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IDA/R2016-0074/1

April 28, 2016

Closing Date: Tuesday, May 17, 2016 at 6 p.m.

FROM: Acting Vice President and Corporate Secretary

Ethiopia - Small and Medium Enterprise Finance Project

Project Appraisal Document

Attached is the Project Appraisal Document regarding a proposed credit to Ethiopia for a Small and Medium Enterprise Finance Project (IDA/R2016-0074), which is being processed on an absence-of-objection basis.

Distribution:
Executive Directors and Alternates
President
Bank Group Senior Management
Vice Presidents, Bank, IFC and MIGA
Directors and Department Heads, Bank, IFC and MIGA

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The World Bank

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Report No: PAD1650

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED CREDIT

IN THE AMOUNT OF SDR 144.8 MILLION

(US$200 MILLION EQUIVALENT)

TO THE

FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA

FOR A

SMALL AND MEDIUM ENTERPRISE FINANCE PROJECT

APRIL 26, 2016

Finance and Markets Global Practice
Africa Region

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of February 29, 2016)

Currency Unit	=	Special Drawing Rights
ETB 20	=	US$1
US$1.0857	=	EUR 1
US$1.38122	=	SDR 1

FISCAL YEAR

July 8 – July 7

ABBREVIATIONS AND ACRONYMS

A2F	Access to Finance
ATM	Automatic Teller Machines
BDS	Business Development Services
BNDES	National Bank of Economic and Social Development
CBE	Commercial Bank of Ethiopia
CFAs	Credit Facility Agreements
CJC	Competitive Job Creation
CPAR	Country Procurement Assessment Review
CPS	Country Partnership Strategy
CQS	Consultants' Qualifications
CSRP	Civil Service Reform Program
DBE	Development Bank of Ethiopia
DBSA	Development Bank of Southern Africa
DFID	Department for International Development
DITD	Domestic Investors Transformation Directorate
DPs	Development Partners
EC	European Community
EDRI	Ethiopian Development Research Institute
EEP	Ethiopian Electric Power
EIB	European Investment Bank
EMCP	Expenditure Management and Control sub-program
ENREP	Electricity Network Reinforcement and Expansion Project
ESMS	Environmental and Social Management System
FeMSEDA	Federal Micro and Small Enterprises Development Agency
FI	Financial Intermediary
FISF	Financial Inclusion Support Framework
FM	Financial Management
FPPA	Federal Public Procurement and Property Administration Agency
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
GoE	Government of Ethiopia
GRS	Grievance Redress Service
GTP	Growth and Transformation Plan
HDI	Human Development Index

HR	Human Resource
IBRD	International Bank for Reconstruction and Development
ICB	International Competitive Bidding
ICs	Individual Consultants
IDA	International Development Association
IDG	International Development Group
IFAC	International Federation of Accountants
IFC	International Finance Corporation
IIWG	Investment and Infrastructure Working Group
IPF	Investment Project Financing
ISA	International Standards of Auditing
ISR	Implementation Status and Results Report
IT	Information Technology
LCS	Least-Cost Selection
LEMS	Mauritius Leasing Equipment Modernization Scheme
LOC	Line of Credit
M&E	Monitoring and Evaluation
MDGs	Millennium Development Goals
MDI	Multi-Donor Initiative
MFIs	Microfinance Institutions
MIS	Management Information Systems
MLAs	Multi-Lateral Agencies
MoFEC	Ministry of Finance and Economic Cooperation
MoI	Ministry of Industry
MSMEs	Micro, Small and Medium Enterprises
NAFIN	National Financing Institute
NBE	National Bank of Ethiopia
NCB	National Competitive Bidding
NPLs	Non-Performing Loans
NPV	Net Present Value
OFAG	Office of the Federal Auditor General
OM	Operations Manual
PBS	Promoting Basic Services
PDO	Project Development Objective
PEPE	Private Enterprise Program for Ethiopia
PFEA	Public Financial Enterprise Agency
PFIs	Participating Financial Institutions
PIC	Project Implementation Committee
PIU	Project Implementation Unit
PMT	Project Management Team
PPESA	Privatization and Public Enterprises Supervisory Agency
PSCAP	Public Sector Capacity building Support Program
QCBS	Quality- and Cost-Based Selection
ReMSEDA	Regional Micro and Small Enterprises Development Agencies
RFPs	Request for Proposals
ROA	Return on Assets

ROE	Return on Equity
ROSCAs	Rotating Savings and Credit Associations
SBDs	Standard Bidding Documents
SFA	Subsidiary Financing Agreement
SIC	Mauritius State Investment Corporation
SMEs	Small and Medium Enterprises
SoE	Statements of Expenses
SORT	Systematic Operations Risk- Rating Tool
SWOT	Strengths, Weaknesses, Opportunities and Threats
TA	Technical Assistance
TCA	Technical Cooperation Agreement
UNDB	United Nations Development Business
UNDP	United Nations Development Programme
WBG	World Bank Group
WEDP	Women Entrepreneurship Development Program

Regional Vice President:	Makhtar Diop
Country Director:	Carolyn Turk
Senior Global Practice Director:	Gloria M. Grandolini
Practice Manager:	Irina Astrakhan
Task Team Leader:	Francesco Strobbe

FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA
SMALL AND MEDIUM ENTERPRISE (SME) Finance Project

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PAD DATA SHEET

Ethiopia

Ethiopia: SME Finance Project (P148447)

PROJECT APPRAISAL DOCUMENT

AFRICA

0000009277

Report No.: PAD1650

Basic Information			
Project ID P148447	EA Category F - Financial Intermediary Assessment	Team Leader(s) Francesco Strobbe	
Lending Instrument Investment Project Financing	Fragile and/or Capacity Constraints [ ]		
	Financial Intermediaries [X]		
	Series of Projects [ ]		
Project Implementation Start Date 17-May-2016	Project Implementation End Date 31-Aug-2022		
Expected Effectiveness Date 17-Aug-2016	Expected Closing Date 31-Aug-2022		
Joint IFC No			
Practice Manager/Manager	Senior Global Practice Director	Country Director	Regional Vice President
Irina Astrakhan	Gloria M. Grandolini	Carolyn Turk	Makhtar Diop

Borrower: MOFEC			
Responsible Agency: National Bank of Ethiopia			
Contact:	Getahun Nana Jembere	Title:	V/Governor
Telephone No.:	251115175262	Email:	getnana@yahoo.com
Responsible Agency: Development Bank of Ethiopia			
Contact:	Esayas bahre	Title:	President
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Responsible Agency: Ministry of Industry			
Contact:	Mebrahtu Meles	Title:	State Minister
Telephone No.:	251115151373	Email:	mebrathu.meles@moin.gov.it

Project Financing Data(in USD Million)					
[ ]	Loan	[ ]	IDA Grant	[ ]	Guarantee
[X]	Credit	[ ]	Grant	[ ]	Other

Total Project Cost:	276.00	Total Bank Financing:	200.00
Financing Gap:	0.00		

Financing Source	Amount
BORROWER/RECIPIENT	0.00
International Development Association (IDA)	200.00
EC European Investment Bank	76.00
Total	276.00

Expected Disbursements (in USD Million)

Fiscal Year	2017	2018	2019	2020	2021	2022	2023	0000	0000	0000
Annual	1.00	19.00	38.00	58.00	48.00	36.00	0.00	0.00	0.00	0.00
Cumulative	1.00	20.00	58.00	116.00	164.00	200.00	200.00	0.00	0.00	0.00

Institutional Data

Practice Area (Lead)

Finance & Markets

Contributing Practice Areas

Cross Cutting Topics

[ ] Climate Change

[ ] Fragile, Conflict & Violence

[X] Gender

[X] Jobs

[ ] Public Private Partnership

Sectors / Climate Change

Sector (Maximum 5 and total % must equal 100)

Major Sector	Sector	%	Adaptation Co-benefits %	Mitigation Co-benefits %
Finance	Banking	20		
Finance	SME Finance	60		
Finance	Other non-bank financial intermediaries	10		

Finance	Credit Reporting and Secured Transactions	10		
Total		100		

☑ I certify that there is no Adaptation and Mitigation Climate Change Co-benefits information applicable to this project.

Themes

Theme (Maximum 5 and total % must equal 100)

Major theme	Theme	%
Financial and private sector development	Micro, Small and Medium Enterprise support	70
Financial and private sector development	Other Financial Sector Development	30
Total		100

Proposed Development Objective(s)

The project development objective is to increase access to finance for Eligible Small and Medium Enterprises in the Recipient's territory.

Components

Component Name	Cost (USD Millions)
Financial Services to SMEs	193.00
Enabling Environment for SME Finance	0.80
Business Development Services for SMEs	2.50
Project Management, Communication and Impact Evaluation	3.70

Systematic Operations Risk- Rating Tool (SORT)

Risk Category	Rating
1. Political and Governance	Moderate
2. Macroeconomic	Moderate
3. Sector Strategies and Policies	Low
4. Technical Design of Project or Program	Substantial
5. Institutional Capacity for Implementation and Sustainability	Moderate
6. Fiduciary	Substantial
7. Environment and Social	Low
8. Stakeholders	Moderate
9. Other	
OVERALL	Substantial

Compliance

Policy	
Does the project depart from the CAS in content or in other significant respects?	Yes [ ] No [X]

Does the project require any waivers of Bank policies?	Yes [ ] No [X]
Have these been approved by Bank management?	Yes [ ] No [ ]
Is approval for any policy waiver sought from the Board?	Yes [ ] No [X]
Does the project meet the Regional criteria for readiness for implementation?	Yes [ ] No [ ]

Safeguard Policies Triggered by the Project	**Yes**	**No**
PS 1: Assessment and Management of Environmental and Social Risks and Impacts	**X**	
PS 2: Labor and Working Conditions	**X**	
PS 3: Resource Efficiency and Pollution Prevention		**X**
PS 4: Community Health, Safety, and Security		**X**
PS 5: Land Acquisition and Involuntary Resettlement		**X**
PS 6: Biodiversity Conservation and Sustainable Management of Living Natural Resources		**X**
PS 7: Indigenous Peoples		**X**
PS 8: Cultural Heritage		**X**

Legal Covenants

Name	**Recurrent**	**Due Date**	**Frequency**
Co-financing Agreement, Article IV, 4.02		31-Dec-2016	

Description of Covenant

The Co-financing Deadline for the effectiveness of the Co-financing Agreement between the Government of Ethiopia and the European Investment Bank is December 31st, 2016.

Conditions

Source Of Fund	**Name**	**Type**
IDA	Project Implementation Manual, Article 5, 5.01	Effectiveness

Description of Condition

The additional conditions of effectiveness consists of the following , namely that the Recipient, through both DBE and MOI, has adopted the Project Implementation Manual in accordance with Section I.B of Schedule 2 to the Financing Agreement

Team Composition

Bank Staff

Name	**Role**	**Title**	**Specialization**	**Unit**
Francesco Strobbe	Team Leader	Sr Financial		GFM01

	(ADM Responsible)	Economist		
Shimelis Woldehawariat Badisso	Procurement Specialist (ADM Responsible)	Senior Procurement Specialist		GGO01
Meron Tadesse Techane	Financial Management Specialist	Sr Financial Management Specialist		GGO25
Aly Salman Alibhai	Team Member	Operations Officer		AFRGI
Andrea Vasquez-Sanchez	Team Member	Sr Program Asst.		GFM01
Andrej Popovic	Team Member	Senior Financial Sector Specialist		GFM01
Asferachew Abate Abebe	Safeguards Specialist	Senior Environmental Specialist		GEN01
Bartol Letica	Team Member	Senior Operations Officer		GFM2A
Chukwudi H. Okafor	Safeguards Specialist	Senior Social Development Specialist		GSU07
Elizabeth Chacko	Team Member	Consultant		GFM01
Jonathan Danjuma Gigin	Team Member	Operations Officer		GFM01
Jose C. Janeiro	Team Member	Senior Finance Officer		WFALA
Mei Wang	Counsel	Senior Counsel		LEGAM
Senidu Fanuel	Team Member	Senior Private Sector Development Specialist		GTC01
Tsehaynesh H Michael Seltan	Team Member	Team Assistant		AFCE3
Wenye Dong	Team Member	Resource Management Analyst		BPSGR

Extended Team

Name	Title	Office Phone	Location

Locations

Country	First Administrative	Location	Planned	Actual	Comments

	Division				

Consultants (Will be disclosed in the Monthly Operational Summary)

Consultants Required ?	Consulting services to be determined

I. STRATEGIC CONTEXT

A. Country Context

1. **Ethiopia is a large and geographically diverse country, with a representation of 98 nationalities and peoples who speak 93 languages, a total population of about 90 million, and a population growth rate of 2.5 percent in 2014 (according to the United Nations).** At that rate, the United Nations estimates that the population will reach 130 million by 2025. Ethiopia is projected to be among the world's 10 largest countries by population in 2050. International Development Association (IDA) commitments to Ethiopia in recent years have been over US$1 billion per year. Making progress on the two goals of the World Bank Group in Ethiopia is, therefore, important both for global progress and for the country itself.

2. **Ethiopia remains one of the world's poorest countries but has achieved high levels of economic growth and made substantial progress on social and human development over the past decade.** Ethiopia's economic growth has been remarkably rapid and stable over the past decade. Real GDP growth averaged 10.9 percent in 2004–2014, according to official data. By taking into consideration population growth of 2.5 percent over the past decade, real GDP growth per capita averaged 8.0 percent per year[1]. The country's per capita income of US$550 (Atlas GNI, 2014) is substantially lower than the regional average of US$1,257 and among the eleven lowest worldwide. Ethiopia is ranked 173 out of 187 countries on the Human Development Index (HDI) (2014) of the United Nations Development Programme (UNDP). However, economic growth has helped reduce poverty in both urban and rural areas. Since 2005, 2.5 million people have been lifted out of poverty, and the share of population below the poverty line has fallen from 38.7 percent in 2004/05 to 29.6 percent in 2010/11 (using a poverty line of close to US$1.25/day). Ethiopia is among the countries that have made the fastest progress on the Millennium Development Goals (MDGs) and HDI ranking over the past decade. It is on track to achieve the MDGs for gender parity in education, child mortality, HIV/AIDS, and malaria. Good progress has also been made in universal primary education, although the MDG target may not be met.

3. **Ethiopia's constitution ensures a federal, democratic system.** Ethiopia's current government system was established in the early 1990s by the Ethiopian People's Revolutionary Democratic Front, which took over the country in 1991 after militarily defeating the previous regime. Since 2003, the country has actively pursued decentralization of governance to the regional and *woreda* levels—a *woreda* is a district with an average population of 100,000. Ethiopia marked an important milestone in August 2012 with the first peaceful and constitutional transition of power in Ethiopia's modern history, with the appointment of H.E. Hailemariam Desalegn as prime minister, following the death of Meles Zenawi, who had led Ethiopia since the Ethiopian People's Revolutionary Democratic Front took over.

4. **The Government of Ethiopia (GoE) has completed its Growth and Transformation Plan (GTP) (2010/11–2014/15), which sets a long-term goal for Ethiopia to become a middle-income country by 2025, with growth rates of at least 11.2 percent per year during**

[1] Using UN population estimates and applying them to the official national accounts data in constant factor prices.

the plan period. To achieve the GTP goals and objectives, the GoE has followed a "developmental state" model with a strong role for the Government in certain aspects of the economy. It has prioritized key sectors such as industry and agriculture as drivers of sustained economic growth and job creation. The GTP also reaffirms the GoE's commitment to human development. The programs of development partners (DPs) are broadly aligned with GTP priorities.

5. **The GoE has developed and issued the GTP II (2016–2020) which emphasizes the key role of small and medium enterprises (SMEs) for the local economy and highlights the promotion of financial inclusion as a main priority in the development agenda.** During the GTP II period, greater emphasis will be placed also on strengthening modern payment systems and developing regulations based on international standards. A National Financial Inclusion Strategy for the next five years was approved in January 2016 by the National Council for Financial Inclusion.

6. **The World Bank Group's Country Partnership Strategy (CPS) for FY13–FY16 sets out the principles for engagement within this framework, as recently reviewed in the 2014 CPS Progress Report.** The CPS supports the GoE in implementing the GTP. It includes two primary pillars and seven strategic objectives. Pillar One (Fostering Competitiveness and Employment) aims to support Ethiopia in achieving the following strategic objectives: (a) a stable macroeconomic environment; (b) increased competitiveness and productivity (a particular area of focus for the IFC); (c) increased and improved delivery of infrastructure; and (d) enhanced regional integration. Pillar Two (Enhancing Resilience and Reducing Vulnerabilities) aims to support Ethiopia through (e) improved delivery of social services; and (f) comprehensive social protection and risk management. The CPS also has a foundation of (g) good governance and state building. In line with the GTP, gender and climate change have been included as cross-cutting issues in the CPS. The CPS Progress Report reconfirmed these strategic objectives while noting that the Bank Group will place renewed emphasis on a stable macroeconomic environment, increased competitiveness and productivity, regional integration, and the urbanization process.

B. Sectoral and Institutional Context

7. **Ethiopia's financial sector is dominated by the banking sector (commercial banks), which currently represents more than 92.6 percent of total assets of the financial sector, excluding the assets of the Development Bank of Ethiopia (DBE) and National Bank of Ethiopia (NBE).** Microfinance institutions (MFIs) constitute 5.2 percent and insurance companies 2.2 percent of the total financial sector assets. The Ethiopian financial sector consists of two public banks (i.e. the DBE and the Commercial Bank of Ethiopia (CBE)), 16 private banks, 17 insurance companies, 33 MFIs, and five capital goods finance companies.

8. **The banking sector is operated exclusively by domestic banks and dominated by state-owned banks.** State-owned banks, which mainly focus on financing large enterprises, constitute 70 percent of total assets of the banking sector and are dominating the credit market share of lending. The government-owned CBE is the dominant commercial bank and accounts for 60 percent of total assets of banks as of June 30, 2015. The share of private banks assets to total assets of the banking sector declined from 36 percent in 2008/09 to 30 percent in Q3 2015.

Domestic credit to private sector as a ratio of GDP was estimated around 18 percent below the Sub-Saharan Africa average of 30 percent in 2013. Total outstanding credit of the banking system - excluding credit to Government and interbank lending - reached ETB 205.7 billion/approx. US$10 billion at the end of March 2015,[2] a 26.2 percent increase compared to the previous year. Finally, the banking sector in Ethiopia remains closed to foreign banks.

Table 1. Overview of Ethiopia's Financial System (Main Formal Financial Institutions)[3]

	Institutions			Branches			Total Capital (Billion Birr)		
	2012 / 2013	*2013 / 2014*	*Q3 2015*	*2012 / 2013*	*2013 / 2014*	*Q3 2015*	*2012 / 2013*	*2013 / 2014*	*Q3 2015*
Banks	**19**	**19**	**19**	**1,728**	**2,208**	**2,636**	**23**	**26**	**30.5**
Private	16	16	16	859	1,205	1,526	11.3	14.6	16.8
State-owned	3	3	3	869	1,003	1,110	12	11.8	13.7
MFIs	**31**	**31**	**33**	**n/a**	**n/a**	**1,593**	**4.5**	**5.6**	**6.6**
Insurance Companies	**16**	**17**	**17**	**273**	**332**	**369**	**1.5**	**2**	**2.5**
Private	15	16	16	224	270	n/a	1.1	1.6	2
State-owned	1	1	1	49	62	n/a	0.4	0.4	0.5

9. **Banks are profitable and well-capitalized although liquidity is a concern.** The Ethiopian banking sector continues to show favorable aggregate indicators: in March 2015 the average risk weighted, system-wide capital adequacy ratio was 16.6 percent (double the minimum requirement); profitability was robust (with return on assets (ROA) at 3 percent and return on equity (ROE) at 45 percent, well above regional averages); and the non-performing loan ratio was only 2.4 percent. However, no Financial Sector Assessment Program (FSAP) has been conducted in Ethiopia and the absence of detailed bank data precludes the assessment of potential vulnerabilities in individual banks.

10. **The minimum deposit rate, regulated by NBE, has remained constant for the past five years at 5.0 percent.** The lending rate to final borrowers is fully liberalized, but has been relatively unchanged over the same period with minimum and maximum observed lending rates unchanged at 7.5 and 16.25 percent, respectively. For banks to increase their lending in support of structural transformation, they need to extend the average maturity of their deposit base. Longer-term deposits currently only account for 11 percent of the deposit base. Banks pay about 10 percent on longer-term deposits, roughly twice the interest rate on savings accounts. However, even these higher rates do not ensure a positive real rate of return on deposits. In addition, depending on the actual nominal lending rate which currently fluctuates between 7.5 and 16.25 percent, the real interest rate might be positive or negative given the headline inflation of 11.8 percent as of July 2015[4].

[2] FX Rate as of 3/31/15: US$1 = ETB 20.43. Source: www.xe.com
[3] Source: NBE 2013/14 Annual Report, and 2015 Q3 Bulletin
[4] According to IMF Article IV Consultation Press Release from September 2015, the reported headline inflation was a result of rising food prices due to below average rainfall, while non-food inflation was approaching 10 percent.

11. **Domestic credit has declined over time, as a share of the economy, as a result of low real interest rates, from 35.7 percent of GDP in 2004 to 28.6 percent of GDP in 2014.** This demonetization trend is mirrored in a similar decline of broad money (M2) as a share of GDP, which declined from 38.5 percent in 2004 to 25.6 percent in 2011/12[5]. Credit growth has been increasingly concentrated in public projects rather than private ones. The share of private credit in total outstanding credit has declined from 37 percent in 2007/08 to 30 percent in 2014/15. Conversely, the share of loans to State Owned Enterprises increased from 21 to 62 percent over this period (while the share of credit to Central Government in total outstanding credit declined from 42 to 8 percent). In terms of share of GDP, private sector credit declined from about 16 to 11 percent of GDP in 2004–14, according to the NBE definition, which counts all DBE loans as private.

12. **The microfinance sector is promising, albeit highly concentrated and facing a number of challenges.** Ethiopia has a strong presence of microfinance institutions (MFIs), credit cooperatives, savings and credit organizations, and rural finance associations. By Q3 2015, there were 33 MFIs regulated by the NBE, which mobilized a total saving deposit of ETB 14.2 billion/US$665 million (40 percent higher than last year) and an outstanding credit of ETB 18.7 billion/US$888 million[6] (32 percent higher than last year). Their total assets increased by 28 percent to ETB 29 billion / US$1.4 billion by the end of March 2015.[7] All these indicators show the growing contributions of MFIs to poverty reduction both in rural and urban areas through their focus on low income segments of the society. However, the MFI sector is highly concentrated. Five major institutions (all owned by different regional governments, operating in different regions and therefore not competing with each other), namely Amhara, Dedebit, Oromiya, Omo and Addis Credit and Savings Institutions, accounted for 83.8 percent of the total capital, 93.7 percent of the savings, 89.8 percent of the credit and 90.4 percent of the total assets of the MFIs. Despite the growth in the sector, the sector faces a number of challenges, which include but are not limited to funding constraints, high operational costs, deficient management information systems, and limited management capacity/expertise.

13. **Capital markets in Ethiopia are mainly comprised of treasury bills and government bonds**. Treasury bills are transacted on a weekly basis while government bonds are occasionally issued. Maturities of T-Bills range from 28, 91,182 and 364 days; 91 days and 364 days are the most demanded terms. In December 2014, the country joined Ghana, Kenya, Senegal and Ivory Coast in issuing the first dollar bond raising US$1 billion in 10-year bond to fund infrastructure related projects for industrial zones and sugar industry sectors.[8] Corporate bond market remained underdeveloped whereby merely only few public institutions and regional governments participate. Ethiopian Electric Power (EEP), Railways Corporation and Addis Ababa Housing Development Agency accounted for 72.7 percent, 14 percent and 13.2 percent of the total corporate bonds issued. The sole purchaser of these bonds is the CBE. As of March 2015, the stock of corporate bonds held by CBE stood at ETB 136.6 billion / US$6.8 billion.

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[5] Getnet Alemu Zwedu, Financial Inclusion, regulation and inclusive growth in Ethiopia, ODI working paper 408
[6] FX Rate as of 9/30/15: US$1 = ETB 21.05. Source: www.xe.com
[7] FX Rate as of 3/31/15: US$1 = ETB 20.43. Source: www.xe.com
[8] Deutsche Bank and J.P. Morgan were managing the bond sale.

14. **The majority of Ethiopians rely on financial services offered outside the regulated financial system.** According to 2014 Global Findex[9] published by the World Bank (and used to inform the Ethiopia's National Financial Inclusion Strategy), only 22 percent of Ethiopians owned a bank account at a formal financial institution, compared to the Sub-Saharan regional average of 34 percent. There is a large untapped market of borrowers and savers in Ethiopia that are not using financial services offered by regulated financial institutions. For instance, 44 percent of Ethiopian adults borrowed within the last year, but only 7 percent borrowed from regulated financial institutions. Similarly, while 48 percent of Ethiopian adults reported saving or setting money aside, only 14 percent saved at a regulated financial institution. Since 2008, the national savings rate of Ethiopia has been growing significantly. National savings which was 22.9 percent of GDP in 2008 has subsequently been rising and reached 31.7 percent of GDP in 2014, surpassing the SSA by about 10 percentage points. The unprecedented growth in the savings rate since 2008 is due to the rise in domestic savings. A national account revision in 2011 effectively doubled the domestic savings rate from 7.6 percent in 2011 (old estimate) to 14.2 percent (new estimate). Still, increasing domestic savings has been identified as a priority area within the GoE's newest Growth and Transformation Plan - GTP II. Annex 7 provides a detailed overview of the savings mobilization practice in Ethiopia.

15. **Beyond the individual and household level, access to finance is also a constraint for micro, small, and medium enterprises (MSMEs).** According to the World Bank Enterprise Survey (2011), 31.1 percent of firms identify access to credit as a major business constraint in Ethiopia (compared to 40.8 percent in SSA). Although 94.7 percent of all firms and 92.9 percent of small firms have access to a checking or savings account, only 15.8 percent have a bank loan or line of credit. Only 6 percent of micro enterprises, 1.9 percent of small enterprises, and 20.5 percent of medium enterprises have a loan or a line of credit.[10] Overall, business investments in Ethiopia are primarily financed internally (86 percent), compared to 8.2 percent by banks, 4.8 percent through equity or stock sales, or 0.2 percent from supplier credit. In addition, collateral requirements remain high at around 200 percent of loan amount.

16. **Despite significant improvement in outreach led by the expansion of the banks' branch network in the past year, penetration of regulated financial institutions remains very limited, particularly in rural areas.** The number of bank branches in Ethiopia increased to 2,636 as of March 2015 and, according to GTP II targets, is supposed to double by 2020. Nevertheless, the country lags behind the regional trends with only 2.9 bank branches per 100,000 adults and only 0.3 ATMs per 100,000 adults compared to the SSA average of 4.5 and 3.4, respectively. While around 80 percent of the population lives in rural areas, access points remain concentrated in the capital city; 35.4 percent of total bank branches and 53.4 of insurance companies' branches are located in Addis Ababa. Thus, the long distances to regulated financial institutions present a barrier to account ownership for the rural population.

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[9] The Findex database is a global database and survey that provides the world's most comprehensive database on financial inclusion. The survey provides in depth data on how individuals save, borrow, make payments, and manage risks. Developed and managed by the World Bank, collected in partnership with the Gallup World Poll, and funded by the Bill & Melinda Gates Foundation, the Global Findex is based on interviews with about 150,000 adults in over 140 countries.

[10] SME Finance in Ethiopia: Addressing the missing middle challenge, WBG.

17. **Ethiopia has made positive strides in financial sector infrastructure lately but it needs to be enhanced to promote financial intermediation.** With the help of World Bank projects[11], a modern national payments system and public credit information system were established recently. However, only 0.2 percent of the adult population is covered in the credit registry. There is no private credit bureau that can provide value added services on credit information such as credit scoring, marketing service, application processing and portfolio monitoring to facilitate quality decision making on credit provision by financial institutions and thereby minimize fraud and mitigate risks. Ethiopia does not have a registry for security interests in movable assets such as equipment, machinery, inventory and account receivables hampering secured lending over movables. Contract enforcement is also challenging adding to the risks for lenders to grant credit.

Analytical Background for the Operation

18. **The recently completed "Ethiopia SME Finance Study 2014" represents the analytical background for the proposed operation.** The study, initiated at a request of the GoE, looks at (the lack of) SME finance as one of the possible obstacles to job creation. Through the combination of a demand-side and a supply-side analysis, the study demonstrates the existence of a so-called "missing middle" phenomenon in Ethiopia, whereby small enterprises are more credit constrained than either micro or medium/large enterprises. The study highlights the inadequateness of Ethiopian banks' business models to address the financing needs of SMEs and the existence of severe limitations in the overall enabling environment for SME lending (e.g. the lack of a collateral registry; an underutilized credit information system and an inefficient insolvency and creditor/debtor regime).[12] The study also highlights the importance of lease finance as a complementary source of funding.[13] Leasing can be an effective mechanism for boosting the Ethiopian economy by providing long-term finance to SMEs which need funds to expand but often do not have the credit history or collateral sufficient for credit from conventional financing sources. Annex 7 provides a summary of the main findings from the study.

19. **The GoE has recently prioritized growing lease financing and is in the process of establishing the necessary legal and regulatory foundation to support its development.** Although leasing legislation and/or mention of it as a financial product has been around since 1998 in Ethiopia, institutions only began offering finance leases locally in 2014. The Capital Goods Leasing Business Proclamation 103/1998 as amended by the Capital Goods Leasing Business (Amendment) Proclamation 807/2013 are the two major pieces of legislations regarding leasing. The current regulatory framework for leasing is considered one of the most advanced and a best practice in the region. The related tax environment is also considered as conducive for leasing business. In March / April 2014, the GoE through the National Bank of Ethiopia (NBE) licensed five regional independent leasing companies to commence business in capital goods finance and hire purchase transactions with the objective of building a strong and

[11] Financial Sector Capacity Building Project (P094704); Improving the Efficiency of Payments System Project (P149104); Cheque Standardization Project (P132042).

[12] The study has been well received by the key counterparts in the GoE and by all the major financial and private sector stakeholders, as confirmed by the dissemination event held on February 2015 in Addis Ababa. A detailed summary of the main findings is provided in Annex 7.

[13] The Leasing Proclamation No 103/1998 has been recently amended by Proclamation No 807/2013 that provides licensing and supervisory authority to National Bank of Ethiopia for finance leasing and hire-purchase leasing.

viable leasing sector in Ethiopia. All the five newly established leasing companies have met the ETB 200 million (US$10 million equivalent) minimum capital entry requirement and are regulated by NBE. The WBG/IFC is currently providing technical assistance to the NBE in drafting all the necessary leasing directives and guidelines to supervise and regulate the leasing market in Ethiopia. Five (out of 15 drafted) directives have been completed and approved by the NBE so far. Ten of the Directives were reviewed in January 2016 by NBE and the WB/IFC leasing team. It will take approximately six months to one year for the management and Board of NBE to approve the rest of the Directives. Similarly, risk management guidelines and risk-based supervision procedures manual are also under review and discussion. Both deliverables are expected to be completed by June 2016 with the technical support of the WBG/IFC.

20. **The sectors likely to benefit from capital goods financing in Ethiopia are enterprises producing goods and services for export and import substituting enterprises as well as enterprises capable of creating large employment opportunities.** In Ethiopia, the leasing companies are expected to provide lease finance for machineries and equipment to the priority areas such as: (a) textile, garment, leather and leather products; (b) metal and wood works; (c) agro- processing, including dairy and poultry equipment; (d) construction machineries; (e) irrigation;(e) wet and dry coffee processing; (f) post-harvest grain processing including seed cleaning equipment; and (g) freight transporters from fields to market centers and warehouses, (h) farm and non-farm cooperatives, unions, and model farmers.

21. **In Ethiopia, capital goods financing includes financial lease and hire purchase but excludes operating lease.** In a financial lease, the lessor retains full ownership until the end of the contract when the lessee can exercise the option to purchase the asset at an agreed price (residual value). In a hire purchase contract, there is a pro rata transfer of ownership upon payment of each rental instalment and only upon payment of the last instalment is ownership automatically transferred to the lessee. While ownership may change at some point from the lessor to lessee, the 'legal title and certain rights' over the asset still remains with the lessor. Therefore, even after ownership has changed by over 51 percent and there is default or non-payment by the lessee, the lessor could seek redress through the Ministry of Industry (MoI) and then exercise the 'right to repossess.' The proclamations also provide for the parties to clearly agree on the manner by which ownership rights and claims shall be settled between the parties, in case there is an early termination of the hire purchase agreements. Where the lessee defaults and does not comply with demands from the lessor to remedy the default, the lessor shall rescind the contract, repossess the capital goods and claim damages. The proclamations empower the MoI to register capital goods agreements, and amendments, modifications and termination of agreements. The MoI shall take appropriate measures to ensure return of capital goods leased, and may order the police to execute the repossession.

22. **In established leasing markets, there is typically an orderly process for repossession.** The first step in default would be to take possession of leased equipment or to repossess to mitigate against the level of risk. The next steps are to safe-keep the leased equipment in a warehouse and then sell it to a third party in a secondary market. (This is an internal process by the lessor). Regardless of any given challenges in repossession, international experience suggests that a secondary market for leased equipment should become active once the leasing business starts in any given economy even for specialized equipment. Lessors are always advised and

encouraged to identify potential secondary markets for specialized equipment. Further details on default risk and repossession in Ethiopia are described in Annex 7.

