Special Study

Russia Small Business Fund

Russian Federation

(A private sector investment operation)

Project Evaluation Department

July 2003

Preface

This Special Study presents the findings of the Bank's Project Evaluation Department (PED) on the evaluation of the Russia Small Business Fund (RSBF) in the Russian Federation (referred to throughout as "the programme"). The Study was prepared by William Keenan, senior evaluation manager, in association with PED colleagues, referred to as the “evaluation team”, and with input from US resident industry experts – Ariel Ventures Inc.

The programme was originally approved by the Bank’s Board of Directors on 28 June 1993 as a pilot project (BDS93-67) and the extended pilot project (BDS94-77) was approved on 7 June 1994. The full-scale operations (BDS95-146) were approved on 29 August 1995. PED carried out earlier reviews of the pilot project (PED94-11S, July 1994), the extended pilot project (PED95-24S, March 1995) and the full-scale operations (PED97-65S, July 1997). The objective of this Special Study is to evaluate the Programme as it reaches maturity.

Approval of the Full-Scale Operations in 1995 provided for total investment by the Bank of US$ 150 million, a sum that was to be matched by a total contribution of USS 150 million from G-7 contributors (donors) for technical assistance and investment funds. Investment funds were to be recycled for up to 10 years. On 24 July 2001 the Bank’s Board approved the expansion and extension of the programme (BDS95-146 [addendum 1]), increasing the Bank’s funding commitment by up to US$ 150 million, of which USD 50 million was made contingent upon the contributors commiting a further US$ 30 million in funding. The expansion and extension therefore increased aggregate commitments to a possible total of US$ 480 million. The life of the programme was extended from 2004 to 2010.

Material and data for this Special Study were gathered through interviews, research, two field visits and, in view of the wide geographical spread attained by the programme, a questionnaire designed to collect information from participating banks (PBs) and branches across the Russian Federation.

PED would like to note its appreciation of the cooperation extended by senior officials of the PBs, the programme consultants, the operation team (OT), staff of the Bank’s Group for Small Business and other Bank staff involved in the preparation of this Special Study. However, the contents of this report are based entirely on the independent judgement of PED.

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Abbreviations

BAS	Business Advisory Service
CBR	Central Bank of Russia
FOPC	Financial and Operations Policies Committee (EBRD)
IADB	Inter-American Development Bank
IFC	International Finance Corporation
IIC	Inter-American Investment Corporation
LTE	Long-term expert
MFI	Microfinance institution
MIS	Management information system
MSE	Micro and small enterprise(s)
MSME	Micro small and medium-sized enterprise(s)
NGO	Non-governmental organisation
OCE	Office of the Chief Economist (EBRD)
OGC	Office of the General Counsel (EBRD)
OT	Operation team
PB	Participating bank
PCR	Project completion report
RSBF	Russia Small Business Fund
RSBISF	Russia Small Business Investment Special Fund
SEEF	Small Enterprise Equity Fund
SME	Small and medium-sized enterprise(s)
TA	Technical assistance
TC	Technical cooperation
USAID	United States Agency for International Development

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Russia Small Business Fund, Russian Federation

Executive summary

RSBF - programme background and objectives

The Bank was requested to establish and administer a facility for financing small businesses in the Russian Federation following a meeting between the G-7 countries in Tokyo in April 1993 and in response to a request from the Russian Government. The EBRD Board approved a pilot project that started in 1994 and was followed by an extended pilot. The full-scale operations were approved in 1995 and comprised of commitments of US$ 150 million from the Bank and a similar amount from G-7 contributors. In 2001 the Bank approved the expansion and extension of the programme to 2010 with the commitment of an additional US$ 150 million of Bank funds, of which US$ 50 million was contingent upon the contributors committing a further US$ 30 million in funding. The potential funding for the RSBF from the Bank and contributors combined totals US$ 480 million. The Board document approving the full-scale operations in 1995 set out the main objectives of the programme as follows:

"This project has two interrelated aims: firstly, to provide short and medium-term financing to micro and small enterprises, and secondly, and most critically, to contribute to institution building within the Russian financial sector by providing training and technical cooperation to banks that will develop the long-term capability to provide small and micro firms with formal sector finance."

As well as MSE lending, the initial design of the programme included business advisory and small business equity components. These did not prove successful and have been discontinued. The programme has concentrated on expanding regional outreach and lending volume with increasing attention on microloans under US$ 10,000. A significant achievement has been the generally high quality of the sub-loan portfolios. The programme functions through selected existing commercial banks, as well as through a specialised microfinance institution (MFI) in which the EBRD is a shareholder. The differences in approach are described in the following box.

Downscaling vs. Greenfield MFI
The RSBF applied the *downscaling* model exclusively in its initial years until the 1998 Russian financial crisis. The downscaling approach requires heavy TC input particularly in the early stages since it entails working with an existing bank institution; changing or developing management thinking and culture; building commitment to MSE finance; and training loan officers in MSE lending skills. In the aftermath of the crisis the Bank participated in the formation of a specialised microfinance institution, which, from 1999 onwards, became the primary engine of RSBF growth. Downscaling and MFI start-up are very different kinds of exercise. When a start-up MFI is formed, senior management is usually recruited from among experienced microfinance professionals who are already committed to the concept. Downscaling, on the other hand, frequently entails a rather steep learning curve for the partner bank's (PB) management and staff. Results in terms of loan numbers and volumes may be slower to come through in a downscaling bank than in a start-up MFI. However, a new MFI needs substantial TC input to help develop a branch network.

Programme lending up to 31 December 2002

At 31 December 2002 cumulative disbursements under the RSBF amounted to US$ 1,068 million for a total of 115,962 loans in 116 towns and cities. This is a noteworthy achievement for a programme that faced disruption and potential collapse in the wake of the August 1998 banking and financial crisis. Swift action at that time limited the losses suffered and enabled the programme to resume growth. At different stages up to 2001, some 21 banks participated in the programme. In the aftermath of the crisis, four active banks remained with two of these accounting for over 95% of new lending. Two regional banks, which survived the crisis, remained active participants. In 2002–2003 a further three regional banks have been accepted as programme participants. Since late 1998 one consulting firm has been the sole supplier of credit advisory services to the programme. By the end of 2002, approximately US$ 76 million in TC funds donated by RSBF contributors, the EU and other sources was used to fund over 70 TC operations.

Overall assessment of programme performance

On the basis of PED's independent review, the Special Study assigns an overall assessment rating of *Partly Successful* to the RSBF programme as evidenced by performance to date.[1] This rating reflects the success of the programme in achieving growth in loan numbers and volume, particularly in the period after the 1998 crisis and the high quality of the sub-loan portfolio. However, there is as yet insufficient indication that the programme has been implemented in a manner that will prove to be sustainable. The final proof of sustainability will emerge only when the programme is completed and the present intention of the Bank and contributors is to continue the RSBF at least until 2010. Nevertheless, evaluating the progress made to date is crucial if the Bank is to achieve the desired goals by the end date.

A key measure is the institutionalisation of the programme's basic principles within the PBs. One PB in particular has declined to demonstrate commitment to the programme at head office level and has repaid the Bank US$ 20 million of US$ 50 million advanced for programme lending. While the long-term position of this partner remains to be clarified in negotiations, the resulting uncertainty in the interim threatens the achievements of the programme to date both within that bank and among micro-entrepreneurs, especially in the towns where it is currently the programme's only channel of distribution. In the downscaling banks, an indication that sustainability is likely to be achieved would be growth of MSE lending supported by counterpart finance. As a precursor to this, PBs need to regard MSE lending as a profit centre alongside other products and activities. A start has been made with some introduction of contribution analysis by the Programme consultants. However, further refinements are needed and targeted TC input may be required to give PB management the skills to cost out MSE lending as a product line. PBs would also benefit potentially from some flexibility in programme design to be able to respond to local market conditions in their region, subject always to adherence to sound banking principles. If the programme's institution building objectives are realised, the RSBF has the potential to achieve a *Successful* or *Highly Successful* performance rating over its remaining life.

The project evaluation department (PED) assigns a rating of *Partly Successful* to the overall performance to date[2] of TC within the RSBF. The programme has achieved rapid growth in loan numbers and volume and has maintained strong portfolio quality overall. However, this growth may have been achieved, to some degree, at the expense of institutionalising the programme within PBs and, consequently, at the expense of sustainability. In addition, the

[1] The following classifications are possible: *Highly Successful, Successful, Partly Successful, Unsuccessful*

[2] TC performance in connection with crisis recovery efforts warrants a *Highly Successful* rating. Allowance must be made for the effects of the 1998 financial crisis and the process of recovery that diverted TC funds away from the direct aims of the programme. A further consequence of the crisis was that the RSBF lost PBs with branch networks that showed signs of responding well to the programme.

Special Study findings indicate that TC resources should be used to make appropriate changes to the lending methodology and transfer the skills necessary to encourage a higher proportion of lending to production enterprises. It is recognised that the distribution of borrowers among production, service and trading activities will vary from region to region. In some, particularly remote areas, small-scale trading activities are likely to predominate until a production base begins to be formed. Any changes in the methodology must continue to adhere to the requirements of sound banking and are dependent on adequate staff training and capacity. The TC component is capable of achieving a *Successful* to *Highly Successful* rating over the life of the programme.

Overall transition impact

Through the RSBF the Bank has addressed the key transition challenge of making commercial finance available to MSEs (a subset of the SME sector), and has contributed to policy dialogue with a view to creating a conducive environment for MSE lending. The Bank has worked with a significant player in the banking sector and has created a significant new player, although the original programme design did not envisage the creation of a specialised microfinance bank. In addition the Bank is continuing to build smaller operations in the sector. The RSBF team pursued a clear and effective plan of recovery after the 1998 financial crisis. Following recent repayments by one PB of RSBF credit lines totalling US$ 20 million, the allocation of funds for RSBF lending by branches has been scaled back. This is already reflected in the falling RSBF portfolio at this PB and in the cessation of the regional expansion of the programme through its branches. On the assumption that this bank intends to use RSBF-trained loan officers in ways that allow them to practice and disseminate the MSE lending skills they have acquired, while continuing to work with the RSBF target customer group, PED considers that an overall transition impact rating of *Satisfactory* (realised to date) would be appropriate. If, however, this bank turns away from the RSBF customer group and MSE lending skills are dissipated, a rating of *Marginal* would be appropriate until the influence of the programme could be re-established. The programme has the potential to achieve a *Good* to *Excellent* TI but the risks to achieving this are assessed as *High*. The evaluation team considers that the following accomplishments would warrant a higher rating:
Indicating a *Good* TI rating –

- removing obstacles to the institutionalisation of the programme thus facilitating continued expansion;
- identifying and recruiting new credit-worthy regional PBs to the programme;
- introducing the appropriate new programme features and technologies.

Indicating an *Excellent* TI rating, in addition to the above –

- encouraging partner banks to commit to funding MSE lending from other sources at a level, which is at least equal to the funding provided by the programme.

Summary of key issues and recommendations

The Special Study identifies a number of key issues and puts forward recommendations aimed at helping the programme achieve its intended objectives and maximise transition impact. The principal issues and recommendations are summarised below.

RSBF strategy and plan of action

The RSBF faces a number of challenges, in particular:

- reducing dependency on a single consultant;
- exploring changes to the current methodology and the potential for additional distribution channels;

- embedding MSE lending in downscaling banks, and encouraging counterpart finance;
- securing additional donor funding for TC.

The Special Study recommends a reappraisal and restatement of the programme's strategic purpose and the development of an action plan to achieve the strategic goals. The action plan should include targets for achieving institution building goals in each downscaling bank in addition to loan numbers and volumes.

Programme management

It is recommended that the EBRD reviews the range of tasks and functions currently outsourced to consultants in order to identify those tasks and functions that could be returned directly to the Bank's control. The Bank should also consider a full review of the management resources allocated to the programme. It is important to note that a member of the Bank's staff has recently been assigned to coordinate policy dialogue relating to the MSE sector in Russia.

TC monitoring.

The absence of records of time spent by consultants with individual banks and branches is a deficiency in management information that hinders comparison of the performance of individual banks and branches within banks, as well as comparison of the performance of individual consultants. Therefore the Bank is recommended to encourage consultants to record the time spent with RSBF partner banks so that the EBRD can enhance performance monitoring (of consultants and partner banks). It is noted that, whether one consulting firm is working with several banks or branches, or whether more than one firm is involved, the monitoring of consultant time input is essential for performance assessment and costing purposes.

Diversifying methodologies and improving systems

PED recommends the following:

The programme's lending methodology should be reviewed with a view to incorporating changes in the methodology to attract a greater proportion of sound borrowers engaged in production activities.

The EBRD should continue dialogue with NGOs operating in Russia to enable the Bank to identify reliable NGO partners with whom it may be possible to work to expand the range of distribution channels for the programme.

The PB's within the programme should be permitted to tailor MSE loan products to meet the requirements of borrowers and the local competitive environment, while continuing to observe sound banking principles.

The RSBF should, instead of imposing software on PBs, define the reporting requirements of programme management that PBs will need to satisfy. Necessary additional technical assistance should be offered to PBs on a cost-sharing basis to enable them to integrate RSBF reporting with their existing systems or to select a suitable alternative MIS product. It is noted that this may, given time, lessen the degree of dependency on a single consulting firm and facilitate the introduction of other suitable consultants when identified.

Commercial sustainability

To date the performance of the downscaling programmes in PBs has been measured primarily in terms of loan numbers and volumes. Attention should be given to assessing the profitability of MSE lending operations in PBs on a full cost basis taking account of the cost of TC inputs. The scope of TC should be extended to include targeted technical assistance to enable PBs to cost out their product lines. The introduction of cost sharing with PBs should be considered for targeted assistance of this nature.

To assist in gauging PB progress towards sustainability of MSE lending, *pro forma* financials should be developed to track the earnings of downscaling banks on their RSBF portfolios, offset by the full cost of the in-kind subsidy represented by TC including consultant input.

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Russia Small Business Fund (Russian Federation)

1. Introduction

1.1 Lending up to 31 December 2002

At 31 December 2002 cumulative disbursements under the Russia Small Business Fund (RSBF) amounted to US$ 1,068 million in 115,962 loans throughout 116 towns and cities. This is a noteworthy achievement for a programme that faced disruption and potential collapse in the wake of the 1998 banking and financial crisis. Swift action at that time limited the losses suffered and enabled the programme to resume growth.

RSBF statistics record the following growth in cumulative lending from 1997 to 31 December 2002:

Table 1: Cumulative RSBF lending 1997–2002

At 31 December	Cumulative no. of loans	Growth in year	Cumulative volume US$ mm	Growth in year
1997	15,551	-	195.5	-
1998	23,368	50%	312.5	60%
1999	30,665	31%	372.2	19%
2000	44,557	45%	504.3	33%
2001	71,606	60%	752.9	49%
2002	115,962	62%	1,068.2	42%

Although programme growth slowed in the period following the 1998 crisis, it continued at a respectable pace. With the increase in emphasis on micro loans, compared with small, there has been a shift towards smaller loans in larger numbers and the growth in numbers of loans can be seen to outstrip the growth in volume.

The total outstanding RSBF portfolio grew during 2002 by about 22 per cent to in excess of US$ 173 million. One partner bank achieved portfolio growth of 36 per cent, while the RSBF portfolio at another bank fell from US$ 49.4 million to US$ 46.6 million as it scaled down RSBF lending to accommodate the credit line repayment in late 2002.[1]

The RSBF is a live organism, which has grown rapidly and is changing shape. To assist in dissecting and analysing the organism for the purposes of this Special Study, the Project Evaluation Department (PED) hired Ariel Ventures Inc. – the US resident industry experts with experience of microfinance operations in other parts of the world. The material that follows in this Special Study is drawn in part from the consultants' findings, and principally from the results of PED's field visits and discussions held by PED inside and outside the Bank.

[1] One partner bank repaid a US$ 5 million RSBF credit line to the EBRD in November 2002, and a second US$ 5 million line in February 2003, when they fell due, reducing its total RSBF credit lines to US$ 45 million at the end of 2002 and 40 million in February 2003. The same bank repaid a third RSBF line of US$ 10 million at maturity in May 2003, further reducing its RSBF funding to US$ 30 million.

