Oesterreichische Entwicklungsbank AG

Evaluation

ProCredit Bank Georgia

Short-Version

Prepared for OeEB and KfW by Prof. Dr. Martin Brown, University St. Gallen, February 2012

Evaluation Report – ProCredit Bank Georgia

February 2012

General information:	
Region	South Caucasus
Country	Georgia
Partner	ProCredit Bank Georgia
Sector	Financial Sector

Project details of evaluated project:		
Project Nr.	13/IF/1	
Type	Debt – Unfunded risk participation	
	Plan	Realized
Investment of OeEB	USD 23,5 Mio.	USD 9,9 Mio.
Investment of KfW	USD 24,0 Mio.	USD 10,1 Mio.
(Co-)Investment of partner	-	-
Total Investment	USD 47,5 Mio	USD 20,0 Mio.
Maturity	5 years	5 years

Evaluation details:	
Project Nr.	13/AP/1
Timeframe	September 2011 – February 2012
Participating institutions	Kreditanstalt für Wiederaufbau (KfW)
Evaluator	Prof. Dr. Martin Brown (University St. Gallen)

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1 List of abbreviations

BMZ	Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung = The German Federal Ministry for Economic Cooperation and Development
DFI	Development Finance Institutions
EBRD	European Bank for Reconstruction and Development
FX	foreign exchange
GDP	Gross domestic product
GEL	Georgian Lari (National currency of Georgia)
HDI	Human Development Index
IFI	International Financial Institutions
KfW	Kreditanstalt für Wiederaufbau
KfW FZ E	KfW Finanzielle Zusammenarbeit Abteilung für Evaluierung = KfW Financial Cooperation Evaluation Department
OeEB	Oesterreichische Entwicklungsbank = Development Bank of Austria
PCBG	ProCredit Bank Georgia
PPP	Purchasing power parity
MSME	Micro, small and medium sized enterprises
USD	US Dollar (National currency of the United States of America)

2 Executive Summary

Short project description

This loan was initiated by ProCredit Bank Georgia (PCBG) in March 2008 as part of their regular wholesale refinancing activities. Following the conflict between Georgia and Russia in August 2008 and the intensification of the global financial crisis in October 2008 the loan was agreed in December 2008. The loan was offered for a period of 5 years and will be repaid in half-yearly installments.

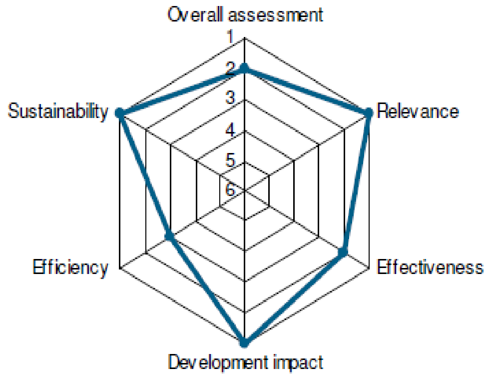
Objective of the project

The development objective of this loan was to expand the access to credit for micro, small and medium sized enterprises (MSME) in Georgia, thereby contributing to the development of the financial system as a whole. The target system was coherent: ProCredit Bank is a development orientated full-service bank, which, due to limited aggregate savings activity in Georgia, is reliant on international funding to provide credit to MSME. Following the Georgian-Russian conflict of August 2008 and the spread of the global financial crisis to the Georgian banking sector in late 2008 a further objective of this loan was to assist PCBG in overcoming potential liquidity constraints and maintaining their development orientated bank services.

Overall assessment

The loan has fulfilled its development objectives. In an extremely challenging economic environment PCBG was provided with access to long-term, affordable financing. Slower credit growth, stable customer funding and access to other (cheaper) sources of wholesale funding led the bank to draw only partly on this loan. However, the “option value” of this loan can be viewed as substantial.
The overall assessment of the project: Grade 2

Assessment based on DAC Criteria[1]



[1]For further information on the DAC evaluation criteria, please refer to Annex 2 (p.19).

3 General information

From 12th -15th September 2011 the evaluation team consisting of Prof. Dr. Martin Brown (University of St. Gallen), Prof. Dr. Eva Terberger (KfW FZ E), Kristin Duchâteau and Reinhard Wagner (both OeEB) visited Tbilisi, Georgia. The evaluation team met with management, staff and clients of ProCredit Bank Georgia (PCBG) as well as representatives of Bank of Georgia (largest commercial bank), National Bank of Georgia (central bank) and EBRD. The mission was excellently prepared by KfW and the compliance department of PCBG. For further information on the evaluation methodology, please refer to Annex 1 (p.18).

