SME line of credit to commercial banks
Summary of the Operation Performance Evaluation Review (OPER)
March 2003

Project description
In December 1996 the EBRD approved a loan facility to private banks in an early transition country for on-lending to small and medium-sized enterprises (SMEs). The credit line was extended directly to participating banks (PBs) developing sound banking principles. EBRD consultants assessed the private sector’s demand for credit and reviewed potential PBs, whilst also assisting them with institution-building programmes. A review of ten banks resulted in the selection of five candidates for the project. As part of the ongoing TC component of the project, each PB benefited from the assistance of resident advisers and short-term experts in specialised areas such as marketing, asset/liability management, internal audit, MIS and IT systems, personnel management and budgeting. The EBRD also requested a sovereign guarantee as the PBs had small capital bases and lacked a track record.

Project rationale and achievement of objectives
The project was designed to address the lack of financing for SMEs and strengthen the banks’ credit skills, enabling support for viable sub-projects. Within the market, there was a high level of demand for hard currency financing, despite the relative stability of the national currency, due to the import of new machinery and other inputs for production. The project had a clear rationale, embracing PBs (and their sub-borrowers), the National Bank and the Ministry of Finance. The project contained significant initiatives to support the country’s transition to a market-based economy, providing finance for the emerging private sector and supporting the development of the domestic banking system. By making the loans directly to the PBs, rather than under an APEX structure, the project allowed the EBRD to build more direct relationships with the PBs and has discouraged interference from government organs in credit decisions. The overall fulfilment of objectives was rated Good. One PB has continued to develop into a strong bank, attracting international investors. A second bank has performed relatively well and has developed an active micro-lending programme utilising, in part, funds made available under the current project. A third PB has taken steps to strengthen its management team by recruiting experienced staff. Although this bank still needs to improve the quality of its loan portfolio and credit skills, its performance has improved in terms of profitability and liquidity. Two PBs, however, have been placed in administration and the EBRD’s loans to these two banks under the credit line are being repaid under the terms of the sovereign guarantee. Despite this, the OPER Team believes the project warrants a Good rating for the achievement of its objectives due to its broad reach to the real economy through the successful banks, and because of the lessons learned by the national authorities and the sector from the failed banks.

OVERALL ASSESSMENT
PED has assigned a rating of Partly Successful to the project. The bankruptcy of two out of the five participating banks, in spite of a Good transition impact rating for the project as a whole, is the main justification for the Partly Successful overall rating.

Transition impact and the Bank’s additionality
PED has assigned a transition impact rating of Good to this project, which contributed to the improvement of management and credit skills in three private banks. When the project was conceived, former state-owned banks dominated the banking system. Following its implementation, competition has increased within the sector. While two of the PBs taking part in the project failed, this was due to fraud, poor management and lack of appropriate action by the regulator. The OPER Team has noted the innovative method of financing TC both from donor funds and from contributions by private sector PBs through the technical assistance component in the loan margin. The wide reach of the credit line among sub-borrowers, including the issue of new loans out of recycled payments, further justifies the Good transition impact rating. This rating has the potential to become excellent if the lessons of the two bankruptcies are taken fully on board by the sector and its regulators. In the OPER Team’s assessment there is medium risk of long-term transition impact not being achieved due to possible political interference in the banking sector in the future, perhaps following a period of political and economic
turbulence. This risk will remain until sound banking practices and competent, confident regulation have been sufficiently institutionalised within the sector and in the government. When the first loan agreements under the credit line were signed, there were no other foreign lenders willing to provide SME finance through local banks. Long-term financing remains scarce and funding is mostly short-term. In designing TC to provide the National Bank with supervision assistance, the EBRD was careful to ensure that consultants coordinated their activities with other IFI and donor-funded programmes so that the assistance provided by the EBRD was complementary and additional to other initiatives.

**Bank handling**
The evolution of this project’s design demonstrated flexibility and responsiveness to the banking environment. Further strong handling was shown during the subsequent period of economic turbulence and in guiding PBs, the National Bank and the Ministry of Finance through the aftermath of two bank failures. For these reasons, the OPER Team has assessed overall bank handling as *Good*.

