01

EVALUATION OF
IDB GROUP'S WORK
THROUGH
FINANCIAL INTERMEDIARIES

SME FINANCE

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ABBREVIATIONS AND ACRONYMS

2TFI	Second-tier financial intermediary
A2F	Access to finance
CMF	Capital Markets and Financial Institutions Division, IDB
E&S	Environmental and social
ESMS	Environmental and social management system
FI	Financial intermediary
GDP	Gross domestic product
IDB	Inter-American Development Bank
IDBG	Inter-American Development Bank Group
IFC	International Finance Corporation
IIC	Inter-American Investment Corporation
LAC	Latin America and the Caribbean
MIF	Multilateral Investment Fund
MSMEs	Micro, small, and medium-sized enterprises
NSG	Non-sovereign-guaranteed
OMJ	Opportunities for the Majority
OVE	Office of Evaluation and Oversight
SCF	Structured and Corporate Finance Department
SG	Sovereign-guaranteed
SMEs	Small and medium-sized enterprises
TA	Technical assistance

I. INTRODUCTION

1.1 **This background paper has been prepared in conjunction with a comprehensive evaluation of the work of the Inter-American Development Bank Group (IDBG) through financial intermediaries (FIs) in Latin America and the Caribbean (LAC).** The paper focuses on those IDBG operations with FIs (mostly commercial banks) that seek to expand access to finance (A2F) for small and medium-sized enterprises (SMEs). IDBG used FI operations intensively during the period covered by the evaluation (2005-2014), and these operations are likely to continue to play a key role within IDBG, in part because they are considered a cost-effective mechanism to reach a large number of relevant beneficiaries like SMEs. They are also a source of significant and relatively stable income for IDBG, and are thus important to its own financial sustainability.

1.2 **This document covers FI operations for SME finance managed by all IDBG windows.** Three units operating in IDB during the evaluation period lent for SME FI operations: the Capital Markets and Financial Institutions (CMF) division, via sovereign-guaranteed (SG) loans to public sector second-tier banks, and the Structured and Corporate Finance Department (SCF) and Opportunities for the Majority Initiative (OMJ), both via non-sovereign-guaranteed (NSG) loans, mostly to private FIs. Two other IDBG windows – the Inter-American Investment Corporation (IIC) and the Multilateral Investment Fund (MIF) – also had direct operations with FIs.

1.3 **This assessment comes at a critical moment, as IDBG is reorganizing its private sector.** As of January 2016, three IDBG private sector windows – IIC, SCF, and OMJ – merged into an expanded IIC that inherited IIC's original 1989 charter mandating a focus on SMEs. This merger is expected to address some of the coordination issues that affected FI operations in the past, including different IDBG windows working with the same clients but under different terms and objectives and with little or no coordination. FI operations – including those targeted to SMEs – will continue in the new IIC as well as in IDB (for sovereign-guaranteed operations with the public sector) and MIF. Thus, coordination will remain a key concern.

1.4 **Although the focus of this paper is on SMEs, many of the findings are also applicable to microenterprises, as they face many of the same barriers to A2F as SMEs.** Though most IDBG FI operations focusing on small firms were directed primarily at formal SMEs, microenterprises were also included in some cases. For example, OMJ included them as part of its mandate to serve the "base of the pyramid," and MIF included them when working with microfinance institutions. SCF included them in its target for the number of enterprises it sought to reach, and IIC and CMF also directed some operations to microenterprises.

II. LAC SMEs' Access to Finance

2.1 **SMEs play an important role in LAC's economy, particularly in terms of job creation.** There are approximately 15 million SMEs in LAC, contributing about 32% to the region's GDP and creating 88% of new jobs.[1] They tend to be less productive than larger firms, however, and are more likely to go out of business.[2]

2.2 **A2F is constrained for most SMEs in LAC.** IFC estimated that there are 2-2.5 million unserved SMEs in LAC, with a credit gap of $125-$155 million.[3] In World Bank Group enterprise surveys, a significant share (about 30%) of LAC SMEs rate A2F as the foremost constraint to growth.[4] Fewer than 40% of smaller firms report having access to credit, compared to 76% of large firms. Furthermore, only 21% of smaller firms turn to banks to fund their investments, and they fund only a small portion (12%) of their investments with credit – again, about half the rate of large firms.[5]

2.3 **SMEs face not only access restrictions, but also worse credit terms.** A significant gap remains between the interest rates charged to LAC's SMEs and large companies: the gap is above 10% in Colombia and Peru and 4-5% in Mexico, Bolivia, and Guatemala – far exceeding the 1-1½% gap in developed countries.[6] Availability is often limited to short-term working capital, rather than long-term funding.[7] Collateral requirements are more stringent for SMEs. Most LAC business loans (72%) require the pledging of collateral. While the average loan-to-collateral-value ratio for SMEs is 49%, large companies are on average granted 62% of the value of the pledged collateral.[8]

2.4 **FIs perceive SMEs as riskier because of their informality, lack of collateral, and low bankability.** Informality limits FIs' capacity to estimate cash flows reliably, as SMEs often lack formal accounting or produce financial information of poor quality. SMEs' limited ownership of assets that can be used as collateral makes it more difficult for them to mitigate risk. In addition, smaller borrowing companies often lack financial sophistication and have volatile earnings and higher mortality rates. Over a quarter of LAC SMEs went out of business between 2006 and 2010, a much higher rate than that of large enterprises.[9] The high churn among smaller and younger firms discourages lenders from incurring the up-front costs of credit analysis, especially when others could later capture the best clients.

