Establishing a Small and Medium-Sized Enterprise Finance Facility Programme Phase I in 1999,

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EEC) No 3906/89 of 18 December 1989 on economic aid to certain countries of Central and Eastern Europe, as last amended by Regulation (EC) No 753/96 of 22 April 1996 and in particular Article 9 thereof,

Whereas Regulation No 3906/89 lays down the rules and conditions for the granting of economic aid to certain countries of Central and Eastern Europe,

Whereas the measures provided for by this Decision are in accordance with the opinion of the Committee on Aid for Economic Restructuring in certain countries of Central and Eastern Europe,

HEREBY DECIDES AS FOLLOWS:

**Article 1**

The programme described in the Annex to the present decision is hereby adopted.

**Article 2**
The maximum amount of Community assistance shall be 50 M€ to be financed through Budget line B7-500.

Done in Brussels,

For the Commission
1. IDENTIFICATION

Countries: 10 applicant countries of CEEC
Programme title: Small And Medium-Sized Enterprise Finance Facility
Year: 1999
Cost: EUR 50 million
Implementing Authority: European Commission
Expiry Dates: Contracting - 31.1.2001
Disbursement - 31.1.2004
Sector: PR
Group: L
Budget Line: B7 - 5000
Task Management: DG II SOF (J Salacz) - implementation will be assured through a subdelegation arrangement with DG II

2. SUMMARY

A strong small and medium-sized enterprise (SME) sector is an essential element in the ten applicant countries' transition to a market economy and in their accession to the European Union. However, the region’s SME sector is highly underdeveloped.

Agenda 2000 and the Phare New Orientations identify the lack of a dynamic and sound SME sector as a key stumbling block to accession and note that one of the main factors preventing the growth of the sector is the reluctance and inexperience of the region’s financial sector to provide equity and debt finance to SMEs. In response, these two key documents call on the Phare programme to establish a new financial instrument - the SME Finance Facility - to induce financial intermediaries in the ten applicant countries to expand and to maintain in the long term their debt and equity financing of SMEs.

EBRD and Phare will cooperate under the Facility. EBRD funds and Phare grants shall be jointly mobilised through a special fund to provide tailored SME loan, guarantee, equity and management support to financial intermediaries (i.e. banks and investment funds) in the region which shall then cofinance and market these components to their SME clients.

The EBRD forecasts that, under certain assumptions, up to 10,000 SMEs could be reached through the Facility over a six year period. It is expected that this number could be significantly exceeded where banks extend on a large scale loans in the Euro 10,000-25,000 range, in particular to take into account the micro-enterprises. A Steering Committee - comprising sponsors of the Facility - will decide on which projects shall be supported by the Facility.

Given that this is a new instrument, the SME Facility will be implemented in two phases. A start-up Phase I shall be undertaken by the Commission and EBRD. Once operational, the Commission shall attract additional sponsors into the Facility that may include the EBRD, EIB, development finance institutions and private sector financial institutions.
3. BACKGROUND AND PURPOSE

*Past Phare support to SMEs.*

Under its National Programmes, Phare has supported SME development in all applicant countries, through the provision of: (i) technical assistance and advisory services to institutions in charge of SMEs; (ii) support to SME policy and legislative development; and, (iii) financial instruments in support of SME creation and development, normally through financial intermediaries. The types of financial instruments used include grant support to both debt finance schemes (including micro-credits, small loans and guarantees) and equity finance schemes.

Total Phare National Programme support to SME financial instrument projects in the SME sector amount to 212 million EURO (excluding JOP – see below). They are in different phases of implementation, some of them having already been closed. In addition, SME financing has been made available in sector programmes such as energy, environment and regional development.

As programmes have been designed and implemented at the country level, no standardised approach has been developed. Yet important similarities have emerged in the experience with these different programmes. When combined with the huge demand for SME support of some kind, the potential benefits from a regional approach but tailored to specific project needs – such as proposed through the SME Facility – are obvious.

In addition to Phare National Programme support to SMEs, JOP (Joint Venture Programme) has been in operation since 1991 to promote the creation of joint ventures in Central and Eastern Europe. Since 1991, an overall amount of 144.5 million EURO \(^1\) has been allocated to JOP under the four facilities: identification of joint venture partners, feasibility studies, equity investment and transfer of know-how and more than 2,300 files have been examined since 1991. Under facility 2 (feasibility studies), out of 404 investment decisions which were finalised on 30.6.98, 208 Joint Ventures were created in the region (i.e. a success rate of 51%). The equity facility has been discontinued in 1998 in the light of this broader proposal for a SME Facility.

### SMEs in Agenda 2000 and Phare’s New Orientations

Agenda 2000 (Impact study) concludes:

"SMEs in candidate countries are still a long way from having the level of support and resources that exist in the EU, for example, in support services, policy coordination, or in development of appropriate legal and regulatory frameworks. Access to finance remains a key bottleneck."

\(^1\) Initially anticipated as a pilot-programme for 3 years, JOP was extended 4 times: in 1993, 1995, 1997 and 1998
“EU membership is likely to put considerable pressure on many SMEs in acceding countries, by exposing them to international competition. This could have an adverse impact on employment. The problem will be less severe, provided the candidate States adopt comprehensive and effective policies to support the emergence and sustainability of SMEs. The Union will have to focus on support to SMEs in acceding countries, both before and after accession.

"Other resources could be mobilised from international financial institutions for work on standards and the development of SMEs. PHARE could be used as a catalyst for co-financing operations with the EIB, the EBRD and the World Bank with whom the Commission will conclude framework agreements"

Phare shall continue to address the SME non-financial support services and regulatory framework needs through its National Programmes with institution building measures and regulatory and policy support. However, to address the poor access to finance, the New Orientations of Phare specifically call for the establishment of a horizontal SME Facility for the region as a whole:

“A horizontal facility for small and medium enterprises (SME) will be available to remedy the shortage of investment capital available to SMEs, in recognition of the very powerful role that they can play in creating a market economy from the ground up. In cooperation with the EIB, EBRD and private sector, market based mechanisms will be developed to provide additional funding for SME investment.”

Lastly, the Memorandum of Understanding on Cooperation for Pre-Accession Preparation of Central and East European Countries which was agreed on 30 March 1998 by EC (in liaison with EIB), EBRD and World Bank refers to the need for “Community assistance initiatives and, more particularly, to grants under the EC-PHARE programme[,] combined with financing from the IFIs” concerning “the development of the financial and enterprise sector (including SMEs)”.

**Working Group and Feasibility Study**

On the basis of Agenda 2000, Phare’s New Orientations and the Memorandum of Understanding, a working group of the Commission, EBRD and EIB collaborated on the design and implementation of the SME Facility.

The Commission undertook a feasibility study and market demand analysis with target financial intermediaries (i.e. banks and Investment Funds) in the EU and in the applicant countries to assist the working group. The EBRD and EIB conducted their own market testing among EU and CEEC financial intermediaries.

On the basis of this research, the working group concluded that:

1. the most effective way to enhance SME development in the region is to focus on financial intermediaries in the countries (i.e. Participating Banks and Investment Funds) and to provide incentives to those intermediaries to expand their operations to SMEs, rather than to directly support individual SMEs.
2. all financial intermediaries agreed that access to a broad range of flexible financial components - including loans, guarantees, equity and technical cooperation - would empower them to increase their operations for SMEs.

3. the needed support to financial intermediaries must be market orientated and market led for it to work.

4. the European Community and EBRD concluded that they could designate funds to a central SME Facility which could meet the requirements of financial intermediaries interested in expanding their SME operations, while other potential sponsors such as the EIB expressed their interest in coming into the Facility once it is operational. Therefore, the Facility will be launched in two phases: a start-up Phase I where the Commission sets up the Facility with the EBRD and a Phase II when other core sponsors will come on board. Phase II will be subject to a further Financing Proposal being presented to the Management Committee. This financing proposal deals with the start-up Phase I.

4. POLICY ASSESSMENT

SME Needs in the EU

The SME sector has been identified as a critical factor for growth and employment within the European Union and the “Growth and Employment Initiative” was set up (Council Decision 98/347/EC of 19 May 1998) to provide various financial products for innovative and job-creating SMEs inside the EU.

