Public Disclosure Authorized

Public Disclosure Authorized

Document of
The World Bank

FOR OFFICIAL USE ONLY

Report No: PAD927

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED LOAN

IN THE AMOUNT OF US$500.00 MILLION

TO THE

FEDERAL REPUBLIC OF NIGERIA

FOR A

DEVELOPMENT FINANCE PROJECT

August 29, 2014

Finance and Markets Global Practice
Africa Region

This document has a restricted distribution and may be used by recipients only in the performance of their official duties. Its contents may not otherwise be disclosed without World Bank authorization.

CURRENCY EQUIVALENTS

(Exchange Rate 07/31/2014)

Currency Unit = Nigerian Naira
NGN161.7000 = US$1

FISCAL YEAR

January 1 – December 31

ABBREVIATIONS AND ACRONYMS

AFD	French Agency for Development
AfDB	African Development Bank
AMCON	Asset Management Company of Nigeria
BOA	Bank of Agriculture
BOI	Bank of Industry
BPP	Bureau of Public Procurement
CAC	Corporate Affairs Commission
CAMA	Companies and Allied Matters Act
CAR	Capital Adequacy Ratio
CBN	Central Bank of Nigeria
CGF	Credit Guarantee Facility
CPAR	Country Procurement Assessment Review
CPS	Country Partnership Strategy
DA	Designated Account
DCA	Development Credit Authority
DFI	Development Finance Institution
DFID	Department for International Development
DLI	Disbursement Linked Indicators
DSA	Debt Sustainability Analysis
ERGP	Economic Reform and Governance Program
ESMS	Environmental and Social Management System
ESOM	Environmental and Social Operations Manual
FAS-PPPP	Finance and Accounts Section in the Public-Private Partnership Project
FGN	Federal Government of Nigeria
FI	Financial Intermediaries
FM	Financial Management
FMBN	Federal Mortgage Bank of Nigeria
FPFMD	Federal Project Financial Management Division
FMOF	Federal Ministry of Finance

FM	Financial Model
FPM	Financial Procedures Manual
FSAP	Financial Sector Assessment Program
GEM	Growth and Employment
IB	Infrastructure Bank
IBRD	International Bank for Reconstruction and Development
ICB	International Competitive Bidding
IDA	International Development Association
IFR	Interim Financial Reports
IFRS	International Financial Reporting Standards
IPF	Investment Project Financing
IPSAS	International Public Sector Accounting Standards
ISA	International Standards on Auditing
ISR	Implementation Status Report
KFW	German Development Bank
KYC	Know-Your-Client
MemArt	Memorandum and Articles of Association
MFB	Microfinance Bank
ML	Management Letter
MOFI	Ministry of Finance Incorporated
MPR	Monetary Policy Rate
NAS	Nigerian Accounting Standards
NASB	Nigerian Accounting Standards Board
NBFI	Non-Bank Financial Institution
NEXIM	Nigerian Export-Import Bank
NIRSAL	Nigerian Incentive-Based Risk-Sharing System for Agricultural Lending
NPL	Non-Performing Loan
NSIA	Nigerian Sovereign Investment Authority
ORAF	Operational Risk Assessment Framework
PFI	Participating Financial Institution
PIU	Project Implementation Unit
POM	Project Operations Manual
PPF	Project Preparation Facility
PPP	Public Private Partnership
PRIMA	Portfolio and Risk Management
ROA	Return on Assets
ROE	Return on Equity
SBD	Standard Bidding Document
SEC	Securities and Exchange Commission
TA	Technical Assistance

TCA	Technical Cooperation Agreement
UNCITRAL	United Nations Commission on International Trade Law
WBG	World Bank Group

Regional Vice President:	Makhtar Diop
Country Director:	Marie Francoise Marie-Nelly
Senior Global Practice Director:	Gloria Grandolini
Practice Manager:	Irina Astrakhan
Task Team Leaders:	Arnaud Dornel and Andrej Popovic

FEDERAL REPUBLIC OF NIGERIA
Development Finance Project

TABLE OF CONTENTS

I. STRATEGIC CONTEXT **1**

II. PROJECT DEVELOPMENT OBJECTIVES **16**

A. PDO 16

Project Beneficiaries 16

PDO Level Results Indicators 17

III. PROJECT DESCRIPTION **17**

A. Project Components 19

Project Financing 23

Project Cost and Financing 25

Series of Project Objective and Phases 25

Lessons Learned and Reflected in the Project Design 25

IV. IMPLEMENTATION **27**

Institutional and Implementation Arrangements 27

Results Monitoring and Evaluation 30

Sustainability 31

V. KEY RISKS AND MITIGATION MEASURES **32**

Risk Ratings Summary Table 32

Overall Risk Rating Explanation 32

VI. APPRAISAL SUMMARY **33**

Economic and Financial Analysis 33

Technical 34

Financial Management 34

Social and Environmental (including Safeguards) 35

Other Safeguards Policies Triggered 36

Annex 1: Results Framework and Monitoring **37**

Annex 2: Detailed Project Description **40**

Annex 3: Implementation Arrangements **55**

Annex 4: Operational Risk Assessment Framework (ORAF) **69**

Annex 5: Implementation Support Plan **73**

Annex 6: Financial Analysis **74**

Annex 7: Economic Analysis **79**

Annex 8: Detailed Sectoral Analysis **89**

Annex 9: Letter of Sector Policy **115**

Annex 10: Key Macroeconomic Indicators and Projections **120**

Annex 11: Sample Technical Cooperation Agreement **121**

Annex 12: Draft Memorandum and Articles of Association **128**

PAD DATA SHEET

Nigeria

Nigeria: Development Finance Project (P146319)

PROJECT APPRAISAL DOCUMENT

Finance and Markets Global Practice
Africa Region

Report No.: PAD927

Basic Information			
Project ID P146319	EA Category F- Financial Intermediary Assessment (FI-2)		Team Leader Arnaud D. Dornel Andrej Popovic
Lending Instrument Investment Project Financing	Fragile and/or Capacity Constraints [ ]		
	Financial Intermediaries [X]		
	Series of Projects [ ]		
Project Implementation Start Date 25-Sep-2014	Project Implementation End Date 31-Dec-2021		
Expected Effectiveness Date 26-Jan-2015	Expected Closing Date 31-Dec-2021		
Joint IFC No			
Practice Manager Irina Astrakhan	Senior Global Practice Director Gloria Grandolini	Country Director Marie Francoise Marie-Nelly	Regional Vice President Makhtar Diop

Borrower: Federal Republic of Nigeria			
Responsible Agency: FEDERAL MINISTRY OF FINANCE			
Contact:	Abdulfatah Abdulsalam	Title:	Assistant Director
Telephone No.:	+234 80 3825 0186	Email:	aabdulsalam@fmf.gov.ng

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

Total Project Cost:	500.00	Total Bank Financing:	500.00
Financing Gap:	0.00		

Financing Source	**Amount**
BORROWER/RECIPIENT	0.00
International Bank for Reconstruction and Development (IBRD)	500.00
Total	500.00

Expected Disbursements (in USD Million)

Fiscal Year	2015	2016	2017	2018	2019	2020	2021		
Annual	23.00	140.00	153.00	103.00	77.00	2.00	2.00		
Cumulative	23.00	163.00	316.00	419.00	496.00	498.00	500.00		

Proposed Development Objective(s)

The project development objective is to increase the availability and access to finance for micro, small, and medium enterprises through eligible financial intermediaries with the support of a new wholesale development finance institution.

Components

Component Name	**Cost (USD Millions)**
Component 1: Technical Assistance and Capacity Building	12.00
Component 2: Line of Credit Facility	445.00
Component 3: Credit Guarantee Facility	35.00
Component 4: Project Management	6.75

The front-end fee of US$1.25 million will be financed out of the proceeds of the loan.

Institutional Data

Sector Board

Finance and Markets Global Practice

Sectors / Climate Change				
Sector (Maximum 5 and total % must equal 100)				
Major Sector	Sector	%	Adaptation Co-benefits %	Mitigation Co-benefits %
Finance	SME Finance	50		
Finance	Microfinance	30		
Finance	Other Nonbank Financial Intermediaries	10		
Finance	Banking	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 percent must equal 100)		
Major theme	Theme	percent
Financial and private sector development	MSME Support	80
Financial and private sector development	Corporate Governance	10
Financial and private sector development	Regulation and competition policy	10
Total		100

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 [x]	No [ ]

Performance Standards	**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

Key Non-Standard Legal Covenants

Name	Recurrent	Estimated Due Date	Frequency
Credit Guarantee Facility (CGF) Entity		July 26, 2016	

Description of Covenant

No later than eighteen (18) months, after the Effective Date, the Borrower shall establish - or cause to be established - a CGF Entity, in form and substance and with resources satisfactory to the Bank, for the purpose of providing Partial Credit Guarantee to PFIs on their Sub-loans to Eligible Beneficiaries

Name	Recurrent	Estimated Due Date	Frequency
Guarantee manual		January 26, 2017	

Description of Covenant

Not later than twenty four (24) months after the Effective Date, the Borrower shall cause the CGF Entity to adopt a guarantee manual, in form and substance satisfactory to the Bank (Guarantee Manual), which shall, as a minimum, address the following elements of the Credit Guarantee Facility: (a) eligibility criteria for potential beneficiaries; (b) detailed conditions to be met by potential beneficiaries in order to receive the benefits of the Credit Guarantee Facility; (c) mechanisms for delivery of the proposed Partial Credit Guarantees; (d) environmental and social risk management arrangements; and (e) monitoring and evaluation system, including details on how to audit said Credit Guarantee Facility.

Name	Recurrent	Estimated Due Date	Frequency
Verification arrangements		July 26, 2016	

Description of Covenant

In order to verify the achievement of DLIs under tranches IV, V and VI, the Borrower shall: (a) not later than eighteen (18) months after the Effective Date, employ a verification agent, in accordance with the provisions of Section III of Schedule 2, with qualifications, experience and terms of reference acceptable to the Bank; and (b) prior to each disbursement of Loan proceeds against the achievement of DLIs for tranches IV, V and VI, ensure that the verification agent has verified the status of achievement of the DLIs corresponding to the tranche with respect of which the disbursement of a portion of Loan proceeds is proposed, all in form and substance acceptable to the Bank.

Name	Recurrent	Estimated Due Date	Frequency
Financial management covenants		April 26, 2015	

Description of Covenant

Not later than ninety (90) days after the Effective Date, the Borrower shall:

(a) appoint the independent auditors referred to in Section 5.09 (b) of the General Conditions, in accordance with the provisions of Section III of Schedule 2;

(b) update its computerized accounting systems to incorporate Project activities, all in a manner satisfactory to the Bank; and

(c) train its internal auditor on risk-based internal audit.

Name	Recurrent	Estimated Due Date	Frequency
Procurement complaint mechanism		April 26, 2015	

Description of Covenant

The Borrower shall, not later than ninety (90) days after the Effective Date, establish a procurement complaint mechanism comprising an online database or a complaint hotline, in form and substance satisfactory to the Bank.

Name	Recurrent	Estimated Due Date	Frequency
DFI Board observer status	x		

Description of Covenant

For the purpose of supervising the implementation of the Project, the Bank representatives may attend the DFI Board discussions, as observers, without the right to vote, the right to move substantive or procedural motions or the right to contribute to deliberations at the meeting. To that end, and without limitation to the provisions of Article V of the General Conditions, the Borrower shall enable the Bank's representatives to participate as observers in the meetings of the DFI Board under the terms set forth in the Project Operations Manual.

Key Non Standard Conditions

Name and description of condition	Type
The Borrower has adopted the Project Operations Manual;	Effectiveness
The DFI has been duly incorporated, in a form and substance satisfactory to the Bank.	Effectiveness
Notwithstanding the provisions of Part A of Section IV, no withdrawal shall be made: (a) from the Loan Account until the Bank has received payment in full of the Front-end Fee; or (b) for payments made prior to the date of the Loan Agreement; or (c) for any payments under Category (1), unless and until evidence satisfactory to the Bank is furnished to the Bank confirming that DFI has met the DLI(s) for the tranche for which payment is requested as set forth in Schedule 4 to the Loan Agreement.	Disbursement

Team Composition			
Bank Staff			
Name	**Title**	**Specialization**	**Unit**
Arnaud D. Dornel	Lead Financial Sector Specialist	Team Leader	GFMDR
Andrej Popovic	Senior Financial Sector Specialist	Co-Task Team Leader	GFMDR
Michael D. Wong	Lead Private Sector Development Specialist	Sector Leader	GTCDR
Stefan Johann Martiniak	Senior Financial Sector Specialist	Financial Sector	AFTFW
Robin Hofmeister	Financial Specialist	Financial Sector	AFTFW
Adetola Olufunke Adenuga	Financial Analyst	Analyst	GFMDR
Johanne Buba	Economist	Financial Sector	GTCDR
Wenye Dong	Resource Management Analyst	Analyst	AFTFW
Laura A. Ard	Lead Financial Sector Specialist	Governance	GFMDR
Alexander S. Berg	Senior Private Sector Development Specialist	Governance	GFMDR
Evarist F. Baimu	Senior Counsel	Country Lawyer	LEGAM
Mary Asanato-Adiwu	Senior Procurement Specialist	Procurement	GGODR
Akinrinmola Oyenuga Akinyele	Senior Financial Management Specialist	Senior Financial Management Specialist	GGODR
Paula F. Lytle	Senior Social Development Specialist	Social Safeguards	GURDR
Joseph Ese Akpokodje	Senior Environmental Institutions Specialist	Environmental Safeguards	GENDR
Luis M. Schwarz	Senior Finance Officer	Disbursement	CTRLA
Faly Diallo	Financial Officer	Disbursement	CTRLA
Magalie Pradel	Program Assistant	Program Assistant	GFMDR
Tolulope Adetoro Aderele	Team Assistant	Team Assistant	AFCW2
Non Bank Staff			
Name	**Title**	**Office Phone**	**City**
Garry Marsh	Consultant (MSME Finance)		
Luiz Alcoforado	Consultant (Governance)		

Halima Usman Zarma	Consultant		
Rabo International Advisory Services	Consulting Firm (Agricultural Finance)		
Janine Thorne	Consultant (DFI Governance)		
Judith Brandsma	Consultant (Credit Guarantees)		
Andrew Lovegrove	Consultant (Development Finance)		
Obi Ugochuku	Consultant (Safeguards)		
Moustapha Doukoure	Consultant (Economic Analysis)		

I. STRATEGIC CONTEXT

A. Country Context

1. **The Nigerian economy has continued to grow at a rapid pace in recent years, although the performance of the oil sector has weakened.** GDP growth has been in the range of 5-8 percent during the last decade, driven by expansion of domestic demand and concentrated primarily in trade, agriculture, and services. Oil output has periodically stagnated or declined since 2010, reflecting both regulatory uncertainty limiting investment and the disruptive effects of oil theft in the Niger Delta. The year 2013 was particularly difficult in that regard, involving major disruptions to pipelines, with oil output estimated at 2.18 million barrels a day, which was 5.8 percent lower than in 2012.

2. **With oil comprising roughly 90 percent of Nigerian exports, Nigeria's balance of payments is very sensitive to movements in oil prices and oil output.** Following an increase in oil prices in the second half of 2011, Nigeria's balance of payments moved into surplus, with gross foreign reserves increasing steadily from US$34 billion in September 2011 to US$49 billion at end-April 2013. Some of the balance of payments improvement came from portfolio capital inflows since 2012, much of which has flowed into the government bond market to exploit high interest rates under expectations of exchange rate stability. Gross portfolio inflows were reported as US$17 billion in 2012 and increased to an estimated US$20 billion in 2013. These inflows now represent an additional potential source of volatility for Nigeria's balance of payments. Foreign currency reserves declined to US$38 billion between April 2013 and March 2014 and stabilized at that level.

3. **Monetary policy in Nigeria has tightened along with the recovery of the banking sector from the 2008–2009 crisis**. In the wake of the recapitalization and subsequent recovery of the banking sector in 2011 the Central Bank of Nigeria (CBN) very sharply increased the monetary policy rate to 12 percent and raised reserve requirements to 8 percent, up from 6 and 1 percent, respectively. Despite sizeable transfers of non-performing assets to the Asset Management Company of Nigeria (AMCON) in 2010 and 2011, the pace of credit expansion to the private sector has remained positive (3.4 percent in 2012 and 7.4 percent in the first 8 months of 2013).

4. **More restrictive macroeconomic policy has reduced inflationary pressures and resulted in lower inflation in 2013.** Inflationary pressures in Nigeria have eased in the context of a more restrictive macroeconomic policy stance since 2011. CPI inflation actually increased from 10.3 to 12.2 percent in 2012, but this was due largely to non-monetary factors: a 50 percent reduction in the fuel subsidy increases in utilities prices, and severe flooding that limited supplies of some goods and services. The pace of CPI inflation declined steadily in 2013, reaching 8 percent in December 2013, and declined slightly below 8 percent in early 2014.

5. **The Central Bank continues to use the exchange rate as a stabilization anchor.** While the official exchange rate policy in Nigeria is a float, the authorities in practice manage the float in order to pursue a high degree of nominal exchange rate stability. After holding the exchange rate of the naira steady at 150 to the US dollar from 2009 until the second half of 2011, the Central Bank gradually introduced more rate flexibility, allowing the naira to move within a band of 150–160 to the US dollar (the interbank rate sometimes exceeds this band), and the band can be changed at regular meetings of the Central Bank's Monetary Policy Committee.

6. **While significant budget consolidation has been achieved since 2011, the recent weakness in oil output presents fiscal challenges**. Strong efforts led by the Federal Government directed at budgetary consolidation have reduced the General Government[1] deficit from an estimated 5.7 percent of GDP in 2010 to 1.9 percent in 2012. As oil revenues account for close to 75 percent of budgetary revenues in Nigeria, the decline in oil output in 2012 and (especially) 2013 tightened the budgetary situation considerably. In 2013, total Federation revenues available for sharing by the three tiers of government fell short of projections by 23.5 percent and the balance of the Excess Crude Account (fiscal reserve) declined from close to US$ 9 billion in early 2013 to US$ 2 billion in early 2014. In line with more pessimistic revenue projections, the Federal Government of Nigeria (FGN) submitted a 2014-2016 Medium Term Expenditure Framework to the National Assembly in September, 2013 which proposes a significant fiscal contraction in 2014. While oil output recovered somewhat in the second half of 2013, Nigeria faces major challenges because oil revenues are not expected to increase in the medium term at the same pace as GDP or the growth in population, making increases in other sources of Government revenues imperative.

