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Transforming Financial Service Markets for Micro, Small and Medium Enterprises (MSMEs) in Ethiopia through Direct Technical Assistance to Financial Institutions

The Case of Enterprise Partners

Enterprise Partners

September 2020

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2013-2020

Enterprise Partners

EP was established in 2013, funded by the United Kingdom's Foreign, Commonwealth and Development Office (formerly the Department for International Development), to facilitate market systems development in order to create jobs and raise incomes of Ethiopians, especially women, living in poverty. The primary focus was to stimulate agro-industrial growth and access to finance, with the objective to leverage over GBP 300 million in additional investment and sales, create 45,000 jobs, increase the income of 65,000 people, and support 150,000 people to access financial services. EP had to achieve these results in a specific context: where there were very few MSD programmes and at a time when the Government of Ethiopia was only just beginning to embrace the private sector as a development partner who could support the pursuit of the country's industry-focused, export-led growth goals.

Enterprise Partners Case Study Series

Enterprise Partners released a series of case studies in November 2020 to share the progress, lessons and insights of the programme's seven years of market systems development in Ethiopia. This case study forms part of that series.

Case Study Compendium: Insights and Lessons for Driving Market Systems Change for Inclusive Growth in Ethiopia

Enterprise Partners Programme | 2013-2020

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Case Study 1
(Synthesis Paper)

Facilitating Inclusive Growth in Ethiopia:

Think Systemically, Act Strategically, Adjust Frequently for Best Results, Enterprise Partners Programme, 2013-2020

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The case study compendium and standalone studies can be downloaded at **https://enterprisepartners.org**

Acknowledgements

Enterprise Partners (EP) is a programme commissioned by the Foreign, Commonwealth and Development Office (FCDO) and implemented by DAI Global UK with the consortium partners - First Consult, ITAD, and Enclude - between 2013 and 2020. Authors of the case study series collaborated closely with the EP team to present findings and learnings of the seven years of the programme.

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Review, editorial support and design services were provided by the firm EngagingDev.

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Acronyms

ACSI	Amhara Credit and Savings Institution
AEMFI	Association of Ethiopian Microfinance Institutions
ATA	Agricultural Transformation Agency
CBE	Commercial Bank of Ethiopia
CGFCs	Capital Goods Financing Companies
DBE	Development Bank of Ethiopia
DFID	Department for International Development
DFIs	Development Finance Institutions
EIB	European Investment Bank
EP	Enterprise Partner
ETB	Ethiopian Birr
FDI	Foreign Direct Investment
GBP	Great Britain Pound
GoE	Government of Ethiopia
GTP	Growth and Transformation Phase
ICT	Information Communication Technology
IFC	International Finance Corporation
LC	Letter of Credit
M4P	Making Markets Work for the Poor
MFI	Microfinance institution
MIS	Management Information Systems
MoU	Memorandum of Understanding
MSD	Market Systems Development
MSE	Micro and Small Enterprises
MSME	Micro, small and medium enterprises
NBE	National Bank of Ethiopia
NPL	Non-Performing Loans

PAR	Portfolio At Risk
PFI	Participating Financial Institutions
PMO	Prime Minister's Office
SME	Small and Medium Enterprises
SMEFP	Small and Medium Enterprise Finance programme
TA	Technical Assistance
ToT	Training of Trainers
USD	United States Dollar
WEDP	Women Entrepreneurship Development Program

1. Introduction

Background to the programme

Enterprise Partners (EP), a seven-year (2013-2020) multi-sector programme funded by the United Kingdom's Foreign, Commonwealth Development Office (formerly DFID) aims to facilitate market systems development in order to create jobs and raise incomes of Ethiopians, especially women, living in poverty. The programme employed a combination of Technical Assistance (TA) and market facilitation to resolve market failures and spur innovation and investment by applying the Making Markets Work for the Poor (M4P) approach for sustainable results. The programme has been at the forefront of addressing core market system failures to increase lending between financial institutions and client firms over the past seven years. It managed numerous interventions that evolved over time and built on one another to drive broader changes in the financial system.

The programme has two overarching pillars:

The **Access to Finance Pillar** aims to increase investment levels in the Ethiopian economy, particularly for growth-oriented Micro, Small and Medium Enterprises (MSMEs). This pillar evolved from addressing market failures at the base of the pyramid (to increase the usage of semi-formal and formal financial services by the poor) to working on increasing MSME finance and investment.

The **Agro-Industrial Pillar** aims to increase returns on investment (productivity) and investment levels in the priority sectors of leather, horticulture and garment sectors. This pillar also incorporates the promotion of climate change awareness and women's economic empowerment.

Under the access to finance pillar, EP worked closely with DFID, the World Bank and the Government of Ethiopia (GoE) to identify and address core market failures in: i) MSE finance; ii) small to medium enterprises (SMEs) working capital finance; and iii) leasing finance. Building the capacity of the financial institutions would contribute towards its broader target of raising GBP 160 million of new investments and generating 48,000 jobs. This report analyses two interventions where EP played a key role in providing impactful capacity building for financial institutions, transforming MSME lending in Ethiopia.

Women Entrepreneurship Development Program (WEDP)

WEDP was a World Bank project to address access to finance challenges of women-owned MSEs residing in targeted urban centers. It comprised a USD 50 million credit line complemented by an intensive capacity building programme for participating microfinance institutions (MFIs) to strengthen their capacity to absorb the credit line and provide MSE lending.

Small and Medium Enterprise Finance Program (SMEFP)

Based on the success of WEDP, SMEFP was launched by the World Bank in collaboration with the GoE to enhance access to finance for SMEs in targeted productive sectors of manufacturing, agro-processing, construction and tourism sectors. SMEFP had a credit line of USD 269 million to be used for lease financing and working capital lending to targeted SMEs in the identified productive sectors.

Objectives/Rationale of the Case Study

EP draws to a close in December 2020. This case study is part of ongoing knowledge management to capture lessons from various inter-linked interventions, understand the systemic changes made possible through EP's facilitation, and to disseminate learnings to the intended audience – government, donors and the private sector.

This case study analyses the development of the financial markets where the existing market systems were very weak and required direct interventions (in the form of TA) to address the core market failures and to kick-start systemic changes. Throughout the seven years of this market systems development (MSD) programme, these interventions evolved and adapted, building on one another while also developing an evidence base for organisations and institutions inside and outside of Ethiopia to adopt new practices.

The case study specifically documents EP's use of direct TA to build and develop MSE and SME financing markets in Ethiopia. It provides evidence of the business case for using direct TA when there are no supporting service markets to drive transformation in the market system. Use of direct TA, as opposed to first building up the support market systems, can stimulate sustainable business practice change within financial institutions, at scale, while creating a market for the supporting systems. This study identifies how to effectively programme direct TA to address specific constraints to unlock broader sector growth and investment opportunities and deliver impact at scale.

Layout of the study

- We start by presenting a brief overview of the financial sector and MSME financing in Ethiopia (**Section 2**), including the systemic constraints.

- **Section 3** presents:

  i. Detailed analysis of the problems in the core markets

  ii. The type of TA that EP provided to address these market failures

  iii. The results at firm and market system changes.

- Lastly, in **Section 4** we conclude with lessons learnt and recommendations for future TA support.