4 Performance indicators

<table>
<tr><th colspan="2">Development objectives:</th></tr>
<tr><td colspan="2">1) Expand the access to credit for micro small and medium sized enterprises (MSME) in Georgia (according to loan documentation).
2) Assist ProCredit Bank Georgia (PCBG) in overcoming potential liquidity constraints and maintaining their development orientated bank services (added by the evaluator).</td></tr>
<tr><td colspan="2">Project outcome 1: Funding constraints of ProCredit Bank Georgia are alleviated</td></tr>
<tr><td>Indicators (quantitative)</td><td>• Customer deposits / outstanding loans (%)
• Domestic wholesale funding / Outstanding loans (%)
• International wholesale funding / Outstanding loans (%)
• Maturity structure of liabilities and loans
• Currency structure of liabilities and loans
• Market interest rates for international funding
...indicate a funding gap which is adequately closed by international wholesale funding from development oriented financial institutions.</td></tr>
<tr><td colspan="2">Project outcome 2: ProCredit Bank Georgia maintains / expands its lending to MSME</td></tr>
<tr><td>Indicators (quantitative)</td><td>• Volume of new loans to MSME / non MSME
• Maturity structure of new loans
• Currency structure of new loans
...indicate that PCBG has continued its lending to MSME</td></tr>
<tr><td colspan="2">Project outcome 3: ProCredit Bank Georgia adheres to principles of responsible finance</td></tr>
<tr><td>Indicators (quantitative)</td><td>• Debt levels of clients are moderate.</td></tr>
<tr><td>Indicators (qualitative)</td><td>• The existing debt of a client is elicited in detail prior to approval.
• PCBG makes use of credit bureau data on existing debt.
• The debt service capacity of a client is elicited in detail during credit assessment.
• Clients are informed about contract terms and particularly about the exchange rate risk involved in USD/ EUR loans.
• PCBG applies buffers for leverage/debt service burden when disbursing FX loans.</td></tr>
</table>

5 Performance measurement

Project outcome 1: Funding constraints of ProCredit Bank Georgia are alleviated

Since the implementation of the project in December 2008 PCBG has improved its liquidity position. Table 1 shows that the deposit to loan ratio has increased from 60% to 84% due in particular to a substantial growth in the deposit volume. Due to its enhanced reputation among depositors following the 2008 crisis, the total deposit volume of PCBG rose by 31% in 2009, compared to only 10% for the aggregate banking sector. Between December 2009 and June 2011 there was a further 18% increase in the deposit volume. Wholesale funding from domestic sources (bonds, interbank loans) has remained negligible.

PCBG was further able to maintain its international wholesale funding throughout the project period. The ratio of international funding to the loan volume has remained constant over the project period, with the absolute volume of funding ranging between 230 Mio GEL and 260 Mio GEL. The stability of PCBG's international funding is in stark contrast to that of other Georgian banks, e.g. Bank of Georgia and TBC. The latter banks received substantial funding from bank syndicates and the capital market prior to the 2008 crisis and were thus strongly hit by the extremely tense conditions in commercial international funding markets. PCBG, by contrast has relied on funding from several development orientated funds (ResponsAbility, BlueOrchard) and International and Development Financial Institutions (IFI's and DFIs), which continued their funding throughout the crisis. The interest rates of the latter loans were close to commercial market rates before the crisis. They went up due to the additional crisis induced risk margin, as was exemplified by the loan under evaluation. However, compared to commercial funds whose interest rate – due to their unavailability - can only be approximated by the Bank of Georgia Eurobond yield of 58%, refinancing lines by IFI's and DFI's, including the KfW/OeEB loan, were considerably below market rates during the crises. When risk assessments came down to normal again, the margin between IFI/DFI-lending rates and commercial market rates adjusted to their low pre-crisis level.

Table 1:ProCredit Bank Georgia: Indicators of funding constraints 2007-2011

	unit	2007/12	2008/12	2009/12	2010/12	2011/06
Deposit / Loans	%	70	60	76	88	84
Other domestic funds / Loans	%	2.1	4.5	1.7	1.2	1.2
International funds / Loans	%	46	48	43	42	43
Deposits in foreign currency	%	71	76	74	71	74

Source: ProCredit Bank Georgia

The currency composition of PCBG's loans and deposits has also remained stable over the project period. Between 70-80% of loans and deposits are denominated in foreign currency (mostly US Dollars). PCBG management, and other market participants see a lack of (deposit and wholesale) funding in domestic currency as the main driver of the "dollarization" in lending. For this reason, EBRD and other international financial institutions are currently promoting the provision of local currency international loans to Georgian banks.

Project outcome 2: ProCredit Bank Georgia maintains / expands its lending to MSME

Since the implementation of the project PCBG has maintained its lending activity. The volume of total outstanding loans by PCBG remained constant between 2008/12 and 2009/12, while the aggregate loan volume of the banking sector fell by 13%. Between December 2009 and June 2011 PCBG experienced a slight growth in lending (8.7%). Table 2 provides information on new loan disbursements by PCBG during the project period.

The table shows that the volume of new loan disbursements did drop significantly during the economic downturn in 2009. However, lending activity recovered swiftly in 2010 and 2011, so that on average annual loan disbursement between January 2009 and June 2011 exceeds that in 2007 and 2008.

The average loan size of PCBG has increased over the project period. However, the share of loans disbursed to micro firms (less than 10 employees) has remained above 90%. Within the segment of business clients PCBG has strengthened its focus on financing sustainable MSME. In line with the strategy of ProCredit Holding PCBG began to phase out business micro-loans below 2'000 USD. The aim of this strategy is to eliminate lending to unsustainable micro enterprises. According to information by the management of PCBG, this view was confirmed by an analysis of the profiles of customers with credits below 2’000 USD prior to strategy implementation. The currency and maturity structure of PCBG’s loans has remained stable over the project period.

