Ex post evaluation - Microfinance Enhancement Fund

›››

Sector: Finance (CRS code 24)
Programme/Project: BMZ-No. 2009 36 575/2011 36 662: Refinancing Facility for MFIs facing liquidity shortages Phase I/II
Implementing agency: Microfinance Enhancement Fund (MEF)

Ex post evaluation report: 2016

		Planned	Actual
Investment *	EUR million	335,00	335,00
Funding	EUR million	335,00	335,00
of which C-shares/first-loss-piece:	EUR million	55,15	55,15
of which BMZ budget funds (C-shares, 2009 36 575)	EUR million	25,00	25,00
of which BMZ budget funds (C-shares, 2011 36 662)	EUR million	20,00	20,00

* These figures refer to the situation after disbursement/commitment of the amounts mentioned, i.e. 12/2011

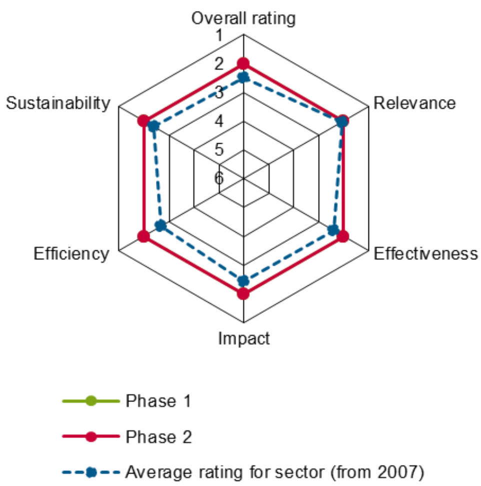
Summary: The MEF was launched as a liquidity provider in times of crisis against the backdrop of the global financial crisis 2008/2009 in order to prevent long-term damage to the microfinance industry in developing and transition countries. MEF became fully operational in 2010, which was a bit too late in the sense that the worst of the crisis was already over. Furthermore, the liquidity shortages resulting from the global crisis were much less severe than previously feared. Subsequently, MEF assumed a dual role. In addition to its original task as a provider of liquidity in times of crisis, the fund also complemented other sources of funding available to the microfinance industry during normal (non-crisis) times. As per June 2016, MEF´s total assets exceeded 514 million USD, including investments in 94 microfinance institutions in 35 countries.

Objectives: The objective was to stabilize the refinancing supply for microfinance institutions (MFIs) by providing a short-term refinancing facility, thus counteracting liquidity shortages. On a broader perspective, the signalling effect and fast access to liquidity aimed at preventing crisis-related decreases in microfinance lending activities. Contributing to a stable or even improved access to refinancing for MFIs subsequently aimed at conserving or increasing employment and income.

Target group: The immediate target group are MFIs. Indirectly it includes micro and small businesses of all sectors.

Overall rating: 2 (Phase I), 2 (Phase II)

Rationale: As the impact of the global financial crisis on the microfinance sector was smaller and more short-lived than predicted, MEF was unable to fulfil its initial, emergency-focused role to a fully satisfactory degree. Only the swift commitment of first-loss funds (EUR 3 million) by the Austrian Republic enabled MEF´s operational start as early as mid-2009, although with limited volumes. Broadening the mission of the fund as a complementary provider of refinancing to the microfinance industry appears to be a promising way to turn MEF into a successful instrument.



Highlights: MEF´s innovative concept of using 'competing' commercial fund managers who invest private funds while also investing MEF´s predominantly public and generally more expensive funds (MEF aims to charge rates above market level for its funds) appears to be a successful mechanism to prevent crowding-out of private investments and be truly complementary in the microfinance market. Still, the mechanism seems to have some sharpening potential as up to now it is applied case by case and not truly identical for all participating investment managers. Further, there are still open questions about how emergency lending and lending in non-crisis times can be combined under one umbrella without trade-offs.

Rating according to DAC criteria

Overall rating: 2 (phase 1), 2 (phase 2)

Overall context

The Microfinance Enhancement Facility (MEF) was launched in the midst of the last global financial crisis 2008/2009, under the leadership of KfW and IFC, as a supra-regional financing facility to support micro-finance institutions (MFI) which - due to the global financial crisis and through no fault of their own - were facing difficulties in securing financing. Against the background of the global financial crisis, it was feared that refinancing problems and resulting liquidity gaps would lead to long-term damage to the microfinance structures of developing and transition countries, and subsequently to their economic development. MEF was created to counteract such adverse effects.