1.2 Scope of the Special Study and methodology adopted

1.2.1 Scope of the Special Study

The main objective of this Special Study is to assess the sustainability of the programme, the effectiveness of technical cooperation (TC) funds and the programme's transition impact, applying PED's standard evaluation indicators. The study also takes into account the influence of the August 1998 banking crisis in assessing the programme. Section 2 of this Study considers the development of the RSBF from the pilot project approved by the Board in 1993 to the full scale programme. Section 3 describes the programme as it appears today in the context of the microfinance environment internationally and introduces some comparative material drawn from the experiences of the still relatively-young microfinance industry in other parts of the world. Section 4 addresses the objectives that the programme has fulfilled, evaluating performance to date. Section 5 assesses TC use and efficiency with some discussion of the consultant selection process and the issue of the predominance of one consulting firm.

Section 6 analyses the programme's transition impact (TI) and considers also the programme's impact in terms of the "event line" analysis elaborated in the *Transition Impact Retrospective*.[2] PED's overall assessment of the RSBF to date is contained in Section 7. The final Section 8 summarises the main issues arising from this Special Study with recommendations designed to improve the future performance of the programme in terms consistent with the Bank's mandate.

1.2.2 Methodology of the special study

In the quantitative and qualitative measurement of the achievements of the RSBF, some comparisons have been made with small and microfinance programmes elsewhere in the world and some implementation issues that could affect performance are considered. The methodology consisted of four components: secondary research[3]; interviews, held primarily in London and via telephone with other locations, with EBRD staff, representatives of the programme consultants and others; field visits (see Section 1.2.4); and the formulation, distribution and evaluation of a questionnaire designed to collect essential information about the operation of the programme at branch level. Where appropriate data was available, the Study looked at how the RSBF is functioning now and how its objectives and recent performance compare with the achievements of similar initiatives in Latin America, Asia and Central/Eastern Europe. The questionnaire, distributed to a large number of RSBF partner bank branches, represented the first independent attempt to obtain a meaningful information sample from the banks and banking staff that have benefited from technical co-operation funds.

1.2.3 The Special Study questionnaire

The questionnaire was created in two separate sections. The first was directed toward Branch Managers, who are not trained by the RSBF. This section of the questionnaire was intended to

[2] The EBRD's *Transition Impact Retrospective* published in April 2001 assesses the Bank's contribution to the process of transition during its first 10 years of operations.

[3] As well as the relevant EBRD documents, PED and the independent consultants appointed by PED reviewed studies, reports and articles produced by the EU Tacis, the World Bank (WB), the International Monetary Fund (IMF), the Inter-American Development Bank (IADB), the United States Agency for International Development (USAID), the Consultative Group to Assist the Poorest (CGAP) and various other sources and publications.

explore how well the Branch Managers perceive and understand the objectives and functions of the RSBF and the performance of their micro and small enterprise (MSE) credit team. In addition, it was hoped to gain some insight into profitability.

The second part of the questionnaire was directed toward the MSE credit teams, excluding any resident long-term experts. The objective here was to develop a clearer picture of the entrepreneurs and enterprises supported by the RSBF and an indication of how well the credit officers have internalised the tools, techniques and values of the lending methodology employed by the programme.

A total of 91 MSE credit units, representing about 66 per cent of the bank branches participating in the RSBF, were selected to receive the questionnaire and all responded to it, although not all respondents answered every question.

1.2.4 Field visits to Russia

During preparation of this Special Study, PED made two visits to Russia. In July 2002 visits were made to the RSBF Office in Moscow, and the Head Offices of partner banks (PBs) in Moscow. Following analysis by PED's consultants of the results of the questionnaire, PED visited 22 PB branches and satellite offices during a two-week visit to Moscow and three Russian regions in September 2002. The trip covered 13 towns outside Moscow. In total, PED visited 38 small and micro borrowers selected from the loan books of each branch. In addition, extensive evidence of RSBF-supported activity was seen among small traders in the market areas of several towns.

1.3 Methods of replicating microfinance activities

Key to developing a long-term capability to provide microfinance is the sustainability of the operations. The Bank has gained experience in capacity building in Russia and other countries of operations via two main approaches. The approach known as "downscaling" entails working with existing commercial banks to develop particular skills that are necessary for use in the MSE sector. TC is needed in the initial stages to train staff and to demonstrate to PBs that lending to this sector is commercially viable, in view of the small loan sizes involved. In an environment with underdeveloped intermediation, such as Russia, PBs may need to be supported also by lines of finance for on-lending. The second approach is to build up a new microfinance institution (MFI) from scratch, providing a contribution to equity, credit lines for on-lending and corporate governance. However, there is also a third approach, which the Bank has so far not attempted in Russia. This entails supporting existing non-bank MSE operations, which may be in the form of NGOs, through the provision of finance and perhaps management training.[4]

The RSBF applied the downscaling model exclusively in its initial years until the 1998 Russian financial crisis. In the aftermath of the crisis the Bank participated in the formation of a specialised microfinance institution, which became the primary engine of RSBF growth.

It is important to recognise that downscaling and MFI start-up are very different exercises. The downscaling approach requires heavy TC input particularly in the early stages since it is necessary to work with an existing bank institution, changing or developing management

[4] The Bank is currently exploring the possibility of establishing a regional framework facility to assist eligible NGOs in the commercialisation of their operations.

thinking and culture, building commitment to MSE finance and training loan officers in MSE lending skills. By contrast, when a start-up MFI is formed, senior management is usually recruited from experienced microfinance professionals who are already committed to the concept. Downscaling frequently entails a rather steep learning curve for PB management and staff. Results in terms of loan numbers and volumes may be slower to come through than in a start-up MFI with dedicated management. A new MFI, however, frequently needs substantial TC input during the start-up period to develop a branch network. During 2003, PED will carry out a Special Study of the EBRD's investments in microfinance banks.

In the context of replication, it is appropriate to mention the issue of rouble financing of micro-loans. For most PBs managing the currency risk associated with borrowing hard currency (from the EBRD) to lend in roubles (to microentrepreneurs) is an important issue. The Chairman of one PB stated to PED that, as a lesson from the 1998 financial crisis, his bank would not lend in hard currency to microentrepreneurs. For the future, the willingness of Russian banks, whether national or regional, to commit counterpart funds to MSE lending will be important in determining the long-term success of the programme.

1.4 "Lending technology"

The expression "lending technology" is used to describe the combination of credit assessment procedures with IT systems created or adapted to meet the processing, information and reporting requirements of MSE lending. Within the RSBF a set of procedures and an associated software package have become the standard tools used by PBs. An exception is one PB, which does not use the RSBF software, although it applies the credit assessment procedures developed for the RSBF programme. The software for the RSBF is based on a free-standing credit module. With one exception, it is not integrated with the in-house MIS of PBs, necessitating dual input of primary data to the PB's own MIS and the RSBF system. The expression "lending methodology" is frequently used to describe the set of credit assessment, loan monitoring and collection procedures used by PBs. In the interests of clarity, this Special Study attempts to distinguish between the credit assessment procedures on the one hand, and, on the other hand, the software used for processing and reporting.

1.5 Programme objectives

Chapter 2 describes the early development of the programme through the pilot projects to the full-Scale operations approved by the Board in August 1995. At that time the Board document defined the main objectives as follows:

"*This project has two interrelated aims: firstly, to provide short and medium-term financing to Micro and Small Enterprises, and secondly, and most critically, to contribute to institution building within the Russian financial sector by providing training and Technical Co-operation to banks that will develop the long-term capability to provide small and micro firms with formal sector finance. The project is introducing new products into the Russian financial sector and it is reaching a target group that has not previously had access to bank loans or investment capital.*"

The Board document set out a number of goals for the programme, the chief among them being expressed as follows:

"*The project will provide finance for small companies and entrepreneurs that have few, if any, alternative means to start and expand business*."

"*The project will support the development of participating banks by introducing small lending and micro-credit technology and extensive monitoring procedures, by improving marketing, increasing and diversifying their client base*."

"*Extensive seminar and on-the-job training will be provided to the participating banks' management and staff*."

The Board document defined the following key performance indicators:

"*Key indicators of RSBF financial performance will include:*
- *profitability of the project for local intermediaries; and*
- *repayment rates, not only in terms of loans to partner banks, but also on their sub-loan portfolio.*

Project performance indicators will include:
- *use of proceeds to support a large number of Micro and Small enterprises;*
- *long-term commitment by partner banks to Small and Micro lending;*
- *training of large numbers of loan officers in sound credit analysis;*
- *strengthening of local banks and institution building; and*
- *increasing acceptance of micro and small firms in the Russian financial sector*."

The expansion and extension of the RSBF was approved by the Board in July 2001 when it was agreed to increase the Bank's funding commitment by up to US$ 150 million with US$ 50 million of this being contingent upon the commitment of US$ 30 million of additional funding by RSBF contributors. In addition, the life of the project was extended from 2004 to 2010. The Board's document approving the expansion and extension complemented the objectives set out in the 1995 Board document. For example, in reinforcing the importance of institution building, it noted that: "The test of the success of the institution building process is not graduation *per se*, but the continued serving post-graduation of MSEs in a professional and efficient manner." The document also noted: "The expansion of the RSBF is expected to enhance transition impact at two levels, by both leading to greater regional outreach and by deepening institution building in partner banks."

One of the conclusions of this Study is that the programme has achieved very good results in terms of the volume and quality of MSE lending, and in the training of PB staff in MSE lending skills using the chosen methodology. The programme has been less successful in terms of the institution building that is essential if MSE lending is to be sustained by PBs. Section 4 considers the achievement of programme objectives, while Section 7 contains an overall assessment of the programme.

2 The early development of the RSBF

2.1 Background

Table 2 RSBF planned commitments (in US$ millions)

RSBF Planned Commitments[5]			
	EBRD	**G-7**	**Total**
The pilot project			
For small business financing[6]	3.00	3.00	6.00
Technical cooperation		4.00	4.00
Subtotal (pilot project)	3.00	7.00	10.00
The extended pilot project			
For small business financing	20.25	20.25	40.50
Technical cooperation		5.00	5.00
Subtotal (extended pilot project)	20.25	25.25	45.50
The full-scale operations			
For small business financing	126.75	75.75	202.50
Technical cooperation		42.00	42.00
Subtotal (full-scale operation)	126.75	117.75	244.50
Subtotals to mid-2001			
For small business financing	150.00	99.00	249.00
Technical cooperation		51.00	51.00
	150.00	150.00	300.00
The expansion and extension *	150.00	30.00	180.00
Total planned RSBF commitments	**300.00**	**180.00**	**480.00**

*Of the additional EBRD commitment, US$ 50 million is contingent upon commitment of a further US$ 30 million by the RSBF Contributors.

Following a meeting between the G-7 countries in Tokyo in April 1993 and in response to "an urgent request from the Russian Government to assist in the development of small businesses in Russia", the Bank was requested to establish and administer a facility for financing small businesses in the Russian Federation. The RSBF has been in operation since 1994 and has developed through four distinct phases: the pilot project, the extended pilot project, the full-scale operations and the expansion and extension of RSBF. With the latest expansion and extension the life of the programme has been extended to 2010. To date the Bank has committed a total of US$ 300 million for small business financing in Russia through the RSBF. Commitments from RSBF contributors amounted to a total of US$ 150 million with US$ 30 million for TC estimated to be required from contributors to support the expansion and extension to 2010.

Of the US$ 150 million pledged by contributors for the full-scale operation, US$ 51 million was intended for TC and US$ 99 million for small business financing, including micro-

[5] These figures exclude finance for TC from the EU Bangkok facility (see Section 5). As at mid-December 2002 actual TC expenditure amounted to approximately US$ 76 million in total, of which US$ 14.2 million was funded by EU Tacis and US$ 66 million by the RSBF Contributors.

[6] The original concept included micro-credits although small loans predominated in the initial stages of the programme.

lending.[7] As at 31 December 2001 there was a shortfall of US$ 13.8 million in the receipts from Contributors. However, in 2002 the United States pledged US$ 10 million to support the expansion and extension of the Programme to 2010.

2.2 The pilot project (January–June 1994)

The Bank recognised several imperfections in the prevailing financial infrastructure at the time, in particular with regard to financial mechanisms and instruments for delivering the Fund's resources to small businesses. The Bank therefore felt it necessary to develop a pilot project where mechanisms for small business financing could be tested and where the format would serve as a basis for a subsequent full-scale operation.

The pilot project commenced in January 1994 for a period of 12 months after being approved by the Board in July 1993. This first part of the pilot project involved a total of US$ 6 million for small business financing (of which the Bank contributed US$ 3 million of its own capital resources matched by another US$ 3 million of funding by the donor countries on a grant basis). An additional US$ 4 million for TC was financed by donor countries on a grant basis bringing the total to US$ 10 million for the pilot project as a whole.

Following preliminary analysis carried out by the Bank, supplemented by screening information prepared by consultants, three regions were identified for the pilot project. Factors such as the responsiveness of the local government to small enterprise development, the existence of basic business support, the advancement of small firm privatisation and the existence of some banking infrastructure played an important role in selecting prospective pilot regions.

In the test phase of the pilot project, the Bank chose to cooperate with five banks. Loan agreements with the banks were signed in February and March 1994. Implementation of the Small Loans component began in January 1994, with the first sub-loan disbursements made in March of that year. Selection of local partner banks for the micro-loan component commenced in April 1994 and the first test sub-loans were disbursed in August 1994.

Three financial products were tested under the pilot project: equity investments in small businesses, small loans and micro loans. Small loans (up to US$ 50,000 with exceptions up to US$ 75,000) were to be provided for up to two years for financing investment projects and working capital for companies with up to 50 employees and majority owned by Russian residents. [8] Micro loans (generally between US$ 2,000-5,000 and up to US$ 20,000 with exceptions up to US$ 30,000) were to be provided for all purposes (investments, working capital and trade) for up to two years, or up to three years in exceptional circumstances, to companies in trade, service or production sectors employing up to 20 people and majority owned by Russian residents.[9] Micro-lending has subsequently become a very significant RSBF product although the definition has been refined. Recently, the Bank decided to adopt the industry standard across all EBRD MSE lending projects, defining “micro loans” as being up to US$ 10,000. PED evaluated the pilot project and recommended continued support by the Bank for the RSBF on a phased basis.[8]

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[7] TC funding has also been provided by the EU Tacis programme under the "Bangkok Facility". The sources and applications of TC funds are described in more detail in Section 4 of the Special study.
[8] The findings of previous PED evaluations of the RSBF are discussed in Section 2.10 of this special study.

2.3 The extended pilot project (June 1994–August 1995)

The Bank came to the conclusion that both the duration and the available resources designated for the pilot project's test phase were insufficient to complete a comprehensive pilot-scale operation on which to draw meaningful conclusions before the launch of the full-scale project. The extension of the pilot project was approved in June 1994. An additional US$ 45.5 million was allocated of which US$ 5 million was set aside for TC purposes (see Table 4 above). The extended pilot saw the addition of five more banks and the geographical expansion of the programme to six new cities.

2.4 The full-scale operations (August 1995–2004)

The full-scale project of the RSBF, which the Board approved in August 1995, involved a US$ 202 million commitment for small business finance purposes (split between the Bank and the contributors in the amounts of US$ 126.75 and 75.75 million respectively). The contributors pledged a further US$ 42 million for technical cooperation. The programme continued its expansion working with 13 partner banks in the period before the August 1998 financial crisis, which itself was preceded by a period of financial instability that adversely affected bank performance. Prior to the crisis seven banks were excluded from the programme because they were perceived to lack commitment to MSE lending and the methodology of the RSBF. Cooperation with six of the remaining 11 was brought to a halt as a result of the crisis and they were assigned sub-loan portfolios in order to recover amounts due to the Bank. It became apparent in the aftermath of the crisis that four banks remained sufficiently solvent to have the potential to continue in the programme. Of these, one ceased to be an active partner after being taken over by a banking group that had no interest in pursuing the programme. The three remaining were joined by a new microfinance bank. In September 2000, another regional bank joined the programme, but ceased to be an active partner in 2002.

