low.

The skills of new entrants on the labour market are often not wanted by the employers, and are adjusted more to the needs of SOEs and other government sectors. Close to 40% of the firms surveyed through investment climate assessments in the Middle East and North Africa reported that the limited availability of skilled labour is a major constraint on business.

Graph 7: Unemployment rates by level of education in selected MPCs



Source: Navtej Dhillon, et al. (2009). "Missed by the Boom, Hurt by the Bust: Making Markets Work for Young People in the Middle East". Middle East Youth Initiative

Youth unemployment rates tend to rise with educational attainment in many countries. In Morocco, young people with a university education had an unemployment rate of 17% in 2009 -- 3.7 times the rate of those with primary education, or less. In Tunisia, 23% of university-educated youth were unemployed in 2010, compared to 11% for non-graduates. In Tunisia, it takes graduates, on average, 28 months to find a job, compared to 19 months for non-graduates. Not only has unemployment been increasing, but the employment deficit is expected to grow more among university graduates than people with less education.

Box 5: The attraction of government jobs in the labour market

The paradox of high unemployment among the highly educated is related to the growth path of countries in the Middle East and North Africa, where the civil service and state-owned enterprises have long been the employers of choice, and education systems were built to feed them with staff. Students aspire to public sector jobs, where benefits are generous and employment is stable, and focus on obtaining academic credentials rather than skills that enhance employability. There is a striking difference between the preferred educational path of youth in the region, and that of youth in the high-performing East Asian countries. In 2009, one-quarter or less of the university students in Algeria, Lebanon, and Saudi Arabia were majoring in science, technology, or engineering. By contrast, in some East Asian countries, such as China, the Republic of Korea, and Malaysia, that share was more than two-fifths.

With so many people jobless, and having little prospects of finding a job, employment in the informal sector becomes an ultimate alternative. It is the counterpart of the increased instability and uncertainty of paid employment and high unemployment rates. Despite the weakness of the local statistics and surveys covering the informal sector, it is estimated that employment in this sector can account for up to approximately 50% of non-agricultural employment. While the informal sector can act as a buffer for employment, wages are much lower and less secure, and there are serious deficits in employee working conditions. Informal employment, as well as a significant informal economy, has become a serious issue in the MENA region, reducing the capacities of the national governments to act on and regulate the job market on an economic and social level.

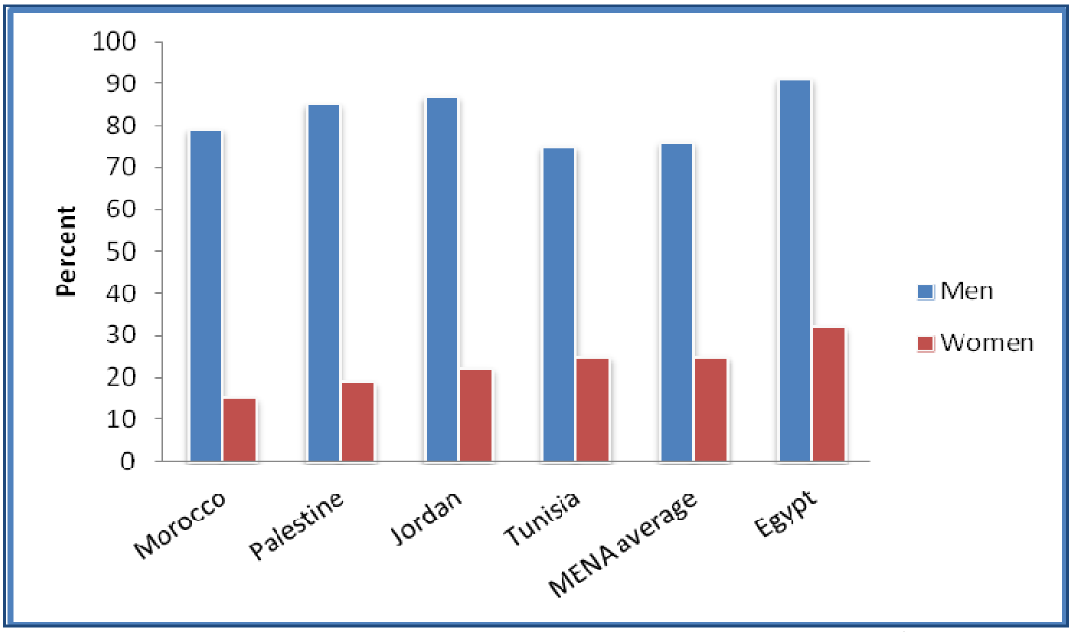
3.3.2 Youth Unemployment

Unemployment is particularly severe among the youth (15–24 years), averaging approximately 25% in the region (see also Table 8). Youth unemployment is about 25% in Jordan and Egypt, close to 30% in Tunisia, and nearly 50% in the Palestinian Authority. Furthermore, the 2.8 million young workers who enter the labour market every year are finding it increasingly difficult to obtain formal employment. Youth unemployment is exacerbated by weak economic growth, restricted government budgets (limiting further expansion of employment in the public sector), and a private sector—the main vehicle for sustainable job creation—that is stifled by red tape, corruption, and unfair competitive practices.

Moreover, the active role of the government in daily economic activities has crowded out the private sector, and created an environment in which young jobseekers find working in the public sector more desirable.

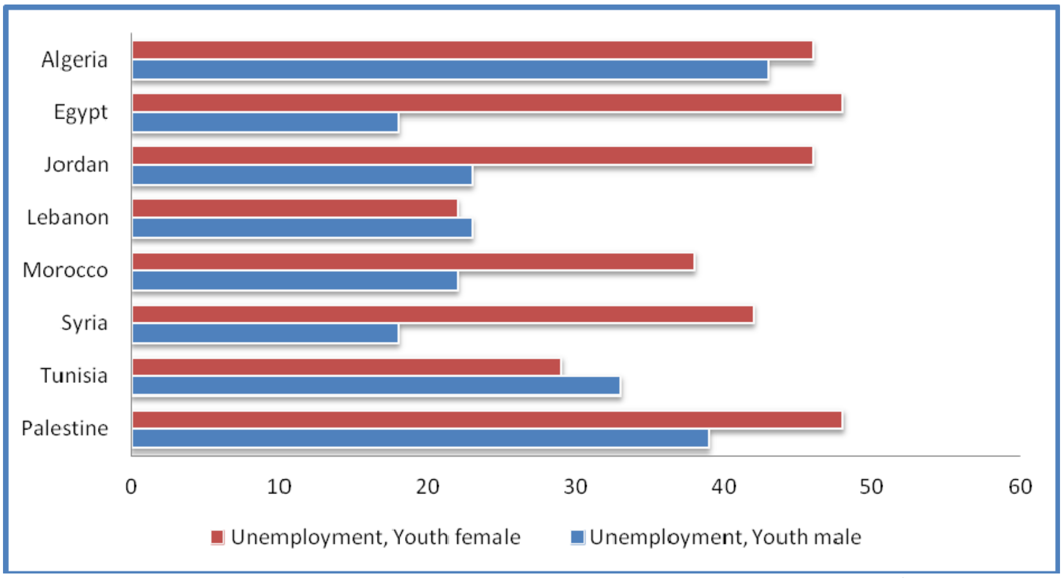
A striking feature of the unemployment situation in MPCs is that many of the jobless are among the most educated -- over 43% of those with tertiary education are unemployed in the West Bank and the Gaza Strip; 22% in Morocco; 14% in Tunisia, and over 11% in Algeria (see Graph 6 for selected MPCs). One of the reasons for the high levels of unemployment among youth and the educated is a persistent gap between the skills acquired at university, and the requirements of business. Enterprises often cite lack of suitable skills (mismatched skills) as an important constraint to hiring; according to the World Bank's Enterprise Surveys, firms identify labour skill levels as a major constraint in Lebanon (38% of surveyed firms), Syria (36%), Jordan (33%) and Egypt (31%).

Graph 8: Female and male labour force participation in selected MPCs and gender gaps in youth unemployment



Source: Opening Doors: Gender Equality and Development in the Middle East and North Africa, World Bank (2013)

Graph 9: Gender gaps in youth unemployment in MPCs



Source: Opening Doors: Gender Equality and Development in the Middle East and North Africa, World Bank (2013)

Box 6: Gender gap in the MENA labour market

Unemployment is also disproportionately high among women. According to the World Economic Forum's Global Gender Gap Report 2010, significant progress has been made in the region to increase women's educational attainment rates, and over the past decade, almost all MENA countries have closed 90% or more of the gender gap in education. However, these improvements in education have not been matched with comparable increases in female labour force participation rates -- approximately 33% of working-age women join the labour force. Furthermore, in all countries of the MENA region, with the exception of the West Bank and Gaza Strip, women who join the labour force have consistently higher unemployment rates than their male counterparts. The gender gap in unemployment is the largest in Egypt, where the female unemployment rate is nearly four times the male unemployment rate. The labour market outcomes for women in the MENA region could be attributed to prevailing cultural attitudes, gender laws, and weak support services.

3.3.3 Conclusions

Job creation is the first priority in the MENA region. The available evidence indicates that the region suffers from long-term unemployment levels ranging from 10 to 25%, and that the employment situation is likely to worsen. Political uncertainties on the outcome of structural reforms deter private and international investments.

Long-term structural unemployment represents a daunting challenge for the MPCs. The MENA-OECD Investment Program estimates that, in order to remain at current unemployment levels, 25 million jobs will need to be created over the next decade, requiring an average annual growth rate of 5.5% -- one point above the average growth of the last decade. More dire estimates from the World Bank suggest that the region will need to create twice as many jobs—at least 50 million—over the next decade in order to ensure social and political stability. Reaching this higher target would require annual growth rates of at least 6.5 to 7.5% for the MENA region -- almost two points higher than the average growth in the last decade, i.e. the period before the Arab Spring.

Box 7: Government reactions to public discontent

In crisis situations such as the Arab Spring, the first reaction of governments usually is to increase salaries and create more jobs in the public sector, as a short-term response to social discontent. The government of Egypt, for instance, has announced a 15% increase in the base wage of all civil servants (5.8 million employees). Tunisia's transitional government has also announced an employment plan, which includes the creation of 20,000 jobs in the public sector. Many other MENA governments have undertaken similar measures. Although such measures are helpful in mitigating unemployment in the short-term, appeasing social discontent, and perhaps temporarily contributing to revitalizing the economy through increased consumption, they also add pressure to the already strained public budgets of governments in the MPCs. In the medium to long-term, they increase public deficit spending and, thus, are unsustainable and do not help to advance the sustainable development of the private sector.

There is a certain level of awareness within government circles, as well as among the public (e.g. unemployed new entrants, particularly the educated ones) and academia on the root causes of the dire economic state and high unemployment levels. However, the issues lined to reform the economy (create a level playing field; privatize or otherwise restructure SOEs; government versus private sector), and the segmentation of the labour market (formal versus informal work, globalized versus marginalized sectors, precariousness of employment, differentiation of social rights by sectors, emigration and immigration policies) are less clearly expressed. For various reasons, the governments do not specifically address these issues (economic reforms would mean more job losses and more public discontent; reforming the labour market hurts segments of the working class and can cause riots), even though it has become a major issue. Instead, the response is a wide variation in policies, ranging from a generalized "*laissez-faire*" approach to a more or less parsimonious reinforcement of labour market institutions (improving the performance of employment agencies, job training institutions and incentives, reinstating social protection systems -- minimum wage, social security, unemployment insurance, retirement plans, health care, etc.; regulation of inbound and outbound migrations) without a true response to the structural reforms that the economy and the labour market needs. Instead of tackling deep economic and labour market reforms, authorities have essentially adopted ambient ultra-liberalism with respect to promoting microcredit intervention and the creation of micro-enterprises as a panacea for all, or most, macro-economic shortcomings in the MENA region mentioned before.

4 Supply and Demand of Mesofinance

4.1 Overview of SME Sector in the MPCs and Assessing Their Need for Finance

In MPCs, the SME sector is the main driver of job creation, growth and economic diversification. SMEs are dominant in the MPC economies, as they constitute over 85% of all registered companies, and contribute to over two-thirds of the total formal employment. Finally, the SME sector has a significant share of value added in the GDP (approximately 60% of the GDP).

Box 8: SMEs in the European Union economy in 2012

Small and Medium-sized Enterprises (SMEs) form the backbone of the EU economy – accounting for 99.8% of non-financial enterprises in 2012, which equates to 20.7 million businesses. The overwhelming majority (92.2%) are micro-enterprises, defined as those with fewer than 10 employees. Some 6.5% of SMEs in the EU are classified as small enterprises (employing between 10 and 49 people) and 1.1% are medium-sized (50-249 employees). Large businesses, with more than 250 employees, account for merely 0.2% of enterprises in the EU's nonfinancial sector. In employment terms, SMEs provided an estimated 67.4% of jobs in the non-financial business economy in 2012 -- almost identical to 2011 (67.4%), but up from 66.9% in 2010.

Source: Eurostat/National Statistics Offices of Member States/Cambridge Econometrics/Ecorys

To put the above in perspective: in Morocco, the SME sector represents over 96% of all existing enterprises in the economy. They contribute approximately 30% to the GDP, and absorb about 50% of the total active labour force. In Jordan, the SME sector constitutes 95% of all economic entities and accounts for 40% of the GDP. The sector also contributes to creating 70% of job opportunities. Data from the Tunisian National Institute of Statistics (NIS) indicates that enterprises employing less than 10 people account for almost 87% of all Tunisian companies, and firms employing between 10 and 99 people approximately account for an additional 11%. In Egypt, there are between 2.25 and 2.5 million micro-enterprises, and 200,000 to 300,000 small and medium-sized enterprises. The actual number may be much higher, for micro-enterprises in particular, as they only list formally registered enterprises, thus, excluding all those entrepreneurs who did not apply for a registration of their businesses. Egypt's private sector is further dominated by a plethora of small businesses in the agricultural sector and furniture making, and includes tailors, potters, metalworkers, and restaurant owners. While the list is long and varied, all businesses in Egypt share a common characteristic: they rarely employ more than 10 people. In most cases, they employ 4 people or fewer. The statistics suggest that 97% of Egyptian enterprises are extremely small.

There is one cautionary note when comparing the importance of the SME sector in the MENA region. Different governments and (international) donors use different definitions when referring to the small and medium-sized enterprises. Often, even within countries, statistics that highlight the extent and importance of the SME sector differ greatly, depending on the definitions used by the various ministries and national statistical offices.

Some of the more qualitative features of the SME sector would be that a large part of the small and medium-sized enterprises in the MENA region operate in the informal sector. The importance of family funds and self-finance is prominent in that sector. Moreover, the relationship between the enterprise and stakeholders is personal, and it is difficult to distinguish the financial situation of the firms from that of the owners. Another feature of the SME sector is the excessive centralization of management and lack of corporate governance, which is a common pattern in many family-owned businesses. Corporate governance standards vary, but are generally considered low. Further, corporate governance principles are usually difficult to enforce in family-owned businesses.

The SME sector faces other additional internal challenges constraining their growth. One of these is the low level of financial literacy of the owner-operators (Table 10). Limited management competencies, and practices that lack strategic vision are other hurdles. The SME sector usually does little to no research in either product development or in understanding the market. Forward and backward linkages in the SME sector are highly personal, and usually do not include written contracts and agreements. The market is very competitive as the entry barrier in this part of the segment is low.

The production processes are usually labour intensive, and there is little specialization required in the jobs the sector offers. Most jobs require a low level of skills and experience. This means that there is a mismatch between supply and demand on the labour market. Tunisia, as well as Jordan and Egypt, appears to have a relatively skilled labour force, however, the country's economy -- including the SME sector -- is not able to absorb this qualified labour force.

Small businesses in the MENA region have several things in common; they operate in an environment with structural rigidities and distortions with macroeconomic imbalances, they sometimes have domestic savings-investment imbalances (e.g. Tunisia), and they always operate within a difficult legal, institutional and regulatory framework. In Egypt, for instance, the sector complains of bureaucracy and red tape such as getting approvals and business registration during the start-up processes. The sector also complains about high taxes, fees, duties and other fees, as well as a banking culture that is biased against the SME sector.

Furthermore, small entrepreneurs in Egypt do not believe that the different government agencies responsible for SME promotion are really supporting or helping the sector. They complain that in areas where they need support such as product design and quality control, understanding the domestic and regional market and promotion of their products to Egyptian customers, there is little forthcoming support from the government.

