Ex post evaluation – Palestinian territories

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Sector: 24030 Formal sector financial intermediaries
Project: EPCGF Phase II - European Palestinian Credit Guarantee Fund II (BMZ No. 2010 65 093)* and Accompanying Measure (BMZ No. 2010 70 481)
Programme executing agency: Ministry of Finance

Ex post evaluation report: 2014

		Project A (Planned)	Project A (Actual)
Investment costs (total)	EUR million	26.60	2.25
Funding, thereof	EUR million		
BMZ funds		5.00	2.25
EU cofinancing		Total 21.60	
Accompanying measure	EUR million	1.73	0.25

*) Random sample 2014

Description: The European Palestinian Credit Guarantee Fund (EPCGF) project provided partial guarantees for investment and working capital loans from banks to micro, small and medium-sized enterprises (MSMEs) via a newly established credit guarantee fund (Phase I). Phase II of the EPCGF saw the expansion of the guarantee portfolio. Since then the fund also offers portfolio guarantees for microfinance portfolios (where, in contrast to individual loans, complete sub-portfolios of partner banks are guaranteed). Phase II also brought the introduction of partial guarantees for loans from local banks to microfinance institutions (MFIs). All of the guarantees secure the lender 60% of the total credit amount in the event a loan defaults.

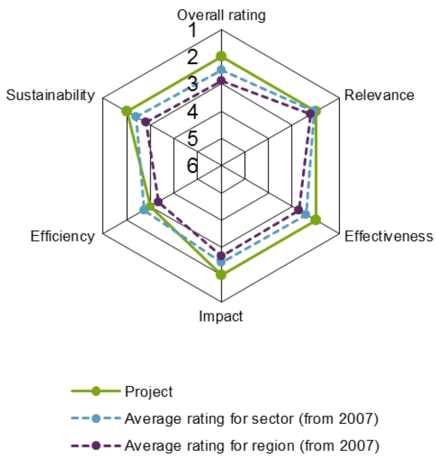
Objectives: The key objective of the FC measure was the sustainable development and expansion of the provision and use of appropriate financial services for private Palestinian MSMEs. To this end, the liquidity in the local banking sector was to be made permanently available for sustainable MSME financing and for funding MFIs.

Target group: The direct target group of the project were formal financial sector intermediaries (banks and MFIs). Palestinian MSMEs were to profit indirectly from the increased lending by the financial institutions.

Overall rating: 2

Rationale: The project succeeded in setting up a professional and sustainable fund to support MSMEs. In spite of shortcomings with expanding the range of products, the fund does mobilise additional MSME funding in the Palestinian territories with its guarantees, without running any excessive risk.

Highlights: An impact assessment on the MSME credit guarantees carried out by the FC evaluation department showed that the guarantees for loans to MSMEs has triggered additional lending. The study also revealed that as a general rule the guarantees are not a complete substitute for collateral raised by the MSMEs. Rather, the guarantees should be used to complement existing collateral.



Rating according to DAC criteria

Overall rating: 2

General conditions and classification of the programme

The European Palestinian Credit Guarantee Fund (EPCGF) is now, in 2014, in its third phase. The main product of the fund is partial guarantees (60 %) to commercial banks for lending to micro, small and medium-sized enterprises (MSMEs), which are refunded to the commercial bank in the event a loan defaults. In Phase II of the project to be evaluated, the product range was extended to include guarantees for refinancing lines to microfinance institutions (MFIs) from local banks, and portfolio guarantees for micro-loans from banks, where parts of a whole portfolio instead of individual loans are guaranteed. Ultimately, a strict division in the evaluation of the individual phases is not feasible and does not make sense due to the uniform provision of the fund with resources from all phases. The evaluation therefore concerns all products of the fund on offer, but with a focus on the guarantee products newly introduced in Phase II.

Relevance

Official statistics estimate that around 130,000 enterprises exist in the Palestinian territories (two thirds in the West Bank and one third in Gaza). Due to the lack of large enterprises in the Palestinian territories, MSMEs (in this instance companies with less than 20 employees) have been and are the key drivers of economic development. By regional comparison it is clear that at the beginning of the project in 2006 (Phase I) local MSMEs relied less on bank loans than MSMEs in other countries of the Middle East and North African region. The results of the enterprise surveys undertaken by the World Bank Group in 2006 indicate that although a large share of the MSMEs (>85 %) already maintain a savings or transaction account at a bank, the share of MSMEs already using a bank loan at the start of the project was just approximately 10 %. Around half of all MSMEs state that they do not require a bank loan. Despite this, at the start of the project there was a sufficiently large number of MSMEs with additional and previously unmet financial needs. In addition, a positive impact on the formalisation of the sector was to be anticipated from the intensified use of bank loans. The provision of bank loans varied significantly between the West Bank and the under-served Gaza Strip. The special demand for funding in the Gaza Strip was pointed out at the beginning of the project.

