Issue Brief:

A New Middle East: Investing Where it Matters Most

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Background

The Middle East and North Africa [MENA] is a region in the midst of change. Many of the key stakeholders in this change — from micro-entrepreneurs to small and medium enterprises (SMEs) to the burgeoning youth population — are traditionally underserved, yet play a central role in the stability and long-term future of the region.

Today, the region is experiencing the highest proportion of youth to adults in its history, with over 30 percent of its population between the ages of 15 and 29 — representing over 100 million youth. Yet unemployment among youth in the Middle East stands at 25 percent — the highest in any region. And in Egypt, in 2006, well over 80 percent of the unemployed were below age 30, and 82 percent of the unemployed had never worked before.[1] According to the World Bank, the region needs to create 40 million jobs in the next decade just to keep pace with its youth bulge. In Syria, unemployment among youth (ages 15-24) is more than six times higher than that among adults — the highest ratio among the region's countries outside of the Gulf States.[2] In addition, the duration of unemployment for new university graduates is extremely long, lasting up to three years in countries such as Morocco.

[1] United Nations Development Programme and the Egyptian Institute of National Planning, Egypt Human Development Report 2010 (Cairo: Institute of National Planning, 2010): 148.

[2] World Bank, United Nations Development Programme, and Middle East Youth Initiative publications, Inclusion: Meeting the 100 Million Youth Challenge, Social Exclusion: Comparative Analysis of Europe and Middle East Youth, Youth Exclusion in Egypt: In Search of Second Chances, Youth Exclusion in Iran: The State of Education, Employment, and State Formation, Youth Exclusion in Syria: Social, Economic, and Institutional Dimensions, Youth Exclusion in Morocco: Context, Consequences and Policies.

While the political instability across the region is likely to cause investor flight and economic contraction, in many ways now more than ever is the time to invest. The unprecedented political and social transformation taking place offers tremendous opportunities to address the economic disparity and lack of opportunity faced by the majority of the population today. Supporting entrepreneurship and the growth of small businesses will accelerate more equitable economic growth and job creation. According to a 2009 study by the Milken Institute, in developed countries, SMEs contribute to over half of gross domestic product and 57 percent of total employment; compared to 16 percent and 18 percent in the developing world. In Egypt, however, SMEs are already the driving force in the economy, representing 90 percent of enterprises, contributing to approximately 80 percent of the country's GDP and growing at an annual rate of six percent from 2006 to 2008.

However, despite a number of interventions and credit enhancement schemes to try to increase access to finance, SMEs in MENA at large still suffer from lack of financing to upgrade and expand. According to a recent IFC / McKinsey study, there are between 1.9 and 2.3 million formal SMEs in the MENA region, and the SME financing gap is estimated to be in the range of $110 billion to $140 billion. SME lending as a percentage of total lending (SME lending ratio) for banks in MENA averages eight percent — far below OECD countries where SME lending averages 27 percent of total lending. This is despite the fact that most major banks in the region hold abundant loan capital and are generally underleveraged. Although more than half of the formal SMEs in MENA maintain bank accounts, most do not have access to credit.

The table[3] below illustrates that Egyptian banks would need to increase the SME portion of their total lending by, for example, $14 billion in order to reach an SME lending ratio on par with OECD countries. Egypt noticeably lags the other MENA countries in terms of SME lending as a percentage of total outstanding loans. Egypt's SME loan balance represents less than seven percent of total loans.

Table 1: Bank SME Lending Ratios by Country

Country	Total Banks	Total Loan Balance (US$ billions)	SME Loan Balance (US$ billions)	Potential SME Loan Balance (US$ billions)*	Increase in SME Loan Balance to Reach OECD Levels (US$ billions)
Egypt	40	69.6	4.6	18.7	14.1
Tunisia	24	24.7	3.8	6.6	2.8
Jordan	23	18.8	2.0	5.0	3.0
Morocco	33	69.9	16.6	18.7	2.1
Lebanon	68	59.3	9.6	15.9	6.3

Research compiled by Arun Hsu, Senior Technical Specialist, CHF International. Central Bank of Egypt, Central Bank of Tunisia, Central Bank of Jordan, Central Bank of Morocco, Central Bank of Lebanon, International Monetary Fund (IMF), The Union of Arab Banks and The World Bank.

*If SME lending increases to OECD level of 26.8% of total 2009 loans.

