DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

MICRO, SMALL AND MEDIUM-SIZED ENTERPRISES STRATEGY

As approved by the Board of Directors at its meeting on 7 February 2006.

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1. INTRODUCTION

The Micro, Small and Medium-sized Enterprises (MSME) strategy focuses on the core elements of the Bank's approach towards supporting the development of MSMEs in its countries of operation. Support for MSMEs is central to the Bank's transition mandate, and the document sets out the underlying principles of EBRD's activities in the sector going forward.

The strategy further aims to outline how the Bank can best support MSMEs across all of the Bank's countries of operations, strengthen the financial sector infrastructure dedicated to financing growth of MSMEs of all sizes, improve the business environment for MSMEs, and develop the skill sets of small entrepreneurs.

The Bank has been active in supporting the growing small business sector in its countries of operation over the last thirteen years through a variety of instruments and activities. This strategy paper will focus on the core elements of the Bank's approach towards supporting the development of micro, small and medium sized enterprises (MSMEs) in its countries of operation.

2. PILLARS AND PRINCIPLES

Long-term sustainable economic growth and job creation will only be achieved through the development of a vibrant entrepreneurial sector. Active promotion of this sector is both a means and an end to the transition to the market economy and the creation of an entrepreneurial class will both mitigate the social costs associated with restructuring enterprises and enhance the likelihood of a durable commitment to democratic societies and the rule of law. The promotion of MSMEs is therefore at the heart of EBRD's transition mandate.

The EBRD targets MSME support because it regards the participation of MSME in the formal financial sector in the respective countries of operation as inadequate and believes that instruments beyond foreign bank entry and bank privatisation are needed to accelerate their development. This intervention by the Bank is designed to bring benefits both to MSMEs and to the financial institutions that engage in MSME financing. The support is designed with a view to ultimately making these activities financially sustainable.

Providing sustainable lending and universal financial services to the MSME sector is a key element of financial sector development. Financial institutions and markets are underdeveloped in each of the EBRD's countries of operations – even the most advanced. The degree of underdevelopment is higher the poorer the country and the less advanced it is in the transition towards an efficient market economy and a pluralistic, open society and political system. Finance for MSMEs is an area where the gap between what ought to be available and what actually is available is relatively large (see also Annex 2).

Available evidence on the financing of MSMEs in the Bank's countries of operations shows that these firms rely more heavily on informal sources of finance and on retained profits to meet their working capital and investment finance needs than larger firms do. This is true even in the most advanced countries. These enterprises also perceive that difficulties in accessing finance are a major obstacle to the operation and growth of their businesses.[1] In addition, the voice of entrepreneurs and MSMEs is weak in the political arena where legislative and regulatory decisions that will determine the future opportunities for MSMEs are taken. The result is that MSMEs are fewer in number and have less economic weight and political clout than is desirable from the perspective of transition and economic development.

There are several reasons for this under-representation and provision of finance to MSMEs and some of them relate directly to the post-communist transition. MSMEs were largely absent from the previous economic system, which concentrated production and investment in large, state-owned enterprises. State banks, which specialised by economic sector, provided the financial resources for investment and working capital for these enterprises. MSMEs were not significant clients for the state banks and, as a result, this segment of the banking market has had to be developed from scratch.

[1] See, for example, EBRD (2002), *Transition Report 2002*, London: EBRD, Chapter 2, and EBRD (2004), *Spotlight on South-Eastern Europe*, London: EBRD, Chapter 3.

Though the Bank can point to some significant achievements in this field, there remains much more progress to be made, and the Bank remains strategically committed to expanding its activities with MSMEs.

Technical assistance, which supports the intermediaries' ability to provide efficient and quality financing on a sustainable basis, has been central to the Bank's support to the MSME sector and made possible the broad reach of the programme across international and local commercial banks, as well through the establishment of greenfield microfinance banks, and through non-bank financial institutions. Through technical assistance, the Bank has been able to accompany its capital resources with significant institution building support, addressing all aspects of banking to the MSME sector including *inter alia;* credit methodology; information technology, universal banking services; rural and agricultural lending; and corporate governance.

As well as providing technical assistance for intermediaries, the Bank strengthens individual MSMEs, pre- and post- financing through the TAM/BAS Programme. TAM/BAS both develops pipelines for financing and helps protect financing already in place, by improving management and business skills.

The strategy aims to provide support for MSMEs across **all** of the Bank's countries of operations, strengthen the financial sector infrastructure dedicated to financing growth of MSMEs of all sizes, improve the business environment for MSMEs, and develop the skill sets of entrepreneurs. In this context, the strategy will continue to be structured around the three pillars established in its 2000 Strategy "Promoting SMEs in the Transition", namely, Finance, Policy Dialogue and Business Support.

2.1 FINANCE

The Bank's primary strength and comparative advantage within the general framework for MSME support undoubtedly lies in its work with financial intermediaries, leveraging on its very broad network of relationships and reaching out to new institutions throughout the region. In general terms a successful transition requires the development of a sound financial sector which commands the confidence of the population, facilitates transactions, and intermediates effectively and efficiently between savers and investors. In the long-term, a financial sector with the necessary technical ability, strategic commitment and long-term financial resources to address the requirements of MSMEs is the cornerstone of healthy MSME development. One of the key instruments of the Bank's MSME strategy is therefore the sustainable provision of finance and financial services to local small enterprises through financial institutions.

The full development of the MSME sector requires a long-term commitment from the financial institutions to ensure that this specialised lending business will remain sustainable without the support of donor and IFI funds. Further, the varying financial needs of the diverse enterprises making up the MSME sector require intermediation through a variety of financial institutions. For this reason the Bank and its partner donor organisations are committed to continue financing and technical assistance programmes until this sustainability is secured, which can be a lengthy process.

All of the Bank's initiatives in the MSME field will continue to be guided by adherence to EBRD's core principles – achieving transition impact, additionality, and applying sound banking principles in all cases.

2.1.1 Transition Impact

In general, the EBRD designs its MSME lending programmes to achieve potential transition impacts by capacity building at the MSME lending institution and by fostering a culture of credit in the MSME segment of the banking market among both borrowers and lenders. The Bank focuses on these impacts because the market and private banks on their own are unlikely to adequately meet these needs. If, in addition, there are other market failures the transition impact potential of MSME financing operations would be further enhanced. However, the two market failures on which the Bank focuses appear to be the most significant.

The first type of transition impact is achieved both through the use of technical co-operation (TC) funds to invest in capacity (such as skills and information technology) and through the experience gained by the MSME lending institution in using the funds successfully to finance MSMEs (i.e. learning by doing).