About ten months after the original decision to create MEF, in mid-2009 the preconditions for first disbursements were in place thanks to the first USD 4.2 million contribution to the MEF equity tranche (=C-shares) by the Republic of Austria (administered in fiduciary trust by Oesterreichische Entwicklungsbank OeEB). The German Financial Corporation (FC) investment in C-shares (BMZ No. 2009 36 575) was completed about half a year later in December 2009, at a time when the first crisis shock wave, hitting foremost the financial sector while affecting the real economy to a much lesser extent, was already over. These developments led the MEF to assume a somewhat broader role than originally envisaged, namely as a facility providing long-term stability to the microfinance market, including the supply of complementary finance over the business cycle to sustainable financial institutions. The resulting construction is a facility with a dual mode of operation:

1. The first mode is a ‘crisis mode’, corresponding to the fundamental mission of the MEF as provider of liquidity to the microfinance market in times of crisis. The facility is supposed to provide liquidity to eligible institutions in times of need arising from exogenous (local, regional or global) shocks or crises. The paramount objective of the MEF in the crisis mode is to preserve important channels of finance.
2. During ‘normal’ times, on the other hand, the objective of the MEF is to operate as an efficient debt fund complementing other sources of finance for eligible MFIs (‘normal mode’ of operation). In this way, the MEF is supposed to ensure its own financial sustainability while at the same time keeping up the emergency liquidity cushion that is needed for its primary role as liquidity backstop for the micro-finance industry.

The distinction between these two modes of operation in this document serves the purposes of the evaluation, but is not part of MEF's official mission statement. Arguably, a clearer distinction between the two fields of activities may contribute to enhancing MEF's profile. As MEF's operations in the 'crisis mode' may be limited to a specific region while operations in other regions may pertain to the 'normal mode', the fund may operate in both modes simultaneously.

Breakdown of total German FC funding

At the time of MEF´s inception, the share of the German FC included 25 million EUR in C-shares (first-loss-piece), which at the time represented 11 % of the total fund volume. At the end of 2011, the FC engagement was increased by an additional 20 million EUR, also in C-Shares. These two investments are the evaluation´s primary focus.

Currently, after several increases of its investment, FC´s investments in MEF C-shares amount to 83 million EUR in the first quarter of 2016.

In addition, KfW as well as OeEB and other DFIs have committed own funds as B-shares (mezzanine tranche).

Relevance

In order to evaluate MEF's relevance, it seems necessary to consider the two modes described above (crisis mode/normal mode) separately.

Crisis mode

Mainly in late 2008 and early 2009, several microfinance institutions, e.g. in Eastern Europe and Latin America, were facing liquidity problems and turned to Development Finance Institutions (DFIs) for help. The underlying dangers the microfinance industry was presumably facing were a withdrawal of commercial funding and a run on MFIs by their depositors. At the time of project appraisal, it was estimated that both sources of funding combined represented about half of MFIs' funding on average.

As it turned out, the liquidity shortage was much less severe than expected and assets in the microfinance industry even continued to grow between 2008 and 2010[1]. This does not automatically mean that MEF was founded on false premises, all the more as MFIs grew at a much slower rate than in the preceding years. An aspect that needs attention is whether this observed slow-down in MFI asset growth during the crisis was due to reduced funding possibilities (which would then justify an intervention such as the MEF) or due to reduced demand from MFIs because they had to cut back their lending operations when the economic crisis hit their SME clients.

Several studies conclude that the liquidity crunch only partially materialized, and that funding available to MFIs, e.g. via Microfinance Investment Vehicles (MIV) exceeded demand from MFIs. Even during the most difficult times of the crisis, the microfinance industry still was able to attract more than USD 1 billion of new funds, a considerable fraction of which remained with the MIVs for lack of sufficient investment opportunities.[2] However, an econometric study by Berg and Kirschenmann (2015) comes to slightly different conclusions. They analyse the demand and supply effects on bank lending to SMEs at a specific MFI in Azerbaijan during the 2008/2009 crisis. The study shows that the MFI reduced lending to all types of borrowers during a short period of funding difficulties (supply effect), whereas it tightened lending standards for the larger and thus more risky borrowers during the economic crisis which followed the financial crisis (demand effect). There are also some indications that during the crisis, MFIs slowed down growth to build liquidity buffers[3]. Nevertheless, the general perception seems to be that the global economic crisis causing a decline in remittances, a deterioration of trade balances and the reduced ability of borrowers to service their debt left more important traces on the microfinance sector than reduced funding possibilities for some MFIs as a consequence of the financial crisis[4].