Table 2: ProCredit Bank Georgia: New loan disbursements 2007-2011

	unit	2007	2008	2009	2010	2011 Jan-June
Volume of new loans disbursed	Mio GEL	402	446	377	518	250
Loans with volume < 50’000 USD	%	75	68	65	58	57
Loans to firms with < 10 employees	%	92	91	91	92	95
Loans in foreign currency	%	82	74	76	79	77

Source: ProCredit Bank Georgia

Project outcome 3: ProCredit Bank Georgia adheres to principles of responsible finance

Responsible finance continues to be a guiding principle of PCBG. The rigorous and conservative credit appraisal process is focused on eliciting the debt capacity of its clients. As a rule, loan installments are expected to be comfortably payable with the level profits documented in the past. While the majority of its loans are denominated in foreign currency (USD), PCBG maintains processes to limit FX risk faced by its clients. Clients are instructed about the exchange risks of FX loans as well as about all other conditions of the loan contract. For long-term loans buffers are applied to FX loans to limit debt service / income ratios.

Conclusion: The KfW/OeEB-loan has fulfilled its development objective of expanding/maintaining the access to credit for MSME in Georgia. Even if PCBG did not draw the full amount of the refinancing line, it served as a most useful liquidity reserve when commercial funding from international lenders dried up during crisis times. PCBG continued to have access to development oriented funding at even lower cost than the KfW/OeEB-line which obviously was used prior to drawing on the loan under evaluation.

Nevertheless, the pricing of the KfW/OeEB loan was well below market rates in crisis times, and PCBG would have certainly called on this refinancing option more extensively without risking its financial stability if no cheaper funds had been around. Therefore, via its option value and without loan terms being unnecessarily soft, the loan assisted PCBG in overcoming potential liquidity constraints and maintaining its policy of providing banking services responsibly.

6 Assessment of the project

Overall assessment: (Grade 2)

The loan has fulfilled its development objectives. In an extremely challenging economic environment ProCredit Bank Georgia (PCBG) was provided with access to reliable and affordable financing. Slower than expected credit growth, stable customer funding and access to other sources of wholesale funding led the bank to draw only partly on this loan.

However, the “option value” of this loan can be viewed as substantial.

Relevance: (Grade 1)

The results chain underlying the design of the loan in question is plausible. It held high potential to contribute to the expansion of access to credit for micro, small and medium sized enterprises (MSME) in Georgia. An analysis of past credit growth, funding structure and maturity as well as business plans of PCBG clearly indicates: At time of approval (2008/12) the loan could be expected to help PCBG, a partner well known for its commitment to MSME finance, meet its increased need for wholesale funding, due to strong expected credit growth and a slack in deposit growth after the August 2008 conflict with Russia.

The collaboration KfW/OeEB could further be expected to help PCBG reduce the transaction costs of funding its activities as there was uniform reporting to both institutions and none of them could have provided the same loan amount on its own.

The conflict between Georgia and Russia in August 2008 as well as the increased tension in international financial markets in autumn 2008 increased the importance of IFI / DFI funding for the Georgian banking sector in general. The Georgia-Russia conflict led to a sudden, substantial withdrawal of customer deposits in August 2008. International commercial lenders fully withdrew from the Georgian financial sector in late 2008-2009. The international capital market (Eurobond) for Georgian financial institutions also dried up.

Conclusion: PCBG, a bank certainly committed to MSME customers, expected a substantial increase in its funding gap, which certainly could not be closed from domestic sources. The need for DFI/IFI funding had even increased after the conflict as commercial funding dried up. Despite of the conflict PCBG was in the position to absorb funding without direct subsidies. Furthermore, the KfW/OeEB-loan had the potential to contribute to closing the funding gap at low transaction cost.

Conclusion: Accordingly, the relevance of the project was rated with 1 (very good).

<u>Effectiveness: (Grade 2)</u>

Due to the availability of other cheaper funding in 2009 and lower liquidity needs in 2009-2010 PCBG could maintain its lending to MSMEs in Georgia without fully drawing on this loan.

Conclusion: However, even if the line was not fully used, it had a high “option value” in terms of a substantial liquidity reserve for PCBG in crisis times. Accordingly, the effectiveness of the project was rated as good (2).

<u>Efficiency: (Grade 3)</u>

PCBG has proved to be an efficient and reliable partner to promote responsible MSME lending in Georgia. PCBG has a clear strategy of lending responsibly to MSME in Georgia. PCBG is further keen on maintaining long-term relationships with its key international funding partners to meet its future funding requirements. Alternative market funding from international commercial sources was not available at the time the loan contract was closed in 2008/12. Therefore, there is no indication whatsoever for a crowding out of commercial lenders by the KfW/OeEB refinancing line.