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1 World Bank Group and IDB, *Creating Jobs and Developing Skills in LAC*, Oct 2014.

2 *IFC Jobs Study*; Assessing Private Sector Contributions to Job Creation and Poverty Reduction. Jan. 2013.

3 IFC, *Scaling-Up SME Access to Financial Services in the Developing World,* 2010.

4 Enterprise Surveys, The World Bank Group.

5 Enterprise Surveys, The World Bank Group.

6 Information taken from *Financing SMEs and Entrepreneurs 2015: An OECD Scoreboard*, OECD and banking regulators of Peru and Guatemala, with data from 2010 to 2014.

7 IFC, *Scaling-Up SME Access to Financial Services in the Developing World*, 2010

8 Data from the Enterprise Surveys. The World Bank Group. Calculations by OVE.

9 World Bank Group and IDB, *Mapping Enterprises in LAC*, 2013. Between 2006 and 2010, 26% of LAC SMEs exited the market. The rate was highest for small businesses (5-19 employees) at almost 30%, and lowest for large business (100 or more employees), at just over 15%.

2.5 **Limited competition in the banking market may also affect banks' desire to enter the SME market, given its perceived riskiness, high operating costs, and generally unfavorable provisioning requirements for capital.** The number of regulated FIs (and particularly banks)[10] has fallen in most LAC countries, partly because of regulators' interest in ensuring stability in the financial system. In an atmosphere of limited competition, it is easier for LAC FIs to grow their consumer and mortgage portfolios, as both businesses can easily be brought to efficient scale through standardization, and they enjoy favorable capital reserve requirements because of the stability of large portfolios and collateralization (in the case of mortgages). LAC FIs have also developed a sizable portfolio of corporate lending to large enterprises. SMEs frequently do not fit the prevailing business models that FIs use for corporate and consumer credit:[11] they are too heterogeneous for the standardized consumer model based on credit scoring, and loans are too small to amortize the high costs of the corporate model. However, some FIs have found innovative ways to finance SMEs while limiting their risk (Boxes 2.1 and 2.2).

Box 2.1. Leveraging supplier networks to mitigate SME information barriers

Costa Rica's Development Banking Law (No. 8634) mandates that private banks that take deposits must maintain an outstanding balance of loans to the Development Credit Fund equivalent to 17% of their deposits. This fund aims at increasing A2F for SMEs. Alternatively, private banks may directly provide credit to MSMEs in the regions identified by the law in an amount equivalent to at least 10% of deposits.

An innovative Central American banking group saw this as an opportunity and, with IDBG technical assistance, built an online platform to be able to profitably serve SMEs. It targeted the SME suppliers of its largest clients (e.g., large retail stores), and used their cash-flow history to offer them credit (and other services as well), meeting the conditions of the law.

Box 2.2. Building an SME business by helping clients mitigate risks

A small, profitable private bank in Costa Rica has developed an algorithm to reduce the financial volatility of its SME clients. It focuses on mitigating SMEs' excessive concentration, e.g., on single products, large clients, or persons within the enterprise. It suggests possible solutions to alleviate the concentration risks and structures the most suitable products for the clients.

This methodology has helped it create long-term relations with its SME clients. Although these products tend to cost more than the market´s average, clients are willing to pay more to get this support and advice. IIC developed a similar SME analysis and improvement platform called FinPYME, which it and other FIs in LAC have used to source clients and help them become more bankable.

2.6 **Funding was not a major constraint for FIs during the evaluation period**. When liquidity is constrained, FIs tend to reduce credit to SMEs if they consider corporate and consumer segments more profitable. However, OVE found that liquidity was not an important constraint during the evaluation period, at least for

10 The top 10 banks' market share (by assets) ranges in IDB's "A" countries, from 80% (Mexico) to 88% (Argentina); in "B" countries from 63% (Colombia) to 96% (Chile); in "C" countries from 61% to 93% (Costa Rica); and in "D" countries from 50% (Nicaragua) to 97% (Guatemala). IDB's classification of country groups is as follows: "A" countries – Argentina, Brazil, Mexico and Venezuela; "B" countries – Chile, Colombia and Peru; "C" countries – Bahamas, Barbados, Costa Rica, Jamaica, Panama, Suriname, Trinidad and Tobago, and Uruguay; "D" countries – Belize, Bolivia, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Haiti, Honduras, Nicaragua and Paraguay.

11 Consumer and micro-credit achieve efficiency by standardizing products and diluting costs in a large homogeneous base of clients. Corporates dilute high origination and supervision costs in large operations.

banks. LAC liquidity has grown steadily – particularly in terms of deposits, which are now on par with developed markets. In OVE's survey of IDBG client FIs, only 18% mentioned funding as a constraint in serving SMEs.[12]

2.7 **Finally, financial infrastructure and regulatory environments also play an important role in SME lending.** Financial infrastructure—such as strong credit bureaus and collateral registries—reduces FIs' cost to assess borrowers' creditworthiness and mitigate risk. Building this infrastructure takes time and is still in the early stages in many LAC countries. Efficient regulation helps FIs serve SMEs without incurring excessive costs. Though LAC countries have made substantial progress in financial reforms in recent years, some countries still have outdated creditor protection laws and excessive capital requirements that discourage lending to smaller borrowers.[13] Stricter anti-money laundering and know-your-customer policies have also disproportionately affected the SME segment, since fixed compliance costs are harder to amortize.[14] In addition, the emergence of financial consumer protection systems has the potential to increase costs for smaller clients.[15]

12 Liquidity was more constrained for microfinance institutions because of their more limited access to deposits and capital markets.