23. **The current secured transactions system of Ethiopia provides a multitude of different and conflicting rules that complicate secured lending over movables.** The existing legal framework that covers secured lending in Ethiopia is primarily included in the Civil and Commercial Codes, Civil Coded of Procedures and Foreclosure Proclamation. Some weaknesses in the current system include: (a) the lack of a single law covering all transactions secured by movable property; (b) non-possessory pledges which exist only as exceptions and not as a rule; (c) the law does not allow the granting of a security interest in future assets; (d) only some types of security interests are subject to registration, creating, therefore, a system with secret liens that is difficult and costly for creditors to discover; and (e) extrajudicial foreclosure is not available for all types of creditors.

24. **In Ethiopia, the majority of finance provided by banking institutions is secured with both immovable and movable assets.** Unsecured credit is granted on an extremely limited basis to longtime clients who have demonstrated earnings equivalent to 100 percent of the loan for the past two years and who have been given a high ranking based on the bank's credibility indicators. While the institutions interviewed disclosed a slight preference for taking immovable property as collateral, most institutions accept movable collateral as well. Movable collateral is largely represented by vehicles and 90 percent of the total movable collateral reported to the Credit Reference Bureau is of this type.[14] While machinery and equipment are also commonly accepted, banking institutions revealed they are reluctant to take fluctuating assets, such as accounts receivables and inventory, as movable collateral. One of the main reasons Ethiopian banking institutions consider movable collateral a higher risk is the lack of a single movable property registry. In Ethiopia, there are several registries in which interests in certain types of movable collateral can be registered depending on the type of asset. These registries are located throughout the different regions of the country and are not linked, thus the information registered within each registry is not automatically shared with the other regional offices.

25. **Overall, the stakeholders welcome the idea of a single nationwide electronic registry for all types of collateral as long as it is reliable.** Creditors indicated that they would be willing to extend credit by taking collateral in property currently not being lent upon, such as agricultural products, if there was a clear system that would provide them with legal certainty. Likewise, civil servants interviewed indicated that there is a need to extend secured credit and collateralize all possible assets in order to promote and expand businesses.

Development Bank of Ethiopia

26. **The Development Bank of Ethiopia (DBE) is a specialized financial institution established to promote the national development agenda through development finance.** The Ministry of Finance and Economic Cooperation (MoFEC) represents the GoE as sole shareholder in DBE. MoFEC liaises with DBE in relation to the Bank's capital position and is represented on the Board of Management. The Public Financial Enterprise Agency (PFEA) has supervisory responsibility for DBE.

[14] Statistics provided by the National Bank of Ethiopia.

27. **DBE currently operates on the basis of a project finance business model, in which it supports projects with loans and technical assistance in selected high-priority sectors**. The Bank has a head office which is responsible for large loans above ETB 25 million / US$1.2 million, and regional offices which book smaller loan amounts and widen the Bank's reach. The DBE President is responsible to the Board of Management and is supported by Vice Presidents responsible for Corporate Services, Branch Operations, Credit Services and Support Services. The value of DBE's total current portfolio of loans and advances is ETB 26 billion / US$1.2 billion (June 2015).[15]

28. **As a development finance institution, DBE is well placed to serve the financing requirements of SMEs.** SME lending represents an important strategic development for DBE, providing an opportunity to further enhance its development role as well as contributing to the country's ongoing financial sector development. Following submission of the DBE Branch Rationalisation Study in late 2013, DBE's Board of Management and executive management considered changing the business model of its branch operations to one based on an SME lending approach, through a significant expansion of the number of regional branches. DBE has prepared a Five Year Credit Plan, 2015–2020, which assumes up to 20 percent of total disbursements over the next five years for SME lending and lease financing purposes.[16] The development of an SME lending capability is viewed as complementary to DBE's existing project finance and wholesaling activities.

29. **The World Bank Group and DBE have a successful track record of partnership.** DBE was selected by the World Bank as the wholesaling institution for the Women's Entrepreneurship Development Program (WEDP), based on its track record of managing lines of credit and on its management commitment to the project. DBE is responsible for the management of a fund of US$42.4 million provided for onward lending through twelve selected MFIs to micro- and small-sized women-owned enterprises. DBE has played the role of a wholesaler very effectively in the WEDP project and has rapidly disbursed the WEDP funds to MFIs. With oversight from DBE, the MFIs have disbursed the funds effectively to final beneficiaries, and have also developed their capacity in lending to women-owned MSMEs and adopted improvements and innovations in credit scoring and appraisal. Box 6.1in Annex 6 provides a detailed overview of the WEDP program.

30. **The World Bank has supported the institutional development of DBE.** In 2012 as part of WEDP, the World Bank conducted an assessment of DBE's compliance with World Bank requirements for financial intermediary financing projects.[17] The assessment confirmed DBE's eligibility, provided that it strengthened its capacity in several key areas, including risk management, human capital, loan process, and IT/MIS. Between April 2013 and June 2014, WEDP funded technical assistance to work with DBE senior management in the design and implementation of an institutional development plan. A summary of the most recent due diligence of DBE along with progress with implementation of the institutional development plan are summarized further below (under Appraisal Summary).

[15] FX Rate as of 6/30/14: US$1 = ETB 19.63. Source: www.xe.com
[16] Current disbursement levels are not available since DBE does not currently segment its portfolio by the size or type of borrower and does not differentiate between public and private ownership of projects.
[17] Then governed by OP 8.30, which has since been replaced by OP 10.00-financial intermediary financing. The new assessment of DBE is based on OP 10.00.

C. Higher Level Objectives to which the Project Contributes

31. **The proposed Ethiopia SME Finance Project is fully aligned with the priorities set out in the FY13–FY16 Country Partnership Strategy (CPS) and the subsequent CPS Progress Report and contributes to their objectives.** The CPS explicitly calls for "increasing competitiveness in manufacturing and services, and SME access to financial services" as one of the key outcomes under its Pillar One. The CPS progress report noted results in this area, reconfirming this objective. The proposed operation addresses the provision of term[18] finance in local currency through eligible participating financial institutions (PFIs) to expand outreach to urban and rural SMEs, thereby addressing the liquidity gap and facilitating sustainable access to finance to SMEs. In doing so the project is taking a comprehensive approach by addressing broader impediments to access to finance by: (a) incentivizing the financial system to deepen the provision of sustainable financial services to SMEs (i.e. through technical assistance to financial intermediaries to deploy novel lending techniques to reach SMEs); (b) by supporting investment in financial infrastructure (i.e. collateral registry, insolvency and creditor/debtor regime); and (c) addressing bankability constraints of the SMEs thorough provision of technical assistance, especially on business development. The proposed approach and project objectives are highly relevant to priorities identified in the CPS.

II. PROJECT DEVELOPMENT OBJECTIVES

A. PDO

32. The project development objective is to increase access to finance for Eligible Small and Medium Enterprises in the Recipient's territory[19].

Project Beneficiaries

33. **The final project beneficiaries will be eligible SMEs operating in the manufacturing and agro-processing industries.** Moreover, for those SMEs receiving leasing finance, or working capital linked to leasing finance, and/or business development services also tour and construction industries will be allowed in line with the priority areas for SMEs indicated in the Lease Financing Policy for SMEs (Code-DBE/03/2007)[20]. SMEs in the tour and construction industries will not be eligible to receive working capital only.

34. **Definition of "SMEs":** the definition of SMEs adopted by the project will be aligned to the one contained in the Lease Financing Policy for SMEs (Code-DBE/03/2007) in terms of minimum number of employees (i.e. above 6). The project will also fix the maximum number of employees per SME at 100. Moreover, under Component 1, working capital loans to SMEs will be limited to a maximum of Birr 10 million, while lease finance loans will be aligned with the Lease Financing Policy requirements: i.e. a maximum lease loan size of Birr 30 million. The

[18] Can include maturities up to 10 years

[19] "Eligible SME" means a small and medium enterprise established and operating in Ethiopia which meets the eligibility criteria contained in the Operations Manual.

[20] Article 2.1.1 of the Lease Financing Policy for SMEs indicates that priority areas for SMEs are (a) Agricultural project; (b) Agro-processing industries; (c) Manufacturing Industries; (d) Tour Industries; (e) Construction industries; (f) Mining and Quarries. Agricultural project as well as Mining and Quarries however are excluded from the project beneficiaries' sectors due to higher risk of potential negative impact on the environment.

policy also indicates that DBE will be focusing on direct provision of lease finance for SMEs in need of loans from Birr 1–30 million, while lease companies will serve SMEs with lease finance needs of below Birr 1 million.

35. **Moreover, the project will benefit participating financial institutions (i.e. lease companies, commercial banks and MFIs), local business development service providers and government agencies like DBE (including DBE branches), NBE and MoI.** In particular:

(a) **SMEs** will benefit from improved access to finance for leasing and working capital loans; from dedicated business development services and from improvements to the financial infrastructure for SME finance (e.g. collateral registry).

(b) **Participating Financial Institutions** will benefit from receiving technical assistance (externally funded) aimed at enhancing their capacity to sustainably serve the SME sector under the proposed project.

(c) **Local Business Development Service (BDS) Providers** will benefit through capacity building and support to better assist and provide services and training to SMEs.

(d) **Government Agencies** will benefit from institutional strengthening and capacity building to facilitate the provision of financial and non-financial services to SMEs and by improving the necessary financial sector infrastructure.

PDO Level Results Indicators

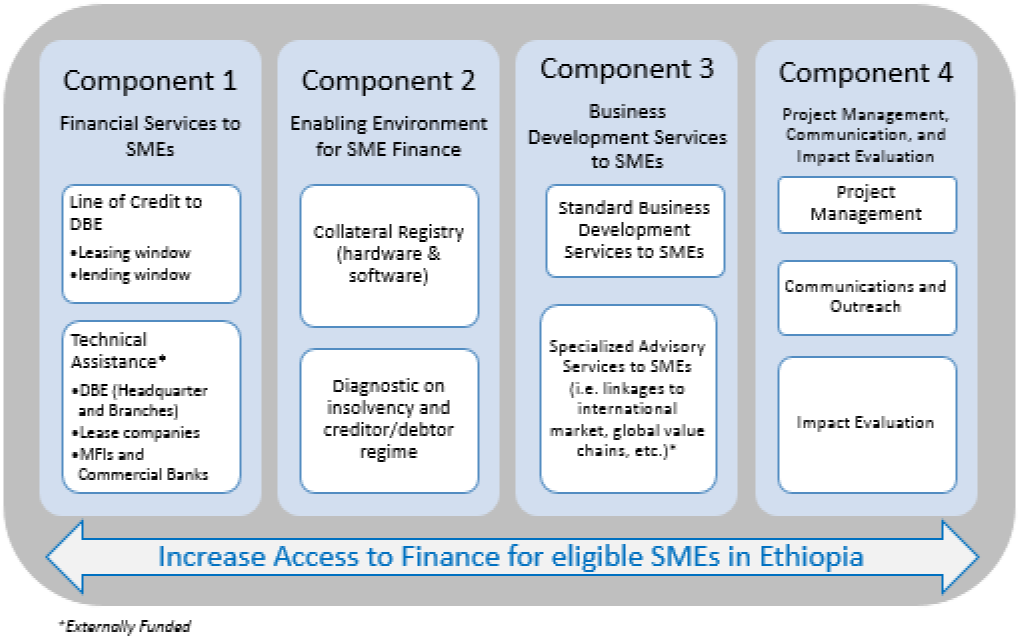
36. The progress towards the PDO will be measured by the following indicators: (a) Volume of Financial Support to SMEs under the credit facility; (b) Number of SMEs reached with financial services under the credit facility; and (c) Portfolio Quality under the credit facility. Proposed intermediate indicators are also detailed which help to achieve the PDO targets. The details are discussed in Annex 1.

III. PROJECT DESCRIPTION

A. Project Components

37. The SME Finance project will have four components: (a) Component 1: Financial Services to SMEs; (b) Component 2: Enabling Environment for SME Finance; (c) Component 3: Business Development Services to SMEs; (d) Component 4: Project Management, Communication and Impact Evaluation. Diagram 1 below provides the project overview.

Figure 1. Project Overview



Component 1: Financial Services to SMEs

38. **The objective of the first component is to establish a credit facility providing access to finance for (a) working capital and leasing finance for participating financial institutions (PFIs) which in turn lend to eligible SMEs and (b) leasing finance for eligible SMEs.** This liquidity support will be complemented with mandatory technical assistance aimed at supporting PFIs in designing, piloting and rolling out financial products utilizing novel lending methodologies (e.g. cash flow-based lending) to successfully expand their outreach to the target SMEs. The technical assistance support will be funded externally through bilateral agreements with development partners.

39. **DBE will provide both direct financing to SMEs and wholesale finance to other financial intermediaries for on-lending to SMEs.** More specifically, DBE will in parallel serve as: (a) direct lender of lease finance to SMEs through its regional branch network; (b) wholesaler of finance to participating lease companies for provision of lease finance to SMEs; and (c) wholesaler for commercial banks and MFIs focused on provision of working capital finance to SMEs. It will do so through two main financing windows:

- **Window 1**: **Lease finance to SMEs.** This window will provide a line of credit to strengthen DBE's capacity to provide lease finance to SMEs both directly through its regional branches and indirectly through the licensed and eligible lease companies operating in the country. DBE, as a retailer through its regional branches, will provide lease financing directly for amounts greater than ETB 1 million and indirectly to eligible lease companies for amounts less than ETB 1 million. Tailored and compulsory technical assistance will be provided to DBE branches and to the participating lease companies (see TA facility below) on how to properly address SMEs' needs in the regions where they operate, as well as enhancing their skills on risk management, product design, management information systems (MIS), funding strategy, and other needs as appropriate.

- **Window 2**: **SME lending.** This window will provide a wholesale line of credit from DBE to eligible commercial banks and MFIs for on-lending of working capital finance to eligible SMEs. Similar to the leasing window, a tailored and compulsory technical assistance (see TA facility below) will be provided to commercial banks and MFIs on how to reengineer their business models so that they can lend to SMEs in a sustainable fashion. This approach has been very successful in several other countries (e.g. Turkey and China), and it has completely changed the attitude of the financial sector players towards SMEs.[21]

40. **A TA facility (funded externally through development partners) will be established to complement and reinforce project implementation.** A critical success factor and a key goal of the project are to build the institutional and human resource capacity of DBE and of the PFIs to effectively serve the SME market. The TA Facility will be closely coordinated with the Credit Facility. The DFID-funded Private Enterprise Project for Ethiopia (PEPE)[22] will be responsible for funding and managing the TA facility, under the technical supervision of the World Bank team.

41. **In order to have access to the Credit Facility, PFIs will be required to enter into technical cooperation agreements (TCA) with the PMT in DBE and with PEPE.** These agreements will build on the outcomes of initial diagnostic review of PFIs where their technical assistance needs will be defined. Under such agreements, PFIs will receive TA free of charge for a period deemed appropriate after the initial gap assessment for building the necessary capacity to undertake the project's assignment. However, the PFIs will commit to adopting internal structures, staffing and systems consistent with servicing the targets SME market under the project.

Component 2: **Enabling Environment for SME Finance**

42. **The objective of the second component is to improve the enabling environment for facilitating SME finance in Ethiopia**[23]. This would require the following:

- creation of a **collateral registry** that would support both the lending and the leasing business;
- a diagnostic of the **insolvency and creditor/debtor regime** to address key bottlenecks to SME lending;

[21] In these countries, mandatory changes to banks' business models included: the creation of an SME department within each participating bank, the creation of decentralized credit committees, and the introduction of a purpose-designed quality assurance process. The TA was provided free of charge to the participating institutions for two years.

[22] The Private Enterprise Program Ethiopia (PEPE) is an existing DFID-funded project designed to support access to finance for small and medium sized businesses and to support productivity and growth in the horticulture, leather and textiles sectors in order to raise incomes and create jobs

[23] This component will be closely coordinated with the technical assistance that will be provided in the area of financial sector infrastructure by Ethiopia Financial Inclusion Support Framework (FISF) and Multi Donor Initiative (MDI), both managed by the WBG.

43. **The project will support the hardware and associated software requirements, licenses, capacity building and training for a centralized electronic collateral registry.** Collateral registries for movable assets, which are part of the broader secured transactions systems,[24] fulfill two key functions:[25] notify parties about the existence of a security interest in movable property (of existing liens) and establish the priority of creditors vis-à- vis third parties.[26] In Ethiopia, it has been identified that a collateral registry is one of the key areas of development for improving Ethiopia's financial infrastructure, thereby facilitating access to finance, especially for the SME sector. This registry is expected to be: (a) the only place where security interests over movables are registered following necessary legal reforms; (b) cost-efficient; (c) designed as a notice-filing system; and (d) accessible exclusively by electronic means.

44. **The main purpose of the diagnostic review on insolvency and credit/debtor regime is to analyze and identify the areas for improvement in the country's insolvency and credit/debtor systems.** Insolvency systems provide a pre-determined set of rules and institutions concerned with the recognition of insolvency, the resultant liquidation or rehabilitation of the insolvent firm, and the allocation of the financial consequences between the stakeholders. They also permit lenders to more accurately price risk and encourage cash flow lending, rather than relationship or directed lending, and disciplines managers to allocate scarce resources efficiently. The assessment is designed to assess and compare a country's institutional practices against the internationally recognized best practices and, if needed, provide recommendations for improvement in a prioritized methodology. The methodology of the diagnostic is based upon a pluralistic approach, which examines whether the goals of an efficient system are met and not how those goals are achieved.

45. These activities complement ongoing technical assistance (including the improvement of legal and regulatory framework for leasing) which is currently funded through other development partners and elaborated upon in Box 2.1 of Annex 2.

Component 3: Business Development Services to SMEs

46. **The objective of the third component is to support SMEs through the provision of tailored Business Development Services (BDS) to address constraints on the demand side.**

47. **BDS support to SMEs can address (but is not limited to) the lack of capacity to develop bankable business plans, the poor quality of financial statements and records, the inability to manage risk, the lack of knowledge of business development and management, the lack of adequate collateral, etc**. The main objective of the provision of BDS will be to

[24] A Secured Transactions project consists of four components: (a) secured transactions law, applicable to all creditors and borrowers, (b) design and implementation of a centralized on-line collateral registry; (c) public awareness and capacity building efforts; and (d) monitoring and impact measurement of the project.

[25] Alvarez de la Campa, Alejandro, 2011. Increasing Access to Credit through Reforming Secured Transactions in the MENA Region. Policy Research Working Paper 5613.

[26] Specifically, three conditions are required for banks to be able to accept movable assets as collateral: the creation of security interest, the perfection of security interest and the enforcement of security interest (see Fleisig, Heywood, Mehnaz Safavian, Nuria de la Peña, 2006. *Reforming Collateral Laws to Expand Access to Finance.* World Bank. Washington DC). The movable collateral registry is a necessary component as it allows for the "perfection" of security interest.

make SMEs more bankable. BDS services may include business management and entrepreneurship training, business plan development, marketing strategy, human resource management, financial systems and bookkeeping. It may also include tailored coaching and mentoring support depending on the needs and the capacity of the SMEs. A consulting firm would be identified through an international competitive bidding process to carry out an assessment of the specific needs of the target SMEs, and support the PIU in developing the Terms of Reference and criteria for the selection of BDS providers. It is anticipated that high caliber local BDS providers will then provide a tailored menu of trainings and mentorship to the SMEs.

48. **In addition to the standard BDS, the project will also aim at providing highly specialized services to growth-oriented SMEs capable of becoming suppliers for global value chains.** In particular, this set of services will link the local producers to international markets through global value chains, product development management and compliance with international market standards. Moreover, it will focus on quality assurance processes and management information systems (e.g. software that could help SMEs manage their production cycle in a more systematic and efficient manner).[27] As these proposed advisory services are more of a specialized technical nature and do not fall within the scope of a standard business training package, they would be provided directly to SMEs by an internationally-selected firm, with expertise in these technical areas. This specialized activity is expected to be coordinated under this project but financed through external/ donors grant funding.

Component 4: Project Management, Communication and Impact Evaluation

49. **The objective of the fourth component is to support overall coordination of project activities, and to rigorously measure the impact of the project on the growth of participating SMEs.**

50. **The two main implementers of the project will be the Development Bank of Ethiopia (DBE) and the Ministry of Industry (MoI).** A Project Management Team (PMT) will be established in DBE with the direct responsibility of managing the credit facility under Component 1. A Project Implementation Unit (PIU) will be established under the MoI with the mandate of overall project's coordination and direct responsibility of Components 2, 3 and 4. NBE will assign a focal person that will act as the key technical referent of the PIU for Component 2. The PIU will be housed under the Domestic Investors Transformation Directorate (DITD) at MoI that reports directly to the Minister of Industry. At the regional level, the regional SME development offices (ReMSEDAs) will serve as entry points.

51. **The impact evaluation will focus on innovation and measurement with the beneficiaries of loans and BDS.** The project's impact evaluation will support rigorous empirical analysis based on a quantitative comparison of a treatment and control groups before and after access to specific project interventions. Empirical analysis will typically build on survey data deliberately collected for this purpose: (1) a base-line survey which will be carried out prior to respondents' exposure to any relevant intervention activities; (2) an end-line survey which will be

[27] While the project cannot provide software to SMEs, the team has agreed to explore the possibility of conducting a needs assessment, to find the gaps in the existing software that the SMEs are using, and to introduce some existing solutions that the SMEs could acquire on their own in case of their interests and needs.

administered after the project is well into operation and (3) a mid-term survey. The main focus of the survey questionnaires will be on standard business performance measures such as sales, profit, investment and employment, with the aim of measuring the impact of the program on enterprise growth over time.

52. **The impact evaluation will also aim to capture heterogeneous impacts across various groups of participants, especially between female and male entrepreneurs, examining differential impacts of access to loans, leases, and business development services for the growth of male and female-owned enterprises.** During the design phase, the team will put emphasis on identifying and evaluating interventions that aim at tackling gender-specific constraints, particularly those that represent obstacles to the growth of female owned business and entrepreneurs. Additionally, analysis will examine differential impacts for younger and older firms, and firms of various sizes and sub-sectors.

53. **The impact evaluation will involve a long-term research partnership with the Ethiopian Development Research Institute (EDRI).** EDRI is a leading Ethiopian research institute, with strong expertise in research on enterprises and manufacturing in Ethiopia. EDRI is currently carrying out its own 5-year research program on 'Small Business Development in Ethiopia'. The SMEFP will partner with EDRI to develop joint research studies, with a focus on impact evaluations and measurement of intervention results. EDRI will serve as a research implementer for the impact evaluation component. EDRI will carry out data collection activities for the impact evaluation (baseline/midline/endline surveys, focus group discussions, qualitative interviews, etc.), and empirical analysis will be carried out by joint teams of impact evaluation experts from the World Bank in partnership with EDRI researchers.

Rationale of the Project Design

54. **The project design aligns with GoE's lease financing momentum and its recently issued Leasing Financing Policy for SMEs (Code-DBE/03/2007).** While leasing finance is extremely valuable to address the missing middle phenomenon for access to finance of SMEs from the capital expenditure perspective, commercial banks and MFIs can provide complementary solutions by providing working capital to the eligible SMEs for their daily operation funding needs.

Pricing

55. **The pricing proposal under the project is to strive to make DBE funding available to eligible financial intermediaries and SMEs on terms that ensure sustainability.** The pricing for the wholesale of leasing and working capital financing is yet to be determined by DBE and will be informed by the recommendations of the technical assistance. The pricing for retail leasing has been determined as the DBE bond price (currently at 6 percent) plus a 3 percent interest margin.

56. **The final pricing approach will be defined during the technical assistance stage to best ensure that new products, which utilize novel lending techniques are rolled out in a sustainable fashion.** It is recommended that the wholesale and direct lending terms offered by DBE therefore need to reflect its imputed cost of borrowing, a spread to cover the costs of

operation, macroeconomic and lending risk-premium, and local lending market conditions so as to avoid market distortions. Charging a margin that adequately reflects DBE's cost and risk would allow it to build a capital base, which could then be reinvested in new loans to eligible SMEs.

Eligibility Criteria of PFIs

57. **Only those financial intermediaries (i.e. DBE, microfinance institutions, lease companies and commercial banks) that meet the stipulated eligibility requirements will be able to obtain the status of Participating Financial Institution and their eligibility will be verified annually.** The World Bank team has appraised the DBE, as summarized previously, confirming its eligibility subject to implementation of an institutional development plan. Furthermore, in addition to support with implementation of institutional development planned (funded externally) the DBE will also receive technical assistance to strengthen its capacity to appraise PFIs, as this is one of the core areas of its wholesale function.

58. **In order to have access to the liquidity of the credit facility, each PFI will agree to undertake, through application of technical assistance, an institutional development plan to enhance its capacity to implement actions related to the on-lending activities envisaged in the project.** The technical assistance will be provided through the TA facility of the project following a technical needs assessment that will be conducted by the DBE and the consulting firm responsible for the TA Facility. Based on the findings of the technical needs assessment a tripartite Technical Cooperation Agreement (TCA) will be signed between the PFI, DBE and PEPE.

B. Project Financing

59. **The project will be financed through investment project financing (IPF) in the amount of US$200 million with the GoE.** The IDA loan will have a maturity of 38 years with grace period of 6 years.

60. **The project will be jointly co-financed with the European Investment Bank (EIB) in the amount of EUR 70 million equivalent.** EIB will have a bilateral loan with GoE only on the Line of Credit Facility (Component 1). The loan from EIB will have a maturity of 16 years with grace period of 6 years. Funds are expected to become available by December 31, 2016.

61. The majority of the technical assistance is expected to be funded externally through DFID, the Multi-Donor Initiative (MDI), and the European Union.

Project Cost and Financing

Project Components	Project Cost (US$)	Source of Financing	% Financing
1. Financial Services to SMEs	269 million	IDA and EIB	70% IDA 30% EIB
2. Enabling environment for SME Finance	0.8 million	IDA	100%
3. Business Development Services to SMEs	2.5 million	IDA	100%

4. Project Management, Communication and Impact Evaluation	3.7 million	IDA	100%
Total Costs	276 [28]	IDA and EIB	72.5% IDA 27.5% EIB
Total Project Costs	–	–	–
Front-End Fees	–	–	–
Total Financing Required	–	–	–

C. Lessons Learned and Reflected in the Project Design

62. **The following set of lessons learned from previous projects has been used by the team to inform the policy dialogue with the GoE and discuss the project's design.** The final project's design takes into account some clear directions received from the national authorities and some binding requirements contained in official policies (i.e. the lease finance policy for SMEs) that required the team to flexibly adapt international best practices to the local context. Still the lessons outlined below remain relevant and will continue to support an active policy dialogue that, over time, will allow for the adoption of more flexible approaches to SME finance.

63. **International experience related to development finance institutions shows that a wholesale model leads to a better performance compared to a focus on retail lending only.** In a wholesale-only model the DFI provides incentives to private sector financial intermediaries to enter new markets or expand services to existing markets by providing funding, other financial products, and linked technical assistance which increases the attractiveness of these markets and/or makes bank credit feasible (e.g. by providing term funds to allow longer-term funding for investment projects). Under the wholesale lending approach, DFIs tend to have lower operating costs because the PFIs select and assess the loan applications of end-customers. Through PFIs, DFIs can reach a larger number of end-customers and cover more locations without incurring high operating costs. The model also promotes the growth of PFIs, which become extensions of the DFI, and helps reach under-served sectors and clients. On the contrary, DFIs following a retail-model are often perceived as an arm of the Government by clients, potentially leading to worse repayment discipline and therewith potentially large contingent fiscal liabilities. Finally, credit risk exposure and credit losses of the DFI can increase in a retail model as a result of its direct credit exposure to end-users without the insulation provided by wholesale lending to other institutions (where the capital of the retail borrower stands between the DFI and any losses). The project's design therefore includes also a wholesale function for DBE.

64. **LOCs should be based on commercial principles.** DFIs that are fully operationally and financially self-sustaining perform better. For example, the Development Bank of Southern Africa (DBSA) needed to be recapitalized in 2011 because of political pressure to work more with poorer segments of society and to take on more risk at subsidized rates beyond its financial capacity. The DBSA case demonstrates that rather than encouraging the dilution of DBSA's mandate, the authorities would have been better advised to provide subsidies to those municipalities that were unable to afford the market-conforming financing otherwise available from DBSA. The project aims at fully incorporating commercial principles.

65. **Experience based on other World Bank financed LOCs shows that the LOC terms should allow for flexibility.** The Turkey Access to Finance for SMEs Project (P082822) was

[28] IDA: US$200 million and EIB: EURO 70 million.

designed to allow for operational adjustments as needed to ensure effective implementation. The loan terms were flexible and they could be granted for working-capital and investment purposes. There were also no restrictions on eligible sectors because historical experience suggests that unviable projects receive financing merely by virtue of the sector requirements.

66. **Evidence from other countries reveals how the authorities have grappled with avoiding situations where DFIs 'crowd out' the private sector and thereby impair their impact.** To avoid cross-subsidization and crowding out, the Mexican DFIs have moved away from lending at subsidized interest rates to lending on market-conforming terms. *Nacional Financeria's* (NAFIN) second-tier lending model was based on granting credit at longer maturities and lower costs than typically available in the Mexican market, reflecting its ability to raise capital at sovereign interest rates. With the reduction of the spread between sovereign interest rates and inter-bank rates, these subsidized rates became less attractive, eventually leading NAFIN to create an innovative program that increases demand for its funding without having to rely on interest rate subsidies. In Brazil, long-term loans are subsidized by the Treasury as a result of the Brazilian Development Bank, *Banco Nacional de Desenvolvimento Econômico e Social* (BNDES), refinancing itself with the Government at a directed long-term rate which is lower than the corresponding yield on government bond issues. Such subsidies eventually impact the federal public debt and have given rise to concerns due to 'crowding out' of commercial banks. The fear is that favored borrowers which already have access to the credit markets have turned to BNDES solely to reduce their financing costs, and that there is low impact associated with BNDES's lending (i.e. the private market would in any case have funded these companies if BNDES had not). In recent years, BNDES has ramped up schemes supporting access to finance for SMEs which do not involve subsidized lending.

67. **WBG's in-house expertise and experience from projects in financial infrastructure recommends strategic partnerships, market-led reform, incorporating local and global expertise, and sustainability through professional human capacity.** The project incorporates lessons from successful secured lending projects (China, Vietnam, Ghana, and Liberia) and unsuccessful reform projects (Nepal and Rwanda). The approach to the initial diagnostics and project design will leverage the following lessons: a) partnering with a politically powerful agency with market knowledge and administrative capacity; b) positioning the reform as the creation of a market (movables financing market) to gather the interest of financial institutions and non-banking financial institutions; c) merging local knowledge with global subject/matter expertise; and d) sustaining a long-term effort with a professional team over time.

68. **WBG experience in Mauritius highlights the potential to substantially and successfully grow lease financing from a nascent stage.** The Mauritius SME Finance Leasing Scheme was structured on the principles of commercial viability, burden sharing and public private partnership. It was initiated in 1985 with commercial banks investing 75 percent and the Government investing 25 percent in equity. The scheme has evolved over time to cater for the needs of specific business segments. Today, Mauritius has a very developed leasing market with an average yearly leasing volume of US$200 million to US$300 million. Mauritius State Investment Corporation (SIC), the investment arm of the Government, was the key player for the scheme as a retailer and wholesaler to lease companies while also providing guarantees for potential losses. Commercial banks were also required to offer SME financing. The more recent program, Mauritius Leasing Equipment Modernization Scheme (LEMS), provided funding to

leasing companies and contributed to the modernization of the manufacturing sector. It was critical in saving approximately 12,000 jobs between 2009 and 2012.

69. **Flexible, responsive, long-term technical assistance to lenders is critical for sustainable changes.** Based on the lessons from WEDP, the existing credit line project in Ethiopia, targeted technical assistance to lenders (microfinance institutions) had markedly improved their ability to appraise borrowers, reducing collateral requirements, promoted the adoption and diffusion of new techniques to reach and serve more women entrepreneurs better, and led to the development of new loan products and acceptance of new forms of collateral. Similarly, the new project is designed to provide tailored technical assistance to participating financial intermediaries and DBE on leasing and SME lending in order to reengineer to their current business models to better service this underserved market.

70. **The proposed project supports a key area in the GoE's industrial policy development agenda as well as on the financial sector development/financial inclusion agenda.** The current project's design follows an incremental portfolio approach that the WBG has adopted over the past four years in developing its support to financial sector development agenda in Ethiopia. This approach by combining the gradual provision of analytical and advisory services and investment lending in areas of financial sector development where the GoE required immediate assistance, has strengthened the trust relationship between the WBG and key government counterparts (especially the Ministry of Finance and Economic Cooperation and the NBE) and has made the WBG the first development partner of the GoE on financial sector development. On the basis of this experience, the current project's design, while taking on board some specific features and requirements imposed by the local context, aims at further developing a policy dialogue that will allow for the gradual introduction of international best practices for the benefit of the SMEs and the local economy.

IV. IMPLEMENTATION

A. Institutional and Implementation Arrangements

71. **The Ministry of Finance and Economic Cooperation (MoFEC):** MoFEC will be the signatory of the IDA Credit and delegate project implementation to the Development Bank of Ethiopia (DBE) and the Ministry of Industry (MoI). The IDA Credit proceeds will be transferred directly to DBE in line with the provisions of the Subsidiary Agreement, and to MoI.

72. **Overall project coordination will be the mandate of a Project Implementation Unit (PIU) established under the Domestic Investor Transformation Directorate (DITD) within the MoI.** The DITD will have the mandate of overall project coordination and direct responsibility for Components 2, 3, and 4. This PIU team should include key technical staff including a Project Coordinator, Procurement Specialist, Financial Management Specialist (accountant), M&E Specialist, and a Non-Financial Services Coordinator. The Project Coordinator will be responsible for management of the PIU and overall project coordination. The Procurement Specialist and FM Specialist will provide regular support on all project procurements and financial management processes. The M&E Specialist will be responsible for setting up and maintaining a client intake system and a central project database. The Non-

Financial Services Coordinator will be responsible for the implementation of Component 3, and the day-to-day coordination with other components.

