LEVERAGING OUTCOME-LINKED LOANS TO IMPROVE THE ESG PERFORMANCE OF SMALL FIRMS

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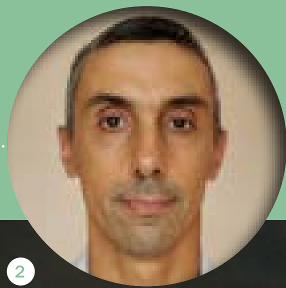

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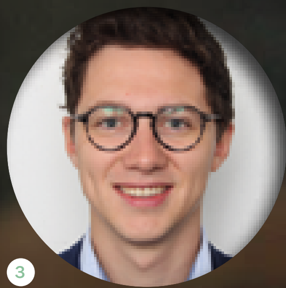

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SMEs play a key role in national economies, but often fail to address their environmental, social and governance (ESG) risks and opportunities adequately. Strong governance, as a key pillar of ESG, helps these businesses boost their competitiveness, integrate better into supply chains and access suitable finance. The EBRD's outcome-linked loan programme helps SMEs to implement crucial ESG improvements and adopt sustainable business practices.

INTRODUCTION

Small and medium-sized enterprises (SMEs) play an important role in both developed and developing economies and serve as a major source of new jobs. However, they face many difficulties, notably in attracting financing through commercial banks or accessing capital markets. Growing evidence suggests that inadequate corporate governance (including in relation to environmental and social risks) is among the top challenges hindering the access of SMEs to suitable medium- and long-term financing.[1] This affects their survival, competitiveness and growth prospects, with the associated negative impact at the macroeconomic level.

The EBRD's outcome-linked loan (OLL) programme is part of the Bank's efforts to support the development of a sustainable SME sector across its economies. The OLL programme is implemented in partnership with the Swiss State Secretariat for Economic Affairs (SECO) and several commercial banks in Central Asia and the Caucasus. This initiative is aligned with the efforts of the EBRD's corporate governance team within the Legal Transition Programme (LTP) to improve corporate governance in the Bank's regions and across sectors.

While SMEs in the EBRD regions are becoming more aware of the positive impact of adopting better environmental, social and governance (ESG) practices, most small businesses have limited capacity and willingness to make such improvements. This is primarily due to a lack of financial resources and expertise. The objective of the OLL programme is thus twofold:

- **Generate impact** by enabling SMEs to improve their ESG practices, thus accelerating their transition to becoming greener, more inclusive and better-governed businesses.
- **Improve competitiveness** by boosting the financial performance and growth prospects of SMEs through implementing relevant and ambitious ESG improvements. This would result in improved access to funding, better integration into supply chains, reduced operating costs and enhanced compliance with local and international regulations.

WHAT ARE SMEs AND WHAT ROLE DO THEY PLAY IN NATIONAL ECONOMIES?

Supporting the SME sector is a strategic priority for governments, development finance institutions, donors and international organisations. The main reason SMEs receive so much attention is that, although individually small, their collective contribution is large: the World Bank estimates that SMEs account for about 90 per cent of businesses and more than 50 per cent of employment worldwide.[2]

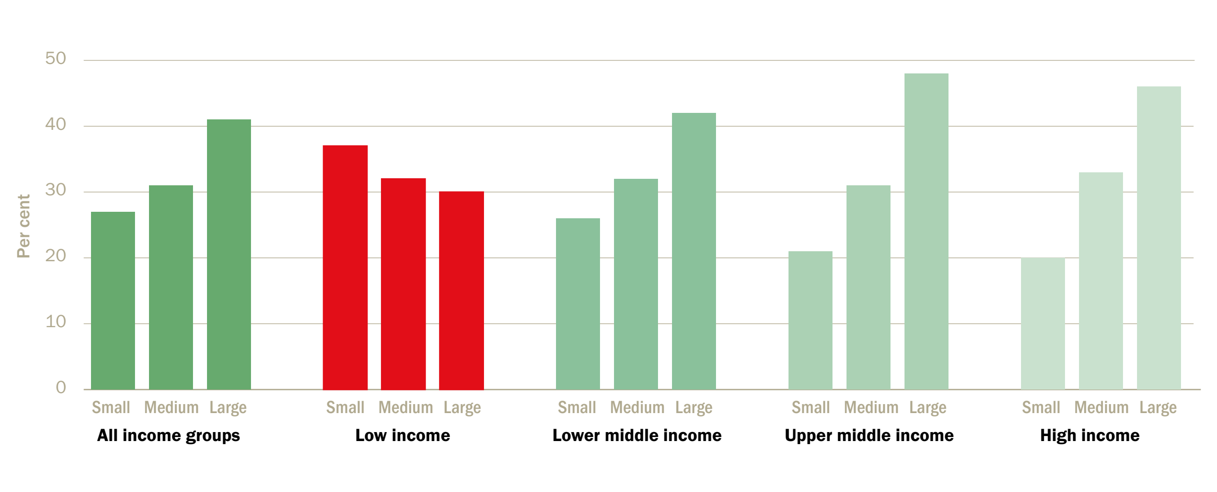
Due to their sheer numbers, SMEs are often referred to as the "backbone" of the economies and "engines" of job creation and economic growth. This is especially relevant in low-income countries, where these firms account for 7 of every 10 jobs (see Figure 1). Moreover, formal SMEs contribute up to 40 per cent of national income in emerging economies. These numbers are significantly higher when informal SMEs are included.[3] SMEs also play a vital role in regional economic and social development, as they often operate in areas outside capitals and urban centres where large enterprises are less present.

