

OFFICE MEMORANDUM

DATE: August 21, 1996

TO: Mr. Ian Johnson, GEF Secretariat

FROM: Lars Vidaeus, Chief, ENVGE 

EXTENSION: 34188

SUBJECT: **UKRAINE: Ozone Depleting Substance Phase-Out Project; the GLOBAL - Small and Medium Scale Enterprise Program Replenishment and the INDIA, KENYA & MOROCCO Photovoltaic Market Transformation Initiative**

Please find attached the camera ready documents for the above project proposals to be submitted for approval at the next Council Meeting on October 8-10, 1996. These documents reflect the understandings reached at the August 14 GEFOP meeting. In this connection we would wish to inform you as follows:

(a) Re. Small and Medium Scale Enterprise Program Replenishment. On the subject of equity financing, IFC has obtained confirmation from the Bank's legal department that from the Bank's perspective the inclusion of the possibility of equity financing in GEF financed projects is fine as long as the GEF Council is made aware (ex-ante) of such possible use. Also, please note that the SME Program Project Document, which was circulated with the GEFOPs submission, should be available for Council members upon request. Copies of this document are currently being printed and should be available to you early next week.

(b) Re. PVMTI and letters of endorsements from country GEF focal points. The Kenya letter is in hand and attached to the document. The letters for India and Morocco are expected by August 28th. In the event that receipt would be delayed a few days we trust that this would not hold back distribution of the documentation.

cc: Messrs./Mmes. M. Rubino, D. Younger (IFC), K. Shepardson (EC4NR), J. Suter and ENVGC ISC

PROPOSAL FOR REVIEW

PROJECT TITLE: SMALL AND MEDIUM SCALE ENTERPRISE
PROGRAM REPLENISHMENT

GEF FOCAL AREA: Biodiversity and Climate Change

COUNTRY ELIGIBILITY: All GEF-eligible countries

TOTAL PROJECT COST: \$ 16.5 million

GEF FINANCING: \$ 15.5 million

GEF IMPLEMENTING AGENCY: World Bank

EXECUTING AGENCY: IFC

ESTIMATED STARTING DATE: January 1997

PROJECT DURATION: 3 years

GEF PREPARATION COSTS: None

SMALL AND MEDIUM SCALE ENTERPRISE PROGRAM REPLENISHMENT

EXECUTIVE SUMMARY

1. This proposal seeks a funding replenishment from the GEF to extend and expand the SME Program. This replenishment request to the GEF is for a present value funding commitment of US\$ 15.5 million.
2. The Small and Medium Scale Enterprise Program ("SME Program") was approved as a Pilot Phase activity in July 1994 and began operations under the administration of the International Finance Corporation ("IFC") in December 1995. The mandate of the SME Program is to finance the incremental costs of GEF eligible projects (projects with biodiversity and/or climate change benefits) as carried out by small and medium scale enterprises ("SMEs"). The SME Program seeks to finance eligible SME projects in all GEF-eligible countries that are party to the Climate Change and Biodiversity Conventions. SMEs, for the purposes of the Program, are defined as private sector enterprises with total assets valued at less than US\$ 5,000,000. There is no defined minimum asset size for an eligible SME.
3. The SME Program is one of the main GEF initiatives focused on small and medium scale enterprises. SMEs provides employment for a large portion of the economically active population in countries in development and consequently financing to SMEs can be expected to have a significant developmental impact.
4. A basic feature of the SME Program is that it operates through Intermediaries. These Intermediaries are selected by IFC on the basis of their experience with SMEs, financial viability, and financial and environmental technical capabilities. The Intermediaries identify, analyze, finance and monitor GEF eligible SME projects and receive a long term, low interest rate loan from the Program to finance these activities.
5. In its first year of operation the SME Program has developed and implemented the procedures for selecting Intermediaries, for analyzing and approving SME projects and for monitoring these projects. Five Intermediaries have been selected to date by IFC and these Intermediaries in turn have committed to finance a total of at least 23 different SME projects. The forecast average amount of financing that any one SME project will receive from the SME Program is approximately US\$ 150,000. Estimated total financing that will be provided to these SME projects from all sources is US\$ 11.5 million which represents a leverage of approximately 4 times on the GEF funds provided.
6. The preceding anticipated results of the pilot phase of SME Program are based on the level of funding provided to date by the GEF (US\$ 4.3 million). Of this total, the funding available for eligible SME projects (US\$ 3.8 million) is forecast to be fully committed by October of 1996. The remaining funds - for SME Program specific administration costs and for technical assistance - are expected to be depleted by June 1997. Independent consultants (STAP and non-STAP) hired to review the SME Program have endorsed the structure and operation of the Program to date and recommend an extension and expansion of activities (see Annexes 1 and 2).

7. To accomplish the goals of the Program as outlined in paragraph 21 of this proposal, requires a budget of US\$ 16.5 million, allocated as follows: US\$ 12 million for SME projects and Intermediaries; US\$ 3 million for Program specific administration and US\$ 1.5 million for Technical Assistance. The budget exceeds this request for funding from the GEF by US\$ 1 million. This is because the administrative costs of the SME Program will be partially offset by interest earned on funds loaned to Intermediaries (US\$ 1 million forecast - see budget outline preceding paragraph 30).
8. At US\$ 3 million, or 18% of the proposed budget, the amount of funding allocated for administrative expenses appears high, but this is the amount required over a ten year period.. On an annual basis, as a percent of loan funds under management, the forecast administrative expenses are a respectable 3% - 4% p.a. by the year 2001. These administrative expenses are for the specified project-related costs of the SME Program team contracted by IFC to implement the Program - not IFC's own management costs. IFC is contributing, and not recovering, significant legal costs and management time to the Program.
9. This proposal requests that the GEF disburse the replenishment funding in two equal tranches of US\$ 8.25 million each, the first on or by December 31, 1996. The second disbursement will be disbursed to IFC at the option of the Chairman of GEF as required prior to December 31, 1999. The Present Value of these two disbursements equals the US\$ 15.5 million funding required by the Program (at 4% p.a. over three years).
10. The requested replenishment will provide sufficient funding to finance an estimated 75 additional SME projects as well as to provide technical assistance funds to increase the financial and technical capacity of the Intermediaries. In addition, the replenishment will provide funding to administer the SME Program and to monitor and evaluate the approximately 100 SME projects which will have been financed by the Program - for the full term of these proposed financings. This period of monitoring and evaluation will in some cases extend to 10 years. It is necessary to commit to the full term of the SME project financings to ensure that the lessons of the SME Program are systematically monitored, analyzed and disseminated.
11. This long-term commitment to evaluate the results of the proposed SME projects relates directly to the fundamental issue being addressed by the SME Program - the critical need for increased participation by the private sector in the finance of small scale projects with global environmental benefits. Financing GEF eligible SME projects is a relatively new opportunity and without evidence to the contrary the private sector will always assume that new initiatives are either highly risky or unprofitable, or both. The SME Program will use GEF funds to first develop a significant number of SME projects and then to document the true risk/return nature of these initiatives. If a significant number of projects funded by the SME Program are shown to be commercially viable, and if private sector funding follows as a result of this experience, GEF funds will have been used in a very strategic and practical manner to leverage much larger flows of capital to GEF focused SME activities.
12. The operational modalities proposed for the SME Program are consistent with GEF Council decisions and guidance, the GEF Instrument, and the GEF's draft policy papers on Engaging the Private Sector and on Incremental Costs and Financing Modalities. At its May 1995 meeting, the Council agreed that Implementing Agencies should be encouraged to prepare project concepts with non-grant financing approaches.

13. Following approval of this proposal, all GEF country focal points in recipient countries will be advised of the SME Program. Countries will be asked to endorse the SME Program, on a no objection basis, with a two month response period. All recipient countries, except those objecting, will then be potential hosts for sub-projects. Thereafter, the GEF focal points for specific countries will be advised each time an SME Program standard Loan Agreement has been signed with a selected Intermediary from that country. The GEF focal points for a specific country will also be advised each time an SME project has been approved. This is the same approach with respect to GEF country focal point notification to be implemented by another global initiative recently approved by Council, the Renewable Energy Energy Efficiency Fund ("REEF") and is consistent with the policy detailed in GEF/C.7/12 ("GEF Strategy for Engaging the Private Sector", paragraph 28).

BACKGROUND AND PROJECT CONTEXT

14. Institutions selected by IFC to be Intermediaries may be traditional financial institutions, NGOs or specialized entities such as venture capital funds. Once selected, Intermediaries receive long term low interest rate loans (up to 10 years at an interest rate of 2.5% per year) from the Program. The Intermediaries commit to use the loan proceeds to finance a specific minimum number of eligible SME projects, providing to these SMEs either debt or equity, but not grants. The long term source of funds from the Program allows the Intermediary to fund long term loans or equity investments in relatively high risk experimental SME projects. A portion of the proceeds of the loan from the Program will be paid to the Intermediary in compensation for identifying, analyzing, structuring and monitoring projects. A final feature of the loan to the Intermediary is a success incentive. Success in this case means providing either debt or equity to an eligible SME project and recovering the full amount advanced. If the Intermediary accomplishes this, the amount of the loan repayment due to the Program will be reduced by 50% of the amount recovered from the SME.