73. **The PIU's responsibilities will include procurement of hardware, software, business development services, capacity building related equipment and other consultancies as needed, as well as overall coordination between the component activities.** The PIU will be responsible for establishing an intake process for entry of clients into the program through regional outlets, and will maintain a central project database of all registered clients. The PIU will also be responsible for communications activities in marketing the project to potential participants. NBE will assign a focal person to closely coordinate with the PIU as necessary in regards to procurement under Component 2.

74. **A Project Management Team (PMT), which is housed at DBE, will maintain direct responsibility for managing the credit facility under Component 1.** Building on lessons from WEDP, to reduce risk, and to ensure complementarity, the DBE will make use of existing structures and expertise to manage this project. DBE in fact already has a track record of managing credit lines and the existing PMT of WEDP has developed adequate capacity to successfully manage WEDP to date. DBE intends to supplement the WEDP PMT with additional capacity as needed to manage the new project. Specifically, a Safeguards Specialist and a Leasing Specialist will be added to the team.

75. **At the regional level, Regional Micro and Small Enterprise Development Agency (REMSEDA) offices will be the entry point for the program. REMSEDAs will be responsible for registering SMEs for the program and issuing ID cards, as well as referring registered SMEs to services under both Component 1 and Component 3 of the project.** REMSEDAs will assign focal staff to the project, and will submit regular reports to the PIU in DITD containing basic information on the registered clients. The PIU will also provide supervision and training to the REMSEDAs, to equip them with the ability to screen and register clients, and to advertise project services within their regions. The Federal Small and Medium Manufacturing Industry Development Agency will coordinate and facilitate the interactions between DITD and ReMSEDAs.

76. **A Project Steering Committee comprised of representatives of the main implementing organizations will provide oversight of the project.** The Steering Committee will be chaired by the Ministry of Industry and co-chaired by the National Bank of Ethiopia. It will include the Development Bank of Ethiopia and other government agencies as deemed appropriate. The Federal Small and Medium Manufacturing Industry Development Agency will be the Secretariat of the Steering Committee. The Ministry of Industry will be represented by either the Minister or State Minister, and representatives of other institutions will be officials of similar rank.

77. **A Technical Committee consisting of director-level staff of the main implementing organizations will be established.** The technical committee will be chaired by the National Bank of Ethiopia, and will consist of the Ministry of Industry, Development Bank of Ethiopia, and other government agencies as deemed appropriate. The technical committee will report to the project steering committee.

78. **Project Implementation Committee (PIC).** As the project will involve close partnerships between a number of stakeholders, including the DBE, MoI, NBE, WB, EIB and the development partners supporting the required technical assistance, there is a risk that lack of effective coordination could constrain implementation and reduce the likelihood of achieving the desired objectives. The project will need to ensure that planning, implementation, and monitoring are adequately coordinated across key stakeholders. The project will address this through the establishment of a Project Implementation Committee (PIC) that, following the WEDP model, will meet on a monthly basis and ensure a smooth implementation and coordination on the basis of a common action framework. The committee will include representatives from each relevant stakeholder and implementing agency[29].

79. **Several development partners have expressed interest in contributing (through external financing) to complementary activities to be coordinated under the SME Finance Project umbrella.** The envisioned role of each partner institution and the specific activities which they will support are outlined below. Close coordination between partners will be ensured through participation of each implementing agency/partner in the Project Implementation Committee (PIC). All development partners will also be invited to participate in official Implementation Support Missions (ISMs) regularly conducted by the World Bank team, to review the project's progress. The envisioned role of each development partner is as follows:

- **European Investment Bank**
  Area of Support: Component 1 (Line of Credit)
  - The European Investment Bank (EIB) will jointly co-finance Component 1 of the project through a bilateral loan of EUR 70 million (or equivalent in US$) between EIB and GoE to be then managed under World Bank's supervision and according to the relevant World Bank's procedures and rules.

- **DFID/PEPE**

  Area of Support: Component 1 (TA Facility Coordination)

  - DFID, through its Private Enterprise Project for Ethiopia (PEPE), will support the creation and operation of the Technical Assistance Facility under Component 1. The TA Facility will include the deployment of Technical Advisors (to be hired by PEPE), to work with the Development Bank of Ethiopia (both on its institutional development plan as well as on its wholesaling and retailing functions under the Project), Leasing Companies, Microfinance Institutions, and Commercial Banks. DFID/PEPE's role will be to set up the TA Facility, conduct needs assessments of each institution, and plan and coordinate delivery of TA activities. The Technical Advisors, as part of their role, will provide regular technical expertise to the participating financial institutions. Moreover, the PEPE team will continue its ongoing engagement in

[29] The Project Implementation Committee (PIC) will include the PIU Coordinator, the PMT Coordinator, representatives from the World Bank Project Team as well as one representative for each of the main development partners that will support the project's implementation either through co-financing (i.e. EIB) or through external financing. The World Bank will be the Secretariat of the PIC.

providing specialized TA to MFIs under WEDP and will expand it in order to cover the MFIs under the SME Finance project (if different) and the commercial banks. This will ensure full coordination and consistency in the approach to the lending-side TA. In line with the WEDP TA model, the World Bank team will keep the technical oversight of the TA delivered under the facility and will assess the technical achievement of key milestones related to this engagement in coordination with DFID.

- **Multi-Donor Initiative (MDI)**
  Area of Support: Component 1 (TA Delivery), Component 2 (TA), Component 3 (Specialized Services)

  - The MDI (coordinated by the WBG/IFC) has in principle agreed to finance:

    (a) the provision of some specialized trainings on the leasing and (possibly) on the lending side of the TA facility under Component 1. The menu and the timing of the specific trainings will be based on the needs assessment conducted by PEPE and will be coordinated by PEPE in close consultation with the recipient financial institutions;

    (b) the support to NBE on establishing a solid regulatory and supervisory framework for leasing finance;

    (c) the support to NBE on establishing a regulatory framework for secured transaction that would complement the establishment of a collateral registry planned under Component 2. This support will be jointly financed with the Financial Inclusion Support Framework managed by the World Bank; and

    (d) the delivery of specialized services to SMEs under Component 3.

- **European Union**
  Area of Support: Component 4

  - The EU is considering to support the impact evaluation activities under Component 4. This would involve support directly to the World Bank, which will deploy researchers to work jointly with the Ethiopian Development Research Institute (EDRI) to carry out a rigorous evaluation of the project, and to pilot and test innovative mechanisms for increasing access to finance for SMEs.

B. Results Monitoring and Evaluation

80. **The monitoring and evaluation (M&E) system will be based on the Results Framework and will be used to track and monitor progress and impact.** The framework is meant to measure project activities using the indicators described in Annex 1. A set of additional indicators will then be collected for monitoring purposes during project's implementation. The table of additional indicators is reported in Annex 8 and shows core results indicators segmented

by type of credit (loan or leasing) in order to measure uptake, demand and disbursement of each line of credit. Moreover, relevant demographic information (most notably gender) will also be segmented in order to track and monitor female participation in the project. A full M&E framework for tracking short, medium and long-term results, segmented by basic demographic features, will be developed with the PIU and PMT to monitor project progress over time. The project will incorporate a citizen engagement feedback loop, as described in paragraph 116 below.

81. **The PMT and PIU will be separately responsible for the M&E of the different components.** In order to leverage preexisting structures and institutions, the PMT will be responsible for establishing, managing and reporting the M&E system for Component 1. The PIU within the MoI will be responsible for establishing and managing the M&E system for Components 2, 3, and 4.

C. Sustainability

82. **The project is using existing structures and institutions to deliver services and support to SME financing.** Considerable time and effort has been made to ensure the involvement and commitment of all implementing agencies, and none of the components contain any costly interventions that cannot be financed by GoE after the project ends.

83. **The components of the project are designed to increase access to finance for SMEs.** Key design features to achieve this goal are: (a) PFIs will be free to set the interest rate on their financial services to SMEs under Component 1, reflecting their cost and risk; (b) the compulsory technical assistance embedded in the project, which will help PFIs reengineer their business models to lend to SMEs profitably and encourage a change in attitude towards SMEs; (c) the creation of a collateral registry as well as the completion of an insolvency regime's diagnostic under Component 2 will help to improve the enabling environment to facilitate SME finance in Ethiopia; (d) the provision of BDS to SMEs will strengthen the capacity of local training providers to enhance SMEs' skills and help them manage their businesses better and to prepare better business plans.

84. **The sustainability of the SMEs is, therefore, supported through the coordinated provision of financial services and of business development skills.** As main beneficiaries of this project, SMEs will see their financing options increase, along with the possibility of strengthening their technical and managerial skills through dedicated training opportunities.

V. KEY RISKS

A. Overall Risk Rating and Explanation of Key Risks

85. **The overall project risk is Substantial.** The overall rating is Substantial, largely due to the project design and fiduciary assessments. This is driven mainly by the nascent nature of the leasing market, the rapid expansion of DBE regional branches and the related complexities associated with building up large scale capacity within DBE's branches to support leasing. Moreover the constraints on SME lending, the need for managing dynamics between multiple public and private sector stakeholders, and the capacity building that will be required to support

the implementing agencies and participating financial intermediaries in meeting World Bank policies and procedures are additional risk factors.

86. **Mitigation measures.** Several mitigation measures will be put in place in order to address the main risks outlined above.

(a) **Technical Assistance (TA)**: The main measure will be the provision of technical assistance at all levels (i.e. on the supply side to DBE and participating financial institutions and on the demand side to SMEs). The TA on the supply side will be provided in the form of resident long-term experts that will help the relevant intermediaries to manage the liquidity of the credit facility according to international best practices. DBE, in particular, will undergo two types of TA: an institutional development plan (outlined in detail in Annex 6) to address key institutional weaknesses that were identified during the due diligence process, and specific TA on leasing and lending targeted towards the Project Management Team at both headquarter and regional branch level. The TA (funded externally) will be front-loaded and can commence before project effectiveness, which should allow for a smoother initial phase of project implementation.

(b) **Disbursement curve:** the project's disbursement curve (and related targets in the results framework) will adopt a conservative approach with a modest increase in the initial phase that takes into account the priority assigned to the role of the technical assistance in strengthening the relevant financial intermediaries.

(c) **Project's implementation support:** the project will be subject to frequent monitoring and implementation support missions by the Bank team, mobilizing all the necessary expertise to cover key areas of project implementation in a timely and competent manner.

(d) **Early mid-term review**: the project's duration is expected to be six years. However, the team will perform an early mid-term review (at the end of year 2) that will offer a window for evaluating the project's implementation at an earlier stage and for proposing adjustments to the design, as needed.

(e) **Flexibility in disbursement categories**: disbursement categories will be defined in a way to allow for maximum flexibility and easy re-allocations of funds depending on demand and disbursement rates without the need for official project restructuring.

(f) **Operations Manual (OM)**: a detailed operations manual for the credit facility under Component 1 will be prepared based on the current OM used for WEDP and regularly used by DBE.

(g) **Project Implementation Committee (PIC).** The establishment of a Project Implementation Committee (including the DBE, MoI, NBE, WB, EIB and the development partners supporting the required technical assistance) will ensure that planning, implementation, and monitoring are adequately coordinated across key stakeholders.

VI. APPRAISAL SUMMARY

A. Economic and Financial Analysis

87. **The economic and financial analysis of this project focuses on Component 1, which accounts for more than 90 percent of the total project financing**. The liquidity support to underserved SMEs will be complemented with mandatory technical assistance for PFIs on designing, piloting, and rolling out financial products utilizing novel lending methodologies (i.e., cash flow-based lending) to successfully expand their outreach to the target SMEs. The technical assistance support will be funded externally through bilateral agreements with development partners. The economic and financial analysis aims to assess the benefits of the project associated with (a) the impact on the increased availability and access to finance for SMEs, and (b) the impact on the additional revenue generated by both SMEs and PFIs as compared to the associated costs.

Impact on Access to Finance for SMEs

88. **The project is expected to have a catalytic effect on the SME finance through both the leasing and the line of credit channel.** This will result in increased SME financing, translated into the ratios below. Without the project, over the six years period under consideration, the ratio of SME loans to total financial sector assets is expected to remain at 7.5 percent and the ratio of SME financing to total financing is expected to remain at 73 percent. With the project, the ratio of SME loans to total financial sector assets is expected to grow from 8.0 percent to 13.2 percent. The ratio of SME financing to total financing will grow from 74.3 percent to 83.4 percent. Without the project, SME financing is projected to grow from ETB 43 billion (US$2.2 billion) to ETB 70 billion (US$3.5 billion). With the project, SME financing is projected to grow from ETB 47 billion (US$2.4 billion) to ETB 130 billion (US$6.5 billion). The additional financing to SMEs over the six years will sum up to ETB 142 billion (US$8 billion), which equals 19 percent of Ethiopia's projected real GDP in 2016.

Impact on the SMEs and PFIs

89. **The project will also help SMEs boost their productivity and generate more revenues.** The increased benefits, which are mainly derived from the additional revenue generated by both SMEs and PFIs, will exceed the costs associated with the project and will result in a positive NPV. On the working capital finance subcomponent and with an assumed interest rate of 9 percent charged by DBE, the ERR of this subcomponent is expected to be 13 percent. The NPV is expected to be about ETB 206 million (or US$10 million) assuming a 10 percent discount rate; or ETB 55 million (or US$2.7 million) assuming a 12 percent discount rate. On the leasing subcomponent and with an assumed interest rate of 9 percent charged by DBE the ERR of this subcomponent is expected to be 14 percent. The NPV is expected to be about ETB 852 million (or US$43 million) assuming a 10 percent discount rate and ETB 313 million (or US$16 million) assuming a 12 percent discount rate.

90. **Overall, ERR is expected to be 14 percent for the combined impact of lending and leasing.** The NPV is expected to be ETB 1.2 billion (US$111 million) with a discount rate of 10 percent, or ETB 412 million (US$39 million) with a discount rate of 12 percent. The positive

valuation indicates that the returns on investment exceed the returns that could be otherwise earned by World Bank financing.

91. **World Bank's value add in this project comes from its significant knowledge in facilitating SME finance programs through financing mechanisms, capacity building and financial infrastructure.** The World Bank's participation in this project is expected to have a catalytic effect on SME financing in Ethiopia. In addition to the projected growth in volume of SME financing in Ethiopia and boost to SMEs' productivity and revenues, the project leverages the World Bank's significant expertise in advising development banks on how to achieve their development objectives in a sustainable manner. With the support of the World Bank, DBE will develop it's SME lending capability and deepen its financial intermediation capacity. This will be complemented by World Bank's resources that help DBE and lease financing companies develop their capacity in servicing a nascent leasing market, thereby opening up another financing channel for SMEs to meet their operating needs. Moreover, by working with commercial banks and MFIs, the World Bank will allow key financial intermediaries to access tools and knowledge for serving the SME market segment. Finally, the World Bank's support will also influence the establishment of critical financial sector infrastructure, thereby improving the enabling environment for SME finance.

B. Technical

92. **The proposed design ensures that the project will act as a catalyst to developing the SME finance market and addressing the needs of the excluded 'missing middle'.** In this regard, the project will provide funding to PFIs that are deemed capable to serve the needs of SMEs following graduation from a mandatory technical assistance program. The PFIs will assume credit risk and the loans will be priced to reflect costs and risks to ensure sustainability. No interest rates subsidies to final borrowers are envisaged. The proposed project design will foster competition amongst the PFIs to serve the target SME market.

DBE Assessment Summary

93. **A due diligence assessment of the Development Bank of Ethiopia (DBE) has been conducted in relation to the proposed World Bank SME Finance Project - in line with World Bank's OP 10.00 policy for the financial intermediary financing projects - to facilitate sustainable provision of lease finance and working capital to SMEs in Ethiopia.** DBE is expected to play a key role in management of the proposed credit facility, both as a wholesaler (lending to other financial institutions for on-lending to SMEs), and as a retailer (direct support to SMEs). The assessment was conducted by way of meetings with DBE executive and senior management and a review of relevant DBE documents (financial reports, policy guidelines, operational manuals, etc.).

94. **Based on this assessment, the DBE is found broadly compliant with key World Bank eligibility criteria, subject to continued implementation of institutional development plan outlined below.** Key risks include the current elevated level of non-performing loans (NPLs), which are partially attributed to one of DBE's largest borrowers being classified as non-performing in the first quarter of the 2015/16 financial year. This resulted in an increase of NPLs from 12.5 percent in June 2015 to 18.4 percent in September 2015. The DBE is currently taking

steps to reduce the level of NPLs through dialogue with the concerned borrowers and is making particular efforts in relation to large borrowers classified as non-performing.

95. **DBE's progress in the implementation of its previous institutional development plan (as of August 2013) supported by the World Bank Women's Enterprise Development Program (WEDP) is summarized as follows:**

- Risk management and internal audit: the DBE has strengthened its risk management policy framework and partially implemented these policies; it has a well-established internal audit function.

- Human capital and performance assessment: the DBE has initiated a succession planning program with further steps incorporated in its human resource (HR) development strategy.

- Lending process: the current level of NPLs would suggest a requirement for further strengthening of the DBE's project finance capabilities.

- IT/MIS: the DBE has considerably enhanced its use of the T24 core banking system and related MIS capabilities

- Treasury operations: the DBE has not yet formed a dedicated treasury unit with responsibility for asset/liability management, liquidity management and funds mobilization

96. **In terms of institutional capacity to participate in the forthcoming SME Finance Project, the DBE has long experience in both direct lending activities through its project finance loans, and wholesale lending through managing the WEDP credit facility and other lines of credit.** Appropriate measures have been incorporated in the DBE strategic plan for the period 2015–2020 to support development of lease finance business line, notably development of the Bank's organization structure to incorporate a Vice President for the Bank's lease financing business. Other recent organizational developments include the creation of a new Vice President position for credit management resulting in separation of credit management (including ongoing portfolio management) from business origination which is expected to strengthen the DBE's credit risk management. In preparation for commencement of its lease financing activities, DBE has laid ground for implementation of an ambitious regional office and branch opening program. This includes opening 7 new regional offices and 75 branches planned in 2015/16 and 42 new branches in 2016/17 and recruitment of around 450 additional staff for its branch operations. So far, the DBE has expanded the branch network from 32 to 100 branches and hired 400 new staff that are undergoing training. DBE has also determined a strategy of continued high growth for the period 2015–2020, based on a combination of project finance, lease financing and wholesale lending business.

97. **Overall, DBE is found to be eligible to take part in the World Bank funded SME Finance Project, subject to implementation of a new institutional development plan.** The key areas where improvements are required include: (a) strengthening of project finance business; (b) addressing current high level of NPLs; (c) business planning for lease financing

business; (d) strengthening of risk management; (e) implementation of treasury operations (fund management process); and (f) implementation of succession planning program. Further details of the new institutional development plan are outlined in Annex 6. The need to ensure continued implementation of the institutional development plan, particularly as it relates to reducing the NPLs, has been stressed in the World Bank's internal OP 10.00 review. The implementation of the institutional development plan will be financed by the DFID-funded PEPE project in close coordination with the SME finance project activities.

98. **A new "Lease Financing Policy for SMEs" (Code-DBE/03/2007) was officially issued by NBE and adopted by DBE in October 2015.** The new policy is meant to guide DBE's lease financing operations and to almost exclusively direct DBE's support to leasing finance when it comes to serving SMEs. This requirement is in line with the recently published GTP II which identifies growing the manufacturing sector as a priority to transform Ethiopia into an industrial economy by 2025. Lease finance is, therefore, seen by NBE as the best way to bypass the collateral issue and make sure that SMEs operate in the manufacturing sector.

99. **In retail leasing, DBE plans to provide lease finance to SMEs for contracts greater than ETB 1 million through its regional branches.** DBE started with one head office, five regional offices and 32 branches in 2015 and has opened 75 additional branches since then. DBE's branches are categorized in Grade A, B and C. According to the new Leasing Finance Policy for SMEs, DBE regional offices can appraise and authorize SME lease financing from ETB 1 million to ETB 30 million. Grade A branches can appraise and approve up to ETB 10 million. (Requests beyond 10 million must be transferred to the regional office). Grade B branches can appraise and approve up to ETB 5 million, and Grade C branches must directly transfer all requests to the regional offices for appraisal and approval. All branches (A-B-C) can administer approved financing from ETB 1 to 30 mill.

100. **There are five licensed lease companies in the country that supply financing for contracts less than ETB 1 million.** There are currently five Capital Goods Financing Companies (leasing companies) in Ethiopia, of which two are based in Addis and were visited by the task team. (Addis Capital Goods and Oromia Capital). Although these five leasing companies should only provide leasing finance for up to ETB 1 million, the two companies that were visited have an average leasing amount of ETB 1 million; they expressed an interest and the capacity to handle requests that exceed this amount. These leasing companies can be potential competitors to DBE's retail leasing business. It is anticipated that the maximum amount leasing companies can lend will not exceed 2 percent of the paid up capital of all the leasing companies (approximately ETB 4 million).[30] With the recent policy approval by the Ethiopian Investment Board that is chaired by the Prime Minister, finance leasing sector can be opened to foreign investment, and therefore the lease finance might encounter competition from foreign leasing companies in the medium to long run.

C. Financial Management

101. **The FM risk of the project is Substantial.** Based on the Financial Management (FM) assessment of DBE and MoI, the FM arrangements meet the IDA requirements according to

[30] The 2 percent limit is still under discussion at NBE.

OP/BP 10.00. The objective of the FM assessment was to determine whether the implementing agencies have adequate financial management systems and related capacity in place to satisfy OP/BP 10.00. The assessment guidelines and details are discussed in Annex 3 “Implementation Arrangements”. The FM assessment took into account the lessons learned from ongoing and previous World Bank projects in Ethiopia and various related assessments. Based on the lessons and assessments, an action plan has been developed to mitigate the risks identified in the project.

102. **The preliminary funds flow mechanism, directs funds from IDA directly to DBE and MoI.** The FM arrangements for the program (see Annex 3 for details) follow the Government’s channel 2 fund flow mechanism, where funds from IDA flow directly to the DBE and MoI. Although overall coordination of the project rests with MoI, the financial management aspect will be handled by both implementers for the respective components they are managing. The Project Management team at DBE which is currently handling other Bank financed operations will be further strengthened with FM staff to carry out the implementation of the project. The project will use SoE-based disbursement for replenishment of project accounts. The project will have Interim Financial Reports and independent auditors report from both DBE and MoI within 45 days of the quarter end and within 6 months of the fiscal year end respectively.

D. Procurement

103. **The Procurement risk of the project is rated high.** Procurement under the SME Financing Project shall be carried out in accordance with the World Bank’s policies and procedures. Specifically, the project will follow the World Bank’s “Guidelines for Procurement of Goods, Works, and Non-Consulting Services under IBRD Loans and IDA Credits & Grants by World Bank Borrowers” dated January 2011 and revised July 2014; “Guidelines: Selection and Employment of Consultants under IBRD Loans and IDA Credits & Grants by World Bank Borrowers” dated January 2011 and revised July 2014; “Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credits and Grants, (Anti-Corruption Guidelines)” dated October 15, 2006, and revised in January 2011; and the provisions stipulated in the Legal Agreement.

104. **Procurement of goods and services under the project will be carried out centrally by the PIU.** All procurement activities for Components 2, 3 and 4 shall be carried out by the PIU. The PIU shall also carry out the procurement of **the hardware and associated software, licenses, capacity building and training** on behalf of the NBE for the collateral registry which will be established in the NBE under Component 2 of the project as well as the procurement of consultants for the insolvency diagnostic under the same component. As all procurement activities are to be carried out centrally at the PIU, a procurement capacity assessment has been carried out in the MoI. The assessment is discussed in full in Annex 3. Based on the assessment, appropriate mitigation measures have been developed and are detailed in Annex 3. A key mitigation measure will be to hire procurement-proficient staff and provide them with the necessary procurement training on the Bank’s procurement procedures to address the capacity limitations. The different procurement methods or consultant selection methods, the need for pre-qualification, estimated costs, prior review requirements, and time frames are agreed between the borrower and the Bank in the Procurement Plan.

E. Social and Environment (including Safeguards)

105. **The project is categorized as a Financial Intermediary (FI) project and the appropriate FI category is FI-2.** This is based on anticipated environmental and social risk impacts of sub-projects as assessed by the World Bank in accordance with OP/BP 4.03 (World Bank Performance Standards for Private Sector Activities). According to the requirements under this World Bank policy, the project will put in place adequate systems and processes, acceptable to the Association, to mitigate any potential risks and impacts.

106. **The two implementation agencies are DBE and MoI and relevant aspects of performance standards will be applied only for activities under Component 1 which is managed by DBE.** DBE will be responsible for Component 1 of the project, covering leasing and lending, and will address any environmental and social risks and impacts through the existing PMT that has considerable experience working with the World Bank (under the WEDP project), including environmental and social risk management (WB Safeguards). The sub-project activities under Component 1 could potentially have only limited adverse environmental and social risks and impacts that are expected to be generally site-specific and minor, largely reversible, and readily addressed through the agreed mitigation measures, including disclosing environmental and social policy statement, and procedures for screening and assessing risks as well as human resources policy, containing the formal rules and guidelines that the DBE will follow in hiring, training, assessing, and rewarding its workforce (permanent and temporary staff) and their rights and obligations as employees and with the DBE, as the employer.

107. **The project will not finance any activities that involve land acquisition.** MoI will be responsible for Component 3 which covers capacity building and business development for the SMEs and these activities are expected to have no adverse environmental or social risks and impacts.

108. **The project will support relatively small lease finance arrangements and working capital loans for enterprises involved in small scale manufacturing sector with relatively low potential environmental and social risks and impacts.** However, it is recognized that there may be some business activities in which the environment and social risk and impacts may potentially be more significant and may require commensurate assessment and management. Business activities of SMEs can potentially generate impacts on the environment, present a hazard to human health or negatively affect local communities as a result of improper planning or management. Environmental and social concerns for SMEs are typically associated with production processes or other activities that generate emissions and byproducts that are potentially harmful to the environment, employees and communities (e.g. issues around labor standards, inappropriate disposal of waste, or unhealthy or hazardous working conditions).

109. **To mitigate against any potential risks, the Development Bank of Ethiopia will put in place and implement an adequate environmental and social management system (ESMS), acceptable to the Bank and endorsed by DBE's senior management.** The ESMS will account for the full scope and scale of environmental and social risks present in SME financing. The ESMS will also build on the revision and update of DBE's 'Environmental Assessment Procedure' and 'Environmental Assessment Policy' which outlines the decision-making process, policies, and procedural steps it uses during the implementation of WEDP. It

will, at a minimum, specify: (a) organizational capacity, including duties and responsibilities within the DBE for managing environmental and social issues as it relates to sub-project/sub-loan/lease financing evaluation procedures; (b) procedures for screening and assessing risks and impacts of sub-projects or individual loan transactions; and (c) provisions for periodic progress reports to financial institutions' senior management. DBE ESMS will include adequate procedures to ensure that all subprojects supported by the Association comply with applicable national and local laws and regulations, as well as are screened against the Project Exclusion List.[31]

110. **The DBE ESMS should incorporate relevant principles of Performance Standard 1 on Assessment and Management of Environmental and Social Risks and Impacts.** Furthermore, the ESMS will ensure that proposed business activities that present higher social and/or environmental risks will be operated in a manner consistent with the World Bank Performance Standards 1–8. DBE will also manage the working conditions of their workforce in accordance with relevant aspects of Performance Standard 2 on Labor and Working Conditions through development and implementation of appropriate human resource policies and procedures acceptable to the Bank and will require the same of the PFIs.

111. **DBE will also ensure that all participating financial institutions (PFIs) develop an ESMS commensurate with the level of social and environmental risks in their portfolio, and prospective business activities.** As part of its due diligence, DBE will make sure that PFIs screen all transactions funded under the project against relevant principles of applicable Performance Standards and the Project Exclusion List, while also ensuring compliance with applicable national and local laws and regulations. Furthermore, any proposed business activities that may present higher social and/or environmental risks will be operated in a manner consistent with the World Bank Performance Standards 1–8.

112. **The World Bank's assessment of the institutional capacity, guidelines and procedures, and practices in environment and social management concludes that the DBE has environmental 'Environmental Assessment Procedure' and 'Environmental Assessment Policy' with limited social aspects and no staff with technical expertise to manage environmental and social effects.** Operationally, DBE outsources its safeguards due diligence function to a consulting firm that has a well-functioning team for environmental and social management, and it's overall exposure to environmental and social risk tends to be very low. To address this gap, in addition to including social dimensions in the ESMS, the DBE's institutional capacity, as well as that of PFIs, in addressing environmental and social issues will be enhanced through assigning dedicated staff to be responsible for the ESMS and training them. The Borrower institutional capacity in addressing environmental and social issues will be further assessed, and the relevant entities will receive needed guidance from the Bank environmental and social safeguards specialists.

Gender

113. **The project will build on significant advances already made by the GoE in supporting women entrepreneurs through WEDP.** WEDP has helped MFIs in Ethiopia to

[31] Project Exclusion list will include IFC Exclusion List, as well as acquisition of land, and mining and quarrying.

develop and scale tailored financial products for women entrepreneurs. Since a dedicated facility for women entrepreneurs already exists, the SME Finance Project will complement this with a credit facility that is open to both male and female entrepreneurs. At the same time, the project will draw on some of the lessons learned from WEDP to ensure that gender-neutral financial services are accessible to both female and male-owned SMEs.

114. **The project will rigorously measure any differential impacts on male and female-owned enterprises**. Gender disaggregated data (in addition to the RF indicators) will be collected for all firm-level indicators, namely the number of SMEs receiving loans, the number of SMEs receiving leases, and the number of SMEs receiving business development services. In addition to monitoring the number and proportion of male-owned and female-owned SMEs accessing services, the project's impact evaluation will focus on understanding any differences in business growth for male and female-owned enterprises that participate in the project. Impact evaluation survey samples will be stratified by gender, to ensure that representative data is captured on female-owned firms, and to enable a comparison of impact between female and male entrepreneurs. The impact evaluation component will also explore piloting innovative mechanisms that could increase access to finance for women-owned SMEs, such as collateral alternatives, angel investing, and crowdfunding.

Citizen Engagement

115. **The project will incorporate a citizen engagement feedback loop by surveying a sample of beneficiaries.** A citizen engagement questionnaire will be provided to a sub-set of beneficiaries and designed to assess overall satisfaction of services (including ease of access, quality, process, disclosure, responsiveness of needs, etc). The results of the survey will be analyzed and assessed in a report, which will also contain proposed recommendations for project adjustments informed by citizen feedback. The survey results and the report will be shared by the project implementation unit and financial institutions and will inform the overall project implementation, as appropriate.

F. World Bank Grievance Redress

116. **Communities and individuals who believe that they are adversely affected by a World Bank (WB) supported project may submit complaints to existing project-level grievance redress mechanisms or the WB's Grievance Redress Service (GRS).** The GRS ensures that complaints received are promptly reviewed in order to address project-related concerns. Project affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

Annex 1: Results Framework and Monitoring

Country: Ethiopia

Project Name: Ethiopia: SME Finance Project (P148447)

Results Framework

Project Development Objectives	
PDO Statement The project development objective is to increase access to finance for Eligible Small and Medium Enterprises in the Recipient's territory.	
These results are at	Project Level

Project Development Objective Indicators

		Cumulative Target Values					
Indicator Name	Baseline	YR1	YR2	YR3	YR4	YR5	YR6
Volume of Financial Support to SMEs under the credit facility (Amount(USD))	0.00	0.00	25000000.00	75000000.00	155000000.00	220000000.00	269000000.00
Number of SMEs Reached with Financial Services under the credit facility (Number)	0.00	0.00	200.00	600.00	1240.00	1760.00	2152.00
Portfolio Quality under the credit facility (Percentage)	0.00	0.00	8.00	8.00	5.00	5.00	5.00

Intermediate Results Indicators

Indicator Name	Cumulative Target Values						
	Baseline	YR1	YR2	YR3	YR4	YR5	YR6
Number of Loans/ Leases disbursed to	0.00	0.00	360.00	1080.00	2232.00	3168.00	3873.00

SMEs under the credit facility (Number)							
Collateral Registry Established (Yes/No)	No	No	No	Yes	Yes	Yes	Yes
Insolvency Diagnostic Completed (Yes/No)	No	No	No	Yes	Yes	Yes	Yes
Number of SMEs that received training through a BDS Program under the project (Number)	0.00	0.00	100.00	300.00	500.00	700.00	912.00
Report drafted on citizen engagement survey (Yes/No)	No	No	No	No	Yes	Yes	Yes

Indicator Description

Project Development Objective Indicators

Indicator Name	Description (indicator definition etc.)	Frequency	Data Source / Methodology	Responsibility for Data Collection
Volume of financial support to SMEs under the credit facility	This indicator captures the financing under the credit facility facilitated from PFIs to target beneficiaries (i.e. SMEs) from both leasing and lending.	Annual	DBE, PFIs	Project Management Team (DBE)
Number of SMEs Reached with Financial Services under the credit facility	This indicator is designed to include all enterprises that are direct recipients of loans and leases under the credit facility.	Annual	DBE, PFIs	Project Management Team (DBE)
Portfolio Quality under the credit facility	This indicator captures the quality of portfolio under the credit facility. The indicator will be calculated as non-performing loans and/or portfolio at risk according to the methodology of the National Bank of Ethiopia.	Annual	DBE, PFIs	Project Management Team (DBE)

Intermediate Results Indicators

Indicator Name	Description (indicator definition etc.)	Frequency	Data Source / Methodology	Responsibility for Data Collection
Number of Loans/ Leases disbursed to SMEs under the credit facility	This indicator will include the number of all loans and leases that were disbursed as part of the leasing and lending window for the DBE and PFIs under the credit facility	Annual	DBE, PFIs	Project Management Team (DBE)
Collateral Registry Established	This indicator will receive a 'Yes' once the registry is established and operational.	Annual	NBE	Project Implementation Unit (MoI)
Insolvency Diagnostic Completed	This indicator will receive a 'Yes' once the diagnostic is completed.	Annual	NBE	Project Implementation Unit (MoI)
Number of SMEs that received training through a	This indicator captures the number of eligible SMEs that receive training as part	Annual	MoI, BDS	Project Implementation Unit (MoI)

BDS Program under the project	of the BDS program under the project			
Report drafted on citizen engagement survey	This indicator captures citizen engagement and feedback in overall project implementation. A “Yes” implies that the survey was administered and a report was drafted that contained sound and in-depth analysis of citizen feedback.	Annual	MoI, BDS Providers	Project Implementation Unit (MoI)

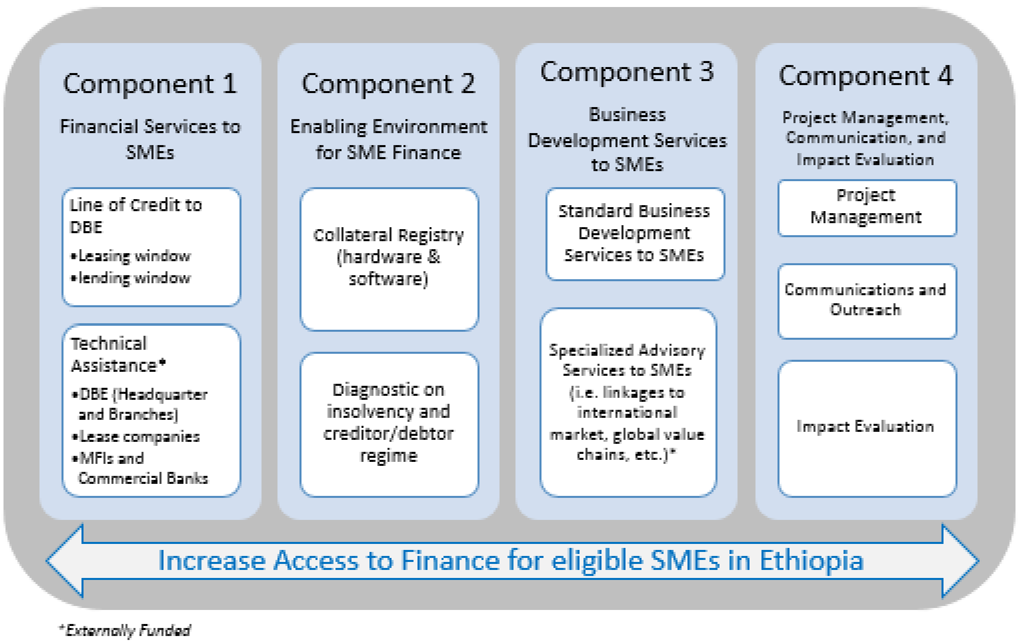
Annex 2: Detailed Project Description

FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA: Small and Medium Enterprise (SME) Finance Project

1. The project development objective is to increase access to finance for Eligible Small and Medium Enterprises in the Recipient's territory[32].

