# Ex post evaluation – India

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**Sector:** 24030 – Formal sector financial intermediaries
**Programme/Project:** Financing and development of small and medium-sized enterprises (SIDBI IV), 2004 65 849* (Inv.) and 2005 70 515 (AM)
**Implementing agency:** Small Industries Development Bank of India (SIDBI)


## Ex post evaluation report: 2015

| | | Project (Planned) | Project (Actual) |
|---|---|---|---|
| Investment costs (total) | EUR million | 44.50 | 44.50 |
| Investment costs (BMZ/KfW funds) | EUR million | 43.50 | 43.50 |
| Personnel support | EUR million | 1.00 | 1.00 |

*) Random sample 2014

**Summary:** The FC measure comprises a reduced-interest loan amounting to the USD equivalent of EUR 43.5 million to the Small Industries Development Bank of India (SIDBI). The FC loan to promote small and medium-sized enterprises (SMEs) was disbursed by SIDBI under a direct lending framework to SMEs. An accompanying measure amounting to EUR 1.0 million was also provided from FC budget funds to provide institutional support to the SIDBI in the SME sector. This accompanying measure was not disbursed in full until January 2015 and comprised, among other things, the installation of video conferencing systems, the implementation of an impact assessment at SME level and training measures for SIDBI staff.

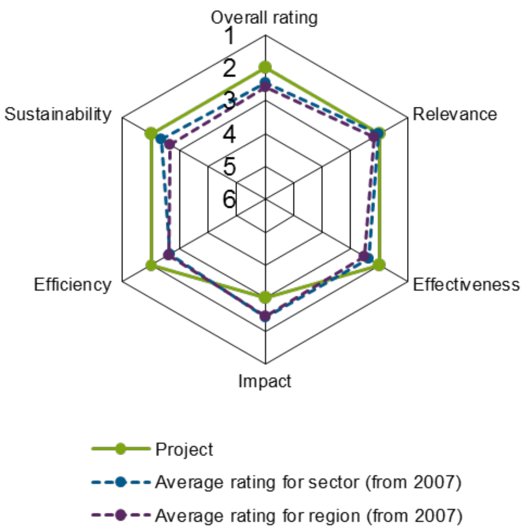
**Objectives:** The overarching development objective was to create employment and income opportunities for SMEs and their employees, thereby helping to combat poverty. The programme objective was to contribute towards better access for SMEs to appropriate investment and working capital loans and thus overcome a key obstacle to development for these businesses.

**Target group:** The target group of the project comprised (i) small and medium-sized banks, whose involvement in the SME business had previously been marginal, and (ii) competitive small and medium-sized companies in India with fixed assets required for operations totalling no more than INR 100 million (roughly EUR 1.89 million) or sales revenues of no more than INR 1 billion (roughly EUR 18.9 million).

## Overall rating: 2

**Rationale:** The project was successful in helping the SIDBI expand its direct SME business significantly, whilst also developing high quality standards and establishing them on a sustainable basis in the bank's credit approval processes. Building up a thorough knowledge base on appropriate SME funding practices enables SIDBI to tap into riskier, under-supplied SME markets, and thereby play a pioneering role in the Indian financial sector.

**Highlights:** Project-executing agency SIDBI has worked continuously since 2006 on improving the general conditions for sustainable SME financing in the Indian financial sector, e.g. by setting up the SMERA rating agency, which specialises in SME ratings. In light of the high share of public banks in the SME business (90 %), the strong focus on under-supplied niche markets and the structural improvements mentioned above, the risk of private funding being increasingly crowded out because of SIDBI's direct lending appears to be low or acceptable.



# Rating according to DAC criteria

## Overall rating: 2

The project was successful in helping the SIDBI expand its direct SME financing significantly, whilst also developing high quality standards and establishing them on a sustainable basis in the bank's credit approval processes. As a result of its pioneering role, the SIDBI was able to contribute to improving funding practices in the Indian financial sector and thus to sustainable financing in the SME sector. In particular, the structural improvements (e.g. rating agency establishment) and the exemplary role of the SIDBI - including in terms of its commitment in previously under-supplied niche markets - have mitigated the risk of crowding out private funding in an Indian SME financing sector, which is strongly influenced by public authorities.