The SME Facility being established by Phare and EBRD mirrors this Growth and Employment Initiative as closely as permitted under the current Phare regulation, on the grounds that all Phare programmes must clearly act as a stepping stone towards internal EU instruments as the applicant countries move towards accession.

The following policy assessment is derived from the supporting documentation for the Growth and Employment Initiative and indicates the need to rapidly address this sector in the CEEC where support to SMEs is a fraction of that available in EU.

SMEs play a vital role in the generation of a dynamic economy and in particular in the creation of new employment. Their ability to develop new business ideas, detect niche markets and to take advantage of innovation ensures future competitiveness. A dynamic SME sector makes a foremost contribution to the continuous renewal of the economy as a whole.

However SMEs are often undercapitalised and face significant problems in raising debt finance and in obtaining risk capital, such as equity or subordinated debt.

Whilst some equity resources are available through national schemes, the role of Investment Funds as providers of risk capital to small firms remains very limited. It is usual for most emerging SMEs, especially the small ones, to have no access to risk capital other than the personal resources of the founders. The raising of debt finance is also difficult for SMEs as banks are often reluctant to lend to them. The lending risk inherent in new firms and expanding SMEs is high and difficult to assess, and is increased by their usual low capitalisation. Loans are often not available to SMEs because of lack of collateral, making new projects particularly difficult to finance. Also, there is frequently a perception that the costs of administering small loans are disproportionately high and that larger loans generate a higher income stream, leading banks to concentrate their efforts on larger companies.
Experience in most industrialised countries shows that unless stimulated through initiatives such as the Growth and Employment Initiative, banks and equity providers will tend to focus on large companies, thereby undermining SME financing.

**SME Needs in the CEEC Region**

Although data and statistics are not very reliable in the region, it is estimated that by the beginning of 1997, there existed at least four million registered non-agricultural enterprises in the CEEC. Some 3.9 million enterprises were very small ("micro"), ranging from sole proprietorships to businesses employing up to 10 people. About 70-75,000 “small” enterprises were in the category of employing 10-50 people and about 20-25,000 “medium” enterprises were employing 50-250 employees.

Financing problems of SMEs in the Accession countries are becoming increasingly serious because of the rapid growth in the sector combined with the continued reluctance and inexperience of banks and investment funds to provide finance to the sector.

In a 1995 survey, it was reported that close to 80 per cent of all enterprises complained about “lack of finance” as their single most important problem.

In short, all market surveys and analyses of current institutional finance practices and bank lending indicate that SMEs are effectively excluded from debt (i.e. loan) and equity finance, an exclusion which occurs virtually in all SME size categories and in all countries.

**“Kickstarting” SME financing in the Region**

This SME Facility Financing Proposal satisfies the new and maturing needs of SMEs in applicant countries

The SME Facility is rooted in the basic policy assessment that Participating Banks and Investment Funds can be persuaded to expand and sustain their business to SMEs, if they themselves receive incentives and other support to overcome their lack of experience and to cover the special administrative costs and risks involved.

However, the intermediaries are well aware that the actual or potential demand for finance is many times larger than an SME Facility could cover. Nevertheless, they hope to establish a critical mass of efficient equity and debt financing projects in the region which, by proving their profitability, will have a clear demonstration effect and entice other banks and Investment Funds to start up similar operations themselves.

5. **OBJECTIVE OF THE FACILITY**

The objective of the SME Facility is to induce financial intermediaries in the ten applicant countries to expand and to maintain in the long term their debt and equity financing of SME operations.

On the basis of this Financing Proposal, a start-up Phase I shall be undertaken by the Commission and EBRD. Once operational, the Commission shall attract additional sponsors into a Phase II of the Facility that may include the international finance institutions and private sector financial institutions.
6. **DESCRIPTION OF THE FACILITY**

As shown in Figure 1 below, the SME Facility’s operation in Phase I is straightforward:

1. EBRD and Phare shall designate EURO 125 million for **projects** supported under the Facility, broken down as Euro 50 million from Phare and Euro 75 million from EBRD. Projects are defined as SME loans and credit lines to Participating Banks or as equity participations in SME Investment Funds and shall generally be Euro 5-15 million in size.

2. a **Steering Committee** comprising Commission and EBRD representatives shall supervise the implementation of the SME Facility.

3. EBRD shall prepare the project proposals for support under the SME Facility with the relevant **financial intermediaries** (ie. Participating Banks or Investment Funds) in the applicant countries.

4. the Facility’s support to projects shall be provided through two closely coordinated **windows**:
   - a Loan and Guarantee Window for Participating Banks - loan funds, guarantees and technical support.
   - an Equity Window for Investment Funds - equity capital and management support.

5. each project will then finance individual **sub-projects** which are defined as equity investments or loans in individual SMEs. There shall be a maximum investment per SME beneficiary of Euro 1 million under the equity window and Euro 250,000 under the Loan/Guarantee window, thereby establishing a clear additionality vis-à-vis existing financial instruments available to SMEs in Central and Eastern Europe. Individual SMEs may receive support from both windows but not exceeding in total Euro 1 million.

6. in accordance with standard practice, the EBRD shall manage the projects resulting from the SME Facility and will engage the financial intermediaries (FIs) in the applicant country to provide finance to SMEs (ie. sub-projects) on a day to day basis.

7. SMEs eligible for support through sub-projects are enterprises employing not more than 250 people.

For ease of understanding, precise definitions of each major part of the SME Facility are set down in Annex 1.

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2 See also Annex 2 (Section 2) for full definition of eligible SMEs derived from Commission Recommendation 96/280/EC of 3 April 1996.
In Phase 1, the Facility is expected to realise 15-20 projects with, in principle, all 10 applicant countries of central Europe being covered. The amount involved in each project is estimated to vary between Euro 5 and 15 million. Obviously, each project shall finance many more sub-projects in individual SMEs. In total, the EBRD forecasts that, depending on the actual growth of the Facility over the coming six years, some 10,000 to 12,000 sub-projects may be undertaken through the Facility.

The procedures and guidelines outlined in this Financing Proposal - including eligibility criteria applied, support offered, financial intermediaries used, final SMEs selected and the implementation conditions and approaches adopted - shall be followed as a general rule. However, given that the particular requirements of projects may differ considerably depending on the country concerned and the SME market segment being targeted, the EBRD may propose to the Steering Committee exceptions to these general guidelines and limits (e.g. focus on larger SMEs, larger allocations to sub-projects). The EBRD shall highlight the particular exceptions and provide justifications, so that the Steering Committee may consider these exceptions on their merits and on a case by case basis.

Figure 2: The Facility’s Windows of Support
<table>
<thead>
<tr>
<th>Window</th>
<th>Component</th>
<th>Funding Source</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>equity participation funds</td>
<td>Phare and EBRD</td>
<td>EBRD and Phare jointly finance equity participations in SME Investment Funds. The Phare contribution is structured so as to provide appropriate incentives for investors to participate.</td>
</tr>
<tr>
<td></td>
<td>management support</td>
<td>Phare</td>
<td>up to 25% of Phare support to an Investment Fund project may be earmarked for the management and operating costs of the fund.</td>
</tr>
<tr>
<td>Loan and Guarantee</td>
<td>loan funds</td>
<td>EBRD</td>
<td>EBRD funds are offered as loans or credit lines to financial intermediaries at market rates.</td>
</tr>
<tr>
<td></td>
<td>loan incentives</td>
<td>Phare</td>
<td>Phare funds are used to provide an attractive margin for onlending to SMEs.</td>
</tr>
<tr>
<td></td>
<td>guarantees</td>
<td>Phare</td>
<td>Phare provides insurance cover or lump sum &quot;set aside&quot; to partially guarantee the SME loan risks.</td>
</tr>
<tr>
<td></td>
<td>technical support</td>
<td>Phare</td>
<td>Phare grants provided to financial intermediaries to strengthen their administrative, credit and management capacities to more effectively address the SME sector’s needs.</td>
</tr>
</tbody>
</table>

**The Equity Window**

The objective of this window is to provide support which promotes self-sustainable SME Investment Funds.

Support through the equity window will not be invested directly into SMEs but into Investment Funds operating in the applicant countries that are specifically designed to take equity investments in SMEs.

The Funds supported by the Facility will be managed by independent fund managers. Great emphasis shall be placed on the track record of the fund managers and the inclusion of high quality local professionals.