This does not automatically translate into a rating of low relevance for the MEF, however, as these are ex-post observations and the observation of limited liquidity gaps could have been actually caused by a crisis-mitigating signalling effect of the MEF initiative. Ex-ante, a liquidity crisis seemed a plausible development, all the more as some MFIs had already asked for support. It should be noted, however, that - last not least due to the generally short loan maturities - liquidity risks are generally smaller for MFIs than for commercial banks outside the microfinance segment.[5]

Nevertheless, the recent crisis situations in CIS countries (2016) and especially Cambodia (2013) illustrated that there is a demand for the services of an instrument like the MEF, not only in the context of global, but also of such regional crises.

Taking as given that liquidity risks as accompanying effects of a crisis cannot be ruled out in the microfinance sector, the question remains whether the chosen institutional structure, an emergency fund with an own legal personality, was an adequate choice. An alternative to MEF's fund structure might have been setting up a standby-facility, committing several DFIs to provide liquidity to the MFIs in times of need without the burden of a fund's cost structure - even though this approach probably would have faced serious implementation problems. MEF's approach, on the other hand, provided advantages - e.g. in the regional crisis in Cambodia mentioned above - in terms of speed, scale and outreach, and certainly it has

[1] 2008: 1 %, 2009: 16 %, 2010: 5 % (Source: MicroRate 2011)

[2] MicroRate, 2010

[3] IFC, 2014

[4] Luetzenkirchen and Weistroffer (DB Research, 2012)

[5] Gietzen, Thomas (2015).

the advantage of having a risk buffer in form of a grant-financed first loss piece. Furthermore, potential coordination problems between DFIs - also due to differences in their respective roles and interests, like it became apparent in the CIS crisis 2016 - might go along with more informal standby-facilities. Such problems will have been solved once a fund with its own governance structure has been successfully set up.

Normal mode

The availability of funding for MFIs also affects the relevance of MEF's operations in 'normal mode'. Indeed, it would be difficult to describe the benefit of yet another fund in a market where numerous funds specialised on offering refinancing for MFIs are already in place. Fortunately, MEF can offer a unique feature also in its normal mode of operation: MEF's innovative mechanism of granting loans through (currently three) private Investment Managers (IMs), in contrast to the usual setup of putting a single investment manager in charge of the fund's investment process, requiring this IM to concentrate on the outlay of the MEF funds.

The setup and terms of MEF funding together with the incentives for the IMs may very well lead to a more focused complementing of private through public or semi-public funding: MEF loans are intended as a complement to available private funding, provided by the IMs themselves or through other sources. In order to achieve this, it is MEF´s strategy to define loan terms slightly above market conditions. To this end, IMs have to comply with a minimum spread above a market reference rate, this spread being defined by the MEF board[6]. Also, the IM´s remuneration scheme provides an incentive for using MEF funds rather as a complement, as the MEF IM-remuneration is well below the usual magnitude for investing IM's private funds and it rises with higher spreads. Furthermore, it is a common practice to ask for competing pricing quotes from more than one IM before a decision for MEF funds is taken. Reporting duties of IMs towards MEF's Investment Committee (IC) and the MEF board might form an additional barrier against falling back on MEF funds before exploring other private sources.

Therefore, IMs have a strong incentive to use primarily their own funds for investment opportunities in MFIs, but at the same time they have the possibility to complement these with MEF's funds. Furthermore, this rather unique design which enables MEF to work with several IMs at the same time provides the MEF with a global outreach that is difficult to replicate. These and other characteristics (pricing above market, positioning as a provider of complimentary funding as opposed to competing with other MIVs, mandatory liquidity cushion to ensure liquidity backstop function, less rigid diversification criteria, and its global outreach) distinguish the MEF from other private-public funds (such as EFSE, MIFA, REGMIFA and SANAD).

What also seems worth mentioning is that MEF provides an informal way for participating DFIs to coordinate or at least discuss their respective efforts in the microfinance sector. Therefore, it seems adequate to rate the relevance of MEF as good.

Relevance rating: 2 (both phases)

Effectiveness

The indicators defined at the time of project appraisal are standard indicators for microfinance-related refinancing projects that do not seem to adequately reflect MEF's very specific goals. Therefore, for the purposes of this evaluation, and specifically for the assessment of its **emergency mode**, four new indicators are introduced. Due to the fact that the fund has been operating mostly in its normal mode, the assessment of these indicators remains largely hypothetical, except for operations during the crisis situations in Cambodia (2013) and CIS (2016).

