

# SME Sector in BSTDB Member Countries

## Financing Strategy for Development and Cooperation

### Introduction

As stated in the preamble to the Agreement Establishing the Bank, the member states of BSTDB have agreed to establish the Bank “in order to promote private and entrepreneurial initiative and to further the implementation of reforms in the financial sector”. Further, Article 1 states that “The purpose of the Bank shall be to effectively contribute to the transition process of the Member States towards the economic prosperity of the people of the region and to finance and promote regional projects and provide other banking services to projects of the public and private sectors in the Member States and trade activities among the Member States.” Article 2, which establishes the functions and powers of the Bank, mentions, among other functions, the following:

- a) to finance productive projects and enterprises in the Member States;
- b) to cooperate with international development institutions and national finance and development agencies of the Member States;
- c) to undertake research and surveys for promoting economic development of the region of the Member States or any of the Member States in order to stimulate development and transition;
- d) to further the aim of regional cooperation for development and to cooperate with the Member States to orient their development policies towards better utilization of their resources in a manner consistent with the objective of making their economies more complementary and of fostering the orderly growth of the economies of the Member States and acting as an advisor in designing sound economic policies;
- e) to undertake such other activities and provide such other services as may advance its purpose.

It results that the main function of BSTDB is to promote development. And it has to do so by making good use of various means, including regional cooperation, trade promotion, policy advice and constructive dialogue, as well as cooperation with international and national development organizations.

The purpose of this strategy is to provide a framework for the Bank’s involvement in SMEs promotion and development, within the broader scope of Private Sector Development support. It is a timely endeavor, as the Bank needed to accumulate experience and to “take the pulse” of the member countries economies in order to identify their needs and to assess the intensity and, if possible, magnitude of such needs. During country missions in preparation of the Country Strategies, as well as during business identification missions, in meetings with private and financial sectors representatives and government officials, SMEs emerged as one of the sectors the most in need of financial support.

BSTDB started operations in June 1999. Within a period of only 18 months it built up a portfolio of 15 operations for a total value of more than a hundred million USD. Small and medium sized enterprise financing reached at the end of year 2000 25.4% of the overall Bank’s portfolio and the Bank gained experience offering both debt and equity SMEs financing. SMEs facilities were extended to Albania, Bulgaria, Romania, the Russian Federation and Turkey. There is growing demand for the Bank’s financing in this sector from the other shareholder countries. In order to further

expand the portfolio and to diversify the instruments for SMEs financing, the Bank needs an overall strategy, which aims to set the stage for achieving maximum efficiency in funds utilization and to fulfilling the cooperation and development mandate of BSTDB.

The Bank has to create the conditions for growth of its portfolio of operations in the SME sector in a structured and controllable way. The present strategy takes stock of developments to date and attempts to reconcile the importance of SME financing with its organizational structure in a manner consistent with its objectives. Therefore, it defines the role of BSTDB in the SME sector in the Bank's member countries and structures this involvement around a set of specific instruments. The strategy takes into account and incorporates the experience and the lessons learned from the experience of other IFIs active in the Black Sea region. It also takes into consideration the BSEC recommendations on SME sector development, as they appear in various seminars and round tables organized by BSEC on this topic.

At the basis of the strategy rests: (i) the experience gained by BSTDB; (ii) the comprehensive understanding of SMEs developments, operational environment and market demand as resulted from analysis of data supplied by member countries; (iii) review of the existing literature on the topic; and (iv) the analysis of the role of IFIs in SMEs lending as well as of the competitive position of BSTDB.

The BSTDB SMEs Financing Strategy takes fully into account the Conclusions and recommendations of the EXPERT MEETING ON BEST PRACTICE IN FINANCING SMEs, which was held between 14-15 May 1998 at the Palais des Nations, Geneva, in the organization of the UN-ECE. These conclusions are the following:

There is a strong demand for the development and implementation of support policies and for the establishment of financial institutions and financial instruments.

There is a need to go beyond country specific approaches, which generate widely divergent approaches and to harmonize those policies and strategies as well as the instruments for implementing them while maintaining the possibility to adopt them according to the specific conditions and requirements of different countries.

The legal framework plays an important role in the creation and successful operation of SMEs and should encourage a simplification of the procedures involved in the creation, financing, training and other aspects of the SME sector.