Box 9: Financial diary of a small entrepreneur in pellet production

Prior to becoming a small entrepreneur, Hisham[33] was a stockbroker. He earned a lot of money that he invested and saved in a bank. Being a stockbroker is a hard and tense job, and Hisham knew he had to do something different by the time he turned 34 or 35 years of age.

It was clear to Hisham that after the telecom boom, the next boom in Egypt would either be in the food sector or the energy sector. When he was touring Europe, he accidently came across a factory that produced pellets (wood processing for the energy sector). This must have an even bigger potential in Egypt, Hisham thought -- processing the wood waste of the big furniture industry into pellets for household heating in Europe. With guts, persistence and willingness to take the risks, Hisham seized this perceived opportunity.

In 2007, Hisham made a business plan, and expected that production would go into full blast after 8 months. He calculated that he needed 11 million EGP. He invested 5 million EGP from his own savings, obtained 1 million EGP from family and friends, and borrowed 5 million EGP from the bank. As a senior stockbroker he was used to dealing with the banks, therefore, they knew him for many years as well.

Hisham soon realized that his business plan and cash flow were based on the wrong assumptions, and his loan agreement with the bank would gradually kill his business. Technical production challenges emerged delaying the actual production from 8 months to 2 years, and after 8 months he defaulted on his loan. Hisham sold land and invested another 2 million EGP as fresh capital to solve the cash flow.

[33] *Not his real name.*

Once the production was coming along, Hisham faced another challenge. His potential buyers were not used to buying pellets from the Middle East and were sceptical about the quality and reliability of the pellets. Hisham offered a big discount of 25% on the pellet price, in order to gain access to the European market.

Hisham started the production unit with 15 workers. Gradually the number of workers increased to 90, as of late 2012. It is not difficult to recruit workers, as the production technology is not very complex. It was, however, more difficult to find a technical production manager to oversee and manage the production process.

The asset total of Hisham's enterprise is close to 13 million EGP. Two-thirds of the assets are machineries (8.2 million EGP) while another 3 million is in inventory. Most of the assets are financed from his own savings, and equity from his family and friends. Of the original 5 million EGP bank loan, Hisham still has to pay 1.8 million.

In 2012, his gross revenues and profits increased every year to reach 10.8 million and 1.2 million, respectively. Hisham's business is not greatly affected by the political crisis of Egypt and the Middle East, or by the financial and EURO crisis in Europe. Hisham has invested the profits in his company to finance working capital, and also to increase the production capacity.

Hisham has plans to expand his business, and wants to set up a second plant. He already has, in principle, the approval for a 5 million EGP bank loan (from a different bank than the first loan), pending Hisham's compliance with a set of conditions, including increasing the equity from 8 to 11.5 million EGP.

Hisham does not like when a bank treats him as a client. He expects that they see him more as a partner, carrying out closer financial monitoring and advising him during the loan, or on other financial issues. He is willing to pay for such services.

Hisham has invested a lot of time and money into building his network, which mainly consists of suppliers and clients. He is critical of the government that has promised several times to financially help him with his efforts to participate in several exhibitions in Europe. While this has never happened, it has not stopped him from going there at his own expense.

Small entrepreneurs in Tunisia also face many environmental challenges that impede growth, unrelated to financials. Here, small entrepreneurs have to cope with the limited size of the local market and high competition within the SME sector. In particular, exporters selling mainly raw materials or semi-final products to European corporations in the automotive, agribusiness and textile sectors are facing tough competition. Additionally, lack of information and access to data is a barrier for enterprises that heavily rely on exports. Finally, there is a significant gap between de jure institutional frameworks, and their actual implementation and effectiveness. The World Bank Enterprise Surveys also suggested that discretionary application of rules and regulations exist, which often work against the SME sector.

One of the results of operating in a volatile environment is that banks often reject loan proposals from the SME sector or that the financial institutions require very high collateral to cover the risk of possible default. Very often, small businesses cannot meet these requirements; this in turn explains the importance of informal finance and the high reliance on own funding. However, the unpredictable macro and micro economic, and political environment in which many small entrepreneurs operate also reduces their willingness to consider external funding, as shown in Table 11. In other words, even if the banks would approach them, it is unlikely that they would accept a loan offer because banks do not understand their business; there is little consideration for the particular cash flows their businesses have, which usually does not permit for a monthly amortization and interest payment in equal instalments; and there is a relatively high interest charged on bank loans (some entrepreneurs even find that interest payments go against their religion).

Therefore, many small entrepreneurs are not satisfied, nor are they waiting for a passive external funder who wants the client to follow a fixed amortization schedule and monthly or quarterly financial statements of the business. Clients want a more active funding agency that also assists in financial engineering of the small enterprise, is willing to be involved in strategy considerations, and perhaps on an ad hoc basis assists in management suggestions (sparring partner). However, banks are not equipped to offer these kinds of services, and, following best international lending practices, should not be involved in lending operations and implementation of SME strategic and operational matters, at the same time.

Table 10: Responses of small entrepreneurs on the different bank products that are offered or could be offered to the SME sector

Views and responses on the different bank products by the SME sector												
	Tunisia						Jordan					
	ST loan	MT loan	Investment loan	WC loan	Overdraft	Trade finance	ST loan	MT loan	Investment loan	WC loan	Overdraft	Trade finance
Would like to use	5%	6%	10%	9%	5%	4%	3%	2%	2%	3%	1%	2%
Frequently used	22%	24%	20%	12%	21%	14%	21%	21%	17%	16%	15%	18%
Rarely used	8%	13%	9%	15%	14%	16%	2%	6%	1%	1%	4%	2%
Don't need	57%	48%	49%	52%	44%	40%	70%	67%	76%	76%	76%	74%
I don't understand	8%	9%	12%	12%	16%	26%	4%	4%	4%	4%	4%	4%

ST = short-term; MT = medium-term; WC = working capital
Source: Authors own calculations based on the qualitative demand survey in Tunisia (N=100).

One final note from the demand side: many small entrepreneurs do not apply for a bank loan because of the high collateral requirements. On average, banks require collateral worth well above the loan granted, which prospective borrowing small entrepreneurs find to be prohibitive, and the chief obstacle blocking their access to bank credit. Thus, despite the search for new lending techniques and procedures, mentioned before, banks still rely on hard collateral to minimize their risk. Further, small entrepreneurs consider the banking procedures too lengthy and complex, but also believe that they need to have a friend within the bank in order to obtain a loan. Indeed, there is a (justified) perception that banks will not lend to the SME sector, and that if they did, the amount provided would only be a fraction of what is required. Finally, some entrepreneurs find interest payments as something that goes against their religion.

4.2 Overview of Mesofinance Providers and Their Financial Services

4.2.1 Banks

Though most small entrepreneurs primarily rely on own funds to finance working capital, and for further growth and investments, when it comes to external financing, banks are the first and most obvious choice to them.

The importance of SME finance within the banking sector varies greatly within the MPCs. About three sub-groups can be identified[34]:

[34] *There could be an element of error in country comparisons, related to different definitions of SMEs adopted by the banks.*

- A first group with SME lending below 10% of total portfolio lending (Syria, Egypt);
- An intermediate group with SME lending between 10-15% of total lending (Palestine, Jordan);
- A third group with SME loans between 15-24% of total loans (Tunisia, Lebanon and Morocco). Countries that report an SME sector with a higher coverage of, or access to, bank loans tend to be those with the highest share of SME loans their total loans (e.g. Morocco and Lebanon), while countries with the lowest shares of enterprises with a loan tend to also have small shares of SME loans (Syria, Egypt, and Palestine).

Box 10: Different definitions for SME lending by banks in the MPCs

Banks were asked to provide their own definitions for SMEs, in terms of employees and turnover. The average minimum number of employees defining a small firm is 4; the average maximum number of employees defining a small firm is 17, while the average maximum number of employees defining a medium firm is 58. Moreover, most banks use turnover as the measure to classify their SME portfolio. As such, they consider that the average minimum turnover for defining a small enterprise is USD 60,000, and the maximum turnover for defining a medium enterprise is USD 4.7 million. It is, therefore, difficult to compare statistics in SME portfolios of banks with different definitions, as banks within a country, as well as across the MPCs, have different and distinct definitions of what falls under SMEs, and therefore, SME lending.

Larger banks (measured by total loans), generally, do not play a more significant role in SME finance in MENA, but banks that have a larger branch network and/or have set up SME units seem to do more SME lending, suggesting that relationship lending may be important in a region where financial infrastructure remains generally deficient.

Statistical figures appear to indicate that many private banks are committed to SME lending, and willing to allocate internal resources to develop the SME business and reach their long-run targets for SME lending.

State banks play an important role in SME lending in several MPCs. This may reflect their mandates to fill a gap in SME lending, especially where the enabling environment remains weak, and the private banks are still reluctant to take more risks. It is also evident that state banks have a larger share of investment loans in their SME loan portfolios. Although state banks are very engaged in the SME business, only half have already set up a separate SME unit, while in the case of private banks this figure is close to seven out of ten banks.

Despite the interest in the SME sector, lending volumes are still not very impressive. The overall share of SME lending in total lending is only 13% in the MENA region. This percentage is lower than the shares of SME lending in developing and developed countries[35]. Perhaps more importantly, the share of SME lending in total lending is substantially below the long-run targets of the commercial banks, suggesting considerable room for further lending to the SME sector.

There are a number of common factors that drive banks to engage more with the SME sector. The most important factor mentioned by banks is the perceived profitability of the SME segment. Another important factor includes the saturation of the market for large corporate lending, and banks see the need to diversify their loan portfolio. Finally, the prospects of generating business through cross-selling are rated as important or very important by a large share of banks. A large share of state-owned banks is also attracted to the SME business due to the perceived profitability of the sector. Interestingly, supply chain links and cross-selling do not seem to be important drivers for these banks, and could reflect the broad policy mandates imposed on them to serve the SME

[35] *Beck, Demirguc-Kunt, and Peria (2008), and OECD (2010).*

sector. However, it could also signal the lower level of development of SME strategies in these banks.

Cross-selling explains that banks offering loans to SMEs also offer deposit and cash management accounts, trade finance, and payments and transfers. These banking services follow closely behind as the most widely offered services to the SME sector. Most banks offer all of these services, which confirms that SME finance is much broader than SME lending, despite the tendency in many reports to often simply use "SME finance" for "SME lending"[36].

It is, perhaps, surprising that neither leasing (a form of asset financing) nor factoring (a form of supply chain financing) are more developed among MENA banks, as these technologies seem to offer a solution to weaknesses in legal and contractual regimes. However, while leasing and factoring are in principle well suited in an environment with weak collateral regimes, in practice, weak protection of ownership rights and contract enforcement dilute, or even eliminate, their supposed advantages. The low presence of banks in leasing in many MENA countries can be explained by the lack of clarity in the legal framework for leasing, including leasing definition, balance in responsibilities between lessor and lessee, regulations for different forms of leasing, a cumbersome process for registering leased assets, weak asset repossession processes, and unfavourable tax treatment. Finally, leasing entails difficulties in disposing of the repossessed assets in thin secondary markets.

The most common distribution channel used by banks to service SMEs are their branches, which may reflect the importance of "*relationship banking*". However, in many commercial banks the decision power of branch managers is very low, and sometimes the credit committee in the head office makes all the credit decisions. Instead, "limited *service branches*" -- including dedicated SME business centres in head offices -- are widely used as distribution channels. Private Banks are the largest users of limited service branches, and place less reliance on full service branches, especially compared to state-owned banks. This suggests a greater emphasis on cost efficiency by private banks, and perhaps also that state banks may benefit from a legacy of more extensive branch networks. ATMs are important, but mobile branches are not widely used for SME financing, although points of sale (POS) are widely used by banks for services such as payments, transfers, and, potentially, withdrawals and deposits. The low use of mobile branches and agents may reflect a lack of emphasis on serving rural SMEs, or restrictive regulations on the use of agents to offer banking services, although it may also suggest that a minimum level of bank staff is required to adequately meet SME needs.

Given that most public registries and private credit bureaus still do not provide scoring models, banks rely on rating models developed by external consulting firms during the appraisal stage. These rating tools, however, are frequently non-customized models. Therefore, almost all the banks are making an effort to develop internal rating systems, combining the credit scores of the business owner with other information from the SME, both qualitative and quantitative. Nevertheless, only few banks use finished internal scoring models to assess the risk of current and prospective clients[37]. It is also evident that very few banks use automated application processing, which likely reflects the weak state of development of credit reporting systems in the MENA region, and the limited reliance on the quality of internal credit scores.

A significantly lower number of state banks have developed internal credit scores or internal ratings systems, and very few have adopted automated application processing, again, revealing

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[36] *Actual SME uptake of these services is likely to be higher for current accounts and payments, which are used for daily transactions, than for loans and trade finance.*

[37] *A very low number of banks inform their SME clients about the factors driving their internal score or ratings. This is a missed opportunity to increase the awareness of small entrepreneurs on their weaknesses, and encourage improvements in performance.*

that these banks have not developed their SME lending technologies and risk management systems as much as the private banks.

Israel, Lebanon and Morocco have implemented Basel 2 requirements and Jordan partially as well. However, a number of state banks in MENA have not yet implemented Basel 2 requirements and, therefore, are generally lagging behind in the development of their governance and risk management systems, despite the fact that they are fulfilling mandates and taking additional credit risk.

The most commonly offered Shariah-compliant product is Murabaha financing, which is more typically used for working capital. Ijara, which is similar to leasing, is the next most prevalent financing for private and state banks.

Box 11: Islamic banking

Islamic finance seems to be an area of increasing involvement for banks around the world. With an estimated 650 million Muslims living on less than USD 2 a day, finding sustainable Islamic models could be the key to providing financial access to millions of poor Muslims who strive to avoid financial products that do not comply with Sharia (Islamic law). Consequently, Sharia-compliant financial inclusion has recently galvanized considerable interest among regulators, financial service providers, and other financial inclusion stakeholders. However, despite a four-fold increase in the number of poor clients using Sharia-compliant products in recent years (estimated at 1.28 million), and a doubling in the number of providers, the nascent sector continues to struggle to find sustainable business models with a broad array of products that can meet the diverse financial needs of religiously observant poor Muslims.

Financial beliefs enshrined in Sharia challenge the banking and microfinance sector’s ability to sustainably provide Sharia-compliant financial products at scale. One such belief is the widely known prohibition on interest, which makes traditional microloan models technically impossible. A lesser-known tenet is the encouragement of wealth creation through equity participation in business activities, which requires risk sharing by financial service providers that do not guarantee returns. To date, Islamic banking accounts for a very small share of overall banking in the MENA region.

Source: El-Zoghbi, M. et al. 2013

4.2.2 Microfinance Providers

The microfinance market in the MENA region is relatively young in comparison to other regions. According to the 2010 Arab Micro Finance report conducted by MIX, the MENA region has the second youngest microfinance sector in the world, following Europe and Central Asia. Prior to the Arab Spring, there was little encouragement from the government side to develop the microfinance sector.

Though the term “*microfinance*” suggests a wide offering of different financial services, the reality is that the current product range offered concentrates mainly on credits. Micro-credit describes the process of offering small loans to low-income individuals that are excluded from the traditional banking system. Thus, the targeted market segment excludes the small and medium enterprise sector, even though some developments emerge where NGO-MFIs upgrade their financial services to also include small businesses.

Within the region, the microfinance markets are in different stages of development, with Morocco, Egypt and Jordan showing higher levels of maturity, compared to younger markets in Syria, Tunisia and Algeria. Indicators of these stages of development include the size of portfolios and assets, funding structures, professionalism of microfinance management, diversity of services offered and the service providers, and, finally, the enabling environment.

Box 12: Islamic microfinance in Algeria

Since many in Algeria are reluctant to use financial products that charge interest (a violation of Islamic financial principles), the Algerian government set out to make a Sharia-compliant product available, which is both affordable and scalable. Along with the Algerian Ministry of Industry, SME and Investment Promotion, Al Baraka Bank partnered with GIZ to pilot one such product in the Ghardaia region of Algeria. Al Baraka Bank is an Islamic bank with Saudi shareholders, and a network of 22 branches, and about 700 employees. It was established in Algeria in March 1990 and started operations in September 1991. Four years later, this musharaka product – a profit-and-loss sharing scheme that emphasizes shared risk between financier and borrower – has provided new opportunities for 131 women. Solidarity groups of 3 to 15 women are organized, and collect compulsory savings for 2 to 4 months before being eligible for a credit. Loan amounts are between EUR 100 and 400 for a duration of 3 to 12 months. To date, Al Baraka has funded 986 qard hassan – benevolent loans – for a total of EUR 170,100, and 131 musharaka for a total of EUR 669,300. Based on this successful experience, it is envisaged that the product would be offered at the national level.

