September 2011 · Number 1

MNA Knowledge Notes

Lessons from Projects

By Sahar Nasr

Introduction. This operation provides a $300m line of credit (Financial Intermediary Loan) through Egypt's Social Fund for Development (SFD), the apex body for micro and small enterprise finance, which would on-lend on commercial terms to eligible Non Governmental Organizations (NGOs), potential microfinance institutions (MFIs), and banks.[1] The project objective is to increase micro and small enterprise credit sustainably and broaden the outreach of finance through innovative delivery mechanisms and financial products. It plans to contribute to a sustainable improvement in inclusive access to finance for micro and small enterprises on a commercial basis. The Project went to the Board in March 2010 and is planned to be completed at the end of 2015. This Note is based on the Project Appraisal Document (PAD). The project is well underway as of the date of this note but it is too early for any implementation lessons to be collected.

Overall, lack of access to finance has been a major factor constraining the growth of micro and small enterprises (MSEs) in Egypt. According to a recent assessment by IFC, around 2.1 million MSEs do not have access to finance. USAID statistics indicate a considerably larger number of unserved MSEs. MSEs generally lack access to external financing for both working and investment capital. The 2009 Investment Climate Assessment found that firm size is the single most influential factor associated with whether or not a firm had a loan or overdraft facility. Moreover, it found that access to working capital is importantly related to firm efficiency and growth. Only 13.4 percent of manufacturing firms have loans. Small firms have the least access; less than four percent of small manufacturing firms report having loans, as opposed to 12 percent of medium-sized firms and 25 percent of large firms. In services, a similar pattern is repeated, except that less than three percent of small firms have loans. Overdraft facilities are similarly rare, especially for small firms. Small manufacturing firms got around 1.5 percent of their total working capital finance and 1.8 percent of their investment finance from banks.

Microenterprise lending in Egypt is supported by a fragmented set of hundreds of NGOs distinct from the mainstream financial sector. SFD finances 390 NGOs that are on-lending to microenterprises, many of which are small in scale.

The lack of MSE finance reflects at least three sets of factors: the restructuring and reforms of the financial sector undertaken since 2004; the recent financial crisis; and factors specific to MSEs. The financial restructuring affected the overall measured provision of credit in the Egyptian economy, as indicated by the sharp decline in private credit-to-GDP from 65 percent in June 2003 to 40 percent in June 2009, as well as a decline in the loan-to-deposit ratio from 70 percent to 50 percent in the same period. Many of the loans in 2003 were long-outstanding, weak loans of both state-owned enterprises (SOEs) and private firms that were written-off, so measured credit declined. In addition, stronger regulation and supervision led both state-owned and private banks to adopt more cautious lending policies and

---

[1] The TTL for the Enhancing Access to Finance for Micro and Small Enterprises Investment Loan (FY10, P116011) was Sahar Nasr, Lead Financial Economist (MNSF1). Specialist members of the team included: Santiago Herrera, Lead Country Economist; Andrew Stone, Lead Private Sector Development Specialist; Tara Vishwanath, Lead Economist; Douglas Pearce, Senior Private Sector Development Specialist; Sara Gonzalez, Senior Counsel; Mohamed Khaled, MENA CGAP Regional Representative; Najy Benhassine, Senior Economist; David Mckenzie, Senior Economist; Zsofia Arvai, Senior Financial Economist; Alaa Sarhan, Senior Environmental Economist

required better provisioning of bad loans. As a result, credit shrunk further. Moreover, the crisis has limited credit to MSEs, as a result of the retrenchment of foreign capital to Egyptian markets, slower deposit growth, and a further increase in the degree of risk aversion by banks.

Egyptian MSEs face problems limiting their access to credit that are common worldwide. These problems include the MSEs' lack of capacity to prepare a business plan and loan application, opaque or non-existent financial statements, and insufficient collateral. On the side of finance, there are high administrative costs of small scale lending, as well as inadequate banking skills for dealing with MSEs, and some remaining deficiencies in financial infrastructure. In this regard, it should be noted that a new private credit bureau, **I-Score** has only begun its credit scoring and is working with the dedicated lenders to MSEs to include their credit information. A legal and regulatory system for moveable collateral that would facilitate lending to small firms is currently being prepared, including establishment of a collateral registry.