The Phare contribution through this window to a project shall be used by the fund manager for both equity or quasi-equity investments in target SMEs as well as support to cover the Fund’s management and operating costs. More detail on this support is provided in Annex 2. These Funds may be either new Funds set up for the purpose of SME investment or existing Funds which open a dedicated operation for SMEs. The Funds may cover a region within one country, a whole country or several countries.

Each Fund will be structured individually to match market conditions in the applicant country concerned as well as best international business practice for investment funds.

The attraction of private capital is an important target for the Equity window. It is intended that a project through the Equity Window would receive indicatively equal financing contributions from Phare, EBRD and private sector sources. However, due account shall be taken of the limited appetite of private investors for SMEs in general and it will be necessary to adapt the capital structure of the funds to specific local conditions. In less advanced countries, private sector participation might be difficult to secure and the Facility may decide to involve partners such as local development agencies. In any case, at a minimum, the EBRD must match the contribution of Phare to a project financed through the Equity Window and must use its efforts to attract additional funds.

Further details on projects through the Equity Window are set out in Annex 2.
**Loan and Guarantee Window**

EBRD shall provide the loan funds or credit line to financial intermediaries under the Facility at market rates. The Phare Contribution to the Loan and Guarantee Window of the SME Facility will provide interest rate incentives, guarantees and technical support to stimulate local Participating Banks into developing and sustaining their loan operations with SMEs.

Project size will generally be up to EURO 15 million.

The principal incentive for inducing Participating Banks to incorporate SME lending as a regular feature of their business is an attractive margin between the interest rate at which loan funds are made available to them under the Facility (i.e. at project level) and the interest they can charge on their on-lending of such funds to the SME sub-borrowers (i.e. at sub-project level). This margin is necessary to compensate for the cumbersome administrative work of managing a portfolio consisting of hundreds of small accounts and to cover the special risks associated with SME lending.

In addition, market research indicates that another major hurdle preventing Participating Banks from expanding their SME banking operations is their lack of financial, operational and administrative skills to meet SMEs’ particular requirements. As such, technical and institutional building support supplied through this window in the Facility to strengthen Participating Bank’s operations in this area is critical.

Lastly, market research indicates that the absence of guarantees to cover SME lending risks is another constraint preventing Participating Banks moving into this area. Therefore, partial guarantees may be considered through this window.

A typical arrangement offered to a Participating Bank on a project through this Window may consist of:

1. a loan or credit line for onlending to the SMEs. The combination of EBRD loan funds with a Phare interest rate incentive shall produce the attractive margin required to induce Participating Banks to take the loan and undertake the necessary organisational changes, most notably the specialisation of loan officers and branches to SME lending.

2. where justified, a partial first-loss guarantee for a fixed certain percentage of losses on the SME loan portfolio managed by the Participating Bank (see Annex 2 for detail).

3. technical assistance to perform institution building in the Participating Banks (e.g. adjust organisational structure, train loan officers in appraisal and supervision, introduce new management information systems, etc.) to meet the special administrative needs of lending to the SME sector, which is very different from the requirements of lending to a small number of large clients.

The precise mix of the support offered under individual projects will vary country by country, depending on the project’s specific circumstances.

At a minimum, the EBRD will provide double the financial contribution of Phare to a project financed through the Loan and Guarantee Window.

The loan or credit line agreement signed by the EBRD with the Participating Bank under the Facility will encompass specific, objectively verifiable criteria by which sub-loan utilisation for the agreed purposes will be controlled.

As with the equity window, EBRD shall manage the loan and guarantee window while the day to day provision of finance to SMEs will be undertaken by the Participating Bank.

Further details on projects through the Loan and Guarantee Window are set out in Annex 2.
7. ACTIVITIES OF OTHER DONORS AND CO-ORDINATION

Since EBRD started its operations, about seven years ago, a wide range of activities have been developed aimed at the strengthening of the financial sector by investing directly in financial institutions and by providing funds to the enterprise sector via financial intermediaries.

By the end of 1997, 189 financial sector operations had been signed for a total of ECU 2.9 billion, representing 29 percent of the total volume of the Bank’s operations.

Direct Operations

At the end of 1997, the EBRD had invested in the share capital of 38 banks, four insurance companies and two leasing companies. It had also provided seven subordinated loans (totaling EURO 86 million), used by the recipients to strengthen their capital bases and expand their operations.

As part of these direct equity investments, the EBRD will often appoint a member to the supervisory council of the investee company to promote transparent corporate governance, management accountability and the implementation of sound banking practices. The EBRD’s direct involvement helps to raise the level of skills in the investee companies, demonstrate sound practices to other market participants and encourage competition in the financial sector.

Wholesale operations

At the end of 1997, the EBRD had invested over EURO 2.3 billion in wholesale operations, including credit lines, private investment funds and trade facilitation programmes. Through these operations, the EBRD is able to mobilise funding for local projects that are too small for it to handle efficiently by itself. Providing access to investment finance for small and medium-sized enterprises (SMEs) is a crucial part of the EBRD’s efforts to strengthen private sector development and to stimulate competition in the enterprises sector. If the EBRD is a core investor in an investment fund, it seeks to strengthen corporate governance by ensuring that a representative of the investment fund manager is included on the board of the investee company.

Figure 3: EBRD signed operations to financial institutions

Cumulative as at 31 December 1997

<table>
<thead>
<tr>
<th></th>
<th>Number of Projects</th>
<th>ECU (million)</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wholesale operations</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit lines</td>
<td>56</td>
<td>1,262</td>
<td>43</td>
</tr>
<tr>
<td>Private equity funds</td>
<td>35</td>
<td>379</td>
<td>13</td>
</tr>
<tr>
<td>Apex facilities</td>
<td>6</td>
<td>310</td>
<td>11</td>
</tr>
<tr>
<td>Trade facilitation programmes</td>
<td>5</td>
<td>119</td>
<td>4</td>
</tr>
<tr>
<td>Stand-by and guarantee facilities</td>
<td>2</td>
<td>109</td>
<td>4</td>
</tr>
<tr>
<td>Special restructuring programmes (SRPs)</td>
<td>3</td>
<td>81</td>
<td>3</td>
</tr>
<tr>
<td>Early-stage equity investments</td>
<td>4</td>
<td>50</td>
<td>2</td>
</tr>
<tr>
<td>Agency and co-financing lines</td>
<td>2</td>
<td>11</td>
<td>0</td>
</tr>
<tr>
<td>Multi-project facilities</td>
<td>3</td>
<td>7</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>116</td>
<td><strong>2,328</strong></td>
<td><strong>80</strong></td>
</tr>
</tbody>
</table>
### Direct Operations

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity investments in banks</td>
<td>46</td>
<td>314</td>
<td>11</td>
</tr>
<tr>
<td>Equity investments in insurance companies</td>
<td>5</td>
<td>6</td>
<td>0</td>
</tr>
<tr>
<td>Other Types of equity investments</td>
<td>5</td>
<td>7</td>
<td>0</td>
</tr>
<tr>
<td>Loans to banks</td>
<td>15</td>
<td>267</td>
<td>9</td>
</tr>
<tr>
<td>Other types of loan</td>
<td>1</td>
<td>11</td>
<td>0</td>
</tr>
<tr>
<td>Business services</td>
<td>1</td>
<td>3</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>73</td>
<td>608</td>
<td>20</td>
</tr>
</tbody>
</table>

| **Total financial institutions operations** | 189 | 2,936 | 100 |

Wholesale projects are also intended to support the development of financial intermediaries by improving, for example, a bank’s ability to identify and appraise new projects. The EBRD asks financial intermediaries to follow specific guidelines when approving sub-loans or equity investments. This helps to build a sound financial sector by ensuring that the intermediary strengthens its internal procedures and upgrades its operating standards as well as providing financing to local enterprises.

**Size of Sub-Projects Supported**

The purpose of many of the wholesale instruments is to allow EBRD to serve a clientele of enterprises which are otherwise too small to qualify for direct support. However “small”, enterprises financed under those schemes are often larger than a definition of SMEs would suggest. As an example, a survey of sub-loans granted under EBRD credit lines indicates an average size much above EURO 250,000 (an exception being Hungary).

