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Collaboration for Post-Conflict Rebuilding and Financial System Development: European Donors with KfW Leadership in Southeastern Europe

by Ann Duval with Ruth Goodwin-Groen

This case study describes how European donors' strategy for post-conflict rebuilding helped develop the financial system in Southeastern Europe, through funds managed by Kreditanstalt für Wiederaufbau (KfW).

Overview

Since the late 1990s, several European donors have worked together to provide long-term lending capital and technical assistance to financial intermediaries in Southeastern Europe as part of their post-conflict reconstruction efforts. By 2003, these donors—which grew to include the European Union (via the European Commission and the European Agency for Reconstruction [EAR]), the Netherlands Development Finance Company (FMO), and the Austrian, Swiss, and German governments—had collectively committed over 110 million euros to the banking sector in the region. Under the leadership of KfW, they forged a common vision for developing strong financial intermediaries, delegated fund management to KfW, and harmonized lending terms and reporting requirements.

KfW's technical know-how as a development bank, including its experience in product design and commercial partner selection, made it a suitable technical partner to manage the lending programs. Individual donors signed management agreements with KfW, giving it the authority to administer all donor funds. KfW was also responsible for selecting local lending institutions, monitoring their performance, and (via separate funding arrangements) contracting technical assistance.

The collaborative effort, often referred to as the European Funds, has had far greater impact than any one donor could have achieved alone, in terms of strengthened local lending institutions, increased outreach, and market development. The accomplishments in Bosnia and Herzegovina (BiH), Montenegro, Kosovo, and Serbia have been significant: At the end of 2003, 26 local lending institutions had been strengthened with more than 14,000 loans outstanding to micro, small, and medium entrepreneurs. Local banks and MFIs now work with one donor representative in the region to tap significant sources of lending capital and technical assistance, instead of individually approaching up to eight different donors.

Setting the stage

By the end of the war in BiH in late 1995, the economy was failing, most of the infrastructure had been destroyed, and over two million people had become refugees abroad or were displaced internally. In early 1996, the international community launched a US $5.1 billion, five-year rebuilding plan for the country—the largest reconstruction effort in Europe since the end of World War II. EU member states agreed that one of the most pressing needs was for housing to support the return of refugees and displaced persons. However, many believed grants were the best instrument for housing projects to spur housing development.

> "There were so many organizations—bilateral donors, multilateral donors and NGOs—working in an isolated way with no coordination. Also, we felt that many donor programs were eroding the financial sector through subsidies and grants. We . . . thought it must be possible to create a program that would coordinate donor financing in order to bridge the housing gap and to strengthen the banks."
>
> *Klaus Glaubitt, Chief, Private and Financial Sector Development Division, KfW.*

Concerned about the negative impact that subsidies and grants could have on the viability of the financial system, KfW designed a program to offer housing loans through local partner banks at near-market conditions. It then sought donors to finance the program. In 1998, the EU provided the first 15 million euros for the Housing Loan Program (HLP) as a "revolving grant," with a clear mandate to KfW to administer the program on their behalf. The Dutch FMO became a donor to the program in 2001, and the German government followed in 2002. Under the HLP, KfW selected and signed loan agreements with local banks to provide them long-term loans at near-market rates. The banks used the capital to on-lend to clients at their own risk. Long-term funding coupled with technical assistance to the banks in designing appropriate housing loan products ensured that low-income clients had access to much-needed, sustainable sources of credit.

Widening Donor Collaboration—New Sectors, New Countries

Expanding into new sectors. In addition to meeting the urgent reconstruction needs, BiH faced many other challenges to ensure its economic recovery and development. In response, KfW began to design a program to support small and medium enterprises (SMEs) through the banking sector. The Austrian government, which had also been preparing to set up a SME program, quickly joined KfW when it heard of its plans and previous experience with the EU on the housing loan program. By mid-1998, an SME credit line (SMELP) for BiH was in place, with a 2.55 million euro grant from Austria. The financing arrangement between the two agencies was substantially the same as that between the EC and KfW for the HLP program.