The second type of transition impact component is broadly measured by the number and value of loans and the proportion of new clients to the institutions that benefit from programme financing. The greater the scale of the EBRD's MSME financing operations and the extent to which these programmes reach new clients, the more widely developed the culture of credit becomes. These impacts are both direct and through the demonstration effects created by MSMEs that grow and prosper. In addition, the transition impact potential of MSME financing can arise from the increased financing of MSMEs it permits, regardless of whether it contributes to building a culture of credit, if there are other reasons for market failure in the credit market for MSMEs.

2.1.2 Additionality

The Bank supports MSME programmes which identify and fill a gap in the existing financing market. The EBRD fills this gap not only by providing finance for MSMEs, but also by mobilising support for capacity building for MSME financing operations in partner institutions and fostering a culture of credit in its countries of operations. Importantly, donor support is used to leverage the Bank's resources and to achieve the broader impacts associated with these activities. The programmes also catalyse private sources of funding for MSMEs with the aim of increasing the share of private financing over time. As the participating financial intermediaries develop and mature, an increasing emphasis is placed on assisting them in attracting and mobilising non-IFI funding and ultimately achieving financially sustainable activities. This aspect is particularly true for the non-bank microfinance institutions with which the Bank has started to work, which have in large part been dependent on donor grants and are new to commercial financing.

2.1.3 Sound Banking Principles

Loans to financial intermediaries, including to non-bank microfinance institutions, are priced commercially and funds are on-lent to MSMEs at prices which cover costs and generate profits for the partner institutions.

OCE is currently carrying out a survey of firms which benefited from EBRD finance and comparing their performance and perception of the business environment to those of enterprises which did not manage to access Bank finance. This will help better tailor the Bank's financial instruments to the needs of the local MSMEs.

2.2 POLICY DIALOGUE

Policy Dialogue work is intended to focus on improving the business climate for MSMEs generally, with a priority on addressing policies and regulations which create impediments to accessing and providing financing for MSMEs. This can take many forms, ranging from ad hoc interaction with local government bodies to speed up the processing time of a regional collateral registry, to long-term policy dialogue with the respective Central Bank, in co-ordination with other IFIs, to adopt provisioning requirements appropriate to micro and small lending. The bank's policy dialogue work related to MSMEs has been carried out by the Legal Transition Team of OGC, the Office of the Chief Economist, the relevant Banking teams: Group for Small Business, Financial Institutions, Country Teams and Resident Offices. The Bank also ensures that its work is closely co-ordinated (and where possible, closely implemented) with that of other IFIs and bilateral or multilateral donors.

The Bank is carrying out specific policy initiatives to improve both the regulatory and business environments in the areas of corporate governance and remittances. The former is based on dialogue at the government level accompanied by specific capacity building at the bank level; the latter, initiated this year, involves intra and inter-regional discussion on capital flows and ways to incorporate such flows in the formal financial sector for the benefit of both the MSME and the respective countries.

The focus on policy dialogue has been a valuable supplement to the MSME finance work of the Bank, and it is indeed a unique strength of the EBRD compared with other MSME financiers. Proximity to the market in the shape of the relationships with the partner banks and specialised microfinance banks and, through them, to the entrepreneurs they serve, provides a unique perspective on the impediments encountered by both credit providers and borrowers. By bringing these impediments to the attention of the relevant authorities, targeted policy dialogue efforts contribute to an improvement in the environment both for individual MSMEs and the institutions which lend to them. In certain cases, the Bank can also directly assist in the changes it advocates in the form of TC projects undertaken, for example, by the Legal Transition Team (LTT) in the area of collateral laws and registries. For example, in 2001, LTT provided technical assistance to the Serbian government for the development of a secured transactions law, which was adopted in 2003 – ProCredit Bank Serbia actively participated to the drafting of this law. In 2003 and 2004, GSB and LTT worked very closely on the development of *Guiding Principles for the Development of a Charges Registry,* providing, for the first time, standards for the development of a key institution for MSMEs. Current plans are to use these principles in countries where the lack of proper collateral registration hampers the development of MSME lending, such as Tajikistan.

Project-related policy dialogue is also undertaken by the Group for Small Business to support several partner bank programmes where a local legal adviser participates in the consultants' team and closely liaises with the Ministry of Justice and with all relevant authorities involved in drafting and implementing laws (e.g. microfinance law, and pledge law). Establishment of new microfinance banks, transformation of non-bank microfinance institutions to banks where it is appropriate and bank privatisations provide specific platforms to forward best practice initiatives.

The Financial Institutions group is engaged in a range of policy dialogue issues in the countries of operation (as described in the annual Financial Intermediaries report) and is co-operating with the "Convergence" initiative, a programme supported by the Government of Italy and aimed at promoting dialogue between private financial sector institutions and the respective regulatory authorities in the countries of South-East Europe.

In addition to the ongoing policy dialogue carried out by banking teams in the context of project development, OCE has recently carried out a number of additional initiatives. OCE has been co-ordinating policy dialogue in the area of business environment for MSMEs in the Stability Pact Region for the past three years, jointly with OECD and the European Commission (DG Enterprises), under the aegis of the Investment Compact[2]. During spring 2004 OCE and Banking initiated policy dialogue efforts to improve the business environment for SMEs in Georgia, as a pilot for future policy dialogue in the other ETC countries. OCE has recently conducted a survey (BEEPS III) and in consultation with Banking will conduct structured interviews to investigate further these survey results and inform policy dialogue on the business environment in ETCs, focusing in particular on conditions for MSMEs.

2.3 BUSINESS SUPPORT

The EBRD TurnAround Management and Business Advisory Services (TAM/BAS) Programme for non-financial enterprise support focuses on assisting and improving the management skills of enterprises, leading to greatly improved business performance and increased job opportunities.

The TAM/BAS strategy is to foster transition through a two-pronged, inter-linked support Programme. TAM restructures and introduces a new management culture in Early Transition Countries, for communities as well as individual enterprises, by utilising the skills of industry-specific, senior managers from developed countries. BAS teaches MSME managers to use external business services, and, at the same time, develops local business consultancy sectors.

TAM/BAS is an essential pillar in the MSME strategy, since financial investment alone cannot answer all the economic development needs of the Bank's countries of operation. Individual MSMEs require urgent assistance in order, for example, to develop strategic business and marketing plans, to improve management skills, to develop new products and to raise quality standards to those demanded by their actual and potential export markets. These goals can only be reached quickly through the provision of customised and focused assistance to individual companies with the explicit objective of achieving such results.

