OPERATION EVALUATION SUMMARY

# Micro, Small & Medium Sized Enterprise Framework

Western Balkans

March 2012

EBRD EVALUATION DEPARTMENT

European Bank
for Reconstruction and Development

This is a summary of one of 13 Operation Evaluations that was scheduled for completion as part of the 2011 Work Programme. EvD independently reviews the self-assessments prepared by Banking teams through either a Validation or a more in depth Operation Evaluation. Both consist of a final evaluation with performance ratings, key findings and recommendations. These ratings are the basis of EvD's regular reporting on institutional performance. EvD's review of self-assessments is primarily a desk effort, but it may also result in a judgment that additional analysis is necessary, including at the field level.

Operation Evaluation

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# Contents

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# 1 Executive summary

The EBRD Board approved the first Small and Medium-sized Enterprise (SME) Framework for the Western Balkans (FW1) in September 2004 (FW1 – €50 million), followed by further approvals in May 2006 (FW2 – €75 million) and April 2008 (FW3 – €250 million). Technical Cooperation (TC) funds were available to accompany investment operations and for policy dialogue. The Framework aimed to broaden the outreach of financial institutions while improving financial intermediation.

A number of operations under FW1 have been evaluated previously by the Evaluation department (EvD). FW3 has not been disbursed at the rate anticipated at approval because of the effect of the crisis on demand and institutional capacity. This evaluation therefore focuses mainly on FW2, which for the most part targeted non-bank microfinance institutions (NBMFIs) and offers the broadest scope for operationally relevant evaluation findings. In view of the importance attributed to technical assistance in the design of the framework, the evaluation considers the associated TC operations in some detail.

Client performance has been uneven. All partner institutions suffered deterioration in loan portfolio quality as a result of the crisis, which exposed underlying weaknesses in risk management in some institutions. While technical assistance has helped some partners deal with the effects of the crisis, it is possible that earlier mobilisation of TC could have put them in a stronger position before the crisis, for example through strengthening risk management capability.

A key TC objective was to support microfinance institution (MFI) transformation into shareholding companies and regulated banks.[1] MFIs seeking to undergo transformation encountered regulatory obstacles in a number of countries, which in some cases remain unresolved. These problems notwithstanding, the Framework has achieved a number of notable successes by committed operation teams in a very challenging environment. On balance the evaluation rates the Framework "Successful" overall with "Good" transition impact taking into account the results of efforts to help partner institutions weather the crisis. Risks to on-going success and further transition impact are "Medium to High".

[1] Transformation is defined as the legal process by which a non-profit, non-prudentially regulated institution transforms into a for-profit institution that will typically take deposits and be subject to prudential regulation. [See: microfinancegateway.org Policy Glossary].

Table 1. Summary of ratings

| | |
|---|---|
| **Relevance** | |
| Additionality<br>(Fully verified, largely verified, partly verified, not verified) | Largely verified |
| **Effectiveness** | |
| Achievement of operation objectives<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Satisfactory |
| Company financial performance<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Satisfactory |
| **Impact and sustainability** | |
| Transition impact<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Good |
| Environmental and social performance<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Satisfactory |
| **Efficiency** | |
| Bank handling<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Good |
| Bank investment performance<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Marginal |
| Overall performance rating<br>(Highly successful, successful, partly successful, unsuccessful) | Successful |

# 2 How relevant was this framework to the EBRD's mandate?

Prior to 2006 the Bank's micro and small enterprise (MSE) efforts in the Western Balkans had focused primarily on the establishment of greenfield microfinance banks and later credit lines to microfinance banks and NBMFIs. There was a strong pipeline for FW2, whose additionality at appraisal arose mainly from its medium-term tenure, its institution-building component and its focus on micro, small and medium-sized enterprises (MSMEs) with limited access to finance.