### Relevance

At the time of the project appraisal in 2005, the SME sector in India was characterised by a lack of competitiveness, which prevented the sector from achieving sufficient economic and employment growth in India and thus from contributing to the fight against poverty. In the Indian government's five-year plan from 2003, it was noted that the SME sector would have the greatest potential to provide better-paying jobs for some of the 70 % of workers that were employed in agriculture at the time. A sharp rise in the competitiveness of SMEs in the industrial and service sectors would be necessary in order to enable the sustainable growth of the country.

The lack of competitiveness of Indian SMEs was partly due to insufficient financing owing to various factors: (a) a legal framework that made the enforceability of contractual provisions for creditors difficult; (b) institutional shortcomings, such as the lack of information systems for the credit assessment of applicants and the lack of risk management tools; (c) inaccurate risk assessments as a result of knowledge deficits in the financial sector and consequently overpriced loan offers. This has resulted in a significant undersupply of the high-growth sector. According to a study by the IFC, the financing gap for MSMEs totals over USD 400 billion[1].

In order to overcome these identified barriers, the SIDBI implemented a well-coordinated framework programme undertaken by several donors, which consisted of a variety of activities: (i) loans to support SMEs in direct business or in business conducted through banks and (ii) a technical assistance package (TA) to improve the quality of the SME credit portfolio, which focused among other things on the establishment of a credit agency, of qualified SME credit rating agencies and of internal credit rating systems for banks, as well as on offering targeted training to the employees of the SIDBI and other financial institutions.

The promotion of the SME sector remains a priority of the current Indian government, as this sector - with an annual growth rate of 10 % in 2014 - represents more than 45 % of industrial production and 40 % of exports and employs more than 100 million Indians. Despite numerous improvements, the very heterogeneous sector - composed of more than 45 million, mostly informal, SMEs - remains undersupplied by the financial sector. In 2014, only around 16-20 % of registered SMEs had access to formal sources of financing. To further narrow the current gap, the Indian government has made it obligatory for financial institutions to direct 40 % of their credit portfolios towards priority lending sectors, including agriculture, the SME sector and export-oriented industries. In addition, the Indian government has set up various support mechanisms for the further development of the SME sector.

The approach of the project being evaluated, to better satisfy the existing SME demand for financing in India and all the while maintaining a high credit portfolio quality, is assessed as relevant from today's perspective. Through a series of measures, the institutional and legal framework conditions have improved considerably. The project had a meaningful concept for supporting the SIDBI to expand its direct SME business significantly, whilst also developing high quality standards and establishing them on a sustainable basis in the bank's credit approval processes. Building up a thorough knowledge base on appropriate SME funding practices enabled the SIDBI to tap potential, even in riskier, under-supplied SME markets,

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[1] MSME Finance in India: A research study on needs, gaps, and way forward (November 2012), IFC

and thereby play a pioneering role in the Indian financial sector. The direct lending business of the governmental SIDBI, which is critical from a regulatory standpoint, must also be seen in this context.

**Relevance rating: 2**

### Effectiveness

The formulated project objective was to contribute to improving the access of SMEs to need-oriented loans and thereby improve their competitiveness. When the project was appraised, the indicators 1 to 3 listed in the following table were formulated to reflect the achievement of the project objective. In addition to this, indicators 4 and 5 were added as part of the ex post evaluation. Indicator 4 was assigned to the overarching development objective at project appraisal.

| Indicator for FC measure objective | Ex post evaluation |
| --- | --- |
| (1) After 3 years, the SIDBI's NPA rate in Apex business was less than 5 % | Achieved (2014: 1.46 %) |
| (2) After 4 years, the SIDBI's NPA rate in direct lending was less than 7 % | Achieved (2014: 3.49 %) |
| (3) Establishment of a credit rating agency and an SME credit agency after 3 years | Met (CIBIL, SMERA) |
| (4) Full disbursement within 2 years (to end borrowers) | Met |
| (5) The SIDBI's SME financing volume has continuously increased significantly | Met (quadrupled in the period 2006-2014) |

As shown above, at the project appraisal there was a lack of reliable information and rating institutions for SME financing, which in turn resulted in a high number of non-performing SME loans and thus made access for SMEs to formal sources of finance more difficult. By expanding its own direct business with SMEs with the support of the FC accompanying measure as well as through the simultaneous development of a good SME credit portfolio with low default rates, the SIDBI set important standards for sound lending processes in the SME sector, thereby acting as a catalyst for market-based SME financing in India. The indicators chosen to illustrate the quality of the SIDBI's credit portfolio, as well as the establishment of a credit rating agency and of a credit information agency, were therefore sensible. In addition, as part of the ex post evaluation, the growth rates of the SIDBI SME portfolio and of country-wide SME financing were investigated by the financial sector, as these indicators provide additional information on the extent to which better access for SMEs to need-based loans was made possible.