Source: CGAP, Al Baraka Bank.

CGAP has calculated that the MENA region, with approximately 370 million inhabitants of which at least 26% are estimated to be living on less than USD 2 a day, has about 6 million households eligible for a microfinance loan. This means that there is a gap of about 3 million potential microfinance customers, for a total of nearly USD 3.5 billion. The supply of microfinance services in the region is modest, at best, especially when factoring in the limited provision of financial services beyond microcredits. Seventeen large MFIs from the more mature markets in the region have a combined portfolio of USD 912 million, which represents 78% of the region's overall portfolio.

Similar to commercial banks and other financial intermediaries, MFIs, generally, have three main sources of funding to finance their portfolio and future growth: deposits, debt, and equity. The main source of funding for MFIs in the MENA region has been donated equity. In Egypt, for example, international bilateral donors and NGOs are the biggest suppliers of microfinance, and contribute (directly and indirectly) to approximately 71% of total funding. Similar funding structures are seen with MFIs in other countries. One reason for this development is that MFIs are not allowed, or interested in, deposit taking, to fund their portfolios. Only Syria currently allows deposit taking by NGO-MFIs, while in all other countries restrictive regulations and the current structure of the financial sectors hamper the growth of the microfinance markets. Recently, and much later than in other regions, MFIs are enlarging the funding of their portfolios through debt financing. Internationally speaking, however, MFIs' debt financing is still the lowest when compared to Asia, Latin America and Africa.

Since most MFIs are not regulated as financial intermediaries, the products they can offer are limited. Consequently, most MFIs in the MENA region continue to offer small loans. In particular, micro-enterprise (business) loans have constituted the majority of loan portfolios (at least in theory, and according to the official statistics). In recent years, however, MFIs began to offer a variety of additional loan products including consumer loans, housing loans, education loans, seasonal loans, and Islamic loans, to meet the demands of their target populations. Other financial services, such as savings, insurance or monetary transfer, are negligible.

Not only is the main activity of the MFI sector the provision of credit, the loan package is highly standardized (one size fits all), and not adjusted to the needs of their clients. This limited diversity of financial services and standardization is a reflection of their restricted internal management capacity. Microfinance institutions can only rarely professionalize their staff; although international development organizations offer much training to the staff, there is a very high turnover of employees.

Microfinance services in the MENA region are delivered through conventional channels (i.e. fixed branch networks), with very few venturing into mobile phone microfinance -- although this development is definitely prominent and promising with new technological innovations and improved infrastructure.

The service providers are specialized NGOs that still dominate this sector; more than 90% of financial services for poorer households in the region are provided by non-governmental organizations. This origin explains that nearly all MFI organizations are registered as not-for-profit companies rather than as investible corporations. Only few microfinance intermediaries outgrow their NGO structure, partly because current NGO laws and the absence of microfinance regulations prohibit them, and partly because there is opposition within the sector to change their status quo. There is fear of mission drifts, which emerges especially when the upgrading of services is discussed.

In other countries, state institutions are major suppliers of microfinance services. In Tunisia, for instance, the government-owned Banque Tunisienne de Solidarité (BTS) provides microfinance services. In neighbouring Algeria, the main agency for microcredit was, and is still, the National Agency for the Management of Microcredit (ANGEM) -- a public institution created in 2004 under the umbrella of the Ministry of National Solidarity and Family Affairs. Lebanon, by contrast, has a number of cooperatives and development programs (UNRWA, Save the Children, Grameen Foundation, CHF, etc.) that provide microfinance credit along with their economic and social development programs. The involvement of the private sector in microfinance remains negligible. Altogether, there is little development in the region that suggests a diversification of the microfinance institutional landscape to include banks, microfinance banks, non-bank financial institutions and service companies.

Microfinance institutions are subject to very different country-specific monitoring, taxation, incentives and regulatory conditions. The enabling environment is best described as ambiguous and inadequate. In Syria, the licensed MFIs are allowed to accept deposits, but there is only one institution that is permitted to actually do so[38]. In Morocco, the government has capped the interest rates, making it very difficult to expand financial services to the more remote areas. In Algeria, the finance environment encourages reckless lending practices with interest free loans, removal of personal contribution requirements for loans, and other governmental directives to encourage lending in a difficult and volatile market segment. In most countries central banks do not want, or do not have, the capacity to monitor non-banking institutions and MFIs.

Among the key policy-related issues and challenges that MFIs in the MENA region face, are the need to introduce microfinance-specific laws and regulatory frameworks to support the commercialization of the sector, as well as the need to clarify the transformation process for MFIs to transform themselves into for-profit institutions. Another point of discussion for the MFI sector is the monitoring and supervision of the microfinance market. There are no laws or institutions that protect the interests of the small clients, and government agencies do not have the capacity to supervise the operations of the microfinance providers.

With the steadily increasing outreach, a new challenge is emerging as well – namely, that of credit information sharing. As competition surges, MFIs are increasingly experiencing that their clients are simultaneously borrowing from other sources. In several countries, new credit information systems are under development as a means to mitigate risk, and improve the maintenance and quality of portfolios. In Morocco and Palestine these credit information systems are public, and are hosted in, and managed by, central banks, whereas in Egypt, the credit agency is a private sector initiative.

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[38] The Aga Khan First Microfinance Institution Syria (FMFI-S) is the first and only regulated MFI in the country. In 2010, FMFI-S had a deposit portfolio of USD 3.6 million, compared to USD 144,000 in 2009. In 2010, the loan portfolio had reached USD 21.3 million.

Nevertheless, what they have in common is that in all three countries MFIs are included in these credit information-reporting schemes and, thus, have to report to the credit bureaus.

In order to meet the above-mentioned challenges, a well-developed regulatory framework and a strong support structure for the MFIs in the region is important. Therefore, it is encouraging that ambitious initiatives are being seen in some countries. In the West Bank/Gaza Strip, for instance, a presidential decree recently set the course for standard monitoring of the microfinance sector by the Palestinian Monetary Authority. Jordan adopted a microfinance strategy providing comprehensive legislative reforms, while in Egypt a bill to that effect was introduced to Parliament, even before the Arab Spring.

Box 12: Initiatives to improve the enabling environment for microfinance

The promotion of the regulatory and institutional framework of the microfinance sector lies at the core of a new regional initiative of the German Development Cooperation. Based in Cairo, and on behalf of the Federal Ministry for Economic Cooperation and Development (BMZ), the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) recently started this six-year program. Core partners in the first phase will be the Sanabel network, as well as Central banks and supervisory institutions in Jordan, Egypt, and Palestine. The main idea behind the regional dimension of the initiative is to enhance peer-to-peer exchange and promote common standards. The aim is to support the professionalization of the microfinance sector, while broadening the services to be offered.

4.2.3 Venture Capital Financing

A more likely provider for Mesofinance services than the MFI sector appears to be the private equity and venture capital sector. Venture capital financing is a common phenomenon in North America and Europe, and is now prevalent in major emerging markets such as India and China, but it is noticeably underdeveloped in the MENA regions. Venture capital is defined as the provision of long-term equity investment and strategic support by financial investors to innovative, scalable companies at the early growth stage. Key criteria used to further define VC investments include:[39]

- Investments are in non-listed companies (private companies);
- Investment commitment over the lifespan of the deal, 5 to 7 years, is usually between USD 3 to 5 million, but can also reach up to USD 15 million;
- The exit strategy is typically through IPOs, mergers and acquisitions, management buy-outs or trade sales and;
- An above average return is expected.

The main economic segments that are of interest to the VC included IT and software, industrial manufacturing, media and telecom. VC is not confined solely to technology investments, but technology is often a core factor that creates the level of scalability required in a VC deal.

The MENA region has witnessed a 28% growth in the number of VC and SME deals executed between 2010 and 2011. This considerable growth in percentage is partly attributed to the nascent nature of the industry in the region (only USD 300 million was raised by the venture capital industry in MENA in 2010), but it also illustrates the increased attention such investments have received regionally from policymakers and investors.

The potential of the VC sector to show a persistent growth with similar percentages as previously mentioned over a prolonged period of time is limited. This is attributed to the challenges inherent

[39] *Seed/angel or investments by non-financial shareholders do not count as VC.*

in venture capital investing, such as the scarcity of the required technical knowledge and expertise in this field, and the inability of many regional financial institutions to adjust their scope of business, strategic objectives, and human and technical resources, to embrace innovative investment activities. Furthermore, the current juridical environment (or rather the absence of it) makes it unlikely that the sector would become an important factor at the magnitude of Europe, North America or India. It is very difficult for venture capital investors to invest in growth capital in MENA companies to achieve legal rights, which are regarded as standard for similar investments internationally. Many of these rights clash with local law principles that typically apply in the MENA region -- some of which are based on Shariah law[40]. A VC, or other growth investor, typically acquires a minority shareholding, while seeking special rights to protect its minority position and mitigate the inherent risks of investing at an early stage in a high growth company. If growth capital providers are unable to obtain and rely on these rights because they conflict directly with local laws (even where no direct conflict exists, their effectiveness and enforceability are doubtful), then this will inhibit the development of a flourishing VC industry in the MENA region, and the availability of growth capital, more generally.

Box 13: The incomplete enabling environment for VC in Tunisia

In an attempt to promote the development of venture capital firms, or Société d'Investissement à Capital Risque or SICAR, the Tunisian government established a tax exemption law for any VC-SICAR created. Although this resulted in a significant increase in the number of VCs, it did not lead to an increase in the level of equity finance. The main reason for this is that commercial banks established VC companies for the sole purpose of reducing tax payments.

A few major investors from the Gulf area dominate the VC market in the MENA region, but there are also regional and national VC companies that originate from this area. Citadel Capital is based in Egypt and is one of the largest venture firms investing in the MENA region. The firm has raised funds worth more than USD 1.8 billion between 2004, when it was founded, and 2010. EFG-Hermes Private Equity was established in 1999 as the wholly-owned subsidiary of the Egyptian Investment Bank, EFG-Hermes. The firm has a significant presence in the MENA region, and in the past has raised several venture vehicles focused exclusively on the region. EFG-Hermes Private Equity has raised private equity funds totalling USD 1.2 billion over the last decade. Finally, the Riyada Enterprise Development (RED) is the Small and Medium-Sized Enterprise (SME) initiative of the Abraaj Group. RED was established in 2009 as an independent platform dedicated exclusively to the SME segment, with a focus on providing long-term capital to high growth, entrepreneurially led businesses. With its capital base of USD 500 million, RED is designed to provide growth capital to an under-served market in the MENA and South Asian regions. Riyada invests in businesses that are proven and have a core management team with the desire and capability to expand their business. The RED fund also provides capital to early-stage enterprises, particularly in the technology and media segments.

In several countries governments, with the support of international finance institutions, have set up state-owned venture capital suppliers. The Government of Jordan, for example, operates two venture capital schemes, managed by JEDCO, the Capital for Growth Fund and the Early Stage Fund. Both funds are developed in close coordination with the EIB. In 2011, the SANAD Fund for MSME was established in Lebanon by the KfW, with the financial support of the German Federal Ministry for Economic Cooperation and Development – BMZ, and by the European Union. SANAD provides medium and long-term loans, guarantees, and equity financing to commercial banks, microfinance institutions, and other financial institutions across the region.

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[40] *One example is the typical investor right for preferential equity terms. Most MENA local law jurisdictions do not allow for different share classes, and the issuance of shares with different economic rights conflicts with local and Shariah law principles.*

5 Mapping Gaps in Mesofinance

5.1 Efforts to Map the Quantitative Finance Gap

Enterprise-level surveys conducted by the World Bank and IFC suggest that small and medium-sized businesses are particularly financially constrained in the MENA countries. These surveys show that only 20% of SME businesses have a loan or line of credit with a formal financial institution, a lower percentage than any other region, and only 10% of their investment expenditures are financed by a bank loan -- a percentage that is higher only in Sub-Saharan Africa. This has led to claims of a "*Mesofinance gap*". A *"financing gap"* for small businesses is defined as a significant number of small businesses that could use funds productively if they were available, but cannot obtain finance from the formal financial system. The IFC has estimated that the SME funding gap in the region is between USD 160 and 170 billion[41]. This is the only study known by the authors that tries to quantify the financing gap in the MENA region. Therefore, it is uncertain how accurate this estimate is, and to what extent this amount should guide governments and international finance institutions in their effort to narrow this gap. The details on how the World Bank/IFC arrived at this figure, and which definitions they have used, are not known. What puts the amount into question is that the statistics on the number of small and medium-sized businesses in each MENA country are unreliable. There are considerable differences in the definitions of the SME sector across banks and countries, and, therefore, there is a substantial measurement error that must be taken into account when numbers for SMEs emerge -- this is the basis on which the SME financing gap is calculated. Further, many small businesses operate in the informal sector, which could indicate that the figure is too small.

Nevertheless, many small businesses may not want to take a bank loan, either because of the risks and nature of their business, or because they feel that the type of financial services offered are not appropriate for them. Some small entrepreneurs do not want to take a bank loan simply because they are satisfied with the business, and do not want to grow any further. Part of the so-called "*SME finance gap*" can also be covered by informal sources or own capital, and even lead to circumstances where the small entrepreneurs in the SME sector would want to turn down the loan offers made by banks (see Table 11).

Table 11: Funding composition of small enterprises by economic sector in Tunisia

Activity sector	Industry	Services	Others	Average
Self-financing	52.0%	52.0%	48.0%	50.6%
Banking credit	23.0%	11.0%	24.0%	19.3%
Leasing	11.0%	15.0%	13.0%	13.0%
SICAR/Venture Capital	1.0%	2.0%	1.0%	1.4%
Financial market	1.0%	2.0%	3.0%	2.0%
Others	12.0%	18.0%	11.0%	13.7%
TOTAL	100%	100%	100%	100%

Source: FEMISE Research Program N°34-09: Enquêtes de conjoncture auprès des PME – PMI en Tunisie 2011.

Banks may also have legitimate reasons why they deny the SME sector access to loans. A substantial portion of the SME sector may not have the security required for conventional

[41] *"Scaling-up SME access to financial services in the developing world", IFC 2010.*

collateral-based bank lending, or high enough returns to attract formal venture capitalists and other risk investors. In addition, markets may be characterized by deficient information, limiting the effectiveness of financial statement-based lending and credit scoring. These are arguments that explain why the SME finance market is not properly functioning, but do not explain why or even whether there is an SME financing gap.

The domestic financial market may contain an incomplete range of financial products and services, and the lack of appropriate financing mechanisms could stem from a variety of reasons, such as regulatory rigidities or gaps in the legal framework. Moreover, development economists increasingly accept the proposition that due to monitoring difficulties such as principal-agent problems (among others related to the shareholder-manager relationship) and asymmetric information, suppliers of financing may logically choose to offer an array of financial services that leave significant numbers of potential borrowers without access to credit. Such credit rationing is said to occur if:

i) Among loan applicants who appear to be identical, some receive credit while others do not; or

ii) There are identifiable groups in the population that are unable to obtain credit at any price[42].

It is not known whether the World Bank/IFC study has applied this operational definition to calculate the SME financing gap.

It could also be argued that there is no evidence of any significant structural barriers to the supply of bank or private equity finance to suitable SME applicants on mutually satisfactory terms and conditions. It may be postulated, for instance, that the main obstacles to funding appear to be on the demand side, rather than the supply side of the business finance market. This is mainly in the form of:

- Lack of satisfactory business plans, accounting and other information;
- Inadequate assets for use as security;
- Insufficient levels of profitability, gearing, liquidity, stability, and other business-financial performance criteria on the part of funding applicants.

Due to their inherent monitoring problems, small businesses will be at a particularly severe disadvantage relative to larger and more established firms, particularly with regard to government bonds. Their difficulty in obtaining financing will be compounded when the business environment lacks transparency, when the legal system is weak, and when monopolies are present. Moreover, banks may avoid providing financing to certain types of small businesses, such as start-ups and very young firms that typically lack sufficient collateral, or firms whose activities offer the possibility of high returns, but in combination with a substantial risk of loss. These developments explain why the SME finance market operates poorly, but do not necessarily indicate that there is an SME financing gap.