Name of Intermediary	Country or countries of operation	Size of Loan from SME Program	Number of projects Intermediary has committed to finance	Forecast total financing for SME Projects
Environmental Enterprises Assistance Fund ("EEAF")	Indonesia, The Philippines, Mexico and Central America	US\$ 800,000	6	US\$ 4,800,000
CARESBAC-Polska S.A	Poland	US\$ 600,000	4	US\$ 3,600,000
FUNDECOR	Costa Rica	US\$ 500,000	2*	US\$ 1,500,000
El Sewedy Electrical Supplies	Egypt	US\$ 500,000	6	US\$ 1,000,000
World Wildlife Fund Inc. ("WWF")	Papua New Guinea	US\$ 500,000	5	US\$ 625,000
Totals		US\$ 2,900,000	23	US\$ 11,525,000

* FUNDECOR will be financing up to 150 separate projects of two basic kinds - sustainable forestry and reforestation - both on a very small scale.

16. As of July 1, 1996 the SME Program has committed to lend US\$ 2.9 million to five different Intermediaries as shown in the preceding table. One or two additional Intermediaries will be selected during the pilot phase of the SME Program, with at least one of the recipients likely to be in sub-Saharan Africa.

17. The procedures of the SME Program require that the Intermediaries present their projects to a Review Committee of the IFC for approval. Once the Review Committee and the Advisory Panel are convinced that an Intermediary can identify, analyze and structure SME projects that are commercially viable and that address the GEF objectives then that Intermediary is authorized to finance projects without Committee approval. The Intermediary must advise the Program Task Manager of the details of all projects financed according to a standard SME Program reporting format. Criteria and procedures for the selection of Intermediaries and eligible SME projects are described in Annex 4. One of the requirements is that Intermediaries forecast the global environmental benefits (climate change and/or biodiversity) of each project. The role of the Advisory Panel is to review and confirm the forecast project GEF benefits and incremental cost calculations.

18. The first of the Intermediaries to submit SME projects for approval is FUNDECOR, an NGO in Costa Rica. The Review Committee has approved FUNDECOR's plans to finance forestry projects with small landowners in a buffer zone around the national parks in the Cordillera Central. The projects that were submitted were for a sustainable forestry initiative on 41 hectares of natural forest and a reforestation project on 25 hectares of land that had been converted from forest to cattle pasture. The amount of financing required for these projects was US\$ 1,757 and US\$ 6,213 respectively.

19. Examples of other proposals currently under development for individual SME projects include the following:

- Environmental Enterprises Assistance Fund (in South East Asia and Central America):
alternative energy projects - biomass and small hydro electrical generation
eco-tourism facilities
- CARESBAC - Polska (in Poland):
energy system conversions (coal to gas furnaces)
suppliers of energy saving equipment (thermostatic valves for centrally supplied
heating, insulated window manufactures, etc.)
- El Sewedy Electrical Supplies (in Cairo, Egypt):
energy efficient lighting
- World Wildlife Fund (in Papua New Guinea):
sustainable community based forestry
community based eco-tourism

19. A complete description of the structure and operation of the SME Program is provided in the Project Document available as Annex 3 to this proposal.

OBJECTIVES OF SME PROGRAM EXPANSION

Global Environmental Objectives and Benefits

20. As in its initial phase of operation the extended SME Program will continue to finance small scale projects with either or both biodiversity and climate change benefit. The number and kinds of projects will increase in the proposed extension, as will the geographic range of the activities financed. The direct global benefits of the projects financed will be relatively small because the funding provided in any one case will be small - less than US\$ 250,000 (and often much less). More important will be the long term demonstration effect that the Program has to encourage the private sector to incorporate global environmental concerns at the level of small businesses and to provide to the private sector examples of replicable environmentally positive projects.

Specific SME Program Objectives

21. To attract greater participation by the private sector in the financing of GEF eligible SME projects more successful examples of these kinds of projects need to be developed and documented. The SME Program seeks the replenishment to fund and evaluate at least 100 different GEF SME projects. IFC believes that this target number of projects is necessary to provide valid conclusions.

PROJECT DESCRIPTION

22. In the proposed extension of the SME Program GEF funds will be used to finance three specific strategies related to the role of the private sector and financing for GEF eligible SMEs.

- **A sufficient number of projects need to be developed to provide for basis for future conclusions and lessons:** Financing for a total of 100 SME projects has been set as the goal of the SME Program. This requires that an additional 75 SME projects be financed with funds from this replenishment request to the GEF. Funding for new SME projects represents approximately 80% of the requested replenishment.
- **Building capacity in non-financial Intermediaries:** Half of the Intermediaries selected to date by the Program are not financial institutions. Two are NGOs without formal financial sector experience in project analysis, financial design or investment monitoring. In the extension of the SME Program more non-financial Intermediaries will likely be selected. IFC has excellent experience in building financial capacity in partner institutions and has an opportunity and responsibility to bring this experience to the Intermediaries. By investing GEF funds in strengthening the capacity of Intermediaries, the Program will be increasing the ability of these institutions to invest in projects with global environmental benefits.
- **Monitoring, evaluation and dissemination of the Program results:** It is not sufficient that the SME Program develop 100 SME projects that are commercially viable and produce global environmental benefits. It is also important to study the experiences of the Program, to analyze them and to disseminate those experiences. In particular, the Program will focus on

the market barriers that confront SMEs that undertake globally friendly projects. The Program monitoring and evaluation activities will build the database for the future analysis of these issues. The dissemination of the lessons learned from the Program is fundamental to the future commercial financing of GEF SME projects.

RATIONALE FOR GEF FINANCING

23. The SME Program responds to the objectives of the Climate Change and Biodiversity Conventions and the GEF Operational Strategy for controlling greenhouse gas emissions and loss of biodiversity. The GEF Operational Strategy suggests that GEF funds should be used to leverage additional finance through collaboration with the private sector. The SME Program addresses and/or seeks to accomplish these objectives and strategies. Based on the experience gained to date, it is estimated that the US\$ 12 million requested for funding to Intermediaries will leverage sufficient private sector funds to finance approximately US\$ 48 million in GEF eligible SME project costs.

24. In general the private sector has not acknowledged the need or the opportunity to finance commercial projects with global environmental benefit. The SME Program is attempting to stimulate the development of this kind of project by using public sector funds from the GEF to finance small projects at the margin of private sector activity. This strategy is new and somewhat radical. It is not at all certain how profitable projects with global environmental benefit can actually be, particularly when carried out at the level of SMEs.

25. If the SME Program is successful in developing a significant number of commercially viable projects with global environmental benefits, this example may cause the private sector to consider investing in these projects as well. If the SME Program is successful, a relatively small amount of GEF funding will have been used to attract much larger flows of capital from the private sector.

SUSTAINABILITY AND PARTICIPATION

26. Sustainability of financing for GEF SME projects is a basic objective of the SME Program in all of its activities. If the SME Program is successful in the pursuit of this objective the following evidence of success will be observed:

- **at the SME level:** With a clear record of profitable operation some of the SMEs financed with Program funds may in the future be able to access commercial financing,
- **at the level of the Intermediaries:** As the Intermediaries determine that the risk of the SME projects and their related financial returns are acceptable they will also be able to attract financing from commercial sources to continue this activity, and
- **at the level of the SME Program:** The final proof of the sustainable nature of GEF SME projects would be the establishment of a private sector financed loan or equity fund targeting these activities. The SME program may attempt to structure this kind of specialized financial vehicle. Subsequent requests for funding of GEF SME projects may then be shared between the GEF and a significantly larger amount of funding from private sector investors and lenders.

27. Many of the non-financial Intermediaries selected by the SME Program have excellent experience with environmental issues or with SMEs but lack the experience necessary to finance commercial projects. As donor funding to NGOs and non-profit institutions becomes constrained and competitive, the sustainability of these organizations will depend on their own ability to attract and manage commercial funds. The SME Program seeks to increase the long term sustainability of non-profit institutions through the provision of technical assistance funds for two purposes:

- **increasing management capacity:** The Program will contract independent consultants to work with non-financial Intermediaries to improve management's ability to identify, analyze and structure commercially viable financial opportunities with global environmental benefit, and
- **commissioning business plans:** Often NGOs have good community based or environmental technical experience but lack the ability to convert this experience to a commercial opportunity. In these cases the SME Program will fund the cost of preparing business plans for the commercialization of their experience.

