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44816

FINANCING MICRO, SMALL, AND MEDIUM ENTERPRISES

An Independent Evaluation of IFC's Experience with Financial Intermediaries in Frontier Countries

IFC
International Finance Corporation
World Bank Group

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Financing Micro, Small, and Medium Enterprises

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World Bank Group

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ABBREVIATIONS

CODE	Committee on Development Effectiveness (of the Executive Board)
EHS	Environment, Health, and Safety
ESRP	Environmental and Social Review Procedure
FI	Financial intermediary
FY	Fiscal year
IEG-IFC	Independent Evaluation Group-IFC
IFC	International Finance Corporation
MFI	Microfinance intermediary
MSME	Micro, small, and medium-size enterprise
MSME-FI	MSME-oriented financial intermediary
NGO	Nongovernmental organization
SME	Small and medium-size enterprise
SME-FI	SME-oriented financial intermediary
WBG	World Bank Group
XPSR	Expanded Project Supervision Report

DEFINITIONS OF EVALUATION TERMS

Rating scales

Six-point scale:	Development outcome is rated highly successful, successful, mostly successful, mostly unsuccessful, unsuccessful, or highly unsuccessful. "Sucess" and "high" ratings include projects with development outcomes of mostly successful and higher.
Four-point scale:	Other indicators are rated excellent, satisfactory, partly unsatisfactory, or unsatisfactory. "Satisfactory" and "high" ratings include projects rated satisfactory and excellent.

Investment operations

Company:	The entity implementing the project and, generally, IFC's investment counterparty; for financial markets operations, it refers to the financial intermediary (or fund manager) as distinct from its portfolio of IFC-financed subproject companies.
Investment:	IFC's financing instrument(s) in the evaluated operation: loan, guarantee, equity, underwriting commitment, and so forth.
Operation:	IFC's objectives, activities, and results in making and administering its investment.
Project:	The company objectives, capital investments, funding program, and related business activities being partially financed by IFC's investment selected for evaluation.
Example:	"Through this operation, IFC provided $55 million for the company's $100 million cement manufacturing expansion project in the form of a $20 million A-loan, a $30 million B-loan from commercial banks, and a $5 million equity investment."
Financial markets objective:	All projects in which the company is a financial intermediary or financial services company, including agency lines and private equity investment funds.
Nonfinancial markets projects:	All other projects; sometimes referred to as "real sector" projects.

Noninvestment operations (advisory services, which could include technical assistance components)

Outcomes of noninvestment operations:	Outcomes refer to implementation of recommendations or advice.

Impacts of noninvestment operations:	Impacts refer to the changes that occurred following the implementation of recommendation.
Example:	"An advisory services operation recommended that the country amend the leasing law to incorporate best practice in similar markets in the region." Outcome—the country amended the leasing law in accordance with the recommendation. Impact—the leasing industry became attractive to potential sponsors as evidenced by new companies that were established following the amendment of the leasing law.

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Foreword

This evaluation assesses IFC's strategies, investment projects, and advisory services operations during FY94–FY06 to support micro, small, and medium-size enterprises (MSMEs) in frontier countries (i.e., low-income or high-risk countries).

The confluence of two IFC strategic priorities—support for MSMEs and support for enterprises in frontier countries—serves as the point of departure of the evaluation. This report is timely because of the widespread interest among economic development practitioners in finding sustainable business models for providing financial support to microenterprises. The report includes an evaluation of the performance of the MSME-FIs in implementing IFC's environmental, health, and safety (EHS) requirements.

IFC's financial commitments to MSME-FIs in frontier countries totaled US$1.4 billion during FY94–06, representing about 38 percent of its worldwide commitments to MSME-FIs. In addition, IFC provided US$9.8 million and partner international financial institutions provided another US$45 million of advisory services funds to help establish and start up its microfinance intermediary (MFI) clients. Moreover, the small and medium enterprise-oriented financial intermediary (SME-FIs) clients received US$6.5 million of advisory services from IFC for capacity building.

The evaluation finds that the MFI and SME-FI projects achieved development outcome success rates better than the IFC-wide development outcome success rate for projects in all sectors. However, while the MFI projects had a comparable satisfactory rate for EHS performance to that for the IFC-wide, all-sector portfolio, the SME-FI projects had a substantially lower satisfactory rate of only 25 percent for their EHS performance.

One important implication of the evaluation is that IFC should move beyond access to finance for MSMEs in frontier countries, and address other banking services, such as saving and remittance services for low-income households and MSMEs. In particular, if MFIs can mobilize savings deposit for lending local currency funds to microenterprises, then this may facilitate their transition out of donor dependency and into long-term sustainability.

The evaluation concludes that IFC's strategy for supporting MSMEs through financial intermediaries, and providing capacity building advisory services to the intermediaries, has been relevant and broadly effective. Going forward, the strategy should be reinforced and modified to substantially enhance the development impacts of MSME-FI projects, by IFC's implementation of the following three initiatives: (i) take a more proactive approach in encouraging other development partners to promote the establishment of prudential regulatory regimes, and associated regulatory supervision capacity, for microfinance intermediaries to facilitate their transition out of donor dependency; (ii) enlarge the scope of its advisory services to MSME-FIs to help selected MSME-FIs better meet the need for savings and other banking services (e.g., remittances) by poor households and small businesses; and (iii) give a high priority to improving the environmental, health, and safety supervision and compliance of SME-FI projects.

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Director-General
Evaluation

Avant-propos

La présente évaluation vise à apprécier les stratégies, les projets d'investissement et les opérations d'assistance technique de l'IFC pendant la période allant de l'exercice 94 à l'exercice 06 en appui aux micro, petites et moyennes entreprises (MPME) dans les pays pionniers (c'est-à-dire, les pays à faible revenu ou les pays à haut risque).

La convergence de deux priorités stratégiques de l'IFC, à savoir l'appui aux MPME et l'appui aux entreprises dans les pays pionniers, sert de point de départ à l'évaluation. Le présent rapport arrive à son heure en raison du vaste intérêt que portent les spécialistes du développement économique à la recherche de modèles économiques viables dans le souci de fournir un appui financier aux microentreprises. Le rapport comprend une évaluation de la performance des IF-MPME dans la mise en œuvre des normes de l'IFC en matière environnementale, sociale, de santé et de sécurité (EHS).

Les engagements financiers de l'IFC vis-à-vis des IF-MPME dans les pays pionniers ont atteint 1,4 milliard de dollars de l'exercice 94 à l'exercice 06, ce qui correspond à environ 38 % de ses engagements au niveau mondial vis-à-vis des IF- MPME. En outre, l'IFC a fourni 9,8 millions de dollars et les institutions financières internationales partenaires ont fourni 45 millions de dollars supplémentaires au titre des fonds d'assistance technique pour aider à la création et au lancement des intermédiaires de la microfinance (IM) bénéficiant de ses ressources. De plus, les intermédiaires financiers bénéficiaires dont les activités sont ciblées sur les petites et moyennes entreprises (IF-PME) ont reçu de l'IFC 6,5 millions de dollars au titre de l'assistance technique pour le renforcement des capacités.

L'évaluation révèle que les projets concernant des IMF et des IF-PME ont réalisé des coefficients de réussite meilleurs en ce qui concerne les résultats de développement par rapport au coefficient de réussite global réalisé à l'échelle de l'IFC au titre de ses projets dans tous les secteurs. Cependant, tandis que les projets concernant des IMF avaient un taux de résultats satisfaisants comparable concernant la performance dans les domaines environnemental, social, de la santé et de la sécurité par rapport à celui enregistré par le portefeuille global de l'IFC tous secteurs confondus, les projets financés par les IF-PME ont enregistré un taux de résultats satisfaisants largement inférieur pour leur performance dans les domaines environnemental, social, de la santé et de la sécurité, à seulement 25 %.

Une des conséquences importantes qui découle de l'évaluation est que l'IFC doit aller au-delà de l'accès au financement des MPME dans les pays pionniers pour s'intéresser aux autres services bancaires comme les services d'épargne et de transfert de fonds aux ménages à faible revenu et aux MPME. En particulier, si les IMF peuvent mobiliser les dépôts d'épargne pour l'octroi prêts en monnaie locale aux microentreprises, cela pourrait faciliter leur transition de la dépendance vis-à-vis des bailleurs de fonds vers une autonomie financière durable.

L'évaluation conclut que la stratégie de l'IFC pour soutenir les MPME par le biais des intermédiaires financiers et offrir aux intermédiaires une assistance technique en matière de renforcement des capacités est pertinente et globalement efficace. À l'avenir, cette stratégie devrait être renforcée et modifiée en vue d'améliorer considérablement les impacts sur le développement des projets concernant des IF-MPME, grâce à la mise en oeuvre par l'IFC des trois initiatives suivantes : i) adopter une démarche plus anticipative en encourageant d'autres partenaires de développement à favoriser la mise en place de régimes réglementaires prudentiels et des capacités connexes de surveillance réglementaire de sorte à permettre aux intermédiaires de la microfinance de s'affranchir de leur dépendance à l'égard des bailleurs de fonds ; ii) étendre ses activités d'assistance technique aux IF-MPME afin d'aider un nombre déterminé d'IF-MPME à mieux satisfaire la demande des ménages pauvres et des petites entreprises pour les services d'épargne et d'autres services bancaires (par exemple, les transferts de fonds) ; et iii) accorder une place importante à l'amélioration de la supervision environnementale, sociale, sanitaire et en matière de sécurité des projets concernant des IF-PME et au renforcement du contrôle de l'application des normes dans ces différentes matières.

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Prólogo

La presente evaluación se refiere a las estrategias, los proyectos de inversión y las operaciones de asistencia técnica realizados por la IFC entre los ejercicios de 1994 y 2006 para respaldar a microempresas y pequeñas y medianas empresas (pyme) en países de frontera (es decir, países de ingreso bajo o de riesgo alto).

La confluencia de dos prioridades estratégicas de la IFC —respaldo para microempresas y pyme y respaldo para empresas en países de frontera— sirve como punto de partida de la evaluación. El informe, que es oportuno, dado el interés generalizado de los especialistas en desarrollo económico en hallar modelos sostenibles de negocios para brindar respaldo financiero a microempresas, contiene una evaluación del desempeño de los intermediarios financieros-microempresas y pequeñas y medianas empresas (IF-microempresas y pyme) en cuanto a exigencias ambientales, sociales y en materia de salud y seguridad (ASSS) establecidas por la IFC.

Entre los ejercicios de 1994 y 2006, el monto de los compromisos financieros de la IFC frente a IF-microempresas y pyme en países de frontera totalizó US$1.400 millones, suma que equivale a alrededor del 38% de los compromisos mundiales de la Corporación frente a esos tipos de entidades. Además, la IFC proporcionó US$9,8 millones, e instituciones financieras internacionales asociadas aportaron otros US$45 millones en fondos de asistencia técnica para ayudar a establecer y poner en marcha a sus intermediarios microfinancieros (IM) clientes. Además, los intermediarios financieros clientes orientados hacia las pequeñas y medianas empresas (IF-pyme) recibieron de la IFC asistencia técnica por un monto de US$6,5 millones para fortalecimiento de la capacidad.

En la evaluación se concluye que los proyectos de IM y de IF-pyme lograron tasas de éxito en cuanto al logro de resultados de desarrollo superiores a las tasas globales de la IFC en esta materia para proyectos ejecutados en todos los sectores. No obstante, si bien, en cuanto al cumplimiento de exigencias ASSS, los proyectos de IM lograron una tasa satisfactoria similar, a la de la totalidad de la cartera de la IFC para todos los sectores, los proyectos de IF-pyme alcanzaron una tasa considerablemente menos satisfactoria, de tan sólo 25%, en cuanto al cumplimiento de exigencias ASSS.

Una importante consecuencia de la evaluación es que la IFC no debería limitarse a conceder acceso al financiamiento a las microempresas y pyme existentes en países de frontera, sino además ocuparse de otros servicios bancarios, como los de ahorro y de remesas para hogares de bajos ingresos y microempresas y pyme. En especial, si los IM pueden movilizar depósitos de ahorro para otorgar financiamiento en moneda local para microempresas, se facilitaría su transición de una situación de dependencia de donantes a sostenibilidad a largo plazo.

En la evaluación se concluye que la estrategia de respaldo a las microempresas y pyme a través de intermediarios financieros que aplica la IFC, y de suministro de asistencia técnica para fortalecer la capacidas de los intermediarios financieros, ha sido pertinente y, en términos generales, eficaz. La estrategia debería reforzarse y modificarse para incrementar sustancialmente los impactos, en materia de desarrollo, de los proyectos de IF-microempresas y pyme, para lo cual la IFC debería aplicar tres iniciativas: i) adoptar un enfoque más proactivo para alentar a otros asociados para el desarrollo a promover el establecimiento de regímenes de regulación de prudencia y capacidad de supervisión conexa para facilitar a los intermediarios financieros una transición que les permita dejar de depender de donantes; ii) ampliar el alcance de la asistencia técnica otorgada a IF-microempresas y pyme, para ayudar a las entidades de ese género seleccionadas a atender mejor la necesidad de servicios de ahorro y otros servicios bancarios (por ejemplo, remesas) experimentada por los hogares pobres y las pequeñas empresas, y iii) dar alta prioridad al mejoramiento de la supervisión y cumplimiento de las exigencias ASSS de los proyectos de IF-pyme.

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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 assocated 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.

Résumé analytique

Les micro, petites et moyennes entreprises (MPME) composent l'essentiel du secteur privé, en particulier dans les pays pauvres. Elles éprouvent plus de difficultés que les grandes entreprises à accéder aux financements et aux services d'infrastructure, de même qu'à se conformer aux dispositions réglementaires difficiles à appliquer pour l'obtention de licences et aux autres dispositions gouvernementales.

But de la présente évaluation

Depuis le milieu des années 90, la **Société financière internationale** (IFC) a élaboré un certain nombre de stratégies pour appuyer les MPME. La stratégie mise en place par l'IFC depuis 2001 est axée sur : i) la fourniture d'un appui financier aux MPME par le biais des intermédiaires financiers ; et ii) la fourniture d'un soutien non financier et indirect destiné aux renforcement institutionnel des MPME à travers des mécanismes d'élaboration de projets cofinancés par les bailleurs de fonds. En outre, les stratégies institutionnelles de l'IFC portent essentiellement sur l'appui au développement du secteur privé dans les pays pionniers (caractérisés par un degré de risque important ou un faible niveau de revenu), compte tenu des niveaux relativement moins importants des apports de capitaux privés vers ces pays et du caractère comparativement peu avancé de leurs systèmes bancaires par rapport aux pays à revenu intermédiaire à moyen (ou faible) risque.

L'objectif de cette étude est par conséquent d'évaluer la convergence de ces deux priorités stratégiques institutionnelles (appui aux MPME par le biais des intermédiaires financiers et appui aux entreprises dans les pays pionniers) et d'émettre des recommandations sur la façon dont la stratégie visant à soutenir les MPME par le biais des intermédiaires financiers (collectivement désignés sous le nom d'IF-MPME) dans les pays pionniers pourrait être améliorée dans le but de renforcer leur impact en matière de développement. Plus précisément, l'étude vise à répondre à quatre questions d'évaluation :

- Quelles ont été les stratégies de l'IFC pour soutenir les MPME dans les pays pionniers, étaient-elles pertinentes et ont-elles été exécutées de manière efficace ?
- Quel a été le degré de réussite des projets concernant des intermédiaires financiers qui ont servi d'instruments pour permettre aux MPME de réaliser leurs résultats en matière de développement et quels ont été les facteurs essentiels de réussite ?
- Comment peut-on comparer les résultats enregistrés en matière de respect des normes

environnementales, sociales, sanitaires et de sécurité par les intermédiaires financiers ciblant leurs activités sur les MPME à ceux des projets traditionnels de l'IFC concernant des intermédiaires financiers ?

- Quelle a été la valeur ajoutée de l'IFC (c'est-à-dire son rôle et sa contribution) aux projets concernant des IF-MPME ?

L'étude couvre les exercices 94 à 06 et évalue : i) les stratégies de l'IFC pendant cette période, ii) la mise en œuvre des stratégies à travers les projets d'investissement engagés et les opérations d'assistance technique en appui aux MPME dans les pays pionniers pendant cette période, et iii) les résultats des projets en régime de croisière, c'est-à-dire qui avaient au moins deux années d'activité et de résultats financiers à la fin 2005 (il s'agit des projets approuvés jusqu'à l'exercice 02). Comme indiqué ci-dessus, une attention particulière est donnée au respect des normes environnementales, sociales, sanitaires et de sécurité par les intermédiaires financiers concernés par l'étude. L'étude n'évalue par les mécanismes d'élaboration de projet de l'IFC destinés au renforcement des capacités des MPME car certains ont fait au préalable l'objet d'évaluation par l'IEG-IFC et d'autres ont été évalués de manière séparée.

Cette étude a évalué les résultats de l'ensemble des 21 projets en régime de croisière concernant des intermédiaires financiers à but lucratif ciblant leurs activités sur les microentreprises (IFM), d'une part, et l'ensemble des 72 projets en régime de croisière concernant des intermédiaires financiers à but lucratif ciblant leurs activités sur les petites et moyennes entreprises (IF-PME), d'autre part, qui bénéficient de l'appui de l'IFC dans les pays désignés comme pays pionniers au moment de l'approbation des projets.

Stratégies, projets d'investissement et opérations d'assistance technique

Les principaux objectifs des stratégies de l'IFC pour soutenir les MPME se présentent comme suit :

i) offrir un appui sous forme de prêts indirects et à large échelle de l'IFC par le biais d'intermédiaires spécialisés de la microfinance et des IF-PME, et à travers d'autres structures financières spécialisées autres que des banques telles que les sociétés de crédit-bail ;
ii) fournir des services d'assistance technique et de conseils à ces intermédiaires financiers en vue d'améliorer leurs opérations, en particulier dans le domaine des prêts aux MPME ;
iii) acquérir une participation au capital de ces intermédiaires de la microfinance et des IF-PME lorsque l'apport de l'IFC génère une valeur ajoutée ;
iv) limiter les prêts directs ou les investissements en actions de l'IFC dans les petites et moyennes entreprises du fait de l'existence du Fonds pour l'entreprise en Afrique ou du Fonds pour la promotion de la petite entreprises, des mécanismes de financement auxquels ont actuellement recours les départements de l'investissement de manière sélective ;
v) offrir une assistance technique indirecte et à large échelle de l'IFC pour le renforcement institutionnel et l'amélioration des capacités des MPME à travers des mécanismes spécialisés de conception de projets qui permettront aux MPME d'améliorer leurs opérations ; et
vi) apporter généralement un appui au développement des marchés des capitaux et du secteur privé en aidant à améliorer les cadres de politique générale, réglementaire et administratif, de même que le climat des affaires.

L'IFC a élaboré des paramètres de conception de projet pour les IMF à but lucratif au milieu des années 90 et a initié la structure de société de portefeuille au cours de l'exercice 99 afin d'accélérer le développement des IMF. Les quatre paramètres, qui sont relatifs aux principes opérationnels et à la qualité des promoteurs, à la gouvernance, au financement et à l'assistance technique, ont été utilisés dans le cadre du premier projet de l'IFC concernant des IMF à but lucratif, qui a été approuvé au cours de l'exercice 96, et également dans l'ensemble des 21 projets concernant des IMF qui ont été évalués.

Le montant annuel net des engagements et l'appui en matière d'assistance technique de l'IFC en faveur des intermédiaires financiers dont les activités sont ciblées sur les micro, petites et moyennes entreprises dans les pays pionniers ont connu une progression rapide entre l'exercice 94 et l'exercice 06, une tendance qui est conforme à ses priorités stratégiques. Le montant annuel net des engagements de l'IFC en faveur des IF-MPME dans les pays pionniers a augmenté de 33 millions de dollars pendant l'exercice 94, passant à 497 millions de dollars pendant l'exercice 06, pour atteindre un montant total de 1 405 millions de dollars de l'exercice 94 à l'exercice 06. Sur ces chiffres, le montant annuel net des engagements en faveur des intermédiaires de la microfinance dans les pays pionniers a connu une hausse, passant de 1 million de dollars pendant l'exercice 96 pour atteindre une crête de 32 millions de dollars pendant l'exercice 03 et l'exercice 04, avant de retomber à 15 millions de dollars pendant l'exercice 05 et l'exercice 06, ce qui correspond à un montant total de 137 millions de dollars entre l'exercice 96 et l'exercice 06. La baisse du montant annuel net des engagements au titre des projets concernant des IMF dans les pays pionniers pendant l'exercice 05 et l'exercice 06 était due à un changement de priorité en faveur des IF-PME aussi bien dans les pays pionniers que dans les pays non pionniers, d'une part, et en faveur des IMF dans les pays non pionniers, d'autre part. Dans le même temps, l'IFC renforçait son réseau de sociétés de portefeuille regroupant des IMF qui constitueraient la base pour l'élargissement de l'échelle des opérations concernant des IMF à travers le monde. Sur l'échantillon d'IMF évaluées, 18 ont reçu des fonds d'assistance technique sous forme de dons pour un montant total d'environ 54,8 millions de dollars, dont environ 18 % ont été fournis par l'IFC et le reliquat par les institutions internationales de développement partenaires. Sur l'échantillon d'IF-PME évaluées, l'IFC a octroyé des fonds d'assistance technique sous forme de dons à 21 IF-PME d'un montant total d'environ 6,5 millions de dollars.

Performance des intermédiaires offrant des services aux microentreprises

71 % des IMF ont réalisé des résultats élevés en matière de développement, supérieurs au coefficient de réussite de 61 % réalisé pour l'ensemble des projets d'investissement de l'IFC situés dans des pays pionniers, de même qu'au coefficient de réussite de 59 % enregistré pour l'ensemble des projets de l'IFC à travers le monde qui ont été évalués à l'aide des Rapports de supervision élargie des projets (XPSR). Les projets concernant des IMF qui ont enregistré des résultats faibles ou insuffisants en matière de développement sont principalement situés en Afrique subsaharienne et, en général, présentaient deux ou plusieurs des caractéristiques suivantes : i) elles n'étaient pas autorisées à accepter des dépôts ou avaient de faibles taux de mobilisation de l'épargne et des dépôts, soit l'équivalent de moins de 60 % des prêts ; ii) un réseau de clientèle comprenant moins de 20 000 micro et petites entreprises emprunteuses ; iii) un niveau total d'avoirs de moins de 15 millions de dollars ; iv) des taux élevés de prêts improductifs, situés à 1,8 % ou plus ; et v) des rendements sur le montant total des avoirs de moins de 1,0 %.

Seulement 22 % des investissements en actions de l'IFC dans les IMF évaluées ont réalisé des rendements sur fonds propres satisfaisants pour l'IFC, ce qui est un pourcentage inférieur au coefficient de réussite de 34 % obtenu pour l'ensemble des investissements en actions de l'IFC (dans tous les secteurs) dans les pays pionniers évalués à l'aide des XPSR, et inférieur au coefficient de réussite de 58 % réalisé pour les investissements en actions de l'IFC dans les IF-PME qui ont été évalués. Le manque d'intérêt de la direction des IMF pour l'amélioration des rendements sur fonds propres, pour les facteurs qui ont contribué aux résultats de développement décrits ci-dessus, et l'absence d'un mécanisme clair de sortie du capital de l'IFC (tels que les options de vente d'actions), constituent autant de facteurs ayant contribué au faible coefficient de réussite des investissements en actions de l'IFC dans les IMF évaluées.

Performance des intermédiaires offrant des services aux IF-PME

61 % des projets évalués concernant des IF-PME ont réalisé des résultats élevés en matière de développement, à l'image du coefficient de réussite enregistré pour l'ensemble des projets de l'IFC à travers le monde qui ont été évalués à l'aide des XPSR (59 %). Cependant, un sous-groupe de 21 projets concernant des IF-PME qui ont reçu une assistance technique de la part de l'IFC ont enregistré un coefficient de réussite en terme de résultats de développement de 76 %, ce qui est largement supérieur au coefficient de réussite de 55 % obtenu pour les 51 autres projets concernant des IF-PME qui n'ont bénéficié d'aucune assistance technique. Les régions ayant les coefficients de réussite les plus faibles en terme de résultats de développement pour les projets concernant des IF-PME ont été la région Moyen Orient et Afrique du Nord et la région Afrique subsaharienne.

53 % des investissements en actions de l'IFC dans des projets concernant des IF-PME qui ont été évalués ont généré des rendements satisfaisants, ce qui est inférieur au coefficient de réussite de 67 % enregistré par les investissements en actions pour l'ensemble des autres projets de l'IFC concernant des banques commerciales à travers le monde qui ont été évalués à l'aide des XPSR, mais supérieur au coefficient de réussite de 31 % des investissements en actions pour l'ensemble des projets de l'IFC dans le monde entier qui ont été évalués à l'aide des XPSR. Le coefficient de réussite relativement plus élevé des investissements en actions de l'IFC pour les projets concernant des IF-PME (et en général pour les projets concernant des banques commerciales dans le monde entier) traduit l'accroissement de la valeur comptable des banques commerciales, qui s'explique surtout par la libéralisation du secteur bancaire dans de nombreux pays en développement et par le nombre important de banques internationales et régionales désireuses d'acquérir des participations substantielles dans les banques commerciales des pays en développement, en particulier dans les plus importantes. La moitié des investissements en actions de l'IFC dans les IF-PME qui ont été évalués ont concerné les IF-PME les plus importants dont les avoirs sont supérieurs à 1 milliard de dollars. Le coefficient de réussite moyen des investissements en actions de l'IFC dans ces IF-PME les plus importants était de 88 %.

Performance environnementale des IMF et des IF-PME

71 % des IMF parmi celles ont été évaluées et plus de 80 % des 65 sous-projets concernant des MPME visitées par l'IEG-IFC avaient des notes satisfaisantes concernant le respect des normes environnementales, sociales, sanitaires et de sécurité. Toutefois, seulement environ 25 % des IF-PME évalués avaient des notes satisfaisantes concernant le respect des normes environnementales, sociales, sanitaires et de sécurité, ce qui s'explique en partie par le non respect des normes par les sous-projets et en partie par l'incapacité des IF-PME d'installer un système de gestion environnementale ou de rendre régulièrement compte à l'IFC (ou les deux), une situation qui a été favorisée à son tour par l'insuffisance de supervision de la part de l'IFC. La qualité du contrôle par l'IFC du respect des normes environnementales, sociales, sanitaires et de sécurité dans le cadre des projets concernant des IF-PME qui ont été évalués n'est satisfaisante qu'à 32 %.

Principales conclusions

Six facteurs essentiels de réussite des projets soutenus par l'IFC sont communs aux projets concernant des IMF et aux projets concernant des IF-PME, un facteur déterminant de réussite concerne uniquement les projets concernant des IMF. Outre la qualité des interventions de l'IFC, quatre des facteurs essentiels de réussite découlent des paramètres de conception des projets concernant des IMF qui ont été utilisés par l'IFC. Les six facteurs essentiels de réussite communs aux projets concernant des IMF et aux projets concernant des IF-PME sont les suivants :

- **la qualité des promoteurs et de la direction :** un promoteur principal ou un partenaire technique expérimenté et une direction spécialisée et adhérant à un modèle économique à vocation commerciale et à but lucratif pour l'IF-MPME ;
- **l'assistance technique :** l'accès aux fonds d'assistance technique sous forme de dons pour faire face aux coûts de démarrage, de formation et d'acquisition des systèmes opérationnels ;
- **les normes opérationnelles :** des normes de bonne pratique pour établir des bases d'appréciation de la performance ;
- **le capital et la gouvernance de l'institution :** une mise de départ substantielle et la supervision de l'institution de développement actionnaire pour aider à obtenir l'approbation des autorités réglementaires, attirer les dépôts, et maintenir l'accent sur les services aux MPME et garantir la conformité des opérations avec le principe de prudence ;
- **la transparence :** assurer la transparence des opérations et susciter la confiance des populations pour aider à mobiliser des financements locaux, en particulier les dépôts ; et
- **la qualité des interventions de l'IFC :** la bonne qualité des interventions de l'IFC, notamment la sélection des IF-PME devant être soutenus. S'agissant des IMF appartenant à une holding, la qualité du partenaire technique et du fournisseur de services de gestion et de formation est également importante et pourrait venir en complément de la qualité des interventions de l'IFC.

En outre, l'un des facteurs essentiels de réussite particulier aux projets concernant des IMF tient à l'existence d'un régime réglementaire spécialisé et favorable (et des capacités de contrôle réglementaire associées) pour les IMF. Un régime réglementaire favorable pour les IMF permet aux IMF d'accepter des dépôts d'épargne, créer des agences, facturer des taux d'intérêt qui génèrent un profit et s'appuient sur la concurrence pour garantir des taux d'intérêt raisonnables aux emprunteurs. L'existence d'un réseau d'agences de banques accroît la base de clientèle et, partant, permet de dégager des économies d'échelle pour les IMF, et aide à étendre l'impact en matière de développement. Les pays dotés de régimes réglementaires favorables aux IMF se situaient surtout dans la région Amérique latine et Caraïbe et dans la région Asie de l'Est.

La qualité des interventions de l'IFC, la qualité des promoteurs et la direction des entreprises sont des facteurs essentiels de réussite constatés invariablement dans les évaluations par l'IEG-IFC des projets de l'IFC dans tous les secteurs et régions qui ont été approuvés au cours des dix dernières années. S'agissant des IMF et des IF-PME évalués, l'assistance technique et les prises de participation de l'IFC ont été également des facteurs essentiels de réussite dans l'ensemble des régions.

La stratégie de l'IFC pour soutenir les MPME à travers des intermédiaires financiers a été pertinente et largement efficace en ce sens que la stratégie :

- a fourni une source fiable, accessible et potentiellement permanente de prêts aux MPME en renforçant les capacités institutionnelles et financières des intermédiaires ;
- a complété les ressources de l'IFC avec celles des IF-MPME, ainsi qu'avec celles des institutions de cofinancement, principalement les banques multilatérales de développement et les organismes d'aide bilatérale dans le cas des IMF ;
- a pu engendrer une forte mobilisation des MPME et un fort taux global de remboursement des prêts, ce que l'IFC ne pouvait réaliser directement ; et
- a démontré que le financement des MPME peut être une activité rentable pour les banques commerciales et a aidé à développer et à accroître la concurrence dans le système bancaire local.

Cependant, l'accent particulier mis par la stratégie et l'assistance technique de l'IFC sur l'accroissement de l'accès au financement pour les MPME a jusqu'à présent conduit à négliger plusieurs dispositions importantes pour renforcer les résultats en matière de développement des IF-MPME, en particulier les IMF : i) l'importance de fournir des prêts en monnaie locale aux MPME qui ne peuvent accepter les risques de dévaluation des taux de change associés aux prêts en devises ; ii) le rôle important que joue la base des dépôts d'épargne en fournissant aux IMF une source durable de fonds en monnaie locale qui leur permet de ne plus dépendre des bailleurs de fonds ; iii) la forte demande de services bancaires (transfert de fonds, épargne, etc.) provenant des ménages à faible revenu et des MPME, à laquelle les IMF pourraient également faire face, en plus de la fourniture de crédits ; et iv) le rôle crucial des régimes réglementaires spécialisés et favorables pour le succès des IMF.

L'existence d'une direction de PME déterminée, d'un personnel qualifié, d'une réglementation environnementale de qualité et le contrôle de l'application des normes dans le pays où ont lieu les opérations favorisaient la durabilité des sous-projets concernant des PME financés par l'IFC par le biais d'intermédiaires financiers du point de l'environnement, de la santé, social et de la sécurité. Toutefois, les considérations liées à l'environnement, à la santé, aux questions sociales et à la sécurité ne sont pas encore largement épousées par les PME dans les pays pionniers et seules quelques IF-PME sont fortement engagés à contrôler et superviser la performance de leurs sous-projets en matière environnementale, sanitaire, sociale et de sécurité. Le contrôle de l'application des réglementations locales en matière environnementale, sanitaire, sociale et de sécurité, en particulier en ce qui concerne les PME, laisse le plus souvent à désirer dans les pays pionniers. La supervision par l'IFC du respect par les projets concernant des intermédiaires financiers des normes environnementales, sanitaires, sociales et de sécurité est donc importante si l'on entend parvenir à appliquer les normes EHS. Face à l'augmentation rapide du portefeuille des marchés de capitaux et aux mauvais résultats enregistrés jusqu'à présent par les projets financés par les intermédiaires financiers en matière de respect des normes EHS, l'IFC a installé une équipe spécialisée en EHS au sein du Département général des marchés de capitaux. L'IFC a aussi lancé le programme « d'intégration » de l'EHS parmi les responsables de l'investissement dans tous les secteurs, de sorte qu'ils puissent compléter les efforts de supervision des spécialistes en EHS. Pour que ces initiatives puissent être couronnées de succès, la direction de l'IFC doit également accorder une grande importance à la supervision des projets concernant des intermédiaires financiers et le respect par ceux-ci des normes EHS.

