Chapter 7

Financing for greening SMEs

This chapter examines different strategies to support enhancing the availability finance for greening SMEs in EaP countries. It highlights the importance of access to finance as an enabler for SMEs to take advantage of opportunities to improve their environmental performance. Finance is also important for start-ups that are developing or introducing new green technology. The current situation of green finance in EaP countries is explored, as is the role of public financial institutions' diversity. Green asset-based finance, soft loans, green microfinance, and green bonds are also briefly addressed.

Introduction

In most countries, small and medium sized enterprises (SMEs) face greater challenges to access finance than larger enterprises. SMEs may find interest rates and collateral requirements of bank loans prohibitive, and may not be familiar with other sources of finance that are available. The size and sophistication of both the SMEs and the finance sector can also make the struggle more difficult, as lenders may not have the capacity to address the challenges that SMEs face as opposed to larger enterprises, and may be less interested in lending to smaller enterprises.

The situation is further compounded for green SMEs and SMEs looking to invest in greener practices. Better access to finance can greatly facilitate SMEs' green initiatives, and, for green start-ups, support the development and expansion of their enterprise. However, it can be challenging to make the case to banks, which remain the main source of SME finance beyond internal funds. SMEs may struggle with having the best information to present to lending parties, both in terms of the initial case for the green investment as well as for ongoing reporting. They may find short-term tenors challenging when contrasted against the longer payback periods of some green investments. Institutions are often unfamiliar with valuing the economic benefits of green initiatives, and may be reluctant to provide loans.

However, there are tools and approaches which can support access to green finance for SMEs, approaches that have been successful in the context of SMEs and sustainable finance more broadly. In the aftermath of COP21 and other international discussions on climate change and green growth, there is a global consensus on the need to make finance available for green infrastructure and industry. Increasingly, international financial institutions (IFIs) have dedicated funds specifically for SMEs. It is not simply a question of money being available – SMEs need to have the tools to access affordable (long-term, low-cost) finance, and risk needs to be addressed appropriately. Risk mitigation instruments are an important part of the puzzle as capital remains too expensive for many SMEs. This chapter will examine the challenges facing SMEs seeking green finance, and consider some examples of what has worked in countries both within and without the Eastern Partnership (EaP) region.

Green finance for SMEs in EaP countries

Most commonly, private financing plays a large role in supporting resource efficiency and in the production of green goods and services in EaP countries, compared to public grants and loan guarantees. For SMEs both in OECD countries and the EaP region, internal SME funds remain the most common source of finance for greening initiatives. Beyond that, bank finance is the primary source of external funds for SMEs. which comes mostly in the form of finance by International Finance Institutions (IFIs) that extend green credit lines through local financial institutions (Box 7.1). Almost all IFIs active in EaP countries have opened such credit lines. These include the European Bank for Reconstruction and Development (EBRD), the International Finance Corporation (IFC), the European Investment Bank (EIB), the Asian Development Bank (ADB), the German public bank *Kreditanstalt für Wiederaufbau* (*KfW*), and the Development Bank of Austria (Box 7.1).

A number of IFIs, such as EIB and ADB, provide funding for relevant environmental activities through credit lines primarily dedicated to SMEs. In addition, there are a number of multilateral and bilateral facilities that have also extended environmental credit lines to local financial institutions in the region that target SMEs, such as the Green for Growth Fund and the Global Climate Partnership Fund (OECD 2016a, 2016b).

Box 7.1. **Examples of financing sources for energy efficiency and renewable energy in Armenia**

- Inecobank and Araratbank are providing “green loans” for energy saving projects, including energy-efficient lighting, heat insulation, installation of thermal solar systems, etc. These loans are provided with the support of the Green for Growth Fund for Southeast Europe.
- Ameriabank (since 2012) and Anelik bank (since 2010) are providing “renewable energy loans” under the Armenian Sustainable Energy Financing Facility initiated by the EBRD, aiming to support financing of energy efficiency and renewable energy projects of private business in Armenia.
- IFC provided USD 15 million financing to HSBC Bank Armenia to help the bank support sustainable energy projects and provide loans to SMEs interested in investing in energy efficient technologies and promoting the efficient use of resources.