At the start of the project's second phase in 2011, the banking sector consisted of 18 commercial banks (8 local and 2 foreign banks and 8 branches of Jordanian banks) and the sector had been in a period of constant growth since 2006. The aggregated balance sheet of the banking sector in the years before 2011 was highly liquid – primarily due to constantly growing customer deposits without a corresponding increase in bank lending – indicating a blocked credit channel between the banks and the MSMEs. The original focus of the fund, which was to mobilise existing liquidity in the banking sector with guarantees for bank lending, is consequently considered relevant. At the time of the project appraisal for Phase I, there was no supplier of comparable credit guarantee products in the Palestinian territories. This also applies if guarantees are not granted for individual loans, but rather for sections of microfinance portfolios as part of the downscaling activities of banks (from Phase II onwards), in which an individual appraisal would not be efficient.

As part of Phase II, another product was introduced to secure refinancing loans from local banks to MFIs. The support of the microfinance sector in the Palestinian territories was justified through the other focus of the institutions (smaller loans), but also through the greater penetration in the Gaza Strip (cf. also Effectiveness). It is not clear, however, if a lack of liquidity in the microfinance sector at the time of the project appraisal constituted an obstacle for bank lending. Guarantees for refinancing lines are a tool aimed at generating liquidity within the MFIs. The mere fact that MFIs, which may not accept deposits, rely on other methods of refinancing does not sufficiently explain the provision of additional liquidity. The refinancing options of MFIs in the Palestinian territories were favourable due to soft loans from international donors anyways. Even though the local banking market was highly liquid at the same time, it could not be assumed that the existing refinancing by the international donor community would be replaced by commercial loans from commercial banks.

We rate the relevance of credit guarantee products for mobilising existing liquidity in the banking sector (both individual credit guarantees and portfolio guarantees from Phase II) as very good. With regard to the refinancing guarantees newly introduced in Phase II, a lack of liquidity in the MFI sector was not apparent and we rate the relevance as just satisfactory. However, based on the approach of the MFIs that differs in comparison with banks in terms of their customer groups and the concentration on the Gaza Strip, we rate the overall relevance as good.

Relevance rating: 2

Effectiveness

The attainment of the programme objectives defined at the programme appraisal for Phase II can be summarised as follows:

Indicator	Status PA	Ex post evaluation
(1) Increase in female and male MSE borrowers overall in the microfinance sector*	182,954 outstanding loans, 67.5 % female borrowers	Not met; 179,588 outstanding loans, 67.2 % female borrowers
(2) Increase in the share of new customers relative to the MSE total loan portfolio of the financial intermediaries	-	57 % of all guaranteed loans from the MSME individual loan portfolio go to new customers (no data on the microfinance product)
(3) Increase in diversity of the product range for MSEs	-	Increased range of MSME products for the partner banks of the individual loan guarantees; new introduction of MSME products for two banks

*Data from mixmarket.org on the nine largest MFIs (same MFIs for PA status and ex-post evaluation) collected in October 2014. Data on the PA status was then collected during evaluation.

At the time of the evaluation, MSME loans amounting to approximately USD 130 million had been guaranteed since the start of the project. In addition, following the expansion of the product range, guarantees for refinancing lines amounting to USD 3.3 million have so far been allocated by commercial suppliers to MFIs as well as guarantees for hedging parts of a microfinance portfolio of a partner bank to the value of approximately USD 1.66 million (60 % of these total amounts was guaranteed respectively).

From the perspective of the evaluation, the increase in bank lending in the microfinance sector (see Indicator 1) should not be the sole indicator of the success of the project. On the one hand, bank lending to MFIs is particularly subject to the volatile overall economy, while on the other, there can only be an increase in the absolute credit volume in a responsible and sustainable manner. As regards the refinancing of MFIs, there was success in issuing guarantees for the refinancing of two MFIs, which have a larger proportion of their portfolio in the Gaza Strip than the rest of the banking sector. The share of loans awarded to Gaza amounted to 8 % in 2010 and 11 % in 2013 across the entire banking sector. In the overall MFI portfolios and in the portfolios that the MFIs' assign to the guarantees, the ratio was between 17 % and sometimes over 30 %. Both supported MFIs have expanded their portfolios during the project. The support of the two MFIs thus has a positive impact on bank lending in the Gaza Strip. The attempt to generate further demand with regard to the guarantee product for refinancing microfinance institutions is proving difficult, however. So far the guaranteed refinancing loans are not cheaper for the MFIs than other concessionary funding sources, which are ubiquitous in the Palestinian MFI market.