The funding collaboration of KfW/OeEB did not realize its full potential as PCBG had access to other funding which responded less to market risk in 2009 and PCBG had lower liquidity needs than expected in 2010. Because the KfW/OeEB loan was only used up to 20 Mio USD the potential efficiency gains from providing a large loan through one transaction were not realized.

Conclusion: Accordingly, the efficiency of the project was rated as satisfactory (3).

<u>Development impact: (Grade 1)</u>

There is no doubt that financial cooperation with PCBG contributes to maintaining and expanding responsible finance to micro, small and medium sized enterprises in Georgia. Indeed, given that PCBG strives to offer a full range of retail banking services also to households (savings) and farmers, one can conclude that financial cooperation with this institution contributes more generally to the access to financial services for firms and households in Georgia.

Since 2008 PCBG has strengthened its focus on financing sustainable MSME. In line with the strategy of ProCredit Holding PCBG began to phase out business micro-loans below 2'000 USD. The aim of this strategy is to eliminate lending to unsustainable micro enterprises. While the average loan size of PCBG has increased since 2008, the overwhelming majority of PCBG loans are still disbursed to the MSME sector. The share of the disbursed loan volume to firms with less than 10 employees still exceeds 90%.

Responsible finance is a guiding principle of PCBG: The rigorous and conservative credit appraisal process is focused on eliciting the debt capacity of its clients. As a rule, loan installments are expected to be comfortably payable out of profits documented in the past. While the majority of its loans are denominated in foreign currency (USD), PCBG maintains processes to limit FX risk faced by its clients.

Clients are instructed about the exchange risks of FX loans, as well as loan terms in general. For long-term loans buffers are applied to FX loans to limit debt service / income ratios.

Beyond financing non-agricultural MSME, PCBG contributes to fostering the use of financial services by households and the agricultural sector. PCBG undertakes regular activities (e.g. in schools) to promoting a savings culture in Georgia. The bank currently has 15 times more deposit customers (300'000) than business clients (20'000). Moreover, PCBG was the first bank in Georgia to offer credit to small farms. While the share of farm-loans in its credit portfolio is still very limited (6%), PCBG is viewed by stakeholders (e.g. EBRD) as a key partner in expanding credit to the agricultural sector in the near future.

Conclusion: Accordingly, the development impact of the project was rated as very good (1).

<u>Sustainability: (Grade 1)</u>

PCBG has established itself as a profitable savings and MSME lending bank. It is now the third largest bank in Georgia with over 300'000 individual clients and 20'000 business clients. As the only bank in Georgia, PCBG was profitable throughout 2008-2010.

The bank has maintained and expanded its funding relationships through the crisis, so that it can be expected to comfortably increase its wholesale funding to meet its financing needs.

There can be no doubt, that PCBG is well established in the Georgian financial market. The bank has a long-term commitment to serve the target group of MSME in urban and agricultural areas as well as households, while being restrictive in retail consumer lending.

Conclusion: Therefore, the sustainably of the project was rated as very good (1).

7 Conclusion (included by OeEB)

Regarding the project

The loan has fulfilled its development objectives. PCBG proved to be the right partner to promote responsible lending to MSMEs in Georgia. The loan was thus a valuable development instrument in times of financial market and / or political turmoil.

The funding collaboration of KfW/OeEB did not realize its full potential as PCBG had access to cheaper funding and because PCBG had lower liquidity needs than expected. However, the fact that the loan was not fully drawn by PCBG does not imply that it had limited development value. The "option value" (in terms of a substantial liquidity reserve) for PCBG was substantial.

Regarding OeEB

As this was the first project evaluation of OeEB, the learning effect was considerable. The added value of evaluating projects and the inclusion of the assessment of the results and lessons learned for the planning and design of future projects was confirmed. This means, that OeEB will conduct further evaluations regularly in a structured manner to assess the developments effects of its projects.

8 Background of the project

Georgia at a glance

Table 2 presents selected socioeconomic indicators for Georgia and its neighboring countries at the time the loan subject to evaluation was initiated (beginning of 2008). At the end of 2007 Georgia was ranked 89th out of 182 countries according to the UN Human Development Index (HDI). The socioeconomic conditions of Georgia were thus ranked slightly below those in Armenia, Azerbaijan and Turkey while they were ranked substantially higher than in Moldova. In terms of aggregate income and employment, Georgian per capita GDP in purchasing power (PPP) terms amounted to 4'516 USD while the unemployment rate stood at 13.3%.

In comparison to neighboring countries, Armenia displayed a similar income level, but a much lower unemployment rate. Azerbaijan and Turkey both had substantially higher income levels than Georgia, while the opposite was the case for Moldova. With respect to income distribution and poverty, the share of the population living below the absolute poverty line (2$ PPP per head and day) stood at 32.6% while the Gini-coefficient of income distribution was 41.3. Compared to the neighboring countries, the share of the Georgian population below the poverty line was substantially higher and the income distribution was less equal.