MSEs also face non-financial issues, including a cumbersome legal and regulatory framework as well as a highly bureaucratic system. They suffer from a lack of adequate business development services, adequate information, advanced technology, and skilled labor. In some cases, there is reluctance to tap into financing that is considered non-compliant with *Shari'a*—religious considerations. Moreover, there are also gender related constraints in terms of access to finance. These problems complicate lending to MSEs by NGOs,[2] and explain the low level of bank finance to them.

Project Components. The project had two components: (a) a line of credit for microenterprises to be channeled through banks and NGOs (and potential MFIs). Proposed channels were mainly via: (i) microfinance NGOs and MFIs; (ii) banks as wholesalers to NGOs and MFIs; (iii) banks lending directly through their branch network; and (iv) a service agent lending through post office branches. Product and delivery innovations including Islamic microfinance and mobile phone banking (linked to anticipated regulatory changes), will be supported; and (b) a line of credit for small enterprises to be channeled through: (i) direct banks' lending through their branch networks; and (ii) bank linkages with NGOs and potential small enterprise finance companies set-up under a new microfinance regulation.

Lessons from experience taken into account in the design

The project design fully reflects lessons from recent analytical work on MSEs, ongoing and completed World Bank Group activities and donor projects, international best practice in the MSE finance area, and also OP8.30 guidelines. Lessons learnt from lines of credit in Egypt and other countries were taken into account in the design of the project. The project also benefited from the IEG assessment of World Bank Lending for Lines of Credit. The IEG report covers a number of topics including: accountability and management capacity of implementing entities; role of apex lenders; identification of suitable products and delivery mechanisms; eligibility criteria for participating intermediaries, and selection of monitoring indicators and adequate supervision during implementation. A summary of the main lessons from the IEG report as they were seen to apply to the project are included below:
Implementing entity's accountability and strong management is essential for successful project execution. In lines of credit in developing countries, intermediation through government agencies has often been unsuccessful in part because these entities lack the appropriate institutional and operational capacity. An effective and successful microfinance industry depends on strong institutions and competent

[2] Egyptian dedicated lenders to microenterprises are termed NGOs, registered under the Ministry of Social Solidarity, reflecting their origination in private institutions that depended on donor funds. NGOs now include various kinds of non-profit institutions that lend to microenterprises, but they are not corporations and are not permitted to take deposits.

managers.[3] SFD is a prominent and credible developmental finance institution with a competent Board, strong management capacity, market knowledge and a good governance structure and as such, has been assigned clear responsibility and full accountability for project implementation. The government with the support of development partners is providing training to further build the capacity of management and staff.

Sustainability of microfinance is often an issue when the microfinance institutions become too dependent on apex lenders. This project, taking stock of challenges in other similar projects, addresses this problem by encouraging greater involvement of banks in direct MSE lending and access of NGOs and potential MFIs to bank and market funds. This way the dependence on funds from apex institutions or donors will be reduced. Moreover, SFD will share MSE market and client knowledge and information with participating banks, as well as techniques (product design, service delivery mechanisms, and loan analysis) for serving MSEs on a commercial basis. The NGO wholesale funding initiative that SFD has recently signed with the Commercial International Bank (CIB) - which will benefit from potential financing under this project - is an example of SFD working with banks to develop commercially viable and attractive microfinance and small enterprise finance models.

Suitable products and delivery mechanisms are crucial for increasing access to finance for MSEs. The project will not just expand credit through existing lending products, but innovate through the development of new products; for example, Islamic financing designed to meet the needs of those who are keen to use products that are in compliance with *Shari'a* for religious reasons, as well as for interest-averse business owners. It will also improve mechanisms for outreach through the development of a participating NGO or a potential MFI that will operate through the post office branch infrastructure. Overall, the project design has benefited from other operations of the Bank and other agencies in terms of products and mechanisms.

Use of sound eligibility criteria that meet Bank guidelines in selecting and monitoring NGOs, and banks to ensure their financial and operational quality. The project will entail SFD allocating its loans based on transparent eligibility criteria taking stock of the recommendations put forwards by the 2006 IEG Evaluation. Banks and NGOs will have incentives to strengthen their performance in order to be eligible to larger loans from SFD. Drawing on lessons learned from similar projects, the selection of NGOs and banks will receive increased attention, because choosing the right intermediary is critical for the success of the project. Sample eligibility criteria and specific support have been provided to SFD to strengthen its capacity to carry out the screening and evaluation of NGOs and banks to ensure that they meet requirements satisfactory to the World Bank and SFD, while at the same time meeting the goals of rapidly expanding access to underserved clients.

