Azerbaijan: Promotion of the Private Sector I-II

Ex-post evaluation

OECD sector	24030 – Formal sector financial intermediaries	
BMZ project ID	1998 66 278 1999 65 997 1998 70 387 (complementary measure) 2001 70 472 (complementary measure)	
Project-executing agency	German-Azerbaijanian Fund (GAF)	
Consultant	LFS Financial Systems, Sparkassenstiftung (Savings Banks Foundation)	
Year of ex-post evaluation	**2005**	
	Project appraisal (planned)	**Ex-post evaluation (actual)**
Start of implementation	December 1999	December 1999
Period of implementation	36 months	48 months
Investment costs	No information available	No information available
Counterpart contribution	No information available	No information available
Financing, of which Financial Cooperation (FC) funds	EUR 8.6 million	EUR 8.3 million
Other institutions/donors involved	None	None
Performance rating	1	
• Significance/Relevance	2	
• Effectiveness	1	
• Efficiency	1	

Brief description, overall objectives and project objectives with indicators

The project comprised the provision of finance for an Apex fund, the German Azerbaijanian Fund (GAF), which is administered by a fund manager and issues credit lines to selected commercial Azerbaijani banks (partner banks for refinancing loans to private micro, small and medium-sized enterprises (MSME). It consisted of two phases: In Phase I, EUR 5.11 million was provided for the refinance component and EUR 1.02 million for the related complementary measure. The refinance component was raised by EUR 3.58 million and the complementary measure by EUR 0.77 million in 2001 (Phase II). The complementary measures were concerned with introducing a lending technology at the GAF partner banks in keeping with the conditions and needs of the target group. The target group was made up of enterprises employing a workforce of up to 100. The project objective was defined as (i) the sustainable development of lending business geared to MSMEs and (ii) the development of other financial services for MSMEs. By ameliorating existing deficits in financial service delivery in the Azerbaijani banking sector, the intention was to contribute to private sector development in Azerbaijan and to deepening and widening the financial system (overall objective).

Programme Design/Major Deviations from Original Programme Planning and Main Causes

The projects were carried out without any major deviations from the original design. The executing agency of the two projects under evaluation here was the Ministry of Finance of the Republic of Azerbaijan. The funds are remitted directly onto a fund account. GAF has been established as an independent operative Apex unit, but is not incorporated.

The GAF is administered by a fund manager appointed by the project executing agency. The tasks of the fund manager are to select the partner banks, conclude credit framework agreements, pay out the loan tranches to the partner banks and monitor them. In Phases I and II, the consultant for the complementary measure acted as fund manager. This arrangement is in danger of creating a conflict of interest as the partner banks are selected, advised and monitored by one person. The interest of a consultant in selling as many consultancy services as possible can come into conflict with the job of the fund manager to select the best qualified banks and provide these with loans, for example. There are also advantages, however (easier coordination, efficiency gains). Even though the possible conflict of interest has not had an adverse effect as yet, in Phase III the project should examine whether the advantages of a clear separation between consultancy and fund management functions outweigh the present synergies and lower information costs.

Since the beginning of consultancy services in March 2000, credit framework agreements have been signed with the following six banks: Bank of Baku, Unibank (from the merger of the M-Bank and Promtekhbank), Bank Respublika, Para Bank, Azerigazbank and Azerdemiryolbank. The last two banks were not included in the local ex-post evaluation since they have only been taking part in the programme since mid-2004 and only have a short project record. The selected banks have received credit lines of up to EUR 2 million. Other banks can be included by using revolving funds from Phase I/II or additional funds from Phase III and this is also the intention.

Since the project began in 2001, altogether 4,364 GAF-financed loans (as at 30 April 2005) averaging EUR 5,666 (total volume of EUR 25 million) have been issued to the target group. As per 30 April 2005 2,394 loans were outstanding totalling EUR 7.9 million. On that date, about 83% of the loans were below EUR 5,000, 9% between EUR 5001 and EUR 15,000 and 8% between EUR 15,001 and EUR 50,000. Altogether, programme outreach included both micro and small and medium-sized enterprises (target group).