Recommandations

La stratégie de l'IFC consistant à soutenir les MPME à travers des intermédiaires financiers et à fournir une assistance technique pour le renforcement des capacités institutionnelles aux intermédiaires financiers, est pertinente et globalement efficace. Néanmoins, à l'avenir, la stratégie doit être renforcée et améliorée afin de renforcer considérablement l'impact en terme de développement des projets concernant des IF-MPME, par la mise en œuvre par l'IFC des trois initiatives indiquées ci-après :

i) adopter une démarche plus anticipative en encourageant d'autres partenaires de développement qui sont fortement engagés avec les gouvernements des pays en développement à favoriser la mise en place de régimes de réglementation détaillés et prudentiels, de même que les capacités de supervision gouvernementale associées, en faveur des intermédiaires de la microfinance dans les pays en développement, en particulier dans les pays pionniers. Ceci permettra de créer des conditions permettant aux IMF de s'arracher à leur dépendance vis-à-vis des bailleurs de fonds, notamment grâce au développement d'une base de dépôts d'épargne et à la réalisation d'économies d'échelle à travers l'élargissement de leur base de clientèle et la création d'agences ;

ii) étendre les activités d'assistance technique de l'IFC aux IF-MPME au-delà de l'orientation actuelle axée sur l'amélioration des techniques de prêt et la gestion du risque lié au portefeuille de prêts, afin d'aider également un nombre déterminé d'IF-MPME qui ont réussi à instaurer de bonnes pratiques de gestion du risque : a) mieux répondre à la demande d'épargne et d'autres services bancaires (par exemple, les transferts de fonds) provenant des ménages pauvres et des petites entreprises ; b) appliquer des procédures de gestion de la liquidité conformes à ce qui se fait de mieux ; et c) s'agissant des IMF, aider à élargir leur base de clientèle afin de toucher aussi les entreprises de petite taille ;

iii) accorder une grande importance à l'amélioration de la supervision des normes EHS et du taux d'observation des normes EHS par les projets concernant des IF-MPME. En particulier, l'IEG recommande que l'IFC fixe un objectif à atteindre dans un délai défini, afin d'améliorer le taux de supervision satisfaisante en matière d'EHS, ainsi que le taux d'observation des normes EHS dans le cadre des projets concernant des IF-MPME.

Resumen

Las microempresas y las pequeñas y medianas empresas (pyme) constituyen el grueso del sector privado, especialmente en los países pobres, y experimentan mayores dificultades que las empresas de mayor escala para obtener acceso al financiamiento y a los servicios de infraestructura y cumplir engorrosos requisitos de obtención de licencias y otras disposiciones gubernamentales.

Finalidad de esta evaluación

Desde mediados de la década de 1990, la Corporación Financiera Internacional (IFC) ha venido diseñando estrategias de respaldo para microempresas y pyme. La estrategia que aplica la Corporación desde 2001 consiste en: i) proporcionar respaldo financiero a microempresas y pyme a través de intermediarios financieros, y ii) brindar respaldo no financiero indirecto a microempresas y pyme para el fortalecimiento institucional, a través de servicios de elaboración de proyectos cofinanciados por donantes. Además, las estrategias institucionales de la IFC están centradas en el suministro de respaldo para el desarrollo del sector privado en países de frontera (los caracterizados por riesgo alto o ingreso bajo), en respuesta a la magnitud relativamente menor del capital privado que a ellos afluye y al hecho de que sus sistemas bancarios están menos desarrollados que los de los países de ingreso mediano con riesgo mediano (o bajo).

El objetivo de este estudio consiste, por lo tanto, en evaluar la confluencia de esas dos prioridades estratégicas institucionales (respaldo para microempresas y pyme a través de intermediarios financieros y respaldo para las empresas en países de frontera) y ofrecer recomendaciones sobre la manera de mejorar la estrategia de suministro de apoyo a las microempresas y pyme a través de intermediarios financieros (conocidos colectivamente como IF-microempresas y pyme) en países de frontera, para intensificar su impacto en materia de desarrollo. Más específicamente, a través del estudio se procura dar respuesta a las siguientes preguntas de evaluación:

- ¿Qué estrategias utilizó la IFC para respaldar a las microempresas y pyme en países de frontera? ¿Fueron pertinentes? ¿Se aplicaron eficazmente?
- ¿En qué medida lograron éxito los proyectos de los intermediarios financieros que actuaron como canales de respaldo para las microempresas y pyme en cuanto al logro de sus resultados en materia de desarrollo, y cuáles fueron los principales motores de ese éxito?

- ¿El cumplimiento, por parte de los intermediarios financieros que se ocupan de las microempresas y pyme, de las exigencias ASSS fue más o menos satisfactorio que el de los proyectos ordinarios de los intermediarios financieros que operan con la IFC?
- ¿Cuál fue el valor añadido por la IFC (es decir, su papel y contribución) en los proyectos de IF-microempresas y pyme)?

El estudio abarca los ejercicios de 1994 a 2006. En él se evalúan: i) las estrategias aplicadas por la IFC en ese período, ii) la implementación de las estrategias a través de proyectos de inversión comprometidos y operaciones de asistencia técnica en respaldo de microempresas y pyme en países de frontera en dicho período, y iii) los resultados de los proyectos que han llegado a la madurez operativa contando con no menos de dos años de resultados operativos y financieros al final de 2005 (es decir, los proyectos aprobados hasta el ejercicio de 2002). Como ya se señaló, se presta especial atención al desempeño en cuanto al cumplimiento de exigencias ASSS de los intermediarios financieros que abarca el estudio. En éste no se evalúan los servicios de elaboración de proyectos de la IFC en materia de fortalecimiento de capacidad para microempresas y pyme porque algunos fueron evaluados anteriormente por el IEG-IFC y otros lo serán separadamente.

En este estudio se evaluaron los resultados de los 21 proyectos maduros desde el punto de vista operativo, con fines de lucro, a cargo de intermediarios financieros orientados a microempresas (IM), y de los 72 proyectos maduros desde el punto de vista operativo, con fines de lucro, cargo de intermediarios financieros orientados a pequeñas y medianas empresas (IF-pyme) respaldados por la IFC en países clasificados como de frontera, a la fecha de aprobación del proyecto.

Estrategias, proyectos de inversión y operaciones de asistencia técnica

Los siguientes son los principales objetivos de las estrategias aplicadas por la IFC para respaldar a las microempresas y pyme:

i) Ofrecer respaldo en amplia escala, indirecto, mediante respaldo de préstamos de la IFC, a través de intermediarios de microfinanciamiento especializados e IF-pyme y a través de otras entidades financieras no bancarias especializadas, como las compañías de arrendamiento financiero;
ii) Dispensar servicios de asistencia técnica y asesoramiento a esos intermediarios financieros, para mejorar sus operaciones, en especial en lo que respecta al otorgamiento de préstamos a microempresas y pyme;
iii) Invertir capital en esos intermediarios microfinancieros e IF-pyme cuando la IFC, al hacerlo, añada valor;
iv) Limitar las inversiones directas en préstamos o inversiones de capital de la IFC en empresas de pequeña y mediana escala en el contexto del Fondo para Empresas Africanas o el Fondo para la Pequeña Empresa; en la actualidad, los departamentos de inversiones sólo utilizan esos fondos con carácter selectivo como mecanismos de financiamiento;
v) Ofrecer asistencia técnica indirecta en gran escala de la IFC para el fortalecimiento institucional de microempresas y pyme a través de servicios especializados de elaboración de proyectos que ayuden a las microempresas y pyme a mejorar sus operaciones, y
vi) Respaldar en forma amplia el desarrollo de mercados financieros y del sector privado ayudando a mejorar los marcos de políticas, regulatorios y administrativos, así como el clima de negocios.

A mediados de la década de 1990, la IFC elaboró parámetros de diseño de proyectos para IM orientados al logro de utilidades, y en el ejercicio de 1999 introdujo la estructura de sociedad de cartera de inversiones de IM para acelerar el desarrollo de los IM. Los cuatro parámetros —relativos a principios operativos y calidad del patrocinador, buena gestión, financiamiento y asistencia técnica— se utilizaron en el primer proyecto de la IFC para IM orientados al logro de utilidades, aprobado en el ejercicio de 1996, y también en los 21 proyectos para IM evaluados.

En los ejercicios de 1994 a 2006 aumentaron aceleradamente los compromisos netos anuales de la IFC y el respaldo brindado mediante asistencia técnica a los intermediarios financieros que se ocupan principalmente de proporcionar financiamiento a microempresas y pequeñas y medianas empresas en países de frontera, lo que refleja sus prioridades estratégicas. El monto neto anual de los compromisos de la IFC para IF-microempresas y pyme en países de frontera aumentó de US$33 millones en el ejercicio de 1994 a US$497 millones en el de 2006, y totalizó US$1,405 millones en ese mismo período. Dentro de esos montos, el de los compromisos anuales netos para intermediarios microfinancieros en países de frontera aumentó de US$1.000.000 en el ejercicio de 1996 a un máximo de US$32 millones en los ejercicios de 2003 y 2004; se redujo a US$15 millones en los ejercicios de 2005 y 2006, y totalizó US$137 millones entre el ejercicio de 1996 y el de 2006. La disminución del monto neto anual de los compromisos en proyectos de IM en países de frontera en los ejercicios de 2005 y 2006 obedeció a que la IFC pasó a ocuparse principalmente de IF-pyme en países de frontera y en otros países, y de IM en países que no son de frontera. Al mismo tiempo, la IFC estaba creando su red de carteras de control de IM, que serviría de fundamento para seguir aumentando la escala de las operaciones de IM en todo el mundo. Dentro de la población de IM evaluada, 18 compañías recibieron fondos de otorgamiento gratuito de asistencia técnica por un total de alrededor de US$54,8 millones; de ese total, alrededor del 18% fue suministrado por la IFC y el resto, por instituciones internacionales para el desarrollo asociadas. Dentro de la población de IF-pyme evaluada, la IFC proporcionó fondos de asistencia técnica en forma de donaciones a 21 IF-pyme, por un total de alrededor de US$6,5 millones.

Desempeño de microempresas que sirven a intermediarios

El 71% de los IM lograron resultados satisfactorios en materia de desarrollo, superando la tasa de éxito del 61% correspondiente a todos los proyectos de inversiones de la IFC en países de frontera y la tasa de éxito del 59% correspondiente a todos los proyectos de la IFC a escala mundial evaluados con informes ampliados de supervisión de proyectos. Los proyectos de IM cuyos resultados en materia de desarrollo fueron escasos o insatisfactorios estaban establecidos principalmente en África al sur del Sahara y, en general, reunían dos o más de las siguientes características: i) carecían de licencia para tomar depósitos o registraban bajas tasas de movilización de ahorros y depósitos, equivalentes a menos del 60% de los préstamos; ii) poseían una cobertura de clientes de menos de 20.000 microempresas y pequeñas empresas prestatarias; iii) contaban con un total de activos de menos de US$15 millones; iv) registraban tasas de incumplimiento de préstamos elevadas (no inferiores al 1,8%), y v) mostraban un rendimiento del total de los activos de menos del 1,0%.

Sólo el 22% de las inversiones de capital de la IFC en la población de IM evaluada lograron para la IFC un rendimiento del capital satisfactorio, inferior al coeficiente de éxito del 34% correspondiente a todas las inversiones de capital de la IFC (en todos los sectores) en países de frontera evaluados con informes ampliados de supervisión de proyectos, e inferior a la tasa de éxito de las inversiones de capital de la IFC en la población evaluada de IF-pyme, que fue del 58%. El hecho de que la administración de los IM no se haya esforzado en mejorar la rentabilidad del capital, los factores que contribuyeron a suscitar resultados insatisfactorios en materia de desarrollo, que arriba se describen, y la inexistencia de un mecanismo de salida claro para la IFC (por ejemplo, opciones de venta de capital) fueron factores que, aunados, contribuyeron a provocar la baja tasa de éxito de las inversiones de capital de la IFC en la población de IM evaluada.

Desempeño de intermediarios que sirven a IF-pyme

El 61% de los proyectos de IF-pyme evaluados lograron resultados satisfactorios en materia de desarrollo, alcanzándose una tasa de éxito similar a la registrada por todos los proyectos de la IFC en el mundo evaluados con informes ampliados de supervisión de proyectos (59%). En cambio, un subgrupo de 21 proyectos de

IF-pyme que recibieron asistencia técnica de la IFC registraba una tasa de éxito en cuanto a resultados en materia de desarrollo del 76%, considerablemente mayor que la alcanzada por los restantes 51 proyectos de IF-pyme que no recibieron asistencia técnica (55%). Las regiones con más baja tasa de éxito en materia de desarrollo alcanzada por los proyectos de IF-pyme fueron la de Oriente Medio y Norte de África y la de África al sur del Sahara.

El 53% de las inversiones de capital de la IFC en la población evaluada de IF-pyme lograron un rendimiento satisfactorio, inferior a la tasa de éxito de las inversiones de capital, que fue del 67%, correspondiente a todos los restantes proyectos de la IFC a cargo de bancos comerciales a escala mundial evaluados con informes ampliados de supervisión de proyectos, pero mayor que la tasa de éxito de las inversiones de capital correspondiente a todos los proyectos de la IFC a nivel mundial evaluados con informes ampliados de supervisión de proyectos, que fue del 31%. El hecho de que ese coeficiente haya sido relativamente más alto para los proyectos de IF-pyme (y para los proyectos de bancos comerciales a escala mundial en general) refleja el incremento de los valores del capital de los bancos comerciales, que puede atribuirse principalmente a la liberalización del sector bancario en muchos países en desarrollo y al interés de numerosos bancos internacionales y regionales en adquirir una proporción sustancial del capital de bancos comerciales de países en desarrollo, especialmente los de mayor escala. La mitad de las inversiones de capital realizadas por la IFC en la población de IF-pyme evaluada corresponde a los IF-pyme más grandes, cuyos activos superan US$1.000 millones. La tasa media de éxito de las inversiones de capital realizadas en esos IF-pyme fue del 88%.

Desempeño ambiental de los IM y los IF-pyme

El 71% de los IM de la población evaluada y más del 80% de los 65 subproyectos de microempresas y pyme que visitó el IEG-IFC registraron puntajes de cumplimiento de exigencias ASSS satisfactorios. No obstante, tan sólo alrededor del 25% de la población de IF-pyme evaluada obtuvo puntajes satisfactorios de cumplimiento de esas exigencias, lo que obedeció en parte al incumplimiento de los subproyectos y en parte a que los IF-pyme no lograron instalar un sistema de gestión ambiental o informar regularmente a la IFC (o ninguna de las dos cosas), lo que a su vez se vio promovido por una inadecuada supervisión de la IFC. La calidad de la supervisión del cumplimiento de las exigencias ASSS a cargo de la IFC para los proyectos en la población IF-pyme evaluada fue satisfactoria sólo en proporción del 32%.

Principales conclusiones

Seis factores impulsores del éxito de los proyectos respaldados por la IFC son comunes a los proyectos de IM y a los de IF-pyme, y uno es exclusivo de los proyectos de IM. Además de la calidad de la labor de la IFC, cuatro de esos factores se originan en los parámetros de diseño para proyectos de IM utilizados por la IFC. Los siguientes son los seis factores comunes a los proyectos de IM y de IF-pyme:

- **Calidad del patrocinador y de la administración:** Un patrocinador principal o asociado técnico experimentado y una administración especializada e identificada con un modelo de negocios con orientación comercial y que opere con fines de lucro para IF-microempresas y pyme;
- **Asistencia técnica:** Acceso a fondos de otorgamiento de asistencia técnica para cubrir costos de iniciación, capacitación y adquisición de sistemas operativos;
- **Normas operativas:** Normas de buenas prácticas para establecer parámetros de desempeño;
- **Capital y buena gestión institucionales:** Considerable capital inicial y supervisión a cargo de los accionistas de instituciones de desarrollo para contribuir a lograr aprobación en la esfera regulatoria, atraer depósitos, mantener un enfoque encaminado a atender a las microempresas y pyme y lograr operaciones prudentes;

- **Transparencia:** Operaciones transparentes y confianza pública para ayudar a movilizar fondos locales, especialmente depósitos, y
- **Calidad de la labor de la IFC:** Buena calidad de la labor de la IFC, incluida la selección de los IF-pyme que hayan de recibir respaldo. En el caso de los IM que están en manos de una sociedad de cartera de inversiones, también reviste importancia la calidad del asociado técnico y proveedor de servicios de administración y capacitación, lo que puede complementar en gran medida la calidad de la labor de la IFC.

Además, un mecanismo impulsor del éxito exclusivo de los proyectos de IM es la existencia de un régimen de regulación especializado y que brinde adecuado respaldo (y la capacidad de supervisión regulatoria conexa) para los IM. Un régimen regulador que respalda a los IM permite a éstos tomar depósitos de ahorro, establecer sucursales, cobrar tasas de interés que generen utilidades y basarse en la competencia para garantizar a los prestatarios tasas de interés razonables. Una red de sucursales bancarias aumenta la base de clientes y, por lo tanto, ayuda a lograr economías de escala para los IM, y además contribuye a ampliar el alcance de su labor de extensión en la esfera del desarrollo. La mayoría de los países con regímenes regulatorios que brindan respaldo a los IM pertenecían principalmente a las regiones de América Latina y el Caribe y de Asia oriental.

La calidad de la labor de IFC, la calidad de los patrocinadores y de la administración de las empresas son factores impulsores del éxito que invariablemente aparecen en las evaluaciones del IEG-IFC de proyectos de la IFC en todos los sectores y las regiones aprobadas en los últimos diez años. Para las poblaciones de intermediarios financieros y de IM-pyme evaluadas, la asistencia técnica y el capital de la IFC fueron también impulsores esenciales del éxito en todas las regiones.

La estrategia aplicada por la IFC para respaldar a las microempresas y pyme a través de intermediarios financieros ha sido pertinente y, en términos generales, eficaz, en el sentido de que:

- Proporcionó a las microempresas y pyme una fuente confiable, accesible y potencialmente permanente de préstamos fortaleciendo la capacidad institucional y financiera de los intermediarios;
- Apalancó los recursos de la IFC con los de los IF-microempresas y pyme y con los de cofinanciadores, principalmente, otros bancos multilaterales de desarrollo y entidades bilaterales de asistencia en el caso de los IM;
- Realizó una amplia labor de extensión entre las microempresas y pyme y logró una elevada tasa de reembolso de préstamos, que la IFC no podía alcanzar directamente, y
- Demostró que otorgar financiamiento a microempresas y pyme puede ser un negocio rentable para los bancos comerciales, y ayudó a crear e incrementar la competencia en el sistema bancario local.

No obstante, la estrategia y la asistencia técnica de la IFC se centraron específicamente en la ampliación del acceso al financiamiento para las microempresas y pyme, habiéndose perdido hasta ahora la posibilidad de atender también importantes objetivos de mejoramiento de los resultados de los IF-microempresas y pyme, especialmente los IM, en materia de desarrollo: i) la importancia de otorgar préstamos en moneda local a microempresas y pyme que no pueden asumir los riesgos de devaluación cambiaria vinculados con los préstamos en moneda extranjera; ii) el importante papel que cumple una base de depósitos de ahorro para proporcionar a los intermediarios microfinancieros una fuente sostenible de fondos en moneda local que les permita realizar la transición, y dejar de depender de donantes; iii) la amplia necesidad de servicios bancarios (es decir, de remesas, ahorro, etc.) que experimentan los hogares de bajos ingresos y las microempresas y pyme, a los que los IM también podrían prestar servicios, además de proporcionarles crédito, y iv) el papel decisivo que cumplen los regímenes regulatorios especializados y de respaldo en cuanto al éxito de los IM.

Una administración diligente de las pyme, un personal apto y una adecuada reglamentación y aplicación de normas ambientales en el país de las operaciones promovieron un cumplimiento sostenible de las exigencias ASSS de los subproyectos de pyme financiados por la IFC a través de intermediarios financieros. No obstante, la dedicación al logro de esa sostenibilidad aún no se ha generalizado entre las pyme en países de frontera, y sólo unos pocos IF-pyme se han consagrado firmemente al seguimiento y la supervisión del desempeño de sus subproyectos en la esfera ASSS. La aplicación de los reglamentos locales en esa materia, especialmente en el caso de las pyme, también tiende a ser insatisfactoria en los países de frontera. La supervisión del cumplimiento de las exigencias ASSS, a cargo de la IFC, en proyectos realizados por intermediarios financieros reviste importancia, por lo cual, para lograr el cumplimiento de dichas exigencias, la IFC ha incluido un equipo de especialistas ASSS en el Departamento de Mercados Financieros Mundiales, en respuesta al acelerado crecimiento de la cartera de mercados financieros y al insatisfactorio historial de cumplimiento de tales exigencias en los proyectos con participación de intermediarios financieros. La IFC ha introducido también el programa de "integración" de las referidas exigencias entre los oficiales de inversiones de todos los sectores, para poder complementar la labor de supervisión realizada por los especialistas ASSS. Para que esas iniciativas den resultados favorables, la administración de la IFC también debe dar alta prioridad a la supervisión y al cumplimiento de exigencias ASSS en los proyectos con participación de intermediarios financieros.

Recomendaciones

La estrategia de respaldo a las microempresas y pyme a través de intermediarios financieros que aplica la IFC, y de suministro de asistencia técnica para fortalecer la capacidad institucional de los intermediarios financieros, ha sido pertinente y, en términos generales, eficaz. No obstante, la estrategia debería reforzarse y mejorarse para incrementar sustancialmente el impacto, en materia de desarrollo, de los proyectos de IF-microempresas y pyme, mediante la aplicación, por parte de la IFC, de las tres iniciativas que a continuación se mencionan:

i) Adoptar un enfoque más proactivo para alentar a otros asociados para el desarrollo que llevan a cabo una labor sustancial con los gobiernos de los países en desarrollo a promover el establecimiento de regímenes de regulación específica y de prudencia y la capacidad de supervisión conexa de los gobiernos, para los intermediarios microfinancieros en países en desarrollo, especialmente países de frontera. Se crearán así condiciones que faciliten una transición que permita a los IM dejar de depender de donantes, especialmente mediante la creación de una base de depósitos de ahorro y el logro de economías de escala a través de la ampliación de su base de clientes y el establecimiento de sucursales.

ii) Ampliar el alcance de la asistencia técnica otorgada por la IFC a IF-microempresas y pyme, de modo que no se limite, como actualmente sucede, a mejorar las técnicas de financiamiento y gestión de riesgos de la cartera de préstamos, sino que además ayude a IF-microempresas y pyme seleccionadas que han logrado aplicar buenas prácticas de gestión de riesgos a: a) atender mejor la necesidad de servicios de ahorro y otros servicios bancarios (por ejemplo, remesas) experimentada por los hogares pobres y las pequeñas empresas; b) establecer procedimientos de gestión de liquidez basados en prácticas óptimas, y c) en el caso de los IM, ampliar su base de clientes para ofrecer servicios, asimismo, a pequeñas empresas.

iii) Dar alta prioridad al mejoramiento de la supervisión del cumplimiento de las exigencias ASSS y al logro de mejores tasas de cumplimiento al respecto por parte de los proyectos de IF-microempresas y pyme. En especial, el IEG recomienda que la IFC establezca un objetivo que haya de alcanzarse dentro de determinado plazo para mejorar su ya satisfactoria tasa de supervisión del cumplimiento de las exigencias ASSS y la tasa de cumplimiento de las exigencias ASSS de los proyectos de IF-microempresas y pyme.

IFC Management Response to IEG-IFC

Financing Micro, Small, and Medium Enterprises: An Independent Evaluation of IFC's Experience with Financial Intermediaries in Frontier Countries*

Management greatly welcomes IEG's report on financing micro, small, and medium enterprises (MSMEs) in frontier countries through financial intermediaries.

The report cuts across two of the five IFC strategic pillars: (i) strengthening the focus on frontier markets, and (ii) developing local financial markets. MSMEs play an important role in private sector development, particularly in frontier countries, but access to finance has been a constraint in their ability to thrive. Over the years, IFC has tried different approaches to providing finance to MSMEs and found that the most effective way to reach a large number of MSMEs is through financial intermediaries. IFC's worldwide annual net financing commitments for MSME-focused financial institutions (MSME-FIs), during the period 1994–2006 covered by IEG-IFC's evaluation, totaled $3.8 billion. Of this amount, 38 percent of MSME-FI commitments were in frontier countries.

*Distributed to IFC's Board of Directors on June 29, 2007, and discussed by the Board's Committee on Development Effectiveness on August 29, 2007. Released by IFC in accordance with IFC's Policy on Disclosure of Information.

Introduction

Management is pleased to note that the IEG's independent study found that IFC's strategy for supporting micro, small, and medium-sized enterprises in frontier countries through financial intermediaries (FIs) has been relevant and effective in promoting successful development and investment outcomes. MSME-FIs have been successful in providing loans to a large number of MSMEs in frontier countries. The study makes three recommendations to further strengthen IFC's contribution to the development of MSMEs through FIs, which will be discussed in detail below.

IEG concluded that FIs were effective channels for wholesaling IFC's financial support to MSMEs because they: (i) provided MSMEs a reliable and accessible source for loans by strengthening the institutional and financial capacity of the intermediaries; (ii) leveraged the resources of MSME-

FIs as well as those of other multilateral development banks and bilateral aid agencies, particularly in the case of microfinance intermediaries; (iii) achieved a high outreach among MSMEs, which IFC could not achieve directly; and (iv) helped to develop and improve the local banking system by, among other things, demonstrating that additional equity capital from IFC can contribute to a profitable lending business line to MSMEs for commercial banks. The report also stated that IFC had a strong additionality through, among others, advisory service (AS), project design, and long-term finance. AS, in particular, tends to be associated with good outcomes, given that small and medium enterprise-oriented financial intermediaries (SME-FIs) that received AS had higher development success rates and a higher average number of borrowers, of about 16,000 per FI, or 10 times more than those that did not benefit from AS.

The study further notes that IFC played significant roles in the success of the MSME-FIs, particularly in structuring MFI projects, establishing a major holding company dedicated to MFIs, and selecting the most suitable SME-FIs. The study states that IFC's roles as a long-term equity investor and proactive shareholder (through its board nominees) in the MFI projects were particularly significant and were only replicated, perhaps, by the European Bank for Reconstruction and Development and the Inter-American Development Bank.

On the environmental, health, and safety (EHS) performance of IFC's MSME-FI projects, the report finds that committed SME management, skilled staff, and good environmental regulations and enforcement in the country of operations promoted EHS sustainability. According to the report, the MSME subprojects visited by IEG achieved higher EHS performance ratings than the MSME-FIs themselves, suggesting that results on the ground were better than the MSME-FIs' compliance with reporting requirements. The study also notes that IFC's EHS supervision of FIs is expected to improve under the new IFC Sustainability Policy Framework, adopted in May 2006.

The FY94–06 period covered by the IEG study witnessed significant liberalization and internationalization of the financial system in many developing countries—mentioned in detail in the World Bank Group Financial Sector Strategy Paper discussed with the Board in April of 2007. This period, especially in the 1990s, was a turbulent one, with major financial crises in East Asia, Russia, and Latin America. IFC's financial sector activities experienced a very large increase in demand from clients as a result of these two factors and led to important roles for the IFC as a facilitator of foreign investment in FIs located in developing countries, and as a counter-cyclical investor and partner in times of need. IFC's investments in the financial sector therefore increased from $236 million in FY94 to $3.3 billion in FY07. Furthermore, MSME finance now accounts for the majority of IFC's financial sector investments, with $2.5 billion committed in FY07.

Because MSME finance in frontier markets will remain central to IFC's work, going forward, Management values the detailed analysis provided by the IEG study on the effectiveness of IFC's MSME-FI operations, and agrees with the overall direction of the three recommendations IEG made in the report.

Responses to Specific Recommendations

IEG-IFC Recommendation 1:

IFC needs to 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 frameworks for microfinance intermediaries in developing—particularly frontier—countries, in order to 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 expanding their client base and the establishment of branch offices.

Management Response:

Management agrees with IEG's assessment on the importance of the appropriate regulatory framework for microfinance institutions. IFC, mostly through its Donor Funded Facilities has been selectively involved in a high-level dialogue with governments, often in collaboration with the Consultative Group to Assist the Poor (CGAP), to help develop a favorable regulatory environment for microfinance. IFC's microfinance strategy stresses, however, that the Corporation should selectively engage in these types of advisory assignments and only with the objective of helping to remove binding constraints that hinder access to finance in target markets. Overall, this is a role that CGAP is best positioned to fulfill in view of its mission and staffing profile.

Regarding the second part of the recommendation that MFIs need to develop a savings deposit base and to achieve economies of scale by expanding the client base and branch offices, we believe that microfinance institutions have an important role to play in providing payment and savings services to the poor. It is an important aspect of expanding access to finance, beyond microcredit. Nonetheless, this should also be done selectively, given that not all markets have clear prudential frameworks for MFIs' deposit-taking function and, even in markets that have the necessary frameworks, not all MFIs are suitable institutions to raise funding through deposits, in particular from their client base, which tends to be of lower income. Because deposits can represent lifetime savings for some clients, it is important to distinguish those financial institutions that have the risk management capabilities, governance structure, and capital base to raise deposits and act in a fiduciary responsibility, from those that have insufficient institutional capabilities.

IEG-IFC Recommendation 2:

IFC could enlarge the scope of its advisory services to MSME-FIs—beyond the present focus of improving lending techniques and loan portfolio risk management, to also help selected MSME-FIs who have achieved good risk management practices to: (i) better meet the need for savings and other banking services (e.g., remittances) by poor households and small businesses; (ii) implement best practice liquidity management procedures; and (iii) in the case of MFIs, help expand their client base to also reach small-size enterprises.

Management Response:

Management agrees that IFC's advisory services should be made available for a wide range of challenges faced by MSME-FIs. However, IFC should not be routinely prescribing strategic changes to our client institutions. Whether additional banking services should be offered to poor households and small businesses is a business judgment best left to the management and board of each FI. Should IFC face demand from its client institutions to help them develop new banking products, or to better manage their liquidity, then it would be appropriate for IFC to consider providing advisory services responding to that specific need.

IEG-IFC Recommendation 3:

IFC gives a high priority to improving the environmental, health, and safety (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.

Management Response:

IFC Management gives a high priority to improving the EHS standards of all projects, including those through MSME-FIs, and this was the rationale behind the comprehensive policy changes brought about with the new IFC Sustainability Policy Framework, which has been in implementation since May 2006. Among other features, IFC Sustainability Policy Framework includes a sophisticated risk-based appraisal and supervision of FIs. This risk-based approach allows IFC to be more cost effective by allocating more resources in high-risk projects than in low-risk projects, instead of taking a one-size-fits-all approach. The risk-based approach entails an analysis of the FI's portfolio and is carried out during appraisal, to establish the risk level of the FI. The portfolio analysis and the performance of the FI's Environmental Management System are captured in an Environmental and Social Risk Rating (ESRR) measure that is established at appraisal and will be tracked by IFC during project supervision.

Under the 2006 framework, IFC actively engages with the client FI upfront, during the investment appraisal stage, and an EHS plan is established and included in the covenants of the investment agreement between the client FI and IFC. This new approach is a significant improvement over the 1998 policy in which the client was required to establish an Environmental Management System after attending training conducted by IFC. IFC's ability to conduct training for clients in all regions/countries was limited due to staffing and geographical constraints. IFC now makes available one-on-one guidance to high-risk clients, while moving the standardized training to an e-learning platform for greater efficiency. Furthermore, the team strength of EHS specialists working on FI projects has doubled since 2006, and there is a formal supervision plan which entails 100-percent annual supervision of high-risk FIs as well as poorly performing ones.

With the above measures already operational, we expect to see a substantial improvement in the EHS performance of FIs going forward. This view is consistent with IEG's independent finding in the report, which indicates that the new IFC EHS Safeguard Policies and Performance Standards, IFC's EHS mainstreaming initiative, and the creation of an EHS specialist team dedicated to financial markets operations are expected to improve EHS supervision of financial intermediary projects.

Chairperson's Summary: Committee on Development Effectiveness (CODE)

On August 29, 2007 the Committee on Development Effectiveness (CODE) considered the report *Financing Micro, Small, and Medium Enterprises: An Independent Evaluation of IFC's Experience with Financial Intermediaries in Frontier Countries*, and the draft IFC Management Response.