Focusing on a few precisely defined and measurable indicators is more important for improving the effectiveness of borrowers from the apex institutions than requiring massive details on the uses of funds. "In the apex's supervision of the MFIs it funds, focusing on institutional performance targets that are few in number, precisely defined, and seriously enforced is probably more effective than requiring massive reporting on detailed uses of funds".[4] The monthly reporting that SFD requires from banks and NGOs contains headline indicators that are in line with the World Bank core indicators for MSE finance projects.[5] The SFD microfinance unit agreed with the Bank on exploring ways to further streamline reporting in line with international good practice.

Adequate supervision of the line of credit should include clearly defined and transparent indicators

[3] CGAP Key Principle of Microfinance - No. 10. See "Building Inclusive Financial Systems: Donor Guidelines on Good Practice in Microfinance", (2004)

[4] "Apex Institutions in Microfinance", CGAP Occasional Paper, No.6 (2002).

[5] Guidance Note: "World Bank Support for Micro- and Small/Medium Enterprise Finance: A Reporting Framework".

for monitoring implementation progress and measuring overall impact. Clear project indicators have been defined for the project. Monitoring will be an important aspect of the project and will reinforce participating NGOs' and banks' performance monitoring by SFD. Little is known globally about the impact of MSE programs, with a recent review identifying this as a key area in which World Bank should invest.[6] This project will include a rigorous impact evaluation (if additional funding is secured) to assess the effectiveness of specific project components in generating enterprise growth and loan outreach. The early results of these evaluations will inform the mid-term review, and help guide the expansion or modification of project components as necessary. Both the regular monitoring indicators and the formal impact evaluation will help to serve as an early warning system indicating the potential need for remedial actions.

Effective donor coordination is essential to ensure synergies in approach and guidelines for lines of credit. Establishing a system for aid coordination is a key requirement for the success of project implementation. The IEG Evaluation of World Bank Lending for Lines of Credit showed that the Bank should engage with other major multilateral donors to assess the extent to which there are differences in guidelines governing lines of credit and to achieve the best possible coordination and synergy. This project puts a clear mechanism for coordination among development partners.

Apex 'lessons learnt' have been incorporated into the project design. Wholesale facilities, or apexes, are set-up to manage and on-lend funds to financial institutions, and to accelerate the growth of sound microfinance retail capacity in order to expand access to finance. Apex institutions have played a critical role in scaling-up microfinance in a number of countries, although they have a very mixed track record in terms of effectiveness, results, and funds utilization.

[6] McKenzie, David (2009), "Impact Evaluations in Finance and Private Sector Development: What do we know and what should we know?" World Bank Research Observer, forthcoming.

Apex 'Lessons Learnt' applied to Project Design.[7] There are various lessons learnt from other apex institutions which have been taken in account in designing this operation. These include:

Apexes have been effective where they have set high performance standards for their financing to MFIs, thus focusing investment on only the best-performing or highest potential MFIs which have the capacity to build large-scale, financially viable operations, and to innovate to meet the needs of clients and to lower costs. SFD will link performance criteria more closely to funding, and already monitors NGO and bank performance. SFD will also start to monitor financial sustainability of MFIs receiving project funding.

Apexes have tended to be too optimistic in assessing the number of MFIs that will qualify for funding. SFD has to date supported over 447 NGOs, with active contracts with 390 NGOs at present but for this project SFD will apply a performance-based system for allocation of funds to well performing and high potential NGOs, which it estimates to be about 20 up to 30 at present (i.e. less than five percent of the NGOs funded to date).

Technical assistance and training is provided to MFIs, in order to increase the absorption capacity, growth potential and sustainability of the microfinance sector.

SFD tailors loans to fit each MFI and bank's cash-flow needs, institutional capacity and past performance, and no longer allocates funding to NGOs based on other priorities (such as presence in a certain community, or institutional type).

