Armenia"German-Armenian Fund GAF"
Loan Programme for the Promotion of Micro and Small Private Enterprises

Ex post evaluation

OECD sector	24030 – Financial intermediaries of the formal sector	
BMZ project ID	2001 65 258 - GAF III 2003 65 320 - GAF IV 2003 70 171 – Complementary measure	
Project-executing agency	Central Bank of the Republic of Armenia (CBA)	
Consultant	IPC, Internationale Projekt Consult GmbH	
Year of ex-post evaluation	**2006**	
	Project appraisal (planned)	**Ex post evaluation (actual)**
Start of implementation	GAF III: 4th quarter 2001 GAF IV: 4th quarter 2003	GAF III: 3rd quarter 2002 GAF IV: 2nd quarter 2004
Period of implementation	3 years	3 years
Investment costs	no information available	no information available
Counterpart contribution (partner banks)	no information available	approx. EUR 3.2 million
Financing, of which Financial Cooperation (FC) funds	EUR 9.6 million	EUR 9.6 million
Other institutions/donors involved	none	none
Performance rating	1	
• Significance / relevance	1	
• Effectiveness	1	
• Efficiency	1	

Brief description, overall objectives and project objectives with indicators

The projects GAF III and IV represent the continuation of the projects GAF I and II (BMZ project ID 1998 65 387), which were subject to final evaluation in the year 2003. The projects involved the provision of refinancing funds that were offered to selected Armenian commercial banks through a local APEX unit established at the Central Bank of the Republic of Armenia (CBA), i.e. the German-Armenian Fund (GAF). As in the first two phases of the project, the funds were granted for a special purpose, namely the refinancing of loans granted to private micro, small and medium-sized enterprises (MSMEs) (see Annex 1).

The programme objective for both projects was to create a permanent access to formal financial services for MSMEs. In this way the projects were to contribute to creating or ensuring jobs and additional income for SMEs able to survive in the long term (<u>overall objective</u>).

The programme objective of Phase III was to be considered achieved if the following indicators were achieved:

(1) The APEX unit GAF accomplishes its tasks (proper assessment and selection of the partner banks and on-lending of the FC funds);
(2) The FC funds of EUR 12.27 million [1] are utilized within a period of not more than 4 years;
(3) The personnel of the partner banks' reviews the sub-loans according to banking standards and in accordance with the needs of the target group;
(4) The partner banks taking part in the programme have increased the number and total volume of the outstanding loans (portfolio perspective) to SMEs to an above-average extent, and
(5) The default rates for this sub-portfolio average no more than 5% ("portfolio-at-risk" perspective).

For Phase IV the indicators were modified or supplemented as follows:

(1) The APEX unit GAF accomplishes its tasks on a sustainable basis (proper on-lending and monitoring of the FC funds);
(2) The FC funds in the amount of EUR 4.5 million provided for Phase IV are utilised over a period of not more than 12 months. Until the end of 2004 the partner banks make available at least 20% of own funds for the refinancing of the MSME portfolio;
(3) The partner banks participating in the programme further increase the share of SME loans in their total loan portfolio (both in terms of number and total amount);
(4) The default rates for this sub-portfolio average no more than 5% ("portfolio-at-risk" perspective) and
(5) The number of branches participating in the GAF rises from 13 to 20 (including the participation of a further bank).

The indicators defined in the context of Phases 1 and II were also used to measure the achievement of the overall objective of Phase III:

(1) Companies' earnings development,
(2) The number of jobs created.

The following indicators for were used to measure the achievement of the overall objective:

(1) Sales development in the event of extension of a follow-up loan,
(2) Development of employment figures in the event of extension of a follow-up loan,
(3) Development of securities requested in the event of extension of a follow-up loan,

Project design / major deviations from the original project planning and their main causes

The official number of MSMEs (enterprises with up to 30 to 100 employees, depending on the industry) in Armenia is about 16,000. The United Nations Economic Commission for Europe, however, estimates the total number to exceed 36,000 enterprises. These enterprises employ around 400,000 persons, thus providing about one third of all jobs in the formal sector. In comparison, the informal sector is much larger and is estimated to account for up to 40% of the official GDP and to provide employment for approximately 600,000 persons. Though the legislation regarding MSMEs has been improved in the last five years there are still many obstacles for enterprises to grow, such as the tax legislation, due to which many MSMEs are incited to do business entirely or at least partially on a clandestine basis without paying taxes, and the weak judiciary system. According to a market study conducted in the context of FC in 2003, there were 20,000 potential bank customers in the MSME segment in Armenia already at the time. At the time of the project appraisal of Phase I in 1999 the lack of access to loans was considered to be the central obstacle to economic development. In the context of the project it was possible to somewhat reduce this obstacle but not to eliminate it entirely (see below). Given