Background

CODE discussed *A Synthesis Evaluation of Four IFC-supported Small and Medium Enterprise Facilities* together with the Draft Management Response on August 30, 2004. The main thrusts of IFC's strategy were considered on April 11, 2007 at a joint Budget Committee and CODE meeting to review *IFC Strategic Directions: FY08–FY10, Creating Opportunities.* On July *25,* 2007 the Committee also considered the *Evaluation of IFC's Private Enterprise Partnership Advisory Services Program (PEP) in Eastern Europe and Central Asia (ECA)* and the draft IFC Management Response.

Main Findings and Recommendations

The IEG report assesses IFC's strategies, investment projects, and advisory services operations from fiscal years (FYs) 1994–2006 to support micro, small, and medium enterprises (MSMEs) in frontier countries. The report also includes an evaluation of the MSME financial intermediaries (FIs) and their performance in implementing IFC's environmental, health, and safety (EHS) requirements. The evaluation concludes that IFC's strategy for supporting MSMEs through FIs, and providing capacity-building advisory services to the intermediaries, has been relevant and broadly effective. IEG recommends that in order to substantially enhance the development impact of MSME-FI projects, IFC should reinforce and modify the strategy by implementing the following three initiatives: (i) take a more proactive approach in encouraging other development partners to promote the establishment of prudential regulatory frameworks for microfinance intermediaries (MFIs) to facilitate their transition out of donor dependency; (ii) enlarge the scope of its advisory services to MSME-FIs to help selected MSME-FIs better meet the need for savings and other banking services (for example, remittances) by poor households and small businesses; and (iii) give a high priority to improving the EHS supervision and compliance of MSME-FI projects.

Draft IFC Management Response

IFC Management agrees with the main thrust of the IEG findings and recommendations. Management also appreciates the study's discussion of IFC's significant role in the success of the MSME-FIs, in particular, its role as a long-term equity investor and proactive shareholder in MFI projects. IFC, mostly through its donor-funded facilities and in collaboration with the Consultative Group to Assist the Poor (CGAP), has been selectively involved in a high-level dialogue with governments to help develop a favorable regulatory environment for microfinance. At the same time, Management believes that this is a role that CGAP is best positioned to fulfill. Since May 2006, under the new IFC Sustainability Policy Framework, a number of important measures to improve compliance with the EHS standards have been taken (for example, engagement with the client FI upfront, one-on-one guidance to high-risk clients, moving standardized training to an e-learning platform for greater efficiency, and so forth). Management believes that the implementation of the above measures will lead to a substantial improvement in the EHS performance of FIs.

Overall Conclusions

CODE welcomed the IEG report for its valuable recommendations and encouragement toward IFC's strategy and operations going forward. CODE was pleased by the IEG findings that IFC's approach to financing MSME in frontier countries through FIs has been relevant and largely successful. Accordingly, members commended IFC for its efforts, and were also gratified to note that Management broadly agreed with the recommendations and appeared to be already acting on them. They also expressed broad support for the IEG recommendations that IFC should promote the establishment of specific regulatory frameworks for MFIs, enlarge the scope of its advisory services to diversify their activities, and improve the EHS supervision. Members stressed the importance of World Bank Group (WBG) synergy in developing prudential microfinance regulations, cautioned against a simplistic approach to diversification of micro FI activities, and emphasized the need to increase compliance with EHS performance standards. In addition, speakers raised a number of specific questions (for example, gender aspects) and made particular suggestions (for example, on local currency operations).

The following main issues were raised during the meeting:

Development of an appropriate regulatory framework. While appreciating and supporting IFC's value added in establishing prudential regulatory frameworks, most speakers felt this recommendation needed to be directed more to the WBG as a whole, and to IBRD/IDA in particular, for a number of reasons including, among others, managing real or apparent conflicts of interest. Some members noted that IFC can be very successful in building capacity of microfinance institutions as well as MSME-FIs through knowledge sharing. A remark was made that IFC should provide advisory services on improving the regulatory framework to local financing institutions, to ensure they have adequate capacities to work with governments and public authorities. Additionally, one speaker stressed that provision of advisory services should always be done in parallel with provision of investments. *Management pointed out that IFC is actively involved in the dialogue with CGAP and the WBG on expediting the regulatory frameworks in countries, based on its global experience in this area.*

Diversification of MSME-FI services. The scope of MFI activities also drew several comments, particularly broadening it beyond the provision of credit. Most members cautioned against an oversimplified interpretation of this recommendation, noting both the value of maintaining a strategic focus as well as the complexities of local regulation, for example, regarding deposit-taking institutions. A few members stressed that client countries need strong regulatory bodies for diversifying MSME-FI services.

Compliance with EHS performance standards. A few members welcomed IFC's work on improving EHS compliance but expressed concerns about its sustainability because of FIs' weak capacity. At the same time, one speaker felt that Management was not fully responsive to IEG recommendations on this particular issue. *Management explained that IFC has started implementing its new decentralized business model, which will bring staff closer to clients. Management believes staff in the field will help improve EHS supervision, which should result in better compliance with EHS performance standards.*

Regional disparities and local conditions. Some members emphasized the importance of considering Regional disparities and specific, local, financial-market conditions for successful implementation of IFC's strategy to support MSMEs through FIs. *Management remarked that IFC is focusing its MFI activities in the Africa Region, which has been lagging behind the others. Management also believes that political and financial crises have to be taken into account when evaluating the success of MSME-FI programs in the different Regions.*

Other issues. Some speakers stressed that IFC's involvement with MFIs should be broadly consistent with the WBG Financial Sector Strategy. A member noted there was no reference to gender aspects in the report even though, in most frontier countries, access to microfinance for women is limited. *Management informed that IFC has a program with the banks, which provide gender-focused credit lines to FIs. An independent entity is analyzing the impact of this program; the results of the analysis will be available later this year.* One speaker encouraged IFC's involvement in building capacity of financial institutions for the local currency loans provision. Such an approach would facilitate the transition of MFIs out of donor dependency.

Jiayi Zou, Chairperson

Chapter 1

Synopsis

The study evaluates International Finance Corporation (IFC) strategies and the performances of project investments and related advisory services for supporting MSMEs in frontier countries during fiscal years (FYs) 1994–2006. The objective of the evaluation is to answer questions that the Board of Directors and IFC Management might pose regarding these strategies and projects, including their success drivers, IFC's value-added roles, and recommendations to improve future strategies and projects aimed at supporting MSMEs, in general, and those in frontier countries, in particular. The loan amount an enterprise receives is used as a proxy to identify the enterprise as a microenterprise, small enterprise, or medium-size enterprise. An evaluation of the projects supporting microenterprises is discussed in chapter 3. The evaluation of projects supporting small and medium-size enterprises (SMEs) is discussed separately in chapter 4 because of important differences in some aspects of the strategies and projects intended to support these two groups of enterprises.

Study Objective, Report Organization, and Methodology

Since the mid-1990s, IFC has made a strategic corporate priority of supporting micro, small, and medium-size enterprises (MSMEs), and since 2000, the IFC strategies for supporting MSMEs have relied primarily on indirect financing through financial intermediaries.

Key Evaluative Questions

In 2001, IFC started to make supporting private sector enterprises in frontier countries[1] (and in underdeveloped and low-income regions of nonfrontier countries) a strategic corporate priority. The confluence of these two corporate strategic priorities—supporting enterprises in frontier countries and MSMEs through financial intermediaries (known throughout this report as MSME-FIs)—is the subject of this Independent Evaluation Group[2] (IEG) evaluation. The evaluation covers FY94–FY06 and aims to answer the following evaluative questions:

- What were IFC's 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?

Evaluation Scope, Methodology, and Study Limitations

To answer these evaluative questions, the evaluation (i) identifies the IFC strategies, related project-financing commitments, and advisory services operations to support MSMEs in countries designated as frontier when the projects were approved during FY94–FY06; (ii) identifies and describes all operationally mature microfinance intermediary (MFI) projects that were intended to support microenterprises in frontier countries (the 21 projects comprising the MFI evaluated population);[2] (iii) identifies and describes all operationally mature small and medium enterprise–oriented financial intermediary (SME-FI) projects (the 72 projects comprising the SME-FI evaluated population).[3] For the purposes of this analysis, operationally mature projects had to have at least two years of operating and financial results by the end of

2005,[4] to provide the bases for evaluating development outcomes. Furthermore, the evaluation (iv) examines the development outcomes of the projects in the two evaluated populations, including EHS performance and other operating results during 1998–2005; (v) identifies the project success drivers, the main findings or lessons learned, and the valued-added role of IFC; and (vi) draws findings and recommends actions for IFC, related to its strategies and operations, to support MSMEs in frontier countries through financial intermediaries.

IFC's strategies during the study period for supporting MSMEs also used indirect advisory services to build MSME institutions and capacity, through specialized project-development facilities, which were cofinanced by partner development agencies. The scope of this study is limited to the evaluation of financial support through financial intermediaries, and does not include an evaluation of the specialized project-development facilities for MSME capacity building because some were evaluated previously by IEG and others will be evaluated separately. The appropriateness and success of the strategies will, therefore, be evaluated primarily within the context of the success of the MSME-FI projects.

The evaluation of each MSME-FI used IFC's standard Expanded Project Supervision Report (XPSR)[5] evaluation framework for development outcomes and for investment outcomes to assess the success of MSME-FI operations.[6] Any IFC advisory services provided in the context of the operation of a specific financial intermediary was also reviewed on the basis of responses to the mail survey questionnaire described below and supplemented by advisory services progress and completion reports as well as field visit findings. IEG conducted: (a) desk reviews of the project documents and publicly available company information; (b) field visits to 7 MFIs including 32 subprojects, as well as visits to 13 SME-FIs including 33 subprojects (for a total of 20 MSME-FIs and 65 subprojects); and (c) a mail survey of 58 MSME-FIs,[7] which resulted in 44 responses (76 percent).

In the approach paper written for this evaluation,[8] 20 MSME-FIs were purposively sampled for field visits. These MSME-FIs were considered by IFC's Global Financial Markets Department staff to be successful projects that had established a sustainable MSME subproject portfolio and, therefore, would provide a good purposive sample for identifying common success factors or drivers across these institutions. These 20 MSME-FIs were distributed widely by Region. The 65 subprojects that were visited were selected by IEG on the basis of their environmental-risk classification, to assess how and to what extent the financial intermediaries have helped MSMEs to achieve good environmental practices. The field visits also assessed the financial sector and MSME business environments to determine their effects on the MSME-FI project performance and outcomes.

The World Bank Group (WBG) defines MSMEs using three determinants: (a) number of employees; (b) total assets in U.S. dollars; and (c) annual sales in U.S. dollars, as shown in table 1.1. An enterprise must meet at least two of the three determinants in each category to be typed as such (that is, micro, small, or medium). The WBG's definitions are consistent with those used by most development agency donors to the WBG's advistory services trust funds. This study adopts the proxy definitions used by IFC in categorizing MSME-FI clients or subprojects on the basis of a financial intermediary's subloan amount or size (also shown in table 1.1). The IFC proxy definitions are necessary because past MSME-FI projects did not systematically check for these three determinants for each borrower, and so they could not report such information to IFC. However, the proxy definitions are reasonable and simple, and are similar to those used by others involved in supporting MSMEs.

IFC financed 72 SME-FI entities in frontier countries that reached operational maturity by 2005. These 72 SME-FIs comprise the SME-FI evaluated population and include 43 existing banks (expansion projects), 17 greenfield projects or new banks, and 12 privatization cases. In order to

Table 1.1. WBG Definitions of Micro, Small, and Medium Enterprises

Enterprise indicators (two out of three must be met)	Micro	Small	Medium
1. Number of employees[a]	≤10	>10; ≤50	>50; ≤300
2. Total assets[a]	≤$100,000	>$100,000; ≤$3,000,000	>$3,000,000; ≤$15,000,000
3. Total annual sales[a]	≤$100,000	>$100,000; ≤$3,000,000	>$3,000,000; ≤$15,000,000
IFC Global Financial Markets Department and IEG proxy			
Financial intermediary subloan amount	<$10,000	$10,000; <$100,000	$100,000; <$1,000,000

a. As of the project appraisal date for expansion projects, and as of the first year of profit break-even for greenfield projects.

better assess the competitiveness and success drivers of the SME-FI projects, the operational and financial performance of a subgroup of 36 (one-half) of these SME-FIs—selected to match the SME-FI evaluated population geographic distribution—were evaluated in greater detail. The 72 SME-FIs and the subgroup are distributed regionally, as shown in table 1.2, with 44 percent in Europe and Central Asia, and 32 percent in Sub-Saharan Africa. The operating and financial assessment is discussed in chapter 4.

The limitations of the data used in this study are as follows:

- The quality of the 44 survey responses varied widely among the MSME-FIs, particularly with respect to subproject data, nonperforming loan data, and advisory services information. Some of the missing subproject information and advisory services data were subsequently provided through the Global Financial Markets Department's ongoing efforts, since FY05, to

Table 1.2. Regional Distribution of SME-FIs in the Evaluated Population and Subgroup

	SME-FIs in evaluated population		SME-FIs in subgroup of 36	
Region	Number	Percentage	Number	Percentage
Europe and Central Asia	32	44	16	44
Sub-Saharan Africa	23	32	9	25
Middle East and North Africa	7	10	4	11
Asia	7	10	4	11
Latin America and the Caribbean	3	4	3	8
Total	72	100	36	100

build up its database on the subproject portfolio of IFC's MSME-oriented commercial bank clients.
- IFC's supervision documents seldom provide detailed data on MSME-FI subproject portfolio performance, although an ongoing effort by the Global Financial Markets Department started addressing this issue in FY05.
- Data on advisory services offered to financial intermediaries have been, until recently, difficult to obtain or difficult to reconcile (or both) among various data sources, in terms of both the number of operations and the amounts involved. Moreover, because IFC has only recently established a monitoring and evaluation function for its advisory services activities, information on the outcomes and impacts of the older IFC advisory services operations relating to the two evaluated populations are limited, and the outcomes are largely inferred from the MSME-FIs' operating results. Whereas IEG was able to obtain data on the amount of advisory services funding that MFIs received from other providers, it was difficult to obtain data for advisory services provided by other international financial institutions that related to the projects in the SME-FI evaluated population. IFC has no mandate to record such data, and client SME-FIs rarely do so. (Although SME-FIs interact with consultants who are paid with grant advisory services funds from international financial institutions, the SME-FIs are not generally aware of the costs and amounts paid directly by the donors to the consultants under the advisory services operations.)

The rest of this report is organized as follows: chapter 2 discusses IFC's strategies and their context; chapter 3 evaluates IFC's investment projects and related advisory services to support microenterprises in frontiers countries; chapter 4 discusses IFC's investments and related advisory services to support SMEs; chapter 5 discusses the EHS performance of the financial intermediary projects targeted to support MSMEs, which form part of the development outcome indicator; and chapter 6 summarizes the main findings, including IFC's role and added value, and presents the main recommendations.

The MFI evaluated population and the SME-FI evaluated population are analyzed separately because of substantial differences in several important variables that affect projects that support microenterprises, as compared with projects that support SMEs. These variables include the business climate (as well as government policy and regulatory regimes), scale of operations, project sponsorships, relative importance of IFC's equity-investment holding period and exit considerations, role of IFC's advisory services support, nature of the project-level risks, and EHS compliance standards applied by IFC. The EHS performance of the MSME-FIs is discussed separately, to highlight this subject and to better respond to the evaluative question of IFC's added value (role and contribution) in MSME-FI projects. Furthermore, support for microenterprises is a relatively new IFC focus, whereas support for SMEs has a longer history in IFC's operations and, therefore, requires a separate evaluation and discussion.

Chapter 2

Synopsis

IFC's strategies for supporting MSMEs began to take form in the late 1990s. Since 2001, these strategies have been as follows:

(i) Offer widescale, indirect IFC funding through specialized microfinance intermediaries and SME-oriented financial intermediaries;
(ii) Provide advisory services to these financial intermediaries to improve their operations, particularly for lending to MSMEs;
(iii) Invest equity in microfinance intermediaries and SME-FIs when appropriate;
(iv) Limit IFC's direct loan or equity investment in SMEs;
(v) Use regional project-development facilities cofinanced by donors, to offer nonfinancial services to SMEs such as institutional capacity building, training, and suggestions for improving local government regulations affecting SMEs; and
(vi) Broadly support the development of financial markets and the private sector by helping to improve policy and regulatory regimes and business climates.

The appropriateness and success of the first three components of IFC's strategies are determined primarily by the success of the MSME-FI projects and are discussed in chapter 6. IFC's annual net commitments for MSME-FIs in frontier countries expanded from $33 million in FY94 to $497 million in FY06, totaling $1,437 million for the period. Within these amounts, microfinance commitments grew from $1 million in FY96 to a peak of about $32 million in FY03 and FY04, before dropping to $15 million in FY05 and FY06, and totaling $137 million during FY96–FY06. Only operationally mature projects (that is, those with at least two years of operating results by the end of 2005) are evaluated for development outcomes and investment outcomes. IFC used five types of financial intermediary vehicles in 37 operationally mature projects to channel financial support to microenterprises, but 28 used one type of vehicle, the profit-oriented microfinance-intermediary business model, and two were regional equity and investment funds, respectively. Of the 28 profit-oriented MFI projects, 21 are located in frontier countries and these constitute the MFI evaluated population. Within the MFI evaluated population, IFC invested equity in 18 MFIs, and a different group of 18 MFIs received significant advisory services funds in the form of grants from IFC and other international development entities. There are 72 projects in the SME-FI evaluated population. IFC invested equity in 36 of these SME-FI projects to provide the capital base to expand their operations and maintain prudent capital adequacy ratios. In addition, IFC also provided advisory services to 21 SME-FIs to either establish or to expand an SME business line.

IFC Support of MSMEs in Frontier Countries, FY94–FY06

Supporting the development of MSMEs is generally regarded as an important component of an effective strategy for promoting private sector development, for increasing employment and economic growth, and for reducing poverty.

Supporting MSMEs Is Pivotal for Private Sector Development

MSMEs account for the bulk of the private sector, particularly in poor countries, and tend to face greater difficulty accessing finance and markets than larger enterprises do. In addition, ownership of microenterprises is also viewed as a way to empower poor women, the evidence being that a majority of the MFI borrowers in developing countries are women.[1] The adversities faced by MSMEs are seen in the transition countries of the former Soviet Union and other Eastern European countries, where the former economic system did not recognize or support MSMEs because priority was given to state-owned or state-sponsored enterprises and cooperatives. The breakup of the communist economies stimulated the creation of MSMEs in these countries, but it did not automatically induce the emergence of a financing and administrative support system for their success and growth. This largely explains the significant proportion of IFC's MSME-FI and mainline commercial bank commitments in Europe and Central Asia (figure 2.3). In general, IFC's strategies and projects for supporting MSMEs have particularly focused on these transition countries and on Sub-Saharan Africa, and these areas evolved during the study period, as discussed below. The private sector enterprises in many developing countries also face inadequate infrastructure services, as well as complex government regulations, as reported in the WBG's series of *Doing Business* reports. These regulatory requirements are relatively more burdensome to MSMEs which have limited resources, low capitalization, and weak institutional capacity, as compared with much larger enterprises.

Paradigm Shift Helped IFC's Entry and Current Major Role in Global Microfinance

The microcredit industry in developing countries started in the 1970s, and it grew through a process in which nonprofit entities, particularly nongovernmental organizations (NGOs), played a large role. Many of these NGOs in turn received below-market funding, or grants (or both) from development agencies, multilateral development banks, and philanthropies to augment the local savings they mobilized, to partly subsidize loans to microenterprises. Some developing country governments also have subsidized credit programs to micro and small enterprises.

However, during the late 1990s and early 2000s, a paradigm shift occurred in the microfinance industry in developing countries, away from donor dependency and subsidized credits and toward commercially oriented or "for-profit" microfinance institutions that are profitable and sustainable in terms of the ability to mobilize their entire funding needs on commercial terms. It was in the context of this paradigm shift or "microfinance revolution"[2] that IFC approved its first microfinance operation in FY96, tried various entities or vehicles for delivering financial support to microenterprises, and made such support a strategic priority in FY01.

The microcredit industry grew rapidly during the 1990s, spearheaded by NGOs in Bangladesh and Bolivia, and by both government-owned and privately-owned microfinance entities in Indonesia. A study by the Center for Global Development (Roodman and Qureshi 2006) estimates that in 2000, private sector microcredit providers (including nonprofit NGO operations) had roughly 41.8 million active microcredit accounts in 29 developing countries with at least 1.0 microcredit account per 100 people. Two countries accounted for about three-fourths of these accounts: Bangladesh had the highest number of accounts, representing 41 percent of the total, and the highest concentration (13.3 accounts per 100 people); and Indonesia had the second highest number of microcredit accounts, representing 36 percent of the total, and the second highest concentration (6.8 accounts per 100 people). Notably, IFC has an operationally mature microfinance project in only 10 of these 29 countries. The other 25 countries in which IFC has at least one operationally mature microfinance project had less than 1.0 microcredit account per 100 people.[3] Likewise, of the 43 recently approved (during FY03–FY06) country-level MFI projects (that is, excluding regional funds and MFI holding companies), that are not yet operationally mature, 27 are in countries with less than 1.0 microcredit account per 100 people. IFC has therefore located about 66 percent of its country-level MFI projects, approved during FY96–FY06, in countries with very low availability of, or access to, credit by microenterprises. In addition, ACCION International, a microlender and technical partner in one of the MFI holding companies established by IFC (see endnote 15), estimates that there are roughly 10,000 private sector microfinance entities in developing countries today, but only 300 to 400 are "investable"[4] (that is, they have the capacity and expertise to prudently use investors' funds).

More recently, a mid-2003 survey by the Consultative Group to Assist the Poor,[5] estimates that there were about US$1 billion of commercially oriented, committed foreign investments in the form of equity, debt, and guarantees that funded various private sector microfinance entities in developing countries. Almost 90 percent of these committed foreign investments came directly or indirectly from public sources—primarily from the private sector funding units of bilateral and multilateral development institutions (the so-called development investors)—and, to a lesser extent, from socially-motivated, privately managed investment funds, financed by both public and private capital (the so-called social investment funds).

The European Bank for Reconstruction and Development, KfW (Kreditanstalt fur Wiederaufbau) and IFC are among the top three development investors, with each having at least US$100 million of investments committed in microfinance entities. The second group of development investors, with between US$40 million and US$100 million of committed investments, consisted of the Multilateral Investment Fund of the Inter-American Development Bank, and the Nederlandse Financierings Maatschappij voor Ontwikkelingslanden N.V. The third group of development investors, with between US$20 million and US$40 million of committed investments, included Deutsche Investitions-und Entwicklungsgesellschaft, the USAID Development Credit Authority, the Corporacion Andina de Fomento, and the OPEC Fund. IFC frequently coinvests with the European Bank for Reconstruction and Development, KfW, DEG (Deutsche Investitions-und Entwicklungsgesellschaft) and FMO (Nederlandse Financierings Maatschappij voor Ontwikkelingslanden NV).

IFC Strategic Priorities: MSME Support and a Focus on Frontier Countries

Within the above context, IFC's strategies for supporting SMEs have evolved since the mid-1990s into the current strategies (in place since 2001) that are being evaluated.[6] The IFC FY95–FY97 three-year business plan made the case for supporting SMEs indirectly through new or existing local financial intermediaries that serve the SME market. The plan was to do so mainly by providing credit lines and advisory services to these financial intermediaries, and by supporting the development of the local financial and capital markets in general. The next three-year business plan, for FY97–FY99, complemented the SME focus with the need to assist the microenterprise sector. By 2000, supporting SMEs was considered a vital element of the WBG's Private Sector Development Strategy, and the SME sector was identified, alongside financial markets, infrastructure, health and education, and information and telecommunications, as the five main strategic priority sectors for IFC. Furthermore, assistance to SMEs in frontier countries and frontier regions[7] within nonfrontier countries (that is, low-income or underdeveloped areas within a nonfrontier country, together referred to as frontier markets) through financial intermediaries was explicitly made a core element of the IFC strategy to support SMEs.

In IFC's 2001 annual strategy paper to the Board of Directors, frontier markets and support for microenterprises also became IFC strategic priorities, while SMEs and financial markets remained among the five main strategic priority sectors. Subsequent strategy papers continued to include MSMEs among IFC's strategic priorities. The 2004 and 2005 strategy papers continued to emphasize sustainability of MSME-FIs. The 2006 strategic directions paper lists "strengthening the focus on frontier markets" as the first of IFC's five strategic priorities, with particular attention on Sub-Saharan Africa, where MSME support is one of the three regional strategic pillars. MSME financing through financial intermediaries was also mentioned among the strategic areas within IFC financial markets operations.

In response to these strategic directions, IFC's model for supporting SMEs has evolved over the period. Starting in 2000, IFC restructured its special SME financing facilities, the Africa Enterprise Fund,[8] and the Small Enterprise Fund, which provided direct financing to SMEs, because these were unsustainable.[9] These funds are now financing sources only (reauthorized through FY08) for projects on an exceptional basis. Instead, IFC is focusing on building widescale, indirect, finance delivery capacity in local financial intermediaries (for example, commercial banks and leasing companies) through a combination of credit lines with specified uses or target borrowers, corporate loans, equity and quasi-equity investments, and institution-building advisory services.

The main objectives of IFC's strategies, since 2001, were and continue to be as follows:

- To offer widescale, indirect IFC funding through specialized MSME-FIs and through other specialized nonbanking financial entities, such as leasing companies (for SME support);
- To provide advisory services to these financial intermediaries to improve their operations, particularly with respect to lending to MSMEs;
- To invest equity in these MFIs and SME-FIs when necessary;
- To limit IFC's direct loan or equity investment in SMEs 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 only on a selective basis;
- To use regional project-development facilities, cofinanced by donors, to provide (widescale and indirect) nonfinancial services to SMEs, such as institutional capacity building and training that will help SMEs improve their operations and business planning, access

financing, and obtain administrative permits and other governmental approvals to transition from informal to formal businesses, and to suggest improvements in local government regulations affecting SMEs; and
- To broadly support financial markets and private sector development by helping to improve policy, regulatory and administrative regimes, as well as business climates.

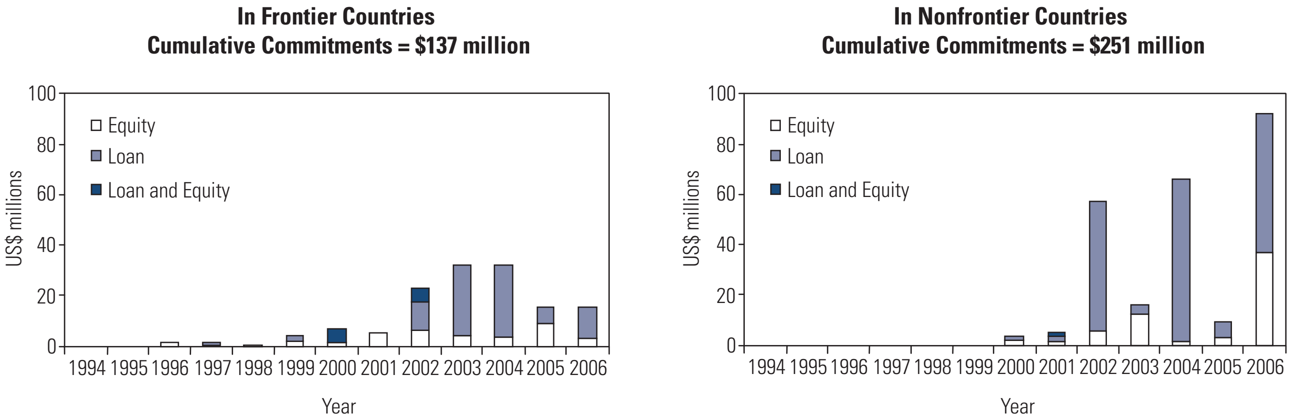
MSME-FI Operations in Frontier Countries Are Consistent with Strategic Priorities

IFC's MSME-FI projects have supported its strategic priorities. Total net commitments to MSME-FIs worldwide, during FY94–FY06, were about \$3.8 billion, of which \$1,437 million (38 percent)[10] were committed to MSME-FIs in frontier countries. Commitments for both MFI and SME-FI projects in frontier markets have grown since FY94 (see figures 2.1 and 2.2). More specifically, annual net commitments to MFIs in frontier countries grew from US\$1 million in FY96 to a peak of US\$32 million in FY03 and FY04, before dropping to US\$15 million in FY05 and FY06, and totaled US\$137 million for the period.[11] The annual net commitments for SME-FIs in frontier markets increased from US\$33 million in FY94 to US\$482 million in FY06, and totaled US\$1,300 million for the FY94–FY06 period.

The decline in FY05 and FY06 of net commitments to MFIs in frontier countries reflected the emphasis on SME-FI projects, with such net commitments increasing worldwide by 24 percent in FY05 (over FY04 net commitments), and then increasing by 54 percent in FY06 (over FY05 net commitments). There was also a 66-percent increase in commitments to microfinance intermediaries in nonfrontier countries in FY06, which involved seven projects, with one large global project accounting for 40 percent of the increase. The other six projects targeted less urban areas and women owners of microenterprises in several countries. In addition, IFC was focusing on establishing more MFI holding companies during FY03–FY07 that would act as vehicles for providing some equity investments as well as management and advisory services to new intermediaries or for converting nonprofit, NGO, microcredit operations into commercially or profit-oriented MFIs.

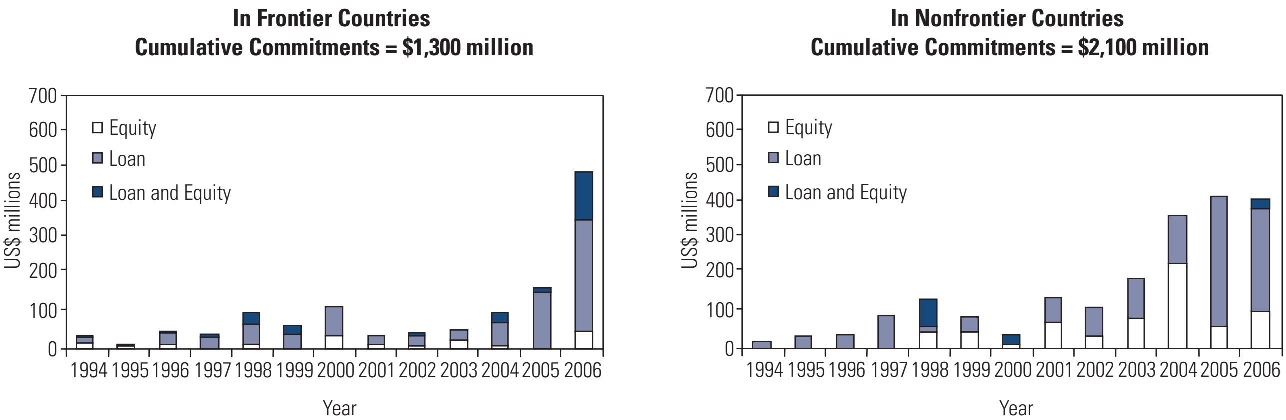
Geographically, 39 percent of IFC's financing to frontier-country MSME-FIs during FY94–FY06 was in frontier countries in Eastern Europe and Central Asia, followed by 34 percent in frontier countries in Sub-Saharan Africa, and 13 percent in Asia (figure 2.3). In contrast, IFC's worldwide financing for all commercial bank projects approved during FY94–FY06 was distributed as follows: 43 percent in Eastern Europe and Central

Figure 2.1. IFC's Annual Net Commitments to Microfinance Intermediaries, FY94–FY06



Note: Includes equity right issues as of June 2006.

Figure 2.2. IFC's Annual Net Commitments to SME-FIs, FY94–FY06



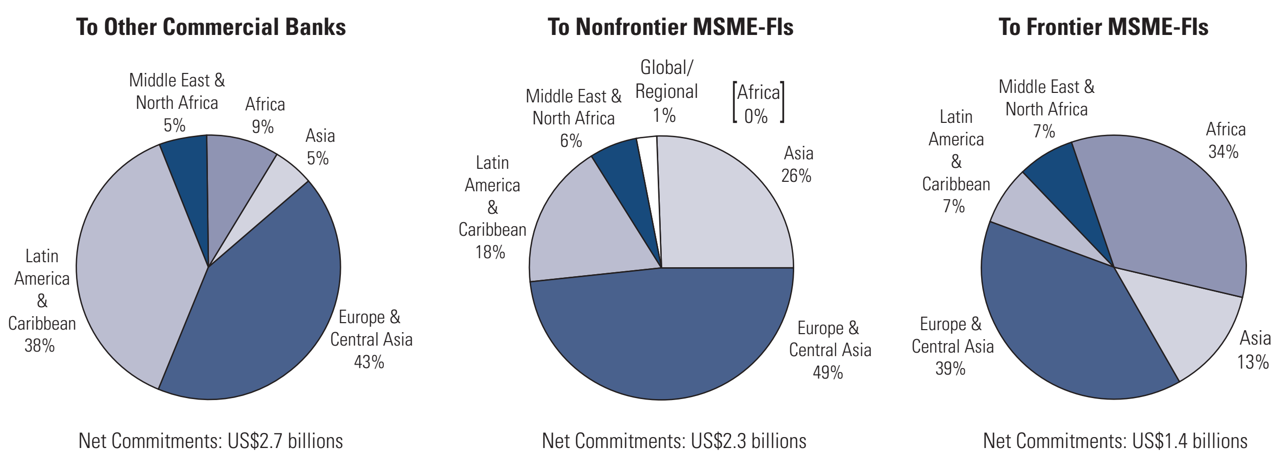
Note: Includes equity right issues as of June 2006.