13 One key issue is regulators' acceptance of scoring methodologies to set capital reserves for smaller clients.

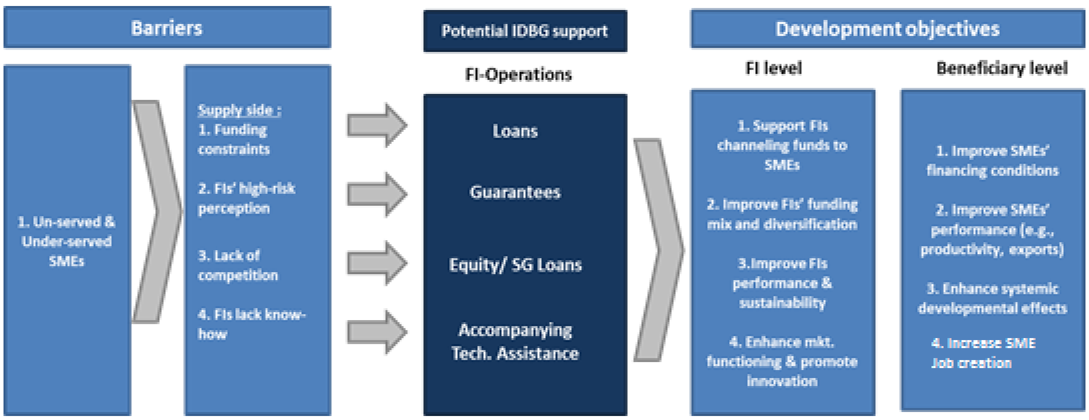
14 This has led to a trend of shifting credit away from MSMEs and onto the SMEs' owners' name, because individuals are often less costly in terms of compliance. However, this detracts from building the firms' ability to build a credit history, and ultimately to grow.

15 In Peru, financial consumer protection was modified by Law No. 28587 (*Ley Complementaria a la Ley de Protección al Consumidor en Materia de Servicios Financieros*); in Colombia the regime was introduced by Law 1328 of 2009; Honduras established a special portal for financial consumers to provide information on their rights and obligations, and on avoiding fraud; and Bolivia's supervisory authority's webpage has a special section for financial consumer issues.

III. RELEVANCE OF SME FI OPERATIONS

3.1 **IDBG sees FI operations as a cost-effective mechanism to reach SMEs.** Lending directly to SMEs is prohibitively costly for IDBG. Therefore, IDBG supports and works with the region's FIs so they can onlend to SMEs. IDB's public sector operations, managed by CMF, typically reach FIs indirectly, by first channeling resources through public development banks (second-tier FIs, or 2TFIs) and obtaining a sovereign guarantee (SG) from the relevant governments. All other windows lend to FIs directly without a sovereign guarantee (NSG). In all cases, FIs make the credit-granting decisions and usually bear the final beneficiaries' credit risk (except, typically, with guarantees – see Figure 3.1).

Figure 3.1. IBG's work through FIs mainly focused on tackling supply side barriers



3.2 **A key objective of the FI operations reviewed as part of this evaluation was to expand A2F for SMEs.** First, IDBG sought to channel funds to these companies by requiring that IDBG proceeds be used to fund a certain number of relevant beneficiaries or to grow the SME portfolio. Second, IDBG sought to improve the conditions of the financing received by SMEs, particularly the lending tenor – for example, by requiring subloans to be longer than 2 years. IDBG usually refrained from setting specific interest rate goals for subloans.

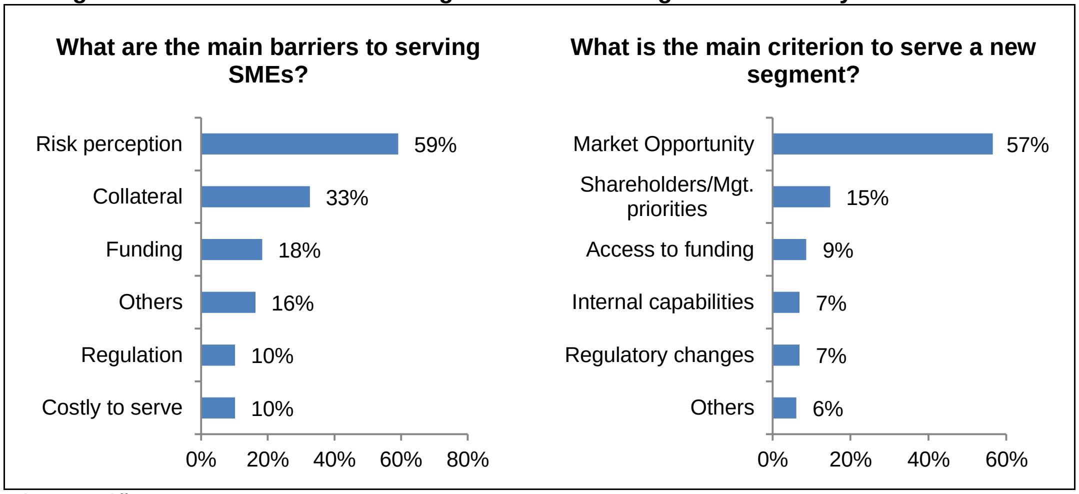
3.3 **In turn, IDBG expected positive outcomes in key economic development variables such as productivity and employment.** These were often the ultimate objectives of SME FI operations. They were reflected in IDBG's strategy documents and were reiterated in OVE interviews with IDBG investment officers, though they were frequently not captured explicitly in project documents or project monitoring and evaluation systems.