Table 3: Socioeconomic indicators in comparison (2007/2008)

	HDI (rank)	Per capita GDP (USD PPP)	Unemployment rate (%)	Population below poverty line (%)	Gini-coefficient of income distribution
Georgia	**89**	**4’516**	**13.3**	**32.6**	**41.3**
Armenia	84	5’618	28.6	12.4	30.9
Azerbaijan	86	8’100	6.1	7.8	33.7
Moldova	117	2’768	4.0	12.5	38
Turkey	83	11’903	11.0		39.7

Source: World Bank: World Development Indicators (www.data.worldbank.org)

Between 2003 and 2007 Georgia had experienced annual real GDP growth of 9.5%.[2] Economic performance had been strong in the manufacturing and services sectors, while the performance of the agricultural sector was comparatively weak. The real-estate and construction sector experienced an unprecedented boom between 2003 and 2007. The price of land in Tbilisi, for example, increased more than ten-fold in this period.

This growth pattern continued during the first half of 2008, with the real-estate sector already cooling down in the second quarter of 2008

In August 2008 the brief armed conflict with Russia had an immediate and severe impact on the construction, transport and manufacturing sectors. In the 3rd quarter of 2008, for example output in the construction sector fell (year-on-year in real terms) by 32% while output in the transport and manufacturing sectors fell by 22% and 7% respectively. These sector specific developments led to a decline in real GDP growth to 2.3% in 2008.

In early 2009 the economic impact of the armed conflict with Russia was amplified by the spread of the global financial and economic crisis to the transition economies. Real GDP fell by 3.9% in 2009 with almost all sectors experiencing negative output growth. The trade (-18%) and manufacturing sectors (-8.4%), i.e. the core business clientele of ProCredit Bank Georgia (PCBG), experienced hereby the strongest decline. The unexpected severe economic downturn in 2009 was followed by an equally unexpected improvement in economic performance in 2010. Real GDP growth reached 6.4% in 2010, with all non-agricultural sectors growing significantly. Table 3 shows that the pattern of economic performance in Georgia in 2009-2010 is mirrored by that in neighboring countries.

[2] EIU country profile 2008, EUI country reports 2008-2011

Table 4: Real GDP growth 2008 – 2010

	2008	2009	2010
Georgia: selected sectors			
Agriculture	-4.4	-5.7	-1.7
Manufacturing	-1.5	-8.4	20.3
Construction	-11.1	-5.5	7.6
Trade	11.8	-17.8	14.1
Comparison to neighboring countries			
Georgia	2.3	-3.9	6.4
Armenia	6.9	-14.3	1
Azerbaijan	10.8	9.3	5
Moldova	7.8	-6	6.9
Turkey	.7	-4.8	8.9

Source: World Bank: World Development Indicators (www.data.worldbank.org)

The political conditions surrounding the project to be evaluated were very volatile in 2008 and 2009, but seem to have stabilized since then. Large protests in November 2007 led President Mikheil Saakashvili to call forward presidential elections which were held in early 2008. Saakashvili won re-election, albeit with only 53% of the vote as compared to 96% in 2004. The president promised to re-instore Georgia's territorial integrity, by reuniting the breakaway regions of Abkhazia and South-Ossetia.

In August 2008 these attempts led to an armed conflict with Russia, with severe military and economic consequences for Georgia. In summer 2009 Saakashvili faced further protests aimed at forcing his resignation. However, divisions within the opposition undermined the success of those protests. This weakness of the opposition and the improvement in economic conditions in 2010 seem to have strengthened the president's position and stabilized overall political conditions.

<u>Financing of small and medium enterprises in Georgia</u>

The main objective of the loan to be evaluated is to enhance access to credit for micro, small, and medium-sized enterprises (MSME) in Georgia. In this section we examine survey data from the 2008/2009 EBRD/ World Bank Business Environment and Enterprise Performance Survey (BEEPS) to assess the availability of credit for MSME and to compare this to neighboring countries.

Table 5: Access to credit for MSME – comparison to neighboring countries

		Georgia	Armenia	Azerbaijan	Moldova	Turkey
Have a loan	(%)	41.9	45.2	19.0	46.8	61.4
Loan denied	(%)	14.2	8.9	38.8	19.0	16.0
Discouraged – Interest	(%)	14.0	14.3	15.3	26.0	7.6
Discouraged - Collateral	(%)	6.8	5.1	9.3	3.3	0.8

Major growth obstacle	(%)	70.9	60.1	57.7	67.9	65.3

Source: Business Environment and Enterprise Performance Survey 2008/2009 (www.ebrd.com)

Table 4 shows that the share of firms which use bank loans in Georgia (42%) is lower than in all neighboring countries, except Azerbaijan. With 42% of the firms having a bank loan the use of bank credit is also low compared to more developed transition countries. Recent evidence based on the same data suggests that in Central and South-Eastern Europe 52% of the firms use bank credit (Brown et al 2011). The share of Georgian firms which are denied credit or discouraged from applying for credit (35%) is higher than in Armenia or Turkey, but much lower than in Moldova and especially in Azerbaijan.

The survey data reveals that 14% of Georgian firms had a loan application denied within the past year. A further 14% of firms did not apply for a loan as they perceived interest rates to be too high, another 7% did not apply as they did not expect to meet the required collateral conditions. The remaining 25% of Georgian firms seem not to apply for credit because they don't need it. Confirming this picture, 71% of Georgian firms view access to credit as a major growth obstacle, while 29% do not.