Asia, 38 percent in Latin America, and only 9 percent in Sub-Saharan Africa. The reason for the relatively high allocation of MSME-FI commitments in Eastern Europe and Central Asia was the large demand for credit created by the widespread start-up and high growth of MSME businesses stimulated by the reforms to support private sector development in transition countries that aspired to European Union membership or affiliation.

Project Design Parameters for Commercially Oriented MFIs

In the mid-1990s, IFC had reviewed the microfinance experience of bilateral and other multilateral financial institutions, as well as its own experience in the commercial banking and leasing sectors, to obtain insights into the parameters that could contribute to a successful financial intermediary project that provides credit to microenterprises on commercial terms and for

Figure 2.3. Regional Distribution of IFC Net Commitments to MSME-FIs and Other Commercial Banks, FY94–FY06



profit. This review identified a few important design parameters for such projects, particularly in frontier countries. These parameters, reflected in IFC's first microfinance-intermediary project in a frontier (and postconflict) country and, subsequently, in all the MFI projects evaluated in this study, were as follows:

- **Operating principles and sponsor quality.** The financial intermediary must specialize in microfinance and operate with state-of-the-art microfinance operating principles, practices, and systems. Therefore, it must start with an experienced sponsor and management with a strategic equity stake. The MFI must also invest in training its staff and in acquiring or developing the required operating systems to be at the leading edge of good-practice standards for microlending operations.
- **Governance.** The intermediary must have a strong corporate governance culture with proactive shareholders on the board of directors providing strategic directions toward financial self-sustainability and profitability, and oversight of management.
- **Funding.** The intermediary must have access to stable sources of funds, preferably local currency funds (for example, savings deposits or loans from other local financial institutions), which means that it must be adequately capitalized by reputable shareholders to attract such funds.
- **Advisory services.** The intermediary should be provided a limited, one-time injection of advisory services grant funds to cover the initial start-up costs, training, and acquisition or development of operating systems and procedures, in order to achieve profitable operations earlier, in about the second or third year of operations (instead of seven or more years without such grant funds).

The project-design parameters described above were IFC's response to the need within the global microfinance industry for a business model of a long-term sustainable microfinance entity that could transition out of donor dependency and eventually attract private sector equity.[12] These four parameters were expected to accelerate the learning curve for microfinance intermediaries and to help them quickly achieve the scale and efficiency of operations needed, in order to be profitable and sustainable while charging reasonable interest rates.

Different Types of Financial Entities Used to Support Microenterprises

IFC approved its first MFI project in a frontier country in FY96. Since then, IFC has used five types of vehicles or business models to channel financing to microenterprises. During FY96–FY02, when the operationally mature projects in the MFI evaluated population were approved, IFC financed 37 microfinance entities in 33 countries (most with advisory services support and in frontier countries) based on five types of institutional vehicles:

(i) For-profit, special-purpose vehicle to help finance a (nonprofit) NGO-sponsored microcredit program:[13] one project in a frontier country;
(ii) Credit unions and consumer cooperatives (nonprofit membership financial intermediaries): two projects, both in frontier countries;
(iii) Special MSME credit facility within a commercial bank: three projects, all in a frontier country;
(iv) Regional private investment funds or private equity funds that specialize in investing in intermediaries that lend to micro and small enterprises: two regional projects; and
(v) Commercially oriented, "for-profit" microfinance intermediaries: 29 projects, 21 in frontier countries (the MFI evaluated population) and 8 in nonfrontier countries.

The 29 "for-profit" microfinance intermediaries are generally new financial intermediaries (either deposit-taking commercial banks or nondeposit-taking financial intermediaries) specifically established to serve microenterprises and eventually, but to a lesser extent, SMEs. Some "for-profit" microfinance intermediaries were conversions of nonprofit microfinance operations of

NGOs. The 21 "for-profit" microfinance-intermediary projects in frontier countries comprise the MFI evaluated population; 20 of these projects were active as of the end of FY06, and one project closed in FY06 (but is evaluated in this study). The MFI evaluated population (and the SME-FI evaluated population) includes only profit-oriented commercial banks and non-deposit-taking lending institutions that provide loans to MSMEs, These comprise the large majority of IFC projects supporting MSMEs. The MFI evaluated population does not include a small number of projects (eight) that involves either collective investment vehicles (such as private equity funds and investment funds) that have a regional or global coverage, or nonprofit membership financial services entities (such as credit unions and cooperatives) and other nonbank financial institutions (such as leasing and other companies) that do not primarily lend for working capital and/or for fixed-assets acquisition, which are the specific types of credits being made accessible to MSMEs under the strategy being evaluated.

Introduction of MFI Holding Company Structure

In FY99, IFC introduced the MFI holding company structure[14] to help microfinance intermediaries become successful. IFC mobilized support for this structure among other multilateral development banks and development agencies. With such support, IFC established and invested equity of about US$68 million in 10 MFI holding companies[15] from FY99 through the first half of FY07. These holding company investments are in addition to the 37 microfinance projects discussed above. The idea is that the MFI holding companies, with their development-oriented institutional shareholders, provide funding support—particularly equity and grant funds for institution building and training—to their MFI subsidiaries or affiliates. In addition, the technical partner in an MFI holding company provides the management and operating expertise needed to train and initially operate the subsidiary and affiliated MFIs. Furthermore, it is expected that an MFI holding company would be a more attractive entity for private sector investors to invest in (compared with the individual microfinance intermediaries) because the holding company provides the large-scale operation and risk diversification that is important to many equity investors.

It is worth noting that 9 of these 10 MFI holding companies were established only after FY01, and the MFI evaluated population includes the subsidiaries and affiliates of only 1 MFI holding company (referred to as the "MFI Holding Company" in this report), with 13 MFI subsidiaries and affiliates, mainly in eastern and southern Europe. Some of these 13 MFIs were established during FY96–FY98, before the "MFI Holding Company" was created. These intermediaries were brought under the "MFI Holding Company" after FY99 as part of a consolidation strategy agreed on by all the shareholders of all the intermediaries involved, as well as by the "MFI Holding Company." In terms of corporate governance and management, MFI holding companies are similar to the typical private equity funds in which IFC invests.

Each of the 10 MFI holding companies is associated with a different technical partner (typically a minority investor in the holding company) that not only manages the holding company but also the subsidiary and affiliated MFI projects (both through management contracts as illustrated in figure 2.4). The technical partner provides the microfinance operational expertise and knowledge for comprehensive institutional capacity building of the MFI projects. The management and training services provided by the technical partner to each associated MFI project is covered by a contract, which, for the MFI evaluated population, have all been financed with grant advisory services funds from donors (who negotiate the contracts) who may also be investors in the holding company or in the MFI project itself. The scope of the management and training services contract for the projects encompass organization and governance, credit training, risk management, market and product development, internal audit, accounting and control, and management information systems. Before becoming technical partners, the different technical partners in these 10 MFI holding companies all had extensive experience providing advisory services work to various nonprofit microfinance institutions in developing countries, such as credit unions and NGO-sponsored microlending entities, all financed by advisory services funds from multilateral development banks and bilateral aid agencies.

In the MFI evaluated population, 13 MFIs have the holding company structure (the same MFI holding company and the same technical partner for all 13).The ownership structure of these "for-profit" MFIs is illustrated in figure 2.4. The remaining eight MFIs have the financial institution or NGO-sponsor company structure, which operates as shown in figure 2.5.

IFC's Recent (Not Operationally Mature) MFI Projects

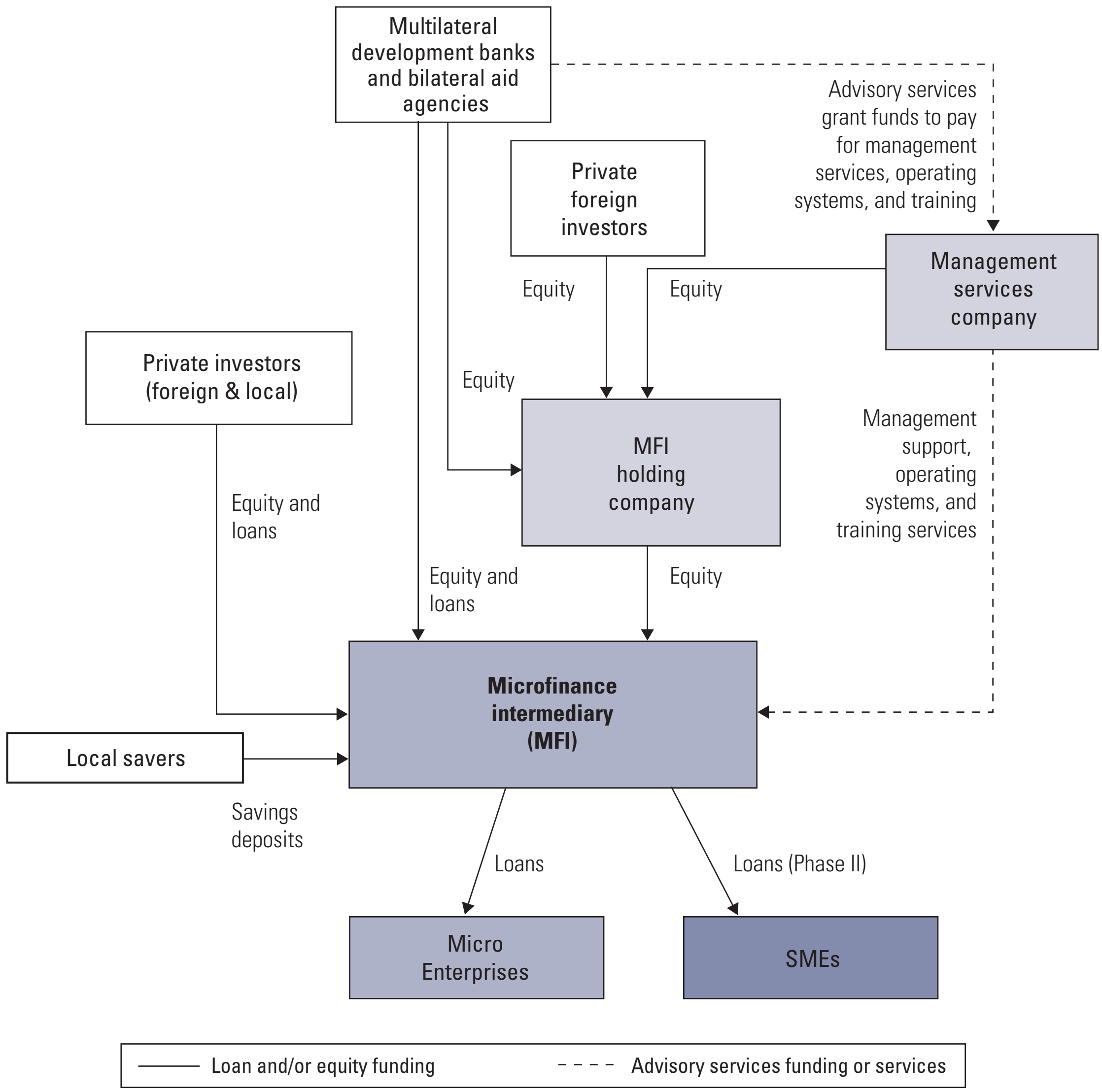
More recently, during FY03–FY06, IFC approved MFI operations with 37 new clients (including seven global or regional entities and 14 repeat clients (including the "MFI Holding Company") to help them meet demand, expand into new business lines, and maintain prudent capitalization. These are described below:

- New MFI clients: 37 new clients, of which 19 were in frontier countries, 11 were in nonfrontier countries, and 7 were global or regional entities (that is, regional investment funds or MFI holding companies). Twenty-five of the 30 new country-level MFI clients are also new MFI entities (that is, greenfield projects or conversions to commercial intermediaries of the microlending operations of nonprofit NGOs).
- Repeat MFI clients: 14 repeat MFI clients, of which 7 were in frontier countries. One of the 14 was the "MFI Holding Company," with IFC equity subscriptions to two rights issues, and another was an MFI in which IFC subscribed to one equity rights issue. For the 12 other repeat clients, IFC had existing equity investments made before FY03, and during FY03–FY06, IFC provided new loans or guarantees to each, as well as subscribed to equity rights issues in 5 of the 12 (described below).

The loans or guarantees with the 12 repeat MFI clients involved significant value-added roles for IFC that a foreign commercial bank or short-term commercial lender could not provide:

- Six clients were in high-risk countries that were not attractive to foreign commercial lenders. Three had low profitability (average return on assets were less 1.2 percent in 2004 and 2005), and five had deposit to loan ratios of less than 60 percent and needed stable or predictable sources of long-term loans. In some MFIs, the IFC loan was part of a loan package provided by international financial institution shareholders.
- Two clients were in medium-risk countries but had low profitability (returns on average assets for 2004 and 2005 averaged less than 1.2 percent) and barely adequate capitalization (the ratio of equity to assets were 11 percent or lower in 2004 and 2005). The two clients were, therefore, not considered creditworthy yet. One needed a subordinated loan from IFC as Tier II Capital.
- Two profitable clients were in medium-risk countries: (i) one client had low capitalization and a low deposit-mobilization rate and needed additional equity as well as long-term loans, which was not available from local sources, as it expanded lending operations to also include small enterprises; and (ii) the second client received an upgrade from an MFI license to a full commercial bank license, and needed additional equity injections (through a rights issue) to maintain prudent capitalization, and also long-term loans to expand its product lines to include term lending to SMEs for fixed assets (as opposed to short-term working capital loans) and to households for home improvements. In particular, this second MFI intended to expand into small agribusiness lending with term loans. These two clients can obtain such long-term loans and equity only from IFC or the other international financial institution shareholders, and preferred to continue the business relationship with its institutional shareholders, such as IFC, for strategic reasons as the MFIs expand into new businesses, such as lending for housing and small and medium-size enterprises. These two

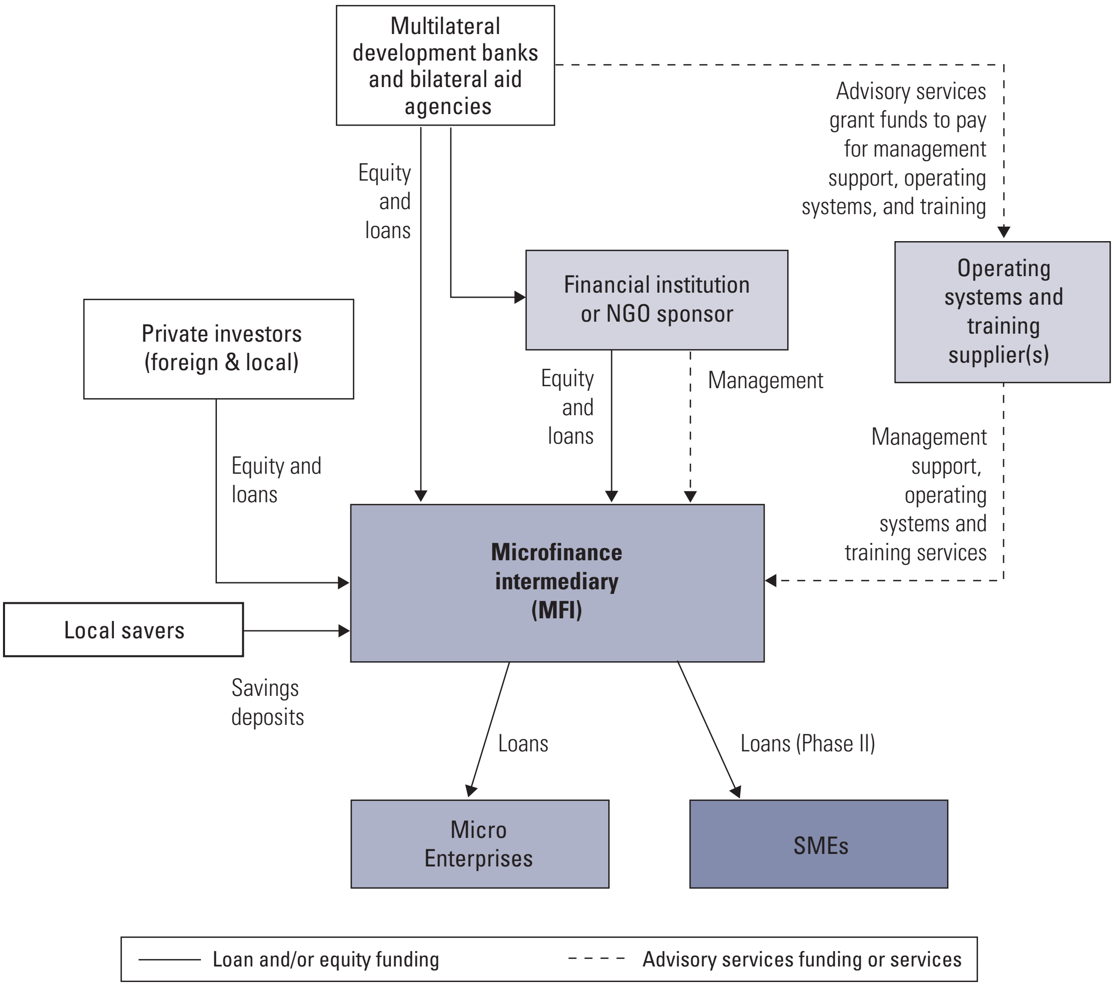
Figure 2.4. Ownership and Funding Sources for Profit-Oriented MFIs: Holding Company Structure



intermediaries are in countries with underdeveloped banking systems; the MFIs' expansion into various forms of lending fills a large, unmet demand for access to credit, and is in line with IFC's strategic priorities to support small and medium-size enterprises, agribusiness, as well as housing finance.

- Two profitable clients were in medium-risk countries: (i) one client had a limited savings-deposit base and required a long-term loan that could be partly in local currency and partly in foreign currency, depending on the needs of the MFI subborrowers. Foreign currency lenders could not provide such a dual currency loan; and (ii) the second client was established only in 2001 as a nonbank financial institution (that is, it had no license to take deposits) with IFC as a founding shareholder and initial lender. It required, and IFC provided, a partial guarantee of an innovative series of long-term, local-currency bond issues, which were followed by an IFC long-

Figure 2.5. Ownership and Funding Sources for Profit-Oriented MFIs: Financial Institution or NGO Sponsor Structure



term local-currency loan two years later. The bonds were intended to qualify as investment grade bonds for the local regulated pension funds and life insurance companies (the main market for the bonds) to buy. Such a partial guarantee can be provided either by a highly rated international financial institution such as IFC, or a highly rated local financial institution. But the underlying risk of the MFI client with a limited operating history meant that only IFC or a similar multilateral development institution could, for all practical purposes, be the guarantor. The MFI received a commercial bank license and could start taking deposits only in 2006. Before then, the MFI was fully dependent on equity and long-term loans from shareholders for its microcredit operations, and it will continue to substantially depend on long-term local currency loans and equity injections until the deposit base becomes sufficiently large enough to fund most lending operations.[16]

IFC Support Involves a Combination of Financing and Advisory Services

For the MFI and SME-FI projects in the respective evaluated populations, IFC provided loans or equity financing (or both), and mobilized or provided advisory services grant funds for almost all of the MFIs and some of the SME-FIs as part of the project design. Among the 21 projects in the MFI evaluated population, 17 were "greenfield" projects involving new entities, and 4 projects involved either conversion of nonprofit, NGO-sponsored microfinance entities, or spinoffs of the microfinance operations of a commercial bank into a commercially oriented, "for-profit" microfinance intermediary. Eighteen MFIs also received advisory services funds from various international financing institutions, including IFC, for initial capacity building, training, and management service contracts in an effort to help accelerate operational learning and reduce the long time needed to reach the profit break-even point in operations.

Among the 72 projects in the SME-FI evaluated population (all commercial banks), 43 were existing private sector banks, 12 were privatized former-state-owned banks, and 17 were newly established commercial banks—the so-called greenfield or "pioneering" projects.[17] Twenty-one mostly small (in terms of total assets) SME-FIs received advisory services from IFC to either establish a new unit (or to train specialized loan officers) within the SME-FI dedicated to serving the small and medium-size enterprise market, or to expand and improve an existing service unit.

The 21 operationally mature MFI projects involved a total of about $46 million of IFC commitments, whereas the 72 operationally mature SME-FI projects in the evaluated population involved a total of about $490 million, altogether aggregating to about $536 million of IFC commitments approved during FY94–FY02.

The 21 MFI projects were financed by IFC primarily with equity. Thirteen were financed with equity alone, five were financed with both equity and loan, and three were financed only with loans. The high proportion of projects (18 of 21) receiving equity investments is in line with IFC's project-design parameters and was primarily dictated by: (i) the start-up nature of a majority of projects that involved very high risks and IFC's strategic interest to ensure that these intermediaries followed good operating practices, had immediate funds to lend while the intermediary built its deposit base or other sources of local currency funding, and served the target markets well; (ii) the lack of interest among profit-oriented investors in investing in new microfinance intermediaries because of their high risk and small scale; (iii) the need for a sufficient equity base to cover operating losses, if any, during the initial operating years; and (iv) the need of the intermediary to have an adequate equity base to obtain a license to operate and take local currency deposits, as well as to provide confidence to depositors, which would be crucial for mobilizing local currency funds (in the form of savings deposits) to lend to microenterprises. In this regard, microenterprises cannot absorb the exchange risk associated with foreign currency loan funding (such as from IFC). Equity investors in microfinance intermediaries are usually multilateral development banks, bilateral aid agencies, NGOs, private sector-oriented international development institutions such as IFC, and a few private sector companies that specialize in providing MSME consulting services. MFI projects also received advisory services via grant funding.

The 72 SME-FI projects were financed by IFC primarily with loans, although a substantial percentage also received equity. Thirty-six were financed with loans only, 12 were financed with both loans and equity, and 24 were financed only with equity. The IFC equity investments were distributed as follows: 15 were in greenfield or new SME-FIs, 13 were in privatized SME-FIs, and 8 were in existing SME-FIs. Most of the SME-FI projects were with existing banks (as opposed to new or privatized institutions) that needed long-term loans to help match their subloan maturities with funding terms, or that needed additional equity to support their growth in lending and to meet prudential capital-adequacy requirements (or both). The SME-FIs that received IFC loans would effectively set aside the local currency equivalent of the IFC loan, and used these local currency funds to lend to SME borrowers who generally do not need long-term or foreign-currency loans. The enterprises utilizing the IFC long-term foreign-currency funds were primarily medium-size and large companies that could take the devaluation risk associated with foreign-currency loan funding and also needed the longer maturities that were possible with the IFC loan funds.

In summary, building on the premise that support for MSMEs in frontier countries is an important component of an effective strategy to: promote private sector development, create employment, increase economic growth, and reduce poverty, IFC has made support for MSMEs into a strategic priority. IFC's support for MSMEs relies on indirect funding through financial intermediaries that target MSMEs as a business line. To enable these financial intermediaries to serve the MSME market, IFC provided loans and invested equity in them. IFC also mobilized or directly provided them with advisory services. IFC also established MFI holding companies to help the development of these MFIs. The success of the MSME-FIs in effectively and profitably serving MSMEs largely determines the relevance, effectiveness, and success of IFC's strategic thrusts for supporting MSMEs in frontier countries.

Chapter 3

Synopsis

Almost three-fourths (71 percent) of the 21 projects in the MFI evaluated population achieved high development outcomes, higher than the 61-percent success rate for all 308 IFC investment projects located in frontier countries evaluated through XPSRs. However, of the 18 MFIs with IFC equity investments, only 22 percent are expected to achieve satisfactory equity returns for IFC. This is about two-thirds of the 34-percent satisfactory rate for 165 equity investments in frontier countries evaluated with XPSRs, and just under one-fourth of the 58-percent expected equity satisfactory rate of the SME-FI evaluated population. Of the 21 MFIs in the evaluated population, 18 provided IFC with data on the number of microenterprise borrowers and reported an average of 39,207 borrowers per intermediary, with each borrower having received an average of about US$1,970 at the end of 2005. The four project design parameters used by IFC and the role of the "MFI Holding Company" mentioned in chapter 2 were all contributors to the high development-outcome success rate. In addition, two other major success drivers were identified: (1) regulations that allow microfinance intermediaries to take deposits, establish branch offices, and not set limits on interest rates that could be charged; and (2) good practice standards to benchmark MFI operations.

Evaluation of the MFI Projects

The MFIs in the evaluated population maintained high-quality loan portfolios with a weighted average rate (weighted by total loans) of nonperforming loans (that is, loans more than 30 days in arrears) of about 1.7 percent at the end of 2005, and a high deposit–to-loan ratio of about 93 percent.

MFIs Maintain High-Quality Loan Portfolios and Many Clients

For the two-year period 2004–05, the 21 MFIs had a weighted average return on assets of about 1.4 percent (the ratio of net income to total assets) and a weighted return on equity of 11.5 percent. Only 3 intermediaries had negative returns on total assets (and on equity), 10 intermediaries had returns on total assets between 0.1 percent and 1.4 percent, and 8 intermediaries had returns on total assets of 1.5 percent or higher.

The intermediaries also established a substantial microenterprise borrower base. The 18 intermediaries for which IFC has borrower data had a total of 663,000 MSME borrowers, accounting for an aggregate outstanding loan portfolio of $1.53 billion at the end of 2005. On average, each intermediary had 39,207 borrowers (mainly microenterprises and a few small enterprises), with an average loan of $1,970 per borrower (see table 3.1). These are remarkable achievements given that these intermediaries were established less than a decade ago and had an average of only six years of operations before 2005. However, there is wide variability in performance among intermediaries, reflecting the high risks in their operations, which are driven primarily by country conditions and, to a lesser extent, by the quality of the shareholder or technical partner managing the intermediary.

The client base or outreach of the microfinance intermediaries grows continuously as the intermediaries mature and add branch offices. The growth depends mainly on their profitability and a supportive regulatory regime that liberally allows branches to be established. The main offices of the intermediaries in the evaluated population, particularly those in eastern and southern Europe and in Central Asia, were established in urban areas where a large concentration of microenterprises could be served. As the MFIs' business became profitable, the intermediaries established branches outward from the urban centers, toward increasingly rural and less densely populated areas.

This reflects a prudent growth strategy because all intermediaries were new entities and needed

Table 3.1. Financial Performance Data for MFIs in the Evaluated Population

Weighted average for 2004–05 unless otherwise indicated	Data for all 21 MFIs in the evaluated population	Data for 13 MFIs under the MFI holding company	Data for 8 other MFIs
Aggregate net income as % of average assets	1.4	1.4	1.9
Aggregate net income as % of average equity[a]	11.5	13.3	6.9
Aggregate interest income and fees from loans as % of average loans[b]	21.1	20.9	22.2
Aggregate administration expenses as % of average loans	13.2	12.5	17.0
Aggregate interest paid on deposits as % of average deposits	3.7	3.5	5.3
Aggregate interest paid on debts as % of average debt	5.3	5.5	4.0
Average deposits as % of average assets	57.6	59.9	41.6
Average debts as % of average assets	20.8	30.4	34.2
Average equity as % of average assets	11.6	9.7	24.2
Average loans as % of average assets[c]	64.1	63.0	72.0
Average nonperforming loan rate (loans more than 30 days in arrears)	1.7	1.0	2.3
Average deposits as % of average loans	93.2	99.3	55.3
Average number of MSME subloans per intermediary (end 2005)[d]	39,207	23,710	76,399
Average subloan size (end of 2005)	$1,970	$2,870	$700
Average total assets per intermediary (end of 2005)	$109.2 million	$153.5 million	$37.3 million
Average number of employees per intermediary (end of 2005)[e]	571	651	399
Average number of branches per intermediary (end of 2004)[f]	19	23	12

a. The annual accounting return on average equity and annual accounting return on average assets are related through the ratio of average equity to average assets. The relationship is given by the formula: (Net Income/Average Assets) = (Net Income/Average Equity) × (Average Equity/Average Assets). For commercial banks in developed countries, a "good" annual return on average equity is about 15 percent, and a "good" return on average assets is at least 1 percent when the minimum equity was 5 percent of total assets before the Basel I risk-adjusted capital requirements were introduced. If the minimum equity is about 10 percent of total assets, the return on average assets has to be about 1.5 percent to yield a 15-percent return on equity.

b. Microfinance intermediaries have other sources of income such as credit life insurance, currency transfer fees, interbank loan interest, and income from short-term investments.

c. In addition to loans, microfinance intermediaries also hold other assets, such as short-term investments and interbank loans. In general, commercial banks are regulated to have not more than 70 to 75 percent of assets in loans, with the balance of the assets held as liquidity and "first loss" support in the form of cash holdings, deposits with the central bank, liquid government securities, and interbank overnight loans.

d. The average number of subloans for 17 intermediaries (including 12 of 13 under the MFI holding company) with data on number of subloans. Only five of the other eight intermediaries have subloan data, and those without data are smaller in terms of total assets; therefore, the average number of subloans for the other eight intermediaries, as a group, is biased upward.

e. The average number of employees for 19 microfinance intermediaries (out of 21) with data on employees.

f. The average number of branches for 14 microfinance intermediaries (out of 21) with data on the number of branches.

Box 3.1. Microenterprises Use Loans to Expand Business

Microenterprises used the subloans they received from microfinance intermediaries primarily to expand their businesses through the purchase of new equipment or to upgrade business facilities, access additional working capital, or some combination of these actions:

East Asia: A clay-pot stove producer received a one-year, $4,000 loan from an intermediary to buy an excavator and to use as working capital. The enterprise employs 15–20 persons and obtains its clay from an adjacent quarry. The operation involves mixing clay in a pit with water, then forming the pots, which are subsequently baked in a furnace, using rice husks as fuel. The product is then sold to retailers in nearby towns and provinces. The clay-pot stove products are fuel efficient and cleverly designed, and cost about $1.00 each to produce.

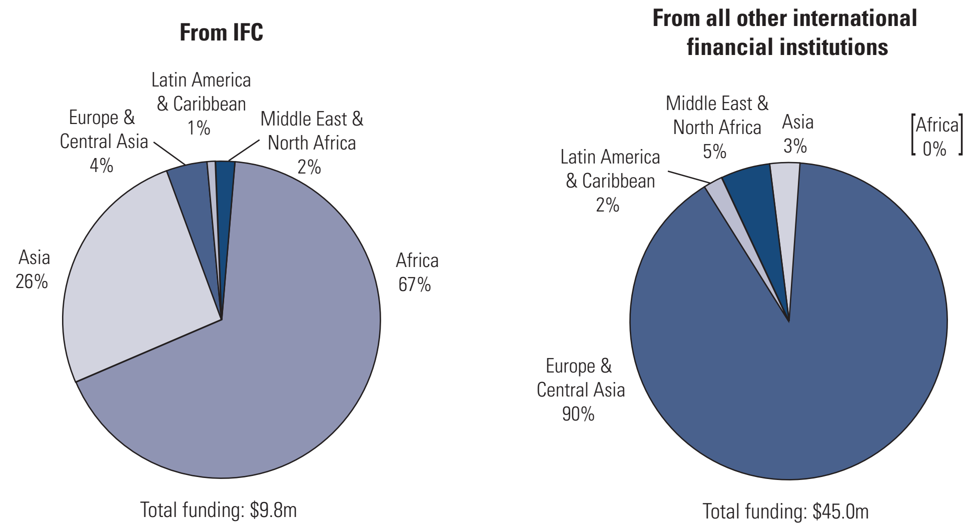
South Asia: A dressmaker received a $280 loan from an intermediary to refurbish the shop and to use as additional working capital to increase sales volume. Customers supplied their own fabric and selected dress designs from fashion magazines and models displayed in the shop. The price for making a dress is about $8.00–$10.00.

