Summary of the Operation Performance Evaluation Review

THE PROJECT

The Early Transition Countries (ETC) Non-Bank Microfinance Institution (MFI) Framework has received three approvals by the Board as follows:

Framework I (FW1)	approved June 2005	US$10 million
Framework II (FW2)	approved May 2006	US$ 25 million
Framework III (FW3)	approved September 2008	US$ 60 million

As of end December 2010, six sub-operations had been approved under FW1 amounting to €5.5 million; FW2 – 15 sub-operations for €18.2 million; FW3 – 16 sub-operations for €32.1 million. In addition a further 21 operations were listed as "exploratory" or "concept reviewed".

In connection with FW1, technical cooperation funding of US$ 1.11 million was approved by TC Com in March 2005. At the time of appraisal of FW3 in September 2008 around US$ 0.66 million of this had been committed to eight MFIs, with US$ 0.55 million available. Additional TC funding of US$ 1.4 million was expected to be needed and this was approved in October 2008. As of January 2011 TC commitments amounted to just over US$ 1 million in total, with just under US$ 0.8 million disbursed. The amount of US$ 1.4 million approved in October 2008 has not yet been utilised.

Project rationale

At the first approval in June 2005 the basic rationale was to enable the Bank to extend its outreach to the smallest borrowers in ETCs, many of whom were in rural areas not fully served, or not served at all, by commercial banks. The Framework would extend senior loans to non-bank MFIs for this purpose. FW1 disbursed rapidly and FW2, approved in May 2006, added provision for subordinated loans and equity investments. Disbursements under FW2 progressed well and FW3, approved in September 2008, included the provision of guarantees in addition to other instruments. FW3, approved just as the full force of the global crisis was beginning to be felt by the ETCs, has been disbursed at a much slower pace. A finding of this OPER is that the principal rationale of the Framework – the need to provide senior loans to existing non-bank MFIs – was well founded in an accurate assessment of the financing needs of non-bank MFIs and their clients. However, the suitability of subordinated loans and equity for such institutions remains open to question.

Achievement of objectives

Two principal operation objectives were stated for FW1 at approval, namely to increase access to finance for the smallest business borrowers (expand financial intermediation) and to improve the capacity of MFIs to expand their loan portfolios (improve operating efficiency). A third objective was added with FW2 and FW3 – to assist the "commercialisation" of non-bank MFIs, meaning the transformation of an NGO-type organisation to a commercial structure capable of distributing dividends and subsequently, circumstances permitting, to a licensed bank.

The evaluation finds that overall the Framework has achieved its key objective of expanding financial intermediation. Volume targets set for sub-operations have been achieved or over-achieved for the Framework as a whole, indicating that the goal of expanding financial intermediation has been accomplished.

The objective of improving operating efficiency has been partly achieved. Portfolio at risk over 30 days (PAR30)[1] and overhead ratio or return on equity were selected at appraisal as measurement targets by which to assess operating efficiency. Historically most of the participating MFIs had PAR30 ratios of 1 per cent or below. Strong currency depreciation together with the impact of the crisis led to sharp deterioration in portfolio quality in about half of the institutions in the Framework. A number of institutions have been able to maintain PAR below covenanted levels of three per cent or five per cent. As regards cost structure, most MFIs engaged in cost cutting and in some cases organisational restructuring during 2009. However, a number of institutions experienced a sharp rise in overhead ratio alongside portfolio contraction. Some MFIs attributed this in part to the increased cost of hedging FX risk.

An overall objective of the Framework introduced with FW2 and restated with FW3 was to assist those institutions

[1] PAR30 = total outstanding loans falling behind repayment schedule by more than 30 days as a percentage of total gross portfolio. This is a standard measure of portfolio performance in microfinance.

that planned to undergo reorganisation and become commercial microfinance companies, or licensed banks, depending on legislative and regulatory conditions from country to country. Such reorganisation was seen as a means of securing the long-term sustainability of the institutions, which would become more profit oriented with the capacity to pay dividends and reward shareholders for their risk. Progress across the board has been slow.

In the view of the OPER team, the MFIs in the Framework have for the most past responded constructively to the crisis and have emerged or are emerging from the crisis period with the capacity to continue building their small business portfolios. Further work needs to be done to improve operating efficiency in a number of cases. On balance a *Satisfactory* rating is assigned to achievement of objectives.