The following table is a summarized overview of major constraints to mesofinance throughout FEMIP countries by policy area.

[42] *"The SME Financing Gap: Volume 1 Theory and Evidence", OECD Publishing, 2006.*

Table 12: Overview of constraints to Mesofinance by country

	Algeria	Egypt	Gaza/West Bank	Jordan	Lebanon	Libya	Morocco	Syria	Tunisia
Ease of doing business (1)	High 152	High 109	High 135	High 106	High 115	-	Moderate 97	High 144	Moderate 50
Regulation quality/implementation (2)	Moderate 44th percentile	Moderate 44th percentile	Moderate 38th percentile	Low 69th percentile	Moderate 44th percentile	High 19th percentile	Moderate 50th percentile	High 31st percentile	Low 69th percentile
Control of corruption (3)	Moderate 50th percentile	Moderate 38th percentile	High 25th percentile	Moderate 63rd percentile	Moderate 38th percentile	High 25th percentile	Moderate 50th percentile	Moderate 38th percentile	Moderate 50th percentile
Getting credit (4)	High 129	Moderate 83	High 159	High 167	High 104	-	High 104	High 176	High 104
% aged 15+ with loan in past year (5)	High 1%	High 4%	High 4%	High 4%	Low 11%	-	High 4%	Low 11%	High 3%
% employment in the public sector (6)	High 34.4%	High 27%	-		Low 16%	-	Low 11%	High 28%	Moderate 22%
Constraining labor market regulations (7)	High	High	High	Moderate	Moderate	High	High	Moderate	High
% of firms reporting skills as a constraint to business growth (8)	High 36.8% (2007)	High 50.1% (2008)	Moderate 25% (2006)	High 32.6% (2006)	High 55.5% (2009)	-	High 30.1% (2007)	High 59.6 (2009)	Moderate

Source: adapted from R. Gatti et al.(2013) "Jobs for Shared Prosperity, Time for Action in the Middle East and North Africa", The World Bank, April 2013

Notes: Rankings : red = high ; orange = moderate; green = low. The notes below show the data sources and threshold levels of the business environment, labor market, and skills constraints in respective countries.

(1) *Ease of doing business ranking.* Source: Doing Business 2013, 10th Edition (World Bank). Thresholds are set as follows: 1 – 49 = low; 50 – 100 = moderate; > 100 = high. Libya does not feature among the 185 economies in the *Doing Business* rankings.

(2) *Regulation quality indicator.* Source: World Governance Indicators (2011). Thresholds: bottom 33

percentiles = high; 33 – 66 percentile = moderate; 67+ percentile = low constraint.

(3) *Control of corruption indicator*. Source: World Governance Indicators (2010). Thresholds: bottom 33 percentiles = high; 33 – 66 percentile = moderate; 67+ percentile = low constraint.

(4) *Getting credit ranking*. Source: Doing Business 2013 (World Bank). This indicator assesses the institutions, regulations, and financial infrastructure in place to enable credit. Thresholds are set as follows: 1 – 49 = low; 50 – 100 = moderate; > 100 = high.

(5) *% aged 15+ with loan in past year*. Source: Global Findex (2011). Thresholds are set as follows: 0 – 50% of world average = high constraint; 50 – 100% of world average = medium constraint; above world average = low constraint. World average (2011) = 9%[43].

(6) *Percentage of employment in the public sector*. Source: ILO Labor Force Surveys (Algeria: National Office of Statistics (2010 data), Egypt Statistical Year 2012; . Public sector includes only employees in public administration. Thresholds: under 20% = low; 20 – 25% = moderate; over 25% = high.

(7) *Labor market regulations*. Authors' estimates based on legislation analysis.

(8) *Skills constraints*. Percentage of firms identifying an inadequately educated workforce as a major constraint, from Investment Climate Assessment Surveys (2005 – 2010). Thresholds: under 25% = low; 25 – 35% = moderate; over 35% = high.

5.2 Explaining Mesofinance Gaps from the Point of View of the Suppliers

Commercial, and government-owned, banks in the MENA region see the financing of the SME sector as a promising market segment, especially when their core business and market become saturated. Traditionally, commercial banks would fund government deficits (investments in government bonds and securities), as well as large cooperate enterprises with whom they have dealt with over extended periods of time. Occasionally banks may have ownership and other ties to industrial interests and, thus, tend to favour affiliated companies. However, high returns in these traditional markets are of the past. This market has become smaller, while at the same time an increasing number of other financial institutions have entered this market segment as well. The increased competition in their traditional core market has convinced commercial banks to look for new and promising markets, of which the SME sector is one. Nevertheless, Mesofinance is still in competition with other profitable investments that either have higher returns, lower risks, or require less appraisal efforts than SME financing. Large parts of the banks' assets are still in government bonds and corporate finance, while consumer finance backed by salaries competes with SME loans. Therefore, for many commercial banks, the SME market is still not very interesting. For some banks this is not an area where they were active in the past, and it will not be part of their core business in the immediate future. Board and senior managements of these commercial banks see SME financing as somewhat outside their comfort zones.

For other banks that might be interested in Mesofinance, the concern for the quality of their portfolio makes it difficult to expand to new market frontiers. A history of substandard lending has left many government-owned banks with weak balance sheets. Significant shares of total credit were often allocated on the basis of government guarantees, or under special programs to support targeted sectors. In the past, banks were also subjected to interest rate ceilings that made it difficult to price credit to SMEs, in order to fully reflect the inherent risk of lending to SMEs [44]. The supervision of the central bank was weak, but in many countries, the authorities have been reluctant to allow banks (government-owned as well as private) to fail, and, therefore, the banking

[43] *Methodology available at: http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/EXTPROGRAMS/EXTFINRES/EXTGLOBALFIN/0,,contentMDK:23172731~pagePK:64168182~piPK:64168060~theSitePK:8519639,00.html#home*

[44] *This is still the case in Tunisia.*

system was supported by implicit or explicit government guarantees. These guarantees have provoked moral hazard. Under SME financing this is not always the case, but the effects of this history are still felt in present day banking options, procedures and operations.

State-owned banks in the MENA region play an important role in providing finance to the SME sector. This largely reflects the perceived gaps in Mesofinance by their owners (i.e. national governments), and their mandates in this area. Government-owned banks also seem to be taking greater risks than private banks in their SME lending business. They are less selective in their strategies to target the SME sector, have a lower ratio of collateralized loans to small entrepreneurs, and a higher share of investment lending in total SME lending. Moreover, they also seem to have less developed SME lending technologies and risk management systems. Only a few state banks have dedicated SME units, make use of credit scoring, and conduct stress tests. Therefore, it is not surprising that the internal procedures produce low quality SME portfolios, which in turn has sent a message to other commercial banks.

Box 13: The opaque role of government-owned banks in SME finance

Government-owned banks traditionally financed other state-owned enterprises (SOEs), but in the process of privatization of these SOEs, and because of restructuring state banks, the SOE portfolio reduced (was often written off), or otherwise became less important. Instead, the government gave these state banks new mandates, of which one was financing the SME sector. Governments often influenced, and sometimes determined, the conditions of SME loans, as they had previously done with lending to the SOE sector (e.g. collateral requirements, ceiling on interest rates, etc.). Not only did this partially carve out the SME lending opportunities of commercial banks, but state banks built up a problematic SME portfolio as well, which deterred commercial banks from entering this market sector. Occasionally, commercial banks seemed to believe that SME lending was the mandate of state banks, and continued to amalgamate SMEs with the poorer population, who were traditionally served by the microfinance sector or specialized government banks.

Macroeconomic instability is another key external obstacle to SME lending. There are a number of rigidities of a macroeconomic, institutional and regulatory nature that bias the entire banking system against lending to SMEs. Until recently (and in some cases this is still the case) macroeconomic policies favoured industrialization and/or import substitution, which effectively gave large domestic firms privileged access to finance.

The attraction of alternative investment opportunities and stiff competition in Mesofinance by government-owned banks, explains why only a few banks have established dedicated SME departments. Many commercial banks simply do not have incentives to change their internal procedures to be more aligned with the realities of the SME sector on the ground. Consequently, banks do not differentiate their appraisal and loan procedures between large corporate lending, and lending to the SME sector. Most banks prefer to rely primarily on collateral-based lending rather than on creditworthiness. As such, most small enterprises do not meet the required collateral and guarantee requirements of the banking industry, leaving creditworthy small businesses unfinanced.

The above does not imply that all commercial banks have turned away from the SME finance market, however, building up an SME portfolio is expensive and takes time. In particular, banks where SME finance is supported by the Board of Directors and top management see a serious effort venturing into this market segment. There are, however, several internal and external challenges for these banks, which makes lending to the sector difficult. One of the most obvious internal challenges is that these banks do not have internal risk assessment tools dedicated to the SME sector, and, in general, lack expertise in addressing the financial needs of small entrepreneurs. Bank employees lack the technical capacities to assess SME lending risks, while the financial institutions lack lending technologies that would reduce the cost of lending to this segment.

Another internal challenge is that, traditionally, loan decisions are highly centralized, preventing banks from learning more about the SME sector. Highly centralized banks have more difficulties introducing and using alternative lending procedures, and developing new financial products more geared toward the SME sector. It complicates the process of "*SME relationship lending*[45]", which is based on close contacts between lender and borrower.

Commercial banks that are engaged in Mesofinance, or that want to venture into this market, need to find answers to address the information asymmetry. Banks complain that small entrepreneurs lack basic accounting skills, and are unable to provide the required documentations such as (audited) financial statements or offer a credit history to secure their loan[46]. Banks also complain about the lack of *reliable* information on the small businesses, which includes the difficulty in obtaining proper credit information -- many small businesses, for instance, are informally financed by friends, relatives and other informal sources without proper documentation. Also, information on the market conditions of the small businesses, contractual arrangements with buyers and suppliers, and governance issues are hard to obtain. Banks have to look for alternative ways to overcome the information asymmetry,[47] and to address this several banks in the region use internal rating systems or scoring models for SME lending. However, banks often use outdated techniques that do not effectively help in risk management or in lowering costs. Further, banks use the aforementioned SME relationship lending approach to learn more about the small businesses through monitoring the use of different financial products (savings, payment services, overdraft facilities and trade finance).

The legal and contractual environment is an important obstacle for banks going into SME lending. The legal system does not provide adequate protection for the rights of creditors, and is relatively inefficient in resolving cases of delinquent payments and bankruptcy. The MENA region has the lowest legal rights index among all other regions. The penal system, in cases of default on loans, fosters a lack of responsibility on the part of the borrower (dole out mentality). Banks feel that the enforcement of basic contractual rights is cumbersome, time consuming and costly. Loan disputes can take several years to resolve, causing banks to choose to write off loans rather than pursue compensation. This has tainted the image of small entrepreneurs, especially in the retail sector, and encouraged the entrenchment of a system based on collateral guarantees – moreover, it represents a significant disincentive for banks when lending to the SME sector.

Due to a lack of legal and fiscal framework, commercial banks cannot provide alternative forms of financing (leasing, receivables, etc.). Additionally, the tax and regulatory framework may encourage small businesses to operate opaquely (e.g. double bookkeeping). Further, while the credit information index has improved in recent years, the coverage of credit agency reporting systems and, thus, the quality of the information is still very limited.

A study published in 2010 by the World Bank reveals that although greatly improving in the last few years, the credit reporting industry in MENA remains still underdeveloped, mainly embodied by Public Credit Registries, and with many relevant areas for improvement. According to the author of the World Bank study, a range of difficulties are still preventing a faster development. These include i) a generally lax, non-specific, or absent legal framework; ii), the limited availability of

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[45] *The core element of relationship lending is that the bank builds a relationship with clients through the offering of multiple financial products, and over time obtains costly, proprietary information on the borrowing clients that remain confidential. Relationship lending, thus, exists if the client has close ties to a financial institution.*

[46] *SME business owners usually lack technical support in the areas of cash flow management, financial reporting, and strategic business development.*

[47] *There is a lack of disclosure and transparency from both SMEs and financial institutions.*

positive credit data from non-regulated entities; iii) the lenders' reluctance to share data as a result of the low awareness about information sharing benefits; iv) a technological divide between different lending sectors (e.g. banks and MFIs); vi) the limitations concerning data quality/quantity (e.g. thresholds) in many of the public credit registries operated for supervisory purposes; vii) the limited availability of public data and National Identification Numbers and viii) the still scarce presence of Private Credit Bureaus.

The development of modern credit reporting systems can support financial development in MENA. Credit reporting systems are essential to facilitate financial intermediation and widen the scope of financial services. In particular, effective credit reporting can help by:

- Increasing the availability of financial services and expanding access to credit
- Supporting the growth of micro-small-medium enterprises (MSMEs)
- Mitigating risks of reckless lending practices and decreasing NPLs
- Improving borrower's repayment behaviour and deducing over-indebtedness
- Replacing collateral needs with "reputational collateral" in small ticket lending
- Decreasing the overall cost of credit
- Tailoring interest rates according to different individual risk profiles

The establishment of public credit bureaus (PCB) is quite a recent phenomenon in the region; indeed two out of ten FEMIP countries have developed their PCBs only in the past five years (Morocco, Egypt). The Central Bank of Jordan is in the process of establishing and regulating the first PCB, expected to start operating early 2014. The majority of FEMIP countries still rely entirely on PCRs, a higher percentage than those in all other regions; except for Sub-Saharan Africa (see also table 13 below).

Table 13: Public Credit Registries and Private Credit Bureaus in MPCs

	Algeria	Egypt	Gaza/West Bank	Jordan	Lebanon	Libya	Morocco	Syria	Tunisia
Private Credit Bureau							X		
Public Credit Registry	X		X	X	X			X	X
Both		X							

Source: The Status of Information Sharing and Credit Reporting Infrastructure in the Middle East and North Africa Region (2010), World Bank

Despite these challenges, over the years banks in the MPCs have built up an SME portfolio and, subsequently, experience in SME lending. Their SME portfolio has grown, although not as quickly as they projected suggesting a significant scope for further SME lending in the MENA region, as shown by the large differences between the long-term SME lending targets (about 27% of the total lending) and the actual shares of SME lending reported by the banks (approximately 13%). Notably, a survey of the World Bank and the Union of Arab Bank showed that banks with experience in SME lending complain less about restrictive regulations (e.g. interest rate controls), excessive competition in the SME segment, or weak demand for loans from small entrepreneurs. In addition, a number of state banks indicated that their own internal technical weaknesses constitute an obstacle to SME lending[48].

Box 14: The importance of collateral in SME lending

Most banks impose high collateral requirements on the SME sector, often more than 100% of the loan value. This reflects the higher perception among banks of risks in the SME business. The most frequently mentioned reasons for the higher collateral are the lack of stability, incompetent management within the SME sector, and difficulties in appraising and evaluating small businesses. Fewer state banks impose higher collateral requirements on SMEs than private banks. This difference persists despite the fact that more often state banks criticize the lack of SME stability, and the difficulty in evaluating SMEs, than private banks. This result, again, reveals that state banks are willing to take higher risks and be exposed to larger losses, relative to private banks, in order to fulfil their mandates.

Banks further reported that there are significant problems in the registration, enforcement, and selling of collateral -- especially movable collateral. While a relatively low number of banks reported serious problems with the registration of fixed collateral, most banks reported that registries of movables remained very deficient. Enforcement of collateral is a major issue for movables, in particular, as well as for fixed collateral. An even greater number of banks reported problems in selling the seized collateral. These responses reveal that banks perceive high risks in SME lending that can only be partially offset through greater reliance on relationship lending, or through the use of other lending techniques such as leasing and factoring, or even through access to a guarantee scheme.

[48] *"The Status of Bank Lending to SMEs in the Middle East and North Africa Region: Results of a Joint Survey of the Union of Arab Bank and the World Bank" by Roberto Rocha; Subika Farazi; Rania Khouri and Douglas Pearce, 2011.*

6 Mapping Initiatives to Reduce Gaps in Mesofinance

6.1 Introduction

The MPCs are rich and inventive when it comes to initiatives to reduce gaps in Mesofinance. These initiatives tackle the gaps from both the supply side and the demand side. Examples to improve access to SME finance are, among others, direct government lending programs, refinancing facilities, and credit guarantee schemes. Additionally, special circulars from central banks are expected to improve the supply side of Mesofinance services.