Sub-Saharan Africa: An automobile air-conditioning repair and installation business, with seven employees, received an $11,000 loan from an intermediary to use as additional working capital (that is, to purchase new air-conditioning units for installation and spare parts, including coolant material, to repair existing units) and to expand operations. The workshop is exceptionally clean, tidy, and properly equipped, including with fire extinguishers. The proprietor provides on-site training to employees. The business complies with IFC's EHS guidelines and, in particular, all new air-conditioning units sold or installed comply with European Union and U.S. standards for greenhouse gas emissions (that is, they use type 134a gas for cooling). While there is no government-mandated phase-out of type R12 gas coolant (a greenhouse or chlorofluorocarbon gas) in the country, the business uses type R12 gas only for older (existing) units that cannot use the type 134a gas.

to develop their staff and systems where the potential client base was most dense, so as to achieve profitability reasonably quickly. As business grew through the establishment of branches, the intermediaries were progressively serving clients in rural areas. Notably, one of the intermediaries successfully pioneered agribusiness loans to private farmers and other rural clients in a transition economy when the commercial banks failed to recognize the viability of serving this micro- and small-enterprise market segment. Because of the high incidence of poverty and low productivity in rural areas, outreach by intermediaries to these rural enterprises—through an expansion of their branch network—can have a direct impact on the rural poor. Such outreach efforts thus contribute to the mission of the WBG and help to reduce poverty, particularly in rural areas.

The microfinance intermediaries in the evaluated population are all new commercial or for-profit entities (some were converted from nonprofits), with length of time in operation ranging from three to nine years (by the end of 2005). Therefore, many are still in their early learning and growth period. Furthermore, some of these intermediaries are not just located in low-income or high-risk countries, but they are also in countries simultaneously undergoing substantial economic and political transition, or postconflict adjustments, particularly with respect to the policy and regulatory regimes in their financial markets. The future performance of many intermediaries will, therefore, depend not only on the ability of their management to improve performance, but also on the evolution of the regulatory regime governing them in these frontier countries, particularly regulations that affect their ability to take deposits, the requirements for minimum equity and second-tier capital (that is, long-term subordinated debt and redeemable preferred shares), their ability to establish branches, and their freedom to set loan interest rates at levels that provide reasonable profit margins. In particular, for intermediaries in the transition economies of eastern and south-

Figure 3.1. Advisory Services Funding to MFIs in the Evaluated Population



ern Europe and in Central Asia, a long tradition of private banking does not exist; neither does the concept of institutional microcredit services exist. A proactive approach by multilateral development banks to introduce a supportive regulatory regime for microfinance intermediaries is therefore important for their long-term sustainability.

MFIs Achieved Early Profitability

As a portfolio, the 21 microfinance intermediaries achieved a satisfactory financial return on invested capital of about 7.3 percent, and a satisfactory economic return on invested capital of about 7.9 percent, for aggregate cash flows from 1998 to 2005, both in nominal dollar terms (table 3.2). The methodology for estimating the aggregate return on invested capital and aggregate economic return on invested capital is summarized in table 3.2, footnote (a). The return on invested capital is a multiyear cash-flow return, whereas the return on assets is a single-year return.

The 13 intermediaries under the MFI holding company have a lower aggregate return on invested capital and economic return on invested capital than the other 8 intermediaries, despite the former having a lower administrative cost (12.5 percent of loans) compared with the latter (17.0 percent of loans). This is partly because (i) the lower weighted average interest rate charged by the 13 MFIs under the “MFI Holding Company,” as a group, is 20.9 percent, as compared with a weighted average 22.2-percent interest rate charged by the other 8; and (ii) the lower weighted average interest rate is 3.5 percent, paid on savings deposit by the 13 MFIs under the “MFI Holding Company,” as compared with the 5.3 percent paid by the other 8. Interest paid on deposits and debts are part of the returns to invested capital in the estimation methodologies for the return on invested capital and the economic return on invested capital.

The intermediaries under the “MFI Holding Company” achieved lower average administrative costs, as a percentage of average loans outstanding, partly owing to better operating practices and systems, and partly owing to serving small enterprises with larger average loan amounts, in addition to serving microenterprises. Such a strategy to also serve small enterprises, is an effective way for MFIs to improve

Table 3.2. Returns on Invested Capital for MFIs

Discounted cash flow, 1998–2005	All MFIs	MFIs under the "Holding Company"	Other MFIs not under the "Holding Company"
CASE A: All MFIs with and without advisory services; grant advisory services funding of start-up and management contract costs for those with advisory services	***21 MFIs***	***13 MFIs***	***8 MFIs***
Financial return on invested capital[a]	7.3%	7.0%	10.2%
Economic return on invested capital[b]	7.9%	7.5%	11.5%
Discounted cash flow return on equity	18.3%	20.4%	13.1%
CASE B: MFIs that did not receive advisory services	***3 MFIs***	***2 MFIs***	***1 MFI***
Financial return on invested capital	8.7%	9.0%	4.9%
Economic return on invested capital	9.4%	9.7%	5.3%
Discounted cash flow return on equity	13.8%	15.3%	4.4%
CASE C: MFIs that received advisory services	***18 MFIs***	***11 MFIs***	***7 MFIs***
Case C-1: Grant advisory services funding of start-up and management contract costs for those with advisory services			
Financial return on invested capital	7.1%	6.7%	10.6%
Economic return on invested capital	7.7%	7.2%	12.0%
Discounted cash flow return on equity	18.9%	21.2%	13.5%
Case C-2: If start-up and management contract costs were funded from operating cash flows rather than grant advisory services			
Financial return on invested capital	5.3%	5.3%	6.5%
Economic return on invested capital	5.9%	5.8%	7.7%
Discounted cash flow return on equity	6.7%	8.8%	3.6%
Cumulative advisory services versus cumulative net income			
Cumulative advisory services grant funds, 1998–2003[c]	$54.8 million	$39.2 million	$15.6 million
Cumulative net income			
1998–2003	$24.0 million	$17.1 million	$ 6.7 million
1998–2004	$41.6 million	$31.4 million	$ 9.9 million
1998–2005	$70.5 million	$55.4 million	$14.8 million

a. The return on invested capital is a discounted cash flow internal rate of return for the period 1998–2005, where the invested capital consists of equity, savings deposits, and debts of the MFI (that is, all the financiers as a group), and the return consists of net income (after taxes), interest paid on deposits and on debts, and depreciation (that is, the income to all the financiers as a group). The terminal value at the end of 2005 is the book value of the invested capital (that is, equity, deposits, and debts). The return on invested capital and the economic return on invested capital above are in nominal dollar terms.

b. The economic return on invested capital includes taxes as cash inflows or benefits.

c. All the advisory services grant funds for the 18 MFIs that received advisory services were disbursed during 1998–2003.

profitability, which is consistent with their broad mission to provide access to finance for underserved businesses. The MSME borrowers of the 13 intermediaries under the "MFI Holding Company," therefore, benefited from the contribution of the holding company in terms of lower administrative expenses and lower costs of funds, leading to lower interest rates.

If the 18 MFIs that received advisory services had used their own operating revenues or capital to pay for their establishment, training, and initial operating expenses, as well as management contracts (instead of being funded through grant advisory services), both the aggregate return on invested capital and economic return on invested capital of the 18 MFIs would have been lower by about 180 basis points, or 1.8 percentage points. The cumulative aggregate net income of the 18 MFIs, from 1998 through 2005, exceeded the total advisory services they received. However, without the grants for advisory services they would not have been profitable as a group until about six years after their establishment, compared with only about two years when grants for advisory services were used to fund the up-front expenses (table 3.2).

The cumulative 1998–2005 net income of the eight MFIs not affiliated with the "MFI Holding Company" was slightly less than the total advisory services they received. This is because many of these intermediaries were established only in 2000–01, and therefore have been in operation for only a few years, as compared with the 13 intermediaries affiliated with the "MFI Holding Company," which were established between 1996 and 2000. The advisory services grant funds therefore accelerated the profit-breakeven operations of the MFIs by about four years, on average, and were instrumental in achieving early financial sustainability because it may have been more difficult for them to mobilize savings deposits or to obtain term debts if they were not profitable.

The "MFI Holding Company" therefore substantially contributed to the development and financial success of the 13 MFIs under its management umbrella in several important ways:

- Lower administrative and operating expenses leading to lower interest charges to borrowers. This was partly achieved through lending to a mix of micro and small enterprises, rather than only to microenterprises, and partly through better operations, practices, and systems. Lending to small enterprises is consistent with the broader strategy of IFC to also support SMEs, particularly in underserved markets. Expanding lending services by MFIs to small enterprises, in addition to microenterprises, is therefore both developmentally and financially sound.
- Higher mobilization rates of savings deposits relative to loans outstanding, thereby reducing reliance on foreign debts, reducing interest expenses, and reducing exposure to devaluation risk for the MFIs and their borrowers. The "MFI Holding Company" has adopted an operating strategy and practice of relying mainly on savings deposits and equity for lending operations in countries with very high potential of local currency depreciation. A savings-deposit mobilization rate sufficient to cover both loans and working-capital needs will make the MFI financially self-sufficient or sustainable, and independent of donor loan support (except for equity injections for growth).
- Maximizing the equity-base leverage of the MFIs to expand lending, thereby increasing both development reach and the return on equity.

Foreign Currency Loans Are Crucial for MFIs but Have Consequences

Mobilizing local-currency funding for an intermediary without a license to take deposits or with a limited deposit base, can be costly and complicated. However, devaluation risks associated with foreign-currency funding is also a major concern for both the intermediary and its borrowers. Neither can take such devaluation risk unless the intermediary operates in a highly or partially dollar-denominated (or other foreign currency) economy, or can mitigate the devaluation risk either by balancing foreign currency assets and liabilities or by hedging. But risk mitigation is also costly and can limit competitiveness. This is illustrated by one case in which the "MFI Holding Company" provided foreign currency funding in a combination of senior and subordinated debts and, as a consequence, the intermediary was not competitive and had difficulty expanding its business.

Successful Development Outcome Ratings for High Percentage of Projects

Table 3.3 summarizes the evaluation results for the 21 projects in the MFI evaluated population and compares these with the evaluation results for the SME-FI evaluated population and selected groupings of projects that were approved in FY90–FY02 and evaluated with XPSRs. Seventy-one percent (15 out of 21) of the MFI projects achieved a successful development outcome rating, which is higher than the development outcome success rate for: (i) the SME-FI population, at about 61 percent (discussed in chapter 4); (ii) all the IFC projects in frontier countries evaluated with XPSRs, at 61 percent; (iii) all nonmicrofinance-intermediary commercial bank projects, worldwide, evaluated with XPSRs, at 60 percent; and (iv) all IFC projects, worldwide, evaluated with XPSRs, at 59 percent. Of the six MFI projects with low or poor development outcomes, four were in the Sub-Saharan Africa Region, one in the Europe and Central Asia Region, and one in the Middle East and North Africa Region (table 3.4), where the prudential regulatory regimes were not supportive of profit-oriented MFIs.

Projects with low development outcomes had two or more of the following characteristics:

(i) No license to take deposits or a low savings-deposit mobilization rate, equivalent to less than 60 percent of loans;
(ii) Low client outreach of less than 20,000 micro- and small-enterprise borrowers;
(iii) Small total assets of less than US$15 million;
(iv) High nonperforming loan rates of 1.8 percent or higher; and
(v) Low returns to total assets of less than 1.0 percent.

IFC's appraisal work quality was also better for the 13 MFIs under the "MFI Holding Company," as compared with all other groups listed above, partly because of the repeat project feature of 12 operations (after the first) with the same technical partner (that is, the technical partner in the "MFI Holding Company") using the same operating systems and practices across all intermediaries under its affiliation, even though the intermediaries were located in different countries. The generally better development outcome success rate of the MFI projects, when compared with other groups evaluated by XPSRs, is partly due to the improvement in the business climate, from high-risk to medium-risk, in some of the countries in which these projects are located. However, the better success rate is largely due to particular success factors, which are discussed below.

Savings Services for Poor Households and Small Businesses

The microfinance intermediaries mobilized savings deposits equivalent to an average of about 93 percent of total loans, and the intermediary with the highest savings mobilization achieved a mobilization rate of 236 percent of loans in 2004–05. However, four MFIs had no license to take savings deposits, although one has a very small, corporate, time-deposit business. The high savings-mobilization rates in the MFI and other studies suggest that there is also a large demand for microsavings services (and other microbanking services such as remittances) by poor or low-income households and by small businesses in the developing and, particularly, frontier countries, not just a large demand for credit by MSMEs.[1] Simultaneously serving the needs of microsavers and microborrowers thus multiplies the development results of the MFI projects. Finally, MFIs with high savings-mobilization rates (relative to loans outstanding), and those that leveraged their equity to increase lending, as a group, charged lower interest rates and still achieved better development and investment outcomes, as compared with MFIs with low savings-mobilization rates and those that did not leverage their equity to increase lending.

Serving the demand for microbanking services and, in particular, the microsavings mobilization aspect of MFI operations, was not a prominent feature of IFC's strategies of using financial intermediaries to support MSMEs. The advisory services support provided by IFC aims primarily to improve lending techniques[2] and risk management by the intermediaries, and does not highlight savings mobilization techniques or liquidity management techniques.[3] Furthermore, as discussed in box 3.2, a large, profitable, and sustainable microfinance lending operation needs to be anchored on a high savings-mobilization rate. A profitable intermediary with large saver and borrower bases, respectively, can also attract private sector equity investors. However, substantial intermediation by MFIs to mobilize savings deposits depends on a regulatory regime that allows, among other things, deposits to be taken, branch networks to be established, and lending interest rates that provide a reasonable profit margin over costs.

Improving the regulatory regime where this is not yet well developed is therefore important for IFC's microfinance strategies. In addition, all MFIs, particularly those that have mobilized savings deposits substantially in excess of their lending and working-capital requirements, need to develop good liquid-asset management techniques and systems to improve profitability. However, as has been indicated, serving the need for savings services by households and MSMEs, developing good liquid-asset management techniques and systems by MFIs, and improving the regulatory regimes for MFIs, are not adequately addressed in IFC's current MSME advisory services support strategies.

The Need to Transition Out of Donor Dependency

Microfinance intermediaries need a stable or reliable funding source. Foreign currency loans are not appropriate to ensure sustainability to microfinance intermediaries because neither the intermediary nor its microenterprise borrowers can afford to take the foreign exchange devaluation risks. The "MFI Holding Company," in particular, has adopted a strategy of relying primarily on savings deposits to fund the lending activities of its MFI affiliates in countries with a high likelihood of local currency depreciation. However, foreign currency borrowings by an intermediary may be unavoidable during its start-up years as it develops its savings deposit base, or if there is no local currency debt market. In addition, adequate equity to meet regulatory and prudential requirements would have to be initially provided by development-oriented private investors. When an intermediary has demonstrated sustainable profitability and has reached a size that would attract private sector equity investors, international financial institutions can exit their investments. This is the business model for IFC's "for-profit" microfinance intermediary projects.

In the long run, to transition from donor dependency to financial self-sufficiency, microfinance intermediaries must: (i) become deposit-taking institutions and expand their deposit base to have a source of local currency funds for their lending; (ii) grow in an efficient and prudent manner with very low rates of nonperforming loans, by establishing state-of-the-art lending technologies and credit risk management systems, sufficient spreads to be profitable, and the ability to manage their liquid assets; (iii) leverage their equity base within prudential and regulatory limits to more fully utilize the capacity of their equity to mobilize deposits or other local currency borrowings, thereby improving the returns on equity; and (iv) reach a scale of operations or volume of loans that would reduce its average transaction costs and improve profitability, and thereby attract private sector equity investors.

Again, the quality of the regulatory regime, the quality of the senior management and loan officers, and strong equity and advisory services support from international financial institution shareholders are thus all crucial to successful and sustainable MFI operations.

IFC Equity Investment Returns in MFIs

Of the 21 MFI projects, 13 were financed by IFC with equity only, 5 projects with both loan and equity, and the remaining 3 projects with loans only. This IFC financing instrument mix, with 86 percent of projects (that is, 18 of 21) receiving equity investments, is much higher than the IFC average of about 50 percent of projects with equity investments (in terms of project counts, and about 20–25 percent in terms of financing

Table 3.3. Outcome Success Rates for Projects in the MFI Evaluated Population

	Number of projects	Percentage with high development-outcome success rate	Percentage with high IFC investment outcome success rate		Percentage with high IFC work quality
			Loans	Equity	
All MFIs in the evaluated population	21	71%[a]	100% of 8	22% of 18	76%
(i) MFIs under the "MFI Holding Company"	13	77%	100% of 7	27% of 11	85%
(ii) All other MFIs	8	63%	100% of 1	14% of 7	63%
SME-FI evaluated population	72	61%	79% of 48	53% of 36	65%
Remainder of commercial bank projects with XPSRs[a]	60	60%	76% of 49	67% of 15	70%
Remainder of financial markets projects with XPSRs[a]	147	59%	80% of 94	41% of 74	66%
All IFC projects with XPSRs (approved FY90–FY02)	619	59%[b]	74% of 466	31% of 322	65%
(i) Projects in frontier countries at approval	308	61%	74% of 227	34% of 165	65%
(ii) IFC projects in nonfrontier countries	319	58%	73% of 239	28% of 157	66%

a. Excludes two MFIs in nonfrontier countries and not in the evaluated population.
b. Difference is not statistically significant due to the small number of projects in the MFI evaluated population.

amounts) and indicates that IFC was willing to take significant equity risks to support microfinance intermediaries in these frontier countries.

About 22 percent (4 of 18)[4] of the IFC equity investments in the MFI evaluated population are expected to achieve satisfactory investment outcomes, less than the 34-percent success rate for all IFC equity investments in frontier countries in all sectors evaluated with XPSRs, and less than the 58-percent success rate expected for the equity investments in the SME-FI evaluated population. The lower IFC equity investment success rate for the MFI evaluated population is primarily due to the unsatisfactory equity investment outcomes for all but one of the seven investments in MFIs outside of the "MFI Holding Company" umbrella, More specifically, the lower success rate is due to the following:

- Some "outside" MFIs with satisfactory profitability in terms of the return on assets have low returns on equity because of limited leverage of the equity base. This implies an underutilization of the equity "capacity" to mobilize deposits or borrowings, and thus to increase loan volumes as well as the return on equity.
- Some "outside" MFIs with low returns on assets (and low equity returns) either have very high administrative expenses because of poor management or sponsor quality, or they do not charge sufficiently high interest rates on loans because of their historical practices as former nonprofit NGOs. These intermediaries will take a long time to resolve the low return on assets.
- Only a few of IFC's "outside" MFI equity investments have a credible exit mechanism (for example, equity put option) because the NGO shareholders of most of these MFIs have no financial capacity to acquire IFC's shareholdings, and the MFIs are too new and/or mostly too small to be listed on a stock exchange (if one exists in the country). IFC must rely on the sale of its own shares or of the intermediary itself, to a strategic private sector investor. This is not expected to occur until 10 to 15 years after IFC's investment approval.

- The same factors that contributed to low development outcomes described earlier, also contributed to a low IFC equity investment success rate.

The common operating practices and standards applied by the "MFI Holding Company" on its 13 affiliated MFIs, and the higher debt leverage these intermediaries achieved within a few years, have largely improved the return on shareholder equity. The improvement, in turn, helps IFC's equity investment return prospects in this subgroup of MFIs. But even under the "MFI Holding Company" structure, which provides IFC with the possibility of exiting its equity investments through the holding company if its shares are listed, the expected sale or exit of IFC's equity investments in those MFIs with low returns on assets at present is likely to be more than 10 years (after approval) and subject to considerable devaluation and other business-climate risks.[5]

MFI projects in high-risk countries have faced several major challenges that contributed to potentially low IFC equity returns. Among these are the high operating costs of intermediaries, the poor regulatory regimes for microfinance institutions in most frontier countries, which limit their ability to take deposits or expand their branch office network, and the lack of broad interest among private sector investors (particularly as potential buyers of IFC's equity) in investing in relatively small financial intermediaries.

However, IFC's loans to these intermediaries achieved a 100-percent success rate (that is, all eight loans were paid on schedule with interest). This success is partly due to the significant advisory services and advisory services available to cover an intermediary's establishment and management contract costs during the initial two to three years of operations, and either because an intermediary was financially successful, or if it was not, the sponsor and main shareholders provided significant equity injections to support the intermediary during the early years when its profits were low or negative.

Regions with Better Development and IFC Equity Outcomes

Table 3.4 shows that MFI projects in the East Asia and Pacific Region, the Latin America and Caribbean Region, and the Europe and Central Asia Region, respectively, had better development outcomes and IFC equity investment outcomes than the other Regions. However, because the number of projects in each Region is small (fewer than 10), no statistical significance can be attributed to the differences in these Regional success rates.

Table 3.4. Outcome Success Rates for Aggregate Regional SME-FI Projects

Region	Number of SME-FI projects	Development outcome success rate	IFC equity outcome success rate
Europe and Central Asia	9	89%	33% of 9
Sub-Saharan Africa Region and Middle East & North Africa Region	6	17%	0% of 6
Asia Region and Latin America & Caribbean Region	6	100%	33% of 3
Total	21	71%	22% of 18

Note: There is only one MFI project in the Middle East and North Africa Region, and three projects each in the Asia Region and the Latin America & Caribbean Region, respectively.

Seven Major Factors Contributed to High Development-Outcome Success Rates

Seven major success drivers for MFI projects were identified by this evaluation. Four of these stem from the microfinance intermediary project design and structuring parameters used by IFC:

(i) **Specialized prudential regulatory regime for MFIs.** A specialized prudential regulatory regime for microfinance intermediaries allowing, among others, gaining access to local currency funds through a license to take deposits, establishing branches, imposing no limits on interest rates, and improving business climates (fostered by reforms). Competition among microcredit providers[6] (such as microfinance intermediaries, nonprofit NGOs, and commercial banks) as well as transparency in interest charges and fees, would be the main instruments for ensuring reasonable and affordable interest rates to borrowers. The Independent Evaluation Group of the World Bank reviewed the Bank's lines-of-credit operations (see box 3.2) and similarly noted the importance of a good regulatory regime and competition as success drivers.

(ii) **Sponsor quality.** A primary sponsor (for example, the "MFI Holding Company" through its technical partner) and management specialized in microfinance-intermediary operations, with a proven business plan and committment to the delivery of microfinance services to underserved enterprises.

(iii) **Advisory services.** Advisory services funded by grants to help cover the establishment costs, acquisition of operating systems, and the know-how, training, and professional management costs for the initial two or three years of operations.

(iv) **Operational standards.** Good practice standards to benchmark and to improve performance.

(v) **Institutional equity and governance.** Substantial equity participation and proactive oversight by development institutions to ensure efficient and prudent management, to maintain a focus on serving microenterprises, and to provide confidence to depositors and regulators. The multilateral development bank shareholders, particularly IFC, proactively calibrated the growth of the MFI deposit base, relative to total assets, making sure that it aligned with the evolving strength, reliability, and coverage of the internal risk management and prudential monitoring capabilities of the MFIs. This was done in order to protect depositors, particularly in the absence of deposit insurance for some of these MFIs and the low income/economic status of most of their depositors.

(vi) **Transparency.** Transparent operations and public confidence (to help raise local currency funds).

(vii) **IFC work quality.** IFC's appraisal, supervision, and role during the project life were important to "outside" MFIs that had weaker local sponsors. In the case of the MFIs covered by the "MFI Holding Company" umbrella, the technical partner was highly experienced and largely substituted for IFC's work quality, although IFC's work quality in these MFIs had a higher satisfactory rate compared with the "outside" MFIs.

IFC's Role and Contribution

IFC was the main driving force behind the establishment of the "MFI Holding Company" as well as many of the microfinance intermediaries in the MFI evaluated population. IFC's value-added roles include the following:

- Taking a proactive role in the project design and selection of a technical partner, as well as the establishment of the "MFI Holding Company" and bringing several microfinance intermediaries within the "MFI Holding Company" umbrella.
- Investing equity in the microfinance intermediary directly or through the "MFI Holding Company" for the long term, in order to make sure it is well capitalized and thus credible to take deposits, to expand business quickly, and to be potentially attractive to private sector investors.

Box 3.2. Success Drivers Also Apply to Public Sector MFIs

The six success drivers for commercially or profit-oriented private sector MFIs also apply to similar public sector MFI projects, for which equity is provided by the government, and corporate oversight is provided jointly by the government and long-term lenders and advisory services providers. This is shown in the case of the Microbanking Division of *Bank Rakyat Indonesia* (BRI), which is not an IFC client, but is a former World Bank client. BRI's Microbanking Division underwent one the most successful transformations during 1983–89, changing from an unprofitable microcredit operation into a profitable business, starting in 1985, and into a financially sustainable large operation since 1990 (that is, able to mobilize savings deposit in excess of its lending and liquidity needs and to expand operations through a very large network of branches) with advisory services and loans from the U.S. Agency for International Development (USAID) and the World Bank; the Harvard Institute for International Development provided the advisory services financed by USAID.

BRI managed to survive the Asian financial crisis because of the profitability of its Microbanking Division when all other divisions (that is, agriculture lending and a small corporate lending operation) were unprofitable. Indonesia has improved the policy and regulatory regimes for microfinance since 1983 and now has the most supportive regime for microfinance among developing countries, resulting in a large mix and extensive reach of microfinance operations in the country. The Microbanking Division of BRI is the largest single microfinance entity in the developing countries. BRI was partly privatized in late 2003, through a sale of 30 percent of its shares to the public on the Jakarta Stock Exchange, largely on the strength of its Microbanking Division.

At the time of privatization (at the end of 2003), the Microbanking Division had 4,185 branches; close to 30 million savings-deposit accounts, with an average deposit of $118 per account; about 3.1 million microenterprise borrowers, with an average loan of $541 per borrower; it had mobilized savings-deposits equivalent to 2.1 times its loans to borrowers, and its return on assets had ranged from 5.7 percent to 6.4 percent during 1999–2003. Compared with the financial intermediaries in the MFI evaluated population at the end of 2005, the Microbanking Division of BRI, at the end of 2003, had more than 22 times the number of borrowers than the MFI with the most borrowers, 27 times more branches than the MFI with the most branches, more than 17 times more assets (at the end of 2003) than the MFI with the largest assets (at the end of 2005), and a 1.6 times higher average return on assets (1999–2003 average) than the MFI with the highest average return on assets in 2004–05. All six success drivers for microfinance intermediary operations discussed in this chapter contributed to the success of the BRI Microbanking Division.

Note: This discussion is based on publicly available information.

- Providing, where possible, long-term loans in the local currency, or guarantees for local-currency bond issues (a more appropriate debt instrument for microfinance intermediaries) and, where it is not possible, providing long-term foreign-currency loans to help ensure more stable funding sources;
- Providing, along with other multilateral development bank shareholders, advisory services grant funds to cover the costs of establishing microfinance intermediaries and training for staff, as well as the initial years of expert management costs.
- Nominating to MFI boards, and the board of the MFI holding companies, people with expertise on how to proactively contribute to good governance and strategic planning. (IFC's Global Financial Markets Department has a system for screening, selecting, and training prospective board nominees. One selection criterion is the ability to positively contribute to a company's success.)
- Targeting most IFC country level MFI projects in countries with low microenterprise access to credit.

In general, IFC's appraisal, project design, and selection of technical partners and sponsors were satisfactory. However, there was no evidence that IFC actively attempted to improve the prudential regulatory regime for MFIs where these were weak or nonexistent. MFI projects with unsatisfactory development and investment outcomes tend to be in countries with unsupportive or nonexistent MFI regulatory regimes. These MFIs are not expected to transition out of donor dependency for some time. IFC's role and contribution was rated by IEG to be satisfactory in 18 of the 21 projects in the MFI evaluated population (an 86-percent satisfactory rate). Three intermediaries given less-than-satisfactory development outcome ratings also had less than satisfactory ratings for IFC's work quality. Appendix D summarizes IFC work-quality[7] ratings for microfinance intermediaries. Strong institutional foreign shareholders with proactive nominees to the intermediary board are also drivers of successful project outcomes. IFC-nominated directors, in particular, advocated a focus on development effectiveness, loan-portfolio risk management, and good governance standards, as well as supported the entry of technical partners and cosponsors.

In summary, the microfinance intermediary projects performed financially well, on average, and achieved a high percentage of successful results, as compared with other IFC operations, aided by IFC's project design parameters, the introduction of "MFI Holding Company" and the active role and contribution of the IFC. The success of the intermediaries includes serving the need for microsavings by both households and businesses, as well as serving the need for microcredit by microenterprises; and mobilizing savings, in turn, helps the microfinance intermediaries to transition out of donor dependence.

Chapter 4

Synopsis

The subgroup of 36 SME-FIs (out of 72 in the SME-FI evaluated population) that had its financial and operating results evaluated in greater detail by IEG had an average return on assets of 1.8 percent and an average return on equity of 19.4 percent for 2004–05; these are fully satisfactory levels of profitability. For the 22 SME-FIs—in the subgroup of 36 that reported borrowers data to the IFC—there were, on average, more than ten thousand micro, small, and medium-size enterprise borrowers per SME-FI, with an average outstanding loan amount of $10,951 per borrower, at the end of 2005. IFC generally provided advisory services to the smaller SME-FIs (in terms of total assets), and they had a higher average number of borrowers—about 16,000 borrowers per SME-FI—but with a lower average outstanding loan amount of $6,700 per borrower. In contrast, the generally larger SME-FIs that did not receive advisory services had an average of only 1,585 borrowers per SME-FI, but with a very much higher average loan amount of $67,578 per borrower.

About 61 percent of the 72 projects in the SME-FI evaluated population achieved satisfactory development outcomes, comparable to the 61-percent development outcome success rate for all other IFC frontier-country projects that were evaluated with XPSRs and approved from FY90 to FY02. The IFC loan investment success rate of 79 percent for the 48 SME-FI projects that received loans is, likewise, similar to the success rate of 74 percent of the loan investments for all other IFC projects in frontier countries evaluated with XPSRs. However, the IFC equity investment success rate of 58 percent for the 36 SME-FI projects with equity investments in the evaluated population is almost twice the 34-percent success rate for all other IFC equity investments in frontier countries evaluated with XPSRs.

Six major success drivers for the SME-FI evaluated population were identified: (1) sponsor quality and management expertise, commitment to serve the small and medium-size enterprise market and a strategic business plan to do so; (2) operational standards for cost-effective but prudent lending procedures and practices; (3) advisory services and staff training and development, specifically for small and medium-size enterprise lending; (4) transparency and good governance; (5) good IFC work quality, including the screening and selection of SME-FIs to support; and (6) IFC equity investment. Overall, the SME-FIs are effective channels for IFC support to small and medium-size enterprises.

Evaluation of the SME-FI Projects

In order to ascertain the operating features of profitable SME-FIs and success drivers for development outcomes, IEG closely evaluated the operating results and performance of a subgroup of 36 SME-FIs from the 72 in the SME-FI evaluated population.

SME-FI Borrower Base and Returns on Equity

In 2005, the 36 SME-FIs as a subgroup[1] achieved an annual return on average equity that was higher than the 15-percent rate, considered to be satisfactory for the banking industry in developed countries. Overall, the subgroup of 36 SME-FIs showed significant growth in lending during the study period, and supported a large number of small and medium-size enterprises at the end of 2005. The generally smaller SME-FIs (in terms of total assets) selected by IFC to receive advisory services had an average of 16,115 borrowers per SME-FI at the end of 2005, almost 10 times the average of 1,585 borrowers per SME-FI for the larger SME-FIs that did not receive advisory services.

SME-FI Development Outcome Success Rate

The development outcome success rate of 61 percent for the 72 projects in the SME-FI evaluated population is comparable to the average success rate for all 308 IFC projects in frontier countries of 61 percent, and also comparable to the success rate for the other 60 IFC commercial bank projects worldwide that were evaluated with XPSRs of 60 percent. However, it is lower than the development outcome success rate of 71 percent for the 21 projects in the MFI evaluated population (table 3.3). A subgroup of 21 SME-FIs that received advisory services from IFC had a development outcome success rate of 76 percent, compared with only 55 percent for the other 51 SME-FIs that did not receive any advisory services (table 4.3). The 28 SME-FI projects with low development outcomes are distributed by Region as follows: Eastern Europe and Central Asia Region, 11 projects; Sub-Saharan Africa Region, 9 projects; Middle East and North Africa Region, 5 projects, and 1 project each in the Latin America and Caribbean Region, the East Asia and Pacific Region, and the South Asia Region (table 4.2).