Local authorities and communities should play a more active role by elaborating measures for promoting SMEs, simplifying and improving administrative and regulatory burdens, and promoting transparency and the dissemination of best practice in a simplified and improved administrative and regulatory environment.

In the majority of CITs (countries in transition) banks do not pay sufficient attention to the development of SMEs. The role of Governments and local authorities should be to open the dialogue and to create instruments together with the banks to promote the financial aspects of successful SME development.

There is a great need for improving different aspects of financial services for SMEs such as seed money, leasing, venture capital, and investment funding. There is a lack of long-term loans, interest rates are still high, etc. All these limit the development of SMEs.

Diversification of financial support for start-ups, growing and successfully operating SMEs will significantly contribute to the creation and development of SMEs.

It is necessary to take into account in all support programmes the different needs of micro, small and medium-sized enterprises.

There is a need for the elaboration of a set of instruments for the monitoring, evaluation and follow-up of different aspect of SME support programmes and activities.

Improvement of regional, interregional and cross-boundary cooperation as well as facilitation of foreign direct investment are urgently required in the SME sector.

Special attention should be paid to the penetration of SMEs into new markets as well as the possibility of accessing foreign markets.

The creation of a system of education and training on different aspects of SME activities for entrepreneurs as well as for the young generation are crucial to the development of an entrepreneurial spirit

It is very important to create an information network for SMEs taking into account the different aspects (such as business information, marketing, trade, financing, etc.).

- NGOs should and can play a more active role in the creation and development of SMEs taking into account their crucial role in the sustainable development of the economy.

BSTDB is coming later than the other local and international lenders to SMEs. There are already policy frameworks set up and institutional frameworks for SMEs support established in most member countries. Notwithstanding such positive developments, the experience and the success of SMEs vary considerably between the member countries. That is why there is still considerable demand for SMEs financing in each member country, and a BSTDB strategy to rest on the realities and to take advantage of the existing opportunities in the member countries became necessary.

The main strategic objective of the BSTDB in financing SMEs is to contribute to the development of this sector by providing financing and facilitating cooperation between the small enterprises in the region directly linking the financed companies, as well as through provision of pre-export financing through the Bank's Trade Facilitation Programme.

The SMEs sector is at different stages of development in different member countries. The operational environment differs, as well as the financial sector, the Governmental policies and the availability of external financing for SMEs. All these differences require, as a main principle of the Bank's SME's strategy, the Bank to offer tailored products specific for the needs of particular countries, sectors, markets. Tailored products will require creativity from the Bank's staff and in depth knowledge of the market demand and conditions. The regional character of the Bank justifies a stronger regional focus on SMEs as well as a demand driven approach in product development.

The two pillars of the BSTDB SMEs strategy are cooperation and development impact. SMEs sector in all developed, transition and emerging markets is attracting significant financing. While providing SMEs financing, BSTDB as the other lenders directly contribute to the economic and social development of the recipient country. BSTDB does not intend to compete with other donors, the private sector, or to take over the role of national governments and their agencies. Rather, BSTDB cooperates with and complements the activities of the other players. The priority of the BSTDB SMEs strategy is given to the operations that imply linkages between the SMEs financed by the Bank. The Bank is not only providing the necessary financing, but also solving the other stringent problem of SMEs – the access to information and to the regional markets. Creation of BSTDB network of SMEs, with support from other BSEC related bodies, will further contribute to the cooperation between the member countries companies, since now only the largest companies in the region are cooperating actively. Further on, matching the SMEs strategy with its trade finance programmes the Bank will provide additional resources for SMEs to grow through exports.

The BSTDB SMEs strategy takes into consideration the natural limitations, such as:

- *limited resources*. The Bank is the smallest IFI in the region and cannot offer large amounts of funds for SMEs. That is why achieving highest possible impact on the development and cooperation is the main guiding principle in SMEs lending. The Bank will seek to complement its resources with funding provided by external and internal co-financiers.