With the benefit of hindsight, it is now known that from 2006 to the onset of the crisis in 2008, the microfinance sector in the region attracted substantial funds from multiple sources including commercial lenders, socially oriented investment funds and international financial institutions (IFIs). Especially in Bosnia and Herzegovina this resulted in an expansion of funds and intense competition contributing to over-indebtedness among a large number of small business borrowers who took loans from several institutions.[2]

Table 2. Additionality ratings

| | |
|---|---|
| **Additionality**<br>(Fully verified, largely verified, partly verified, not verified) | Largely verified |

# 3 How effectively were framework objectives met?

## 3.1 Financial intermediation

Targets were set at approval for the number and volume of sub-loans and average size of sub-loans. Most clients experienced a portfolio decline after the onset of the crisis. Overall targets were exceeded despite the portfolio contraction. In aggregate more than 500,000 loans were extended under FW2, amounting to a total volume in excess of €1 billion. This equates to an average loan size of around €2,000, well below the maximum of €5,000 stipulated. MFIs expressed their appreciation of the EBRD's continued support with funding during the crisis, which enabled them to continue intermediation, albeit at a lower rate.

## 3.2 Operating efficiency and sustainability

Operating efficiency and sustainability are frequently measured by portfolio quality and by the ratio of operating expenses to loan portfolio. Both measures were seriously distorted by the crisis. All institutions reported a sharp deterioration in portfolio quality from 2008 onwards with PAR over 30 days reaching almost 26 per cent in the worst case.

[2] There is already fairly extensive literature on the issue of over-indebtedness. See, for example, the Consultative Group to Assist the Poor (CGAP) paper "Too Much Microcredit? A Survey on the Evidence on Over Indebtedness", September 2011.

However a number of institutions reported a much improved portfolio quality when considering younger vintage loans disbursed from mid-2009 after steps were taken to improve credit assessment and collections.

As regards operating expenses, efforts to cut overheads have been offset by the higher costs of dealing with problem loans. In most cases net savings have been insufficient to compensate for the contraction in loan portfolio so that the operating expense ratio has continued to deteriorate. This drop in efficiency and consequent impact on potential sustainability is likely to continue for some time even as institutions begin to return to profit.

Table 3. Rating of objectives

| | |
|---|---|
| **Achievement of objectives**<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Satisfactory |
| **Company financial performance**<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Satisfactory |

# 4 What impact did the project have and was it sustainable?

## 4.1 Financial intermediation

Transition benchmarks were set at appraisal to measure the number and volume of sub-loans, branch network expansion and portfolio quality. The outreach benchmark was met or exceeded by all partner institutions with one exception. Portfolio quality has been problematic in most cases. Efforts have been made through technical assistance to improve credit assessment and collection procedures with the result that a number of institutions report significantly higher quality on their post-2009 portfolios and a return to profitability.

## 4.2 Institutional transformation

Bosnia and Herzegovina was something of a test ground for this transition goal of the Framework. It was hoped that the legislation adopted by the two entities in 2006 would create an enabling environment for transformation of microcredit organisations (MCO) into non-profit microcredit foundations (MCF) or for-profit microcredit companies (MCC). There were differences in the two sets of legislation adopted and difficulties have been compounded by differing interpretations from the regulator in each entity. As a result, NBMFIs registered in Republika Srpska have gained a significant comparative advantage over their competitors registered in Bosnia and Herzegovina.

In late 2009 the Bank commissioned an assessment of the legal and regulatory environment for microfinance institutions in Bosnia and Herzegovina with a specific focus on legal issues hindering transformation. The Bank shared the study with the International Finance Corporation (IFC) and the regulatory authorities. Following discussions in 2010 the Bank drafted a Memorandum of Understanding (MoU) to coordinate actions to allow for the transformation of selected MFIs into full-service microfinance banks. The MoU was not signed as a result of the high level of political uncertainty and the absence of fully functioning government.