(1) Speed (i.e. the time it takes for the MEF to respond to requests for emergency funding); in practice, the MEF is seen to have been reasonably successful in overcoming initial teething issues (related to the complexity of having three as opposed to one IM) to ensure that it can respond rapidly to crisis situations. Speed of disbursement is a key factor in this regard[7]. Beside these positive developments it should not be

[6] e.g. for 2015, the minimum spread (over 6 month US Libor) was 450 bps.

[7] According to the MEF, this indicator is an impressive 1.6 months (especially compared to DFI lead times) (Source: MEF Feedback on

forgotten, however, that the fund's set-up came too late for its service as a liquidity backstop during the global financial crisis of 2008/09. As a result of a survey among MFIs, 80 % of MFIs were satisfied with MEF´s disbursement speed in comparison to other funds. Also, MEF´s activities in the CIS and Cambodia crises (during the latter in 2013 the number of loan approvals doubled) demonstrate its ability to react quickly. A precondition for this were frequent meetings of the decision-making bodies[8].

(2) Firepower (i.e. the availability of sufficient liquidity at all times to respond to crises in a timely manner); While some level of firepower has been there most of the time, there has apparently been at least one occasion when the liquidity reserves of the MEF have been allowed to dwindle below what the Board considered to be a desirable liquidity cushion, i.e. EUR 30 million. Furthermore, one must question whether this was a sufficient buffer for a facility whose main mission is to serve as a liquidity backstop to the microfinance industry. The Board seemed to share our view that a higher liquidity buffer is necessary as MEF increased its liquidity significantly in the past years. While in 12/2013 MEF`s cash position amounted to USD 51 million, it increased to USD 115 million in 12/2015 and to an even higher level of USD 152 million in 06/2016. Last but not least, the DFIs backing the fund can enhance the available amount of funds within 15 days (or even less using the custodian bank overdraft and EFSE liquidity facility of USD 30 million each) with significant volumes in times of need. Even if it is not quite clear how far liquidity is allowed to drop if demand for MEF's funds in 'normal mode' picks up significantly, the current liquidity level is deemed sufficient to ensure effective operations at least in the scope of regional crises. As a rule, firepower is limited in the sense that there is a trade-off between the size of the liquidity cushion and the fund's ability to gain income. Unused liquidity reduces the fund´s profitability, and thus its attractiveness for current or potential shareholders. The current trade-off seems well-balanced.

(3) Flexibility (i.e. the ability and willingness to sidestep ordinary risk management criteria - such as diversification - in order to act decisively at times of need); some decisions made by the Investment Committee were criticized by IMs, who have suggested that the MEF has not been sufficiently flexible in the fulfilment of its liquidity mandate on certain occasions, even acting more conservatively than other funds managed by the same IMs. MEF Board and IC members, on the other hand, have explained that other reasons lay behind the decisions of the IC on most (if not all) of the instances mentioned by the IMs9. That MEF's organizational set-up does allow for sufficient flexibility if the necessity arises has been demonstrated during the CIS crisis of 2016 when MEF provided funds to a globally operating MFI network after it had been hard-hit by effects of this crisis.

(4) Accuracy (i.e. the ability to identify MFIs with problems limited to their liquidity and to distinguish them from MFIs with deeper-rooted, structural problems); a full due-diligence is executed for every MFI that is being considered for an investment by MEF. Still, the distinction between those MFIs facing a simple liquidity shortage and those confronted with problems of a more structural nature can be very difficult. This task is made somewhat easier by the fact that the IC monitors MFI clients (via the three IMs) on a continuous basis. Good portfolio quality suggests that investments in MFIs with solvency problems have been happening, if at all, on a very small scale (impairment rate < 1%). However, due to the limited borrowing in emergency mode, this indicator is extremely difficult to assess in a meaningful way. During the 2016 CIS crisis, MEF took a differentiated approach, after assessing whether the problems of the respective MFI were liquidity-based or indicated deeper structural deficits. It is yet too early to judge whether these assessments were accurate or not. However, in the earlier crisis in Cambodia (2013), 8 institutions were provided with liquidity during a problematic situation that MEF perceived as primarily liquidity-induced. None of these exposures have resulted in defaults, speaking in favour of MEF's accuracy regarding these decisions.