Initiatives to improve the demand side are the numerous government-initiated technical assistance programs that target small businesses -- assistance given by small business advisory providers and business incubators. While these initiatives do not directly improve the demand side for SME finance services, they could better prepare the small entrepreneurs to become potential bank clients.

The impact of these initiatives can only be assessed to the extent that they address the underlying issues that hamper a smooth functioning of the Mesofinance space. Further, the impact (or the lack thereof) can only be understood through the role that governments play in the domestic financial market, and in creating an enabling environment for small businesses.

6.2 Direct Lending Programs

Despite reforms in the banking sector, state-owned banks are still dominant in several MPCs. Government banks play a dominant role in Algeria, Libya, and Syria, where they hold more than 50% of the total assets. In Egypt, Jordan, Morocco, and Tunisia, government banks no longer lead in terms of total assets, but still hold significant shares varying from 25 to 50% of total assets[49].

State banks tend to have large branch networks, and can provide essential financial services in remote areas where access to finance is constrained by large fixed costs. Government banks can also address market failures resulting from asymmetric information and poor enforcement of contracts that ultimately restrict access to finance in key areas, such as SME finance.

Therefore, there is a justification for the presence of government-owned banks. In particular, the weak financial infrastructure in the region (e.g. weak credit reporting systems, weak creditor rights) is a major factor hindering access to SME finance, and provides a rationale for policy interventions, including the use of government-owned banks. Ideally, these institutional and legal weaknesses should be addressed first, however, it takes time to correct these deficiencies. Until then, and during this period, government banks can make a contribution to access Mesofinance.

As sole owners, governments determine the SME mandate, including the priorities of lending sectors and conditions of the loan. Lending procedures and conditions usually differ from those of other commercial banks. Furthermore, they take more risks than private banks. Government banks are less selective in their strategies to target the SME sector, have a lower ratio of collateralized loans to the SME sector, and a higher share of investment loans in total SME lending. As a result of these more relaxed procedures and operations, government banks carve out the SME lending opportunities of other commercial banks.

By contrast, government-owned banks do not seem to have the capacity to manage the associated SME lending risks[50]. This lack of risk management capacity has contributed to the poor financial

[49] *In Morocco, only 15% of total assets are held by majority state-owned banks, and in Jordan there are no state-owned banks.*

[50] *See previous chapter, which highlights that only few government-owned banks have dedicated SME units, make use of credit scoring, and conduct stress tests.*

results of these banks, including higher non-performing loans (NPLs), higher levels of loan loss provisioning, and, ultimately, lower profitability.

Therefore, state bank interventions in the SME finance arena come with a significant cost. These banks are not very profitable and sometimes operate with a loss due to, *inter alia,* excessive employment, higher costs, and lower asset quality. The "profitability" of state banks may actually be inflated by interest accrual on NPLs, and under-provisioning.

In conclusion, the effectiveness of fulfilling the SME mandate by MPCs' state banks has been mixed. Regarding SME finance, there is evidence that state banks have contributed to accessing this important area, although they do not appear to have developed the capacity to manage the associated risks.

6.3 Credit Guarantee Schemes

One popular distinctive approach in the MPCs to overcome the SME financing gap is the establishment of credit guarantee schemes. It broadens the *collateral-based approach* and encourages bank lenders to finance small businesses with insufficient collateral. The guarantees should help offset the bank's (traditional) collateral requirements, while an external agency provides a partial guarantee of the loan exposures. This third party is often a government agency with support from international development agencies or International Finance Institutions. However, private institutions such as US Overseas Private Investment Corporation (OPIC) have also been active in promoting and participating in credit guarantee schemes.

Box 15: Kafalat: the largest guarantee scheme in the Middle East

The Lebanese Kafalat scheme is the largest SME credit guarantee scheme in the Middle East and North Africa Region, and provides a relevant example of a privately-owned scheme that has generated reasonable outcomes. It has a good outreach, has generated positive returns on equity for the past several years, and has retained and reinvested all of its profits in newly issued guarantees. Kafalat loans are provided at subsidized interest rates, financed by the Lebanese treasury, and administered by the Central Bank of Lebanon. In 2006, Kafalat signed a partnership with the European Union and the Ministry of Economy and Trade of Lebanon (MoET) to increase the amount and size of the loan guarantees beyond the level offered until 2005. Banks that will lend to SMEs based on the Kafalat loan guarantees developed under this partnership will be required not to impose any collateral requirements on top of the guarantee from Kafalat. In April 2010, projects guaranteed under the Kafalat "Plus" scheme reached a total number of 474, the total loans amount was LBP 214,092,369,480, and the average loan amount was LBP 451,671,665. The distribution of loans per sector is as follows: Industry 61.5%, Tourism 23.4%, Agriculture 8.2%, New Technologies 5.9%, and Handcrafts 1%.

Source: http://www.kafalat.com.lb

Egypt has five agencies that offer credit guarantee services to banks to hedge their SME portfolio. Three public sector banks have established the largest credit guarantee scheme, with minority participation from other private banks. Further, the Tunisian Government set up a partial credit guarantee scheme (2003), which co-guarantees SME loans up to USD 2.5 million, and can have a maturity of up to 15 years. In particular, start-ups and small entrepreneurs operating in the manufacturing sector, and sometimes in the services sector, are eligible. The coverage of the guarantee scheme is between 60-75%. Algeria has several guarantee funds aimed at mitigating the risks of commercial bank loans, and boosting their SME portfolio.

In a period when these countries are still addressing their weaknesses in financial infrastructure, there is some evidence that these schemes have contributed to more SME lending.

Nevertheless, these results do not necessarily imply that these guarantee schemes are cost-effective, additional, or promote good practice SME lending (i.e. moral hazard by banks). It is unclear whether they are able to target and reach the maximum number of credit constrained SMEs with the volume of guarantees offered (cost-effectiveness measured in terms of leverage), or whether banks use the guarantees to extend loans to start-up or smaller SMEs (additionally).

In some MPCs, commercial banks hardly participate and/or use credit guarantee schemes. In Egypt, for instance, the update has been unsatisfactory, as commercial banks fear that their borrowers will not honour their debt obligations when they know that the default is being guaranteed through such a scheme (moral hazard). In Tunisia, the impact has been limited, and the associated risks have not been properly identified and provisioned for. Finally, in Algeria, credit guarantee schemes have been mostly utilized by government-owned banks, with private banks accounting for only 2% of the use of guarantee funds.

Moreover, some argue that, often, these schemes are contrary to basic free market principles, and tend to be unsustainable. Saadani, Arvai and Rocha (2010) provide a preliminary assessment of credit guarantee schemes in the MENA region, and argue that there is scope for design improvements leading to gains in cost-effectiveness and improved outreach. In their 2011 review of the design of partial credit guarantee schemes in MENA, Saadani *et al.* recommend that guarantee schemes could play a more proactive role in capacity building. The low share of SME lending in some MENA countries may be due not only to weak financial infrastructure but also to weak lending technologies. In these cases, according to the authors, the partial credit guarantee schemes can play a fundamental role in jumpstarting SME lending while also improving risk management practices of domestic banks. Finally, guarantee schemes should institutionalize a comprehensive review process. In order to ensure cost-effectiveness, MENA guarantee scheme should conduct systematic assessments of outreach, additionality, and customer satisfaction (bankers and borrowers). This comprehensive review should be conducted in a regular basis using appropriate analytical tools, including an SME survey and a banking survey argue Saadani and Rocha.

Box 16: Overcoming collateral constraints through the viability-based approach to lending

A new approach to improve access of Mesofinance in Europe and America has been called "*the viability-based approach*". A common aim or feature of the viability-based approach is the provision of appropriate finance that is tailored to the cash flows of the SME (i.e. cash flow lending). Since the viability-based approach is concerned with the business itself, the aim has been to provide better general business development assistance to reduce risk and increase returns. This often entails a detailed review, and assistance with the business plan.

In the past, a significant obstacle to applying this approach has been getting the information required to assess viability, plus the costs of transferring and providing business development assistance. However, in more recent years, improved information and communications technology have made the process easier and more affordable. As technology and information sharing continue to improve, the approach could become significantly more cost-effective and attractive. Some investors have promoted this approach as a means of achieving wider social benefits, while others have been interested in developing it largely to generate better financial-economic returns for shareholders, investors, employees, and clients.

6.4 Circulars from, and Actions of, Central Banks

Central banks have issued circulars to entice commercial banks to venture into SME lending. One popular circular is that commercial banks are allowed to release 100% of the balance of the credit facilities granted to the SMEs from the required reserve amount, provided certain criteria on either the SME sector or loan conditions are met (Jordan, Egypt). In Tunisia, the central bank has issued a circular, allowing banks to reschedule loans due from companies hurt by the political turmoil of 2011. A positive initiative in Jordan has been the one of the central bank setting a standard definition for the SME sector, which all commercial banks need to adopt. Other central banks have continued to inject much needed liquidity in the banking sector, and kept policy interest rates steady.

In terms of improving the enabling Mesofinance environment, the Central Bank of Egypt has established a specific SME unit in the Egyptian Banking Institute (EBI) to perform specialized trainings for the banks and SMEs. The central bank has recognized that the current compliance lending rules and regulations do not accommodate SME lending, and is presently working on proper SME lending regulations and SME risk management principles. The CBE is also considering the idea of having a specialized SME bank.

The impact of these measures is difficult to assess, but such circulars should always be accompanied by close supervision, especially when these concern a release from the required reserve amounts and the rescheduling of loans. It is precisely in these areas where central banks in the MPCs perform poorly. The central bank in Tunisia falls well short of international best practices. The supervision has been hampered by weak capacity and outdated practices – i.e. does not require banks to apply international best practices for loss reporting, collateral valuation and classification, and provisioning of non-performing loans - NPLs.

Moreover, such circulars are issued in an environment where past bank reforms were haphazard, incomplete, and produced little results in terms of making the banking sector financially healthy or easing Mesofinance access. Structural balance sheet weaknesses continued to constrain the availability of finance for SMEs.

6.5 Non-Financial Support to Small Businesses

Non-financial services help small businesses enhance their competiveness in the market through technical assistance and management training. In Morocco, many non-financial services dedicated to the SME sector are related to entrepreneurship training, capacity building, technical assistance, value chain development, market assessment, etc. These services help SME entrepreneurs to better understand their own activities and environment in terms of competition and regulation, and their strengths and weaknesses. Such initiatives have spread throughout the MENA region. Interventions do not directly narrow the Mesofinance gap, but if small businesses are better managed and better know their market, as well as their strengths and weaknesses, they indirectly contribute to bridging the gap.

Non-financial services come through special government programs, often supported by international donors, but are also provided by local business development service centres or through business incubators. Government or semi-government agencies provide most of the non-financial services to the SME sector. The market for private initiatives is very difficult, with most small entrepreneurs unwilling to pay for the services – or perhaps because the market is spoiled by the free training and consultancy services that are offered by government agencies, and supported by international donors.

The region has hosted a wide variety of non-financial service measures, but the merit of all these initiatives is curtailed by the lack of coordination and agreement on definitions, policies and strategies. Much effort is, therefore, wasted as overlaps and duplications are often found in these initiatives; contradictions in SME objectives can sometimes be observed. This has substantially reduced the opportunity to develop synergies and complementarities between different programs and projects, as well as between institutions and agencies. Not only is there an overlap between different government entities, resulting in an inefficient use of resources, but there is also a substantial overlap in activities when it comes to donor and foreign aid support.

Further, there is an on-going debate on the quality of these non-financial services. One complaint is that donor supported projects tend to import ready-made models based on realities in developed countries, and are of little relevance to the SME sector in the MPCs. In Tunisia, these efforts focus only on the pre-creation phase of the enterprise cycle, and the would-be small entrepreneurs are pampered, with little equity -- beyond time spent on the training -- coming from their end. This approach results in little ownership, and opportunistic behaviour of the trainees. Furthermore, the range of consultancy services available in the market is limited, and its growth has been largely dependent, in number and variety, on the availability of funded business development service (BDS) programs. The technical skills and know-how available locally are especially limited in the areas of applied, strategic, and operational management. Typically, they do not offer financial literacy training, cash flow management challenges and financial engineering, or, at best, give these topics minor attention. Many government-led initiatives lack the resources, both financial and non-financial, to be efficient or have a significant impact on raising the capacities of the small businesses. In Egypt, small entrepreneurs do not feel that these services make a difference or are attuned to their needs.

6.6 Shortcomings and Lessons Learned

The different interventions to reduce the Mesofinance gap have produced mixed results, to say the least, whether these concern the supply side or the demand side. One of the more important reasons for this weak impact is that each of these interventions are introduced in relative isolation from the bigger picture of why the Mesofinance market is poorly operating. Table 12 lists the challenges from the banking side and from the side of the small businesses. The interventions listed do not touch upon the underlying reasons, and assume that other interventions will solve these, or even ignore that these are issues that need to be dealt with upfront, during the conceptual phase. Studies from the World Bank have shown that within an overall environment of weak financial infrastructure, countries that were able to strengthen creditor rights, and provide more information to creditors succeeded in inducing more SME lending overall, or more long-term lending to SMEs. Further, in a competitive market, suppliers of finance have powerful incentives to overcome barriers to SME finance. Whether any country experiences a financing gap will ultimately depend on whether the business environment is sufficiently robust to enable borrowers and lenders to interact with confidence on an "arm's length" basis.

Table 14: Why is the Mesofinance market poorly functioning?

From the perspective of the lending institution	From the perspective of the borrowing client
Lack of reliable information on SMEs (information asymmetry)	Difficult land ownership registration (dead capital)
Significant gap between de jure institutional frameworks and their actual implementation and effectiveness	An environment with corruption and political interference
No risk assessment tools dedicated to SMEs available	Bureaucracy and red tape, such as getting approvals, business registration and start-up processes
Limited understanding of demand side of the SME finance (lack of expertise in addressing the financial needs of SMEs)	Low level of financial literacy
No, or poorly operating, credit bureau (a major challenge in developing credit reports, in Egypt for instance, is the relatively small size of the credit markets)	Poor or limited management competencies and practices that lack strategic vision management
No securing of transactions (e.g. there is little	Excessive centralization of management

progress in Egypt on improving secured transactions)	
Loan decisions are highly centralized, making relationship lending and new SME products, procedures more difficult	Lack of corporate governance, particularly a common pattern in many family-owned businesses

Narrowing the Mesofinance gap needs to address a more fundamental issue -- the role of government in creating and supporting an enabling SME environment. However, government policies towards the SME sector and SME finance are full of ambiguities, contradictions, and certainly are not comprehensive. Below are a few salient features and reasons for this:

1. Effective policy formulation is hampered by a lack of specialized knowledge about the SME sector in government departments, a lack of interest in research, and insufficient credible data on the sector. Further, civil servants have vested interest, and corruption is endemic. This, in turn, means that many small entrepreneurs lack confidence in government initiatives.

2. SME policies either seem to suggest a "one size fits all" approach, or target specific sectors while hurting others. In the first case, the SME policy has little impact, as the sector is too diverse, and, thus, many directives and measures are not geared toward the specific conditions and characteristics of the SME segment. In Egypt, for instance, the SME policies focus on the formal sector, whereas most small entrepreneurs operate in the informal sector. Targeted policy tools favour medium-sized, well-established industrial enterprises over younger, smaller ones. In Morocco, the current policies and regulations for business development also seem to favour large companies, creating an even less level playing field with smaller businesses. In Tunisia, conversely, SME policies favour start-ups, while very little support is geared towards enterprises that have been in existence for a number of years and may need support to survive or grow.

3. Often it is difficult to distinguish between SME policies and labour policies. In Tunisia, the aim is to turn all unemployed people into small entrepreneurs, while in other countries the SME sector is being supported because governments see this sector as a panacea for employment problems. However, little is being done to reform the labour market.

4. The institutional setting for SME policy formulation in most MPCs is complex and involves a range of ministries and specialized agencies -- each having their own point of departure (employment; SME support; access to finance), but there is little cooperation and communication among all the stakeholders. There is no common framework and no common definition for the SME sector. This does not simply result in contractions in the SME policies -- SME policies in the region are neither comprehensive, nor integrated, nor encompassing.

