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Experienced Consortium Deepens Bulgarian Financial System by Creating ProCredit Bank, a Commercial Bank for Microenterprises

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This case study describes how a consortium of international development organizations, a commercial bank, and a microfinance technical-service company worked closely to establish ProCredit Bank Bulgaria, a highly successful, full-service commercial bank for micro and small enterprises.

Overview

Over a three-month period in Summer 2001, ProCredit Bank Bulgaria (PCBB) went from an idea to a functioning full-service bank for micro and small enterprises (MSEs). The five donor-investors that created PCBB, together with the Bulgarian government and Bulgarian National Bank, worked with unprecedented efficiency to launch the bank. Three years later, PCBB had become the fastest growing bank in Central Europe.[1] Its success can be attributed to the common vision and diverse experience of its investors; influential champions in donor agencies; dynamic Bulgarian counterparts; skilled staff; and significant equity, loans, and technical services from international financial institutions and donors.

Four members of the consortium—International Finance Corporation (IFC), European Bank for Reconstruction and Development (EBRD), KfW Bankengruppe,[2] and ProCredit Holding AG[3]—have been investing together in best-practice microfinance institutions since 1997. Commerzbank AG, a commercial German bank, joined them in 2000. To achieve their shared goal of financial deepening in Eastern Europe, these partners had already financed nine ProCredit Banks in the region, all of which were managed by IPC. To date, the consortium has made more than €21 million in equity investments in PCBB and continues to provide ongoing governance of the bank through a supervisory board. In addition, the partners have collectively provided PCBB more than €46.5 million in loans for onlending, plus significant technical assistance.

"Elux" manufactures fluorescent lighting to European standards in Sofia. (Photo: Valentin Mechkanov Feb. 2004).

As of December 2004, PCBB had 26,532 savers with deposits of €74.9 million, and €139 million in outstanding loans to 26,852 clients. Loans of less than €10,000 (i.e., microloans in the Bulgarian context) accounted for 92 percent of the total number and 33 percent of the total value of outstanding loans. (Loans of less than €1,000 comprised 40 percent of total outstanding loans.) Only 0.35 percent of the outstanding loan portfolio was late by more than 30 days, and the bank's credit clients represented over 25 percent of all private enterprises accessing credit in Bulgaria. As of 31 Dec. 2004, PCBB's adjusted return on equity[4] (AROE) was 15.57 percent; unadjusted ROE was 19.22 percent. PCBB's success has encouraged other banks to enter the small enterprise market, expanding services for microentrepreneurs and creating tough competition.

Setting the Stage

Bulgaria has made a reasonably successful transition to a

[1] The Banker, *Financial Times*, January 2005, 58.

[2] Kreditanstalt für Wiederaufbau Bankengruppe includes KfW Entwicklungsbank and its subsidary Deutsche Investitions und Entwicklungsgesellschaft GmbH (DEG).

[3] ProCredit Holding AG was formerly Internationale Micro Investitionen Aktiengesellschaft (IMI). Shareholders include Internationale Projekt Consult GmbH (IPC), KfW Bankengruppe, and IFC, owning 21.8 percent, 10.6 percent, and 9.3 percent of its shares, respectively.

[4] Adjusted for inflation, in-kind donations, cost of funds by PCBB.

market-led economy. GDP growth has been strong, inflation and budget deficits are under control, and exports have continued to perform well. Because of its strong economic performance and fiscal discipline, Bulgaria is a candidate for European Union (EU) membership in 2007. In spite of these positive indicators, Bulgaria's GDP per capita remains among the lowest in Europe (€1,900 in 2001). Official unemployment is 12 percent, and a recent World Bank survey demonstrated that 24 percent of the population lives in poverty.

MSEs together account for 54 percent of total employment in Bulgaria's private sector. Of the country's 226,586 registered businesses, 81 percent are microenterprises that employ fewer than ten people. In the late 1990s and early 2000s, these crucial businesses were starved for cash because banks were reluctant to lend to "risky" clients. At the end of 2001, for example, banks had collectively extended only 16,336 loans under €100,000 to private enterprises in Bulgaria.

Responding to the Market: Creating a Full-Service Commercial Bank

Each consortium member had experienced staff with a deep knowledge of both the Bulgarian market and the region. These staff served as champions for the PCBB project. Aftab Ahmed at the IFC; Elizabeth Wallace, Jana Sivcova, Elvira Lefting, and Stephan Boven at EBRD; Dr. Klaus Glaubitt at KfW; and Dr. Claus-Pieter Zeitinger and Cristoph Freytag at IPC, all knew there was huge demand for a bank that focused on MSEs, which could deepen the financial system. Loan applications to local banks required microentrepreneurs to complete mountains of paperwork, and then wait up to three months—with most applications subsequently rejected.

