

Evaluation of a micro lending operation

Summary of the Operation Performance Evaluation Review

October 2007

THE PROJECT

The project is a framework facility whereby the European Bank for Reconstruction and Development (EBRD) made available funds to partner banks for on-lending to micro and small enterprises (MSEs).

The project comprised two stages: a pilot phase, during which the partner banks lent to MSEs using their own sources, followed by the full-scale operation in which the partner banks financed MSE lending from the EBRD's credit lines instead of their own funds. The project was approved by the EBRD in May 2002 and the Bank's credit line of up to US\$ 20 million was made available to partner banks. Consultancy services for capacity building were provided to the partner banks from January 2001 to July 2006 under a US\$ 5 million technical cooperation (TC) grant financed by the Japan-Europe Cooperation Fund.

PROJECT RATIONALE

The micro lending programme appealed to the country because of:

- the US\$ 20 million framework facility
- the single largest TC grant of US\$ 5 million
- the focus on the development of the microfinance sector, the economic potential of which, at that time, was still unknown to the government.

Because of the programme's strong rationale, the government agreed to certain conditions that would facilitate the partner banks' MSE lending. From the EBRD's standpoint, the first MSE project in the country carried high expectations. The project was finalised in a period of financial downturn in the country. To encourage future reforms, international financial institutions (IFIs) and aid agencies provided various external assistance programmes.

ACHIEVEMENT OF OBJECTIVES

The programme had two objectives: (i) to support the development of the financial sector by increasing the credit skills of local banks for MSE lending; and (ii) to provide finance on a permanent basis to MSEs. While the objectives of the TC were substantially achieved (which demonstrates the efficacy of the operation) the actual MSE lending performance was lower than the target figures, due mainly to the difficult regulatory environment. The operation performance evaluation review (OPER) team assessed the achievement of the programme objectives as *Good*, given the circumstances encountered.

OVERALL ASSESSMENT

The programme was rated overall as *Successful*. Despite an unfavourable operational climate, in which the partner banks and sub-borrowers had to bear high transaction costs in a cash rationing regime, the initial policy dialogue paved the way for a successful operation. The programme's objectives – building capacity at the partner banks and providing MSE lending in the unserved market – were achieved and resulted in a highly satisfactory roll-out and qualitatively significant performance, including productivity that was higher than the EBRD's average for similar MSE programmes. However, the sub-loan portfolio did not grow as expected, mainly because of cash constraints.

Overall, the fulfilment of objectives is considered *Good*. Transition impact is also rated *Good*. This was mainly from successfully delivering fully trained loan officers and other positive effects from the programme's features. Those effects are demonstrating the commercial viability of micro

lending, creating fair competition among the partner banks, resulting in lower interest rates and better services for micro enterprises and promoting regional trade. However, there is concern about the sustainability of the programme and, therefore, the risks are considered *High*. The financial aspect of the programme is rated overall as *Satisfactory*, although in general there was low use of the committed amount of credit lines, which resulted in an unsatisfactory return for the EBRD. Given nearly 70 per cent of the portfolio consisted of micro enterprises, the lending programme is believed to cause minor environmental change. The environmental performance of the programme is *Satisfactory*. Bank handling for the long-term programme was *Good* for both the TC and the investment.

TRANSITION IMPACT AND THE BANK'S ADDITIONALITY

Transition impact of the Programme is considered *Good*. It comprised:

- a positive corporate-level transition impact delivered by the TC for capacity building
- significant impact – albeit limited due to a restrictive regulatory environment – on the MSE and banking sector by creating a competitive environment and demonstrating the commercial viability of microfinance
- a positive impact on the economy at large, which resulted from three factors: (a) efficiently and effectively increasing financing capacity for MSEs, which was mainly derived from the hard currency loans, not being subject to the cash allocation regime; (b) facilitation of regional trades; and (c) an unexpectedly-induced shift of black market players to the formal economy.

Risks associated with transition are rated *High*. Perceived high risks are based on the significant uncertainty of the programme's sustainability after graduation. Sustainability is weak because of (i) unsigned graduation memoranda with the partner banks; (ii) uncertain continuity of competitive recruitment practices and incentive-based salary schemes in the partner banks; (iii) the sensitive quality of the programme's portfolio after the consultants' audit ceased; and (iv) the uncertain level of protection of client information stored at the partner banks. The EBRD's additionality is *verified in all respects* given the programme's specific conditions.