Two more indicators are introduced for MEFs operations within its **normal mode**. These should aim at refinancing MFIs in a way that meets the following criteria:

(5) Additionality, that is striving to provide funding that is additional to other sources of funding, public or private, available to MFIs. Although - in absence of a counterfactual - no definite proof can be given as to the extent of the additionality of the funding disbursed to MFIs, the modalities of MEF's investment alloca-

Evaluation Questionnaire, dated 2nd November 2015).

[8] At the onset of the CIS crisis (2016), the Investment Committee met 14 times within 6 months.

[9] In some cases, prior knowledge of imminent investments of DFIs could lead to a negative decision by the IC, opting to save MEF´s firepower for other MFIs. This of course may lead to conflicts of interest with the IM.

tion give a strong indication that these funds probably are, in most instances, indeed additional. Especially the lending terms, which are designed to be less attractive than comparable offers and thus above-market, should point MFIs first towards other sources of financing and rely on MEF funds only as a last resort.[10] Moreover, the relatively meagre management fees (1% fixed plus up to 0.3% incentive) motivate the IM to offer MEF funding to their clients only if no other sources of funds are available. It has to be noted that this principle is not valid for one of the three IMs, as its other funds have closed since the inception of MEF. Therefore, the additionality logic does not stand up in this case. Currently, investments brought in by this IM represent about one third of MEF's total portfolio. However, MEF has recently selected a fourth investment manager with significant other funds under management, which might gradually replace one of the three existing IMs.

(6) Cost coverage: MEF is supposed to generate sufficient income to cover its total costs, sustaining its role as liquidity backstop in emergency mode. To achieve cost coverage, there needs to be sufficient demand - in spite of the disadvantageous conditions for MFIs and IMs mentioned above. This is clearly the case. MEF's investment portfolio has grown strongly since its set-up to a total volume of USD 590 million as per 09/2015. In combination with the aforementioned relatively expensive lending terms and a lean cost structure, also due to the low management fees for the IM, MEF has been profitable since its second year of operations.

Judging by these new indicators defined to reflect MEF's specific mission, the targets have been met, though for some of the more qualitative indicators (e.g. indicators 4 or 5) no clear target level can be defined or measured. However, even for these, targets have been reached in all likeliness to a sufficient degree.

Although MEF's unique setup of going through three private IMs for deal generation and portfolio maintenance produces clear benefits, it also carries potential for negative influence on MEF's effectiveness, namely the problems of adverse selection and moral hazard. Since MEF funding is more expensive than market funding, the so-called lemons’ problem would mean that the riskiest MFIs request MEF funding, i.e. exactly those institutions that for a good reason would not receive any market funding. Is it likely that MEF is affected by this unwanted selection bias?

In a crisis, MEF is actually designed to select the fund recipients "in trouble" because it is by definition a facility that aims to help MFIs that have difficulties in finding market funding due to the crisis. To rule out any misunderstandings: Even in crisis times, MEF is not supposed to finance MFIs with solvency problems. MEF's liquidity rather is supposed to bridge short term liquidity gaps in order to save otherwise sound MFIs. Unfortunately, in reality it is not easy to distinguish between liquidity problems caused by external shocks and more serious problems.

In normal times, given that MEF's loans are based on strict lending standards and each investment must be agreed upon not only by the IM but also by MEF's Investment Committee (IC), the risk of unnoticed adverse selection is highly unlikely. Nevertheless, it should be noted that high lending volumes of expensive loans are usually not granted to the 'prime quality' MFIs exclusively.

The moral hazard problem that might arise in allocating MEF money to MFIs is that the IM have an incentive to provide money to such MFIs that previously received money through their Microfinance Investment Vehicles (MIVs) and are now - whether caused by a crisis or any other influence on business performance - in a state that threatens the repayment of the previously lent money. In this situation the IMs would have an incentive to "throw good money after bad" to prevent a default and write-down of some of their investments. The two-stage decision process of the MEF allocation mechanism is intended to prevent such moral hazard issues because the IMs do the screening and monitoring of the investments but the actual decision-making lies with the IC. However, DFIs and private funds are largely invested in the same institutions, which reduces the control function of the two layers. Indeed, a possible motivation of both the DFIs and the investment managers could be to "rescue" their investments in institutions that are facing problems during the crisis.

