



# IDEV

Independent Development Evaluation  
African Development Bank

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*From knowledge to action...*  
*From action to **impact***



## Do Lines of Credit Attain their Development Objectives?

### An Evaluation Synthesis 2010-2017

Executive Summary

November 2018



AFRICAN DEVELOPMENT BANK GROUP

# Executive Summary

## Context, Objectives and Methodology

This evaluation synthesis (the synthesis) was prepared in response to a request made in February 2017 by Board members of the African Development Bank (AfDB) to be informed on the performance and effectiveness of the lines of credit (LOCs) extended by AfDB, in the context of an increasing volume of LOCs approvals. The Independent Development Evaluation (IDEV) has prepared this evaluation synthesis covering IDEV's past evaluations and those of peer institutions both to respond to the request and to contribute to the evaluation knowledge in this area.

LOCs are long term loans, either in local or hard currency, provided by an International Financial Institution (IFI) to a Financial Intermediary (FI) for on-lending to their customers, also referred to as sub-borrowers, or end-beneficiaries. These LOCs aim to improve access to finance for the private sector by enhancing the financial and technical capacity of FIs. However, because of the lack of well-documented impact on development, they have become the object of increasing scrutiny in recent years.

By looking at 12 recent evaluations of LOCs, this synthesis assesses the extent to which LOCs are a relevant, cost-effective, and sustainable instrument in increasing access to finance and fostering inclusive growth. It suggests points for consideration by IFIs which employ LOCs in terms of design, implementation and evaluation.

The synthesis builds on: (i) findings from evaluations of LOCs carried out by IFIs between 2010 and 2017, and from a broader literature review of relevant publications; (ii) interviews with subject-matter experts both within and outside AfDB; (iii) focus group

interviews with AfDB's task managers and higher-level managers; and (iv) an internal workshop with the staff from the Financial Sector and the Private Sector Development Departments, the Additionality and Development Outcome Assessment Division of the Chief Economist Complex, and Treasury Risk Management, organised on June 5, 2018, to present and discuss emerging findings and the points worthy of further consideration.

## Findings

**Evaluations reviewed and subject-matter experts interviewed in operational departments of AfDB, AFD, and PROPARCO, consider LOCs to be relevant for IFIs and client FIs. The relevance of LOCs to the end beneficiaries is more open to debate.** LOCs are well aligned with IFI strategies for private sector and financial sector development. LOCs are considered by IFIs to be an appropriate instrument for reaching a large number of beneficiaries in underserved market segments, while also keeping project origination and supervision costs at an acceptable level, for the following reasons:

- Most IFIs have a limited field presence and transactional capacity on the ground within their countries of operations, which makes the use of financial intermediation necessary.
- By working through financial intermediaries, IFIs can leverage their budgetary resources with those of other IFIs, or private investors, and take advantage of FIs' knowledge of the local market.
- LOCs can also be used flexibly to pursue different development objectives and can be easily combined with other support measures utilizing FIs.

- The individual financing needs of the large majority of micro, small and medium-sized enterprises (MSMEs) are lower than the direct-lending thresholds of most IFIs.
- LOCs are financially profitable for the IFIs and contribute to their financial sustainability, while limiting their risk exposure, which does not extend to the individual sub-loans

**LOCs respond to the FIs' need to secure long-term loans.** The literature emphasizes that the demand for LOCs is driven by the need of FIs to secure long-term loans, given that in most developing countries bank financing is limited to providing short-term loans. However, to minimize the risks, IFIs often favour larger commercial banks or subsidiaries of international banking groups.

**The relevance of LOCs to the end-beneficiaries is more open to debate.** Evaluations show that, in the design of LOCs, it can be a challenge to find a balance between achieving risk and profitability in IFIs and client FIs on the one hand, and providing financial services to underserved but riskier market segments on the other hand. The selection of client FIs is driven by a need for fiduciary integrity, due diligence, and credit-risk considerations. This has typically led to the prioritizing of top banks and more developed financial systems, thereby reducing the potential for LOCs additionality. For this reason, CGAP and some evaluations, including those of AfDB, question whether LOCs are the most appropriate instruments for addressing financial access constraints for underserved market segments, including MSMEs.