ROSOL
INDUSTRIAL

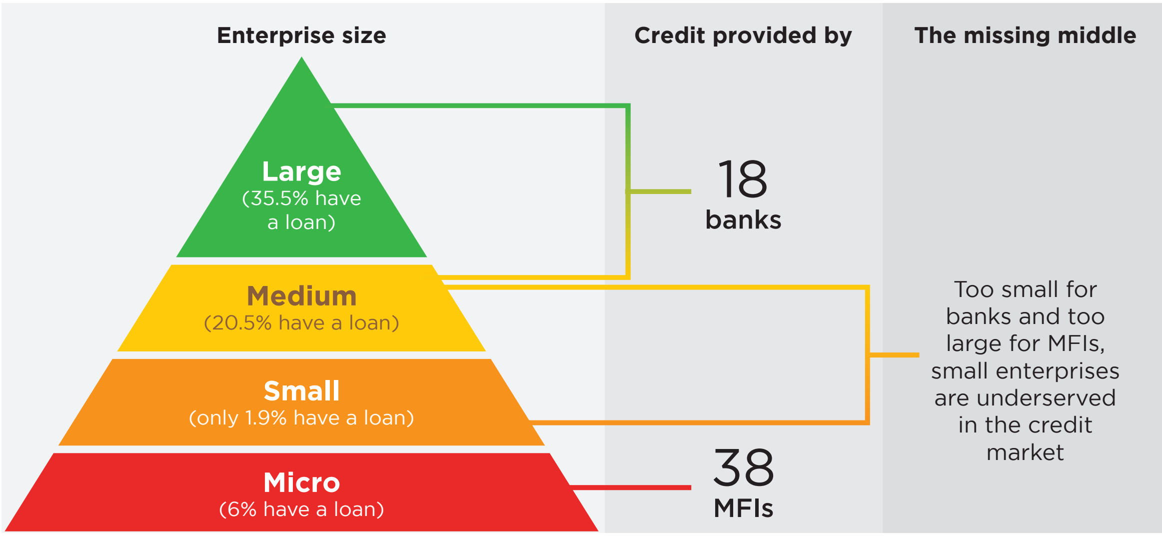
2. Background to the financial sector in Ethiopia

Overview of the Micro, Small and Medium Enterprise finance market in Ethiopia

There are 17 commercial banks (one state owned and 16 private), one development bank (the Development Bank of Ethiopia - DBE), 38 MFIs (10 Regional Government affiliated and the rest private), five regional leasing companies and one private leasing company in the Ethiopian financial sector. The MFIs mainly focus on serving the base of the pyramid, lending to low income rural clients and micro-enterprises using a solidarity group lending methodology, while banks focus on corporate and big-ticket customers. The DBE, on the other hand, focuses on project financing. Leasing is a relatively new financial service in Ethiopia and hence not widely available to enterprises, despite its potential to address one of the key access to finance challenges - lack of eligible collateral.

This has created a 'missing middle' scenario, where many enterprises are in-between, considered too big for MFIs and too small for banks as depicted in Figure 1.

Figure 1 Financing Segmentation: the missing middle



Source: World Bank 2016

Ethiopia's financial sector is dominated by government-owned financial institutions with state-owned banks accounting for 57 percent of the sector's capital, of which the Commercial Bank of Ethiopia (CBE) alone accounts for nearly 47 percent.[1] Likewise, the microfinance sector is dominated by government-affiliated MFIs. According to the National Bank of Ethiopia (NBE),[2] the top five largest MFIs are state-affiliated and accounted for 83.4 percent of the total capital, 90.4 percent of the deposits, 86.7 percent of the credit and 87 percent of the total assets of MFIs. Yet, they all lend to the private sector and play a crucial role in providing access to finance for MSMEs because of their relatively stronger resource base and wider outreach.

However, credit from the banking sector to the private sector had been increasing and reached 65 percent of all credit as of June 2019, reflecting 33 percent year-on-year growth. The private banking sector was characterised by liquidity challenges as, until November 2019, they were required to purchase government bonds amounting to 27 percent of any fresh loan they disbursed. The microfinance sector also struggles with liquidity, as deposit mobilisation by MFIs is limited. Unlike the banking sector, most MFIs borrow the funds they lend out, and many different government and donor initiatives try to address liquidity challenges within the sector. In the microfinance sector, government affiliated MFIs account for over 80 percent of market share in different parameters – credit, deposits, total assets and capital.

Until very recently, Ethiopian law restricted entry of foreign banks and MFIs into the market. However foreign participation is now allowed in the leasing sector, and the Ethiopian diaspora can now own shares in private banks.[3]

Ethiopia has an estimated 800,000 MSMEs of which only around 130,000 have access to credit and the total financing gap is estimated to be around USD 4.2 billion.[4] Around 70 percent of micro-enterprises[5] and 40 percent of SMEs are credit constrained in Ethiopia, which stands to be on the higher side compared to other countries in the region.[6] The European Investment Bank (EIB) (2018) and World Bank Enterprise Survey (2017) indicate that MSMEs cover 73 percent of their financial needs from internal funds (equity), while only 10 percent is from financial institutions and the rest is from suppliers and other informal sources. Africa accounts for only 0.7 percent of global leasing volume and the IFC estimates that the market potential for leasing in Sub-Saharan Africa is USD 87 billion, and for Ethiopia it is USD 1.05 billion.[7] Currently only 20 percent of the potential leasing market in Ethiopia is served by the DBE and the five regional leasing companies, leaving a leasing financing gap of USD 800 million.

Key constraints in MSME finance market systems

MSMEs make up the economic backbone of a country due to their potential for employment creation and overall contribution to economic growth. In developing nations, they contribute up to 40 percent of GDP and 70 percent of employment creation. This economic opportunity is not unlocked in Ethiopia due to the under-developed MSME sector. Many factors have contributed to sluggish development of MSMEs in Ethiopia, including poor infrastructure (power, workplace, market, etc.), difficulty in starting business (restrictive requirements, licensing, tax, etc.), weak focus by government and weak market linkages, poor access to finance (Figure 2), and others. Lack of access to finance is often reported as the key constraint hindering enterprise development in Ethiopia.

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[1] NBE annual report 2018/19

[2] NBE quarterly bulletin, Second quarter 2019/20

[3] The only foreign leasing company, Ethio Lease, started operations in 2020.

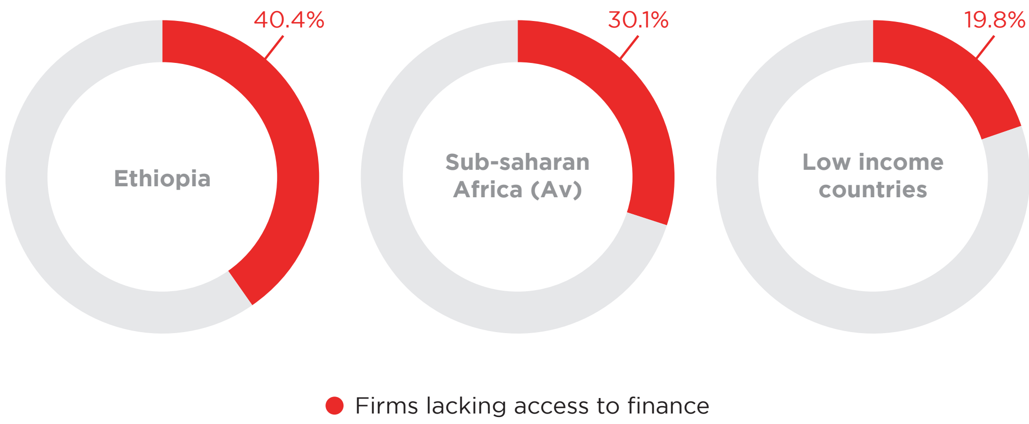
[4] https://www.smefinanceforum.org/data-sites/msme-finance-gap

[5] https://www.eib.org/attachments/efs/economic_report_banking_africa_2018_en.pdf

[6] In Kenya, for instance, 40% of micro and 30% of SMEs are credit constrained.