LESSONS LEARNED AND TECHNICAL REVIEW

28. The Pilot Phase of the SME Program has in a relatively short period of time laid the groundwork for the proposed extension by concentrating on the following activities:

- **Establishment of the procedures and processes for approval, disbursement and monitoring:** The procedures developed for the SME Program have been fully designed and implemented. All activities except for monitoring of the individual projects have been tested. As of July 1, 1996 the Program has reviewed 15 potential Intermediaries, approved five and signed standardized loan agreements with three of them.
- **Selection of a diverse group of institutions as Intermediaries:** The Program has selected Intermediaries with good geographic diversity and a variety of structures. Two are small business venture capital funds financed by a combination of grants and private sector capital (EEAF and CARESBAC). One is a private company (El Sewedy). Two are non-profit NGOs (FUNDECOR and WWF). The Intermediaries are committed to financing projects that are small by traditional IFC or World Bank standards. FUNDECOR projects, for example, will require as little as US\$ 1,500 in Program funds and even the maximum allowable contribution (US\$ 250,000 per project) is not particularly large for private sector projects. Both biodiversity and climate change projects will be prepared by the selected Intermediaries.
- **Training the Intermediaries in how to identify, analyze and monitor SME projects that meet the SME Program criteria:** Each Intermediary has been trained in the preparation of a standard evaluation technique for proposed SME projects. This evaluation requires that the Intermediary forecast the financial viability of the project as well as the incremental costs and the anticipated GEF benefits. In addition, the Intermediary is required to carry out an Environmental Review of the project, to avoid negative environmental impacts, and to test that the amount of financing provided by the SME Program does not exceed the incremental cost of the project. The instructions provided to the Intermediaries for monitoring SME projects are outlined in the Project Document (Annex 3).

- **Development of contacts with potential Intermediaries:** In anticipation of an extension of the SME Program a pipeline of potential Intermediaries has been developed. Contacts have been made with a range of institutions, from NGOs to IFC's traditional financial intermediaries.

29. All of these elements of the current Program have been reviewed and are strongly supported by independent consultants. There is no reason at this time to change significantly how the SME Program operates. A draft of the Interim Review prepared by the consultants is attached as Annex 2. The STAP review of the Program replenishment proposal by a consultant on the STAP roster is provided in Annex 1.

PROJECT BUDGET AND FINANCING

Budget Summary

A.	Financing to Intermediaries and projects	US\$ 12,000,000	73%
B.	Administration (including long term requirements for monitoring SME projects)	3,000,000	18%
C.	Technical Assistance		
1.	technical assistance	750,000	
2.	monitoring and evaluation	250,000	
3.	dissemination	<u>500,000</u>	
	Total technical assistance	US\$ 1,500,000	9%
	Total SME Program cost	US\$ 16,500,000	100%
	Estimated reflows (interest earned on loans to Intermediaries)	US\$ 1,000,000	6%
	Total Project (replenishment request)	<u>US\$ 15,500,000</u>	✓

Financing to Intermediaries and Projects

30. During the extension of the SME Program, the size and range of SME projects that the Program has developed to date will be maintained. Additional geographic diversity will be sought as will more projects. A particular effort will be made to develop SME projects in Africa. As a rough guideline the Program will attempt to finance projects by region as follows.

Region	Target number of projects	Number of projects as of July 1, 1996
Central America, South America and Caribbean	15	5
West Africa	5	
South and East Africa	10	
Northern Africa and Middle East	10	6
Eastern Europe	10	4
India and Pakistan	15	
South East Asia	10	
China	15	
Oceania	10	8
Total	100	23

31. A list of potential Intermediaries that has been collected over the last year will serve as the initial pipeline of opportunities for the extension to the SME Program. In addition, IFC's Project Development Facilities based in Africa, the South Pacific region and South East Asia have committed to actively seek out projects which meet the Program criteria. A conservative estimate is that the Project Development Facilities will identify and structure at least 10 of the targeted 75 new GEF eligible SME projects. Some of the current group of Intermediaries will advance all of the funding currently available to them from the SME Program and will be eligible for new loans within the proposed extension. These existing Intermediaries are expected to provide an additional 15 new SME projects. The remaining target of 50 new SME projects can realistically be obtained through the selection of an additional 10 to 12 new Intermediaries. The process of identifying and selecting the next group of Intermediaries is expected to take three to four years.

32. For the purposes of forecasting the required funds for the proposed increase in the number of SME projects the Program has assumed that US \$ 4 million per 25 projects on average will be sufficient and that as a result US\$ 12 million is required to reach the target number of projects.

Administrative structure

33. The administrative structure and functions of the team contracted by IFC to implement the first phase of the SME Program operation will continue but will be expanded. The requirement to monitor loan documentation, disbursements and repayments as well as the work associated with selection and approval of SME projects and Intermediaries will necessitate the extension of the contract with the Task Manager and the hiring of an Assistant Task Manager and an Administrative Assistant. The Assistant Task Manager will start in January 1997 and the Administrative Assistant will start part time in March 1997. By December 1997 it is estimated that the Administrative Assistant will be full time. The basic assumption is that the SME Program will require an administrative structure for at least ten years from the date of the first proposed disbursement from the GEF. These administrative expenses are offset in part by interest earned by the Program on funds loaned to the Intermediaries at 2.5% p.a. This forecast of interest income is the Estimated Reflows item in the budget.

Technical Assistance to Intermediaries

34. (see paragraph 27) Funding for six years of technical assistance are forecast in the SME Program budget.

Monitoring and Evaluation of SME Project Risk and Return

35. IFC will assist in the design and management of these activities. Expenses include the cost of hiring consultants to design the information database for the collection and storing of the information on risk and return characteristics of each project financed by the Program.

36. Some preliminary analysis of this information can be carried out in the short term but since many of the SME projects may have long financing terms (as long as 10 or 12 years in extreme cases) it is unlikely that conclusive results will be obtained before December 1999. Expenses for the monitoring and evaluation activities are forecast to be required for as long as the administrative structure is required, i.e. ten years.

Dissemination of Experiences

37. A conference will be scheduled each year to bring the Intermediaries together and to discuss lessons and practices. Intermediaries will develop and present case studies of projects with innovative technology or financing. The major costs of the proposed conferences will be space rental, materials and coordination of participants. In addition, funds will be set aside to assist participants from smaller Intermediaries to travel to the conferences. These expenses are assumed to be required until the termination of the Program, i.e. for at least ten years.

INCREMENTAL COSTS

38. The SME Program has developed an approach to incremental costs which is applied by the Intermediaries at the level of SME projects rather than at the level of the Program itself. This approach is outlined in the Project Document attached as Annex 3 to this proposal. Also, the technical assistance provided by the SME Program and the proposed research and project evaluations should be considered as incremental costs that the private sector will not fund.

ISSUES, ACTIONS AND RISKS

39. The risks associated with the proposed extension of the SME Program are the same as were considered prior to the implementation of the pilot phase of the Program. These risks are significantly reduced however due to the experience gained to date from the operation of the Program.

40. Among the risks to be considered in the proposed replenishment request are the following:

- **Deal flow risk:** There is a risk that the number of SME projects which meet the GEF requirements while at the same time demonstrating a basic level of financial viability will be lower than anticipated. The funding requested from GEF is to be staged, however, and if the demand for the SME program funds does not manifest itself before December 1999 the second tranche of funds will not be released to IFC. Based on the relative speed with which the SME

Program was able to identify Intermediaries prior to July 1, 1996 and the strategies for expansion, it is considered probable that the target of 100 SME projects will be attained.

- **Program operating expense risk:** The funding required for administration of the SME Program over the full term of the project financings depends on the forecast operating expenses and the anticipated interest income that the Program will earn from Intermediaries on the loans provided. The estimates for both the expenses and the income potential are considered conservative and realistic.

INSTITUTIONAL FRAMEWORK AND PROJECT IMPLEMENTATION

41. The basic features of the SME program as it is currently structured will continue in the extension phase. The Program will continue to provide loans to Intermediaries on attractive terms to offset the risks and to cover the costs of the activities that they are being asked to carry out. The Intermediaries will continue to provide debt or equity to SME projects with rates of return in excess of the cost of funds from the Program. Intermediaries will analyze projects according to the Evaluation Report format and methodology as outlined in instructions provided to the Intermediaries by the Program. One new feature that will be added is the proposed relationship with IFC's project development facilities discussed in paragraph 31 of this proposal.

42. The SME Program during its pilot phase of operation has prepared the ground and planted the seeds for the proposed extension. Time has been invested during the first year of operation to ensure that the Program can control the quality and quantity of the SME projects which are now beginning to be presented. It is important the SME Program build on this foundation and harvest the results of the first phase of activity.

**TECHNICAL REVIEW
SMALL AND MEDIUM SCALE ENTERPRISE PROGRAM REPLENISHMENT**

ANNEX 1

TECHNICAL REVIEW
SMALL AND MEDIUM SCALE ENTERPRISE PROGRAM REPLENISHMENT

The Global Importance of the SME Program in the Area of Reducing Carbon Emissions and/or Preserving Biodiversity

The SME program is an extremely important and innovative initiative in bringing the private sector into work on climate change and biodiversity. The critical factor that remains to be addressed is whether the individual projects are making a significant contribution to reducing carbon emissions or preserving biodiversity. The Technical Advisory Committee that has been established to address the issue of the magnitude of global benefits provided by any particular project could perform this function.

The Effectiveness of the SME Program in Achieving Regional Objectives

The main challenge in achieving regional objectives is to locate the appropriate Intermediaries, and to provide them the necessary training to ensure their capacity to deliver. The technical assistance component of the project is therefore crucial in this regard.

The Adequacy of Project Design

The project design is elegant, including the targets to implement some 100 SME projects, to systematically monitor and analyze these projects, and to disseminate the results. The budget available for such dissemination is adequate and should be seen as a critical element in this initiative. Some thought might be given to bringing some larger firms into the discussion when the Intermediaries meet to discuss progress. If, for example, the several investments in sustainable forestry in Costa Rica were to lead to a cooperative merger, they might no longer qualify as an SME; such growth should be seen as a success indicator.