2. The SME Finance project will have four components: (a) Component 1: Financial services to SMEs; (b) Component 2: Enabling environment for SME Finance; (c) Component 3: Business Development Services to SMEs; (d) Component 4: Project's management, communication and impact evaluation. Figure 2.1 provides a graphic representation of how the four components would be combined to increase access to finance for SMEs in Ethiopia.

Figure 2.1. Overview of Proposed Project's Technical Components



Component 1: Financial Services to SMEs

3. **The objective of the first component is to establish a credit facility providing access to finance for (a) working capital and leasing finance for participating financial institutions (PFIs) which in turn lend to eligible SMEs and (b) leasing finance for eligible SMEs.** This liquidity support will be complemented with mandatory technical assistance aimed at supporting participating financial institutions (PFIs) in designing, piloting, and rolling out financial products utilizing novel lending methodologies (i.e. cash flow-based lending) to successfully expand their outreach to the target SMEs. The technical assistance support will be provided externally by development partners.

[32] "Eligible SME" means a small and medium enterprise established and operating in Ethiopia which meets the eligibility criteria contained in the Operations Manual.

4. **The Development Bank of Ethiopia (DBE) will provide both direct financing to SMEs and wholesale finance to other financial intermediaries for on-lending to SMEs.** More specifically, the DBE will in parallel serve as: (a) direct lender of lease finance to SMEs through its regional branch network; (b) wholesaler of finance to participating lease companies for provision of lease finance to SMEs; and (c) wholesaler for commercial banks and MFIs focused on provision of working capital finance to SMEs. It will do so through two main financing windows:

- **Window 1**: **Lease finance to SMEs.** This window will provide a line of credit to strengthen DBE's capacity to provide lease finance to SMEs both directly through its regional branches and indirectly through the licensed and eligible lease companies operating in the country. DBE, as a retailer through its regional branches, will provide lease financing directly for amounts greater than ETB 1 million and indirectly to eligible lease companies for amounts less than ETB 1 million. Tailored and compulsory technical assistance will be provided to DBE branches and to the participating lease companies (see TA facility below) on how to properly address SMEs' needs in the regions where they operate, as well as enhancing their skills on risk management, product design, management information systems (MIS), funding strategy, and other needs as appropriate.

- **Window 2**: **SME lending.** This window will provide a wholesale line of credit from DBE to eligible commercial banks and MFIs for on-lending of working capital finance to SMEs. Similar to the leasing window, a tailored and compulsory technical assistance (see TA facility below) will be provided to commercial banks and MFIs on how to reengineer their business models so that they can lend to SMEs in a sustainable fashion. This approach has been very successful in several other countries (e.g. Turkey and China), and it has completely changed the attitude of the financial sector players towards SMEs.[33]

5. **A TA facility (funded externally through development partners) will be established to complement and reinforce project implementation.** A critical success factor and a key goal of the project are to build the institutional and human resource capacity of DBE and of the PFIs to effectively serve the SME market. The TA Facility will be closely coordinated with the Credit Facility. The DFID-funded PEPE project will be responsible for funding and managing the TA facility, under the technical supervision of the World Bank team.

6. **In order to make the credit facility effective, PFIs will receive a mandatory, specific, high-quality, technical assistance**. This will be delivered through a combination of specialized trainings and the presence of resident technical advisors with proven relevant international experience to help build capacity in financial services to SMEs. This capacity building will enable PFI officials and staff to serve SMEs adequately - training them in assessing SME business proposals and developing suitable financial products and lending methodologies for the target group.

[33] In these countries, mandatory changes to banks' business models included: the creation of an SME department within each participating bank, the creation of decentralized credit committees, and the introduction of a purpose-designed quality assurance process. The TA was provided free of charge to the participating institutions for two years.

7. **In order to have access to the Credit Facility, PFIs will be required to enter into technical cooperation agreements (TCA) with the PMT in DBE and with PEPE.** Under such agreements, PFIs will receive TA free of charge for a period deemed appropriate after the initial gap assessment for building the necessary capacity to undertake the project's assignment.

Rationale of the Project Design

8. **The project design aligns with GoE's lease financing momentum and its recently issued Leasing Financing Policy for SMEs (Code-DBE/03/2007).** While leasing finance is extremely valuable to address the missing middle phenomenon for access to finance of SMEs from the capital expenditure perspective, commercial banks and MFIs can provide complementary solutions by providing working capital to the eligible SMEs for their daily operation funding needs. This is a positive step forward in the policy dialogue.

9. **The NBE expects that leasing will be taking up to 80 percent of the financing under Component 1 and the rest will be absorbed by the working capital window.** These allocations can be revisited and adjusted during project implementation in order to respond to SMEs' financing needs.

10. **The available funding will be used on a "first-come-first-served" basis to ensure efficiency and encourage competition amongst PFIs.** Small advances will be considered for building initial portfolios during technical assistance stage to support piloting of new lending techniques. Subsequently, the funds will be made available on reimbursement basis to ensure that PFIs are in compliance with eligibility criteria. In case a PFI is not able to utilize the initially drawn resources over a specific period of time, these funds will be recalled and returned to DBE for reallocation. The repayments will be collected in a revolving fund and will be used to provide funding for new sub-loans under the same conditions.

11. **Beneficiaries:** The final project beneficiaries will be eligible SMEs operating in the manufacturing and agro-processing industries. Moreover, for those SMEs receiving leasing finance, or working capital linked to leasing finance, and/or business development services also tour and construction industries will be allowed in line with the priority areas for SMEs indicated in the Lease Financing Policy for SMEs (Code-DBE/03/2007)[34]. SMEs in the tour and construction industries will not be eligible to receive working capital only.

12. **Definition of "SMEs":** the definition of SMEs adopted by the project will be aligned to the one contained in the Lease Financing Policy for SMEs (Code-DBE/03/2007) in terms of minimum number of employees (i.e. above 6). The project will also fix the maximum number of employees per SME at 100. Moreover, under Component 1, working capital loans to SMEs will be limited to a maximum of Birr 10 million, while lease finance loans will be aligned with the Lease Financing Policy requirements: i.e. a maximum lease loan size of Birr 30 million. The policy also indicates that DBE will be focusing on direct provision of lease finance for SMEs in

[34] Article 2.1.1 of the Lease Financing Policy for SMEs indicates that priority areas for SMEs are (a) Agricultural project; (b) Agro-processing industries; (c) Manufacturing Industries; (d) Tour Industries; (e) Construction industries; (f) Mining and Quarries. Agricultural project as well as Mining and Quarries however are excluded from the project beneficiaries' sectors due to higher risk of potential negative impact on the environment.

need of loans from Birr 1–30 million, while lease companies will serve SMEs with lease finance needs of below Birr 1 million.

Pricing

13. **The pricing proposal under the project is to strive to make DBE funding available to eligible financial intermediaries and SMEs on terms that ensure sustainability.** The pricing for the wholesale of leasing and working capital financing is yet to be determined by DBE and will be informed by the recommendations of the technical assistance. The pricing for retail leasing has been determined as the DBE bond price (currently at 6 percent) plus a 3 percent interest margin.

14. **The final pricing approach will be finalized during the technical assistance stage to best ensure that new products which utilize novel lending techniques are rolled out in a sustainable fashion.** It is recommended that the wholesale and direct lending terms offered by DBE, therefore, need to reflect its imputed cost of borrowing, a spread to cover the costs of operation, macroeconomic and lending risk-premium, and local lending market conditions so as to avoid market distortions. Charging a margin that adequately reflects DBE's cost and risk would allow it to build a capital base which could then be reinvested in new loans to eligible SMEs.

15. **Other PFIs funded by DBE will assume full credit risk on their SME portfolio under the project and will be free to price the sub-loans reflecting their cost and risk, thus ensuring sustainability of their SME loan portfolio.** Also, the DBE will not be competing with its wholesale clients in reaching the final borrowers, as the wholesale and direct lending facilities will target different market segments in leasing, while DBE will not be involved in direct provision of working capital. The impact of the project on affordability of finance would be based on extending loan tenors that will ultimately have a large positive impact on eligible SMEs' cash flow. Longer loan tenors could substantially reduce monthly payments resulting in debt service relief and expanding SME borrowing capacity and allowing them to further develop and grow their businesses. Overall, the pricing strategy should serve the purpose to attract the eligible PFIs to participate in the scheme at a sufficient margin, while enabling more affordable finance to the SMEs.

Eligibility Criteria for PFIs

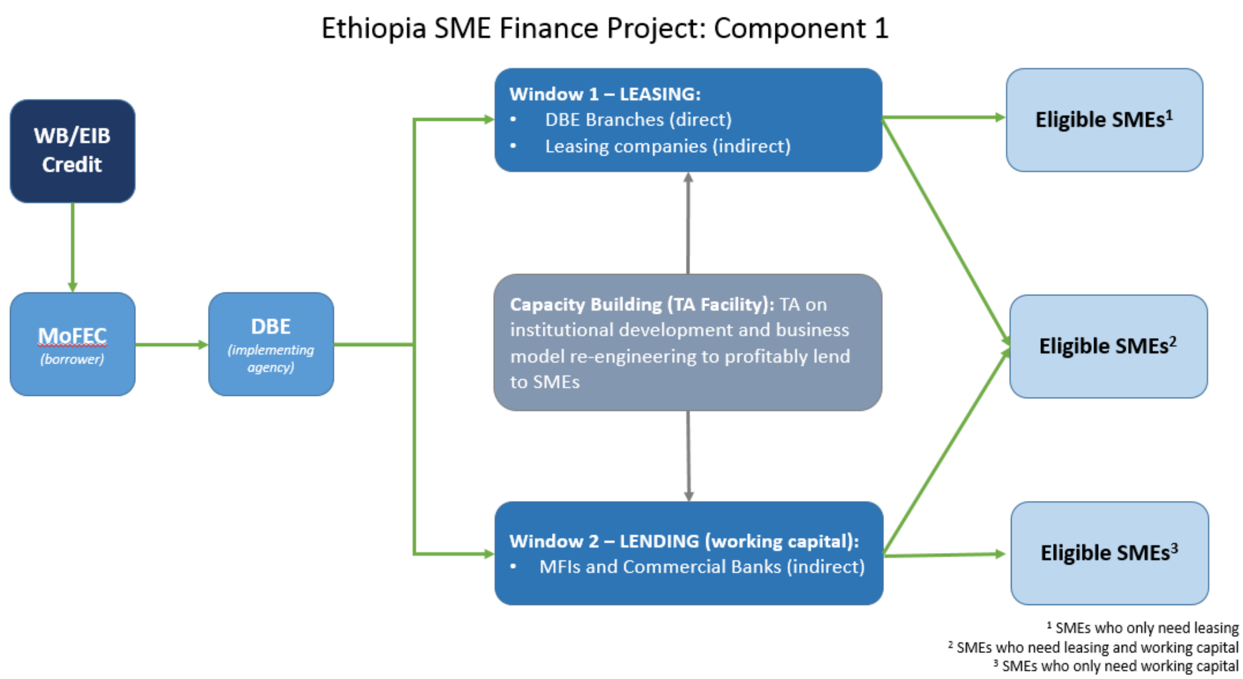
16. **Only those financial intermediaries (i.e. DBE, microfinance institutions, lease companies and commercial banks) that meet the stipulated eligibility requirements will be able to obtain the status of Participating Financial Institution and their eligibility will be verified annually.** The World Bank team has appraised the DBE, as summarized previously, confirming its eligibility subject to implementation of an institutional development plan. Furthermore, in addition to support with implementation of institutional development planned (funded externally), the DBE will also receive technical assistance to strengthen its capacity to appraise PFIs, as this is one of the core areas of its wholesale function.

17. **The appraisal of each PFI will be summarized in an appraisal report reflecting institutional practices for financial intermediary financing projects requiring an assurance**

that all PFIs in a World Bank financed Line of Credit (LOC) are viable financial institutions determined by: (a) adequate profitability, capital, and portfolio quality as confirmed by audited financial statements; (b) acceptable level of loan collections; (c) appropriate capacity, including staffing, for carrying out subproject appraisal (including environmental and social assessment) and for supervising subproject implementation; (d) capacity to mobilize domestic resources; (e) adequate managerial autonomy and commercially oriented governance; (f) appropriate prudential policies, administrative structure, and business procedures; g) the PFIs must have adequate management information system.

18. **All PFIs will be required to reflect the minimum standards of financial consumer protection in their on-lending activities under the project.** These minimum standards will be finalized during the technical assistance phase and will be reflected in the credit agreements with PFIs. The types of standards for fair treatment of borrowers that will be considered include full disclosure of borrowing costs and transaction fees using a standard methodology, ban on undisclosed, unilateral changes to interest rates and fees undertaken without due warning, requirement for charging interest on reducing balances basis, and other as appropriate. Figure 2.2 below provides an overview of the funds flow over Component 1:

Figure 2.2. Overview of the Flow of Funds for Component 1



19. **The proposal under the project is to make DBE funding available to eligible financial intermediaries and SMEs on terms that ensure sustainability and avoid perpetual reliance on government facilitated resources.** The pricing for the wholesale of leasing and working capital financing is yet to be determined by DBE. The pricing for retail leasing has been determined as the DBE bond price (currently at 6 percent) plus a 3 percent interest margin. The final pricing approach can be finalized during technical assistance stage so as to best ensure that new products which utilize novel lending techniques are rolled out in sustainable fashion. The wholesale and direct lending terms offered by the DBE therefore need to reflect its imputed cost of borrowing, a spread to cover the costs of operation, macroeconomic and lending risk-

premium, as well as local lending market conditions so as to avoid distortions. Charging a margin that adequately reflects DBE's cost and risk would allow it to build capital base which could then be reinvested in new loans to eligible SMEs. In addition, the rates on DBE's direct lending lease finance portfolio must be aligned with prevailing market conditions so as to avoid market distortion and potentially undermine business of competing leasing companies that will benefit from DBE's wholesale facility, ultimately constraining access to finance of eligible SMEs. The reason for this precaution is that DBE will benefit from lower borrowing costs than its wholesale clients. Other PFIs funded by DBE will assume full credit risk on their SME portfolio under the project and will be free to price the sub-loans reflecting their cost and risk, thus ensuring sustainability of their SME loan portfolio. The impact of the project on affordability of finance would be based on extending loan tenors that will ultimately have a large positive impact on eligible SMEs' cash flow. Longer loan tenors could substantially reduce monthly payments resulting in debt service relief and expanding SME borrowing capacity and allowing them to further develop and grow their businesses.

20. Overall, the pricing strategy should serve the purpose to attract the eligible PFIs to participate in the scheme at a sufficient margin, while enabling more affordable finance to the SMEs. The pricing strategy should also ensure sustainability and avoid perpetual reliance on government facilitated resources in the long run.

21. **The flow of funds under the project will be regulated with the following legal agreements:** (a) Credit Agreement between the Association and the MOFEC; (b) Subsidiary Financing Agreement (SFA) between MoFEC and DBE; and (c) Credit Facility Agreements (CFAs) between DBE and other PFIs. These will specify terms and conditions on the use of the line of credit as agreed between MOFEC, DBE and the Association and will be subject to the Association's no objection.

Eligibility Criteria for Sub-borrowers and Sub-Projects

22. **Sub-borrowers will be creditworthy private sector SMEs in the eligible sectors.** Eligible sectors include manufacturing and agro-processing. Moreover, for those SMEs receiving leasing finance, or working capital linked to leasing finance, and/or business development services also tour and construction industries will be allowed in line with the priority areas for SMEs indicated in the Lease Financing Policy for SMEs (Code-DBE/03/2007). Tour and construction industries will not be applicable to SMEs receiving working capital only.

23. **Sub-loans will be extended to eligible SMEs for working capital loans and lease finance.** The sub-loans will be denominated in Ethiopian ETB. The sub-loan amounts will be up to 10 million ETB and will be restricted to working capital only.

24. **All sub-projects will be in compliance with environmental and social performance standards of the World Bank.** The goods and services on World Bank Group Project Exclusion List will not be eligible for financing. In addition, land acquisition will not be eligible for financing under the project.

25. **To ensure smooth commencement of the line of credit operations, the World Bank team will undertake prior review of a few initial sub-loans for each PFI.** During project

implementation, the World Bank (together with DBE in the case of wholesale business line) will prior review a few sub-loans for each PFI to ensure that they adequately complying with the eligibility criteria. The thresholds for prior review will be determined together with DBE and specified in the Operations Manual. The prior review will help address any initial gaps that PFIs may have in applying the eligibility criteria and will help manage risks.

Component 2: Enabling Environment for SME Finance

26. The objective of the second component is to improve the enabling environment for facilitating SME finance in Ethiopia[35]. This would require the following:

- creation of a **collateral registry** that would support both the banking and the leasing business;

- a review of the **insolvency and creditor/debtor regime** to address key bottlenecks to SME lending.

27. **The project will support the hardware and associated software, licenses, capacity building and training for a centralized electronic collateral registry.** Collateral registries for movable assets, which are part of the broader secured transactions systems,[36] fulfill two key functions:[37] notify parties about the existence of a security interest in movable property (of existing liens) and establish the priority of creditors vis -à- vis third parties.[38] In Ethiopia, it has been identified that a collateral registry is one of the key areas of development for improving Ethiopia's financial infrastructure, thereby facilitating access to finance, especially for the SME sector. This registry is expected to be: (a) the only place where security interests over movables are registered following necessary legal reforms; (b) cost-efficient (c) designed as a notice-filing system; and (d) accessible exclusively by electronic means.

28. **The main purpose of the diagnostic review on insolvency and credit/debtor regime is to analyze and identify the areas for improvement in the country's insolvency and credit/debtor systems.** Insolvency systems provide a pre-determined set of rules and institutions concerned with the recognition of insolvency, the resultant liquidation or rehabilitation of the insolvent firm, and the allocation of the financial consequences between the stakeholders. They also permit lenders to more accurately price risk and encourage cash flow lending, rather than relationship or directed lending, and disciplines managers to allocate scarce resources efficiently.

[35] This component will be closely coordinated with the technical assistance that will be provided in the area of financial sector infrastructure by Ethiopia Financial Inclusion Support Framework (FISF) and Multi Donor Initiative (MDI), both managed by the WBG.
[36] A Secured Transactions project consists of four components: (a) secured transactions law, applicable to all creditors and borrowers, (b) design and implementation of a centralized on-line collateral registry; (c) public awareness and capacity building efforts; and (d) monitoring and impact measurement of the project.
[37] Alvarez de la Campa, Alejandro, 2011. Increasing Access to Credit through Reforming Secured Transactions in the MENA Region. Policy Research Working Paper 5613.
[38] Specifically, three conditions are required for banks to be able to accept movable assets as collateral: the creation of security interest, the perfection of security interest and the enforcement of security interest (see Fleisig, Heywood, Mehnaz Safavian, Nuria de la Peña, 2006. *Reforming Collateral Laws to Expand Access to Finance.* World Bank. Washington DC). The movable collateral registry is a necessary component as it allows for the "perfection" of security interest.

The assessment is designed to assess and compare a country's institutional practices against the internationally recognized best practices and, if needed, provide recommendations for improvement in a prioritized methodology. The methodology of the diagnostic is based upon a pluralistic approach, which examines whether the goals of an efficient system are met and not how those goals are achieved.

29. **These activities complement ongoing technical assistance which is funded through other development partners and elaborated upon in Box 2.1.** The recent G20 Investment and Infrastructure Working Group (IIWG) and the G20 GPFI SME Finance Sub-group calls for a joint action plan on financial infrastructure reform. The priority reform measures include improvements of the credit reporting framework for SMEs, as well as reforms that allow banks and non-banks to lend to SMEs against movable collateral. In light of this initiative, the WBG has already laid out some work on the credit reporting framework and collateral registry in Ethiopia under its Multi Donor Initiative (MDI) and Financial Inclusion Support Framework (FISF) programs. Box 2.1 gives a brief overview of activities covered by these programs.

Box 2.1. Financial Infrastructure Activities under FISF and MDI

Stringent collateral requirements, the need for improvements in the creditor/debtor regime and lack of a centralized collateral registry are also recognized as key areas of development for improving Ethiopia's financial infrastructure, thereby facilitating access to finance, especially for the SME sector. In addition to addressing information asymmetries in the market, an improved secured transactions regime and the creation of a collateral registry carry multiple benefits for Ethiopia's financial sector. These benefits include reducing the cost of credit, mitigating the risk perception for borrowers who could leverage their assets into capital for investment and growth and thereby positively impacting economic development in the country.

In the area of credit information, the findings and recommendations from a Gap Analysis report that was prepared under MDI funding indicate that the primary need and objective is to increase the coverage of the database of the NBE credit registry. Follow-up activities will, therefore, focus on: (a) credit registry technical and structural capabilities; (b) data collection, quality and expansion of the current database; (c) organizational / institutional structure and staff capacity of the credit registry by deploying a consultant as noted above. The technical assistance that FISF will support is to center on capacity building for oversight practices and technical education to NBE's most relevant units, including the Credit Reporting unit, Directorates of Banking, Microfinance and Insurance Supervision, Legal Services Directorate and the Economic Research Directorate.

For the areas related to the collateral registry, FISF will also coordinate closely with the MDI to provide a coordinated support package for the NBE in order to maximize this timely opportunity for building a key financial infrastructure for Ethiopia's financial sector. In particular, it is envisioned for FISF to cover the improvements of the legal and regulatory environment, the creation of the collateral registry (all necessary support functions to the NBE except for hardware and software acquisition) and post-registry set-up capacity building, training and awareness building. These efforts are expected to be started once a Diagnostic Assessment is delivered to the NBE, which is the initial activity to be supported through the MDI.

Component 3: Business Development Services to SMEs

30. **The objective of the third component is to support SMEs through the provision of tailored Business Development Services (BDS) to address constraints on the demand side.**

31. **BDS support to SMEs can address (but is not limited to) the lack of capacity to develop bankable business plans, the poor quality of financial statements and records, the inability to manage risk, the lack of knowledge of business development and management, the lack of adequate collateral, etc**. The main objective of the provision of BDS will be to

make SMEs more bankable. Eligible SMEs will be those with a minimum of 6 and a maximum of 100 employees. BDS services may include business management and entrepreneurship training, business plan development, marketing strategy, human resource management, financial systems and bookkeeping. It may also include tailored coaching and mentoring support depending on the needs and the capacity of the SMEs. A consulting firm would be identified through an international competitive bidding process to carry out an assessment of the specific needs of the target SMEs, and support the PIU in developing the Terms of Reference and criteria for the selection of BDS providers. It is anticipated that high caliber local BDS providers will then provide a tailored menu of trainings and mentorship to the SMEs.

32. **In addition to the standard BDS, the project will also aim at providing highly specialized services to growth-oriented SMEs capable to become suppliers for global value chains.** In particular, this set of services will link the local producers to international markets through global value chains, product development management and compliance with international market standards. Moreover it will focus on quality assurance processes and management information systems (e.g. software that could help SMEs manage their production cycle in a more systematic and efficient manner).[39] As these proposed advisory services are more of a specialized technical nature and do not fall within the scope of a standard business training package, these would be provided directly to SMEs by an internationally-selected firm, with expertise in these technical areas. This specialized activity is expected to be coordinated under this project but financed through external/ donors grant funding.

33. **The component would seek to coordinate with other existing support services for SMEs.** This will include providers such as the Entrepreneurship Development Centre, sectoral institutes, and development partners supported programs. This would enable leveraging existing initiatives to set up a referral system so that eligible SMEs benefiting from the BDS services can be integrated with this project and be exposed (although not automatically entitled) to the access to finance opportunities under Component 1. In addition, the project would capitalize on synergies with the Competitiveness and Job Creation Project financed by the World Bank Group, which focuses on creating linkages between SMEs and FDIs operating in the targeted industrial Parks. This would enable building on the CJC's strong technical support for SMEs and complement it by support on business development and financing under the SMEFP.

Component 4: Project Management, Communication and Impact Evaluation

34. **The objective of the fourth component is to support overall coordination of project activities, and to rigorously measure the impact of the project on the growth of participating SMEs.**

35. **The two main implementers of the project will be the Development Bank of Ethiopia (DBE) and the Ministry of Industry (MoI).** A Project Management Team (PMT) will be established in DBE with the direct responsibility of managing the credit facility under Component 1. A Project Implementation Unit (PIU) will be established under the MOI with the mandate of overall project's coordination and direct responsibility of Components 2, 3 and 4.

[39] While the project cannot provide software to SMEs, the team has agreed to explore the possibility of conducting a needs assessment, to find the gaps in the existing software that the SMEs are using, and to introduce some existing solutions that the SMEs could acquire on their own in case of their interests and needs.

NBE will assign a focal person that will act as the key technical referent of the PIU for Component 2. The PIU will be housed under the Domestic Investors Transformation Directorate (DITD) at MoI that reports directly to the Minister of Industry. At the regional level, the regional SME development offices (ReMSEDAs) will serve as entry points.

36. **The impact evaluation will focus on innovation and measurement with the beneficiaries of loans and BDS.** The project's impact evaluation will support rigorous empirical analysis based on a quantitative comparison of a treatment and control groups before and after access to specific project interventions. Empirical analysis will mainly build on survey data deliberately collected for this purpose: (a) a base-line survey which will be carried out prior to respondents' exposure to any relevant intervention activities; (b) an end-line survey which will be administered after the project is well into operation and (c) conditional on sufficient implementation of a mid-term survey. The main focus of the survey questionnaires will be on standard business performance measures such as sales, profit, investment and employment, with the aim of measuring the impact of the program on enterprise growth over time. The impact evaluation will also aim to capture heterogeneous impacts across various groups of participants, especially between male and female entrepreneurs, younger and older firms, and firms of various sizes and sub-sectors. Information will be collected from representatives of both the treatment group as well as the control group.

37. **The impact evaluation will also aim to capture heterogeneous impacts across various groups of participants, especially between female and male entrepreneurs, examining differential impacts of access to loans, leases, and business development services for the growth of male and female-owned enterprises.** During the design phase, the team will put emphasis on identifying and evaluating interventions that aim at tackling gender-specific constraints, particularly those that represent obstacles to the growth of female owned business and entrepreneurs. Additionally, analysis will examine differential impacts for younger and older firms, and firms of various sizes and sub-sectors.

38. **The impact evaluation will involve a long-term research partnership with the Ethiopian Development Research Institute (EDRI).** EDRI is a leading Ethiopian research institute, with strong expertise in research on enterprises and manufacturing in Ethiopia. EDRI is currently carrying out its own 5-year research program on 'Small Business Development in Ethiopia'. The SMEFP will partner with EDRI to develop joint research studies, with a focus on impact evaluations and measurement of intervention results. EDRI will serve as a research implementer for the impact evaluation component. EDRI will carry out data collection activities for the impact evaluation (baseline/midline/endline surveys, focus group discussions, qualitative interviews, etc.), and empirical analysis will be carried out by joint teams of impact evaluation experts from the World Bank in partnership with EDRI researchers. Box 2.2 provides an overview of some innovative approaches to perform the impact evaluation on SME financing mechanisms, which could be further explored at a later stage. These innovative activities are currently outside of the scope this project, and maybe pursued with separate donor-funded projects as they become available.

Box 2.2. Possible Innovative SME Financing Mechanisms to be Tested

Subject to the availability of dedicated donors' funding, the project would identify and test through rigorous impact evaluation possible innovative mechanisms through which SMEs can be supported, and measure both whether they are commercially viable, and whether they are effective in catalysing SME growth. Commercial viability will be measured according to context, often looking at non-performing loans and profitability for PFIs. Growth of SMEs will be measured by examining changes over time in standard business performance measures such as sales, profit, investment and employment. A focus will be on understanding gender dimensions of business growth, and how innovations impact both female and male-owned enterprises.

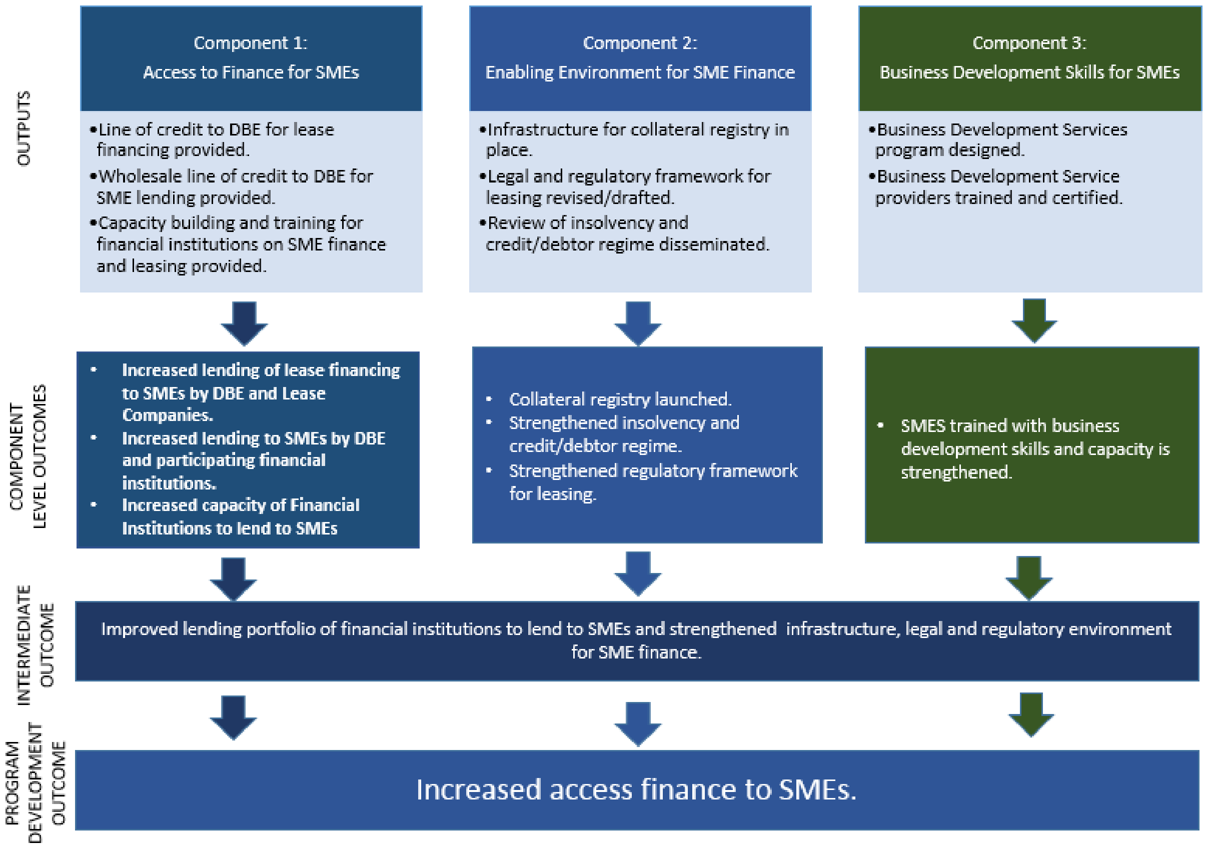
Currently, the World Bank and governments around the world have a very limited range of policy instruments that are typically employed to support small and medium enterprise growth. Innovations with the potential for local and global scalability will be explored with project implementers and PFIs in detail during the project preparation phase. Impact evaluation workshops will be conducted with project implementers in order to identify suitable pilot innovations, which project stakeholders and implementers feel could improve the ability to serve SMEs. Potential innovations would be agreed and specified in more detail following the impact evaluation workshops, but could include:

- **Angel Investing**: Early stage financing and angel investment has played a catalytic role in the growth of innovative and start-up enterprises around the world, but remains fairly nascent in Sub-Saharan Africa. Connecting existing angel investors and firms with high-growth potential SMEs in Ethiopia could have transformative impacts, and could be an alternative to formal bank financing for high-potential but still un-bankable SMEs. The impact evaluation would explore the possibility of measuring the impact and viability of angel investment in Ethiopian SMEs.
- **Big Data Solutions:** The rise of 'big data' solutions to information asymmetries in the provision of finance to SMEs is beginning to take shape. The impact evaluation component would explore the potential of tapping into existing large-scale data sources to develop predictive models for loan repayment behavior which could be used by financial institutions to screen borrowers. Sources of big data could be external to the financial institution, such as bill repayment behavior of potential borrowers from national telecommunications or energy providers, or it could draw on existing databases within the financial institution.
- **Crowdfunding:** Similar to angel investing, crowd-funding has also taken shape as a catalytic alternative form of finance for innovative SMEs. Crowd-funding platforms such as 'Crowdonomic' in Southeast Asia have demonstrated that these peer to peer platforms can play a critical role for SMEs which cannot access the formal banking sector. Crowdfunded loans, in which collateral for SME loans by private banks is provided by larger bank customers, has already been piloted by a private bank in Ethiopia, and could be a model to explore. The impact evaluation would explore the possibility of working with crowdfunding platforms to measure their impact on SME growth and access to finance.
- **Online Marketplaces**: With limited networking capital, SMEs often struggle to become known to a broader customer base or access new business opportunities. Online technology provides an excellent opportunity to enhance the networking capital of SMEs at low marginal cost. Online marketplaces and business to business platforms could reduce the cost for buyers to search for SMEs, provide a platform for SMEs to market themselves, or open up potential export opportunities. The impact evaluation will explore the possibility of supporting or launching business to business marketplaces that could improve sales performance and innovation for SMEs.