[3] Rocha, R., Farazi, S., Khouri, R. & Pearce, D. (2011, January) The Status of Bank Lending to SMEs In The Middle east and North Africa Region: The Results of a Joint Survey of the Union of Arab Banks and the World Bank.

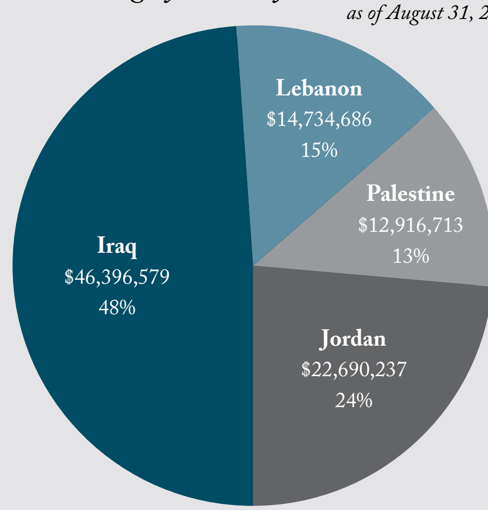
CHF International in MENA

CHF's commitment to the region is demonstrated by our diverse programming in Egypt, Iraq, Jordan, Lebanon, West Bank and Gaza and Yemen. Over the years, CHF has built a reputation as a neutral facilitator and an organization that achieves tangible, positive results. Our programs range from access to credit and community-led infrastructure in Iraq, to entrepreneurship opportunities for women and youth in the West Bank and Gaza.

CHF International is the largest international network of microfinance lending in the Middle East, with more than 83 percent of its $157 million outstanding portfolio worldwide in four countries: Jordan, Lebanon, West Bank & Gaza, and Iraq, where we have nearly 55,000 clients and over 680 staff — all of whom are of Arab origin. CHF serves a broad spectrum from micro to small and medium businesses, what we consider to be the "missing middle" entreprises too large for traditional microfinance instititutions, but too small for commercial banks. For example, in MENA CHF's customer base of microenterprises typically employ 1-5 people and loans range from $500 to $10,000 (average $2000); compared to SMEs which employ 5 to 150 employees and loans range from $10,000 up to $2 million (average $120,000). Since 2004, CHF has disbursed more than $620,568,403,

MENA Active Portfolio of Credit Programs Outstanding by Country

as of August 31, 2011



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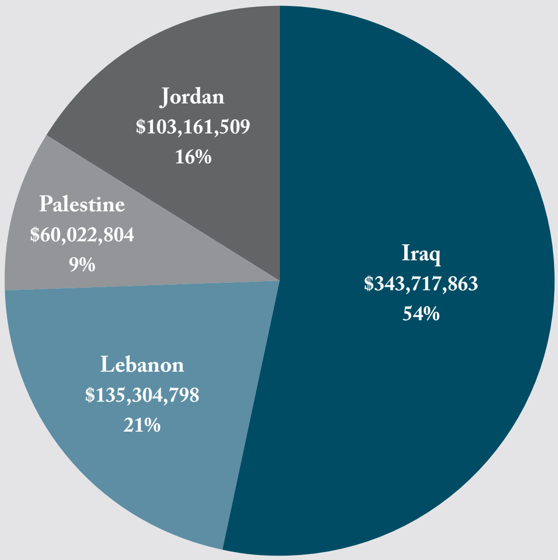
MENA Cumulative Loans Disbursed by Country

Since Inception



provided loans to over 260,000 people and helped create an estimated 520,000 jobs in the region. In Iraq alone, CHF's microfinance program serves more than 50% of the microfinance clientele and last month disbursed its 124,388th loan.

There is growing and persistent income disparity and absence of a sizeable middle class in many of the countries where we have seen the Arab Spring unfold, but there is a huge majority of working class. Much of CHF's success in the region is due to the fact that the people and families we serve are the working class: They pay back, and they have no other choice but to stay in the country and make things work. They live through war, conflict, disaster, regime change, stagnation, and regime change again. They represent the future, and they will determine what their countries ultimately become. They cannot flee their country in the event of an emergency — they have to invest in it, and in their future. CHF's repayment rates in MENA are its highest, above 98%.