The sectoral breakdown of the outstanding loan portfolio is in keeping with the pattern and development of the Azerbaijani private sector (except for the oil and gas sector): Commerce makes up 66% of outstanding loans, production, 19%, services, 10% and agriculture, 5%.

Measured in terms of volume, the regional priority is Baku with 74%, followed by Ganja (15%), central Azerbaijan (4%) and the other regions (7%).

Key Results of Impact Analysis and Performance Rating

In the appraisal report, private micro (1-20 employees) and small enterprises (21-50 employees) from all sectors (including agriculture) are defined as the target group. When funds were raised (Phase II), the target group was enlarged to include enterprises with workforces of up to 100. We consider enlarging the target group to be warranted as it encompassed a broader range of enterprises with insufficient access to credit.

Objectives achievement at project level is as follows:

Indicators	Objectives achievement
The repayment rate of the commercial banks to GAF amounts to 98%.	The repayment rate of the partner banks to GAF is 100%, exceeding the target of 98%. (met)
Funds are called in under 3 years.	The appraisal report did not define the exact date for the start of implementation. We recommend adducing the following times for checking the indicator: Phase I:

	beginning of the consulting assignment in March 2000, Phase II: signing of the replenishment agreement in January 2004. Although Phase II has not been paid out completely yet (outpayments made: EUR 3.3 million), disbursement is expected to be complete inside the defined period of 3 years. (partly met)
Staff of the commercial banks vet final loans according to banking procedure in line with the target group.	All partner banks have adopted the lending technology introduced by the consultant (incl. credit rating analysis and bonus system) and make effective and efficient use of it. Good results have been achieved with the lending technology introduced, above average quality of the FC portfolio, for example. (met)
The commercial banks have raised the number and value of loans in the small loan portfolio (all loans up to US$ 50,000) above average.	The MSME portfolio of all partner banks has developed very rapidly: (a) UniBank: growth rates of 134% (2003) and 97% (2004), (b) Bank of Baku: growth rates of 75% (2003) and 49% (2004), (c) Bank Respublika: growth rates of 20% (2003) and 49% (2004) and (d) ParaBank: growth of 86% (2003) and 79% (2004) (met).
Rate of arrears < 8% (portfolio at risk) and maximum loan chargeoff rate equals 5%.	With a portfolio at risk (more than 30 days arrears) of 1.2%, the quality of the loan portfolio was very good; the loan chargeoff rate was 0%. (met)
Programme has been institutionalization through setting up special divisions and branch offices for the clientele of small borrowers.	All banks have set up or expanded special divisions and new branch offices to serve the MSME clientele. (met)

The project objective of promoting additional financial service delivery for the clientele was not operationalized with project measures. Nor were any indicators defined. Owing to the lack of appropriate project measures, this project objective would lapse from today's standpoint. The final inspection revealed that all partner banks also offer their customers other financial services (such as payment transactions) besides loans, but the project made no contribution to this.

Overal objective achievement is as follows:

Indicator	Objectives achievement
Ratio of loans to GDP (1999: 11%) is increasing.	The total amount of credit has risen continuously since 1999, but at 12% of GDP it is still at a very low level. (met)
MSMEs are developing positively.	The impact analysis carried out shows that more than 80% of the enterprises questioned have increased their income since project start. In addition, 26% of micro enterprises and 54% of SMEs have raised the number of their full-time personnel. (met)

We consider the indicators defined for measuring objectives achievement to be useful and appropriate, except for the following: To measure the sustainable use of the fund, the institutionalization of the Apex setup should have been applied as an indicator.