[2] Annual reports of these policy dialogue initiatives can be accessed at http://www.investmentcompact.org/general/library.htm

The TAM/BAS Programme has a long and successful record in assisting the development and growth of MSMEs, and the linking of banking projects with TAM/BAS activities is now and will remain a high priority for banking teams. TAM and BAS are able to produce strong pipelines of potential candidates for external financing by the Bank's instruments or those of its partner banks, because working with enterprises on advisory projects is a very effective screening procedure. Moreover, TAM/BAS expertise can also be applied to strengthening the performance of enterprises in the post-investment phase.

An immediate productive feature of closer Bank/TAM/BAS relationships could be direct collaboration in MSME programmes in the Early Transition Countries. For example, in those countries there is a demonstrably strong demand for micro and small loans which is being met by the Bank's MSE lending programs and microfinance banks. Based on feedback from MSMEs in the Caucasus, the synergy of linking this type of financing with TAM/BAS projects would be very beneficial and create an extremely high demand for overall transition assistance.

3. CORE PRODUCTS AND COUNTRY SPECIFIC APPROACH

The structure and needs of the MSME sector vary among countries at different stages of transition and are also influenced by the history and economic structure of the countries. An assessment of these differences should inform each country approach and will be reflected in the respective country strategies.

Over the last 13 years the Bank has utilised its core products through financial intermediaries to cater for the financing and development needs of MSMEs. These include credit lines to existing commercial banks (so called "partner banks") focussed on MSE and/or SME sub-borrowers, investments in and loans to specialised microfinance banks, SME leasing operations, and loans to non-bank microfinance institutions. These products have proved durable and successful and with the necessary evolution and adaptation, they will remain at the heart of the strategy moving forward. In addition, the Bank will explore the use of guarantees, capital markets and local currency instruments to provide a diverse range of products to meet the need of the evolving regional markets. The Bank will also encourage intermediaries in the provision of universal services in addition to lending which are recognised as a need of the MSME market.

In addition, the Bank has provided non-financial support directly to enterprises through the TAM/BAS programme. This Programme, the core of the Business Support Pillar of the Bank's SME strategy, operates throughout the Bank's countries of operation. TAM/BAS Programmes are developed in line with the priorities of the Bank and Donor organisations and, at present, are increasing activities in the ETC countries and the Western Balkans.

It is important to note that where different approaches co-exist in the same country, the Bank ensures that these approaches are broadly complementary, and are aimed at developing different market segments in response to the different strategic needs of partner institutions.

Going forward, the core strategy will be to leverage on the Bank's wide network of relationships with established financial institutions (commercial banks and leasing companies) and use them as the main channel of delivery of MSME products. Though the market segments are different, many commercial banks are engaged across the whole continuum of MSE and SME borrowers. While delivery mechanisms may vary, the Bank's approach is to have a set of tools available that enables it to address the whole range of banks' needs, wherever an individual bank determines its strategic focus lies. Whether institutions choose to move up in target market from MSE to SME or conversely move down from SME to MSE, the Bank should be able to address their requirements.

Specifically concerning the smallest "micro" borrowers, the central plank of the strategy will be to work with existing commercial banks to provide intensive institution building support which will allow them to lend profitably and sustainably to this category of borrower. This "downscaling" approach has already proved successful in many EBRD countries of operation, most notably across Central Asia where commercial banks have recognised the market potential of micro borrowers and engaged dynamically in capturing this customer segment. In other countries, such as Ukraine and Georgia, the demonstration effect of the EBRD funded specialist microfinance banks has prompted local commercial banks to compete for MSE market share. The Bank's recent loans to non-bank MFIs under the ETC Framework have enabled EBRD to reach even smaller borrowers; in Tajikistan the average loan size is under USD 500.

The table below provides a snapshot of which of these products is currently active in which of the Bank's countries of operation:

	MSE programmes through established commercial banks	**Specialised Microfinance Banks**	**Non-bank Microfinance Institutions**	**SME financing through established commercial banks**	**SME leasing through established leasing companies**	**TAM/ BAS**	**Policy Dialogue**
CEB							
Croatia				X	X	X	X
Czech Republic				X	X	P	
Estonia				X	X	X	
Hungary				X	X	X	
Latvia				X	X	X	
Lithuania				X	X	X	
Poland			P	X	X	P	X
Slovakia				X	X	P	
Slovenia				X	X	X	
SEE							
Albania		X				X	X
Bosnia & Herzegovina		X	P	X		X	X
Bulgaria		X		X	X	X	X
Macedonia		X		X		X	X
Romania	X	X	P	X	X	X	X
Serbia and Montenegro	X	X	X	X	X	X	X
ETC							
Armenia	X		P	X		X	P
Azerbaijan	P	X	P	X		X	P
Georgia	X	X	P	X		X	X
Moldova	X		P	X		X	X
Kyrgyzstan	X		X			X	X
Tajikistan	X		X			X	P
Uzbekistan	X	P	P	X	X	X	X
CIS non-ETC							
Belarus	X	P		X		P	X
Kazakhstan	X		X		X	X	
Russia	X	X	P	X	X	X	X
Turkmenistan	P					P	P
Ukraine	X	X		X	P	X	X

X denotes existing programmes, P denotes pipeline

3.1 MSE PROGRAMMES THROUGH ESTABLISHED COMMERCIAL BANKS

The provision of long-term credit lines coupled with intensive specialised technical assistance has been a central part of the Bank's MSME strategy since the Russia Small Business Fund was established in 1994. MSE programmes through existing commercial banks generally target an average loan size of under USD 10,000 and have proved a particularly effective way of delivering funding to clients which have previously had little or no access to formal sector finance. In Central Asia particularly, commercial banks have been enthusiastic in embracing this new and dynamic target customer group.

Even in the larger countries with relatively more developed financial sectors such as Kazakhstan and Ukraine, banks have seen the potential in extending their reach down to smaller borrowers. The following table shows the extent to which this has been occurring in selected countries and is indicative of the basis on which the future activity can be built:

End October 2005	Project start date	No. of banks	No. of loans granted	US$ volume of loans granted	US$ average loan amount
Kazakhstan	May 1998	7	168,608	1,113,743,494	6,606
Kyrgyz Republic	April 2002	5	31,659	57,845,150	1,827
Russia	August 1994	7	278,068	2,486,297,399	8,941
Tajikistan	October 2003	4	7,822	20,973,455	2,681
Ukraine	September 1998	6	202,744	1,155,759,432	5,701

Going forward, working with an expanded range of established commercial banks will be a key priority in expanding the scope of MSE lending programmes. The existing model is based on providing intensive technical assistance with an institution-building approach. It involves strengthening banks' staff capabilities and technical capacity to enable them to lend efficiently and sustainably to MSEs. Often this can entail root and branch restructuring of credit departments and internal procedures in order to put in place the necessary conditions for this very specific lending business to operate profitably.

