FMO EX-POST EFFECTIVENESS STUDY: LOCAL CURRENCY FINANCING OF (M)SME FINANCIAL INSTITUTIONS IN CENTRAL AMERICA - Evaluation executed by Dalberg

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Anonymised EXECUTIVE SUMMARY

CONTEXT AND OBJECTIVES

The main objectives of this report are to assess the effectiveness and additionality of MASSIF's local currency financing in Central America in (i) strengthening the financial institutions receiving the financing, and (ii) expanding and improving the provision of financial services to (M)SMEs. MASSIF is a Private Sector Development Program set up by the Dutch government in 2006 and managed by FMO (The Netherlands Development Finance Company). It has been set up to contribute, by means of a revolving fund, to constructing and improving the financial infrastructure in developing countries, aimed at serving entrepreneurs and consumers at the lower end of the financial market. The fund has a total committed portfolio consisting of over 120 projects, with an outstanding amount of EUR 325 million by the end of 2013. Financing activities of the fund include the provision of equity, subordinated loans and medium to long term credit to banks with an SME focus, microfinance institutions, other nonbank financial institutions (such as leasing companies) and small enterprise investment funds.

This study has been commissioned as part of a wider set of FMO evaluations. Currently the Dutch Ministry of Foreign Affairs is assessing the relevance and effectiveness of its funding to the private sector. The Ministry has asked FMO to complete 22 separate evaluations of its activities. This study has been commissioned as part of this set of 22 evaluations.

This study aims to assess the effectiveness of local currency (LCY) financing in Central America. Improving access to local currency financing can have positive effects on the economies of the region. (M)SMEs make an important contribution to the economies of Central America, accounting for more than 97% of all firms and employing almost half (44.5%) of the economically active population. A large financing gap still exists in the region. The credit gap for formal SMEs has been estimated at USD 235 billion in Latin America during the 2003-2010 period, with an even larger gap when informal (M)SMEs are taken into account. One of the main gaps is in the availability of local currency financing, which tends to have a positive effect on (M)SMEs as it reduces their exposure to currency exchange fluctuations.

MASSIF is a pioneer in local currency financing. Between 2008 and 2012, the average percentage of local currency debt out of total debt for the MASSIF portfolio was 71%. MASSIF provides financial intermediaries with local currency financing, allowing these intermediaries to offer local currency products to their (M)SME clients. Given this, the study will contribute in providing additional research and evidence on the effectiveness of local currency financing.

METHODOLOGY AND SCOPE

The study assessed MASSIF's LCY interventions against five criteria. (i) the ex-ante assessment of the intervention, (ii) its effectiveness at strengthening the receiving financial institution, (iii) its effectiveness at increasing and improving local currency financing for (M)SMEs, (iv) the impact it had on (M)SMEs, and (v) its additionality in strengthening the receiving financial institution. It is important to note that increasing the provision of (M)SME financing was not part of MASSIF's intervention's original goals. However, it is useful to assess these unintended benefits of LCY interventions to identify behavior patterns in the FIs. The study also includes observations on MASSIF's additionality in increasing and improving financing for (M)SMEs in LCY. However, additionality at MSME level was not an initial objective of MASSIF's transactions, and therefore, the evaluation team did not score this criteria.

In order to conduct this assessment, nine financial institutions were included in the scope:

- A microfinance institution (MFI) in Nicaragua which received direct LCY financing from MASSIF. This FMO client is one the five largest microfinance institutions (MFIs) in Nicaragua and offers mainly working capital and fixed asset investments products.
- A bank in Honduras, which has received direct LCY financing from MASSIF. This bank is offering mortgages, commercial finance and consumer loans.
- A fund [referred to as 'the Fund'] which has received financing and equity in USD directly from MASSIF and extends LCY financing to MFIs in Latin America and the Caribbean (LAC), including LCY loans, as well as other instruments (e.g., local bonds, notes, syndicated loans) in the range of USD 250,000 – 1.5M.
- Six microfinance institutions that have received LCY financing from the Fund and, therefore, indirectly from MASSIF. In order to ensure representativeness of the Fund's portfolio, the scope includes four NGOs (one in Costa Rica, two in Nicaragua and one in Honduras) as well as two banks (both in the Dominican Republic).

All of these interventions were assessed against the five criteria identified above. For the assessment of the interventions, we followed the KfW development bank's guidelines for development effectiveness evaluations. The interventions are assessed on the basis of a 6-category rating scale: 1 "very good and good," 2 "satisfactory," 3 "overall sufficient," 4 "overall slightly insufficient," 5 "insufficient," and 6 "failure." Interventions assigned to categories 1 to 3 are considered successful. Measured by current standards these interventions have long-term positive financial and developmental impacts. Interventions assigned to categories 4 to 6 are considered not successful. The data for conducting this assessment was collected through a variety of methods. Specifically, we conducted phone interviews and a two-week field visit to Central America to speak with the management team of each of the institutions. In addition, we prepared a detailed data request, which all of the institutions completed.