The two major reasons for the difference in the overall development outcome success rates of the MFI projects and the SME-FI projects are as follows:

Table 4.1. Financial Performance Data for a Subgroup of 36 SME-FIs in the Evaluated Population

Weighted average for 2004–05, unless otherwise indicated	Subgroup of 36 SME-FIs in the evaluated population	16 SME-FIs in the subgroup that received advisory services	20 SME-FIs in the subgroup that received no advisory services
Aggregate net income as % of average assets	1.8	2.1	1.8
Aggregate net income as % of average equity[a]	19.4	18.4	20.3
Aggregate interest income and fees from loans as % of average loans[b]	12.4	15.5	11.5
Aggregate administration expenses as % of average loans	7.0	9.5	6.3
Aggregate interest on deposits as % of average deposits	5.5	4.7	5.8
Aggregate interest on debts as % of average debt[c]	5.6	8.2	4.0
Average deposits as % of average assets	70.3	76.0	68.0
Average debts as % of average assets	20.5	13.0	23.0
Average equity as % of average assets	9.2	11.0	9.0
Average loans as % of average assets[d]	50.4	53.0	48.0
Average nonperforming loan rate	4.7	3.8	5.1
Average deposits as % of average loans	142.5	145.0	142.0
Average number of SME borrowers per SME-FI (end 2005)[e]	10,171	16,115	1,585
Average loan size per SME borrower (end of 2005)	$10,591	$6,716	$67,578
Average total assets per SME-FI (end of 2005)	$1,249.8 million	$548.8 million	$1,810.5 million

a. The annual accounting return on average equity and annual accounting return on average assets are related through the ratio of average equity to average assets. The relationship is given by the formula: (Net Income/Average Assets) = (Net Income/Average Equity) × (Average Equity/Average Assets). For commercial banks in developed countries, a "good" annual return on average equity is about 15 percent, and a "good" return on average assets is at least 1 percent when the minimum equity was 5 percent of total assets before the Basel I risk-adjusted capital requirements were introduced. If the minimum equity is 10 percent of total assets, the return on average has to be about 1.5 percent to yield a 15 -percent return on equity.

b. The SME-FIs have other sources of income, such as credit life insurance, remittance fees, interbank loan interest income from short-term investments.

c. The aggregate interest paid on debts/average debt excludes banks that had no other interest expense related to debt.

d. In addition to loans, SME-FIs also hold other assets such as short-term investments and interbank loans. In general, commercial banks have 70 to 75 percent of assets in loans, with the balance of the assets held as liquidity and "first loss" support in the form of cash holdings, deposits with the central bank, liquid government securities, and interbank overnight loans.

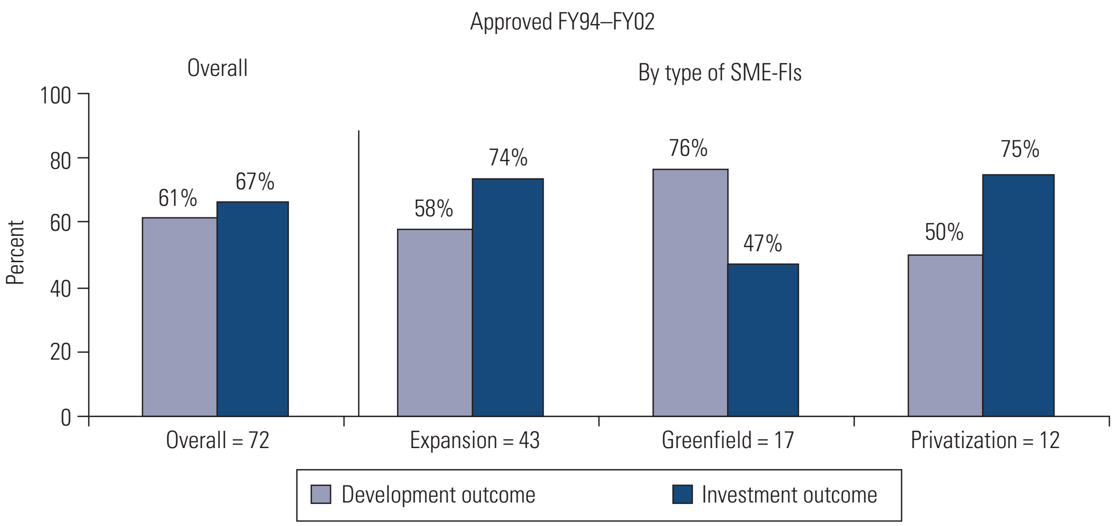
e. The average number of SME borrowers for the 22 SME-FIs (including 13 of 16 SME-FIs that received advisory services, and 9 of the other 20 SME-FIs which did not receive advisory services) have SME borrower data, and those without data are the smaller SME-FIs.

1. A relatively higher portion (86 percent, or 18 of 21) of the MFIs in the evaluated population received advisory services. Most were sponsored by experienced groups with a proven MFI business model, and almost all were established in Regions with large unserved markets, which had to overcome the risks associated with their status as new or greenfield projects. In addition, every greenfield project was the first of its kind in the country or Region, and each had a large development impact, compared with expansion projects, whose incremental market may not be as economically disadvantaged as the initial or existing market (figure 4.1). By contrast, only 29 percent of the 72 SME-FI projects re-

Table 4.2. Outcome Success Rates for Regional SME-FI Projects

Region	Number of SME-FI Projects	Development Outcome Success Rate	IFC Equity Outcome Success rate
Europe and Central Asia	32	66%	53% of 15
Sub-Saharan Africa	23	61%	55% of 11
Asia and the Pacific	7	71%	67% of 6
Middle East & North Africa	7	29%	33% of 3
Latin America & Caribbean	3	67%	0% of 1
Total	72	61%	53% of 36

Figure 4.1. Development and Investment Outcomes of SME-FIs, by Project Type



ceived advisory services, and those that did not receive such assistance were mostly larger banks that were more focused on their larger corporate clients rather than on their small and medium-size enterprise clients. This offset the lower risk of the SME-FI evaluated population because of the relatively smaller proportion of only 24 percent (17 of 72) new or greenfield projects, 60 percent (43 of 72) of which were expansions of existing operations (the other 12 SME-FIs were cases of privatization).

2. IFC's status as a member of the World Bank Group reduces the political and country risk for private sector coinvestors. This ability of IFC to reduce the perceived risks was sought in the privatization of some SME-FIs, which were indeed very risky and, as a subgroup, had a development outcome success rate of only 50 percent. In addition, the SME-FI projects in Central Asia, and those in the Middle East and Northern Africa (a total of seven projects) had a very low development outcome success rate of 43 percent, which reduced the overall av-

Box 4.1. SMEs in Frontier Countries Use Loans to Expand Business

The loans from the SME-FIs were used by SMEs primarily to expand their business through the purchase of new equipment or to upgrade their business facilities, access additional working capital, or some combination of these actions:

Southern Europe: A chicken grower received a $440,000 loan from an SME-FI to expand operations, involving mostly the construction and outfitting of a new building for housing chickens, and to increase working capital. The loan financed approximately 50 percent of the project cost, with the owner supplying the balance. The project was nearly completed at the time of the IEG field visit. All facilities were in excellent condition, and were safely and professionally operated, in compliance with local authority requirements. The owner was satisfied with the loan and assistance provided by the SME-FI.

Eastern Europe: A local entrepreneur received a $2 million loan from a regional SME-FI to fund approximately 75 percent of a $2.7 million greenfield project for a glass cutting factory. The loan financed the purchase of equipment, including machines for glass cutting, carving, laminating, bending, finishing, and tempering. This enabled the company to produce a range of automobile glass products and flat glass for the construction and furniture industries, using state-of-the-art machinery that met IFC and local environmental, health, and safety guidelines. The project was technically completed at the time of the IEG field visit, with the production sites and lines well designed and with efficient material flow and good housekeeping. The present owner is the widow of the original owner, and according to her, the company would not have been able to survive without the SME-FI loan. At present, the company has a sustainable financial condition and supports a number of local charities that help children and the environment.

Eastern Europe: A printing company received a $1.8 million loan from a regional SME-FI to finance 90 percent of an expansion project involving the purchase of two offset printing machines, used for printing high-quality magazines, brochures, postcards, and labels (mostly for automotive and food uses) that it sells to local clients. The project was technically completed in December 2004. At the time of the IEG field visit, the core production lines were in good overall condition and operating smoothly, with modern machinery in compliance with IFC and local environmental, health, and safety guidelines. The owners intended to continue observing these guidelines and to upgrade their operations in accordance with environmental, health, and safety best practices. The expansion enabled the owners to maintain their competitive position in supplying quality products to discerning customers.

Latin America: An organic coffee grower received a $600,000 loan from an SME-FI for working capital and for expanding production capacity. The production system and coffee bean processing practices are all environmentally sustainable. Shade trees of various species are planted between the coffee plants or shrubs to produce better coffee and to provide a natural habitat for birds and other small animals. Organically grown coffee beans are hand-picked to preserve quality. The coffee beans are placed in fermentation tanks with water to brew the beans naturally, separating the pulp from the core. The bean cores are then washed to stop the fermentation process and remove the remaining pulp. After sun-drying and machine sorting, broken and discolored beans are manually removed by experienced sorters (mostly women). Residual parchments are used as fuel for the boilers, and the pulp is used as fertilizer in the coffee plantation. The loan also financed improvements in the chemical/aerobic/anaerobic wastewater treatment system and reforestation of three wasteland areas. The coffee producer also runs a community development program and supports a local school.

erage for the SME-FI evaluated population. The projects in Central Asia and the Middle East faced serious regulatory constraints or market distortions (or both), including government intervention in the management.

Savings Services for Households and Businesses, and Credit for SMEs

The development role of the SME-FI projects includes serving the large need for savings and other banking services by households and businesses, in addition to the large demand for credit by small and medium-size enterprises. The SME-FIs in the evaluated population, on average, mobilized savings deposits equivalent to about 142 percent of their loans outstanding. They achieved satisfactory private sector development ratings mainly by helping SMEs become sustainable, partly by providing banking services to households, and partly by demonstrating (to other banks) that lending to SMEs can be profitable. However, as in the case of MFIs, serving the demand for savings services by households and businesses, and helping to introduce good liquidity management systems, were not prominent features of IFC's strategies to support SMEs.

IFC's Investment Outcome Success Rate in the SME-FIs

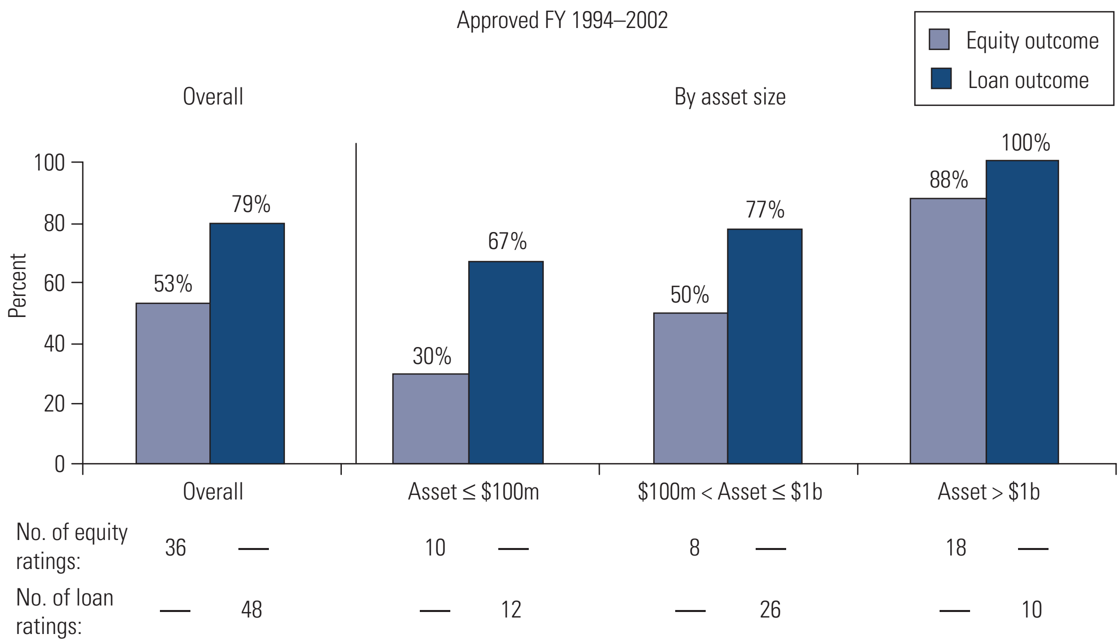
The projects in the SME-FI evaluated population achieved a high IFC investment outcome (a composite for loan and equity investments) success rate of 67 percent, comparable to the 72-percent investment success rate for all other IFC commercial-bank projects worldwide evaluated with XPSRs, but higher than the 38-percent investment success rate for the projects in the MFI evaluated population, and the 56-percent investment success rate for all IFC projects worldwide evaluated with XPSRs (appendix B). The higher investment success rate of the SME-FI evaluated population is explained by the relatively higher equity investment success rate of 58 percent for the SME-FI projects (table 3.3), as further discussed below.

Performance of IFC Equity Investments in the SME-FIs

The equity investment success rate of the SME-FI evaluated population of 58 percent is only exceeded by the 67-percent equity investment success rate of the 15 other commercial bank projects worldwide evaluated with XPSRs, but is almost twice the success rate of 34 percent for all the other 165 IFC equity investments (in all sectors) in frontier countries, and the 31-percent success rate for the 322 IFC equity investments worldwide evaluated with XPSRs (table 3.3). The higher IFC equity investment success rate for the SME-FI evaluated population is partly attributable to:

- The higher success rates for the larger SME-FIs (figure 4.2) that involved: (i) expansion projects, generally representing an established business but with growth potential as the business climate improves, and with lower risk; and (ii) privatization cases, representing one-offs or unique opportunities with potentially high risks but also potentially high scarcity value and efficiency improvement op-

Figure 4.2. Investment-Outcome Success Rate Results for SME-FIs, by Asset Size



portunities, which contribute to high shareholder value;

- Improvements in the business climates of many countries in which IFC made equity investments in commercial banks, which improved the value of these banks; and
- The large number of international and regional banks that were investing in bigger commercial banks in frontier countries with banking sectors undergoing liberalization, which provided a significant pool of potential buyers for IFC's equity holdings in these SME-FIs. Small SME-FIs, however, do not enjoy economies of scale and may not be attractive investment targets for international banks, and may have financially weaker sponsors who are not able to offer equity-put options to IFC, thus limiting the value of IFC's equity and IFC's equity exit mechanisms. In other words, IFC's equity investments in small SME-FIs face the same valuation and exit issues as IFC's equity investments in MFIs.

Regional SME-FI Success Rates

The table below shows that the SME-FI projects in all Regions, except in the Middle East and North Africa Region, had development outcome success rates at least as good (and some higher) than the IFC average. Likewise, IFC's equity investments in SME-FIs in all Regions, except the Latin America and the Caribbean Region, had success rates at least as good as (and some higher) than the IFC average (although the Latin America and the Caribbean Region had only one equity investment, and the equity success rate of zero percent is not significant).

Advisory Services Contributed to Success

IFC's advisory services were specifically directed at helping smaller SME-FIs (in terms of total assets) either by: (a) establishing a new unit (or train specialized loan officers) dedicated to serving the small and medium-size enterprise market; or (b) expanding and improving existing unit and core staff. Advisory services for building capacity and institutions have played a very important role in the ability of SME-FIs to reach out and profitably serve small and medium-size enterprises, and has contributed to the SME-FIs' successful development outcomes.

As shown in table 4.3, IFC provided advisory services to 29 percent (21 out of 72) of the SME-FIs in the evaluated population. Most SME-FIs that received advisory services from IFC were locally owned, second-tier (that is, small) commercial banks with an existing SME client base. The SME-FIs that received IFC's advisory services had a higher development success rate (76 percent) than those that did not (55 percent). The success of advisory services in helping microfinance intermediaries perform better confirms the observations from the IEG field visits about the

Table 4.3. Advisory Services to SME-FIs in the Evaluated Population Improved Development Outcome Success Rates

	Number of SME-FIs	SME-FIs with high development outcome	SME-FIs with high equity outcome	SME-FIs with high loan outcome
SME-FIs that received IFC advisory services	21	76%[a]	56% of 9	82% of 17
SME-FIs that did not receive IFC advisory services	51	55%[a]	52% of 27	77% of 31
All 72 SME-FI projects	72	61%	53% of 36	79% of 48

a. Statistically significant difference at the 0.02 confidence level.

Table 4.4. High IFC Appraisal Work Quality Is Another Development Outcome Success Driver

	Number of SME-FIs	SME-FIs with high development outcome	SME-FIs with high equity outcome	SME-FIs with high loan outcome
SME-FI projects with high IFC appraisal work quality	43	79%[a]	68% of 22	89% of 28
SME-FI projects with low IFC appraisal work quality	29	34%[a]	29% of 14	65% of 20
All 72 SME-FI projects	72	61%	53% of 36	79% of 48

a. Statistically significant difference at the 0.0001 confidence level.

positive contribution of advisory services to the development performance of SME-FIs.

Six Major Factors Drive the Development Outcome Success Rate

The development outcome and the investment outcome success drivers for SME-FI projects are similar to those for microfinance-intermediary projects discussed in chapter 3. More specifically, the six major success drivers for the SME-FI evaluated population are as follows:

- ***Sponsor quality***: Sponsor and management expertise in SME lending, commitment to serving the SME market, and a strategic business plan;
- ***Advisory services***: Advisory services for staff training and development, as well as for establishing good lending practices and loan portfolio risk management systems;
- ***Operational standards***: Cost-effective but prudent lending procedures and practices (see appendix E), as well as good benchmarks for comparing performance;[2]
- ***IFC equity investment***: IFC equity investment in new or privatized SME-FIs, and in existing SME-FIs to support faster growth than what retained earnings alone can achieve;
- ***Transparency***: Transparency and good governance to attract depositors, borrowers, and investors, and to comply with regulatory requirements; and
- ***IFC work quality***: Good IFC work quality, including the screening and selection of suitable SME-FIs for serving the SME market and for IFC support.

IFC Work Quality and Contribution Played Major Roles

IFC's role in providing added value to the SME-FI evaluated population was primarily in the following areas:

- Equity capital to anchor the growth in lending and to maintain prudent capital adequacy ratios;
- Term financing to help reduce maturity mismatches and liquidity risk;
- Screening and selection of SME-FIs to ascertain their commitment to serving the SME market; and
- Advisory services to establish risk management and credit analysis systems, to improve lending procedures and governance structures, to help increase transparency, and to help expand outreach to small and medium-size enterprises.

IFC's appraisal work quality—particularly the selection of SME-FIs to finance—and its decision to provide advisory services, also helped drive the success of SME-FI projects, as shown in table 4.4. The quality of IFC's appraisal work for the projects in the SME-FI evaluated population's

Box 4.2. IEG Findings on World Bank Lines-of-Credit Operations

The following findings on the World Bank's lines-of-credit operations with financial intermediaries are from a review by the Independent Evaluation Group of the World Bank:

- Lines of credit outcomes were poor, with 52 percent satisfactory, by number of operations, and 45 percent satisfactory, by net commitment amount.
- Cancellation rates were high (over 40 percent of original commitments), although smaller lines of credit are associated with lower cancellation rates.
- Better outcomes of lines of credit were associated with
  (i) Stable macroeconomic conditions;
  (ii) Stronger financial sectors, including satisfactory competition policies and good legal and regulatory regimes governing financial institutions, and mostly market-determined interest rates, few distortionary credit and tax policies, and limited state ownership of financial institutions;
  (iii) Use of clear eligibility criteria in the selection of participating financial institutions; and
  (iv) Use of only private sector financial intermediaries.
- Roughly one-third of the lines of credit that could have environmental impacts had no mention at appraisal of requiring environmental assessments on subprojects; and of the closed lines of credit, only about half had any mention of environmental impacts.

Source: IEG-World Bank 2006.

success rate of 65 percent (47 out of 72, see table 3.3 and appendix B) satisfactory, is similar to the satisfactory rate for all IFC projects worldwide that were evaluated with XPSRs.

In summary, the SME-FIs succeeded in developing a large base of small and medium-sized enterprise clients and in achieving profitable operations. Likewise, they achieved a development outcome success rate commensurate to that of other IFC supported commercial banks. IFC's advisory services and work quality contributed to their success. Furthermore, IFC's equity helped the SME-FIs expand their business and maintain prudent capital adequacy ratios. The success rate for IFC's equity investments in the SME-FI study population is estimated to be almost twice the average success rate for all IFC equity investments in all sectors worldwide, and similar to the equity success rate for all other commercial bank projects worldwide evaluated with XPSRs.

Chapter 5

Synopsis

The WBG Safeguard Policies, the WBG/IFC EHS Industry Guidelines, and IFC's 1998 Environmental and Social Review Procedure (ESRP) were applied to the MSME-FI projects evaluated by IEG for this review. The 1998 ESRP required: (a) MSME-FIs to follow certain processes for screening and monitoring subprojects as well as to report to IFC annually; and (b) most of the subborrowers to comply with the applicable IFC Exclusion List, the local EHS regulations, and for some to also follow the WBG Safeguard Policies.

IEG visited 20 MSME-FI projects and conducted a desk review of the other 73 MSME-FIs in the two evaluated populations, to review their EHS performance. In addition, IEG visited 65 subprojects that were financed by the 20 MSME-FIs covered in the field visits. These 65 subprojects were selected by IEG because of their potential environmental risks. About 70 percent of the MFI evaluated population had a satisfactory EHS rating, aided by the commitment and efforts of the "MFI Holding Company." Among the 60 SME-FIs with sufficient EHS data to be evaluated, only 25 percent had a satisfactory EHS rating, with about 50 percent rated as partly unsatisfactory, and 25 percent rated as unsatisfactory.

The partly unsatisfactory ratings were mainly due to one or both of the following: (i) poor compliance with the process requirements to screen and monitor subprojects or poor reporting to IFC; and (ii) poor EHS compliance by some subprojects. The poor EHS compliance of some of the SME-FI subprojects were due partly to weak government enforcement of local EHS regulations, partly to weak commitment by the management of SMEs to good EHS compliance, and partly to a lack of commitment to good EHS monitoring and reporting on the part of the SME-FI, enabled by weak IFC EHS supervision.

The main success drivers for good EHS compliance are: (i) commitment by the MSME sponsor and management to good EHS practices and skilled staff; (ii) good local EHS regulations and enforcement; (iii) commitment by the MSME-FI sponsor and management to good EHS screening and monitoring of subprojects; (iv) good IFC supervision of the SME-FI; and (v) the participation of other international financial institutions (with EHS requirements) in the financing of the MSME-FI projects. The use of local EHS consultants to help mitigate or resolve EHS compliance issues of subprojects is not a common practice of MSME-FIs or their borrowers, but could help improve EHS compliance.

EHS Performance of Projects in the Evaluated Populations

The WBG Safeguard Policies, the WBG/IFC EHS Industry Guidelines, and IFC's 1998 Environmental and Social Review Procedure (ESRP) were applied to the MSME-FI projects evaluated by IEG for this review.

EHS Requirements for the MSME-FIs and Their Subprojects

The 1998 ESRP[1] required: (a) MSME-FIs to follow certain processes for screening and monitoring subprojects, as well as to report to IFC annually; and (b) most of the financial intermediary subborrowers to comply with the applicable IFC Exclusion List,[2] the local EHS regulations, and for some to also follow the WBG Safeguard Policies. To achieve this, the financial intermediaries were required to:

- Develop an environmental management system (which usually contains the environmental policy statement of the intermediary's management; a description of the organization, training, authority, and duties of environmental staff; and the EHS appraisal, monitoring, and documentation procedures for subprojects).
- Train responsible environmental staff and report to IFC annually on meeting environmental objectives, and ensure that subprojects comply with the appropriate IFC EHS requirements.
- Obligate their subproject companies to comply, as well as monitor the subprojects' compliance, with one of three graduated requirements, depending on the level of potential EHS risks for the various business sectors or activities of the subproject companies, applied as follows:

  (a) No compliance requirements for activities that have no or minimal EHS impact; or
  (b) No engagement in activities on the applicable Exclusion List, and compliance with local EHS laws and regulations; or
  (c) Compliance with the applicable Exclusion List plus the local EHS laws and regulations as well as the WBG Safeguard Policies and WBG/IFC EHS Guidelines.

Under IFC's 1998 ESRP, which applies to the projects in the two evaluated populations, microfinance intermediaries generally must comply only with requirement (b) above. SME-FIs must comply primarily with requirement (b), although for a credit line with targeted subborrowers, requirement (c) applies for subprojects with high EHS risks (category-A subprojects), and for agency lines (with IFC as the lender of record) requirement (c) applies for subprojects with high EHS risk (category-A subprojects) and medium EHS risk (category-B subprojects).[3]

IFC generally undertook to help train the financial intermediaries' environmental officer(s) on IFC's EHS requirements during the initial period of project implementation with a half-day or one-day seminar and a five-day workshop.

EHS Compliance Requirements and Rates

Microenterprises financed by MFIs were required to comply with IFC's Exclusion List and host country environmental regulations. However, most frontier countries did not have EHS regulations that applied to microenterprises. Partly because of this, MFIs effectively had simpler EHS requirements, and had a 70-percent EHS satisfactory rating (table 5.1). This high satisfactory rating was also aided by the 13 microfinance intermediaries under the "MFI Holding Company," which had instituted a very good EHS compliance, monitoring, and reporting system in 12 of the 13 intermediaries under its overall management.

On the other hand, the SME-FI evaluated population achieved only a 25-percent (15 of 60) satisfactory rating for EHS compliance (table 5.1), partly because of the following factors:

- SME-FIs had to comply with a larger set of EHS requirements, including the WBG Safeguard Policies and the WBG/IFC EHS Industry Guidelines, compared with MFIs, which were exempt from this set of policies and guidelines;
- There was lack of commitment to good EHS practices and compliance with IFC's requirements by the SME-FIs or by their borrowers (or both);[4]
- Local EHS regulations and/or enforcement were weak; and
- The SME-FIs were not closely supervised by IFC for their implementation of process requirements for EHS screening and monitoring of subprojects and reporting to IFC. IFC's EHS supervision quality for the projects in the SME-FI evaluated population is only 32 percent satisfactory (out of 66 projects rated for EHS supervision quality).

Table 5.1 shows the comparative EHS ratings for the MFIs, the SME-FIs, all other IFC commercial bank projects worldwide, and all other IFC financial market projects worldwide (excluding collective investment vehicles, such as private equity funds) evaluated with XPSRs. IFC did not have enough EHS information on four SME-FIs (three financed with loans only and one with equity only) covered by the desk review and rated them "No Opinion Possible" or "NOP" for EHS compliance. Finally, eight SME-FIs (six financed with equity only and two with loans) and one microfinance intermediary (with equity investment only) did not have EHS compliance requirements because they were incorrectly identified at project appraisal as having no potential adverse EHS impacts and were, therefore, designated as category-C projects under IFC's 1998 EHS policies and procedures (category-C projects such as trade finance, brokerage services, insurance, etc., were exempt from IFC's EHS requirements). During the review period, there was also a widespread belief among investment officers that IFC's EHS requirements did not apply to equity-only investments, both in real sectors and in financial markets projects.[5]

MSME-FI Subprojects Achieved Higher EHS Compliance Rates

IEG visited 20 MSME-FIs and 65 subprojects that were selected by IEG from a list (prepared by the MSME-FIs) with the highest potential EHS risks. IEG found that 83 percent of the 65 subprojects had satisfactory EHS performance, but only 50 percent of the 20 MSME-FIs themselves did. The subprojects had a higher EHS satisfactory performance rate than the MSME-FIs because many MSME-FIs did not do one or more of the following: implement a good environmental management system, train their staff, properly screen

Table 5.1. EHS Satisfactory Ratings

			Satisfactory rates		
Financial markets project groupings	Number of not applicable[a]	Number of no opinion[b] possible	Project EHS performance	IFC EHS supervision quality	IFC overall work quality[c]
21 projects in the MFI evaluated population	1		70% of 20	83% of 18	76% of 21
(a) 13 intermediaries under the MFI holding company			85% of 13	92% of 13	85% of 13
(b) 8 Other microfinance intermediaries,	1		43% of 7	60% of 8	63% of 8
72 SME-FI projects in the SME-FI evaluated population	8	4	25% of 60	32% of 66	65% of 72
(a) 52 active SME-FI projects	4	3	31% of 45	33% of 49	69% of 52
(b) 20 closed SME-FI projects	4	1	6% of 15	29% of 17	55% of 20
42 Other commercial bank projects worldwide evaluated with XPSRs			55% of 42		64% of 42
108 Other financial market projects (excluding collective investment vehicles[d]) worldwide with XPSRs			63% of 108		64% of 108
All IFC Projects with XPSR s (approved FY90–FY02)			67% of 569		65% of 627
(i) Projects in frontier countries at approval			62% of 274		65% of 308
(ii) Projects in nonfrontier countries			72% of 287		66% of 319

a. IFC's EHS requirements are not applicable because the project has been given a category-C designation for EHS purposes. Category-C projects have no or negligible potential EHS adverse impacts, and are therefore exempt from IFC's EHS requirements. Examples of category-C projects are trade finance, insurance, and brokerage projects. For the two evaluated populations, there should have been no category-C projects. The eight SME-FI projects and one MFI project with not applicable EHS ratings were incorrectly given category-C status.

b. No opinion possible due to insufficient information about the project's EHS performance.

c. IFC overall work quality covers appraisal, supervision, and role and contribution, including work quality on EHS aspects.

d. For example, private equity funds and mutual funds.

the subprojects before providing the loans, or regularly submit annual EHS reports to IFC.

EHS Appraisal Work and Supervision

Whereas IFC's EHS appraisal work was satisfactory in most (about 80 percent) of the 20 MSME-FIs that IEG visited, about half did not regularly submit annual EHS reports to IFC. Moreover, IFC's support for EHS training and EHS supervision of MSME-FIs has been limited. As a result, IEG found very little EHS performance data for about half of the MSME-FIs. The quality and timeliness of the annual EHS reports have often been less than satisfactory. IFC has not considered EHS supervision of financial market projects to be a high priority for its limited environmental staff resources, which focus more on environmentally high-risk projects with category-A or category-B EHS risk designations.

The current supervision practice of the IFC's Environment and Social Development Department for financial market projects is to visit the projects, as needed, on the basis of the EHS risk profile of an intermediary's subborrower portfolio, and deficiencies in the intermediary's environmental management system, as identified through the intermediary's annual EHS reports. This practice is weak because the EHS risk profile of the subborrower portfolio can change, and many intermediaries either do not submit annual EHS reports to IFC, or they submit deficient reports, as shown by the IEG field visits and by the XPSRs for financial markets projects.

The Global Financial Markets Department and the Environment and Social Development Department have jointly taken steps to address the poor EHS compliance record of financial intermediary projects and to improve IFC's EHS supervision of financial market projects.

Subprojects with Medium Risk in IFC's EHS Framework

The EHS risks of many SME subborrowers that IEG visited, especially in the manufacturing and processing industries, are comparable to risks in many real-sector projects with medium EHS risks (that is, category-B projects) and governed only by local EHS regulations under IFC's 1998 ESRP. Eleven of the 65 MSME-FI subprojects that IEG visited had EHS issues, for example, (1) a gasoline station with soil contamination and the improper discharging of effluents with petroleum and storage of fuels; (2) a tannery with wastewater and health and safety problems; (3) a steel mill with health and safety problems; (4) four automobile and machining shops with soil contamination or health and safety problems; (5) a textile plant where ear protection for the workers was not available despite high noise levels; (6) two lead industry subprojects with high emissions; and (7) a hotel project with some deficiencies in fire safety.

Although the environmental impact of one small or medium-size manufacturing/processing enterprise may be minimal or insignificant in the short term, the cumulative and aggregate effects over the long term, of the large number of such category-B enterprises (including those not financed by IFC-supported SME-FIs), in an urban area or region can be substantial. Diligent enforcement of IFC's EHS requirements on its SME-FI projects is therefore important (as is diligent enforcement by the government of its environmental regulations, not just for large companies but also for small and medium-size enterprises).

MFI subprojects, for example, street kitchens, retail shops, and tailoring shops, do not generally pose environmental concerns and may have significant positive social effects in providing job opportunities and gender-oriented lending programs (for example, through women's enterprise loans). Subprojects in sensitive industry sectors, however, may not be within the EHS appraisal competence of the MSME-FIs and, if not properly addressed, may cause limited local EHS problems, as was found at two automobile repair projects and at a tannery project. The potential environmental impacts usually included contaminated soil and groundwater; air emissions; effluent discharges; wastes; fire safety; storage of hazardous and flammable chemicals; and the use of materials with polychlorinated biphenyls, chlorofluorocarbons, and asbestos. Judging the environmental sensitivity and effects of the project on the basis of loan size is, in many cases, arbitrary. A better indicator would be the EHS risk profile of the financial intermediary's loan portfolio, showing the number (or proportion) and size of borrowers whose businesses have moderate to high EHS risks. IFC recently developed a system to identify EHS risks in various industry sectors, to be used by its MSME-FI clients.