Within this framework, the Bank's future strategy as regards these programmes has a number of key emphases and potential new directions:

- Programmes will be put in place in countries where there are currently no MSE credit lines, such as most of the Western Balkans, Azerbaijan and Moldova. With smaller commercial banks in the ETC countries or in the Western Balkans, the aim will be to provide combined MSE/SME support, managed as a single product and client relationship. Depending on the participating banks' needs and capacity, MSE and SME lending could be combined in a single credit facility managed and supervised by the same team of consultants.

- In Central and South-Eastern Europe, the focus will be on co-operating via credit lines and TC with the larger established mainstream commercial banks (often foreign owned) already active in the SME market, which are strategically looking at reaching to the MSE market as a new business opportunity. The bank will also particularly seek to mobilise private capital alongside its own interventions in order to leverage donor and IFI finance, through syndicated loans or other leveraged fund structures such as the envisaged European Fund for Southeast Europe.

- In the countries covered by existing programmes, efforts will be intensified to bring in more partner institutions to deepen the impact on the banking sectors, while at the same time encouraging continued regional outreach to broaden the impact in the respective countries. In parallel with this, much more emphasis will be placed on creating and tailoring products for rural and agricultural lending. In Kazakhstan, Kyrgyz Republic, Ukraine, the EU Accession countries (EU/SME rural finance) and in the New Member states (Preparatory Action) for example, specific technical assistance has been sourced to develop these initiatives.

- The Bank will continue to interest other potential funding sources in participating in these programmes. Co-financing and risk-sharing initiatives such as those currently in place via the US/EBRD SME Finance Facility, and with SECO and the IFC in Central Asia will be explored with other partners in order to leverage EBRD funding and increase overall volumes being made available to partner institutions and MSE borrowers. In addition, the Bank will look to extend the Syndications' initiatives which have so far been used only with the ProCredit network to local partner banks in MSE programmes.

- In existing institutions ongoing efforts will continue to enhance the efficiency of MSE operations. In particular, this entails making continuous improvements to loan officer productivity in order to ensure TA efficiency ratios remain at acceptable levels.

- In the mature MSE lending programmes attention will increasingly turn to managing "graduation" strategy in the optimal way, putting in place systems to monitor partner banks' continued commitment to the MSE target group once the technical input has withered away. In Kazakhstan, a Graduation Agreement was recently signed with one of the participating banks in the Kazak Small Business Programme to address such issues. The agreement states the obligation of the participating bank to keep a portion of the overall MSE portfolio in micro loans (below USD 10,000), to continue to use the EBRD's credit technology, to maintain the same incentive structure for loan officers, to establish an internal audit position responsible for auditing the MSE portfolio on a regular basis, and to maintain monthly reporting on the MSE portfolio to the Bank.

3.2 MICROFINANCE BANKS

The Bank has made equity investments in and provided credit lines to 12 specialised microfinance banks. This has proved an excellent way of kick-starting the market for MSE finance in these countries, and creating a demonstration effect and a significant competitive stimulus for other commercial banks. The primary focus will now be on continuing activities in these countries through commercial banks which will be at the heart of a sustainable MSE finance sector. While the creation of new microfinance institutions is not envisaged to be a mainstream delivery mechanism going forward, it will remain a possibility in order to stimulate the MSE finance market in countries where there is no alternative. This might concern countries where the financial sector remains unreformed or under government control and where existing banks are structurally unsuited to become MSME partners, such as Uzbekistan. The Bank will also consider making equity investments in existing specialised microfinance banks, or in financial institutions which demonstrate a strong strategic commitment to MSME lending. The Bank will also work with selected non-bank microfinance institutions in their transformation to fully licensed banks where appropriate.

Ten of the microfinance banks where EBRD has investments are part of the ProCredit network, and a recent paper submitted to the Board addressed the issue of the Bank's staggered exit strategy for these institutions. It is important to re-emphasise that the Bank will continue to be a significant creditor of the network and will consider making additional senior loans on a case-by-case basis. The purchase by Banca Intesa of a majority stake in KMB Bank Russia is an excellent example of how mainstream commercial banks are increasingly coming to view MSME lending as a profitable and sustainable business which warrants the investment of significant capital. As one of the conditions to the purchase of part of EBRD's shareholding in KMB, Banca Intesa has undertaken to significantly grow KMB Bank's MSME portfolio, and EBRD will maintain a holding of 25% plus one share in order to monitor and assist Banca Intesa in this task.

The Bank will also maintain its existing Board representation and will participate in capital increases in order to maintain current shareholding levels and the rights associated with them, except in circumstances where the proximity to our final exit would make such an investment a sub-optimal use of the Bank's resources.

In addition the Bank will continue to explore possibilities for syndicated loans using the A/B loan structure, building on the successful experience with such facilities in the cases of ProCredit Ukraine, ProCredit Bulgaria, ProCredit Romania and ProCredit Serbia.

3.3 SME PROGRAMMES WITH PARTNER BANKS AND LEASING COMPANIES

The EU/EBRD SME Finance Facility (EU SME Facility), initiated in 1999, is the Bank's main instrument for financing small businesses in the EU Accession countries. Under the programme, the EBRD is making EUR 1,100 million funding available for lending and lease financing to SMEs with an EU contribution of EUR 156.75 million for technical assistance and financial incentives. Close to 90% of these amounts will be committed as of 31 December 2005. With an average transaction size of EUR 22,000 in the more advanced countries, the programme has proved to be an effective instrument to catalyse banks and leasing companies to provide financing to SMEs and reach the lower end of the market. However, average size of sub-loan and lease financing are higher in the less advanced countries.

Going forward, working with increased number of financial intermediaries will be a key priority in expanding the scope of SME lending programmes. Within the framework of the existing model, the Bank's future strategy for the programme has a number of key emphases and potential new directions:

- Although the Bank works through different financial intermediaries, banks will remain the main vehicle for SME finance. The Bank will continue to focus on providing long term funds to established commercial partner banks for SME lending.