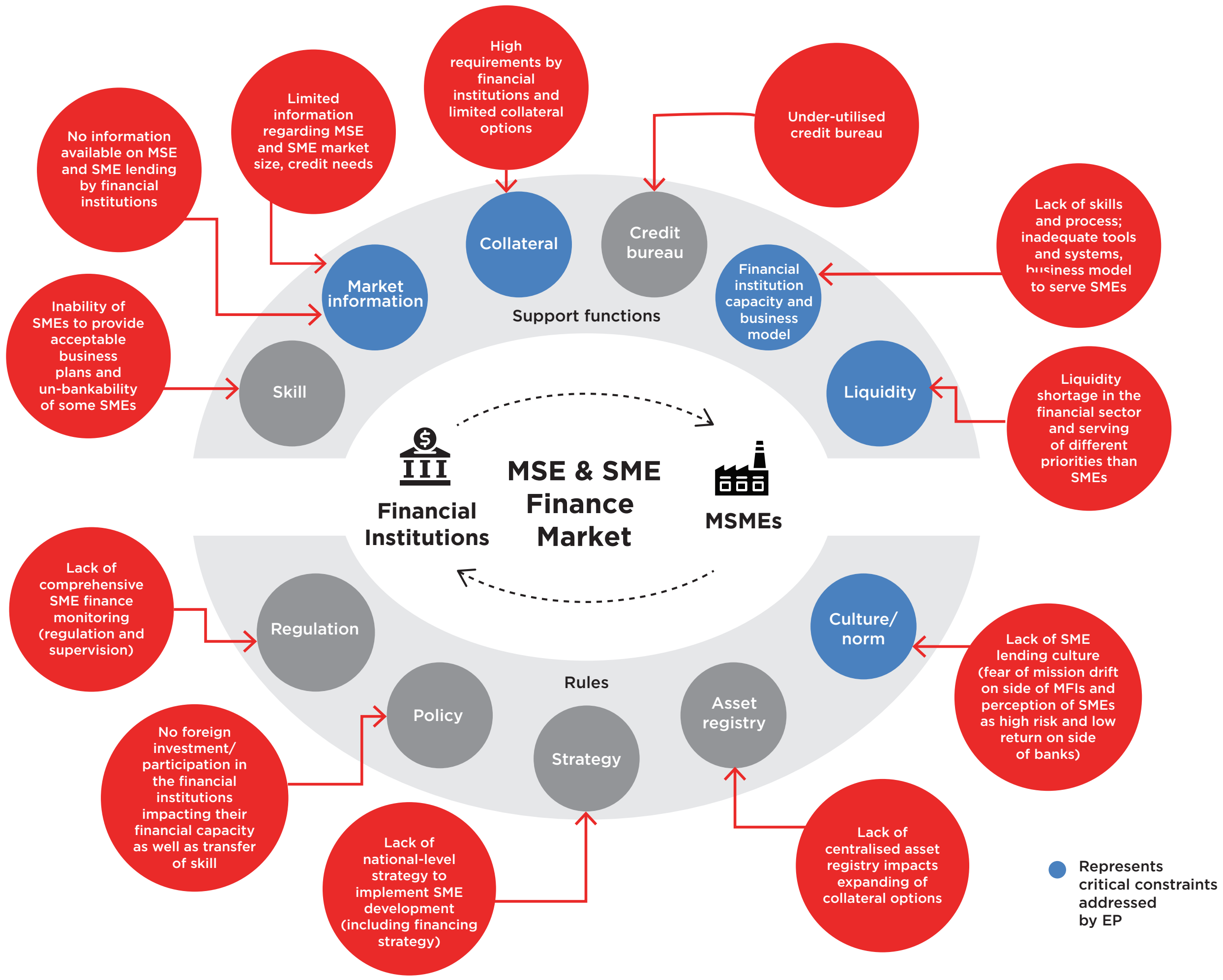
[7] IFC-Equipment-Leasing-Africa-Handbook-2017.pdf

Figure 2 Percentage of firms lacking access to finance in Ethiopia, Sub-Saharan Africa and low income countries



The following diagram (Figure 3) presents combined MSE and SME financing market systems. It presents the core market actors, support market constraints as well as rule side constraints that were contributing to a lack of access to finance for micro (upper segment), small and medium enterprises, as identified in the project's early analysis in 2013.

Figure 3 MSE and SME Finance Market System



The key constraints hindering the ability of firms to access finance, depicted in Figure 3, and the ones addressed by EP's interventions are summarised below:

Poor market information and targeting

The MFIs did not understand the financing needs, or the market potential presented by MSEs. This was due to the focus of MFIs on the bottom of the pyramid, having over 90 percent of their loan portfolio in rural group-based loans, the rest in urban petty loans, also on a solidarity group basis. There was virtually no individual lending.

Weak institutional capacity and business models in financial institutions

This ranged from weak management capacity to devise market driven strategic plans and directions to weak technical capacities to implement. MFIs operated under a 'business as usual' scenario. Financial institutions did not properly understand the MSE and SME markets and often did not have a dedicated unit or window for SME finance. There were no innovative or tailored products and services to the specific needs of MSEs and SMEs, and their existing business models were not suitable for individual non-collateralised lending. Moreover, financial institutions did not have adequate systems, tools and techniques to serve the two market segments. Traditional group-based lending approaches were used by MFIs and staff lacked skill in appraising and monitoring individual MSME loans. Banks had adopted traditional asset/collateral-based lending models which were not suitable to SMEs (see collateral, below). This resulted in a limited menu of solidarity group-based financial products and traditional approaches of service delivery. Lease financing was not on the menu of financial services until recently, when it was introduced by DBE in 2014 and new regional leasing companies in the big five regions. Both DBE as well as the regional leasing companies had huge capacity gaps and there was limited local leasing know-how.

High collateral requirements

Individual loans were made only against collateral (200-300 percent coverage) with limited options on the types of collateral accepted; only buildings were deemed as eligible collateral. However, the MSMEs in general, and women entrepreneurs in particular, had limited eligible collateral. It was worse for women as they typically lacked control over household assets.

Liquidity constraint

There was limited liquidity in the market due to a combination of government policy towards private banks (for SME lending) and limited resource mobilisation strategies by the MFIs. The private banks preferred to use scarce resources for lending to large enterprises and MFIs for micro-enterprises at the bottom of the pyramid. MFI liquidity challenges came from weak capacity to generate capital from internal sources, weak capacity for savings mobilisation, and limited commercial borrowing. With limited resources for SME lending there was little interest in serving the target market with the appropriate loan sizes.

Absence of effective supporting services

The market for supporting services was highly distorted in Ethiopia. MFIs had been receiving most capacity building donor project support for free and were not able to identify their specific needs. As it had been free, they also did not have any real understanding of the value proposition for purchasing capacity building services. There was no supply of qualified technical advisors to assist the financial institutions to develop new and innovative loan products and to put in place the systems required to manage them.

3. Lending interventions supported by EP

The two World Bank projects introduced credit lines to address the liquidity issue, but they also focused on using the funds to meet the enterprise needs through new products, especially cashflow-based lending products. However, as there was no local market for technical advisory services, the projects needed a TA facility to address the institutional and staff capacity gaps, strategic targeting, and to also address collateral challenges. Until a local market for technical services could be developed, the two projects required EP to train and certify each financial institution before it was able to access the lines of credit.

This section starts by highlighting the key financial institution capacity gaps and EP's approach to addressing them.

EP's TA Approach and Scope

Key MFI capacity gaps to serve MSMEs

The key MFI capacity gaps are summarised below:

- MSME lending was not captured in MFI strategic plans and directions. The MSE segment was not among the markets being targeted. Some MFIs had very few urban branches.
- MFIs had no appropriate MSME loan products to address the needs of the women MSE operators. Only a few MFIs had individual loan products, and on a very limited scale. Loan size and conditions were not suitable to MSE operators and were collateral-based. Most MFIs lacked the loan products for MSMEs, and those who attempted, provided loans that were too small to satisfy MSME financing needs. The average individual MSE loan size was about ETB 19,000 (USD 600), which was one tenth the amount required by MSEs, as later revealed to be over ETB 250,000 during WEDP, and incomparably lower than the average SME loan size of ETB 1.3 million as evidenced under SMEFP.
- MFIs did not have policies and procedures for individual MSME lending in place or, if they did, they needed significant revision.

- Staff lacked skills to process individual MSME loans. As they worked strictly on collateral-based lending, they did not know how to assess the MSME businesses.
- High/prohibitive collateral requirements. Only houses or buildings valued at 200-300 percent of the loan amount were accepted as eligible. MSMEs in general, and women entrepreneurs in particular, lacked physical collateral.
- The traditional collateral-based appraisal techniques was not suitable for MSMEs as it resulted in inappropriate loan size and loan conditions. Cashflow-based lending was not in use.
- MFIs had many institutional capacity gaps – weak strategic planning, weak governance, weak internal control and risk management, weak internal capacity to identify capacity gaps and seek support, weak reporting and portfolio tracking systems, weak MIS, etc.

Key bank capacity gaps hindering SME lending

- Banks were engaged in some SME lending but not in a targeted manner. They were also using a traditional collateral-based lending approach which was not convenient for SMEs. Banks were not classifying their customers based on firm size but mostly based on loan size, which created difficulty in knowing precisely what percentage of their portfolio was geared towards SME financing. This emanated from poor strategic targeting and tracking of different market segments, including SMEs. Bank management information systems (MIS) were not designed to capture firm sizes (by capital, number of employees, etc.), even if they had the capability to do so. Banks limited the loan size to the collateral coverage (often higher than 200-300 percent coverage) instead of actually looking at business needs. This resulted in either over-financing or under-financing an enterprise, either way creating loan repayment problems.
- Cashflow-based lending approaches were not yet adopted by banks for making SME loans.