- *limited technical assistance funds available.* At this initial point of time the Bank has not attracted significant special funds to fill in the need for providing grant funding to SMEs and participating banks, for training and advisory services. The Bank cannot develop and offer to the Governments ambitious development agendas for SMEs. The aim of the Bank is to contribute to the development of a healthy SMEs sector and to create a network of small enterprises in the region. Technical assistance funds will be provided when mobilized. Until that time, the Bank will restrain from offering to provide non-financial services to SMEs.
- *strong market competition.* In SMEs lending the major lenders are IFIs through a variety of schemes with attached institutional and policy conditionalities. Such schemes include grant components and are provided mostly on concessional terms. From another side the reliable financial intermediaries in the local markets have already received substantial support at very good terms and conditions. That is why careful analysis of the experience of other lenders is important before entering the SMEs market in any member country.

The Country Strategies adopted by the BSTDB Board of Directors in 1999 underline the importance for BSTDB member countries to promote SMEs as an efficient way to foster development and sustain employment.

### ***SMEs Role in Development – Experience of Developed Countries***

Small and medium-sized enterprises (SMEs) are the key sector for generating employment opportunities and growth. The significance of SMEs in the developed market economies is extremely important. For instance in the EU SMEs account for more than 99.5% of the total number of enterprises and provide two third of all jobs. They also contribute about 60% to 80% of GDP. Total employment in non-primary private enterprises amounts to well over 100 million jobs. On average in Western Europe, an enterprise provides a job for six people.

Small businesses employ 53 per cent of the private work force in the United States, contribute 47 per cent of all sales in the country and are responsible for 50 percent of GDP. During the recent economic boom in the United States, over 45% of all newly created jobs were in SMEs.

In almost all industrialized countries, Governments have implemented a wide spectrum of programs promoting SMEs. Direct support and long-term loans are provided under favorable conditions, thus permitting the financing of businesses, which would otherwise be frustrated due to lack of resources. Governments generally consider financial support as the major component of promotion policies for the development of entrepreneurship and SMEs.

**TABLE 1: SMEs Role in the Economy of Selected Developed Countries (%)**

<b><i>Countries</i></b>	<b><i>Share of Total</i></b>	<b><i>Employment</i></b>	<b><i>Investment</i></b>	<b><i>Value Added</i></b>	<b><i>Export</i></b>
France	99	67	45	54	26
Germany	99	64	44	49	31
Great Britain	88	40	NA	50	NA
Japan	99	81	40	52	38
Korea	99	59	35	35	20
Netherlands	98	57	45	32	38
Taiwan	99	80	NA	45	NA
USA	90	53	38	48	32

## ***SMEs Sector Characteristics in BSTDB Member Countries***

In many countries SMEs are synonymous to the private sector. In BSTDB member countries development of an entrepreneurship culture is reflected in SME sector development. SMEs are of a strategic importance because: (i) contribute to employment growth in the long-term, while in the short-term are an unemployment mitigating factor, reducing thus the negative social impact of large enterprise restructuring; (ii) favor large-enterprise restructuring, enabling them to abandon non-core activities; (iii) offer flexibility in the provision of services; (iv) increase the competitiveness of the market; and (v) provide the fertile soil for the appearance and growth of domestic capital and consequently of a middle class which values economic freedom and democratic principles.

SMEs are not a homogeneous group and the definition varies from country to country. For the purpose of this strategy document we will use a definition derived from that used in the European Union. This means that enterprises, in order to qualify for being considered SMEs must concurrently meet the following criteria: (i) must be fully registered as legal businesses, in conformity with the relevant legislation in force in the country of incorporation; (ii) must have up to 250 employees; and (iii) must not be majority owned subsidiaries of large enterprises, either domestic or foreign based. We will further consider enterprises with 1 to 9 employees as being micro-enterprises, those with 10 to 49 employees as small enterprises, and those with 50 to 250 employees as medium sized enterprises. Enterprises with more than 250 employees will be treated as large enterprises.

In many BSTDB member countries were undertaken studies on the SME sector, many with technical assistance provided by various EU programs, or commissioned by the World Bank or the EBRD.