3.4 **IDBG also aimed at strengthening its client FIs, and particularly their capacity to sustainably serve SMEs.** In most cases IDBG also aimed to provide additionality for client FIs themselves, for example by supporting them in diversifying their funding sources or improving their capital structures. IDBG also aimed to provide nonfinancial additionality by supporting FIs in implementing good business practices (such as applying environmental and social standards) and in serving SMEs (for example, by developing new business lines or implementing risk assessment technologies).

3.5 **FI lending operations are unable to tackle many problems that constrain A2F, such as weak legal and regulatory frameworks, poor financial infrastructure, or low creditworthiness of potential borrowers.** Other IDBG instruments can be more effective in tackling these A2F constraints. Technical assistance (TA) or policy-based loans to governments can help authorities create better laws and regulations—for example, by strengthening creditor protection laws or reducing excessive capital requirements for lending to SMEs. TA or investment lending can also support key market players (such as public agencies or bank associations) in building financial infrastructure such as credit reporting, collateral registries, or payment systems.

3.6 **The fact that liquidity was not a major constraint to FI lending during the evaluation period calls into question the relevance of IDBG's direct loans as an instrument of support.** An OVE survey of client FIs reinforced the finding noted earlier that liquidity was not a primary issue for these FIs: over half of client FIs (59%) perceived high SME risk (stemming mainly from informality) as the main barrier, while only 18% mentioned funding as a constraint (Figure 3.2). This points to the relevance of risk management products, such as guarantees, rather than loans. The survey also showed that the "availability of additional funding" rarely drives FIs to pursue a new business segment (9%), whereas over half of respondents (57%) cite the "perception of a business opportunity." FI operations, particularly loans, may thus have limited relevance in addressing the most important A2F constraints.

Figure 3.2. FIs interested in serving SMEs saw funding as a secondary A2F constraint

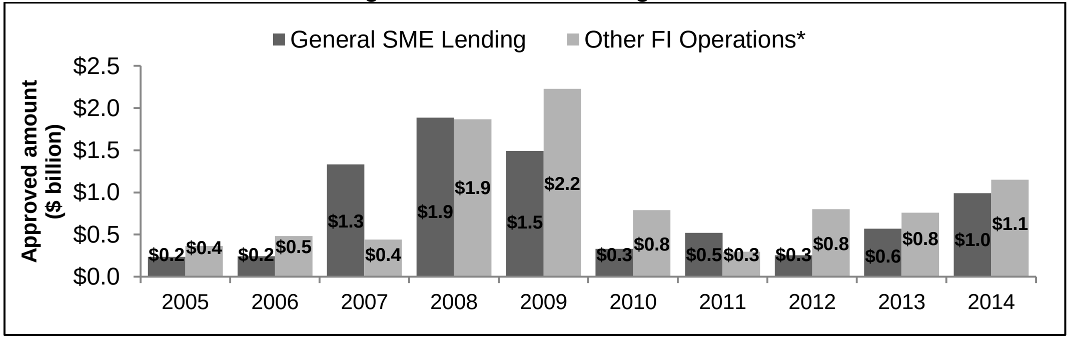


Source: Client FI survey

IV. IDBG'S SME PORTFOLIO

4.1 **FI SME operations totaled $7.85 billion in the evaluation period and accounted for half of the total FI operations of $17 billion (Figure 4.1).** Throughout the period, approvals averaged $785 million annually, increasing considerably during the global financial crisis (2007 to 2009), when approval volumes were 6.5 times the average pre-crisis level.

Figure 4.1. IDBG FI lending trends



***** Other FI operations: liquidity lines, green lending, housing finance, leasing & factoring, and trade finance.
Source: OVEDA

4.2 **The average size of SME operations was $30 million, and it varied significantly by window.** CMF approved 24 large operations to 2TFIs with an average size of $196 million. SCF's and IIC's operations averaged $47 million and $11 million, respectively. SCF tended to work with bigger FIs, while IIC focused on mid-sized FIs. OMJ and MIF had significantly smaller operations (averaging $7 million and $1.8 million, respectively), generally targeting microenterprises that needed smaller amounts of funding.

4.3 **Geographically, SME FI operations were concentrated in Mexico and Brazil, both by size and number of operations** (see Annex II). Brazilian SME operations totaled $3.4 billion, or about 44% of total SME operations – dominated by $3 billion to the Brazilian Development Bank. Operations in Mexico accounted for $838 million, or 10% of the total SME FI portfolio. As in Brazil, a single Mexican public bank accounted for most of the funds (82%). Together, "C" and "D" countries, an important priority for IDBG's private sector windows, accounted for 28% of the approved amount ($2.2 billion), but for over half (129, or 52%) of the number of SME FI operations.