- **Collateral Alternatives:** Collateral requirements in Ethiopia are some of the highest in the region, and the continent. Novel forms of appraisal and lending by PFIs can reduce the need for high requirements for fixed asset collateral. Screening entrepreneurs using psychometric testing platforms has demonstrated potential for financial institutions in Africa, including leading SME lenders such as Standard Bank and Equity Bank. The impact of psychometric testing as a viable appraisal tool for screening SME borrowers in Ethiopia could be explored. The impact of leasing compared to traditional lending on catalysing SME growth could also be examined.
- **Invoice Financing**: This scheme uses a financial structure and a technology platform to purchase accounts receivable from large companies that supply many SMEs. Doing so frees up working capital that the suppliers can use to extend more credit to SMEs, helping to solve the access to finance problem. The scheme leverages the close relationships between large suppliers and their SME customers. The suppliers can provide credit to SMEs at relatively low risk because suppliers visit their clients often for delivery of goods and services making the additional cost and risk for providing finance low relative to other arms' length financial transactions. The accounts receivable portfolios of these large suppliers then can be diversified. These qualities (close relationships, frequent monitoring, and portfolio diversification) are the building blocks for the financing scheme and have a big potential in helping SMEs expanding their business, at the same time enhancing their payment behavior.

The impact evaluation analysis for each potential pilot innovation will be based to a large extent on the quantitative comparison of a treatment group with an adequate control group. By definition, access to the pilot is given to the treatment group only. It is crucial, however, to tailor the selection of the treatment and the control group to the intervention. This exercise is key to guarantee statistical identification of changes that can be causally linked to the intervention. The main challenge will lie in identifying project features that offer the potential to select a control group sufficiently suitable to allow for the envisaged analysis. Such features include but are not restricted to capacity constraints, phase-in stages, treatment status randomization and cut-off rules.

Figure 2.3. Theory of Change



Annex 3: Implementation Arrangements

FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA: Small and Medium Enterprise (SME) Finance Project

Project Institutional and Implementation Arrangements

1. **The Ministry of Finance and Economic Cooperation (MoFEC):** MoFEC will be the signatory of the World Bank and delegate project implementation to the Development Bank of Ethiopia (DBE) and the Ministry of Industry (MoI). The World Bank loan will be transferred directly to DBE and MoI.

2. **The WEDP Project Management Team (PMT), which is housed at DBE, will maintain direct responsibility for managing the credit facility under Component 1.** Building on lessons from WEDP to reduce risk and to ensure complementarity, the program is making use of existing structures and institutions by using the existing PMT. DBE already has a track record of managing credit lines and the existing PMT under DBE has developed adequate capacity to successfully manage WEDP to date. The PMT will be supplemented with additional capacity as needed to manage the new project. Specifically, a Safeguards Specialist will be added to the team.

3. **A Project Implementation Unit (PIU) will be established under the Domestic Investors Transformation Directorate (DITD) within the MoI with the mandate of overall project coordination and direct responsibility for Components 2, 3, and 4.** This team will include a Project Coordinator and dedicated specialists. The PIU's responsibilities will include procurement of hardware, software, business development services, capacity building related equipment and other consultancies as needed. NBE will assign a focal person to closely coordinate with the PIU as necessary in regards to procurement under Component 2.

4. **Technical assistance at all levels will reduce risks and improve performance.** Building on the successful investments in technical assistance and organizational strengthening made through WEDP, a continued program of technical assistance would support both DBE and its regional branches in SME lending, leasing, and overall institutional development. Dedicated TA on the supervision of the leasing finance industry would continue to be provided to NBE, in line with the current IFC leasing advisory project. For the TA to DBE and the other PFIs, the use of a trusted technical assistance (TA) partner to DBE, DFID's Private Enterprise Program for Ethiopia (PEPE), would be recommended as this will eliminate the risks associated with introducing a new TA provider. Moreover the track record of success in partnering between WB and DFID/PEPE under WEDP also ensures harmonization with one of the leading bilateral donors working on financial sector issues in Ethiopia. PEPE will establish a TA facility: this will be run by PEPE under the technical supervision of the World Bank team and will be closely coordinated with the Credit Facility under Component 1 of the project.

Project administration mechanisms

Financial Management, Disbursements and Procurement

Financial Management and Disbursements

5. A financial management assessment was conducted at the implementing entities of the project, Ministry of Industry (MoI) and Development Bank of Ethiopia (DBE) in accordance with the Financial Management Manual issued by the Financial Management Sector Board on March 2010 and re issued in February 2015. Furthermore, the Guideline for Financial Intermediary financing has also been referred to for determination of disbursement arrangement and fund flow mechanisms. The objective of the assessment was to determine whether the participating institutions have adequate financial management systems and related capacity in place which satisfies the Bank's Operation Policy/ Bank Procedure (OP/BP) 10.00.

6. The financial management assessment considers the degree to which (a) the budgeted expenditures are realistic, prepared with due regard to relevant policies, and executed in an orderly and predictable manner, (b) reasonable records are maintained and financial reports produced and disseminated for decision-making, management, and reporting, (c) adequate funds are available to finance the Project, (d) there are reasonable controls over Project funds, and (e) independent and competent audit arrangements are in place. The assessment also included the identification of key perceived financial management risks that may affect program implementation and proceeded to develop mitigation measures against such risks.

7. DBE has experience in implementing Bank financed operations namely, the Women Entrepreneurs Development Project (WEDP) and the Electricity Network Reinforcement and Expansion Project (ENREP). Furthermore, MoI was assessed in December 2013 for the implementation of the Competitive Job Creation (CJC) project which was later on implemented by another implementing entity. The below assessment has taken into account the lessons learned from the existing projects to ensure smooth financial management implementation.

Country Issues

8. GoE has been implementing a comprehensive PFM reform with support from DPs, including the Bank, for the last twelve years through the Expenditure Management and Control sub-program (EMCP) of the government's civil service reform program (CSRP). This has been supported by the closed IDA financed Public Sector Capacity building Support Program (PSCAP), the ongoing Promoting Basic Services (PBS) program and other donor financing as well as Government own financing. These programs have focused on strengthening the basics of PFM systems: budget preparation, revenue administration, budget execution, internal controls, cash management, accounting, reporting, and auditing.

9. The 2014 PEFA assessment has been completed for the Federal Government as well as Tigray, Amhara, SNNPR, Oromia, Somali regions and Addis Ababa city administration. Good improvements were noted in most of the federal government ratings although the rating differs among regions. Generally, the budget credibility of the country remained to be good supported with continuing robust budget execution and internal control systems. Budget transparency and comprehensiveness has also strengthened since the 2010 assessment. Good performances were

noted on arrears management, access by public to fiscal information and revenue administration. Tax audit function is gradually increasing focusing on risk assessment but capacity constraints still remain. Budget execution systems appear to continue to work well. Robust internal control systems remain. Procurement systems are strengthened since the 2010 assessment although publication of procurement information has not progressed as much. Furthermore, effectiveness of scrutiny has strengthened to an extent given that MEFF is being reviewed by relevant legislation unit and the procedure for the review of the draft budget has been strengthened.

10. Although improvements are noted, strengthening internal audit function has proceeded at a slower pace than expected. The assessment revealed that high staff turnover and capacity constraints remain in procurement and internal audit capacity. The lack of provision of electronic linkages between the IBEX systems in BoFEDs and those in sector bureaus, where IBEX was being established on a stand-alone basis remains a constraint affecting the ratings on accounting and reporting. In addition, timeliness of the preparation of statements and coverage has progressed although regional reports are submitted to federal with delay. The assessment also indicated that external audit has progressed overall but capacity constraints still remain.

Project Financial Management Arrangements

Budgeting Arrangements

11. *Existing budget systems*: MoI's budgeting process follows the Federal Government of Ethiopia's budgeting procedure[40]. Following this procedure, MoI receives notification of the authorized budget for the previous years mostly on the 28th date of the last month of the FY which is early July. Budget procedures are documented in the Federal Government of Ethiopia Budget Manual.

12. DBE has a planning department responsible for the budgeting process. All units are involved in the process of budgeting, and prepare individual unit budgets, submitted to the planning department which compiles and consolidates the master budget for discussion with management. The budget is subsequently forwarded to the Board of Management for approval. After approval, it is sent to PFEA (Public Financial Enterprise Agency) a directorate under the Prime Minister's Office which regulates the bank. The bank prepares three types of budgets (Capital budget, Recurrent Budget, and the Loan performance budget). Performance is monitored on a quarterly basis and variances must be justified. These quarterly reports are presented to the board to evaluate performance. The Loan performance budget is used to budget credit activities at the beginning of every fiscal year to determine how many loans to approve, disburse and monitor performance of these loans.

13. **Budget preparation for the project:** MoI will prepare the annual budget of the project for components two, three and four, in close collaboration with NBE given that the latter is responsible for Component 2 but will not manage resources from the project. Once the budget is

[40] The federal budgeting process usually starts by issuing the budget preparation note to the Budgetary Institutions (BIs). Based on the budget manual, the BIs prepare their budgets in line with the budget ceilings and submit these to MoFEC within six weeks following the budget call. The budgets are reviewed at first by MoFEC and then by Council of Ministers. The final recommended draft federal budget is sent to parliament in early June and is expected to be cleared at the latest by end of the EFY.

prepared by the MoI-PIU and approved by the management of the MoI, it will be submitted to the World Bank for no objection. Afterwards, MoI will include the budget of the project in to its own annual budget and work plan and submit it to MoFEC following the government's budget calendar. The budget will be proclaimed under the name of MoI after being endorsed by the Council of Ministers.

14. For Component 1, DBE will receive the annual budget from lease companies, MFIs, and commercial banks for both lines of credit (leasing and working capital). Using its experience and professional judgment, DBE will approve an annual work plan and will submit it to the Association, the European Investment Bank, the DBE management and the Board of management for approval. Once approved, it must be forwarded to PFEA for final authorization. The budget of DBE will not be proclaimed in the government's budget proclamation.

15. **Budget monitoring:** MoI has an adequate budget monitoring and control system. It reports budget utilization on a monthly basis to management and MoFEC. The expenditures are compared with the budget and the variances are analyzed and budget reallocation/readjustment/variation requests are made (at least twice per year) to adjust the approved budget. The reports are produced by using spreadsheets instead of directly by automated accounting system. Similarly DBE, as experience shows from other projects it has implemented, monitors the budget to ensure that it disburses amounts to MFIs within the approved budget limit. It also monitors if the MFIs have actually disbursed to the final beneficiaries within the approved plan of the MFIs. These monitoring mechanisms will be followed for this project and the quarterly IFRs will report on the budget utilization with adequate explanation for major variances.

Accounting Arrangements

16. The Ethiopian Government follows a double entry bookkeeping system and modified cash basis of accounting, as documented in the government's Accounting Manual[41] and these procedures have also been implemented in many regions. The government's Accounting Manual provides detailed information on the major accounting procedures.[42]

17. **FM Manual:** MoI uses the Federal Government of Ethiopia's financial manual. DBE has its own financial management manual to implement World Bank and other multilateral agency (MLA) projects. To ensure smooth implementation of the project, as part of the project's Operations Manual, the project will have its own financial management manual which will largely follow the government accounting manual, depicting all accounting policies, procedures, internal control issues, financial reporting, fund flow arrangements, budgeting and external audit.

[41] FGE Accounting system, Volume I.
[42] The main elements of the accounting reform are the adoption of (a) a comprehensive Chart of Accounts consistent with the budget classification; (b) a system of ledgers accommodating all types of accounts (including transfers, assets, liabilities, and fund balance in addition to revenues and expenditures); (c) double entry bookkeeping (thus, a self-balancing set of accounts); (d) a system of control for budgetary commitments (recording commitments as well as actual payments); (e) modified cash basis transaction accounting; and (f) revised monthly report formats to accommodate double-entry bookkeeping and commitment control and permit better cash control.

18. **Accounting software:** MoI will use the Peachtree accounting software for accounting the project funds as in the case for other projects. The chart of accounts will be mapped with the project budget to meet the project activities and included in the FM manual.

19. DBE uses a computerized accounting system which is a product of TEMENOS called T-24 Core Banking system (T-24) release 10 to process and journalize the project's transactions. Chart of accounts will be created for the project and project transactions will be recorded in the DBE accounts. However, the DBE system might not produce the required reports to meet the reporting requirements of the project as a result of possible differences in treatment of the following two accounts:

- **Account Receivable (**Loan to MFIs, commercial banks and leasing companies): depending on further discussions that will be held regarding the disbursement modality for the project, should the advance method be used for this project, the loan disbursement to the financial intermediaries is captured as receivable and will be settled upon repayment of the loan in the DBE accounts. However, the project is expected to report to World Bank and European Investment Bank the disbursements to MFIs, commercial Banks and leasing companies as receivable and subsequent disbursement by these financial intermediaries to eligible beneficiaries as expenditure/uses of funds/ regardless of repayment of loan proceed to DBE by these intermediaries.

- **Use of Funds**: As stated above, the project is expected to recognize expenditure/use of funds/ when MFIs and commercial banks disburse to eligible SMEs for working capital loans. For leasing loans, the level of expenditure recognition will be further discussed. But in the DBE system, these are considered loans hence not seen as uses of funds.

20. Such treatment differences need to be supplemented with memorandum records, i.e. spreadsheet, so as to produce the required reports as per the Financing Agreement. For existing projects, DBE is maintaining a memorandum record. Such mechanism will also be adopted for this project. It is noted that most category “A” and “B” branches of the DBE are on line with the core banking system which allows the head office to get reports on a daily basis from each branch regarding the approved load for specific products, the sector, the business type and all the loan details. It has been disclosed to us the lease financing could also be identified separately in the system which makes the consolidation process from regions very easy. For existing projects, DBE has a good filing and record keeping mechanism and data entry is done in real-time and accounts are fairly up to date. Timely backups are taken by IT units and anti-virus is timely updated.

21. **Accounting at MFIs, commercial banks and leasing companies:** as per the design of the project, only those financial intermediaries that meet the stipulated eligibility requirements will be able to obtain the status of participating financial institution and their eligibility will be verified annually. It is expected that the normal operating procedures of the MFI/commercial bank/leasing companies will be used for the project. However, for the purposes of this project, there will be an Operations Manual which will highlight the eligibility criteria for on-lending to this project’s beneficiaries. Accordingly, although the accounting system of the financial

intermediary will be used, there is a need to hold memorandum recording which will allow for identifying the resources used for the project and to put in place a proper trail for audit exercise.

22. **Accounting at SME level:** sub-loans will be extended to eligible SMEs for working capital loans up to ETB 10 million and lease financing ranging up to 30 million. For these SMEs, special financial management arrangements will not be requested. However, each of the SMEs are expected to maintain proper books of accounts as indicated in the establishment by law of the SMEs. The one stop shops and the City/regional SME development agencies have a responsibility along with TVETs to train the SMEs with good financial management systems and also do reviews and monitoring as to whether the enterprises are keeping up as required. Although the supervision and assistance continues for small and medium enterprises, the annual external audit will be carried out by registered audit firms. These audit reports are required for obtaining loans from MFIs as well as for determining the grading of the SME. Therefore for this project, specific reporting requirements will not be requested from the SMEs but the Operations Manual will indicate that the financing agreement to be signed between the MFIs and the SMEs will include a section on the expected financial management arrangements of SMEs. DBE, the external auditors, the World Bank and European Investment Bank will have access to review the SMEs on a sample basis during implementation support and supervision missions or as required.

23. **Accounting staff:** The financial management team under the Finance and Supplies Directorate of MoI was staffed with 8 personnel from a structure that needed 10 personnel. From the eight staffs, six are accountants and two are cashiers. The accountants have more than ten years of experience with three of them holding BA degree and three holding Diploma in accounting. In addition to this, for the implementation of donor financed operations such as EU and DFID projects, the ministry has established PIUs with two accountants for each project. The overall assessment of staffing arrangement in the MoI revealed that the existing accountants are adequate in managing the existing funds. MoI has an experience in managing Bank financed projects and the director of the Finance and Supplies Directorate has adequate experience. However, the current six accountants do not have experience in managing the Bank's projects. Given this circumstance, MoI will have one accountant recruited/placed to be positioned in the PIU to be formed for the project. The accountant will be responsible for preparing financial reports, managing resources of the ministry, have the accounts audited, etc. in collaboration with the finance directorate of the ministry.

24. The PMT of WEDP at DBE has currently four accountants working on WEDP and the energy project of the World Bank. The accountants are well qualified and sufficient for the projects. For this project, the unit will be further strengthened by adding two additional finance officers. DBE branches, leasing companies, MFIs, commercial Banks and leasing companies will continue to use their existing staff. However, these financial intermediaries will be required to assign a focal person for the project’s financial management whose responsibility will be to submit required financial management information to DBE as well as availing assistance to World Bank missions, external auditors and DBE monitoring and evaluation teams.

Internal Control and Internal Audit Arrangements

25. Internal control comprises the entire system of control, financial or otherwise, established by management in order to: (a) carry out the project activities in an orderly and efficient manner;

(b) assure adherence to policies and procedures; and (c) safeguard the assets of the project and secure as far as possible the completeness and accuracy of the financial and other records. MoI is using those control procedures prescribed by the government which are adequate to ensure authorization, recording and custody control.

26. **Internal Audit**: MoI has an internal audit directorate. The numbers of staff in the directorate are currently two, with BA degree and modest experience. The structure of the internal audit directorate requires a total of 15 staff; one director, four team leaders, three senior auditors and seven auditors. The directorate is severely under staffed and as a result mainly performs financial audit of the ministry. The internal audit directorate of the MoI conducted audit for the EFY 2008 1st quarter and provided the internal audit report. Review of the report reveals no significant reportable internal control weaknesses. Strengthening the internal audit function must be a priority area of the ministry to ensure the existence of a strong internal control environment.

27. DBE has an independent internal audit department reporting to the Board of Management. The department is divided into two teams; one team is responsible for the operational audits (Process audit, procurement, risk analysis, property management, IT Audit and legal audit) the second team is responsible for financial related audit and international banking. The teams are guided by the internal audit charter formulated specifically for the bank. It provides the framework for operations and the enhancement of the independence of the internal audit functions within the bank. DBE's internal audit unit regularly reviews the transactions of Bank financed operations. The same approach will be adopted for this project as well.

Financial Reporting Arrangements

28. Two Interim Financial Reports (IFRs) will be required from the project. One will be submitted by DBE, after consolidating the quarterly information from its own branches, leasing companies, commercial banks and MFIs. The other report will be due from MoI. Both reports will be due within 45 days of the quarter end. The format and content of the IFR between the Bank and both DBE and MoI has been agreed before negotiations.

29. In summary, the contents of the IFR will include:

- Executive Summary
- Statement of Sources and Uses of Funds; and
- Statement of Uses of Funds by Project Activity/Component.
- Designated Account activity statements
- Notes to the IFR
- Trial balances and other related schedules.

30. The project will also prepare two project's annual accounts/financial statements within three months after the end of the accounting year in accordance with accounting standards

acceptable to the Association. The audited financial statements should be submitted to the Association within six months after the end of the accounting year.

31. Annual audited financial statements and audit reports (including Management Letter) will be submitted to the Association within six months from the end of the fiscal year. Two audit reports will be due, one from DBE and another from MoI. The annual financial statements will be prepared in accordance with the standards indicated in the audit TOR agreed during negotiations. The audit will be carried out by the Office of the Federal Auditor General (OFAG), or a qualified auditor nominated by OFAG and acceptable to the Association.

32. The audit will be carried out in accordance with the International Standards of Auditing (ISA) issued by the International Federation of Accountants (IFAC). The auditor will prepare a work plan to ensure adequate coverage of the various institutions that receive project funds and cover all the major risk areas. In addition to the project audit, the entity audit report of DBE must also be submitted to the Association within six months of the fiscal year end. The draft entity audit report for the year ended July 7, 2015 has been submitted to the World Bank. Going forward, DBE will share its entity audit report with the Bank on a yearly basis.

33. Based on lessons learned from the similar projects, the following mechanisms are proposed to systematically monitor the timing of audit reports and the timely action on audit findings: (a) In addition to the internal control system of the DBE, the auditor will further look into the appropriateness of the expenditure claims made by the commercial Banks, leasing companies and MFIs by including these implementers in the sample review exercise ; (b) both DBE and MoI have the responsibility to prepare audit action plans within one month of the receipt of the annual audit report. The prepared action plan will be disseminated to concerned implementers and (c) Within two months after the receipt of the audit report, both DBE and MoI should report back to the Association the actions taken on the audit report findings.

34. In accordance with the World Bank’s policies, the Bank requires that the borrower disclose the audited financial statements in a manner acceptable to the Association; following the Association’s formal receipt of these statements from the borrower, the Bank makes them available to the public in accordance with The World Bank Policy on Access to Information.

FM-related Costs

35. **The program work plans and budget at MoI will include the costs of** (a) audit costs; (b) related logistics and supervision costs (for example, transportation, per diem, and accommodation while travelling); (c) FM-related trainings; (d) bank charges; etc.

FM Risk Assessment, Strengths, Weaknesses, Lessons Learned, Action Plan

36. **Risk assessment.** The FM risk of the project is Substantial. The preliminary mitigating measures proposed in the action plan will help reduce the risk of the project once implemented and applied during project implementation.

37. **Strength and weaknesses.** The program will inherit the various strengths of the country’s PFM system. As discussed earlier, several aspects of the PFM system function well, such as the budget process, classification system, and compliance with financial regulations.

Significant ongoing work is directed at improving country PFM systems through the government's EMCP. The government's existing arrangements are already being used in a number of projects which are under implementation. The program also benefits from the country's internal control system, which provides sufficiently for the separation of responsibilities, powers, and duties. It benefits from the effort being made to improve the internal audit function. Additional strength for the program is the experience of the DBE in handling Bank-financed projects.

38. The main drawback in FM arrangements is the involvement of a number of financial intermediaries which could lead to reporting delays and identification of eligible expenditures under the project. Given that memorandum records need to be maintained for all of them, the risk on the memorandum records not being up to date and not being given priority may be a risk facing the project. Furthermore, the internal audit unit of MoI is severely understaffed which could affect the internal control of the project.

Financial Management Action Plan

39. The action plan that encompass as the mitigation measures for the risks and weaknesses are prepared in Table 3.1.

Table 3.1. Financial Management Action Plan

	Action	Date Due By	Responsible
1	Prepare a financial management manual	Following effectiveness as part of the operations manual	MoI-PIU
2	Staff recruitment: • Recruit two finance officers at the DBE PMT to oversee the FM of this project • Recruit/assign one finance officer at MoI PIU for the project • MFIs, commercial banks, leasing companies to assign a focal FM Person to look after the project requirements.	Three months after effectiveness. Until such a time, the existing staff at MoI and PMT of DBE will implement the project. MFIs, leasing companies and commercial banks must assign accountants by signing and effectiveness.	MoI-PIU
3	Accounting: • DBE to maintain a memorandum record for the project • MFIs, commercial banks and leasing companies to maintain a memorandum record for the project	Ongoing	
4	Internal auditor of the MoI and DBE will include the project in their annual plans and will perform an audit on an ongoing basis	At least annually based on the annual work plan of the units.	MoI
5	IFR/Report issues 1. Trainings will be provided by the Bank 2. Quarterly submission of IFRs from DBE and MoI	1. Within three months of effectiveness 2. Within 45 days of the end of quarter	1. 2. WB 3. MoI/DBE
6	Audit issues 1. Recruitment of external Auditors at early stages of the project; 2. Project annual financial statements will be prepared on time and on timely closure of accounts will be made.	1. Within three months of effectiveness 2. Within three months of year end 3. Within six months of the end of each fiscal year	1–4. MoI

	Action	Date Due By	Responsible
	3. Submission of annual audited financial statements and audit report including the management letter; 4. Disclosure-In accordance with Bank Policy, (a) the Bank requires that the borrower disclose the audited financial statements in a manner acceptable to the Bank; (b) Following the Bank's formal receipt of these statements from the borrower, the Bank makes them available to the public in accordance with The World Bank Policy on Access to Information.	4. Annually –	

FM Covenant and Other Agreements

(a) Maintaining satisfactory financial management system throughout the life of the project,

(b) Submitting Interim financial reports (IFRs) within 45 days of the quarter end from both DBE and MoI and

(c) Submitting audited financial statements within six months of the year end from both DBE and MoI.

Supervision Plan

40. The overall residual risk rating for the project is substantial; hence the project will have joint WB-EIB on-field supervision at least twice a year. This is in addition to regular implementation support, desk assessments, quarterly IFR reviews and annual audit report reviews. After each supervision, the risk will be measured and recalibrated accordingly. Supervision activities will include: the compliance with the agreed upon FM arrangements, review of quarterly IFRs; review of annual audited financial statements as well as timely follow-up of issues arising; transaction review; participation in project supervision missions as appropriate; and updating the FM rating in the Implementation Status and Results Report (ISR).

Conclusion of the Assessment

41. The conclusion of the preliminary assessment is that the project's financial management arrangements meet the Bank's minimum requirements under OP/BP10.

Funds Flow and Disbursement Arrangements

42. In addition to IDA resources, the project is expected to also have contribution from European Investment Bank (EIB) for a total of EUR 70 million. The guideline for financial intermediaries lays down three types of disbursement arrangements that could be considered for financial intermediary financing. These include: (a) back to back financing – financing or refinancing of an eligible sub-loan portfolio which has been initially approved by the participating financial institution's credit committee and the disbursement of funding is made against eligible sub-loans on a back to back basis; (b) fixed-term financing – financing or refinancing of an eligible sub-loan portfolio which has been initially approved by the

participating financial institution's credit committee and the disbursement of funding is made against eligible sub-loans on pre-established loan terms and conditions and (c) if a strong business case is made, an advance can be disbursed to the participating financial institutions in line with the project's eligibility criteria.

43. This project will follow the option outlined on point (a) above and is elaborated as follows:

- **For Component 1:**

  (a) **From IDA/EIB to DBE** - DBE will sign a Subsidiary Agreement (SA) with MoFEC before receiving resources from IDA/EIB. Once the SA is signed, DBE will open two foreign currency nominated accounts at the National Bank of Ethiopia (NBE), one for IDA and another one for EIB. The initial advance amount will be indicated in the disbursement letter.

  (b) **From DBE to leasing companies and DBE branches** - From there, DBE will transfer resources to its branches and lease companies for lease financing. For the lease financing, advance from IDA (as a ceiling to the DA) based on estimates, will be provided to DBE. Once the business proposal/feasibility study has been approved as per the working procedures to be developed for the project, and the leasing process is finalized, up on presentation of the invoices, DBE will transfer the money to the leasing companies and branches. Eligible expenditures in this case will be the provision of the items hence once the leasing companies and branches finalize the process, they must submit the documents evidencing the procurement/leasing to DBE. This will be the basis for IDA to document expenditures and replenish the designated account.

  (c) **From DBE to MFIs and commercial banks for SME lending** – to ensure liquidity in the project, the DA ceiling will incorporate the best estimate amount for this line of credit. Although advance is provided to DBE, DBE can only release resources to the financial institutes when each presents evidence to DBE that they have on lent to SMEs or have loans already approved as per the operations manual of the project at which time they will get replenishment from DBE. Expenditures will be recognized when evidence is provided that the money has been on lent to the final beneficiaries.

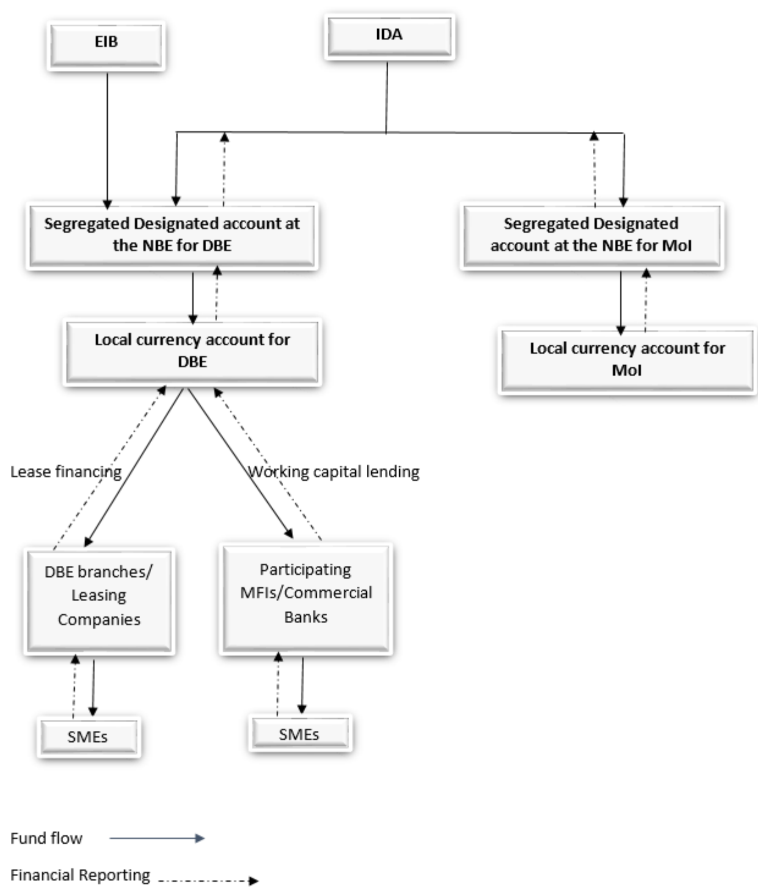
- **For Component 2:** MoI will open two separate designated accounts for the project, one for IDA and another one for EIB. Based on the advance ceiling to be established on the disbursement letters, the ministry will receive resources from IDA. A separate local currency account will also be opened at MoI which will be used for local transactions and transferring resources to regional offices if necessary. Regional-level implementation will be done through the ReMSEDAs. However, no fund will flow to the ReMSEDAs. All requirements to the ReMSEDAs will be handled by the MoI itself. Furthermore, NBE will not be opening a Bank account but procurement on its behalf will be conducted by MoI.

44. The financing shares of the respective partners to finance the annual work plan and budget will be determined by the TTL in consultation with the various donors. The TTL will advise the World Bank's team of the share of financing to be disbursed by the World Bank for the project by linking it to the quarterly project cash flow which will then be reflected in the Statement of Expenditures to be used by the project. Additional information with regards to disbursement such as minimum value of application for direct payments, reimbursement and special commitments to be used by MoI will be indicated in the disbursement letter of the project.

45. Before transferring any money, DBE and MoI will ensure that all pre-request arrangements which will be outlined in the project Operations Manual are satisfactorily met, and there are adequate financial management systems including financial management staff capable of producing the required financial deliverables.

46. The funds flow arrangement for the project is summarized in the following diagram.

Figure 3.1. Funds Flow Arrangement



47. **Disbursements Arrangements:** The transaction-based disbursement method using statements of expenditure will be used when disbursing funds to the Designated accounts for the project. Other methods of disbursement that can be used by MoI include;

- Direct payments to a third party for works, goods and services upon the Borrower's request;

- Special commitments e.g. letters of credit;

- and reimbursements for expenditures incurred under the project

48. Further details about disbursements to the project will be included in the disbursement letter. If ineligible expenditures are found to have been made from the Designated Account, the Borrower will be obligated to refund the same. If the Designated Account remains inactive for more than six months, the Borrower may be requested to refund to IDA amounts advanced to the Designated Account. IDA will have the right, as reflected in the Financing Agreement, to suspend disbursement of the funds if reporting requirements are not complied with.