In 2000 Albania has realized and published a Medium Term Strategy for the Development of SMEs. In Azerbaijan in 1997 was approved the "State Program on State Support to Small and Medium Entrepreneurship in the Azerbaijan Republic (1997-2000)". In 1998 Bulgaria has approved a National Strategy for Stimulating the Development of Small and Medium Sized Enterprises. The major objective of the strategy is to create a favorable institutional, regulatory, administrative, financial and competitive business environment to promote SMEs development. To this end, a specialized SME Agency was established. Georgia has benefited from sustained EU technical assistance for institutional development. Recently it had approved an SME strategy. In Greece although there is no specific SME policy, special attention is given to newly created businesses and tax incentives are granted to enterprises at expansion stage. SME sector is very important for Greece with 99% of industrial business activities being performed by SMEs. Moldova seems to be an emerging country concerning entrepreneurship development with clear national SME policy and governmental commitment. In June 1996, a National Forum of Private SMEs in Romania was held in Bucharest to analyze the political, economic, social, institutional and legal framework of SMEs in the country. In 1999 was realized a comprehensive survey of the SME sector, and in 2000 was approved a national Action Plan for the SMEs. A comprehensive SME Strategy is expected to be ready in 2001. The SME sector in the Russian Federation received important financing from IFIs, in particular the EBRD, which provided about USD350 million through its Small Business Development Fund. In Turkey 95 per cent of the total enterprises are SMEs, which employ more the 40 per cent of the workforce. SMEs account for half of the investment and 30-40 per cent of the total exports.

The development of the SME-sector lags behind in some member countries where the lack of specific legislation, infrastructure and financial means are major obstacles for its rapid development. In addition, the prevailing work culture in all transition BSTDB member countries favors employment versus entrepreneurship, while the high level of education regards starting a new business in an economic activity unrelated with the area of education as a failure in the previous occupation.

## **Operating Environment of SMEs in BSTDB Member Countries**

Small and medium-sized enterprises (SMEs) are the key sector for generating employment opportunities and growth. On aggregate in BSTDB member countries over 98% of registered companies in the private sector are SMEs. Over 95% of the SMEs are very small and they may be classified as micro enterprises employing between 1 and 10 employees. The number of SMEs per 1000 inhabitants is just a bit less than half the ratio in the European Union. It is justified thus to consider that as progress is achieved in structural reforms and privatization the number of SMEs, in particular medium sized enterprises – currently referred to as the missing middle – will grow considerably.

Most SMEs (especially micro-enterprises) are in retail trade being owner operated, representing mainly a way to increase family income. Often they represent only a secondary occupation, with hope from the owner that it's just a temporary solution. These SMEs are an expression of necessity rather than of entrepreneurial spirit.

Moreover, many microenterprises, although legitimate businesses in nature, often represent the bulk of the gray/informal economy. However, its importance is high the sector development representing a true and effective poverty alleviation instrument. On the contrary, SMEs (employing 10 to 250 employees) are a genuine expression of entrepreneurship. These enterprises represent the largest portion of the domestically owned private sector of the economy.

The majority of medium sized enterprises (50 to 250 employees) are established in industry, construction and services. These companies are in their early stages of existence, have good growth prospects and as they grow they would present great opportunity to create employment.

Surveys conducted in a number of member countries have singled out unavailability of finance as the most important obstacle to growth. Some of these companies are resulting from larger state-owned enterprises under restructuring (both pre and post privatization) or liquidation. In most cases they own fixed capital with a high degree of obsolescence that is also worn out, have temporary and inappropriate premises and face large fluctuations in volume, quality and timeliness of supplies.

These enterprises represent the target group for BSTDB SME sector development activities, with a view to upgrade their capital endowment, access to technology and export markets.

**TABLE 2: Distribution of SMEs by Sector in BSTDB Member Countries (%)**

<b>Countries</b>	<b>Industry</b>	<b>Trade</b>	<b>Construction</b>	<b>Services</b>	<b>Other</b>
Albania	10	52	3	32	3
Armenia	NA	NA	NA	NA	NA
Azerbaijan	13	59	7	10	11
Bulgaria	13	51	4	26	6
Georgia	15	57	3	3	22
Greece	NA	NA	NA	NA	NA
Moldova	1	39	17	34	9
Romania	10	68	3	17	2
Russia	16	47	17	4	16
Turkey	NA	NA	NA	NA	NA
Ukraine	14	53	11	5	12

Source: Official country data submitted at BSTDB request

**TABLE 3: Distribution of SMEs by Size in BSTDB Member Countries (%)**

<b>Countries</b>	<b>Micro 1-9 employees</b>	<b>Small 10-49 employees</b>	<b>Medium 50-250 Employees</b>
Albania	98	2	0
Armenia	NA	NA	NA
Azerbaijan	NA	NA	NA
Bulgaria	92,5	5,5	2
Georgia	NA	NA	NA
Greece	96	3	1
Moldova	95	4	1
Romania	92	6	2
Russia	NA	NA	NA
Turkey	95	3,5	1,1
Ukraine	NA	NA	NA

Source: Official country data submitted at BSTDB request

## Financial Environment of SMEs

As opposed to the EU where the majority of external financing for SMEs is provided by banks, in our region financing comes from owners, sponsors or the informal sector. The banking system for the financing of SMEs has always been characterized by higher collateral requirements. SMEs usually have to pay higher interest rates than their larger counterparts. In practice there is often an inverse correlation between enterprise size and interest rates paid.