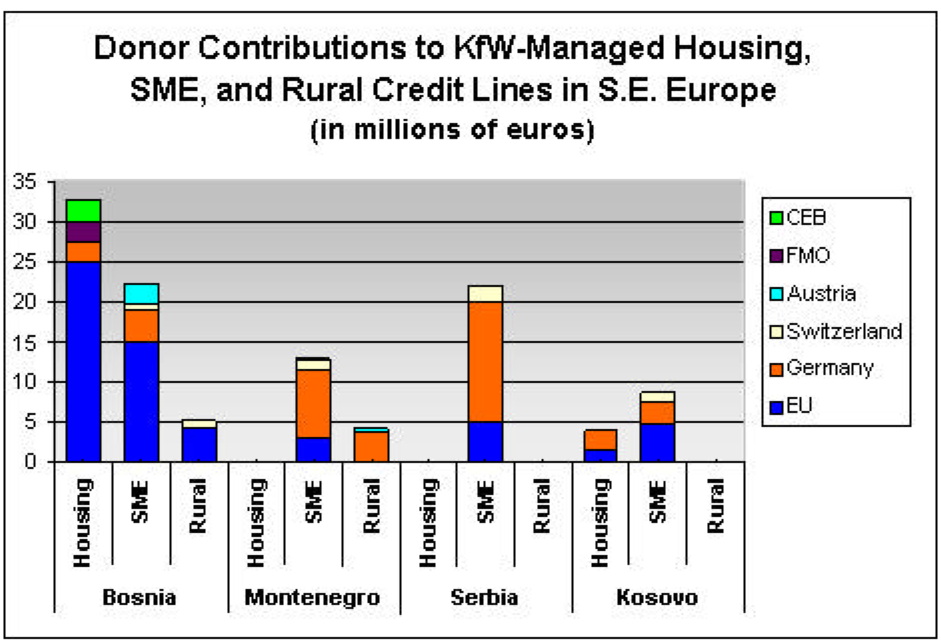
By December 1998, the Swiss and German governments had also signed contracts with KfW, providing another 1.11 million euros for SMELP. They were joined by the EU in 1999, which initially contributed 5 million euros.

In 2001, the Swiss government provided initial financing to launch a credit line for yet another sector, rural development. KfW established the Rural Lending Program (RLP) in BiH, to which the EU began to contribute in 2002.

Moving into new areas. Building on the experience in BiH, in 2000, KfW began creating similar programs to promote financial intermediaries in other post-conflict areas in the region.

- *Montenegro*: KfW launched an SME fund with Austrian government financing. Within two years, it was managing 15 million euros (on behalf of the EAR and the German, Austrian, and Swiss governments) for both SME and rural lending.
- *Kosovo*: KfW initially channeled funds from EBRD, FMO, and Germany into a new microfinance bank, and later launched an SME lending program (with EAR, German, and Swiss funding) and a housing loan program (with EAR and German funds).
- *Serbia*: As in Kosovo, KfW channeled EBRD, FMO, and German funds to a new microfinance bank, and also provided refinancing for SME loans (with EAR, German, and Swiss funds) to four existing commercial banks.

The graph below gives a snapshot of how much major donors have contributed to the different programs currently managed by KfW in Southeastern Europe. (It does not, however, show all the different partner banks and MFIs that are borrowing these funds.)



Challenges of Donor Collaboration

Need for visibility of individual donor funds reduces effectiveness and adds costs. Donors usually want to maintain the visibility and accountability of their respective funds to track results. For this reason, each donor had discrete contracts with KfW. This arrangement meant the financial institutions were not able to mix donor funds and money remained idle because re-flows into individual donor accounts were often insufficient to finance new loans. Furthermore, each donor required separate reports from the banks and KfW on each individual credit line, adding administrative costs.

Insufficient policy coordination between field, administrative, and legal staff slows implementation. Typically, donor operational field staff spearhead collaboration, with headquarters eventually following their lead. Operational staff understand the efficiencies to be gained for both their own and local institutions. Especially when programs are innovative and charting new ground, changing procedures and designing new types of legal arrangements can take a long time. For example, in BiH, it took the donors' headquarters a year to approve their field staff's initiative to pool SME funds, and then another year for the policy to be operationalized due to new contracting mechanisms and other procedures.

Complex administration reduces efficiency. For KfW, the principal challenge has been the legal and administrative management of donor funds in multiple countries. By 2003, KfW was managing eight funds for different donors, providing lending capital to 26 partners in four countries. Each new funding tranche, donor, program, and local partner added administrative complexity for KfW.

Lack of precedent for translating grants into loans, confuses donors' procedures. One operational challenge —transforming the donor grant instrument into an ongoing credit line—results from the excellent repayment rates of the financial institutions. The "revolving grants" are never actually "spent" because the money is lent out and repaid by local financial partners, thus keeping the funds on the donors' books. This confuses donor agency procedures, since their instruments are designed to spend money on short-term projects.

Uncertainty over regional fund reduces impact. KfW has been interested in creating a regional institution (or fund) to which donors could easily donate grants. But that option raised many questions. Donors earmarked their funds for particular programs and countries. How would they be able to ensure that their funds continued to be allocated as originally intended within a regional fund? Donors also needed to ensure adequate governance for the long term. What would their role be in a new structure? What would be the role of relevant national actors and how could they be included in the decision-making process? The donors are continuing to discuss options for pooling their funds on a regional and/or country basis to ensure maximum use of their funds. (Although, in 2003, the EC decided against placing its BiH investments in a regional fund.) In Montenegro, Kosovo, and Serbia, KfW and the donors agreed in principle to pool funds within sectors in November 2003, but formal agreement is still pending from some donors and they have now held off implementation until they explore the alternative possibility of a regional fund.