Developing the Use of Local EHS Consultant Capacity

Use of EHS experts by MSME-FIs or their borrowers could improve subproject EHS appraisal and support remedial actions to correct noncompliance. In many cases, government environmental authorities performed some EHS appraisal work in the context of issuing operating licenses and monitored some small and medium-size enterprises. However, only the top-performing MSME-FIs actively used EHS consultancy resources and proactively cooperated with EHS consultants, NGOs, and authorities to improve subproject EHS performance.

The IFC's Environment and Social Development Department had, until 2005, undertaken along with donor funding, an EHS local consultancy training and capacity-building program in selected developing countries. However, the department ended this program in 2006, even though donors remained interested, because it believed this work was not part of its mandate. The EHS consultancy training program has been transferred to the Global Financial Markets Department and is being restructured so that it can be incorporated within the permanent training program for commercial bank staff and administered by training partners. Establishment of a permanent training program or center for commercial bank staff is currently under way in China and India, respectively. Four to five more training centers are planned for other regions in 2008. At the same time, the EHS consultancy training module will also be made available electronically (that is, online via the Internet) by 2008. Oversight of the training program by the Global Financial Markets Department is assisted by a dedicated EHS team embedded in that department.

EHS Success Factors for MSMEs

The main drivers of EHS success for MSMEs are a committed management, some staff with EHS technical skills and a profitable business. Compliance with IFC's EHS guidelines depends on the strong role of the chief executive officer and other senior management officers experienced in the production processes and EHS issues in the specific industry, and who communicate with industry associations and other organizations that provide technical information related to EHS improvements. Some MSMEs strive to be good examples in their industry and are willing to undertake an EHS program beyond compliance (that is, to "do good and not just do no harm") and to use external donor funding for environmental improvements. Finally, the profitability of micro, small, and medium-size enterprises is vital to allow investments in EHS-related facilities.

The main EHS success drivers for financial intermediaries are a committed management and good IFC EHS supervision.[6] However, only a few financial intermediary managements are committed to good EHS practices by their subborrowers. Most financial intermediaries in developing countries generally view the enforcement of local EHS regulations as the role of the government through the issuance of permits and various business licenses, and not the role of financial intermediaries. The business culture and practices of most financial intermediaries in developing countries, therefore, generally do not include EHS screening and supervision of their subprojects, relying instead on the permits and licenses issued by the regulatory authorities to ensure that subprojects comply with local EHS regulations. However, in many developing countries, enforcement of EHS regulations, with respect to SMEs, is typically weak. Unless IFC and other multilateral development banks that provide financing to these local financial intermediaries closely supervise their compliance with the EHS requirements in the financing agreements, local financial intermediaries will generally not follow the requirements.

New EHS Initiatives to Improve Supervision

The 1998 WBG safeguard policies, WBG/IFC industry guidelines, and the IFC ESRP that applied to the two evaluated populations were ambiguous in defining IFC's role and that of financial intermediaries in meeting IFC's EHS compliance requirements. In February 2006, the Board of Directors approved a revised IFC safeguard policy and ESRP titled "IFC's Policy and Performance Standards on Social and Environmental Sustainability" and the "IFC Environmental and Social Review Procedure," respectively. The new performance standards are a risk-based framework, which is implemented through the new ESRP, and the two together are expected to better focus IFC requirements on those SME-FI projects that represent the highest EHS risks. The new policy and ESRP aim to more clearly impose on the financial intermediaries the obligation to screen and monitor subprojects, with IFC's role focused on examining the overall EHS risk of the subproject portfolio, rather than individual subprojects.

Compliance with the first exclusion list (see endnote 2 in chapter 5) is applicable to all financial intermediary projects, *except category-C projects*, and the second exclusion list applies specifically to MFIs only. Both exclusion lists have proven their effectiveness. In addition, IFC has initiated an EHS "mainstreaming" initiative that requires investment officers to understand IFC's EHS policies and procedures and to be able to assist staff of the Environment and Social Development Department in supervising EHS compliance and other EHS oversight functions. Finally, in response to the fast growth of the financial markets portfolio, and relatively poor EHS compliance of financial intermediary projects, the Environment and Social Development Department has created a dedicated team of EHS specialists (with four full-time staff members, as of April 2007, and a few short-term consultants) that is "embedded" in the Global Financial Markets Department. These initiatives can provide the foundation for better EHS supervision of financial intermediary projects in the future. In order for mainstreaming to work, however, IFC management needs to place a high priority on addressing the poor EHS compliance and supervision of financial intermediary projects.

In summary, a large majority (70 percent) of the MFIs had satisfactory EHS compliance but only a small percentage (25 percent) of the SME-FI projects had satisfactory EHS screening and monitoring of subprojects, as well as annual EHS reporting to IFC. The low compliance rate among SME-FIs is due to either or both (1) deficient local EHS standards and/or enforcement; and (2) lack of commitment to good EHS compliance by the SME-FIs, enabled by inadequate EHS supervision by IFC. The use of local EHS experts by SME-FIs and their subprojects can improve EHS compliance but is not a common practice yet and should be encouraged. IFC's "mainstreaming EHS" initiative among investment staff should enable them to assist the Environment and Social Development Department in EHS supervision, but a high priority should be placed on the EHS supervision of SME financial intermediaries and the timely identification of risks posed by their portfolios.

Chapter 6

Synopsis

IFC's strategies and advisory services for supporting micro, small, and medium-size enterprises indirectly through MSME-FIs have been relevant and effective, based on the performance of the MSME-FIs in the two evaluated populations. However, the strategies did not explicitly address the need for a supportive regulatory regime for MFIs, and the need to serve the large demand for banking services (particulary savings) by low-income households and small businesses, which have synergies with the MSME-FIs' lending operations. Nonetheless, with equity, long-term loans, and advisory services from international financial institution shareholders, the MSME-FIs have been successful in providing loans to a large number of micro, small, and medium-size enterprises in frontier countries, and in many projects, they also served the needs of low-income households and small businesses for savings and other banking services (for example, remittances).

IFC's strategies as well as MSME-FI project design parameters are among the drivers for the successful outreach to micro, small, and medium-size enterprises. A supportive regulatory regime that allows microfinance intermediaries to take deposits and establish branches, among other features, is essential to ensuring local currency funding and sustainability for their lending operations, as well as for achieving maximum development results. A large savings deposit base is the key for MFIs to transition out of donor dependency. Advisory services to MSME-FIs is a critical input for their success. Committed sponsors and managements specializing in microfinance and finance for small and medium-size enterprises that use good-practice standards to benchmark their operations are also essential for successful MSME-FI operations.

Good EHS compliance by MSME-FIs and their borrowers depends on the commitment of the financial intermediary management to comply with IFC's and the host-country's EHS guidelines, and would also benefit from better IFC supervision and the use of local EHS consultants. Developing the EHS consultancy capacity in frontier countries and having IFC place a high priority on good EHS supervision are therefore important.

Main Findings and Recommendations

This evaluation's findings regarding IFC's strategy of supporting MSMEs in frontier countries through financial intermediaries are as follows:

Evaluation Findings and Conclusions

Finding 1: IFC's strategy for supporting micro, small, and medium-size enterprises in frontier countries through financial intermediaries has been relevant and, overall, effective in promoting successful development and investment outcomes. However, the strategy has been specifically focused on providing access to finance for MSMEs, and has assigned lower priority to the large need and potential benefits of mobilizing savings and providing other banking services to MSMEs and the underserved population, particularly low-income households. Financial intermediaries were effective channels for providing IFC's loans to a large number of MSMEs because they: (i) provided MSMEs with a reliable, accessible, and potentially permanent source for loans by strengthening the institutional and financial capacity of the intermediaries; (ii) leveraged IFC's budgetary resources with those of the MSME-FIs as well as of other multilateral development banks and bilateral aid agencies, particularly in the case of microfinance intermediaries; (iii) achieved high outreach among micro, small and medium-size enterprises, which IFC could not achieve directly; and (iv) helped to develop and improve the local banking system by, among other things, demonstrating that additional equity capital from IFC can contribute to a profitable lending business line to micro, small, and medium-size enterprises for commercial banks. However, the specific focus of IFC's strategy and advisory services on issues related to MSME access to finance resulted in lost opportunities to also serve the large need for savings and other banking services (for example, national and international remittances) among low-income households as well as MSMEs. Serving both the credit needs of MSMEs and the banking needs of underserved households and MSMEs, can exploit synergies that greatly increase the development impact of MSME-FI projects and facilitate the transition of MFIs out of donor dependency. As a group, the MFIs provided savings and other banking services (for example, remittances) to households and small businesses to a limited extent.

Finding 2: IFC's design parameters for MSME-FI projects contributed to high rates of satisfactory development outcomes, enhancing the effectiveness of IFC's strategy. IFC's financing to micro, small, and medium-size enterprises, through financial intermediaries, in the two evaluated populations had a development outcome success rate of 71 percent for MFIs and 61 percent for SME-FIs. These success rates are at least as good as the development outcome success rate for all other frontier country projects evaluated with XPSRs. Furthermore, the subgroup of 21 SME-FIs that received advisory services from IFC achieved a development outcome success rate of 76 percent. The MFIs and the SME-FIs, as separate groups, earned satisfactory profitability. The MFIs had, on average, about 39,000 borrowers per intermediary at the end of 2005, whereas the SME-FIs had 10,170 borrowers per intermediary. The main elements of IFC's MFI and SME-FI project design formulae were among the main drivers of project success.

Finding 3: IFC played significant roles in the success of the MSME-FIs. IFC had a key role in developing the project design parameters for microfinance intermediary projects, in establishing the "MFI Holding Company" (and nine other similar entities), and in selecting the SME-FIs most suitable for reaching out to small and medium-size borrowers. IFC's roles as a long-term equity investor and proactive shareholder (through its board nominees) in the MFI projects were particularly significant and were only replicated perhaps by the European Bank for Reconstruction and Development and the Inter-American Development Bank. However, the former operates only in eastern and southern Europe and in central Asia and often coinvests with IFC; the latter operates only in Latin America and the Caribbean, leaving IFC to play the major role of supporting MFIs in Africa, the Middle East, and Asia. IFC also differentiates itself among international financial institutions supporting MSMEs through MSME-FIs through its ability to package equity investment, loans (including local currency loans and guarantees of local bond issues), advisory services, EHS sustainability objectives, project design experience, supervision, global reach, focus on both profitability and development outcome, metrics for measuring development outcomes, learning from other similar operations worldwide, and relationship with governments as a member of the WBG.

Finding 4: Committed SME management, skilled staff, and good environmental regulation and enforcement in the country of operations promoted EHS sustainability of SME subprojects financed by IFC through financial intermediaries. However, IFC's EHS supervision of MSME-FI projects was inadequate, as was the EHS compliance of SME-FIs. The SME management's commitment to a sustainability agenda, and technical staff skilled in EHS matters, as well as strong environmental law enforcement, had a more positive effect on the environmental performance of small and medium-size enterprises than interventions by the financial intermediaries did. This partly explains the good subproject environmental performance in many cases where environmental oversight by financial intermediaries was lacking or absent, particularly where governmental permits are issued annually and are accompanied by inspections. However, only about 25 percent of SME-FIs in the evaluated population have satisfactory EHS ratings because of weak local EHS regulations and enforcement or to a lack of commitment to good EHS practices by some SME-FIs (or both). The latter is fostered by inadequate IFC EHS supervision. Most financial intermediaries in developing countries generally view the enforcement of local EHS regulations as the role of the government through the issuance of permits and various business licenses, and not the role of financial intermediaries. The business culture and practices of most developing country financial intermediaries therefore generally do not include EHS screening and supervision of their subprojects, relying instead on the permits and licenses issued by the regulatory authorities for insuring compliance by subprojects with local EHS regulations. Unless IFC and the other multilateral development banks providing financing to these local financial intermediaries closely supervise their compliance with the EHS stipulations in the financing agreements, the local financial intermediaries will generally not follow these EHS financing conditions. Within IFC, financial intermediary projects are also generally viewed as having low EHS risks and are not a priority for EHS supervision, given the need to use limited EHS supervision capacity more strategically by the Environment and Social Development Department. For MSME-FIs to follow and enforce IFC's EHS financing conditions, IFC itself must give such compliance a high priority.

Findings and Conclusions Specific to MFIs

About two-thirds of IFC's country-level MFIs are in countries with relatively very low access to credit by microenterprises. Of the 78 country-level MFI projects (that is, excluding regional funds and MFI holding company investments) approved by IFC during FY96–FY06, 52 (66 percent) are in countries with less than 1.0 microcredit account per 100 people in 2000.

The seven primary success drivers for the MFI projects are as follows:

- A specialized MFI prudential regulatory regime;
- A high-quality sponsor and management specialized in MFI operations;
- Advisory services;
- Transparent operations and public confidence;
- Good practice standards;
- Substantial equity participation and proactive oversight by development institutions to ensure efficient and prudent management, and a focus on lending to microenterprises and providing confidence to depositors and regulators; and
- IFC work quality, particularly for the MFIs with weaker sponsors.

MFIs can transition out of donor dependency, be sustainable, and attract private sector equity if they can develop a substantial deposit savings base and a large micro and small enterprise client base. A supportive regulatory regime for microfinance is essential for these things to happen. However, IFC has not focused on developing a substantial savings deposit base and on improving regulatory regimes for MFIs. The most successful MFIs in terms of development outcomes are those that fund most, if not all, of their loans with savings deposits. But an MFI can develop a significant deposit base only if the regulatory regime is supportive. As in the case of commercial banks, MFIs need to be and are regulated in many countries. However, many countries have not yet adopted a regulatory regime for them (or the countries have deficient regimes that need to be reformed), and the regulations for commercial banks are not appropriate for MFIs. Just as leasing cannot develop in the absence of a specific leasing regulation, MFIs also cannot develop and, in particular, may have difficulties in transitioning out of donor dependency in the absence of a specific supportive regulatory regime. IFC's strategies and advisory services have not addressed this issue.

MFIs serving SMEs in addition to microenterprises achieve better development and financial results, which make them attractive equity investments for private sector investors. Several MFIs (mainly those under the "MFI Holding Company") achieved better development and financial results by also serving small and medium-size enterprises, while a few MFIs enhanced their results by serving the banking needs of households and small businesses. For example, one MFI, with the largest branch network, has developed a substantial national remittance business. After receiving a full commercial bank license recently, it started an international remittance service and also started to give term loans for equipment and fixed-asset financing to small and medium-size enterprises, particularly in the agribusiness sector. Serving both micro and small enterprises helps to increase the average loan amount per borrower, thereby reducing administrative expenses as a percentage of loans outstanding, leading to lower interest charges to borrowers and higher profitability.

MFIs generally complied with IFC's EHS Exclusion List. Moreover, while they were often not subject to the host country's EHS regulations, their subprojects had no significant EHS issues.

Findings and Conclusions Specific to SME-FIs

The six primary success drivers for SME-FIs are:

- A sponsor and management with a commitment to serve the small and medium-size

enterprises, and a strategic business plan to do so;
- Cost-effective and prudent lending procedures and practices, including good practice standards to benchmark performance;
- Advisory services for staff training and development, institutional capacity building, and for acquisition of risk management systems;
- Transparency and good governance;
- Good IFC work quality, including screening and selecting SME-FIs to support; and
- IFC equity investments (in half of the SME-FI evaluated population) either for the initial capital of a new SME-FI, or for an increase in capital of an existing SME-FI, to support growth in lending and maintain prudent capitalization.

IFC's equity investments in the SME-FIs perform as well as those in all commercial banks worldwide but better than IFC's equity investments in all other sectors in frontier countries. IFC's equity investments in commercial banks worldwide, including the SME-FIs in the evaluated population, have benefited from improving country business climates. More importantly, the equity valuations for commercial banks in developing countries with liberalizing regulatory regimes and improving business climates have been further buoyed by the large number of international and regional commercial banks competing to acquire substantial equity stakes in these developing country commercial banks. The market value of IFC's commercial bank equity portfolio, including the SME-FIs in the evaluated population, have benefited from these trends, which are expected to provide better-than-average equity investment success rate for the SME-FI equity investments.

Recommendations

IFC's strategy of supporting MSMEs through financial intermediaries, and providing advisory services for institutional capacity building to the financial intermediaries, has been relevant and broadly effective. Nonetheless, 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. IFC could promote the transition of MFIs out of donor dependency and into sustainability by helping them develop a substantial savings deposit base as well as a large micro and small-size enterprise client base; this will require adoption of specific supportive prudential regulatory regimes for microfinance intermediaries in developing countries.

Background: MFIs can serve a large number of microenterprises, be profitable, and transition out of donor dependency, but only if they can develop an extensive branch network and a substantial savings deposit base as well as charge interest rates that provide a reasonable profit margin. These require a supportive prudential regulatory regime specific to MFIs. However, some countries have not yet adopted a regulatory regime for them (or the countries have deficient frameworks that need to be reformed), and the regulations for commercial banks are not appropriate for MFIs. MFIs also cannot develop and, in particular, may have difficulties in transitioning out of donor dependency, in the absence of a supportive prudential regulatory regime. Three critical features of a supportive prudential regulatory regime for MFIs are:

- The right to take deposits;
- The right to establish branches; and
- The reliance on competition to ensure reasonable interest rates.

Improving the regulatory regime for MFIs is therefore important for the establishment and growth of a commercially oriented and successful MFI industry in developing—particularly frontier—countries.

Recommendation: IFC needs to 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, in order to 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 expanding their client base and the establishment of branch offices.

II. IFC could seek to strengthen the sustainability of its MSME-FI projects, and achieve an even wider development reach, by encouraging selected MSME-FIs that have achieved good risk management practices and by supporting their efforts to diversify product lines and target clients. Such IFC support could include enlarging the scope of its advisory services beyond facilitating access to finance by MSMEs to also include serving the need for savings and other banking services by other underserved segments of the population in frontier countries, as well as improving the liquid asset management of MSME-FIs.

Background: IFC's advisory services to MSME-FIs has focused on developing good lending practices and procedures, as well as loan portfolio risk management systems, to facilitate access to finance by MSMEs. However, there is a large need among low-income households and small businesses for savings and other banking services (for example, remittances), particularly in rural areas, which could also be served by the MSME-FIs. MSME-FIs could also improve their profitability, and reduce interest charges to borrowers, through better liquid asset management, especially if they are successful in mobilizing substantial savings in excess of their lending and working capital needs. MFIs can also improve profitability by increasing their borrower base to achieve economies of scale, which they can do by also lending to underserved small enterprises, in addition to microenterprises. The scope of future IFC Advisory Services to MSME-FIs could therefore include capacity building in savings mobilization, liquidity management, and other banking services needed by households and underserved businesses, in addition to lending techniques to MSMEs and loan portfolio risk management. This will help broaden the development impacts of IFC's MSME-FI projects, and also facilitate the transition of MFIs out of donor dependency.

Recommendation: IFC could enlarge the scope of its advisory services to MSME-FIs beyond the present focus of improving lending techniques and loan portfolio risk management. IFC could help selected MSME-FIs that have achieved good risk management practices to: (i) better meet the need for savings and other banking services (for example, remittances) by poor households and small businesses; (ii) implement best-practice liquidity management procedures; and (iii) in the case of MFIs, help expand their client base to also reach small-size enterprises.

III. IFC needs to improve the EHS compliance and supervision of financial intermediaries.

Background: The business culture and practices of developing country commercial banks and financial intermediaries generally do not include EHS screening and supervision of their subprojects, relying instead on the permits and licenses issued by the regulatory authorities for insuring compliance by subprojects with local EHS regulations. However, in many developing countries, enforcement of EHS regulations with respect to SMEs is typically weak and, generally, there are no EHS regulations for microenterprises. Unless IFC and the other multilateral development banks providing financing to these local financial intermediaries closely supervise their compliance with the EHS regulations in the financing agreements, many local financial intermediaries will generally not follow these EHS regulations. IFC's EHS supervision of the SME-FI evaluated population is satisfactory in only 32 percent of projects. Thus, it is not surprising that financial intermediary subprojects have poor, just 25 percent satisfactory in EHS compliance. Within IFC, financial intermediary projects are viewed as having low EHS risks and are not a priority for EHS supervision, given the need to use limited EHS supervision capacity more strategically by the Environment and Social Development Department. However, many SME-FI borrowers have operations that would be designated as EHS category-B (medium EHS risk) under IFC's EHS risk framework. In response to the fast growth of the financial markets portfolio and the poor EHS compliance history of financial intermediary projects, a dedicated team of EHS specialists have been embedded in the Global Financial Markets Department. In addition, the "mainstreaming EHS" initiative among investment officers was a way to complement the capacity of the Environment and Social Development Department to supervise projects across all sectors; but to be effective, the mainstreaming initiative needs to be accompanied by IFC placing a high priority on improving EHS supervision and compliance of financial intermediaries.

Recommendation: IFC should give a high priority to improving the environmental, health, and safety 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.

APPENDIXES

APPENDIX A: LIST OF FRONTIER COUNTRIES

IFC country / region	Frontier status 1994			Frontier status 2002		
	Institutional Investor country credit rating	Income group	Status	Institutional Investor country credit rating	Income group	Status
Afghanistan*	9.7	na	Frontier	5.7	na	Frontier
Albania*	11.2	LM	Frontier	15.0	LM	Frontier
Algeria*	25.5	LM	Frontier	31.2	LM	–
Angola*	11.0	L	Frontier	13.4	L	Frontier
Argentina*	36.5	UM	–	19.8	UM	Frontier
Armenia	na	na	Frontier	na	na	Frontier
Azerbaijan	na	LM	Frontier	na	L	Frontier
Bangladesh*	21.6	L	Frontier	26.8	L	Frontier
Belarus*	15.6	UM	Frontier	13.9	LM	Frontier
Belize	na	LM	Frontier	na	LM	Frontier
Benin*	16.7	L	Frontier	19.0	L	Frontier
Bhutan	na	na	Frontier	na	na	Frontier
Bolivia*	20.5	LM	Frontier	29.9	LM	Frontier
Bosnia and Herzegovina	na	L	Frontier	na	LM	Frontier
Botswana	46.6	UM	–	57.8	UM	–
Brazil*	29.6	UM	Frontier	40.1	UM	–
Bulgaria*	20.3	LM	Frontier	39.7	LM	–
Burkina Faso*	17.4	L	Frontier	18.3	L	Frontier
Burundi	na	na	Frontier	11.1	na	Frontier
Cambodia	na	L	Frontier	na	L	Frontier
Cameroon*	19.5	LM	Frontier	18.4	L	Frontier
Cape Verde	na	LM	Frontier	na	LM	Frontier
Chad	na	L	Frontier	14.1	L	Frontier
Chile	54.3	LM	–	65.1	UM	–
China	57.7	L	Frontier	58.3	LM	–
Colombia	43.4	LM	–	39.1	LM	–
Congo, Republic of*	15.5	LM	Frontier	9.8	L	Frontier
Congo, Dem. Republic of*	7.6	L	Frontier	8.6	L	Frontier
Costa Rica*	29.0	LM	Frontier	45.4	UM	–
Côte d’Ivoire*	16.7	LM	Frontier	17.8	L	Frontier

IFC country / region	Frontier status 1994: Institutional Investor country credit rating	Frontier status 1994: Income group	Frontier status 1994: Status	Frontier status 2002: Institutional Investor country credit rating	Frontier status 2002: Income group	Frontier status 2002: Status
Croatia*	13.7	LM	Frontier	46.7	UM	–
Czech Republic	51.3	LM	–	62.7	UM	–
Dominica	na	na	Frontier	na	na	Frontier
Dominican Republic*	22.0	LM	Frontier	37.1	LM	–
Ecuador*	23.5	LM	Frontier	21.0	LM	Frontier
Egypt, Arab Republic of	30.4	L	Frontier	45.7	LM	–
El Salvador*	18.0	LM	Frontier	44.8	LM	–
Eritrea	na	L	Frontier	na	L	Frontier
Estonia*	22.2	UM	Frontier	57.9	UM	–
Ethiopia*	11.8	L	Frontier	15.2	L	Frontier
Fiji	na	LM	Frontier	na	LM	Frontier
Gabon*	26.8	UM	Frontier	21.7	UM	Frontier
Gambia, the	na	L	Frontier	na	L	Frontier
Georgia*	8.6	LM	Frontier	14.8	L	Frontier
Ghana*	27.4	L	Frontier	25.2	L	Frontier
Guatemala*	20.8	LM	Frontier	33.1	LM	–
Guinea*	13.3	L	Frontier	15.2	L	Frontier
Guinea–Bissau	na	L	Frontier	na	L	Frontier
Guyana	na	L	Frontier	na	LM	Frontier
Haiti*	7.8	L	Frontier	14.6	L	Frontier
Honduras*	16.6	L	Frontier	24.8	LM	Frontier
Hungary	46.2	UM	–	65.6	UM	–
India	41.1	L	Frontier	47.7	L	Frontier
Indonesia	51.6	L	Frontier	22.7	L	Frontier
Iran, Islamic Republic of*	27.3	na	Frontier	33.6	na	Frontier
Jamaica*	24.1	LM	Frontier	27.7	LM	Frontier
Jordan*	23.3	LM	Frontier	38.0	LM	–
Kazakhstan*	17.7	LM	Frontier	36.9	LM	–
Kenya*	23.3	L	Frontier	21.9	L	Frontier
Korea, Republic of	69.8	UM	–	64.2	UM	–
Kyrgyz Republic	na	LM	Frontier	16.9	L	Frontier
Lao People's Dem. Republic	na	L	Frontier	na	L	Frontier
Latvia*	20.5	LM	Frontier	50.1	LM	–
Lebanon*	21.5	LM	Frontier	26.2	UM	Frontier
Lesotho	na	L	Frontier	26.4	L	Frontier
Liberia	6.2	L	Frontier	8.8	L	Frontier
Lithuania	19.2	LM	Frontier	48.6	LM	–
Macedonia, Frmr Yugoslav Rep. of	na	LM	Frontier	na	LM	Frontier
Madagascar	na	L	Frontier	na	L	Frontier

IFC country / region	Frontier status 1994			Frontier status 2002		
	Institutional Investor country credit rating	Income group	Status	Institutional Investor country credit rating	Income group	Status
Malawi*	18.2	L	Frontier	18.9	L	Frontier
Malaysia	67.1	UM	–	56.5	UM	–
Maldives	na	LM	Frontier	na	LM	Frontier
Mali*	16.9	L	Frontier	17.8	L	Frontier
Mauritania	na	L	Frontier	na	L	Frontier
Mauritius	43.9	UM	–	52.7	UM	–
Mexico	46.5	UM	–	58.1	UM	–
Moldova	na	LM	Frontier	14.9	L	Frontier
Mongolia	na	LM	Frontier	na	L	Frontier
Morocco	36.8	LM	–	46.0	LM	–
Mozambique*	11.1	L	Frontier	19.1	L	Frontier
Namibia*	na	LM	Frontier	39.7	LM	–
Nepal*	23.6	L	Frontier	24.2	L	Frontier
Nicaragua*	9.6	L	Frontier	18.0	L	Frontier
Niger	na	na	Frontier	13.1	na	Frontier
Nigeria*	18.5	L	Frontier	17.7	L	Frontier
Oman*	52.7	UM	–	56.5	UM	–
Pakistan*	29.3	L	Frontier	19.1	L	Frontier
Panama*	23.3	LM	Frontier	46.6	UM	–
Papua New Guinea	33.0	LM	–	29.1	LM	Frontier
Paraguay*	29.9	LM	Frontier	28.8	LM	Frontier
Peru*	19.3	LM	Frontier	37.7	LM	–
Philippines	31.7	LM	–	43.7	LM	–
Poland	31.8	LM	–	59.9	UM	–
Romania*	25.8	LM	Frontier	32.3	LM	–
Russian Federation*	18.3	LM	Frontier	35.6	LM	–
Rwanda	na	L	Frontier	na	L	Frontier
Saint Lucia	na	UM	Frontier	na	UM	Frontier
Samoa	na	LM	Frontier	na	LM	Frontier
Saudi Arabia	58.0	UM	–	57.2	UM	–
Senegal*	21.1	LM	Frontier	26.5	L	Frontier
Serbia and Montenegro	na	na	Frontier	na	na	Frontier
Seychelles*	24.2	UM	Frontier	26.4	UM	Frontier
Sierra Leone*	7.3	L	Frontier	9.0	L	Frontier
Slovakia	32.4	LM	–	50.1	UM	–
Slovenia	35.1	UM	–	67.1	High	–
Somalia	na	na	Frontier	na	na	Frontier
South Africa	39.5	UM	–	51.3	UM	–
Sri Lanka*	29.1	L	Frontier	32.7	LM	–

	Frontier status 1994			Frontier status 2002		
IFC country / region	**Institutional Investor country credit rating**	**Income group**	**Status**	**Institutional Investor country credit rating**	**Income group**	**Status**
Sudan*	6.1	na	Frontier	9.4	na	Frontier
Swaziland*	27.2	LM	Frontier	28.5	LM	Frontier
Syrian Arab Republic*	23.6	LM	Frontier	22.6	LM	Frontier
Tajikistan	na	L	Frontier	12.7	L	Frontier
Tanzania, United Republic of	14.6	L	Frontier	20.9	L	Frontier
Thailand	61.7	LM	–	50.1	LM	–
Togo*	16.3	L	Frontier	14.8	L	Frontier
Trinidad and Tobago	31.9	UM	–	52.2	UM	–
Tunisia	43.2	LM	–	52.4	LM	–
Turkey	43.8	LM	–	33.5	UM	–
Uganda*	10.9	L	Frontier	20.6	L	Frontier
Ukraine*	14.8	LM	Frontier	23.3	L	Frontier
Uruguay	36.6	UM	–	45.5	UM	–
Uzbekistan*	14.3	LM	Frontier	17.8	L	Frontier
Vanuatu	na	LM	Frontier	na	LM	Frontier
Venezuela, R. B. de	36.8	UM	–	32.5	UM	–
Vietnam*	23.5	L	Frontier	30.8	L	Frontier
West Bank and Gaza	na	LM	Frontier	na	LM	Frontier
Yemen, Republic of	na	L	Frontier	15.1	L	Frontier
Zambia*	13.5	L	Frontier	15.5	L	Frontier
Zimbabwe*	28.5	L	Frontier	11.6	L	Frontier
REGIONS (simple average)						
*Africa**	19.2	L	Frontier	21.0	L	Frontier
*Europe & Central Asia**	24.3	LM	Frontier	37.1	LM	–
Middle East & North Africa	31.7	LM	–	34.5	LM	–
Asia	42.6	L	Frontier	40.5	LM	–
*Latin America & the Caribbean**	27.6	LM	Frontier	36.3	LM	–
*World**	26.7	LM	Frontier	31.5	LM	–

Note: Frontier countries are defined as low-income and/or high-risk countries (as in the definition adopted by IFC).

*High-risk country (Institutional Investor country credit rating lower than 30).

Income group codes: L = low, LM = lower middle, UP = upper middle.

APPENDIX B: EVALUATION RATINGS OF MSME-FI PROJECTS

Percentage of High Ratings, by Number of Projects

	MFI (%)		SME-FI (%)		Rest of commercial banks[a] (%)		Rest of financial markets[a] (%)		All IFC (%)	
Number of projects	21		72		60		147		627	
Development outcome	**71**	(15/21)	**61**	(44/72)	**60**	(36/60)	**59**	(86/147)	**59**	(372/627)
Business success	48	(10/21)	54	(39/72)	55	(33/60)	48	(70/146)	46	(283/620)
Economic sustainability	71	(15/21)	64	(46/72)	63	(38/60)	59	(85/145)	62	(381/617)
Environment	70	(14/20)	25	(15/60)	56	(30/54)	64	(74/122)	67	(384/569)
Private sector development	86	(18/21)	69	(50/72)	65	(39/60)	66	(86/136)	72	(443/619)
Investment outcome	**38**	(8/21)	**67**	(48/72)	**72**	(43/60)	**61**	(89/147)	**56**	(351/627)
Equity outcome	22	(4/18)	53	(19/36)	67	(10/15)	41	(30/74)	31	(100/322)
Loan outcome	100	(8/8)	79	(38/48)	76	(37/49)	80	(75/94)	74	(343/466)
Work quality	**76**	(16/21)	**65**	(47/72)	**70**	(42/60)	**66**	(97/147)	**65**	(409/627)
Screening and approval	67	(14/21)	60	(43/72)	65	(39/60)	60	(88/146)	55	(341/620)
Supervision	81	(17/21)	64	(46/72)	70	(42/60)	68	(99/146)	68	(422/620)
Role and contribution	81	(17/21)	68	(49/72)	77	(46/60)	73	(106/146)	81	(501/620)

a. Excludes evaluated population projects with XPSRs, two MFIs outside of the evaluated population, and collective investment vehicles.