**The design of LOCs is often not underpinned by sufficient analytical work.** The use of LOCs is generally justified by the need to address market failures in financial markets, but evaluations indicate that most LOCs designs are not underpinned by sufficient analytical work to carefully explore the constraints to access to finance for specific market segments in specific country contexts. The selection of the partner FIs does not always match well with the LOCs' intended objectives. This happens, for instance,

when LOCs targeting the SME market are provided to FIs that have little commitment, or no strategy, to operate in such markets. The eligibility criteria for sub-loans are based on definitions of what is an SME, which differ from one FI to another FI, implying that client FIs receiving funds from several IFIs need to use different parameters to identify their SME client base in each case. LOCs also lack consistent metrics for measuring and reporting development impact at both the levels of the FIs and of the sub-borrowers. This poses an obstacle to drawing robust conclusions on the development impact of LOCs.

**The effectiveness of LOCs is often questionable because information at the end-beneficiary level for analysing the development results through the evaluation criteria are missing.** A common challenge in LOCs evaluations is the lack of reliable and complete information on LOCs sub-borrowers, and the difficulty of attributing development results to LOCs. Because money is fungible and FIs raise funding from several sources, it is not possible to trace to the end-beneficiary level. Most IFIs have adopted a portfolio approach, which consists in setting expectations and tracking changes in the composition of client FIs' portfolios, and determining to what extent the LOCs provided have induced the desired changes in sectors or themes agreed upon with the FIs. This, however, does not address the daunting task of attributing the impact to LOCs at the end-beneficiary level. This is also the case with the pipeline approach (also called the projects list) applied by some IFIs, including AfDB.

**Impact on FIs.** The main impact of LOCs is to provide FIs with long-term loans to on-lend to sub-borrowers. While the reviewed evaluations conclude that FIs are able to achieve better financial performance, such as profitability, diversification of sources of funding, mitigation of liability maturity mismatches, capital adequacy and asset quality, the attribution of these impact to LOCs remains difficult, especially when an LOCs is provided to a large FI in which the LOCs only accounts for a small percentage of the FI's total long-term liabilities. This finding is also applicable to non-financial performance, including improved internal procedures and corporate governance.

**Impact on end-beneficiaries.** There are no reliable data on the impact of LOCs on the final beneficiaries in terms of improved profitability or employment levels. Similarly, there are no data on the impact of green LOCs on energy efficiency and energy consumption. This is because: (i) FIs typically do not collect data on the impact of their loans; (ii) FIs do not have management information systems in place to perform such tasks; and (iii) the IFIs exercise poor oversight during LOCs disbursement.

**Impact on countries' financial systems.** The attribution of impact to LOCs is not possible, especially when they are delivered to middle- or upper middle-income countries. Attribution is only really possible when a financial market is severely undersupplied with credit. Thus far, the impact of LOCs in promoting financial inclusion in terms of extending access to financial services to unbanked people still has to be demonstrated. Neither has the capacity of LOCs to introduce financial innovation in FIs been documented.

**The efficiency of LOCs is satisfactory when measured in terms of LOCs profitability for the IFIs, disbursement rates, and time.** LOCs positively contribute to the performance of IFIs' portfolios by increasing their margins and reducing risk, which also creates strong internal incentives in favour of LOCs. LOCs can be more cost-effective than other instruments because they allow the packaging of a large amount of financial aid into a limited number of operations that are then channelled through existing institutions that do not require the setting-up of separate administrative systems. However, there is a trade-off between LOCs efficiency, and the rigour of eligibility criteria and oversight requirements. Disbursement of an LOCs is more rapid when eligibility criteria are broader. As a result, the tightening-up of eligibility criteria and controls can significantly slow down the delivery of LOCs.