2.5 The RSBF response to the Russian financial crisis

At the time of the Russian financial crisis in August 1998, the Bank, through the RSBF, was working in 23 regions with an outstanding sub-loan portfolio of close to US$ 100 million distributed over approximately 6,500 sub-loans. Shortly after the crisis had taken hold, three of the PBs suspended their operations and were removed from the programme. The programme continued working with three other banks throughout the spring of 1999, but by June that year the work with these banks was also discontinued. Repayment schedules were agreed upon for three banks, while four banks stayed on with the programme.

In response to the crisis, the Bank suspended the lending programme in late 1998, accelerated the loans to certain banks, and arranged the assignment of their sub-loan portfolios directly to the EBRD. These assignments represented 616 transferred sub-loans for a value of US$ 17.2 million. In the first half of 1999, the EBRD accepted a second line of assignments from other banks representing a further 796 sub-loans for US$ 13.2 million. In total, 1,412 sub-loans amounting to US$ 30.4 million were assigned to the Bank.

Some sub-loan portfolios, amounting to approximately US$ 14 million, were re-assigned to the newly-formed micro-finance bank. Of the total, over US$ 12 million has been collected in this way for remittance to the EBRD. However, the initial level of capitalisation made it impossible to use the bank as the sole collection vehicle for assigned sub-loans. Also, because two banks failed to transfer the collateral for the assigned loans or the original loan documents to the EBRD, their sub-loan portfolios could not be re-assigned and, as a result, RSBF staff worked on the collection of these sub-loans on behalf of the EBRD. Overall, as of 30 June 2002, approximately US$ 23.5 million of the US$ 30.4 million in assigned sub-loans had been recovered. The remaining assigned portfolio comprises approximately 300 sub-loans for a total value of less than US$ 7 million. Approximately US$ 70,000 continues to be recovered each month in sub-loan repayments.

2.6 Small enterprise equity fund (SEEF)

The extended pilot project contained an equity investment component through the establishment of the small enterprise equity funds (SEEFs). An amount of US$ 15 million was committed to the SEEFs. Funds were established in two regions targeting enterprises with up to 100 employees and revenues between US$ 100,000 and US$ 1 million. Investments were sought ranging in size from US$ 25,000 to US$ 200,000 constituting 25–75 per cent of the total capital of the enterprise. The basic objective of the SEEF investments was similar to that of RSBF's lending component, namely to promote the development of small, private Russian enterprises on a commercially sustainable basis through the provision of investment capital in the form of equity or quasi-equity financing.

An external investment manager was retained as manager of the fund through an agreement signed in 1994. The investments did not perform well and the operation team concluded that the objective of investing small amounts of equity in a large number of companies was unachievable in the prevailing Russian environment. The SEEFs were restructured in 1999. A temporary fund manager is currently involved in the process of closing the remaining SEEF investments.

In all, the SEEFs made equity investments in 27 enterprises for a total of US$ 2,960,745 and, in addition, accompanying SEEF loans amounting to US$ 1,226,435 were advanced. To date, 12 investees – representing US$ 335,564 in equity investments – have either been liquidated, are undergoing bankruptcy proceedings or are no longer engaged in business activities. In terms of exits, by the end of June 2002, 13 successful buy-outs or sales had been completed representing an initial investment of US$ 1,964,542. Assuming zero proceeds from those holdings that have not yet been sold, the fund would incur a loss of approximately US$ 920,000.

2.7 The expansion and extension (2004–2010)

In July 2001, the Bank further expanded the programme and extended its duration until 2010. The Bank committed another US$ 150 million of which US$ 50 million was contingent upon commitment of a further US$ 30 million from RSBF contributors. At the time of the proposal for the expansion and extension of RSBF, the programme had expanded to 73 towns and cities across Russia working with four active partner banks. By June 2002, the programme was active in over 110 towns and cities in Russia with further planned geographical expansion.

2.8 Loan losses and the first loss guarantee

In October 1993, two special purpose funds were established for contributors – the Russia Small Business Investment Special Fund (RSBISF) and a Technical Cooperation Special Fund (TCSF). A “first loss guarantee” of US$ 75 million, provided by RSBF contributors, means that losses on Bank and special fund shared investments up to this amount are absorbed by the RSBISF. Further losses, if any, are to be shared between the RSBISF and the

Bank on an equal basis until the full amount of the RSBISF is exhausted. Any subsequent losses would be absorbed solely by the Bank up to the full amount of the Bank's investment.

As at 30 September 2002, a total of US$ 32.7 million had been written off as losses, largely arising from the Russian financial crisis.[9] Almost US$ 30 million of the amount was in respect of balances of RSBF loans owed by failed banks which were not covered by assignments of sub-loans, and where little or no recovery was anticipated. A substantial proportion of the amount was covered by existing provisions. In addition, provisions of US$ 11.2 million have been made against loans to partner banks and small equity investments. If these provisions crystallise, the balance available to cover future losses will be US$ 31.1 million.

2.9 Risk sharing arrangements

In earlier stages of the programme, the small loans component included a risk sharing arrangement with PBs because of the unstable business environment facing small production firms in Russia and in order to provide incentives to the local PBs. The programme started out with automatic risk-sharing of 50 per cent where the EBRD took up to half the risk on sub-borrowers, but this was soon reduced to the 10 – 40 per cent range. In the initial period a total of US$ 600,000 was written off in risk-sharing on sub-loans. However, as the overall good quality of the sub-loan portfolios became established, it became apparent that risk sharing offered no tangible benefits. The scheme was terminated in 1997 and no risk-sharing arrangement is in place on any of the outstanding EBRD-to-bank RSBF loans.

2.10 Previous PED evaluations

PED carried out progress review reports of the first and second phases of the pilot project and of the full-scale operation of the RSBF programme.[10] The progress review report in 1997 concluded at the time that the RSBF had been a successful credit line and institution building programme, but that the programme was by no means settled and an important issue was how to maintain competition and choice in the arrangements for TC consultants. Other key issues and recommendations highlighted in the 1997 progress review chiefly concerned product mix, diversity and size; graduation and cost sharing; and programme implementation.

In respect of product mix and diversity, PED pointed out that the differentiation between micro and small loans should be made more clear and that the RSBF product offering could be diversified further to include loan guarantees, leasing and express loans. PED was supportive of the decision to develop RSBF activities in smaller towns and argued that consideration should be given to promoting more varied fee and interest rate structures on existing on-lending. During the field visit in connection with the present Special Study, a number of interviewees echoed the sentiment that some flexibility in fee and interest rate structures would be welcome. However, the rigidity of the technology currently in use does not permit this flexibility (see further Section 3.2). In contrast to the participating banks, members of the RSBF team interviewed were not in favour of a varied structure, arguing that the introduction of flexibility would lead to an unacceptable increase in risk.[11]

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[9] As at mid-2001, the figure was US$ 35.6 million. Over 15 months, approximately US$ 3 million was recovered and applied against previous write-offs.

[10] PED reports referenced PED94-11S (July 1994), PED95-24S (March 1995) and PED97-65S (July 1997).

[11] The evaluation team stresses that it is not proposing the credit discipline should be relaxed. Rather, PBs should be permitted to introduce some flexibility in repayment terms when appropriate for the borrower and supported by the credit assessment.

With regard to graduation and cost sharing, PED suggested a more formalised graduation process. This could be achieved by setting target bands for the distribution of funds between graduated and non-graduated branches of the same partner bank and for specifying the amount of TC funds available under loan agreements. PED argued that such measures would allow the partner banks to take more ownership of the product and maintain the momentum after graduation. During the field trip, PED confirmed by observation and discussion that the programme's RSBF team were implementing the lending limits at branches. However, it remains impossible to calculate the amount of TC input per participating bank or branch as the programme consultants have not been required to maintain the necessary breakdown of time spent by their staff. (See further the discussion of TC efficiency in Section 5.)

In relation to TC management and programme implementation, PED urged for more diversity in the delivery of the TC component. In PED's view, the Bank could run the risk of being too closely associated with an individual consulting firm's credit technology. Hence, PED urged for the delivery of a choice of technologies for the PBs to adapt to their own environment. This recommendation, which has not been implemented, is brought forward and reiterated in the conclusions of the present Special Study.

A number of the issues raised earlier by PED have been addressed. For instance, the programme has introduced a new express micro-loan product and a leasing product; the geographic spread of the programme is confirmed; exit and subsequent monitoring procedures have been formalised. However, cost sharing in the form of counterpart funding of RSBF lending, which was proposed also under the expansion and extension of the RSBF programme, has not been realised to any significant degree. The much-called-for diversity and competition in the delivery of TC has also not been realised.

3 The RSBF and the microfinance environment

3.1 Characteristics of the RSBF lending programme

The RSBF uses a single lending methodology, with some implementation differences, to serve micro and small enterprise clients throughout Russia. This section first describes the strengths of the programme's micro-finance lending methodology, which has produced some impressive results, and then discusses potential constraints on maintaining or improving upon this performance in the future.

Key strengths of lending methodology

- Cash flow is thoroughly analysed
- Strong portfolio monitoring maintains high levels of asset quality
- Collateral requirements are of secondary importance to cash flow, or liquidity analysis.

The methodology includes the traditional scaled lending model of micro-finance in which borrowers begin with very small, very short-term loans and work their way up to larger amounts and longer terms by demonstrating good repayment behaviour. Scaled lending is particularly suited to commerce and service enterprises that are labour rather than capital intensive. Specific to the Russian context, the methodology, which correctly looks at the micro-enterprise and household as a single unit, is accessible to sole proprietorships, the increasingly predominant form of organisation for smaller enterprises. Within the RSBF, sole proprietorships accounted for 73 per cent of all loans in 1998, rising to 87 per cent of all loans by the end of 2001.

3.1.1 Liquidity analysis

The methodology does not rely exclusively on asset value. For both micro and small enterprises, trained loan officers prepare pro forma balance sheets to assess collateral and liabilities, and income statements to assess cash flow. Although relatively basic for micro borrowers, the *pro formas* for small enterprise borrowers include more complex cash flows and projected results post loan disbursement. All of this work is recorded on specialised forms to facilitate consistent borrower evaluations. As the loan officer is responsible for the paperwork, potential borrowers do not have to take time off work to attend training courses on finance and accounting.

3.1.2 Use of collateral

Almost any possession that has value to its owner (in monetary or sentimental terms) can be used as collateral. Initial loans are typically for relatively small amounts and short time periods. Over time, as a client proves his or her creditworthiness, the amount and tenor increase. Programmes that use this technology tend to maintain fairly short tenors, rarely exceeding 12–18 months, even with repeat borrowers. Due to the difficulties of obtaining judicial settlements in most emerging markets, the financial institution using this methodology in some countries holds the collateral in a vault or bonded warehouse until the client has proven him or herself to be creditworthy.[12] Although a practical tool for risk

[12] Although PBs took possession of collateral in the early years of the RSBF, the practice to a large extent has been discontinued due to the low arrears rate. Enquiries during the September 2002 field trip confirmed that the practice has largely been discontinued in the regions visited.

management, the costs of safeguarding an institution's collateral must be considered explicitly when calculating profitability.

3.1.3 Strong portfolio management

The highly disciplined nature of the RSBF training regime and the management of long-term experts (LTEs) and loan officer trainees help maintain portfolio quality. Scrupulous attention is paid to monitoring repayment behaviour and arrears are pursued early and aggressively. Client financial institutions must establish separate small and micro-lending units enabling trained credit officers to focus exclusively on the target markets.

The quality of the portfolio has been a significant achievement of the programme, particularly in the Russian environment where strong credit assessment skills have been lacking. Loan officers are accountable for the performance of the loans they process and this performance is subject to scrutiny at different levels. The system is set up to alert loan officers immediately to any arrears, enabling them to take swift action. Further portfolio monitoring may be carried out by the PB's credit department and thereafter by the RSBF at regional office level and/or at the RSBF office in Moscow.

A key statistic applied when assessing the RSBF portfolio is arrears in excess of 30 days as a percentage of the outstanding portfolio. This is calculated monthly at the level of each participating bank branch and aggregated by RSBF management to show the picture for the programme as a whole. This statistic may not be wholly effective for management purposes if used to predict credit quality within a rapidly growing portfolio since an increase in the numerator (arrears) may scarcely be visible against a sharp increase in the denominator (total outstandings). Nevertheless, the statistic remains a useful general indicator of portfolio quality provided that close monitoring of individual loans continues and requisite action is taken without delay when arrears present themselves. In this connection it should be mentioned that loan officers are trained to observe the financial performance of borrowers on an ongoing basis and to take preventive measures to forestall arrears if possible.

3.1.4 Loan size

Within the RSBF, analysis of portfolio data highlights variations among the partner banks. One bank has shown a steady increase in loans of up to US$ 20,000, with strongest growth in loans of under US$ 5,000. Another bank has steadily increased its loans in the US$ 5,001–20,000 category, but retains a strong focus on loans of US$ 1,001–5,000 as well. In contrast, a third partner bank appears interested almost exclusively in loans of US$ 5,001–20,000 while at the fourth loan sizes have increased such that the US$5,001–20,000 category is now predominant.

Tables 3 and 4 show the portfolio breakdown at the four RSBF partner banks from two different perspectives: number of loans made and the relative weighting of the loan size category within the total portfolio. Generally speaking, this information confirms that the RSBF has focussed increasingly on micro, rather than small enterprises as loans above US$ 20,001 are less common in 2001 than they were in 1999. The trend continued in 2002.

Table 3: RSBF partner bank portfolio breakdown by loan size (number of loans)

Loan size category	Bank A			Bank B			Bank C			Bank D		
	1999	2000	2001	1999	2000	2001	1999	2000	2001	1999	2000	2001
<US$1000	179	394	2,846	855	1,130	1,352	7	28	39	1	3	5
US $1,000-5,000	655	1,568	7,451	1,837	3,452	4,862	43	101	232	80	129	180
US $5,001-20,000	531	1,343	3,808	1,166	2,424	3,222	531	1,343	3,808	52	111	206
US $20,001-50,000	247	515	1,207	277	509	572	27	24	37	25	28	41
US $50,001-150,000	222	353	523	90	136	133	5	3	3	19	18	17
US $150,001-500,000	20	47	54	-	11	19	-	1	-	3	2	1

Table 4: Relative ranking of loan size within partner bank portfolios (Ranking 1 to 6)

Loan size category	Bank A			Bank B			Bank C			Bank D		
	1999	2000	2001	1999	2000	2001	1999	2000	2001	1999	2000	2001
< US $1000	5th	4th	3rd	3rd	3rd	3rd	3rd	3rd	3rd	6th	5th	5th
US $1,000-5,000	1st	1st	1st	1st	1st	1st	2nd	2nd	2nd	1st	1st	2nd
US $5,001-20,000	2nd	2nd	2nd	2nd	2nd	2nd	1st	1st	1st	2nd	2nd	1st
US $20,001-50,000	3rd	3rd	4th	4th	4th	4th	3rd	4th	4th	3rd	3rd	3rd
US $50,001-150,000	4th	5th	5th	5th	5th	5th	5th	5th	5th	4th	4th	4th
US $150,001-500,000	6th	6th	6th	6th	6th	6th	6th	6th	6th	5th	6th	6th

3.1.5 Loan tenor

In general, sources interviewed for this Study indicated that the Russian banking sector offers maximum lending tenors of three to six months for private enterprise, with larger enterprises making use of revolving credit lines. In consumer lending, the tenors stretch a bit longer. However, long tenors for working capital loans are not necessarily the best practice to adopt. Where long-term working capital is required, revolving credit lines would be a sensible alternative.