**Figure 4: Past Average Sub-Project Size**

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>Average size of sub-project (Credit lines) Euro</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>N/A</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>N/A</td>
</tr>
<tr>
<td>Estonia</td>
<td>367,866</td>
</tr>
<tr>
<td>Hungary</td>
<td>86,957</td>
</tr>
<tr>
<td>Latvia</td>
<td>404,460</td>
</tr>
<tr>
<td>Lithuania</td>
<td>396,666</td>
</tr>
<tr>
<td>Poland</td>
<td>638,700</td>
</tr>
<tr>
<td>Romania</td>
<td>407,433</td>
</tr>
<tr>
<td>Slovakia</td>
<td>1,491,660</td>
</tr>
<tr>
<td>Slovenia</td>
<td>1,062,500</td>
</tr>
</tbody>
</table>

As the strengthening of the financial sector is making considerable progress and local banks can diversify their operations, the EBRD has been able to expand its cooperation with banks in the direction of SME finance. Perhaps the most known programme of the EBRD is the G7 sponsored Russia Small Business Fund, which is being implemented with more than 12 Russian banks. By the end of 1997 a total of EURO 185 million had been disbursed to over 15,000 sub-borrowers. Arrears levels were low, at 1.8 percent for micro loans and 2.8 percent for small loans. This Fund involves support mechanisms from donors to kickstart the operation, similar to those foreseen under the SME Facility.
However, outside the Russian Federation, the EBRD has not yet been able to embark upon an equally comprehensive undertaking to cooperate with financial intermediaries for the introduction of term finance and equity of SMEs.

The pattern in investment funds is similar, though at much higher average size levels. Statistics gathered by EBRD show that only one out of seven projects financed by private investment funds in central and eastern Europe are smaller than two million Euro. This finding is based on 282 unlisted sub-investments made by 21 private investment funds in which EBRD has invested. Interestingly, in terms of scale, these 21 funds make up approximately one third of all capital invested in private equity in central and eastern Europe and the CIS, excluding donor-sponsored funds.

It is for this reason that EBRD has been cooperating with the Commission to establish the SME Facility.

With the combination of Phare and EBRD resources and with the flexible and wide package of support now possible through the Facility’s two windows, the EBRD is confident of being able to significantly expand the equity and debt instruments offered to SMEs in the central European region.

8. COST AND FINANCING PLAN

The start-up Phase I of the SME Facility has a budget of 50 million EURO from the Community budget.

Figure 5a: Phare Contribution to SME Facility

<table>
<thead>
<tr>
<th>Sector</th>
<th>Allocation</th>
<th>Investment</th>
<th>Institution Building*</th>
<th>TA*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan/Guarantee/Equity Support</td>
<td>50</td>
<td>50</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>TOTAL of the FM 1999</td>
<td>50</td>
<td>50</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

100% 100% 0% 0%

* Institution Building and Technical Assistance cannot be separated out as distinct Phare actions under the SME Facility but are included as integral components of each investment support project financed under the Facility.

An amount of 1.25% of the Phare contribution shall be used for EBRD’s programme management fees for Phase I.

Figure 5b: Co-Financing to SME Facility

<table>
<thead>
<tr>
<th>Window</th>
<th>Phare</th>
<th>EBRD</th>
<th>Financial Intermediary*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Window</td>
<td>25</td>
<td>25</td>
<td>+/-</td>
</tr>
<tr>
<td>Loan and Guarantee Window</td>
<td>25</td>
<td>50</td>
<td>+/-</td>
</tr>
<tr>
<td>Total</td>
<td>50</td>
<td>75</td>
<td>+/-</td>
</tr>
</tbody>
</table>

* Cofinancing from the Financial Intermediary in both windows will vary depending on the circumstances of the project but shall be pushed to the maximum possible and shall always respect the minima set down in this Financing Proposal.

9. IMPLEMENTATION

The administration of the Phare grant shall be undertaken by the EBRD, under monitoring of the Commission, and shall not be implemented according to the standard Phare Decentralised Implementation System. The Commission shall exercise its responsibilities
over use of funds throughout the duration of the programme and implementation shall be assured through a subdelegation arrangement with DG II.

9.1 Principles

As well as the basic aspects of the Facility set out above, there are certain principles of implementation which can be highlighted:

1. the EBRD shall seek before the end of 1998 approval from its Board of a framework facility through which it shall approve its Euro 75 million to cover its cooperation under the Facility.

2. the financial and operational management of Commission funds under the SME Facility shall be delegated to the EBRD. To this end, the Commission contribution shall be paid into an interest bearing account termed the SME Facility Special Fund in the EBRD. The modalities shall be set down in a Contribution Agreement agreed between the Commission and EBRD which shall comply with this Financing Proposal and which shall specify the modalities for implementation, for funds flow and for the rules and regulations relating to the SME Facility Special Fund.

3. after an initial advance, the Commission shall approve the release of further funds to the SME Facility Special Fund in tranches in accordance with section 1 of Annex 2. All funds remaining unused or revolving within the Special Fund will be reused for the purpose of the SME Facility according to the same rules and procedures.

4. no Phare funds will be used for the purposes of a project without prior approval of that project by the Steering Committee.

5. projects will be particularly welcomed which address key problems in the relevant country’s National Programme for the Adoption of the Acquis and which focus on micro-enterprises as well as larger SME’s.

6. the Commission shall exercise its responsibility over the use of its funds by EBRD for the duration of the Facility on the basis of monitoring reports and accounts provided by EBRD in accordance with the rules and regulations of the Special Fund.

7. the Facility will be available for all applicant countries and an effort will be made to reach a balanced country usage although, of course, final project selection must be on the basis of the quality of the proposals (see Annex 2).

8. the specific procedures relating to the implementation of the project in question will be set down in EBRD project agreements with the financial intermediary in question.

9. Phare funds resulting from realisation of investments made under the Facility shall be returned to the SME Facility Special Fund for use again on new projects, until termination of the SME Facility Special Fund’s activities. Interest earned on the account shall be returned to the SME Facility Special Fund for use again on new projects, until termination of the SME Facility Special Fund’s activities. The EBRD is also committed to the continuation of the operations until the Facility’s termination provided that it is consistent with EBRD’s policies. Any funds remaining at termination shall be returned to the Commission (see section 13).

9.2 Project Implementation in Phase I

At the level of projects, the precise procedures for implementation of the projects shall be set down in the specific project agreements (i.e. contracts) signed between the EBRD and the financial intermediaries involved (e.g. an EBRD loan agreement with the Participating
Bank). These project agreements will specify the terms and conditions applicable to the use of funds. Subject to the rules of confidentiality, the members of the Steering Committee shall be provided with copies of these project agreements in due course.

In the case of default on project agreements, the EBRD will undertake recovery proceedings in a manner consistent with the care and diligence applied in EBRD projects financed out of its ordinary resources. The Commission will assist in this process where required.

9.3 Preparation for Phase II - Multiple Sponsors

To ensure success of the second Phase of the Facility’s operation, a marketing initiative shall be carried out by the Commission immediately on approval of this Financing Proposal to elicit additional interest and possible commitments to Phase II of the Facility. Focus shall be on those financial intermediaries already contacted in the preparation of Phase I, including EIB and new potential sponsors (and project co-funders) from: (i) development finance institutions (ii) the banking community, and (iii) the Investment Funds industry.

If funds are available and this marketing initiative produces concrete commitments from potential sponsors, Phase II shall consider the establishment of a new legal and administrative entity within which the additional sponsors may participate in the Facility. The other principles of implementation as outlined in this Financing Proposal for Phase I shall be extended to Phase II.

The Phare contribution to Phase II could be further increased through the re-allocation of unused resources from other programmes, as set out in the PHARE guidelines. Any such additional allocations are expected to be matched by other Sponsors, such as the EBRD, EIB or other financial institutions, subject to appropriate approval by these institutions.

10. VISIBILITY

All projects financed under the Facility involving Commission funds shall reflect explicitly the input of the Commission through: (i) announcements in the Official Journal and in the national press of the FI concerned; and; (ii) inclusion of specific clauses promoting visibility in the projects supported at the FI level.

In addition, under Phase I, EBRD will report accounts for the SME Facility Special Fund for inclusion in its Annual Report at the same visibility level granted to other special funds.