Box 17: A dialogue platform in Jordan

The Association of Banks in Jordan (ABJ) and Jordan Enterprise Development Corporation (JEDCO) have signed a Memorandum of Understanding that aims at facilitating access to finance for SMEs, hence, facilitating the development of banks -- SME activities, through the forming of SME Financing Advisory Committee (SMEFAC). The SMEFAC is hosted by the ABJ, and constitutes representatives of banks and relevant partner institutions involved and interested in developing their SME financing activities. The SMEFAC plays the role of a dialogue and advocacy platform between the banking sector and other relevant financial institutions, the SMEs, government officials, regulatory institutions, donors, and non-banking financial institutions; it is aimed at advocating SME financing both within and outside the banking industry.

5. Although the legal framework for privatization in Algeria has been in place since 2001, to date very few of the state-owned enterprises (SOE) have been privatized. Similar privatization developments have occurred in other MENA countries, to varying degrees. These SOEs have a

crowding out effect on private enterprises because of direct competition and superior access to government contracts.

6. Countries pursue a policy to support or create an enabling environment for Mesofinance, while favouring direct lending intervention through government banks. The idea is that direct intervention produces quicker results, as it needs less cooperation from other parties (commercial banks), however, direct intervention, currently, is usually in conflict with the creation of an enabling SME finance environment, in the future. The direct operations of government banks in the market carve out SME investment opportunities for other commercial banks, sending a message that SME finance is only for government financial institutions. In Tunisia, for instance, commercial banks perceive SME funding as the sole responsibility of the government, and in most cases refer their SME clients directly to state financial institutions.

7. Governments play a dual role in the domestic financial market. They compete for funds to finance their deficit and, therefore, leave less capital available for the SME sector.

Consequently, despite all the previously mentioned interventions, the business environment in the MPCs remains unfriendly, and there is still a great deal to improve in the Mesofinance market.

7 Recommendations

7.1 Introduction

The Mesofinance sector accounts for a very high share of private sector employment in the MPCs, particularly in countries with large informal sectors. According to official statistics, SMEs typically account for 10-40% of all employment in MENA. However, given that many businesses operate in the informal sector, employment in this sector is likely to be significantly underestimated in official records.

It is estimated that the total number of small and medium-sized enterprises in MENA is between 19 and 23 million (formal and informal), which is equal to 80-90% of total businesses in most countries. Access to financing is one of the challenges facing this sector, as nearly 63% of small businesses do not have access to bank finance. A recent World Bank/Union of Arab Banks survey of over 130 banks shows that only 8% of lending goes to the SME sector across the region. The total financing gap for the SME sector in the region is estimated at USD 210-240 billion, of which the formal SME financing gap is estimated at USD 160-180 billion[51].

Governments can play an important role in supporting the sector, particularly in cases of market failures or incomplete markets that inhibit the provision of adequate financing, or financing on terms suitable for the SME development. Government measures to promote the SME sector should be carefully focused, aiming at making markets work efficiently, and providing incentives for the private sector to assume an active role in SME finance.

Unfortunately, the implemented reforms to reduce red tape and improve the overall business climate have yielded little success, with arbitrariness and unequal treatment still hindering competition and private sector development. In many Mediterranean Partner Countries, political connections still matter more for success than entrepreneurial capacity. This is one of the reasons that the rates of new firm registration are still low in most countries, and that even when they do get started small firms face barriers to growing into sizable companies.

The Arab Spring highlighted the need for governments to adopt and institute broader and deeper reform policies encompassing education, job creation through investment in infrastructure and entrepreneurship, and the development of a more competitive and participative private sector. The Arab Spring, therefore, is not strictly a threat, but also has the potential to usher in improved governance, greater transparency and a more stable investment environment. This should lead to a more enabling environment for small businesses, and the opening up of financial markets to foreign banks, venture capitals, private equity players, etc., which have traditionally offered limited opportunities to these financial institutions.

Mesofinance in MPCs is restricted by the lack of an enabling environment. Regulations are insufficient, financial infrastructure is inadequate, lending capacity and tools are lacking, the availability of collateral is scarce, SME management skills need to be improved, and financial transparency needs to be encouraged. Banks and financial institutions in the region are also not equipped to offer sustainable and profitable SME banking products. This chapter will highlight recommendations in all of the areas previously mentioned for governments, financial institutions, small businesses and International Finance Institutions (IFI).

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[51] *"Overcoming Constraints to SME Development in MENA Countries and Enhancing Access to Finance", Qamar Saleem, IFC.*

7.2 Recommendations for Governments

In terms of the "ease of doing business" index and the corruption index, MPCs still score poorly. Much needs to be done to improve the business environment, especially for the small and medium-sized enterprises. Components of an improved business environment include: registering property, getting credit and access to facilities, as well as getting access to basic things like electricity. All procedures affecting the SME sector -- from registration to tax payments -- should become more transparent. Governments play an important role in the creation of an enabling environment for the SME sector. The following are some of the recommendations directed at governments.

1. Building reliable data sources for the SME sector and Mesofinance

An effective data collection framework at the national level of the SME sector starts with a commonly accepted standard definition of SMEs -- there are still too many SME definitions in use by different market players, which affect the output quality and the degree of reliability of official market information; it also hinders effective SME policy formulation. In addition, a reliable data source involves a central collection of the supply side data by national statistical and census offices, the central bank/banking supervisors and other financial supervisors, and a survey of the SME sector to identify and quantify underserved SME segments. Demographic data on SMEs by number of employees, turnover, and asset size should be available and help normalize access to data. Computerized business registries would further facilitate the data gathering process, and would serve as an important first step for firms joining the formal sector. Annual business and financial reports can provide important measures over time on the size and trends of the SME sector. A reliable data source for the SME and SME finance helps government policies, strategies and programs. Further, it helps the financial institutions build their credit decision on a solid market information base.

2. Amending current legal and fiscal framework to work in support of SME and SME finance

An enabling juridical and fiscal environment tackles issues such as good regulation on property rights, enforcement of contracts, a lower entry cost into the market, and a good tax system. These can have a significant impact on the development of the economy, and can spur the creation and development of SMEs[52]. These are also measures that can help reduce the size of the informal sector. The current legal and fiscal framework should also be changed to incentivize the commercial banks providing alternative forms of financing to the SME sector (leasing, receivables, discounting, factoring, etc.). By promoting a broader framework for banks to operate in a risk savvy manner with small businesses, there would be greater demand for alternative financial products and services.

3. Formalising the SME sector

Formalizing the SME business creates an equal playing field, and affects the quality and sustainability of the SME development policies. It also distributes benefits equally, and improves the effectiveness of every component of government policy towards the SME sector (taxation, regulations, innovation, labour). To support the formalization, the fiscal regime should not inadvertently place SMEs at a disadvantage.

4. Creating synergies of government intervention, and a coherent policy towards the SME sector

In each of the MENA countries, several ministries are involved and responsible for labour and SME policies. They approach these markets from their respective mandates. Coordination and

[52] *"IFC: scaling-up SME access to financial services in the developing world". 2010.*

cooperation need to be tightened within the current and future legislative frameworks to make operations more efficient, policy planning and formulation more inclusive, and monitoring more effective. It also means harmonizing approaches to policymaking, and coordinating the work of institutions active in implementing policy. This is especially important when it comes to medium-sized enterprises and those with high-growth potential[53]. Currently, SME policies and operations often lack transparency and cohesion, and little quality control or monitoring is done to ensure that they are having the foreseen impact.

Governments need to formulate a coherent policy towards the SME sector, and review all legislation that affects the sector. Moreover, governments can use the output or results of reliable data sources for the SME sector and finance previously mentioned. The formulation of a coherent SME policy should secure the cooperation of other stakeholders (chambers of commerce, employers' federations, small business associations, representatives of the banking industry, NGOs, expert bodies and academia), and a government agency should be made responsible for coordinating communication among them, and monitor how they implement policy.

5. Special support to innovative SMEs and small businesses with potentially high production efficiency levels

This is another operational/strategic recommendation. Special support is particularly important for medium-sized and innovative enterprises, and for those with high-growth and export potential. Improved coordination of technical services for innovative SMEs creates synergies (measured in terms of higher effectiveness and efficiencies) among different support programs. These innovative and growth enterprises would also benefit from developing alternative financing (banks are typically very reluctant to finance innovative enterprises), as well as R&D funds. Governments in the MENA region can draw on the experience of the European Union, where the European Seed Capital Fund encourages the private sector to supply equity[54]. Interviews with entrepreneurs have shown that access to bank credit on appropriate terms and conditions is difficult. The role of governments is to ensure that such credit and surrounding ecosystem are available. In addition, publicly-funded credit agencies, present in most of the MENA countries, should introduce special schemes tailored to the needs of innovative SMEs. As an example, Kafalat, the Lebanese credit guarantee agency has already introduced a facility for high growth and high-tech enterprises (see also Box 15).

Another key element of innovation policy should be to enhance SMEs' technology absorption capacity, and to diffuse and adapt existing and proven technologies and innovative management tools, rather than developing new technologies and tools. In more general terms, there is an urgent need for higher quality capacity building services covering new topics provided to SMEs: these include not only managerial and marketing skills (packing, storing and transportation), measures to improve the business and financial planning, but also help in how to deal with financial institutions, especially banks.

6. Establishing single-window contact points

This is another operational/strategic recommendation. A single-window contact point would be the SMEs' sole ports of call in the regions/provinces/governorates when seeking assistance and information about government support programs. The contact points would identify SMEs' needs, direct them to the right institution or organization, and help entrepreneurs in completing forms. A single online portal site should also be created to offer SMEs a customized information service.

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[53] It is equally important to streamline donor initiatives with the operations of the government's SME strategies and programs.

[54] http://ec.europa.eu/enterprise/policies/finance/risk-capital/start-up-finance/

Box 18: The bundling of all consulting services into a one-stop shop

The Israel Small and Medium Enterprises Authority (ISMEA) is engaged in establishing and supporting the operation of Small Business Development Centres (MATI centres in Hebrew) in several Israeli cities. MATI centres act as a one-stop shop for the business owner or entrepreneur, by providing them a package of services for their own benefit and successful business performance. SME promotion programs have been developed over the past 20 years, and have contributed to creating a complex network of tools to support SMEs – first, under the authority, and later, under the management of the SME Agency. The move into a concentrated program of support enables the SMEs to apply for support, and enjoy a combination of the same tools as before, while now, in principle, applying only once to get all they need. This is expected to reduce the transaction costs for them, allowing the Agency to use the funds better and reduce the evaluation costs.

7. Strengthening the financial infrastructure

Governments play a critical role in promoting an enabling environment in which private banks can fulfil their SME finance targets prudently and responsibly. Improving financial infrastructure (auditing and accounting standards, credit registries/bureaus, collateral and insolvency regimes) should be the priority item in the policy finance agenda of MENA countries.

(i) Credit bureaus: The aim should be to develop a comprehensive credit reporting system that covers both personal and commercial credit information, as well as small businesses. The credit registries should help lenders better manage credit risk, and extend access to credit.

(ii) A well-functioning collateral regime: This means the acceptance of a wide range of allowable collaterals (immovable and movable), the establishment of clear priority rankings of claims over collateral, efficient collateral registries making priority interests publicly known, and an effective enforcement of collateral in the case of default (i.e. strengthened creditor rights). The security value of hard collateral depends very much on the enforcement possibilities following foreclosure of the assets[55].

Box 19: Broadening the definition of security and collateral

Central banks play an important role in shaping the enabling SME financial environment for both the banking sector and small entrepreneurs. They can widen the concept of acceptable securities, for instance, allowing small entrepreneurs to use moveable assets such as equipment (*chattel mortgage*), or their credit history as guarantees for bank loans. A broader definition of acceptable collateral would assist small entrepreneurs to meet the bank's security requirements, and would improve the SME finance environment. This broadening of the collateral definition is of particular importance for the fast growing number of SMEs operating in the services sector. Also, broadening the definition of security should be accompanied by a strengthening of creditor rights.

8. Credit guarantee schemes

Partially guaranteeing the SME portfolio could make this market more competitive, even though experiences with on-going credit guarantee schemes are not very positive. Despite current shortcomings, (partial) credit guarantee schemes remain an important form of intervention. The rationale for such a scheme remains valid. Banks require hard collateral for loans, which are sometimes much higher than the value of the loan. This collateral requirement is considered as one of the major constraints for business development, and hampers loan proposals that are valid but

[55] *Further in support of collateral, there is a need to update and modernize tenure laws, and to make the operations more transparent. Additionally, high taxes and fees make it more difficult for small entrepreneurs to register land and, thus, curtail the possibility of providing security for the bank loans (dead capital).*

are rejected for the sole reason of not meeting the collateral requirement. In such cases, credit guarantee schemes, or improvements in their performance, can play a role in improving access to SME loans.

The credit guarantee schemes, however, should improve their design. Key guiding principles on such schemes contain guidelines on eligibility criteria, coverage ratios, scalable credit approval mechanisms, fees, payment rules, use of collateral/down payment, and equity ratios, among other parameters.

Box 20: European Palestinian Credit Guarantee Fund (EPCGF)

The EPCGF was established in 2005 with an initial capital of EUR 29 million. Supported by the European Commission, Germany and the European Investment Bank (EIB), it was designed to jumpstart SME lending in a very challenging environment that had resulted in very limited bank lending, and virtually no lending to SMEs. The EIB targets SMEs with less than 20 employees, but avoids start-ups due to the perception of excessive risks in this segment. EPCGF guarantees provide incentives to local banks to lend to SME borrowers with insufficient bankable collateral. The scheme provides a coverage ratio of 60%, a maximum loan amount of USD 100,000, and a 1% upfront fee complemented by a 1.5% annual commission on the outstanding guarantee. It provides guarantees on loans with maturities from 1 to 5 years and does not impose interest rate caps. Early on in the start-up, the European Commission and the EIB expressed interest in the project. As a result of EIB's unexpected engagement, the initial loan guarantee fund capital of EUR 5 million provided by KfW increased by EUR 13.3 million from the EC, complemented by parallel financing of EUR 10 million from the EIB. The number of partner banks exceeded from the originally planned 2 banks to 7 partner banks (Arab Bank, Bank of Palestine, Cairo Amman Bank, Bank of Jordan, Arab Islamic Bank, Housing Bank for Trade and Finance, and Jordan Ahli Bank), while serving SMEs throughout Palestine, and in different sectors, and creating or retaining approximately 6,705 jobs. By the end of September 2010, EPCGF had approved 1,551 loan guarantees covering a loan portfolio of USD 46,753,403, with an average loan size of USD 30,000. As a result of the achievements of EPCGF, and the increasing demand for microfinance products, EPCGF has recently established the cooperation with a specialized Microfinance Bank (Al Rafah Bank) for further penetration of smaller borrower especially in the agro-industry and agriculture.

9. Supporting financial sector reform programs in MENA countries

The task of governments is to ensure that a diversity of funding sources, including asset-based finance, term loans, overdrafts, overnight funding, leasing, factoring, and even personal credit cards are provided by financial institutions in marketplaces that are competitive. The banking system has been subject to numerous financial reforms without producing the desired results. Nevertheless, continued bank reforms are needed to bring the sector more in line with generally accepted financial market-based principles. Some of these features include:

(i) Removal of restrictive entrance barriers for foreign banks: More competition can contribute to further SME lending. Internationally, there are private banks that have more effective lending technologies, and are able to generate and manage a significant SME portfolio, even within weak enabling environments. The entry of these banks into other MENA countries could contribute to more SME lending, both directly and through spill over effects. In this case, the policy implication is to ensure that entry requirements are not overly restrictive, and that banking markets remain contestable.

(ii) Repositioning or reform of government banks: Until financial infrastructure is improved, government banks will continue to play a role in SME lending. To a large extent they play a compensatory role for the low private bank involvement in SME finance. State banks take more risks than private banks, as indicated by broader selection criteria, more exposure to term lending, and softer collateral requirements. However, they do not seem to have developed sufficient risk management capacity to manage these risks. Only a small number of state banks have introduced dedicated SME units, adopted internal scoring models, and conducted regular stress tests to monitor the risks related to SME lending. Governments need to reposition and reform government banks in the medium-term (repositioning once the financial infrastructure is in place). In the meantime, government banks need to place a higher emphasis on improved governance and risk management, so that the greater risks they are currently taking in extending SME finance arise from well-informed decisions, and are better monitored (i.e. equip the banks with state-of-the-art and internationally recommended SME policies and procedures). This recommendation comes with a special note: direct lending through government banks may be well justified, but it should not be the main component of the structure of SME finance in the region. For this, more sustainable structural solutions are needed, as mentioned.