One consequence of the 1998 financial crisis was that the RSBF lost the main banks that had a stronger focus on small loans. Analysis of RSBF loan tenor information reveals that each partner institution increased the percentage of its portfolio in the 12–18 month category, every year, and all of them have by far the majority of their loans maturing between six and 18 months. All show a steady drop in the one to six month maturities, with the exception of one bank whose portfolio in this category rose slightly in 2002 as a result of greater focus on micro loans. The questionnaire results reveal that the RSBF average loan tenor (with responses from 82 branches) is 11.2 months, with an average range of 9.5 months at one bank and up to 12 months at two others. Repeat borrowers are more likely to receive longer terms, but the programme averages are slow to rise. This may be due in part to relatively low indices of repeat borrowing.[13] The proportion of the RSBF on-lending portfolio with 18–24 month maturities has remained relatively stable at 5 per cent or less. Given the terms of the RSBF

[13] Based on the RSBF research data, the average repeat borrower takes between two and three loans. Repeat loans account for between 40 per cent and 50 per cent of the current portfolio. Encouraging a higher rate of repeat borrowing is important for profitability and sustainability.

lending policies, if small enterprises were participating on a more equal footing with micro-enterprises, one would expect to see more loans in the 18–24 month category, and a correspondingly larger contribution of the medium loan sizes to overall portfolio.

Although the limited use of longer loan terms is, perhaps, disappointing, a gradual increase of loans in the 12–18 month category can be observed, which is encouraging. If the repeat borrower rates remain at recent levels, methodological impetus alone should push tenors out further in the future. It should, however, be noted that the increase in micro loans (under US$ 10,000) is unlikely to lead to longer loan tenors. The smallest borrowers are predominantly engaged in small-scale trading activities with a fast turn-around and require funding for short-term working capital rather than asset purchase.

3.1.6 Sectoral distribution

In all micro-enterprise programmes, survival-type enterprises, as well as some larger firms, frequently use micro-credits to finance household needs instead of (or in addition to) business needs. Over time, businesses that both survive and grow use their micro-credit loans to strengthen and expand their business activities, since their personal needs can already be met through internally-generated cash flows.

The issue of financing trade versus productive activities is a perennial debate in micro-enterprise circles. On the one hand, some argue that distinguishing between commerce, services and industry is pointless: a creditworthy business is a creditworthy business full stop.

Table 5: Breakdown of micro-enterprise lending by economic sector[14]

Programme	Commerce	Services	Industry	Agriculture
Brazil MSME 2000	11%		21%	41%
Brazil MSME 2001	10%		21%	44%
Colombia MG1	5%	30%	65%	n.a.
Colombia MG2	11%	1%	88%	n.a.
Peru MG1	68%	14%	9%	9%
Peru MG2	74%	9%	5%	12%
RSBF 2001	79%	12%	9%	n.a.

Others make a compelling argument that enterprises involved in the transformation and processing of raw materials or in the production of semi-finished or finished goods add greater value to the economy and create relatively stable jobs. By providing work for both suppliers and distributors, they also tend to strengthen employment in other firms. They may invest in fixed assets, rather than simply consuming working capital.

As can be seen in the above table, the RSBF lends primarily to commercial establishments. Trade financing can have an important impact on a developing market economy in that it can promote inter-regional and international exports and/or import substitution, and reduce MSE dependence on barter relationships. Although the RSBF does not track whether its borrowers are engaged in import substitution or export activities, responses from the Special Study questionnaire suggest that neither is relevant to RSBF borrowers. A very small percentage of borrowers import goods, but for all practical purposes, most RSBF borrowers are passive acquirers of goods for resale: they do not produce, export or import on their own.

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[14] Sources: Beck, Alison et al, (June 2002), *The second story: wholesale microfinance in Latin America*, BNDES Boletim MPME. The Brazilian numbers include micro, small and medium sized enterprises and do not cover all sectors that receive loans.

Financing working capital for retail commerce, personal and professional services can stabilise employment for enterprises receiving loans and stimulate the creation of (primarily) low skill, low wage positions (waitress, counter clerk, receptionist, etc.) that reduce unemployment at least temporarily. Many commercial enterprises also contribute to establishing a dynamic market economy, satisfying pent-up demand for business services, consumer goods, entertainment and convenience products. Micro commerce, "shuttle trading" or otherwise, is a sector of the economy with relatively low barriers to entry. Ease of entry makes it possible for those who might otherwise be unemployable to earn a living and affordable credit can mean the difference between subsistence levels of income and surplus generating profitability. One risk in concentrating the focus of credit on commerce in Russia is that as the economy becomes efficient, many small traders, distributors and kiosk owners will be unable to compete against mid-sized firms that can offer a broader range of products, faster delivery and lower prices. It should also be noted that finance needs to be made available to industry, including small-scale manufacturing, as well as to commerce and services in a well functioning economy. In this context, the extra effort and attention to risk management involved in reaching out to a greater proportion of transformation and production enterprises is clearly worthwhile.

3.2 Importance of a flexible methodology

Quality control and attention to detail are two of the factors that enable the RSBF to produce high performing micro-credit loan portfolios even when operating in difficult economic and political circumstances. Nevertheless, some PBs and branches have complained that the implementation stage is too rigid. At the inception of the programme, an inflexible approach may have been appropriate as a means of minimising risk with new, untested PBs. The lack of flexibility, however, further emphasises that RSBF lending remains separate from the PBs' other activities and may limit the willingness of PBs to take ownership of the technology and to commit their own resources to MSE lending. On the other hand, surveys on downscaling among commercial banks have confirmed that if micro-lending is not handled by a separate department, it may become overwhelmed by the general culture of centralisation and high documentation requirements within the bank. This indicates that the institution-building component of a downscaling programme must also give attention to explaining the nature and purpose of micro-lending, and its potential to contribute to the overall success of the bank. Some integration is essential as the micro-lending function cannot be cut off from other essential functions of a bank, such as the allocation of funds, asset and liability management, management information system and general administration.

During PED's field visit, a number of banks and branches that were interviewed stated that they would like to be able, within the RSBF portfolio, to consider offering short capital repayment holidays to selected borrowers and to offer varying repayment schedules when appropriate to a particular type of business. They considered that the programme would also benefit from giving loan officers specific training in the credit assessment of start-up enterprises and production enterprises, which could help reduce the tendency towards retail and trading activities among borrowers. In discussions during the field visit a number of programme participants identified, in particular, the exclusion of carefully assessed start-up businesses as a weakness. With regard to tenor, PBs and branches observed that they would like to make more loans for periods in excess of 24 months. Several participants noted that, without this capability, they could not reach enterprises primarily engaged in production.

4 Evaluation of the RSBF – fulfilling objectives

In assessing the performance of the programme and the fulfilment of objectives, the following section reviews the transition impact (TI) of the programme and considers the measures that may enhance the TI. PED acknowledges that, since 1993/94 when the pilot and extended pilot projects were approved, the Bank has put greater emphasis on TI and has developed a set of indicators to assist in its measurement.[15] This section attempts to reflect the Bank's current thinking on TI, rather than purely achievements in developmental terms.

4.1 Qualitative analysis of the RSBF portfolio

This analysis is focused on identifying trends in the structure of the on-lending portfolio. There are certain factors that have led to the conclusion that RSBF lenders are not taking enough risks. For example, proceeds being primarily used for working capital, as well as the relative maturity of sub-borrower enterprises. The bulk of the RSBF portfolio appears to be in self-financing working capital loans for inventory purchase. Such loans are very low-risk propositions, especially where the lender does not serve start-up enterprises, as is the case with the RSBF. Although credit regulations require only that an enterprise has been operational for at least three months, RSBF research indicates that the average programme sub-borrower has been in business for more than three years. While this may have a positive effect on arrears rates, it may leave newer enterprises without support, regardless of their merit.

In an economy in transition, knowledge of the enterprises and actual use of loan proceeds is essential in assessing the risk taken by the lender and the economic impact made by the sub-borrower. Hence the fact that the Special Study questionnaire focuses on the socio-economic status of the sub-borrower, the sub-sector of his or her enterprise and the use of proceeds of his or her RSBF loan. The objective here is to identify trends in portfolio structure during the period 1999–2001. The principal source of information is the RSBF database. Questionnaire findings provide a snapshot, admittedly imperfect, of what the programme looks like at present. [20]

4.1.1 Outreach

There are no reliable estimates of demand for enterprise finance in Russia, from the World Bank or any other source, which means that the coverage implied by RSBF's aggregate figure of 86,335 loans to roughly 38,335 borrowers[16] (4 per cent of the estimated universe of MSEs according to data from Goskomstat) cannot be accurately assessed.

From responses to the Special Study questionnaire, it is known that most borrowers have post-secondary technical or university education and one to ten years of prior work experience in both state-owned enterprises and private Russian enterprises. A few come from academia or the military, but none have worked for Russian enterprises with foreign participation.

[15] There is a discussion of transition impact and the RSBF in Section 6 of the Special Study.

[16] Based on the RSBF research data, the average repeat borrower takes about 2.5 loans. Working backwards, from the cumulative number of loans made and using an average of the repeat borrower indices for the period 1999–2001, there are approximately 32,000 repeat borrowers and 6,335 new or non-repeat borrowers, as of May 2002. It is possible that this method has overestimated the number of repeat borrowers and underestimated single loan clients, but as a proxy for total clients, the number is reasonable.

The typical borrower travels up to 15km to reach an RSBF loan officer, except in the case of one bank where some clients travel between 16 and 21km or more. A slightly higher number of borrowers fall in the 21–40 age range than in the 41–60 age range, but hardly anyone falls outside of the two ranges. In the former group, there are a few more men than women, while in the latter the reverse is true. The questionnaire results are in line with RSBF estimates of aggregate, women's participation in the programme, which at 41.2 per cent is quite respectable.

Table 6: Participation of women in RSBF lending

1999-2001 Loan size ranges (Amounts in US$)	Total loans made	Total loans to women	Women's participation
< 2,000	7,444	4,495	60.4%
2,001–5,000	6,778	3,051	45.0%
5,001–10,000	5,286	2,020	38.2%
10,001–15,000	1,842	564	30.6%
15,001–30,000	3,494	870	24.9%
30,001–50,000	1,198	224	18.7%
50,001–100,000	1,038	153	14.7%
100,001–150,000	626	75	12.0%
150,001–300,000	70	4	5.7%
300,001–500,000	9	1	11.1%
TOTAL	27,785	11,457	41.2%

4.1.2 Supporting new business growth

Credit regulations for the RSBF state that a business must have at least three months operating history before seeking a loan. The intention is to ensure that the partner bank is financing a going concern rather than a pipedream. Although prudent, in practice the average business receiving RSBF financing is already three years old. Newer companies, regardless of their long-term prospects, are still forced to turn to informal moneylenders when their capital needs exceed their savings and the means of their friends and family. While it is true, in general, that more than 50 per cent of small businesses fail within their first year, the period between years one and three is also a time of very strong growth. As can be seen in Charts 1 and 2 below, small businesses in both Latin America and Asia experience strong growth in number of employees and sales between their first and third years of operations.[17]

[17] Kantis, Hugo; Komori, Masahiko; and Ishida Masahiko (editors) (2002), *Entrepreneurship in emerging economies: the creation and development of new firms in Latin America and East Asia,* Inter-American Development Bank, Washington, DC.

Chart 1: Employment in small businesses from start-up

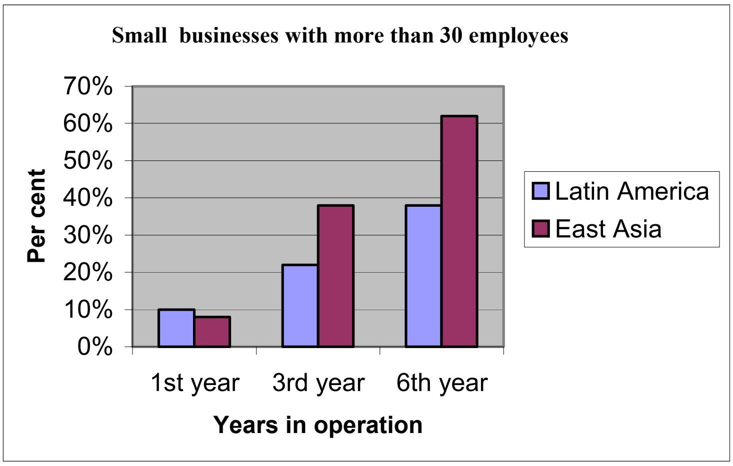
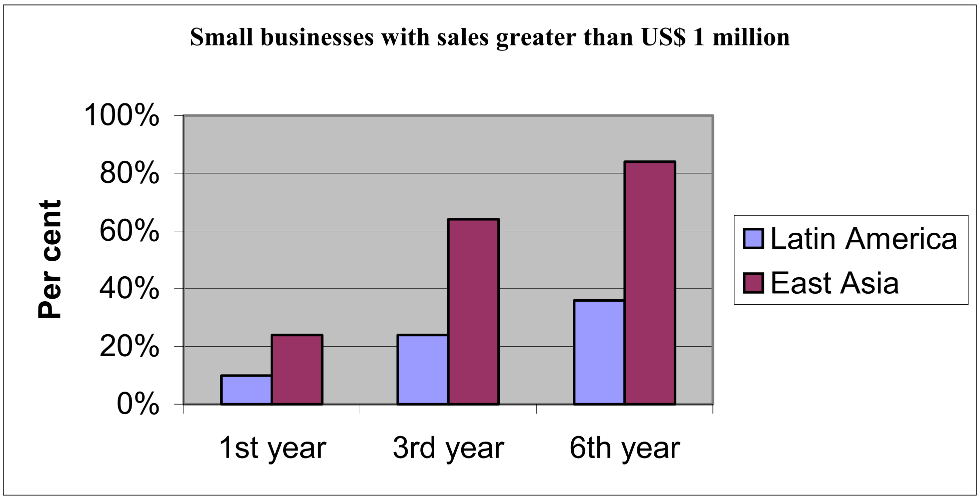


Chart 2: Sales growth in small businesses from start-up



While there is also significant growth from years three to six, at this point in a firm's development, it is more likely to have the capacity to attract bank financing. By applying basic principles of the lending methodology (for example, smaller loans with short tenors, increasing over time), the RSBF should be able to target new businesses with appropriately-priced loan products without inordinately increasing repayment risk.

4.1.3 Job creation

In the early stages of the programme, for example at approval of the pilot and the extended pilot, one objective was expressed in terms of building employment opportunities. Job creation is one of several possible indicators of the achievement of developmental goals. Figures compiled by the RSBF make an estimate of the 'job creation effect' of the programme by comparing the average number of employees for repeat borrowers currently with the average number of employees for repeat borrowers at the time they received their first loan. Based on the data as at 31 December 2001, as shown in Table 7 below, the RSBF had created an estimated 34,000 jobs among repeat borrowers rising to 78,000 jobs with the inclusion of first time borrowers since its inception. It has supported a further 855,000 jobs.

Table 7 Estimate of job creation effect

Total number of loans to 31 December 2001	71,306	A
Average number of employees for first time borrowers	11.1	B
Average number of employees for repeat borrowers at time of first loan	12.7	C
Average current number of employees for repeat borrowers	13.8	D
Percentage of repeated loans in portfolio	44%	E
Percentage of first time borrowers in portfolio	56%	F
Index of employee growth for repeat loans	1.09	G (=D/C)
Estimate of jobs supported	855,386	(A*B*E) + (A*C*F)
Estimate of jobs created by repeat borrowers	34,198	A*E*G
Estimate of jobs created if assumed that growth index applies also to first time borrowers	77,723	A*G

Source: RSBF statistics

It should be acknowledged that these figures are tentative. It is possible that they overstate the level of job creation since they apply averages based on the outstanding portfolio at end 2001 to the cumulative number of loans since the programme began. Furthermore, the averages are not weighted to take account of the increase in micro loans (over 80 per cent of the portfolio by number at end 2001). It is also possible that the calculation understates the employment effect by underestimating the number of jobs created by first time borrowers.