The microfinance work CHF International does in the MENA region is part of a larger effort of microfinance providers. According to 2009 MENA statistics from the MIX Market, there are approximately 2.5 million microfinance borrowers, 76 civil society organizations, over 5,000 employees involved. And yet MENA is the least developed region in the microfinance industry in terms of its outreach, ability to attract investment, and profitability. A large part of the problem is the amount of donor and government subsidy that has in some cases distorted markets, and the lack of legal frameworks that enable more commercially-oriented, yet still mission driven, models of microfinance — exactly the model that CHF is trying to pursue. When donor funds dry up, investment is a must. The challenge is that while many investors have limited exposure, see the positive track record, and are increasingly interested in this region, the vehicles for that investment are few. All that said, CHF's experience in the region has proven that commercial models can and do work.

Models in MENA that Work

Microfinance

Microenterprises on average only employ a few people – but they do create job opportunities where very few exist. Most people assume that all lending in MENA must be Sharia compliant. CHF's experience shows the contrary: Islamic compatible lending models have proven more affordable to customers and have in many cases received the "blessing" from religious leaders. The fatwa that CHF received during its early years of operation in Iraq paved the way for a community-driven, demand led model of financial services for microentrepreneurs. Today, the challenge is accessing capital to keep up with that demand. For this reason, CHF has pursued a local company license in each country in MENA to serve as a vehicle for both debt and equity investments that can fund future growth independent of donor funds which are not guaranteed. Thus far, CHF has obtained the first ever financial company license in Lebanon, and is in the process of registration in Jordan, West Bank and Iraq. This is a means to an end of securing the future growth and sustainability

A CHF loan recipient, Iraq

A CHF loan recipient, Lebanon

of our operations for long-term service to our low-income customers, and as important, paving the way for others by setting a precedent that is proven to work.

SME Financing

SMEs are crucial drivers to economic growth, creating jobs and providing income to people who own and work in them. Small and growing businesses (the S of SME) are often the entrepreneurial engines of growth, particularly among young people ages 25-30. It is difficult to sustainably finance this segment due to the lack of clear financial statements, and knowledge gap that exists for the financier to comfortably take a risk. Whereas microcredit is not collaterized and largely based on household repayment capacity, SME lending requires a deeper analysis of cash flow and business strategy. CHF has begun to test new methodologies in underwriting these small businesses. The model is simple: Diversify the risk across sectors that are considered growth sectors and work with loan staff trained in those sectors. Establish a pull mechanism whereby businesses that cannot produce a business plan but are creditworthy have an incentive to improve and invest in better business planning, accounting, systems, driven by the application process for a loan. First time rejected applicants can come back as successful applicants, as they are walked through the process and understand what it takes to be bankable and credit-ready. Long-term presence and relationships count: In some cases, microbusinesses graduate to this "small and growing" category, but more often than not, CHF subsidiaries develop a separate portfolio of SMEs that can be priced and managed in a way that makes it sustainable and affordable. This is a welcome move for microfinance to reach up to this segment, as hopefully banks reach down.

Fully Banking SMES

There is a long history of guaranty schemes over the last decade or so to motivate banks to serve the SME market. No model is perfect. But CHF has hit on some key criteria that have made a new and improved model of loan guaranty facilities pay off. It is simple: Think like a bank. Show that there is profit to be made; the rewards are greater than the risks. Take away enough risk to be palatable to the credit team. Build the back office to handle small loans. Build the front line staff with profiles that suit the SME client. Since profitable SME customer relationships are often based on transactional services, offering credit products helps strengthen existing customer relationship and provides opportunities for cross selling new products. This is not done overnight, but the result is a slow culture shift among champions in the banks that see how to profitably serve this sector. Most importantly, it is from within the bank that this change happens, and not pushed from the outside, largely driven by the shadow relationship of CHF staff that intermediate between the bank and the guaranty. Loan officers get immediate feedback on their underwriting of a small business, and loan guarantee rejection rates in CHF's experience come down from 60% to under 20% within the first year. This hands-on approach is expensive, and requires an appropriate subsidy from a development bank or donor, yet it is the kind of upfront culture shift in systems, personnel, and management outlook needed within a bank to prove that serving SMEs is not only doable, but more profitable that parking their funds in government securities. It is going beyond business as usual and only the most aggressive banks in MENA region, in the absence of competition, are likely to succeed.

Challenges the "Collective We" Need to Address

There are long-standing structural challenges in the region, and the current flux of the political situation offers an opportunity for private, non-governmental and new government actors, the "collective we," to engage more deeply for permanent change. But the quick wins that most actors want to see in the region pose a threat to doing more than business as usual. The governments may have changed in a country, but the vested interests are still there, and do not like change.