Following the provision of the FC loan amounting to EUR 43.5 million, corresponding funds were disbursed in direct business to 366 SMEs in 14 SIDBI branches across 10 different Indian states within one year (cf. indicator 4). The prompt disbursement of these funds can be seen as an indication of the high demand that existed for SME financing at that time.

The SIDBI's SME portfolio (in direct business and in business conducted through banks) quadrupled in the period from 2006 to 2014 from a credit amount of EUR 1.98 billion in 2006 to EUR 8.75 billion in 2014. Between 2011 and 2014, business conducted through banks grew by 40 % from EUR 5 billion to EUR 7 billion, while direct business grew by 10 % from EUR 1.55 billion to EUR 1.71 billion. Since 2008, the SIDBI has directly financed more than 46,000 SMEs from different sectors.

As shown by the project objective indicators, the percentage of defaulted loans in direct business and in indirect business conducted through banks throughout the entire period from 2006 to 2014 fell significantly below the targets of 5 % and 7 % respectively, despite significant portfolio growth. The framework programme TA package, funded by the DFID, GIZ, KfW and the World Bank, was a decisive factor in this development. In the last 3 years, the rate of defaulted loans within the SIDBI has increased, particularly in the case of direct business. This development is in part attributable to the ongoing global recession, which has also impacted on the Indian SME sector. The SIDBI holds the political mandate of extending its direct business to under-supplied SME sectors in which risk-averse financial institutions do not advance independently. Operating in these higher risk niches has also led to a higher rate of default. The SIDBI is, however, aware of this risk and limits its niche business accordingly.

Overall, given the achieved objective indicators and the strong growth of both direct business and of the SIDBI's Apex business conducted through banks, the effectiveness is rated as good.

**Effectiveness rating: 2**

### Efficiency

The loan to the agency is denominated in euros. The SIDBI grants credits to Indian SMEs exclusively in the local currency (Indian rupees). In addition to the (reduced) interest payments for the loans granted, the agency is obliged to fully hedge the exchange rate risk. Moreover, the FC development loan is secured by a guarantee from the Indian government for which the agency pays guarantee fees. At the time of disbursement, the terms of the loan were advantageous despite the hedging costs and guarantee fees in direct business. The SIDBI was able to offer SMEs loans that were roughly around 150 basis points below market conditions. In the Apex business, the SIDBI's on-lending conditions vis-à-vis local banks were not competitive, due to the fact that, at the time, financial institutions were able to refinance on the market at lower rates. The SIDBI was able to offer loan periods of 5-7 years due to longer-term funding sources, while the market norm was 3-5 years. Longer credit periods enable SMEs to carry out pro-competitive investment measures such as production expansion and product diversification.

It was established in the specific arrangements for the loan agreement that the project funds could be used for the direct financing of SMEs, but also for Apex business conducted through banks. At the time of the project appraisal, the SIDBI had an established Apex structure, by means of which loans could be transferred through the financial sector to SMEs with a high degree of efficiency. In direct business, the SIDBI had fewer established structures. As a result of the aforementioned market situation, the SIDBI used 100 % of the equivalent value of the FC funds in direct business and was thus able to gain valuable knowledge and experience in this area.

This in turn was consistent with the strategic management decision to develop a high-quality SME portfolio in direct business. In line with SIDBI demand, the FC accompanying measure amounting to EUR 1.0 million focused on supporting the SIDBI in this task through the following activities: (i) setting up of videoconferencing facilities in 15 SIDBI branches, as a result of which it was possible to half the average approval time for SME loans, (ii) subscription for conditional access to the database of the "Centre for Monitoring Indian Economy (CMIE)", which gave the SIDBI better access to SME-relevant information and sector analyses, (iii) training and educational seminars in the field of SME financing for relevant SIDBI personnel, (iv) performance of impact assessments for measuring project impact on the income and employment growth of financed SMEs and (v) 30 studies on selected SME clusters to identify barriers to development and to the development of solutions and suitable financial instruments (last disbursement in January 2015). All in all, the accompanying measure supported the SIDBI in developing essential capabilities in direct business as well as in implementing process improvements. This in turn enabled the SIDBI to continuously develop direct business while maintaining a high portfolio quality and thereby, for example, to operate counter-cyclically to the financial sector in the global crisis of 2008/09.

