

An SME credit line to a development bank

Summary of the Operation Performance Evaluation Review

THE PROJECT

In 2001, the Board of the EBRD's approved a co-financed loan to a development bank in Eastern Europe. The total commitment amounted to €20 million, of which the Bank's share was €12 million. The facility benefited from a sovereign guarantee by the country. The purpose of the facility was to enable the client to extend loans to privately owned small and medium-sized business (SMEs), thereby contributing to private sector development and generating employment. Three years after signing of the loan agreements just over €9 million of sub-projects had been approved. The EBRD cancelled the unutilised part of its loan. Subsequently the co-financier and the client entered into negotiations to resume the facility on a bilateral basis.

PROJECT RATIONALE

The facility as approved was offered to the client for on-lending to SMEs through the country's commercial banks, or by the client directly. The client opted not to use the services of other banks. There was a sound rationale for using the client as an intermediary channel of funds to local banks as its extensive existing co-operation with banks of good standing gave it access through them to potential borrowers around the country. The rationale for permitting the client to commence lending directly without technical assistance to improve its capacity to carry out SME business was less sound.

ACHIEVEMENT OF OBJECTIVES

The fulfilment of objectives is rated *Marginal*. The facility faced a number of obstacles in implementation which together limited outreach. About 40 per cent of the facility was utilised, measured by disbursements to sub-borrowers. The signing of the facility coincided with a downturn in market interest rates which encouraged the client to adopt the direct lending route. One objective of the facility was to assist in mitigating the maturity mismatch of assets and liabilities of domestic banks. This was made redundant by the client's decision to lend directly to SMEs without involving local banks, which would have benefited by way of improving their maturity matching.

OVERALL ASSESSMENT

The Evaluation Team assigns a rating of *Unsuccessful* to the facility. The client only drew down just under half of the facility during a period of three years. Based on the Evaluation Team's review and discussions with the client's management and staff, the quality of the outstanding sub-loan portfolio appeared to be declining at the time of the evaluation. The remainder of the facility was cancelled upon the EBRD's insistence and the client subsequently prepaid the outstanding balance of the EBRD portion of the loan. The main reason for slow disbursement appears to have been the client's lack of capacity to lend effectively to the SME sector directly, although the client's management point to what they regard as excessively restrictive sub-loan conditions and unworkable sub-loan approval procedures. The Evaluation Team considers that these are issues which should have been identified and addressed at appraisal and certainly long before signing.

TRANSITION IMPACT AND BANK'S ADDITIONALITY

Transition impact is rated *Marginal*. There is little remaining transition impact potential from the facility which has been cancelled and prepaid. A number of sub-borrowers spoke appreciatively of the facility, but others complained of being locked into fixed interest rates at a time when market rates locally declined. However, the experience of handling the facility focused the attention of the client's management on the need to improve its SME lending capacity and

efforts in this direction gathered pace subsequently with the reorganisation of SME lending operations. Additionality is *Verified only in part*. Although this was the first credit line to this client for on-lending to the SME sector, it appears that there was no lack of funding from other sources for SME lending. If the client had chosen to utilise the facility by lending indirectly via local banks, the additionality would have been clearer as the private commercial banks by and large lacked access to longer-term funds.

BANK HANDLING

Bank Handling is rated *Satisfactory*, although the project had a number of design flaws. With the benefit of hindsight, it appears that the client did not have the capacity to service SME borrowers at the lower end of the scale with loans of up to €1 million, the ceiling upon which the EBRD insisted. Shortly after signing the client also claimed that it needed approval for sub-loans of longer tenor in order to disburse the facility successfully. The Bank declined this request also. Important lessons have already been learned from the experience by the client, as evidenced by the concerted effort to improve SME lending capacity. The design flaws notwithstanding, the Evaluation Team considers that the Bank handled the implementation of the project well. The Bank took its position on the questions of loan size and tenor based on its experience of handling SME credit lines in other countries of operations. The less than satisfactory quality of the sub-loan portfolio suggests to the Evaluation Team that the Bank was right to maintain its position.

MAIN OPER ISSUES AND LESSONS LEARNED

The EBRD should ensure that client banks possess and maintain the skills necessary to operate a credit line for on-lending successfully. In the Bank's experience, successful SME lending projects with new partners have as a rule involved some level of technical assistance to improve lending skills. When considering the suitability of a partner bank for an SME credit line, the Bank should analyse the skills level of the potential partner, the capacity of its distribution channel, back office functions and portfolio monitoring procedures.

Consider assigning responsibility for sub-loan approvals to one institution when planning the implementation of co-financed credit lines. In the present case, sub-loan approval procedures were necessary because of the limited SME lending experience of the intermediating bank. In future operations of this kind, the EBRD should assess with its co-financing partner the skills and capacity of the funding institutions involved. Wherever possible, agreement should be reached so that one institution assumes responsibility for approvals, applying agreed conditions and parameters in order to avoid delays in approval and disbursement. The need for TC support to facilitate this process should be assessed at the same time.

Carefully consider the effects of modifications to project design prior to implementation. When changes in external circumstances necessitate modifications to project design or structure, careful consideration should also be given to the effects of the changes on project implementation. Modifications should be consistent with the original goals and intentions of the project. When considering design modifications, it is important to avoid the introduction of features which may lead to fresh difficulties in project execution.