The special study questionnaire sought information about job creation at the level of the participating branches. In answer to the question "On average, how may new jobs are created by each repeat borrower", the most common response was between "one and five" and "none" was the only other response. Although this is not seriously out of line with the above estimates, caution should be applied in the use of the data. To assess the social impact of the programme through job creation more accurately, the Bank could consider running panel surveys on samples of enterprises embracing both enterprises receiving RSBF loans and others. However, such an exercise would be costly and time-consuming.[18]

4.1.4 Repeat borrowing

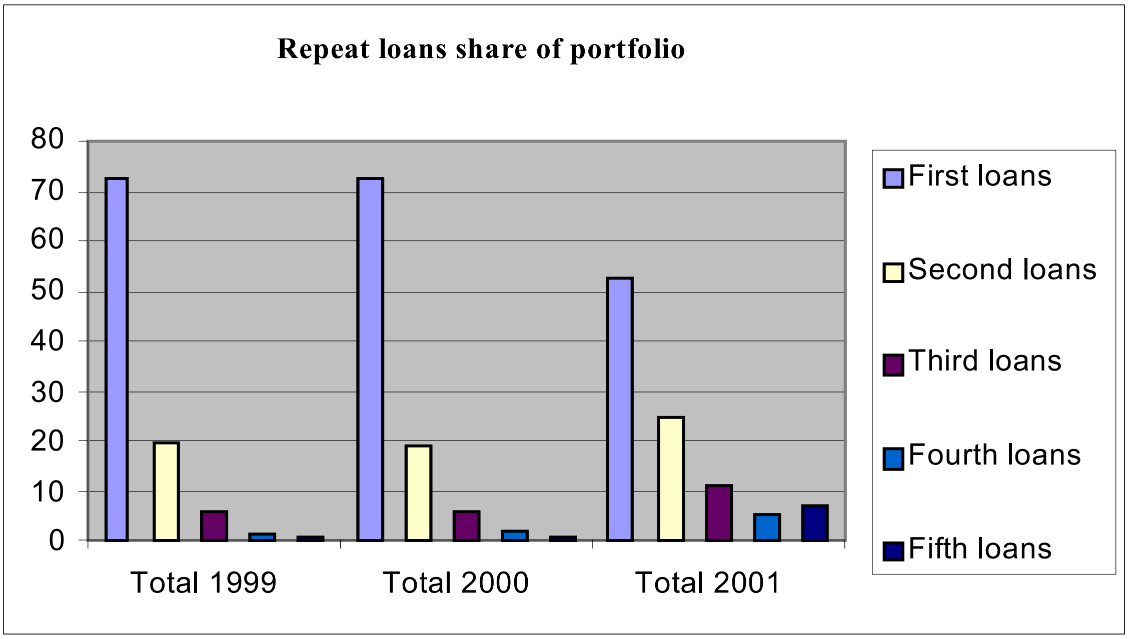
Over time, repeat borrowers make up an increasing percentage of the portfolio, rising from just under a quarter in 1999, to 48 per cent in 2001. Since one objective of the methodology is to remove information asymmetries and reduce portfolio risk by building client relationships, increasing the number of repeat borrowers and repeat loans is important. It is evident that the share of repeat borrowing in the overall RSBF portfolio has increased over time (see Chart 3 below), although not as much as might be expected using a methodology that relies on repeat borrowers to establish creditworthiness and bring down costs.

[18] A preliminary two-week study by a long-term expert recruited by the programme consultant was carried out in one region where the programme is well established and issued as an "Impact Assessment" of the RSBF in July 2002. One conclusion was that, on average, even the smallest RSBF micro borrowers hired two additional employees during the loan period. A more widespread and methodical survey, perhaps using a control group and building in comparisons over time, would be required to reach reliable conclusions.

Enquiries during PED's field visit suggest the existence of several factors that may influence the rate of repeat borrowing:

- the borrower ceases trading after repaying the loan (there is believed to be a high, but unquantified attrition rate among micro-entrepreneurs);
- at the other end of the scale, the borrower grows beyond the limits of the programme and seeks finance from other sources;
- further investment needs are met from own generated funds;
- borrower reluctance to develop the banking relationship further.

Chart 3: Repeat borrowers[19]



4.1.5 Financial performance of the programme

The Special Study questionnaire sought to obtain information on profitability from PB branches and enquiries were also raised during the field visit. The responses suggest that RSBF partner banks, such as the Russian banks in general, have little understanding of how to cost out their product lines, making it difficult for them to ascertain with certainty whether individual products are profitable or not. Out of 91 branches participating in the Special Study questionnaire, 57 (63 per cent) stated they believed they made a profit in first quarter 2002, although 21 of these were not sure how much profit. This suggests that 37 per cent either estimated that RSBF lending was unprofitable or lacked information to consider the issue. Given that demonstration of the profitability of micro-lending is key to the decision of whether or not to continue the activity, the evaluation team considers that the programme should work to formalise the calculation of profitability within PBs at branch level.[20]

[19] Source: RSBF research indicators in worksheet format.

[20] The calculations may of course be done at the partner bank's head office rather than at the branches, depending on how reporting within the bank is structured.

On the basis of discussions at bank branches during the field visit, the evaluation team considers that it is important to equip PBs with the means to calculate the contribution to earnings of different lending products. During discussions, the question as to whether business loans of under US$ 1,000 could be profitable at all, given the associated costs was also posed. However, those raising the question stated that they lacked the information and analytical tools to calculate whether very small loans were capable of making a positive contribution to earnings.

RSBF consultants have taken an important step in this direction by providing the evaluation team with estimates of the contribution to profit from RSBF lending activities at some PB branches. In mid-2001, an exercise aimed at estimating the profitability of three of a mature PB's branches was carried out for inclusion in the Board paper proposing the expansion and extension of the programme. The Board paper described the approach used as "rather rudimentary" since branches are not used to the concept of profit centres. The evaluation team understands that the contribution analysis is now undertaken at least quarterly. However, the examples seen of contribution analyses undertaken in 2002 did not include estimates of TC cost in the calculations. An authoritative source has observed recently that MFI's, in the long term, "should be able to operate without subsidies, relying instead on commercial sources and private investment at market rates. An adjustment that cancels out the effects of the present subsidies will reveal how close the MFI is to having a business that could expand viably in a subsidy-free commercial environment."[21] PED's discussions and review of the literature indicate that the capacity for pure MFIs to achieve consistent long-term profits is yet to be seen. In the case of downscaling institutions, the costs of organising micro-lending, including the ongoing overheads of maintaining micro-lending skills and capability, can erode the contribution of the activity to profitability. The evaluation team considers that the programme should encourage partner banks to measure the costs of MSE lending at branch and bank level systematically as a management tool, using an estimate of TC cost based on actual TC use per branch and bank. This exercise could also help improve the practice of sound banking principles if the results were used in pricing the risk premium for MSE products.

4.2 Sustainability and graduation

Sustainability and graduation are two sides of the same coin. The RSBF cannot be sustainable unless PBs graduate in the sense that they become able and willing to continue MSE lending using their own resources and without the support of donor-funded TC. In this context, graduation implies several things:

What makes a "graduated" MSE lending unit sustainable?

- An end to the need for technical cooperation grants and the ability to develop human resources internally or through market mechanisms;
- Corporate strategy that reflects a commitment to the target market, including the ability to develop appropriate financial products and services;
- Allocation of financial resources to back the strategic commitment; and
- The ability to verify, on a regular basis, the cost, pricing and profitability of financial products and services offered to the MSE market.

[21] *Definitions of selected financial terms, ratios and adjustments for micro-finance,* The Small Enterprise Education and Promotion Network, Washington, November 2002.

4.2.1 Graduating financial institutions – the role of counterpart funding

The RSBF's current approach for developing financial institutions is to provide training for credit officers and show them how to place credit lines using their new skills. Most FIs are happy to receive well-trained credit officers at no extra cost to them and many will allow these officers to use borrowed money to lend to the target market. Once the trainers have left and the credit line is repaid, some of these FIs will continue to lend to MSEs, having developed an appreciation for the size of this virtually untapped market. Other FIs will return to business as usual, with the added benefit of being able to advertise the EBRD affiliation.

Although there are limited circumstances in which specific instruments or contracts might be able to guarantee that an FI will maintain its commitment to the MSE market, there are steps that the RSBF could take to increase the level of FI buy-in and enhance the probability of sustainable interventions. One of the lessons learned at the Inter-American Development Bank (IADB) is that while many FIs will apply for a reasonably priced hard currency credit line, those that are primarily seeking an IADB "seal of approval" tend to lose interest when counterpart funding is required. While it is true that most IADB global lines are placed through sovereign institutions,[22] the IADB's SME arm, the Inter-American Investment Corporation (IIC) works only with private sector companies and without government guarantees. The IIC also typically requires a commitment of counterpart funding and/or counterpart assumption of any technical cooperation requirements of a specific lending programme. Even grant funding offered by the IADB's multilateral investment fund includes a stipulation that 30 per cent of the cost of the technical assistance project be covered by the grant recipient.

Table 8: Counterpart funding for micro and small enterprise loan programmes
(Amounts in US$)

Country	Lender	Programme	Multilateral loan amt	Counterpart loan amount	Counter part pct
Argentina (1997)	IADB	IADB small and micro global	49,000,000	16,000,000	24.6%
Argentina (ongoing)	IADB	IADB small and micro global	98,000,000	98,000,000	50.0%
Bosnia & Herzegovina	EBRD	Micro-enterprise bank	2,338,223	n.a.	n.a.
Brazil (1999)	IADB	Banco do Nordeste	30,000,000	30,000,000	50%
Brazil (2000)	IADB	BNDES MSME Line	980,000,000	980,000,000	50%
Colombia (1993)	IADB	IADB small business line 2	15,000,000	7,000,000	31.8%
Colombia (1997)	IADB	IADB small business line 3	30,600,000	20,210,000	39.8%
El Salvador (1997)	IADB	IADB micro global 1	24,000,000	6,000,000	20.0%
Georgia (2001)	EBRD	Microfinance bank - micro	8,025,996	n.a.	n.a.
Indonesia (1996)	n.a.	Bank Rakyat Indonesia	Micro Loans Financed via Deposits		100%.
Paraguay (1999)	IADB	Micro global	22,200,000	2,800,000	11.2%
Peru (1998)	IADB	Micro global	27,750,000	11,900,000	30.0%
Peru (2001)	IADB	Micro global	30,000,000	12,860,000	30.0%
Russia (2001)	**EBRD**	**RSBF**	300,000,000	n.a.	n.a.

Source: Ariel Ventures, Inc.

[22] It is worth noting that IADB frequently requires that the Ministry of Economy or Finance incorporate a purposely-designed credit programme implementation unit if neither the Central Bank nor a state-owned Development Bank is deemed acceptable. In such cases, IADB technical cooperation includes training public sector officials in all aspects of credit programme implementation and monitoring.

BNDES, the Brazilian National Bank for Economic and Social Development has developed an additional incentive to encourage qualified FIs to actively serve the MSME market. For every 1 million *reais*[23] that is on-lent through an approved MSME programme, a partner bank may draw down 100,000 *reais* (10 per cent) to use at their own discretion for MSME lending.

The Russian financial crisis seriously hampered the ability of local banks to finance activities. Even today, when in the view of some commentators the Russian banking sector is stronger than it was before the crisis, banks generally lack medium-term rouble external funding. Nevertheless, some partner banks have been willing to lend to some extent from own funds to increase the MSE portfolios developed with the assistance of the RSBF. The evaluation team considers that the absence of the requirement for counterpart funding was a weakness in the design of the RSBF concept. A requirement after a certain time to commit at least a small amount of resource would mobilise additional funds for micro-lending and demonstrate the PBs' commitment, improving the prospects for programme sustainability.

4.2.2 Sustainability – staff retention and training

The RSBF provides thorough, expert credit training. Many of the basic tools and techniques are applicable to small business lending in general, making trainees a valuable commodity for participating banks. In fact, there appears to be a strong demand within the banking system for loan officers who have completed the RSBF training programme. There is still an insufficient number of well-trained bank staff in the sector, especially in the field of credit assessment. Retaining trained staff is an important concern. The incentive payment scheme is a step in the right direction. However, to the extent that it only applies to MSE credit officers, the possibility of friction with other PB staff members remains a threat. Furthermore, if other banks are luring staff away with higher salaries, it may be that RSBF credit officers receive too little income in the form of salary and too much linked to incentives. This is an area that should be monitored with some potential changes worth considering. The RSBF could require banks to reimburse all or part of the associated technical cooperation costs if an MSE credit officer is moved out of the MSE unit or leaves the bank before they have served at least a year. The banks, in turn, could give potential credit officers guaranteed positions (upon completion of credit training) in exchange for one or two-year commitments.

Appropriate training plays an important part in staff retention. Loan officers are trained within the programme on-the-job as well as attending training seminars. During the period 1999–2001, some 79 training seminars of varying lengths were held, attended by a total of 1,757 participants, for a total of 7,294 person/days of training. Russian credit experts contracted to work with the RSBF carry out the on-the-job training and participate in training seminars in addition to their normal supervisory and project implementation functions. In response to the programme's changing needs, the number of Russian credit experts hired has fallen from 30 in June 2002 (9 based in Moscow and 21 in the regions) to 21 in March 2003 (6 based in Moscow and 15 in the regions). In addition, PBs that are sufficiently advanced in the programme are encouraged to employ, at their own cost, a fully trained micro-credit expert to oversee MSE operations and provide for ongoing training needs. The evaluation team considers that this is an effective means of organising the training function, creating a body of specialists in the PBs possessing technical expertise combined with the skills required to cultivate local staff.

[23] Approximately US$ 433,000 as of 8 August 2002

Although outside the current scope of the RSBF, there is an opportunity to build a generation of trainers to work more widely with Russian banks to improve their understanding and practice of small business lending skills, not necessarily using the current methodology. To this end the Bank and donors may wish to consider setting up a stand-alone TC project to train the trainers, perhaps working with central or regional credit training agencies.

4.3 Institution building

The RSBF, which continues to lend to an increasing number of borrowers whilst maintaining very low arrears rates, clearly has found and/or developed certain strengths in dealing with partner institutions.

- Many partner bank branches in the regions have been enthusiastic participants in the RSBF;
- The creation of a specialised microfinance bank has had a significant positive effect on the RSBF's ability to lend to micro-enterprises;
- The market places a high value on RSBF credit training and to a lesser extent on RSBF credit policies and practices.

However, a number of limitations of the institutional development activities to date should also be flagged.

- Since the 1998 financial crisis, RSBF has depended in some regions on one lending channel which could not be replaced easily;
- While the recently-created specialised vehicle has proved successful at micro-lending, the question must be asked whether it can be considered a viable bank until it can develop more indigenous funding sources and a broader product line;
- Institutional development requires more than micro-lending credit policies and skills, but there is little evidence of a plan for adding other organisation development activities in the downscaling banks.

Partner bank loan agreements are specific to those institutions. It is in drafting these agreements that the EBRD has an opportunity to make individual diagnosis of technical cooperation needs and the prospects for counterpart funding. The regional banks have the potential to realise the true institutional development goals of the programme. With new regional banks joining the programme in 2002 and 2003, the scope for extending the demonstration effect of the RSBF is widened. As discussed below, the evaluation team considers that the introduction of some flexibility in certain aspects of the programme could widen its appeal to banks in the regions. The opportunities for the provision of counterpart funds by PBs should be investigated when assessing new PBs for admission to the programme. New entrants should be required to commit themselves in principle to the concept of counterpart funding, with due account taken of their liquidity position. Similarly, the opportunity to secure such commitments from existing PBs should be taken when extension of the EBRD's credit lines is being negotiated.

4.3.1 Management information systems

Even before the creation of regulated MFIs, micro-enterprise lending programmes struggled internationally to manage and present programme data in ways that met the needs of daily administration, donor concerns and strategic planning. The universe of micro-lending programmes consisted almost entirely of numerous, small not-for-profit organisations. Thus, while the need for customised software was great, the market characteristics were not sufficiently attractive to lure traditional software companies into developing and supporting micro-lending software. Every MFI uses software that has been customised, to a greater or lesser extent, to meet its specific requirements. While the software provided by the RSBF consultant may contain the same arrears alert features as other programmes, the platform (single user, desktop personal computers) is likely to be out of date.