Box 4.1. FinPYME – TA to improve SMEs' bankability

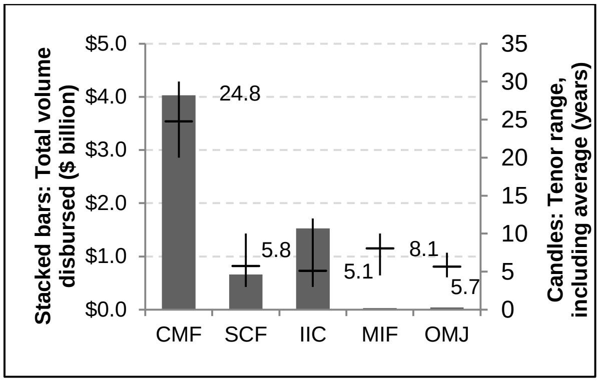
FinPYME is an initiative executed by IIC to provide TA directly to SMEs to enhance their competitiveness and bankability. IIC developed FinPYME Diagnostics as a tool to assess the competitiveness of SMEs, and disseminated the tool through third parties, such as business schools in the region, so that they could follow up with companies over time.

More recently, IIC expanded FinPYME to target specific TA needs, such as corporate governance, management skills, and export readiness. A key challenge has been to reach a critical mass of SMEs. The delivery method has had limited reach, and the mostly grant-based TA has had to rely on donor funding.

4.4 **IDBG provided mostly US-dollar-denominated senior loans for SME funding.** For SME lending, the most common instrument was the US-dollar senior loan, which was used in 82% of the loans and accounted for 94% of the total approved amount. Other instruments were rarely used: subordinated debt (7.8% of operations), equity (4.7%), guarantees (3.1%), and TA (2.7%) (see Box 4.1 for an example of TA). SCF, IIC, and MIF used subordinated debt to support FIs' capital structure, but the amounts were small ($220, $124, and $13 million, respectively). SCF, IIC, and OMJ also approved about $100 million as guarantees, mostly as risk-sharing facilities. Finally, MIF and IIC approved equity operations for about $30 million, to supplement FIs' capital and to provide added value by helping to improve their corporate governance and business practices.

4.5 **Most senior loans had mid- to long-term tenors, with CMF providing significantly longer terms.** SG loans provided by CMF averaged 25-year tenors, while the longest tenor the NSG windows offered to first-tier FIs was 12 years. Tenors for SG lending ranged from 20 to 30 years, while NSG lending ranged from 5 to 12 years (Figure 4.2). Longer tenors for public banks may not create significant financial risks, since they are covered by the sovereign guarantees offered by countries. However, they are clearly longer than what SMEs need. Such long tenors thus create the risk that after the initial disbursements, the 2TFI may use the funds for different purposes or in a different manner (for example, one of the 2TFIs was considering acting also as direct lender, but it was unclear whether it had sufficient capacity to do that).

Figure 4.2. SG lending offered the longest tenors to 2TFIs



Source: OVEDA

4.6 **Regarding environmental and social (E&S) risks, SMEs are highly heterogeneous, and their risks can range from low to high.** SMEs do not have a homogenous business profile, and they operate in low- to high-risk sectors. E&S risks for SMEs depend on such factors as the sector, location, local communities or nearby ecosystems, waste management practices, potential site contamination, labor regulations, and conditions of safety and occupational health. FIs can assess these factors in a professional manner only if they have an environmental and social management system (ESMS) in place and also apply it to SME operations.[16]

4.7 **IDBG relied on FIs to mitigate E&S risks and focused only on the list of projects reported by the FI.** All IDBG windows relied on FIs' ESMS. FIs were required to classify subloans according to their potential risks and put in place requirements commensurate with the risk classification. However, the required scope of application focused on a list of projects reported by the FI as using IDBG proceeds. Given the fungibility of money, FIs could select subprojects with low E&S risk to present to the IDBG and systematically exclude subloans with high E&S risks, thereby circumventing the more demanding E&S requirements.

[16] More detailed information on the application of E&S standards is available in the background paper on Environmental and Social Safeguards.

4.8 **The majority of FIs had ESMS systems in place, but often with limited application to SMEs.** Although IDBG relied on FIs to manage E&S risks, the implementation of an ESMS was not a prerequisite for the approval of FI operations. According to OVE's survey of client FIs, the majority of FIs (64%) integrated an ESMS into their credit cycle. However, only 62% of FIs applied the ESMS to all of their loans, while another 26% applied it only to loans financed by development finance institutions or to loans over a certain amount. When FIs used loan amount as a criterion to apply the ESMS (e.g., loans greater than $5 million), SMEs would often be left out of the screening. Ensuring that the ESMS covers SMEs thus remains a challenge.

V. Results

A. Did SME FI operations expand A2F for relevant beneficiaries?

- **<u>Did resources reach the FIs?</u>**

5.1 **The majority of SME operations were disbursed (80%).** CMF, the largest window by approved amounts (60% of the SME portfolio) disbursed 86% of its approvals, in large part because it lent to larger public banks that were able to absorb the funding. IIC also disbursed a high share (81%) of the approved amounts. For other IDBG windows, disbursement rates averaged 50%. SCF's low disbursement rate (58%) was mostly the result of a $400 million risk-sharing facility that was dropped by a Jamaican bank. Disbursement raties were also low (about 50%) for OMJ and MIF, in part because their FI clients were unable to reach target markets (especially "base of the pyramid" micro-enterprises), and sometimes because the financial support offered to FIs at approval did not meet their clients' needs (particularly for MIF).