---

[10] A survey among a small sample of MFIs that have made use of MEF funding seems to confirm higher-than-average interest rates, since more than half of the MFIs judged MFIs pricing as being expensive/above market. Only one MFI described the interest rates as attractive, while many MFIs suggested lower interest rates in order to improve MEF´s offer.

Still, judging by MEF's good portfolio quality, no negative consequences seem to have arisen from potential moral hazard and adverse selection problems.

As documented, MEF became operational too late to provide liquidity support to the microfinance market at the time of its greatest need. The key lesson learned in the process is that if the intention of the DFIs is to have a crisis-response instrument at their disposal, it needs to be in place before the onset of the crisis. Thus, such an instrument needs to act as a permanent facility, as the MEF does today. Despite of its 'non-performance' in 2008/09 the effectiveness of both FC investments into the equity tranche under evaluation here are rated as good due to MEF's potential for speedy disbursement in future crises and its innovate mechanism to provide finance in normal mode.

Effectiveness rating: 2 (both phases)

Efficiency

The particular structure of the MEF has proven to be surprisingly efficient, most likely because the effect of utilising the existing capacities of established IMs for deal generation and portfolio maintenance outweighs the extra costs of their coordination. By leveraging the infrastructure and networks of existing IMs, the founders of the MEF have come up with a highly efficient solution to the problem they were facing at the time (time to market), while also developing an attractive fund concept for the longer term.

This reflects in MEFs lean cost structure. The scale afforded by the level of the MEF’s operations, combined with the competitive management fees, resulted in a total expense ratio (TER) of only 1.48 % in 2015. This compares favourably with an average TER ratio of 3.1 % (simple average) or 2.3 % (weighted average) for 46 MIVs analysed in the Symbiotics 2016 MIV survey (using 2015 data). The equivalent TER benchmarks covering only fixed income MIVs (29 of 55) were 2.8 % (simple average) and 2.3 % (weighted average).

Its lean cost structure and conservative pricing ensured that the MEF reached profitability already in the second year of operations[11]. Competitive returns have since allowed the MEF to place USD 111 million (currently representing 16 % of total assets of USD 695 million) in senior (N) notes with private investors.

While MEF’s policy of pricing slightly above market conditions aims to avoid crowding out of private sector funding (and to direct MEF funds to those MFIs that have no alternative sources of comparable funding), it also boosts the fund’s profitability – thus enhancing the MEF’s ability to leverage public funds through private investment. Although the innovative MEF mechanism to ensure complementarity is not perfect for several reasons (competitive pricing quotes are no obligation, there is no obligation for IMs to bind themselves by investing own funds, all the more as one IM has no private funds to invest) it can be seen as very promising, even if further sharpening of the incentive instruments is desirable.

It should be pointed out, however, that MEF’s pricing policy has led to a deviation from the facility’s original strategy of targeting only systemically important MFIs. Since these larger MFIs typically have access to cheaper, commercial funding, this has meant an expansion of the fund’s outreach to cater for sustainable tier 2 MFIs. These account for no more than 12.5 % of MEF´s loan volume, however. At the same time, systemically important MFIs (and banks playing a major role in local markets micro and SME finance markets) continue to be interested in becoming clients of the MEF, with a view to establishing a relationship with the MEF and thus having easier access to emergency liquidity funding if needed in the future. During its ‘normal mode’ of operation (i.e. when providing complementary finance to client MFIs), the MEF is effectively ‘qualifying’ MFIs through its initial, extensive due diligence and subsequent, on-going monitoring for easy and rapid supply of emergency funding in times of crisis. Although this does not figure as a part of the formal modus operandi of the fund, the risk assessment processes implemented by the MEF Board and IC essentially lead to this type of qualification. At least one IM indicated that it encourages client MFIs to take even relatively small loans from the MEF in order to establish a working relationship, thus ensuring that in times of crisis it no longer has to undergo the initial, extensive due diligence process but only the much faster due diligence update, thus being in a position to access emergency funds in a timely manner. This demonstrates how the two different modes of operation interact to create synergies between each other.

---

[11] Source: 2014 KfW Project Report.