High quality apex management is a key to success. In the past 4 years SFD has brought in senior managers and staff with appropriate skills and experience. The new Managing Director and

[7] Sources: CGAP reports: Donor Brief, 'Apex Institutions in Microfinance', July 2002; Pearce, Douglas, 2002, 'Lessons Learned from the World Bank -supported Apex Facility in Bosnia'; 2009, 'Focus on Apexes'; Levy, Fred, 2001, 'Apex Institutions in Microfinance'; CGAP Occasional Paper, No. 6. Also: Vega, Claudio Gonzalez, 1998, 'Microfinance Apex Mechanisms: Review of the evidence and policy recommendations'.

General Manager are former bankers for example, while the head of the microfinance department is a microfinance expert with significant experience in Egypt and the wider region.

Apex boards must be sufficiently protected or independent from political influence, and include members from the private sector or civil society. SFD is an autonomous entity that does not report to any minister, and the SFD board has broadly equal representation in terms of numbers from government and from outside government. Moreover, SFD's activities are supervised by the independent Central Accounting Organization.

Alternatives Considered and Reasons for Rejection. Taking account of lessons and experience, several alternatives were considered to find the most appropriate wholesale mechanism for channeling and institutionalizing MSE finance in Egypt. SFD was chosen for a number of reasons. As mentioned earlier, SFD is the responsible entity for MSEs, as mandated by Law. There have been major changes in SFD's management over the past four years, and the current Managing Director and General Managers are all former bankers, with solid financing knowledge ensuring effective implementation of the operation. Recent assessment of SFD by several donors indicates significant improvements in its capacity and performance which is consistent with the Bank's assessment. SFD has managed a number of loans and grants for MSE finance from the African Development Bank (a US$200 million loan that has been disbursing faster than projected), EC and others. SFD also has the ability to both encourage commercial practices among NGOs and banks, and enforce conditions of the on-lending agreements. Finally, SFD has a mandate to support economic development policies, and hence, this project fits into the broad scope of its mission.
Other alternatives considered for wholesale included Egypt Post and state-owned commercial and specialized banks. Despite Egypt Post's nationwide network, strong deposit base and computer network, the conversion of Egypt Post into a lender would entail many legal and regulatory reforms, which would be well beyond the scope of this project. With regard to state-owned banks, they are currently involved in substantial restructuring that is expected to fully command management attention for the next several years, and correspondingly were not considered as candidates for being implementing agencies of this project. The largest specialized bank, Principal Bank for Development and Agricultural Credit (PBDAC), in addition to currently undergoing major restructuring, has only agricultural focus.

In terms of project design, one of the considerations was whether or not to include a technical assistance component to complement the credit line. This was considered at an early stage of the project's preparation. However, numerous donors, including the WB, are already providing support to banks and participating financial institutions in the areas of skills development, systems advancement, new product testing, and capacity building for expanded coverage. They also support the development of auxiliary services such as rating services, specialized audit forms and specialized management information systems which is helping the microfinance market to mature. Donors use grant money to support these endeavors which makes it difficult for the government to justify borrowing for technical assistance. Development partners' support will continue during the life-time of the project and beyond,[8] ensuring sustainability and complementarity (See PAD Annex 9 for more details on donors' assistance). Additionally, a variety of government entities including the General Authority on Free Zones and Investments, Egyptian Banking Institute, and National Council of Women which are themselves supported by several bilateral donors (including CIDA, JICA and KfW)[9] provide technical support and business development services.

Associated Documents of Particular Interest:

[8] Total amount of grant money allocated to technical assistance exceeds US$200 million and ends 2016.

[9] Canadian International Development Agency, Japan International Cooperation Agency, and KfW Development Bank (Kreditanstalt für Wiederaufbau - Entwicklungsbank)

There are several technical Annexes in the Project Appraisal Document[10] which are of particular interest. These are:

- Overview of the Egypt microfinance sector (PAD Annex 5)
- Overview of the Egypt Small Enterprise Sector (PAD Annex 6)
- Eligibility criteria for Banks, NGO's and potential MFI's (PAD Annex 14)
- Mainstreaming Gender (PAD Annex 15)
- OP 8.30 Reviewer Comments (PAD Annex 20).

Contact MNA K&L:
Director, MNACS: *Laura Tuck*

Regional Knowledge and Learning Team:
Omer Karasapan Roby Fields, Rory O'Sullivan
Tel #: (202) 473 8177

MNA Knowledge Notes:
http://mnaknotes

[10] See the Project Appraisal Document