11. AUDIT

The accounts and operations of the Phare grant under the Facility may be checked at the Commission’s discretion down to the level of sub-projects by an outside auditor agreed to by the Commission, without prejudice to the responsibilities and rights of the Commission and European Union’s Court of Auditors.

In addition, the use of Phare funds under the Facility and the operations of the Facility shall be audited by the EBRD and the resulting findings shall be reported in the Annual Report of the EBRD. There shall be full coordination between the EBRD, the Commission and Court of Auditors to minimise any potential disruption to activities.

The Commission services shall ensure that an ex-post evaluation is carried out after completion of the Programme.
12. **MONITORING AND ASSESSMENT REPORTS**

The Commission services shall monitor the implementation of the Financing Proposal on the basis of regular 6 monthly progress reports prepared by the EBRD and Commission (DG II SOF) which may be based upon already existing reports and which shall be submitted to the Steering Committee members.

These reports will assess progress both at the Facility and project levels, indicating compliance with this Financing Proposal and with the criteria set down in the original project application forms.

The Commission shall exercise its responsibility over the use of funds through these regular reports and audited accounts. Further funding of the SME Facility Special Fund as set out in the Contribution Agreement may be terminated if the EBRD fails to perform any of its material obligations under the Facility.

In addition, the Commission monitoring and evaluation units may also carry out operational assessments and one ex-post evaluation if required.

To facilitate monitoring, a set of performance criteria is included in the logical framework matrix set out in Annex 3. These focus on:

1. compliance of projects with eligibility criteria as set down in this Financing Proposal.
2. numbers of sub-projects supported through both windows.
3. the leverage achieved by Phare support on additional EBRD and private sector funds.
4. the degree to which funds revolve.
5. the number of SME Facility supported Banks and Investment Funds still maintaining their SME operations after termination of the SME Facility.

13. **SPECIAL CONDITIONS - TERMINATION**

Phase I of the Facility shall terminate 10 years after date of effectiveness. The funding of the SME Facility Special Fund shall terminate on 31.1.2001, if the resources as outlined in this Financing Proposal are not designated for projects by the Steering Committee.

The funding of the SME facility Special Fund may be terminated if the EBRD or Commission fails to perform any of their material obligations under the Facility.

Any Phare funds on the SME Facility Special Fund at termination shall be returned to the Commission in accordance with the rules and regulations of the SME Facility Special Fund. Any funds remaining due to the SME Facility Special Fund at termination shall be returned to the Commission when such resources are received in the SME Facility Special Fund.

The Commission shall exercise its responsibility over the use of funds for the duration of the Facility until termination.

14. **RISKS AND ASSUMPTIONS**

At the operational level, the principal risk is that the Participating Banks and Investment Funds supported by the SME Facility will not continue their operations once the SME Facility
support has ended. This risk is considered very low, since experience with similar programmes elsewhere clearly shows that financial intermediaries tend to continue on their own once they have the capacity to administer such loans, have gone through the learning curve and have realised the profit potential of such SME operations.

At the policy level, the Facility assumes a sustained effort by applicant countries to press ahead with making further progress in relation to SME regulations and laws, most particularly in the adoption of the acquis communautaire as it relates to SMEs.

A further risk is that projects financed will have limited impact on SME development. Given the experience of the JOP and other SME programmes and the changes which the Facility plans to introduce, the risks of poor impact would seem reduced.
Annexes to project Fiche

1. Definitions

Project Fiche: SME Facility Phase I Operational Guidelines

Implementation time chart

Cumulative contracting and disbursement schedule

Project proposal format

- Visibility / Publicity
- Article 118 summary for the Official Journal
ANNEX 1
DEFINITIONS

To ensure consistency of understanding of this Financing Proposal and of the SME Facility overall, definitions of the key components of the SME Facility are set down here:

1. SME Facility - this describes the cooperation arrangement by which EBRD funds and Phare grants will be jointly mobilised by way of a special fund to finance projects with financial intermediaries. In Phase I, it is not structured as a legal entity.

2. Steering Committee - a committee set up under the aforementioned cooperation arrangement comprising three Commission officials and one EBRD official which shall meet to evaluate and approve/reject projects submitted for support under the SME Facility and which shall monitor performance of the Facility. Phare funds will be paid to the Special Fund under the Contribution Agreement.

3. SME Facility Special Fund – a special fund according to Art.18 of the Agreement Establishing the EBRD into which the Phare funds will be paid and which will be governed by the rules and regulations agreed for this purpose between Phare and the EBRD.

4. Financial Intermediary (FI) - FIs are defined as Participating Banks and Investment Funds operating in the applicant countries, possibly in association with EU-based partners, including locally registered companies and also subsidiaries or branches of EU firms. The EBRD shall be responsible for measuring the financial soundness and operational capacities of these FIs through their “due diligence” exercise.

5. Project - A financial package to an FI which can comprise one or more of the components according to the rules and regulations of the Facility and as defined hereunder.

6. Sub-Project - sub-loans to or investments in individual SMEs made by the FI according to rules and conditions set down in the project agreement signed with the EBRD.

7. Window - the SME Facility has two windows of support, the Equity Window for equity support to Investment Funds and the Loan/Guarantee window for loans/guarantees to Participating Banks.

8. Component - the types of support supplied through the windows are described as “components”. These components will be combined within projects, depending on the needs of the project in question. On Equity Window projects, there are two possible components: equity participation funds and management support. On the loan and guarantee window projects, there are four components: loan funds, loan incentives, guarantees and technical assistance.
ANNEX 2

PROJECT FICHE

SME FACILITY PHASE I - OPERATIONAL GUIDELINES

1. OPERATIONAL ARRANGEMENTS

Administration of Phase I

Phase I shall be administered as follows:

1. The Phare contribution shall be released to a SME Facility Special Fund at the EBRD in tranches. The SME Facility Special Fund shall be set up as a special fund according to Art. 18 of the Agreement establishing the EBRD in accordance with the rules and regulations agreed between the Commission and EBRD concerning the use of the SME Facility Special Fund resources.

2. A first tranche of Euro 10 million shall be transferred on signature of the Contribution Agreement between the Commission and EBRD. The Commission shall approve release of additional tranches to the SME Facility Special Fund at the EBRD on the basis of a financial report indicating that 70% of the resources available to the SME Facility Special Fund have been disbursed to projects. Additional tranches shall be calculated to replenish the SME Facility Special Fund to a level of Euro 10 million. Larger tranches may be considered in periods of heavy planned disbursements on the basis of a disbursement schedule. The Steering Committee shall be kept informed of tranche releases. The Contribution Agreement with appendices (Rules and Regulations and Rules of Procedure) will outline all procedures including those for the release of the tranches to the SME Facility Special Fund.

3. Once transferred to the SME Facility Special Fund, the EBRD shall manage the disbursement of the Phare funds for the purposes of the SME Facility.

4. EBRD undertakes to account and report on the use of funds in the SME Facility Special Fund and on specific projects in conformity with this Financing Proposal and the Contribution Agreement.

5. The Commission shall exercise its responsibility over the use of Commission funds for the full duration of the Facility through regular reports and audited accounts. The further funding of the SME Facility Special Fund may be terminated if the EBRD fails to perform any of its material obligations under the Facility.

Steering Committee and Project Selection

The Steering Committee shall consist of three representatives of the European Commission and one representative of EBRD. All decisions shall be made by unanimity without the necessity of taking a formal vote. The Steering Committee shall convene at the request of any of its members but shall meet at least twice per year. It shall be chaired by DG IA. DG II SOF shall manage the administration of the Steering Committee.

Project proposals prepared in accordance with Annex 6 shall be evaluated by the Steering Committee. The first project proposals are planned to be completed with financial intermediaries within the first six months of 1999. Acceptance or rejection of a project proposal by the Steering Committee will be made within 20 working days of its submission.
The Steering Committee shall:

1. supervise the implementation of the SME Facility, which will include assessment and approval of the mobilisation of resources for projects as described in this Financing Proposal.

2. monitor financial and operational progress of projects supported under the Facility and on the use of Phare funds within the Facility on the basis of 6 monthly progress reports supplied by the EBRD and DG II SOF.

3. receive relevant sections of the EBRD annual report before publication outlining progress on the SME Facility which shall be prepared by the EBRD.

4. review the experiences during the start-up phase of the Facility and progress in the establishment of Phase II.