Table 1: General Government Budget of the Nigerian Federation: 2008-2013

	2008	2009	2010	2011	2012	2013*
			(Shares of GDP)			
Government Revenues	30.2	19.4	22.6	25.5	22.9	19.0
of which: Oil	24.2	11.5	15.0	20.6	16.9	14.3
VAT	0.2	1.8	1.8	1.6	1.8	1.9
Federal	11.0	9.7	9.9	8.3	8.0	8.0
State (est.)	12.2	11.8	11.7	10.0	9.4	9.0
Extrabudgetary Funds	1.1	1.9	1.5	1.4	1.7	1.5
Deductions for Fuel Subsidy	2.6	1.7	2.2	4.6	2.5	2.3
Net Accumulation to ECA	3.4	-5.7	-2.7	1.2	1.3	-1.8
Expenditures	25.5	26.0	28.2	28.0	23.9	22.6
Federal	10.7	11.0	13.5	10.9	9.4	9.3
State (est)	11.2	11.4	11.2	10.8	10.2	9.5
Extrabudgetary Funds	1.1	1.9	1.5	1.7	1.7	1.5
Fuel Subsidy	2.6	1.7	2.2	4.6	2.5	2.3
Balance						
Federal Budget	0.3	-1.3	-3.5	-2.6	-1.4	-1.3
State Budgets (est)	1.0	0.4	0.5	-0.8	-0.8	-0.5
Consolidated Federal and State	1.3	-0.9	-3.0	-3.4	-2.2	-1.8
General Government	4.7	-6.6	-5.7	-2.2	-0.9	-3.6

* Projection

Sources: Ministry of Finance, Accountant General's Office, Central Bank of Nigeria, Bank calculations

Macroeconomic Outlook and Debt Sustainability in Nigeria

7. **Under a baseline scenario of oil output and oil prices stability, Nigeria should continue to experience stable and strong growth in the medium term**. The projections in Table 1 assume that oil output recovers to 2.3 million barrels a day in the second half of 2013 and 2.4 million barrels in 2014–2015. The assumption is that the price of Bonny Light oil will weaken gradually to 97 dollars a barrel by 2015. This supposes a gradual return to "normal" levels of oil production following the exceptionally difficult situation in the first half of 2013. It

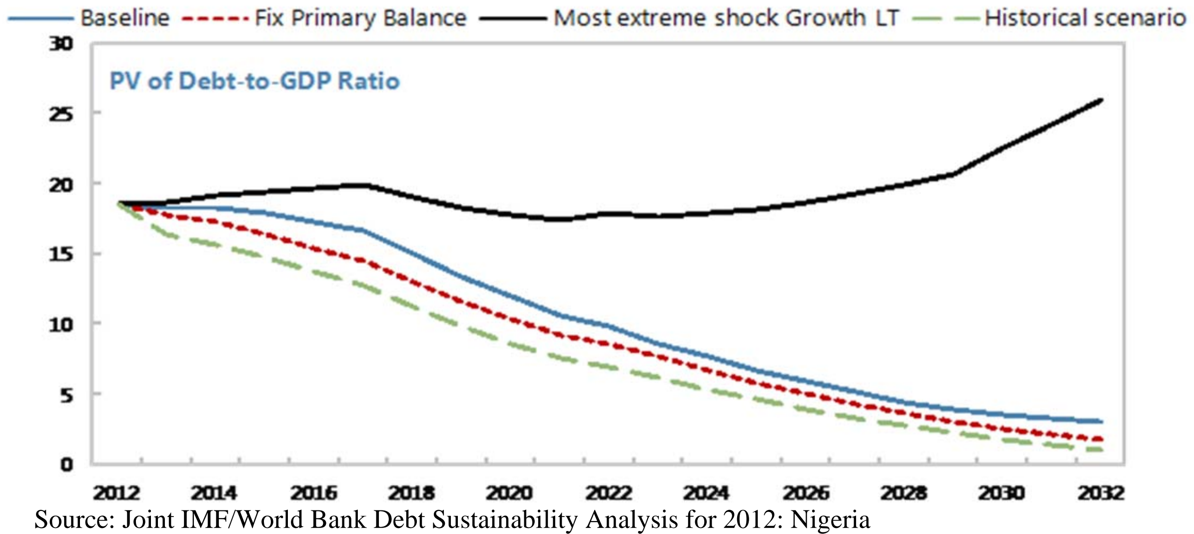
[1] General government balance—the balance of federal, state, local, and extra budgetary funds plus net accumulations to the fiscal reserve (Excess Crude Account).

also builds on the assumption that the FGN succeeds in following its medium-term plan for the compression of real budget expenditures, despite political pressures in the run up to the 2015 elections. The monetary policy stance is assumed to remain unchanged, although the base rate is expected to decrease gradually in line with falling inflation. Under these conditions, the economy should exhibit positive trends: the continuation of rapid GDP growth, budgetary consolidation, a continued fall in inflation, the re-establishment of a balance of payments surplus, and a positive net accumulation to the fiscal reserve.

8. **Nonetheless, there are significant risks to the baseline scenario.** The most important risks come from assumptions regarding oil prices and output, as well as political pressures on macroeconomic policy in the pre-election period. In the event that the recovery in oil output is not achieved or prices for Bonny Light oil decline significantly, balance of payments and budgetary pressures can be expected to increase, and short-term capital flows could reverse. Under these circumstances, the Naira could come under strong pressure, with implications for inflation, and the fiscal reserve could be exhausted. In the absence of a fiscal reserve, budgetary distress would be particularly acute at the state and local levels, as borrowing is quite expensive and difficult for most Nigerian states. While the Federal Government currently has the fiscal space to increase borrowing over the medium term (see details in Annex 10), increased borrowing would further compromise the modest levels of credit expansion that Nigeria has achieved in recent years, because banks would divert funds from lending to investment in government securities that offer relatively high and risk-free returns.

9. **Debt-sustainability analysis (DSA) indicates that Nigeria is at low risk of debt distress.** A debt-sustainability analysis conducted in 2013–2014 by the IMF and World Bank concludes that Nigeria's debt outlook remains robust under standardized stress tests. The baseline scenario in the DSA has average GDP growth at 6.8 percent during 2013–2033 and oil prices moderating from US$104.5 a barrel to 2013 to US$86.7 in 2018. Under this scenario and standardized stress tests, the debt-to-GDP ratio stabilizes in the medium term and declines steadily in the longer term (0.3 percent by 2033 in the base case). Two extreme scenarios of a persistent high-oil price shock or permanently lower GDP growth had debt-to-GDP ratios growing over time. In the former scenario, debt would reach 32 percent of GDP by 2033, and under the latter, 15 percent. It should be noted, however, that the standardized DSA may not account for all significant risks to the Nigerian economic picture, not least Nigeria's failure to develop strong, diversified competitiveness outside of oil and gas. It is here that the support provided by the Development Finance Project could be instrumental in helping to diversify the economy by stimulating greater provision of credit by the financial system to the micro-, small, and medium enterprise (MSME) sector.

Figure 1: Nigerian Indicators of Debt under Alternative Scenarios: 2012–2032



Source: Joint IMF/World Bank Debt Sustainability Analysis for 2012: Nigeria

B. Sectoral and Institutional Context

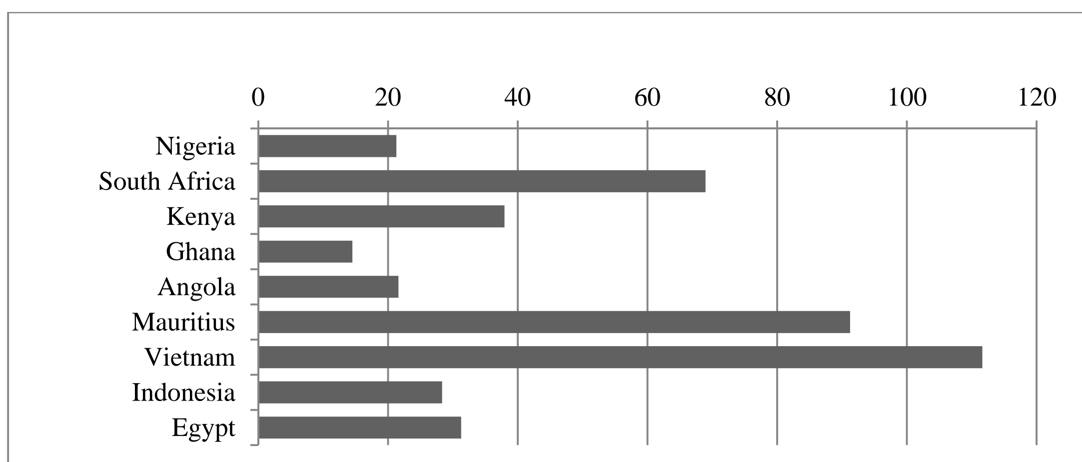
10. **The Nigerian financial system is dominated by banks.** At end-2013 deposit money bank assets accounted for 30.3 percent of GDP (after GDP rebasing exercise). The twenty deposit money banks dominate the financial system, and do so in several ways in addition to lending. Banks are the main players in the money markets and also act as settlement agents in the capital markets. In addition, bank shares represent more than one-third of the market value of listed companies and are among the most actively traded shares. Underdeveloped corporate bond and equity markets have resulted in bank credit being the main source of formal financing for Nigerian corporations.

11. **Following a period of turbulence, the Nigerian banking system is well capitalized, liquid, and profitable, according to the Financial Soundness Indicators.** Rapid credit growth following the tenfold increase in the minimum capital requirement for banks and the subsequent consolidation of the banking system (from 89 to 24 banks) in 2005 led to asset quality deterioration and contributed to the banking crisis of 2008–2009. Following the banking crisis and decisive measures taken by the CBN, including the establishment of AMCON, significant strengthening of the CBN's supervisory enforcement and the introduction of International Financial Reporting Standards (IFRS) for all banks as of end-2012, the level of banks' nonperforming loans (NPLs) has declined steadily since the peak of 35.6 percent reached in September 2010. As of December 2013, the NPL ratio was 3.2 percent. Further, banks' capital adequacy ratio (CAR) grew from less than 2 percent to 17 percent from end-2010 to end-2013. The regulatory threshold for the CAR is 10 percent, and 15 percent for internationally active banks. By end-2013, return on assets (ROA) for the industry rose to 2.1 percent, while return on equity (ROE) rose to 20.1 percent. The restructuring and consolidation process (from 24 to 20 banks) that followed the 2008–2009 crisis resulted in a stronger and more resilient banking system, both as a result of the relief provided to the banks by AMCON, which allowed banks to surrender their nonperforming assets to the asset management company, and due to the introduction of IFRS per January 1st, 2012, coupled with the CBN's more stringent prudential

regulation and oversight of banks. In recent years the CBN has pursued a stable monetary policy with the monetary policy rate (MPR) that sets the benchmark for government borrowing and deposit money bank interest rates remaining stable at 12 percent since October 2011. The MPR has been set to allow the authorities to maintain a relatively stable nominal Naira/USD exchange rate. While any sharper depreciation of the naira/USD could give rise to inflationary pressures that could result in the deterioration of the banks' lending portfolios, the authorities remain committed to a continued policy of measured exchange rate depreciation coupled with fiscal prudence, i.e., a combination of macroeconomic policies aimed at enhancing competitiveness and strengthening local production.

12. **While a well-functioning financial sector is an important catalyst for shared, private sector-led growth, the contribution of the Nigerian financial sector remains low.** Private credit to GDP in Nigeria remains significantly below peer countries, such as Kenya and South Africa (see Figure 2). High concentration of credit and limited access to finance reduces the contribution of the financial sector to economic efficiency and shared prosperity. Efficient enterprises lack access to finance for expansion, hindering sustained employment growth, particularly in the formal sector. Rural households' limited access to finance increases income volatility and reduces households' ability to mitigate exogenous shocks, thereby greatly affecting the extremely poor and undermining their capability to move out of poverty. Efficient and inclusive financial systems are an essential catalyst in promoting equitable growth and poverty reduction, and empirical findings confirm a strong causal relationship between a sound financial system and economic growth[2] and confirm that financial-system development promotes more inclusive, shared prosperity by providing funding for viable projects where internal funding is not available.[3]

Figure 2: Private Sector Credit/GDP (2011)—Nigeria vs. Peer Group



[2] An overview is provided by Levine, R., 2005. "Finance and Growth: Theory and Evidence" in P. Aghion and S. Durlauf (eds.), *Handbook of Economic Growth*, Elsevier, Amsterdam.

[3] See Beck, T., A. Demirguc-Kunt, and R. Levine (2004). "Finance, Inequality and Poverty: Cross-Country Evidence," World Bank Policy Research Paper 3338.

Market Gaps

13. **Limited access to financing severely constrains opportunities for economic diversification.** The "value-chain" driven business model adopted by Nigerian banks results in a lack of focus on lending outside established value chains. Competition is high for the largest corporations, with banks accepting low margins for the high-end corporations in order to exploit the higher yields from credit and other fee-based products offered to the value chain of distributors, suppliers, and employees.

14. **The impact of financing constraints is pervasive, and the critical obstacles include limited availability of medium- to long-term credit tenors, short grace periods, and high collateral requirements.** Also, the high prevalence and reliance on relationship banking beyond normal know-your-client (KYC) models, lack of banks' capacity to apply cash-flow lending methodologies based on market information, nonexistence of efficient high volume-small loans systems, and limited local capacity to deal with market risks adequately, in combination, have led to a prohibitively high risk aversion to lending to MSMEs. The tenors of funding offered by banks are short, mostly up to one year, with longest tenors of about three to five years (with exceptions for up to seven years), the latter being extremely scarce for MSMEs.

15. **Access to finance is a major obstacle faced by SMEs.** Only around 9.5 percent of Nigerian SMEs had a loan or line of credit in 2011, and bank financing of working capital and fixed assets was estimated to fill respectively only 3 and 2 percent of outstanding needs. SME lending averages about 5 percent of total lending in terms of volume by commercial banks (equivalent to only 2 percent of banking-sector assets). A total of six Nigerian commercial banks with SME loan portfolios were surveyed in early 2014 to assess current trends in SME finance, and the results were generally consistent with those in the 2011 survey (for details, see Annex 8).

16. **According to the 2014 survey conducted for the purposes of this project, only 6.7 percent of enterprises in Nigeria reported having a loan or active line of credit (compared to the global Enterprise Survey average of 36.5 percent), lagging behind other countries.** A mere 3 percent of micro firms (with less than 5 employees) have a loan or line of credit; among SMEs (with more than 5 and fewer than 250 employees), this rate is 7 percent; and of large firms (more than 250 employees), 44 percent have access to a loan or a line of credit. Moreover, while the utilization of loans by large firms is in line with rates in comparator economies, this rate among SMEs lags well behind other countries like Brazil (63 percent), Ghana (36 percent), China (30 percent), Kenya (24 percent), and South Africa (21 percent). For more details see Annex 8.

17. **Constraints arising from the legal and regulatory framework result in banks perceiving SME[4] lending as difficult and costly**. SMEs lack formal collateral and documentation. The absence of a functioning personal identification system and the high costs of verifying and obtaining official documentation also present challenges for banks in financing SMEs, both in satisfying legal and regulatory requirements and in managing their risks effectively. Credit bureau data quality and scope is lacking, limiting confidence in credit history

[4] Reference MSMEs and SMEs are used deliberately throughout this document. While the project has an overall objective to support MSME access to finance, different terminology is used to describe specific issues and/or instruments supporting specific market segments (e.g., SME vs. MSME).

information, which is still at an early stage of development and as yet encompasses only negative information from banks. In addition, the difficulty of enforcing contracts and collateral as well as long delays in the judicial process hamper banks' willingness to lend. On the part of the banks, capacity constraints relate to the provision of suitable lending products. In general, the lack of appropriate lending methodologies for SME lending and the limited understanding of how to assess the potential viability of SMEs and mitigate the associated risks appropriately severely constrain the development of SME finance. On the part of the SMEs, constraints arise in being able to prepare bankable projects. Overall, these issues, coupled with comfortable returns on safe investment in government securities, result in a situation where banks are reluctant to expand into new market segments.

18. **Women entrepreneurs are in particular affected with less than two percent of women having access to credit from a formal financial institution.** Access to finance is particularly challenging for women as, according to the Global Financial Inclusion Database (2012), only 5 percent of women use accounts for business purposes and less than 2% have accessed credit through formal financial institutions. According to the most recent Enterprise Survey (2007),[5] Nigeria lags behind other sub-Saharan countries on standard indicators in this area. Specifically, female participation in firm ownership in Nigeria is at 20 percent compared to 36.3 percent in other regional economies. Women entrepreneurs in Nigeria are constrained by knowledge gaps, limited access to markets and supply chains, and challenges in some regions in regards to rights to ownership of property.

19. **Access to finance is a key constraint to enterprise growth and self-employment ventures, particularly for youth.** The impact assessment carried out by the Business Plan Competition "You Win," funded by the Government, is showing that start-up grants have a direct impact on youth self-employment. Firms have an average employment of 7.5 including the owner. Most owners hire other youth rather than family members. The share of young people in total population is about 51 percent according to the Living Standards Survey of 2010. The national youth unemployment rate is 38 percent, both in urban and rural areas. Youth unemployment is particularly high in the north, especially in the states of Kaduna (50 percent), and Niger (47 percent).

Financial Infrastructure

20. **Despite progress over the recent years, credit infrastructure in Nigeria remains underdeveloped.** Weaknesses in credit infrastructure significantly inhibit the growth of lending to MSMEs in Nigeria. In 2008 the CBN issued the guidelines governing licensing, operations, and regulation of credit bureaus, which facilitated establishment of three private credit bureaus. In 2010 the guidelines were expanded to include a requirement for banks to consult at least two credit bureaus prior to lending, which in turn facilitated expansion of their records. However, the credit bureau industry remains nascent, and the key priorities in the short to medium term include enforcing requirements regarding submitting data and including data as regards all credit institutions (e.g., including microfinance banks) as well as broadening the scope of credit reporting to select non-financial institutions extending credit (e.g., including utilities, telecoms firms, etc.). At the same time, efforts to establish a movable collateral and the law regulating secured transactions, drafted in 2012, need to be accelerated. For details, see Annex 8.

---

[5] The new Enterprise Survey for Nigeria is currently underway.

21. **Following an extensive debate involving all major stakeholders, a decision was made to align Nigerian financial reporting with international practice by adopting International Financial Reporting Standards (IFRS[6]).** Adoption involved the replacement of existing Nigerian Accounting Standards (NAS) with IFRS by the Nigerian Accounting Standards Board (NASB). On approval by the NASB, each IFRS standard becomes legally binding as a new Statements of Accounting Standards under the Companies and Allied Matters Act (CAMA) and thus also comes into effect for taxation purposes. Since 2012, with the help of the Bank-executed trust fund, the Bank has been building the capacity of the Securities and Exchange Commission (SEC) to regulate listed companies' reporting using IFRS. The project intends to extend this support to the Corporate Affairs Commission and also incorporate this support under the Growth and Employment project for MSMEs. The objective is to ensure that compliance with financial standards does not hinder access to finance and also to prepare MSMEs for external financing.

22. **Under the Nigeria MSME project (which closed in December 2012), the World Bank supported a diagnostic of the legal and regulatory framework for secured transactions.** This review identified the following issues with the current framework: (i) the system is fragmented with different and conflicting pieces of legislation and serious gaps in certain areas; (ii) the system is only applicable to companies that are registered in the companies registry, therefore excluding the majority of the business sector composed of unregistered SMEs; (iii) certain types of transactions that are secured with movable property, such as sale of an account, conditional sales contract, consignments, hire-purchase contract and long-term leases are not included; (iv) the current system restricts businesses to accessing credit from only one lender, thus limiting competition in the market; (v) the existing system fails to establish priority among secured creditors, as only the security interests of corporates are registered, thus excluding the majority of SMEs; and (vi) the cost and operation of the registry are high due to the use of obsolete systems. While a draft secured-transactions law and the design of a reformed collateral registry have been prepared, no progress was recorded until recently. In 2013 the IFC re-engaged with the authorities to reach consensus on the draft law, the establishment of the registry, and capacity building for stakeholders. This work is in progress.

Existing Development Finance Institutions and Schemes[7]

23. **The existing DFIs have been unable to effectively address market gaps, facilitate meaningful increases in financial intermediation in terms of outreach and scale, or galvanize sustainable development in their respective sectors.** The existing DFIs include Bank of Agriculture (BOA), Bank of Industry (BOI), Federal Mortgage Bank, Nigerian Export-Import Bank (NEXIM), and Infrastructure Bank (IB). Most of these institutions intervened directly in the marketplace, substituting for private sector investment and risk taking. As commonly seen in old-style development finance, by assuming credit risk, most of the Nigerian DFIs were quickly confronted with high levels of NPLs, caused by factors such as lack of appropriate lending methodology and capacity, an inadequate incentive structure to originate and maintain a performing loan portfolio and avert nonperformance, and politically influenced governance structures. The ability to take direct lending decisions also made these institutions

---

[6] In April 2001 the International Accounting Standards Board (IASB) adopted all International Accounting Standards (IAS) and continued their development, calling the new standards IFRS. IFRSs are considered a principles-based set of standards in that they establish broad rules as well as dictating specific treatments.

