KfW ENTWICKLUNGSBANK

Egypt: Social Fund for Development – Promotion of Micro and Small Enterprises I and II (EDP I and II)

Ex-post evaluation

OECD sector	24030 – Financial intermediaries of the formal sector	
BMZ project ID	1993 66 279 / 1995 66 886	
Project-executing agency	Social Fund for Development (SFD)/ Small Enterprise Development Organization (SEDO)	
Consultant		
Year of ex-post evaluation	**2005**	
	Project appraisal (planned)	**Ex-post evaluation (actual)**
Start of implementation	EDP I: Q 3 94 EDP II: Q 2 96	EDP I: Q 4 94 EDP II: Q 4 96
Period of implementation	EDP I: 18 months EDP II: 34 months	EDP I: 48 months EDP II: 86 months
Investment costs	EDP I: EUR 7.6 million EDP II:EUR 6.1 million	EDP I: EUR 6.1 million EDP II: EUR 6.1 million
Counterpart contribution	Not specified	Not specified
Financing, of which Financial Cooperation (FC) funds	EDP I: EUR 5.1 million EDP II: EUR 5.1 million	EDP I: EUR 5.1 million EDP II: EUR 5.1 million
Performance rating	4	
• Significance / relevance	4	
• Effectiveness	4	
• Efficiency	4	

Brief Description, Overall Objective and Project Objectives with Indicators

The overall objective of both projects was to create and preserve jobs and income in small private Egyptian enterprises and to create access for enterprises to services offered by the formal financial sector. The project objective was to promote company founders operating independently and profitably as well as existing small enterprises and the successful target group-oriented granting of investment loans through commercial banks. Both projects were supported by FC loans totalling EUR 10.2 million.

The executing agency for the measures was the Social Fund for Development (SFD) and die Small Enterprise Development Organization (SEDO) which on-lends the FC loans to the enterprises in its capacity of apex institution through Egyptian commercial banks. Under the project EDP I the FC funds were extended to the enterprises exclusively through the state agricultural development bank, the Principal Bank for Development and Agricultural Credit. Under the project EDP II the FC funds were extended through Banque Misr, the Bank of Alexandria and the National Bank of Egypt. The indicators established to measure the achievement of the project objective were

on-time debt service by at least 85% of the borrowers, the creation or preservation of at least 2000 jobs, and an increase in turnover in 85% of the enterprises by the end of the loan term. Similarly, for EDP II the indicators chosen where a default rate of not more than 15%, on-time debt service of at least 85%, and maximum loan losses of 5% after the end of the project period.

Achievement of the project objectives was taken to imply achievement of the overall objectives.

Project Design / Major Deviations from the original Project Planning and their main Causes

The projects were carried out without any major deviations from the original conceptions.

The Arab Republic of Egypt, represented by the Egyptian Central Bank, is the borrower of the two FC loans totalling 10.2 million. The funds were on-lent in local currency to the Social Fund for Development, which had been established at the beginning of the 1990s in order to mitigate negative impacts of structural adjustment measures. Within the Social Fund for Development the Small Enterprise Development Organisation is in charge, which was created by presidential decree as a quasi-autonomous institution from the Enterprise Development Program (EDP) of the SFD in 1999. The function of the SEDO is that of an apex institution which grants credit lines to banks and non-governmental organisations at the national level for onlending to SMEs.

Under EDP I a total of LE 22.2 million was channelled through SEDO to the five governorate banks of the Principal Bank for Development and Agricultural Credit (PBDAC) in the governorates of Kafr El Sheik, Assuit, Giza, Minia and Sohag for onlending of small loans. The sub-borrower interest rate was set at 12%. The maximum loan amount was limited to LE 50,000 for investment loans and LE 25,000 for working capital loans. The disbursement of the funds was effected between 1994 and 1998, delayed by more than two years against the initial assumptions made at the time of project appraisal. A total of 2420 loans was granted in a total volume of LE 38.9 million, so that the FC funds could be used 1.75 times (on a revolving basis). Most of the loans were used on a short-term basis to finance working capital. Only 16% of the loans were extended to founders of new enterprises. An even distribution between investment and working capital loans, although intended at the time of project appraisal, was not achieved. The reason for the type and structure of the sub-loans and for the delay in the disbursement of the funds was that other SEDO funds were available through the PBDAC for investments, particularly for founders of new enterprises, at a more favourable interest rate at the same time. In the five regional governorate banks the repayment rate for the currently outstanding SEDO loan portfolio is 97.5%, so that the target indicator for EDP I has been achieved.