Since the project implementation and the accompanying measure have successfully contributed to the establishment of direct business, which is strategically important for the SIDBI, the overall efficiency of the project can be assessed as good.

**Efficiency rating: 2**

### Impact

The overarching development objective was to create employment and income opportunities for SMEs and their employees, thereby helping to combat poverty.

| Indicator | Status 2006-07 (baseline) | Status 2008 (in comparison to baseline) | Status 2010 (in comparison to baseline) | Ex post evaluation |
|---|---|---|---|---|
| (1) Increased sales at financed SMEs | Average sales of INR 80.0 million | 37 % | 60 % (INR 128.0 million) | N/A |
| (2) Increased employment at the financed SMEs (monitoring by means of impact assessment) | Average employment rate of 41 persons per SME (8 management, 19 skilled workers, 14 unskilled workers) | 5 % | 7.4 % (Average employment rate of 56 persons per SME: (8 management, 31 skilled workers, 20 unskilled workers) | N/A |
| (3) After 3 years, more than 70 % of the repayments for new SME loans are paid back | N/A | N/A | N/A | Met |

A consulting firm was commissioned to carry out an impact assessment in order to verify the achievement of the overall objective indicators in the period from 2006 to 2011. 100 of the 366 financed SMEs were selected for this purpose. The ‘actual state’ was defined before the project implementation in 2006 and this was compared with the values recorded in 2008 and 2011 respectively. The impact assessment shows that the financed SMEs generated higher average revenues and that their employment rates increased on average. The percentages vary considerably, however, depending on the geographical area, sector, size and legal form of the recipient SME. For example, while the SMEs financed in Jaipur showed average increases in sales of 113 % between 2006 and 2008, the SMEs in Faridabad only saw a 3.5 % increase in sales, while employment rates were also down in this region. Since no control group was set up, no statement can be made as to how the recipient SMEs would have developed without SIDBI refinancing.

All SMEs selected for the impact assessment were profitable companies. 97 % of the companies stated that they had had access to alternative, formal sources of financing from the financial sector, albeit at less attractive terms. Whether there was a potential crowding-out effect or to what extent alternative financing offers and their respective conditions would have contributed to the similar success of the SMEs surveyed cannot be assessed due to lack of information, especially as the reliability of the above figure of 97 % can be called into question. In any case, this potential crowding-out must be seen against the backdrop that the market share of public credit institutions in Indian SMEs is around 90 % (the potential crowding-out concerns private suppliers only to a limited degree) and the strong government influence in this sector will decline only very gradually.

In comparison to 2006, when only around 2 % of the SMEs surveyed had made investments in production expansion and/or technology improvements, in 2011 nearly 30 % of the companies surveyed had invested in these priorities. A further 17 % was invested in product diversification measures.

The SIDBI branches in Noida, Jaipur and Mumbai surveyed during the ex-post evaluation trip confirmed that the FC project-funded SMEs were selected by them following a positive credit assessment and risk analysis. Potential customers were and are subject to an on-site evaluation and pass through the SIDBI's internal credit rating system (e.g. CART) and a tiered approval process (e.g. regional or central risk committee) depending on their credit volume and previous track record. The previous track record of the entrepreneur and of the SME, as well as a sound business plan were the main criteria for the SIDBI’s final financing decision. The SIDBI branches surveyed reported that they are in strong competition with other banks for the best customers. It is likely, however, that this relates primarily to other state-owned banks.

The branches also reported that in 2006/07, the SIDBI's competitive advantage over other banks resulted from the fact that, in addition to loans with attractive terms, the SIDBI was also able to award grants to SMEs, e.g. for technology improvements. In recent years, the SIDBI has striven to strengthen its competitive advantage through customer-oriented financial products, as well as expand its financing activities to under-supplied areas in the SME sector.

