Uruguay: Promotion of the Small and Medium-Sized Industry (BROU IV)

Ex post evaluation report

OECD sector	24030 - Financial institutions of the formal financial sector	
BMZ project ID	1999 65 138	
Project-executing agency	Banco de la República Oriental del Uruguay (BROU)	
Consultant	not applicable	
Year of ex-post evaluation	**2006**	
	Project appraisal (planned)	**Ex-post evaluation (actual)**
Start of implementation	01/2001	01/2001
Period of implementation	no information available	33 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 2.2 million	EUR 2.0 million
Other institutions/donors involved	none	none
Performance (overall rating)	4	
• Significance / relevance (sub-rating)	4	
• Effectiveness (sub-rating)	4	
• Efficiency (sub-rating)	4	

Brief description, overall objective and project objectives with indicators

The overall project objective was to contribute to increasing growth, income and employment in the small and medium-sized industry in Uruguay. The project objective was to ensure the efficient credit supply to industrial SMEs for ecologically and economically sound investment projects at positive real interest rates. The project's target group were small and medium-sized industrial enterprises as well as service companies related to the manufacturing industry. The project-executing bank was the public Banco de la República Oriental del Uruguay (BROU) which extended loans to SMEs to finance investment projects in the context of the project. DINAPYME, a consulting unit for small and medium-sized enterprises of the Ministry of Industry, Energy and Mining supported the target group in the planning of their projects and in the preparation of loan applications. FC funds in the amount of EUR 2.2 million were provided to finance the project.

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

The relevant institutions for the project are the project executing bank, Banco de la República Oriental del Uruguay (BROU), and the Dirección Nacional de Artesanías, Pequeñas y Medianas Empresas (DINAPYME), which provided support to the SMEs in the preparation of loan applications and conducted marketing activities to advertise the credit line (events and newspaper advertisements).

DINAPYME is a consulting unit of the Ministry for Industry, Energy and Mining and, as such, responsible for providing political advice to the government and advisory services to SMEs.

BROU was founded by law in 1986 and is an autonomous public institution which is 100% owned by the Republic of Uruguay. Its Board of Managing Directors is appointed by the President of the Republic and approved by Parliament. Typically, in case of a change of political power, the Board of Managing Directors is also replaced.

Since 1997, the bank has been undergoing a tenacious reform process to increase professionalism and efficiency. The difficult situation faced during the years of the banking crisis has accelerated this reform process. Important changes implemented since the time of the project appraisal include the strengthening of the internal control system, the introduction of a transparent promotion system in the context of staff development, further development of the credit technology and the appointment of loan committees, an improvement of risk management and the improvement of the management information system.

BROU's organisational structure is, overall, appropriate and has improved considerably since project appraisal. The bank has an independent internal auditing department. The external control system includes an annual audit conducted by an internationally recognised auditing firm (since 2002), regular audits by the Central Bank and an annual audit by an institution in charge of auditing public institutions. The bank's risk management in the areas of credit and market risk is satisfactory. The loan approval process is in line with accepted banking standards. What has to be criticised, however, is that the bank did not prepare any process manuals for the numerous processes modified in the course of the reform process. However, these will be prepared with the help of PriceWaterhouseCoopers in the context of the establishment of an integrated internal control system. A further weak point is the lack of control of operative risks. Such an operative risk department, however, is also currently being established.

The bank's headcount is adequate. Due to the employment contracts and the strength of the labour union, the bank has only very limited possibilities to dismiss employees so that in times of the banking crisis, the total number of staff was rather inflated. Salaries are below the level of the commercial and private banks; compared to other sectors, however, they are quite attractive. Staff advancement and promotion takes place under a transparent job application scheme and there are a number of further training measures available to the employees.

In summary it can be said that in institutional terms, BROU has made considerable progress compared with the time of the project appraisal and is now able to offer professional banking services.

The on-lending conditions offered under the project were in line with market standards and were appropriate. Under the project, BROU acted as borrower and the Republic of Uruguay as guarantor. The FC funds were passed on to BROU at an effective interest rate of 5.75% p.a. for a term of 20 years with 5 grace years. Of this interest rate, 4.5%[1] is repaid to KfW, 0.25% to DINAPYME as a fee for the advisory services and 1% is paid into a guarantee fund to serve as collateral for those loans whose borrowers could not provide sufficient security.