To provide MSEs with a range of financial services, the consortium had two options: (A) buy an existing commercial bank, or (B) create a new microfinance bank. In 2001, KfW and IPC helped a local commercial bank downscale. Although they generated little management interest, the two partners trained 56 young, motivated loan officers in microenterprise lending. The consortium sought to purchase this bank, but decided against it when questions arose in the later stages of due diligence.

Unwilling to give up, the consortium team immediately went to plan B: create a new bank. Consortium staff, local loan officers, and Central Bank officials worked day and night from June to September 2001, when the team was granted a full banking license for a new institution. ProCredit Bank Bulgaria opened its doors on October 15, 2001, positioning itself as an institution for micro and small businesses and depositors. Within a month, it had disbursed 360 loans.

Contributions of Consortium Members

Commerzbank AG. A German retail bank, Commerzbank brought in-depth knowledge of international banking relationships to the project. It serves as PCBB's correspondent bank. In 2004, Commerzbank helped PCBB staff set up "ProPay," an international money transfer service between ProCredit Banks. The service offers transfers at half the price and twice the speed of standard international transfers.

EBRD. EBRD brought specialized knowledge of Bulgaria and Eastern Europe to the project. The development bank has been a major catalyst for investment in the country, having directly invested €784 million itself in various infrastructure and development initiatives. As a result, EBRD carries tremendous political clout in Bulgaria.

IFC. IFC, with its AAA rating and deep pockets, brought leadership, credibility and experience in structuring commercial transactions. Together with IPC, it designed the original financing model, and it was the "lender of record."

> *"A key aspect of the model is for the management team to invest cash up front equivalent to 10 percent of the new bank's equity (at a minimum)."*
> Aftab Ahmed, senior manager, IFC

KfW Bankengruppe. KfW has banking and capital market expertise, together with a broad range of financial instruments (e.g., equity, mezzanine and debt instruments, as well as grants). KfW played a leading role in the consortium, providing debt, equity, and technical assistance, and in 2003, helping PCBB place its first mortgage bond issue in the local-currency market.

EBRD and KfW-Entwicklungsbank. These investors both have "preferred creditor status," which permits them to assume credit risk for development-oriented investments beyond the scope permitted private commercial banks. This ability proved important for PCBB while it was establishing credibility with international bankers.

ProCredit Holding AG and IPC. It takes hard skills and real experience to run a full-service bank. IPC (founder of ProCredit Holding AG, which now owns 19 banks globally) brought deep experience in financial institution management, staff training, product and branch design, and a commitment to transparency to the PCBB project.

PCBB's Rapid Expansion

PCBB quickly expanded its size, services and financial base. By December 2004, the bank had 35 outlets that covered 23 regions (or about 85 percent) of the country. Staff grew proportionately, from a total of 71 in 2001 to 623 in December 2004, including 182 loan officers.

Substantial external financial investment. PCBB's growth was supported by substantial consortium investments. The bank opened with €6.15 million in equity contributed equally by IFC, EBRD, KfW Bankengruppe, Commerzbank, and ProCredit Holdings AG. The shareholders subsequently more than doubled their individual investments so by December 2004, the bank's equity reached €18.6 million.[5] Like most formal Bulgarian financial institutions, the bank does not yet have Bulgarian shareholders.

In addition to equity investments, KfW, EBRD, and IFC have lent €19 million, €17 million, and €10 million to PCBB, respectively, for onlending to MSEs. (The EBRD loans were provided through a small-and-medium-enterprise financing facility cosponsored by the USA.) Loan conditions included six-to-seven-year terms, commercial pricing (based on EURIBOR plus a margin for risk), and three-to-four-year grace periods. Commerzbank AG also lent PCBB a commercially priced bullet-loan of €3 million with a maturity of three years.

Ability to tap local capital. PCBB has been as successful in leveraging local sources of funding as it has in attracting external financing. The bank's deposit base has grown rapidly, exceeding €74.9 million in December 2004. The bank successfully issued its first mortgage bond in 2003 for 10 million Bulgarian leva (€5 million), and two corporate bonds in 2004 totaling €15 million. Bank profits, which reached €2.98 million in 2004, are also being reinvested.

Wide range of products and services for MSEs. Although PCBB's core business is loans to micro and small enterprises approved within 24 hours, the bank offers a wide range of financial products and services. It provides business development loans, agricultural loans, overdraft facilities, credit lines, and consumer and housing loans. It also offers six types of deposits and other standard banking services (e.g., current accounts in local or foreign currency, debit cards, foreign currency exchange, internet banking, and "ProPay" transfers).

5 Shareholders are: ProCredit Holding AG/IPC, 21.74 percent; EBRD, 19.71 percent; KfW Bankengruppe, 19.71 percent; Commerzbank AG, 19.71 percent; and IFC, 19.13 percent.