[7] For a more detailed review of existing development finance schemes, see Annex 9.

more vulnerable to capture, a situation further exacerbated by the lack of independent and effective oversight. According to the government's *Ad Hoc Sub-Committee on Development Finance in Nigeria* which recently reviewed the DFIs' performance, the cumulative losses of the three main DFIs (BOI, BOA, and FMB) in the past five years have reached approximately NGN43 billion, eroding their capital to a net negative position despite combined capital injections of approximately NGN25 billion. As a result the existing DFIs were not able to achieve operational and financial sustainability, reach unbanked segments of entrepreneurs at scale, or sustainably provide finance.

C. Government Reform Program and Progress to Date

24. **Recognizing the limitations of the existing DFI model, the Federal Government has decided to establish a new development finance framework, which will be better regulated and more clearly aligned with development priorities.** As with the recently restructured IB, which has recently been partially (51 percent) privatized, BOA and BOI will be partially or fully privatized and run as fully private sector banks regulated by the CBN. The authorities are currently in the process of hiring transaction advisors that would support the restructuring and privatization process of BOI and BOA. The intention is to also restructure NEXIM, while the FMB will be subject to diagnostic review and restructuring under a separate World Bank-funded housing finance project. Due to the limited penetration and impact of existing development finance initiatives, the Government has chosen to adopt an innovative model for addressing the access to finance gaps through the proposed wholesale DFI.

25. **To ensure sustainable impact and scale, the mandate, governance, and operations of the new DFI will be grounded in internationally recognized good practice principles** (see Box 1). These will include observance of the following criteria:

- The DFI will be operationally and financially sustainable. The products delivered by the wholesale-only (second-tier) DFI will be designed to effectively address market gaps, to complement and leverage private sector funding, and to ensure that pricing fully reflects costs and credit risk.
- The DFI will be subject to strong corporate governance standards, the implementation of which will be supported by equity stakes by reputable international institutional investors.
- The management and board will be independent and professionally highly qualified and selected on the basis of merit.
- The DFI will be subject to prudential regulation and supervision by the CBN, which will enforce requirements similar to those applied to commercial banks, including strong prudential transparency and accountability standards.
- Strong policy oversight will be undertaken by the designated department in the Federal Ministry of Finance (FMOF).
- The DFI will establish an effective monitoring and evaluation capacity.
- Only banks and other financial institutions living up to a full set of eligibility requirements, including the CBN's prudential requirements, will be eligible to receive financing from the new DFI.

26. **The government program and the design of the proposed project have been informed by an in-depth review of global experience relating to DFI reforms**. A summary of experiences with development finance institutions is presented in the *Lessons Learned and Reflected in the Project Design* section of the Project Appraisal Document (PAD). As part of their awareness-raising efforts, Government delegations also undertook study tours to Brazil, Germany, and South Africa to learn how reforms could best be implemented in Nigeria.

27. **The new development finance framework is being developed by taking into account the overall conditions affecting increased access and affordability of finance**. Certain constraints in the operating environment cannot be addressed in the short term; namely, the availability of credit information, the enforceability of contracts, and the legal framework for financial instruments such as leases, collateral registration, and formalization of property registration.[8] The strategy of developing a new DFI rather than reforming an existing DFI has been carefully considered, concluding that a new DFI is preferable in order to ensure the shift from a more risky first-tier/retail approach in providing development finance to a second-tier/wholesale institution. Further, the establishment of a leaner DFI structure with professional expertise in the management and strong governance arrangements is considered to be significantly easier to achieve in the context of a new DFI than to attempt to restructure an existing DFI.

28. **In order to provide the institutional framework to ensure provision of stable and predictable funding to support the growth of Nigeria's MSME sector, the government has decided to establish a new wholesale DFI.** The choice of using a new DFI as a vehicle for on-lending rather than using instruments such as credit lines is driven by the opportunities for leveraging donor funding within an environment where on-lending products can be quickly adapted to market needs and developments without being constrained by individual donor program design and approval processes. World Bank-provided funding for the DFI would be heavily leveraged by credit lines and equity provided by other donors and institutional investors attracted on the one hand by the DFI's independent governance structure and sound balance sheet and on the other by the opportunity to provide funding for on-lending, which can be delivered through market-driven designs. The wholesaling of donor funds will also reduce approval processes for donor credit lines and lessen the administrative burden imposed on participating financial institutions (PFIs) by having to comply with distinct procedures for each donor credit line. The PFI status will be granted to financial intermediaries that meet the project eligibility criteria, elaborated further in the Project Description section. The DFI will be able to design products to respond to emerging market developments at commercial rather than donor speed and would—within the limits imposed by the Bank and other donors—be able to offer products designed in response to market demand. Bank and donor funding would in turn be leveraged by the DFI's access to the local (and ultimately international) wholesale markets where investors would view Bank and other donor involvement as providing a degree of political and governance risk mitigation.

[8] See: *Financing Small and Medium-Sized Enterprises in Nigeria*, Berg, Fuchs, Lovegrove, Jaeggi, Iacavone & Sanchez, World Bank 2012.

Box 1: Global Development Finance Institutions Practices

Almost every country (including the most advanced economies) has a development bank of some kind, with the World Federation of Development Finance Institutions having 280 development finance institutions in 2011. Globally, DFIs vary considerably in ownership, governance, regulation and supervision, financial structure, and performance.

The DFI sector is poorly represented in the literature, with few comparative studies available, though in 2011 the World Bank published the results of a survey of 90 DFIs worldwide, conducted in 2009. This survey identified trends in the DFI sector (although for each trend there are many counter-examples):

- **The favored ownership model has moved away from 100 percent state ownership** toward an increasing use of a mixed public-private capital structure.
- **In emerging economies, DFIs still serve as the largest source of long-term credit for agriculture, housing, and infrastructure.**
- **Governance reforms have been gathering speed - driven in part by the trend toward mixed ownership structures - as governments seek to make DFIs self-sustaining** (i.e., profitable and self-funding) and insulate them from political interference. Increased transparency (auditing and publication of financial statements) and the professionalization of boards of directors exemplify this trend.
- **As part of the trend toward improved governance, regulation and supervision of DFIs is being strengthened**, with the favored model now being to require DFIs to comply with commercial banking regulations.
- **The credit model used by DFIs is trending away from a mixed wholesale/retail model toward a wholesale-only model.**
- **The majority of DFIs are profitable, and the trend is for DFIs to achieve nonperforming ratios of below 5 percent** reflecting greater wholesale credit activity, better governance, professionalization of management, and stronger risk management practices; and
- **The financing structure of DFIs is evolving away from accepting deposits** toward transparent budget funding and funding from the wholesale markets.

29. **The authorities have already completed important preparatory steps in establishing the new DFI.** Importantly, the President of Nigeria has given his written endorsement of the mandate of the new DFI and fully supported its establishment. The CBN has developed a draft regulatory framework that provides the framework for oversight, regulation, and supervision of the new DFI. The FMOF has hired PricewaterhouseCoopers to undertake the tasks required in setting up the new institution. Already this has resulted either in preparation or an advanced stage of the key legal documents required to establish the new DFI (e.g., Memorandum and Articles of Association) which is required for the registration of the new DFI as a public liability company with the Corporate Affairs Commission, initiation of the process of obtaining a CBN license for the DFI, and finally registration of the DFI with the Securities and Exchange Commission.

DFI Governance Structure

30. **While the new DFI will be majority government-owned and managed in partnership with other shareholders,[9] the articles of agreement establishing the new DFI will stipulate the business model and strategic direction of the institution.** The Memorandum and Articles of Association (MemArt) will stipulate that a majority of directors are independent and

[9] Only African Development Bank is currently planning an equity investment.

competitively selected by the shareholders with the assistance of an independent recruitment firm and will constitute a majority of the Board at all times (see Annex 12). The project envisages an innovative governance structure whereby compliance with the DFI's strategic mandate is ensured both by the majority of DFI Board members being competitively selected independent directors, through the World Bank's participation as an observer on the Board of the DFI for the purpose of supervising the implementation of the project. Cognizant that governance failures contributed to thwarting the effectiveness of DFIs, the authorities are fully committed to establishing a robust governance structure for the new institution. In addition to providing comfort as regards the strategic direction of the new institution, the MemArt will stipulate a process of appointing independent Board members that requires candidates to live up to specific professional and technical qualifications. In addition to on-lending the funding provided by this Project going forward the new DFI is expected to act as conduit for funding from other donors, and so as to reflect that the DFI is a locally-based initiative, the government's preference is that the majority of the independent directors are Nigerian citizens. The independent directors are to be selected from a qualified pool of candidates recruited by an independent search firm. The DFI will also be subject to regulation, licensing, and supervision by the CBN, thus further strengthening the governance arrangements as well as due diligence as regards the DFI's operational and financial capacity.

DFI Scope and Instruments

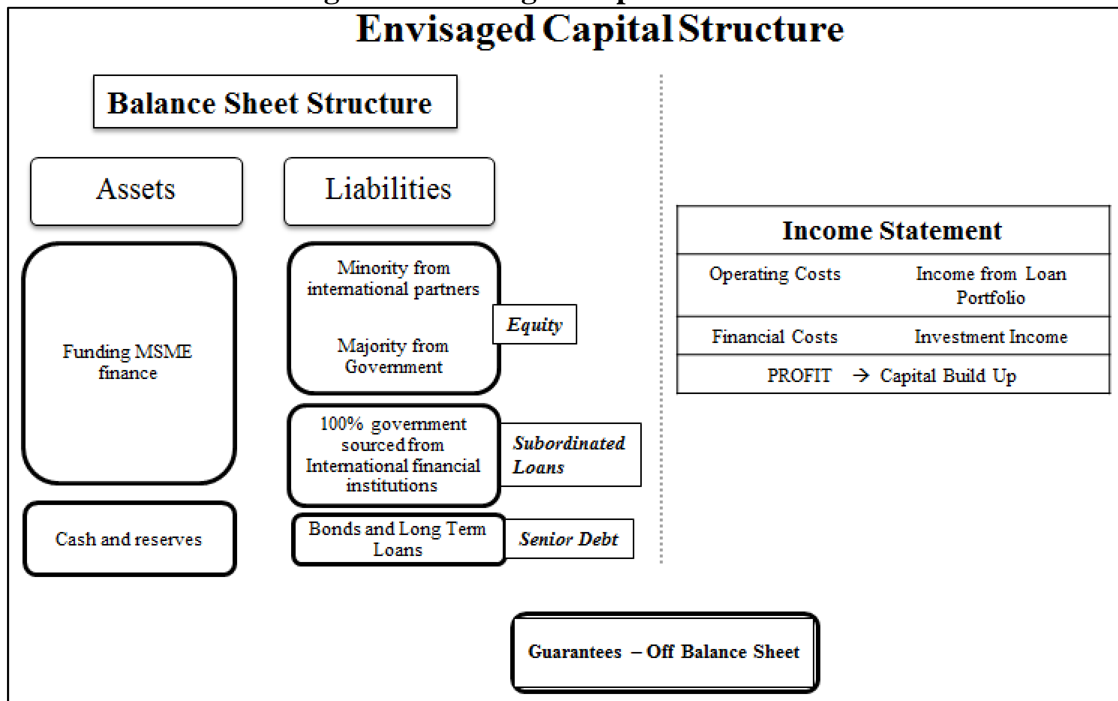
31. **The critical contribution of the new DFI will be in providing wholesale term-funding and risk-sharing facilities to participating financial institutions to better serve the MSME sector.** The intention is to responsibly enhance the risk appetite of banks and to provide MSMEs with access to term-financing, which the banks are unable to provide due to the short-term nature of their liabilities. The intention is to adopt a phased approach, both as regards the instruments offered to the market, and gradually augment the number of participating financial institutions. Given the complexity of designing and establishing a partial credit guarantee facility, the DFI will initially focus on providing wholesale term credit. After the subsequent introduction of risk-sharing products, other instruments key to supporting the development objective of the DFI of facilitating market-based MSME financing, such as establishing a reverse factoring platform, could be considered. Specifically, the DFI will initially prepare to offer products such as the following:

- **Term Finance:**
  - ✓ Funding to commercial banks and nonbank financial institutions (NBFIs) to finance new term lending
  - ✓ Funding to MFBs to expand their outreach

- **Partial Credit Risk Guarantees provided to:**
  - ✓ Commercial banks and NBFIs for MSMEs
  - ✓ Commercial banks for bank loans to MFBs for on-lending

32. **The liabilities of the new DFI are expected to initially comprise US$150 million in equity[10] contribution from the Federal Government of Nigeria (FGN) and African Development Bank (AfDB), and eventually around US$1 billion of loans[11] sourced from the FMOF through loans provided by the World Bank, AfDB, and other international institutional investors.** Equity will be provided by the FGN via FMOF (US$100 million has already been budgeted by the government) and it is envisaged that the AfDB will contribute US$50 million; it is expected that the government will provide additional US$150 million in equity in next budget year. It is envisaged that funds for on-lending will be provided through the FMOF in parallel by the World Bank and – pending the AfDB's approval processes – by the AfDB in the amount of US$445 and US$450 million, respectively. The US$445 million provided by the World Bank will be solely dedicated for the implementation of a Line of Credit Facility (see Component 2 below) in line with the requirements outlined in this document. Other institutions that have expressed preliminary interest in supporting the new DFI with debt finance include the KfW (German Development Bank) and the French Agency for Development (AFD). The government has initiated the process of soliciting potential international institutional investors to augment investment in the new DFI in the medium term. All donor financing will be provided in parallel via separate but complementary projects and through a coordinated approach, but without co-mingling of funds. Figure 3 provides an overview of the envisaged capital structure of the DFI.

Figure 3: Envisaged Capital Structure[12]



[10] The amount of equity will in part depend on the regulatory requirements which are still in the making, see discussion in paragraph 33.

[11] Envisaged to be subordinated to other debt. As a subordinated lender the FMOF will bear more risk than other lenders and, although they are not equivalent to equity, such subordinated loans can in part be used to fulfill the CBN's capital requirements.

[12] The subordinated loans or a portion thereof could be extended by the FMOF to the DFI as equity.

33. **The Government will also have the option to extend the World Bank funds to the DFI in form of equity as long as the funds are deployed for their designated purpose according to the project design –** i.e. for lines of credit and guarantee facility (see description of the project's components 2 and 3) and following compliance with the disbursement linked indicators (see Project Financing section). The Government may choose to use this option in order to meet the regulatory requirements. Though the CBN has as yet only issued the DFI regulations in draft and discussions between the FMOF and the CBN as to the amount of minimum capital are still on-going, current draft regulations envisage minimum fully paid up capital for wholesale DFIs of NGN100 billion. The CBN has indicated that compliance with the minimum capital requirement would be staggered over a three year period. Allowing the Government to provide the World Bank loan to the DFI in the form of equity could help the DFI meet the regulatory requirements for paid up capital as currently drafted by the CBN. The use of the World Bank's funds, whether they are on-lent or injected as equity, will be strictly in line with the project design and will be stipulated in the subsidiary agreement to be entered into between the FMOF and DFI in concurrence with the World Bank.

34. **The development partners involved with the DFI (e.g., AfDB, AFD, KFW) will coordinate their parallel disbursements with a view to front-loading the availability of funding in the first two to three years.** Front-loading the availability of funds will support the DFI in building up its capital, thereby strengthening its balance sheet from the outset. At the same time, all donors have agreed to adhere to channel their funding through the FMOF and to a performance-based disbursement schedule, whereby the funding would be made available to the DFI once certain targets are reached (similar to the Bank's disbursement linked indicators listed in the Project Financing section of the PAD). Finally, all TA needs will be jointly assessed and executed so as to ensure full complementarity of donor support.

D. Higher Level Objectives to which the Project Contributes

35. **The mandate of the new DFI fully supports the dual objectives of stimulating more diversified and inclusive growth.** The new DFI will contribute to alleviating specific financing constraints that hamper the growth of domestic production and commerce by providing targeted wholesale funding to fill identified enterprise financing gaps in the MSME and agricultural sectors. MSMEs in Nigeria have enormous potentials to play a crucial role in economic growth, poverty reduction, employment creation, and shared wealth creation. The recent GDP rebasing in Nigeria reveals a much more diversified and complex structure of the economy, with pockets of high growth potential in manufacturing and services for the expansion of MSMEs. However, many find it difficult to survive and grow, as they lack access to the finance, skills, and information to expand and grow. Similarly, boosting the productivity of rural and agricultural MSMEs and improving farmers' linkages with agro-processors could have major implications for Nigeria's rural economy and import competitiveness. The wholesale DFI will play a focal and catalytic role in providing funding and risk-sharing facilities. It will also incentivize financial institutions, predominantly deposit-money and microfinance banks, by augmenting their capacity and by providing them with funding facilities designed to meet the needs of these smaller clients.

36. **In achieving the given objective, the DFI will complement its financing with technical assistance, leveraging development partner institutions' and the Bank's operations**. This support will be provided to banks and to other financial intermediaries. Based on the team's interaction with potential beneficiaries—financial institutions and MSMEs—there

is a broad-based, strong demand for the instruments to be provided by the new DFI (lines of credit, partial credit guarantees) and for the accompanying technical assistance. The strong commitment of the FMOF and CBN, supported by the presidential endorsement of the proposed project, offer additional guarantees for successful implementation.

37. **The proposed Development Finance Project is fully aligned with the priorities set out in the FY14-17 Country Partnership Strategy (CPS).** The CPS explicitly calls for focusing on **"**increasing access to finance, including long-term financing, for key sectors such as housing, SMEs, agriculture, and infrastructure, through various mechanisms involving both private sector and public private partnerships (PPPs), and potentially through a state-owned wholesale financing mechanism". The proposed operation addresses the provision of finance, including term finance, through eligible PFIs to expand outreach to urban and rural MSMEs. While recognizing the imperative of addressing in parallel both the macroeconomic and structural impediments to diversification of bank lending, the approach to development finance supported by this operation seeks to incentivize the financial system to deepen the banking system's provision of *market based, sustainable* financial services.[13]

38. **The funding made available and facilitated through the DFI operation will supplement other projects in the portfolio and increase the impact of the overall CPS in Nigeria**. The DFI operation will in the first instance benefit from other operations such as the Growth and Employment (GEM) Project, and Public Private Partnership (PPP) Project. The GEM project has commenced the construction of a national business support platform to facilitate access to MSME training support. MSMEs applying for support under this program will be provided with various levels of training and screening that may ultimately result in access to GEM-funded grant support for business plans that fulfill certain criteria. These efforts are expected to make MSMEs more bankable. The efforts to strengthen the capacity of MSMEs to be serviced by the DFI will also benefit from and be coordinated with the ongoing IFC engagement in the MSME sector. The PPP project will support restructuring and privatization of two existing DFIs: the Bank of Industry and the Bank of Agriculture.

39. **The proposed project is a joint effort between the World Bank, AfDB, KFW, AFD, and the United Kingdom's Department for International Development (DFID).** All financing will be provided by the respective donors in parallel through their own individual projects, which while complementary and coordinated will not require co-mingling of funds**.** The project preparation has been marked by the close coordination and consultation with these partners, who have jointly supported the process of establishing the new wholesale DFI**.** The World Bank and DFID have jointly worked from the outset on data gathering and analytical work that informed the project design. In parallel with the World Bank, the AfDB has committed to providing both debt and equity, thus significantly contributing to the capacity of the DFI. KFW and AFD have conducted their initial project assessments and are currently considering provision of parallel debt financing.

---

[13] Crucial to this pro-market approach is the careful identification of market failures and their causes, designing interventions that address these failures while complementing market development, and only applying solutions that are cost effective. The approach is essentially dynamic with a view to piloting approaches that continuously extend the frontiers of financial access.