Because of institutional weaknesses on the part of the PBDAC there was deliberately no cooperation with the PBDAC under EDP II and the sub-loans were extended through state-run commercial banks. Thus, agreements were signed with the Bank of Alexandria (BoA) and Bank Misr (BM) for LE 5.0 million each and with the National Bank of Egypt (NBE) for LE 10.0 million. Altogether, 774 loans were extended in a total amount of LE 21.4 million. Owing to political requirements the standard loan interest rates of SEDO were reduced to 7% (founders of new enterprises, up to LE 50,000) to 11% (existing enterprises, loans up to LE 200,000), while reducing the margins for the on-lending banks. Contrary to this general interest policy of the SEDO the interest rate for loans of up to 50,000 to the founders of new enterprises was fixed at 9% under EDP II. As a consequence, the sub-loans were granted mostly to existing enterprises under EDP II as well because SEDO offered more favourable loans for founders of new enterprises via the same banks at a rate of 7%. The standard loan interest rates

of the SEDO programmes are below the market level, which is currently between 13% and 16% for comparable loans in Egypt. Sometimes they are even below the average interest rate for savings deposits (7.8%) and below the interbank interest rate (11.5%). Considering the growing inflationary pressure, interest rates of 7% for founders of new companies will probably be negative in real terms soon.

Bank Misr extended a total of 97 loans from the FC funds with an average individual volume of LE 51,500 exclusively to existing enterprises in the furniture industry in the governorate of Damietta. Terms were between 42 and 60 months. The arrears ratio of the FC credit line is high, at 26.8%, but it is also not only better than the average of the SEDO portfolio with BM in Damietta (35.1%) but also better than the SEDO portfolio with BM overall (33.9%). The target repayment rate of 85% was not reached. 21.8% of the entire SEDO portfolio with BM in Damietta was in default for over 360 days, so that loan losses are likely to be well over 5% for the FC credit line as well. BoA extended 209 loans from the FC funds in 18 governorates with terms between 18 and 60 months, also exclusively to existing enterprises. At the time of the ex-post evaluation 80% of the loans had been repaid and 17% of the repayment instalments outstanding were in arrears. Thus, the quality of the sub-loan portfolio of the FC credit line is better than the overall SEDO portfolio with BoA, which has an average arrears rate of 32.8%. As with BM, the arrears rate with BoA (longer than 360 days) is quite high, at 28.7%. NBE extended a total of 449 loans from the FC credit line with a total volume of LE 10.8 million and terms of 40 to 54 months. The loans were given exclusively to existing enterprises in the governorates of Aswan and Monofia, as the repayment rates in the existing SEDO portfolio were over 85% in these governorates at the time the loan agreement was concluded between NBE and SEDO. So far all repayments on the loans refinanced from the FC credit line have been made on schedule. Given an arrears rate of 4.33% for the entire SEDO portfolio of NBE in Aswan and 3.38% in Monofia it is safe to conclude that the target portfolio quality was achieved for the sub-loans of the FC tranche that were extended through NBE. Reasons for the poor quality of the SEDO loan portfolio at BoA and BM included political pressure on the banks to quickly disburse loan programmes of the SFD/SEDO in combination with a lack of experience and institutional prerequisites on the part of the two banks for extending loans to the target group of small and medium-sized enterprises.

Key Results of the Impact Analysis and Performance Rating

At the moment of project appraisal the main impacts of both projects were seen on the the overall economic level of income and employment effects among the target group. SEDO estimates that both FC projects contributed to creating and preserving approximately 5200 jobs. Even if SEDO overestimates the extent of the employment impact its programmes had, there is empirical evidence of the positive employment effects which the SEDO programmes apparently did have.

However, the projects made only a limited and temporary contribution to improving the target group's access to credit. Under EDP II the portfolio quality is in part well below expectations. The institutional and financial sustainability of SEDO as an apex institution is not guaranteed, and the business and interest-rate policy of the SEDO fails to make SME lending viable for commercial banks; rather, the fixing of sub-loan interest rates below the market level, an approach that fails to take risks and costs into account, prevents the commercial banks from establishing a sustainable lending business with funds of their own. A continuation of the SEDO policy is dependent on grants and concessionary financing provided by donors. As the subsidisation of sub-loan interest rates has been and is possible only by giving SEDO access to concessionary financing and grants, these limited resources should be utilised in a more targeted, complementary manner that does not distort the market. An adequate financing offer for SMEs can be made available on a sustainable basis only in line with market conditions through the local financial market if it has sufficient liquidity. The

increasing assumption of banking functions by the SEDO - without being subject to banking supervision - including the direct and indirect assumption of credit risks - contradicts the function of SEDO as an apex institution and reduces the function of the commercial banks to mere handling agents.