The Feasibility of Implementation and Operation

While the first phase of the SME program has demonstrated the feasibility of implementation and operation, some additional points might also be considered. A critical factor in the feasibility of implementation is building capacity in non-financial Intermediaries. Increasing management capacity and commissioning business plans are important elements in the overall program.

Conclusion

This review of the SME program replenishment endorses the views of previous reviewers that the SME program is an innovative and useful contribution to global efforts to conserve biodiversity and control the impacts of the climate change. By bringing the private sector increasingly on board, the most innovative and energetic parts of national economies can be brought into these important fields.

**INTERIM REVIEW DRAFT REPORT
SMALL AND MEDIUM SCALE ENTERPRISE PROGRAM**

ANNEX 2

DRAFT

INTERIM REVIEW

IFC/GEF SMALL AND MEDIUM SCALE ENTERPRISE PROGRAM

July 29, 1996

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prepared by: Frank Vorhies, Environmental Economist Biodiversity Programme IUCN - The World Conservation Union	
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prepared by: José M. Ruisánchez	

EXECUTIVE SUMMARY

1. The purpose of this review is to provide opinions on the potential for the SME Program as it is currently structured to attain its GEF and financial objectives. Opinions are also provided on issues relating to IFC's intention to request additional support for the Program from the GEF.
2. The environmental aspects of the review have been carried out by Mr. Frank Vorhies of IUCN-The World Conservation Union, and the financial aspects by Mr. José M. Ruisánchez, in June/July 1996.
3. Overall, the IFC/GEF Program is a very well structured, innovative pathbreaking program. It is sure to provide new lessons and insights on funding projects for the global environment, as well as having a positive impact on the global environment. The Program's structure is sound and suitable and its resources are being used effectively. IFC is acting diligently in the execution of the Program.
4. The innovative aspects of the US\$ 4.3 million Program are: to engage IFC's cooperation in pursuing GEF objectives of climate change and biodiversity through viable projects of SME's; to channel funds to SME's through intermediaries, mostly NGO's; and to maintain an R&D-type approach that permits the accumulation of lessons on how to blend GEF objectives with the capacity of the private sector to implement sustainable projects based on commercial practice. Noteworthy is the small size of the Program, the intermediaries, the SME's and their projects.
5. Aside from being of GEF relevance, the Program requires the SME projects to be commercially viable, defined as having a minimum IRR of 4%. The GEF usually provides grants and has no minimum IRR requirement. The Program's minimum IRR requirement is nevertheless compatible with GEF objectives. The Program's concessional loans call for a mechanism that relates the minimum interest rate charged by the intermediary with the project's capacity to repay the loan. The IRR is a reasonable proxy for the latter, and the 4% level seems an appropriate level at which to initiate the Program. As the Program evolves, the 4% floor could be adjusted as appropriate. This minimum IRR requirement should be handled as a practical tool and an indicator in the context of the Program's analysis of a project's financial viability.
6. The Program's approach to the complex concept of incremental cost is a practical and innovative application of that concept to concessional rather than grant financing. Experimentation with "incremental cost financing" appears quite appropriate in this pilot phase, especially as a source of useful information for both IFC and the intermediaries in managing the financing of SME projects. As with others, this indicator should not replace judgment in ensuring that a project makes good sense from the GEF's perspective.
7. The decision to work through intermediaries is sound, as it permits reaching a larger number of (smaller) SME's, enhances timeliness in Program implementation, increases efficiency in the utilization of Program resources, and reduces risk. The Program's criteria and controls for

the selection of intermediaries are sound, and the selection process is well structured and functions reasonably well. It should be noted, however, that the selection process has resulted in the Program's working with 4 (and, soon, maybe 5) NGO's who are quite different from the typical IFC intermediary. While this is commendable, care should be taken to ensure that IFC's traditional sponsor quality is maintained; and that the Program has adequate budget resources to provide the necessary technical assistance. It is also suggested that the intermediaries (and not only their projects) be assessed from a GEF perspective. A variety of kinds of intermediaries in channeling the Program's funds is likely to enrich the prospects for generating good lessons for GEF/private enterprise cooperation.

8. The Program's definition of an SME is congruent with IFC practice. The Program should be commended for fostering the support of a size of enterprise which is well under its maximum size of US\$ 5 million. Limiting the amount per intermediary and per SME seems a good incentive to keep the size of firm small; and appears adequate for generating a sizeable and varied sample of projects to be financed by the Program.

9. Given that the Program seeks the commercial viability of GEF- oriented projects, and that it works with private SME's, it is appropriate that it provides loans and equity investments rather than grants. Also, loans and equities --rather than grants-- fit well with IFC's experience in financing private firms; and permit familiarization by NGO's with these traditional instruments of private sector funding. Similarly, the Program's incentives to its intermediaries are responsive to the extra cost and risks of pursuing GEF objectives and are output/success oriented, which is sound. Ideally, and eventually, the incentives should be refined to relate them with the costs and risks of the intermediary as well as with the GEF impact of the SME projects.

10. It is suggested that the Program consider the introduction of a standardized framework for the forecasting, monitoring and reporting of the SME project's global environmental benefits. This framework would reflect the appropriate Convention and would be joined by a guide to assist the intermediaries in its application. A similar comment can be made in relation to the financial aspects of SME projects. Key is not to encumber intermediaries with paperwork that yields little in Program insights and lessons.

11. The structure of the Advisory Committee or Panel, involving experts who review the GE aspects of SME projects and report through remote communication, is quite acceptable. Suggestions are: to foster the development of a guide for the intermediaries to standardize the presentation of GE aspects of projects; and a companion guide for the members of the Committee to facilitate their work. The Committee's members should have adequate incentives to devote the time necessary to provide substantive advice to the Program.

12. The overall operating structure now in place appears adequate for the remainder of the pilot phase. It appears to function in a smooth way and it harmonizes the many aspects and complexities of the Program. This reflects good cooperation between the two IFC departments that oversee the Program's implementation, as well as good work on the part of the Task Manager and the other persons involved. Sufficient Program resources should be available for ensuring adequate monitoring and supervision of the Program, for identifying good practices and capturing

the lessons, and for disseminating the Program's results. Also, there should be resources to provide intermediaries with the necessary technical assistance and support in problem solving. With proper expansion/deepening, there is no conceptual or practical reason why this structure cannot work well in the expanded Program that is envisaged.

13. A US\$ 4.3 million Program is too small to permit a proper accumulation of GEF private sector experiences and an adequate base for launching a sustainable GE fund. Additional support from the GEF would increase the Program's base to US\$ 15 to US\$ 20 million. Success at this level should permit evolving into a self-financing environmental investment fund. A larger Program may permit identifying projects which are suitable for such a fund and others which are likely to require concessional financing. Thus IFC may well pursue different types of instruments in order to fit GEF objectives to the commercial viability of SME projects.

14. The GEF through IFC can open debt and equity markets for the global environment. Just as GEF money is "greening" the world in which IFC lives, the IFC can assist in "commercializing" the world in which GEF lives. To date, grants have made up the bulk of flows for the global environment, and there is much that IFC can do in complementing those flows with loans and equities. Similarly, governments and NGO's have been the main players in the GE arena, and IFC can help private enterprise to develop complementary roles in support of biodiversity and climate change. The Program's focus on debt and equity financing and IFC's reputation as the prime source of private development funding provide an ideal combination of elements for the GEF to support. IFC in partnership with the GEF has an opportunity --as the leading multilateral private sector financial intermediary-- to provide leadership in mainstreaming the environment into the world of private financial markets.

ENVIRONMENT STRUCTURE REVIEW

15. The purpose of this review is to provide opinions with respect to the potential for the SME Programme as it is currently structured to attain the GEF objectives. Specifically, as requested, the review comments on the issues outlined in points 1 to 5 below. Section 6 provides additional opinions on issues relating to the IFC's plan to request additional support for the Programme from the GEF.
16. Overall, the IFC/GEF SME Programme is a very well-structured, innovative, path-breaking programme. It is sure to provide new lessons and insights on funding projects for the global environment, as well as actually having a positive impact on the global environment.
17. **The SME Programme requirement that SME projects have a minimum level of commercial viability (defined by the Programme as 4% p.a. IRR in real terms).**
18. The bulk of the funding provided by the GEF is in the form of grants to the national governments of eligible countries. Nevertheless, the *Instrument for the Establishment of the Restructured GEF* does expect that "private sector entities" will also be engaged in "GEF project preparation and execution." In addition, the *Instrument* sees the GEF as "a mechanism . . . for the purpose of providing new and additional grant and concessional funding." Thus debt financing of private enterprises to meet the objectives of the GEF is an appropriate use of GEF funds.
19. With grant funding, there is no expectation that the money will be repaid. With concessional funding, however, the expectation is that the principal plus interest will be repaid. The GEF does not have any set requirements about the rate of interest or the length of the repayment period for the loan. If money is to be lent, however, it must be lent for the purpose of encouraging the private entity to engage in activities which they otherwise probably would not have in order to benefit the global environment. Thus the financial package of the loan, including the rate of interest and the term of the loan, would probably have to be more attractive than what is available in local commercial financial markets. In this sense, the funding is intended to be concessional.
20. The GEF, of course, also does not want its grants used to subsidise normal commercial operations. Just as grant funding is, for the most part, inappropriate for private enterprises, concessional funding at zero or very low interest rates is also inappropriate for private enterprises. The challenge facing the SME Programme is to set the interest rate at a level below the commercial rate so as to provide an incentive for the private concern to refocus its activities to the benefit of the global environment, while at the same time not to set it at so low of a rate as to provide a subsidy to normal commercial operations.
21. In order to set an appropriate rate of interest for the concessional loan, it may be necessary to project the both the internal rate of return (IRR) of the SME project as well as the commercial

risk-adjusted, commercial cost of capital. Thus from a GEF perspective, a method for determining the appropriate rate for a concessional loan requires calculation of the IRR and the cost of commercial financing. This technique is discussed in more detail in the next section.