Members of the Steering Committee will be fully mandated to act on behalf of their respective institution.

The Steering Committee will assess projects proposed to the SME Facility Special Fund and their eligibility pursuant to the following criteria:

1. the compliance with the principal regulations and requirements of the Loan and Guarantee Window or the Equity Window, as set down in this Financing Proposal.

2. the impact of the proposed project’s subprojects on accession and on SME development.

3. the country in which the project is located, taking into account the objective of the Facility’s windows being implemented over time in all accession countries.

4. the degree to which the requested grant leverages additional funds from EBRD and financial intermediaries.

DG II/SOF shall manage the administration of the Steering Committee. Its tasks shall be:

1. initial review of EBRD’s proposals. DG II SOF shall have access to all relevant information in particular to all elements concerning the proposed allocation of Phare funds.

2. coordination of the common position of the Commission services in view of Steering Committee decision.

3. organisation of Steering Committee meetings, including distribution of Steering Committee documents.

4. monitoring of financial and operational progress of projects in cooperation with the EBRD.

5. preparation of the necessary documentation for the release of tranches to the SME Facility Special Fund.

DG II SOF will ensure in cooperation with DG IA the interface with internal and external supervisory authorities (i.e. Financial Control, Court of Auditors, Council and Parliament) on aspects related to the implementation of the SME Facility.

2. ELIGIBLE INTERMEDIARIES, SMES, EXPENDITURE AND COUNTRIES

Financial Intermediaries

Eligible Financial Intermediaries (FIs) are banks or Investment Funds as defined in Annex 2.
On an exceptional basis, a state-owned bank may also participate in the Facility. Criteria for participation of state-owned bank will be set out in the rules and regulations of the SME Special fund.

They may be: geographic outreach, possibility for setting the example for transforming the state bank sector, and the existence of credible financial and commercial autonomy, including the option to be privatised.

Selection of Participating Banks will concentrate on their credit worthiness and branch networks, possibly already involved in institution building programmes. In deciding on bank branches, the criteria will be:

1. geographic location: are there competing bank branches? Is there major business potential?
2. branch management competence: commitment to SME lending; openness to new technology and willingness to devote personnel.

Participating Banks that are to become involved in SME lending under the Facility will be expected in principle to continue lending to this sector after the incentives from the Facility have been withdrawn. To this end, Participating Banks shall be required to make a policy statement committing themselves to SME lending with clear sanctions where obligations are not observed.

It shall be the responsibility of the EBRD to evaluate the financial viability of the project and to apply the same standard of due diligence and care as applied on its own operations. The Steering Committee recognises the fundamental importance of financial viability but also recognises that it is not in a position to measure it. The EBRD shall however present information on this issue – as well as the due diligence results on the FI concerned - for each project in its proposal to the Steering Committee.

**Eligible SMEs**

Enterprises eligible for sub-loans or investments from FIs under the Facility will comply with the definition of SME as per Commission Recommendation of 3 April 1996 (OJ L 107 of 30 April 1996).

**Figure 6: Eligible SMEs**

<table>
<thead>
<tr>
<th>Enterprises</th>
<th>Maximum number of employees</th>
<th>Maximum annual turn over (million EURO)</th>
<th>Maximum annual balance-sheet (million EURO)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro-enterprise</td>
<td>10</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Small enterprise</td>
<td>50</td>
<td>7</td>
<td>5</td>
</tr>
<tr>
<td>Medium-sized</td>
<td>250</td>
<td>40</td>
<td>27</td>
</tr>
</tbody>
</table>

The project agreement (i.e. contract) signed by the sponsor with each successful FI for its project will in each case specify the categories of SME which are to be financed. Enterprises selected for financing should be:

1. legal entities
2. privately owned
3. not conducting business comprising the manufacture, supply or other activities relating to: gambling, real estate, banking, insurance or financial intermediation, arms and activities on EBRD’s Environmental Exclusion List.

**Eligible Project Expenditures**

Loans or equity participations by FIs under the Facility may be to SMEs in the following sectors: manufacturing industry, agro-allied business, hotel, tourism, energy saving and environment, construction, trade and services. Funds utilisation may be for the financing of investment in fixed assets and working capital and may involve new projects, or the modernisation or expansion of existing business.

**Eligible Countries**

Eligible countries are the ten applicant countries of central Europe - Bulgaria, Czech, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia. While access to the Facility will be on a “first come, first served” basis, special efforts will be made to reach a balanced country utilisation within the limits of the demands received.

3. **DESCRIPTION OF FACILITY SUPPORT**

The mix of support (equity, interest rate incentive, guarantee, technical assistance) made available through the respective windows of the SME Facility for each project will be determined to meet the requirement of that particular project, within the overall contribution described above.

3.1. **Loan and Guarantee Window (LGW)**

3.1.1 Description

While the LGW will be implemented on the basis of a set of generally applicable criteria, the package of support offered through this window in favour of a particular project may range from one component only (such as an interest rate incentive alone) to a combination of an interest rate incentive, technical cooperation, and, where justified, a first-loss guarantee. The choice of components will depend on the particular requirements of the Participating Bank (PB) concerned, which in turn will depend on the PB’s chosen strategy for targeting SMEs. On the basis of the existing structure of the private enterprise sector and current research in the applicant countries, it is assumed that activities under the LGW will involve, at least initially, lending by Participating Banks to SMEs at the lower end of the SME size spectrum. Exceptions to this general rule may be necessary (if, for example, a Participating Bank chooses to focus on a particular market segment, such as high-growth and technology based enterprises, or medium-sized companies involved in cooperation with private foreign investors). Such cases shall be indicated at the project proposal stage and will be clearly justified in the project proposal to the Steering Committee.

The average size of a project through the LGW will be 10-15 million EURO. For one EURO contributed by Phare, EBRD shall cofinance a minimum of two EURO. The maximum sub-project size shall generally be 250,000 Euro.

The Phare contribution to the LGW comprises three basic components, which may be provided in varying proportions, depending on the project’s specific needs:

1. **Higher Margin Loan Funds.** By combining EBRD resources with a PHARE grant, loans are granted through this window of the Facility to Participating Banks with a
maturity and at an interest rate that enables the Participating Bank concerned to onlend to SMEs with a sufficient margin to allow the Participating Bank to cover its higher administrative costs and special risks involved in lending to SMEs.

The Participating Bank is not *a priori* required to use its own resources for its SME loans, but will in principle be asked to do so.

The actual level of the margin as granted under EBRD’s loan agreement may vary from Participating Bank to Participating Bank and from country to country. It will be based upon an analysis of the particular bank’s funding costs and lending margins. The aim is to provide the level of incentive that will compensate the PB for the particular risks and administrative burden of SME lending, while ensuring that they fully utilise the Facility, but is sufficiently modest that, once it is removed, the PB will continue with such lending.

The Steering Committee will be informed of the percentage level of the interest rate incentive against information on the prevailing market rates. The incentive will generally vary between three and seven per cent.

Interest rate incentives may be provided to a Participating Bank for a period up to a maximum of six years, though Sponsor’s loans may have a longer maturity. The incentive may be determined on a downward sliding scale over the period.

The interest rate incentive to Participating Banks will be provided as rebates paid to the Participating Bank as a grant from the SME Facility Special Fund. EBRD will lend its funds to Participating Banks at its usual lending rates in accordance with the credit risk of the Participating Banks. The incentive will be charged periodically and calculated in such a way that the PB receives it only on funds that have been on-lent, not for funds that are maintained on its own account.

2. **Technical Cooperation:** Technical cooperation is provided to the Participating Bank concerned for institution building purposes and shall be specified as one of the integrated and inseparable elements within the project agreement signed between EBRD and the Participating Bank. In essence, the technical cooperation encompasses expertise to:

- install management information systems specifically geared towards SME portfolios.
- recruit and train FI staff in SME customer support and small loan appraisal, supervision and loan administration skills.
- assist in the introduction and implementation of organisational and managerial procedures and practices involved with SME lending.

The SMEs themselves will not be provided with direct assistance from the Facility, but shall continue to have access to such support through advisory services that are already available from a number of sources, such as the PHARE national programmes.