- In the Accession states, the Bank will continue to implement the EU SME Facility. As experience shows that this capacity-building programme for the financial sector has been particularly successful in reaching its objectives, it is expected that the EU SME Facility may be enlarged to the pre-candidate countries of South Eastern Europe as part of the Instrument for Pre-Accession Assistance (IPA) initiatives from 2007 onwards. In the EU candidate and pre-candidate countries, a combination of performance fees and technical assistance will continue to be used to achieve the potential transition impacts.

- In the new Member States, the Bank will implement the EU/EBRD Preparatory Action programme, which is an evolution of the SME Facility with the aim of encouraging microfinance in particular. Since the EU SME Facility has widely demonstrated the potential for banks and leasing companies to serve the SME market segment in the new Member States, technical assistance for institutional building will focus on expanding further into the MSE segment. Under this programme, no performance fee support will be provided.

- To support improved access to finance for the development of SMEs and development of micro-credit, the Bank will co-operate with the European Investment Fund in the implementation of a new EU initiative, JEREMIE (Joint European Resources for Micro to Medium Enterprises) which will be available from 2007 onwards in the Member States. In particular, the programme will address the need to enhance support for start-ups and micro-enterprises through technical assistance, grants, as well as non-grant instruments such as loans, equity, venture capital or guarantees. In line with its mandate, the EBRD will engage selectively with countries and instruments where the transition gaps have been identified.

- The Bank will mobilise donor funding to implement programmes similar to the EU/EBRD SME Finance Facility in countries that have not yet been covered or are in an immature stage of development. Examples are the Western Balkans SME Finance Facility, and Ukraine.

- Leasing may in some cases be the only funding source available to SMEs as SMEs in many instances cannot afford other ‘traditional’ bank financing. On the other hand, leasing is a key part of more developed financial markets and it generally follows the development of the banking system as financial sectors become more advanced and adequate legislation is in place. The Bank’s goal is to continue to work with leasing companies to improve their lease underwriting to reduce losses and ensure their long-term viability.

- Risk-sharing is one way to alleviate bank balance sheet and equity requirements under Basle II, which should be fully implemented by the end of 2006. The Bank is planning to introduce risk-sharing products for banks’ SME portfolios in the more advanced markets. This will be a key product with which the Bank will remain additional including in the advanced countries.

3.4 EXISTING PORTFOLIO AND INDICATIVE PROJECTION FOR MSME BUSINESS

The table below shows both the Bank's current exposure and the indicative volume of new commitments to the MSME business by the end of 2008.

EUR mln.	MSE local partner banks	Specialised Microfinance Banks	Non-bank Microfinance Institutions	SME financing through established partner banks	SME leasing through established leasing companies	Totals
Existing						
CEB	-	-	-	433	232	**665**
SEE	3	55	1	265	39	**363**
ETC	20	14	-	89	1	**124**
CIS non-ETC	149	56	-	169	12	**386**
Totals	**172**	**125**	**1**	**956**	**285**	**1,539**
Planned 2005-8						
CEB	0	0	5	100	100	**205**
SEE	10	30	40	200	150	**430**
ETC	60	15	20	65	10	**170**
CIS non-ETC	195	50	10	380	100	**735**
Totals	**265**	**95**	**75**	**745**	**360**	**1,540**

3.5 CO-ORDINATION WITH OTHER IFIS AND DONORS

The Bank co-ordinates with other IFIs and donors active in its countries of operation on a regular basis in order to ensure the most effective focus of the Bank's MSME programmes, utilisation of donor technical assistance funds and platform for policy dialog on specific MSME related issues. Tangibly the Bank has jointly established twelve microfinance banks jointly with other IFIs and bilateral agencies. In other instances, the Bank has been able to attract additional funding for its client financial institutions from other international and bilateral financial institutions.

Going forward, the Bank will continue to closely co-operate with other agencies. Specifically the Bank will seek to establish common benchmarks with other institutions to better measure the breadth, depth and effectiveness of its MSME programs.

4. NEW PRODUCTS AND CHALLENGES

4.1 NEW PRODUCTS

A number of new products and areas will continue to be explored as the Bank seeks to enhance the impact of its operations with MSMEs and to leverage its own resources. The following concepts are early exploratory stage.

- Support to non-bank microfinance institutions (MFIs): ETC Framework & other countries

A recent study of microfinance across Central and Eastern Europe and the CIS found that nearly 6,000 microfinance institutions operated in the region – approximately a third of all microfinance was undertaken by traditional financial intermediaries i.e. commercial banks (including formalised microfinance banks). The remaining two thirds of all microfinance was provided by non-bank MFIs (credit unions, finance companies, NGOs).

Non-bank MFIs provide an important new delivery mechanism for the Bank and a first framework facility for providing on-lending funds to such institutions in the ETCs was approved this year and should be fully committed by early 2006. Technical assistance will support these MFIs in their efforts to transform into sustainable institutions. The Bank will also look at ways of delivering funding to successful non-bank MFIs across the Bank's countries of operation.

- Local Currency Financing

A significant part of the demand for microfinance is in local currency, whereas much of SME finance can be provided in USD or EUR given that SMEs are more likely to be able to match their loan service payments with export earnings. The Bank has already successfully engaged in local currency financing through programmes in Hungary and Russia. Going forward, Kazakhstan, Bulgaria and Romania may be considered as well. However, providing local currency loans to partner organisations remains a key challenge in other countries.

The Bank is exploring various ways to raise local currency, including standby credit lines and the issuance of securities. The proceeds of such initiatives could be on-lent on a long term basis to partner institutions. The feasibility of such attempts is of course dependent on the level of development of local capital markets, and in the meantime foreign currency based MSME programmes remain highly successful even in countries such as Kyrgyzstan and Tajikistan.

- Microleasing

Entrepreneurs in the MSE sector requiring asset finance are frequently caught in a "missing middle" between products available from MFIs (often short-maturity) and those available from leasing companies (often too high value). Leasing provides a solution to the problem of lack of collateral faced by smaller businesses mostly involved in the production sector. The Bank could potentially play a role in downscaling existing leasing operations to amounts that could benefit MSE clients, or assisting non-bank MFIs to develop this product. Building on the experience of the EU/SME leasing programme will be critical in this respect.

- Risk Sharing

In the most advanced countries of the Bank's operation Basle II will need to be implemented by the end of 2006. The Bank is developing risk-sharing products where the Bank would share the risk of SME portfolios of partner banks. This product will be highly additional as it is critical to alleviate bank balance sheet and equity requirements.

A further development would be the securitisation of loan portfolios. Though the legal framework in the Bank's countries of operation tends to make securitisation fraught with difficulty, the quality and uniformity of MSME portfolios in our partner institutions would suggest that securitisation could possibly become an innovative and useful instrument, especially as loan portfolios are reaching a serious critical mass in a number of partner institutions.