40. **The proposed institutional response to identified market failure in the area of access to finance was chosen in order to facilitate a comprehensive and long-term solution in support of broader structural reform**. The new policy framework also provides a platform for leveraging the support of other donors and for coordinating various access to finance programs. In parallel, and with the support of another World Bank-funded project (PPP Project) the Government has embarked on the process of restructuring the existing DFIs associated with MSME finance (the Bank of Industry and the Bank of Agriculture). Following their restructuring and/or privatization and upon verification of their observance of the eligibility criteria applied to all participating financial institutions (see section on Project Components), the existing DFIs could also benefit from the facilities made available by the new DFI. Going forward the role and responsibilities of the CBN will be focused on its core supervisory mandate of ensuring the stability of the financial system, including regulation and supervision of the new DFI to be established under this operation. However, the CBN has indicated that it intends to remain engaged in development finance with much more targeted interventions to be conducted in parallel with the new DFI.

41. **A premise of the proposed operation is that all development funding by the new DFI will be provided on terms that are market-conforming and thereby complement the provision of funding by the private sector**. In the Nigerian context the strategic focus on a pro-market approach to development finance represents a distinct break with recent practice. According to this approach, funds will be made available on transparent terms and with clear accountability and with the overarching objective of strengthening the engagement of the private sector in fostering the diversification of Nigeria's domestic economy on a sustainable basis. To ensure that these principles are observed, while also providing the necessary impetus and facilitation to expand the banks' capacity and market penetration, it is envisaged that the responsibility for government-funded development finance will be assembled in a new wholesale-only DFI. In accordance with the principles outlined, the new DFI will play an important role as catalyst in expanding the business frontier of the financial system and by ensuring that scarce public resources are leveraged to their best advantage and deployed flexibly so that financing gaps are targeted efficiently.

II. PROJECT DEVELOPMENT OBJECTIVES

A. PDO

42. **The project development objective is to increase the availability and access to finance for micro, small, and medium enterprises through eligible financial intermediaries with the support of a new wholesale development finance institution.**

Project Beneficiaries

43. **The main project beneficiaries are private sector MSMEs and the PFIs.** MSMEs will benefit from improved access to term finance for investment and working-capital loans. PFIs will benefit from technical assistance, term funding, and partial credit guarantees aimed at enhancing their capacity to sustainably serve the MSME sector. The project will also provide limited

support to the small corporate sector, which is also seen as credit constrained, although to a lesser extent than MSMEs.[14]

PDO Level Results Indicators

44. **Key PDO indicators include the following:**

- Volume of sub-loans facilitated by the Line of Credit Facility
- Volume of sub-loans facilitated by the Credit Guarantee Facility
- PFI sub-loan portfolio at risk

45. **Key intermediate indicators are as follows:**

- Volume of DFI's wholesale loans
- Volume of guarantees issued
- DFI portfolio at risk
- DFI return on assets
- Number of PFIs reporting on lending to women sub-borrowers

46. **Additional indicators are described in Annex 3.**

III. PROJECT DESCRIPTION

47. **The project will facilitate increased access and availability of finance for MSMEs.** This will be achieved by supporting the new wholesale DFI and PFIs with technical assistance and financial resources. The project will facilitate development and funding of a diverse set of DFI instruments including medium- and long-term loans and credit guarantees to be provided to participating financial institutions with a view to expanding their outreach to urban and rural MSMEs with limited or no access to formal finance and, to a limited extent, small corporates with 10% of line of credit facility under Component 2.

48. **Funding, and guarantees provided by the new DFI, will be made available to eligible PFIs for eligible sub-borrowers and sub-projects on market-conforming terms**. Strong emphasis will be placed on designing funding products that respond to the needs of the commercial banks as well as those of MFBs and leasing companies that meet the stipulated eligibility requirements (see Box 2). In this regard, the initial appraisal of interested financial intermediaries will be done under the supervision of the World Bank, while the DFI will be subsequently tasked with this role with the support of the CBN, in line with the World Bank requirements for financial intermediary financing. Financial intermediaries that are deemed eligible will be granted a PFI status and enter into a credit agreement with the DFI, allowing access to term finance and/or partial credit guarantees based on demand and the availability of funding. PFI status allows financial intermediaries to access the financing facilities provided by the DFI and in no way obligates them to draw on these facilities (interest costs and other fees would be charged only upon accessing the line of credit or CGF).

[14] While there is intense competition among banks in Nigeria for the key large corporate clients, this takes place to the detriment of smaller corporations where competition is less intense and banking services are more costly (cross-subsidization). See analysis in Annex 2 as well as the monitoring and evaluation to be developed under Component 4.

Box 2: Eligibility Criteria for Participating Financial Institutions

The following are minimum eligibility criteria which will be confirmed in an annual due diligence process conducted by the new DFI: i) The PFI must be *duly licensed* and at least two years in operation; ii) PFI's owners and board of directors should be "*fit and proper*"; iii) the PFI must have qualified and experienced management, adequate organization and institutional capacity for its specific risk profile; iv) the PFI must be in "*good standing*" with its supervisory authority (i.e. it should meet all prudential and other applicable laws and regulations) and remain in compliance at all times; v) the PFI must have well defined policies and written procedures for *management of all types of financial risks* (liquidity, credit, currency, interest rate and market risk, as well as risks associated with balance sheet and income statement structures); vi) the PFI must maintain *capital adequacy* as prescribed by prudential regulations; vii) the PFI must have *adequate liquidit*y; viii) the PFI must have *positive profitability and an acceptable risk profile*; ix) the PFI must have *adequate portfolio quality*; x) the PFI must have *adequate internal audits and controls* for its specific risk profile; xi) the PFI must have *adequate management information systems*; and, xii) the PFI must demonstrate commitment to serving the MSME sector and have in place satisfactory MSME loan approval processes and risk management procedures.

Eligibility Criteria for Sub-borrowers and Sub-Projects

49. **Sub-borrowers will be creditworthy private sector MSMEs and small corporates that meet all of the following criteria:**

Enterprise Type	# Employees	Annual Turnover	Total Assets	Max. Loan Size
MSMEs	< 250	< $3.125mn (N500mn)	<$3.125mn(N500mn)	< $500k(N80mn)
Small Corporates	< 500	< $15mn (N2.4bn)	< $15mn (N2.4bn)	< $2mn(N320mn)

Note: The total amount of funding provided by the new DFI for PFIs to on-lend to small corporates will be limited to 10 percent of available project credit line resources.

50. **Eligible Sub-projects and Terms:** Sub-loans will be extended to eligible MSMEs and small corporates for investment and working capital loans in amounts of up to US$500 thousand equivalent for MSMEs and up to US$2 million for small corporates. The sub-loan maturity is expected to be up to ten years with a grace period of up to 18 months. Specifics are as follows:

a. **Investment Loans:** the maximum available sub-loan amount will be US$500 thousand for MSMEs and US$2 million for small corporates. Maximum maturity[15] will be ten years with a grace period of up to 18 months.
b. **Working Capital Loans:** the maximum available sub-loan amount will be US$200 thousand for MSMEs and US$800 thousand for small corporates. Maximum maturity will be three years with a grace period of up to six months.

51. **All sub-projects will be in compliance with environmental and social standards as defined in the Environmental and Social Operations Manual (ESOM), while the goods and services on World Bank Group exclusion list will not be eligible for financing.**

[15] As discussed in the section on Market Gaps, short-term maturities of up to one year dominate the Naira lending landscape, while longer maturities (one to three years) in local currency are scarce.

52. **The terms offered by the DFI will reflect the DFI's cost of funds and a spread to cover the DFI's costs of operation plus a risk premium**. As the new DFI is designed to maintain a strategic focus, its own sustainability is paramount, and the viability of the products it provides will be crucial to its success. Thus, rather than providing the market with periodic relief, the new DFI will maintain a product line that Nigerian financial intermediaries can depend upon and on which they will be able to leverage their own businesses' development.

A. Project Components

53. **The project consists of four components**: (i) Technical Assistance and Capacity Building in the amount of US$12 million; (ii) Line of Credit Facility in the amount of US$445 million (iii) Credit Guarantee Facility in the amount of US$35 million; and (iv) Project Management in the amount of US$6.75 million. In addition, the front-end fee of US$1.25 million will be financed out of the proceeds of the loan.

Component 1: Technical Assistance and Capacity Building (US$12 million)

54. **The project will fund tailored technical assistance to the PFIs.** Other development partners will also allocate resources for complementing and coordinated technical assistance. Based on an initial diagnostic review, technical assistance will be provided to prospective PFIs by competitively selected firm(s) with demonstrated international experience in similar projects. Experience from other countries, such as Turkey, China, and Russia, which have implemented large-scale programs with a view to significantly enhance MSME finance, is that broad-based technical assistance support is crucial to program success. Technical assistance is instrumental in the following: (a) supporting banks to reach out to MSMEs, i.e., beyond their traditional client base—not just from the banks' headquarters, but in direct interface with MSMEs at the branch level; (b) enhancing banks' understanding and usage of more appropriate (cash-flow based) lending techniques, which are required in environments where MSME's access to collateral is limited and weaknesses in the financial infrastructure inhibit efficient foreclosure on collateral; and (c) strengthening communication concerning the appropriate use of new financing instruments on offer (term financing and partial credit guarantees).

55. **The project will coordinate with IFC during implementation of the technical assistance components in order to benefit from its experience in this field, both in Nigeria and internationally.** In keeping with the new development finance framework in which the public sector will retreat into the second-tier market (interventions), the private sector and the IFC will focus on primary markets. The project will therefore build on and collaborate with IFC's direct engagement in private sector financial institutions. This will translate into coordinating with IFC capacity building for banks funded by development partners, working with the IFC deep-dive SME capacity-building program, which is under review, and working with the IFC in the enabling environment for MSMEs in Nigeria.

56. **The project, and potentially other donors, will finance provision of operational support to the new DFI**. This includes, but is not limited to, defining and establishing robust operating principles, policies, procedures, and governance, design and rollout of finance instruments, assistance with pilot bond issuance, setting up and implementing monitoring and evaluation practices, impact-assessment methodologies, covering initial operational costs, and so forth. This component will also support capacity building for the FMOF to ensure that the

ministry has the capacity to oversee development finance policies and, in that context, support the new DFI so as to fulfill its mandate. Finally, it may support the review, restructuring, and potential transfer of some of the exiting DFI schemes operated by CBN to the new DFI, as necessary.

57. **By strengthening the institutional and human resource capacity of PFIs, the tailored TA will lay the foundation for progressive, nationwide scaling-up of commercially sustainable MSME finance.** Among the areas to be supported are recruiting and training new loan officers, strengthening of lending policies and procedures, putting in place appropriate accounting, risk management and management information systems, supporting the sub-loan application process through enhancing screening and decision-making capacity, supporting development of capacity in sub-loan monitoring and collections, and establishing and implementing an environmental and social safeguards framework.

58. **To benefit from the credit and guarantee facilities, the PFIs will be required to enter into Technical Cooperation Agreements (TCA) with the PIU.** In addition, so as to ensure that the PFIs have the required level of capacity, their access to the line of credit and CGF will be made contingent on achieving agreed benchmarks. These Agreements will build on the outcomes of an initial diagnostic review of the PFIs, where their technical assistance needs will be defined. Under the TCA's, see further details in Annex 11. PFIs will commit to adopting internal structures and staffing consistent with servicing the target MSME market (in line with project eligibility criteria), as well as to continued financing of facilities and newly trained staff, once the project-funded services under the TCA have been delivered. The Agreements will describe (i) the technical cooperation package, which the project will make available to the PFI, and (ii) foster within the PFIs the processes and procedures under which MSME loans will be made available to sub-borrowers. As the success of the credit and guarantee facilities depends on the application of modern MSME lending technologies and risk-control procedures, the TCAs fulfill the dual objective of providing the basis for delivery of the required expertise and ensuring the commitment of the PFIs to adopt the technical assistance services tailored to strengthen the PFI's MSME lending practices. The intention is that the banks' access to the facilities will be contingent on achievement of monitored outcomes under the TCAs to be determined during the diagnostic phase and agreed with the PFIs.[16]

59. **This component will also support establishment of specific financial consumer-protection measures, such as disclosure requirements, to be adopted by all PFIs to facilitate competition and thereby enhance responsible finance and affordability.** Competition among banks is hampered by lack of transparency about the costs of banking services—both on the cost of borrowing and income on deposits as well as fees on transaction services, etc. For example, MSMEs face difficulty comparing borrowing terms among banks and are often subject to undisclosed fees and arbitrary changes to agreed interest rates. To move toward improving transparency, PFIs that on-lend funds provided by the new DFI will be encouraged to implement a set of consumer protection standards in-line with international practices, including fair treatment of borrowers, full disclosure of borrowing costs including fees, and a ban on applying changes to interest rates and fees without due disclosure/warning.

[16]In the case that a PFI does not adhere to an agreed TCA, consideration may be given to suspending access to the DFI's facilities.

60. **Specific attention will be paid to cater to supporting the needs of female entrepreneurs, given that their access to finance is particularly constrained.** This will be primarily achieved by sensitizing PFIs to gender issues during provision of TA, specifically targeting women entrepreneurs. This may include piloting and rolling out products designed to fit low-income women and/or high-potential women entrepreneurs (e.g., loans to women with low or no collateral), including opening a window dedicated to women entrepreneurs, allocating funds linked to outreach to women clients, and monitoring and reporting on lending to women sub-borrowers.

61. **Given that the PFIs' adoption of lending practices suited to expansion of their MSME lending will be needed prior to more widespread uptake of the project's facilities, high priority is associated with expeditious roll out of the TA activities described.** In this regard, the team may attempt to secure the project preparation facility (PPF) to: i) facilitate the establishment of the DFI by providing funding for the initial operational expenses of the DFI and ii) provide funding for the initial roll out of the technical-assistance program.

62. **The responsibility for administering the technical-assistance component will reside with the project implementation unit** (see Component 4). The delivery of these services will be undertaken by qualified external providers with experience in the delivery of similar broad-based technical assistance services in other countries. Among the first steps to be undertaken will be to procure services of an international technical advisor to complement the existing skillset of the project implementation unit.

Component 2: Line of Credit Facility (US$445 million)

63. **This component will provide US$445 million to the new DFI designated for lines of credit to eligible PFIs for on-lending to eligible enterprises and subprojects.** The PFIs will extend sub-loans to eligible MSMEs and small corporates (up to 10 percent of available DFI credit line resources will be allocated for the latter), which will include both investment and working capital loans in the expected amount of up to US$500 thousand equivalent for MSMEs and up to US$2 million for small corporates. Interest rates to final borrowers will not be subsidized or capped, and as a result the project will test an innovative market-based approach to reduce spreads offered by PFIs to final borrowers. For details, see Component 4.

64. **The PFIs will receive funding from the DFI upon submission of internally approved sub-loans in line with eligibility criteria.** Upon verification of compliance with eligibility requirements, the DFI would extend funding to the PFIs matching the amount, maturity, and grace period of each sub-loan. In the case of MFBs (due to small loan sizes and short maturity), consideration will be given to offering a line of credit with fixed terms (e.g., maturity and grace period**).** For a detailed description of the Line of Credit Facility, eligibility criteria for sub-borrowers, sub-projects, and other details related to operation of lines of credit, see Annex 2.

Component 3: Credit Guarantee Facility (US$35 million)

65. **This component will provide US$35 million for a Credit Guarantee Facility (CGF) to be established as the DFIs wholly owned subsidiary and housed within the DFI.** This is to avoid conflicts of interest due to misalignment of incentives between the DFI's instruments: in

the early years of the new DFI's operation, it would be more attractive for the DFI to make loans instead of issuing guarantees in order to generate revenue from earning assets. The CGF will have its own management team and a lean organizational structure.

66. **The credit guarantee facility will provide a 50 percent guarantee on PFI loans made to eligible MSMEs; it is also expected to guarantee bank loans to MFBs for on-lending to their target market.** Guarantees will be priced based on each PFI's performance indicators for management of its SME portfolio, chiefly the level of NPLs and write-offs. Given the wide range of such indicators among banks (e.g., non-performance ranges between 1 and 11 percent of banks' SME portfolios), pricing will be differentiated by bank instead of using a sector average. In this way the situation will be avoided whereby good banks are punished (by charging a fee that is too high) and not-so-good banks are subsidized (by charging a fee that is too low). Initially, the CGF will individually review *each* sub-loan submitted for coverage. Over time, the approval process may evolve so that guarantee coverage is provided on an MSME portfolio basis, once a satisfactory track record has been established (measured by NPL ratios). Claim payout will be executed after a loan has been 90 or 180 days in arrears, provided that the bank has demonstrated that it has taken agreed steps to collect the arrears. Recovery proceeds will be shared with the CGF. The CGF reduces the risk exposure of banks and thereby the amount of security the banks will require in the form of collateral. This may disproportionately benefit women, as they are less likely to own real estate, which is the banks' preferred form of collateral. For a more detailed description of the proposed CGF, see Annex 2.

Component 4: Project Management (US$6.75 million)

67. **This component will fund the project management functions supporting overall project implementation.** This component will be administered by the existing Project Implementation Unit (PIU) housed in the FMOF and responsible for the World Bank funded Public-Private Partnership (PPP) Project. The project management functions include fiduciary requirements such as procurement, financial management, and withdrawal and disbursement requests, as well as program outreach, communication and reporting, monitoring and evaluation, support with implementation of environmental and social safeguards, and impact assessment. This component will fund relevant staff, consultants, training, equipment, and operational expenses. As part of this, component funding will be provided to ensure that proposed technical-assistance activities and consulting services under the project's components 1 and 4 are undertaken in compliance with the World Bank fiduciary requirements.

68. **This component will pilot and test various mechanisms for reducing the cost of MSME credit, including auctioning of credit line funds, an incentives-based first-loss facility,[17] and other such initiatives to be implemented by the DFI with the assistance of qualified external providers, as appropriate.** These activities will be undertaken as part of the innovation and impact assessment agenda. They are designed to strengthen the efficiency of financial intermediation by encouraging banks to reduce the costs of MSME credit and to increase their exposure to MSME borrowers who are potentially creditworthy but regarded as too risky, given the business models hitherto deployed by banks in Nigeria. It is intended that these activities will build on experience gained from implementation of the new DFI's credit and

[17] Unrelated to the Credit Guarantee Facility presented in Component 2.

guarantee facilities, particularly as regards determining appropriate spreads (interest costs and fees) to be passed through to the end users of these facilities. Thus, the design of these innovation activities will build on initial experience and data assembled by the DFI.

69. **The project will support the development of mechanisms to put pressure on banking spreads using auctions of funds provided under the Line of Credit Facility.** In order to put pressure on the spreads offered by banks to final borrowers, PFIs will be required to compete on the level of interest rates they charge to final borrowers using an auction process. Given that large corporations already benefit from cross-subsidization at the expense of small corporates, as described in Annex 2, this approach will be tested in the first instance on spreads on Line of Credit Facility funding on-lent by PFIs to small corporates (as defined earlier in the PAD). A mechanism for monitoring and evaluating the outcomes of these auctions and their impact on the cost of banking services to bank borrowers will be developed under the responsible finance initiative elaborated below.

70. **With a view to expanding PFI lending to the MSME segment, a first-loss facility will be tested to encourage PFIs to reduce the spreads they charge to their MSME clients**. Hitherto banks have experienced high losses on their MSME portfolios, resulting in a portfolio at risk of up to 15 percent. This high level of risk is factored into bank spreads and lending rates potentially resulting in the exclusion of borrowers of good standing. The focus of this activity will be to explore the potential benefits associated with providing up to 15 percent first-loss coverage for loans to first-time borrowers, thereby reducing PFI credit risks for the first one to two years of a loan's term. In exchange for the new DFI providing such first-loss coverage, the PFIs will be expected to reduce their lending spreads in-line with the reduced credit risk associated with borrowers with first-loss coverage.