The “asset based lending” for SMEs (mainly for medium sized, whilst small sized are actually cut-off) in an environment with imperfect markets for collateral, still unclear property rights and not yet in place/operational/enforceable legal framework for secured transactions, is effected for amazing short term at prohibitive costs.

Financial intermediaries and investors are either unable or unwilling to respond sufficiently to the financing needs of small private enterprises for a variety of reasons:

- lack of experience, particularly in business appraisal and monitoring, means that finance for SMEs is seen as too risky;
- lack of a monitoring system in a bank means that only very secured short-term lending is made;
- lack of a secondary market means that valuation of collateral is difficult to perform, and that collateral is difficult to realize when loans are in default;
- the fact that the banks are undercapitalized means that they may be unable to give long-term credit from their own resources. This problem is compounded by the ready availability of better investment opportunities, in particular government bonds;
- lack of track records for entrepreneurs and enterprises coupled with the fact that the environment is changing very quickly means that the inherent risk of projects is much higher than in a comparable western situation;
- lack of pressure or incentives by governments to encourage the banks to take greater interest in lending to SMEs.

Small business owners are reluctant to disclose their business secrets because they see this as a threat to their autonomy. Problems that entrepreneurs have are:

- lack of personal security for loans;
- lack of any track record and/or managerial capabilities or reliable information make it difficult to put together a reasonable business plan;
- the fast-changing environment, including inflation in some member countries, means that normal "commercial" interest rates are very high and make long-term investment risky;
- there is a real lack of small amounts of start-up capital;
- only trading companies are in a position to deal with foreign currency and exchange risk. This inhibits manufacturing companies;
- lack of regulatory framework and facilities for leasing.

Commercial banks have little experience of dealing with SMEs. The administrative costs of lending to SMEs are very high and the size of loans is too small to cover these costs. Lack of transparency in evaluating loans for SMEs is an additional problem adding to the perceived high risk of providing loans to SMEs.

New and innovative financing solutions are still missing or are only at an experimental stage. This is an area where BSTDB, in conjunction and coordination with other donors, can help to fill the



gap and support through various financing measures and instruments the institutional building and capacity development to improve SMEs access to financing.

## **Promoting SMEs: an effective way to create growth and employment**

The promotion of widespread entrepreneurship through the setting up of small and medium-sized enterprises is crucial for the transformation to a market economy and for economic and social development. Small and medium-enterprises are of special importance because they are considered as the cradle of entrepreneurship.

SMEs are the embryos of the new healthy economy these countries aim to create and develop. SMEs are an engine of economic growth and a source of sustainable development, in particular for the creation of jobs, and provide income-generating opportunities to alleviate poverty.

Many Governments of BSTDB member countries in transition appear to be focusing more attention on questions related to privatization and restructuring of large state-owned enterprises rather than SMEs. This approach has the risk of considering privatization as an aim of economic transformation rather than as an instrument to make the economy more efficient through private initiative. Change in ownership alone can only ensure a level playing field where all economic agents are treated in a similar way by the authorities. However, without proper and well functioning institutions, a spirit of entrepreneurship, and clear and enforceable legislation an economy would not become more efficient. Clear property rights as a concept refers not only to the transfer of assets from state to private hands, but to the entire framework which would allow the free initiative to materialize within the pre-established rules for ownership. Therefore, as SMEs are the private sector, development of SMEs is intrinsically bound together with the other policy instruments.

## **Reasons that justify a special attention on SME financing**

- ***Offsetting market failures and imperfect competition***

While there is no evidence that SMEs are better performers than other enterprises, they do represent a large part of the economy and employment. The SMEs are also the emerging private sector in most BSTDB markets and therefore form the basis for a private sector-led growth. It is why their promotion is important, at the first place.