No more than 25% of Phare support through the Loan and Guarantee window may be used for technical cooperation. The specific proportion may vary slightly between projects

3. **Loan Guarantee.** Where appropriate, a partial first-loss guarantee may be provided on the SME subloan portfolio managed by the Participating Bank. It is envisaged to limit this guarantee to a maximum of 40% of the first loss risks of the beneficiary bank involved in its first year SME loan portfolio.
Where such a loss occurs, EBRD shall verify that the criteria for triggering the guarantee, as set down in the original project proposal, have been met. Any funds used to meet an acceptable claim would be earmarked for servicing of the SME related loan/credit line agreement with the EBRD and deducted from the principal amount owed by the Bank to EBRD. Any funds drawn from the SME Facility Special Fund for disbursement on guarantees shall be notified to the Steering Committee with appropriate justification.

The guarantee can take the form of a lump sum or specific insurance premium for a fixed period bought on the open market.

In principle, Participating Banks will be discouraged from taking on SME lending based upon any other financial incentive than a higher than usual margin (between the cost of funds and interest earned). However in exceptional cases a first loss guarantee as defined above, may be made available.

### 3.1.2 Lending policy

As the essence of the Facility is that it will encourage new lending, ie lending that is not at present available, it will be important to avoid a monopoly situation in the SME market. Therefore, in principle, the EBRD will introduce the SME loan facility into competitive settings (e.g. by providing the facility to at least two Participating Banks in a given country, or region, at the same time).

The EBRD loan to a Participating Bank will usually be classified as a senior loan.

However, Participating Banks may see the possibility of obtaining a subordinated loan as important, because subordination is essentially seen as strengthening the capital base, expanding their opportunities to grow. However, central banks allow the attaching of specific conditions for loan utilisation to a senior loan, but not to a subordinated loan. This opportunity of attaching conditions is important for the Facility as it allows EBRD with more credible certainty to ensure that the Participating Banks will indeed use the Facility specifically for SME lending, as defined each time in the loan agreement with EBRD.

EBRD will be in situations where it will try to promote SME lending with private commercial banks ranking among the top banks of a country. However, while this should be kept as an objective in principle, market testing shows that those top banks would not necessarily always be the most interested in SME lending. For example, these top banks might already enjoy relatively high growth rates and would not necessarily feel inclined to take on a type of business that is perceived as cumbersome and unattractive. At the same time, there may be other banks that are in a phase of early build-up and might want to opt for a new component in the form of SME lending in order to establish for themselves in a niche in the market. Choice may differ between micro-lending, small loans or somewhat larger loans to the upper brackets of the SME size spectrum. This choice would each time entail for the bank different organisational concepts (e.g. expanding on a branch network or not).

The possession by Participating Banks of a branch network is considered important for SME lending as it allows the PB to have a close knowledge of its clients, allows for risk diversification, and offers linkages between deposit taking and savings as a base for future deepening of SME lending. This has a implications for the average minimum size of loans from EBRD to a Participating Bank under the Facility. Needs may range from 10 to 15 million EURO in order for Participating Banks to warrant such fundamental steps as the introduction of organisational changes (i.e. creation of an SME credit department, developing loan officers specialised in SME lending, specialisation of branches etc.).
A Participating Bank will have to decide clearly to adopt SME lending and the loan agreement with EBRD will encompass specific, objectively verifiable criteria by which EBRD can control loan utilisation for the agreed purposes. Firstly, a Participating Bank will have to agree in a Policy Statement its commitment to a specific type of SME lending. Then covenants will have specific references defining the type of sub-loans involved, such as particular debt/equity and debt service ratios, exclusion (if any) of start-ups, or loan minima and maxima. There would also be specific sanctions on adherence to the criteria, such as the threat of calling the loan, or applying an interim increase of the interest rate on the debt, in case the Participating Bank did not fulfill SME size criteria.

3.1.3 Marketing

The EBRD has acquired a thorough knowledge of the transition process of the financial sector in the 10 Accession countries. This is to a large extent due to the fact that the EBRD has significantly invested in financial intermediaries: for example, in 3 countries EBRD is participating in the share capital of 4 different banks; in 3 more countries it is participating in the share capital of 3 banks; and in 2 more countries in 2 different banks. Furthermore, the EBRD has altogether extended more than 35 loans to more than 25 banks in the Accession countries.

However, the cooperation between EBRD and the banking system in the Accession countries can not be said to encompass SME financing in any significant way. Perhaps it is only in Hungary that EBRD loans to banks have been utilised in a regular manner for sub-loans below average size levels of EURO 100,000.

During the period of studying the feasibility of, and preparing the launching of the SME Facility, EBRD has extensively discussed the demand for the components of the Loan Window in the accession countries. The Bank has met with universal and keen interest in all countries.

Given the fact that the Loan Window’s instruments should be introduced with at least two different Participating Banks in one single country at more or less the same time, the implementation of the Facility at the EBRD will be entrusted to the existing relationship managers of the Financial Institutions team. This will ensure a ready uptake by the prospective Participating Banks concerned. The team comprising some 30 professionals support a gradual build up of the Facility’s activities in a reasonable time span.

3.1.4 Project Concept

On the basis of marketing activities and preparatory work already undertaken, a typical project to be funded under the LGW can be described as follows:

1. a senior loan would be granted by EBRD to a Participating Bank amounting to Euro 10 million for sub-loans to SMEs at average size levels of say Euro 50,000.
2. the total cost of the interest rate incentive could vary between say Euro 1-2 million.
3. the technical cooperation grant would be estimated to amount to between Euro 0.85-1.0 million.
4. the risk cover guarantee could vary between say Euro 1-2 million.

The EBRD loan would have a maturity of six years while the Participating Banks would - at least initially, out of caution - extend sub-loans for a shorter period. At average size levels of EURO 50,000 per sub-loan, 600 sub-loans could be granted over the six year period from one project.
If the Facility aims at least two Participating Banks per country, 1,200 loans could be granted per country, or close to 12,000 enterprises over six years in all Accession countries, involving 20 loans to banks for a total amount of Euro 200 million. These numbers could be significantly higher if banks were to aim at categories of SME at the lower end of the size spectrum.

It is evident that at the moment there exist wide differences in the pricing of loans to Participating Banks in the Accession countries. Also, there are wide differences between the stage of development of Participating Banks in the various countries. This means that loans to be made available under the Facility will carry interest rates that in advanced countries will be ostensibly lower than in less advanced countries. In a similar vein, the margin spread to be granted by EBRD under such loans will also considerably vary from country to country, which will in turn affect the actual size of PHARE grants per project.

In all countries, a particular interest rate structure will prevail beyond which Participating Banks (even in cases of newly offered SME lending) would become uncompetitive. Interest rate levels for hard currency may vary from 10-11 per cent in the advanced countries, to say 15-16 per cent in the less advanced countries. At some level, interest rates could become prohibitively expensive to allow for any investment financing. Therefore, EBRD will seek ways to arrange their loan facilities in such a way that Participating Banks would apply reasonable rates on sub-loans and seek to lower the cost to SMEs.

3.2 Equity Window

3.2.1 Description

The Equity Window is a wholesale product that invests into projects defined as SME Investment Funds, the final beneficiaries (sub-projects) being small and medium-sized enterprises.

As a minimum, the EBRD must match Phare cofinancing to a project. This basic funding will be complemented at the project level by contributions from private investors. This involvement may vary from country to country, depending on the environment. The actual proportion will be decided by the market when fund managers and investors make proposals. In the less advanced countries, the proportion of private capital may be very limited. Private capital could be attracted in a second stage, when the SME Funds have developed a track record.

Two components are foreseen to be offered through the Equity Window:

1. **Equity Co-Investment funding**. Phare takes equity participations alongside EBRD and other investors on the following basis:

   - with regard to rewards, Phare funds will participate in profits when other investors have received a minimum return (hurdle rate) which shall be negotiated on a case by case basis;
   - with regard to losses, the basic principle is equal sharing. However, in exceptional circumstances to be justified, Phare may accept a higher proportion of losses on its contribution as compared with other investors.

2. **Management Cost funding**. Phare funds are used to cover costs of the Investment Fund on a grant basis and shall be specified as one of the integrated and inseparable elements within the project agreement signed between EBRD and the Investment Fund. The management cost would be financed mainly during the early years of investment, as no capital gains or dividends can be expected during this period.
The structuring of the investment will be made on a case-by-case basis with a view to maximise the involvement and risk sharing of all investors.