As to overall and project objectives achievement, almost all target indicators were met or exceeded. The defined target group was reached. Added to this, SME finance has established itself as an important business line of the partner banks. Lending and monitoring procedures were rationalized during the consultant assignment in the complementary measure so that the loan portfolio could be enlarged significantly while maintaining a high quality. A caveat here is that Phases I/II did not succeed in institutionalizing the fund (as explicitly intended in the project appraisal), by means of a management contract, for example. For the long-term use of revolving FC funds, however, this step is of key importance and should be prepared and implemented in Phase III, as provided for in the project appraisal report for Phase III of 22 February 2005. Notwithstanding this objection, important sustainable impacts have already made themselves felt at partner bank level.

Besides the beneficial impacts on income and employment, the business survey conducted by GAF as part of an impact study ascertained the following additional benefits for the target group:

- Sustainable access to credit enhances planning certainty for the enterprises and their readiness to invest as a result.
- Contact with the partner banks has enabled most GAF clients to analyze and assess their financial situation better.
- Sustainable access to credit alleviates risks due to liquidity constraints.

Although the loans need not promote the poor directly, by generating and securing incomes and employment, the project makes a contribution to improving the conditions of life for this target group. The impact analysis carried out shows that 54% of the SMEs and 26% of the micro enterprises have raised their numbers of full-time employees. A major part of the new employees stem from the pool of unemployed. The change in mentality induced in the banks and their greater accessibility for lower client segments means improved financial services for micro enterprises and low-income private households.

Very positive impacts have also been achieved in the partner banks. These have had positive repercussions on the whole financial/banking sector. The main impacts are:

- The reputation of the partner banks and the confidence of prospective borrowers and savers have been considerably enhanced through inclusion in the FC project. This has had a beneficial effect on mobilizing savings and expanding lending business in all partner banks.
- The problem of unmatched maturities has been mitigated by providing long-term refinance lines to partner banks.
- The lending technology has been upgraded or introduced (including credit rating analysis and a bonus system for loan officers) at all partner banks. This lending technology is applied for the whole SME lending business of the partner banks, not just for the GAF portfolio. Moreover, the lending technology developed was adopted by some non-partner banks via loan officers recruited from the partner banks.
- Thanks to the intensive training in the two complementary measures and the ongoing upgrading measures, the professional competency of approx. 110 loan officers was raised. Due to the relatively high turnover of loan officers already trained and the resulting know-how gaps, more thought should be given to the 'training of trainers' approach already practised since March 2005.
- The greater transparency of the partner banks due to GAF and the general improvement in their performance have helped to arouse keener interest on the part of international investors (e.g. DEG, EBRD) in contributing equity to these banks. In three cases, either EBRD or DEG have already acquired equity holdings or are in negotiations.

The findings of the impact analysis sample show that depending on segment the ratio of loans allocated to women ranges between 6.6% (microloans in agriculture) and 15% (off-farm microloans). The participation of women as final borrowers in the programme is thus comparatively low, even less than the share of female sole businesses (approx. 17%). Direct client contact in lending, however, clashes with the traditional gender role so that they are hardly active in this area.

A summary assessment of the above impacts arrives at the following ratings for the developmental efficacy of the project.

<u>Effectiveness:</u>

The project objectives were the sustainable development of lending business for MSMEs and the promotion of additional financial services for this clientele. Measured in terms of the project objective indicators, developing lending business to meet MSME needs has been fully accomplished. The objective of promoting additional financial service delivery was not tied to project measures. This objective has also been achieved (without a contribution by the project). The quality of the GAF portfolio is above average (1.2% portfolio at risk). All four partner banks have extended their capacity in MSME finance in large measure and introduced other products for this clientele. A particularly positive aspect is that all banks have continued to grant sequel loans and also provide their own funds for financing MSME loans. Altogether, we assess the effectiveness as very high (Subrating 1).