The recent flare-up of the Gaza conflict in 2014 has not led to any defaults by the MFIs to date.[1] In the worst case scenario, the fund anticipates a rescheduling of repayments.

The portfolio on the individual loan guarantee product includes a large number of new customers (57 %), for whom the banks are mostly not willing to grant loans without a guarantee in the first instance. Once the banks have confidence in the creditworthiness of the customer, they often grant follow-up loans without a guarantee. However, some partner banks use guarantees for other reasons, for example not to exceed internal loan limits (which do not apply for guaranteed loans), or to hedge cluster risks in the portfolio (because a bank has granted a large number of loans at a certain branch for example). The fund is rightfully prepared to insure against cluster risks too. Limiting guarantees to particularly long-term loans - the current practice - does not make sense with regard to adjusting to the requirements of customers in a flexible manner. Nevertheless, offering guarantees for ultimate borrowers, the fund has expanded both the volume and the product range of partner banks. Two partner banks report that the MSME segment was not actively addressed until the guarantees were offered.

We rate the effectiveness of the SME instrument with the pronounced effect on new customers as excellent and that of the refinancing tool for MFIs, on the basis of the volume attained in the Gaza Strip, as good. Overall, we rate the effectiveness of the fund's work as good.

Effectiveness rating: 2

Efficiency

The average outstanding guaranteed sum of loans to ultimate borrowers (i.e. 60% of the aforementioned volumes) amounted to roughly USD 12 million (from 9 partner banks in total). The outstanding guaranteed sum for the refinancing guarantees for MFIs newly introduced in Phase II as well as a portfolio guarantee for a partner bank (where – in contrast to individual loans – an entire microfinance portfolio is hedged) currently stands at around USD 2.1 million. Consequently, in comparison with average funding from FC funds in both phases (on average approximately EUR 6 million, i.e. roughly USD 7.3 million), a leverage of approximately 2 is reached.

Nevertheless, if the entire fund capital including EU funds are taken as a basis (just over EUR 32 million in total), less than half of all funds are used for guarantees. In view of the low number of defaults (the defaults for the MSME product are less than 1 %), and even if these significantly increase in the future, the leverage of the funds is thus not adequate.[2] The evaluation reaches the conclusion that this is not attributable to a lack of production efficiency or allocation efficiency. In reality, the capitalisation of the fund by the FC and the funds of the EU have not been adjusted to the demand to be expected for the products of the fund – with the given size of the Palestinian financial sector. As bank guarantees are principally used for new customers and risky loans, and customers often then migrate to the non-guaranteed part of the portfolio, full use of the current funding is not to be expected in the long term. Unused capital is managed by an international bank on a trust basis. The flexibility of the fund in selecting the offered products has a positive impact on efficiency. The lack of demand for a product can be compensated by other products, without new funds having to be provided or the organisational structure of the fund having to be fundamentally changed.

The low number of defaults thus far is mainly due to the professional operation of the fund management. On the one hand, the fund maintains close relations to other partner banks, which prompts the banks to not only move high-risk loans into the guaranteed portfolio. On the other hand, the fund has introduced its own Management Information System (MIS) that is mandatory for the banks, which facilitates a detailed check of all applications. Together with the partial risk acceptance by the banks (40 %), the fund has succeeded in avoiding a "moral hazard" on the part of the banks (for example due to poor monitoring or a lack

[1] The Palestinian Monetary Authority (PMA) adopted an instruction this summer, directed at the banks, to postpone all repayments of customers in the Gaza Strip until January 2015.

[2] Especially as the key advantage of guarantees for a diversified portfolio is having to maintain less than the entire guaranteed sum in liquid assets, as it is very unlikely that claims will arise from all guarantees at the same time.

of creditworthiness checks). Standardisation brings additional expenditure for the banks with registering applications, but it also significantly speeds up the decisions of the fund.

Due to the excessive provision of capital, if one considers the co-financing of the EU, we rate the efficiency of the project as satisfactory only despite the professional work of the management.

Effectiveness rating: 3

Impact

In light of the MSME ultimate borrower guarantees, the fund attains its intended developmental effect of increasing the range of financial services for MSMEs without having to accept a high number of defaults in the process. This indicates that the customers, whose loans were covered by a guarantee, are in the position to manage these loans and not overcommit themselves financially by borrowing.