- Credit Scoring

Current lending methodologies in EBRD MSME programmes have proven to be able to generate excellent quality loan portfolios yet it would be appropriate to explore the possibility of shifting to credit scoring mechanisms where and when wage costs become excessive for currently used methodologies, and begin to affect the profitability/sustainability of programmes for partner institutions. Credit Scoring has long been seen as the logical next step in terms of improving efficiency, profitability and sustainability of operations with MSMEs. So far, most Bank MSME programmes have focussed on achieving the maximum possible efficiency, while remaining within the existing state-of-the art lending analysis techniques which involve case-by-case assessment of the client's ability to repay. Any new initiatives in this arena could usefully build on the experience gained with a number of financial institutions under the technical assistance programme of the EU/EBRD SME Finance Facility.

- MSME Focussed Equity and Loan Funds

Consideration will be given to investing in or alongside the increasing number of regional funds which have been created to invest in financial institutions with a strategic commitment to the MSME market in the Bank's countries of operation. Clearly, in such cases the Bank will need to be convinced of the capabilities of the Fund Manager, especially in terms of the value-added they will bring. Shorecap, which is a global fund with an MSME focus, is an interesting model in this respect, as it brings its technical expertise to bear on its investee institutions. A regional fund for South East Europe is presently under preparation.

➢ TAM/BAS Innovative Programmes

TAM/BAS has taken many initiatives in 2005 and the following will be broadened:

- “Cross-border” programmes;
- Women in Business projects;
- Tourism programmes;
- Utilisation of TAM/BAS methodology and expertise for environmental programmes (in collaboration with the Environment Department) and for development of business incubators;
- Support of privatization programmes in the Western Balkans

4.2 CHALLENGES

➢ Technical Assistance Requirements

There will remain a need for significant TC funding to support MSME lending initiatives in the coming years, and the Bank will continue to rely on the generosity of many interested donors to provide this funding. Recent years have seen the ratios of TC spend relative to lending volume in constant decline as programmes and banks mature and move away from the necessarily high levels of start-up TC funding. The Bank’s clear intention is to leverage as far as possible the sunk cost of existing and spent TC, and constantly strive to improve TC efficiency ratios in all programmes.

To support the level of new business foreseen from 2006-2008, the approximate level of TC funding required would total up to EUR 100 million across all products and countries.

➢ Staffing

The planned increase in exposure for MSME lending initiatives will lead to heightened monitoring requirements as regards the implementation of the programmes and the utilisation of the Bank’s funds. It is anticipated that these needs will be addressed in team business plans primarily by increasing staffing in Resident Offices, since monitoring activities need to be undertaken through close contact and co-operation with those involved in project implementation.

5. CONCLUSIONS

Providing support for the development of MSMEs is and will remain one of the Bank’s core businesses going forward. Each of the Bank’s countries of operation has specific needs which reflect the varying stages of transition and development of their MSME sectors. In response, the Bank has to have at its disposal a wide range of different instruments to address these requirements effectively, and must be prepared to adapt the use of these instruments over time in order to reach the different sub-segments within the overall MSME sector, and to push outward the frontiers of private sector development. Established commercial financial institutions will be the main channel to deliver these products.

Established commercial financial institutions will be the main channel to deliver these financial products, while TAM/BAS will add value by strengthening competitiveness and all business aspects, including management skills of individual MSMEs.

The need for the Bank to support the MSME sector in Central Europe is expected to decline gradually and to move towards more difficult segments and regions. In all other countries of operation, it is likely to remain a core business for the foreseeable future, especially the ETCs.

The measure of the success of the Bank’s MSME strategy will be seen in evidence that partner institutions across countries of operation are sourcing increasing proportions of funding for MSME lending from the private sector, either via commercial banks or private depositors, and sustaining increased levels of activity that have been associated with the Bank’s operations. The allocation of non-IFI, non-directed funding to MSME lending will indicate that the business has developed sufficiently to be incorporated by partner banks as a regular core profitable business line. At the same time, the ability of specialised microfinance banks to attract private sources of equity will indicate the extent to which these institutions have progressed towards financial sustainability. When these benchmarks for success are attained, the Bank can be reasonably assured that MSMEs will have increased and sustainable access to finance from the formal financial sector, which is the ultimate goal of these operations.

Annex 1: MSME Definitions

The Bank has traditionally defined its target group of the smallest borrowers by using a definition based on sub-loan size. In some programmes the Bank has tried to specify its target further by including a definition based on the number of employees of the sub-borrower.

Loan Size – In the EU/EBRD SME Facility a micro loan/lease is a loan up to a maximum of €30,000, and a small loan/lease between €30,000 and €125,000. In the MSE lending programmes a micro loan is a loan up to US$ 10,000 and a small loan can go up to $200,000. Other credit lines targeting SMEs have traditionally exceeded the loan size targets of the two types of programmes mentioned above.

Sub-Borrower - MSMEs are often defined in terms of the size of the sub-borrower, either by the number of employees, value of assets or the company's turnover. If one used the EU SME definition then microenterprises are companies with up to 9 employees (including sole proprietors), small enterprises have between 10 and 49 employees and medium companies have between 50 and 249 employees. This definition has been adopted in all new EU member countries, in countries currently negotiating for accession, and in countries aspiring to begin negotiating for accession. It has to be noted however that in some of the EBRD countries including those from SEE aspiring for accession, adopting the EU definition would de facto include all enterprises in the country. In this respect talking about targeting SMEs would be equivalent to targeting any enterprise in the country, in other words invalidating the effort of targeting only the smaller borrowers (this is relevant if smaller size of the company is indeed associated with higher risk perception and information asymmetries). Therefore there might be a case to adopt tighter definitions for SMEs than the EU definition in countries at earlier stages of development.

Maturity - Microloans tend to be for shorter maturities than small or medium sized loans and for short-term working capital needs. Longer maturities are needed for the purchase of productive assets and these tend to be for larger loan amounts.

Price - Shorter maturities and smaller loan sizes tend to command a higher price, reflecting the higher transaction costs.

Delivery Mechanisms - Each of the EBRD MSME programmes specialise in different sub-segments within the full range of MSME clients. The programmes with microfinance banks and MSME participating banks tend to focus on smaller clients with smaller average loan amounts at shorter maturities than do the EU/EBRD-SME programmes with participating banks and leasing companies. Other SME credit lines target even larger clients at longer maturities.