The key reason why the SMEs should be treated separately from the rest of companies is the presence of a number of market failures, typical for the BSTDB region, which often affect the SMEs more than the larger firms. Among others, such failures include limited access to information and financial resources. Therefore, a tailored SME promotion may offset some of these failures and lead to a more competitive overall economic environment.

SMEs have historically lacked access to the formal financial system due to weak financial sector/competition and/or difficulties/costs for the banks to verify their creditworthiness. However the growing success of many institutions provides confidence that access can be improved sustainably in many settings. It has now become possible to identify and agree upon the basic principles that support successful SME finance, so that lessons of success are translated to innovative approaches.

- ***Social and equity justifications***

SME support often aims a positive effect of a more equitable income distribution. However, as the argument that owners and employees are among the poorest groups in the society may hold for micro-enterprises, SME owners -- in particular those of upper mid-sized companies -- and workers are unlikely to be among the poorest groups, rather they are among the well-off, and therefore SME support does not prove to be always effective in poverty alleviation. It is nonetheless effective in promoting development of a financially secure middle class and proves to be efficient active labor measures to fight unemployment resulted from restructuring of large enterprises.

Combining social goals with sound banking/commercial principles often resulted in a policy conflict and unsatisfactory/unsustainable outcomes. Even when some social objectives (income redistribution) are achieved, often the cost of doing it via SME support tends to be higher than if direct transfers were applied. BSTDB should therefore make a clear distinction between economic efficiency and social goals in its SME promotion activities.

SMEs in transition countries are a direct result of the process of economic transformation. Failure to support their healthy development may have disastrous social and economic consequences, as public support for continuing and deepening reforms may weaken, poverty may increase, inflation may soar, and the economy may enter a period of prolonged recession.

Important for the promotion of entrepreneurship and development of domestic capital – and as a consequence of a medium class – the development of SMEs require sufficient and well targeted financing.

### **BSTDB role and priorities**

BSTDB regards SMEs as the backbone of the private sector. The Bank does not attempt to favor a particular market configuration on the basis of the size of firms. However, the Bank would concentrate on providing support for the development of a healthy private sector, identify and correct distortions related to the provision of finance to SMEs, and remove as much as possible existing barriers to growth that are of a financing nature.

BSTDB has at the center of its policy to focus on the financing of small, but with potential to grow into medium, companies in manufacturing, construction, services (health, software production, repairs and maintenance, etc.) with high earning potential.

The Bank will provide financial support, by making effective use of the instruments presented in detail further, to SMEs at expansion stage and active mostly in manufacturing, transportation, construction, agribusiness and food-processing, tourism, health and education services, research and development, telecommunications and high technology (software production), repairs and maintenance, and other services. The Bank will make all efforts to support investment by entrepreneurs previously involved only in retail trade activities. Although the Bank does not intend to pick winners or to promote specific economic sectors, giving utmost importance to local conditions and trying to respond to local market needs, it will use its limited resources only on those activities that provide the maximum of economic and social development benefit.

For these reasons, but also in direct correlation with its size and outreach capability, the Bank would concentrate on small and medium size enterprises, rather than on micro-enterprises which would however not be neglected, and would give priority to delivering finance through both traditional (commercial banks) and innovative (non-bank) financial institutions.

### **What Global Development Institutions and International Organizations are Doing to Promote SMEs?**

There is a need to disseminate the experiences and methods of the advanced European countries with the aim of creating and developing a solid and effective infrastructure mechanism capable of promoting the creation of new SMEs and the economic growth of existing SMEs. In particular in disadvantaged rural and industrial regions affected by industrial decline and undergoing industrial restructuring and structural adjustment SMEs could play a significant role because they produce and distribute local products and services. They create jobs and generate income. The ongoing process of industrial restructuring, privatization, market-oriented institution building, liberalization and foreign market competition have already contributed to emerging market conditions.

In view of the importance of the development of SMEs, the *European Union* has provided assistance to the development of SMEs through two major programmes: *Phare* and *TACIS*. The microcredit experiences provided within the Phare aid programme are very promising.

*UNDP* was very active in promoting Business Advisory Services and Business Incubators in many member countries.

*The International Fund for Agriculture and Development* (IFAD) is directing its financial aid to the rural poor, much of it through micro-credit programmes. As an example of this approach in countries in transition, IFAD and the World Bank have jointly designed and financed a pioneering project in order to meet the credit needs of small farmers and artisans in rural areas of Georgia.