TA delivery method

The TA delivery followed a structured approach where the ultimate objectives were to bring about change in practice. Accordingly, a dedicated team was established to take each financial institution through the different stages and processes until the intended result was achieved. MSE and SME product development served as an example. The intervention started with a thorough market assessment, followed by an institutional readiness assessment, thereby arriving at an optimal product feature that was within the capacity of each financial institution to offer. Once the product was developed, policies and procedures for the product were prepared, management and staff were trained in the new product, policies and procedures, and the cashflow-based appraisal system, Then middle and front-line staff were mentored on the use of the cashflow-based appraisal tool by actually doing real business appraisals and guidance on arriving at a lending decision. This TA approach resulted in effective capacity building and changes in practices. Staff and institutional capacity were highly enhanced and MSME lending started to grow enormously.

The TA plan for each financial institution was based on a comprehensive TA needs assessment. The specific gaps were discussed with management to ensure buy-in and direct efforts towards addressing the agreed upon capacity gaps. A comprehensive TA plan was then developed, which addressed the capacity gaps in a way that rapidly created MSME lending capability and sustained the changes.

The following forms of TA were provided:

- Strategic support to management to help with revision of strategic plans, to enable product diversification and expanding of target markets, product development, development/ revision of policies and procedures.
- Trainings were designed for the board, senior management, middle management and front-line staff.
- Mentoring and coaching of staff to be able to implement key learnings/recommendations to address gaps. Mentoring was very valuable in upgrading front-line staff skills in appraisals and management of MSME loans. Front-line staff were supported by EP consultants to process loans by applying key methods taught in classroom training and by using a cashflow-based appraisal tool. This helped individual staff members upgrade their skills and to comfortably do MSE lending on their own.
- Advisory support to the board and management on issues including defining strategic directions, expansion and scale-up plans, addressing structural issues and in addressing challenges encountered.

Key features of EP's intervention

- Based on thorough analysis of underlying constraints
- Needs-based, aligned with participating financial institution pain points and priorities
- Strong relationship with participating financial institutions and gained trust and commitment
- Long term engagement – pursue intervention until change in practice and skill transfer was evident
- Combined local and international expertise

MSE Lending market system – WEDP

Overview of WEDP

The World Bank developed WEDP in order to improve MSE access to finance, especially for women-owned MSEs. The project was organised into three components – access to microfinance, business development services to MSEs, and monitoring and impact evaluation. WEDP provided an initial credit line of USD 50 million to address MFI liquidity constraints. The fund was earmarked for on-lending to women entrepreneurs on an individual (not group) basis only. Repayments by the MFIs to the DBE would then be blended into the DBE's core resources.

Due to the factors summarised in the text box at right, MSE lending was not on the menu of products and services of most of the 12 WEDP partner MFIs which had been selected to disburse the credit line. The World Bank realised that the weak institutional capacity of the MFIs could not absorb the allocated credit line and on-lend to women entrepreneurs. This called for intensive TA support to the MFIs to enable them to utilise the credit line and serve the target segment. EP was mandated to deliver intensive TA to build the capacities of partner MFIs to enable them to offer larger MSE loans to women entrepreneurs using a new individual cashflow-based lending methodology on a sustainable basis. The project design dictated that TA would prepare and certify the MFIs to apply the new practices before they could access the line of credit, which would greatly increase the uptake of the line of credit.

Why the MSE lending market was not functioning

- Poor targeting by MFIs
- Misconception - MSE individual lending considered a mission drift by MFIs
- Weak institutional capacity- structure, product, policy and procedure, business model, human capital
- Business case of MSE lending not clear to MFIs
- Liquidity constraints.

EP's Capacity Building Interventions

Direct TA to MFIs

In a well-functioning market system, MFI capacity gaps should be addressed by technical support market players. However, the technical service support market to MFIs to address their capacity gaps to enable them to provide MSE lending was virtually non-existent. Given this weak market system and due to the urgency to stimulate the MSE lending market, a direct capacity building programme was created for MFIs.

The TA was designed to meet the specific needs of each MFI to introduce MSE lending as quickly as possible. It was realised at the very beginning that a 'one-size-fits-all' approach would not address each MFI's capacity gaps. Even if the MFIs had similar capacity gaps in broader terms, individual MFI capacity and readiness to implement new ideas, systems and techniques varied, so a specific level of effort and methodology had to be adopted with each MFI. The principle followed was to work with management and build on the already existing systems, rather than scraping away what they had and telling them to follow a new set of procedures all together. This was very important to gain MFI management buy-in and continued support in bringing the required changes overtime.

Building the support market for technical services to MFIs

Ideally, the technical services to MFIs should have been provided by private service providers, but as noted above, the market for services of the right quality was very under-developed in Ethiopia. There was limited capacity to deliver, as well as no solvent demand from the MFIs. Given the technical requirements of the supporting services, it would require years and lots of experience to build up this service market as well as to create the demand by the MFIs.

However, EP recognised that TA support services would be needed in order to service new MFIs wishing to access lines of credit in the future. As MFIs worked with EP TA, they started to understand the value proposition of TA services. They began to come with many requests to EP, a clear indication of their new demand, and of how weak the supply side of the technical services market was. This situation called for a more systemic level intervention for the creation and/or development of a technical services market for MFIs to ensure sustainable access to technical services beyond the programme lifetime.

EP conducted a study to identify and document key market constraints in the technical services support market for MFIs to guide the design of its intervention. The market study revealed the following constraints in the market:

Supply side

There was inadequate number and capacity of technical service providers to provide need-based technical services to MFIs, partly due to weak demand from the MFIs and limited willingness to pay for such services.

Demand side

There was weak internal capacity within MFIs to identify institutional weaknesses and know what kind of support to seek, either through donor support or buying it from the market. The appetite/willingness to pay for technical services by the MFIs was very low due to historical intensive donor support in the sector. Since it had always been given for free, the value of TA was not appreciated, and MFIs were not willing to pay.

EP designed three interventions to address key constraints in the technical services delivery market which were started under WEDP and then continued into SMEFP. The interventions sought to increase the number and quality of service providers on the one hand and enhance MFI understanding of the value proposition of technical services, on the other. The latter required developing capacity to conduct internal technical needs assessment, show value propositions of technical assistance so as to cultivate demand and convince MFIs to start paying for technical services.

Technical Service Provider certification

EP supported a certification programme that was co-branded between the Frankfurt School of Finance and Management and the Association of Ethiopian Microfinance Institutions (AEMFI) to certify service providers in the top five priority areas of MFI technical assistance needs. These needs were identified during the market study and included product development, risk management, strategy formulation, customer service and relationship management, and training-of-trainers (TOT). In the first batch (2018), 18 service providers were certified, and market linkages created with MFIs. Those service providers were listed on the AEMFI website with their profiles and expertise so that an MFI could identify potential service providers for their needs and directly approach them.

To build the initial market, EP facilitated trainings delivered by the certified technical service providers to MFIs, with the MFIs contributing a significant cost-share, a major change from the status quo of not paying for technical services. On average, MFIs paid ETB 500 per day per participant (USD 20), which was unthinkable a few years earlier. The intervention worked on the supply side by facilitating certification of the technical service providers, creating an information sharing portal and market linkages. It worked on the demand side by cultivating demand through the demonstration of TA value propositions and equipping the MFIs with the necessary tools to identify internal capacity gaps.

Establishing an MFI Centre of Excellence

The intervention aimed to establish a centre of excellence to provide technical services to MFIs on a commercial basis. The intervention was implemented in collaboration with Amhara Credit and Savings Institution (ACSI), the biggest MFI in Africa which had an under-utilised facility that served as a training centre. The objective of the intervention was to convert ACSI's training centre into a Microfinance Centre of Excellence so that it provided technical service not only to ACSI, but other players in the microfinance sector. A consultant was hired to support the development of the business model and implementation plan for the Centre of Excellence which was successfully completed. However, ACSI was not fully prepared for implementation and the intervention was slow to achieve results. At the time of writing, this intervention was half completed and required commitment from the partner to take it forward and implement the business model by allocating adequate resources. Once completed, it will significantly contribute to addressing the technical service needs of MFIs.

Enforcing investment on capacity building – changing the rules

This intervention aimed to facilitate issuance of a regulation to enforce investment of up to two percent of recurrent MFI budgets into capacity building. The intervention aimed to create demand by requiring MFIs to invest in capacity building by paying for technical services in an attempt to change the norm of not paying for services. The draft directive was prepared, but was pending issuance by the NBE at the time of writing.