49. **Foreign currency and risks** – the foreign currency risk of the project will be borne by the Government (MoFEC). Through the subsidiary agreement that MoFEC will sign with DBE, it is up to the government to decide and agree as to specifically who (MoFEC or DBE) should be bearing the foreign currency risk of the project. Regarding the credit risk, DBE extends subsidiary loans to lease companies, commercial banks and MFIs with its own credit risk. Furthermore, the subsidiary loans to be provided by the financial intermediaries to the SMEs will be borne by the financial intermediaries.

Procurement

50. **General procurement environment.** For federal budgetary bodies, public procurement is regulated by the Public Procurement and Property Administration Proclamation No. 649/2009. The proclamation establishes the Federal Public Procurement and Property Administration Agency, which is responsible for regulation and monitoring of federal public procurement activities. The nine regional states and two city administrations do have their own procurement proclamations and directives which are drafted using the federal procurement proclamation as a prototype.

51. The Ethiopia 2010 Country Procurement Assessment Review (CPAR) identified weaknesses in the country's procurement system and recommended actions to address these areas. The government has implemented many of the CPAR recommendations, but challenges remain in the areas of coordination of procurement reforms, shortage of qualified procurement staff, high level of procurement staff turnover, lack of proper institutional structures for procurement management, weak institutional capacity, inordinate process delays, absence of systematic procurement performance M&E, and lack of organized effort in capacity building in the area of procurement. Many of the weaknesses identified in the 2010 CPAR are prevalent in the MoI which is the focal organization for the implementation of the SME Finance Project.

52. **Applicable Procurement Guidelines.** Procurement for the SME Finance Project under the IDA Credit shall be carried out in accordance with the World Bank's 'Guidelines for Procurement of Goods, Works, and Non-Consulting Services under IBRD Loans and IDA Credits & Grants by World Bank Borrowers', dated January 2011 and revised in July 2014 (the 'Procurement Guidelines'); 'Guidelines: Selection and Employment of Consultants under IBRD

Loans and IDA Credits & Grants by World Bank Borrowers', dated January 2011 and revised in July 2014; 'Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credits and Grants, (the Anti-Corruption Guidelines)', dated October 15, 2006 and revised in January 2011; and the provisions stipulated in the Legal Agreement.

53. The general descriptions of items under different expenditure categories are described below. For each contract to be financed by the Credit, the different procurement methods or consultant selection methods, the need for prequalification, estimated costs, prior review requirements, and time frame are agreed between the borrower and the Bank in the Procurement Plan. The Procurement Plan will be updated at least annually or as required to reflect the actual project implementation needs and improvements in institutional capacity.

54. The Bank's Standard Bidding Documents (SBDs) will be used for procurement of works and goods under International Competitive Bidding (ICB), and the Standard RFPs will be used for consultants' contracts. In addition, the implementing agency will use the Standard Bid Evaluation Form for procurement of goods and works for ICB contracts and the Sample Form of Evaluation Report for Selection of Consultants. National SBDs acceptable to the Association may be used for procurement of goods, works, and non-consulting services under National Competitive Bidding (NCB) procedures, subject to the exceptions indicated below. Alternatively, the Bank's SBDs would be used for the NCBs, with appropriate modifications.

55. The Bank has reviewed the SBDs issued by the Federal Public Procurement and Property Administration Agency and has found them acceptable with some modifications. The NCB shall follow the Open and Competitive Bidding procedure set forth in the Public Procurement and Property Administration Proclamation No. 649/2009 and Federal Public Procurement Directive issued by the Ministry of Finance and Economic Cooperation dated June 10, 2010, provided that such procedure shall be subject to the provisions of Section I and paragraphs 3.3 and 3.4 of the Procurement Guidelines and the following additional provisions:

(a) The recipient's SBDs for procurement of goods and works acceptable to the Association shall be used. At the request of the recipient, the introduction of requirements for bidders to sign an anti-bribery pledge and/or statement of undertaking to observe the Ethiopian law against fraud and corruption and other forms that ought to be completed and signed by him/her may be included in bidding documents if the arrangements governing such undertakings are acceptable to the Association.

(b) If prequalification is used, the Association's standard prequalification document shall be used.

(c) No margin of preference shall be granted in the bid evaluation on the basis of the bidder's nationality, origin of goods or services, and/or preferential programs such as, but not limited to, small and medium enterprises.

(d) Mandatory registration in a supplier list shall not be used to assess bidders' qualifications. A foreign bidder shall not be required to register as a condition for submitting the bid. If recommended for contract award, the foreign bidder shall be given reasonable opportunity to register before contract signing, with the reasonable cooperation of the recipient. Invitations to bids shall be advertised in at least one newspaper of national circulation or the official gazette or on a widely used website or electronic portal with free national and international access.

(e) Bidders shall be given a minimum of thirty (30) days to submit bids from the date of availability of the bidding documents.

(f) All bidding for goods shall be carried out through a one-envelope procedure.

(g) Evaluation of bids shall be made in strict adherence to the evaluation criteria specified in the bidding documents. Evaluation criteria other than price shall be quantified in monetary terms. Merit points shall not be used, and no minimum point or percentage value shall be assigned to the significance of price in bid evaluation.

(h) The results of evaluation and award of contract shall be made public. All bids shall not be rejected and the procurement process shall not be cancelled, a failure of bidding declared, or new bids solicited, without the Association’s prior written concurrence. No bids shall be rejected on the basis of comparison with the cost estimates without the Association's prior written concurrence.

(i) In accordance with paragraph 1.16(e) of the Procurement Guidelines, each bidding document and contract financed out of the proceeds of the Financing shall provide that the bidders, suppliers, contractors and subcontractors, agents, personnel, consultants, service providers, or suppliers shall permit the Association, at its request, to inspect all accounts, records, and documents relating to the bid submission and performance of the contract and have them audited by auditors appointed by the Association. Acts intended to materially impede the exercise of the Association’s audit and inspection rights constitutes an obstructive practice as defined in paragraph 1.16(a) (v) of the Procurement Guidelines.

56. **Procurement under Financial Intermediary Institutions and SMEs.** Most of the resources under the SME Finance Project are to be channeled to SMEs through financial intermediaries including the Development Bank of Ethiopia, commercial banks, lease companies and microfinance institutions in terms of lending and leasing arrangements. Since the proceeds under SME Finance Project are made to financial institutions and entities (or their designated agencies) that subsequently on-lend the credit proceeds to SMEs, the latter may carry out the procurement of goods, works, and non-consulting services, and the selection of consultants, in accordance with well-established private sector procurement methods or commercial practices that are acceptable to the Association.

57. The Project Implementation Manual of the SME Finance Project, shall describe the basic guiding principles, the established methods, procedures and commercial practices, contract forms, and the main responsibilities of the financial intermediary institutions and entities applicable to the Project.

Applicable Procurement Methods

58. **Scope of procurement.** The implementation of the SME Finance Project entails procurement of goods, works, and services of various types. Procurement activities shall be carried out for Components 2, 3, and 4 of the Project. The goods and equipment to be procured under the project are expected to include vehicles, IT equipment, including hardware and software for collateral registry, and capacity-building items such as office equipment and office furniture for implementing agencies. Consultancy services such as technical assistance for business development skills for SMEs, studies, impact assessments, preparation of guidelines and manuals, employment of consultants for the PIU, and financial audits are expected to be included under the procurable services.

59. **Institutional arrangement for procurement.** As the focal organization for the implementation of the project, the PIU at the Domestic Investors Transformation Directorate (DITD) of the MoI shall be responsible for the overall coordination of procurement activities of the project. It shall be responsible for the overall coordination of planning, procurement processing, and contract management of goods and services to be procured at central level. The PIU at MOI shall be responsible for the procurement of strategic goods and services as well as other capacity building items. It shall be responsible for the coordination of procurement plans for other implementation agencies. It shall also serve as a focal point for correspondence with the Bank on procurement issues.

60. **Procurement of goods.** The procurement of goods shall be carried out using the Bank's SBDs for all ICB contracts and national SBD agreed with or satisfactory to the Bank for NCB contracts. Contract packages for goods estimated to cost US$1 million equivalent per contract and above will be procured through ICB procedures. Goods contracts estimated to cost less than US$1 million equivalent per contract would be procured through NCB procedures. Goods contracts estimated to cost less than US$100,000 equivalent per contract may be procured through shopping procedures by comparing quotations received from at least three reliable suppliers. In such cases, request for quotations shall be made in writing and shall indicate the description and scope of the goods to be procured, the time required for delivery of the goods, and the payment terms. All quotations received shall be opened at the same time. As a general rule, a qualified supplier who offers goods or materials that meet the specifications at the lowest price shall be recommended for award of the contract. Limited International Bidding for goods may be used as an exception when there are only a limited number of known suppliers worldwide.

61. **Direct contracting and single source selection** can be used when it is considered beneficial to the borrower. Under the SME Finance Project there might be circumstances which justify direct contracting by implementing agencies, where there is only a single supplier, or service provider for the provision of small value goods and services. Direct contracting below US$100,000 will require task team leader review; and above US$100,000 will require full Bank review.

62. **Procurement of mass media broadcasting services.** Implementing agencies may require radio broadcasts and television programs to disseminate information on the objectives and beneficiaries of the project. There might be a need to disseminate to SMEs of the

opportunities available to them under the project. Under such circumstances there shall be a need for the project to procure air time for dissemination of such information to beneficiaries of the project. In Ethiopia, radio and television programs with a wider coverage are limited to the Ethiopian Broadcasting Corporation and some regional radio and television stations which are state-owned enterprises. A study of the media outlet in the country clearly indicates that there are no private sector alternatives in the provision of airtime services with wider coverage to reach the clientele of the project. In view of this, project implementing agencies may procure airtime for broadcasting services from the Ethiopian Broadcasting Corporation and Oromia Television on a direct contracting basis according to the procedures outlined in paragraph 3.7 of the Procurement Guidelines. However, where there are private sector alternatives as in the case of broadcasting services required for project beneficiaries in and around Addis Ababa, other appropriate methods of procurement of non-consulting services may be used.

63. **Procurement of non-consulting services.** Depending on the nature of the services, procurement of non-consulting services, such as transport services, will follow procurement procedures similar to those stipulated for the procurement of goods. NCB procedures acceptable to the Bank would be used for contracts above an estimated monetary amount of US$100,000. Contracts valued at less than US$100,000 equivalent shall use Shopping procedures in accordance with the provisions of paragraph 3.5 of the Bank's Procurement Guidelines. The procurement of non-consulting services shall follow the Bank's existing SBD for ICB or national SBDs for NCB, with appropriate modifications.

64. **Selection of consultants.** The project will make use of consultant services for technical assistance for business development skills for SMEs, studies, project management, monitoring and evaluation, and annual financial audits of the project. Contracts above US$200,000 will be awarded through the use of the Quality- and Cost-Based Selection (QCBS) method described under Section 2 of the Consultant Guidelines. Consulting services for audit and other contracts of a standard or routine nature may be procured under the Least-Cost Selection (LCS) method described under section 3.6 of the Consultant Guidelines. Consulting services of small assignments may be procured through the Selection Based on the Consultants' Qualifications (CQS) method. Short lists of consultants for services estimated to cost less than US$200,000 equivalent per contract may be composed entirely of national consultants.

65. **Individual Consultants (ICs).** ICs will be selected on the basis of their qualifications and experience by comparison of CVs of at least three candidates from those expressing interest in the assignment or those approached directly by the implementing agency in accordance with the provision of section V of the Consultant Guidelines.

66. **Training and workshops.** The project will fund training activities including business development skills for SMEs and capacity building of implementing agencies. The training plan of the project shall be approved by the Bank. The training plans would include details on (a) type of training to be provided; (b) number of beneficiaries to be trained, duration of training, and estimated cost; (c) institutions selected based on their expertise; and (d) expected learning outcomes. Workshops shall be prior reviewed as part of the annual work plans of the project.

67. **Operating costs.** Incremental operating costs include expenditures for maintaining equipment and vehicles; fuel; office supplies; utilities; consumables; workshop venues and

materials; per diems, travel costs, and accommodation for staff when travelling on duty during implementation of this project but excluding salaries of civil/public servants. These will be procured using the borrower's administrative procedures, acceptable to the Association. Operating expenditures are neither subject to the Procurement and Consultant Guidelines nor prior or post reviews. Operating expenditures are verified by the task team leaders and FM specialists.

68. **Record keeping.** The PIU of the SME Finance Project at the MoI as well as all the project implementing agencies, as appropriate, shall be responsible for record keeping and filing of procurement records for easy retrieval of procurement information. Each contract shall have its own file and should contain all documents on the procurement process in accordance with the requirements of the Bank and as described in the national Procurement Proclamations.

69. **Margin of preference for goods.** In accordance with paragraphs 2.55 and 2.56 of the Procurement Guidelines, the borrower may grant a margin of preference of 15 percent in the evaluation of bids under ICB procedures to bids offering certain goods produced in the country of the borrower, when compared to bids offering such goods produced elsewhere.

70. **Coordination of procurement activities.** The PIU of SME Finance Project at the MoI, which is the focal organization for the implementation of the Project, shall coordinate all procurement activities of the project at the central level and shall be responsible for communicating with the Bank on requests for prior reviews. Responsibilities of the federal PIU will also include procurement of strategic goods and equipment, consolidation of procurement plans for all contracts, placement of adverts for ICB contracts on United Nations Development Business (UNDB) online, supervision of other implementing agencies, coordination of post procurement reviews, and follow-up on findings.

Assessment of the Agency's Capacity to Implement Procurement

71. The PIU at the Domestic Investors Transformation Directorate (DITD) in the MoI shall serve as the focal organization for the project. It shall also be responsible for the overall coordination and execution of procurement activities centrally. In view of this a procurement capacity assessment has been carried out in the Finance and Supplies Directorate of MoI which is responsible for financial, procurement and property administration, and general services under the MoI. The Directorate is composed of three case teams namely finance, procurement and property administration, and general service case teams.

72. As a follow-up to the second preparation mission of the SME Finance Project a procurement capacity assessment was undertaken in the Finance and Supplies Directorate of the MoI on December 11 to 14, 2015. The capacity assessment was carried out using the Procurement Risk Assessment Management System – P-RAMS questionnaires. The assessment reviewed the organizational structure for implementing the proposed SME Finance Project and the staff responsible for procurement in the Ministry of Industry. The assessment also looked into the legal aspects and procurement practices, procurement cycle management, organization and functions, record keeping, staffing and the procurement environment.

73. Procurement under the MoI is carried out by the Procurement and Property Administration case team of the Finance and Supplies Directorate. The case team is currently staffed with a procurement staff and two purchasers. Procurement activities carried out by the case team are limited to shopping of goods and services, with very limited contracts of open bid for procurement of goods and a couple of selection and employment of consultants under a donor financed project. The staff have no experience and exposure in handling procurement of goods and services of the nature to be carried out under the SME Finance project. In general, since the staff do not have experience in handling procurement under Bank financed projects, lack of procurement proficient personnel with experience under Bank financing stands out as a prominent challenge going forward with the SME Finance Project.

74. Procurement activities under the procurement case team in the MOI are expected to be carried out on the basis of the legal framework provided by the Federal Government and the Procurement Directive issued by the Federal Public Procurement and Property Administration Agency (FPPA). Accordingly, procurement planning, procurement processing and record keeping are expected to be carried out in accordance with the directives issued by FPPA of the Federal Government. However, the assessment has revealed that there are key issues and risks which need to be addressed in the implementation of the procurement aspect of the SME Finance Project. According to the findings of the assessment the key issues and risks for the implementation of procurement under the SME Finance Project include lack of systematic procurement planning and follow-up in procurement, lack of procurement proficient personnel in the procurement and property administration case team for executing procurement of goods and services under a Bank financed project, lack of experience in the use of World Bank SBDs/RFPs which are to be used under the proposed project, lack of experience in the evaluation and award of contract using the Bank's standard forms for bids/proposals evaluation, lack of skill development schemes for procurement personnel, and the level of pay scale for procurement personnel which is too low to attract qualified procurement personnel. Moreover, lack of adequate experience in the case team in procurement record keeping under a safe and secure environment, lack of experience in contract administration and management, a high level of staff turnover, and the inadequacy of the procurement environment for implementation of projects appear to be the major risks in the implementation of procurement activities under the SME Finance Project.

75. Based on the foregoing findings, the procurement risk for the project is rated high. On the basis of the findings of the assessment mitigation measures are proposed. The identified risks and proposed risk mitigation measures are provided in Table 3.2 below.

Action Plan to Mitigate Procurement Risks

Table 3.2. Summary of Findings and Actions (Risk Mitigation Matrix)

No.	Major Findings/Issues	Actions Proposed	Responsibility	Targeted Date

No.	Major Findings/Issues	Actions Proposed	Responsibility	Targeted Date
1.	Inadequate capacity at the Ministry of Industry to handle procurement activities under the SME Finance Project	1. Establish a PIU which shall have a strong procurement unit to handle procurement activities under the project. 2. Employment of qualified and procurement proficient consultants acceptable to the Association in the PIU. 3. Provide procurement staff at the PIU with the necessary facilities to create conducive working environment including mobility to facilitate procurement activities under the project.	MOI	One month after project effectiveness
2.	Lack of familiarity with World Bank procurement procedures	1. Procurement staffs shall be provided with basic procurement training in the procurement of goods and equipment, and selection and employment of consultants offered at the Ethiopian Management Institute (EMI). 2. Staff of MOI involved in the implementation and decision making of procurement activities such as Tender/Bid Approval Committee members, and bid evaluation committee members shall be provided with procurement clinics on procurement procedures under Bank financed projects.	MOI	Two months after project effectiveness
3.	Lack of systematic procurement planning and follow-up in procurement	1. Make systematic procurement planning and follow-up a requirement as part of the preparation of annual work plan and budget. 2. Train procurement staff in the preparation and use of procurement plan as a planning, follow-up and monitoring and management decision making mechanism.	MOI/PIU	During project implementation
4.	The need for written procedural manuals/systems in place including procurement code of ethics	1. Prepare a procurement manual of the SME Finance Project which provides detailed and step by step procedures for the implementation of the procurement activities of the Project. 2. Include procurement code of ethics in the manual. 3. Provide training on the use of the procurement manual. 4. Disseminate the procurement manual to all concerned in the implementation of the procurement activities of the project.	MOI	One month after project effectiveness

No.	Major Findings/Issues	Actions Proposed	Responsibility	Targeted Date
5.	Lack of capacity in procurement data management and maintenance of procurement audit trail Inadequate facility for storage of procurement records	1. Procurement clinic on procurement records keeping to be provided to procurement staff of the project. 2. Establish satisfactory procurement data management system. 3. Provide adequate facility for safe keeping and storage of procurement records.	MOI	During project implementation
6.	High level of staff turnover	1. Make employment at MOI attractive to procurement staff by providing the necessary incentives.	MOI	During project implementation

Procurement Oversight and Supervision Plan

76. The Bank will provide oversight over procurement activities through 'prior' and 'post reviews'. Prior reviews will be based on the risk level assessed by the Bank during appraisal and shall be updated annually. Post reviews will be carried out by Bank staff or consultants in the PIU. Based on the initial risk rating, which is high, the borrower shall seek Bank prior review for equivalent value of contracts as detailed in Table 3.3**.**

Table 3.3. Procurement Methods and Prior Review Thresholds

Category	Prior Review Threshold (US$)	ICB Threshold (US$)	National Short List Maximum Value (US$)
Works	≥ 5,000,000	≥ 7,000,000	n.a.
Goods	≥ 500,000	≥ 1,000,000	n.a.
Consultants (Firms) Consultants (Engineering and works supervision)	≥ 200,000 ≥ 300,000	n.a. n.a.	< 200,000 < 300,000
Consultants (Individuals)	≥ 100,000	n.a.	n.a.

Readiness for Implementation and Procurement Plan

Procurement Plan

77. The borrower has prepared and submitted a Procurement Plan for the first 18 months of the project life which provides the basis for the procurement methods. This plan is agreed between the borrower and the project team and will be available at the project coordination unit at the DITD of the MOI. It will also be available in the project's database and on the Bank's external website. The Procurement Plan will be updated annually in agreement with the project team or as required to reflect the actual project implementation needs and improvements in institutional capacity. Details of the Procurement Arrangements are provided below.

Goods, Works, and Non-consulting Services

Table 3.4. List of Contract Packages to be Procured following ICB and Direct Contracting Procedures

1	2	3	4	5	6	7	8

Ref. No	Contract (Description)	Estimated Cost (US$)	Procurement Method	Pre-qualification (Yes/No)	Domestic Preference	Review by Bank (Prior/Post)	Expected Bid Opening Date
1	Supply, installation, and commissioning of the hardware and associated software and licenses, for the collateral registry	500,000	NCB	Prior	No	Prior	Oct. 1, 2016
2	Procurement of project vehicles, 4 wheel drive	130,000	Shopping	Post	No	Post	July 1, 2016
3	Office Furniture	5,000	Shopping	Post	No	Post	July 1, 2016
4	IT equipment for PIU staff	12,000	Shopping	Post	No	Post	July 1, 2016

Table 3.5. List of Consulting Assignments with Short List of International Firms

1	2	3	4	5	6
Ref. No.	**Description of Assignment**	**Estimated Cost (US$)**	**Selection Method**	**Review by Bank (Prior/Post)**	**Expected Proposals Submission Date**
1	ICR Diagnostic – International Consultant	100,000	IC	**Prior**	Jan. 1, 2017
2	ICR Diagnostic – Local Consultant	20,000	IC	**Post**	Jan. 1, 2017
3	Collateral registry – provision of capacity building and training related to the adoption of the new IT, hardware and software solutions (international or local TBD)	100,000	IC	**Prior**	Oct. 1, 2017
4	BDS Needs assessment of SMEs in Ethiopia	300,000	QCBS	**Prior**	Dec. 1, 2016
5	Business Development Services to 912 SMEs	1,700,000	QCBS	**Prior**	Oct. 1, 2017
6	Consultancy Service for Baseline Survey	250,000	QCBS	**Prior**	Jan. 1, 2017
7	M&E System Design	200,000	QCBS	Prior	Nov. 1, 2016
8	Project Coordinator	72,000	IC	Prior	July 1, 2016
9	FM Specialist	50,400	IC	Post	July 1, 2016
10	Procurement Specialist	50,400	IC	Prior	July 1, 2016
11	M&E Specialist	50,400	IC	Post	July 1, 2016
12	Non-Financial Services Coordinator	50,400	IC	Post	July 1, 2016

78. **Short lists composed entirely of national consultants.** Short lists of consultants for services estimated to cost less than US$200,000 equivalent per contract may be composed entirely of national consultants in accordance with the provisions of paragraph 2.7 of the Consultant Guidelines.

79. All consultancy services for the selection and employment of procurement and legal consultants, regardless of the contract amount, shall be subject to the Bank's prior review.

80. ToR for all consultancy services shall be cleared by the Bank.

81. The selection of ICs will normally be subject to post review. Prior review will be done in exceptional cases only, for example, when hiring consultants for long-term technical assistance or advisory services for the duration of the project and prior review of these contracts will be identified in the procurement plan.

82. A procurement manual of the project shall be prepared and submitted to the Bank for approval one month after project effectiveness.

83. Project procurement staff, as detailed in this annex, shall be employed and shall be provided the necessary procurement training two months after project effectiveness.

Safeguards

84. **The project is categorized as a Financial Intermediary (FI) project and the appropriate FI category is FI-2.** This is based on anticipated environmental and social risk impacts of sub-projects as assessed by the World Bank in accordance with OP/BP 4.03 (World Bank Performance Standards for Private Sector Activities). According to the requirements under this World Bank policy, the project will put in place adequate systems and processes, acceptable to the Association, to mitigate any potential risks and impacts.

85. **The two implementation agencies are DBE and MoI and relevant aspects of performance standards will be applied only for activities under Component 1 which is managed by DBE.** DBE will be responsible for Component 1 of the project, covering leasing and lending, and will address any environmental and social risks and impacts through the existing PMT that has a considerable experience working with the World Bank (under the WEDP project), including environmental and social risk management (WB Safeguards). The sub-project activities under Component 1 could potentially have only limited adverse environmental and social risks and impacts that are expected to be generally site-specific and minor, largely reversible, and readily addressed through the agreed mitigation measures, including disclosing environmental and social policy statement, and procedures for screening and assessing risks as well as human resources policy, containing the formal rules and guidelines that the DBE will follow in hiring, training, assessing, and rewarding its workforce (permanent and temporary staff) and their rights and obligations as employees and with the DBE, as the employer.

86. **The project will not finance any activities that involve land acquisition.** MoI will be responsible for Component 3 which covers capacity building and business development for the SMEs and these activities are expected to have no adverse environmental or social risks and impacts.

87. **The project will support relatively small lease finance arrangements and working capital loans for enterprises involved in small scale manufacturing sector with relatively low potential environmental and social risks and impacts.** However, it is recognized that there may be some business activities in which the environment and social risk and impacts may potentially be more significant and may require commensurate assessment and management. Business activities of SMEs can potentially generate impacts on the environment, present a hazard to human health or negatively affect local communities as a result of improper planning or management. Environmental and social concerns for SMEs are typically associated with production processes or other activities that generate emissions and byproducts that are potentially harmful to the environment, employees and communities (e.g. issues around labor standards, inappropriate disposal of waste, or unhealthy or hazardous working conditions).

88. **To mitigate against any potential risks, the Development Bank of Ethiopia will put in place and implement an adequate environmental and social management system (ESMS), acceptable to the Association and endorsed by DBE's senior management.** The ESMS will account for the full scope and scale of environmental and social risks present in SME financing. The ESMS will also build on the revision and update of DBE's 'Environmental Assessment Procedure' and 'Environmental Assessment Policy' which outlines the decision-making process, policies, and procedural steps it uses during the implementation of WEDP. It will, at a minimum, specify: (a) organizational capacity, including duties and responsibilities within the DBE for managing environmental and social issues as it relates to sub-project/sub-loan/lease financing evaluation procedures; (b) procedures for screening and assessing risks and impacts of sub-projects or individual loan transactions; and (c) provisions for periodic progress reports to financial institutions' senior management. DBE ESMS will include adequate procedures to ensure that all subprojects supported by the Bank comply with applicable national and local laws and regulations, as well as are screened against the Project Exclusion List, including acquisition of land.

89. **The DBE ESMS should incorporate relevant principles of Performance Standard 1 on Assessment and Management of Environmental and Social Risks and Impacts.** Furthermore, the ESMS will ensure that proposed business activities that present higher social and/ or environmental risks will be operated in a manner consistent with the World Bank Performance Standards 1–8. DBE will also manage the working conditions of their workforce in accordance with relevant aspects of Performance Standard 2 on Labor and Working Conditions through development and implementation of appropriate human resource policies and procedures acceptable to the Bank and will require the same of the PFIs.

90. **DBE will also ensure that all participating financial institutions (PFIs) develop an ESMS commensurate with the level of social and environmental risks in their portfolio, and prospective business activities**. As part of its due diligence, DBE will make sure that PFIs apply Performance Standards to higher-risk transactions, taking into account the transaction size, tenor, type, sectors; and will make sure that compliance with applicable national and local laws and regulations, as well as screening against the Project Exclusion List is included as a requirement. The Borrower institutional capacity, as well as that of PFIs, in addressing environmental and social issues will be enhanced through assigning and training dedicated staff to be responsible for the ESMS.

Monitoring & Evaluation

91. The implementation of the SMEFP M&E system will ensure that timely data is collected to inform project activities, and that all data necessary for the reporting on the results indicators is collected.

92. In addition to the indicators in the results framework, the SMEFP M&E system will monitor the additional indicators listed in Annex 8 below for analytical purposes. The responsibility for reporting will rest with the PIU, PMT, DBE and PFIs.

93. The SMEFP M&E system will be housed electronically. A central project database will be utilized to store all information on SMEFP clients, including registration data, access to

financial products and BDS. A web portal will enable all project partners to access the M&E system. To the extent possible, the SMEFP will aim to build on existing government databases, with the support of an IT consultancy firm to modify and upgrade systems as needed.

94. Project data will draw on four major sources: membership registration, implementing agency reports, financial institution reports and impact evaluation surveys.

95. **Membership registration.** Membership registration will be done at the program entry point for all participants, and the registration form will capture basic information from entrepreneurs and their enterprises. The Project Implementation Manual (PIM) will detail the process to be followed as well, but it is expected that registration will include information on business characteristics such as business sector and sub-sector, age of business, age of start-up capital, previous credit history, annual earnings, and number of employees, as well as on characteristics of the entrepreneur, such as age, education level, and experience.

96. Each registrant will receive an ID card and an automatically generated unique ID number, and their information will be stored by ID number in a central project database, accessible online to all implementers. This baseline data will help to inform the analysis of beneficiaries' performance and will additionally qualify its findings. The unique, 10-digit membership number will serve as the central individual identifier that will enable the establishment of linkages between different data sources.

97. **Implementing agency reports.** In order to leverage preexisting structures and institutions, the PMT will be responsible for establishing, managing and reporting the M&E system for Component 1. The PIU within the MoI will be responsible for establishing and managing the M&E system for Components 2, 3, and 4. This will include data collection, compilation and reporting from relevant stakeholders and implementing agencies for Components 2, 3 and 4. An M&E Framework will be established and detailed in the Operations Manual. Both the PMT and PIU will provide bi-annual and annual progress reports.

98. **Financial Institution reports.** All financial institutions tapping the line of credit offered by SMEFP are required to fulfill a number of reporting requirements which will provide a wealth of information to the project. Each FI should report on every loan or lease product disbursed, including the amount, date of the agreement with borrower, business sector of borrower, name of borrower, and ID number of borrower. These reports will be compiled by the PIU in DBE on a monthly basis.

99. **Impact evaluation surveys.** The impact evaluation will largely build on a panel data set containing information on individuals in the treatment and control group. The impact evaluation sample will be a random sub-set drawn from the project’s registration data. Conditional on sufficient implementation, the baseline and end line data collection will be complemented by a midterm survey. The survey tools will be designed to capture extensive information on the entrepreneurial/business activities of respondents. The impact analysis will be able to measure the project's effectiveness on indicators for standard business performance, such as income and employment. The impact evaluation will also contain qualitative studies of a range of issues to provide evidence on the results of the program.

Role of Partners (if applicable)

100. **Several development partners have expressed interest in contributing (through external financing) to complementary activities to be coordinated under the SME Finance Project umbrella.** In particular, the intention of DFID to support the technical assistance activities to PFIs under Component 1 has been confirmed. This support will be provided externally, in line with the WEDP model. The European Investment Bank (EIB) will jointly co-finance Component 1 of the project through a bilateral loan of EUR 70 million (or equivalent in US$) between EIB and GoE to be then managed under World Bank's supervision and procedures. The Multi-Donor Initiative (MDI) will support technical assistance on the collateral registry (in coordination with the Financial Inclusion Support Framework) and has agreed, in principle, to support the provision of specialized training on leasing, banking (under Component 1 and subject to PEPE's coordination in the TA facility) and the provision of specialized services to SMEs under Component 3. The European Union has expressed an interest in supporting the impact evaluation activities under Component 4.

Annex 4: Implementation Support Plan

FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA: Small and Medium Enterprise (SME) Finance Project

1. **Overall.** This implementation support plan (ISP) describes how the World Bank will support the risk mitigation measures and provides the technical advice necessary to help the client achieve the PDO. This ISP also identifies the minimum requirements to meet the World Bank's fiduciary obligations. It has been developed based on the nature of the project and its risk profile. Formal implementation support visits and field visits will be carried out semi-annually and focus on the areas detailed below.

2. There will be strong coordination between the World Bank, the PMT and the PIU, the party responsible for day-to-day administrative project management. The World Bank task team will bring a comprehensive set of instruments and expertise to advise on project activities. It will work closely with the PIU to ensure project success and take a flexible approach to ensure that it meets client needs as circumstances evolve. The team will conduct three implementation support visits on average per year to Ethiopia, as well as maintain an ongoing dialogue via audio conferences and email.

3. In addition to implementation support visits and ongoing engagement, the World Bank project team will carefully monitor the progress of project implementation and achievement of results via formal and informal reporting channels. Formal reporting channels include ISRs, and results monitoring reports supplied by the PIU. Informal channels include interaction with direct beneficiaries of the project, reports from local media, and country economic analysis.

4. Moreover the World Bank project team will establish a Project Implementation Committee composed by one representative for each key implementing partner (PIU in MoI, PMT in DBE, WB, EIB, relevant donors). The committee will meet once a month and will work on the basis of an action matrix outlined a detailed set of tasks to be completed within the coming month to allow for a smooth implementation.

5. **Financial Management.** The project will have on-field supervision at least twice a year. This is in addition to regular implementation support, desk assessments, quarterly IFR reviews and annual audit report reviews. After each supervision, the risk will be measured and recalibrated accordingly. Supervision activities will include: the compliance with the agreed up on FM arrangements, review of quarterly IFRs; review of annual audited financial statements as well as timely follow-up of issues arising; transaction review; participation in project supervision missions as appropriate; and updating the FM rating in the ISR.

6. **Monitoring and Evaluation.** The monitoring and evaluation (M&E) system will be based on the Results Framework and will be used to track and monitor progress and impact. The framework is meant to measure project activities using the monitoring arrangements described in Annex 1. Since the project takes a programmatic approach in Ethiopia, activities of other related project holistically strengthen the effects of this project's outcomes, and many programmatic (and in some cases intermediate) outcomes may be in line with other related activities outside of the SME Finance project. In order to leverage preexisting structures and institutions, the PMT will be responsible for establishing, managing and reporting the M&E system for Component 1. The PIU within the MoI will be responsible for establishing and managing the M&E system for Components 2, 3, and 4. This will include data collection, compilation and reporting from relevant stakeholders and implementing agencies for Components 2, 3 and 4. An M&E Framework will be established and detailed in the Operations Manual. Both the PMT and PIU will provide bi-annual and annual progress reports. The project will also undertake an impact evaluation to assess outcomes. It will support rigorous empirical analysis based on a quantitative comparison of a treatment and control groups before and after access to specific project interventions.