Relevance/Significance:

By ameliorating existing deficits in financial service delivery for private small enterprises in the Azerbaijani banking sector, the intention was to contribute to (i) promoting the private sector in Azerbaijan and (i) deepening and widening the financial system (overall objective). With almost 4,400 final loans issued in different regions of Azerbaijan, the project has had a relatively broad impact. Added to this, the broad impact is assured in the long term by making the partner banks accessible for the MSME client segment - not just by way of FC funds. Affording a large number of MSMEs access to formal lending and other services makes an important and significant contribution to economic development and to supporting transition. The project has successfully introduced a new lending technology and raised general transparency in the sector. The lending technology introduced is regarded as a major success factor in the sector and has been increasingly emulated by non-partner banks. A negative factor, however, is that the Apex unit has not been institutionalized and established locally (e.g. by concluding a management contract for the fund). By virtue of the sustainable impacts at partner bank level already discernible today, however, we assess the relevance/significance as satisfactory (Subrating: 2).

Efficiency:

We gauge the production efficiency of the partner banks as good: The SME portfolios in all partner banks have expanded rapidly (annual growth rates of up to 134%). Despite the considerable increase in the loan portfolios, they even managed to reduce the rates of arrears (exception: ParaBank). Portfolio at risk in all partner banks is below the sectoral average. We judge the equity base and cost efficiency of the partner banks as good. Equity capital is still not adequate at the Parabank (presently falling short of the central bank's minimum capital requirements). The leverage of the funds deployed for the complementary measure is good in relation to the amount of revolving funds (cf. Annex 6). We also assess the allocative efficiency as good: The SME loans are issued to the target group on market terms. Altogether, we assess the efficiency as high (Subrating 1).

We judge the developmental efficacy of the project overall as high (Rating 1).

Despite the very positive results of the projects so far, improvements can be made in the following areas:

- Institutionalizing the Apex structure is crucial to raise the effectiveness of GAF. For this reason, a viable strategy needs to be prepared and implemented in Phase III.
- Expanding banking activities in the regions is very important for national economic development. Major progress has been made here in the course of project implementation but the present concentration on Baku at 74.4% of total volume is still high. Most Azerbaijani banks are seeking regional expansion and should be given even more support in Phase III.
- Till now, the introduction of an environmental impact analysis and the provision of a training programme to raise awareness of environmental aspects amongst loan officers as originally planned have not been implemented by the project. In close cooperation with other donors (e.g. EBRD), more attention should be paid to this area in Phase III.
- Applying the principles of bank loan appraisal, Phase III should examine how the percentage of the final borrowers could be raised with specific measures.
- In the past, the GAF refinance rate has been lower than the deposit and refinance rates on the banking market (6 months). Since GAF has already built up a significant portfolio, the refinance rate should not amount to less than the relevant reference interest rates in future. Instead, where possible the refinance rate should be set so that the banks also have an incentive for soliciting savings deposits.
- To broaden the impact of the training programme, the training of trainers programme should be put to more use in future.

– Partner bank acquisition and handling of client information should be improved in future. This is important for analyzing programme impacts better but also for marketing purposes and better loan monitoring and as a basis for the possible introduction of a credit scoring system.

General Conclusions and Recommendations

In the event of projects with an apex structure the partner banks/financial institutions should be chosen in the context of a transparent, public selection procedure. Such a procedure will ensure a free and fair competition for the scarce promotional funds and will also increase the efficiency.

To avoid any conflicts of interest in the implementation of the projects with an apex structure the advantages of separating the functions of fund manager and advisor should be carefully weighed against the disadvantages of higher expenses in terms of coordination and information.

The partner banks are often supported by several donors with debt and equity capital but also with advisory services. In order not to overstrain their capacity to absorb funds and their management capacities it is necessary to seek close coordination between all donors. One major aspect in these areas is to largely harmonize the reporting duties of the partner banks towards the individual donors.

The concept of “training of trainers” can make an important contribution to increasing the sustainability and strengthening the institutional establishment of training programmes for loan officers.

In the event of financial sector projects, the refinancing conditions should, if possible, be determined so as to ensure that the partner banks / financial institutions still have an incentive to raise funds in the form of savings deposits.

Key

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.