One partner bank stated that the RSBF credit module, which is operated in isolation from its own MIS, is used only because it is a requirement of the programme. They would much prefer to be able to generate reports for the RSBF from within their own MIS. During PED's field visit, several PB branches stated that they carry out additional analysis of the RSBF data manually for their own purposes since the RSBF credit module is not capable of generating the reports that they require for local management. One PB is understood to have embarked on a major MIS development programme to overcome the processing and reporting limitations of the RSBF software.

RSBF interests may prove more useful in helping partner banks to identify the most appropriate software based on each bank's needs, circumstances and systems. As long as each bank can meet the programme reporting requirements, the RSBF should be indifferent as to which software package is used. Partner banks that have operating and reporting platforms that are not compatible with the RSBF software would be better off with a choice of alternative products. Further, some banks have different internal reporting and management priorities that might be served more effectively by using other MIS options.[24] The ability to exercise these options should be integrated within the RSBF framework. One partner bank, for example, does not use the software. Under current arrangements, this means that data from this bank is sometimes excluded from periodic RSBF reports. Nevertheless, imposing the software on this bank would be counterproductive on balance, as it would expose the bank to the limitations of a product that is not integrated with the bank's core system. A more effective solution would be to determine detailed reporting requirements from the participating banks to the RSBF while assisting the banks in developing the systems modifications necessary to provide the information.

4.3.2 Central micro-creditor database

One of the major issues in micro and small enterprise lending is information sharing. Given its database of information on more than 38,000 MSEs, the RSBF has the opportunity to create a centralised credit-reporting database. In Bolivia, when the onset of consumer lending led clients to take on multiple loans and fall into arrears, several MFIs banded together to create a lenders database that ultimately was adopted by the entire banking system. The database contained the names of all individuals with outstanding loans, together with the status (current, in arrears, in default) of loan repayments. The best MFIs used the system to bring arrears down and avoid over-extending credit.

In Brazil, the Commercial Association of São Paulo was the first to recognise the effect that information sharing had on entrepreneurs. To combat bad cheques, the Association developed

[24] Responses to the special study questionnaire illustrate the differences in bank practices. At one bank, regular site visits are of primary importance, while for others visits are given higher priority after a late payment has occurred. All of the banks monitor profitability, but at two partner banks, "use of proceeds" was the second most important loan monitoring priority although it is not tracked well by the RSBF software. At two banks "loan terms and conditions" were of prime concern and here too, customised software would be useful.

a database of credit information for individuals and businesses that interacted with its members. This system, Telecheque, is now in use throughout Brazil and is one of the most important credit reference sources available in the country.

In Peru, the Superintendency of Banks promised credit information but was extremely slow to update information. A private centralised micro-credit bureau was developed to encourage micro-lending by providing more timely information.

The RSBF could consider making use of the information it has developed. Creating a private credit information system with up-to-date information could have a strong and lasting impact on the Russian banking system and could significantly improve small enterprise access to loans of appropriate size and tenor. During PED's field visit it was observed that at least one RSBF regional office acts as an informal credit information agency for PB's who contact the RSBF office when they receive a fresh loan application to establish whether the applicant is known to the RSBF. In other words they check whether the applicant already has an RSBF loan with another bank. A more formal system would almost certainly benefit the RSBF and the sector.

4.3.3 Policy dialogue

Narrative reports on RSBF activities cite numerous examples of discussions with various bodies at the local and/or regional level (local governments, enterprise associations, large enterprises). Given the numerous legal, regulatory and fiscal policies cited by many sources as obstacles to small business growth and development, there is a clear need for RSBF to build and maintain its relationships with government (at all levels), enterprise associations, trade groups and so forth. It is primarily at the level of EBRD that RSBF interests can be considered together with general financial sector interests, transition objectives and so forth. The evaluation team notes that from late 2002 a member of the Bank's Group for Small Business has been assigned to coordinate policy dialogue in Russia on issues relating to microfinance.[25]

[25] It should also be noted that over a number of years the EBRD Office of the Chief Economist (OCE) and Office of the General Counsel (OGC) have led policy dialogue with the Russian authorities on various matters relating to SME development and finance. The operation team (OT) advises that the operation leader (OL) has also been active in a number of discussions.

5 Technical cooperation and the RSBF

5.1 Background

Technical cooperation (TC) was, and remains, a significant component of the RSBF. The TC operations have been in place since 1993 and, by late 2002, some US$ 76 million was spent on over 70 TC operations. As originally conceived, the main purpose of RSBF TC was to provide Russian financial institutions with a credit methodology appropriate to MSE lending, credit training to develop MSE loan officers and a software programme tailored to the realities of micro-finance. The deployment of technical cooperation has included some supervisory and management functions, among them programme monitoring and reporting, policy dialogue, determination of credit limits and the taking of credit decisions at newly entered bank branches. The use of TC funds has exceeded the original projections made at the outset of the programme. This is mainly due to the expansion of the programme, which has proved greater than expected, and the effects of the Russian financial crisis of 1998 which necessitated a costly but highly successful recovery effort resulting in higher TC spending.

> The RSBF has benefited from TC input in a variety of ways. Credit advisory services (CAS) are the single most important kind of TC input aiming at institution building through the provision of on-the-job training in credit methodology for loan officers at participating banks (PBs). Such training is delivered by on-site, TC-funded experts. In the early stages of the programme, another important use of TC input was to bridge the gap between the sub-borrowers and the PBs in terms of the sub-borrowers' ability to fulfil the requirements in order to obtain funds. Business advisory services (BAS), are also key in providing input of this nature, for example, assistance with business plan preparation and credit applications.

As the geographic expansion of the Programme has progressed and new cities and branches have been taken on, the TC input has continued. It is anticipated that the programme will require a diminishing rate of TC funding as Russian credit advisers and loan officers gradually become able to take on more responsibilities.

The manner in which RSBF technical cooperation is implemented does not permit calculation of the amount or the precise nature of TC provided to each bank, much less to any particular branch. Consultants are assigned to regions and work with a number of banks and bank branches at a time, but do not use a timesheet tracking system that would permit cost allocation by bank and/or branch. It is possible to develop some estimates of TC efficiency in the aggregate. However, no information is available to explore the ratios of TC funding to lending by bank or branch, TC funding per trained loan officer and so forth. Given the bank and branch level performance variations that can be perceived in the narrative reports submitted by the programme consultant, it appears that the RSBF is missing an opportunity to learn from its considerable TC expenditures.

5.2 Funding

The TC effort supporting the RSBF is funded from two main sources:
i) the RSBF TC Special Fund which is administered by the Bank, drawing resources from the G-7 countries;[26] and
ii) the EU Tacis programme under the "Bangkok Facility"[27].

[26] In October 1993, the Bank's Board approved the establishment of the Russian Small Business Investment Special Fund (RSBISF) and the Russia Small Business Technical Cooperation Fund (RSBTCF)

Different rules apply concerning extensions of contracts under the two sources of funding. RSBF funded contracts may be extended for up to five years without new tendering (provided that the consultant's performance is satisfactory and that further funding is secured). On the other hand, due to the regulations governing EU funded contracts, these may only be extended once and the extension may not exceed the original contract amount or duration (again provided that the consultant's performance is satisfactory and that further funding is secured). Some 81 per cent of the funding for completed TC operations and for billed work in progress as at December 2002 comes from the RSBF TC special fund with the balance (19 per cent) from the EU Tacis programme.[28]

The RSBF's semi-annual operation report for June 2002 highlighted that seeking additional funding from TC contributors is a crucial issue for the programme. Of the US$ 150 million increase in Bank funding approved in July 2001, US$ 50 million is contingent upon commitment of a further US$ 30 million by TC contributors to cover the cost of TC from 2002 to 2010. The use of TC resources is expected to continue at a reduced level, but long-term TC support is considered necessary to manage the RSBF in the field and to maintain quality control. The United States has pledged US$ 10 million to support the extension of the programme to 2010, adding to earlier US contributions of US$ 28.4 million for MSE finance and US$ 8.1 million for TC. In respect of TC funding, the USA has been the largest contributor to the RSBF, followed by the UK, France, Canada, Japan, Germany, Italy and Switzerland.

5.3 TC efficiency

5.3.1 Performance reporting

Within the Bank the performance of TC operations is normally evaluated through a project completion report (PCR), which the operation leader is prompted to prepare once a TC operation has been completed. There is a lack of consistency in the monitoring and reporting of RSBF TC assignments within the Bank. PCRs have been completed for five RSBF full-scale project TC operations funded by EU Tacis with one funded by the UK-EBRD technical cooperation fund. However, PCRs have not been prepared for the 38 assignments covering credit advisory, legal and other services under the full-scale project funded by the RSBF technical cooperation fund. Instead, the reporting on these assignments has been in the form of an operations report which OT produce bi-annually.[29]

The PCR contains five main sections:

(i) *Commitment details* such as commitment number, country, sector, amount and name of consultant;

(ii) *Objectives and tasks* and their level of achievement;

(iii) *Assessment of inputs* in the form of consultant's services, the Bank's performance and an evaluation of the consultant's work in terms of timeliness, organisation and execution of the task; and the consultant's overall compliance with the Terms of Reference; and

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[27] The European Commission agreed to provide the Bank with a grant from the EU-EBRD cooperation agreement, "Bangkok Facility" (EU Tacis programme) to finance TC assignments.

[28] In addition, in 1999, the supply of a strategic advisor to one PB in the aftermath of the previous year's financial crisis was funded by the UK-EBRD Technical Cooperation Fund.

[29] In addition, OT prepares periodic monitoring reports (MRs) as required by the credit department. The purpose of these is to assist in the assessment of the risks attached to the EBRD's credit lines to RSBF partner banks. Although the MRs include general comments on the availability of TC funding and transition impact, they do not address consultant performance.

(iv)	*Assessment of outputs* – commenting on donor visibility, the level of know-how transfer, sustainability and transition impact; and	
(v)	*Lessons learned.*	

The overall rating for TC operations in the PCR is*: Highly Successful*, *Successful*, *Partly Successful* and *Unsuccessful*.

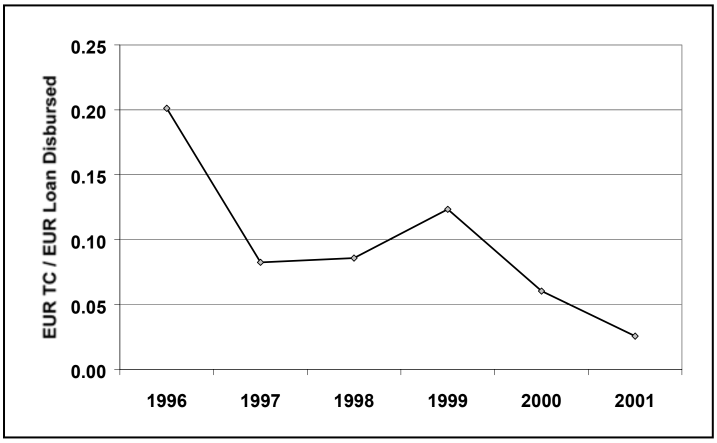
A member of the relevant operation team completes the standard PCR within the Bank. It therefore represents the Bank's assessment of the consultant's performance and adds valuable information and experience to the Bank's corporate memory to be used in designing future operations with the same or alternative consultants. A major benefit of the centralised reporting that the PCR system represents is that the experiences and lessons of operations are available outside the immediately responsible OT to other interested teams and departments in the Bank. The evaluation team understands that a request to design a new reporting format for TC operations under the RSBF has been approved by the Bank's Automation Steering Committee and that this would bring the level of reporting detail closer to the standard PCR. This affords an opportunity to achieve two related goals:

(i) enhanced reporting for internal management purposes; combined with
(ii) harmonisation with donor reporting requirements to avoid duplication.

Given the substantial overall TC spend, it would be informative to compare the TC resources consumed by different programme banks. The ability to make such comparisons would become increasingly valuable with the entry of new banks to the programme. An inter-branch comparison of TC utilisation within PBs would facilitate the planning of future TC needs, as would comparative data showing the amount of TC consumed by individual banks and branches in making them ready to graduate from the TC component of the programme. However, the data required for such comparisons is not readily available since the programme consultant has not been required to record time spent by its staff on working at, or with, individual banks and branches.

Using available data, other possible measures of global TC efficiency would be to compare TC spent with the volume of loans disbursed and loan officer productivity, as discussed in more detail below.

5.3.2 Quantitative performance assessment



While qualitatively the emphasis on building volume may have led to reduce emphasis being paid to institution building, in quantitative terms, one measure of the efficiency of a TC operation is to compare the amount of TC spent with the volume of loans disbursed. For the year 2001, the TC to Loan ratio of the RSBF was approximately 0.03, indicating that for every €1 disbursed approximately 3 cents were spent in TC. The available data therefore suggests that in 2001 there was a significantly higher return on TC expenditures than in previous years. This is to be welcomed. However, it must also be acknowledged that a figure of 3 cents of TC per €1 lent potentially represents an additional 3 per cent of cost that has not been recognised in the income statements of the beneficiary PBs. Moreover 3 per cent is an average across all banks and is likely to vary widely from bank to bank depending on the success of each bank in assimilating the principles of the programme and building its MSE portfolio. As indicated in the previous section, the information that would permit an accurate assessment of the full burden of cost represented by TC consumption by bank and branch is not available. Therefore, it is not possible to provide a realistic estimate of the costs that have to be absorbed at bank and branch level after graduating from TC.[30] In other words, the TC represents an in-kind subsidy, the cost of which should be taken into account in formulating the business plan of the microlending unit and in assessing its long-term commercial viability. (See also Section 4.1.5 above.)

5.3.3 Loan officer productivity

Another method of assessing the effectiveness of technical cooperation is to look at loan officer productivity. Table 9a below offers comparative numbers for programmes on several continents, including some programmes considered to be "best practitioners" of micro-lending, and a comparison of the performance of different kinds of micro-finance organisation in the CEE/NIS region.

Table 9a: Comparative loan officer productivity[31]
Sample of non-EBRD programmes

Country	Programme	Outstanding portfolio in US$	Loan officers	Active clients	Clients per loan officer
ABA (2000)	Egypt	14,200,000	175	23,653	135
Bolivia (2001)	Caja Los Andes	51,044,000	132	43,350	329
Brazil (1999)	Banco do Povo do SP	3,700,000	99	2,029	20
Brazil (1999)	CEAPE –Pernambuco	4,800,000	15	9,123	608
Brazil (1999)	CEAPE – Rio Grande N.	2,200,000	10	4,859	486
Brazil (1999)	Portosol - Porto Alegre	3,100,000	12	2,383	199
Colombia (2001)	WWB Cali	17,588,000	74	38,063	514
Dominican Republic (2000)	Banco Ademi	49,000,000	101	16,408	162
El Salvador (2001)	Financiera Calpia	31,216,000	103	36,318	352
Indonesia (2000)	Bank Rakyat Indonesia	1,700,000,000	4,664	2,500,000	536
Kyrgyz Republic (2000)	FINCA	2,100,000	122	18,210	149
Mexico (2001)	Compartamos	24,441,000	267	92,773	347
Poland (2001)	Fundusz Micro	9,803,965	72	9,405	131
Uganda (2000)	Centenary Bank	10,400,000	100	16,640	166
CEE/NIS Regional	NGOs	137,000,000	1,204	197,376	164
CEE/NIS Regional	Microfinance Banks	156,000,000	732	35,118	48
CEE/NIS Regional	**Commercial Banks**	**114,000,000**	**716**	**20,759**	**29**
CEE/NIS Regional	Credit Unions	400,000,000	11,029	1,830,824	166

Table 9b below looks at loan officer productivity across a number of EBRD supported programmes, including the RSBF.

[30] In discussion with PED, the programme consultant stated that it could be possible to estimate TC usage if PBs were able to draw on the memory of staff involved. Although this would provide an approximation at best, the evaluation team suggests that OT should consider instructing the consultant to carry out this exercise in order to provide some data for benchmarking purposes in future.

[31] Prepared by consultants involved in the special study from the following sources: MicroRate Online Database, Microfinance Network Online Database; Forster, Sarah and Pytkowska, Justyna (May 2002) *Initial findings of a regional mapping of microfinance in central and eastern Europe and NIS,* CGAP, OSI, and USAID.