> "One of the lessons we have learned is that it would have saved a lot of time if the [program] had been set up as a fund in the first place."
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> *Mark Priestley, Task Manager for Economic Development, EC Delegation, Sarajevo*

Successes of Donor Collaboration

Forging a common vision of financial sector development. European donors were initially focused on disbursing funds quickly in the post-conflict situation. However, through a process of regular exchange and consultation, they quickly recognized the advantages of a adopting a common longer-term approach. Their shared vision of helping to develop a dynamic and stable financial sector allowed them to leverage one another's strengths. As a result, they contributed to building strong, sustainable financial institutions that could provide financial services on a large scale—the backbone of all financial systems. This vision allowed the donors to achieve a high degree of harmonization on near-market lending policies, and a common reporting format.

> "KfW had an idea and were very proactive in getting support. The EC was very receptive because this mechanism allowed us to move very quickly, which was especially important in the post conflict situation."
>
> *Mark Priestley, Task Manager for Economic Development, EC Delegation, Sarajevo*

Delegating management to a suitable technical partner. The donors agreed that KfW had the technical expertise to select and maintain professional relationships with commercial lending institutions, coordinate effective technical assistance, and manage donor funds. For a fee, KfW eagerly fulfills this role, thus also leveraging the impact of its work. The other donors benefit from the arrangement because it is less labor-intensive and more cost-effective to delegate program management to KfW. Local banks benefit from the financing arrangement because they only have one direct partner. All financial intermediaries also receive valuable technical assistance in credit line management, risk management, etc.

> "KfW has expertise in fund management and a proven track record in the region. It makes no sense going it alone when a proven mechanism is in place."
>
> *Michael Kilcommons, Programme Manager, Enterprise Development, EAR Operational Center, Belgrade*

Creating a robust vehicle for coordination. In 1999, KfW and the donors established a steering committee to ensure coordination among their programs. Sustained discussions among steering committee members as well as local staff at the regional level have allowed the donor agencies to tackle difficult policy issues, such as interest rates and client targeting, and achieve a high degree of harmonization of near-market lending policies. Today, the committee is the forum for discussions on transforming the programs into a long-term legal entity.

> "We knew that KfW would be around for 12 years because of their agreement with the EU, and we knew they were a committed and efficient organization. It made sense to develop the SME program together with a long-term partner."
>
> *Michael Ingrid Sager, Head, Department for Development Cooperation with Eastern Europe, Austrian Foreign Ministry*

Agreeing to pool funds. In 2001, the donors to the SME program in BiH agreed in principle to pool their funds into a single credit line. Legal and contract revision for the SME funds was completed in 2002, and a single credit line became operational in BiH in 2003. This decision greatly reduces the inefficiencies of individual donor credit lines. Building on the success of the SME pooled fund, a multi-sector fund for Bosnia has been proposed to pool multiple donor funds across sectors.

Achieving greater impact. The common approach adopted has permitted European donors to have significant impact in the region in terms of the number of local financial institutions strengthened and the number of low-income clients reached. As of December 2003, local banks and MFIs in Bosnia and Herzegovina had 60 million euros available for lending and 9,900 loans outstanding. In Montenegro they had disbursed 2,400 loans totaling 10 million euros, while maintaining a portfolio at risk (PAR) below 1 percent. Local lending institutions in Kosovo had disbursed 1,900 loans and were managing a 9.5 million euro portfolio with a PAR less than 2 percent. Local banks in Serbia had disbursed 163 loans totaling 5.6 million euros.

The increased impact of collaborative action is particularly important for smaller donors, who do not have the resources to manage complex projects. Even in the absence of pooled funds, the fact that the donors have agreed to similar lending terms has provided local financial institutions with a unified source of long-term financing at near-market conditions.

The Way Forward

European donors have collaborated at progressively deeper levels in the six years since they began supporting local financial intermediaries in Southeastern Europe. They are now discussing ways to institutionalize the so-called "European Funds" to create a legal entity in which donors could pool their funds. Such an approach would increase their impact by reducing transaction costs for the financial institutions, increasing KfW's efficiency, and providing an effective exit strategy for all donors.

Their successful collaboration offers one model for donors in other areas of the world.

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Contacts and Websites

EFBH: www.efbh.ba

KfW: www.kfw.de

Ann Duval is an independent microfinance consultant. This case study is based on a review of the documents cited above, as well as input received from Klaus Glaubitt, Ingrid Sager, Mark Priestley, Michael Kilcommons, Aida Soko (Head, EFBH), Dominik Ziller (Head, European Division, German Ministry of Economic Cooperation BMZ]), Haje Schütte (Vice President, Financial and Private Sector Development Division, KfW), Roland Siller (Vice President, Financial and Private Sector Development, KfW), and Johannes Feist (Director, KfW office, Belgrade).

Ruth Goodwin-Groen is a microfinance consultant and is currently the managing editor of the CGAP DIRECT Donor Good Practice Case Studies.