The majority of SMEs surveyed in the ex-post evaluation reported that, although they would have had access to alternative sources of funding in 2006/07, they opted for a collaboration with the SIDBI as it was able to offer more attractive terms and, in most cases, also offered government grants. All SMEs surveyed took out an SIDBI loan in order to finance either technology upgrades or production expansions. The SMEs reported that revenue and the employment figures for skilled and unskilled workers increased as a result. New staff were recruited both as permanent employees and as temporary workers without social security. Temporary workers received the statutory minimum wage and made up between 30 % and 70 % of the workforce in the surveyed operations. It can be assumed that the project has had a positive impact on the revenues of and on employment growth in the recipient SMEs as a result of the disbursed loans.

Although a high number of SMEs still lack access to formal sources of financing (especially informal SMEs, SMEs with no track record, start-ups, and SMEs in the service sector without collateral security), total lending to the SME sector in India has risen significantly. The number of financed SMEs increased in the period 2008-2014 by 150 %, while the volume of all SME loans during the same period increased by 285 %. Portfolio quality improved, however: while the rate of non-performing loans at public banks (90 % share of total SME financing) was still at 16-19 % in 2005, this rate has settled in the past 3 years (2012-2014) at around 6 %. This favourable development was also positively influenced by the TA package of the framework programme: the CIBIL credit check system is actively used by the financial sector. In addition to SMERA, the rating agency founded by the SIDBI, 6 further rating agencies operate profitably on the market today. The Credit Appraisal and Rating Tool (CART) designed by the SIDBI has served many banks as a model for establishing their own credit rating systems.

On the whole, we rate the overarching developmental impact as satisfactory.

**Impact rating: 3**

## Sustainability

The SIDBI's credit and risk management processes comply with international standards, enabling the bank to work in a highly professional and profitable way.

Since the project began in 2006, the SIDBI has continuously expanded its SME portfolio, even after the FC loan was fully disbursed. In the period from 2006 to 2014, the SIDBI's balance sheet total quadrupled. At present, the SIDBI's credit portfolio is made up of 20 % direct business and 80 % Apex business. The SIDBI intends to maintain the established direct business structures and the workforce that it has built up for this purpose in the future in order to continue to diversify its portfolio risk, and to be able to achieve its political mandate of playing a pioneering role in the development of new niche markets. The SIDBI aims to significantly increase its direct business in absolute terms, and to increase the share of direct business in the overall portfolio to 25 % by 2017.

Niche products which the SIDBI is currently developing include the supply of risk capital, sustainable financing for the promotion of energy efficiency projects and cash flow-based financing of the service sector. In the future, the SIDBI also wishes to focus more on the financing of under-supplied clusters.

In the past, the SIDBI was able to expand its SME portfolio enormously, without this deteriorating credit quality. The implementation of the TA components of the framework programme played an important role in this regard. The SIDBI developed the internal credit rating system CART which, since its introduction 10 years ago, has constantly improved and adapted to new challenges and financial products.

The SIDBI actively uses the services of SMERA - a rating agency founded by the SIDBI - and of the CIBIL Credit Information Bureau. SMERA, which holds a market share of 25 %, has rated 33,000 SMEs in India since its inception. CIBIL increased its data collection from 0.67 million companies in 2006 to 8.48 million companies in 2011. CIBIL currently provides 1,197 financial institutions with all information pertaining to the financial transactions of their private or business customers. To date, this has allowed CIBIL to collect data for 20.5 million entries on commercial financial transactions and 377 million entries on private transactions.

SME financing through the formal financial sector in India also grew considerably during the period from 2006 to 2014, during which time the proportion of defaulted loans also declined. The introduction of credit rating agencies for the SME sector and the development of CIBIL have also made positive contributions in this regard. The vast majority of Indian financial institutions, for example, use CIBIL for credit checks on their customers. Furthermore, the SIDBI made its internal credit management system CART 38 available to public banks and financial institutions, which meant that the majority of these institutions developed similar systems.

The sustainability of the project can be assessed as good, because the institutional landscape developed as a result of the project and the corresponding framework programme has greatly contributed to the improvement of the SME portfolio in the Indian financial sector. In the future, the SIDBI will focus on continually improving and adapting this institutional landscape to new challenges.

**Sustainability rating: 2**

**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).