Table 9b: Comparative loan officer productivity EBRD programmes 2002[32]

Country	Programme	Facility start date	Outstanding portfolio in US$	Loan officers	Active clients[33]	Clients per loan officer
Albania	FEFAD Bank	Jan-96	29,772,246	33	5,534	168
Bosnia	MEB	Nov-97	32,156,368	37	5,982	162
Kosovo	MEB	Feb-00	20,989,886	71	4,493	63
FR Yugoslavia	MFB	Apr-01	30,649,747	52	4,515	87
Bulgaria	ProCredit Bank	Oct-01	29,112,795	64	4,909	77
Romania	MIRO	Jan-00	10,589,825	31	2,591	84
Ukraine	UMLP	Sep-98	53,776,801	272	13,121	48
Moldova	MEC	Dec-99	4,184,328	32	1,111	35
Georgia	MBG	May-99	28,771,929	81	7,149	88
Kazakhstan	KSBP	May-98	73,386,089	273	17,411	64
Kyrgyz Republic	MSEFF	Apr-02	566,085	10	312	31
Uzbekistan	J-USBP	Apr-01	1,095,672	43	737	17
Russia	**RSBF**	**Aug-94**	**$194,290,327**	**531**	**33,762**	**63**

Tables 9a and b reveal that the performance of the RSBF does not yet match that of some other established programmes. However, this observation must be balanced by two important considerations:

(i) the RSBF has undergone a rapid expansion geographically and the constant addition of new outlets naturally reduces the overall programme average of "clients per loan officer";

(ii) consistently derived details of portfolio quality are not available for the non-EBRD programmes listed in Table 9a.

5.4 Overall assessment of TC performance

The RSBF programme has achieved rapid growth in loan numbers and volume and has maintained strong portfolio quality overall. For reasons discussed in this special study, it is considered that the growth may have been achieved to some degree at the expense of institutionalising the programme within PBs and, consequently, at the expense of sustainability. Allowance must be made for the effects of the 1998 financial crisis, the process of recovery from which effectively diverted TC funds that would otherwise have been used to further the direct aims of the programme. A further consequence of the crisis was that the RSBF lost PBs with branch networks that showed signs of responding well to the programme. The evaluation team considers that a rating of *Highly Successful* would be appropriate as regards TC performance in connection with the crisis recovery efforts. Swift action by OT and strong performance by the consultant enabled the programme to minimise, as far as possible, the financial and institutional effects of the crisis on the RSBF. However, the findings of this Special Study suggest that considerable work remains to be done to institutionalise the programme in the existing PBs. For this reason, the evaluation team assigns an overall rating of *Partly Successful* to the RSBF's use of TC to date. [41] TC effectiveness would be enhanced if PBs demonstrated commitment to the programme by providing counterpart funding. A further conclusion of this Special Study is that, provided sufficient attention is given to strengthening the institution building aspects of the RSBF, the TC component is capable of achieving a *Successful* to *Highly Successful* rating over the life of the programme.

[32] Extracted from the EBRD's internal documents.

[33] Number of loans outstanding

6 Transition impact and the Bank's additionality

6.1 Overall TI [34] (Rating: Satisfactory realised, with potential for Good to Excellent)

The *Transition impact retrospective companion paper* in 2001 developed a series of "event lines" to measure the transition progress in different sectors.[43] The main targets of the RSBF – the MSEs, are a subset of the SME sector and there are two points on the event line that form a basis by which to measure the programme's overall transition impact within this sector. The first of these is "Increased access to commercial finance". The RSBF has made debt finance at close to standard interest rates available to an increasing number of micro and small enterprises in over 100 Russian cities. The programme has provided TC support to acquire the necessary skills by training credit officers. The second relevant point on the SME sector event line is "Transfer of commercial skills to SMEs". With the run down of the business advisory and training component after the pilot project, the programme has not focused on the training of SME management. However, the programme has contributed to the development of a credit culture in borrowers, in some cases also introducing them to other banking services.

Through the RSBF the Bank has addressed the key transition challenge of making commercial finance available to MSEs (a subset of the SME sector), and has contributed to policy dialogue with a view to creating a conducive environment for MSE lending. The Bank has worked with a significant player in the sector and has created a significant new player, although the original programme design did not envisage the creation of a specialised micro-finance bank. In addition, the Bank is continuing to build smaller operations in the sector. The August 1998 crisis and the failure of a number of RSBF PBs disrupted the programme. The RSBF team pursued a clear and effective plan of recovery after the crisis. In the post-crisis years approximately 96 per cent of RSBF sub-loans have been generated through two banks. Following recent repayments by one PB of three RSBF credit lines totalling US$ 20 million, the allocation of funds for RSBF lending by branches has been scaled back. This is already reflected in the falling RSBF portfolio at this PB and in the cessation of the regional expansion of the programme through its branches. On the assumption that this bank intends to use RSBF-trained loan officers in ways that allow them to practice and disseminate the MSE lending skills they have acquired, while continuing to work with the RSBF target customer group, PED considers that an overall transition impact rating of *Satisfactory* (realised to date) can be applied to the RSBF contribution to promoting sector transition. If, however, this bank turns away from the RSBF customer group and MSE lending skills are dissipated, a rating of *Marginal* would be appropriate until the influence of the Programme can be re-established.

The results of the programme among sub-borrowers have been positive. This is confirmed by observations during the September 2002 field trip, described in more detail in Section 6.2 below. The institution building impact of the programme to date is assessed as *Marginal*.[35] Reasons for the *Marginal* rating are discussed in Section 6.3 below. The impact of the small equity component, which was only a small part of the original programme, is assessed as *Unsatisfactory*. The small equity funds were unable to identify a sufficient number of good quality investments.[36] A great deal of time has been invested in seeking to wind down the remaining investments to minimise losses.[37]

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[34] Ratings Scale: *Excellent, Good, Satisfactory, Marginal, Unsatisfactory, Negative*

[35] It should be mentioned that the 1998 crisis had a negative influence on institutional development as many of the banks participating in the programme at that time ceased trading.

[36] The SEEFs were restructured in 1999. A temporary fund manager was employed in 2001 to manage the process of closing the remaining SEEF investments.

[37] The business advisory and training component is not assessed. This component was run down when the pilot project was completed because there were already a number of agencies providing business advisory services.

The programme has the potential to achieve a *Good* to *Excellent* TI, but the risks in achieving this are assessed as *High*. The evaluation team highlights the following areas where the programme could achieve a higher rating:

Indicating a *Good* TI rating –

- removing obstacles to the institutionalisation of the programme thus facilitating continued expansion;
- identifying and recruiting new credit-worthy regional PBs to the programme;
- introducing the appropriate new programme features and technologies.

Indicating an *Excellent* TI rating, in addition to the above –

- encouraging partner banks to commit to funding MSE lending from other sources at a level, which is at least, equal to the funding provided by the programme.[38]

6.2 The programme's contributions to the structure and extent of markets (Rating: Good Realised)

The impact of the RSBF among end-borrowers and the communities in which they function is visible in the evident stimulation of competitive behaviour resulting from the financing of small and micro businesses. This confirms a finding of PED's earlier progress reviews of the RSBF (see Section 2.10 above). The PED field trip in September 2002 covered 13 towns in three regions outside Moscow.[39] During this field trip PED visited a total of 38 borrowers at their places of business and gathered ample evidence of RSBF-supported activity within several towns.[49]

As well as the visible evidence of business activity stimulated by RSBF funds, discussions with various participants during the field visit confirmed that in many cases the RSBF offered the only alternative to unofficial sources of finance for small borrowers. The manager of a PB branch in a small town reported that an unofficial small loan operation run by three individuals in the town charged interest at an annual rate in excess of 70 per cent. The director of a local government-sponsored Regional Small Business Support Fund confirmed that the only available sources for MSE finance apart from the RSBF, especially outside the regional centre, were family, friends and the black market. He commented, however, that businesses involved in production need three to five-year finance at least, which is a rather longer tenor than currently available from the RSBF. Nevertheless he praised the marketing efforts of one PB in particular, which had helped to educate potential borrowers who were not familiar with the disciplines that borrowing imposes. He stated also that he knew of two cases in the previous six months when a borrower took loans from two competing programme banks secured on a movable asset, then sold the asset and defaulted on the loans. He would like the EBRD to encourage banks to exchange credit information on borrowers. It should be noted, however, that several branch managers commented to PED that they regularly contact the RSBF regional office as part of their checks on new borrowers to establish whether the applicant is already known to the RSBF. This suggests that a more formalised credit bureau system could benefit the programme and participating banks. In two regions various interviewees confirmed that, although some local banks were interested in the MSE market, the RSBF for the time being offered the only official source of finance.

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[38] It should be noted that some of the PBs that failed after the 1998 financial crisis had begun to apply non-RSBF funds to MSE lending using the programme methodology.

[39] In addition senior evaluation managers took the opportunity afforded by trips to two other cities to visit PBs and programme borrowers in those areas and reported their findings to the evaluation team.

The field trip also revealed evidence of client growth facilitated by RSBF financing. Some borrowers engaged in trading have taken loans to enable them to enlarge the scale of their activities. This frequently entails moving to more formal or larger premises, adding new outlets, and/or expanding the range and type of goods traded. This also leads to the creation of employment by hiring staff. In the regional Russian environment the jobs thus created, although relatively low-level, are more frequently filled by unemployed adults than by those moving from other jobs. In a number of cases, traders can be seen to be managing some of the risk of growth by diversifying into different types of product. In other cases, especially in the food sector, borrowers who started in business buying for resale have moved or are planning to move into production.

> **Example of small business growth**
> A striking example was a producer of convenience foods who had begun trading in foodstuffs and then borrowed to invest in the purchase of an imported machine. Production had begun manually about four years ago. Although the 40 people involved in manual production was reduced to 10 after the machine was installed, staff numbers overall had grown to 150 by expanding the product range, setting up a distribution network with four refrigerated trucks and opening retail outlets. The production premises were clean with modern equipment. The owner expected further rapid growth and had invested in a new system that cut the time for freezing the product from 24 hours to 30 minutes while at the same time enhancing quality.

On the basis of these, and other ‘verifiable examples’, the evaluation team concludes that the RSBF has contributed to the increase in private sector activity in the areas where the programme is active. The evidence of the field visit suggests also that the impact on market structure at the MSE level has been significant. Many borrowers are operating in an environment with few competitors and therefore any increase in activity facilitated by RSBF finance will encourage competitors and others who have not yet entered the market. In terms of a transition objective set when the full-scale operation was approved in 1995, the programme has been successful as it has introduced new products into the Russian financial sector and in doing so reached a target group that has not previously had access to bank finance.

6.3 The programme’s contributions to institutions and policies that support markets (Rating: Marginal Realised)

A second transition objective stated at the approval of the full-scale project was to contribute to institution building within the Russian financial sector by providing training and technical assistance to banks that would develop the long-term capability to provide small and micro firms with formal sector finance.

Post-crisis, the Bank has had one major downscaling partner in the RSBF, and two smaller partners. However, the major partner at head office level has not yet committed itself wholeheartedly to the programme consultant’s lending methodology. By contrast, many, but not all, of the local branches visited during the field trip expressed enthusiasm for the programme, which was reflected in their MSE portfolios. Nevertheless, at head office this particular bank considers its role in the RSBF to be that of agent for the EBRD. Under this interpretation, it is not willing to provide counterpart funding to finance lending using the RSBF methodology.

6.4 The programme’s contributions to market-based behaviour patterns, skills and innovation (Rating: Marginal to Good)

6.4.1 Transfer and dispersion of skills

Between 1999 and 2001 over 1,700 participants attended 79 RSBF seminars with significant attention being paid to credit analysis and information system skills. In 2002 in the region of 520 trained loan officers participated in the programme at PBs. While some loan officers will have attended more than one seminar, the figures suggest that a number of individuals who have received some credit training either did not complete the course, or have subsequently moved on. In some cases this was because of inadequate performance. Interviews conducted during the field trip confirmed that programme trainees are a valuable commodity for PBs and in the market, although the demand for these skills outside the RSBF varies considerably from region to region and from town to town. Other banks, not participating in the programme, are known to have recruited staff from RSBF-trained personnel. Among these are banks that are believed to be preparing to make an entry into the market for micro-credit. Therefore. it is reasonable to conclude that there has been some dispersion of skills beyond the programme's PBs.

6.4.2 Demonstration effects

During the field visit it became apparent from discussions held in many of the towns visited that some local banks were watching the development of the programme with interest. This was most evident in locations where two or more programme participants were competing for MSE business. It was less evident in a region where there is currently only one programme lender. In a number of locations it was reported that other banks were cold-calling selected RSBF borrowers to offer loans on more favourable terms. This perhaps unwelcome form of flattery can be seen as an endorsement of the programme's training in credit skills since some other banks seemed willing to lend to existing RSBF borrowers ("small" rather than "micro") on the basis that they have already undergone an RSBF credit assessment, and did not require further analysis.

6.4.3 Corporate governance and business conduct

The programme may appear to be pulling in two opposing directions as regards regulating the activities of borrowers who currently operate in the informal economy. On the one hand, where a new borrower is introduced through the act of borrowing to the banking system, this may signal a move in the direction of improved business conduct and corporate citizenship. This will be the case if a growing business that has previously, for example, kept out of sight of the tax authorities, is motivated to legitimise its business activity. Frequently, taking a first bank loan will indicate the borrower's acceptance of the need for greater disclosure and transparency than previously. On the other hand, the RSBF has attempted through policy dialogue to gain approval for the issue of loans of under US$ 10,000 equivalent to unincorporated sole traders in cash without opening a bank account.[40] If this approval is granted, it should widen the market for mirco-lending by PB's and, potentially, enable a larger number of loans to be disbursed. In sound banking terms there is no reason for not making loans in cash provided the credit screening criteria are met. However, the evaluation team considers that the transition impact goal would be better served by encouraging small borrowers without bank accounts to become users of banking services.

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[40] Under Central Bank regulations, business loans must be disbursed to the bank account of the business. However, sole traders are not obliged to operate a bank account.

Much of the success of the RSBF has been measured in terms of speed of disbursement and volume of new business. Almost inevitably, this has been accompanied by some instances of fraudulent behaviour. In response to PED enquiries, the RSBF programme management team disclosed details of three cases of fraud in the RSBF programme. In two cases the frauds appear to have been on a relatively small scale (involving five and two micro-loans respectively) and carried out by loan officers with connected parties or acquaintances. Swift action appears to have been taken to deal with these instances. It would not be reasonable to expect large scale lending activity over a wide geographical area to proceed entirely without attempts at fraud. In the third case reported to PED, however, the circumstances suggest that features of the programme may have helped create conditions that enabled the fraud to succeed. It is possible that the relative isolation of the programme from other branch activities led to reduced vigilance in the oversight of the MSE lending department at the branch concerned. It is also possible that the operation of a separate record system installed for RSBF lending created more favourable conditions for the perpetration of the fraud. If the installation of a stand-alone credit module, not integrated with the branch's main system, is made a condition of participation in the programme, then the programme should ensure that effective reconciliation procedures are in place to prevent deliberate or accidental errors in one system or the other.

6.5 Environmental aspects

As part of EBRD's environmental due diligence of the RSBF programme, PB's are to:

1) receive environmental training;
2) develop their own environmental policies and procedures; and
3) incorporate the EBRD's environmental exclusion lists into their procedures.

Staff in the EBRD's Environment Department (ED) conducted periodic site visits to PB's. Over 80 per cent by number of RSBF loans are self-assessed and recorded in the 'low' risk environmental category. Less than 1 per cent by number are rated 'high' risk and fall mostly within the waste and water management category. High-risk projects must be forwarded to the EBRD for ED review and approval prior to the PB investing. PBs must observe environmental procedures as set out in the RSBF policy statement. ED has noted that the quality of environmental reporting by the RSBF team could serve as an example for other framework facilities. However, a sign of some complacency was revealed during a visit to a PB branch in one city.[41] A supplier of building materials with an RSBF loan was trading in products manufactured from asbestos, in violation of the Bank's exclusion list. The regional RSBF representative knew of the exclusion list, but was surprised that this business included trading in asbestos products. The loan officer at the local bank branch had not received training on environmental issues and took the view that companies engaged in trading and sales activities did not have any environmental issues.