[1] EUR 7.16 million of this amount refer to Phases I and II and EUR 5.11 million to Phase III.

the growth of enterprises in the last five years, there was, as expected, an increasing demand for financing of investments and working capital (underlined by the growth in borrowing on the part of GAF customers). In the longer term, the MSMEs will not be able to cover their financing needs from their own resources or in the capital market. For this reason, the banking sector will continue to play a central role in the development of the MSME sector.

According to the Financial System Stability Assessment of the World Bank, which quotes the number of 21 banking institutions (2001: 30 institutions) in Armenia, the Armenian financial sector has overall taken a positive development in the period since the minor crisis of the 2000-2001. This development continued in 2004, too: The capitalisation of the banks is good (average capital adequacy ratio: 32%) – even though their absolute equity capital is very low – and their liquidity is sufficient. The non-performing loans in the banking sector (around 7% of total loans outstanding) are covered over 100% by reserves. The positive sentiment in the banking sector is expressed in the increasing willingness of the banks to grant loans. Bank lending grew by 37% in 2004 after an average growth of 24% in the period 2001-2003. This is a positive development, however, which bears the risk that non-performing loans might increase. In order to minimise this risk the corporate governance standards in the Armenian corporate sector, the rights of the lenders and the monitoring of credit risks (70% of loans are extended in foreign currency) have to be improved. The central bank has started to develop the required measures. In 2005 the central bank granted two new banking licences to institutions with foreign participation. By international comparison the banking sector is relatively small and has considerable efficiency potential: For instance, interest rates charged by the banks are around 20% p.a., while the banks' refinancing costs amount to only about 7% p.a. Moreover, the banks long-term refinancing is not sufficient to grant customers adequate maturities for loans to finance investments in capital goods and housing investments. In 2005 total assets of banks in Armenia made up only 19.8% of GDP (2001: 17.5%), while the average figure for all CIS states is more than 30% (Annex 2, Annex 3).

Overall, however, lending to the corporate sector is of relatively low importance for the majority of banks, as was the case when the programme was started in 1999, because margins on government bonds tended to be high and the existing credit technology was usually not adequate. The willingness of the banks to extend their lending business has increased and their portfolio of corporate loans reached roughly USD 409 million in 2005 (2001: approx. USD 133 million). Nevertheless, MSMEs still find it difficult to obtain sufficient loans in domestic currency, especially in the medium to long-term maturity range. Due to the lending activities of the GAF the situation of these customers has improved considerably in the last five years. Since the inception of the GAF the associated partner banks have extended a total volume of roughly EUR 155 million in local currency (EUR 132 million not including additional funds provided by the EBRD). Against this background and from today's perspective we consider the conceptual approach of the project – i.e. the provision of loans for MSMEs through an apex structure and local commercial banks and at the same time institution building activities – as adequate to solve the problem. In 1999, when Phase 1 of the programme started, MSMEs were for the first time addressed as a profitable customer group. Though it was possible through the GAF to significantly improve the access of MSMEs to financial services there is still a large share of MSMEs, especially in the informal sector, which do not have access to financial services provided by the formal sector.

The GAF is a revolving credit fund based on local currency. Institutionally, the GAF is situated in the Central Bank of the Republic of Armenia (CBA), which also hedges the currency risk. In the context of the GAF funding in local currency is provided to selected partner banks for on-lending to MSMEs (Annex 4). The programme comprised the following elements:

- Establishment of a revolving refinancing fund (the GAF) with the Central Bank of Armenia (CBA).
- Provision of credit lines for on-lending to MSMEs to qualified commercial banks selected by CBA in agreement with KfW.
- Under a complementary FC measure, training measures were provided to selected Armenian partner banks (especially training of loan officers) and to the project management unit (PMU) of CBA.