Implementation Support Plan

7. The tables below detail the key areas of focus of the implementation support activities for the duration of the project's term. These have been determined based on an understanding of the priority activities to be implemented over the life of the project. Future updates will be based on progress on project activities, timing of major new activities, and the expertise required to address any issues that arise, among other things.

Implementation Support Plan

Time	***Focus***	***Skills Needed***	***Resource Estimate***	***Partner Role***
Year 1	Project/Task Management	TTL / Financial Sector Specialist (HQ)	12 weeks	PIU: Project Coordinator
	Procurement Supervision	Procurement Specialist (Addis)	2 weeks	PIU: Procurement Specialist
	Financial Management Supervision	Financial Management Specialist (Addis)	3 weeks	PIU: Financial Management Specialist

	Performance Standards Supervision	Environmental & Social Specialists (Addis)	3 weeks	PMT: Safeguards Specialist
	Implementation Support	2 Sector Specialists (Addis)	8 weeks	PIU: Project Coordinator
Years 2–5	Project/Task Management	TTL / Financial Sector Specialist (HQ)	36 weeks	PIU: Project Coordinator
	Procurement Supervision	Procurement Specialist (Addis)	8 weeks	PIU: Procurement Specialist
	Financial Management Supervision	Financial Management Specialist (Addis)	8 weeks	PIU: Financial Management Specialist
	Performance Standards Supervision	Environmental & Social Specialists (Addis)	8 weeks	PMT: Safeguards Specialist
	Implementation Support	2 Sector Specialists (Addis)	24 weeks	PIU: Project Coordinator

Skills Mix Required (over 60 month period)

Skills Needed	*Number of Staff Weeks*	*Number of Trips*	*Comments*
TTL/Financial Sector Specialist	48	16	Based in HQ
Procurement Specialist	6	0	Based in Addis
Financial Management Specialist (Pretoria)	6	0	Based in Addis
Environmental Specialist	10	0	Based in Addis
Social Specialist	10	0	Based in Addis
Sector Specialists	32	0	Based in Addis

Partners

Name	*Institution/Country*	*Role*
PIU	MoI / Ethiopia	Implementing Agency - Administrative management
PMT	DBE / Ethiopia	Implementing Agency - Credit line management
DFID	UK	Provider of external funding for TA under Component 1
EIB	International Financial Institution	Provider of joint financing to DBE
MDI	Multi Donors Initiative	Provider of external funding for TA under part of Component 1 and part of component 3
EU	European Union Delegation	Provider of external funding for Component 4 (impact evaluation)

Annex 5: Economic and Financial Analysis

FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA: Small and Medium Enterprise (SME) Finance Project

1. The strategic focus of this project is to increase access to finance for eligible SMEs in Ethiopia. Access to finance for SMEs remains a major challenge in Ethiopia. While the majority of micro and small enterprises do have checking and savings accounts, only 6 percent of micro enterprises, 1.9 percent of small enterprises, and 20.5 percent of medium have a loan or a line of credit[43]. Collateral requirements remain high at around 200 percent of loan amount, although improvement is observed compared to the 2011 Enterprise Survey data when these requirements were at 234 percent. There are some significant ongoing efforts to create an enabling legal and regulatory environment to promote SME access to finance in the country, since constrained access to finance hinders SMEs' growth and ability to generate new jobs. Enabling access to financial services for these SMEs, which will be achieved by this project, will, therefore, accelerate their growth and competitiveness, as well as generating a more sustainable growth for the country's economy. In addition, access to finance is vital to poverty reduction and improve health, education, gender equality, which will enhance shared prosperity.

2. The economic and financial analysis of this project will focus on Component 1: Access to Finance for SMEs. This component accounts for more than 95 percent of the total project financing: US$269 million out of US$276 million. This includes US$193 million from the WB, as well as EUR 70 million that is assumed to be equivalent to US$76 million from the EIB. The component aims at providing eligible financial intermediaries with a line of credit facility for the provision of leasing and working capital finance to eligible small and medium enterprises (SMEs). This liquidity support will be complemented with mandatory technical assistance aimed at supporting participating financial institutions (PFIs) in designing, piloting, and rolling out financial products utilizing novel lending methodologies (i.e. cash flow-based lending) to successfully expand their outreach to the target SMEs. The technical assistance support will be funded externally through bilateral agreements with development partners.

3. The economic and financial analysis aims to assess the benefits of the project associated with (a) the impact on the increased availability and access to finance for SMEs, and (b) The impact on the additional revenue generated by both SMEs and PFIs as compared to the associated costs.

Impact of the Project on the Access to Finance for SMEs

Reference Scenario (Base Case):

4. The economic analysis, mainly based on Component 1, aims to quantify the larger economic impact of the project. The project is expected to have a catalytic effect on the SME finance through both the leasing and the line of credit channel. The technical assistance embedded in Component 1 will instill knowledge about new lending and leasing techniques, strengthen the capacity of financial intermediaries to help them make profitable lending to

[43] SME Finance in Ethiopia: Addressing the missing middle challenge, WBG.

SMEs, and provide support for institutional development geared toward enhancing SME finance. As a result of improved market conditions on both the supply and demand sides, it is expected that banks will scale up their SME lending beyond the facilities (leasing and line of credit) provided by the project.

Counterfactual

5. Without the project, over six years period under consideration, the ratio of SME loans to total financial sector assets is expected to remain at 7.5 percent and the ratio of SME financing to total financing is expected to remain at 73 percent. SME Financing refers to lending provided by Microfinance institutions, Commercial Banks and DBE, as well as leasing provided by DBE and leasing companies to the eligible SMEs.

Base Case

6. With the project, the ratio of SME loans to total financial sector assets is expected to grow from 8.0 percent in 2016 to 13.2 percent in 2021. The ratio of SME financing to total financing will grow from 74.3 percent to 83.4 percent.

7. Without the project, the SME financing is projected to grow from ETB 43 billion (US$2.2 billion) in 2016 to ETB 70 billion (US$3.5 billion) in 2021.

8. With the project, the SME financing is projected to grow from ETB 47 billion (US$2.3 billion) to ETB 130 billion (US$6.5 billion). The additional financing to SMEs over the six years will sum up to ETB 142 billion (US$8 billion), which equals to 19 percent of Ethiopia's projected real GDP in 2016.

Figure 5.1. Volume of Additional SME Financing

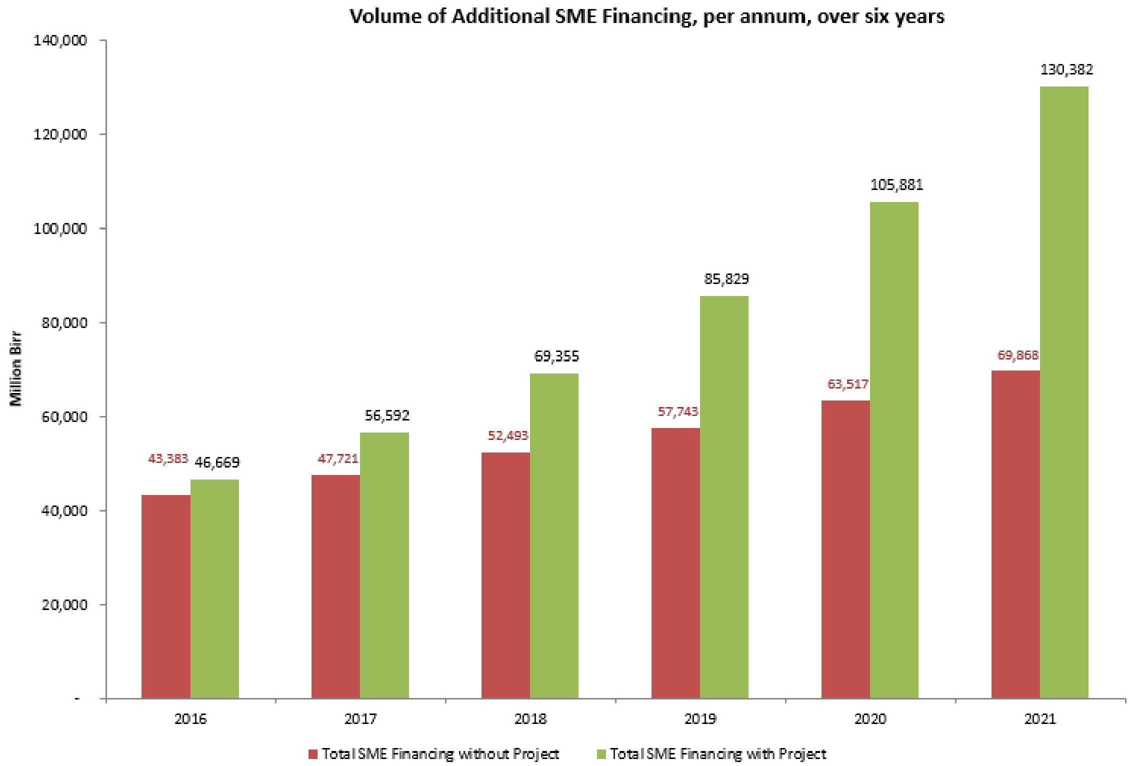


Table 5.1. Six Year Projections

Items	Unit	2016	2017	2018	2019	2020	2021
Real GDP	Million Birr	735,983	792,136	851,937	915,826	984,480	1,053,394
Total Financing*	Million Birr	62,819	74,357	88,897	107,325	129,526	156,392
Counterfactual - SME Financing without Project							
Total SME Financing without Project	**Million Birr**	**43,383**	**47,721**	**52,493**	**57,743**	**63,517**	**69,868**
MicroFinance Institutions Lending	Million Birr	*17,938*	*19,731*	*21,705*	*23,875*	*26,262*	*28,889*
Commercial Banks & DBE Lending	Million Birr	*19,087*	*20,996*	*23,095*	*25,405*	*27,946*	*30,740*
DBE Leasing	Million Birr	*5,610*	*6,171*	*6,788*	*7,467*	*8,214*	*9,035*
Leasing Companies	Million Birr	*748*	*823*	*905*	*996*	*1,095*	*1,205*
Total Financing without Project	**Million Birr**	**59,533**	**65,486**	**72,035**	**79,238**	**87,162**	**95,878**
Total Financial Sector Asset**	**Million Birr**	**577,347**	**635,082**	**698,590**	**768,449**	**845,294**	**929,823**
Total Assets MFI	Million Birr	30,450	33,495	36,845	40,529	44,582	49,040
Total Assets Commercial Banks	Million Birr	*506,525*	*557,177*	*612,895*	*674,184*	*741,603*	*815,763*
Total Assets DBE	Million Birr	*39,292*	*43,222*	*47,544*	*52,298*	*57,528*	*63,281*
Total Assets Leasing Companies	Million Birr	*1,080*	*1,188*	*1,307*	*1,437*	*1,581*	*1,739*
Volume of SME Financing/Real GDP	**%**	**5.9%**	**6.0%**	**6.2%**	**6.3%**	**6.5%**	**6.6%**
Volume of SME Financing/Total Financing	**%**	**72.9%**	**72.9%**	**72.9%**	**72.9%**	**72.9%**	**72.9%**
Volume of SME Financing/Total Financial Sector Asset	**%**	**7.5%**	**7.5%**	**7.5%**	**7.5%**	**7.5%**	**7.5%**
Base Case Scenario - SME Financing Market with Project							
Total SME Financing with Project	**Million Birr**	**46,669**	**56,592**	**69,355**	**85,829**	**105,881**	**130,382**
MicroFinance Institutions Lending	Million Birr	19,446	25,334	33,045	43,142	56,241	73,230
Commercial Banks & DBE Lending	Million Birr	20,692	23,437	26,594	30,235	34,321	38,901
DBE Leasing	Million Birr	5,763	6,732	8,047	9,830	11,731	13,727
Leasing Companies	Million Birr	768	1,088	1,670	2,623	3,588	4,525
Total Financing with Project	**Million Birr**	**62,819**	**74,357**	**88,897**	**107,325**	**129,526**	**156,392**
Total Financial Sector Asset	**Million Birr**	**580,633**	**643,952**	**715,452**	**796,536**	**887,658**	**990,337**
Volume/Real GDP	**%**	**6.3%**	**7.1%**	**8.1%**	**9.4%**	**10.8%**	**12.4%**
Volume of SME Financing/Total Financing	**%**	**74.3%**	**76.1%**	**78.0%**	**80.0%**	**81.7%**	**83.4%**
Volume of SME Financing/Total Financial Sector Asset	**%**	**8.0%**	**8.8%**	**9.7%**	**10.8%**	**11.9%**	**13.2%**

**Total Financing: Total Leasing and Lending provided*
*** Total Financial Sector Balance Sheet: Total Assets from Commercial Banks, DBE, Leasing Companies and MFIs.*
1 USD = 20 Birr
Real GDP Data: IMF World Economic Outlook Database

9. The Counterfactual SME financing market size has been estimated using various sources of information combined with some assumptions. The sources of information includes the most recent Annual Report from the National Bank of Ethiopia (NBE), Development Bank of Ethiopia (DBE), Commercial Bank of Ethiopia (CBE), the recently published Ethiopia SME Finance Study, and the meetings with the financial institutions during the preparation mission, etc. Below are the Assumptions:

- PFIs grow their working capital finance portfolio by 10 percent annually without the project and 13 percent annually with the project. 80 percent of MFI's loans are to SMEs, and 60 percent of Commercial Banks and DBEs' loans are to SMEs.

- DBE grow its leasing portfolio by 10 percent annually without the project and 13 percent annually with the project, for both wholesale and retail business.

- The biggest two leasing companies, Addis Capital Goods and Oromia, account for 50 percent of the total leasing market.

- Total Financing include total leasing and working capital finance provided by MFIs, Commercial Banks, DBE and Leasing companies only (Since they are only type of institutions participating the Leasing and Line of Credit scheme).

- Total Financial Sector Balance Sheet represents the total assets of these MFIs, Commercial Banks, DBE and Leasing Companies only.

10. The assumptions used for the base case scenario are as the following:

- Among the US$276 million financed by WB and EIB, US$269 million is used for and the Financial Service to SME component (Component 1), and will split 80:20 between leasing and working capital financing.

- The leasing portfolio (US$215 million) will be split 50:50 between DBE and the 5 leasing companies.

- The working capital finance portfolio (US$54 million) will be split 50:50 between Commercial Banks and MFIs.

- The disbursement for both leasing and working capital finance is shown in the below table:

Table 5.2. Estimated Disbursement

Disbursement for Component 1 (USD)	2016	2017	2018	2019	2020	2021	Total
Working Capital	-	5,000,000	10,000,000	16,000,000	13,000,000	9,800,000	**53,800,000**
Leasing	-	20,000,000	40,000,000	64,000,000	52,000,000	39,200,000	**215,200,000**
Total	-	**25,000,000**	**50,000,000**	**80,000,000**	**65,000,000**	**49,000,000**	**269,000,000**

- The technical assistance will have a positive effects on both leasing and working capital finance portfolios as of year 2 (2017) due to the enhanced know-how and capacity for PFIs to finance SMEs through leasing and lending. This positive effect will translated as the additional financing as a percentage of the total liquidity injection of these years (2017–2020).

- Therefore, the US$269 million (Birr 5,380 million) liquidity injection into the project, with additional financing generated by PFIs due to technical assistance (US$42.3 million, or Birr 846 million), will result in US$311.3 million (Birr 6,226 million) liquidity to the PFIs. The additional liquidity injection and the positive effects on Technical Assistance is shown in the table below:

Table 5.3. Liquidity Projections and Effects of TA

	Liquidity injection per annum (Million Birr)						
Type of Institutions	2016	2017	2018	2019	2020	2021	Total
LoC	-	***100***	***200***	***320***	***260***	***196***	***1,076***
MFIs	-	*50*	*100*	*160*	*130*	*98*	*440*
Commercial Banks	-	*50*	*100*	*160*	*130*	*98*	*440*
Leasing	-	***400***	***800***	***1,280***	***1,040***	***784***	***4,304***
DBE Leasing	-	*200*	*400*	*640*	*520*	*392*	*1,760*
5 Leasing Companies	-	*200*	*400*	*640*	*520*	*392*	*1,760*
Total	-	**500**	**1,000**	**1,600**	**1,300**	**980**	**5,380**

	Additional financing generated by PFI due to Technical Assistance (Million Birr)						
Type of Institutions	2016	2017	2018	2019	2020	2021	Total
LoC	-	***10***	***20***	***48***	***52***	***39***	***130***
MFIs	-	5	10	24	26	20	85
Commercial Banks	-	5	10	24	26	20	85
Leasing	-	***40***	***80***	***192***	***208***	***157***	***520***
DBE Leasing	-	20	40	96	104	78	338
5 Leasing Companies	-	20	40	96	104	78	338
Total	-	**50**	**100**	**240**	**260**	**196**	**846**

Impact of the Project on SMEs and PFIs

11. The project will also help SMEs boosting their productivity and generating more revenues. The increased benefits, which is mainly contributed by the additional revenue generated by both SMEs and PFIs, will exceed the costs associated with the project and will result in a positive NPV.

The Analytical Model

12. The model considers the net cost and benefits of SME financing under both leasing and working capital finance mechanism due to the World Bank's line of credit. This analysis is limited to the net cost and benefits arising directly from the US$269 million for the working capital and leasing mechanism under Component 1. It is assumed that the joint WB-EIB's line of credit will be allocated in the proportion of 80:20 to the leasing and working capital finance mechanism for US$215 million and US$54 million respectively. It is also assumed that the disbursement schedule is shown in Table 5.2 during the 6 year project life.

13. All calculations are in Birr. For ease of conversion and comparison, an exchange rate of US$1 = Birr 20 is assumed. Given the structure of the loan, the economic analysis considers the net cost and benefits over 20 years, the life of the loan.

14. The cost component of the analysis considers the net cost for DBE in (a) channeling wholesale loans to PFIs which on-lend to end-borrower SMEs, (b) channeling wholesale lease finance to the leasing companies and (c) provide retail leasing finance to SMEs. In particular, the cost component models the cost of the joint WB-EIB's line of credit to DBE while taking into consideration the interest and fees DBE earns, as well as any net cost DBE incurs on these three activities.

15. The benefit component of the analysis considers the net benefits arising from the leasing and working capital finance to income generation and tax revenue while accounting for the interest payments made by the end-borrowers. The net benefits are calculated based on the estimated difference in cash flow to beneficiaries. As a result of the project, eligible SMEs, the end-borrowers of the funds, will be able to start-up or expand their business, improve their productivity.

16. The model takes the assumption that the financing agreement would follow the IDA credit pricing as per suggested by the Treasury department, which is 1.38 percent regular charged on disbursed balance on 38 years. The loan will be disbursed within the first six years, which is the same as the project implementation period.

17. The Technical Assistance embedded under Component 1 (externally funded) is taken into account in the model. The total value of technical assistance is ETB 120,000 (US$6 million). This cost is split evenly between working capital finance and leasing subcomponent, and distributed evenly over the six years.

Working Capital Finance

18. According to the analysis on the working capital finance mechanism, the ERR of this subcomponent is expected to be 13 percent. The NPV is expected to be about ETB 206 million (or US$10 million) assuming a 10 percent discount rate; or ETB -55 million (or US$-2.7 million) assuming a 12 percent discount rate. The assumed discount rates are similar to the current lending rates of the commercial banks in Ethiopia.[44] This is based on the assumption that interest rate charged by DBE is 9 percent (current Bond Price + 3 percent premium, as discussed with DBE during the project pre-appraisal.) The interest rate is slightly lower than the interest rate commercial banks charge to the SMEs (12–15 percent), in order to ensure sustainability. The positive valuation indicates that the returns on investment exceed the returns that could otherwise be earned by World Bank financing. As such, the improvements in the income of both PFIs and end-borrowers, net of interest costs paid by end-borrowers, outweigh the cost of investment under this component.

Table 5.4. Economic Analysis of Line of Credit Subcomponent

NPV (10 percent discount rate)	ETB 206 million
NPV (12 percent discount rate)	ETB 55 million
ERR	13 percent

19. The economic component of the working capital finance subcomponent is based on the following assumptions. The assumptions for the cost component of the analysis are summarized in Table 5.5 and the assumptions for the benefit component in Table 5.6.

20. Data and assumptions are estimates based on existing studies, annual reports, interviews and market data. In many cases, numbers were adjusted downwards to arrive at more conservative estimates.

21. It is assumed that the average annual revenue for SMEs that apply for loans are ETB 700,000. The average annual revenue growth without the project is assumed to be 5 percent for SMEs. It is assumed that SMEs (especially those engaging in the manufacturing sector) will grow very little without the necessary machineries to produce their goods. However, once they manage to obtain financing for the machineries, they are expected to grow an additional 30 percent per year.

[44] The recent interview with Dashen Bank and Awash Bank has indicated a lending rate of 12%.

22. The average annual revenue growth without the project is assumed to be 10 percent for PFIs, lower than the reported growth in Total Assets of 17 percent according to PFI's annual reports. The additional growth resulted by the project will be 3 percent.

23. The interest rate charged to end-borrower by PFIs is assumed to be 9 percent. This is close to the current bank's lending rate to SMEs. Therefore it is a sustainable rate for PFIs to provide lending to SMEs even after the WB project is fully disbursed.

24. Loan loss ratio is assumed to be 2.5 percent, as per our recent interview with the commercial banks.

Table 5.5. Cost Assumptions for Working Capital Finance

	Line of Credit
Interest rate due to World Bank by DBE	1.38%
Interest rate charged to PFIs by DBE	9.00%
Year 1 fees by PFIs to DBE	0.50%
Loan Loss Ratio	2.50%
Year 1 average loan size	Br5,000,000
Year 1 number of loans (disbursement/average loan size)	37
Growth rate in average loan size	0%
Growth rate in number of loans	5%

Table 5.6. Benefit Component Assumptions for Working Capital Finance

SMEs	
Average revenue	Br1,000,000
Percentage costs	80%
Average value added (revenue*(1- percent cost)	Br200,000
Annual growth (without loan)	5.0%
Annual additional growth increase with loan (Years 1–5)	30.0%
Number of years growth increases due to loan	6
Percentage of SMEs showing revenue additionally	100%
Tax rate	30%
PFIs	
Average revenue	Br629,351,460
Percentage costs	60%
Average value added (revenue*(1-%cost)	Br251,740,584
Annual growth (without loan)	10.0%
Annual additional growth increase with loan (Years 1–5)	3.0%
Number of years growth increases due to loan	6
Percentage of PFIs showing revenue additionally	100%
Tax rate	30%
Technical Assistance (year 1–5)	Br60,000,000

Leasing

25. According to the analysis on the leasing mechanism, the ERR of this subcomponent is expected to be 14 percent. The NPV is expected to be about ETB 852 million (or US$43 million) assuming a 10 percent discount rate; or ETB 313 million (or US$16 million) assuming a 12 percent discount rate. This is based on the assumption that interest rate charged by DBE is 9 percent (current DBE Bond Price + 3 percent premium, as discussed with DBE during the project pre-appraisal.). The interest rate is also similar to the current rate charged by the leasing companies (12 percent) in order to ensure sustainability. The positive valuation indicates that the returns on investment exceed the returns that could otherwise be earned by World Bank financing. As such, the improvements in the income of both PFIs and end-borrowers, net of interest costs paid by end-borrowers, outweigh the cost of investment under this component.

Table 5.7. Economic Analysis of Leasing Subcomponent

NPV (10% discount rate)	ETB 852 million
NPV (12% discount rate)	ETB 313 million
ERR	14%

26. The assumptions for the analysis of this subcomponent is as follows:

27. Leasing will reduce SME's costs from the 80 percent in the working capital finance assumptions to 60 percent. This is the saving on the operational costs due to leasing rather than owning the physical assets (machineries).

28. Average annual revenue is ETB 140 million for leasing companies and ETB 150 million for DBE.

29. It is assumed that DBE will issue 10 leases in year 1, with the average leasing size of ETB 15 million. And the leasing companies will issue 100 leases on year 1, with the average lease size of ETB 500,000.

30. Annual growth for the leasing companies and DBE is 10 percent without the project, and an additional 5 percent with the project.

31. Lease loss ratio is assumed to be much lower than the loan loss ratio, which is 0.5 percent, as versus to 2.5 percent loan loss ratio.

Table 5.8. Cost Assumptions for Leasing

	Leasing
Interest rate due to World Bank by DBE	1.38%
Interest rate charged to lease companies by DBE	9.00%
Year 1 fees by PFIs to DBE	0.50%
Lease Loss Ratio	0.50%
Year 1 average Lease size (DBE)	Br15,000,000
Year 1 number of leases (DBE)	10
Year 1 average Lease size (leasing companies)	Br500,000
Year 1 number of leases (leasing companies)	100

Growth rate in average lease size for DBE	0%
Growth rate in average lease size for leasing companies	0%
Growth rate in number of leases (for DBE & leasing companies)	5%

Table 5.9. Benefit Component Assumptions for Leasing

SMEs	
Average revenue	Br700,000
Percentage costs	40%
Average value added (revenue*(1-%cost)	Br420,000
Annual growth (without Lease)	5.0%
Annual additional growth increase with Lease(Years 1–5)	30.0%
Number of years growth increases due to Lease	6
Percentage of SMEs showing revenue additionally	100%
Tax rate	30%
DBE and Leasing Companies	
Average revenue Leasing Companies	Br140,000,000
Average revenue DBE leasing business	Br150,000,000
Percentage costs	60%
Average value added (revenue*(1-%cost)	Br116,000,000
Annual growth (without loan)	10.0%
Annual additional growth increase with loan (Years 1–5)	5.0%
Number of years growth increases due to loan	6
Percentage of PFIs showing revenue additionally	100%
Tax rate	30%
Technical Assistance (year 1–5)	Br60,000,000

Overall: Lending and Leasing combined

32. Overall, ERR is expected to be 14 percent for the combined impact of lending and leasing. The NPV is expected to be ETB 1.2 billion (US$111 million) with a discount rate of 10 percent, or ETB 412 million (US$39 million) with a discount rate of 12 percent. The positive valuation indicates that the returns on investment exceed the returns that could otherwise be earned by World Bank financing.

Table 5.10. Economic Analysis of Leasing Subcomponent

NPV (10% discount rate)	ETB 1,164 million
NPV (12% discount rate)	ETB 412 million
ERR	14%

Sensitivity Analysis

33. The sensitivity analysis is performed on the most important elements that affect the cash flow on the lending and leasing component respectively, which, in both case, are the interest earned by DBE from PFIs from performing the lending and leasing activities. Interest earned by

DBE are a key components in the cash flow projections for both lending and leasing activities, and therefore have large impact on the NPV result.

Sensitivity Analysis in the Working Capital Finance Subcomponent:

34. In the base case, it is assumed that the number of loans to end borrowers is 19, average loan size is Birr 5 million, and the interest rate charged to PFIs by DBE is 9 percent. As a result, the interest earned by DBE via lending is Birr 8.6 million. This interest earning varies depending on the actual number of loans given to the end borrowers, or average loan size, or the interest rate charged to the PFIs.

35. The table below shows that, if the number of loans to end borrowers reduce to 10, and the average loan size is Birr 1 million, the interest earned by DBE via lending will be only Birr 900k. On the contrary, if the number of loans to end borrowers increases to 30, and the average loan size increases to Birr 10 million, then the interest earned by DBE via lending will be Birr 27 million.

36. Same applies to the changes in the interest rate charged to the PFIs by DBE. The current assumed interest rate is 9 percent. If this rate reduces to 7 percent, with other factors stay constant, the interest earned by DBE from lending will be Birr 6.7 million. If the rate increases to 12 percent, which is the same rate used by the commercial banks for lending to SMEs currently, the interest earned will increase to Birr 11.4 million.

Table 5.11. Sensitivity Analysis on the Working Capital Finance Subcomponent

Sensitivity Analysis	
Number of loans to end borrowers	19
Average loan size	5,000,000
Interest rate charged to PFIs by DBE	9%
Interest Earned by DBE from PFIs for Lending	**8,550,000**

		Number of Loans to end borrowers				
Interest Earned by DBE from PFIs from Lending	**8,550,000**	10	15	19	25	30
Average Loan Size	1,000,000	900,000	1,350,000	1,710,000	2,250,000	2,700,000
	2,000,000	1,800,000	2,700,000	3,420,000	4,500,000	5,400,000
	3,000,000	2,700,000	4,050,000	5,130,000	6,750,000	8,100,000
	4,000,000	3,600,000	5,400,000	6,840,000	9,000,000	10,800,000
	5,000,000	4,500,000	6,750,000	**8,550,000**	11,250,000	13,500,000
	6,000,000	5,400,000	8,100,000	10,260,000	13,500,000	16,200,000
	7,000,000	6,300,000	9,450,000	11,970,000	15,750,000	18,900,000
	8,000,000	7,200,000	10,800,000	13,680,000	18,000,000	21,600,000
	9,000,000	8,100,000	12,150,000	15,390,000	20,250,000	24,300,000
	10,000,000	9,000,000	13,500,000	17,100,000	22,500,000	27,000,000

		Interest rate charged to PFIs by DBE					
		7%	8%	9%	10%	11%	12%
Interest Earned by DBE from PFIs from Lending	**8,550,000**	6,650,000	7,600,000	**8,550,000**	9,500,000	10,450,000	11,400,000

Sensitivity Analysis in Leasing Subcomponent

37. On the leasing side, as for the number of leases to end borrowers, it is assumed that DBE will lease to 10 SMEs, while leasing companies will lease to 100 SMEs. The average lease size

is assumed to be ETB 15 million for DBE and ETB 500k for the leasing companies. The interest rate charged to PFIs by DBE is assumed to be 9 percent.

38. If the number of SMEs DBE provides lease to is reduced to 1, and the average lease size is reduced to ETB1 million, then DBE will only earn ETB 60,000 on the interest. If the number of leases increases to 20, and the average lease size increases to ETB 30 million, DBE will earn ETB 36 million on interest.

39. Similarly, if the number of SMEs the leasing companies provide to SMEs are reduced to 50 and the average lease size is reduced to ETB 100k, then the leasing companies will only earn ETB 300,000 on interest. If the number of leases increase to 250, and the average lease size increase to ETB1 million, the leasing companies will earn Birr 15 million on interest.

40. The total interest earned by DBE and leasing companies on the leasing activities will also vary based on the change of interest rate charged to PFIs. If the interest rate is 5 percent, total interest earned is ETB 10 million. If the rate increases to 10 percent, then total interest earned from leasing activities will increase to ETB 20 million.

Table 5.12. Sensitivity Analysis on the Leasing Subcomponent

Sensitivity Analysis - leasing	
Number of Leases to end borrowers	**110**
DBE	*10*
Leasing Companies	*100*
Average Lease size	**1,000,000**
DBE	*15,000,000*
Leasing Companies	*500,000*
Interest rate charged to PFIs by DBE	**6%**
Interest Earned by DBE from PFIs for DBE Leasing	9,000,000
Interest Earned by DBE from PFIs for leasing companies leasing	3,000,000
Interest Earned by DBE from PFIs (total)	12,000,000

		No. of leases to end borrowers by DBE				
Interest earned from DBE leasing	**9,000,000**	*1*	*5*	*10*	*15*	*20*
Average lease size	*1,000,000*	60,000	300,000	600,000	900,000	1,200,000
	5,000,000	300,000	1,500,000	3,000,000	4,500,000	6,000,000
	15,000,000	900,000	4,500,000	**9,000,000**	13,500,000	18,000,000
	20,000,000	1,200,000	6,000,000	12,000,000	18,000,000	24,000,000
	15,000,000	900,000	4,500,000	9,000,000	13,500,000	18,000,000
	30,000,000	1,800,000	9,000,000	18,000,000	27,000,000	36,000,000

		No. of leases to end borrowers by Leasing companies				
Interest earned from leasing company leasing	**3,000,000**	*50*	*100*	*150*	*200*	*250*
Average lease size	*100,000*	300,000	600,000	900,000	1,200,000	1,500,000
	300,000	900,000	1,800,000	**2,700,000**	3,600,000	4,500,000
	500,000	1,500,000	3,000,000	4,500,000	6,000,000	7,500,000
	700,000	2,100,000	4,200,000	6,300,000	8,400,000	10,500,000
	900,000	2,700,000	5,400,000	8,100,000	10,800,000	13,500,000
	999,999	2,999,997	5,999,994	8,999,991	11,999,988	14,999,985

		Interest rate charged to PFIs					
		5%	6%	7%	8%	9%	10%
Interest earned from leasing (total	**12,000,000**	10,000,000	12,000,000	14,000,000	16,000,000	18,000,000	20,000,000

Rationale for Public Sector Involvement

41. The Project builds on the prior analytical work on the SME finance environment in Ethiopia, which addressed a market failure in essence of the “missing middle” phenomenon, caused by the mismatch between SME’s demand for and financial institutions’ supply of quality

financial services. On the demand side, SMEs in Ethiopia performs much worse than large firms across a host of financial indicators. They are more likely to be rejected for loans, and less likely to have a loan, line of credit, or overdraft facility. These firms are more likely to avoid loan applications all together due to high collateral requirements. The lack of financial access is even more severe in the case of small firms than microenterprises. Lack of access have resulted in (a) impediments in job creations and growth; (b) the existence of missing middle phenomenon in financial services catering to small firms. (c) poorer performance and productivity for firms lack of financial services. The supply-side analysis confirms that SMEs are being underserved compared to micro and large firms. Micro finance institutions (MFIs) primarily cater to micro firms, leaving small and medium firms financially excluded. Large banks are discouraged from serving this segment primarily because of perceptions of lower returns and higher risk. Public sector intervention in this project will help channel the funds to eligible SMEs through the Participating Financial Institutions (PFIs) to help their financing needs for business start-up, expansion, as well as working capital needs. The project will help reducing the missing middle phenomenon.

