

Financing Micro, Small and Medium Enterprises through Financial Intermediaries, FY 1994 - 2006

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About Findings

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Micro, small and medium enterprises (MSMEs) constitute the bulk of the private sector in most developing countries and can contribute significantly to economic growth, employment creation, and poverty reduction. However, limited access to finance has often constrained their development, particularly in high-risk or low-income countries (the so-called "frontier countries"). IFC's strategic priorities in these countries aim to support the development of the private sector; they also aim to support the development of MSMEs by: (i) indirect financing via financial intermediaries, and (ii) by indirect institution-building support via specialized regional small and medium enterprise (SME) development facilities. The confluence of these two strategic thrusts is the subject of IEG's report.

The main messages of this review are:

- IFC's strategy of providing indirect financial support to MSMEs through specialized financial intermediaries has been relevant and effective in terms of both development outcomes and IFC investment returns. Advisory services and equity investments from IFC (and other development institutions) contributed to the strategy's success.
- In the case of financial intermediaries (FI) that specialize in lending to micro-enterprises (the so-called MFIs), an important success driver is a specific and supportive regulatory framework that, among other things, allows deposit-taking, establishment of branches, and reliance on competition to set reasonable interest charges.
- MFIs can transition out of donor dependency and become profitable and sustainable if they: i) develop a large savings deposit base as a source of local currency funds for lending; and ii) expand the scale and scope of their operations to serve both micro- and small enterprises, thereby improving operating efficiency and outreach.
- The development results of MFI projects can be further enhanced if MFIs also serve the large need for savings and other banking services, such as remittances.

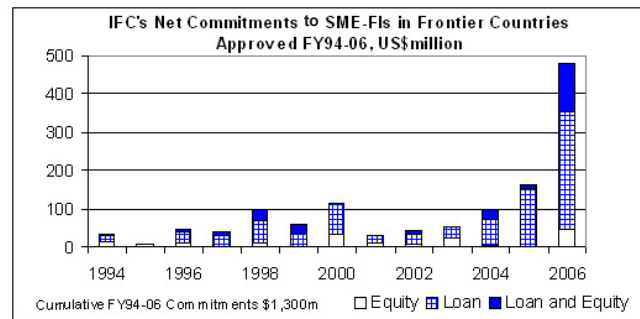
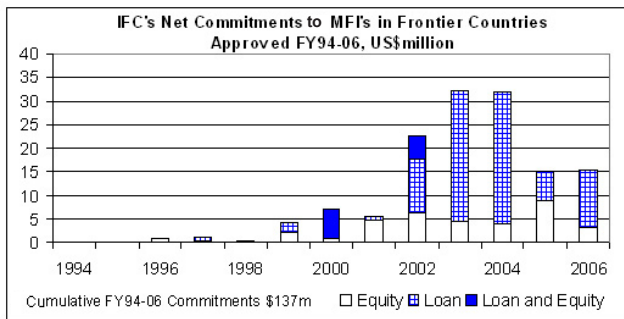
The rapid growth in commitments to MSME-FIs in frontier countries reflects IFC's strategic priorities.

IFC's annual net commitments for MSME-FIs in frontier countries expanded from \$33 million in fiscal year (FY) 1994 to \$497 million in FY06, and totaled \$1,405 million between FY94-FY06. Of this total, annual net commitments to

MFIs grew from \$1 million in FY96 to a peak of \$32 million in FY03 and FY04, then fell to \$15 million in FY05 and FY06, and totaled \$137 million between FY96-06. The drop in annual net commitments to MFI projects in frontier countries during FY05 and FY06 (Figure 1) was due to a shift in emphasis to FIs that focus on SMEs (SME-FIs).

FINANCING MSMEs THROUGH FINANCIAL INTERMEDIARIES, FY94-06

Figure 1: IFC's FY94 - 06 annual net commitments to MFIs and SME-FIs in frontier countries



The development outcomes of the MSME-FI projects are at least as good as the IFC average. Table 1 compares the development outcomes, the investment outcomes, and the Environmental Health and Safety (EHS) compliance of the MFI and MSME-FI projects with other groups of projects, and with all IFC projects evaluated under IFC's Expanded Project Supervision Report (XPSR) system administered by IEG. The development outcome success rate for the MFI projects is higher than any other group of projects shown in Table 1, but the success rate of IFC's equity investment in MFIs is lower, partly due to the small size (in terms of assets) of many

MFIs, their low debt leverage, which reduces equity returns, and the potentially long holding period before IFC can exit most of its MFI equity investments. IFC's equity investment success rate for the SME-FIs is almost as high as that of IFC's mainline commercial bank projects because of the significant proportion of larger SME-FIs (i.e., those with assets over \$1 billion) with a high equity success rate, driven by the large number of international and regional banks interested in acquiring stakes in large commercial banks in developing countries. However, the environmental compliance rate of MSME-FI projects is low, fostered by poor IFC environmental supervision.

Table 1: Comparison of development outcomes, IFC investment results and EHS compliance of the MFI and the SME-FI projects with other groups and IFC-wide averages

	No of projects	% with satisfactory development outcome	% with satisfactory IFC investment outcome		EHS compliance rate
			Loans	Equity	
All MFIs in the study population	21	71% ^{b/}	100% of 8	22% of 18	70% of 20
(i) MFIs under the MFI Holding Company	13	77%	100% of 7	27% of 11	85% of 13
(ii) All other MFIs	8	63%	100% of 1	14% of 7	43% of 7
SME-FI study population	72	61%	79% of 48	53% of 36	25% of 60 ^{c/}
Remainder of commercial bank projects with XPSRs ^{a/}	60	60%	76% of 49	67% of 15	55% of 42
Remainder of financial markets projects with XPSRs ^{a/}	147	59%	80% of 94	41% of 74	63% of 108
All IFC projects with XPSRs	627	59% ^{b/}	74% of 466	31% of 322	67% of 569
(i) Projects in frontier countries at approval	308	61%	74% of 227	34% of 165	62% of 274
(ii) IFC projects in non-frontier countries	319	58%	73% of 239	28% of 157	72% of 287

^{a/} Excludes two MFIs not in the study population

^{b/} No statistically significant difference due to the small number of projects in the MFI study population

^{c/} Eight SME-FI projects had no EHS compliance requirements and four did not have enough information to rate

CONCLUSIONS AND RECOMMENDATIONS

IFC's strategy of indirectly supporting MSMEs through financial intermediaries and providing them with capacity-building advisory services has been broadly effective. IFC should reinforce and improve these development impacts by:

- Encouraging other development partners (with strong government engagement) to promote the development of a specific and supportive prudential regulatory framework for MFIs that allows deposit taking and the establishment of branches and fosters competition to set reasonable interest rates for borrowers. This will facilitate the transition of MFIs out of donor dependency;
- Encouraging selected MSME-FIs who have achieved good risk management practices to diversify their product offerings, and supporting these MSME-FIs with a broader advisory services scope that includes the development of techniques and systems to: i) mobilize savings; ii) provide other banking services to low-income households and businesses; and iii) manage liquid assets;
- Placing a higher priority on supervising and ensuring compliance by SME-FIs with IFC's EHS requirements.

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