Results

EP's capacity building intervention to unlock the MSE lending potential of MFIs was a tremendous success. The World Bank had expected the USD 50 million credit line for lending to women MSE operators to be disbursed over five years. However, the effective capacity building support significantly increased the MFI absorption capacity, resulting in greatly enhanced disbursement. The initial credit line was fully disbursed in two years with very high repayment rates (>98 percent). This success led to several major changes in the overall supply of capital for lending to MSEs:

- It attracted more than USD 100 million in additional lines of credit from other donors[8] to add to the initial USD 50 million from the World Bank, more than tripling the funds available. Considering the value provided by the direct TA, the EIB contributed to contracting TA needed in the project extension as they added new MFIs and expanded to new cities.
- MFIs, after realising the business case of MSE lending, contributed their own resources toward MSE lending, which accounted for over 30 percent of disbursements to women entrepreneurs.

[8] JICA added USD 50 million, Italy added USD 17 million (EUR 15 million), EIB added USD 33 million (EUR 30 million). EIB contributed additional funding for TA needed in the extension new MFIs were added.

- EP also made a business case to DBE to revolve the credit line for MFI lending to women, which was not a common practice by DBE in other funds it managed. No external funding managed by DBE had been revolved in the past, but through EP's facilitation, DBE agreed to use reflows to continue funding to MFIs. With improved efficiency in the MFI lending system, enhanced turnover of the available funds enabled more MSEs to be reached.

Overall, capacity building support resulted in enhanced funding flows towards MSE lending by more than four times the initial allocated credit line, it creating more access and increased MSE incomes and job creation. Over 15,000 women-owned MSEs accessed loans, of which 62 percent were new to credit services. This resulted in the creation of more than 18,000 jobs, as estimated based on an impact evaluation study by the World Bank which indicated that, on average, 1.19 jobs were created per MSE that accessed a loan.[9]

The capacity building support resulted in a breakthrough in MFI lending methodology. MFIs now provided bigger loans with confidence as a result of adopting cashflow-based lending using an automated excel tool to support them in collecting, summarising, analysing and interpreting financial and non-financial information to guide their lending decisions. Lending decisions were now made based on the cashflow-generating capacity of MSEs rather than physical collateral presented by the entrepreneurs. This helped MSEs to access bigger loans that met their financing needs, with better loan conditions helping them to operate effectively and grow their business.

The stronger lending methodology equipped with clear policies and procedures and appraisal and monitoring systems resulted in excellent portfolio quality (PAR>90 days stood less than 3 percent).

Enhanced MSE lending improved the portfolio mix of MFIs and reduced exposure to credit risk. MFI loan portfolios had been concentrated on agriculture loans (over 90 percent) but now MSE loans accounted for up to 25 percent of many MFI portfolios. This gave the MFIs a better risk profile, made them more stable and less susceptible to concentration risk. It contributed to the stability and soundness of the microfinance sector at large.

Key achievements – indicators of a now-functioning MSE lending market

- Leveraged more funding, from USD 50 million to over USD 150 million in credit line, and additional resources from MFI-own sources and DBE reflows
- Average loan size increased from ETB 19,000 to ETB 250 thousand
- 62 percent first-time borrowers as more access created
- Collateral coverage reduced from 200-300 percent to 100 percent
- Over 15,000 MSEs served, > ETB 3.8 billion disbursed
- PAR>90 days remained below three percent
- MSE loans accounted for 10-50 percent of MFI portfolio, compared to >90 percent agri-loans at inception
- >1,400 MFI staff trained
- Cashflow-based system adopted
- MFIs investing own funding towards MSE loan accounting for >30% of total disbursement.

[9] WEDP Impact evaluation report by the World Bank, 2015

The MFI industry recognised the MSE market as a bankable and profitable market segment. This opened the door for more MSEs to access credit, helping unlock their economic potential to contribute to the development of the country. MFI perceptions about the needs of the poor in Ethiopia also shifted; from purely poverty-based lending, the microfinance sector began reaching more segments of the poor. MSE lending enhanced MFI performance and increased profitability for cross-subsidisation of MFI products that served their mission.

Adoption of the cashflow-based lending approach reduced reliance on physical collateral for making lending decisions. The norm of accepting only buildings as collateral changed and other options such as vehicles, personal guarantees, sales contracts, post-dated checks, were now accepted as eligible collateral. The MFI collateral requirement was reduced from between 200-300 percent to 100 percent, with a few MFIs even going as low as 70 percent for repeat customers. MFIs were also now accepting a combination of collateral options to make up the coverage requirement. This opened opportunities for those MSEs lacking previously eligible collateral to access credit and grow their business.

The support market for technical service to MFIs was developing and demand increasing. With the effective capacity building support from EP, MFIs now understood the value of receiving technical support. The MFIs started to realise the business case for spending time, effort and resources on receiving technical services. EP worked on building the supply side of the technical service market, i.e. the creation of capable technical service providers that could provide quality service to MFIs, to meet this demand. This was achieved through the technical service providers certification intervention, under which 18 technical service providers were certified and market linkages created. Another remarkable achievement was the attitudinal change of MFIs towards the need for technical services and their willingness to pay. In the past year, certified technical service providers had provided six trainings to over 120 MFI staff and MFIs paid ETB 500 per day per participant.

Key achievements from MFI technical service market intervention

- 18 certified technical service providers in the 1st batch
- AEMFI collaborated with others to continue certification programme
- MFIs now understood the value proposition of technical services and had internal capacity to identify TA needs
- Market linkage created between certified technical service providers and MFIs
- MFIs willing to pay for technical services, and started to do so
- Six trainings to over 120 MFI staff delivered.

With combined and integrated interventions following direct delivery and MSD approaches, EP strengthened the MSE lending market and enhanced the MFI technical services market. EP's direct delivery approach addressed the weak capacities of core market actors, while also developing the support market for technical service delivery. This resulted in facilitating significant increases in core market transactions and ensuring sustainable access to technical services by core market actors.

SME Finance Market System – SMEFP

Background to SMEFP

As WEDP was successfully unfolding, the World Bank conducted a study in 2015 which indicated a huge financing gap for SMEs, the missing middle, in Ethiopia (see Figure 1). This financing gap for SMEs, coupled with the need to support growth-oriented SMEs with potential to contribute to Ethiopia's economic growth and industrialisation process were among the triggers for SMEFP. The study was debated with senior GoE officials during a three-day retreat devoted to developing a strategy response to the need for increased investment by SMEs in productive sectors, especially manufacturing, agro-processing, tourism and construction. The financing of SMEs for investment in equipment and for working capital loans was a priority topic.

The success of WEDP and its use of TA for building capacity and introducing new products to accelerate the uptake of lines of credit greatly influenced the design of SMEFP. With MFIs gaining institutional and human capacity to disburse MSE loans through EP's technical assistance, WEDP had become a global showcase within the World Bank for how to effectively stimulate viable lending to target firms and won several awards. While WEDP had no targeted economic sector, SMEFP was designed to focus on productive sectors to drive growth. At the GoE's request, the World Bank committed USD 270 million from April 2017 to address the missing middle by building a strong market system for SME lending. This market would be built through lease financing (to meet the investment needs of SMEs) and working capital financing to address the working capital needs of SMEs. Under SMEFP, commercial banks would down-scale their lending to productive SMEs, while MFIs would be lending to MSEs with the potential to up-scale into SMEs. The next section focuses on the working capital financing to SMEs by MFIs and banks, while the section after details the more specific constraints to lease financing and EP's responses.

.... I am glad to inform you that the SME Finance Project has won the World Bank VPU Award (vice president award). EP's technical and implementation support is critical to the success of SMEFP and the TA was one of the major factors that made our project stand out among others. The award is a testament to the professionalism, hard work and commitment of all our partners, notably, EP!'

- Mengistu Bessir, *Task Team Leader, SMEFP, The World Bank*

SMEFP SME Working Capital lending

SME growth in Ethiopia was hampered by low levels of access to finance. Banks (private and public) and MFIs, which were considered as a major source of finance for SMEs, were not serving the market due to information gaps on the size of the market, the needs and potential of the SME segment, weak targeting, limited institutional capacity, and lack of appropriate products and lending procedures.

In addition to the key constraints stated above, the prevalence of a highly illiquid market also deterred financial institutions from expanding their product range and taking on additional risk. Instead, they financed 'low hanging fruit' such as large industries and trade finance. Banks and MFIs had limited experience and capacity, and a perception problem when it came to serving the SME market. Understanding of the opportunities within financial institutions, as well as the financial and non-financial needs of SMEs, was very low.