Table 6: Access to credit for MSME in Georgia– comparison across firm types

		Small firms	Young firms	Manufacturing
Have a loan	(%)	36.0	41.9	41.6
Loan denied	(%)	13.3	15.1	13.6
Discouraged – Interest	(%)	14.2	13.6	12.3
Discouraged - Collateral	(%)	7.4	7.9	7.7
Major growth obstacle	(%)	71.9	69.1	71.7

Source: Business Environment and Enterprise Performance Survey 2008/2009

Table 5 shows that within Georgia the availability of credit seems to be similar across firm types. Small firms are less likely to use bank credit (36%) than the average (42%, see Table 4), while firm age or sector of activity (services vs. manufacturing) does not affect credit use. With respect to loan denials, loan discouragement, or the role of credit as a growth obstacle there are hardly differences across firm types. Taken together these results suggest that access to credit in Georgia is lower than in most of its neighboring countries and that access is similar for all (non-agricultural) firms, while the demand for credit seems to be lower among small as compared to medium-sized firms.

The Georgian banking sector

The Georgian banking sector currently[3] consists of 19 Banks with 669 points of sale (branches and service centers) throughout the country. The total assets of the banking sector currently stand at 11'570 million GEL or roughly 55% of GDP. There are also 57 registered microfinance organizations

[3]Data as per August 2011, source: National Bank of Georgia

operating in Georgia. As their consolidated assets (360 Mio GEL in June 2011) are just 3% of the total assets of commercial banks and substantially lower than the loan portfolio of PCBG alone (see Table 7 below). This section focuses on the structure and developments in the commercial banking sector only.

The two largest banks in the country are the Bank of Georgia and TBC Bank which hold 36% and 21% of total banking assets respectively. Both of these banks are universal banks providing retail services to households and small enterprises through a large branch network. Bank of Georgia has over 1 million customer accounts and 137 branches, while TBC has 435'000 accounts and 45 branches. Both these banks also offer corporate banking services.

The number of banks in Georgia has remained stable since the end of 2007. However, the ownership structure of the banking sector changed during the crisis due to international bailout of TBC. Currently 17 of the 19 commercial banks are foreign controlled.

The Georgian banking sector experienced a credit boom between 2003 and 2007 with the volume of domestic loans rising from 1'336 Mio GEL (16 % of GDP) to 7'208 GEL (42.4% of GDP). The total volume of customer deposits rose strongly during this period from 717 Mio GEL in 2003 to 3'215 Mio GEL in 2007. As the increase in the deposit volume could not match that of lending, however, the banking sector became more reliant on wholesale funding from international financial institutions (e.g. EBRD, IFC, KfW), but also from the capital market and the syndicated loan market. In 2007 for example, Bank of Georgia issued a Eurobond in the volume of 200 Million USD, while it also received short-term funding from international banks.

Table 6 shows that despite the armed conflict with Russia, lending activity and deposit taking by Georgian banks did not decline in 2008. The conflict led to a severe, but only short-lived withdrawal of deposits from the banking sector. Immediately during and after the conflict (end August 2008 as compared to end July 2008) the total volume of bank deposits fell by 13.5% from 3'543 Mio GEL to 3'067 Mio GEL. In the following 3 months, however, confidence in the banking sector was restored, so that by December 2008 the deposit volume had reached pre-conflict levels (3'568 Mio GEL). Immediately following the conflict banks' provisions for loan losses soared, both due to loans outstanding in conflict areas as well as to the collapse of activity in the real-estate sector. In the second half of 2008 banks' total provisions for loan losses reached nearly 400 Mio GEL, compared to only 140 Mio GEL in the first half of 2008.

The expansion of bank lending came to an abrupt halt in 2009 as a result of the collapse of activity in the real-estate sector and the widespread economic downturn. From December 2008 to December 2009 the volume of loans outstanding decreased by 13%. However, the rebound of the economy in 2010 spurred an immediate recovery in lending activity, the outstanding volume of loans increasing by 20% from December 2009 to December 2010.

Table 7: Development of the Georgian banking sector 2007-2010

	unit	2007/12	2008/12	2009/12	2010/12	2011/08
Assets	Mio GEL	7'208	8'866	8'292	10'564	11'570
Loans to non-banks	Mio GEL	4'580	5'982	5'181	6'256	7'116
in foreign currency	%	69.7	72.9	78.7	71.3	71.2
Customer deposits	Mio GEL	3'215	3'568	3'950	5'489	6'000
in foreign currency	%	70.3	79.3	72.7	70.9	68.6
Loan loss provision	Mio GEL	-114	-540	-314	-100	-37
Net Profit before tax	Mio GEL	149	-208	-65	187	256
Capital / Assets	%	20	17.1	18.3	16.9	16.3

Source: National Bank of Georgia

At the end of 2007 the Georgian banking sector was well capitalized, highly profitable and displayed a low level of non-performing loans. Between 2008 and 2010 the share of non-performing loans climbed from less than 1% to 7%, while the capital/asset ratio declined from 20% to 16.7%. During 2008 and 2009 almost all Georgian banks, with the notable exception of ProCredit Bank Georgia, posted losses. The major source of losses in the banking sector was loss provisions on real-estate related loans.