22. The GEF does not, however, call for a minimum IRR or concessional loan rate. Nevertheless, the SME Programme has decided to limit eligibility to SME Projects with at least a 4% IRR. The Intermediary is also required to set its lending rate no lower than 4%. Are these requirements compatible with GEF objectives? The short answer is yes.

23. A further question might be asked. Why 4% and why not 2% or 6% or some other rate? If the SME project expects an IRR of less than 4% it is hardly a commercially viable project. Increasing the rate higher than 4% will reduce the number of eligible projects for consideration. In this pilot phase of the SME Programme, a cut-off rate of 4% seems an appropriate rate at which to initiate the programme. As the Programme evolves, the 4% floor could be adjusted - probably upwards - as appropriate.

24. The technique outlined in the Programme with respect to the calculation of the incremental cost component of the SME project costs; i.e. is this approach a reasonable one considering the size of the financings and the SMEs involved? Does it represent a practical application of the complex concept of incremental cost?

25. The GEF Secretariat has spent a considerable amount of effort on making the incremental cost concept operational for funding GEF-eligible projects. For example, in 1993 it published a working paper on "The Incremental Cost of Climate Change Mitigation Projects." It also has a working paper on "Incremental Costs of Conserving Wetland Biodiversity." These papers, however, focus on the application of incremental costs to grant-financing of projects.

26. The SME Programme is offering debt and equity finance for projects, and thus is attempting to apply the concept of incremental cost to concessional rather than grant financing. In so doing, it is experimenting with a technical measure of incremental cost derived from a comparison of the commercial cost of capital and the internal rate of return (IRR) of a possible SME project. Thus the SME Programme is engaged in "incremental cost financing" of SME projects related to the stated GEF objectives.

27. The Programme's approach to the complex concept of incremental cost is a practical and innovative application that may provide useful information for both the IFC and the Intermediaries in managing the financing of SME projects. It will thus also provide lessons for the GEF on the application of incremental costs to concessional financing of GEF projects. How useful this approach actually will be, however, can only be judged after it has been tested. Thus in this pilot phase, it is quite appropriate that such a technique be applied and studied.

28. The SME Programme is focusing its incremental cost assessment primarily at the level of disbursing the funds to SME projects. It is not trying to apply an incremental cost assessment to either the decision of the GEF to provide a grant to the IFC for the overall IFC/GEF SME

Programme or the decision of the IFC to provide a loan to an Intermediary who in turn will invest in SME projects.

29. There are, however, important incremental cost aspects of both the grant to the IFC and the loans to the intermediaries. In addition to motivating SME projects to support GEF objectives, the GEF grant is also motivating the IFC and the intermediaries to support GEF objectives. Thus the grant is having an incremental impact at three levels. At least in descriptive terms, this should be noted in the monitoring and reporting on the SME Programme.

30. The Programme criteria and controls for the selection of the Intermediaries, including the analyses carried out by the Task manager and the approval process.

31. The SME Programme expects the Intermediaries to be: (1) financially secure, (2) experienced with investing in small and medium scale enterprises, (3) familiar with debt and equity financing, and (4) knowledgeable about climate change and biodiversity conservation. Very few, if any, organisations meet all four of these criteria. Thus the SME Programme is catalysing the development of such Intermediaries.

32. It will consider organisations that have the first two criteria and at least one of the latter two. The Programme then looks for outside support to help the potential Intermediary in the area(s) where it is weak. The IFC is best positioned to help Intermediaries lacking financing skills and thus is best suited to focus on Intermediaries with environmental expertise. This bias, however, is quite acceptable in the pilot phase as it means that GEF money will be used to expose environmental and conservation organisations to debt and equity markets for financing GEF objectives.

33. The approval process for the Intermediary is well structured, but perhaps could be strengthened by ensuring that someone reviews the applications from a GEF perspective. This implies not only reviewing the environmental qualifications, but also the appropriateness of the Intermediary in terms of GEF criteria for eligibility. For example, a large “northern” NGO or venture capital company may not be seen by some as an appropriate intermediary for a GEF project. Including a person with a GEF perspective on the Review Committee would help to ensure that GEF as well as IFC objectives are met in the selection process.

34. The ability of the Intermediaries to forecast and monitor the specified global environment benefits deriving from the SME Programme financing.

35. As explained in the GEF paper on “Incremental Costs,” the GEF was established “to provide new and additional resources for the agreed incremental costs of measures to achieve agreed global environmental benefits.” This paper further explains that “To estimate the incremental costs it is necessary to quantify costs, but is sufficient merely to identify benefits.” Thus the Intermediaries must be able to explain how the SME projects are achieving agreed global environmental benefits, but they need not attempt to assess the economic value of these benefits.

36. An appropriate approach to forecasting and monitoring the specified global benefits would be to assess the SME projects in terms of the Convention on Biological Diversity and the Convention on Climate Change, as well as in terms of the decisions of the Conferences of the Parties to these two Conventions. For example, the above-mentioned paper suggests that “if the Conference of the Parties to the CBD deems a particular ecosystem or species worth protecting in the global interest, then the incremental cost of a GEF project that protects it is the incremental cost of achieving that agreed global environmental benefit.”

37. This would imply that at the very least that the Intermediaries identify and monitor the expected global benefit in terms of the concerns, objectives, policies, and instruments of the Conventions. For example, the Convention on Biological Diversity is “concerned that biological diversity is being significantly reduced by certain human activities.” Its objectives are conservation, sustainable use and the equitable sharing of the benefits of conserving and using biological resources. Furthermore, the Convention calls for new policies and instruments relating to such matters as identification and monitoring, in-situ conservation, ex-situ conservation, incentive measures, public education and awareness, access to genetic resources, technology transfer, and financial resources.

38. If the Intermediaries were asked to assess the SME projects in terms of the appropriate Convention(s), this would provide a standardised framework for their forecasting, monitoring and reporting. The SME Programme should consider developing a basic guide or checklist to assist the Intermediaries in this respect.

39. The role of the Advisory Committee.

40. The Advisory Committee, also referred to in the documentation as the Advisory Panel, has been set up to advise the IFC on the GEF eligibility of proposed SME projects. It consists of a World Bank/GEF member who acts as the Chair plus two members of the GEF Science and Technology Advisory Panel. One of the STAP members is an expert on climate change and the other on biological diversity. This structure is quite acceptable.

41. As the Panel members are expected to review numerous SME projects and present their reviews through remote communication (email, fax, post), it is important that a well-structured reporting procedure is used. If the Intermediaries are to use a standard guide or checklist, as suggested in the previous section, then a companion guide or checklist should be designed for use by the Advisory Panel. The Panel could then use this list to identify quickly projects approved, projects rejected, and projects that require further discussion among the Panel members.

42. Because the SME Programme is path-breaking - loans and equity financing instead of grants, enterprises instead of governments, small and medium scale instead of large, use of Intermediaries - it is quite important that the Advisory Panel pay close attention to the projected global environmental benefits of proposed SME projects. Thus consideration should be given to ensuring that the members of the Advisory Committee have sufficient incentives to devote the time and effort needed to provide substantive advice to the Programme.

43. Issues relating to the intention of the IFC to request additional support for the Programme from the GEF.

44. If the SME Programme becomes successful, it could evolve into a self-financing environmental investment fund. Start-up costs and the incentives to the Intermediaries as well as to the SMEs in terms of concessional rates and retained earnings, however, are high. Though there may be room for improving the returns from the SME projects to the Programme (or Fund), clearly \$4.3 million is too small a capital base. Thus it makes sense to request additional support from the GEF to increase the base to \$15 or \$20 million.

45. In making this request, the IFC should, however, think carefully about whether it wants to consider this to be its last request for support for the SME Programme, or just the last request for support for a broad-based SME Programme. If the Programme proves successful, then more targeted programmes - focusing on SME projects, for example, in nature-based tourism or sustainable harvesting of wild resources - might be developed. These could also be "kick-started" by support from GEF.

46. In its request for additional support, the IFC may also want to emphasise and, if possible, show the impact of GEF funding on the operational strategy of the IFC. As stated above, GEF funding is encouraging the IFC to move into financing global environmental benefits. Thus the GEF through the IFC is opening up debt and equity markets for the global environment. With the increasing interest within the environmental community in the impact of private sector capital flows on the global environment, the GEF-IFC relationship could be quite significant.