After the acceptance of Ineco Bank in 2004 as a partner bank the GAF has now concluded framework agreements with altogether five partner banks, which were chosen on the basis of the following criteria:

- Financial stability (good earnings situation, compliance with CBA standards, international auditor);
- Adequate business policy – i.e. experience in the business area of "small enterprises" or the willingness to acquire such experience. The banks' business strategy is based on a documented strategy including target indicators (after a 6 to 8 months' participation in the GAF the business volume in the area of MSMEs is expected to amount at least USD 1 million);
- Infrastructure (loan department concentrating on MSME lending, branch offices, adequate offices);
- Personnel development (nomination of a managing director, suspension of staff or hiring of new staff);
- Credit policy (rapid decision-making, collateralisation).

In the framework agreements the partner banks commit themselves to use the funds provided by the refinancing fund for loans extended to MSMEs at an interest rate of currently 6% (previously 8%) and to assume the credit default risk. The interest differential funds remaining after deduction of FC conditions of 0.75% and an administration fee of currently 1% flow back to the GAF and can be used on a revolving basis. In addition to the four partner banks (ACBA, Anelik, Converse and Armeconom), cooperation with which was successfully established already in the context of the predecessor projects, Ineco Bank, which is specialised on MSMEs, also become a partner bank of the GAF in 2004. All partner banks also participate in programmes implemented by other donors (e.g. IFAD, USAID). Since February 2003 the structures set up under the GAF have also been used by the EBRD, which offered additional refinancing funds to two partner banks (ACBA, Anelik) to finance their MSME business. In the Armenian context we judge the financial and operative efficiency of the partner banks to be above average. All banks show a positive return on equity and the product "MSME financing" is operated profitably in all partner banks. Interest rates charged to sub-borrowers differ from bank to bank and depending on the loan product and range between 17% and 27%. Thus, the interest margin earned is sufficient to cover the relatively high operative costs especially in the area of "express micro-loans" (Annex 5).

In the initial phase the apex function was assumed by the CBA department in charge of banking supervision, regulation and licensing. Since 2001 a project management unit (PMU) established within the CBA for this specific purpose has been entrusted with the apex function. A Supervisory Council, on which two representatives from KfW and one from CBA are represented, meets twice a year to take decisions about all strategic questions concerning the GAF and the budget of the PMU. The costs incurred by the PMU are covered by an administration margin of 0.7%, which is included in the refinancing rate of the partner banks. Part of the administration margin should also be used to built up limited reserves, which serve to finance assignments of short-term experts (if required) (for instance to conduct due diligence reviews) once the complementary measures has been terminated.

The partner banks are monitored by means of monthly inquiry of basic data, such as portfolio development, quality of the GAF portfolio and staff development. In addition, extensive audits of the partner banks' GAF portfolios are conducted by the auditors working in the PMU. Further information on the partner banks are made available to the PMU by other business areas of CBA. The cooperation between the GAF and the partner banks is running smoothly and is coordinated at the management board level. Up to now the annual audits conducted on the GAF by international auditors have not given rise to any objections.

In the lending business the focus is on the customer's creditworthiness, in particular the ability to repay the loan (which is determined on the basis of a cash-flow analysis). Credit appraisal in the MSME sector is far more complex and takes much more time than appraisals in the traditional lending business. For this reason the partner banks were given support in the context of a complementary measure in order to develop a credit technology specifically tailored to the target group. The credit rules and the credit manual have been formulated precisely and in detail and cover all relevant items of a credit appraisal. Lending to the target group requires the careful review of all information and data provided by the applicant enterprise. During the assessment of the customer's creditworthiness the loan officers usually visit their customers both in the enterprise and at home in order to gain a valid picture of the income situation and the overall financial situation of the customer. Since many applicants in the MSME sector can only provide insufficient or incomplete documents the data is made more plausible and more information is gathered by questioning suppliers, buyers, neighbours, competitors, etc. to make sure that the figures established are in line with the actual income situation of the loan applicant. Besides this extensive credit analysis the credit risk is reduced through strict and timely monitoring. Defaulting customers are contacted already after the first day of default and the responsible loan officer will exert pressure, if necessary by taking legal proceedings, on the borrower until the problem has been solved.

While programme phase III focused especially on the further growth of the GAF portfolio, the focus in programme phase IV was more on micro-enterprises. From the end of 2003 onwards so-called "express micro-loans" were introduced specifically for this group of customers, which are by now successfully handed out by four partner banks. Such express micro-loans have a maximum amount of EUR 2,000. They are processed in a period of less than two days and the requirements on the securities to be provided are lower (registration by notary public is not required).