Source : OECD (2015a), *Promoting better environmental performance of small and medium-sized enterprises in Armenia*, www.oecd.org/environment/outreach/SME-greening-country-pilot-report-Armenia-en.pdf.

Recently, domestic finance institutions have begun to play a growing role. For example in 2013, Moldova’s ProCredit Bank launched an EcoLoan programme for business clients, becoming one of the country’s first banks to provide “green” loans to small and micro-enterprises for investments in energy efficiency (with required energy savings of at least 20%), renewable energy, and other green practices (organic agriculture, water and soil protection, etc.). ProCredit Bank Georgia operates a similar programme and is itself ISO 14001:2015 certified (OECD 2017-forthcoming).A few banks have established environmental management units, and two banks in Georgia, JSC Bank of Georgia and JSC TBC Bank, have formally adopted environmental and social policies and respective procedures. In some countries, green financing is supported by public interventions, such as the example in the Lviv region of Ukraine where the regional government subsidises interest rates of commercial loans for energy efficiency projects in partnership with five private banks.

Building the capacity of SMEs and lenders

Ensuring that SMEs have access to green finance requires not just ensuring that funds are available, but also building the capacity of different parties when it comes to sustainable investment. As green finance for SMEs is an emerging area of finance, there is often a gap in expertise on both sides of the table. Providing SMEs’ with capacity training to make a business case for investments that make their operations more resource efficient or environmentally friendly is important. Equally, financial institutions need to be supported so that they are better equipped to assess the risk and rewards of green investments, and thus put realistic judgements of interest rates. The funds deployed by IFIs through local intermediaries, such as those mentioned in Box 7.1, often include technical capacity as part of the loan programme. For example, since 2006, EBRD’s project “Identification and promotion of energy efficiency investments” has combined the provision of credit lines through financial institutions in Moldova and Ukraine with legal, technical, financial and environmental technical assistance to potential beneficiaries (EU 2017). Governments can further enhance this by working through other channels such as local business associations and municipal governments to reach SMEs and ensure that they are informed about the availability of finance options and have the technical knowhow to make the case for initiatives.

The role of public financial institutions

Public financial institutions, local and international, may offer reduced interest loans for environmental investments by SMEs. Such loans are usually conditional on the planned measures going beyond regulatory requirements and the use of best available techniques and/or best environmental management practices, and applications need to be certified by the competent environmental authority (Box 7.2). There are programmes that allow loans to be converted into grants (i.e. do not have to be paid back) upon demonstration of expected environmental performance.

Box 7.2. **Low-interest loans for green investments: Examples from selected countries**

France: OSEO public investment bank offers loans at favourable rates and without collateral from EUR 50 000 to EUR 3 million for up to seven years for SMEs who adopt environmentally friendly technologies (with the share of capital costs exceeding 60%) or develop new ones.

UK: The Energy Saving Trust (a UK-wide non-profit organisation) provides zero-interest small business loans of up to GBP 100 000 to help businesses install renewable energy technologies or measures that reduce energy consumption.

USA: In the US state of Virginia, a co-operative agreement between the Department of Environmental Quality and the Department of Business Assistance has allowed the state's small businesses, since the year 2000, to obtain loans of up to USD 50 000 to finance the purchase of equipment to implement voluntary pollution prevention measures or to introduce agricultural best management practices. These loans have an interest rate of 3% with favourable repayment terms based on the borrower's ability to repay and the useful life of the equipment being purchased.

Sources : Energy Saving Trust (2014), www.energysavingtrust.org.uk; ECOS (2012), *2012 State Innovations,* https://www.ecos.org/documents/2012-state-innovations/.

There are not very many domestic public finance institutions in EaP countries that can provide targeted soft loans for environmental investments by SMEs, although Ukraine and Belarus do provide some funds. It would be useful to consider stablishing public green finance institutions (banks or funds), or strengthening functions of existing state institutions, so that they can support specifically green projects at SMEs.

