OPERATION EVALUATION

Lending for SMEs, Women in business, and Energy Efficiency in SMEs

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European Bank
for Reconstruction and Development

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Executive Summary

This is an evaluation of a second EBRD project and pilot effort with an established state bank providing a loan package for on-lending to private sector SMEs, women in business and energy efficiency at SMEs. It followed the first project, a loan for on-lending to SMEs, which was successfully utilised in the preceding year. The three components of the second project included:

1. **A further SME loan**, complemented by a TC to strengthen the Borrower's institutional capacity to lend to SMEs. It covered the introduction of credit scoring, strengthening risk management and building the Borrower's advisory service for SMEs. Transition impact was to be derived from continuing support for market expansion of SME lending. The Borrower was to allocate at least 3x the EBRD loan from its own funds for SME lending.
2. **A Women-in-Business (WiB) loan**, the first in the country designed specifically to support women-led businesses. Its key objective was to pilot this type of financing, with a view to launching a country-wide programme. This loan was complemented with a First Loss Risk Cover (FLRC) grant, and two TCs: (i) for WiB-specific capacity-building; and (ii) for WiB business support, to be delivered through the EBRD's Advice for Small Business facility (ASB). Transition impact was to come from the demonstration effect of the new WiB-specific product and from the transfer of skills via TCs.
3. **An Energy Efficiency (EE) loan**, intended to finance energy efficiency investments and renewable energy projects. As the first dedicated Sustainable Energy Financing Facility (SEFF) in the country, it was designed to test the market before the roll-out of a countrywide programme. The facility included TC funding to develop the Borrower's EE lending capacity and for project preparation, and to cover incentive payments for sub-borrowers and success fees for the Borrower. Transition impact was to be derived from the demonstration effect of new lending products and technologies, and the transfer of skills to the Borrower in respect of EE financing.

The overall objective of this project was to contribute to the development of the SME sector – the backbone of the national economy. To support this, the Bank intended to embark on **policy dialogue** with national authorities to improve the SME lending environment. The objectives of this policy dialogue were only broadly formulated at approval and were developed two years later with the Borrower as a ten-point action plan.

Ultimately, the Bank's policy dialogue was limited. The action plan took somewhat more than optimal preparation time and could have been better researched and designed as the Bank later realised that there were many other IFIs already addressing some of the action plan's objectives. Frequent management changes at key governmental agencies made it difficult to conduct such a dialogue where it was still needed. The Bank's contribution was limited to two relatively modest achievements. Other of the Bank's policy dialogue objectives were achieved, but by other IFIs.

The three loans were fully disbursed and on-lent, and the intended outputs and outcomes of the package were largely achieved, although with some shortcomings as identified in this report.

As for wider impact, the Bank's package did make a contribution to the ultimate goal of supporting SME development in the country, financing over 170 companies in this sector. It also strengthened the Borrower's SME lending capacity and processes and introduced new specialised loans, which targeted new market segments.

However, as a pilot project (not designed to make a large impact) and in a country with over 2.5 million MSMEs, the Bank's package was too small to make a substantial sector-wide impact. Moreover, in later years, the Central Bank introduced a subsidised programme for SME financing. By then most of the Bank's funds from SME and WiB loans were on-lent but the utilisation of EE loans (which took longer to prepare) was delayed. Ultimately, the Borrower lent to SMEs 60x the value of the EBRD's extension loan (large part of it under the Central Bank programme).

As to the impact on the economy, the majority of sub-loans were for working capital, granted to trading companies, typically enabling them to purchase merchandise (often imported, as the country has only a small manufacturing base). There is limited evidence that additional financing resulted in increased revenues or employment at SMEs. However, EE loans to larger companies did contribute to such increases. Moreover, according to ASB's evaluations, the majority of women-owned SMEs increased turnover and employment following training or advisory services provided under the ASB programme, although it was not linked to the provision of EBRD financing.

The Bank's package largely **fulfilled its role as a pilot**, testing demand for various types of SME loans and demonstrating new products to other banks. Since then the Bank provided seven SME lines of credit to five private banks. It also approved a country-wide WiB Programme for the country, under which the first sub-project was signed soon after. Furthermore, the Bank signed a country-wide SEFF programme with three private banks.

The most important, lasting achievement of the Bank's programme was the development of the credit scorecard, which substantially improved efficiency of SME loan application processing at the Borrower. Overall, the project's key achievement was that it paved the way for the Bank's subsequent engagement with private banks in the country. The relevance of these new loans to smaller SMEs has now been reduced due to the Central Bank's subsidised programme, which is still on-going. Nevertheless, these new interventions, amounting to around EUR 0.5 billion in aggregate, have the potential to make a strong impact by supporting larger SMEs. The project is rated overall ***Good***.