The Georgian banking sector was further hit by the contagion of the international financial crisis to the transition economies. Mirroring the freeze of the interbank market in Western Europe and the USA, the availability of wholesale funding for Georgian banks from the capital market or commercial bank syndicates essentially dried up in late 2008 and early 2009. Illustrative of the non-availability of international funding, the yield on the Eurobond of the Bank of Georgia, issued in February 2007 with a yield to maturity of 9%, reached 58% in March 2009.[4]

As a result of the freeze in international funding and loan losses TBC and Bank of Georgia required substantial debt and equity injections from international financial institutions (IFC, EBRD) in late 2008 and early 2009.[5] In December 2008 IFC and EBRD both provided long-term convertible-bond financing to Bank of Georgia, while in April 2009 each institution took a 20% equity stake in TBC Bank.

In 2010 and 2011 the sharp increase in lending and the reduction in loan loss provisions restored profitability in the Georgian banking sector (see Table 6). According to the opinion of market participants, international funding conditions have improved substantially in 2010 and 2011. This sentiment is mirrored by the reduction of the yield of the Bank of Georgia Eurobond from a high of

[4] Source: Bloomberg

[5] *http://georgiandaily.com/index.php?option=com_content&task=view&id=12981&Itemid=77*

58% in March 2009 to 5.8% in March 2011.[6]Confirming the normalization of funding conditions, the Georgian government issued a 10-year Eurobond in April 2011 at a yield to maturity of 7.125%.[7]

The crisis in 2008/2009 has had no impact on the currency composition of banks' loans and deposits. More than 70% of bank loans and customer deposits are denominated in US dollars. Wholesale international funding is entirely provided in foreign currency. Market participants reported that the majority of prices for durables and investment goods are indexed to the US Dollar. Moreover, it seems that the pass-through of exchange rate changes to retail prices for consumption goods is also high. This suggests, that so far foreign currency lending to business clients has involved limited currency induced credit risk. Efforts to provide international funding in domestic currency (GEL) are currently of high priority among international financial institution (e.g. EBRD). Local currency funding is seen as especially important in view of expanding the credit provision to the agricultural sector.

<u>ProCredit Bank Georgia</u>

ProCredit Bank Georgia was founded in 1999, then being named Microfinance Bank of Georgia, as a joint initiative of development-oriented private and international public shareholders. The bank was equipped with a full banking license right from the beginning, and it was and still is committed to the mission of sustainably serving customers formerly underserved by the formal banking market, namely credit-constrained micro and small enterprise. In 2003 the bank was fully integrated into the ProCredit Banking Group, becoming a 100% owned by ProCredit Holding AG & Co, KGaA, Frankfurt, and its name being changed to ProCredit Bank Georgia (PCBG).

ProCredit Holding is the head of ProCredit Banking Group, consisting of 21 banks in developing and emerging countries. The holding is registered as a shareholder company under German law (Kommanditgesellschaft auf Aktien) and is owned by development oriented private and public-sector shareholders, underneath them KfW (14%).

Today, PCBG is the third largest bank in Georgia with currently 7% of the total banking assets. PCBG has established itself as a fully-fledged retail bank with 320'000 clients. Within the segment of non-agricultural business clients PCBG focuses on financing sustainable MSME. Beyond the traditional MSME segment PCBG offers savings, payment and (limited) credit services to households. The bank currently has 15 times more deposit customers (300'000) than business clients (20'000). PCBG was also the first bank in Georgia to offer credit to small farms. While the share of farm-loans in its credit portfolio is still very limited (6%), PCBG is viewed by stakeholders (e.g. EBRD) as a key partner in expanding credit to the agricultural sector in the near future.

The project being subject to evaluation here was initiated by PCBG in March 2008 as a part of its regular international funding activities. PCBG has established long-term relationships with several

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[6]Source: Bloomberg

[7]*http://www.government.gov.ge/files/34_32444_651189_GEORGIASSUCCESSFULEUROBONDISSUE.pdf*

international financial institutions (among them KfW) as well as managers of development oriented mutual funds (responsAbility, Blue Orchard). In addition, PCBG has access to short-term and medium-term credit lines as well as long-term subordinated debt from ProCredit Holding.

Table 8:Procredit: Financial indicators 2007-2011

	unit	2007/12	2008/12	2009/12	2010/12	2011/06
Assets	Mio GEL	547	680	722	863	825
Loans to non-banks	Mio GEL	367	501	517	578	562
Customer deposits	Mio GEL	276	293	384	480	456
Loan loss provision	Mio GEL	-3.9	-6.6	-0.3	-3.3	-0.4
Net Profit before tax	Mio GEL	12.8	16.1	23.4	24.4	10.7
Capital / Assets	%	13.3	13.6	14.0	14.1	14.7

Source: ProCredit Bank Georgia

The armed conflict between Georgia and Russia and the subsequent collapse of the real-estate sector in the second half of 2008 had much less impact on PCBG than on other Georgian banks. PCBG experienced substantial deposit withdrawals (16%) during the conflict, but as with the banking sector as a whole, customer deposits recovered to their prior-conflict level by 2008/12. As PCBG was the only bank in Georgia which never put a moratorium on deposit withdrawals during the crisis, it successfully defended its reputation as a safe and reliable bank. In contrast to the aggregate banking sector PCBG continued to expand its credit activity in the second half of 2008, with total outstanding loans increasing from 437 Mio GEL to 520 Mio GEL. One reason for this continued expansion was that PCBG was much less involved in real-estate related lending than other banks. This also implied that PCBG had to provision for much less loan losses in 2008 compared to other banks. As a consequence PCBG remained profitable in 2008, while on aggregate the banking sector made losses.