47. Just as GEF money is "greening" the world in which the IFC lives, the IFC can assist in "commercialising" the world in which the GEF lives. The vast majority of international capital flows for the global environment are in the form of grants - multilateral, bilateral and non-governmental - to governmental and non-profit agencies responsible for conservation and environmental management. Though there is indeed an important role for grant or donor funding, there are also other ways of moving money for environmental purposes.

48. The Programme's focus on debt and equity financing and the IFC's well-established expertise in the global debt and equity markets can help the GEF, as well as other multilateral, bilateral and non-governmental organisations, learn how to operate in commercial financial markets in order to generate additional investments in the global environment. Thus the IFC in partnership with the GEF has an opportunity - as the leading multilateral private sector financial intermediary - to provide leadership in mainstreaming the environment into the world of private financial markets.

FINANCIAL STRUCTURE REVIEW

49. This report covers part of an independent review of the SME Program and provides an opinion on the potential of the Program as it is currently structured to attain its financial objectives. A companion part of the review focuses on the Program's potential for achieving its GEF objectives and has been done by Mr. Frank Vorhies of IUCN. The review work was carried out at IFC with the assistance of Mr. Doug Salloum and his colleagues during the week of June 24, 1996. The terms of reference for the review are dated May 22, 1996. Below, the topics at the beginning of each paragraph refer to the topics in the terms of reference.

50. Persons met in connection with this part of the review were: Mr. Kenneth Newcombe of the World Bank; and IFC's Mrs. Farida Khambata and Messrs. Andreas Raczynski, Martyn Riddle, Hanny Assaad, Roy Karaoglan and Doug Salloum.

51. Essence of the SME Program. The Program seeks to attain GEF's climate change and biodiversity objectives through its support for commercially viable projects of SME's. The Program is innovative in that neither the GEF nor the IFC has tried this kind of approach before. Other salient characteristics of the Program are:

- (a) IFC is acting as the Program's Executing Agency rather than directly providing funding or advice, which are its predominant forms of doing business.
- (b) GEF is pursuing its environmental objectives through cooperation with private SME's and through the use of loans and equity investments, rather than grants.
- (c) The Program reaches SME's through six intermediaries which, with one exception (Egypt's El Sewedy), involve NGO's. It is unusual for IFC and NGO's to cooperate in this fashion.
- (d) Two of IFC's departments are sharing the oversight of the Program's implementation. The Capital Markets Department looks over the Program's financial aspects while the Technical and Environmental Department focuses on the environmental matters. The Program's Task Manager receives guidance and review inputs from both departments. In addition, there is an Advisory Panel that provides GEF-type review inputs on SME projects.
- (e) The Program's overall size is small compared to the typical IFC project, yet the Program is ambitious as to its geographic range and the variety and number of SME projects which it supports.
- (f) The size of the SME projects supported by the Program is small compared to the typical IFC SME line of credit.

- (g) The Program is R&D in nature in that its main goal is to learn how to blend GEF objectives with the capacity of the private sector to implement sustainable projects based on commercial/market principles and practices.

52. The essence and salient characteristics of the Program are quite challenging. On the other hand, the resources and approach used by IFC, as well as its commitment and dedication to the Program's success, appear to be up to that challenge.

53. Decision to work through intermediaries rather than to finance SME's directly. The main considerations are as follows:

- (a) Working directly with small and medium enterprises is time-intensive and calls for very good knowledge of the local environment and ways of doing business. Given the US\$ 4.3 million size of the Program, it would not have been cost or time effective for IFC to try to reach SME's directly. Working through intermediaries permits IFC to tap into their client networks (thus saving time) and their knowledge of the local business environment (a more efficient/cost effective approach).
- (b) The tendency when working directly with enterprises is to gravitate toward the medium size firms and away from the smaller ones. By working through intermediaries, the Program can reach many more/smaller enterprises than would have been the case with the direct approach. This increases the Program's sample size of SME's and enhances the chances to learn good lessons about how to pursue GEF objectives through the private firms.
- (c) The chosen approach permits IFC to work with NGO's and to amplify its knowledge of how to cooperate with them.
- (d) Risk can be minimized through the choice of suitable intermediaries. IFC's experience is that the risk is lower when working with intermediaries than directly.
- (e) IFC has a track record of institution building in working through intermediaries. The Program can tap into this IFC knowhow for the benefit of intermediaries who work with small firms and in GEF matters. The result should be a much greater GEF-type impact than if IFC were working directly.

54. IFC should ensure that the Program has the necessary focus and resources to capture and disseminate the lessons and to carry out such institution building tasks. Some considerations follow:

- (a) So far, the priority has been assigned to the tasks connected with the design and launching of the Program (e.g. structure, procedures, identification of intermediaries). This is considered appropriate.

- (b) As the Program enters its disbursement stage, the focus should be on the tasks related to monitoring, lesson extracting and institution building. These tasks are always time/resource consuming and particularly when launching an innovative project and when working with small enterprises.
- (c) Also, one must anticipate that there might be problem situations which require much effort for their resolution. It is not clear whether the Program has made budget provisions that are commensurate with these tasks.

55. Decision to provide loans and equity and not grants to the SME's. The main considerations are as follows:

- (a) Grants and a commercial approach seldom mix well. From a conceptual (private sector) perspective, there is good logic in designing the Program on the basis of loans and equity instruments rather than through grants.
- (b) The bulk of IFC's business is related to the making of loans and equity investments. In the SME Program, IFC is doing what it knows best.
- (c) Loans and equity instruments facilitate accountability, transparency, the measurement of results and the administration of SME projects.
- (d) On the other hand, one must recognize that innovation can be risky and that working with small firms has a high transaction cost. The design of a success fee appears well suited to providing the necessary incentive in a commercially oriented way.
- (e) The use of loans and equity investments facilitate the familiarization of NGO's (and the GEF) with the traditional instruments of private sector funding.

56. The World Bank Group has learned that lower-than-market interest rates in their development credit lines can be distorting to intermediaries and disrupting to local financial markets. At issue, then, is whether a lower-than-market interest rate to the Program's intermediaries constitutes the wrong kind of mechanism to help defray the unusual costs of the Program (e.g. innovation, GEF, transaction). The considerations in this regard are as follows:

- (a) The Program is small and the amounts involved in the case of each intermediary are very small. This means that there is little potential for the distortion/disruption mentioned above.
- (b) The Program is costly, risky and time consuming for each intermediary and hence requires some form of offsetting compensation. The package of a rate of interest, closing and monitoring fees, plus an incentive fee appears reasonable.

- (c) An alternative (to the low interest rate) could be to charge a market interest rate to the intermediary and to provide some sort of lump sum grant as a subsidy to help cover those costs. This and other design alternatives may be considered in a further stage of the Program, but care should be observed not to complicate the Procedures unnecessarily.
- (d) While there are many alternatives that can be tried, it appears that the chosen approach is easy to understand and straightforward to implement.

57. Program's criteria and controls for the selection of intermediaries.

- (a) The four main criteria for selecting intermediaries (i. e. experience with SME's, financial viability of the intermediary, capacity for financial analysis, capacity for environmental capability) are congruent with the Program's objectives.
- (b) A review of the files shows that the four criteria have been used in a careful way. The analysis of the Task Manager for the selection of the intermediaries appears adequate.
- (c) There is also evidence that the controls have worked in that the Task Manager has rejected certain candidates and the Review Committee has provided inputs to ensure that a proper choice is made.
- (d) In selecting intermediaries, it appears sound to uphold that the first two criteria cannot be compromised; while one can strengthen the intermediary regarding the other two criteria through adequate training and support. This principle should not be compromised. Some comments:
 - (i) In the case of FUNDECOR, consideration should be given to ways (e.g. technical assistance, alliances) of building this institution's capabilities, since this is the first time this forestry NGO makes loans.
 - (ii) In the case of WWF, a similar comment is in line. It may be that the SPPF's involvement in the structuring of the WWF's SME projects will suffice. The Program should be alert to ensuring that such is the case; and also that the WWF's access to top financial talent is adequately used.
- (e) It is appropriate to have an absolute limit (currently US\$ 1 million) per intermediary to ensure a balanced portfolio and sample of experiences. When evaluating an intermediary, the analysis may benefit (as IFC usually does) from relating the size of the Program loan to the size and capital of the intermediary.

- (f) The Program's intermediaries are quite different from the usual IFC intermediary, especially as to their nature (i.e. NGO's rather than financial institutions) and size. IFC seeks sponsor quality as a key element for the success of its investments. Often, a large size is assumed to be a sign of quality. NGO's haven't qualified previously. The Program is to be commended for pursuing quality intermediaries without letting their NGO nature or their size be an impairment. This might be another area for lessons to be learned from the Program.
- (g) IFC also seeks in its intermediaries (and projects) the presence of private sector investors with a significant cash exposure at risk alongside IFC. Thought should be given to finding some sort of equivalents when the Program works with intermediaries of an NGO type.
- (h) The Program should include the greater budget resources that are needed when working with small intermediaries (as well as with small SME's/projects). Also to learn how to work more effectively with the NGO's. The resulting benefits should help to compensate for those costs and likely complications. (cf. 5 (f) above)
- (i) The Program might benefit from a lesson that IFC has learned in the past: that one should not trade sponsor quality for geographic diversification.
- (j) EAAF, CARESBAC and WWF are all NGO's which are based in the USA. The Program should remain open and sensitive to supporting non-Part 1-countries NGO's, such as FUNDECOR.
- (k) At least 3 of the Program's 6 intermediaries have been funded previously by USAID. The evaluation work detected no particular bias in the analysis for the selection of the intermediaries nor in their approval process. The Program should continue to remain open to selecting all kinds of intermediaries.