As the number of programme outlets expands, the task of training participants at each level in compliance with the Bank's environmental policies will become more complex and demanding. In PED'S view, the RSBF should consider appointing a trained environmental specialist to its team in Russia to provide ongoing training and support and to facilitate monitoring.

6.6 The Bank's additionality

[41] Two senior evaluation managers, one of them an environmental specialist, took the opportunity afforded by a trip to the city on other business to visit a partner bank branch there and some sub-borrowers.

Funding for MSE finance on standard commercial terms was not available from other official sources and continues to be in short supply. The programme continues to be highly beneficial in this area.

7 Overall assessment of programme performance

On the basis of its independent review, PED assigns an overall assessment rating of *Partly Successful* to the RSBF programme as evidenced by performance to date.[42] This rating reflects the success of the programme in achieving growth in loan numbers and volume, particularly in the period after the 1998 crisis, and the high quality of the sub-loan portfolio. However, there is as yet insufficient indication that the programme has been implemented in a manner that will prove to be sustainable. The final proof of sustainability will emerge only when the programme has been completed and the present intention of the Bank and contributors is to continue the RSBF at least until 2010. Nevertheless, an attempt can and should be made now to assess the extent of progress made, in order to achieve the desired goals by the end date. A key measure is in institutionalising the programme's basic principles within the PBs. One PB in particular has refused to commit to the programme at head office level and has repaid to the Bank US$ 20 million of US$ 50 million advanced for programme lending. While the long-term position of this partner remains to be clarified in negotiations, the resulting uncertainty in the interim threatens the achievements of the programme to date both within that bank, and among micro-entrepreneurs, especially in the towns where it is currently the programme's only channel of distribution. In the downscaling banks, an indication that sustainability is likely to be achieved would be growth of MSE lending supported by counterpart finance. As a precursor to this, PBs need to regard MSE lending as a profit centre alongside other products and activities. A start has been made with some introduction of contribution analysis by the programme consultants. However, further refinements are needed and targeted TC input may be required to give PB management the skills to cost out MSE lending as a product line. PBs would also benefit potentially from some flexibility in programme design to be able to respond to local market conditions in their region, subject always to adherence to sound banking principles. If the programme achieves its institution building objectives, the RSBF has the potential to achieve a *Successful* or *Highly Successful* performance rating over its remaining life.

PED assigns a rating of *Partly Successful* to the overall performance of TC within the RSBF to date. The programme has achieved rapid growth in loan numbers and volume and has maintained strong portfolio quality overall. However, it is considered that this growth may have been achieved to some degree at the expense of institutionalisation of the Programme in PBs and, consequently, sustainability. In addition, the Special Study findings indicate that TC resources should be used to make appropriate changes to the lending methodology and transfer the skills necessary to encourage a higher proportion of lending to production enterprises. It is recognised that the distribution of borrowers among production, service and trading activities will vary from region to region. In some, particularly remote areas, small-scale trading activities are likely to predominate until a production base begins to be formed. Changes to the methodology must always be subject to the requirements of sound banking and are dependent on adequate staff training and capacity. It is considered that the TC component is capable of achieving a *Successful* to *Highly Successful* rating over the life of the programme.

Transition impact is an important factor in determining the overall performance to date. Section 6 explains the overall transition impact rating of *Satisfactory* with potential to achieve *Good* to *Excellent* depending on the future progress of institution building. The visible evidence that the programme has contributed to the increase in the small scale entrepreneurial

[42] The following classifications are possible: *Highly Successful, Successful, Partly Successful, Unsuccessful*

activity signals a sound foundation for the broader and more lasting transition goal of embedding sound micro-lending skills in local banks. This should be combined with more attention to production micro-enterprises.

8 Key issues and recommendations

8.1 RSBF strategy and plan of action

The RSBF programme faces a number of challenges, in particular:

- reducing dependency on a single consultant;
- exploring changes to the current methodology and the potential for additional distribution channels;
- embedding MSE lending in downscaling banks and encouraging counterpart finance;
- securing additional donor funding for TC.

Recommendation
To address these challenges, the programme would benefit from a reappraisal and restatement of its strategic purpose and an action plan designed to ensure that the programme remains on course to achieve its strategic goals. The action plan should include a business plan setting targets for achieving institution building goals in each downscaling bank in addition to loan numbers and volumes.

8.2 Programme management

A large number of management functions in relation to the RSBF are performed by the programme consultants. Programme management, monitoring and reporting to the Group for Small Business are carried out at the RSBF Moscow office and maintained by the programme consultant. Currently no member of the Bank's management or staff is allocated full time to the Programme, whereas the evaluation team understands that in the early years of the programme up to three EBRD staff were engaged full-time on the RSBF. Pressure on the Group for Small Business has grown with the rapid expansion of the Bank's investments in microfinance institutions in other countries of operations.

Recommendation
It is recommended EBRD reviews the range of tasks and functions currently outsourced to consultants in order to identify those tasks and functions that could be returned directly to the Bank's control. The Bank should also consider a full review of the management resources allocated to the programme. It is important to note that a member of the Bank's staff has recently been assigned to coordinate policy dialogue relating to the MSE sector in Russia.

8.3 TC monitoring

At present the time spent by RSBF consultants on individual banks and branches is not recorded. It has therefore been impossible to compare the levels of TC input consumed by different banks or branches within the programme. It has also not been possible to quantify the TC consumption of PBs and branches with a view to calculating profitability on a full-cost basis. In the evaluation team's view, this information is required to assess realistically the sustainability of MSE lending at individual banks and branches. The operation team has argued in discussion that proxy measures are used to provide adequate information for performance monitoring.[43] The evaluation team acknowledges the value of the proxy measures used, but considers that the full recording of TC funded consulting inputs would

[43] Examples of proxy measures in use are: loans disbursed, outstanding portfolio, arrears, repeat clients, loan officer productivity.

enhance the quality and usefulness of management information as well as providing the basis for costing the value of the in-kind subsidy represented by TC. In particular this would provide a more informed view of progress by banks and branches towards graduation from the programme, improving the allocation of TC resources.

Recommendation
The absence of records of time spent by consultants with individual banks and branches is a deficiency in management information that hinders comparison of the performance of individual banks and branches within banks, as well as comparison of the performance of individual consultants. Therefore the Bank is recommended to encourage consultants to record the time spent with RSBF partner banks so that the EBRD can enhance performance monitoring (of consultants and partner banks). It is noted that, whether one consulting firm is working with several banks or branches, or whether more than one firm is involved, the monitoring of consultant time input is essential for performance assessment and costing purposes.

8.4 Diversifying methodologies and improving systems

In discussion with the evaluation team several banks and branches complained of lack of flexibility in the lending methodology imposed by the RSBF programme. For example, some believed that MSE loans would be more attractive if the programme introduced repayment schedules to reflect a borrower's particular circumstances, for example by granting brief capital repayment holidays or structuring unequal repayments to accommodate the seasonal nature of some businesses. (N.B. Bullet repayments are not considered appropriate and the offer of flexible structures could be restricted to repeat borrowers with a good repayment record.) The rigid structure of the current RSBF programme may be a deterrent both to potential banks and their customers thereby limiting the outreach of the programme, and its ability to reach small-scale production enterprises. There are already signs of banks outside the programme showing interest in the MSE market. Therefore growth of the MSE loan portfolios of downscaling PBs may be constrained by the programme's unnecessarily rigid structure in an increasingly competitive environment. The evaluation team recognises that the software the programme provides to PBs is designed to capture and record transactions whose structure follows the parameters set by the methodology. This in itself restricts flexibility on loan terms and repayment conditions. It also leads to duplication of work when basic data has to be input twice with the attendant danger of input errors and requirement for additional control procedures. During the field trip, complaints were heard about the duplication of data input, and about the limited reporting capabilities of the software necessitating manual analysis of data to satisfy the requirements of local management. It is noted that one PB is working on a software solution to overcome the limitations of the existing system.

Recommendation
PED makes the following recommendations:

- The programme's lending methodology should be reviewed with a view to incorporating changes in the methodology to attract a greater proportion of sound borrowers engaged in production activities.
- The EBRD should continue dialogue with NGOs operating in Russia in that the Bank can identify reliable NGO partners with whom they can work to expand the range of distribution channels for the programme.

- The PB’s within the programme should be permitted to tailor MSE loan products to meet the requirements of borrowers and the local competition, while continuing to observe sound banking principles.
- The RSBF should, instead of imposing software on PBs, define the reporting requirements of programme management that they will need to satisfy. Necessary additional technical assistance should be offered to PBs on a cost-sharing basis to enable them to integrate RSBF reporting with their existing systems or to select a suitable alternative MIS product. It is noted that this may, given time, lessen the degree of dependency on a single consulting firm and facilitate the introduction of other suitable consultants when identified.

8.5 Commercial sustainability

Key to the commercial sustainability of MSE lending is the profitability of the exercise. In the case of downscaling operations, PB management will need to be able to allocate costs and revenues to the MSE portfolio on a reasonable basis. PBs will also need to consider the opportunity costs that arise from committing resources to MSE lending that could be applied to alternative products. Failure to treat the MSE unit as a profit centre is likely to mean that resource allocation does not reach its optimum level. This may in turn result either in the failure to recognise the full profit earning potential of MSE lending or in the cross-subsidisation of MSE lending costs by earnings from other activities.

Recommendation

- To date the performance of the downscaling programmes in PBs has been measured primarily in terms of loan numbers and volumes. Attention should be given to assessing the profitability of MSE lending operations in PBs on a full cost basis taking account of the cost of TC inputs. The scope of TC should be extended to include targeted technical assistance to enable PBs to cost out their product lines. The introduction of cost sharing with PBs should be considered for targeted assistance of this nature.
- To assist in gauging PB progress towards sustainability of MSE lending, *pro forma* financials could be developed to track the earnings of downscaling banks on their RSBF portfolios, offset by the full cost of the in-kind subsidy represented by TC including consultant input.

Management response to the RSBF Special Study

The Bank's management thanks the project evaluation department (PED) for its report on the Russia Small Business Fund. It notes PED has rated the RSBF "*Partly Successful*" while also acknowledging RSBF's potential to become *"Successful"* over its remaining life.

The Bank's management would like to comment on certain aspects of the report. Some additional observations from the Office of the Chief Economist (OCE) are also outlined.

The objectives set for RSBF at its inception were first to provide micro and small enterprises with commercially-based finance and second to do this on a financially sustainable basis by institutionalising the programme within participating banks.

The performance against the first objective has been well acknowledged in the report in terms of number and volume of loans granted to SME's and micro enterprises. Despite the 1998 Russian financial crisis, 120,000 loans have been made with a 1 per cent arrears rate.

As regards the limited achievement to date of the second objective, we believe the following should be highlighted.

The crisis of August 1998 decimated the Russian banking system. At that time RSBF had 14 participating banks in the programme. All but three of the partner banks failed in the aftermath of the crisis. The resuscitation of the banking system has been painfully slow and the difficulty has been to find institutions that adhere to sound banking principles and are interested in MSME. Only now are candidates emerging as evidenced by the recent addition of three banks to the programme.

Faced with this reality the Bank pursued the following three objectives:

(i) Establishment of a dedicated MSME institution to demonstrate the sustainability of commercial microfinance.

(ii) Continuing to work with the dominant provider of financial services to the Russian economy. This partner bank has demonstrably increased its commitment to the MSME sector in recent years which management believes is at least, in part, due to engagement with RSBF. The partner bank is looking to consolidate and expand these activities.

The failure of this partner bank to fully adopt RSBF lending methodology in its lending to small and micro businesses with its own resources is no reflection on the RSBF, its lending methodology or the partner banks. It is expected that the optimal microfinance methodology for a stand-alone, microfinance and small business financial institution (and all other similar banks and lending institutions) would be quite different from that of a microfinance unit/department of a bank with a much wider portfolio of borrowers and financial instruments.

(iii) Collect monies from failed banks. The report points to significant success in achieving this objective.

Although institution building is taking longer than originally anticipated this is due to the banking failures post-August 1998 and does not reflect inattention to this important objective or ill design. In this context the special study insufficiently describes the scope of institution building achieved prior and post the financial crisis. Especially the human capital and skills developed via the RSBF and the small business departments, so far built in 119 towns and cities, are understated in the study.

It is far too soon to expect a conclusive verdict on the financial sustainability of micro and SME financing activities in Russia. Less than five years have passed since the onset of the Russian crisis and the kind of economy-wide institutional development and structural reform required to give profitable SME and microfinancing a chance, is likely to take not years, but decades. Even in the most advanced industrial and financial nations of western Europe and North America, there is continued subsidisation of certain forms of SME finance. Much more time and much more patience is needed.

An area where management would dispute the findings of the report relate to the dependency on a single consultant. This subject bas been addressed on a number of occasions, most recently at the EBRD's Financial and Operations Policies Committee (FOPC) on 13 February 2003. The conclusion of this was to acknowledge the potential problems of dependency on a single service provider but, moreover, to acknowledge the overriding imperative of compliance with the Bank's procurement rules i.e. the consultant has repeatedly bid for EBRD contracts and has been selected based on their technical competence and financial acceptability. To compromise this principle would undoubtedly benefit other consultants but sub-optimise the use of donor funding and the effectiveness of the RSBF.

Additional comments raised by the EBRD Office of the Chief Economist (OCE)

- The PED Study argues that the methodology as currently implemented discriminates against small-scale production enterprises. We do not concur with this view. The fact that few loans to production enterprises have been made does not constitute evidence of either a bias against lending to production units or of lower lender competence in lending to production enterprises.

  What we are seeing in the data is a reflection of (a) the technological fact that the minimum efficient scale of many (but by no means all) manufacturing activities is larger than that of most (but by no means all) service activities and (b) the usual lifecycle of entrepreneurship and enterprise in the poorer regions of Russia (and other transition economies). Typically, budding micro entrepreneurs start by borrowing (very) small amounts as working capital and seed money for trading and other service activities, using just their own labour and that of close relatives. If these early trading and other service activities are successful, the entrepreneur may graduate to setting up a small workshop, employing a few more people, some from outside the immediate family. If this too works out, the productive activities may be expanded to the point that they can be described as manufacturing. We would expect to see this entrepreneurial evolution to be reflected in the composition of micro and SME lending institutions as they mature and there is indeed evidence of that. This is not a process that should be artificially hurried along. The same commercial risk and return considerations should be applied to both lending to services and lending to production enterprises. OCE and PED agree that the transition impact potential and risk associated with making tangible things is neither inherently greater than, or smaller than, that of making intangible things (services). A well-functioning economy will need finance for both kinds of activities. Each is essential to the other's success.

- OCE believes that the employment created or maintained through SME and microfinance is a significant part of the transition impact of this activity. While the determination of a proper counterfactual or control ("what would have happened to employment in the absence of the RSBF?) makes a definitive and non-contestable assessment of the employment creating effect of SME and micro finance extremely difficult, if not impossible, it is important that future evaluations of this and other SME/microfinance programmes provide a full, descriptive accounting of the employment performance of those firms that benefited from SME and micro finance.

- Finally, the key political and social contribution of SME and microfinance should be recognised, even if it cannot be quantified. This is the creation and support of a Mittelstand without which democracy and the rule of law have thrived nowhere.

- Evaluating the RSBF's transition impact at this point in the life of the project falls right in the middle of OCE ex-ante or pre-natal assessment and PED's ex-post or post-mortem assessment. From where we stand we view the realised transition impact as *Good*. Not *Excellent*, because financial sustainability has not been achieved and remains an open question. Looking forward, the transition impact potential would be *Excellent.* This would be realised if the scope of activities continued to expand at its recent rate and if financial sustainability were to be achieved. The risk to this further potential being realised is, however, high because we cannot be confident that financial sustainability will ever be achieved.