> "*We did not wish to become solely a lending institution; rather, we aimed to develop a stable client base consisting of both business loan customers and depositors.*"
> PCBB, Annual Report 2003

Success sparks competition. One of PCBB's great successes is aggressive competition from other banks, predominantly in small-scale consumer lending. "Competition is cutthroat now in Bulgaria. ProCredit's services are so good because it is fighting for each customer," remarks Judith Brandsma, the EBRD representative on the PCBB board. Competition is welcomed by PCBB investors as a way to drive efficiency. However, lack of a national credit bureau (until recently), inadequate lending technologies, and insufficient transparency also create a risk of over-indebtedness in Bulgaria's market.

Keys to Investor Success

Common investor vision. The founders and shareholders of PCBB shared a clear vision of establishing a profitable full-service bank with a core microlending product. They sought to use the bank to demonstrate the viability of the MSE market, generate commercial competition, and thus deepen the financial system. They backed their vision and strategy with substantial funding, enabling PCBB to keep pace with the dynamic Bulgarian market. Their insistence on a commercial approach also ensured that PCBB could augment its capital through deposits and other local debt instruments.

> "*Adopting a common formal-sector banking approach has been important. There is no way that sufficient capital to meet market demand could have been raised by just donors*."
> Elizabeth Wallace, former director, Group for Small Business, EBRD

Shared aversion to competing projects. Each member of the consortium chose to support a common project, rather than create their own, to prevent competing projects that could potentially undermine the market. As Dr. Glaubitt, financial sector division chief of KfW Bankengruppe, said, "We did not want to find ourselves on an island and achieve nothing."

Qualified management from day one. The consortium made a conscious decision to launch PCBB with expert staff. "It is crucial to employ specialized and experienced consultants to provide management services at the beginning of such a project," noted Jana Sivcova, EBRD operation leader for PCBB. EBRD channeled €3.75 million in technical assistance to PCBB from the United States to support the bank's start-up and growth phase. About 70 percent of this funding covered the cost of management and branch advisors (provided by IPC) and other start-up costs, while 30 percent was devoted to loan-officer training and stipends. IPC's management team then groomed their own staff, using financial and career incentives. Two of the top four PCBB managers are now Bulgarian.

Learning from the ProCredit Holding AG Network. PCBB has benefited from belonging to a profitable[6] network of ProCredit microfinance banks, all of whose management services are provided by IPC and are largely financed by the same shareholder group. The PCBB Supervisory Board consists of one representative from each shareholder. Because many individuals are on the boards of several of the network banks, board meetings for all banks in a given region are held at the same time so lessons can be applied across the network. PCBB management also participates in the regional network, with IPC facilitating the flow of information among the staff of all banks. Consequently, PCBB was able to learn from its peers and become the frontrunner in the region.

Commercial reporting and governance. Shareholders receive monthly financial reports similar to those of a commercial bank, including detailed lending statistics, balance sheets, profit and loss statements, and reports on asset-liability management. The Supervisory Board meets quarterly (initially it was monthly) to review PCBB performance; approve the bank's strategy, budget, work plans and major investments; and discuss progress in deepening the financial system.

Future Consortium Challenges

Sufficient financing for growth. PCBB has been successful in building a solid depositor base, but credit demand far outstrips deposit growth. The bank must overcome a triple challenge to increase savings: a basic public distrust of the banking sector in Bulgaria (following several bank failures), reaching out to a new type of client (not the MSEs they know well), and tough competition for deposits. Developing instruments to access financing from capital markets, such as securitization, is another big hurdle. However, it looks probable that PCBB will be able to take advantage of the market for syndicated loans and undertake additional bond issues.

Balancing shareholder goals. Commerzbank is facing pressure to increase ROE. KfW is facing pressure to expand outreach to remote rural areas. PCBB management sees new client potential in small towns and villages. Balancing the social and financial goals of the shareholders and the bank is difficult.

Future ownership. A key challenge for the long-term success of PCBB (and the other 18 banks in the network) is crafting an exit strategy that ensures continuation of the bank's social mission. EBRD, KfW, and IFC have given their approval, in principle, to the sale of their shares to ProCredit Holdings at an appropriate time. This strategy will ensure PCBB's long-term commitment to providing MSEs with sustainable access to finance, as well as maintain the ProCredit network.

Conclusion

The consortium of donors and investors that established PCBB learned that they could achieve far more together than they could alone. Fundamentally changing a financial system so that it serves microentrepreneurs and low-income clients requires bold decisions and a wide range of skills, experience, and instruments. But it is not without its challenges. PCBB's investors, aware of the challenges inherent in their approach, think they are best addressed within the context of profitable, dynamic financial institutions committed to changing the lives of poor people.

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KfW: www.kfw-entwicklungsbank.de/EN

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[6] ProCredit Holding AG had a projected after-tax return on equity of 14 percent in December 2004.