



Executive Summary

Micro, small, and medium-size enterprises (MSMEs) account for the bulk of the private sector, particularly in poor countries, and face greater difficulty in accessing finance and infrastructure services, as well as in complying with burdensome regulatory licensing and other governmental requirements, as compared with larger enterprises.

Purpose of this Evaluation

Since the mid-1990s, the International Finance Corporation (IFC) has designed a number of strategies for supporting MSMEs. The IFC strategy in place since 2001 focuses on: (i) providing financial support to MSMEs through financial intermediaries; and (ii) providing nonfinancial, indirect, institution-building support to MSMEs through project-development facilities cofinanced by donors. In addition, IFC's corporate strategies focus on supporting private sector development in frontier countries (characterized by high risk or low income), in response to their relatively lower private capital inflows and less developed banking systems, as compared with medium- (or low-) risk middle-income countries.

The objective of this study, therefore, is to evaluate the confluence of these two institutional strategic priorities (support for MSMEs through financial intermediaries, and support to enterprises in frontier countries) as well as to provide recommendations on how the strategy to support MSMEs through financial intermediaries

(collectively known as MSME-FIs) in frontier countries could be improved to enhance its development impacts. More specifically, the study is intended to answer four evaluative questions:

- What were the IFC strategies to support MSMEs in frontier countries, were they relevant, and were they implemented effectively?
- How successful were the financial intermediary projects that acted as channels for supporting MSMEs in achieving their development outcomes, and what were the main success drivers?
- How does the environmental, health, and safety (EHS) compliance performance of financial intermediaries that focus on MSMEs compare with those of IFC's mainstream financial intermediary projects?
- What was IFC's added value (that is, role and contribution) in the MSME-FI projects?

The study covers the fiscal years (FYs) 1994–2006, and evaluates: (i) IFC's strategies during this period, (ii) implementation of the strategies

through committed investment projects and advisory services operations in support of MSMEs in frontier countries during this period, and (iii) outcomes of the projects that have reached operational maturity—having had at least two years of operating and financial results by the end of 2005 (that is, projects approved through FY02). As indicated above, special attention is given to EHS compliance performance of the financial intermediaries covered by the study. The study does not evaluate IFC’s project-development facilities for MSME capacity building because some were evaluated previously by IEG-IFC and others will be evaluated separately.

This study evaluated the outcomes of all 21 operationally mature, for-profit, microenterprise-oriented financial intermediary (MFI) projects and all 72 operationally mature, for-profit, small and medium-size enterprise-oriented financial intermediary (SME-FI) projects supported by IFC in countries designated as frontier countries at the time of project approval.

Strategies, Investment Projects, and Advisory Services Operations

The main objectives of IFC’s strategies to support MSMEs are as follows:

- (i) To offer widescale, indirect, IFC loan support through specialized microfinance intermediaries and SME-FIs, and through other specialized nonbanking financial entities such as leasing companies;
- (ii) To provide advisory services to these financial intermediaries, to improve their operations, particularly regarding lending to MSMEs;
- (iii) To invest equity in these microfinance intermediaries and SME-FIs when there is an IFC value-added role for doing so;
- (iv) To limit IFC’s direct loan or equity investment in small and medium-size enterprises within the context of the Africa Enterprise Fund or the Small Enterprise Fund—both of which are now used as funding mechanisms by the investment departments on only a selective basis;
- (v) To offer widescale, indirect IFC advisory services for MSME institution and capacity building through specialized project-development facilities that will help MSMEs improve their operations; and
- (vi) To broadly support financial markets and private sector development by helping to improve policy, regulatory, and administrative frameworks, as well as business climates.

IFC developed project-design parameters for profit-oriented MFIs in the mid-1990s and introduced the MFI holding company structure in FY99, to accelerate the development of the MFIs. The four parameters—relating to operating principles and sponsor quality, governance, funding, and advisory services—were used in IFC’s first profit-oriented MFI project, approved in FY96, and were also used in all 21 MFI projects evaluated.

IFC’s annual net commitments and advisory services support to financial intermediaries that focus lending on micro, small, and medium-size enterprises in frontier countries grew rapidly during FY94–FY06, reflecting its strategic priorities. IFC’s annual net commitments for MSME-FIs in frontier countries expanded from \$33 million in FY94 to \$497 million in FY06, and totaled \$1,405 million from FY94 to FY06. Within these amounts, annual net commitments to microfinance intermediaries in frontier countries grew from \$1 million in FY96, to a peak of \$32 million in FY03 and FY04, falling to \$15 million in FY05 and FY06, and totaling \$137 million during FY96–FY06. The drop in annual net commitments in MFI projects in frontier countries during FY05 and FY06 was due to a shift in emphasis to SME-FIs in both frontier and nonfrontier countries, and to MFIs in nonfrontier countries. At the same time, IFC was building up its network of MFI holding companies that would form the foundation for further scaling-up of its MFI operations worldwide. Within the MFI evaluated population, 18 received advisory services grant funds totaling about \$54.8 million, of which about 18 percent was provided by IFC and the balance by partner international development institutions. Within the SME-FI evaluated population,

IFC provided advisory services grant funds to 21 SME-FIs totaling about \$6.5 million.