58. It appears striking that not a single financial intermediary has been selected of the IFC traditional type, i.e. a bank or some other sort of for-profit financial institution. The considerations in this regard are as follows:

- (a) It appears sound to have given priority to the environmental over the financial capabilities of intermediaries, on the assumption that they are likely to have a better chance of attaining the GEF objectives.
- (b) On the other hand, the Program should ensure that any weakness on the financial capabilities side (which environmental NGO's may have) is adequately addressed through technical assistance and other instruments.
- (c) In the past, IFC has used technical partners as an instrument to transfer specialized knowhow to greenfields projects. This type of instrument may inspire ways of building up the financial capabilities of the Program's intermediaries, if necessary.

- (d) The Program's sample will be enriched by including some of the more traditional financial institutions as intermediaries. This way one can test the assumption that institutions that are for-profit can be properly trained on environmental matters. Also, the credibility and demonstration effect of these institutions among banks and other traditional intermediaries is likely to be very high.
- (e) A case can be made that the for-profit traditional type of intermediary is likely to have a special advantage in coming up with breakthroughs that can push the attainment of GEF objectives in a commercial/sustainable direction. This is another reason for including them in the Program.
- (f) In the case of EEAF, its subsidiary is a for-profit venture capital fund for environmental investments. The Program may consider supporting directly this kind of intermediary rather than the parent, which is a non profit NGO.

59. The Program's definition of an SME is one with assets of less than US\$ 5 million equivalent. Considerations in this regard are as follows:

- (a) This definition is in line with other IFC projects.
- (b) From conversations with the Task Manager and a review of Program documents it appears that most SME's which are funded by the Program will have assets of US\$ 1 million or less. This is unusual (and commendable) for an IFC or World Bank credit line.
- (c) It appears to make sense for the Program to retain the flexibility of going up to US\$ 5 million if necessary.

60. In the application of the SME definition it appears that, to date, the one exception to the size guideline has been in the El Sewedy project, where large hotels and other businesses can receive the Program's benefits. Also, there seems to be little design work or risk in that project relative to other Program projects. Hence the 50% incentive may be generous, especially when considering that it would be received by the intermediary after just a couple of years. For the future, it is suggested that the Program consider flexibility in setting the incentives to try to fit them to the characteristics of each project.

61. The Program's limit per SME of US\$ 250,000 suggests the following considerations:

- (a) Since the amount per intermediary averages about US\$ 600,000, this means that in theory one could have only about 2 SME's per intermediary, which is on the low side.
- (b) Even on this low side, reaching about 12 to 15 SME's would be commendable for a Program of this small a size.

- (c) The fact is that in most cases the intermediaries intend to have more than 2 or 3 SME's; and are committed to funding a minimum number of SME projects.
- (d) While retaining the flexibility, the Program should encourage its intermediaries to have as many small SME's participate in the Program as possible.

62. The Program's other limitation per SME is related to the incremental cost of the Project and is reviewed below.

63. The issues to be considered by an intermediary in the analysis of SME projects (i.e. financial viability, GEF benefit, incremental cost analysis and environmental review) appear relevant and adequate. Other considerations in this regard follow:

- (a) A 4% IRR alone is no guarantee of financial viability. Other fundamental elements that affect the viability of the SME project (e.g. sponsor quality, financial plan) should also be considered by the intermediary. The same can be said about aspects of security, deal structuring and the like. The Program may consider including those other elements among the criteria for project analysis. The intermediary, however, appears to have adequate (positive and negative) incentives not to ignore those other elements, assuming that it has the capacity to soundly administer a loan/equity investment program of this kind.
- (b) One can wonder whether it is relevant to make the intermediaries aware of the traditional approach that IFC follows to the analysis of projects. It may be, however, that this approach is too cumbersome for small projects and intermediaries, and that simplified methods of analysis work much better for SME's. The Program should focus on this question and try to identify best practices in this area. The idea should be to ensure that the methodology for analysis works well, rather than trying to impart any particular methodology.
- (c) There is no reference to the economic analysis of the SME's projects. Apparently the assumption is made that for these projects the IRR is a good proxy for the ERR. This is likely to be the case, but it may be advisable to enlist the concurrence and guidance of the Economics Department in this regard.
- (d) In the IFC's lines of credit there are a number of other requirements to guide intermediaries in the selection and analysis of SME projects as well as in the structuring of the sub-loans. It appears reasonable in this pilot stage not to encumber the intermediaries with those requirements. However, it is suggested that the Program take another look at a later stage to ensure that those requirements that can be of benefit aren't ignored.

64. The incentives provided by the Program to the intermediaries (i.e. fees, low interest rates, possibility for keeping half of the principal amounts recovered) raise the following points:

- (a) There is no information collected on the cost and risk of an intermediary in working to further GEF objectives. Hence it is not possible to do a quantitative analysis that compares the incentives with the extra load carried by the intermediary. The suggestion is that information be accumulated during this pilot stage of the Program.
- (b) Care should be taken, however, not to overload the intermediaries with time consuming information requirements that yield little insight.
- (c) A better approach is probably to gain a feel for Program costs and risks at the intermediary level through field visits and analyses.
- (d) The ultimate test, however, is likely to come through negotiations with the intermediary for a second transaction. The Program should be able to argue that there are little or no design costs in a second round and that the innovation risks have been dominated, and hence the incentive should be lower. This approach appears congruent with a private sector-oriented program such as this one.
- (e) No question that incentives are needed in order to stimulate the cooperation of quality intermediaries to start a program of this kind. Some comments follow:
 - (i) The approach followed by IFC appears sound. Of particular merit is that the incentives are output/success-oriented.
 - (ii) Incentives are much better than 100% grants when working with private sector firms.
 - (iii) The present structure should permit a gradual transition toward a more commercial approach which relies less on incentives and more on market opportunities.
 - (iv) There seems to be a need for budget resources to study how to promote such a transition.
- (f) Ideally, the Program's incentives should not only be connected with the costs and risks of an intermediary but also with GEF (biodiversity/greenhouse) impacts. The best possible scenario would be to have an incentive structure which induces the intermediaries to:
 - (i) Transfer the Program's funds to those SME projects with the greatest GEF impact per dollar of incentive; and
 - (ii) Foster commercial funding of such GEF-oriented projects without the need for Program incentives.

Care should be taken not to try to optimize everything through Program design. Better to learn gradually and improve in successive approximations through expansions of the Program.

65. A suggestion of form is not to use the words "partial loan forgiveness" but rather refer to a success incentive. An issue related to the substance of this incentive is whether the incentive is being earned fairly. This means that the incentive accrues to:

- (a) The intermediary's incurring costs of designing the mechanisms to implement their part of the Program, and not to do "business as usual" with a slight GEF slant. For example, in this regard, El Sewedy's projects contrast sharply with FUNDECOR's.
- (b) The intermediary's taking special risks as a result of promoting GEF objectives. The same example also helps illustrate this aspect.
- (c) The intermediary's promoting projects with real and high GEF impact. One obstacle is that there is no universal measure of such impact. One example is the IFC development questionnaire, where numerous parameters are considered when measuring the development impact of an IFC transaction. The questionnaire also illustrates a tool which entails cost and time needed for its effective use.

66. The suggestion is that, without going overboard in the direction of measurements, progress is sought in this regard, taking advantage of a possible Program expansion.

67. Another aspect to be aware of is that sometimes small or NGO intermediaries might be inefficient and the presence of a Program subsidy may help cover the shortcomings/weaknesses that produce the inefficiencies. This is another relevant area for information gathering and monitoring. The Program might benefit from tapping into IFC's methodology for supervising the performance of intermediaries.

68. Operating structure now in place and for the remainder of the pilot phase.

- (a) The structure is adequate for the tasks of launching the SME Program, selecting intermediaries, structuring and formalizing deals with them, and starting disbursements.
- (b) In fact, the structure is highly commendable in terms of having two of IFC's departments work closely in providing orientation and oversight to the Task Manager both in informal contacts and through the Review Committee.
- (c) Similarly, the involvement of World Bank GE staff and other environmental experts through the Advisory Panel is very attractive in order to ensure that SME projects remain focused on GEF objectives and that there is a "GEF quality control".

- (d) The adequacy of the structure also reflects its sensible implementation through the efforts of the Task Manager and the other persons involved. Hopefully, it will be possible to maintain quality cooperation/relationships when the Program expands.