9 Annex 1: Evaluation Methodology

The evaluation was conducted in three-steps. The first step of the evaluation was a desk-study by Prof. Dr. Martin Brown of project documents provided by KFW as well as financial data provided by ProCredit Bank Georgia (PCBG). In particular the following items were studied:

- Kreditvorlage KFW
- Entwicklungspolitisches Rating KFW
- Loan contract (original and revised version)
- Correspondence between KFW-BMZ
- Financial statement data of PCBG
- Business plans of PCBG
- Data provided by PCBG on structure of loans, customer deposits and international funding

The desk-study was conducted between 20th August and 9th September in preparation of the evaluation mission in Tbilisi. The output of the desk-study were (i) a set of indicators for the project evaluation, (ii) a preliminary assessment of the funding and lending activities of (PCBG), and based on the latter (iii) a list of requested interview partners and topics to be covered during the evaluation mission in Tbilisi.

The second step of the evaluation was the visit by the whole evaluation team to Tbilisi from 12-15th September. In this on-site evaluation the preliminary analysis from the desk-study was validated through interviews with PCBG management and staff as well as with selected other participants in the Georgian financial sector. The on-site evaluation mission was concluded with the signing of minutes of meetings by PCBG management and the evaluation team.

The third step of the evaluation involved analysis of further data and material gathered during the onsite evaluation. Together with the desk-study research and the minutes of meetings of the on-site evaluation this analysis was comprised to a first draft of this evaluation report. The draft report was presented to the OeEB on November 4th 2011 in Vienna. Following that presentation the report was finalized.

10 Annex 2: DAC Criteria for evaluating development assistance[8]

<u>Relevance:</u> The extent to which the aid activity is suited to the priorities and policies of the target group, recipient and donor.

In evaluating the relevance of a programme or a project, it is useful to consider the following questions:

- To what extent are the objectives of the programme still valid?
- Are the activities and outputs of the programme consistent with the overall goal and the attainment of its objectives?
- Are the activities and outputs of the programme consistent with the intended impacts and effects?

<u>Effectiveness:</u> A measure of the extent to which an aid activity attains its objectives.

In evaluating the effectiveness of a programme or a project, it is useful to consider the following questions:

- To what extent were the objectives achieved / are likely to be achieved?
- What were the major factors influencing the achievement or non-achievement of the objectives?

<u>Efficiency:</u> Efficiency measures the outputs – qualitative and quantitative – in relation to the inputs. It is an economic term which signifies that the aid uses the least costly resources possible in order to achieve the desired results. This generally requires comparing alternative approaches to achieving the same outputs, to see whether the most efficient process has been adopted.

When evaluating the efficiency of a programme or a project, it is useful to consider the following questions:

- Were activities cost-efficient?
- Were objectives achieved on time?
- Was the programme or project implemented in the most efficient way compared to alternatives?

<u>Impact:</u> The positive and negative changes produced by a development intervention, directly or indirectly, intended or unintended. This involves the main impacts and effects resulting from the activity on the local social, economic, environmental and other development indicators. The examination should be concerned with both intended and unintended results and must also include

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[8] Source: *http://www.oecd.org/dataoecd/42/6/49756382.pdf*

the positive and negative impact of external factors, such as changes in terms of trade and financial conditions.

When evaluating the impact of a programme or a project, it is useful to consider the following questions:

- What has happened as a result of the programme or project?
- What real difference has the activity made to the beneficiaries?
- How many people have been affected?

Sustainability: Sustainability is concerned with measuring whether the benefits of an activity are likely to continue after donor funding has been withdrawn. Projects need to be environmentally as well as financially sustainable.

When evaluating the sustainability of a programme or a project, it is useful to consider the following questions:

- To what extent did the benefits of a programme or project continue after donor funding ceased?
- What were the major factors which influenced the achievement or non-achievement of sustainability of the programme or project?

11 Annex 3: Description of the rating system

In order to assess the relevance, effectiveness, efficiency, development impact and sustainability of projects, the following methodology is applied:

Successful project	
Grade 1	very good result (above average)
Grade 2	good results (no essential shortcomings)
Grade 3	satisfactory results (not all expectations have been met, but positive results dominate)
Not successful	
Grade 4	unsatisfactory results (positive results, but expectations have not been met)
Grade 5	insufficient results (some positive results, but negative results dominate)
Grade 6	useless results (things are worse than before)