Currently, credit lines extended by IFIs and disbursed through local commercial banks are the main source of long-term financing for environmental investments in the region. Such credit lines facilitate access to longer-term finance and make it more feasible to borrow. This does not mean the funds are necessarily cheaper than ordinary loans (i.e. the interest rates are not subsidised), but the end user and the local bank can often benefit from grant-funded consultancy services and training to develop feasible projects. This helps to reduce the risk to the local banks, making them more willing to lend, and also improves the overall effectiveness of the investment.

Important factors of successful implementation of a soft loan programme for environmental investments include:

- ***early definition of the environmental goals*** to be achieved by each project
- ***inclusion of environmental requirements in the loan agreement*** with a clear definition of environmental measures to be taken and adequate monitoring processes
- ***close monitoring and evaluation by the lending institution*** of the use of funds and of progress in achieving its environmental goals.

The role of co-operative banks

Credit unions, co-operatives and other depositor owned banks are more likely to offer the long-term loans that are most valuable to SMEs, and potentially lower collateral requirements. They also have different strengths in terms of supporting access to finance for green SMEs. Credit unions and other depositor owned banks are more likely to take the time to work with SMEs and be familiar with SMEs in their community, helping to minimise information asymmetries. This is also facilitated by local branch offices, with people from the community at hand (UNEP 2017). This suggests that governments in EaP countries as well as IFIs operating in EaP countries may be able to take advantage these institutions as complements to commercial banks, by offering more flexible financial solutions and using their extensive local networks.

Box 7.3. **Measures to support the aggregation of green bonds**

Warehousing: This refers to using a single entity – a "financial warehouse" – to aggregate and package loans together so that they can be issues as bonds to investors. IFIs can establish these warehouses in-country.

Standardised contracts: As SMEs often do not have individual credit ratings, simply aggregating loans into green bonds leaves a lot of uncertainty for investors. By setting requirements for standardised loan contracts, governments can ensure that bond issuers are able to supply accurate risk information to investors.

Green covered bonds: Governments can also specify that collateral for covered bonds needs to be provided through green assets. This helps encourage SMEs to invest in green assets, as they can then act as loan collateral to pay for the asset investment.

In Mexico, the IADB has set-up a financial warehouse focusing on funding new investments in energy efficiency. The warehouse, which operates as a Special Purpose Vehicle (SPV), makes a senior credit line of up to USD50 million available to three Energy Service Companies (ESCOS) in order to finance energy efficiency investments among SMEs. In a second phase, IADB will make available another USD 56 million to purchase the loans from the SPV, aggregate them and issue them as green bonds on the Mexican market. The Clean Technology Fund makes available another USD 19 million as a credit guarantee for the underlying loans. Additional support is provided through non-reimbursable technical co-operation to develop capacity and knowledge for the assessment and identification of energy efficiency opportunities in accordance to the guidelines for energy efficiency projects. The project is now being replicated across Latin America with funding that has been made available by the Green Climate Fund (GCF) in November 2015.

Source : European Commission (2016), *Study on the potential for green bond finance for resource-efficient investments,* Publications Office of the European Union, Luxembourg. http://ec.europa.eu/environment/enveco/pdf/potential-green-bond.pdf.

Green bonds

Green bonds have rapidly become an important source of finance for projects in the green economy, including low carbon and climate resilient infrastructure and green business investments. In 2016, USD 95 billion worth of green bonds were issued, a sharp increase from USD 3 billion in 2011 (OECD 2017). While green bonds are a valuable tool for supporting access to sustainable finance, "bonds typically have to have a size of above USD 200 million to be relevant for institutional investors" (European Commission 2016). To address the fact that SMEs generally seek significantly lower sums than this, IFIs are developing green bonds targeted at supporting SMEs by aggregating and securitising loans for SMEs, and then issuing the resulting green bonds to investors. This helps bring in investors into markets which they might otherwise view as being less financially developed, as it provides investors some assurance through institutional involvement. It also decouples green loans from local interest rates, and allows for longer payback periods, depending on the specifics of the bond being issued.

Asset based financing

In OECD countries and increasingly in emerging economies, asset-based finance is used by SMEs for their working capital needs and to support domestic and international trade. Through asset-based finance, firms obtain funding based on the value of specific assets, including accounts receivables, inventory, machinery, equipment and real estate, rather than on their own credit standing. In this way, it can serve the needs of young and small firms that have difficulties in accessing traditional lending (OECD 2015b). To support access to green finance, institutions can create special funds dedicated to providing asset-based finance specifically to designated green assets.