A CHF loan recipient, Iraq

For this reason, CHF is appealing to broad range of actors and influential stakeholders that the time is ripe to coordinate, collaborate, and promote real, incremental change that can last.

Policy and Legal Environment

One of the most significant barriers to increasing access to finance for micro, small and medium enterprises (MSMEs) is the legal barriers that exist for the non-traditional financier itself. Registering company-like vehicles that can attract debt and equity investment is extremely difficult. Laws are introduced, reversed, put on hold, and changed. These laws are often understood differently among the various decision makers within a country, and clear processes for receiving a license to offer non-bank financial services rarely in place. There is a general lack of understanding of what is a double bottom line, a socially responsible investor. More is needed to educate and ultimately help promote legislation that will encourage microfinance banks, investment vehicles, mobile money operators, and a range of actors that are playing in the financial services space for the micro and missing middle enterprises. The next generation of policy makers needs incentives to take some risk. No one can afford to wait another two years to have favorable policies in place. The lost time will ultimately cost under and unemployed youth and the potential growth for economic activity in the region.

A CHF loan recipient, Jordan

Business Environment

The absence of competition — the kind of dynamic, competitive environment needed and that drives most developed economies — is one of the most significant obstacles, according to a recent World Bank report on MENA region. Several measures should be taken to make the environment more conducive to business by creating an enabling investment environment by enhancing business regulations, easing trade restrictions and facilitating inclusive access to finance. The region would also greatly benefit from programs that facilitate skills matching, promoting entrepreneurship and modernizing labor intermediation and employment services. A strong focus should be placed on strengthening and harmonizing bank regulation, improving access to finance for SMEs and the housing sector, while generating data for private capital flows.[4] The World Bank, IFC, KfW, USAID and others have projects and plans that speak to the business enabling environment. However, these efforts take months and years to progress, and should be more

[4] MENA Regional Strategy, Update 2011, World Bank

A CHF loan recipient, Jordan

A CHF loan recipient, West Bank/Gaza

coordinated among the parties and with work already on the ground. The extent to which CHF can have real impact through its microfinance and SME activities will ultimately depend on an improved environment that makes it easier to do business and use financing more successfully.

Focus on Youth

CHF needs partners that complement our financial products currently being developed for youth, but we have found a dearth of good local youth organizations, training centers, support organizations in MENA. While some do exist, they are relatively small programs, with weak capacity, inconsistent donor funding streams and with little ability to scale. In a market study CHF conducted last year in the West Bank, for example, many young people surveyed had big dreams but few concrete coaching opportunities to achieve them, especially after they graduated from school and training programs ended. Thus, there is a gap in coaching and mentoring during the critical period most likely for entrepreneurship to make a dream business idea a reality. Other issues include improving education quality to align skills to global economy demand, increasing women's participation in the labor force (by investing in early childhood development, as home-based work, for instance) and enhancing the productivity of informal, disadvantaged workers and youth. There is an appropriate area for donor subsidies, to test new products that require adjustments that acknowledge the risks and skills gaps in trying to serve the young population. But there is also a potential for sustainable, fee-based coaching services in the long-run based on CHF's research. This is an important area for further exploration and coordination among donors, youth-focused organizations, schools and universities, and financiers.

Conclusion

The transformation taking place today in MENA is a signal that now is the time to invest, and to invest in people that matter most. In CHF's experience, these are the young, the entrepreneurial, and the small business owners with potential to grow and create jobs for the next generation and will lead to greater stability, rather than disappointment and disillusionment. With change come tremendous opportunities for us to engage more deeply with both new policy makers and young entrepreneurs alike, to work toward permanent change, not business as usual. CHF's success in the region has proven that thousands of viable small businesses are investment worthy and do pay back. Yet finance in a vacuum is not enough. We need to place more emphasis on the enabling legal, policy and business environment to make programs more successful and to better address the needs of the young population that is at the crux of the region's success. It is a lost opportunity if we do not take up the challenge.

CHF International

Founded in 1952, CHF International currently operates in 26 countries and territories. CHF's mission is to be a catalyst for long-lasting positive change in low- and moderate-income communities around the world, helping them improve their social, economic and environmental conditions.
For more information, please visit our website at: **www.chfinternational.org**