Project Financing

Lending Instrument

71. **The project will be financed through investment project financing (IPF) in the amount of US$500 million on IBRD terms, to be implemented over seven years.** After considering the alternative financing products, the Borrower has chosen an IBRD Flexible Loan (IFL) with Variable Spread and automatic rate fixing of new disbursements. The loan has a maturity of 21 years including a grace period of five years, with repayment schedule linked to each disbursement and annuity repayment. The front-end fee of 0.25% of the loan will be financed out of the proceeds of the loan.

Disbursement Tranches

72. **Disbursements to the DFI under the second and third components in the total amount of US$480 will be made against a set of targets, in-line with the disbursement-linked indicators (DLIs) outlined in the following table.** The achievement of indicators under tranches IV–VI will be verified independently and presented for the World Bank to review. Other development partners supporting the DFI will adhere to similar indicators to ensure a coordinated approach.

73. **The disbursement-linked indicators are designed to provide the DFI with liquidity and income from investments in the early years of its operation.** Front-loading of disbursements will allow the DFI to accumulate liquidity during the first years of its operation. By investing this liquidity, the DFI will earn investment income and be able to strengthen its capital base, thereby bolstering its longer-term financial sustainability.

Table 1: Disbursement Linked Indicators

Tranche	Maximum Amount Allocated (USD)	Disbursement Linked Indicators
I	**20,000,000**	Evidence, in form and substance satisfactory to the Bank, that: (i) the DFI chief executive officer has been duly appointed and the DFI Board duly constituted; (ii) the Subsidiary Agreement has been duly executed on behalf of the Borrower and the DFI, such execution has been duly authorized or ratified by the Borrower and the DFI and the Subsidiary Agreement is legally binding upon the parties thereto; (iii) the DFI has adopted the Environmental and Social Operations Manual and the DFI Operations Manual; and (iv) the DFI has acquired the license from the Central Bank of Nigeria required for its operation and a legal counsel, acceptable to the Bank, has issued an opinion confirming that the DFI has been duly established and has the mandate and capacity to perform the functions and obligations assigned to it under the Project, all of the above in form and substance satisfactory to the Bank.
II	**100,000,000**	Evidence, in form and substance satisfactory to the Bank, that DFI has selected at least two PFIs, based on the eligibility criteria set forth in the DFI Operations Manual and signed Master Credit Agreements with the PFIs.
III	**35,000,000**	Evidence, in form and substance satisfactory to the Bank, that a CGF Entity has been established as a subsidiary of the DFI, the CGF Entity's manager has been duly appointed, and the CGF Entity has adopted the Guarantee Manual.
IV	**150,000,000**	Evidence, in form and substance satisfactory to the Bank, that during the period starting on the day immediately following Tranche II disbursement, DFI has provided to PFIs a minimum volume of USD30 million equivalent in DFI Loans.
V	**100,000,000**	Evidence, in form and substance satisfactory to the Bank, that during the period starting on the day immediately following Tranche IV disbursement, DFI has provided to PFIs a minimum volume of USD50 million equivalent in DFI Loans.
VI	**75,000,000**	Evidence, in form and substance satisfactory to the Bank, that during the period immediately following Tranche V disbursement, DFI has: (i) provided to PFIs a minimum volume of USD100 million equivalent in DFI Loans; and (ii) unless otherwise agreed in writing by the Bank, issued and sold new bonds the proceeds of the sale of which shall be used to fund lines of credits to PFIs for on-lending to Eligible Beneficiaries with a minimum volume of bonds outstanding equivalent to USD50 million.

Note: The conditions under Tranche III are not a requirement for disbursement of Tranches IV-VI. The pilot bond issuance requirement in Tranche VI would apply only in case the DFI is in need of additional financing.

Project Cost and Financing

Project Components	Project cost	IBRD or IDA Financing	Percent Financing
1. Technical Assistance and Capacity Building	US$12 million	IBRD	100%
2. Line of Credit Facility	US$445 million	IBRD	100%
3. Credit Guarantee Facility	US$35 million	IBRD	100%
4. Project Management	US$6.75 million	IBRD	100%
Total Costs			
Total Project Costs	US$498.75 million	IBRD	100%
Front-End Fees	US$ 1.25 million	IBRD	100%
Total Financing Required	US$500 million		

74. **Eligible expenditures under the project will include: i) traditional expenditures for consultants, goods, works, and non-consulting services for Components 1 and 4; and ii) performance based expenditures linked to establishment and operations of the DFI for Components 2 and 3.** In regards to the latter, the eligible expenditures under Component 2 will include DFI wholesale loans to PFIs. Under Component 3, the eligible expenditures will include establishment of the CGF as a wholly owned subsidiary of the DFI.

Series of Project Objective and Phases

75. *Not applicable*

Lessons Learned and Reflected in the Project Design

Lessons Learned Informing the Design of the New DFI

76. **Transparent reporting, a clear incentive structure for board and management, strong corporate governance, and independent and effective regulation and supervision are key factors in developing a sustainable DFI.** Accurate and detailed financial and performance reporting, with an independent rating, is essential in maintaining a self-sustaining institution. Making a DFI subject to market scrutiny keeps the board and management focused on the key principles of well-managed and disciplined institutions while maintaining its societal objective. These factors also provide the board and management with necessary insulation against politically driven trade-offs that would undermine the sustainability of the institution. Independent regulation and supervision by the financial sector regulator rather than a line ministry with conflicts of interest further enforces the disciplined prudent management of a DFI. Supervision and regulation of DFIs is best exercised by financial sector regulators, largely by enforcing the similar regulatory requirements for DFIs that are applied to commercial banks.

77. **For access to finance initiatives to succeed, consideration must be given to the dynamics of reform within the targeted sectors and government**. State-owned and managed DFIs can be captured by internal and external interest groups, making institutional reform

impossible. As a result, this project builds on a government-initiated stakeholder consultation group, including existing DFIs, which has agreed on a dual path of reform encompassing the following: first, the partial privatization of the existing DFIs; and second, withdrawal from the primary market of public sector driven interventions by using a wholesale-only DFI. In addition, the chosen governance model builds on equity stakes of other shareholders and/or partnerships with other reputable international institutional lenders, which should act as further insulation against political capture.

78. **Experience suggests the importance of tightly defined mandates, clear performance targets, transparent reporting, and insulation from political interference**. The new DFI's mandate is narrow in scope to address specific gaps in the provision of development finance combined with the requirement that it be financially self-sustaining. However, it remains important to guard against pressure on the DFI to expand its mission (mission creep) into areas where it competes with the private sector. International experience confirms the importance of oversight by both internal and external auditors, codes of conduct, and of effective monitoring and evaluation. In this regard, credit and investment decisions that are insulated from outside interference, rigorous financial management, and wholesale-only business model would mitigate against these risks.

79. **International experience relating to DFI reform confirms that wholesale-only DFIs (second-tier institutions) that provide incentives to private sector banks to enter new markets perform better than DFIs that engage in retail operations.** The wholesale-only model means that the DFI will provide incentives to private sector banks to enter new markets (or expand service to existing markets) by providing funding, other financial products, and linked technical assistance, which increase the attractiveness of these markets and/or make commercial bank credit feasible, e.g., by providing term funds to allow longer-term funding for investment projects. This model also confers other important advantages.[18]

80. **International experience also shows that a wholesale approach is particularly appropriate with respect to SME finance.** Operating the DFI on a retail basis would present significant disadvantages, as follows:

- The DFI would have to build a retail infrastructure from the ground up. This would entail very significant additional capital and ongoing operational costs for the establishment, staffing and operation of a branch network and attendant back office costs[19];

---

[18] "Under the second-tier (or wholesale) lending model, DFIs tend to have lower operating costs because financing is provided by the DFI to private financial institutions which subsequently select and assess the loan applications of end-customers. Under this model, the DFIs can reach more end-customers and cover more locations without incurring high operating costs. This model also promotes the growth of private financial intermediaries that become the arms of DBs that reach under-served sectors and clients. Moreover, the credit risk is partially absorbed by the private financial institution that intermediates the DFIs' funds… second-tier DFIs tend to report lower nonperforming loan ratios than first-tier DFIs. However, interest rates for end-customers tend to be higher because private financial institutions pass on to them their cost of financial intermediation plus any other margins." *Global Survey of Development Banks*, de Luna-Martinez & Vicente, World Bank Policy Research Working Paper 5969, 2012.

[19] "There are various advantages and disadvantages of first versus second-tier lending. Under the first-tier (retail) lending model, DBs deal directly with the end-customers. Often, this requires the DB to have a large number of branches to access its target customers. This can pose enormous pressure for agriculture, housing, and SME banks

- The task of recruiting and staffing the DFI would become much more complex and the costs would escalate, because of the need to recruit much larger numbers of managers with a much broader range and scarcity of skills;
- The DFI would inevitably be perceived as a state owned bank by retail customers, and thus create a potentially large contingent fiscal liability for its deposits;
- The DFI would have access to deposit funding without the discipline (in terms of transparency, governance requirements, and performance) imposed by domestic and international wholesale markets;
- Credit risk exposure and probable credit losses of the DFI would 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[20]);
- The DFI's exposure to political pressure and malfeasance would both significantly increase (with the ability for such factors to come into play at the local level) and the ability to insulate management from these pressures and monitor the activities of the DFI would become both more complex and vastly more difficult.

81. **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.** 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, turn to DFIs to reduce their financing costs and that there is low impact associated with DFIs' lending (i.e., the private market would in any case have funded these companies if the DFI had not). Altogether, it is important that DFIs avoid providing funding in areas where there is relatively easy access to funding provided by commercial banks, pointing to the need for regular review of the mandates of DFIs to guard against "mission creep" into areas where a DFI provides no impact.

82. **Additional lessons learned informing the design of proposed DFI instruments - credit lines and partial credit guarantees - are included in Annex 2.**

IV. IMPLEMENTATION

Institutional and Implementation Arrangements

83. **The IBRD loan of US$500 million will fund four project components:** Component 1: Technical Assistance and Capacity Building (US$12 million); Component 2: Line of Credit Facility (US$445 million); Component 3: Credit Guarantee Facility (US$35 million); and Component 4: Project Management (US$6.75 million). The front-end fee of US$1.25 million will be financed out of the proceeds of the loan.

84. **The bulk of the financing (US$480 million) - supporting components 2 and 3 - will be extended to the FMOF for direct on-lending in local currency and/or for provision of equity to the new wholesale Development Finance Institution.** The Government will have the

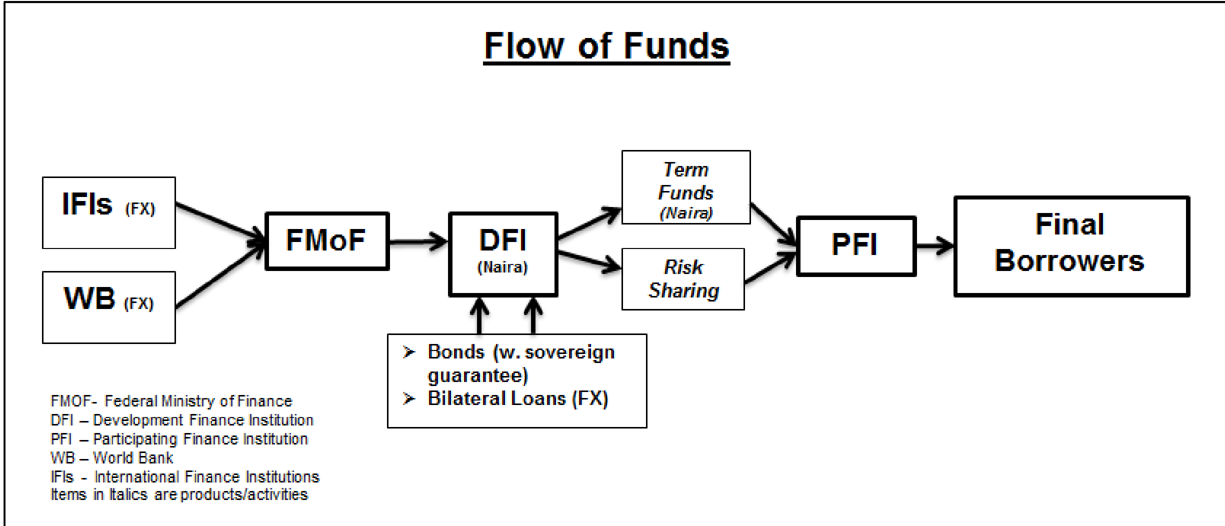
---

whose clientele is usually large and geographically dispersed throughout a country." De Luna-Martinez & Vicente Op Oit.

[20] Risk-sharing guarantees would be the exception to this rule, because for this type of product, the DFI is deliberately assuming a portion of the direct credit risk of retail lending.

option to extend the World Bank funds to the DFI in form of equity, provided the funds are deployed for their designated purpose according to the project design (lines of credit and guarantee facility, see description of the project's components 2 and 3). The use of funds, whether they are on-lent or injected as equity, will be stipulated in the subsidiary agreement to be entered into between the FMOF and DFI in concurrence with the World Bank. The FGN will assume foreign exchange risk that will not be passed to the DFI, participating financial institutions, or final borrowers. The project will be governed by the following agreements: i) loan agreement between IBRD and the Federal Republic of Nigeria (as represented by FMOF); ii) subsidiary agreement between the Federal Republic of Nigeria (as represented by FMOF) and the DFI; iii) master credit agreement between the DFI and eligible PFIs; and iv) sub-loan agreements between PFIs and eligible beneficiaries. The envisaged flow of funds under these two activities is summarized in Figure 3.

Figure 3: Flow of Funds



85. **The remaining two components (1 and 4) will reinforce operations of the DFI and implementation of the Line of Credit and Credit Guarantee facilities.** Specifically, the Technical Assistance and Capacity Building Component will be used to source external expertise assisting financial intermediaries to provide sustainable financing to MSMEs. Finally, the Project Management Component will fund the administrative arrangements underpinning implementation of technical components and development of innovative mechanisms and instruments aimed at improving affordability of finance, as well as independent impact assessments.

86. **The FMOF will be responsible for monitoring project implementation and assuming the policy and advocacy role**. This will be achieved with the FMOF's appointment of staff dedicated to development finance policy and the DFI reform agenda for the duration of the project, with capacity building support being provided by the project. This unit will interface with relevant government entities and the financial sector to ensure a coordinated approach to development finance and the smooth functioning of the new DFI and achievement of the project's development objectives, as well as overall high-level project promotion. In addition, the FMOF will oversee the work of an existing PIU – housed in the FMOF and responsible for the World Bank funded PPP project – which will be tasked to oversee administrative aspects of

project implementation. The new project will therefore benefit from the expertise and capacity of the existing PIU.

87. **The PIU will be an administrative interface between the FMOF and the DFI tasked with ensuring project compliance with all relevant World Bank requirements.** These include fiduciary requirements such as procurement, financial management, and withdrawal and disbursement requests, as well as project outreach, communication, reporting, monitoring and evaluation, compliance with environmental and social safeguards requirements, and impact assessment. In this capacity the PIU will be responsible for implementation of the technical assistance component of the project working alongside the new DFI. In addition to the PIU head, the current staff includes ten specialists: two project development specialists, two procurement specialists, one monitoring and evaluation specialist, an environmental safeguard specialist, one social safeguard specialist, two accountants, and an internal auditor. Throughout the duration of the project, the PIU will be adequately staffed and funded and will cooperate closely with the DFI staff.

88. **Implementation of the facilities funded by the project (i.e., lines of credit, the credit guarantee facility) will be entrusted to the new DFI.** Once the DFI is fully operational it will be responsible for managing all aspects of line of credit and CGF implementation, as well as for monitoring, reporting, and, with the support from the PIU, ensuring compliance with environmental and social requirements mandated by the World Bank and elaborated in the environmental and social operations manual.

89. **The project will also support the development of an effective and detailed communications strategy.** This strategy would include improving understanding of the role of the new DFI for CBN, FMOF, financial intermediaries, and other high-level stakeholders (e.g., ministries responsible for commerce and agriculture), as well as of financial sector policies and dissemination of essential aspects of the new operation to the broader public in a manner that is easy to understand (e.g., on such sensitive topics as loan pricing and consumer protection, environmental and social safeguards). In addition, it will aim to sensitize the public to the new DFI and gauge stakeholder and public perceptions to, and knowledge of, the project.

90. **The mandate and governance arrangements, including requirements related to organization, risk management, and transparency of the new DFI, will be set out in relevant legal documents, agreements, and regulations.** Among others, this will include formalizing the DFI's status as a provider of only wholesale funding and its mandate to supporting the financial services needs of Nigerian MSMEs. The DFI will be licensed and supervised by the CBN and will be subject to its prudential oversight and reporting requirements. The DFI's products will be priced to reflect costs and risks, thus ensuring full financial sustainability and development impact.

91. **The events that may call for potential suspension or accelerated repayment of the IBRD loan would include amendment or violation of the agreed project concept and/or eligibility conditions.** Specifically, these may include the following: (i) violation of signed agreements or regulations affecting the ability of the new wholesale DFI to fulfill its mandate or that affect the DFI's financial sustainability; and (ii) extending loans and guarantees to financial intermediaries and sub-loans to final borrowers that are not in compliance with agreed eligibility criteria, terms and conditions, and approval procedures.

92. **Given majority government ownership of the new DFI, measures aimed at strengthening governance will include a merit-based process for appointing independent directors to the new DFI's Board.** The mandate and governance arrangements for the new DFI will be set out in a MemArt to be filed when the DFI is registered as a public liability company (see Annex 12). The MemArt will also stipulate that a majority of directors are independent and competitively selected and will constitute a majority of the Board at all times. To reflect local ownership, the government intends to ensure that a majority of independent directors are also Nigerian citizen, selected from a shortlist of candidates prepared by an independent search firm. The project envisages an innovative governance structure whereby compliance with the DFI's strategic mandate is ensured both by the majority of DFI Board members being competitively selected independent directors, and through the Bank's participation as an observer on the Board of the DFI (as described in the next paragraph).

93. **In addition, the World Bank will have observer status on the DFI Board until the project closing date for the purpose of supervising the implementation of the project and will designate a qualified senior staff member to fulfill this role.** As an observer, the Bank staff member may attend the DFI Board discussions, without the right to vote, the right to move substantive or procedural motions or the right to contribute to deliberations at the meeting. The details of the World Bank's observer status will be outlined in the Project Operations Manual, including as regards confidentiality and immunity arrangements. The observer will be authorized to report to the World Bank management on implementation progress and will not include any direct involvement in decisions relating to the management of the DFI. This position will be unpaid and all related costs (e.g., travel) will be covered by the World Bank.

94. **The proposed ownership structure of the new DFI is outlined in this paragraph, while the detailed arrangements will be finalized in discussions between the FGN and equity investors.** The DFI will have majority government ownership, while AfDB is planning an equity investment of US$50 million. For registration purposes the Ministry of Finance Incorporated (MOFI)[21] and the National Sovereign Investment Authority will be the initial shareholders. The two entities will register the DFI as a public liability company and will subscribe to the MemArt (see Annex 12) with the Corporate Affairs Commission (CAC), obtain a license from the CBN, and register the company with the SEC. Management and governance of the DFI will be conducted in partnership between FGN as majority shareholder, AfDB, and potentially other international financial institutions as equity holders.