Policies to promote asset-based finance relate primarily to the regulatory framework, which is key to enable the use of a broad set of assets to secure loans. Across OECD countries, active policies exist to support asset-based finance for businesses that are unable to meet credit standards associated with long-term credit (OECD 2015b).

One example of asset based financing is warehouse receipt financing (WRF). In WRF, farmers, food processors, or exporters place their goods in a secure warehouse owned by a third party. They are issued a receipt for the goods, which can then be used as collateral for getting a loan from a financial institution. Depending on the structure of the WRF arrangement, once the goods are sold to a buyer, the buyer can either pay the borrower or pay the funds directly to the financial institution. Enabling factors for WRF include supporting legislation, a responsible regulatory agency, licensed and supervised public warehouses, and banks familiar with warehouse receipts (Hollinger et al. 2015).

Microfinance

The money required for efficiency investments, especially for microenterprises, is often more than what is on hand as cashflow but less than what traditional banks offer as loans. Microfinance institutions are already active in the EaP countries – in 2012, there were 12 in Armenia, 30 in Azerbaijan, and 60 each in Georgia and Moldova. Microfinance institutions are often familiar with the communities they serve and can help reach microenterprises that would otherwise to access finance (OECD 2016). These microloans can make a major difference in microenterprises' ability to pursue efficiency gains, such as better equipment or structural changes that support better energy use and bottom-line savings on energy purchases. They can also act as conduits to help develop the understanding of microenterprises in terms of the costs and potential benefits of investing in more efficient equipment for their businesses. This can be as simple as more efficient refrigeration equipment for a food processor, or more energy efficient heating systems. However, for larger investments, such as more efficient production machinery or rooftop solar installations, the interest rates offered by MFIs may be too high.

In Tajikistan, the Asian Development Bank's Access to Green Finance Project provides 8.8 million USD for five year local currency dominated credit lines for selected microfinance institutions. The loans support microenterprises and households in making investments in more energy efficient and environmental friendly approaches, and have a maximum value of 5 000 USD. The government of Japan is providing additional support (750 000 USD) for technical assistance training to the microfinance institutions involved, with a particular focus on building capacity of the institutions around green finance and investments in efficiency (OECD 2016).

Conclusion

This toolkit chapter is a brief overview of what is a complex challenge for countries around the world. There is no one silver-bullet solution though, and the recommendations presented here act in concert to support access to finance for green SMEs of all types. SMEs are incredibly heterogeneous as a group, spanning every sector of the economy and ranging in size from a handful of employees to hundreds, and from cutting edge start-ups driving innovation in new green technology to local grocery stores that could save on their energy bill by investing in more efficient fridges. Meeting the needs of diverse SMEs requires a broad array of different solutions working in concert, and a co-ordinated policy response.

Recommendations

- Governments can support SMEs in accessing finance by raising awareness of the options that are available to them, and building the capacity of SMEs to assess the attractiveness of different finance options for their particular circumstances. SMEs should also be supported in building their capacity to better make the case to lending institutions of what their business fundamentals are and what the benefits to their business are going to be if they are able to invest in greener practices.
- Financial institutions should also be supported in building capacity so that they can better conduct due diligence and assess the risk factors of supporting green SMEs, and thus better assign interest rates and collateral requirements. Governments can also raise awareness among smaller financial institutions that are used by SMEs of available options for funds they can take part in to support green SMEs.
- Supporting soft loans or interest rate subsidies for green SMEs to encourage access to bank finance should be explored with a critical eye. While potentially beneficial for increasing green SME access to finance, there is a hazard of lending institutions keeping interest rates high if there is no impetus to lower them due to the expectation of subsidisation.
- In addition to making it easier to access existing bank finance, governments should support the development of non-bank financial channels for SMEs. This potentially decouples the availability of finance from interest rates and collateral requirements. Green bonds that aggregate and securitise loans into packages which can then be floated for investment can provide an important source of non-bank finance for SMEs. Asset-based financing is also an important form of non-bank finance.

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