The complementary measure aimed at imparting a credit technology specially tailored to MSMEs was concluded at the end of 2004 for the four "older" partner banks and at the end of 2005 for Ineco Bank. In 2005 a further complementary measure was implemented with the objective to ensure that the successful growth of the banks' MSME business was also reflected in other business areas, e.g. internal organisation and risk management (Annex 6).

Key results of the impact analysis and performance rating

All programme indicators defined for phases III and IV were entirely fulfilled or even exceeded:

Since the end of 2002 the PMU (five employees) has successfully and in its own responsibility taken care of the supervision, monitoring and reporting of the GAF.

The FC funds provided in programme phase III had been fully disbursed by August 2002 (6 months after the signing of the agreements) and the FC funds provided in programme phase IV by June 2004 (7 months after the signing of the agreements).

At the end of 2005 the outstanding loan portfolio comprised 8,245 loans in the total amount of EUR 38.8 million (also including additional funds provided by the EBRD the figures are 5,030 loans of a total of EUR 30.0 million). Altogether under the GAF, a total of 30,670 sub-loans in the total volume of EUR 155 million were extended. The share of the GAF portfolio in the partner banks' total loan portfolio increased from 16 % in 2001 to 29 % in 2005.

The credit technology used by the partner banks to analyse the sub-loans is in line with customary banking practice and in accordance with the needs of the target group.

In comparison with international standards the quality of the credit portfolio is very good – with a "portfolio at risk" over 30 days of 0.7%.

The number of branches participating in the GAF has risen from 10 in the year 2001 to 35 in 2005. The GAF is now represented in 11 cities (2001: 7).

The stronger focus on micro-entrepreneurs, which was the objective of phase IV, was reached in particular through the introduction of the "express micro-loans". Thus, the average amount of loans outstanding decreased by around 35% in real terms in the period 2003 to 2005. In the same period the relative share of micro-loans (< AMD 1,000,000) increased from approx. 46 % to 56 %. This development was also due to the fact that enterprises which are not officially registered were won as new customers. But as no agreement was reached with the central bank on the legal framework for dealing with lending to such enterprises, especially higher-volume loans (< USD 10,000) are only extended to officially registered enterprises.

As regards the achievement of the overall objective, the development of incomes, assets and employment figures of the sub-borrowers is an indication that incomes have increased and jobs have been created or safeguarded. The average net income in the group of multiple borrowers that were the subject of an impact analysis increased by 82% for small enterprises and 47% for micro-enterprises since the time when the first loan application was made. At the same time the average number of employees increased by more than 30% in both groups. In general, participation in the GAF increases the confidence of owners in their enterprise and therefore also makes MSMEs more dynamic. The majority of the customers and also former customers were very satisfied with the service and loan conditions. Requirements on the securities to be furnished, for instance for the "express micro-loans" were lowered.

The protection of the environment and natural resources was not part of the project objectives and, thus, environmental impacts worth mentioning did not occur. The customers were serviced without regard to gender. The programme did not explicitly pursue the goal of improving the participation and good governance. At the central bank level the project helped to increase the understanding of the fact that supplying the MSME sector with financial services and improving the institutional framework at the partner banks and other financing institutions are of major importance.

In a summary evaluation of the developmental effectiveness achieved by the project, we have arrived at the following assessment of the "Loan Programme for the Promotion of Micro and Small Private Enterprises III and IV":

<u>Effectiveness</u>

The programme objective – creating permanent access to formal financial services for MSMEs - was well achieved. Using the target-group oriented credit technology introduced in programme phases I and II, the partner banks again succeeded in substantially increasing the number of sub-borrowers by tripling the number of branches participating in the GAF and by introducing the "express micro-loans". Since the start of programme phase III the totol number loans extended in the context of the GAF in different regions in Armenia rose from 3,700 to over 30,000. With a cumulated total volume of more than EUR 155 million (also including additional EBRD funds) the project has a high broad-scale effect. The FC funds provided for MSME loans were requested by the partner banks very rapidly and were even supplemented by considerable own funds made available by the partner banks (approx. 40% of the total loan volume). We therefore classify the **effectiveness** of the project as **good** (**sub-rating 1**).

