Peru: Promotion of Micro and Small Enterprises through Subordinate Capital Finance, Phase I

Ex-post evaluation report

OECD sector	24040 – Informal and semi-formal financial intermediaries	
BMZ Project number	1998 66 625	
Programme executing agency	Corporación Financiera de Desarrollo S.A. (COFIDE)	
Consultant	Not applicable	
Year of ex-post evaluation	**2006**	
	Programme appraisal (planned)	**Ex-post evaluation (actual)**
Start of implementation	October 1999	December 2001
Period of implementation	39 months	15 months
Investment costs	Not applicable	Not applicable
Counterpart contribution	Not applicable	Not applicable
Finance, of which FC funds	EUR 5.1 million	EUR 5.1 million
Other institutions/donors involved	None	None
Performance rating (Overall)	1	
• Significance/Relevance (Subrating)	1	
• Effectiveness (Subrating)	1	
• Efficiency (Subrating)	1	

Brief Description, Overall Objective and Programme Objectives with Indicators

Promotion of micro and small enterprises (MSEs) via the financial sector. To sustainably improve the credit supply to Peruvian micro and small businesses (project objective), highly qualified financial intermediaries are provided with subordinated long-term borrowed capital on commercial terms via COFIDE, the public Peruvian development bank. This raises the equity and the capability of these institutes to refinance themselves through savers and on the interbank market. As some of the funds can be assigned to equity capital, it also enlarges their lending scope. The project was intended to make a contribution to the deepening of the financial sector and to securing jobs and raising incomes in poor sections of the population (overall objectives). In line with the Agenda 2015, the project also makes a contribution to poverty alleviation. The funds provided from FC for this project amounts to EUR 5.1 million. COFIDE's own contribution - 20% of the subordinate loans - totals EUR 1.3 million.

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

Borrower, project executing agency and operators. The borrower is the Republic of Peru, represented by the Ministry of Finance. The ministry transfers the funds on FC terms and conditions to the state development bank COFIDE (project executing agency), which administers the funds on its own account and at its own risk. COFIDE in turn channels the funds to qualified microfinance institutions on near-market terms, contributing 20% of the total disposable fund volume for the refinancing of the MFIs. The MFIs, in their capacity as financial intermediaries, extend loans to the target group and play a key role for the success of the project.

Selection of partner institutions. The partner institutions were selected by COFIDE on the basis of criteria stipulated in the programme agreements. These pertain in particular to portfolio quality, financial strength and the target-group orientation of the financial institutions. The criteria were deemed appropriate for the identification of generally suitable institutions for participation in the programme. However, meeting the basic eligibility criteria did not automatically lead to a participation in the project: Ultimately, it is at the discretion of the executing agency, COFIDE, to decide which financial institutions are suitable for participation and how much support they should receive from the programme. In view of the high professionalism of the executing agency, it would seem warranted to entrust it with the selection of programme participants. Even though some of the Peruvian commercial banks now issue microloans to the target group, it would still seem appropriate to concentrate this programme on non-banks, i.e. in particular, CMACs. In this way, economically disadvantaged regions outside the Lima area can be better reached and the CMACs can counteract the risks associated with the the concentration of the market on a few banks.

Assignability to equity capital. The subordinate loans granted to the partner MFIs under the programme can be assigned to so-called effective equity capital (patrimonio effectivo) up to a limit of 50% of the book value of equity capital.This way, the funds provided can have a leverage effect. Thus, by raising equity capital securities the subordinate loan instrument makes a substantial contribution to the effectiveness of the programme. At the time of the project appraisal, most of the CMACs had already exhausted their equity capital for lending. The additional subordinate capital available from FC finance could therefore be used fully for extending the lending business further. Depending on the risk structure of the portfolio and liability maturities, most of the CMACs work with a leverage factor (apalancamiento) of 5 to 6, meaning that up to five to six times the volume of the effective equity capital can be issued as loans: Consequently, each CMAC has mobilized an additional five to six times the amount of the FC funds in credit. In our assessment, this is a good ratio. The subordinate loans to the CMACs allow them effectively to provide loans to the target group in an amount several times the height of the subordinated loans themselves.

Retention of profits. The MFIs participating in the programme are obliged to retain a certain part of their earnings as equity capital during the five-year grace period of the subordinate loans (reinvestment). Participating private MFIs must retain at least 50% of their profits after tax. whereas CMACs are obliged to retain a quota of 75%. The letter exceeds the statutory retention ratio for CMACs of 50%. Thus, besides the addition of the loans to effective capital as described above, the programme contributes to the sustainable increase in the partner MFIs' equity base and thus to improving their lending capability and financial stability. By virtue of this contractual obligation, the management of several participating CMACs see their position strengthened in relation to the municipal authorities, which have a basic interest in a higher payout of dividends to improve their budgets. There is at least one known case of a CMAC not participating in the programme due to this obligation. In this respect, the provision performs a certain selective function as it tends to exclude MFIs that are subject to heavier political influence from local government.