Results Monitoring and Evaluation

95. **The Borrower, the new DFI, and the PFIs will monitor and evaluate progress against the proposed indicators through regular reports.** The PIU will monitor the PDO and intermediate indicators of the Results Framework and additional indicators, as set out in Annexes 1 and 3, and any additional operational indicators that may emerge during the implementation stage on a quarterly, semi-annual, and yearly basis. The data will come from the new DFI's internal reports, CBN, and mandatory reports provided by the PFIs. The PIU will prepare semi-annual Interim Financial Reports (IFRs) for the project. The specific reporting templates will be further agreed and defined in the Project Operations Manual (POM). The financial performance

[21] FMOF subsidiary that can undertake such investment projects.

of the DFI and the PFIs will be monitored through external auditors' reports and separate management letters confirming adherence to prudential norms. For the DFI, such letters will be provided by the CBN, and for the PFIs, such letters will be provided by the DFI and the CBN. Finally, a survey of sub-borrowers (beneficiaries) and impact assessment will be conducted during the last year of project implementation to gauge project impact.

96. **The DFI will be evaluated according to a set of performance criteria.** The performance criteria to which the DFI's Board of Directors and senior management will be held responsible are to be aligned with the business strategy and mandate of the DFI and will include high-level indicators reflecting development impact, sustainability/efficiency, and organizational capacity. These are reflected in the results framework as well as in additional indicators developed to monitor project and DFI performance (see Monitoring and Evaluation in Annex 3).

97. **In addition, the DFI will be licensed and supervised by the CBN** and required to meet prudential requirements as regards capital adequacy, loan provisioning, and recognition of loan losses, as well as other regulations. As an issuer in the capital markets, DFI will be subject to Securities and Exchange Commission oversight. As the DFI is also a public liability company, it will be subject to the Corporate Affairs Commission's regulatory oversight.

Sustainability

98. **The project is explicitly designed to support the full financial self-sustainability of the new DFI**. This design focus is crucial so as to be able to ensure that the capital and other funding provided to the DFI will: (a) facilitate a significant and growing contribution toward filling the funding gap that exists in the Nigerian market for MSME financing; (b) be used to complement and catalyze the activities of the private sector rather than replace them; and (c) to avoid a situation where the DFI gets drawn into cross-subsidizing or providing direct subsidies to its clients. Such subsidies would both create an unlevel playing field and undermine the role of the DFI as a catalyst in encouraging private sector provision of financing and may be subject to attempted capture and thereby detract from the DFI's mandate.

99. **The mandate of the DFI is to act as a catalyst by encouraging greater intermediation by the financial sector while refraining from creating distortions in financial markets.** The DFI will lend, at a markup to the marginal cost of the funds, supporting term loans (one-year deposits). The instruments deployed by the DFI - whether on-lending to financial intermediaries, partial credit guarantees, or other instruments - will be designed with market-conforming terms. Indeed, the intention is that any advantage that may accrue to the DFI in being able to fund itself on terms below market rates, e.g., as provided by IBRD, and other donors, be accrued by the DFI as a contribution to its equity (see detailed project description in Annex 2). Thus, rather than replacing markets, the DFI will enhance them by providing term financing to financial intermediaries to on-lend to MSMEs - providing maturities that are otherwise unavailable to this sector - and/or by sharing credit risk with financial intermediaries on a sustainable basis, i.e., only with those intermediaries that have acquired the capacity to effectively manage the credit risk of lending to MSMEs. To this end, technical assistance will be provided to strengthen the financial intermediaries' capacity to manage their credit exposures.

100. **Recognizing the imperative of becoming fully self-sustaining combined with the need to achieve scale in its operations, the DFI will prepare to issue a Naira-denominated**

bond on the Nigerian stock exchange. Depending on the exact profile of the DFI's disbursements and thereby its funding needs, a pilot issue will be considered within the implementation period of the project. The purpose of this issue will be for the DFI to demonstrate to the market its ability to prepare all relevant documentation, the strength of its governance structure and competence of its management, and the viability of its mandate and business model, in order to pass the test of accessing market funding, reducing its reliance on donor funding, enhancing the confidence in the DFI as being fully financially self-sustaining, and providing the platform for broadening the scale and mandate of the DFI so that it can eventually engage in frontier financial markets beyond the MSME market. It is also envisaged that at the time of accessing non-concessional funding, a review of the DFI's pricing policies will be appropriate. While it is envisaged that the first series of DFI bond issues will be supported by an FGN guarantee, the plan is that later issues will leverage the good practices and results of the DFI's operations and not require such enhancement.

V. KEY RISKS AND MITIGATION MEASURES

Risk Ratings Summary Table

Risk Category	**Rating**
Stakeholder Risk	**High**
Implementing Agency Risk	
- Capacity	**High**
- Governance	**High**
Project Risk	
- Design	**Substantial**
- Social and Environmental	**Moderate**
- Program and Donor	**Substantial**
- Delivery Monitoring and Sustainability	**Substantial**
Overall Implementation Risk	**High**

Overall Risk Rating Explanation

101. **The overall project implementation risk is rated *high* because the new DFI is an institution that is being established in a challenging environment. The project has been prepared with strong dedication of the FMOF**. In addition, the project has been designed in partnership with other multilateral and bilateral international financial institutions and donors that have expressed interest in or are already preparing to provide equity or debt financing to the new DFI. However, the success of the project and maximizing the impact of the new DFI will depend on the robustness of its governance structure. Therefore, the project envisages an innovative governance structure whereby assurance is provided through (a) equity investment by reputable international investors; and (b) measures designed to ensure compliance with the DFI's strategic mandate, both through the Bank's participation as an observer on the Board of the DFI

and a majority of competitively selected independent directors. In parallel, the authorities' continuing commitment to reform of development finance policies in Nigeria, as well as adjustment of macroeconomic policies (e.g., fiscal consolidation), as reflected in this PAD and the accompanying Letter of Sector Policy (see Annex 9) will be of paramount importance.

VI. APPRAISAL SUMMARY

Economic and Financial Analysis[22]

Financial Analysis

102. **The World Bank Financial Projection Model was used to model the dynamics of the new DFI.** Rather than providing a forecast, the financial model simulates the impact of different assumptions as regards the operations of the DFI for a low-, base-, and high-case scenario. Based on demand and pricing assumptions, the model simulates the balance sheet and income statement of the DFI and quantifies the DFI's financial performance according to the CAMEL[23] methodology. The balance sheet of the DFI is driven by the PFIs' demand for DFI's lending and guarantee products.

103. **In the base case scenario, by year seven the DFI is expected to finance 15 percent of the market for MSME finance.** Lending operations constitute 13.1 percent and the CGF constitutes 1.9 percent. It is expected that the DFI, through its lending, guarantee, and TA operations, will demonstrate to the banking industry that MSME financing is a profitable business and thereby increase the proportion of PFI lending being provided to MSMEs beyond the funding provided by the DFI. The financial analysis is presented in Annex 6.

Economic Analysis

104. **In addition to the impact of the project on the financial sector, the economic analysis captures the broader impact on the overall MSME lending market.** In providing funding and guarantees, the new DFI will contribute toward alleviating credit constraints faced by MSMEs. The DFI is expected to decrease banking risks and thereby energize bank lending to MSMEs. The DFI is also expected to promote a more favorable lending environment through structural change and institutional capacity building. The economic analysis captures the impact of the DFI on the overall MSME lending market compared to a counterfactual, where market conditions are assumed to be unchanged.

105. **Over seven years MSME's lending grows gradually from 2.2 percent to 4 percent of banking system assets**, representing a net addition of US$6.7 billion of credit. Equivalent to removing a credit constraint, the contribution of the project to the overall economy is captured by assessing the additional economic activity generated by new loans provided to MSMEs. Thus,

[22] While the financial and economic analyses are based on a comprehensive set of assumptions, that reflect both Bank's project funding, expected support by other donors as well as the DFI's access to capital market funding, the expected parallel financing, while contributing to the scale of the anticipated outcomes is not a requirement for meeting the project's development objective and does not impact the expected economic return of the Project.
[23] The CAMEL methodology assesses the financial, operational and managerial performance of banks according to five areas: **C**apital Adequacy, **A**sset Quality, **M**anagement, **E**arnings and **L**iquidity.

the economic analysis captures the impact at the firm level of increased availability and access to finance.

106. **In the base case scenario, the project yields an ERR of 26 percent (after seven years).** The project will increase lending to MSMEs by generating value added in the form of (i) increased interest income for banks and (ii) increased sales by those MSMEs that obtain a loan. On aggregate, over seven years the net benefit of the project is estimated at NGN472 billion (US$2.9 billion) as compared to the counterfactual, which is measured against an estimated project cost of US$13 billion. For every dollar invested in the project, MSME will generate an additional US$2.23 dollars of value added. The project's NPV is US$1.6 billion, yielding an ERR of 26 percent over seven years and 38 percent over ten years. The economic analysis is presented in Annex 7.

Technical

107. **The proposed project design ensures that the new DFI and its operations will be sustainable and that the support it provides will act as a catalyst for market development and will be market conforming.** In this regard, the funding and guarantees offered to PFIs will be priced to reflect DFI's costs and risks, thus ensuring its sustainability and avoiding market distortions. Conversely, the on-lending by the PFIs will be done in conformity with market conditions, with PFIs assuming credit risk and ensuring sustainable pricing based on the costs and risk. The proposed project setup will foster competition amongst PFIs to serve the target MSME market.

Financial Management

108. **Based on the request from the FMOF the Finance and Accounts Section in the Project Implementing Unit of the Public-Private Partnership Project (FAS-PPPP) in the FMOF will be responsible for establishing and maintaining acceptable financial management (FM) arrangements for the project.** In view of the Federal Treasury Circular of March 19, 2010, which established the Federal Project Financial Management Division (FPFMD), assigning the responsibility for FM functions on all Bank funded projects at federal ministries, departments and agencies to the FPFMD, the FMOF will request a waiver from the Office Accountant General of the Federation. If the waiver is not granted, the project will be restructured to reflect the provisions of the stated treasury circular of March 19, 2010. The FAS-PPPP is presently involved in the implementation of a Bank funded project at the national level and the Bank's recent review showed that the FAS-PPPP has been performing moderately satisfactorily. The FAS-PPPP consists of Accounting and Internal Audit Sections with qualified accounting and auditing staff with appropriate expertise. The project accountant and internal auditor will be supported by accountants to ensure that internal controls and a thorough segregation of duties are not undermined. As workload necessitates, additional professionally qualified accountants and internal auditors may be recruited for the duration of the project. The financial management arrangements will meet the minimum FM requirement in accordance with OP/BP 10.00. Taking into account the risk mitigation measures, the financial management risk for this financing is assessed as *substantial*. Annex 3 provides additional information on financial management.

109. **Procurement activities under the project will apply to Components 1, 2, and 4.** Procurement activities in Components 1 and 4 will include goods and external consultants to provide technical assistance and capacity building. Component 2 will provide loans to the new

DFI for on-lending to PFIs. It is envisaged that PFI's procurement activities shall be in accordance with well-established private sector procurement methods or commercial practices.

110. **Procurement will be carried out according to World Bank Guidelines.** Procurement of goods, works, and non-consulting services will be carried out in accordance with the World Bank's "Guidelines: Procurement of Goods, Works, and Non-Consulting Services Under IBRD Loans and IDA Credits & Grants by World Bank Borrowers", dated January 2011 (Procurement Guidelines); and procurement of consultant services will be carried out in accordance with the World Bank's "Guidelines: Selection and Employment of Consultants under IBRD Loans and IDA Credits & Grants by World Bank Borrowers", dated January 2011 (Consultant Guidelines); and the provisions stipulated in the Loan Agreement. The World Bank's "Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credit and Grants", dated October 15, 2006 and revised on January 2011, will also apply to the project, including all stakeholders (FMOF, DFI, and PFIs).

111. **Procurement under the sub-loans will be carried out by sub-borrowers following well-established private sector procurement methods or commercial practices** acceptable to the World Bank, in accordance with paragraph 3.13 of the World Bank's Procurement Guidelines and Consultant Guidelines.

Social and Environmental (including Safeguards)

112. **The project is categorized as a Financial Intermediary (FI) project and the appropriate FI category is FI-2.** This is based on the assumption that the sub-loan portfolio may potentially comprise sub-projects that have limited adverse environmental or social risks or impacts that are few in number (generally site-specific, largely reversible, and readily addressed through mitigation measures) or that it may include a very limited number of subprojects with potential significant adverse environmental or social risks or impacts that are diverse, irreversible, or unprecedented.

113. **In terms of the proposed sub-project activities, while they are not limited to specific sectors, they are expected to include small-scale manufacturing, light industry, transport, trade, hospitality, agriculture, and similar activities.** It is important to note that these activities will be limited in scope due to the fact that the loan sizes are relatively small and capped, and given that the MSME and small corporates sector is either not, or is only to a limited extent, engaged in larger scale manufacturing or agriculture. It is therefore expected that these activities may only have a limited negative environmental and social footprint. Nevertheless, adequate measures will be taken to screen any project that may potentially have a more significant adverse impact.

114. **While the project is not expected to have adverse social risks or long-term or large-scale negative environmental impacts, adequate measures will be taken to mitigate potential environmental and social risks**. Specifically, the Environmental and Social Operations Manual (ESOM), along with the Environmental and Social Management System (ESMS) that will be established by each PFI, will also meet the requirements of the World Bank Group Performance Standards for financial intermediary lending. Participating financial institutions are required to establish or arrange for proper capacities to duly set up their ESMS in a manner consistent with the guidance provided in the ESOM. If a PFI does not have the capacity

to establish such an ESMS and/or prepare appropriate environmental and social management documents (e.g., environmental and social management frameworks, environmental and social impact assessments, and/or environmental and social management plans, resettlement policy frameworks, resettlement action plans, etc.), the World Bank Group reserves the right of prior review and approval of all transactions that take place under the DFI until such capacity is developed. Also, capacity-building measures will be provided under the project. Alternatively, satisfactory arrangements, which include external expertise assisting the PFIs in establishing the ESMS and implementing the environmental and social management documents, may be considered. Finally, while Performance Standards 1, 2, and 5 are expected to be the only applicable standards for this project, each PFI will assess environmental and social risks of transactions according to Performance Standards 1 through 8 and will require its borrowers/investees to comply with these Performance Standards in their operations.

115. **The project is fully consistent with World Bank requirements for all PFIs whose portfolio and/or proposed business activities present moderate social or environmental risks** (i.e., Category FI-2) to ensure that any such activities supported by the Bank are operated in a manner consistent with World Bank Performance Standards.

Other Safeguards Policies Triggered

116. The project did not trigger other safeguard policies.

Annex 1: Results Framework and Monitoring

Country: Nigeria
Project Name: Nigeria: Reform of the Nigerian Development Finance Sector (P146319)

Results Framework

		Project Development Objectives
		PDO Statement **The project development objective is to increase the availability and access to finance for MSMEs through eligible financial intermediaries with the support of a new wholesale development finance institution.**

These results are at	Project Level

Project Development Objective Indicators

Indicator Name	Core	Unit of Measure	Baseline	Cumulative Target Values								Frequency	Data Source/ Methodology	Responsibility for Data Collection
				YR1	YR2	YR3	YR4	YR5	YR6	YR7	End Target			
Volume of PFIs' MSME sub-loans facilitated by Line of Credit Facility	Yes	US$ (mn)	No	n/a	50	125	205	305	405	445	445	Quarterly	DFI and PFI reports	DFI/PIU

Volume of PFIs' MSME sub-loans facilitated by CGF[24]	Yes	US$ (mn)	No	n/a	n/a	60	157	297	460	651	651	Quarterly	DFI and PFI reports	DFI/PIU
PFIs' MSME sub-loan portfolio at risk (30 days)	Yes	%	No	n/a	8%	7%	6%	5%	5%	5%	5%	Quarterly	DFI and PFI reports	DFI/PIU

Intermediate Results Indicators

Indicator Name	Core	Unit of Measure	Baseline	Cumulative Target Values								Frequency	Data Source/ Methodology	Responsibility for Data Collection
				YR1	YR2	YR3	YR4	YR5	YR6	YR7	End Target			
Volume of DFI's wholesale loans[25]	Yes	US$ (mn)	No	n/a	50	125	205	305	405	445	445	Quarterly	DFI reports	DFI/PIU
Volume of guarantees issued	Yes	US$ (mn)	No	n/a	n/a	30	79	149	230	325	325	Quarterly	DFI reports	DFI/PIU

[24] These targets will result in the following outstanding guaranteed PFI loan amounts annually of which 50 percent are guaranteed: YR3-US$60mn; YR4-US$97mn; YR5-US$139mn; YR6-US$163mn; and YR7-190mn.

[25] From the Project Component 2: Line of Credit Facility.

DFI's portfolio at risk	Yes	%	No	n/a	0%[26]	0%	0%	0%	0%	0%	0%	Quarterly	DFI and CBN reports	DFI/PIU
DFI's ROA	Yes	%	No	n/a	5%	5%	5%	5%	5%	5%	5%	Annual	DFI and CBN reports	DFI/PIU
Number of PFIs reporting on lending to women sub-borrowers	No	#	No	n/a	n/a	2	3	4	5	6	6	Quarterly	DFI and PFI reports	DFI/PIU/PFIs

Project Development Objective Indicators

Indicator Name	Description (indicator definition, etc.)
Volume of PFIs' MSME sub-loans facilitated by line of credit facility	This indicator measures total amount of loans extended by eligible PFIs to eligible sub-projects, generated as a result of the support from DFI's Line of Credit Facility
Volume of PFIs' MSME sub-loans facilitated by the CGF	This indicator measures total amount of loans extended by eligible PFIs to eligible sub-projects, generated as a result of the guarantees issues by the CGF
PFIs' MSME sub-loan portfolio at risk (30 days)	This indicator measures portfolio quality of the PFIs' sub-loans funded by the Line of Credit Facility and CGF

Intermediate Results Indicators

Indicator Name	Description (indicator definition, etc.)
Volume of DFI's wholesale loans	This indicator measures the total amount of loans extended to PFIs
Volume of guarantees issued	This indicator measures the total amount of guarantees issued from DFI to PFIs
DFI portfolio at risk	This indicator will measure portfolio at risk at 30 days
DFI ROA	DFI return on assets
Number of PFIs reporting on lending to women sub-borrowers	This indicator measures the number of PFIs that monitor and report on lending to women sub-borrowers

[26] The PAR of 0% for the DFI is based on strict eligibility criteria to be applied to borrowing intermediaries.

Annex 2: Detailed Project Description

FEDERAL REPUBLIC OF NIGERIA: Development Finance Project

1. **The project will facilitate increased access and availability of finance for MSMEs.** This will be achieved by supporting the operations of a new wholesale DFI. A new DFI will also provide the institutional framework, ensuring that this effort is sustained, achieves meaningful size, and that the instruments supported by the operation are provided on a market-conform, and thereby sustainable, basis. It will support the development of diverse lending products, including the provision of medium- and long-term loans in local currency (Naira) and partial credit guarantees to be provided to participating financial institutions with a view to expanding their outreach to MSMEs and, to a limited extent, small corporates. The DFI will be registered as a public liability company and will be regulated, licensed, and supervised by the CBN. To this end, the proposed US$500 million loan provided under the project will fund the following four components: Component 1: Technical Assistance and Capacity Building (US$12 million); Component 2: Line of Credit Facility (US$445 million); Component 3: Credit Guarantee Facility (US$35 million); and Component 4: Project Management (US$6.75 million). The front-end fee of US$1.25 million will be financed out of the proceeds of the loan.