Table 4. Transition and environmental impact ratings

| | |
|---|---|
| **Realised transition impact**<br>(Excellent, good, satisfactory, marginal, unsatisfactory, negative) | Good |
| **Potential transition impact**<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Good |
| **Risk to potential transition impact**<br>(Excessive, high, medium, negligible, low) | Medium |
| **Overall transition impact**<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Good |
| **Environmental and social performance**<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Satisfactory |

# 5 How efficiently was the framework handled?

## 5.1 How well did the Bank handle the project?

Client MFIs praised the strong operational support from EBRD Banking teams and from consultants. They were especially appreciative of the Bank's continued support and flexibility after the onset of the crisis. The banking regulator in Bosnia and Herzegovina commented that the market was flooded from 2007 with funds made available to MFIs with poor exercise of due diligence by investors. This contrasted with the EBRD's practice of scrutinising potential partners closely before committing funds.

The Office of the Chief Economist (OCE) engaged with one partner MFI in Bosnia and Herzegovina to carry out a randomised trial of lending to new borrowers who, following the MFI's standard procedures, would be considered "marginal" and therefore presenting a higher or excessive risk profile. At the time of preparing this evaluation, the findings of the OCE exercise are being finalised. A report is expected in the coming months with proposals to follow up certain actions with the MFI.

### 5.2 How well did the Bank's investment perform?

The Bank's Corporate Recovery Unit has become involved in three partner institutions of the Framework. These instances draw attention to the fragility that is characteristic of institutions operating in an unstable and underdeveloped regulatory environment.

Efforts to improve matters through policy dialogue have to a large extent been frustrated by political uncertainties, particularly in Bosnia and Herzegovina, Kosovo and FYR Macedonia.

Table 5. Efficiency ratings

| | |
|---|---|
| **Bank handling**<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Good |
| **Bank investment performance**<br>(Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory) | Marginal |

## 6 Key issues and findings

### 6.1 MFI transformation, commercialisation and consolidation

The regulatory risk of transformation and commercialisation in Bosnia and Herzegovina appears to have been underestimated at the time of approval. Whereas the banking agency in Republika Srpska was proactive in addressing the challenge of donated equity and the transformation of foundations to commercial and privately owned NBMFIs, in Bosnia and Herzegovina the banking agency has not yet approved a single transformation from a foundation into a commercial NBMFI. Furthermore, the issue of cross-entity consolidation remains unresolved as the banking agency in the Federation is not ready to approve such a merger.

The experience highlights the resource-heavy nature of policy dialogue in an uncertain political environment. As the EBRD operation teams are aware, it could be expedient to engage with the authorities to devise an acceptable mechanism to resolve contentious issues such as the treatment of donated equity drawing on the experience of other countries that have already tackled the issue with Bank assistance. However, constructive engagement is only possible when a properly empowered interlocutor can be identified.

## 6.2 Findings relating to TC operations: recording and reporting TC performance and results

It appears that a number of MFIs could have benefited from earlier mobilisation of technical assistance in areas of governance, risk management and credit assessment. In some cases, after the onset of the crisis, technical assistance has been redirected away from transformation to capacity building, especially in risk management. The crisis exposed underlying weaknesses in some MFIs that perhaps could have been identified sooner. When the market was expanding rapidly, there may have been an element of putting the cart before the horse as institutions began making plans for transformation before key policy issues were clarified with government and before the institutions themselves had upgraded their management capacity and systems. Early TC efforts might have been better focused on helping MFI management to understand fully the risk profile of their portfolio.

The scope of TC evaluation was constrained by the lack of an appropriate results-oriented monitoring mechanism. On the basis of the evaluation team’s qualitative assessment described in this Operation Evaluation, it is possible to conclude that TC resources were by and large mobilised in a reasonably effective way and that clients have for the most part responded well by internalising the results of consulting inputs. However, a more robust evaluation of TC outcomes and impact is not possible given the absence in many cases of baseline data and measurable indicators by which to assess performance.

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