The evaluation concludes that the partner banks have granted a considerable additional amount of MSME loans with the guarantees (additionality). Due to the associated costs for the banks (guarantee fees), using guarantees only makes sense in certain cases (particularly for high-risk loans to new customers without previous involvement with the bank or history in the credit registry). Guarantees can therefore affect the credit volume in the financial sector by helping to include new customers. From the perspective of the evaluation, the coverage rate of 60% adopted thus far is suitable for guaranteeing risk assumption by the banks and at the same time offering attractive guarantees (see Indicator 3). The fund also has a positive impact on the operation of the financial sector. The use of a professional MIS, which is mandatory for banks, has a benign effect on the operation of banks. However, the success due to the MSME ultimate borrower guarantees is almost entirely limited to the West Bank. According to the number of loans, barely 4 % of the guarantees were awarded in the Gaza Strip.

The refinancing loans guaranteed in Phase II are consistent with the general efforts of the international donor community to support lending in the Gaza Strip. Bank lending was promoted in Gaza with the two MFIs. The supported MFIs and banks developed well throughout (see Indicators 1 and 2). In particular, the supported MFIs have significantly expanded their credit portfolio without recording a considerable number of defaults thus far. Following the Gaza conflict in 2014, however, a significant increase in all risk indicators was evident at the time of the evaluation.

The achievement of indicators formulated for Phase II is as follows:

Indicator	Status PA	Ex post evaluation
(1) The average annual growth of the MSME loan portfolio of the respective partner banks or MFIs reflects at least the increase in the balance sheet total of the respective financial institution	-	Achieved at 2 of 3 institutions from Phase II (2011-2013) 17.3 % - 74.6 % (balance sheet total vs. loan portfolio, growth); 71.5 % - 68.2 % 42.0 % - 53.2 %
(2) The portfolio quality of the partner banks and MFIs are reflected on average for the duration of the programme in PAR30 < 5 % and a default rate of < 3 %.	-	Achieved, portfolio quality adequate thus far
(3) The guarantee acceptance by EPCGF declines over the project term; it decreases from 60 % at the beginning to	-	Not achieved (Not absolutely necessary to achieve the developmental impact from the per-

50 % after 3 years and < 50 % after 5 years		spective of the evaluation)

1) The evaluation focuses on three measurable indicators of the six ones originally formulated.

The developmental (signalling-) effect of refinancing lines to MFIs on the financial sector is only minor. The idea of introducing MFIs with guarantees to the Palestinian banking market for refinancing has not been successful thus far (cf. Effectiveness too). The use of refinancing tools, which should introduce the MFIs to commercial suppliers, only makes sense if soft funds are limited at the same time, as the MFIs otherwise prefer more favourable donor funds. The FC has even provided favourable refinancing funds for one of the MFIs through a regional fund it supports at the same time.

We rate the developmental impact of the MSME ultimate borrower guarantees as excellent. The impact of the guarantees for refinancing loans from local banks to MFIs is unsatisfactory. Overall, however, we rate the impact of the fund on the Palestinian financial sector as good. Due to its interaction with many relevant stakeholders in the sector, the fund has taken on a facilitator role for the principles of responsible finance and the progressive professionalization of the sector.

Impact rating: 2

Sustainability

Since the launch of the fund in 2006, the costs from the guarantee payments and the operative costs are roughly equal to revenues comprising fees and interest income. There are no signs that indicate a long-term decrease in fund assets. The professional management of the fund, for which the preservation of the fund capital is an important parameter, ensures the sustainable provision of guarantees. In times of political escalation in the conflict with Israel, however, recent losses in the fund portfolio could not be avoided. Nevertheless, even in this situation the fund fulfils its task of risk assumption, and temporary losses are not an obstacle to the developmental goals or the operability of the fund. Furthermore, the fund has been more than sufficiently provided with capital in order to offset losses. Against this backdrop, a greater involvement of the fund in the volatile Gaza Strip – provided there is demand for guarantees – would not be an obstacle to sustainability.

The rapid growth of one of the MFIs supported in Phase II (the considerable balance sheet total more than tripled over the last 5 years) should give reason to be cautious with regard to the sustainability of the business model of this MFI.

The fact that the fund is guaranteeing a declining proportion of all loans in the banking sector with its guarantee products for MSME individual loans as the years progress does not jeopardise the sustainability of the fund. The fact that banks no longer query guarantees for customers they have got to know through dealings is in fact a sign of successful customer maturation and the development of the sector. If the fund management has the chance to adapt the product range of the fund in a relatively flexible manner (e.g. shorter terms, other coverage rates), the fund could react better to events in the immediate environment, which in turn would improve sustainability. A transition of the fund structure to an independent and autonomous foundation is currently being prepared.

From today's perspective, the fund will continue to be in a position to support a stable volume of MSME loans through guarantees. A significant increase in the volume of guarantees to MFIs seems unlikely from where we stand for the aforementioned reasons. Overall, we rate the sustainability as good.

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

Ratings level 1-3 denote a positive assessment or successful project while ratings level 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. Ratings 1-3 of the overall rating denote a "successful" project while ratings 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” (rating 3).