*Opportunity International*, a non-governmental and non-profit oriented international network of micro-finance institutions whose objective is to promote enterprise development and employment generation as a poverty alleviation strategy had a very successful initiative in Eastern Europe. There are support partners in the USA, Germany, the United Kingdom and Australia. Since 1993, Opportunity International has established partner institutions in Bulgaria, Romania, and the Russian Federation. Local microfinance institutions have been created which provide financing, business support services, training and counselling.

*EBRD* focus on SMEs is demonstrated by the share of its financing through financial intermediaries (25% of its portfolio or EURO2.6 billion). However, EBRD focus is on strengthening the financial sector to ease the liquidity constraint on SMEs in general and to build the capacity of financial institutions to deal with SMEs in general, rather than providing direct support to the “target group” (SMEs targeted lending and equity investment amounts to EURO1.5 billion). EBRD policy on SMEs is characterized by: institution building, commercial approach and financial system orientation.

*World Bank and IFC* focus their support on a market oriented SME strategy. This policy covers the Business Environment, Business Development Services and Financial Services, with a view to: (i) open access to markets and accelerate market development; (ii) invest in public goods and build institutional capacity; and (iii) rationalize traditional public interventions.

## ***Financing Solutions for SMEs***

### **General Priorities**

The main priority of the SMEs operations is to have as high as possible both co-operation and development impact. Linking the SMEs, which benefit of financing from BSTDB will be one of the main criteria for the SMEs financing. In each SMEs operation a strong development and cooperation impact shall be sought. The main reason for providing SMEs with financial support is that they exist and represent the vast majority of private enterprises in the member countries.

The Bank will promote intra-regional investment and networking with a view to promote economic growth through regional cooperation. Fostering stronger links between SMEs in the region will be a facilitating factor of increased trade flows and would provide a basis for economic integration. Furthermore, the Bank would make all efforts to bring together large enterprises with SMEs, with a view to facilitating technology and know-how transfer. The Bank will, therefore, support subcontracting and clustering.

The bank targets that SMEs operations will represent about 30% of the total operational portfolio. This share reflects the importance of the SMEs in private sector development in the member countries and tries to adequately respond to the demands expressed by member countries authorities and business representatives. It also reflects the specific risks involved in SME financing, and the overall strategy of the Bank towards broader sector and product diversification. SMEs financing has to strike the right balance between commercial profitability and development impact.

The Bank will actively maintain dialogue with governments, donors and the local financial and business community, in order to achieve the intended results, among which the most important are:

- build export capacity and joint ventures;
- create legal and institutional environment conducive to private sector development;
- mobilize domestic and foreign resources;
- mobilize resources and local commitment for SMEs financing;
- facilitate technology and know-how transfer;
- create jobs;
- generate income;
- foster private-public sector partnership.

The Bank will cover all its member countries as the market requires and it will strive to have an as equitable distribution of operations as possible, with at least one SMEs operation in each country. Even in the most developed member countries there is a strong need for SMEs financing at affordable terms.

With the exception of the Russian Federation, where the Bank focuses attention on the three regions in the vicinity of the Black Sea, without neglecting SMEs in other regions or otherwise limiting itself to those regions, the Bank does not intend to concentrate its activities on specific regions.

### **Prerequisites to SME development**

In order for the private SME sector to growth and evolve into the driving force for economic development, it is necessary that a certain number of preconditions are satisfied. These include: (i) macroeconomic stability; (ii) favorable business environment; (iii) access to finance; and (iv) effective legal system.

### **Cofinancing and Technical Assistance**

Cofinancing will be primarily sought from domestic sources, to ensure cooperation with the local funds, banks, governmental agencies, as to build credible commitment from the part of local players and to lay the ground for sustainability when the Bank withdraws. At the same time contribution of foreign investors as well as mobilization of resources from outside the region will remain a priority. To the extent that the Bank mobilizes technical assistance funds, those will be used for preparation of projects, transfer of know how, and non-financial services.

### **SMEs strategy and environment**

The strategy towards sustainability requires a wide range of instruments including:

- i. Legislation to set environmental standards;
- ii. Economic instruments to encourage the production and use of environment friendly products and processes;
- iii. Horizontal support measures, such as education, Research & Development, information; and
- iv. Financial support measures.