(iii) Support and encouragement of the venture capital sector: The core issue pertaining to the limited access of Mesofinance in the MPCs is the psychological distance between commercial bankers and the small entrepreneurs, and the resulting type of financial services made available to the SME sector. The demand for current, traditional financial services is low, because many small entrepreneurs are dissatisfied and are not waiting for a passive external funder who wants the client to follow a fixed amortization schedule and monthly, or quarterly, financial statements of the business. Clients want a more active funding agency that also assists in the financial engineering of their small enterprise, and is willing to be involved in strategy considerations -- and perhaps on an ad hoc basis assists in management suggestions (sparring partner). For these situations, venture capital should be promoted in MPCs. Venture capitalists often enter the firm at the middle to later stages of the small business life cycle, and can provide a link between the SME and institutional sources of capital. Funds are usually obtained from institutional investors, but financial intermediaries and the corporate sector are, or can be, major investors as well. At the end of the process, the venture capitalist aims to realize a return on the investment through "exit" via trade sale, or a public issue (initial public offering, i.e. IPO). The legal, tax and regulatory framework should be reviewed in order to assure that the business environment encourages the development of venture capital, including opportunities for exit strategies. In Jordan, the emphasis might be more on the development of the VC sector, while in Morocco and Egypt evaluation of the VC regulations might be more appropriate.

(iv) Introduction of mezzanine financing: Mezzanine financing is essentially debt capital that gives the lender the right to convert to an ownership or equity interest in the enterprise if the loan is not paid back in time and in full. It is a hybrid of debt and equity financing that is typically used to finance the expansion of existing businesses. Mezzanine financing can be advantageous because it is treated like equity on a company's balance sheet, and can make it easier to obtain standard bank financing. Commercial banks and venture capital companies can issue mezzanine financing. Mezzanine financing is only suitable for a small number of enterprises that can demonstrate a track record in the industry with an established reputation and product, a history of profitability, and a viable expansion plan for the business (e.g. expansions, acquisitions, IPO). To introduce mezzanine finance, governments need to formulate a legal framework, registration requirements, and review the fiscal regime and monitoring practices.

(v) Support of "*Business angels*": Business angels are individuals who commit business experience as well as own capital, often during the formative stages of a firm's life. The role of business angels in early-stage finance appears to be growing in MPCs, and is increasingly recognized as a vital link in the financing chain. It is also an area where government technical support may have a very high payoff. Governments should determine whether the market for informal "*business angels*" risk capital can be made to operate more efficiently through government technical support (creating an enabling legal, fiscal and procedural environment).

10. Strengthening bank supervision

With SME finance as the new frontier for commercial banks, central banks' supervision needs to be strengthened. Even without SME finance, this supervision has been inadequate and insufficient, especially against the background of the overall financial health of the sector in the MENA region. Financial soundness indicators suffer from deficiencies, and banking sector data should be urgently improved. In particular, stricter regulatory and reporting requirements should be introduced and enforced (introduction of internationally accepted audit and accounting standards, among others). Furthermore, supervision should take into account (SME) loan classifications, assets, and collateral valuation and provisioning, yet always in compliance with international best practices. Central banks are already burdened, and do not always apply international best practices when sending out circulars and monitoring the financial sector. Focusing central banks' attention to the needs of the SME sector will further complicate their supervision and monitoring tasks, hence, the urgency to strengthen their capacity to supervise the finance sector.

7.3 Recommended Support at the Level of Financial Intermediaries

SME banking can be a very profitable business. Risk-return ratios can outperform ratios found in other portfolio segments of the bank. To achieve superior performance, however, financial institutions must develop specific strategies and business models to build a strong and sustainable SME portfolio.

Banks have traditionally relied on a combination of documentary sources of information, interviews and visits, and the personal knowledge and expertise of loan officers and managers in assessing and monitoring business loans. However, when assessing comparatively small and straightforward business credit applications, banks largely rely on the quality of collateral and/or standardized--and often out-dated--credit scoring techniques (quantifying such things as the characteristics, assets, and cash flows of businesses/owners).

Banks, thus, need to invest considerable resources in overcoming information asymmetry problems by using new and adapted credit scoring card models adjusted to this market segment, and other sophisticated techniques to discriminate between high and low-risk borrowers. These appraisal mechanisms enable banks to identify which businesses are likely to survive and expand, and which are worthwhile for developing a long-term relationship.

Using such techniques – and also centralizing or rationalizing business-banking operations, generally – can significantly reduce processing costs. Standardized computer-based assessments may also be more accurate and fair than reliance on the personal judgments of local bank managers. However, standardized computer-based assessment is only one of the tools applied during the appraisal stage, and should be used intelligently, as business lending, as a whole, is substantially more diverse and complex than personal and residential mortgage lending. This, coupled with the large size and inherently risky nature of many business loans, limits the scope and desirability of computerized credit scoring in assessment and monitoring. Nevertheless, with credit scoring tools banks may be able to offer more loans, faster and in greater amounts, and reduce previously high security requirements.

Box 21: Customer profitability and cross-selling opportunities

Lending is just one part of a larger overall package that banks provide to SMEs. Banks find SMEs profitable through a combination of services, which places cross-selling at the heart of the banks' SME business strategy. In effect, banks have developed a wide range of fee-based, non-lending products and financial services for SMEs. These products and services can be very attractive in terms of profitability; in fact, the evidence suggests that lending is not always the main, or the first, product offered to SMEs, and that it is often offered as a way to eventually cross-sell other lucrative fee-based products and services, including payments, savings, and advisory services.

Cross-selling is a way for banks to maximize their scarce resource (capital). Moreover, selling products and services to SMEs: deepens the engagement of banks with the firms, becomes part of the banks' efforts to be the principal bank that the SMEs engage with, and may facilitate increasing the amount of lending to each SME while attracting other clients (like the SME employees, the owners, and their families). To the extent that these products and services gain importance, the institutional environment relevant to credit contract writing and enforcement becomes less of a constraint.

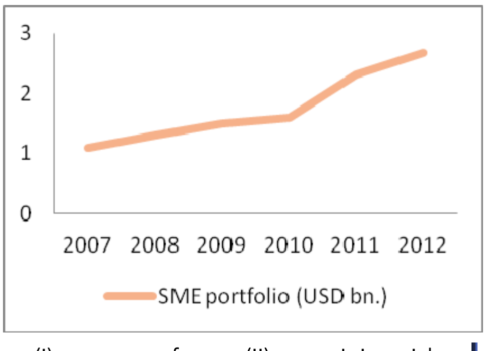
Source: Bank involvement with SMEs: Beyond relationship lending. Augusto de la Torre, Maria Soledad Martinez Peria, Sergio L. Schmukler (2010)

SME banking is also much more than SME lending. The relationship approach adopted by banks in other emerging economies, such as ICICI in India, shows the rationale for engaging in SME banking, customer profitability, and cross-selling opportunities offered by the SME segment as the main incentive (Boxes 24 and 25). The focus on loans does not allow financial institutions to really look at the client's needs and design a suitable proposition. SME customer needs are primarily deposit, transactional, and credit based. While focus is usually on credit needs (loans, overdrafts, trade finance, receivable finance, etc.), deposit (operating accounts, term deposits, investment options) and transactional banking (internet banking, phone/mobile banking, transfers, debit cards, foreign exchange, etc.) can contribute 50-60% of the SME business revenues, thereby demanding greater attention. This high percentage in revenues is because these banking products are offered on a fees basis, which gradually changes the SME business model of the banks as well. Therefore, an increasing proportion of bank revenues would now come from fees for the use of these different services, which, in turn, favours lending to entities such as SMEs.

When banks simultaneously offer different financial products (cross-selling) it develops what is generally known as "relationship banking" with the SME clients. The core element of relationship banking is that the bank builds a relationship with clients through the offering of multiple financial products, and over time obtains costly, proprietary information on the borrowing clients, which remains confidential. Relationship lending, thus, exists when the client has close ties to a financial institution. Relationship banking facilitates the design of tailor-made cash flow lending, and other SME financial products, hedging products that protect SME borrowers from currency devaluation, and the like.

Box 22: ICICI Bank Limited and relationship banking

ICICI Bank Limited, the second largest bank in India by assets and third largest by market capitalization, is a major financial service provider in the Indian market, and caters to a wide range of corporate and retail customers by meeting their entire gamut of banking needs. Other non-banking financial services are provided through its specialized subsidiaries in the areas of investment banking, life and non-life insurance, venture capital and asset management. Having acknowledged the development of SMEs as pivotal to the growth of the national economy, and in keeping with its mandate to increase outreach to more regions and customer segments, ICICI Bank has, over the years, taken extensive measures to widen its reach to more SMEs across India. This has manifested into the introduction of a dedicated SME-focused set of solutions (loans, deposit and transactional products beyond advisory and support services). Consequently, a focused SME strategic business unit (SME- SBU) was created to cater to the emerging needs of the sector. The bank formulated a 4-C strategy for SME financing, based on the following key business elements: (i) customer focus, (ii) containing risks, (iii) managing costs and efficiency optimization, and (iv) cross-selling. Given the risks posed by the



SME clients, the bank has adopted new credit risk evaluation techniques to screen the clients. They have introduced innovative products and services like receivable financing, factoring, and cash flow-based lending. The bank has also adopted a sector specific approach (cluster approach) to get a better understanding of the sector, and develop credit proxies to evaluate the business of the SMEs in the cluster. ICICI Bank did market segmentation across 165 industries to identify 12 priority industries at the national level. Subsequently, the bank worked to develop deeper expertise in serving SMEs in these industries. To strategically serve the market, ICICI divides its SME clients into the following three groups: (1) Corporate Linked Businesses, which are SMEs linked to ICICI's current corporate client group, either as vendors or distributors of goods and services, (2) the Cluster Banking Group consisting of pre-selected and pre-defined customer industry clusters that represent promising opportunity markets within India, and (3) the Business Banking Group that includes the remaining clients. During the last six years, the SME portfolio of ICICI Bank has shown a steady growth.

Source: New Ways of Financing Small and Medium Enterprises, Vijay Chandok, ICICI Bank, 2006.

Finally, banking (i.e. extending loans as well as accepting deposits) is all about trust -- trust on the part of the bank that the borrower will repay the loan, and trust on the part of the client that the bank will manage and protect the deposits and savings very well. This level of confidence is not always a given, and, therefore, banks need to initiate confidence-building measures.

To summarize, commercial banks should:

- Adjust internal credit and risk policies and procedures to the particularities of SME lending;
- Broaden the financial services package for the SME sector, and introduce fee-based financial services for small businesses;
- Introduce alternative collateral techniques to overcome the information asymmetry (credit scoring cards, relationship banking, and rationalizing business-banking operations);
- Adjust the MIS measures for the SME portfolio;
- Train line management (e.g. loan officers) and senior management (credit committee members of financial institutions) for MSME lending operations;
- Initiate confidence-building measures in the SME market.

An overall consideration that should be kept in mind is that new and growing SME businesses within a financial institution require deep engagement, commitment and discipline. Banks will not build up an SME portfolio, or adjust credit and risk policies and procedures to meet the requirements of the SME market without the support and commitment of the Board and senior management.

7.4 Recommended Support at the Level of the SME Sector

Technical shortcomings within small businesses include: product design, quality control, the understanding of market needs, product marketing tools (such as packaging, storing and transportation), strategic business development and financial planning (including cash flow management, financial reporting and financial administration), and financial engineering. The challenges that micro and meso/national economic systems pose to small entrepreneurs include: labour market and policies, registration and transaction enforcement, permits, tax regime, corruption, and access to information and electricity. These shortcomings and challenges are arguably more exhaustive and important for their stability and growth potential than their problematic access to external funding.

There are a wide variety of technical assistance programs for the SME sector, from government and donor backed TA services, to incubators and service providers, to tackle one or more of the above noted challenges of small businesses. The share or importance of private business providers to the MPCs Mesofinance space is modest. Training and consultancy services are often free of charge, thereby taking away an important feedback mechanism. Moreover, most of these TA interventions do not support the SME consultancy and training market, while the intervention itself is non-sustainable. Government-backed TA programs often lack the financial and non-financial resources to be effective or have a significant impact on raising the capacities of the SME sector.

Nevertheless, millions of US dollars are spent every year to offer such services to the sector, and very little is known on the impact of all these interventions. Programs suffer from the lack of transparency and cohesion, and have little quality control, while monitoring and impact assessments are seldom carried out. Additionally, there is no agreement on the objectives, and how to measure the impact (tangible targets). In Tunisia, for instance, technical assistance programs have been launched that focus exclusively on start-ups, and tend to pamper the would-be entrepreneurs. This government program confuses jobless people with small entrepreneurs. In other countries most of these programs and initiatives are poorly coordinated, and TA services are disconnected from the actual needs.

It is clear that these programs are very important to supporting access to Mesofinance initiatives -- particularly if policymakers, private sector consulting groups and financial institutions offer advice that the sector really needs to grow, and in the process creates new jobs. TA programs should also include activities to narrow the psychological gap between small entrepreneurs and potential investors. Additionally, since micro and medium-sized enterprises target different segments of the labour force, balanced investments in both should be considered. These measures will be most effective when combined with steps to address other constraints, such as a poorly developed financial infrastructure, a business climate unfavourable to growth, or lack of access to basic infrastructures like electricity and transportation. Finally, government TA programs should also focus on enabling enterprises to become formal.

Box 23: TEB SME Academy

Turk Ekonomi Bankasi (TEB) was among the first banks in Turkey to recognize that providing capacity building to support SMEs could have enormous potential in building a client base of healthy businesses, increasing customer loyalty, and decreasing credit risk in the SME sector. In 2005, TEB began offering training services through its SME Academy. The primary goal of training is to build SME competitiveness and strategic planning capabilities. It also helps SMEs take a market-centric approach to their businesses, giving them the tools to identify and respond to new opportunities for products and services. In 2008, TEB began to complement its "low-touch" training, with "high-touch" one-on-one management consulting, delivered through a cadre of trained relationship managers. TEB has emerged as a leader in experimenting with innovative non-financial approaches to SME capacity building. The International Finance Corporation (IFC) named TEB one of the top three world banks for its SME banking activities. The bank's capacity building efforts have resulted in a decrease in loan delinquency rates in its SME portfolio, in addition to new client acquisition and greater customer loyalty.

To summarize, providers of Technical Assistance programs should:

- Conduct an operational audit of the various SME support programs to gauge their impact to date, identify overlaps, strengths, weaknesses, and if necessary encourage the realignment of their missions, visions and mandates in support of greater synergies (building capacities of staff, better allocation of government resources, etc.);
- Improve efficiency of TA programs by being clear on which types of small businesses they want to target (start-ups, existing SMEs, innovative and growth businesses), adjust their services to the needs of these segments, and by (gradually) introducing training and consultancy fees for their services;

- Include or give more emphasis on financial literacy and financial engineering, as well as focus on best management practices and governance;
- Include confidence-building measures to deal with and understand commercial banks and other SME investors;
- Create an enabling environment for private business providers (no carving out or competing with the private sector);
- Agree on a set of measurable objectively verifiable indicators (OVI), and adjust their internal monitoring and external evaluation exercises to these criteria;
- Improve the feedback mechanisms of their TA programs through surveys and training assessments to be completed by small entrepreneurs, as well as feedback and suggestions from the investors.

7.5 Recommended Support at the Level of IFI

International Finance Institutions (IFIs) can offer advisory and investment services to the MENA region that foster improved access to SME finance to create new jobs. These advisory and investment services should be adjusted to the situation in each of the countries, and would be better conducted as concerted interventions, thus, involving several IFIs, multilateral and bilateral agencies, where appropriate.

This is particularly important when it comes to macro-economic, macro-finance and macro-political reforms. For example, EIB efforts in changing the legal and fiscal framework, financial reforms to ease access to foreign banks, or strengthening the financial infrastructure is likely to fail if it is not done in close cooperation with, and support from, other IFIs, such as the World Bank/IFC and the EBRD. Concerted action is also important to ensure improved levels of synergies.

An important intervention area for IFIs is awareness raising and assisting national governments in building up a reliable database of the SME sector, and the design of a comprehensive SME policy. As mentioned in this report, IFIs, as a group, can convince national governments, and offer support, on reforms of the banking sector, privatization of SOEs, improvement of the judicial and tax system; strengthening of credit bureaus and collateral registries, and advise in terms of alignment with international standards of independence (governance), accountability and transparency. IFIs can play a role in introducing and popularizing venture capital and mezzanine financing, supporting the creation of a more enabling environment for such financial interventions, and, if necessary, offering equity finance for these investment schemes.