**LESSONS LEARNED**

Wherever reasonable the EBRD should negotiate access to specific information necessary to verify the condition of client balance sheet items on an ongoing basis. This is particularly important where reliance cannot be placed on the conclusions of external auditors because of underdeveloped audit skills in the local environment. While the loan agreements in this case provided for extensive access to information, loan agreements, where appropriate, should provide also for right of access to certain specific information and records in addition to the standard provisions on access. The scope of the provisions should be determined on a case-by-case basis having regard to the Bank’s previous experience in the local environment and any constraints imposed on disclosure by local legislation or regulation. In the present case, for example, such additional provisions could have included requests for:

- details of the loan portfolio, including large exposures and related party lending;
- access to credit files;
- cashbook entries and documentation verifying loan advances and repayments;
- documentary evidence of interbank transfers to substantiate interbank deposit.

It should be remembered that in some jurisdictions which otherwise do not permit disclosure, access to information is permissible if agreed upon in writing beforehand by the parties to an agreement.

Maintaining regular dialogue with different government departments and regulatory bodies is a useful tool in the process of educating legislators and administrators in good practice and business standards. It may not be possible for the Bank to ensure full transparency of operations of local institutions in an environment which generally does not welcome such transparency. Nevertheless the present case demonstrates the value of frequent, ongoing contact and dialogue, both formal and informal, with the authorities. The use of opportunities for dialogue to convey messages about sound governance and business conduct is a potent catalyst in the transition process.

The EBRD should continue to enhance the level of sector skills and experience in ROs, especially in early and intermediate transition countries. Sector skills, combined with local knowledge and proximity to the environment can improve monitoring, assist business relationships and facilitate policy dialogue with the authorities.

Making provision for liquidity sweeps in loan agreements to banking sector intermediaries can mitigate the risk of EBRD funds being used for unapproved purposes. The utilisation of EBRD funds to flatter a local bank’s liquidity position, or for the purchase of non-loan assets, increases credit and reputational risk for the Bank. The EBRD should ensure that liquidity sweeps are included in loan documentation in high-risk environments, so that repayments by sub-borrowers which are not recycled can be used to amortise the Bank’s loan if necessary. Such provision is particularly important where, as in the present case, the term of the Bank’s loans significantly exceeds the tenor of sub-loans.

Financial and operational covenants should be designed on a case-by-case basis to encourage the development of sound banking practices over time. As shown with this project, the careful design of covenants on such matters as portfolio concentration, related party lending limits and prudential bank
ratios can improve local management’s understanding of banking risks and provide management with a useful additional tool for performance monitoring and business planning.

The EBRD should be flexible and responsive when a client bank shows an aptitude for, and interest in, developing a product that is consistent with the Bank’s broader transition objectives. By agreeing in such circumstances to amend loan documentation, the Bank can encourage the evolution of the client bank, while simultaneously extending the reach of the project, in this case, to the micro and small enterprise sector.

During the appraisal stage, the capacity of local environmental authorities to enforce environmental laws and regulations should be assessed. Where capacity is recognised to be weak, the Bank should consider teaming up with other multilateral or bilateral agencies, or use available TC funding, to boost local agency capacity. Where capacity is assessed as strong, it may be appropriate for the EBRD’s Environmental Department to consider reducing the level of monitoring of projects within that jurisdiction to maximise the effective use of its own resources.

Consider encouraging PBs to contract for environmental services locally to review SME subprojects. Where appropriate skills and services are available in the local market, some encouragement should be given by the EBRD to PBs to enlist their services in optimising the environmental aspects of sub-borrowers’ activities. The Bank, in fostering such an approach, can help PBs acknowledge the environmental liabilities that may attach to their SME lending activities. Additional potential benefits include enhanced reputation for the PB and sub-borrower and, for example through cleaner production and pollution prevention, increased profits for the sub-borrower.