- **<u>Did resources reach the intended beneficiaries?</u>**

5.2 **IDBG typically required FIs to submit a list of beneficiaries that met certain eligibility criteria; however, given the fungibility of money, such a list cannot ensure that money "reaches" those beneficiaries.** IDBG typically required FIs to report a self-selected list of beneficiaries as "use of proceeds" requirement. For SMEs, IDBG typically used a definition based on loan size (see Box 5.1) as the eligibility criterion, and sometimes other criteria as well (e.g., women entrepreneurs). However, the fungibility of money makes it difficult, if not impossible, to attribute the funding of specific beneficiaries to IDBG, so that beneficiary lists are an unreliable mechanism to monitor the FI's relevant portfolio. As long as an FI has a large enough portfolio, it can easily pick a list of companies fulfilling certain eligibility criteria – companies that it may have financed in any event – and could conceivably even shrink its SME portfolio while fulfilling all of IDBG's requirements. OVE found that FIs can – and do – report to IDBG loans that they would have granted anyway, or in some cases had already granted. FIs told OVE that they often chose projects for the reporting that they thought IDBG would approve of, and sometimes substituted individual loans when IDBG did not (even if they had already financed these projects).

- **<u>Did the SME portfolio grow?</u>**

5.3 **IDBG usually targeted SMEs using its own definitions, which were not aligned with those of FIs, making it difficult to measure the growth of the relevant portfolio (loans to SMEs) and its performance** (Box 5.1). While more recent Board reports and monitoring requirements (particularly for SCF) also focused on the growth of the portfolio, an analysis of how the FI's definition differed from IDBG's was often missing. CMF was the only window that used the FIs' definitions in its SME FI operations.[17]

[17] OVE found that in countries like Colombia and Mexico, CMF used client FIs' definition for SMEs on its FI operations. As a result, information about the relevant portfolio was captured.

Box 5.1. Defining the target market: An MSME is not the same for the FIs as for IDBG

The definition of an SME varies from country to country. The most used definitions are based on sales and employment, although definitions are also based on total assets or even a combination of some of these variables.

IDBG's client FIs also have their own definitions, and their criteria to define SME size are not homogenous. For example, according to OVE's survey of client FIs, 35% of FIs said they classify SMEs by revenue, 25% by loan amount, and a smaller number by assets (16%) or employees (10%).

IDBG had its own classification of SMEs for operations through FIs (see table below). This complicates further the targeting of SMEs, because FIs reported a list of SMEs meeting IDBG's definition but were unable to track the relevant SME portfolio according to that definition. During country visits, FIs also mentioned that reporting according to IDBG's definitions created additional costs.

IDBG definitions of MSMEs; criterion: loan size			
Countries	**Micro**	**Small**	**Medium**
A and B countries	$10,000	$250,000	$1,000,000
C and D countries	$10,000	$150,000	$500,000

Note: All numbers are upper limits, currency is US dollars.
Source: Documents OP-580-2 and CII/GP-15-12

5.4 **Only about a sixth of the FI operations considered increasing the FI´s SME portfolio as an objective, and only half of them set a specific target for it.** FI operations that were intended to increase A2F for SMEs usually did not include the objective of increasing the client FI´s relevant portfolio as part of its monitoring and evaluation framework. Only about 16% of the SME FI operations had an objective related to increasing the FI´s SME portfolio. Of these operations, only half set a specific target. Target achievement was also not anchored in legal agreements, as there were no covenants that required growing the relevant portfolio by a minimum amount, such as the amount of financing by IDBG. Only recently did SCF start to include in its legal agreements indicators to monitor the size and performance of the relevant portfolio (such as number, average loan amount, average interest rate, average tenor, economic sector of subloans, and nonperforming loans), but this was not done consistently.

5.5 **For about a quarter of the FI operations, OVE was able to independently estimate the increase in the relevant portfolio, finding that in 75% of cases MSME portfolios grew at least as much as the funding provided by IDBG.** CMF was the only window with negative growth in an FI operation, and in 40% of IIC´s operations the portfolio increased by less than IIC´s funds. The FI operations of the other windows typically showed an increase of at least the IDBG amount.

5.6 **However, the extent to which this increase is attributable to IDBG is unclear.** It was not possible to gather information about the relevant portfolio for all SME FI operations, as it is usually not publicly available or reported to the IDBG. Among the operations for which OVE was able to obtain the information,[18] only for small and medium FIs can a modest but significant relationship be discerned between IDBG's investment and its SME-relevant portfolio. For small

[18] This analysis could only be done for 12 of the 45 SME FI operations randomly selected for this evaluation: three small FIs (total loans under $200 million), and five medium FIs and four large FIs (total loans over $5 billion). In none of the large FIs did IDBG's funds exceed 3.5% of the relevant portfolio.

and medium FIs, IDBG´s funds represented on average about 20% of the FI´s relevant portfolio, but for large FIs only 1.6%. For large FIs IDBG’s funding is most likely to make a significant difference if it is in the form of subordinated debt (or capital) (for an example, see Box 5.2).