The OPER team considers that additionality is fully verified solely for its specific conditions of the operation. In this country, each foreign-funded investment is unique. Privileges of the programme were unrivalled because of the inhibitive regulatory environment. None of the micro lending programmes or IFIs has secured conditions as favourable as those for this operation and for the MSEs in the country. If the economic system is not fully functioning, it could be attributable to the rigid command-and-control system as opposed to a market economy. The more the restrictions are tightened, the more the operation shines, which is its paradoxical strength in the rigidly controlled regime.

BANK HANDLING

From 2000 to 2006, the EBRD handled the programme in a professional manner. Bank handling is therefore considered *Good*.

KEY OPER ISSUES AND LESSONS LEARNED

Cash is an impetus to foster a grass-roots economy in an early transition country. Cash is important for a bazaar-style culture in a country such as this. Excessive cash restrictions limit essential economic activities, inputs and outputs and sound economic growth, as well as impeding entrepreneurship. These restrictions may even increase the number of transactions in the informal economy. The Programme that was evaluated cut across the restrictive environment and demonstrated a genuine need for entrepreneurs at the grass-roots level.

The importance of designing a microfinance project, taking difficult local circumstances into account. Technical assistance, which primarily strengthens the status quo and embraces a country's economic model in principle, is likely to deliver good quantitative results but may not be conducive to transition. Lending by IFIs was often formulated in line with the government's economic framework, and when the IFI's investment objective did not fit in with the country's economic model, the outcome of the assistance was poor due to the absence of the counterpart's commitment or receptiveness. In a highly regulated country, the quantitative achievement of the investment could be traded off against the degree of transition impact. If a project is incorporated into the established mechanism, it is likely to succeed. If not, it is deemed to fail either due to lack of the counterpart's commitment or the ownership of the project, or due to the country's inadequate mechanism to undertake transition endeavours.

Better coordination among IFIs in the financial sector, including microfinance, is essential. Loosely united policy dialogue and fragmented messages from IFIs might diminish the effectiveness of their assistance. Sometimes their assistance could weaken policy dialogue brought by other IFIs in an indirect manner. The IFIs may need to harmonise their aims and goals regarding the country and recipient government. Future joint evaluation and sharing of operational results is essential to enhance future project selection, formulation and implementation.

Coordination among IFIs not only regarding policy dialogue but also at the operational level could avoid product clashes and operational mix-ups. The coordination among IFIs not only for appraisal and project formulation, but also for post-evaluation by exchanging the outcomes and results could enhance the effectiveness of future technical assistance and investments. Updating each other on implementation progress may also help improve the project performance in a difficult investment climate. The performance of a partner bank or a grant recipient could also serve as informative input for future SME/MSE project formulation.

The challenge of policy dialogue regarding microfinance in an early transition environment. Policy dialogue can be limited while implementing a project when the operational aspect is impeded by an unexpected issue. In this project, the degree of scarcity of cash could not be anticipated prior to the lending programme. Therefore a strong policy dialogue upfront was not fully realised. The restrictive environment surrounding cash emerged only after MSE lending under the credit line began. Remedial measures were difficult due to unclear accountability regarding the counterparts.

A marginal effect of deregulation could be significant in an excessively controlled economy. The Programme closely witnessed a positive impact of deregulation measures as well as tightened control that negatively affected the economy at large. In various circumstances, deregulations and market incentives could work more effectively than rigid regulatory measures. The evaluated microfinance project gave micro enterprises in a curb market the opportunity to cross over to the formal economy.

Self-financing of micro lending operations helps a partner bank to increase the ownership of the MSE programme and to enable self-sufficiency and sustainability. Financing MSEs from its own funds increases the partner bank's ownership of the Programme and creates self-sufficiency. This process seems to be difficult in a large state-owned bank in the country as it involves internal politics and too many layers of administration. In addition, a frequent change of management made the programme operations insecure. Permeation of self-sufficiency was faster and management's commitment proved to be more stable in the privately owned banks. Potential for corporate transformation is an important factor in carrying out a new activity in the partner bank's operations. Before granting the credit line, the EBRD may need to assess a partner bank's potential for self-sufficiency and constant management commitment.