Meanwhile, the regulatory side of SME financing was conducive for both banks and MFIs to lend to SMEs. There were no restrictions to adopting novel lending approaches such as cashflow-based lending. Financial institutions were free to innovate as long as the proper risk management mechanism was put in place to meet MFI and bank requirements on portfolio quality. The one possible limitation for MFIs to lend to SMEs was the single borrower limit, which capped loans to one percent of MFI total capital to avoid over-exposure to one client. A recent (2019) regulation was issued to allow use of movable assets as eligible collateral. Houses and/or buildings had been the only acceptable collateral by banks prior to this.

SMEFP activities began in April 2017, with EP providing direct TA to financial institutions. The main goal of the TA facility under SMEFP was to build the institutional and human resource capacity of DBE and of participating financial institutions to effectively serve the productive SME market.[10] In order to make the credit facility effective, participating financial institutions were required to receive specific, high-quality technical assistance to be certified to qualify for the DBE line of credit.

For MFIs, the capacity building support built on the model developed under WEDP. The focus was to expand lending to SMEs in productive sectors (not for trading) and ensure it was well targeted. Production-oriented SMEs were a higher value market segment than MSEs and MFIs needed appropriate products, systems and capable staff to provide effective SME lending. MFIs were supported to develop SME strategies to ensure sustainable services to SMEs in terms of having adequate organisational structure, branch networks, expansion/scale-up strategies and resource mobilisation to increase SME loan portfolios, among others.

With private banks, the focus of the TA was on supporting them to better target and serve SMEs by putting in place clear strategies, definitions, MIS coding, and ensuring separation in reporting. In parallel, the banks were supported to revisit their lending policies and procedures and working capital loan product features to ensure they met the financing needs of SMEs in the target sectors of manufacturing, agro-processing, tourism and construction. Cashflow-based lending was introduced to the banks for the first time, supported by a semi-automated excel tool. This was a major shift from their traditional collateral-based loan products, so the TA included intensive training to management and frontline staff of banks to ensure their understanding of the product. TA to banks focused on SME lending and addressing the access to finance challenges of SMEs, most notably appropriate loan sizes and terms, and collateral issues.

In summary, the EP capacity building intervention supported MFIs to up-scale their client base and private banks to down-scale theirs, using the provided credit line to on-lend to eligible, growth-oriented SMEs. Key TA areas included developing/refining working capital loan products that met SME needs, refining credit policies and procedures including collateral issues, a cashflow-based lending tool, training management and staff in use of the cashflow-based lending tool and enhancing risk management systems to improve portfolio quality.

[10] With target sectors of manufacturing, agro-processing, tourism and construction.

Results of working capital lending

The programme achieved its goal of better targeting and serving SMEs. Before EP's intervention, the financial institutions did not have the required business plans, market studies and targets to serve them. They also did not have the know-how on the market potential of the segment and on how to recruit and monitor SME customers.

Participating financial institutions now had a well-segmented and productive SME target market, distinct from other customer groups. For MFIs, it was an entirely new market segment, but they now had products to serve the financial needs of SMEs. Banks and MFIs now had SME working capital loan products, accompanied by all the necessary revisions of credit policies and procedures, appraisal systems, monitoring and reporting systems. Some participating financial institutions assigned dedicated staff at head office to enhance SME lending. This resulted in more targeted operations and increased the funds flowing to SME lending and the growth of the SME market system.

SME lending is included as a key target market segment for both banks and MFIs. As of June 2020, over 550 SMEs had benefited from working capital loans from seven MFIs and six private banks, with loans amounting to around ETB 1.3 billion (USD 39 million). Six of the 12 banks and seven of eight MFIs selected for the programme were actively disbursing. Increased disbursement by MFIs and banks would eventually result in narrowing the missing middle scenario, with more access created and potential to grow further.

More of the line of credit could have been disbursed for working capital loans. However, with SMEFP focused on leasing at the beginning of the programme, only a small portion of the available funding was allocated to financial institutions for working capital loans.[11] Given the total size of their portfolios, this was a small amount for many of the commercial banks, which affected their motivation; banks were reluctant to continue in the programme, and some big banks withdrew. Yet, with continued facilitation by EP, the funds available for working capital lending increased, and some banks returned to the programme and enhanced disbursement.

A cashflow-based appraisal system was adopted by banks and MFIs continued to adopt it for SME lending. This led to more appropriate loans for each SME, as the credit decision was based on the absorptive and cashflow-generating capacities of each SME rather than the value of collateral pledged. The strength of the appraisal system and improved financial institution portfolio and risk management systems resulted in an SME loan portfolio of excellent quality with APR>90 days below five percent.

Both the MSE and SME finance market systems were growing with the critical support and facilitation role played by EP. The financial institutions were addressing new markets. The average MFI loan size to MSEs had grown from ETB 250,000 to ETB 1.3 million, a clear indication that MFIs were gradually moving towards SME financing. Meanwhile, the average bank loan was down to ETB 3.5 million (USD 103,000), clearly showing that the needs of the missing middle were being addressed.

Access to finance remained a key constraint hampering SME growth in Ethiopia. However, a more competitive market for SME lending was emerging. Competition was resulting in a more efficient SME finance market system, with better terms and conditions for SMEs. Productive SMEs now had options for accessing working capital loans (MFIs, banks) and leasing services. With more financial institutions lending appropriately based products to SMEs and more SMEs accessing loans, access to productive finance will steadily grow into the future. This will result in a wider contribution to Ethiopia's inclusive growth employment creation.

[11] Initially the GoE planned to gear 80 percent of the SMEFP credit line towards lease financing of productive equipment and only 20 percent for working capital finance. This initially impacted the amount of funds available for working capital loans which affected the motivation of commercial banks to stay in the programme. However, the fund flow to leasing and working capital has since been balanced.

Key achievements of SMEFP working capital

- Seven MFIs and six private banks were actively investing in lending to SMEs
- Financial institutions using new cashflow-based loan products
- 550 SMEs in productive sectors received working capital loans worth USD 39 million
- Requirements for collateral by SMEs significantly reduced, expanding loan opportunities
- More than 900 bank and MFI staff trained
- SME lending now targeted as a viable market segment
- Average loan size by MFIs increased from ETB 250,000 (MSE average) to ETB 1.2 million (SME average). An average SME loan size by banks is ETB 3.5 million, evidence of MFI up-scaling and bank down-scaling, precisely hitting the project objective.

SMEFP lease financing

Background to leasing in Ethiopia

Lease financing was the major component of SMEFP, heavily emphasised by the GoE. Leasing is an alternative financial product that addresses the collateral challenges of SMEs to access productive equipment. However, leasing was in its infancy in Ethiopia. It was a novel solution to meet the needs of growth-oriented SMEs to expand, or new SMEs to purchase productive equipment. The core market was the provision of lease financing services to SMEs by specialised leasing companies: DBE as well as regional leasing companies. SMEs in the targeted manufacturing and agro-processing sectors required a lot of investment in productive equipment. This made lease financing an ideal product for such SMEs.

Leasing was introduced in Ethiopia in 2014, much later than in other emerging markets in Africa. The 'Capital Goods Leasing Business Proclamation' was issued in 1998, but no leasing activity began until after the 2013 Amendment to this Proclamation, giving the NBE licensing authority for capital goods finance leasing. In 2014, five Regional Capital Goods Finance Companies (CGFCs) were established under regional government ownership to lease to micro-enterprises (leases below ETB one million – USD 30,000). In 2015, the DBE was mandated to provide lease financing to SMEs and to offer leases from ETB one million to ETB 30 million (USD one million). Private sector entities and foreign participants were legally allowed to join the leasing market, but regulatory impediments discouraged foreign owned companies. The first privately-owned leasing company (Ethio-Lease) with foreign participation received its license in 2019.

The IFC estimated Ethiopia's leasing market potential to be USD 1.05 billion (ETB 30 billion).[12] As of December 2019, total lease financing disbursement from the five CGFCs and the DBE was approximately ETB six billion, serving around 6,200 MSMEs. The DBE dominated this market and its disbursements of nearly ETB 5.5 billion through December 2019 represented more than 90 percent of total leasing disbursements. However, the quality of the DBE's leasing portfolio in 2017 when SMEFP started was poor (NPL of 11 percent and worsening) and required strengthening. EP therefore targeted capacity building support to the DBE to change practices and policies and improve its capacity and portfolio quality.