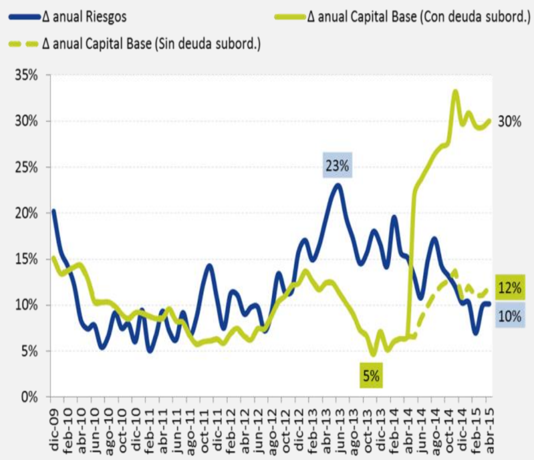
Box 5.2. Subordinated debt provides strong attribution to IDBG, but it is unclear whether this was the best way to remove A2F barriers for MSMEs

Before the IDBG´s subordinated loan was made, the liquidity and capital adequacy levels of the largest public bank in Costa Rica fell almost to the minimum regulatory level. In 2013, IDBG approved a $100 million subordinated loan with the objective of increasing A2F for SMEs and improving the bank’s capital adequacy ratio. This operation caused an immediate jump of 2 percentage points in the capital adequacy ratio (from 10.6% to 12.6% in two months), reversing its deterioration. Also, its capital base increased considerably during this period (see graph to the right).

Although the operation represented only 4% of the SME portfolio (and less than 1% of the FI´s total assets), it solved a crucial capitalization problem and helped the FI maintain and even grow its SME portfolio. Without the operation, it is likely that the bank would have reduced its overall portfolio emphasizing MSMEs.

However, the bigger development rationale of this IDB loan was unclear. Public banks in Costa Rica benefit from numerous advantages and dominate the market (with over half the market share). It is unclear whether IDB’s support to the largest public bank in the country was necessarily the best way to support MSME lending.

Figure: Because of IDBG’s operation, the annual capital base of the FI increased more than it would have without IDBG’s support



- <u>**Did financing conditions for SMEs improve?**</u>

5.7 **There is limited information on the effects of IDBG financing on beneficiaries, especially regarding interest rates for onlending.** Targets were rarely set by IDBG for the interest rate of subloans, as the FIs made all credit decisions, and this indicator was typically not even monitored by IDBG.

5.8 **Regarding the tenors of subloans, SME FI operations included targets that were mostly achieved.** Many operations required a minimum tenor for the subloans granted to SMEs. On average, SME operations reached or exceeded the targets. When subloan tenors were tracked – for a self-selected list of enterprises notionally financed by IDBG – they averaged 51 months (versus a 38-month target). A more meaningful target would have been tenor improvements in the relevant portfolio, ideally against prevailing market conditions, but this was not consistently tracked.

B. Did SME FI operations improve the performance of beneficiaries (productivity, growth, exports, etc.)?

5.9 **There is little information about the effect of improved A2F on SME performance – such as increases in jobs, sales, and productivity.** Although these were often the ultimate objectives of SME FI operations, IDBG did not track SMEs' performance on revenues, jobs, and exports. When OVE visited FIs, some indicated that IDBG's loans were already expensive, and that incurring further costs for collecting additional data would make the operation even less attractive. Others indicated that they routinely track sales and employees in their management information systems, but that IDBG did not request such information. Together with weak eligibility conditions, this lack of monitoring makes it impossible to connect project inputs and desired outcomes at the beneficiary level.

5.10 **A few impact evaluations have found positive effects in SME support programs.** A CMF study of the lending activity of Bancoldex,[19] a Colombian 2TFI, found significant positive effects on firm output (increase of 24%), employment (11%), investment (70%), and productivity (10%) over the four years after the first IDBG loan, and found that effects were more sustainable when firms received long-term credit. An evaluation by OVE of programs of support to firms in Brazil[20] found positive impacts on wages, exports, and innovation, and found that the impact on employment was even larger and more robust when credit was combined with business consulting.

[19] M. Eslava, A. Maffioli, and M. Melendez (2012), "Second-tier Government Banks and Firm Performance." IDB Working Paper Series No. IDB-WP-294.

[20] OVE (2014), "A Comparative Analysis of IDB Approaches Supporting SMEs: Assessing Results in the Brazilian Manufacturing Sector".

VI. GOING FORWARD

6.1 **To enhance the relevance of its SME FI operations, IDBG needs to work with country partners to understand the main barriers to A2F for SMEs in each country and to pursue FI lending operations only where they are the appropriate tool.** The diagnostic prepared as part of country strategies provides one avenue for such analytic work, and country and sector strategies can help to define the mix of operations and instruments that together will best address the key barriers to A2F. This approach will require much greater coordination across the various parts of the IDBG than has been typical in the past.

6.2 **If IDBG is to enhance the development impacts of its SME financing, it will need to overhaul the way it structures its loans and monitors outputs and outcomes.** Requiring lists of specific SME loans is an ineffective way to to monitor development results. Given the fungibility of money, growth in the FI's relevant (i.e., SME) portfolio is the more appropriate indicator to track. And with little additional effort compared to its current approach – by obtaining a representative rather than FI-selected list of SME beneficiaries and by including information that FIs typically have or should have readily available when they approve loans (such as sector, E&S risk classification, sales, and employment) – IDBG could significantly enhance the assessment of outcome variables such as growth of jobs, sales, and productivity, and the quality of the FI's ESMS. While tracking this for all operations may not be feasible or cost-effective, IDBG could conduct selected evaluations – on both the SG and the NSG side – particularly with FIs that already track indicators related to the final beneficiaries. IDBG could also ask FIs to systematically report on indicators such as the average interest rate, average tenor, and purpose of the subloans for the targeted SME portfolio.