**The sustainability of LOCs is not well investigated in the literature.** This is linked to the difficulties in assessing LOCs effectiveness at the end-beneficiary level. But it is also due to the

fact that the concept of sustainability deals with the likelihood of development impact that continue after the closure of a project and the withdrawal of the IFI. This requires some forward-looking analysis to be conducted, at the same time as the IFI has ceased to earn any revenue from the project and is seeking to redeploy its funding elsewhere. Hence, there is little incentive to address the issue of sustainability beyond some fairly perfunctory statements recording the status quo at the time of closure.

**Enforcement of environmental and social standards considerations is problematic.** While the vast majority of countries have adopted environmental, social, health and safety standards in line with those of IFIs, the quality and consistency of enforcement of the standards remain a problem. Inadequate monitoring and reporting on the effective implementation of such standards are a source of issues relating to the accountability and transparency of LOCs. They also can lead to significant reputational damage to the IFIs.

## Points for Consideration

**The reporting obligations on development results.** IFIs need to be more accountable and transparent in their reporting on LOCs effectiveness. IFIs should also be more proactive in holding FIs to account for reporting on LOCs development objective obligations. This implies improving the assessment capacity of the FIs to deploy LOCs in accordance with the IFIs' target beneficiaries.

**Ex-ante scrutiny of the business case for LOCs approvals.** IFIs need to underpin the rationale and design of LOCs by analytical work to make more realistic assumptions about how LOCs will contribute to improving access to finance for underserved market segments. IFIs' funding additionality to the market needs to be determined, implying that LOCs should primarily go to FIs that cannot easily obtain such funding elsewhere. Second, IFIs should tighten up LOCs covenants to identify eligibility criteria that can be consistently implemented by the

partner FIs and are aligned to the LOCs objectives. Finally, the selection of FIs should be based on clearly determined parameters that measure the commitment and performance of an FI in serving a specific market segment.

**Resources for other instruments to address the binding constraints of the demand-side of access to finance, in parallel with the LOCs.** LOCs are not sufficient on their own to create an efficient and effective financial intermediation system to support private sector development. Evaluations emphasize that LOCs require complementary measures provided to the partner FIs. Technical assistance could be used to help FIs to enter new market segments, such as green lending, to assess the risk of lending to MSMEs, and to fulfil their reporting obligations. For instance, Technical Assistance (TA) accompanying green LOCs could develop standardized financial products for supporting energy-saving investments. In parallel with LOCs, it is imperative for IFIs to promote and support reforms of the regulatory environment of financial systems, and of the financial information system, for instance in setting up effective credit bureaus.

**The need for an effective monitoring and evaluation (M&E) system.** Overall, it is important to address LOCs transparency and accountability problems. Reporting requirements on sub-loan and sub-borrower performance should be defined ex-ante and followed through closely during the disbursement of sub-loans. More effective checks are needed to verify that funds are used as originally agreed. Evidence shows that eligibility criteria alone will not give the IFIs assurance on the desired deployment of LOCs. It is necessary to identify key performance indicators that better reflect what can be reasonably monitored and attributed to LOCs without overburdening the client FIs with administrative requirements. In parallel, FIs need to

receive adequate assistance to ensure that they can set up management information systems (MIS) that produce information on development results at the sub-borrower level. Finally, it is important to consider that conducting more proactive supervision will have an impact on the cost-effectiveness of LOCs from an IFI perspective. IFIs could consider using new information and technology tools using mobile phones to collect information on outputs, outcomes, and impact directly from end-beneficiaries.

**IFIs' capacity.** Staff competence requires strengthening expertise in: (i) banking and the private sector on financial needs and how to address them; (ii) ex-ante assessment, including compliance with E&S standards within FIs; and (iii) monitoring and evaluation. As part of the IFIs' due diligence on their FIs, IFIs' investment officers should carefully screen FIs' existing portfolios to identify areas of the highest value-added and where to intervene. To this end, IFIs need to carry out economic and sector work on the financial sector to develop a solid understanding of the needs and how to address them. For AfDB, this will require increased collaboration between investment officers of the financial sector department and country economists in analysing local financial markets.