The Black Sea Trade and Development Bank should take a leading role in improving the flow of environmental information and create special instruments supporting start-up and growth of small

businesses in the field of environment protection. In this respect the Bank would use in principal the cooperation opportunities with EBRD and the World Bank Group.

While Bulgaria, Greece, Romania, Russian Federation and Turkey already acknowledge the interrelation of the SMEs and environment protection issues, in other member countries environment protection measures and development of the SME private sector appear to be two unrelated issues.

Key factors for success:

- Self-commitment of the SMEs towards ecology and environment protection;
- Taking into consideration the process of globalization in the world market, the relation of the entrepreneurial activities with the environment is unavoidable and linking these issues in a mutually supportive manner will facilitate integration into the world trading system;
- SME supporting institutional infrastructure, i.e. chambers of commerce and industry, financial intermediaries, etc. should play more active role in assisting SMEs also in the field of environmental protection through inter alia; a) preparing and disseminating environmental guidelines for different sectors/activities and b) helping to overcome obstacles on the way ranging from innovation to products and services;
- Create appropriate financial instruments including for innovation, know-how and environmental protection;
- Make SMEs' access to medium and long-term finance easier, especially by applying environmentally advanced technologies;
- Encourage the development of industrial and technological parks, in order to make them environmentally oriented through operation within a concerted framework integrating prevention and pollution control while expanding production.

## **SMEs Procurement Policy**

Procurement practices to be used in SME operations are consistent with the Bank's procurement policies. In this context, the Bank will:

- Aim to ensure transparent, fair and open competitive procurement practices
- Provide margin of preference to domestic and regional suppliers of goods and services
- Observe the negative list - tobacco, hard alcohol, weapons, ammunition, hazardous materials, narcotics
- Provide financing only for approved purposes

## **Security Structure**

Considering the specific risks of lending to SMEs: (i) reduced reliability of information; (ii) weak financial management skills; (iii) unavailability of collateral; (iv) weak and under developed financial systems; (v) risk of low disbursement rates, the Bank will consider from case to case security structures which would include – but will not be restricted to -- one, or a combination, of the following:

Assignment of collateral – possible or alternatives

Assignment of insurance rights

Assignments of receivables

Bank guarantees

Escrow accounts

Pledge of government securities  
Personal guarantees  
Pledge of shares  
Property  
Sovereign guarantees  
Warehouse receipts

Such security can be provided by the intermediary, final beneficiary, sponsor, individually or jointly. Notwithstanding the importance attached to the amount and solidity of the security, its provision will not form the basis for the Bank's decision to lend; rather it provides only additional comfort that the Bank's exposure could be recuperated in case of undesirable developments.

## Implementation

In order for BSTDB to have clear SME sector support program and a consistent set of guidelines to favor implementation, it needs to establish:

- Objectives;
- Monitoring indicators; and
- Instruments

### Objectives

Among the most important objectives of the Bank intervention in support of SMEs are:

- Providing financial support at affordable terms to fast growing small and medium size-companies in manufacturing, food processing, transportation, construction, telecommunication and hi-tech sectors, market and social services.
- Increase export capacity.
- Promote job creation and revenue generation.
- Increase competitiveness of firms in the member countries.
- Promote intra-regional investment.
- Facilitate know-how and technology transfer.
- Mobilize external capital to the region.
  - Facilitate networking.
  - Improve financial sector ability to deal with and supply financing to SMEs.

The above mentioned objectives could be achieved by adequately addressing the following technical and institutional arrangements:

- Development of retail lending capacities in the participating financial institutions;
- Institutional arrangements to deliver the necessary technical assistance, where necessary;
- Support for the development of micro-finance and specialized small enterprise finance institutions; and

- Leasing as a financial technique.

### Monitoring Indicators

Detailed info is found in the Portfolio Risk Management and Investment Policies document, SMEs Program, Section 6.2

### Instruments

*Credit Guarantee Funds*

*Microfinance/SMEs Specialized Financial Institutions*

*Venture capital/Equity Investment Funds*

*Leasing*

*Credit Lines through Selected Financial Intermediaries*

Detailed info on all Instruments is found in the Portfolio Risk Management and Investment Policies document, Sections 2.5.C Types of Loans and 6.2 SMEs.

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