CMACs. So far, six CMACs have received refinancing from the project for microloans. CMACs are joint-stock companies owned by the local authorities. Despite their private-sector status, they are subject to various public service regulations (particularly procurement, personnel management and pay as well as supervision). CMACs operate as for-profit commercial enterprises. The legal provisions require that at least 50% of their annual surplus must be retained to equity capital. As a rule, the management board consists of three managers who are appointed by the supervisory board, usually made up of three municipality representatives as well as one representative from the church, the chamber of commerce, small businesses and COFIDE.

Market terms and conditions. The financial intermediaries for target-group lending have been provided with FC funds in the form of subordinate loans amounting to about EUR 5.1 million. The term period of the loan ranges between eight and ten years with a five year grace period. The loan is denominated either in USD or the local currency. To avoid market distortions, the refinancing interest rates may not fall below the long-term interest rate payable, which is regularly determined and published by COFIDE. An additional up-front fee of 2% is charged on conclusion of the loan agreement. In line with the agreed programme criteria, COFIDE redisburses repayments (revolving use). The exchange rate risk is borne by COFIDE, which has sufficient financial resources and suitable means to insure itself against the remaining risk. The interest rates on the final loans to the target group are determined independently by the MFIs according to market situation. The effective interest rates for the final borrowers ranges widely between about 12% and about 33% per annum and depend essentially on the maturity and type of loan. Altogether, the margins would seem to us to be adequate, although a rise in credit supply should reduce MFI margins with a possible fall in interest rates as a result.

Split-interest counterpart funds and operating costs. The difference between the FC interest rate of 2% a year (corresponding to COFIDE's prime rate) and the refinancing interest rate of USD LIBOR +5% a year or the local reference interest rate of VAC +10% a year is used as follows: One per cent a year of the volume of credit provided by COFIDE to the partner institutions (FC share) is channelled into a fund for technical support (Fondo de Asistencia Técnica). The other part of the margin is collected by COFIDE and is used (without further itemization) to cover its administrative and risk premiums, to pay for bearing exchange rate risk in EUR/PEN or EUR/USD and to earn a profit contribution. The present margin set at 6.4% for fund management and risk-bearing would seem adequate to us.

Fondo de Asistencia Técnica. The task of the technical support fund is to raise the capacity of the microfinance sector and improve financial service delivery to MSEs by financing consultancy services and training measures. So far, an expert has been financed from the fund to support one CMAC that was facing difficulties. As of the 31st December of 2005, about US$ 130,000 was still available in the fund. To date, an impact analysis of the FC project as provided for in the project appraisal has not yet been financed from the fund.. We recommend conducting this analysis before the ex-post evaluation of the second phase, provided the funds are not used for another purpose.

Own contribution and application of funds. As mentioned previously, 80% of the subordinate refinancing loans are FC funds, the remaining 20% are contributed by COFIDE. The contribution of the financial intermediaries (CMACs) consists in the retention of earnings as described above. At the level of both the partner MFI and the executing institution (COFIDE), the repaid funds are redisbursed. The first retransfer of funds to the executing institution will take place in March 2007. No indications of any improper use of funds could be ascertained in the ex-post evaluation. The account for the fund, which is maintained by COFIDE, has been audited every year by an international auditor (KPMG) with no objections raised.

Key Results of Impact Analysis and Performance Rating

Programme and overall objectives. The programme objective was the sustainable increase in lending to MSEs by the participant financial institutions. The programme intended to make an contribution at the institutional level to deepening the financial sector and to securing jobs and raising income in poorer sections of the population (overall objectives).

Target group. The target group are micro and small businesses in Peru with a bankable demand for credit, that is, that have a real need for financing,and the ability and willingness to repay the loans. The intermediaries are particularly well qualified financial institutions with special access to the target group.

Indicators and objectives achievement rating. The target indicators of the programme have been exceeded at overall objective level and have surpassed the expectations at programme objective level by very a large margin.