DBE was the pioneer financial institution to offer leasing as a product. However, DBE's entry to the leasing service was mainly driven by GoE policy direction rather than a thorough study and preparation. The DBE specialised in project financing, had no prior experience in leasing and its staff lacked lease financing skills. As a result, when DBE set up the leasing business it lacked the right organisational set-up, policies and procedures were inadequate, staff lacked skills in lease financing, monitoring and reporting of lease transactions needed improvement, proper NPL management systems were required, as were arrears and repossession guideline and polices. Within the DBE, lease financing was mixed with project financing despite the differences in the two products. The DBE's many years of experience in project financing overshadowed the new lease financing service; there was no separation between project financing and lease financing appraisal and portfolio management as they were managed under one vice president.[13]

Severe constraints on hard currency availability in Ethiopia limited the DBE's ability to conclude most of its early leasing applications, about 85 percent of which involved imported equipment.

[12] IFC, 2017 Equipment Leasing in Africa: Handbook of Regional Statistics

[13] For instance, the culture and NPL level of project financing is far from the standards expected for leasing.

While the SMEFP line of credit was designed to address this, the World Bank also made the DBE's leasing unit's access to the line of credit dependent on EP capacity building and certification. This gave assurance that the DBE had adequate systems and processes in place to efficiently utilise the credit line. The first disbursements of the SMEFP facility occurred in late 2017 and hard currency constraint was overcome in early 2018.

Another challenge was the shortage of local equipment suppliers/dealers to provide the productive equipment required by customers. This led the DBE to engage in procurement functions to help companies purchase the equipment directly from overseas, including opening letters of credit and dealing with suppliers. This required a considerable effort by DBE, diverting attention to non-core lease financing functions.

EP's Intervention: TA to DBE and leasing companies

EP began its TA for leasing with DBE in April 2017, about one year after the DBE had started its leasing activities. EP's focus was to support DBE's institutional capacity building, to bring the needed leasing know-how and capacity to DBE for efficient utilisation of the WB credit line and to eventually grow the leasing market in Ethiopia. Access to the credit line was conditional on receiving technical assistance from EP to address clear leasing capacity gaps on the side of DBE and CGFCs.

EP's capacity building to DBE addressed both strategic level as well as technical level challenges. These included strategic advice to senior management, revision/development of policies and procedures, recommendations to enhance leasing organisational structure, development of portfolio monitoring procedures and tools, and training and mentoring of staff at different levels.

In the second year of SMEFP (2018), EP began providing TA to Addis Capital, one of the five CGFCs. EP supported Addis Capital to update its business plan, trained staff in basic lease financing and advisory support on areas such as restructuring the institution to ensure efficient leasing processes, support for MIS procurement processes, and others. Initially, regional leasing companies were only mandated to serve micro-enterprises with a lease value less than ETB one million. Later, however, the regulatory cap on single borrower limit was raised to 2.5 percent of a leasing company's total capital, significantly increasing the maximum lease size that could be provided. Regional leasing companies could now provide lease sizes up to ETB 10 million, opening the door for serving real SMEs. Addis Capital had significant growth from its position in 2018 which was about USD two million (ETB 65 million) to USD six million (ETB 200 million) in 2020. EP facilitated linkages with DBE for Addis Capital to access the credit line and ETB 200 million (USD six million) was approved to be released in tranches. This fund would go to SME financing, a customer base above their existing clientele which was limited by the previous regulatory cap. EP's assistance extended from providing the basic training to all staff, to revising lease forms and contacts, drafting policies and procedures, developing portfolio monitoring dashboards, assisting in the development of business plans, recommending organisational restructuring and designing marketing activities to broaden the customer base.

EP only recently started providing support to the other four CGFCs as they failed to meet project requirements, especially meeting single borrower limit, capital adequacy and portfolio quality. This emanated from their exposure to turnkey projects.[14] EP supported initial assessments and proposals for resolution of turnkey projects for regional leasing companies. Recently, TA was provided to prepare them for future certification to join the programme. In the meantime, regional governments of the respective leasing companies were in the process of resolving the turnkey exposures to relieve the companies of the debts they owed to the CBE. EP played a facilitation role and held high-level meetings with responsible regional government bodies to expedite the process. EP conducted a comprehensive capacity needs assessment for the leasing companies, prepared capacity building plans and provided leasing overview trainings to two companies – Walia (Amhara region) and Kaza (Tigray region), and supported them to prepare business plans. EP continued its facilitation role of expediting inclusion of the four regional companies in the programme and access to the credit line. Based on advice from EP, Oromia leasing submitted an application to the World Bank to access the credit line as it had secured a decision to remove the exposure from the balance sheet of the company and transfer it to the regional government. The World Bank approved the company's access to the credit line in-line as per EP's advice. Walia Capital was also pursuing the same route and hopefully all remaining companies will gain access based on the route opened by Oromia Capital through EP's active facilitation role.

Leasing Results

EP's support to improve DBE's leasing capacity yielded a much stronger institution with an improved portfolio. As of March 2020, the DBE had disbursed USD 83 million from the SMEFP line of credit to 301 SMEs and maintained a 4.4 percent NPL. This compared favourably to 23 percent NPL from leases to 426 SMEs that companies made prior to SMEFP, using the DBE's own resources. This expanded the use of leasing for productively-oriented SMEs. Other financial institutions, such as the CBE, were considering launching leasing products.

The DBE's human and technical capability was now enhanced to do lease financing and ensure a strong leasing portfolio was built. Over 1,150 DBE staff and over 150 staff of regional leasing companies had been trained in basic lease financing. Twenty staff underwent TOT training using IFC Business Edge modules and were certified. This all contributed to creating leasing know-how within the Ethiopian leasing market and to the continued delivery of basic leasing training using certified DBE, NBE and CGFC internal staff.

By increasing the senior management understanding of the leasing functions, EP improved NPL management. The most important shift was to move from a culture of project financing practices with unlimited tolerance for poor repayment, to business lending. Timely

[14] The turnkey project was initiated by the GoE to establish flexible workshops (manufacturing facilities) in the five big regions (Addis Ababa, Oromia, Amhara, Tigray and SNNPR) to support the country's industrialisation plan and youth employment. The project included construction of sheds as well as the delivery of the full machinery sets required to run the workshops. In total, 32 workshops were initiated with the aim to handover to associations formed by unemployed youth (101 members per facility) under a lease financing modality where the youth were expected to pay back the cost (roughly ETB 48 million) over a certain period. The Addis Ababa project did not materialise and hence Addis Capital was not involved in the project. Regional leasing companies were encouraged to own the project and transfer it on leasing modality to the youth. This required funding for the leasing companies and the GoE arranged for them to borrow up to ETB 500 million from the CBE with a guarantee provided by their respective regional states. The Metals and Engineering Corporation (METEC), an industry group owned and run by the military) was in charge of construction work and delivery of the required machinery for the workshops and most of the 32 projects (worth approximately ETB 1.1 billion) were not delivered, or quality was poor and did not meet the required specifications, and hence were not in a position to be transferred to the youth under leasing contract. In the meantime, the leasing companies were required to pay back CBE but failed to do so as the projects were not functional. Exposure to the turnkey project therefore left four of the five leasing companies closer to bankruptcy. The flexible workshops were supposed to produce input for mega-projects implemented by METEC such as the renaissance dam, sugar projects etc.

and clear data on the status of each leasing transaction could now be tracked and action taken. A strong portfolio tracking and monitoring system provided monthly report collection and analysis to management, which contributed to building a healthy leasing portfolio.

DBE management now fully understood that an effective leasing structure was still not in place and began discussions with government on a separate leasing function, either as a new division within the DBE or a separate legal entity (DBE leasing subsidiary). EP provided a proposal to support this process.