Although the original mission as defined in the programme appraisal report was broader - stabilizing the funding supply to MFIs - it could be argued that MEF should focus its limited liquidity means on the systemically relevant MFIs when acting as an **emergency** lender. Does this provide any reason to limit MEFs activities to these tier 1 MFIs when operating in its **normal mode**? Frankly, such a restriction on prime MFI customers does not seem feasible without abandoning the unique approach specific to MEF, for potential lack of interested borrowers to the above-market conditions during its normal mode. In this constellation, it could be argued that larger tier 1 MFIs benefit in times of crisis from the high interest rates paid by smaller tier 2 MFIs in normal times. But that argument seems to be more philosophical than practical, since there obviously was demand for the funding provided to tier 2 MFIs, and no more advantageous funding solution was available to them. From another perspective, however, there might be reason to argue that MEF should only serve those MFIs in its normal mode that it is ready to support in a crisis as well. There are very few MFIs in the world that are of systemic importance for the financial market they operate in. Therefore, being of systemic importance for the microfinance segment does not equate to carrying systemic risk for the financial market, e.g. for being 'too big to fail'. In fact, systemic risk in microfinance has a lot to do with reputational risk. Flagship MFIs failing or DFI's withdrawing support might ruin the reputation of microfinance in general and lead other investors to turn their back as well. Against this background, it cannot be ruled out that MEF is creating a new source of reputational risk by serving MFIs that had no relation to DFI before. Withholding support during times of crisis from some MFIs which have been served under the normal mode might trigger exactly those adverse reactions that MEF was set up to prevent.

Overall, MEF and its specific allocation mechanism seem to be a reasonably fast, cost-effective and practical way to provide public as well as private funding to MFIs, to a large degree through its combination of crisis mode and normal mode of operation. Therefore, efficiency for both phases is rated as good.

Efficiency rating: 2 (both phases)

Impact

In terms of asset volume, MEF´s impact largely can be attributed to its **normal mode** of operation. The fund grew strongly from 2011 to 2015, from around USD 130 million in total assets and USD 100 million in total loan portfolio at the beginning of 2011, to around USD 700 million and USD 560 million respectively by the end of 2015, when the portfolio consisted of 203 loans distributed across 95 FIs and 36 countries. Cumulative disbursements amounted to over USD 1.14 billion (almost 380 loans in 41 countries) by the end of 2015, benefiting some 585,000 end-borrowers (of whom 56 % women) with an average loan balance of just under USD 3,200. 71 % of end-loans disbursed are reported as disbursed to businesses (i.e. for ‘productive purposes’), with the balance financing mortgages (4 %), consumption (16 %) and other purposes (9 %). Figures indicating that the bulk of lending by client MFIs is to businesses suggest that MEF funding probably has contributed to the preservation and creation of employment and income. Nevertheless, all these achievements have little to do with the original purpose of MEF. On the contrary, MEF's growth which goes along with serving more tier 2 MFIs might prove to be counterproductive to its mission as a crisis facility because these MFIs cannot be denied support in times of crisis without causing reputational damage to the sector.

Although MEF became operational when the global financial crisis of 2008/09 was almost over or rather had already turned into an economic crisis, MEF has almost certainly contributed to the stabilisation of the microfinance industry during the global financial crisis nevertheless. The signalling effect that major DFIs sent to the market in early 2009 by acting quickly and decisively to establish the fund (as a conduit for providing emergency liquidity to the microfinance market) most likely was far more significant than the single cases that MEF was able to provide liquidity when the crisis was already wearing off. By announcing their intention to found MEF, the DFIs arguably were able to reassure microfinance vehicles and investors alike that support would be forthcoming when needed, thus averting a run on the microfinance vehicles on the part of investors and convincing microfinance investment vehicles (and other investors) to maintain their exposure to the most important financial institutions in the microfinance industry. During 2013 and 2016, MEF operated within its crisis mode in selected regions, serving MFIs in Cambodia and the CIS countries.

Overall, considering its crucial signal to the market at the time of its inception and its role as liquidity backstop for future crises and past regional crises (**crisis mode**) as well as its contribution to piloting innovative allocation mechanisms helping to define the complementary roles of private and public funds and avoiding crowding out, impact is rated as good for the initial FC contribution as well as for the additional tranche.

Impact rating: 2 (both phases)

Sustainability

By design, MEF´s own sustainability relies on its activities in **normal mode** as well as its governance structure**,** while its **emergency mode** aims at improving the sustainability of the MFI sector. The profitability of the fund as well as the good quality of underlying MFI portfolios reflects the sustainability of MEF as an instrument. From today's perspective, the fund is well-positioned to continue serving its original mission, while also complementing other funding instruments available to financial institutions operating in the microfinance market. It is advised, however, that MEF's policy towards tier 2 MFIs in 'normal' and in 'crisis mode' is further clarified. Closely connected to this are the questions of 1) how the mechanism to assure complementarity of MEF funds while avoiding moral hazard and adverse selection could be sharpened (for example: Should the simultaneous investment of IM´s own funds be an obligation in 'normal' mode? Should asking for pricing from several private sources be made an obligation?) and 2) whether a policy of growth is adequate for such an emergency vehicle as the MEF, its current size being sufficient to allow for a financially sustainable operation.