Finally, it is important to note three caveats to our conclusions. First, our analysis and results reflect the sample of financial institutions included in the study. Three of the institutions are based in Nicaragua, which has an uncommon exchange regime (a crawling peg) and underwent a major financial crisis (*No Pago* movement) during the time-period analyzed in the study. Second, not all data was easily available. Especially for the data at the financial institution portfolio level and at the (M)SME level, some estimates were used together with qualitative assessments by the institutions' management teams. Third, most of MASSIF's and the Fund's interventions were relatively small compared to the size of the institutions. As a result, other trends and events (e.g., the institutions' strategic decisions, regulatory changes, other sources of funds) made it particularly difficult to attribute causality.

RESULTS

MASSIF's interventions were satisfactory at strengthening the financial institutions, and overall sufficient at increasing and improving financing for (M)SMEs. While strengthening financial institutions can be a direct result of MASSIF's financing, improving and increasing financing for (M)SMEs is one step further away in the theory of change. In other words, when MASSIF provides a financing to a financial institution, this financing directly goes to the FI's balance sheet and strengthens its risk profile. On the other hand, in order to improve and increase (M)SMEs' financing, MASSIF's financial intervention is not enough. In order to be effective the financial institution also needs a strategy directing MASSIF's funding towards improving and increasing (M)SME LCY financing. For some of the financial institutions' included in this study, this strategy was not in place nor implemented as a result of the intervention. In the following paragraphs we will summarize in more detail the results for each criteria.

Overall, the ex-ante relevance of the interventions has been assessed as satisfactory. Specifically, all the interventions were intended at improving the financial infrastructure in developing countries by providing local currency financing and/or uncommon financial products (e.g., a subordinated loan in the case of the bank in Honduras). However, the interventions were not all focused at serving (M)SMEs. Specifically, this bank had a limited number of (M)SME clients and no robust plans for building up this client segment. The Fund, instead, was lending to microfinance institutions that, in turn, largely had a micro-entrepreneur client base. However, the Fund's mandate, and the type of interventions it structured, focused more on diversifying MFIs' funding base rather than on improving financing to (M)SMEs.

The effectiveness in strengthening financial institutions has also been assessed as satisfactory. The assessment was satisfactory or very good across all transactions, albeit for different reasons. The assessment was very good for the MFI in Nicaragua because the LCY financing strengthened its risk profile thanks to improved ALM and CAR ratios. For the bank in Honduras it was satisfactory because the subordinated loan strengthened the CAR ratio. For the Fund investees it was satisfactory because the interventions mainly helped in diversifying the institutions' funding sources. The assessment was not very good for two reasons. First, for the Nicaraguan bank and most of the Fund investees, the intervention did not strengthen the currency ALM ratio as the institutions already had access to LCY financing. Second, MASSIF's products did not include a technical assistance component, which could have benefited its clients.

Similarly, the additionality in strengthening the financial institutions has been assessed as satisfactory. MASSIF's and the Fund's loans to the Nicaraguan MFI and the two Nicaraguan NGO's were assessed as very good given that, at the moment of the interventions, LCY financing was very limited in Nicaragua and these were the only loans the institutions received in LCY. The assessment was satisfactory for the other institutions because although they all already had access to LCY financing, MASSIF's and The Fund's financing terms were better than the market (e.g., subordinated debt, longer tenor). It is important to mention that for all interventions the financial institutions' management teams recognized that MASSIF's and the Fund's loans contributed to some extent to mobilizing further financings.

The effectiveness in increasing and improving the financing to (M)SMEs has been assessed as overall sufficient. For the Nicaraguan MFI, the assessment is satisfactory because the first LCY product was introduced in Nicaragua following MASSIF's intervention. For the Honduran bank, the assessment is overall slightly insufficient, and for the majority of the Fund's investees, the assessment is overall sufficient. At the time of the interventions, the FIs already had LCY products and they did not introduce new products or modified existing ones as a result. The interventions however supported the continued growth of the LCY portfolios.

Additionality in increasing and improving the financing to (M)SMEs was not formally assessed given that it was not within MASSIF's interventions stated goals. Although not relevant for the purpose of this evaluation, during our field visits we found that none of the financial institutions within the study have strategically targeted new clients or new segments/sectors. Specifically, the receiving institutions did not introduce any new processes or mechanisms in order to target segments most in need of the LCY financing.

Finally, impact on (M)SMEs has been assessed as satisfactory. It is important to note that not enough data was available in order to complete this assessment for the bank in Honduras and for the Fund's investees. As specified in the inception report, because the financial institutions do not track (M)SME level data disaggregated by currency, it was not possible for the evaluation team to reach conclusions. However, we have assessed the intervention with the MFI in Nicaragua as satisfactory as the institution's management argued that clients' non-performing ratios had been reduced thanks to the introduction of the LCY product.