Annex 2: Assessment of Transition Challenges for MSMEs

Two impediments to MSME growth at the start of transition resulted from vested interests against market entry and competition and from rigidities in the labour and property markets (lack of skilled labour and business premises). In addition, the SME sector was highly credit constrained due to the banking sector's focus on lending to large and/or foreign owned enterprises. Finally, administrative and fiscal measures appropriate for the MSME sector were not in place. These four challenges define the elements of the MSME transition process:

Structure and extent of markets

- Development of simple and transparent entry procedures (removal of laws and regulations preventing MSMEs entry and creation of clear and transparent administrative channels in which all formal requirements, including tax payments, can be dealt with). Best practice includes creation of one-stop shops for company registration; possibility to register on-line, short time needed to register a business, adoption of principle of "silence equals consent" on the part of the authorities.

Market institutions and policies

- Development of a legal and regulatory framework conducive to MSME development, including simplification of the tax system for MSMEs. Specific measures may include: the creation of a flat rate structure for enterprises below a certain size (presumptive taxation), dispensation from detailed reporting / accounting requirements, limits on the discretion of inspecting officials and the improvement of systems for dispute settlement and contract enforcement. In order to promote tax compliance one important measure is to encourage and support MSMEs representative organisations to actively participate in the government's consultative process on tax legislation and regulation.
- Introduction of an institutional, legal and regulatory framework supportive of the development of MSME commercial finance, targeting broader sharing of credit information and stronger legal rights in and out of bankruptcy. Best practice would include the creation of public credit registry (a database managed by the public sector) and/or of private credit bureaus (private firms or a non-profit organisations) that maintain a database on the standing of borrowers in the financial system and facilitates exchange of credit information among banks and financial institutions.
- Improved access to skilled labour through measures to increase labour mobility, such as the expansion of job centres in order to reduce search costs, and improved access to business premises through development of property markets and underpinned by necessary privatisation legislation.

Market-based conduct, skills and innovation

- Transfer of commercial skills to MSMEs, for example, business strategy and planning. Establishment of business support environment (establishment of commercial associations and provision of suitable locations with appropriate utilities, e.g. business parks). Business advisory services are best managed and operated like commercial entities, even though they might initially have been set up by IFIs, donors and/or governments with subsidies.
- The transfer of MSME financing skills in order to increase access to external finance. Best practice includes the existence of banks that have regional branch networks and specialised SME departments (credit officers trained in SME lending and rural lending), and/or dedicated micro-finance banks, and NGOs targeting the start-up

segment of the market on commercial and sustainable basis. In these contexts, targeted and time-bound subsidies can support training and fostering a culture of credit within existing providers of finance to the MSME sector.

Remaining transition challenges were assessed against these transition milestones and rated on a scale from negligible (smallest remaining challenge), small, medium to large (largest remaining challenge). The following table summarises the assessment.

Country	Structure and extent of markets	Market institutions and policies	Market-based behaviour
Albania	Large	Medium	Medium
Armenia	Small	Large	Large
Azerbaijan	Large	Large	Large
Belarus	Large	Large	Large
Bosnia	Large	Large	Small
Bulgaria	Medium	Medium	Small
Croatia	Small	Small	Large
Czech Republic	Medium	Small	Medium
Estonia	Small	Small	Medium
FYR Macedonia	Medium	Medium	Medium
Georgia	Medium	Large	Small
Hungary	Medium	Small	Medium
Kazakhstan	Medium	Large	Small
Kyrgyz Republic	Medium	Large	Medium
Latvia	Medium	Small	Medium
Lithuania	Medium	Medium	Medium
Moldova	Medium	Medium	Medium
Poland	Medium	Medium	Medium
Romania	Medium	Medium	Medium
Russia	Medium	Large	Large
Serbia	Medium	Medium	Medium
Slovak Republic	Small	Medium	Medium
Slovenia	Medium	Small	Medium
Tajikistan	Large	Large	Medium
Turkmenistan	Large	Large	Large
Ukraine	Medium	Large	Medium
Uzbekistan	Large	Large	Large

Annex 3: Group for Small Business – Historical Performance

(i) GSB commitment volumes

GSB has executed 139 projects since 1994 for a cumulative signed volume of EUR 541.9m (USD 650m). To the end of 2005 EUR 448.3m (USD 538m) has been disbursed and the current outstanding committed portfolio is EUR 354.2m (USD 425m).

See the table below for details of how GSB's business volume has developed over the years:

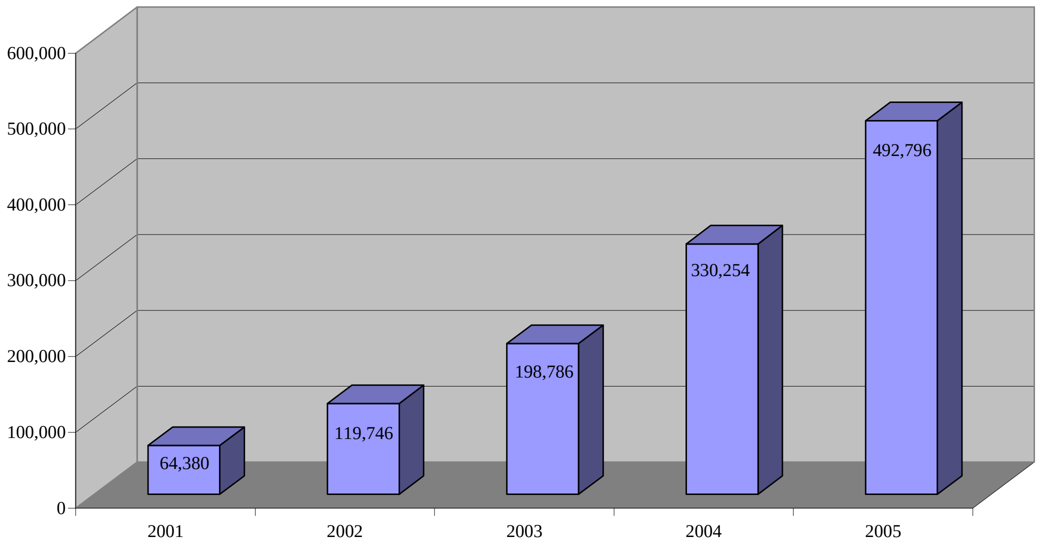
Year	Total Project Value (EUR m)	EBRD Share (EUR m)	Number of Projects*
1994	23	12.2	15
1995	13.9	8	8
1996	65.8	30.8	15
1997	24.5	11.2	7
1998	130.6	116.7	7
1999	11.1	1.8	3
2000	166.8	84	10
2001	105.1	46.4	7
2002	59.9	23	9
2003	111.2	83.4	17
2004	97.5	68.1	18
2005	85.3	56.4	23
Totals	**894.8**	**541.9**	**139**

* The figures represent the number of projects shown as signed for each year in DTM at the operation level. Some of these operations include both debt and equity facilities which are not counted separately.