2. **While the new DFI will be majority government-owned and managed in partnership with other shareholders (such as the AfDB), the project envisages an innovative governance structure.** The assurance is provided through: (a) equity investment by reputable international investors; and (b) measures designed to ensure compliance with the DFI's strategic mandate, both through the Bank's participation as an observer on the board of the DFI, agreement that a majority of directors are independent and competitively selected at all times. Given that previously established DFIs were not able to attain financial sustainability, the importance of a robust corporate governance structure cannot be overemphasized. In this context, following best international practice provisions have been designed to safeguard the process of Board appointments, emphasizing the importance of technical and professional qualifications and enshrining the principle that the majority of Board members are independent. In addition to on-lending the funding provided by this Project going forward the new DFI is expected to act as conduit for funding from other foreign donors, and so as to reflect that the DFI is a locally-based initiative, the government's preference is that the majority of the independent directors are Nigerian citizens. The independent directors are to be selected from a qualified pool of candidates recruited by an independent search firm. The DFI will also be subject to regulation, licensing, and supervision by the CBN, thus further strengthening the governance arrangements. By linking the disbursement of the Bank's investment operation to the achievement of specific milestones, the Bank will also be in a position to exercise due diligence as regards implementation progress. For details, see the disbursement linked indicators table in the Project Financing Section.

4. **Funds provided by donors will be on-lent (in parallel as they become available) to the DFI by the FMOF in local currency (Naira).** In the initial years of the DFI's operation, the intention is to predominantly use the financial benefits associated with this low-cost donor funding to build the financial strength of the DFI.[27] In later years it is envisaged that the DFI will need to access Naira borrowing on local market terms to sustain its expansion. The governance arrangements and business model for the new DFI will be designed to ensure full operational and financial sustainability of the new DFI.

5. **The Government will also have the option to extend the World Bank funds to the DFI in form of equity as long as the funds are deployed for their designated purpose according to the project design –** i.e. for lines of credit and guarantee facility (see description of the project's components 2 and 3) and following compliance with the disbursement linked indicators (see Project Financing section). The Government may choose to use this option in order to meet the regulatory requirements. Though the CBN has as yet only issued the DFI regulations in draft and discussions between the FMOF and the CBN as to the amount of minimum capital are still on-going, current draft regulations envisage minimum fully paid up capital for wholesale DFIs of NGN100 billion. The CBN has indicated that compliance with the minimum capital requirement would be staggered over a three year period. Allowing the Government to provide the World Bank loan to the DFI in the form of equity could help the DFI meet the regulatory requirements for paid up capital as currently drafted by the CBN. The use of the World Bank's funds, whether they are on-lent or injected as equity, will be strictly in line with the project design and will be stipulated in the subsidiary agreement to be entered into between the FMOF and DFI in concurrence with the World Bank.

6. **Funding and guarantees provided by the new DFI will be made available to eligible PFIs for sub-borrowers and sub-projects on market-conforming terms.[28]** Strong emphasis will be placed on designing funding products that respond to the needs of the commercial banks and other financial intermediaries, such as MFBs and leasing companies that meet the stipulated eligibility requirements (see Box 1). In this regard, the initial appraisal of interested financial intermediaries will be done under the supervision of the World Bank, while the DFI will be subsequently tasked with this role with the support of the CBN, in line with the World Bank requirements for financial intermediary financing. Financial intermediaries that are deemed eligible will be awarded a PFI status and enter into a credit agreement with the DFI, allowing access to term finance and/or partial credit guarantees, based on demand and the availability of funding. PFI status alone will not oblige the financial intermediaries to draw on the instruments provided, and interest costs and other fees would be charged only upon accessing the line of credit or CGF.

[27] See Box 2 for further discussion of the DFI's funding.
[28] The terms of funding are discussed in Box 2.

Box 1: Eligibility Criteria for Participating Financial Institutions

The following are minimum eligibility criteria which will be confirmed in an annual due diligence process conducted by the new DFI: i) The PFI must be *duly licensed* and at least two years in operation; ii) PFI's owners and board of directors should be "*fit and proper*"; iii) the PFI must have qualified and experienced management, adequate organization and institutional capacity for its specific risk profile; iv) the PFI must be in "*good standing*" with its supervisory authority (i.e. it should meet all prudential and other applicable laws and regulations) and remain in compliance at all times; v) the PFI must have well defined policies and written procedures for *management of all types of financial risks* (liquidity, credit, currency, interest rate and market risk, as well as risks associated with balance sheet and income statement structures); vi) the PFI must maintain *capital adequacy* as prescribed by prudential regulations; vii) the PFI must have *adequate liquidit*y; viii) the PFI must have *positive profitability and an acceptable risk profile*; ix) the PFI must have *adequate portfolio quality*; x) the PFI must have *adequate internal audits and controls* for its specific risk profile; xi) the PFI must have *adequate management information systems*; and, xii) the PFI must demonstrate commitment to serving the MSME sector and have in place satisfactory MSME loan approval processes and risk management procedures.

Eligibility Criteria for Sub-borrowers and Sub-Projects

7. **Sub-borrowers will be creditworthy private sector MSMEs and small corporates that meet all of the following criteria:**

Enterprise Type	**# Employees**	**Annual Turnover**	**Total Assets**	**Max. Loan Size**
MSMEs	< 250	< $3.125mn (N500mn)	<$3.125mn(N500mn)	< $500k(N80mn)
Small Corporates	< 500	< $15mn (N2.4bn)	< $15mn (N2.4bn)	< $2mn(N320mn)

Note: The total amount of funding provided by the new DFI for PFIs to on-lend to small corporates will be limited to 10 percent of available credit line resources.

8. **Eligible Sub-projects and Terms:** Sub-loans will be extended to eligible MSMEs and small corporates for investment and working capital loans in amounts of up to US$500 thousand equivalent for MSMEs and up to US$2 million for small corporates. The sub-loan maturity is expected to be up to ten years with a grace period of up to 18 months. Specifics are as follows:

a) **Investment Loans:** the maximum available sub-loan amount will be US$500 thousand for MSMEs and US$2 million for small corporates. Maximum maturity will be ten years with grace period of up to 18 months.
b) **Working Capital Loans:** the maximum available sub-loan amount will be US$200 thousand for MSMEs and US$800 thousand for small corporates. Maximum maturity will be three years with grace period of up to six months.

9. **All sub-projects will be in compliance with environmental and social standards as defined in the ESOM, while the goods and services on the World Bank Group exclusion list will not be eligible for financing.**

10. **The terms offered by the DFI will reflect the DFI's cost of funds and a spread to cover the DFI's costs of operation plus a risk premium**. Given that the DFI's MSME clients will be unable to shoulder exchange rate risk, the Government has committed to take this risk. The Government will pass on donor funds in Nigeria Naira to the DFI. Thus, the DFI will benchmark its on-lending interest rate to reflect the alternative cost of funding to the PFIs in accessing term deposits. In as much as this exceeds its cost of funding, the income generated will be used to augment the DFI's capital base, thereby strengthening its sustainability. For further details, see Box 2 below.

Affordability of Finance in Nigeria

11. **Interest rates charged by banks to borrowers in Nigeria are high due to a combination of macroeconomic and market factors.** The CBN's monetary policy rate (MPR) that sets the benchmark for government borrowing and deposit money bank interest rates has remained stable at 12 percent since October 2011. During recent years the level of the MPR has been set to allow the authorities to maintain a relatively stable nominal Naira/USD exchange rate. As a result, interest rates on 'risk-free' government securities are at or somewhat above 12 percent, and given the challenging operating environment, banks are obliged to charge relatively high rates on lending. Among the challenges faced by banks are low coverage and untimeliness of information provided by Nigeria's credit bureaus, weak property and collateral registration, as well as uncertain and costly recourse to foreclosure.

12. **These circumstances have led banks to compete fiercely for the business of large, well-regarded corporate clients that are predominantly associated with resource extraction industries.** Banks offer these corporations interest rates below prime rate (currently 16 percent) so as to secure both their business as well as the business provided by those smaller corporates that deliver directly to the value-chains supported by their large corporate clients. This strong competition among banks for the business of the largest corporations leads to a 'negative feedback loop' pressing up the borrowing costs even of those relatively good credit risk smaller corporations that deliver to 'blue chip' large corporations, as discussed further in the 2012 FSAP. Thus, when accessing bank financing, smaller corporates may be reliant on the security provided by the 'blue chip parent' enterprise in the value chain to which they deliver. Indeed, such enterprises may become captive or reliant for funding on the bank of the large corporate to which it delivers in the value chain. Finding alternative funding sources with competitive loan terms may be difficult.

13. **Small corporates and SMEs that operate outside these value chains find accessing bank lending on affordable terms even more challenging**, as they are impacted by the financial infrastructure weaknesses (discussed in Annex 8) as regards access to credit information and the pledging of security. In addition, these SMEs are exposed to uncertainty as regards unilateral changes in borrowing terms imposed by banks and weak transparency as regards borrowing costs and conditions, which exposes them to *ad hoc* adjustment in their borrowing terms.

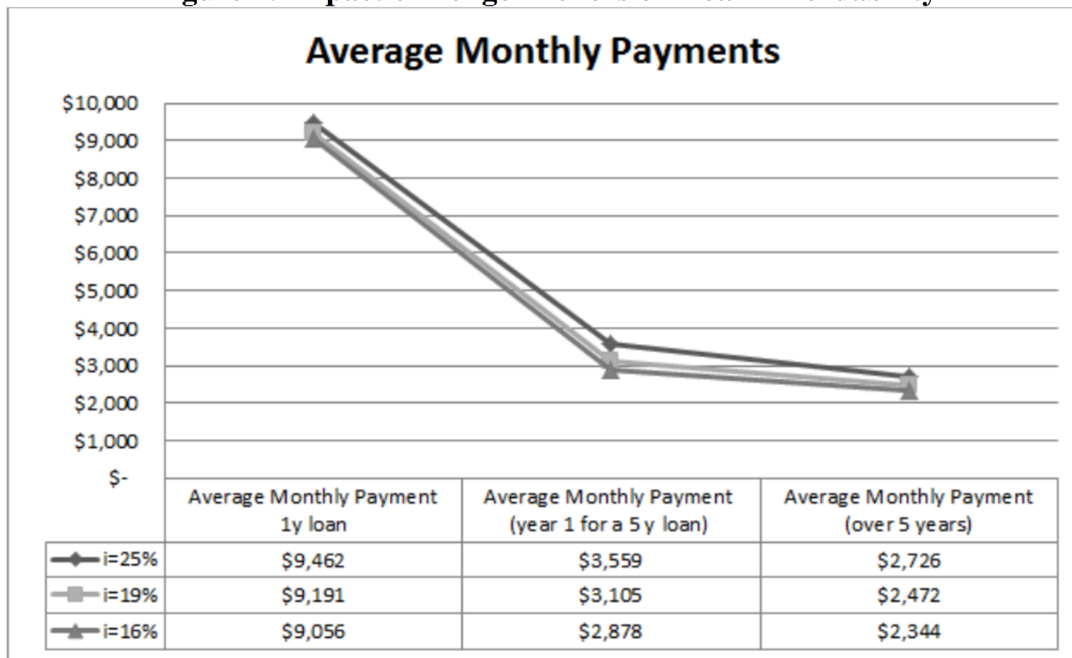
DFI Impact on Affordability of Finance

14. **While the proposed DFI will facilitate sustainable reduction in interest rates to final borrowers over the medium term and subject to wider sector reforms, it will also seek to put pressure on bank lending terms in the short term.** Among the medium-term measures are: i) lower base rates as the macro-environment improves, thereby strengthening MSME competitiveness; ii) lower credit spreads made possible by upgraded financial infrastructure and legal/regulatory reforms; and iii) adoption of improved MSME lending techniques by participating financial intermediaries.

15. **In the short term, the DFI will contribute to bringing down the cost of funds to small corporates and SMEs by**: i) providing term financing in local currency; ii) encouraging financial intermediaries to reduce their spreads through a competitive auction of term funds; and iii) introducing consumer protection requirements to the benefit of borrowers.

16. **Extending loan tenors will have a large impact on cash flow and thereby affordability** (see Figure 2). For example, the extension of loan tenors from one year – which is typically the tenor of small corporate and MSME loans in Nigeria today – to five years reduces monthly debt service by 60 percent during the first year and two-thirds or 72 percent over five years. This sizeable debt service relief will considerably strengthen MSME cash flows, thereby allowing them to expand their borrowing capacity and further develop their businesses.

Figure 1: Impact of Longer Tenors on Loan Affordability



	Average Monthly Payment 1y loan	Average Monthly Payment (year 1 for a 5 y loan)	Average Monthly Payment (over 5 years)
i=25%	$9,462	$3,559	$2,726
i=19%	$9,191	$3,105	$2,472
i=16%	$9,056	$2,878	$2,344

*example for a $100,000 loan

How Interest Rate Spreads in Nigeria Compare to other Countries

17. **Commercial bank financial statement data show that Nigeria's rates and spreads do not appear unreasonably high when compared with other large economies in Africa** as well as other international benchmarks (Figure 2).

18. **However, borrowing rates for risky market segments, such as the SME sector, and products offered by non-bank financial institutions (i.e., microfinance banks) are much higher than the banks' effective lending rates**, given (a) commercial banks' preference for large corporate clients and (b) banks' relatively very small exposure to these market segments.

19. **Following the disruption of the banking crisis on Nigeria's financial sector growth, there are no clear trends or a definitive driver of these spreads.** Private credit-to-GDP data (Figure 3) show that the banking system has not yet stabilized. As the banking system was being restructured and new capital requirements led to further consolidation between 2009 and 2011, there are a number of structural breaks in the underlying data, which cause large shifts in different components of the banks' spreads.

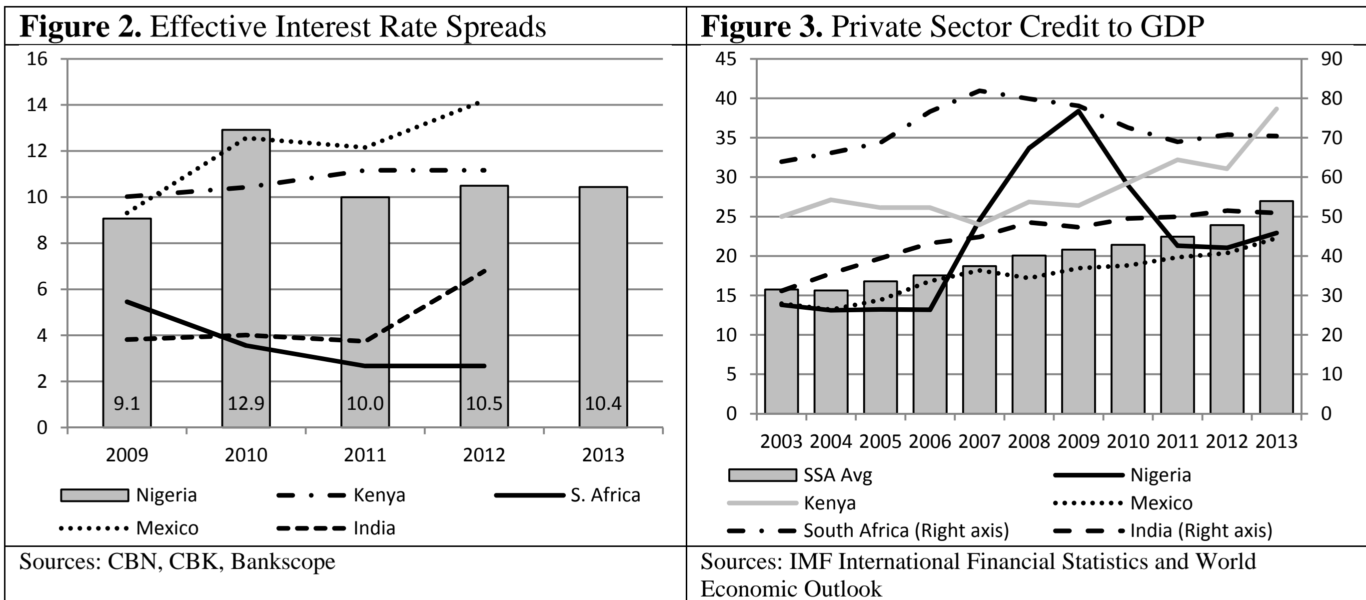


Figure 2. Effective Interest Rate Spreads

Sources: CBN, CBK, Bankscope

Figure 3. Private Sector Credit to GDP

Sources: IMF International Financial Statistics and World Economic Outlook

Component 1: Technical Assistance and Capacity Building (US$12 million)

20. **The project will fund tailored technical assistance to the PFIs.** Other donors will also provide resources for complementing and coordinated technical assistance. The technical assistance will be provided by competitively selected firm(s) with demonstrated international experience in similar projects. Experience from other countries, such as Turkey, China, and Russia, which have implemented large-scale programs with a view to significantly enhance MSME finance, is that broad-based technical assistance support is crucial to program success. Technical assistance is instrumental in: (a) supporting banks to reach out to MSMEs, i.e., beyond their traditional client base, not just from the banks' headquarters, but in direct interface with

MSMEs at the branch level; (b) enhancing banks' understanding and usage of more appropriate (cash-flow–based) lending techniques required in environments where MSME's access to collateral is limited and weaknesses in the financial infrastructure inhibit efficient foreclosure on collateral; and (c) strengthening communication concerning the appropriate use of new financing instruments on offer (term financing and partial credit guarantees).

21. **The project will coordinate with IFC during implementation of the technical assistance components in order to benefit from its experience in this field both in Nigeria and internationally.** In keeping with the new development finance framework where the public sector will retreat into the second-tier market (interventions), the private sector and the IFC will focus on primary markets. The project will therefore build on and collaborate with IFC's direct engagement in private sector financial institutions. This will translate into coordinating with IFC capacity building for banks funded by development partners, working with the IFC deep-dive SME capacity-building program, which is under review and working with IFC in the enabling environment for MSMEs in Nigeria.

22. **The project, and potentially other donors, will finance provision of operational support to the new DFI.** This includes but is not limited to defining and establishing robust operating principles, policies, procedures, and governance; designing and rolling out of finance instruments; assisting with pilot bond issuance; setting up and implementing monitoring and evaluation practices; impacting assessment methodologies; covering initial operational costs; and so forth. This component will also support capacity building for the FMOF to ensure adequate policy and technical oversight of the new DFI and to increase the CBN's DFI regulatory and supervisory capacity. Finally, it may support the review, restructuring, and potential transfer of some of the exiting DFI schemes operated by CBN to the new DFI, as appropriate.

23. **By strengthening the institutional and human resource capacity of PFIs, the tailored TA will lay the foundation for progressive, nationwide scaling-up of commercially sustainable MSME finance.** Among the areas to be supported are recruiting and training new loan officers; strengthening of lending policies and procedures; putting in place appropriate accounting, risk management, and management information systems; supporting the sub-loan application process through enhancing screening and decision-making capacity; and supporting development of capacity in sub-loan monitoring and collections. In addition, so as to ensure that the PFIs have the required level of capacity to administer the line of credit and CGF, their access to these facilities will be made contingent on entering and implementing TA agreements with the DFI.

24. **To benefit from the credit and guarantee facilities, the PFIs will be required to enter into Technical Cooperation Agreements with the PIU.** In addition, so as to ensure that the PFIs have the required level of capacity, their access to the line of credit and CGF will be made contingent on achieving agreed benchmarks. Under such agreements, the PFIs will commit to developing capacity to service the MSME target client group and to acceptance of project-sponsored advisory services, implementation arrangements, and appropriate cost-sharing arrangements. The agreements will specify: (i) the technical cooperation package that the project will make available to the participating bank; and (ii) set forth the procedures under which the participating bank shall enter into MSME loan agreements with sub-borrowers. The PFIs' access

to the credit and guarantee facilities will be linked to achievement of monitored outcomes under the technical cooperation agreements, thereby ensuring that the PFIs have adopted the capacity in the form of modern MSME lending technologies and risk-control procedures required to ensure prudent expansion of their MSME lending. For further detail regarding the content of a Technical Cooperation Agreement see Annex 11.