As had been agreed, the interest differential funds were used to feed the guarantee fund and to pay the fee owed to DINAPYME. For administrative reasons, DINAPYME has so far not requested the respective funds, but will shortly do so. Despite the high default rate, the guarantee fund has still not been drawn on either, because the bank first has to realise all other securities that exist and this has not been done so far. It is to be expected that the funds will be requested in 2006.

It must be critically stated that the project has hardly had any broad-scale effect. At the time of the project appraisal it was envisaged that in the first round of lending under the credit line approx. 25 loans with an average loan amount of EUR 88,000 were to be extended. In fact,

[1] The FC funds are from the loan commitment made in 1987. These funds were granted in accordance with the loan conditions valid in 1987, i.e. an interest rate of 4.5% p.a. and a term of 20 years with 5 grace years.

however, only 6 sub-loans were granted. Essentially, the reason for this was the extension of a large credit in the amount of USD 1.2 million. The other loans amounted, on average, to USD 150,000. The remaining funds amounting to EUR 230,931.18 were not used because in the wake of the banking crisis the demand for euro loans declined drastically. The residual funds were set off against BROU's redemption payments.

The conditions for the sub-loans were slightly below usual market conditions, but, on the whole, can still be classified to be in conformity with the market. As had been agreed, the loans were granted at a fixed interest rate of 7.5% p.a. and for terms between 5 and 10 years with 1 to 3 grace years. The exchange rate risk had to be borne by the final borrowers. The loans were extended in DEM (and later on in EUR). The margin of 1.75% charged by BROU can be judged to be appropriate in the Uruguayan context.

The number of loans in default increased dramatically in the course of the currency devaluation. Up to 2002, there had been no defaulting loans. After 2002, however, none of the enterprises, which produced mostly for the national market and had hardly any revenues in foreign currency, was able to honour their debt service (interest and redemption payments). In the meantime, three loans have been restructured and are now being serviced properly. Two enterprises filed for bankruptcy and one of the loans still has to be restructured. It has to be assumed that the SMEs were not really aware of the exchange rate risks they had incurred.

BROU did not make a follow-up on the loans extended in the second round of lending. Due to the fact, however, that approx. 92% of corporate clients belong to the project's target group, it can be assumed that most of the funds were used, as agreed, to refinance further SME loans.

The final evaluation did not give any indications of an improper use of funds.

Key results of the impact analysis and performance rating

The overall project objective was to increase growth, income and employment in the small and medium-sized industry. The project objective was to ensure the efficient credit supply by BROU to industrial SMEs for ecologically and economically sound investment projects at real positive interest rates. The target group of the project are Uruguayan small and medium-sized enterprises which comply with the following criteria:

Sector:	Manufacturing industry or service companies related to the manufacturing industry
Number of employees:	Between 5 and 99 employees
Net sales:	< USD 2.0 million p.a.

From the perspective prevailing at project appraisal, the target system can be judged as adequate and was in accordance with the objectives of Uruguayan development policy. Taking into account the current BMZ concept for financial sector support, the overall project objective focuses too one-sidedly on the impact on the real economy. Thus, for the purpose of project evaluation, the sustainable improvement of the efficiency of the financial system in terms of *financial deepening* (tapping of new customer groups) is considered as an additional overall project objective.

One indicator laid down to determine whether the project objectives have been achieved was that the share of defaulting loans in the overall portfolio must not exceed a share of 10%. Basically, this indicator is adequate to measure the achievement of the project objective. At the time of the project appraisal, no indicator to measure the achievement of the overall objective was defined. To evaluate the generation of income and employment, the number of newly-created jobs is usually used as an indicator. The ratio of bank loans extended to private non-financial institutions to the gross national product is normally used as an indicator to measure the broadening of the financial sector. The target level was to achieve a significant improvement of the situation at the time of the ex post evaluation as compared with the situation at the time of the project appraisal. The situation is as follows:

Indicators to measure the achievement of the overall objective	Actual project appraisal	Actual ex-post evaluation
Jobs created or safeguarded	-	neglectable
Bank loans extended to the private sector / GNP	50 %	**21 %** (2005)
Indicator to measure the achievement of the project objective	**Target: Project appraisal report**	**Actual: Ex post evaluation**
Number of non-performing loans (30 days)	< 10 %	50 %[2]

The project objective, as measured by the target indicator, has not been achieved. However, it has to be pointed out that this is due to the massive external shocks caused by the economic and currency crisis. It has be assumed that at the time of the extension of the loans and measured in terms of the expectations at the time regarding future economic development, the funded projects were, for the most part, economically sound. Up to 2002, there were no loans in default. The devaluation of the Uruguayan peso, however, led to a dramatic rise[3] in the debt burden of enterprises, which had to be paid in local currency and overstrained their financial possibilities.