**Harmonizing of IFIs' approaches towards LOCs.** As one FI might partner with more than one IFI, harmonization of procedures would be beneficial in reducing transaction costs for beneficiary FIs. Because the IFIs' monitoring requirements can add a substantial administrative burden to FIs, IFIs should work with a shared definition of what constitutes an SME and apply the same indicators for the M&E of LOCs outcomes at the sub-borrower level. There is a need to support initiatives to harmonize SME definitions among stakeholders to facilitate the collecting and comparing of data (Dalberg, 2011).

**Pipeline approach vs portfolio approach.** Good practice in providing LOCs still needs to be prepared to guide investment officers in their daily work. A portfolio approach is appropriate in assessing whether an LOCs has had any impact on an FI business model entering new market segments. The portfolio approach also tends to reduce administrative costs for both FIs and IFIs. The portfolio approach is based on assessing changes in the composition of an FI's portfolio following the implementation of the LOC. The attribution problem can be overcome by benchmarking data on the trends of the market segment of the portfolio of an FI that has received an LOCs with data from a comparable FI that did not receive an LOC. The evaluations reviewed by this synthesis did not show any evidence that the portfolio approach was superior to the pipeline approach in measuring development outcomes of LOCs at the end-beneficiary level. A further study to determine when to use either approach is therefore recommended.

**Environmental and social standards considerations.** IFIs should ensure that, where required, the client FIs have appropriate and effective environmental and social management systems in place, and the necessary capacity for E&S monitoring and compliance at the sub-borrower level.

**Communication of the LOCs lending policy.** IFIs are advised to widely communicate their LOCs lending policy, which would help to foster competition between FIs and provide information to MSMEs to make them aware of the IFIs' LOCs funding policies. This should contribute to better results in terms of complying with loan covenants and the development results at the end-beneficiary level.

**Dealing with fragile situations.** The analysis of the portfolio of AfDB over the period 1969-2017 shows that 11 countries out of 54 were never provided with LOCs, and that 17 countries did not use LOCs instrument after 2000. Most of those countries were small in size and were coping with the challenges of fragile situations. The objective of universal access to finance implies that IFIs should find ways to extend their financing instruments to MSMEs in fragile situations, including by supporting microfinance bank branches (Horus Development Finance, 2014; AfDB, 2015). This would require reviewing non-sovereign operations guidelines to accommodate more high-risk situations.





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## About this Evaluation

The Independent Development Evaluation (IDEV) conducted an evaluation synthesis of Lines of Credit (LOCs) with an aim to interrogate the design, implementation and effectiveness of LOCs in order to improve future investments in LOCs. The main objectives of the evaluation were to identify good practices from the experience of the AfDB and peer institutions in the achievement of LOCs' development objectives; and to draw strategic and operational lessons that could inform the design, implementation and use of future LOCs.

The evaluation team assessed 12 selected evaluations in terms of the extent to which LOCs are a relevant, cost-effective, and sustainable instrument for increasing access to finance and promoting inclusive growth. They also interviewed investment officers, managers of LOCs and subject matter experts both at the AfDB and at other related institutions. Focus group interviews were conducted with AfDB's task managers and senior managers working on finance matters, and a workshop was organized to discuss emerging findings with AfDB staff from relevant departments.

Overall, the evaluation synthesis revealed that LOCs represent 10% of the Bank's total approved amount and they are relevant for International Financial Institutions (IFIs) and client Financial Intermediaries (FIs). There are however a number of challenges that need to be addressed including insufficient analytical work to guide the design of LOCs; lack of reliable information from which to deduce development results; inadequate literature on sustainability of LOCs; and inadequate enforcement of environmental and social standards. To partly address these challenges, the synthesis underscored the need for IFIs to be more accountable and transparent in their reporting on LOCs' effectiveness; and to be more proactive in holding FIs to account for reporting on LOCs' development objective obligations.



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