69. The deployment of the Program's budget resources will need expansion in order to carry out properly the monitoring/supervision of intermediaries and SME projects. This includes:

- (a) Monitoring the health of the intermediaries and projects and being able to have a suitable role in problem identification and resolution. It is likely that there will be at least one problem case among the six intermediaries, and the Program should be capable of assisting in such a situation. As IFC knows well, problem projects and intermediaries can consume huge time, effort and human resources.
- (b) Identifying and arranging for the delivery of technical assistance and other mechanisms needed for ensuring that the intermediaries have strong financial capabilities.
- (c) Capturing the lessons that can be learned from the pilot phase of the Program.
- (d) Expanding the development work on the above mentioned items (e.g. developing ways for inducing the intermediaries toward the market and away from the need for the Program's incentives in order to further GEF objectives).
- (e) Expanding the research work on the above mentioned items (e.g. measuring the relationship between incentives and costs, risks and GEF impact).
- (f) Organizing for the dissemination of lessons, results from development work, results from research work, etc.

70. The Program has benefitted from effectively combining IFC's own human resources with an outsourcing-type approach, as well as from flexibility as to the main location of the Task Manager. These strengths should be preserved and enhanced.

71. Operating structure for the expansion of the Program by an additional US\$ 10 to 12 million.

- (a) The present structure can work for an expanded program. There is no conceptual or practical reason why the present structure and approach cannot work very well in such a scenario.
- (b) Clearly, the personnel and related budget resources would have to be expanded accordingly (see par. 18 above).

- (c) Consideration should be given to also having a person who can act as a sort of deputy task manager to provide greater depth in the Program's management, but the basically flat structure of today's should be preserved.
- (d) Care should be taken to maintain the present non-bureaucratic and network-type approach to the Program's administration which is used today.
- (e) The expansion is likely to benefit from the ease in administration and efficiency that generally result from repeats. This would also permit trying new things with old intermediaries and, possibly, inducing them toward the market and a lesser reliance on the incentives in order to pursue GEF objectives.
- (f) While it should be easier to improve the tried model than to create new ones, the expansion should retain the basic R&D orientation of the original pilot operation. This is because a US\$ 4.3 million program is likely to be too small to provide a large enough sample for optimum learning of how to achieve GEF objectives through SME's.
- (g) Probably the sound approach will be to combine the R&D elements with the starting of the process of trying to get the old intermediaries toward the market.
- (h) Consideration should be given to having a panel of outside business persons/financiers/environmentalists contribute their guidance, advice and constructive criticism.
- (i) Consideration should also be given to permitting the progress toward a further next stage wherein the Program operates with lesser reliance of GEF support and a greater reliance of commercial inputs. It may be possible to combine both in a way that permits the channelling of GEF resources to those intermediaries/ projects that need the subsidy while inducing the more advance intermediaries/projects toward market incentives.

72. The requirement that the SME projects have a minimum 4% IRR. The question here is whether this is a reasonable balance between the desire to finance commercial opportunities and at the same time encourage experimentation. The following considerations apply to this issue:

- (a) There is a basic challenge when mixing two objectives in that it is difficult to identify the various weights of each objective and corresponding tools. For example, let's suppose that:
 - (i) There is a project with a 5% IRR because of the inefficiencies and challenges, etc. that arise from pursuing innovation or GEF objectives. In this case, the 4% limit would be appropriate.

- (ii) In contrast, assume that there is another project which uses an outdated technology that is independent of the innovative requirements or the GEF objectives and as a result it has a 5% IRR. In this case, the 4% limit could be inappropriate.
 - (iii) How, then, to separate the effect of innovation from that of inefficiency? It seems that there is no substitute for vetting/analyzing the projects.
 - (iv) In another case, suppose that the project is efficient yet it has a component of innovation or of GEF aspects which result in both a very high GEF impact yet also in an IRR of 1%. In this case, the 4% limit would be inappropriate.
 - (v) In yet another case, it is better to encourage experimentation of the kind that only requires a limit of 8% IRR, yet setting a 4% limit ends up encouraging less than an optimum/economic kind of experimentation. In this case, the 4% limit would be less than appropriate.
- (b) A quantitative limit, such as 4%, is appropriate as a start and a source of discipline but it is only a start and not a substitute for judgment. Hence the need for the monitoring of the intermediaries and the vetting of the SME projects to ensure that the incentives/limits and other Program mechanisms are adequately focused.
 - (c) In keeping with the R&D nature of the project, it is suggested to consider the use of other indicators to complement the 4% limit. Care should be taken, however, not to create a cumbersome analysis process.

73. Regarding the leveraging or use of other IFC capabilities, the following considerations arise:

- (a) Dealflow. It seems that a good portion of the pipeline of intermediaries for the SME Program has resulted from IFC's deal flow. The SME Program's intermediaries seem to have been well received by IFC but, because of size or their NGO nature, could not be served from IFC's regular operating mechanisms. The SME Program appears to be a good complement to IFC's regular operations. Thought should be given to the possible/eventual "graduation" of intermediaries onto regular IFC operations.
- (b) Project Development Facilities. To date, the South Pacific facility has cooperated with the SME Program. There is ample room for the Program to cooperate with all of IFC's facilities. Already there have been contacts with several of them. Thought should be given to making a presentation about the Program to the managers of the facilities in the next opportunity that they meet (usually at the time of the annual meeting).

- (c) Similar presentations should be made to the IFC representatives and to the members of the Africa Enterprise Fund.
- (d) Review/due diligence process. (see par. 17 above).
- (e) Co-financing. It is suggested that the Program continue to accumulate its own experiences before starting to provide other institutions with guidance on investing their through cofinancing mechanisms. Once the Program has accumulated a substantial track record, it would be in order to promote cofinancing operations.

74. Incremental cost analysis. The following comments are offered:

- (a) IFC should be commended for making the effort to adapt the GEF's concept for its application to private sector projects.
- (b) There may be conceptual obstacles with the way that incremental cost is dealt with that are worth discussing further. For example, incremental cost seems to contrast with the traditional IFC approach of trying to relate the costs and benefits of a project.
- (c) Care should be taken to ensure that the incremental cost test is applied in a context of a project that makes sense; and that the Program avoids using this concept in a mechanistic/check list-type of way.

75. Conclusion. The Program's current structure is appropriate for attaining the financial objectives defined in the Terms of Reference for this review. IFC is implementing an innovative and promising design for furthering GEF objectives through SME's. IFC's implementation is both diligent and cost effective. The Program has very good potential for generating commercially viable ways of promoting GEF objectives, but the size of the sample is too small and the Program's time span is overly short. It is thus worthwhile to seek an expansion of the Program in the amount of US\$ 12 to US\$ 15 million in order to enlarge its coverage and provide it with a suitable size and an appropriate time frame for the accumulation of new experiences and a track record.

**PROJECT DOCUMENT
SMALL AND MEDIUM SCALE ENTERPRISE PROGRAM**

(Available upon request)

CRITERIA AND PROCEDURES FOR SELECTION OF SME PROGRAM INTERMEDIARIES

SMALL AND MEDIUM SCALE ENTERPRISE PROGRAM

Criteria and Procedures for the selection of SME Program Intermediaries:

A. Intermediaries are selected on the basis of four criteria:

1. **experience with small and medium scale enterprises:** All potential Intermediaries must have several years of field experience in working with SMEs - either in the environmental or the financial sector,
2. **financial viability:** The SME Program is providing a long term loan to Intermediaries and as a result potential participants are analyzed carefully to determine their long term credit worthiness,
3. **financial technical expertise:** Each Intermediary will have to have the technical ability to analyze and structure commercially viable SME projects,
4. **environmental technical expertise:** The Intermediary must analyze the GEF benefits of the proposed SME project and must also carry out an Environmental Review consistent with IFC's requirements for all financial institutions receiving financing.

Intermediaries must be acceptable on the basis of the first two criteria and may contract out for either of the second two if these specific forms of expertise are not available in the institution.

B. Approval of Intermediaries:

All Intermediaries are first identified by the SME Program Task Manager and then reviewed by the Program Review Committee, consisting of representatives of IFC's Technical and Environment Department (CTE) and Central Capital Markets Department (CCM). If accepted by the Review Committee the recommendation for the selection of an Intermediary is submitted to IFC management for approval.

Criteria and Procedures for the Selection of GEF eligible SME projects:

A. Intermediaries are instructed to finance SME projects which have the following characteristics:

1. **financial viability:** All projects must demonstrate a minimum IRR of 4% p.a. in real terms. The proposed financing provided by the Intermediary must match the base case financial forecast for the project, i.e. an Intermediary may provide financing at 4% p.a. or more, but not less,
2. **GEF benefit:** All projects must forecast a benefit which relates to the climate change and/or the biodiversity objectives of the GEF,
3. **incremental costs only:** The Intermediary may not provide more than the incremental cost portion of the proposed SME project financing (see paragraph 38 of this proposal for additional information with respect to the incremental cost calculations), and
4. **no negative environmental impact:** The Intermediary must carry out an Environmental Review of the proposed project.

B. Approval of projects:

Initially all projects developed by an Intermediary are submitted to the Review Committee for approval. In addition, all projects are reviewed by an independent Advisory Panel consisting of two consultants from the STAP roster and chaired by a representative of the World Bank's Global Environment Division. The role of the Advisory Panel is the confirmation of the forecast project GEF benefit and the incremental cost calculations.