Also the overall project objective has not been achieved as can be seen from the corresponding indicators. The employment effects of the funded investments are neglectable. Moreover, it cannot be assumed that the project has contributed to a broadening of the financial sector.

The main expected impacts of the project at the time of the project appraisal were defined as follows:

- improvement in the production processes used by SMEs and in their national and international competitiveness
- contribution to economic growth
- creation and safeguarding of income and employment in industrial SMEs

The expected impacts were not achieved. Only two thirds of the funded enterprises were still economically active at the time of the ex-post evaluation. The employment effects of the funded investments are neglectable. However, for the most part, this is due to macroeconomic distortions. One unintended negative impact of the project was that the extension of loans in foreign currency to SMEs which normally do not generate any income in foreign currency has led to overindebtedness of formerly economically sound enterprises in the wake of the currency crisis of the Uruguayan peso.

The main risks – among others, the macroeconomic development and the potential impact of the currency risk on the final borrowers–- were identified correctly during the project appraisal. The severity of the risks that occurred was not foreseeable at that point of time. As far as possible, the project-executing bank reacted adequately to the risks that occurred.

In a summarised evaluation of the above mentioned aspects we rate the overall developmental effectiveness of the programme as follows:

Effectiveness:

The project objective of ensuring an efficient credit supply to industrial SMEs for ecologically and economically sound investment projects was not achieved. This is mainly due to an external shock, but partly also to the project design (unhedged currency risks of the sub-borrowers). A

[2] Three of the six loans granted were restructured and the enterprises are serving their debt properly.

[3] For a loan extended in 2001 for a term of 7 years with 2 grace years, the average effective interest rate to be paid in local currency amounted to approximately 65% p.a.

positive point worth mentioning is that the project-executing bank works together primarily with the target group of the project, also outside of the project. For this reason, sustainability of SME financing is ensured also after project completion. Overall, we classify the project's effectiveness as slightly insufficient due to the fact that the project objectives were not achieved (**sub-rating 4**)

Significance and relevance

The project design chosen was only partly adequate to contribute to the solution of the identified macroeconomic problems (relevance). The indicators defined to measure the achievement of the overall project objective show that the overall objective of increasing economic growth, income and employment in the small and medium-sized industry was not achieved (significance). The FC project had a complementary effect because BROU did not have any comparable alternative long-term sources of funding. The low broad-scale impact of the project has to be judged critically. Instead of the originally envisaged 25 loans, only 6 loans were finally extended. The role of the project executing bank has to be viewed critically because due to its double role as a commercial and promotional bank and due to its dominance in the Uruguayan financial market, it tends to obstruct competition in the field of SME finance. Overall, we rate the project's significance and relevance as slightly insufficient (**sub-rating 4**).

Efficiency

The efficiency of the project executing bank (production efficiency) has improved considerably in the course of project implementation. However, in terms of efficiency, it is still lagging behind the efficiency of private and commercial banks. The allocation efficiency of the project is to be judged as low because due to the high default rate and the restructuring of the sub-loans hardly any funds have been available for the second round of lending up to now. Overall, we judge the project's efficiency to be slightly insufficient (**sub-rating 4**).

In a summarised assessment of the above impacts and risks we rate the programme as having an overall sufficient developmental effectiveness **(overall evaluation: rating 4)**. It has to be pointed out, however, that this result was heavily influenced by the negative overall economic development in Uruguay in the period under review.

General conclusions and recommendations

The extension of loans in foreign currency to borrowers who do not generate any income in foreign currency has to be avoided. It is recommendable that either the participating banks or the state assume the exchange rate risk if this is practicable. Otherwise it should be made sure that loans are only extended to export oriented SMEs. Alternatively, interest differential funds can be used to hedge the exchange rate risk.

Assessment criteria

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.