Performance of Intermediaries Serving Microenterprises

Seventy-one percent of the MFIs achieved high development outcomes, higher than the 61-percent success rate for all IFC investment projects located in frontier countries, and the 59-percent success rate for all IFC projects worldwide that were evaluated with Expanded Project Supervision Reports (XPSRs). The MFI projects with low or poor development outcomes were mainly located in Sub-Saharan Africa and, in general, had two or more of the following characteristics: (i) had no license to take deposits or had low savings-deposit mobilization rates, equivalent to less than 60 percent of loans; (ii) client outreach of less than 20,000 micro and small enterprise borrowers; (iii) total assets of less than US\$15 million; (iv) high nonperforming loan rates of 1.8 percent or higher; and (v) returns to total assets of less than 1.0 percent.

Only 22 percent of the IFC equity investments in the MFI evaluated population achieved satisfactory equity returns for IFC, lower than the 34-percent success rate for all IFC equity investments (in all sectors) in frontier countries evaluated with XPSRs, and lower than the 58-percent equity success rate of the IFC equity investments in the SME-FI evaluated population. The lack of focus by the MFI management on improving equity returns, the factors that contributed to low development outcomes described above, and the absence of a clear IFC equity exit mechanism (such as equity put options), all contributed to the low success rate for the IFC equity investments in the MFI evaluated population.

Performance of Intermediaries Serving SME-FIs

Sixty-one percent of the SME-FI evaluated projects achieved high development outcomes, similar to the success rate for all IFC projects worldwide that were evaluated with XPSRs (59 percent). However, a subgroup of 21 SME-FI

projects that received advisory services from IFC had a development outcome success rate of 76 percent, significantly higher than the 55-percent success rate for the 51 other SME-FI projects that did not receive any advisory services. The Regions with the lowest development outcome success rates for SME-FI projects were the Middle East and North Africa Region, and the Sub-Saharan Africa Region.

Fifty-three percent of the IFC equity investments in the SME-FI evaluated population achieved satisfactory returns—less than the 67-percent equity investment success rate for all other IFC commercial bank projects, worldwide, evaluated with XPSRs, but higher than the 31-percent equity investment success rate for all IFC projects, worldwide, evaluated with XPSRs. The relatively higher IFC equity investment success rate for the SME-FI projects (and commercial bank projects, worldwide, in general) reflects the increase in commercial-bank equity values, mainly due to the liberalization of the banking sector in many developing countries and the large number of international and regional banks interested in acquiring substantial equity stakes in developing country commercial banks, particularly the larger ones. Half of the IFC equity investments in the SME-FI evaluated population are with the larger SME-FIs having assets over US\$1 billion. The IFC's average equity investment success rate in these larger SME-FIs was 88 percent.

Environmental Performance of Both MFIs and SME-FIs

Seventy-one percent of the MFIs in the evaluated population and more than 80 percent of the 65 MSME subprojects that IEG visited had satisfactory EHS compliance ratings. However, only about 25 percent of the SME-FI evaluated population had satisfactory EHS ratings, partly due to noncompliance by subprojects, and partly due to a failure by the SME-FIs to install an environmental management system or to regularly report to IFC (or both), which, in turn, was fostered by inadequate IFC supervision. IFC's EHS supervision quality for the projects in the SME-FI evaluated population is only 32 percent satisfactory.

Main Findings

Six success drivers of the projects supported by IFC are common to both MFI projects and SME-FI projects, and one success driver is unique to MFI projects. In addition to IFC work quality, four of the success drivers stem from the design parameters for MFI projects used by IFC. The six success drivers common to both MFI and SME-FI projects are the following:

- **Sponsor and management quality:** An experienced main sponsor or technical partner, and management that is specialized and committed to a commercially oriented and for-profit business model for the MSME-FI;
- **Advisory services:** Access to advisory services grant funds to cover start-up, training, and acquisition costs of operating systems;
- **Operational standards:** Good practice standards to benchmark performance;
- **Institutional equity and governance:** Substantial start-up equity and oversight from development institution shareholders to help obtain regulatory approval, attract deposits, maintain a focus on serving the MSMEs, and ensure prudent operations;
- **Transparency:** Transparent operations and public confidence to help mobilize local funds, particularly deposits; and
- **IFC work quality:** Good IFC work quality, including the selection of which SME-FIs to support. In the case of MFIs under a holding company, the quality of the technical partner and provider of management and training services is also important, and may largely complement IFC's work quality.