1 International Finance Corporation (2019).

2 World Bank (2024a).

3 The International Labour Organization estimates that SMEs are responsible for two-thirds of global employment. See ILO (2024).

Figure 1. Share of employment by firm size and country income group



Source: World Bank Enterprise Surveys (2024b).

> "The governance solutions for SMEs should aim to: (i) improve strategic decision-making; (ii) oversee the performance of management (from overview of expenditures to strategy implementation);(iii) establish strong management controls that also help to ensure the integrity of the company's financial reports; and (iv) build a strong internal culture and staff morale."

ESG CHALLENGES FOR SMEs

Many studies clearly demonstrate the link between good corporate governance and benefits such as improved firm performance, better access to capital and greater sustainability. Failure to enact good corporate governance practices may result in underperformance or, in extreme cases, the failure of the business. Common SME weaknesses include the lack of established strategy and business planning, non-formalised practices and weak internal controls.

In addition, SMEs often fail to recognise and integrate environmental and social (E&S) risks and opportunities in their strategies and have limited capacity to develop and implement appropriate E&S risk management practices. The situation in many SMEs is complicated even further by the succession risk and the increased role of extended family in the affairs of family-owned firms.

Due to their smaller size and various stages of development, SMEs have their own unique characteristics and challenges. Consequently, the governance and broader ESG guidance for SMEs should not be a simplified version of the governance requirements applicable to listed companies or banks. For example, SMEs often do not have the separation between owners and managers typical of larger companies. Instead, the ownership of SMEs is usually highly concentrated, and the owners are involved in both the strategic decision-making and day-to-day management. They usually oversee the relevant areas of the company's work (including finance, operations, marketing and sales).

The most compelling reason for SMEs to improve their ESG performance is to ensure their long-term viability and competitiveness in a rapidly changing marketplace. To do so, SMEs should put in place suitable arrangements to direct and control the company effectively. This can be achieved by establishing internal functions and governance bodies as well as developing policies on topics ranging from cash management, budgeting and financial reporting to health and safety and sustainability, as appropriate for the size, sector and stage of development of the company (that is, start-up, active growth, organisational development and business expansion).[4]

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In the current environment, sustainability issues represent major risks and opportunities for all companies. In this context, the corporate governance frameworks should be designed to support the sustainability of firms. On the one hand, the larger ones face more complex challenges, but often have sophisticated governance structures and sufficient capacity to understand and manage the sustainability issues. SMEs, on the other hand, frequently lack sufficient awareness and expertise to analyse their material ESG areas and need to put in place a suitable governance framework to help them develop solutions to mitigate any significant E&S risks and adapt to the effects of climate change. Given their growing importance, sustainability issues should be integrated into the SME strategy-setting process and risk management. SMEs should also develop capacity to regularly produce the additional non-financial reporting, including on ESG performance, that many financial institutions and supply-chain participants increasingly require.

4 International Finance Corporation (2019).

OLL PROGRAMME: WHAT HAS BEEN DONE SO FAR AND NEXT STEPS

Enhancing corporate governance practices among SMEs is an important priority for the SME Finance and Development team at the EBRD. For instance, 51 per cent of the recently initiated 254 international advisory projects with SMEs explicitly incorporate corporate governance as either a core or a secondary objective. Such advisory support helps small businesses establish robust organisational frameworks, ensuring their long-term sustainability and growth.

As part of its efforts to improve the ESG practices of small firms, the EBRD and SECO launched a pilot OLL programme in 2023. An OLL is a financing instrument that combines an ordinary loan with a commitment of the borrower to achieve certain outcomes in the form of specific ESG performance improvements. The direct reward that the borrower receives is an incentive payment, which effectively lowers the interest rate on the loan and is proportionate to the achieved impact. The proceeds from an OLL could be used for capital expenditure (for example, new facilities and equipment), working capital or other legitimate business purposes.

The outcome-linked loan programme targets SMEs aiming to address their ESG risks and opportunities, regardless of whether they already have internal capacity to adopt ESG improvements on their own.

There does not need to be a direct link with the ESG outcomes that the borrower aims to achieve (for example, the procurement and installation of solar photovoltaic panels on the company premises). Instead, the outcomes must focus on areas that are material, given the sector and business model of the borrower. The level of ambition in terms of the magnitude of the improvements needs to be substantial (usually going beyond the applicable local regulations). On this basis, the OLL programme supports companies seeking to become ESG champions and provide positive demonstration effects in the local market.