SME Funds will use the full range of equity and quasi-equity support, choosing those with greatest relevance to the needs of the SMEs in question.

Where Management Costs are being funded by Phare, no more than 25% of the Phare financing may be used for this purpose.

3.2.2 Investment policy

The Equity Window will target Funds committing in their investment policy to focus on medium sized companies with between 50 and 250 employees, maximum turn-over of EURO 40 million and maximum balance sheet size of 27 million EURO. The size of sub-projects will be up to one million EURO.

SME Funds will be allowed to use the full range of equity and quasi-equity support. In particular, they will be allowed to do term lending where they offer at the same time participating products, in such a way that the financial package has the characteristics and achieves the returns of an equity investment. SME Funds will hold minority positions in their investee companies, with a minimum stake of 10 per cent and a maximum of 49 per cent. The average shareholding is expected to be between 25 and 49 per cent. The fund managers will secure the usual rights so that they can exercise the much-needed governance over the SME portfolio.

The Equity Window will be open to all investment funds meeting the eligibility criteria and willing to develop their SME activity, within the limits of the local market conditions and their absorption capacity.

3.2.3 Structure of the SME funds

In view of the small size of individual investments and the necessity to have a portfolio for risk diversification purpose, each SME Fund will have an initial capital of 10 to 15 million EURO. This size would allow building a portfolio of between 15 and 25 investees on average.

Attracting private investors into the Equity Window is an important objective of EBRD and EU. It will provide a reality check, establish discipline with the fund managers and pave the way for the SME funds to be sustainable in the long term. However, private sector involvement may vary from country to country, depending on the environment. The true proportion will be decided by the market when fund managers and investors make proposals. An initial ratio of one-third EU, one-third EBRD and one-third private sector can be set as a target.

The private sector participation could either be new capital raised by fund managers for specific SME Funds or an allocation from the capital they have already under management (through a co-investment agreement with the Equity Window). The latter case is seen as a quick and flexible way to induce fund managers to tackle the lower end of the market, while demonstrating faith in the scheme.

3.2.4 Market testing

Having signed investments in 58 investment funds and committed EURO 928 million by December 1997, EBRD has a 15 per cent share of the investments made in the private investment fund market across its 26 countries of operation. This means a wealth of experience and contacts to build upon to establish the Equity Window of the SME Facility.
In preparation of the SME Facility, EBRD has approached 13 private investment funds operating in Poland, the Czech Republic, Hungary, Slovakia and Romania. All fund managers recognised that there is a market for equity finance to SMEs. They also recognised that this market is not adequately covered at present. The main obstacles mentioned were:

1. the higher cost of running SME operations.
2. the risk involved in dealing with companies with limited assets or no established market.
3. the reluctance of shareholders of small companies to accept outsiders; and
4. the lack of exit opportunities.

A risk and cost mitigation mechanism needs to be offered to lure investors to this difficult market segment. The SME Facility will be used for this purpose by contributing resources to acquire experience and get up the learning curve so as to bring the risk level of SME investment closer to that of large scale operations.

It is only with the presence of higher risk taking capital and/or support of costs of fund management that several fund managers operating in the one to three million EURO bracket expressed interest for a SME scheme targeting the EURO 250,000 – 1,000,000 niche.

3.2.5 Project modeling

The financial model below shows the practical functioning of two SME funds, one in an advanced or “first wave” country and one in an intermediate or “second wave” country. The typical capital structures envisaged are set out in Figure 7.

<table>
<thead>
<tr>
<th>Million EURO</th>
<th>Advanced countries</th>
<th>Intermediate countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU-PHARE</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>EBRD</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Private sector</td>
<td>5</td>
<td>0.2</td>
</tr>
<tr>
<td>Total SME Fund</td>
<td>15</td>
<td>10-12</td>
</tr>
</tbody>
</table>

Financial modeling shows that an SME fund in an advanced country would bear an annual management fee of five per cent of the committed capital, or six million EURO cumulated over a period of 10 years. It would be in a position to make about 20 investments of 0.6 million EURO on average.

3.2.6 Business plan and pipeline

The market feedback and the experience with equity investments in EBRD’s countries of operation all point at the difficulties of doing small equity deals. With this in mind, EBRD wishes to follow a prudent approach, more likely to bring success and generate support for Phase II of the SME Facility.

The Equity Window will have 50 million EURO at its disposal. As it will be demand driven, it is not possible to establish an accurate business plan. However, an indicative forecast of signed commitments can be made:
It is assumed in this forecast that three to four SME Funds will be located in the "first wave" Accession countries and one to two in a "second wave" country. In the latter case, the attraction of private capital is likely to be more difficult. In addition, global conditions in "second wave" countries are less favourable. Therefore, the balance between countries will be a combination of market demand, EBRD experience with the relevant country and the challenge for a speedy and successful start up of the Equity Window. The above forecast may prove to be too ambitious, in particular in terms of disbursements.

There are indications that option 2 would represent between one and two funds. Those could be implemented more quickly and represent a lower risk of failure, since the fund managers are already operating on their respective markets. Option 1 and 3 may represent one fund each, whilst it is likely that at least one SME fund will be a combination of option 1 and 3, in other terms an existing SME operation completely reshaped and expanded.

Multi-country (regional) SME Funds are not considered to be suitable if they do not have a network of local offices. The nature of enterprises to be dealt with by the SME funds requires a local presence. SMEs have often limited substance except for their management and it is crucial to be able to develop a close relationship with those in the due diligence phase and eventually in the monitoring phase. Countrywide funds might be acceptable for relatively small countries with good infrastructure. In the case of large countries such as Poland and Romania, a regional approach might be necessary.
ANNEX 3 -

PROJECT PROPOSAL FORMAT

EBRD will submit project proposals in the same form as documents that it uses to obtain approval from its Board.

These proposals will comprise the following but may be changed with the agreement of the Steering Committee if so required:

A Loan And Guarantee Window
1 The Financial Intermediary
   1.1 Introduction
   1.2 Current financial position
2 The Project
   2.1 Objectives
   2.2 Description, including impact on employment
   2.3 Agreement with the Participating Bank including detailed description of Loan/Guarantee/Technical cooperation
   2.4 Environmental Issues
   2.5 Risks and risk-mitigating measures
3 The SME Facility’s Involvement
   3.1 Eligibility criteria, including any exceptions to general conditions and justification for these exceptions
   3.2 Accession and transition impact
   3.3 Additionality
   3.4 Modalities of Phare contribution, including any exceptions to general guidelines and supporting justifications for such exceptions
4 Implementation
   4.1 Start-up and implementation timetable
   4.2 Disbursement schedule
   4.3 Monitoring and reporting, including reports to Steering Committee
   4.4 Termination
   4.5 Visibility, including specific provisions for Phare visibility

B Equity Window

1 The Fund and Project
   1.1 Objectives and description
   1.2 Capital structure including cofinancing
   1.3 Legal structure
   1.4 Region of operation
   1.5 Investment policy, risk and risk mitigation measures
   1.6 Draft Agreement: Principal terms and conditions
   1.7 Governance
   1.8 Deal flow sources
   1.9 Exit strategy
   1.10 Financial model, including expected returns

2 The Fund Manager
   2.1 Legal structure of the Fund Manager
2.2 The Fund Manager
2.3 The management team
2.4 Contract and remuneration

3. Project
3.1 Objectives
3.2 Description
3.3 Project Agreement including Subscription Agreement with the Fund including detailed description.
3.4 Co-investment by other private investors
3.5 Risks and risk mitigating measures

4 The SME Facility’s Involvement
4.1 Eligibility criteria
4.2 Accession and transition impact
4.3 Additionality
4.4 Modalities of PHARE contribution
4.5 Environmental issues
4.6 Employment impact
4.7 Visibility, including specific provisions for Phare visibility

5 Implementation
5.1 Start-up and implementation timetable
5.2 Commitments and disbursements schedules
5.3 Fund monitoring and reporting, including specification of reports to be copied to Steering Committee
Annex 4

Log-frame Matrix
Annex 5

Implementation time chart
Annex 6

Cumulative contracting and disbursement schedule
Annex 7

Visibility / Publicity
Annex 8

Article 118 summary for the Official Journal