IFIs can engage in a long-standing and constructive dialogue with board members and top management of commercial banks who are open to the idea of offering services to the SME sector. They can advise commercial banks on best international practices for internal credit and risk policies, and procedures that take into account the particularities of SME lending, development of non-collateral based lending practices, and diversification of the product services for the SME sector, as well as share global innovative approaches to risk analysis and appropriate MIS measures for SME portfolios, etc. Technical assistance to commercial banks should also include measures to narrow the large psychological gap between the lender and potential SME clients. A technical assistance team can be placed in the central bank, or be based in the individual commercial banks, if so requested by them.

Box 24: Fostering SME growth through international cooperation

In May 2011, the G8 launched the Deauville Partnership as a response to the historical changes underway in several countries in the Middle East and North Africa region. The Deauville Partnership was launched as a long-term, global initiative that provides Arab countries in transition with a framework based on technical support to: (i) strengthen governance for transparent, accountable governments; and (ii) provide an economic framework for sustainable and inclusive growth. To support the countries in transition to formulate policies and programs, and implement reforms, the Deauville Partnership set up the MENA Transition Fund. The Transition Fund demonstrates a joint commitment by G8 members, Gulf and regional partners, and international and regional financial institutions to support the efforts of the people, and governments of the partnership countries as they overhaul their economic systems to promote more accountable governance, broad-based, sustainable growth, and greater employment opportunities for youth and women. Recipient entities in beneficiary countries include, in principle, all levels of government, judicial bodies, central banks, other state agencies, and parliaments from Egypt, Jordan, Libya, Morocco, Tunisia, and Yemen.

Source: *http://www.menatransitionfund.org/*

IFIs can support debt financing for the banking sector in countries where there is a liquidity squeeze (as appears to be the case in Tunisia), but only if this is simultaneously done with other measures that improve the overall portfolio quality of the banks -- in particular the SME portfolio. Debt financing can be supported through the central banks, directly by their offering of a refinancing window facility to select commercial banks. IFIs can also assist in an improved design of credit guarantee schemes that makes these more efficient and effective (thus, leading to additionality of the SME portfolio, and avoiding dole out and moral hazard).

To summarize, International Finance Institutions could:

- Advise on an improved design of credit guarantee scheme (following international best practices) to enhance risk taking capacity, and provide capital relief via low risk weightings, avoid foreign exchange mismatches, and encourage domestic resources for SME financing and co-funding of such a scheme;
- Study the justification for a refinancing window/debt financing and fund such a facility (e.g. revalidate the assessment of the IFC study on the potential financial gap -- both in local and hard currency -- taking into account the liquidity position of banks only, thus, excluding other reasons why there is an SME lending gap), conduct or assign a rating exercise on the individual banks to assess which banks would meet the eligibility criteria for debt financing, agree on the institutional setting and details of the debt financing and open the facility to participating banks while monitoring the performance;
- Offer (equity) investments in financial institutions that have a genuine interest in Mesofinance or in equity funds for SMEs with a special focus on underserved segments, such as women entrepreneurs, innovative small businesses or enterprises with potentially high production efficiency levels;
- Offer (equity) investments in and/or strengthen lease facilities and innovative financing schemes such as venture capital, mezzanine finance;
- Support initiatives for a reliable SME sector and Mesofinance database, and the use of this database for the formulation of a coherent SME policy;
- Support the development of secured transactions, legal and regulatory framework;
- Assist in strengthening of the financial infrastructure (credit bureaus, collateral registries), develop credit reporting infrastructure based on country needs;
- Sensitize and raise awareness of the SME banking opportunity with the Board and top management of commercial banks;
- Raise awareness on best practices in SME finance;
- Build capacity within financial institutions on strategy, market segmentation, design of alternative securities, appraisal techniques, new SME finance services and monitoring/risk

management measures of the SME portfolio to support the scaling-up of their financing for SMEs on a sustainable basis;

- Enhance the dialogue between banks and small businesses and, where relevant, structure it along a Code of Conduct to improve their understanding of one another;
- Support central banks in the overall supervision of the banking sector.

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Annex 2
Proposed Draft Agenda for Stakeholders Consultation

SME and job creation: opportunities for mesofinance in Tunisia

4 March 2014

Location: Mövenpick Hotel Gammarth Tunis, Avenue Taieb Mhiri, La Marsa

Access to finance is a crucial aspect in supporting entrepreneurial activity. It is also a determinant of the capacity of enterprises to grow and create employment. Against this background the FEMIP Trust Fund (FTF) launched a study to assess "*The Potential of Mesofinance for Job Creation in Mediterranean Partner Countries*". This workshop will present the main findings of the study and discuss the implications for policy, market and institutional development. The workshop will serve as a forum to discuss solutions to the problem of the "missing middle", and provide guidance for follow-up programmes.

Agenda
Moderator : Katia Mehanneche, Expert in Microfinance
8:00 – 9:00 Registration and welcome coffee
9:00 – 9:15 Introductory remarks ▪ Philippe de Fontaine-Vive, Vice-President, European Investment Bank ▪ Nourredine Zekri, Secretary of State for International Cooperation
9:15 – 10:15 Session I: Presentation of the regional study "Potential of Mesofinance for Job Creation in Mediterranean Partner Countries" Presentation of "Potential of Mesofinance for Job Creation in Mediterranean Partner Countries" undertaken by Frankfurt School of Finance & Management on behalf of the European Investment Bank. Based on surveys and consultations with stakeholders in Egypt, Jordan and Tunisia and taking into account the existing studies on the subject (World Bank, International Finance Corporation, International Labour Organization, OECD), the study identifies three areas suitable for pilot actions that lend themselves to an involvement of the major stakeholders: upscaling programmes of MFIs, downscaling programmes of banks and further innovative potential responses. These pilots should lead to the formulation and implementation of coherent national strategies for mesofinancing, thus laying the basis for noticeable positive effects on job creation. 9:15 – 9:35 : Presentation of the Regional Study 9:35 – 9:55 : Presentation of the study's results for Tunisia 9:55 – 10:15 : Q&A session with the audience *Speaker:* ▪ Bernd Balkenhol, Senior Policy Expert, Frankfurt School of Finance & Management *Documentation:* ▪ EIB FEMIP Trust Fund Potential of Mesofinance for Job Creation Study (executive summary)
10:15 – 11:30 Session II: Is upscaling microfinance institutions towards the SME sector a solution? Traditionally microfinance institutions conduct business with a clientele from the informal sector: household/micro-enterprises managing a revenue generation activity with the objective to ensure survival and a constant positive cash-flow. These micro-enterprises, rather informal and with little capital, have few opportunities to grow. A few MFIs, for their part, have looked to widen their client base towards larger businesses geared towards growth. Mesofinance has thus become the playing field for a few innovative MFIs looking to diversify their portfolio: ACEP in Senegal, ACLEDA in Cambodia, ADEMI in the Dominican Republic, BRAC in Bangladesh, Centenary in Uganda, and others. In practice, this new orientation necessitates organisational changes (SME-dedicated tellers, easing of collateral requirements), a larger products and services base (leasing, payment options, long term loans, joint loan/insurance products) and

sometimes alliances with banks (new distribution points in the bank branches). This session has as its objective to present how certain innovative MFIs went about addressing these challenges, and determine applicability in Tunisia of the lessons learned.

Speakers:

- Julia Assaad, Advisor to the Board of Directors at Grameen-Jameel Microfinance Limited
- Mickael Cracknell, Co-Founder Secretary-General of ENDA Inter-arabe Tunisie
- Thelma Tajirian, Senior SME Expert, Former Director Access to Finance, Silatech
- Yassine Oussaifi, Investment Officer, Tuninvest-Africinvest

11:30 – 11:45 Coffee break

11:45 – 13:00 Session III: Bank Downscaling

In other regions of the world, mesofinance is an attractive segment for local financial institutions (banks, MFIs, and others). There are similar opportunities in the Middle East and North Africa (MENA) region. The risk/return on investment ratios may even be higher than other clientele segments. To achieve this, financial service providers must develop appropriate SME finance development strategies. This session will present successful regional experiences, identify success factors and determine replication conditions.

Speakers:

- Houssein Mouelhi, CEO Banque Tuniso-Koweitienne
- Souhir Taktak, BFPME, Former General Director for Funding, Ministry of Finance
- Zied Sdiri, Head of the SME Department, AMEN Bank
- Fethi Mestiri, General Manager, Tunisie Leasing

13:00 – 14:30 Lunch break

14:30 – 16:00 Session IV: Intermediary and innovating as possible responses to the "missing-middle"

Beyond upscaling initiatives for microfinance institutions, and downscaling initiatives for banks, other innovative solutions are in development, such as business development support to entrepreneurs and innovating financial products and tools. International Financial Institutions such as the EIB also have the potential to be strong stakeholders and to propose solutions with new tools, with an integrated value-chain approach. This session will present an opportunity to discuss a few of these new tools, and consider the possibility of their integration in the Tunisian system.

Moderators:

- Bernd Balkenhol, Katia Mehanneche

Speakers:

- Zeineb Farhat, Director of "Entreprendre" Network, Réseau Entrepreneur International, Tunis
- Richard Finke, Managing Director, MEII Tunisia (The Middle East Investment Initiative)
- Nazeem Martin, Managing Director, Business Partners Ltd
- Malek Bakir, European Investment Bank Representation Office in Tunis
- Mohammed Kaaniche, CEO of Banque Tunisienne de Solidarité

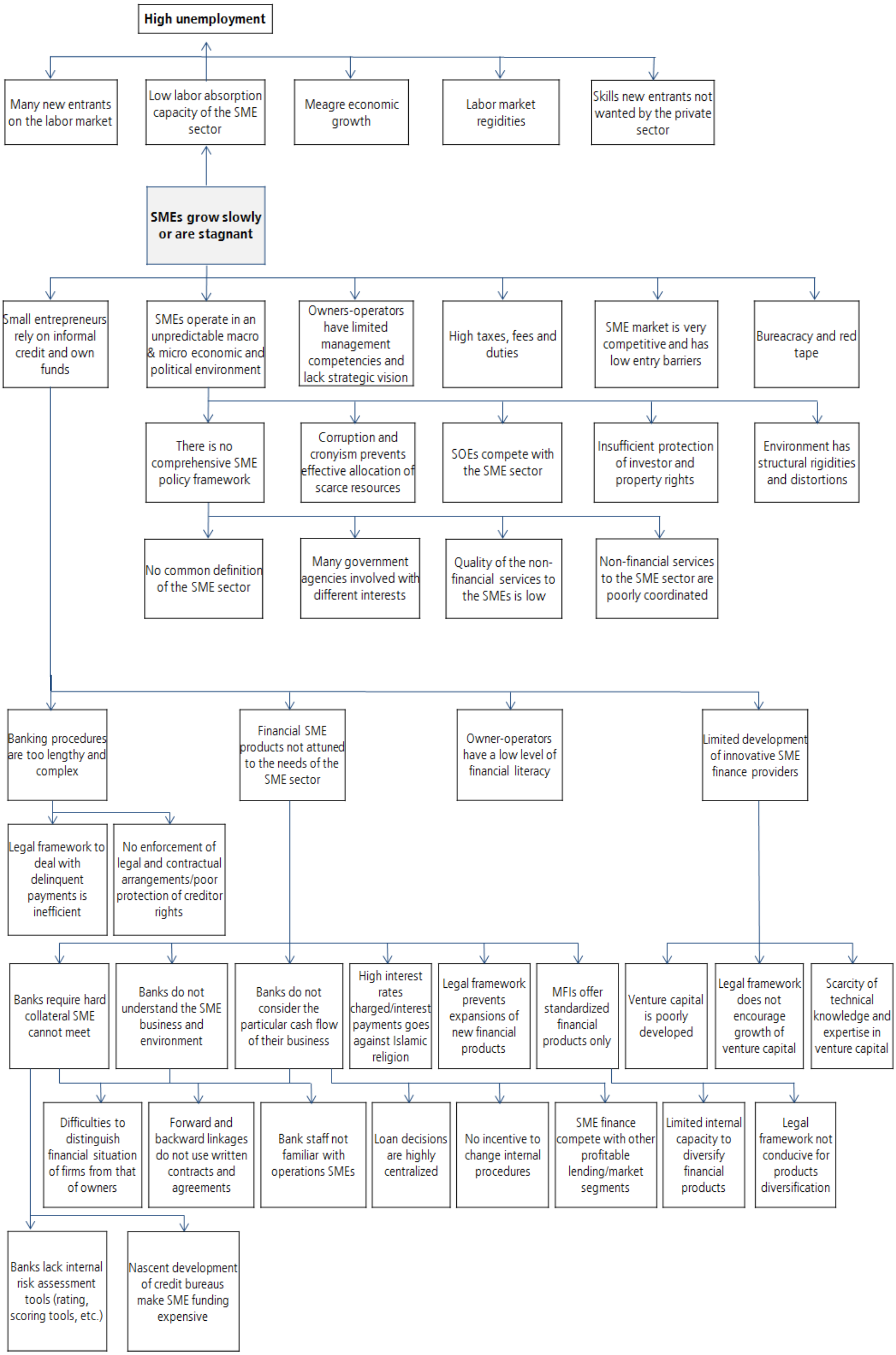
16:00 – 16:10 Conference Wrap-Up: Katia Mehanneche

16:10 – 16:15 Closing Remarks by Joyce Liyan, Head of Unit, Neighbourhood Business Development, Directorate for Operations outside the EU of the EIB

16:15 Closing reception

17:30 End of the Event

Annex 3
Problem Tree


High unemployment
Many new entrants on the labor market
Low labor absorption capacity of the SME sector
Meagre economic growth
Labor market regidities
Skills new entrants not wanted by the private sector
SMEs grow slowly or are stagnant
Small entrepreneurs rely on informal credit and own funds
SMEs operate in an unpredictable macro & micro economic and political environment
Owners-operators have limited management competencies and lack strategic vision
High taxes, fees and duties
SME market is very competitive and has low entry barriers
Bureacracy and red tape
There is no comprehensive SME policy framework
Corruption and cronyism prevents effective allocation of scarce resources
SOEs compete with the SME sector
Insufficient protection of investor and property rights
Environment has structural rigidities and distortions
No common definition of the SME sector
Many government agencies involved with different interests
Quality of the non-financial services to the SMEs is low
Non-financial services to the SME sector are poorly coordinated
Banking procedures are too lengthy and complex
Financial SME products not attuned to the needs of the SME sector
Owner-operators have a low level of financial literacy
Limited development of innovative SME finance providers
Legal framework to deal with delinquent payments is inefficient
No enforcement of legal and contractual arrangements/poor protection of creditor rights
Banks require hard collateral SME cannot meet
Banks do not understand the SME business and environment
Banks do not consider the particular cash flow of their business
High interest rates charged/interest payments goes against Islamic religion
Legal framework prevents expansions of new financial products
MFIs offer standardized financial products only
Venture capital is poorly developed
Legal framework does not encourage growth of venture capital
Scarcity of technical knowledge and expertise in venture capital
Difficulties to distinguish financial situation of firms from that of owners
Forward and backward linkages do not use written contracts and agreements
Bank staff not familiar with operations SMEs
Loan decisions are highly centralized
No incentive to change internal procedures
SME finance compete with other profitable lending/market segments
Limited internal capacity to diversify financial products
Legal framework not conducive for products diversification
Banks lack internal risk assessment tools (rating, scoring tools, etc.)
Nascent development of credit bureaus make SME funding expensive

European Investment Bank

Facility for Euro-Mediterranean Investment and Partnership

With a view to considering ways to expand its support for private sector development, and with a focus on promoting Small and Medium Enterprises (SMEs), which face particular challenges in terms of access to finance, the European Investment Bank, via the FEMIP Trust Fund (FTF), commissioned a study to assess "The Potential of Mesofinance for Job Creation in Mediterranean Partner Countries". The study, carried out by the Frankfurt School of Finance and Management, is based on a literature review, surveys of small entrepreneurs and consultations with government officials, staff of supervisory institutions, international donors as well as financial institutions in Egypt, Jordan and Tunisia. It may serve as a basis for pilot actions to test innovative approaches in enhancing access to finance for SMEs in the Mediterranean partner countries.

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