Annex 6: DBE Appraisal Assessment

FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA: Small and Medium Enterprise (SME) Finance Project

DBE Assessment Summary

1. **A due diligence assessment of the Development Bank of Ethiopia (DBE) has been conducted in relation to the proposed World Bank SME Finance Project - in line with World Bank's OP 10.00 policy for the financial intermediary financing projects - to facilitate sustainable provision of lease finance and working capital to SMEs in Ethiopia.** DBE is expected to play a key role in management of the proposed credit facility, both as a wholesaler (lending to other financial institutions for on-lending to SMEs), and as a retailer (direct support to SMEs). The assessment was conducted by way of meetings with DBE executive and senior management and a review of relevant DBE documents (financial reports, policy guidelines, operational manuals, etc.).

2. **Based on this assessment the DBE is found broadly compliant with key World Bank eligibility criteria, subject to continued implementation of institutional development plan outlined below.** Key risks include the current elevated level of non-performing loans (NPLs) which area partially attributed to one of DBE's largest borrowers being classified as non-performing in the first quarter of the 2015/16 financial year. This resulted in increase of from 12.5 percent in June 2015 to 18.4 percent in September 2015. The DBE is currently taking steps to reduce the level of NPLs through dialogue with the concerned borrowers and is making particular efforts in relation to large borrowers classified as non-performing.

3. **DBE progress in implementation of its previous institutional development plan (as of August 2013) supported by the World Bank Women's Enterprise Development Program (WEDP) is summarized as follows**:

- Risk management and internal audit: the DBE has strengthened its risk management policy framework and partially implemented these policies; it has a well-established internal audit function.

- Human capital and performance assessment: the DBE has initiated a succession planning program with further steps incorporated in its human resource (HR) development strategy.

- Loaning process: the current level of NPLs would suggest a requirement for further strengthening of the DBE's project finance capabilities.

- Quality assurance process: the DBE has considerably enhanced its use of the T24 core banking system and related quality assurance process capabilities.

- Treasury operations: the DBE has not yet formed a dedicated treasury unit with responsibility for asset/liability management, liquidity management and funds mobilization.

4. **In terms of institutional capacity to participate in the forthcoming SME Finance Project, the DBE has long experience in both direct lending activities through its project finance loans, and wholesale lending through managing the WEDP credit facility and other lines of credit.** Appropriate measures have been incorporated in the DBE strategic plan for the period 2015–2020 to support development of lease finance business line, notably development of the Bank's organization structure to incorporate a Vice President for the Bank's lease financing business. Other recent organizational developments include the creation of a new Vice President position for credit management resulting in separation of credit management (including ongoing portfolio management) from business origination which is expected to strengthen the DBE's credit risk management. In preparation for commencement of its lease financing activities, DBE has laid ground for implementation of an ambitious regional office and branch opening program. This includes opening 7 new regional offices and 75 branches planned in 2015/16 and 42 new branches in 2016/17 and recruitment of around 450 additional staff for its branch operations. So far, the DBE has expanded the branch network from 32 to 100 branches and hired 400 new staff that are undergoing training. DBE has also determined a strategy of continued high growth for the period 2015–2020, based on a combination of project finance, lease financing and wholesale lending business.

5. **Overall, DBE is found to be eligible to take part in the World Bank funded SME Finance Project, subject to implementation of a new institutional development plan.** The institutional development plan includes the following measures that will be financed by DFID funded PEPE project in support of and closely coordinated with SME finance project activities:

- **Strengthening of project finance business**

  (a) Portfolio review to assess overall portfolio quality and key risk areas

  (b) Review of project appraisal process

  (c) Review of portfolio management, project follow up and loan collection processes

  (d) Review of project rehabilitation and loan recovery processes

  (e) Updating of all project finance process and procedures manuals and related staff training

- **Address current high level of NPLs**

  (a) Development of an NPL resolution strategy

  (b) Ongoing monthly monitoring of NPL resolution progress

- **Business planning for lease financing business**

  (a) Preparation of a business plan for the Bank's lease financing business, to include quantification of the business opportunity, product definition, marketing and sales strategy, resource/training requirements, financial projections, etc.

(b) Development of appraisal, credit administration and portfolio management processes and procedures

(c) Quality assurance process development for enhanced portfolio monitoring

(d) Staff training

- **Strengthening of risk management**

(a) Operationalization of DBE *Risk Management Program,* Board Risk Management Committee and quarterly consolidated risk management reporting

(b) Operationalization of DBE *Asset/Liability Management Guidelines*, Asset/liability management committee (ALCO) and treasury operations

(c) Assessment of anti-money laundering awareness/practice and due diligence review of all existing DBE clients

- **Implementation of treasury operations**

(a) Implementation of measures detailed in the WEDP-supported institutional development plan as incorporated in the DBE *Redesigned Fund Management Process*

- **Implementation of succession planning program**

(a) Operationalization of measures detailed in the WEDP-supported institutional development plan and incorporated in the DBE succession planning program

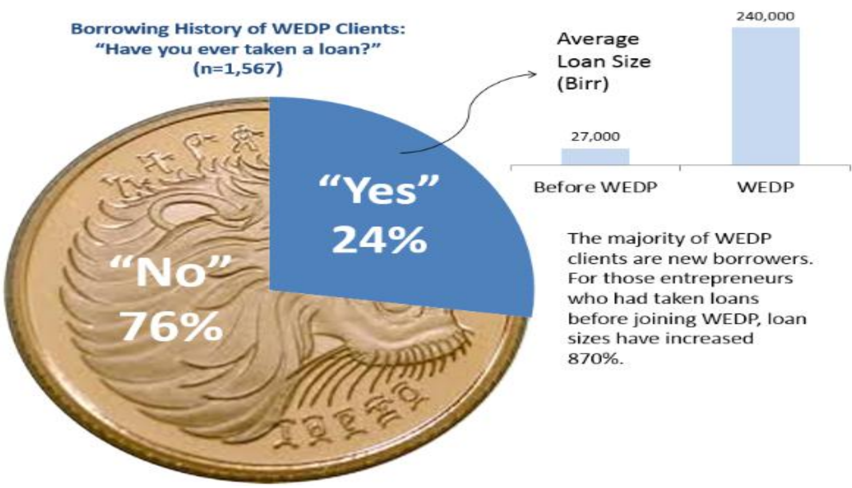
Box 6.1. The Women's Entrepreneurship Development Project (WEDP)

WEDP is a US$50 million IDA investment lending operation designed to address the key constraints for growth-oriented women entrepreneurs in Ethiopia. DFATD Canada and UK's DFID are key development partners funding part of the project's activities with an additional US$13 million. The project became effective in October 2012.

WEDP involves a market "up-scaling" operation where the Development Bank of Ethiopia acts as a wholesaler and MFIs act as retailers. The project uses an incentive approach aimed at (i) helping DBE developing a new business line involving wholesaling of MSE subsidiary loans and provision of related technical support to participating MFIs; and (ii) helping the MFIs build up a high-quality MSE loan portfolio based on credit techniques that have been developed and validated under successful micro and small loan programs in other countries.

WEDP has made rapid and sustained progress since its launch in 2012, demonstrating the capacity of DBE as a highly effective project implementer. The WEDP line of credit is disbursing roughly US$2 million in loans to growth-oriented women entrepreneurs every month, far exceeding initial targets. Some key highlights of WEDP's progress are as follows.

- **Exceeding Targets:** WEDP's line of credit was 90 percent disbursed before the half-way point of the project. As of August 2015, the project has provided loans to over 3,000 women entrepreneurs and entrepreneurship training to 4,500. It is amongst the highest-disbursing and highest-rated projects in the region, and was awarded a Vice Presidential Unit (VPU) Team Award in 2015.
- **Reaching the underserved:** WEDP is successfully reaching its target segment of under-served women entrepreneurs, who have the desire and potential to grow their businesses. 76 percent of WEDP clients have never taken a loan before.
- **Catalyzing growth:** According to initial survey data, the average WEDP loan has resulted in an increase of 24 percent in annual profits and 17 percent in net employment for Ethiopian women entrepreneurs, one year after taking the loan. These female-owned businesses are continuing to grow, as the impacts of capital investments play out. Repayment of loans stand at 99.6 percent.
- **Unlocking needed capital:** One of WEDP's objectives was to increase loan sizes, since most Ethiopian women-owned enterprises were stuck in a 'missing middle' trap where loans offered by microfinance were too small to meet their needs. For repeat borrowers, loan sizes have increased on average by 870 percent.
- **Improving capacity of lenders:** Through the technical assistance component, WEDP is building the capacity of Ethiopia's leading MFIs to deliver loans to women entrepreneurs. The MFI's improved ability to appraise, resulted in their capacity to reduce the collateral requirements from an average of 200 percent of the value of the loan to 125 percent. At the same time, WEDP MFIs are developing new loan products and recognizing new forms of collateral such as vehicles, personal guarantees, and even business inventory, to secure loans.
- **Underwriting Innovation**: Through partnership between the World Bank's Finance & Markets Global Practice and the Gender Innovation Lab, WEDP is introducing innovative credit technologies to lenders, such as psychometric tests which can predict the ability of a borrower to repay a loan and reduce the need for collateral. These innovations are being piloted and subjected to rigorous impact evaluation. Scaling up these technologies, which other MFIs are already requesting, could bring about a notable change in access to credit in Ethiopia.



"With WEDP, the microfinance institutions' appetite for risk has increased. Previously, they provided loans in small amounts of $1000 - $ 1500. Now, they are making WEDP loans averaging over $10,000. Plus, they have taken part in a capacity building program, which helped them assess these larger loans using cash flow analysis and risk mitigation techniques. So the MFIs are strengthening both in terms of loans disbursed as well as in their knowledge of lending" (Beimnet Foto, Principal Appraisal Officer, Development Bank of Ethiopia)

Annex 7: Overview of Selected Financial Sector Issues in Ethiopia

FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA: Small and Medium Enterprise (SME) Finance Project

Savings Mobilization in Ethiopia

1. **Savings mobilization is a central challenge for financial institutions in Ethiopia.** Ethiopia's savings rate was estimated at 5.5 percent of GDP in the 2000s, a number substantially lower than comparator countries in Sub-Saharan Africa. Moreover, the savings rate declined during the last decade of very high economic growth.

2. **A negative real interest rate on deposits is one of the main drivers of Ethiopia's low savings rate (shown in Figure 7.1 below).** Establishing a stable macroeconomic environment with low, but positive real interest rates and low levels of inflation, is among the main policy tools to increase the saving rate in Ethiopia.

3. **The World Bank's 2nd Ethiopia Economic Update focused on the savings challenge, and provided a series of recommendations to increase the domestic savings rate.** In addition to a stable macro-economic environment, several specific financial sector policy initiatives also have the potential to leverage gains in the savings rate.

4. **Expanding bank branches in Ethiopia in recent years has led to a significant increase in the likelihood of saving in banks by individuals, and continued expansion is likely to yield increasing gains.** Many households save through Rotating Savings and Credit Associations (ROSCAs), which have relative merits such as ease of access and social interaction compared to banks. Integrating savings from ROSCAs into MFIs and banks will help to raise the savings rate, if an amendable macro-economic environment persists. Continuing to support MFIs' savings mobilization capacity, with liquidity and technical assistance through initiatives such as the World Bank's Women's Entrepreneurship Development Project (WEDP), can also significantly influence savings rates by low-income households. The development of mobile banking and better facilitation of remittances will be further catalysts.

Figure 7.1. Policy Recommendations to Increase Domestic Savings

Policy Area	Recommendation
Macro-economic policy	1. Macroeconomic stability with positive real interest rates. 2. Pursue a strategy of monetization
Financial sector measures	3. Facilitate remittance transfers, including establishing formal savings products, increasing transparency, and reducing costs. 4. Continue bank branch network expansion. 5. Enhance Micro Finance Institution (MFI) capacity. 6. Integrate informal savings schemes with formal. 7. Develop mobile banking. 8. Improve financial literacy.

Recommendations to Increase Savings
(Source: Ethiopia Economic Update II, 2013)

SME Finance in Ethiopia

5. **Findings from both demand-side and supply-side surveys clearly indicate the existence of a missing middle phenomenon in Ethiopia whereby small enterprises are more credit constrained than either micro or medium/large enterprises.** In particular, the demand-side analysis shows that MSMEs in Ethiopia perform much worse than large firms across a host of finance indicators. MSMEs are much more likely to be rejected for loans, and less likely to have a loan, line of credit, or overdraft facility. These firms are also more likely to avoid loan applications all together due to high collateral requirements. However, the data reveals that the lack of access to finance is even more severe for small firms than for microenterprises. Main findings from the demand-side can be summarized into the following three categories:

(a) *Job creation and employment growth:* Job creation and employment growth is concentrated in large established (i.e. older) firms in both service and manufacturing sectors. Moreover, job creation and employment in the services and retail sectors are higher than in the manufacturing sector.

(b) *Access to finance:* overall, data indicates the existence of a missing middle phenomenon in terms of financial services catering to small firms. Young and smaller firms are much more likely to be rejected for a loan or a line of credit than firms who are more established or larger. Moreover, despite confirming their need for improved access to finance, SMEs are discouraged from applying for loans due to excessively high collateral requirements.

(c) *Firms' performance:* Firms that are credit constrained exhibit poorer performance and productivity.

6. **The supply-side analysis confirms that small and medium enterprises are being underserved compared to micro and large firms.** Micro finance institutions (MFIs) primarily cater to micro firms, leaving small and medium firms financially excluded. Large banks are discouraged from serving this segment primarily because of perceptions of lower returns and higher risk, since SMEs are often unable to prepare adequate business plans and lacking basic business development skills. However, most MFIs and banks also view the SME segment as the most promising one for growth and having good prospects. Capacity building activities that help SMEs improve their business management skills will also increase Bank's confidence in their financing. Key findings from the supply-side survey include the following:

(a) **SME finance culture:** Financial institutions lack an "SME finance culture": a harmonized definition of MSMEs is missing and consequently specific MSME financing strategies are not in place.

(b) **Perception of SMEs' market segment:** Financial institutions believe that market potential is very good for the SME segment. Expected returns and the contribution to the economic development of the country are seen as main drivers for lending to SMEs and microenterprises.

(c) **Risks and obstacles to SME finance***:* SME-specific factors and macroeconomic factors were indicated by all MFIs and banks as significant obstacles to the development of SME lending. While banks and MFIs believe there is high growth potential in lending for small enterprises, the current lack of involvement is due to perceived risks.

(d) **The missing middle phenomenon:** SMEs represents a missing middle in the financial sector with high heterogeneity of lending patterns between MFIs and commercial banks.

(e) **Business models:** The business models of the surveyed financial institutions are mostly inadequate to serve SMEs: they lack a dedicated and specialized SME unit or department within their organizational structure; loan appraisal techniques are still mostly based on traditional relationship lending rather than on transactional technologies such as credit scoring etc.; products are highly standardized and there is very limited product innovation; distribution channels are still largely based on branches and long-term financing needs of SMEs do not seem to be properly addressed.

(f) **The importance of government-financed programs:** Government-financed programs (credit guarantee programs and line of credit with technical assistance) are important drivers.

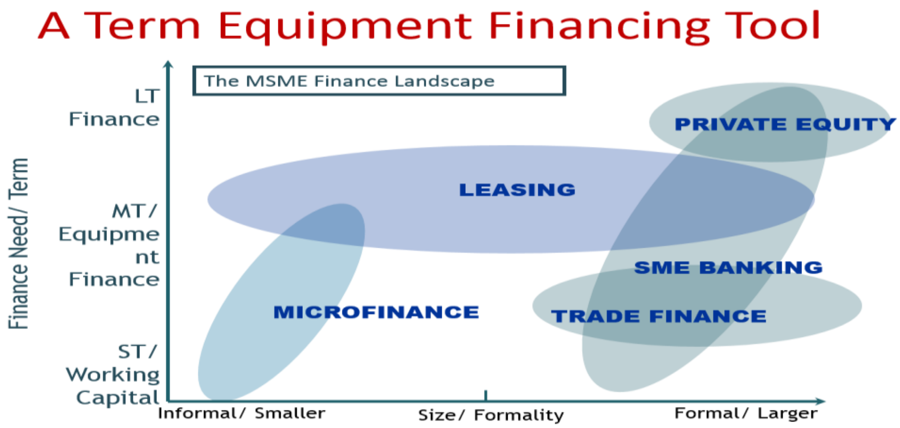
(g) **A supportive financial sector infrastructure.** The potentialities of the credit bureau are not effectively exploited.

(h) **Regulatory and judicial issues.** The contractual environment and lack of collateral registry inhibit secured lending and constrain access to finance for SMEs. Changes in the market due to imposed lending restrictions are seen as a hindrance causing liquidity constraints.

Background on Leasing Finance

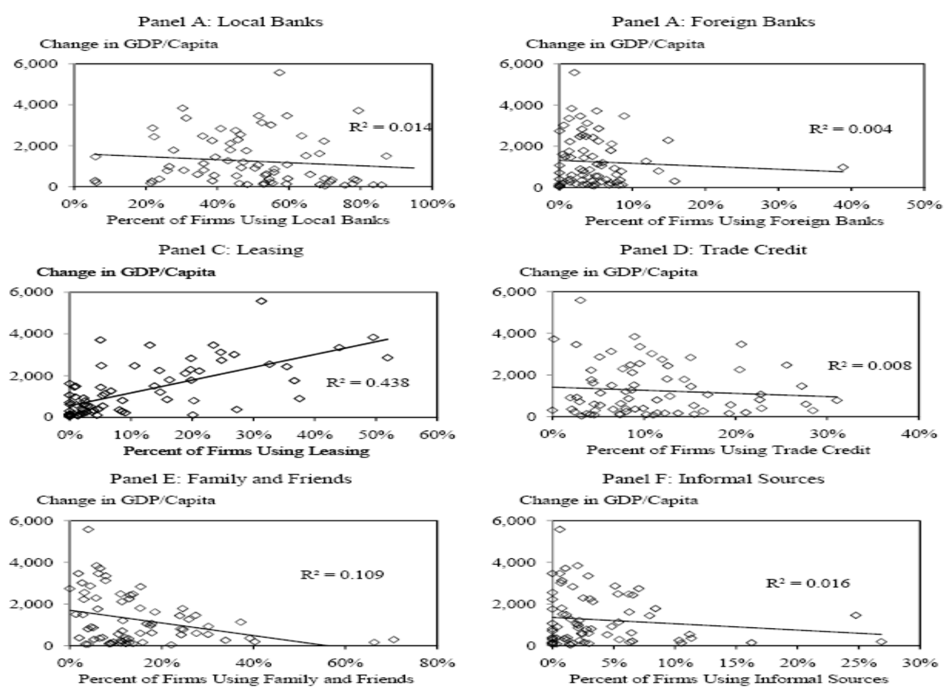
7. **Leasing financing is one of several financial products commonly used by SMEs to support growth.** Over the business life cycle of a growing MSME, the type of appropriate financing products changes as depicted in the Figure 7.2 below. Leasing, when available, is often the entry point in the financial product spectrum for formal businesses seeking equipment financing. Leasing typically targets small businesses that are towards the lower end of any sector, particularly those with no credit history and/or no collateral but with strong cash flow.

Figure 7.2. Financial Product Spectrum



8. **Leasing finance has a strong positive correlation to GDP per capita growth compared to other SME financing options.** In 2008, the World Bank and UNC Kenan-Flagler Business School undertook a study[45] covering 75 countries and 35,000 SMEs to measure the role of different financial products on the impact of the SMEs and the GDP per capita growth. The results in Figure 7.3 show the correlation between GDP per capita growth and the type of financial products used by the SME. Leasing presents the strongest positive correlation with GDP per capital growth.

Figure 7.3. GDP per Capital to Sources of Financing



[45] A New Lease on Life: Institutions, External Financing and Business Growth (July 11, 2008) By Gregory W. Brown, Larry W Chavis (Kenan-Flagler Bus Sch); and Leora F Klapper (World Bank)

Overview of Leasing Finance in Ethiopia

9. **The task team conducted an appraisal of the leasing finance market in October 2015 to identify the current state of the market, opportunities, and challenges in order to assess market readiness and appropriately design the project.** As part of the appraisal, DBE and the 5 leasing companies were queried on: (a) Portfolio size and market opportunities; (b) Leasing knowledge, skills and competences; (c) Internal audit and established control systems; (d) Business development and product innovation; (e) Established leasing policy and operational guideline; (f) Leasing strategy, asset management, risk and structuring techniques; and (g) Management information systems.

10. **In-house leasing expertise is limited, but there is strong potential future demand for leasing.** All the five leasing companies and DBE have basic knowledge of finance leasing operations, but no prior work experience in the leasing sector. The current total portfolio size of leasing transactions undertaken by all the five leasing companies for the period 2014–2015 is approximately ETB 318 million (US$15.9 million). The future market projections for the period 2016–2017 is estimated to be ETB 3.8 billion (approximately US$190 million), and the target number of SMEs to be reached is 5,500.

11. **The sectors likely to benefit from capital goods financing are enterprises producing goods and services for export and import substituting enterprises as well as enterprises capable of creating large employment opportunities.** In Ethiopia, the leasing companies are expected to provide lease finance for machineries and equipment to the priority areas such as: (a) textile, garment, leather and leather products; (b) metal and wood works;(c) agro-processing, including dairy and poultry equipment; (d); construction machineries;(e) irrigation;(e) wet and dry coffee processing; (f) post-harvest grain processing including seed cleaning equipment; and (g) freight transporters from fields to market centers and warehouses, (h) farm and non-farm cooperatives, unions, and model farmers.

12. **Lease default risk is the most significant risk inherent in the leasing business, and partly accounts for liquidity risk.** Together they represent around 60 percent to 70 percent weight in the risk-based framework for leasing companies. In Ethiopia, there are guidelines on repossession in the event of default. However the Proclamation does not elaborately specify the steps towards repossession. The guidelines for repossession on default indicate that the lessor is expected to notify the Ministry (responsible for registering of capital goods agreement) in case of default, and having duly complied with the repossession procedure and notices served to the lessee, the lessor should seek help from the Ministry to repossess. Article 18 (3) (as renumbered by the proclamation 807/2013) clearly states that 'The Ministry shall take appropriate measures in order to ensure the return of the leased capital goods to the lessor, where the lessee has obligation to return the capital goods to the lessor but fails to return it, and may order the police to facilitate the execution'. The Proclamation allows the lessor to rescind the lease agreement, repossess the capital goods and claim related damages (legal, logistics, dismantling, repairs, re-marketing and so on). Even if the equipment is physically installed, it remains a leased asset and the lessor maintains its right on it.

13. **In an ideal scenario, there is an orderly process for repossession.** The first step in default would be to take possession of leased equipment or to repossess to mitigate against the

level of risk. The next steps are to safe-keep the leased equipment in a warehouse and then sell it to a third party in a secondary market. (This is an internal process by the lessor). Regardless of any given challenges in repossession, we anticipate that a secondary market for leased equipment should normally become active once the leasing business starts in any given economy even for specialized equipment. Lessors are always advised and encouraged to identify potential secondary markets for specialized equipment.

14. **As the leasing industry is in its infancy, there are several potential challenges to repossession.** The biggest challenges could include:

(a) The lessor cannot repossess without the consent of lessee because the Proclamation recognizes the right of the lessee to quiet enjoyment of the leased equipment. As a result, while proceeding with repossession, leasing companies may find themselves unable to have an amicable resolution with the lessees and this could pose a significant problem for the lessors.

(b) The lack of market knowledge of how to repossess, what to expect at the point of repossession, or the length of time required to repossess could result in possible loss of rental payments or in equipment downtime.

(c) The Proclamation provides for the Ministry of Industry to take appropriate measures to ensure the return of the capital goods to the lessor, where the lessee is bound to return the leased equipment. The Proclamation also states that the Ministry may order the police to facilitate the execution, however, this process has not been tested yet for flaws or effectiveness.

15. **Strong internal audit and risk control systems are in place at each of the leasing companies**. The leasing companies have strong risk mitigation systems in place; they are regulated by NBE and submit quarterly reports to the Central Bank. However, only two of the five leasing companies incorporate residual value risk in their risk structure. Residual value[46] remains a risk factor to lessors if not understood and clearly defined before contract is signed by lessee.

16. **Cash flow analysis is the primary consideration for processing and booking new leases.** Once a transaction is completed and approved, an initial contribution from the lessee is required. These contributions are collected upfront and ranges from 15 percent to 20 percent of the cost of the asset being financed. Thus far, the values of the smallest and largest single leasing transactions have been ETB 13,700 (US$685) and ETB 552,828 (US$27,641), respectively.

17. **The aggregate leasing portfolio quality and monitoring capacity of the companies is well-managed.** In the past year, there have been no defaults recorded, equating to an NPL of less than 1 percent at each of the leasing companies. All assets are duly insured and monitored on a monthly basis through on-site inspection.

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[46] This is the value that can be realized upon disposal of asset in case of default and repossession, and it should always be higher than the outstanding lease instalment, otherwise a lessor is exposed to a residual value risk.

Table 7.1. Leasing Market SWOT Analysis in Ethiopia

Strengths: ▪ Strong capital base ▪ Industry regulated by the Central Bank (NBE) ▪ Strong corporate governance, controls and compliance ▪ Strong management and sales capabilities ▪ Good credit culture and asset management ▪ Good leasing portfolio quality, zero default ▪ Favorable legislation and regulatory guidelines in progress ▪ Strong government support and commitment to private sector development	**Weaknesses**: ▪ Limited leasing skills and expertise in the market ▪ Lack of technical partners to improve skills ▪ Weak IT, quality assurance process and Reporting capabilities ▪ High Operational risk (most back office processes are done manually) ▪ Weak infrastructure - Lack of effective collateral registry and credit bureaus ▪ Lack of product innovation and competition among players ▪ Lack of flexibility in processing leasing transactions
Opportunities: ▪ Huge market growth potential for leasing ▪ Untapped private sector ▪ Medium- to long-term funding opportunities ▪ Expected good returns for potential investors ▪ Conducive leasing environment for sustainable leasing business ▪ Huge opportunities for regional technical partners	**Threats**: ▪ Inadequate regulatory and supervisory functions and guidelines. ▪ New leasing market with no sufficient leasing experience ▪ Lack of medium- to long-term funding ▪ Residual value risk not duly incorporated in the risk structure of most leasing companies

Overview of Financial Infrastructure in Ethiopia

18. **World Bank studies and global experience validate the economic significance of collateral registries.** Modern secured transactions systems enable businesses to use their full range of movable assets as security for a loan, generating new productive capital, and fostering access to finance, particularly for SMEs. The World Bank has assisted more than 35 countries worldwide in modernizing their secured transactions legal frameworks and in implementing collateral registries. Some economies with successful secured transactions reforms relevant to Ethiopia are China, Colombia, Ghana and Mexico among others.[47] In 2013, the World Bank conducted a study comparing access to finance pre and post the introduction of collateral registries in 73 countries. The study showed that the impact of introducing collateral registries is economically significant as the access to loans increased by 7 percent. Additionally, these countries saw a reduction in interest rates paid on loans of 3 percent and an increase in the maturity of bank loans of six months.[48]

19. **At the request of the GoE, the task team conducted a diagnostic study on the current state of the legal framework and practices that govern secured transactions and the registration of security interests in Ethiopia.** As a part of the diagnostic, the existing system was compared to the best international practices to identify weaknesses and opportunities for improvement for GoE consideration. The main recommendations include undertaking a comprehensive approach which consists of four components: (a) the drafting of a new secured

[47] These countries improved in the Getting Credit indicator of the Doing Business Report after implementing a secured transactions reform.
[48] Inessa Love, et. al., *Collateral Registries for Movable Assets: does Their Introduction Spur Firms' Access to Bank Finance?*, Policy Research Working Paper 6477, The World Bank, June 2013.

transactions legal and regulatory framework; (b) the creation of a collateral registry; (c) building of key stakeholders' capacity including the focus on specific sectors such as agribusiness and manufacturing; and (d) monitoring and impact evaluation. The diagnostic report was approved and all recommendations were fully accepted by the NBE.

20. **The current secured transactions system of Ethiopia provides a multitude of different and conflicting rules that complicate secured lending over movables.** Some weaknesses in the current system include: (a) the lack of a single law covering all transactions secured by movable property; (b) non-possessory pledges which exist only as exceptions and not as a rule; (c) the law does not allow the granting of a security interest in future assets; (d) only some types of security interests are subject to registration, creating, therefore, a system with secret liens that is difficult and costly for creditors to discover; and (e) extrajudicial foreclosure is not available for all types of creditors.

21. **In Ethiopia, the majority of finance provided by banking institutions is secured with both immovable and movable assets.** Unsecured credit is granted on an extremely limited basis to longtime clients who have demonstrated earnings equivalent to 100 percent of the loan for the past two years and who have been given a high ranking based on the bank's credibility indicators. While the institutions interviewed disclosed a slight preference for taking immovable property as collateral, most institutions accept movable collateral as well. In Ethiopia, movable collateral is largely represented by vehicles and 90 percent of the total movable collateral reported to the Credit Reference Bureau is of this type.[49] While machinery and equipment are also commonly accepted, banking institutions revealed they are reluctant to take fluctuating assets, such as accounts receivables and inventory, as movable collateral. These institutions perceive the risks related to these types of collateral as too high because: (a) there are no registries to register a security interest in such assets, (b) there are no clear rules to determine priority against other competing claimants, and (c) often businesses do not keep proper records of these assets. To account for these higher risks, some institutions take actual control of a business' merchandise, locking the premises where the merchandise is kept and assigning a full-time employee at the site. However, this method of monitoring these types of business assets is inefficient as these businesses' operation costs are significantly increased.

22. **Registration of all movable collateral is not consistent and can be duplicative.** In Ethiopia, there are several registries in which interests in some type of movable collateral are registered, depending on the type of asset being registered. These registries are located throughout the different regions of the country and they are not linked. Thus, the information registered within each registry is not automatically shared with other regional offices. For instance, interests in vehicles are registered with the Transportation Authority of the corresponding locality and the appropriate local office to register with is the same as where the vehicle's plate number was issued. Similarly, security interests over machinery for construction are registered with the Ministry of Works and Urban Development and business mortgages are registered in the Commercial Register (in this case the registration includes a list of movable property that is encumbered). Only a couple of banks extend agricultural credit taking crops as collateral and when doing so they register the encumbrance with the Ministry of Agriculture. These banks also accept warehouse receipts as collateral to a limited extent. Interests over any

[49] Statistics provided by the National Bank of Ethiopia.

other types of machinery and other movable property, including floating assets, are not subject to registration. For this reason, creditors perceive a greater risk for these types of collateral and would often rather not take non-registrable assets as collateral at all or, if they do, will increase interest rates.

23. **The registries charge fees according to their own criteria, and differences across regions can be significant.** Some of them charge flat fees while others charge a fee based on a percentage of the asset value or of the amount of the loan. Banks and MFIs in Ethiopia perceive these pricing differences as an important flaw in the security interest registration system. MFIs find that in some localities registry offices are inefficient and unreliable and in some West Ethiopian localities, they do not exist at all. Furthermore, the variety of existing registries can cause confusion and priority conflicts among competing claimants. For instance, a vehicle encumbered pursuant to a business mortgage and registered in the Commercial Register, could also be encumbered under another device registered with the Transport Authority. To avoid this conflict, a creditor entering into a business mortgage agreement should not only register its interest in the Commercial Register but also with the Transport Authority. Although some stakeholders follow such a practice, others only make one registration.

24. **Efficient resolution and enforcement in the case of a borrowers default is also an important component of any secured transactions system.** The existing framework for enforcement in Ethiopia allows only financial institutions to use extrajudicial foreclosure methods. Banks and MFIs are entitled to sell encumbered property by providing 30-days prior notice to their debtor. However other creditors, such as suppliers, are not entitled to this procedure and can only enforce their interests before the Courts. According to the interviews, a judicial procedure of this type can take more than two years.

25. **Overall, the stakeholders interviewed welcome the idea of a single nationwide electronic registry for all types of collateral as long as it is reliable.** Creditors indicated that they would be willing to extend credit by taking collateral in property currently not be lent upon, such as agricultural products, if there was a clear system that would provide them with legal certainty. Likewise, civil servants interviewed indicated that there is a need to extend secured credit and collateralize all possible assets in order to promote and expand businesses.

Annex 8: Additional Indicators for Analytical Purposes[50]

FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA: Small and Medium Enterprise (SME) Finance Project

Additional indicators will be developed and monitored under the project for analytical purposes. The responsibility for reporting will rest with DBE, PFIs, and PIU. These may include, but are not limited, to the following:

Volume of Financial Support to SMEs under the credit facility • Volume of Financial Support: SME Loans • Volume of Loans: Female-Owned Enterprises • Volume of Financial Support: Leases • Volume of Leases: Female-Owned Enterprises
Portfolio Quality under the credit facility • Portfolio Quality: Loans • Portfolio Quality: Loans - Female-Owned Enterprises • Portfolio Quality: Leases • Portfolio Quality: Leases - Female-Owned Enterprises
Number of Loans/ Leases disbursed to SMEs under the credit facility (Intermediate Indicator) • Number of Loans Disbursed • Number of Loans Disbursed: Female-Owned Enterprises • Number of Leases Disbursed • Number of Leases Disbursed: Female-Owned Enterprises
Number of SMEs that received training through a BDS Program under the project (Intermediate Indicator) • Number of females that received training through a BDS Program under the project

[50] Information on these indicators will be regularly collected by the team during official Implementation Support Missions and used as an additional tool to help project's management and implementation.