Although their regional scope was limited, the crises in Cambodia and the CIS region were (and are) an important 'stress test' of the MEF's investment approach and its ability to react effectively to liquidity shortages. MEF's performance was particularly convincing in its support for Cambodian MFIs in need of liquidity. The deteriorating situation in the CIS countries, in and in Azerbaijan in particular, still poses a challenge to MEF. It remains to be seen whether MEF has to suffer severe losses for the first time, even if these can be compensated by former profits. Either way, it should be kept in mind that it is necessary to take this kind of risk if MEF is to fulfil its original mission.

Crucially, from a sustainability perspective, the MEF benefits from a strong governance structure. This is based on a Board of Directors with strong representation by DFIs backing the fund, an IC formed by three experienced experts, and three IM with a longstanding track record and strong credentials in the microfinance investment market.

Significantly, the establishment of the MEF has had and is likely to have a positive impact on the sustainability of the MFIs and their ability to withstand ongoing and future crises, as it has been the case for Cambodian MFIs in 2013. In view of its liquidity reserves and its likely access to supplementary funding (via the MEF or directly to MFIs) from stakeholder DFIs in times of crisis, the MEF has a continuous stabilising effect on the operation of the microfinance industry. In this sense (and as almost certainly was the case when the MEF was formally announced by the founding DFIs), DFIs are sending a powerful signal to the microfinance industry at large that they are at hand and ready to support the sector with the required liquidity.

Last but not least, it should be emphasised that the MEF depends on the on-going commitment of public sector funders and DFIs in the junior tranches of the MEF structure. The MEF's attractiveness to other investors (e.g. private investors in senior notes) is based fundamentally on the premise that public sector funders assume those risks that the private sector is unwilling to take on (at least at a price that allows for the provision of sustainable funding to MFIs and, subsequently, to target MSME end borrowers).

Sustainability rating: 2 (both phases)

Notes on the methods used to evaluate project success (project rating)

Projects (and programmes) are evaluated on a six-point scale, the criteria being **relevance, effectiveness, efficiency** and **overarching developmental impact**. The ratings are also used to arrive at a **final assessment** of a project's overall developmental efficacy. The scale is as follows:

Level 1	Very good result that clearly exceeds expectations
Level 2	Good result, fully in line with expectations and without any significant shortcomings
Level 3	Satisfactory result – project falls short of expectations but the positive results dominate
Level 4	Unsatisfactory result – significantly below expectations, with negative results dominating despite discernible positive results
Level 5	Clearly inadequate result – despite some positive partial results, the negative results clearly dominate
Level 6	The project has no impact or the situation has actually deteriorated

Rating levels 1-3 denote a positive assessment or successful project while rating levels 4-6 denote a negative assessment.

Sustainability is evaluated according to the following four-point scale:

Sustainability level 1 (very good sustainability): The developmental efficacy of the project (positive to date) is very likely to continue undiminished or even increase.

Sustainability level 2 (good sustainability): The developmental efficacy of the project (positive to date) is very likely to decline only minimally but remain positive overall. (This is what can normally be expected).

Sustainability level 3 (satisfactory sustainability): The developmental efficacy of the project (positive to date) is very likely to decline significantly but remain positive overall. This rating is also assigned if the sustainability of a project is considered inadequate up to the time of the ex post evaluation but is very likely to evolve positively so that the project will ultimately achieve positive developmental efficacy.

Sustainability level 4 (inadequate sustainability): The developmental efficacy of the project is inadequate up to the time of the ex post evaluation and is very unlikely to improve. This rating is also assigned if the sustainability that has been positively evaluated to date is very likely to deteriorate severely and no longer meet the level 3 criteria.

The **overall rating** on the six-point scale is compiled from a weighting of all five individual criteria as appropriate to the project in question. Rating levels 1-3 of the overall rating denote a "successful" project while rating levels 4-6 denote an "unsuccessful" project. It should be noted that a project can generally be considered developmentally "successful" only if the achievement of the project objective ("effectiveness"), the impact on the overall objective ("overarching developmental impact") and the sustainability are rated at least "satisfactory" (level 3).