Overall objectives	Indicators
1. Contribution to deepening the formal financial sector	Development of the following indicators for the formal financial system up to 2005: i. Ratio of M3 money supply to GDP remains at 24%. As of December 2004: 27.69% (estimate December 2005: 27.96%) ii. Ratio of public deposits in the banking system to GDP remains at 18%. As of December 2004: 21%, December 2005: 23% (banks, CMACs and CRACs)
2. Contribution to job security and increased income in favour of poor sections of the population	No indicator in programme appraisal report. The direct contribution of the programme at overall objective level is difficult to verify directly. Plausibility yardsticks (average loan amount, character of borrower) and studies on the impact of microfinance in Peru suggest, however, that planned contribution has been made.
Programme objectives	**Indicators**
Sustainable increase in lending facilities for MSEs via programme financial intermediaries on market terms.	The following applies for the financial institutions in the programme: i. The number of microloans under the limitation of the Banking Superintendence (Superintendencia de Bancos y Seguros) increases by 10% a year. Status of objectives achievement: Altogether, the partner CMACs recorded growth rates of about 28% (2003), 26% (2004) and 20% (2005)[1] ii. The volume of microloans under the limitation of the SBS increases by 10% a year. Status of objectives achievement: Altogether, the partner CMACs recorded growth rates of about 42% (2003), 39% (2004) and 29% (2005).

Assessment of indicators and objectives achievement. The indicators chosen to measure objectives achievement were found to be valid and appropriate, although the lifetime of the project up to 2002 is no longer applicable due to the delayed project start. Instead of confining the overall objective indicator ii (public deposits in the banking system) to commercial banks we include the other deposit-taking institutes, CMACs and CRACs to obtain a full picture. As is to be expected at overall objective level, the project impacts are not directly reflected in the macroeconomic figures. This applies in particular to overall objective indicator i. We may, however, plausibly assume that the programme support to the CMACs and the attendant decentralization and deconcentration has made a basic contribution to stabilizing the financial sector and raising its efficiency. As to overall objective indicator ii, a positive contribution can be attributed more directly to the project in view of the tenfold increase in CMAC deposits from about PEN 240 million to PEN 2.42 billion.[2]

Developmental role of CMACs in the financial system. The CMACs play a very important role in the Peruvian financial system, particularly in mobilizing savings deposits and issuing loans to micro and small enterprises in the regions outside Lima. Despite the increasing entry of

[1] The project objective indicator of 10% has not been met every year by all CMACs. Altogether, as the rates for all participant CMACs show, however, the targets have been well exceeded. The only institute that ever recorded a drop in credit volume or client number was CMAC Paita (in 2005). After strong growth in previous years, this small CMAC is currently undergoing a consolidation phase.

[2] The deposits at commercial banks only increased by about 35% in the same period from approx. PEN 40.5 billion to PEN 54.6 billion.

commercial banks into the microfinance market, the CMACs are still at the forefront in Peru in competing for small clients and innovation.

Poverty impact. The low average loan amount[3] of the participant CMACs is evidence that MSE target group outreach has been very good. Several studies on various microfinance facilities in Peru reveal beneficial impacts on income in the loan-receiving households and attendant improvements in the quality of life and on jobs.[4] Thanks to the operational focus of the participant CMACs on regions outside Lima, economcially weak regions with a higher ratio of poor populations have been reached.

Moderate long-term potential risks. The very positive results of the programme so far will probably continue into the medium term. The very good performance of the CMACs could be impaired in the long term by weaknesses in the governance structure: Firstly, the management of CMACs usually lack international working experience or experience in local commercial banks. Hence, CMACs increasingly lack access to new, ideas from outside, which is vital to the process of adjusting products and processes to the state of the art level. ,Secondly, most members of the CMAC supervisory boards have a political or social background and lack banking expertise. In view of the expected continued growth of CMACs, an expansion of services and increasing complexity in the processes involved in providing these services, it is essential to professionalizing the supervisory boards so that the management can be overseen in a competent manner. There is a latent danger that the municipalities will not make enough efforts to acquire this level of this professionalization so as to retain political influence over the savings banks. In principle, the municipalities, as owners of the CMACs have the means to deal with both these risks.

Summary assessment. To summarize the assessment of all the above impacts and risks, we rate the developmental efficacy of the programme as follows:

Effectiveness. The programme objective was the sustainable improvement of credit supply to Peruvian MSEs. Measured against the indicators, this objective was met in full. Some of the participant CMACs surpassed the target level by a multiple factor. The quasi-equity type of refinance provided through the programme enabled the participating institutes to extend their lending in a way that far exceeds the amount of the subordinate loans themselves. The obligation under the programme for a higher retention of earnings ensures a sustained consolidation of the equity base of the participating CMACs and enhances their lending capability and economic stability. These CMACs use public deposits and other refinancing largely for provide loans to micro and small enterprises, which make up their core client segment. Thus, we rate the effectiveness to be very good **(Subrating 1)**.