Key findings – policy dialogue and TCs:

- The Bank's policy dialogue was limited due to long preparation process and the proliferation of other IFIs supporting SME policy development. The EBRD contributed in two ways: (i) advising on the regulatory environment, which fed into the SME Development Strategy (prepared by CIDA and ILO), and (ii) advising on improvements to the One-Stop Shops, created by the Borrower to encourage the formalisation of unregistered SMEs.
- Although it was planned at approval, there was no policy dialogue in respect of energy efficiency and renewable energy markets. In the Bank's and its consultant's opinion, the government's policy of increasing electricity tariffs (agreed with IMF) was effective and no further intervention was needed.

- The key achievement of the SME capacity building TC was the development of a credit scoring system, which made loan application assessments more efficient and it has been widely used by all the Borrower's branches since September 2017. The TC also developed a sustainable business model and operational strategy for the Borrower's Business Advisory Units and contributed to improved SME risk management.
- The WiB-related TCs helped to create a WiB-dedicated working group at the Borrower and the training of staff to better respond to the needs of women-led businesses. The ASB-managed TC was loosely linked to the WiB loan and it benefited only one borrower of WiB loan. However, during the four years of its operation, the programme advised 115 women-led businesses and trained a further 350.
- The EE-related TC helped in the selection and preparation of investment projects, maximising energy savings. However it suffered from a substantial turnover of consultants, while clients complained about the long process of verification and obtaining an incentive grant. This TC also trained the Borrower's loan officers and local engineers.

Key findings - loans:

- The Borrower's SME portfolio increased two-fold during the project period, while the number of loans grew 50% to over 50,000. The contribution of the Bank's loans to this growth was 5.5% of total growth[1]. The Bank's loans helped the Borrower to separate SME products and brand them differently, which in turn increased the effectiveness of their marketing.
- The main impetus for increased lending by <u>all</u> banks in the country to SMEs came from the Central Bank's programme launched during the project period, which set a target for all banks to provide at least 20% of their total financing to SMEs within 4 years. This programme is supported by subsidised loans from the Central Bank, which banks on-lend to SMEs about 2-4 times cheaper than the current market rate. Loans under this programme accounted for 35% of the Borrower's total SME portfolio growth. Therefore, since the introduction of the Central Bank programme, the EBRD programme has been used predominantly to finance larger SMEs, ineligible for Central Bank loans[2].
- Despite the exponential growth of SME lending, it has decreased as a share of the Borrower's total portfolio from 10% at the outset to 8% now, well below average of private banks in the country, with an SME share of 14%. This was due to a currency devaluation of more than 50% during the project. As the Borrower's loans to corporates were often in foreign currency, the SME portfolio share (entirely in local currency) shrank. Nevertheless, the Borrower remains the largest financier of SMEs in the country, with a current market share of 38% (up from 33% in at the project's ouset).

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[1] The Bank's contribution includes the original and the extension SME loans and WiB loan but excludes the EE loan as it was granted mainly to larger companies. From mid-2013 to mid-2017 the Borrower's SME portfolio grew by ca. $1.8 bil.

[2] The Central Bank programme offers loans at lower interest to SMEs with a turnover of up to €2.25 mil equivalent and slightly higher for those with a turnover up to €9 m. The EU (and EBRD) definition of SME is companies with up to €50 m turnover. Therefore borrowers of Bank's funds were mainly companies with a turnover between €9 and €50 m, i.e. "medium" according to the EU definition but "large" according to this Central Bank.

- The Borrower was initially unconvinced about the need for a dedicated WiB product, but eventually agreed to it and doubled the number of WiB loans, and their volume grew two-fold. The EBRD's WiB loan accounted for 11% of this increase. The sub-loan terms were only slightly better than those of standard SME loans. They were popular until the launch of the subsidised Central Bank programme, which had the largest impact on the increase of the Borrower's WiB portfolio. Due to the equally strong increase in general SME lending, WiB's share of the total the Borrower SME portfolio only grew by about one percentage point (from 9% to 10%).

- The EE loan demonstrated the viability of EE investments to medium and large industrial companies. However, the strongest encouragement for such investments came from the government's policy of gradually increasing electricity tariffs, which jumped three-fold in 2017 and are set to double in 2018. Despite some delay, the EE loan was fully utilised and produced aggregate energy savings of 380,000 MWh/year (almost four times the benchmark figure) and carbon reduction of 62,700 ton CO^2 eq/year (20% over the benchmark).

Issues and lessons

(i) State-owned banks may be suitable to initiate the Bank's support for SMEs in a new country

The Borrower was (and still is) state-owned and it is the largest bank in the country. At project approval, there were questions as to whether it was the most suitable partner to launch the EBRD's SME support package. The main arguments for working with the Borrower were:

- Strategic fit and the commitment of the Borrower to the SME sector, combined with its institutional capacity, which was important in the context of the limited interest and capacity of private banks in this sector. Private banks considered corporate lending (more profitable and lower risk) to be their core activity;
- The Borrower's large network of branches (400), was crucial to reaching SMEs in the regions;
- Visibility of the Borrower as the largest bank in the country, was important for generating demonstration effect;
- The Borrower's position as a state-owned bank was to facilitate policy dialogue with the authorities, particularly on the introduction of a new collateral law and on formalising unregistered SMEs;
- EBRD's due diligence and reporting requirements were seen by private banks as unusual and extremely onerous as very few banks had dealt with IFIs. Banking secrecy laws protecting client information prevented information sharing. The partner banks required the Central Bank's approval for the Bank's due diligence.