6.3 **To be able to capture information about the SME targeted portfolio, IDBG would need to adapt its SME definition to that of the FI.** FIs track portfolios only by the definition that is relevant for them and their market. If IDBG wants to focus on increasing access for a certain group of beneficiaries, it will need to adopt the FI's SME definition, of course after verifying that it is aligned with IDBG's development objectives.

6.4 **Finally, IDBG could usefully ramp up its contributions to strengthening the bankability of SMEs, so FIs are more likely to provide them with financing.** As OVE's survey of client FIs showed, the top factor driving FIs to pursue a customer segment is the perception that it represents a profitable business opportunity. Lending to SMEs will be more profitable if the costs of assessing their creditworthiness are lower and the likelihood that they will succeed is higher. IDBG has at several points pursued programs, like FinPYME or Women Entrepreneurship Banking, that have tried to reinforce the capability of SMEs and make them more bankable. IDBG has also worked with leading FIs in the region to define viable service models for SMEs. These and other examples provide promising models for the future.

ANNEX I

EVALUATION PORTFOLIO AND SAMPLING APPROACH

OVE performed a comprehensive project review on a sample of 45 SME FI operations that was statistically representative of the whole population of 246 SME FI operations under evaluation.

A complete list can be found at this link: Portfolio Under Evaluation and Statistics.[21] Representativeness extends also to the following strata within the population: FI subproducts (in this case, SME FI operations), IDBG windows, country groups and regions, and projects with FIs operating with multiple IDBG windows. Representativeness within each of these strata was set at a minimum of a 90% confidence interval, with a +/- 20% error margin.

Each of these criteria was considered sequentially, so that the representative sample selected according to the prior criterion (SME FI operations) was enlarged as needed to also achieve representativeness for the current criterion (e.g., IDBG window). In addition to the random representative sample, a purposive sample was also drawn, comprising (i) all FI operations above a certain approval level ($100 million); (ii) a sample of FIs that had operations with multiple IDBG windows; and (iii) all impaired or written-off operations.

[21] This link includes the entire portfolio used for the evaluation that this background paper supports (the evaluation of IDB Group's work through financial intermediaries).

ANNEX II

THE STORY OF THE FI THAT RECEIVED THE MOST IDBG RESOURCES THROUGH SME FI OPERATIONS

Box A2-1. A Brazilian development bank was the main recipient of IDBG funds for supporting MSMEs' A2F

One of Brazil's three key public development banks, supports the availability of enterprise lending at preferential rates. Although it mainly focuses on long-term investment, infrastructure, and project financing, it also plays an important role in short-term export, working capital financing, implementation of countercyclical programs, and support for companies and financial markets.

During the period of this evaluation (2005-2014), the bank's total loan portfolio almost quadrupled, mainly because of the increase in lending to large enterprises (from $75.7 to $279.3 billion), which represented about 72% of its' portfolio. Lending to MSMEs (which represents the remaining 28% of the portfolio) grew almost fivefold. The biggest increases were from 2007 to 2008 and from 2009 to 2010, when its total loan portfolio grew 50% and 70%, respectively. During this same period, the bank's nonperforming loans decreased significantly from 4.2% in 2006 to 0.26% in 2014, falling below the public banks' average and staying at lower levels every year since 2008. This bank has maintained an almost equal distribution between direct and indirect disbursements (45% and 55% respectively).

On the funding side, governmental sources of funding, such as the National Treasury (50.9%) and the Worker's Assistance Fund (23%), have remained the most important, while shareholders' equity (8.9%), the Fundo PIS-PASEP (4.7%), international funding (3.8%, of which IDBG's support represented about 70% on average), and other sources (8.7%) have been of lesser importance.

In 2004 IDBG's Board approved a $3 billion conditional line of credit with this bank to support its efforts to strengthen MSMEs' competitiveness and job creation through medium- and long-term financing for investment projects. Between 2007 and 2009, three operations under this line of credit were approved, each for $1 billion. This investment represented an important part of IDBG's total SME-FI portfolio between 2005 and 2014 (37.5% of approved amounts and 47.7% of disbursed amounts), as well as an important share of the bank's SME portfolio (3%-5% between 2007 and 2009).

According to the Project Completion Reports – which were not validated by OVE – on the variables of job creation and gross sales all three operations included estimates of increases instead of targets: micro, 65%-85%; small, 15%-25%; and medium, 10%-15%. The results showed that the increases in numbers of employees and gross sales of SMEs were higher than the estimates for all three operations, while for microenterprises they were lower in two of the operations (one did not have results). Other variables—the level of activity, time for SMEs to access credit, contribution of additional financing from other companies or FIs—did not have targets at the time of approval and were estimated only afterwards (the Project Completion Reports only include the results without comparing them to targets). Also, the number of FIs participating in the program was higher than expected, but no data regarding the performance of their MSME portfolios (e.g., nonperforming loans) were gathered.