Percentage of High Ratings, by IFC Net Commitments

	MFI (%)	SME-FI (%)	Rest of commercial banks[a] (%)	Rest of financial markets[a] (%)	All IFC (%)
Development outcome	**85**	**58**	**66**	**63**	**65**
Business success	54	53	60	52	50
Economic sustainability	85	62	69	64	65
Environment	75	34	74	70	72
Private sector development	98	64	67	66	76
Investment outcome	**42**	**68**	**72**	**70**	**62**
Equity outcome	20	56	59	41	32
Loan outcome	100	75	82	82	78
Work quality	**88**	**55**	**83**	**76**	**73**
Screening and approval	85	55	73	70	62
Supervision	92	61	82	78	75
Role and contribution	92	61	87	78	84
By net commitment amount (US$m)	46	490	1,441	2,268	10,617

a. Excludes evaluated population projects with XPSRs, two MFIs outside of the evaluated population, and collective investment vehicles.

APPENDIX C: IEG'S EVALUATION METHODOLOGY AND GUIDELINES FOR PROJECT PERFORMANCE RATINGS

All IFC investments are evaluated on eight or nine performance indicators: four indicators of development outcome, one or two indicators of IFC's investment outcome (loan and/or equity), and three indicators of IFC's overall work quality. The outcomes and underlying indicators are rated on the following scales:

- The project's development outcome is rated on a six-point scale, from highly unsuccessful to highly successful. The bottom three ratings (mostly unsuccessful and worse), taken together, are described as "low" outcomes, and the top three (mostly successful or better) as "high" outcomes.
- The other two performance dimensions (IFC's investment outcome and IFC's overall work quality) and all of their underlying indicators are rated on a four-point scale: unsatisfactory, partly unsatisfactory, satisfactory, and excellent. Unsatisfactory and partly unsatisfactory ratings, taken together, are described as "low" ratings; satisfactory and excellent as "high" ratings.

Development Outcome

Four indicators measure distinct aspects of each operation's fulfillment of IFC's Article 1 in purpose and contribution to its mission. The development outcome rating is a bottom-line assessment of the operation's results "on the ground," relative to what would have occurred without the project. The results are rated on a six-point scale: highly successful, successful, mostly successful, mostly unsuccessful, unsuccessful, and highly unsuccessful. The rating is not an arithmetic weighting of the four indicators. Instead, it is determined case-by-case and considers the relative importance of each indicator in the specific operation and what performance would have been necessary for the operation to merit the next higher or lower development outcome rating. Some of the development outcome indicators are evaluated differently for nonfinancial market and financial market operations.

Project business success: Project business success covers the performance of the project and IFC-financed subprojects and their contribution to the company's profitability, financial condition and development, as well as the related objectives established at approval. An *excellent* rating is one in which the project substantially raised the company's profitability; *satisfactory* if the project had a neutral to positive impact on the company's profitability; *partly unsatisfactory* if the project returns were sufficient to cover the cost of debt but did not provide adequate returns to shareholders; and *unsatisfactory* if the project returns were insufficient to cover the cost of debt.

Economic sustainability: These are ratings of whether subprojects financed with IFC funds are economically viable (for example, as reflected in economic rates of returns or the financial portfolio performance combined with the absence of portfolio concentrations in protected industries); whether the project has led to economic viability criteria in the company's investment decisions; and benefits to the economy. Note that, in most cases, quantitative information on the economic viability of subprojects is not available. The judgment therefore relies on assessing the financial portfolio performance, combined with an assessment of to what extent the intermediary invests in protected industries. In addition, the indicator takes into account the project's impact on the living standards of the company's and the subproject companies' local employees, as well as of its customers, competitors, and suppliers. Also taken into account are direct and indirect taxes, and gender, child labor, and regional development impacts.

Impact on private sector development: Projects and subprojects are rated on economic and financial profitability and growth prospects, pioneering attributes, transfer of skills or technology, resource allocation efficiency, impact on competition, demonstration effects, linkages, catalytic effects on other companies, and financial market development. The indicator also assesses whether project-related advisory services or the project's activities and services have helped create conditions conducive to the flow of private capital into productive investment. This might include changes in the specific laws and regulations or an improvement in their administration and enforcement.

Environmental sustainability: This indicator considers both the environmental and the social health and safety performance of projects financed by the intermediary and its internal environmental management system. Ratings are described below.

Excellent: The company engages in practices and sets standards beyond those required for the project type. For example, it requires all projects that it finances (not only IFC-financed subprojects) to meet IFC's at-approval requirements, and monitors/enforces compliance through visits and reporting.

Satisfactory: The company meets requirements for the project type. For example, the company requires only the IFC-financed subprojects to comply with IFC at-approval requirements, and monitors/enforces compliance through visits and reporting; or, the project has no impact potential.

Partly unsatisfactory: The company requires subprojects to comply with IFC at-approval requirements but does little or nothing to follow up on compliance; or, it does not require subprojects to comply with IFC at-approval requirements but is taking action to implement appropriate procedures; or, IFC did not require subproject reviews, but there is no evidence of material negative environmental impacts.

Unsatisfactory: The company does not require its subprojects to comply with IFC at-approval requirements, and action to implement procedures is doubtful; or, IFC imposed no at-approval requirements and a significant portion of the subproject portfolio is causing materially negative environmental impacts. In addition, obtaining accurate information on the subproject's environmental effects can be a challenge.

IFC Investment's Profitability

Where IFC had both a loan and an equity investment, the rating is a synthesis of the separate ratings of the two investments. The ratings address the gross contribution of the investments, that is, without taking into account transaction costs or the cost of capital. The ratings will not in every case align directionally with net profitability-based outcome quality ratings, which take into account investment size, loan margin differentials, combined loan and equity cash flows, actual transaction costs, discounting for differential risk (such as between realized-to-date and still-to-go cash flows), and IFC's cost of capital. Also, the gross contribution equity ratings use IFC's loan pricing as underlying benchmarks and, therefore, implicitly rely on the overall weighted-average pricing, thus adequately compensating for the risk relative to IFC's corporate profitability objectives at approval.

Loan ratings

Excellent: The loan is fully performing and, through a "sweetener" (for example, income participation), it is expected to earn significantly more than a loan "without sweetener" in a paid-as-scheduled case.

Satisfactory: The loan (i) is expected to be paid as scheduled; (ii) is prepaid; (iii) has been rescheduled and is expected to be paid as rescheduled with no loss of originally expected income; (iv) is IFC-guaranteed, meaning all fees are expected to be received and guarantee is not called, or called but expected to be fully repaid in accordance with the terms of the guarantee agreement; or (v) is a IFC swap or other risk-management facility, meaning IFC has not suffered any loss due to nonperformance of the swap counterparty.

Partly unsatisfactory: The loan has been rescheduled or guarantee is called. In either case, IFC expects to receive sufficient interest income to recover all of its principal but less than the full margin originally expected.

Unsatisfactory: The loan (i) is in nonaccrual status, (ii) is one for which IFC has established specific loss reserves, (iii) has been restructured and IFC does not expect to recover all of its loan principal, (iv) has been or is expected to be wholly or partially converted to equity in a restructuring of a "problem" project, or (iv) is one for which IFC experiences a loss on its guarantee or risk-management facility.

Equity, active
Excellent: Nominal US$ internal rate of return on equity (equity IRR) = fixed loan interest rate (FR) +8 percent. *Satisfactory*: equity IRR = FR+5 percent. *Partly unsatisfactory*: equity IRR = FR+2 percent. *Unsatisfactory*: equity IRR < FR+2 percent, where FR is the actual or notional fixed rate loan interest rate that was or would have been approved by IFC for the project financing.

Equity, closed
Excellent: Nominal US$ equity IRR = FR+6 percent. *Satisfactory*: equity IRR = FR+3 percent. *Partly unsatisfactory*: equity IRR = FR. *Unsatisfactory*: equity IRR < FR, where FR is the actual or notional fixed rate loan interest rate that was or would have been approved by IFC for the project financing.

IFC Work Quality

IFC overall work quality is based on three indicators and is rated on a four-point scale: excellent, satisfactory, partly unsatisfactory, and unsatisfactory. This synthesis rating reflects a judgment of the overall quality of IFC's due diligence and value added at each stage of the operation to a country's development and to IFC's profitability. The overall work quality rating can be no lower than that of the worst of the three indicators and no higher than that of the best indicator, and it is related to them according to the relative importance of each (recognizing that IFC's ability to influence an operation is greatest between screening and disbursement) and the considerations that would favor assigning the next higher or the next lower rating. IFC's work quality is judged against established good-practice standards, such as those embodied in credit notes or other guidance and policy. As much as possible, work quality is evaluated independent of the project's outcome, so as to avoid bias in the ratings, although in practice actual project results can influence work quality ratings. For example, projects performing poorly can expose or exaggerate weaknesses in IFC's structuring or supervision, which, in the absence of significant negative variances, might be undetected or given less weight. Conversely, a project that is performing very well may be doing so despite initial IFC weaknesses which may, under different circumstances, be readily exposed. Considering the inherently high exogenous risk faced by IFC's operations over their first five years, and IFC's status as an offshore, minority financier with limited leverage after disbursement, the frequency of successful outcomes, despite IFC work quality shortfalls, is believed to be very low.

Screening, appraisal, structuring: With hindsight, how well did IFC perform in appraising and structuring the operation? Were there significant variances from the appraisal assumptions about the market, sponsors, enabling environment, and company performance prospects (including environmental), which, with good due diligence, should have been anticipated at screening and appraisal? Were significant risks identified and did IFC mitigate them appropriately within good-practice project finance practices and prescribed IFC policies and procedures?

Supervision and administration: How well did IFC address company reporting, supervise the project, detect emerging problems, and respond expeditiously with effective interventions?

Role and contribution: Along with investing in the company and supervising the project, to what extent did IFC: adhere to its corporate, country, and sector strategies and business principles; play a catalytic role; and make a special contribution? Was IFC timely and efficient, and was the client satisfied with IFC's service quality?

APPENDIX D: INDICATORS USED FOR EVALUATING THE DEVELOPMENT OUTCOMES OF MSME-FI PROJECTS

DEVELOPMENT OUTCOME											
Project business success	Board reports goals achieved?	Board reports targets/ projections met?	Bank/company profitable?	Project profitable for bank/company?	Return on Average Assets (annual)	Return on Average Equity (annual)	Return on Invested Capital	MSME-FI current portfolio size	MSME-FI portfolio growth during project years	Utilization (disbursed to MSME-FI borrowers as % of IFC approved and committed amounts)	Average MSME-FI loan size under credit line
	Average loan size in MSME-FI portfolio	Total number of MSME-FI clients since IFC project	Nonperforming loan rate for MSME-FI portfolio	Nonperforming loan rate for the rest of the loan portfolio	Provisions to non-performing loans for MSME-FI portfolio	Provisions to non-performing loans for the rest of the loan portfolio	Does the FI use funding below market rate?				
Economic sustainability	Percentage of MSME-FI loans performing to MSME-FI loans granted (by number of loans)	Total number of MSME-FI borrower employees (most recent data)	Average number of MSME-FI borrower employees (most recent data)	Total amount of MSME-FI borrower assets (most recent data)	Average amount of MSME-FI borrower assets (most recent data)	Top three sector concentrations and percentages (by $$ volume) in MSME-FI portfolio	Monitor environmental matters at subproject supervision?	Economic Return on Invested Capital	Does the FI use grant funding?	If yes, amount of grants/in-kind contributions (nonrepayable)	If yes, is it to cover start-up costs?
Environmental effects	Environmental category at approval; compliant?	Environmental category current; compliant?	Environmental management system established?	Designated officer present?	Training attended by officer?	Check environmental matters at sub-project appraisal?		Evidence of negative impact?	For MFI: exclusion list applied?		
Private sector development	Were there institutions in the market lending to MSME-FIs before the project?	Have other FIs started or expanded lending to MSME-FI since the project?	Have other FIs copied or adapted the company's policies and procedures?	Have other FIs attracted MSME/MI-targeted funding since the IFC project?	Has the project resulted in a change of the regulatory framework?						
IFC INVESTMENT PERFORMANCE											
	Equity return	Loan									
IFC WORK QUALITY											
Screening, appraisal & structuring	Goals/targets in Board report realistic?	Risks correctly identified in Board report? (see IEG XPSR guidelines)	Risks adequately mitigated?	Adequate covenants present in loan agreement (see IEG XPSR guidelines)?	Adequate definition of eligible subborrower?	Subloan size limit?	Equity exit appropriately structured (if applicable)?	Environmental requirements and reporting present in legal documentation?			
Supervision & administration	Regular client visits?	Client reporting received according to requirements?	Project status reports well-documented?	Was there a need for IFC interventions?	If yes, did IFC act appropriately?	Was environmental supervision adequate?					
Role & contribution	Actual outcomes compared with Board reported expectations	Was IFC's role (per Board report) adequate in retrospect?	Did IFC contribute to the project's success during its life?	Did IFC provide advisory services funding?	If yes, was it effective?						

APPENDIX E: BRIEF DESCRIPTIONS OF MFI AND SME-FI LENDING TECHNIQUES

Microcredit Lending Techniques of NGOs and MFIs

Group lending: Between three and seven (generally five) borrowers/families from a village or neighborhood community form a borrower group with joint and individual liability for the repayment of the loan. The members of the group each take turns being the actual borrower, and when the outstanding loan is repaid, the next person in the group takes a new loan, until everyone in the group has taken a turn at borrowing—only one person has a loan outstanding at any one time. The social pressure and fear of being shamed are the main motivations for repayment.

Village banking: Village banks involve 15 to 30 people/families from the same village or neighborhood community, who borrow as a group and then split the loan into individual subloans to the group members. The members elect the officers to the village banking group, who are responsible for running the lending business and repayment collection in the group. In some cases, village banks also take deposits from members, which form part of the loan funds, together with the funds provided by outside funding agencies or NGOs.

Individual lending: The primary information used by lenders is based on "soft" personal, family, social, and business information about the borrower, obtained by a bank's loan or credit officer through close and frequent personal contact and observation. This is a "know–your-client-well" lending approach. Relationship lending is labor intensive, and may be best delivered by small institutions such as an MFI. This technique is identical to the relationship lending used by SME-FIs described below.

SME-FI Lending Techniques

Financial statement or corporate lending: Financial statement or corporate lending involves underwriting loans, based on the strength of a borrower's financial statements. Financial statement lending depends on the existence of a strong information environment, particularly with respect to accounting standards and credible auditors. It is not feasible for financial institutions (i.e., SME-FIs) in many frontier countries to offer a substantial amount of financial statement lending because of underdeveloped accounting systems and lack of independent auditing profession and standards, as well as the poor corporate governance culture, in these countries.

Small-business credit scoring: Small-business credit scoring is a transactions-lending technology based on hard information about the SME and its owner. The information on the owner is primarily personal consumer data (for example, personal income, debt, financial assets, and home ownership) obtained from consumer credit bureaus. This is combined with data on the SME collected by the financial institution and, in some cases, from commercial credit bureaus. The data are entered into a loan performance prediction model, which yields a score, or summary statistic for the loan. Either a strong information environment, large institution size, or both, appear to be needed to use this technology.

Asset-based or project finance lending: For asset-based or project finance lending, the financial intermediary (that is, the SME-FI) looks to the underlying assets of the firm and/or the project to be financed (which are taken as collateral) as the primary source of repayment.

The lending environment must include a strong and unambiguous set of commercial laws governing security and must include a legal and bankruptcy environment that ensures priority in the preservation of collateral in liquidation and reorganization circumstances. This may not be practical in many frontier countries.

Factoring: Factoring involves the purchase of accounts receivable by a "lender," known as a factor. Factoring may be a particularly valuable technology in countries with weak lending infrastructures. Factoring removes the underlying asset from the bankruptcy estate, and therefore may be feasible in countries with weak commercial laws on security interests, weak collateral registration systems, and/or weak bankruptcy systems. It can also work well in weak information environments if the receivables are associated with large borrowers or borrowers located in strong information environments.

Trade credit: Many of the procedures and processes associated with the other lending technologies appear to be used in underwriting trade credit. The ubiquitous nature of trade credit also suggests that it may have advantages over the other technologies, particularly in the nations with the most problematic financial institution structures and lending infrastructures.

Relationship lending: The primary information used by lenders is based on "soft" personal, family, social and business information about the borrower, obtained by a bank's loan or credit officer through frequent and close personal contact and observation. This is a "know-your-client-well" lending approach. Relationship lending may be best delivered by small institutions such as MFIs or small SME-FIs. This technique is identical to the MFI individual lending technique described above.

ENDNOTES

Chapter 1

1. "Frontier" countries refer to countries that can be described as being either or both of the following: (a) high risk, with an Institutional Investor country credit rating below 30, or (b) low income, as defined by the World Bank at the time of project approval. The commonly used definition, within IFC, of a country with a high-risk business climate is condition (a). The Institutional Investor Country Credit rating ranges from 0 (worst or highest country risk) to 100 (best or lowest country risk). See appendix A for a list of frontier countries.

2. Unless specifically noted, IEG means IEG-IFC in this document.

3. A list of projects in the MFI evaluated population is available in a supplementary appendix on this publication's Web site at http://www.ifc.org/ieg/msme.

4. A list of the SME-FI projects included in the SME-FI evaluated population is available in a supplementary appendix on this publication's Web site at http://www.ifc.org/ieg/msme.

5. IFC receives the audited report on the financial and operating results of MSME-FI clients about four to six months after the end of the financial year for the MSME-FIs; most end on December 31. Therefore, the latest available, complete set of audited financial reports from SME-FI clients in the evaluated populations is for 2005.

6. In the XPSR evaluation framework, the development outcome indicator has four subindicators: business success (mainly the project discounted cash-flow financial rate of return); economic sustainability (mainly the economic rate of return); environmental and social effects; and contribution to private sector development (that is, impacts beyond the project company, such as supply chain linkages, demonstration effects and increased local competition, improvements in laws and regulations, improved corporate governance in the country, increased international competitiveness of businesses in the country, etc.). The IFC investment outcome indicator is a composite of the IFC loan outcome and the IFC equity investment outcome, if IFC provided both loan and equity financing.

7. See appendix C for IEG's standard set of XPSR evaluation guidelines for financial intermediary projects.

8. The original evaluation scope in the approach paper for this review (available at www.ifc.org/ieg/msme) included 21 MFIs and a purposive sample of 37 SME-FIs (out of 72 in the evaluated population), for a total of 58 MSME-FIs. Subsequently, IEG decided to increase the SME-FI coverage to include the entire population of 72 SME-FIs.

9. Available on this report's Web site at www.ifc.org/ieg/msme.

Chapter 2

1. Figure 4 in Roodman and Qureshi (2006) shows the proportion of women borrowers within four groups of MFIs (grouped based on their lending model): (1) for the median MFIs that lend on an individual basis, almost 55 percent; (2) for the median MFIs that lend on an mixed individual and group (or solidarity) basis, about 65 percent; (3) for MFIs that lend on a group basis, almost 90 percent; and (4) for those MFIs that lend on a village banking basis, almost 95 percent.

2. See, for example, Robinson 2001. The focus of this book is the paradigm shift pushing the microfinance industry toward commercially viable microfinance by not just providing credit at a profit, but more importantly, by also serving the savings and related banking needs of the poor and the rural population. Large-scale mobilization of savings and a supportive regulatory system are seen as the keys to long-term sustainability of most microfinance entities.

3. IFC has 37 microfinance intermediary clients with operationally mature projects approved during FY96–FY02 in 33 countries (three MFIs were in one country and two projects were regional investment funds). Ten of IFC's country-level MFI clients are in 10 of the 29 developing countries with at least 1.0 micro-credit account per 100 people. Seven of these ten country-level clients are in the MFI evaluated population. The 25 other country-level clients with operationally mature projects were in 23 countries with less than 1.0 micro-credit account per 100 people, including 14 microfinance intermediaries in the MFI evaluated population. The final two MFI clients were a regional private equity fund and a regional investment fund (providing loan and equity) focused on investing in MFIs and commercial banks lending to micro-enterprises.

4. *The Economist,* March 15, 2007, "Small Loans and Big Ambitions."

5. CGAP 2004. The survey covered five multilateral development institutions, five bilateral aid agencies, 26 existing (that is, created before 2003) social investments funds and 10 social investments funds created or that became operational in 2003. The Consultative Group to Assist the Poor is a consortium of 33 public and private development institutions or agencies (including the World Bank) established to help create providers of financial services to the poor (that is, microfinance entities).

6. A summary of IFC's MSME-FI and frontier strategies, 1994–2006, is available in a supplementary appendix on this publication's Web site at http://www.ifc.org/ieg/msme.

7. This evaluation does not include IFC's MSME-FI projects in frontier areas of nonfrontier countries.

8. An IEG report concluded that the AEF was not sustainable. Subsequently, IFC also concluded that the SEF was unsustainable.

9. Before 2000, IFC financed SMEs in two ways: (1) a direct and one-on-one approach of supporting individual SMEs through SME enterprise funds with their own staff in field offices; and (2) an indirect widescale approach through financial intermediaries, including leasing companies. The first such SME fund was the Africa Enterprise Fund (AEF), established in 1988. This was then followed by the Small Enterprise Fund (SEF), a global SME and large enterprise, direct-funding facility, established in FY97 as part of the "Extending IFC's Reach" initiative in FY96–99, and which targeted countries with very difficult business climates and high project-transaction costs.

10. In comparison, during the same period of FY94–FY06, IFC's total net commitments in all sectors worldwide were 34 percent in countries classified as frontier in 2002.

11. IFC's investments in the MFI holding companies and in regional private equity and investments funds are considered nonfrontier country commitments, except for regional investment funds focused on Sub-Saharan Africa, which are considered frontier country commitments.

12. For example, an Asian Development Bank study (Charitonenko and Afwan 2003) lists four stages toward the commercialization of a microfinance intermediary: (1) adoption of a professional business-like approach to operations; (2) progression toward operational and financial self-sufficiency by increasing cost recovery and expanding outreach; (3) use of commercial or market sources of funds; and (4) operation as a for-profit, formal financial institution, subject to prudential regulation and able to attract equity investment.

Another example, Roodman and Qureshi 2006, states that "in this paper we analyze microfinance institutions (MFIs) as businesses, asking how some MFIs succeed in reducing and covering costs, earning returns, attracting capital, and scaling up."

Finally, *The Consultative Group to Assist the Poor: Key Messages for the Year of Microcredit 2005* is available in a supplementary appendix on this publication's Web site at http://www.ifc.org/ieg/msme (or from the group's Web site at www.cgap.org).

13. For a good discussion on the microcredit lending methodologies of nonprofit NGOs, see Roodman and Qureshi 2006.

14. The multilateral development banks and other development agencies generally constitute the majority of the shareholders of an MFI holding company, and their nominees to the board of directors also constitute the majority. The board of the holding company provides strategic guidance to the manager, and also exercises strong oversight functions to avoid potential conflicts of interest on the part of the manager. The fees for managing the holding company are authorized by the board and paid from the holding company resources. However, the fees for providing management and training services to a microfinance intermediary

project are negotiated and paid by donors (who could be shareholders).

15. The 10 MFI holding companies are: (1) Access Holding, (2) AfriCap Microfinance Fund, (3) AIM ACCION, (4) European Fund for South East Europe, (5) Global Microfinance Facility, (6) Lafayette Investissments, (7) MicroCred, (8) ProCredit Holdings, (9) ShoreCap International, and (10) Solidus.

16. This MFI was successfully listed in the home-country stock exchange in the second quarter of 2007.

17. This study defines "pioneering" projects as projects supported by IFC that are sponsored by foreign banks to establish new (start-up or greenfield) subsidiary operations in untested markets.

Chapter 3

1. For example, an Asian Development Bank study (Charitonenko and Afwan 2003) found that demand for microcredit is considerably lower and more variable than the demand for microsavings. Women, in particular, demand savings services because they try to build up reserves for school expenses, family health care, or their children's wedding expenses, and often have to hide the reserves from their husbands. Another example is found in Ledgerwood and White 2006, which argues that poor households and microenterprises need savings and other bank services (for example, money transfers)—not just credit services, which microfinance intermediaries should supply.

2. See appendix E for a brief description of MFI lending techniques and mainline bank lending techniques.

3. Financial intermediaries subject to prudential regulations are generally required to keep a certain percentage of total assets—typically 25 percent to 35 percent—in liquid form to meet unforeseen deposit withdrawals, unforeseen repayment delays and defaults, and unexpected curtailment of access to new debts, or roll-over of maturing debts, as well as to provide comfort to depositors and lenders. The management of this liquid asset portfolio to earn some returns is therefore an important activity to help the intermediary improve its profitability.

4. About 28 percent of IFC's equity investments in the MFI evaluated population are expected to earn negative internal rate of returns (IRRs), about 50 percent are expected to earn positive but low IRRs [as compared with the minimum satisfactory equity IRR of 10 percent (in nominal terms) used in this study], and 22 percent of the equity are expected to earn IRRs of at least 10 percent. The 18 equity investments, when taken together as a portfolio, have an expected internal rate of return of between 5 percent and 9 percent (in nominal terms), based on current IEG valuations, although this is subject to wide variability because the exits for these investments are still several years away.

Nonetheless, the XPSR equity aggregate portfolio success rate has proven to be very stable, despite the high volatility of the individual project IRRs and the aggregate portfolio IRR. The aggregate portfolio IRR of IFC's equity investments in the MFIs is expected to be much lower than the MFI's own aggregate equity IRR (that is, the MFI aggregate equity discounted cashflow IRR in table 3.2) because of the lack of an assured IFC equity exit. Additional reasons are: (1) the MFIs are expected to have declining equity returns due to competition as they mature, as well as the termination of the grant advisory services after two or three years, and projected rising interest rates (that is, borrowing costs) in the future; and (2) IFC's returns are assumed to be realized as capital gains at the time of the investment exit several years from now, while the MFIs' own aggregate equity returns are partially realized each operating year in the form of annual profits and depreciation (covering 1998–2005 only), and therefore not time-discounted as much as the IFC single recovery at the future sale of IFC's investment.

Almost all the microfinance intermediary projects with positive but low IFC equity returns still achieved satisfactory development outcomes. By comparison, IFC's equity investments worldwide (in all projects evaluated with XPSRs to date) show that roughly 33 percent have negative returns (by number of projects), 36 percent have positive but low returns, and 31 percent have satisfactory or better IRRs. The XPSR system's satisfactory equity IRR cutoff level is project specific, and equals the senior loan fixed-rate interest for the project, plus an equity premium (ex post) of 500 basis points (that is, 5 percentage points). It typically varies between 9 percent and 13 percent in nominal terms.

Note, however, that within IFC's overall equity portfolio, 21 percent of investments have very high or excellent equity returns (that is, IRRs that are at least 800 basis points (ex post) above the senior loan fixed rate interest), which contribute to a better overall internal rate of return for the entire IFC equity portfolio, whereas the MFI evaluated population equity portfolio does not have a significant percentage of excellent equity IRRs.

5. The evaluation of the success of IFC's equity investments in the intermediaries assumed that some form of exit becomes available within 10 to 15 years after disbursement of IFC's investment.

6. A recent paper commissioned for the Global Microcredit Summit (Rhyne and Otero 2006) found that the interest rates on microfinance loans in Bolivia continuously decreased from about 29.6 percent in December 1998 to 21.2 percent in mid-2005, owing to competition as more MFIs were established and as mainstream commercial banks began to also provide microfinance services. Similar trends were observed in Nicaragua, Bangladesh, and Uganda where competition among microcredit providers has existed for several years.

7. IFC's work quality, as defined in the XPSR system, includes appraisal quality, supervision quality, and role and contribution over the duration of the IFC investment.

Chapter 4

1. The subgroup of 36 SME-FIs was sampled to have the same regional distribution as the 72 SME-FI evaluated population (shown in table 1.2). Some operating performance indicators for the subgroup—such as the funding (liability) structure, the cost structure and profitability, and the number of small and medium-size enterprise borrowers—are summarized in table 4.1.

2. Berger and Udell 2004.

Chapter 5

1. IFC's 1998 ESRP categorized projects according to their potential EHS risk levels and adverse impacts. **Category A**: Projects with potential significant adverse social and environmental impacts that are diverse, irreversible, or unprecedented. **Category B**: Projects with potential limited adverse social or environmental impacts that are few in number, generally site-specific, largely reversible, and readily addressed through mitigation measures. **Category C**: Projects without (or only minimal) adverse potential environmental and social impacts. **Category FI**: Financial intermediary projects whose subprojects may have potential adverse environmental impacts.

Category-FI projects are further divided into three types: **FI–type 1**, when IFC funds are not targeted to specific subprojects or subborrowers, or when it is not practical or feasible for the intermediary to impose EHS obligations other than local regulations on subprojects, in which case, IFC's EHS requirements for the financial intermediary focus on the *process* for EHS management by the intermediary, rather than on the subproject EHS performance; **FI–type 2**, when IFC funds are targeted to specific subprojects or subborrowers, in which case the IFC EHS requirements for the intermediary focus on both the *process* for EHS management and the *subproject* EHS performance; and **FI–type 3**, when IFC is the lender of record, and the intermediary acts merely as IFC's agent, rather than as lender (such as with agency credit lines), in which case the IFC requirements for FI–type 2 apply, plus (i) IFC must clear all subprojects; (ii) subprojects must comply with IFC's applicable EHS guidelines; and (iii) disclosure requirements for IFC's direct investments apply.

2. The IFC had **two exclusion lists under the 1998 ESRP.** The first is a general exclusion list which applies to all IFC projects. The second (and longer) list applies only to MFIs. The **general exclusion list** prohibits financing of the following activities: (1) production or activities involving harmful or exploitative forms of forced labor/harmful child labor; (2) production or trade in any product or activity deemed illegal under host-country laws, or regulations, or international conventions and agreements; (3) production or trade in weapons and munitions; (4) production or trade in alcoholic beverages (excluding wine and beer, and except as minor and ancillary aspects to a company's primary operations); (5) production or trade in tobacco; (6) gambling, casinos, and equivalent enterprises; (7) trade in wildlife or wildlife products regulated under the Convention on International Trade in Endangered Species of Wild Fauna and Flora; (8) production and trade in radioactive materials (except medical, quality control, and other instruments/equipment for which IFC considers the radioactive source to be trivial or adequately shielded); (9) production or trade in or use of unbonded asbestos fibers; (10) commercial logging operations or the purchase of logging equipment for use in primary moist forest (prohibited under the Forestry policy); (11) production or trade in products containing PCBs; (12) production or trade in pharmaceuticals subject to international phase-outs or bans; (13) production or trade in pesticides and herbicides subject to international phase-outs or bans; (14) production or trade in ozone-depleting substances subject to inter-

national phase-out; and (15) drift net fishing in the maritime environment using nets in excess of 2.5 km in length.

In addition to the 15 prohibited activities in the general exclusion list, applicable to all IFC projects, the **MFI exclusion list** includes three additional prohibited activities: (16) production or trade in wood or other forestry products from unmanaged forests (which is more appropriate for MFIs than activity 10 in the general exclusion list); (17) production, trade, storage, or transport of significant volumes of hazardous chemicals, or commercial-scale usage of hazardous chemicals; and (18) production or activities that impinge on the lands owned, or claimed under adjudication, by indigenous peoples, without full documented consent of such peoples.

IFC's revised 2006 Safeguard Policies, Procedures, and ESRP have three exclusion lists, created by regrouping the prohibited activities included in the two exclusion lists under the 1998 safeguard policies into three lists. But the exclusion list applicable to all financial intermediaries that are not category-C projects, as well as the exclusion list applicable specifically to MFI projects, are the same under the 1998 ESRP and the new 2006 Safeguard Policies and Procedures.

3. None of the IFC financing instruments in the MSME-FIs in the evaluated populations was an agency credit line. Furthermore, none of the IFC financing provided to the MSME-FIs in the evaluated populations was targeted to specific subprojects. All the MSME-FI projects in the evaluated populations are therefore category FI-type 1 under the 1998 ESRP and need to comply with the exclusion list as well as local EHS regulations only, except when a category-A subproject is involved, which MSME-FIs rarely finance.

4. See box 4.2 for the World Bank's experience with environmental aspects of lines of credit to financial intermediaries.

5. In projects for which IFC provides only an equity investment (for both real sector and financial market projects), particularly in listed companies, IFC does not generally directly obligate the investee company to comply with IFC's EHS requirements because that would provide IFC with special rights and access to information not generally available to all shareholders. In such equity-only investments involving projects that are not classified as having no or only minimal EHS risks (category-C projects), IFC will generally enter into an agreement among the top shareholders to use their voting rights (constituting the majority block of shareholders) to nominate directors who would, in turn, lead the board of directors to direct the company to follow good EHS practices, such as IFC's EHS stipulations, and report the company's EHS performance to all its shareholders.

6. As reported in IEG-IFC 2003, IFC's supervision quality is a driver of EHS compliance by projects.

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