The evaluation confirmed that the first three arguments were correct. The Central Bank and a private bank interviewed by EvD confirmed that in 2013-14 the private banks were focusing on their corporate business, while the Borrower was a recognised leader in the SME business. Loan beneficiaries indicated that the Borrower had an established "SME-friendly" brand. The Borrower's large network of branches with staff dedicated to SMEs has proved crucial to reaching companies in the regions, where personal contacts, rather than the internet, play a key role in commercial relations. The Borrower provided the EBRD with high visibility, as confirmed by a private bank interviewed by EvD.

However, the partnership with the Borrower did not facilitate policy dialogue, which was limited. The private banks interviewed confirmed EBRD's due diligence and reporting requirements were not out of the ordinary, being even more streamlined than the procedures required by other IFIs. Officially, the Central Bank confirmed that their approval is not required for IFIs' due diligence (although the Operations team reports that in practice the Central Bank must be notified of such due diligence).

However, the key arguments supporting the choice of the Borrower as the EBRD's partner to launch an SME programme have proved compelling. In the opinion of the Central Bank and a private bank interviewed by EvD, the Borrower's SME lending department has been operating autonomously. The Borrower has demonstrated its approval process for SME beneficiaries has been decentralised, effectively being removed from politicised committees, while all EBRD loan proceeds were on-lent to privately-owned SMEs, as agreed. Finally, private banks opined that in the SME sector the Borrower operates commercially in a competitive environment (as demonstrated by the Borrower rejecting a credit-enhancing grant for the WiB loan).

Lesson: Although engagement with a private bank is preferred, in certain circumstances a partnership with a state-owned bank can be the EBRD's best option when initiating an SME programme in a new country.

(ii) Governmental subsidised SME financing programmes may reduce relevance of EBRD loans

One year after the Bank's loan package was approved; the Central Bank launched a programme providing all banks with subsidised lines of credit for smaller SMEs. With an interest rate 2-4 times lower than loans under the Bank's package (extended at a market rate), it crowded out the Bank's financing (although by that time most off the Bank's SME and WiB loans had been on-lent). The Bank, unlike some other IFIs (e.g. EIB and IFC) chose not to allow the Borrower to lend the proceeds of its loan at what became prevailing lending rates due to concerns over subsidies. This reduced the target market of its product offering.

Lesson: Before launching SME financing programmes with state-owned banks, the Bank should consult with the relevant governments on their financing strategy for this sector, paying particular attention to potential plans to offer subsidised financing. The Bank should consider taking a written statement from the governments (or an MoU), which confirm they are not planning subsidised programmes, which could reduce relevance of Bank's SME loans.

(iii) Policy dialogue on improving the environment for SME financing in SEMED could be a crowded field.

Unlike in eastern Europe, where EBRD had the advantage of being the “first-mover” and remained the leader in policy dialogue for a long time, in SEMED many IFIs and donor organisations have been conducting policy dialogue for years. According to the Central Bank, one of the primary targets for these organisations has been the improvement of the financing environment for SMEs. The Bank’s policy dialogue action plan called for some actions that have already been undertaken by others, e.g. development of collateral law (by IFC and EFSA) or drafting of the SME Strategy, done by CIDA and ILO.

Lesson: The EBRD, as a relative late-comer to SEMED, should choose its areas of policy dialogue carefully and only after consultations with all key actors.

(iv) Design of Women-in-Business programmes

The loan offer under the WiB programme was initially seen by its clients as attractive (half the standard margin, no commission and in most cases no collateral). In practice, a large increase in the interbank rate and the introduction of a subsidised Central Bank programme quickly decreased its perceived attractiveness.

Moreover, the Bank intended to provide advisory and training services to women who borrowed from the WiB facility, with the double objective of training women in better business management and reducing the risk of the WiB loan portfolio. However, it was difficult to deliver this output as many WiB borrowers were from the regions, far from the main business centres, and they were not offered (or they declined) training and advisory services. The ASB programme reached over 600 women but only one of them was a WiB loan beneficiary.

Lesson: when designing women-in-business programmes, ensure: (i) a clearly distinctive and attractive loan product to appeal to women-led businesses is offered; (ii) stronger links are built between WiB loans and WiB TCs, through e.g. cross-referencing; and (iii) the loan is tailored to specific needs of the financial partner.

(v) Need for in-depth research before offering subsidised EE financing products

The EE loan was intended to finance energy efficiency and renewable energy investments. Thirty proposals were received for renewable energy projects but, since the facility already carried a subsidy element, the Bank decided these projects which benefit from subsidised FiT tariffs should be excluded. As FiTs were introduced in the country in 2014, before the project was approved, this issue could have been better researched and foreseen from the start.

Lesson: Launching subsidised products requires prior in-depth impact analysis, to clearly articulate eligibility criteria from the start of the project.