In summary, we have arrived at the following assessment of the developmental effectiveness of the projects:
Effectiveness: Measured against the formulated target indicators, the overall economic objectives were achieved in the case of EDP I.
In the case of EDP II the objectives were achieved only to a limited extent.
In regard to the financial sector, no positive structural impacts can be ascertained. On the contrary, the lending and interest policy applied by SEDO is not risk and cost-oriented. It prevents the banks from going into the lending business for small loans with funds of their own. The supply of credit established under the direction of SEDO is not financially viable in the long term because of the poor portfolio quality and the resulting erosion of the funds provided. It was not possible to establish sustainable access for SMEs to loans. Despite the positive overall economic impacts we rate the effectiveness of the project as inadequate **(sub rating: 4)**.

Significance / relevance: The loan programmes administered by the SEDO made a positive contribution to improving the access for SMEs to financial services and, thus, to creating employment and jobs in the past years. However, for the above reasons this contribution is neither sustainable nor is it capable of building structures or serving as a model. The projects have insufficient significance both in regard to their impacts on the workings and function of SEDO as an apex institution and in regard to the lending practice of the banks. The significance and relevance of the project approach for solving the main problem of providing a sustainable supply of loans for SMEs is not given, so that we rate the significance and relevance of the projects as inadequate **(sub-rating: 4)**.

Efficiency: As an apex institution, SEDO has significant institutional weaknesses, and the financial sustainability of SEDO is not given. Despite pressure exerted by various donors and development cooperation organisations, including KfW, the interest policy is still socially oriented, politically influenced and hampers a commercially efficient business policy. The very poor portfolio quality of certain onlending banks allows the conclusion that the funds are not being utilised efficiently in these cases. The delayed implementation of both programmes must also be seen from this perspective. We rate the efficiency of the projects as insufficient (**sub-rating: 4**).

In a summarised assessment of the above impacts and risks we rate the programme as having an insufficient developmental effectiveness overall **(overall rating: 4)**.

A positive side effect is that because of the insistence of German Financial Cooperation on a stronger market orientation of the policy of the SEDO the two projects have contributed in a decisive manner to shaping the profile of German Financial Cooperation in the dialogue among donors. The German Federal Ministry for Economic Cooperation and Development (BMZ) has drawn the consequences from the weaknesses of the policy of the SEDO, has reprogrammed funds already committed in 2002 and made further cooperation with a SEDO contingent on specific reform steps that include putting in practice a market-driven interest rate policy and greater autonomy.

General Conclusions

Although the projects had some positive impacts on the economy as a whole, the assessment of the developmental effectiveness underscores the need for focusing the appraisal of projects on objectives at the level of the target group that are not primarily directed at the overall economy. Rather, in accordance with the sector strategy for financial system development that has been in place since 2004, the project objective and project conception should be consistently focused on increasing the efficiency of the financial system and its institutions in order to secure the sustainability of the projects.

A subsidisation of interest rates for small enterprises, which runs counter to market forces, should not be supported by FC funds, particularly when they prevent the emergence of markets. In connection with the definition of interest rates, a rigid prescription of sub-loan interest rates and, thus, the margins for the banks should be avoided as well. What should be sought is a risk and cost-oriented definition of sub-loan interest rates by the banks, as they improve the incentives for banks to implement the programmes by taking account of credit risk, promote competition among the banks, prevent negative crowding-out effects and, not least, lead to an efficient utilisation of scarce donor funds.

In comparable FC projects in which the design has a strong political dimension and in which various donors are involved in the financing, a common donor position should be established in advance in order to underscore the demand for structural reform and guarantee uniform conditions. As in the case at hand, cooperation should be linked to specific reform steps. Increased donor harmonisation in programme design, monitoring and reporting requirements also leads to a reduction in transaction costs for the apex institutions.

Where the apex institution or the onlending banks have considerable institutional weaknesses the planning of the project conception should also consider targeted personnel support measures in order to ensure the effectiveness and sustainability of credit lines.

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 above 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 concept)?
- 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, organizational and/or technical support has come to an end.