Overall assessment

The evaluation finds that the Framework was timely in coinciding in a number of instances with the transformation of NGO-type micro-credit organisations into commercially focused companies that remain faithful to the social mission of broadening outreach to improve access to finance, especially in peri-urban and rural areas. Although the third tranche of funds approved for the Framework has been slow to disburse because of the crisis, the EBRD was able to use experience gained working with non-bank MFIs since 2005 to continue supporting selected institutions as the financial crisis hit, and also during the periods of conflict experienced in Georgia and the Kyrgyz Republic. The Bank’s continued support when other lenders withdrew was especially appreciated. Overall the portfolios supported by the Bank have performed well and there are signs of recovery from the crisis. There have been some instances of fraud, from which lessons can be learned. In the OPER team’s view, the Framework has achieved its primary objective of expanding financial intermediation. The objective of improving operating efficiency has been partly achieved. MFIs have generally taken time to study their systems and procedures in the light of the crisis in order to improve operations going forward. Progress with organisational transformation has been slow and is impeded in some countries by political opposition or by regulatory reluctance to issue new banking licenses. Achievement of objectives is rated *Satisfactory* overall.

Realised transition impact is rated *Good*. With the assistance of technical cooperation funds the Framework has made sound progress towards the transition goals of broadening and deepening outreach and institution building. The Framework has supported the expansion of lending to small businesses in rural areas. Remaining transition potential is rated *Excellent* with *Medium* to *High* risk.

The OPER team assigns an overall performance rating of *Successful* to the ETC Non-Bank MFI Framework.

Bank handling

When the Framework was launched in 2005 it represented a serious effort by the Bank to extend its reach to a new market segment. While the EBRD has worked actively with banks since the mid-1990s to encourage downscaling in order to open up access to banking services to smaller borrowers, and while the Bank has been instrumental in the establishment of greenfield microfinance banks in the region, the Framework was the first concerted attempt to broaden and deepen intermediation through non-bank lending institutions. Some partner institutions have encountered additional difficulties as a result of poor management or fraud. There are lessons here concerning the need for thorough assessment of the management capacity and systems of potential partner institutions. However, the OPER team emphasises the close involvement of Resident Office teams as well as the Small Business Finance team in seeking local solutions through complex discussions and negotiations with government and other bodies in order to put small business lending operations on a more secure footing in a challenging environment. Bank handling is rated *Good* overall.

Key OPER issues and lessons learned

Corporate governance, management structure and the prevention of fraud

Lesson:
In conducting due diligence of partner institutions, the Bank must make a careful assessment of the strengths and weaknesses of the system of governance and of internal controls. MFIs need transparent and efficient internal organisation to be sustainable in the long term. A clear policy on fraud prevention is needed, with appropriate checks and balances to facilitate detection of fraudulent activity. The due diligence assessment of governance should determine the location of decision-making powers within the organisation and the processes by which decisions are implemented. The assessment should cover monitoring and control procedures, the evaluation

of measures for the prevention and detection of fraudulent activity, and the effectiveness of the internal audit function.

'Non-bank to bank' transformation: Laying the groundwork for significant sectoral change

Lessons:
The Bank should take a proactive approach to policy dialogue with country authorities concerning the transformation of non-bank microfinance organisations to licensed deposit-taking institutions. An early approach to policy dialogue by the EBRD could help country authorities design and implement changes to the regulatory regime. A two-tier regime may be appropriate, distinguishing between universal commercial banking institutions and institutions licensed to undertake a more limited range of deposit taking and banking activities.

In addition to promoting organisational transformation in appropriate circumstances, there may be opportunities for the Bank to further the transition by encouraging strategic partnerships between bank and non-bank credit institutions. The commitment of substantial technical assistance may be necessary to enable MFIs to assess the feasibility and long-term viability of institutional transformation. It may be more appropriate for MFIs serving remote areas to negotiate a form of strategic partnership with a licensed bank rather than seek bank status. Experience in several countries has shown that such an arrangement can extend the range of services available in remote areas while allowing MFIs to remain focused on their core business.