<u>Relevance/Significance</u>

The overall real-economy objectives have been well met. By providing a large number of SMEs with access to formal loans and other services for the first time, the project made a significant contribution to economic development and supported the transformation process. Substantial income and employment effects have been achieved at the MSME level. From a financial perspective, the project's relevance/significance is very high. Due to their regional outreach and the introduction of further financial products tailored to the needs of MSMEs ("express micro-loans") programme phases III and IV had a structure-building impact on the financial sector. The good image of the GAF enabled the partner banks to improve their business position. Thus, as regards the criterion of **relevance** / **significance** we rate the project overall as **very good** (**sub-rating 1**).

<u>Efficiency</u>

We rate the allocation efficiency of the project as good. The apex unit works efficiently and covers its costs. Its portfolio-at-risk ratio is at a constantly low level, credit interest rates are positive in real terms and the MSME business of all partner banks is operating with a profit. The operational efficiency is also high. We also rate the production efficiency as good. The leverage effect of the funds employed under the complementary measure is excellent in comparison with the volume of the revolving fund. Due to interest income and additional funds provided by the EBRD, the volume of loans outstanding in the framework of the GAF already exceeds the volume of funds originally provided by KfW for refinancing purposes by more than 75%. Thus, the availability of the funds for purposes of MSME financing is ensured on a long-term basis. For this reason, we consider the **efficiency** of the project to be **good** (**sub-rating 1**).

In a summarised assessment of all impacts and risks described above, we **rate the project's developmental effectiveness as good (rating 1).**

General conclusions and recommendations

It should be pointed out that the success of a downscaling project strongly depends on the country situation. It is important that

a) the central bank supports the project,

b) the competitive pressure within the banking sector is correspondingly high so that there is an incentive to pursue new, cost-intensive business areas such as MSME finance,

c) the participating banks are not too large so that their SME business can become a cornerstone of their business operations within a short period of time and, thus, will receive the required attention from the management.

d) the relations to the target group are relatively close owing to transactions in other business areas,

e) under the complementary measure the consultant introduces an appropriate credit technology and gains the confidence of the local stakeholders.

f) a clear regulation is found as to who will bear the exchange rate risk.

In order not to jeopardize the further growth of the respective MSME loan portfolio, in the event of future downscaling projects, increasing attention should be paid from the very beginning to building up refinancing possibilities of the banks which do not depend on donor funding. Here, the possibility of involving private investors in refinancing activities of such revolving funds, for instance in the context of the European Fund for Southeast Europe, should be taken into consideration from the beginning in order to be able to cover the financing needs of the target group also beyond the FC funds. In addition, the possibility should be considered to introduce different refinancing terms depending on the creditworthiness and/or loan volumes of different customer segments. In this way a specific incentive structure can be established that takes account of different target groups.

Legend

Developmentally successful: Ratings 1 to 3	
Rating 1	**Very high or high degree of developmental effectiveness**
Rating 2	**Satisfactory developmental effectiveness**
Rating 3	**Overall sufficient degree of developmental effectiveness**
Developmental failures: Ratings 4 to 6	
Rating 4	**Overall slightly insufficient degree of developmental effectiveness**
Rating 5	**Clearly insufficient degree of developmental effectiveness**
Rating 6	**The project is a total failure**

Criteria for the Evaluation of Project Success

The evaluation of the "developmental effectiveness" of a project and its classification during the ex-post evaluation into one of the various levels of success described in more detail below concentrate on the following fundamental questions:

- Are the **project objectives** reached to a sufficient degree (aspect of project **effectiveness**)?
- Does the project generate sufficient **significant developmental effects** (project **relevance** and **significance** measured by the achievement of the overall development-policy objective defined beforehand and its effects in political, institutional, socio-economic and socio-cultural as well as ecological terms)?

- Are the **funds/expenses** that were and are being employed/incurred to reach the objectives **appropriate** and how can the project's microeconomic and macroeconomic impact be measured (aspect of **efficiency** of the project conception)?
- To the extent that undesired **(side) effects** occur, are these tolerable?

We do not treat **sustainability**, a key aspect to consider for project evaluation, as a separate category of evaluation but instead as a cross-cutting element of all four fundamental questions on project success. A project is sustainable if the project-executing agency and/or the target group are able to continue to use the project facilities that have been built for a period of time that is, overall, adequate in economic terms, or to carry on with the project activities on their own and generate positive results after the financial, organisational and/or technical support has come to an end.