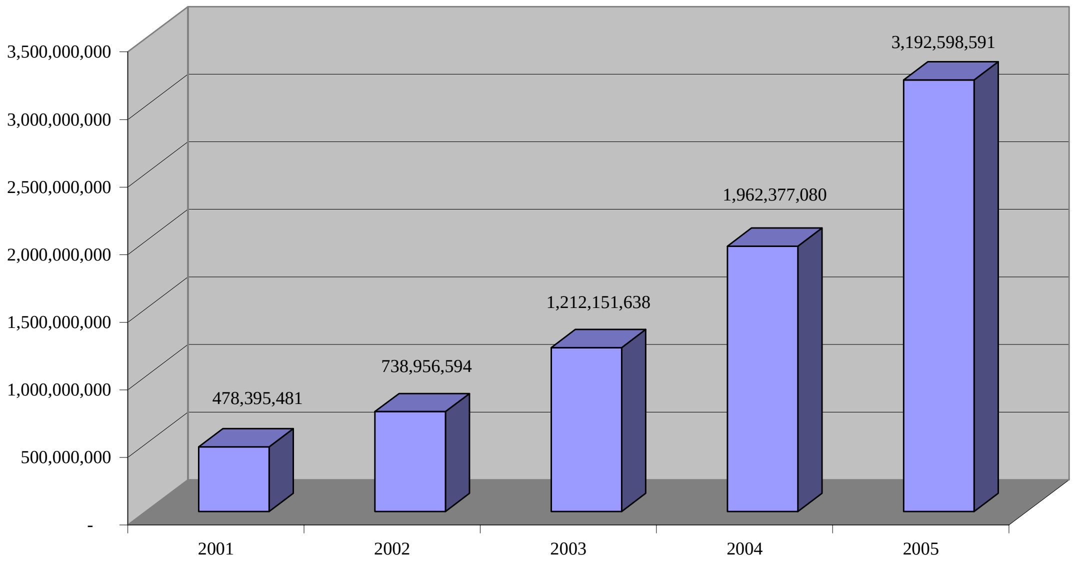
(ii) MSE sub-loan statistics as at December 2005

Country	Start Date	No. of loans granted	US$ amount of loans granted	US$ average loan amount	Arrears % > 30 days	No.of Active Loan Officers
Albania	Feb-99	39,846	257,560,547	6,464	2.11%	101
Armenia	Oct-02	15,991	37,722,721	2,359	0.05%	33
Azerbaijan	Nov-02	13,713	46,737,594	3,408	0.36%	79
Belarus	Apr-01	2,896	39,396,747	13,604	0.00%	10
Bosnia	Nov-97	58,685	267,872,771	4,565	0.48%	154
Bulgaria	Oct-01	64,794	577,930,286	8,920	0.31%	150
Georgia	May-99	99,080	463,178,890	4,675	1.47%	299
Kazakhstan	May-98	177,048	1,195,979,897	6,755	0.77%	666
Kosovo	Feb-00	39,184	361,567,711	9,227	0.69%	140
Kyrgyz Republic	Apr-02	37,777	71,488,675	1,892	0.73%	247
Macedonia	Jul-03	23,868	123,165,628	5,160	1.50%	103
Moldova	Dec-99	26,657	67,135,156	2,518	1.14%	76
Romania	May-01	34,672	228,232,961	6,583	1.46%	100
Russia	Aug-94	291,474	2,644,438,213	9,073	1.00%	662
Serbia & Montenegro	Apr-01	81,250	536,094,848	6,598	0.72%	420
Tajikistan	Oct-03	24,982	31,538,137	1,262	0.25%	122
Ukraine	Sep-98	224,001	1,288,622,528	*5,753*	0.60%	1468
Uzbekistan	Apr-01	21,783	53,360,280	2,450	0.27%	140
TOTAL		**1,277,701**	**8,292,023,589**	**6,490**	**0.84%**	**4,970**

Number of Loans Disbursed to end December 2005



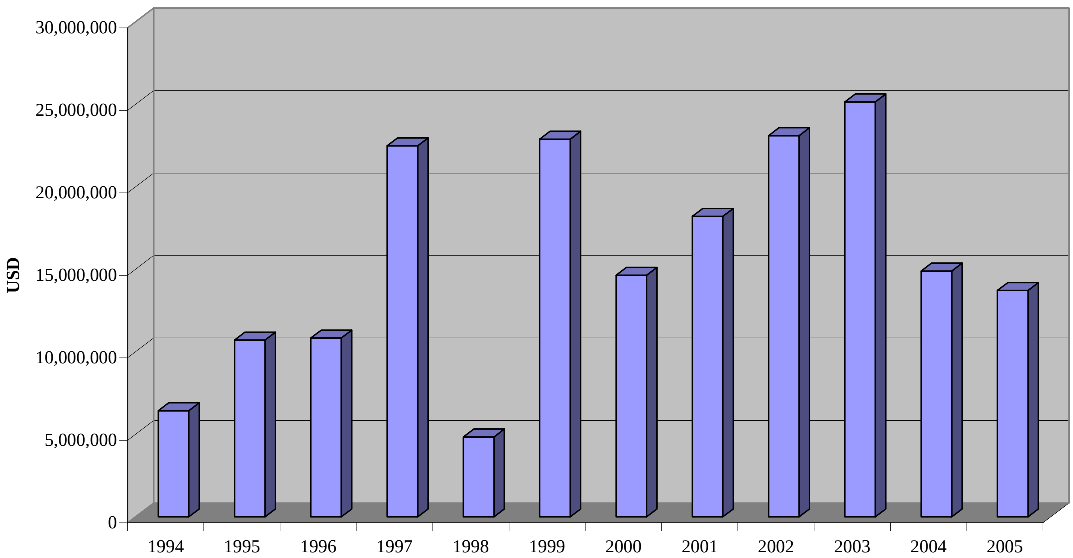
USD Volume of Loans Disbursed to end December 2005



(iii) Year by year TC Committed and Disbursed by GSB

The total amount of TC committed by GSB comes to USD 187.9 million, and the year-by-year breakdown is as follows:

Technical Cooperation Funds Committed to 2005



Technical Cooperation Funds Disbursed to September 2005