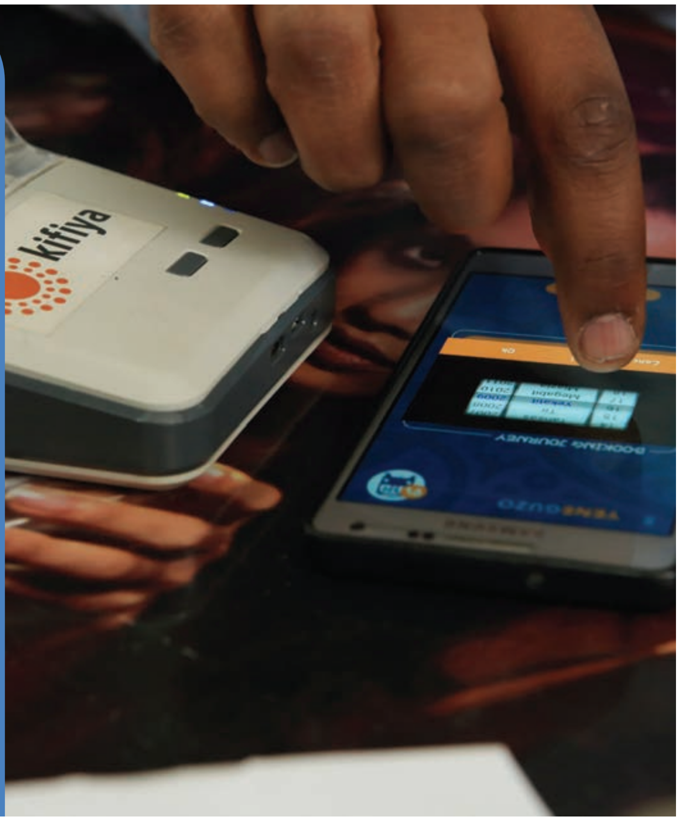
Overall, the policy environment for leasing improved. Through lobbying the NBE and the Federal Small and Medium Manufacturing Industries Development Agency, EP contributed to changes in regulation relating to single borrower limits for CGFCs, which was raised from ETB one million to 2.5 percent of their capital. This was a significant shift in addressing SME's access to finance.

EP's capacity building to the DBE created a stronger foundation for leasing in Ethiopia and new market entrants and existing service providers would learn from DBE. EP's capacity building support, therefore, had a direct impact on building the capacity of the DBE and leasing companies, influencing leasing polices and regulation as well as changing market norms and standards for the leasing market in Ethiopia.

Another key result was the linkage of the leasing companies to the DBE credit line. Through EP's capacity building support to Addis Capital, DBE granted it access to the credit line. EP further facilitated resolving of the leasing companies exposure to the turnkey projects, and linkages between the regional leasing companies and DBE to access the credit line. Following the decision of the Oromia regional state to resolve the turnkey exposures of the Oromia leasing company, EP supported the company to organise its request and seek approval from the World Bank. Their access to the credit line was approved. The remaining leasing companies were expected to follow the same route to get access. With the regulatory limit on single borrower limits now relaxed and the leasing companies accessing liquidity, more SMEs will be able to access leasing services going forward.

Key results

- Enhanced lease disbursement -USD 83 million over two years to 305 SMEs
- Local leasing know-how developed
- Improved leasing policy and procedures
- Improved portfolio quality
- Alternative financing option now available for growth-oriented SMEs
- Certified leasing trainers created.



4. Conclusions and Lessons

Ethiopia's financial industry had been challenged to meet the financial needs of its missing middle and under-served market segments – MSMEs, especially women, for debt and productive asset finance. Challenges included financial liquidity for the institutions and the capacity of the financial institutions to design and deliver products to the target market segments. The World Bank and other multilateral donors were willing to help address the liquidity constraint, but the lack of institutional capacity of financial service providers was a major bottleneck to building a strong and growing inclusive market for financial services which reached the under-served poor and the missing middle of MSMEs. Within the context of a sound market system, supporting service providers should assist financial institutions to develop their products and capacity to reach that market in a sustainable manner. However, Ethiopia's financial services market system was lacking quality and strong supporting service providers that could help design the products and systems needed to make this market work. Donor-subsidised training had distorted the market, while not successfully addressing the challenges.

This case provides a good example of the need, under a market systems development project, to take a hands-on approach to addressing problems when the supporting services are missing. EP worked closely with the GoE and the World Bank to design and deliver direct TA support to tackle these challenges with innovative solutions that created the proper incentives, tools and control mechanisms to develop diverse and transparent financial services markets. While there had been different programmes providing credit lines to MFIs, they had not been effective. WEDP's unique design accompanied finance with an intensive capacity building component. The capacity building component was a game changer, as WEDP facilitated disbursement of the credit line in a shorter period than initially expected by the WB. It also transformed the sector by introducing new lending products that were more appropriate for MSMEs, building the capacity of the financial institutions to grow into the future, and stimulating additional investments from other donors.

The initial TA transformed the way the financial industry operated, greatly increasing lending by financial institutions to the target market and attracting significant additional funding into the market segments. It also demonstrated the value of purchasing TA services to address market opportunities and began addressing the missing supporting service provision markets.

Some of the lessons and recommendations from EP's use of TA as capacity building to achieve these results are:

Monitor the development of the market system

It is important to understand that the evolution of market systems takes time and needs a sequenced process, with different types and levels of support as the market system develops. As a necessary starting point, there must be a clear understanding of the market system with a defined core market, the constraints and challenges to be addressed. The interventions should take into consideration the existing status of the supporting market systems but have a vision for what the sector should look like after the interventions.

Use of direct TA can be appropriate to address underlying constraints in core and support markets

Direct TA is effective in addressing core market challenges when there is a very weak market system with no supporting market. While using direct TA is not typically recommended under market systems programming, it may be the necessary starting point. The direct TA can make the core market work while demonstrating the value propositions for using (and paying for) technical services (supporting market). Taking advantage of direct technical assistance to address the core market failures, while simultaneously and gradually building the supporting markets to address them sustainably in the future, has proven to be an effective tool for stimulating better and more efficiently functioning markets.

The direct delivery approach worked very well in quickly building institutional capacities of financial institutions to serve the financial needs of MSMEs. EP worked in parallel to build the support function of technical services for MFIs and created a technical service provider certification programme. Direct delivery yields quicker results for weak market systems while also providing a demonstration effect to incentivise adaptation. However, it may not be a sustainable model and as the market starts to respond, a facilitative indirect TA model can further enhance the market system. A combination of approaches could also be used depending on the maturity level of the market system.

Understand and build the incentive for change to get buy-in from partners

The intervention design needs to create incentives for market actors to bring about the intended changes; they must see the value proposition to change. The aim of TA is to effect systemic changes or improve the practices of financial institutions. To do this effectively, it is necessary to establish how a specific financial institution develops its strategies, makes its decisions, and puts them into practice. In other words, understand the behaviour of the financial institution and their incentive to change. In the case of MSE and SME markets, access to liquidity was the key incentive for partner financial institutions to open up for initial capacity building. Later on, they started to understand the value proposition of the capacity building which led them to seek (and pay for) more support. Under WEDP, securing buy-in and commitment required time for this understanding to be realised. Once the value proposition was understood, TA delivery was smooth and remarkable results were achieved. Allowing changes to be led from within the organisation will ensure quicker buy-in and programmes are less likely to face resistance. A unique feature of EP's capacity building intervention was to identify capacity gaps and collaborate with the partner organisation to work on an agreed capacity building plan. As EP's experience shows, understanding the local context before adapting and aligning international best practice is necessary.

Understand the capacity building requirements, and tailor the support

TA support needs to be tailored to the specific needs and capacity of individuals at different levels of an organisation. It should also consider the differences in perception and behaviour within the organisation's hierarchy so that tailored support can be offered. Under WEDP and SMEFP interventions, EP conducted comprehensive needs assessments and had them validated by management and designed a plan to address specific gaps identified with each institution.

Establish good feedback loops for adaptation

To make effective use of TA, programmes should aim for deeper institutional change through **longer-term engagement** and be **adaptive/flexible** to adjust interventions based on early learnings. SMEFP identified challenges to participating financial institution interest due to the limited availability of the working capital line of credit, and so adjusted the flow of funding. This requires projects to invest in a good monitoring and evaluation system.

Building a fully functioning, inclusive and vibrant market system takes time

It requires changes in practices at the core and addressing weaknesses in the supporting systems and the regulatory framework. It is a gradual process. Through WEDP and SMEFP, EP's work led to a significant increase in the volumes of lending going to previously under-served markets by many more financial institutions to many more borrowers. It changed the nature of many relationships in the core market, which was necessary, but was not yet sufficient for accelerating inclusive growth. It began building the necessary supporting technical service market systems (both supply and demand) and provided evidence to the regulators on other policy changes that would be needed. On the market systems continuum, it was in an emerging market context, but would still take more time and investment to reach the status of 'a market system that is functioning for the poor'.

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