In addition, one success driver unique to MFI projects is the existence of a specialized and supportive regulatory regime (and associated regulatory supervision capacity), for MFIs. A supportive regulatory regime for MFIs allows MFIs to take savings deposits, establish branches, charge interest rates that provide a profit, and rely on competition to ensure reasonable interest rates to borrowers. A bank branch network increases the client base, and thereby helps achieve economies of scale for MFIs, as well as helps increase their development reach. The countries

with supportive regulatory regimes for MFIs were mostly in the Latin America and Caribbean Region, and in the East Asia Region.

IFC's work quality, the quality of the sponsors, and the enterprise managements are consistent success drivers found in IEG's evaluations of IFC's projects in all sectors and Regions approved during the last 10 years. For the MFI and the SME-FI evaluated populations, advisory services and IFC equity were also essential success drivers across all Regions.

IFC's strategy to support MSMEs through financial intermediaries has been relevant and broadly effective in the sense that the strategy:

- Provided MSMEs a reliable, accessible and potentially permanent source of loans by strengthening the institutional and financial capacity of the intermediaries;
- Leveraged IFC's resources with those of the MSME-FIs as well as with those of cofinanciers, mainly other multilateral development banks and bilateral aid agencies in the case of MFIs;
- Achieved a high outreach among MSMEs and an overall, high loan-repayment rate, which IFC could not achieve directly; and
- Demonstrated that financing MSMEs can be a profitable business for commercial banks and helped to develop, as well as increase, competition in the local banking system.

However, the specific focus of the IFC strategy and advisory services on increasing access to finance for MSMEs has thus far missed the opportunity to also address several important considerations to enhance the development outcomes of MSME-FIs, particularly MFIs: (i) the importance of providing local currency loans to MSMEs that cannot take the foreign exchange rate devaluation risks associated with foreign currency loans; (ii) the important role of a savings deposit base in providing MFIs with a sustainable source of local currency funds that would allow them to transition out of donor dependency; (iii) the large need for banking services (that is, remittances, savings, etc.) by low-income households and MSMEs, which the MFIs could also

serve, in addition to providing credit; and (iv) the critical role of specialized and supportive regulatory regimes for the success of the MFIs.

Committed SME management, skilled staff, and good environmental regulation and enforcement in the country of operations promoted EHS sustainability of SME subprojects that were financed by IFC through financial intermediaries. However, commitment to EHS sustainability is not yet widespread among SMEs in frontier countries, and only a few SME-FIs have strong commitments to monitoring and supervising the EHS performance of their subprojects. Enforcement of local EHS regulations, particularly for SMEs, also tends to be weak in frontier countries. IFC's EHS supervision of financial intermediary projects is important, therefore, if EHS compliance is to be achieved. IFC has embedded an EHS specialist team in the Global Financial Markets Department, in response to the fast growth of the financial markets portfolio and the poor EHS compliance history of financial intermediary projects. IFC has also introduced the "mainstreaming" EHS program among investment officers in all sectors so they can complement the supervision efforts of the EHS specialists. For these initiatives to work, IFC management has to also give high priority to EHS supervision and compliance of financial intermediary projects.

Recommendations

IFC's strategy of supporting MSMEs through financial intermediaries, and of providing advisory services for institutional capacity building to the financial intermediaries, has been relevant and broadly effective. Nonetheless, going forward, the strategy should be reinforced and improved to substantially enhance the development

impact of MSME-FI projects, by IFC's implementation of the three initiatives listed below:

- (i) Take a more proactive approach in encouraging other development partners who have substantial engagements with the developing country governments to promote the establishment of specific and prudential regulatory regimes, and associated government supervisory capacity, for microfinance intermediaries in developing—particularly frontier—countries. Doing so will create conditions that will facilitate the transition of MFIs out of donor dependency, especially through their development of a savings deposit base and achievement of economies of scale, by expansion of their client base and the establishment of branch offices.
- (ii) Enlarge the scope of IFC advisory services to MSME-FIs beyond the present focus of improving lending techniques and loan-portfolio risk management, to also help selected MSME-FIs that have achieved good risk management practices: (a) better meet the need for savings and other banking services (for example, remittances) by poor households and small businesses; (b) implement best-practice liquidity management procedures; and (c) in the case of MFIs, help expand their client base to also reach small-size enterprises.
- (iii) Give a high priority to improving the EHS supervision as well as the EHS compliance rate of MSME-FI projects. In particular, IEG recommends that IFC set a goal—to be achieved within a defined period of time—to improve its satisfactory EHS supervision rate and the EHS compliance rate of MSME-FI projects.