Relevance/Significance. The programme was supposed to make a) a contribution to deepening the financial sector and b) to securing jobs and raising income to benefit poorer sections of the population (overall objective). Overall, the supported CMACs have been able to enlarge their microlending and loan portfolio at high, steady growth rates. The majority of them number among the leading microfinance providers in Peru. Their success has transformed the CMACs into market leaders that have contributed to improving the quality and expanding the volume of MSE lending of other providers as well, particularly private banks (demonstration effect). So the programme has had a broad impact well beyond the institutes directly involved. Various studies have proven the beneficial poverty and income effects of microlending in Peru. Moreover, the participating CMACs are operational in less prosperous regions of Peru so that they play an important role in promoting balanced economic development. Altogether, we rate the relevance/significance as very good (**Subrating 1**).

Efficiency. The efficiency in the participant CMACs can be assessed as very good. Although in our view there is still room for raising efficiency in the institutes, the Peruvian CMACs already number among the leading MFIs worldwide for efficiency, as evidenced in particular by the very good returns on investment and strong portfolio growth, despite a slightly higher non-performing

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[3] The average loan amount for the CMACs in the microloan segment (as defined by SBS) amounts to about PEN 4,700 (about EUR 1,800). For comparison: The average loan amount in the microloan segment in the commercial banks (excluding the specialist microbank Mibanco) is about twice as large.

[4] See for example Revolledo-Wright, Assessing the Social Performance of Microfinance Using the QUIP, Imp-Act Working Paper No . 10, 2004; Dunn and Arbuckle, The Impacts of Microcredit: A Case Study From Peru, AIMS, 2001; or Horn Walch and Devaney, Poverty Outreach Findings: Mibanco, Peru, publication series Acción Insight No. 5, 2003.

loans ratio. The final loans to the MSEs are granted solely on market terms so that allocative efficiency is not affected by rationing effects. The slightly higher non-performing loans ratios as compared with other microfinance institutions may, however, be an indication that the CMACs do not always manage to identify the MSEs with the best success and growth prospects. The efficiency of COFIDE in programme implementation is assessed as good to satisfactory. The CMACs and banks surveyed consider COFIDE to be rather slow in preparing and approving the loan and the interest rates tend to be too high in their view. In our opinion, the implementation of the programme could have been carried out more speedily by COFIDE. Its allocation of programme funds to the individual CMACs would, however, seem to have been successful in the final outcome. Despite these reservations, we still judge efficiency to be good **(Subrating 1).**

Overall assessment. Weighting up effectiveness, relevance and efficiency, we gauge the developmental efficacy of the programme overall to be very good (**Rating 1**). The conceptual design of the programme succeeded in selecting partner institutions with close target-group proximity and a high level of efficiency and in mobilizing the specific growth potential of the institutions by providing quasi-equity subordinate loans.

General Conclusions

Use of subordinate refinance (mezzanine capital). Providing MSME refinance to local financial intermediaries in the form of subordinate loans that can be assigned in full or in part to equity capital is a useful tool for generating powerful multiplicator impacts and raising the effectiveness of FC funds to a remarkable level. More use should therefore be made of this innovative instrument in German FC. However, it requires an executing agency with a comparatively high capability for managing and bearing risk on its own. Where this kind of executing agency is lacking, one can resort to FC trust-fund contributions that can also be used for quasi-equity loans as provided for in the BMZ financial sector policy paper of 2004.

Obligation to retain earnings. When issuing subordinate loans, the borrower should be obliged to retain a certain ratio of profits in excess of the usual requirements. This can have two effects on the sustainability of the project success: a) On the one hand, it strengthens the long-term equity base. This usually has a beneficial impact on the economic sustainability of the financial institution concerned and at the same time the improved equity base helps secure the subordinate loan, which mitigates risks. b) On the other, the demand for higher retention could deter institutions that attach more importance to a fast investment yield instead of long-term development. So requiring a higher retention ratio can help select more suitable partner institutions for long-term FC.

Technological modernization and international integration. In comparison with other microfinance institutions that belong to international networks (Acción, ProCredit, Opportunity International, etc.), CMACs are less able to grasp opportunities for technological modernization early on. Less know-how and experience is transferred from other countries and the transferral is slower as comparatively little exchange takes place and there are no international owners to take up and implement new technologies as a matter of policy. Seminars and other capacity–building measures can only compensate for this to a limited extent. Integrating local microfinance institutions into international networks can give a substantial impetus to raising efficiency and professionalism and thus, facilitating better outreach to the target group.

Assessment criteria

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

Criteria for Evaluating Project Success

The evaluation of the developmental efficacy of a project and its classification into one of the various levels of success during the ex-post evaluation concentrates 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. These facilities should allow the project activities to continue generating positive effects once the financial, organisational and/or technical support have come to an end..