The structuring of an OLL involves the following steps:

1) **ESG diagnostic:** Aims to establish the main ESG risks and opportunities that the borrower faces and is usually carried out by an expert in the field.
2) **ESG action plan:** Specifies up to 10 key performance indicators (KPIs) that the borrower intends to tackle as part of the OLL, together with the applicable baseline values, the agreed ambitious targets and a timeline for their achievement.
3) **Implementation arrangements:** Specify the mechanics of the OLL structure, including the reduction in the interest payment to which the borrower would be entitled, if and when it achieves the targets stipulated in the ESG action plan. These also define appropriate advisory support (if any) that the EBRD would provide to the borrower to achieve the stipulated outcomes.
4) **Reporting and verification:** Define the features of the periodic (usually annual) reporting to the lender on the implementation of the ESG action plan and the performance against the KPIs. The lender verifies this performance by using its in-house resources or with the help of an external verification consultant.

The OLL programme targets SMEs aiming to address their ESG risks and opportunities, regardless of whether they already have internal capacity to adopt ESG improvements on their own. As most SMEs lack sufficient resources to tackle their ESG challenges on their own, the programme provides both external advisory support and a suitable financial incentive to engage in such activities. At this stage, the incentive needs to be significant (up to 10 per cent of the loan principal) and is frequently paid out of grant funding provided by various donors (in this case, by SECO). As the markets develop, the amount of the incentive will be reduced and gradually phased out.

Box 1. **Case study: Multimodal Trans Terminal**

In April 2024, the EBRD signed the first OLL with Multimodal Trans Terminal (MTT), a provider of logistical and warehousing services in Uzbekistan. The loan of US$ 1.1 million will finance the modernisation of MTT's railway logistics terminal in Tashkent and is complemented by a comprehensive ESG action plan developed jointly by the EBRD and the company.

During the initial discussions about the potential OLL structure, MTT demonstrated strong commitment to the adoption of ESG standards. While the company had already initiated some measures on its own, the ESG diagnostic revealed important gaps compared to industry best practices. For example, on the environmental side, the company does not use any renewable energy sources and lacks water and waste management strategies. On the social side, women make up only 11 per cent of the MTT workforce and there is no formal strategy to promote the active participation of women, youth or individuals from underrepresented or marginalised communities. On the governance side, the company lacks a succession plan for key leadership roles and does not engage in any ESG reporting practices.

The ESG action plan entails a commitment to 10 material ESG improvements and outlines specific steps to address the identified challenges. These steps include:

- decreasing energy consumption by more than 20 per cent
- increasing the share of materials or waste stored and recycled to 90 per cent
- setting up an internship programme for young people, at least 25 per cent of whom will be women, in partnership with a local educational institution
- integrating ESG reporting into annual management reports.

These ESG measures represent uncharted territory for MTT and the EBRD will provide support for their implementation through technical assistance. The first ESG improvements are expected to be achieved in February 2025.

The external advisory support is used not only to identify the main areas for potential ESG improvements, but also to help the company develop internal capabilities to design and implement suitable solutions. In our experience, the success of this programme depends not only on the quality of the consultant, but also on the commitment of the company.

Given the low starting position of most SMEs, the ESG diagnostic could identify many "easy wins" – that is, measures that could be implemented easily and without incurring significant costs. Such easy wins typically involve adopting processes to collect data and introducing policies to facilitate the implementation of best ESG practices. Once these are in place, the next steps focus on ESG measures that require greater preparation and may involve certain investments/costs. To help with these, the EBRD often offers the borrower assistance through its International Advisory programme.

Awareness and understanding of various ESG-related topics among SMEs in the EBRD regions are growing, but still relatively limited. Therefore, maximising the impact of an outcome-linked loan requires the lender to lead the design of the ESG action plan and to provide suitable technical assistance in the implementation phase, so the borrower can apply the agreed measures and report on the achieved impact.

By their very nature, OLL instruments are more complex to structure and monitor than conventional EBRD loans. This implies that they are a niche product that is attractive mainly to aspiring ESG champions. Making outcome-linked loans a mainstream product would require:

- increasing the quality and quantity of data on the ESG performance of SMEs – to make it easier to establish the baseline and set the level of ambition for each KPI
- streamlining and standardising the loan terms – to reduce the cost

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- developing capacity among local commercial banks to implement such a product – to increase their ability to structure such loans without the involvement of a development finance institution like the EBRD
- recognising that such instruments can be supported with donor funding only in the beginning – that is, until the adoption gathers momentum. Once that is the case, the level of incentive would gradually decline and the OLLs will play the signalling role for which they were originally intended.

The initial experiences with the OLL programme in Central Asia are encouraging and would enable the EBRD to streamline the operational modalities further and scale the programme in other regions.[5] As these loans become more popular and awareness of ESG improvements increases, the level of ambition of borrowers should rise while the need to provide incentives and technical assistance would diminish. This would gradually allow for ESG elements to be embedded in more financing instruments and would position those SMEs keen to use them on a more sustainable footing.

5 SECO is providing technical assistance to the EBRD to develop a robust and scalable OLL framework in partnership with iGravity, a Swiss consultancy.

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