25. **This component will support the introduction of financial consumer protection requirements that will facilitate competition and thereby enhance responsible finance and affordability.** MSMEs face difficulty comparing borrowing terms among banks and are often subject to undisclosed fees and arbitrary changes to agreed interest rates. They also face difficulties in assessing fees charged on transaction services and the reasonableness of earnings made on deposits. All PFIs that on-lend funds provided by the new DFI will be required to implement a set of consumer protection standards in line with international practices, including fair treatment of borrowers, full disclosure of deposit rates, borrowing costs (including fees) and transaction fees, and a ban on undisclosed, unilateral changes to interest rates and fees undertaken without due warning. Before providing access to project facilities, the DFI will require that PFIs subscribe to a specific set of measures, such as disclosure of the effective interest rates on borrowing using a standard methodology. In addition, the project will support a monitoring framework relying on mystery shopping and other tools gauging objective impact of the implemented consumer protection measures.

26. **Specific attention will be paid to cater to supporting the needs of female entrepreneurs, given that their access to finance is particularly constrained.** This will be primarily achieved by sensitizing PFIs to gender issues during provision of TA and specifically targeting women entrepreneurs. This may include piloting and rolling out products designed to fit low-income women and/or high-potential women entrepreneurs (e.g., loans to women with low or no collateral), including opening a window dedicated to women entrepreneurs, or allocating funds linked to outreach to women clients, and monitoring and reporting on lending to women sub-borrowers.

27. **Given the high priority of TA activities, a project preparation facility is envisaged to:** i) facilitate the establishment of the DFI by providing funding for the initial operational expenses of the DFI; and ii) provide funding for the initial roll-out of TA program.

28. **The responsibility for administering the technical assistance component will reside with the project implementation unit** (see Component 4). The delivery of these services will be undertaken by qualified external providers with experience in the delivery of similar broad-based technical assistance services in other countries. To facilitate implementation of technical assistance, among the first measures to be undertaken by the PIU will be to procure services of an international technical advisor with experience in similar operations to support the implementation process and complement the existing skillset of the project implementation unit.

Component 2: Line of Credit Facility (US$ 445 million)

29. **This component will provide US$445 million to the new DFI designated for lines of credit to eligible PFIs for on-lending to eligible enterprises and sub-projects.** The PFIs will extend sub-loans to eligible MSMEs and small corporates (up to 10 percent of available DFI credit line resources will be allocated for the latter), which will include both investment and working capital loans in the expected amount of up to US$500 thousand equivalent for MSMEs and up to US$2 million for small corporates.

30. **The PFIs will receive funding from the DFI upon submission of internally approved sub-loans in line with eligibility criteria.** Upon verification of compliance with eligibility requirements, the DFI would extend funding to the PFIs matching the amount, maturity, and grace period of each sub-loan. In the case of MFBs (due to small loan sizes and short maturity), consideration will be given to offering a line of credit with fixed terms (e.g., maturity and grace period**).**

Box 2: Indicative Pricing of DFI Wholesale Funds

So as not to have a distorting effect, the DFI's on-lending rate should be aligned with the prevailing rates at which the commercial banks are able to raise term deposits, given that local currency term financing is extremely scarce. Currently, only around 7 percent of the financial liabilities (including deposits) of large Nigerian banks have maturities in excess of 90 days. Under current market conditions, wholesale lending by the new DFI could therefore be offered an interest rate of around [11] percent with a maturity of up to ten years should be highly attractive to commercial banks. This interest rate is regarded as reflective of current market circumstances (i.e., more or less on par with bank term funding for much shorter maturities and somewhat below interest rate of government paper of similar longer term maturity). Thus, after making allowance for the cost of its operations, during this initial period, the DFI will be able to set aside funds to strengthen its capital base due to the interest rate differential between its on-lending rate and the concessional cost of funds from the international development partners. This accumulation of equity capital will only be possible as the government will bear the cost of exchange rate risk associated with foreign currency borrowing, allowing the DFI to benefit from the larger spread. In order to be able to ensure continued stable, predictable, and sustainable source funding to support MSME sector in Nigeria, it is critical that the DFI is able to build its capital early on.

Once the DFI reaches scale and has fully utilized the funds provided by international development partners, the DFI will need to finance continued growth on commercial terms by raising bonds on the Nigerian market. It is envisaged that DFI bonds would be issued at a rate comparable to Treasury bills, currently around [13] percent. This could imply a potential negative spread if the DFI continues to lend at rates slightly below government paper rates. The DFI will therefore need to balance the initial positive spread on any concessional liabilities and the subsequent potential negative spread on commercial borrowing. As a result, the DFI would adjust its pricing policy accordingly so as to avoid a negative spread. While this may prove to be a constraint, it is likely that, once the DFI reaches scale, the market (PFIs and MSMEs) will have learned to appreciate the value of the DFI's products and - bolstered by the growth of the MSME market segment - there will be strong demand for the DFI's products at on-lending rates commensurate with the cost of DFI's bond-financing.

31. **Sub-loan credit risk and pricing:** the PFIs will assume full credit risk for their sub-loan portfolios and will price the loans in conformity with market conditions, fully reflecting their costs and risk to ensure their sustainability. The interest rates to final borrowers will not be subsidized or capped, and as a result the project will test an innovative market-based approach to reduce spreads offered by PFIs to final borrowers. For details, see Component 4.

32. **Performance indicators:** the performance of PFIs will be monitored in line with the relevant indicators listed in the results framework in Annexes 1 and 3. The responsibility for data collection and monitoring will rest with the DFI and the PIU.[29] Additional relevant indicators may be developed during implementation.

33. **Reporting:** the PFIs will be expected to report on their sub-loan portfolio and key financial and performance indicators on quarterly basis and/or annual basis, as relevant.

34. **Supervision:** The new DFI will be responsible for implementing the credit lines that it administers. This will include assessing and monitoring PFI compliance with eligibility criteria, sub-loans, and reporting on the credit line implementation progress. The initial selection of PFIs will be supported by the World Bank, while the DFI will take this task upon initial capacity building and in cooperation with the CBN. The supervision process will also include review of the PFI's audited financial statements on an annual basis, review of PFI loan books, and periodic on-site supervision and interaction with PFI management.

Box 3: Key Factors for Success of Credit Lines[30]

- Lines of credit produce better outcomes in countries with stable macro-economic conditions, stronger financial sectors, with well-regulated financial institutions and market determined interest rates, and limited state ownership of financial institutions ;
- Implementation of lines of credit projects relies on commercially-oriented private sector financial intermediaries selected based on clear and quantifiable eligibility criteria;
- Independent confirmation of PFI selection (e.g. by World Bank) and confirmation of compliance by external auditors can mitigate political interference and ultimately ensure that sound credit decisions are made;
- The eligibility criteria should be based on clearly defined and transparent indicators for monitoring of the financial performance of concerned financial intermediaries;
- Selection of larger number of PFIs facilitates better competition and outreach. Access to finance should be kept open to all interested financial institutions on a first-come-first-served basis providing that they are able to meet the eligibility criteria;
- It is critical to define and intensively monitor key indicators that measure the quality of the loan portfolio; also, sound analysis and data on the financial performance of PFIs, and external audit for verification, should be applied;
- The approach whereby the wholesale apex assumes credit risk towards the PFIs, and where PFIs assume sub-loan credit risk ensures that both the most capable intermediaries and final borrowers are selected to participate under the project and generally yields better results.
- To ensure sustainability the PFIs that assume credit risk should be free to set interest rates reflecting costs and risk;

[29] It is envisaged that the DFI and the PIU will work closely with the CBN Banking Supervision Department in this regard.

[30] Experiences from World Bank funded line of credit projects globally.

- The size of the branch network of PFIs can be essential in ensuring a broader outreach;
- The ability of the wholesale apex institution to attract funds from diverse sources is important for enhancing sustainability of the support provided by credit lines as a catalyst to deepening the engagement of private sector intermediaries;
- PFI status should not be limited to commercial banks, and could be extended to other regulated financial intermediaries deemed eligible. For example, supporting leasing companies or microfinance banks may facilitate better inclusion of smaller firms that do not have access to commercial banks;
- Inflexibilities in project design make it difficult to adjust to changing ground realities, so the instruments (both investments and working capital financing) and the terms and conditions to be used in MSME finance should be flexible;
- Implementation problems have stemmed mainly from weak borrower accountability and management capacity, so complementing credit lines with TA is crucial.

Component 3: Credit Guarantee Facility (US$35 million)

35. **This component will provide US$35 million for a Credit Guarantee Facility (CGF) to be established as the DFIs wholly owned subsidiary and housed within the DFI.** This is to avoid conflicts of interest due to misalignment of incentives between the DFI's instruments: in the early years of the new DFI's operation, it would be more attractive for the DFI to make loans instead of issuing guarantees in order to generate revenue from earning assets. The CGF will have its own management team and a lean organizational structure.

36. **The credit guarantee facility will provide a 50 percent guarantee on PFI loans made to MSMEs in line with the project eligibility criteria discussed earlier; it is also expected to guarantee bank loans to MFBs for on-lending to their target market.** Guarantees will be priced based on each PFI's performance indicators for management of its SME portfolio, chiefly the level of NPLs and write-offs. Given the wide range of such indicators among banks (e.g. non-performance ranges between 1 to 11 percent of banks' SME portfolios), pricing will be differentiated by bank instead of using a sector average. In this way the situation will be avoided whereby good banks are punished (by charging a fee that is too high) and not-so-good banks are subsidized (by charging a fee that is too low). Initially, the CGF will individually review *each* sub-loan submitted for coverage. Over time, the approval process may evolve so that guarantee coverage is provided on an MSME portfolio basis, once a satisfactory track record has been established (measured by NPL ratios). Claim payout will be executed after a loan has been 90 or 180 days in arrears, provided that the bank has demonstrated that it has taken agreed steps to collect the arrears. Recovery proceeds will be shared with the CGF. The CGF reduces the risk exposure of banks and thereby the amount of security the banks will require in the form of collateral. This can be expected to disproportionately benefit women, as they are less likely to own real estate, which is the banks' preferred form of collateral.

The Framework for the Design and Operational Setup of the Credit Guarantee Facility

37. **Guarantee terms to PFIs:** the guarantee will cover 50 percent of the loan amount plus interest, but only for the period until a sub-loan is 90 days in arrears. The guarantee maturity will

match the loan maturity (up to ten years) with a consideration for an appropriate grace period on principal repayment, matching the PFI sub-loans to final borrowers. The guarantee fee will be an annual percentage of the average outstanding guaranteed amount. The fee will be differentiated for different PFIs, based on the historic or projected SME NPL or write-off ratio plus some basis points to cover the CGF's administrative cost. In addition to the annual fee, an upfront fee (fixed amount) will be charged for each application covered by the guarantee. The PFIs will be responsible for appraisal of the loan applications and will price the sub-loans in conformity with market terms, fully reflecting their costs and risk.

38. **Guarantee exposure:** the CGF will set maximum exposure guidelines per participating bank and per sub-sector. These could be adjusted from time to time. PFIs that consistently do not perform under the CGF could be excluded for a period of time.

39. **Guarantee application process:** the PFI's will make the loan decision. In case of insufficient collateral, the PFIs would have to approve a loan contingent upon CGF approval. The guarantee application (according to an agreed-upon format) together with the loan file would be sent to the CGF, which does a lite-check and rejects or approves within 48 hours. In order to be able to do so, the CGF would need to ensure during due diligence that the bank has proper MSME lending systems and procedures in place. TA will be made available for the PFI to improve its systems before it can become eligible. The fact that a loan is guaranteed will not be communicated to the borrower, thereby mitigating moral hazard.

40. **Guarantee claim payout:** PFIs will be able to claim for payout after the loan has been 90 or 180 days in arrears. The PFIs file a claim according to a pre-agreed format where they have to demonstrate that they took sufficient steps to pursue the borrower (such as visiting the borrower, calling in personal guarantors, seized inventory, etc.). PFIs will not be asked to exhaust all legal procedures (as these do not function optimally). Recovery proceeds after claim payout will be shared with the CGF, with built-in incentives to encourage PFIs to actively recover.

41. **Eligible sub-loan activities and terms:** Guarantees will be offered for sub-loans to eligible MSMEs that require credit-enhancement measures (excluding small corporates) in line with project eligibility criteria outlined earlier.

42. **Performance indicators for PFIs:** the performance of PFIs will be monitored in-line with the relevant indicators listed in the results framework in Annexes 1 and 3. The responsibility for data collection and reporting will be with the DFI and the PIU. Additional relevant indicators may be developed during implementation.

43. **Reporting:** The PFIs are expected to report to the CGF and the DFI on their guaranteed portfolio and key financial and performance indicators on a quarterly basis. Ideally, banks will do this online direct into the DFI's monitoring system.

44. **Supervision:** The DFI and the CGF will be responsible for implementing and supervising the guaranteed loans. This will include assessing and monitoring PFI compliance with eligibility criteria, supervision of sub-loans, and reporting on the guarantee implementation progress. The

supervision process will also include review of PFIs' audited financial statements on an annual basis, review of loan books, and periodic on-site supervision and interaction with PFI management.

Box 4: Key Factors for Success of Credit Guarantee Facilities

Traditional "old style" CGFs were often government-owned and bureaucratic, having slow procedures (with guarantee approval sometimes taking up to three to six months) and cumbersome payout procedures, for instance, requiring banks to exhaust all legal procedures before being able to file a claim. This obviously did not work in countries where the legal environment for bad debt enforcement is weak. Finally bureaucrats are not necessarily good bankers. Emerging lessons with "new style" CGFs in countries like Afghanistan, West Bank, and Gaza as well as lessons learned from USAID's global DCA (Development Credit Authority) program point at the following five key factors for success:

Independent Institutional Setup and Governance

One of the key determinants of a CGF's success is the extent to which it gains the trust of the participating banks. Banks will only use the CGF when they trust that the CGF will deliver on its promises. This trust in turn usually depends on the following factors: (i) the extent to which the banks perceive the CGF to be independent, autonomous, and free from government interference; and (ii) the financial viability of the CGF, e.g., does the CGF have sufficient funds to pay out when banks file claims. In this context it is imperative that the fees charged by the CGF cover its costs.

Quality of the Participating Banks

Only banks that meet a set of strict minimum criteria for eligibility should be allowed to use the CGF. These criteria will look at the financial health of the bank, the level of NPLs, profitability, etc. The reason to have strict criteria is simple: if "bad" banks are allowed to use the CGF, the "good" banks will fear that the capital of the CGF may be depleted, thereby affecting their eventual claims for payout.

Lending Decisions Based on Cash Flow rather than Collateral

The borrower's ability to repay is the key distinguishing feature between an eligible sub-borrower loan request and an ineligible one. The ability to repay is best measured through cash flow analysis, i.e., whether the cash flow of the business ensures repayment capacity. The cash flow of the business and the sufficiency of reliable collateral are the most important factors in determining whether the CGF will approve or reject a guarantee application. Hence the importance of technical assistance to ensure that banks have appropriate small business lending procedures in place.

Avoiding Moral Hazard

A major criticism of credit guarantee facilities is the "moral hazard" – namely, the impact of the facilities in weakening the will and commitment of borrowers to repay and the commitment of banks to vigorously collect payment when they know that the guarantee will reimburse a substantial part of the loss incurred. One way of mitigating this risk is to ensure that the banks assume at least 50 percent of the risk of default. In order to address the "moral hazard" issue on the side of the borrower, the borrower should not be informed as to whether any particular loan is guaranteed or not. Borrowers in many developing countries are accustomed to benefitting from donor grants and soft donor loans and may therefore be less motivated (or not motivated at all) to repay a loan once they find out that it is guaranteed with the support of a donor or government agency.

Efficient Guarantee Application Process and Claims Payout Process

It is usual that a bank's credit committee decides on the loan application first and approves the loan contingent upon approval of the CGF. The credit committee then sends the application for the guarantee together with the loan files to the CGF. The CGF is then obligated to approve or reject the loan within a

certain period of time, often in less than 48 hours. It is important for the credibility of credit guarantee facilities that payouts are made promptly, i.e., within three to six months after a loan has defaulted (trigger date). This is made to depend on banks fulfilling their contractual agreements as regards undertaking efforts to recover the loan in arrears in the period before the "trigger" date. Such arrangements substitute for the "old practice" of having to exhaust all legal efforts while maintaining pressure on the borrower to repay. Claims are processed within a period of up to two weeks. Again, contractual arrangements are made with the banks so that they continue efforts to recover on the defaulting sub-loans. Any revenues arising from these recovery efforts are shared between the banks and the credit guarantee facility, usually in the same proportion as the risk sharing percentage provided by the CGF.

45. **Ownership and management:** the CGF will be a wholly owned subsidiary of the DFI and housed within the DFI. This is to avoid conflict of interest due to misalignment of incentives between the DFI's instruments. In the early years of the CGF, it will be more attractive to the DFI to makes loans to PFIs rather than to guarantee the PFIs' loans to MSMEs. This arises due to the substantial difference between the DFI lending rate to the PFIs (which is based on market-conform interest rates) and the DFI guarantee rates (fees) to the PFIs (which are based on the level of loan NPLs or the write-off rate of the individual PFI). For instance, the DFI lending rate to a PFI could amount to 11 percent (of the loan amount), while the guarantee rate would be 2 percent of the (sub-loan) amount. Hence, only when the CGF reaches leverage (a multiple of over 5) would the incentives between the two instruments be aligned. The CGF will have its own management team and a lean organizational structure.

Component 4: Project Management (US$6.75 million)

46. **This component will fund the project management functions supporting overall project implementation.** The PIU will have responsibility for implementation of Components 1 and 4. This component will be administered by the existing project implementation unit housed in the FMOF and responsible for the World Bank-funded PPP Project. The project management functions include fiduciary requirements such as procurement, financial management, withdrawal and disbursement requests, as well as program outreach, communication and reporting, monitoring and evaluation, support to the DFI with implementation of environmental and social safeguards, and impact assessment. This component will fund relevant staff, consultants, training, equipment, and operational expenses. As part of this component, funding will be provided to ensure that proposed technical assistance activities and consulting services under the project's Components 1 and 4 are undertaken in compliance with the World Bank fiduciary requirements.

47. **As a part of the innovation and impact assessment agenda, this component will also provide support for developing and testing mechanisms for auctioning credit line funds, a first-loss facility,[31] to be implemented by the DFI with the assistance of qualified external providers, as appropriate.** These activities are designed to strengthen the efficiency of financial intermediation by encouraging banks to reduce the costs of credit for the MSME sector and increase their exposure to potentially creditworthy MSME borrowers that are regarded as "too risky" given the business models hitherto deployed by banks in Nigeria. It is intended that these

[31] Unrelated to CGF proposed in Component 2.

activities will build on experience gained from implementation of the new DFI's credit lines and partial risk-sharing instruments, particularly as regards determining appropriate spreads (interest costs and fees) being charged to end users of these instruments.

Competitive Auction Process

48. **The activities will include development of the mechanism for auctioning credit line funds provided by the DFI.** In order to put competitive pressure on the spreads offered by banks to final borrowers, interest rates will be determined by an auction process under which PFIs will compete on the basis of the spread they propose to offer to particular market segments. Given that large corporations already benefit from cross-subsidization at the expense of small corporates, this approach will be tested in the first instance on spreads on DFI funding on-lent by PFIs to small corporates (as defined previously). This targeted approach is appropriate to use to test this innovative auction technique prior to full-scale roll out to MSME lending.

First-Loss Facility

49. **This component will also seek to reduce the spreads banks charge to their MSME clients using the first-loss facility (unrelated to CGF).** Here the focus will be on encouraging banks to deploy new lending techniques and skills in expanding their exposure to the MSME segment. Hitherto banks have experienced high losses on their MSME portfolios resulting in a portfolio at risk averaging about 15 percent. This high level of risk is factored into bank spreads and lending rates resulting in the exclusion of borrowers of good standing. The focus of this activity will be to explore possibilities for providing 15 percent first-loss coverage for loans to first-time borrowers in order to reduce bank credit risks for the first one to two years of a loan's term. In exchange for the new DFI providing such a facility, the participating banks will be expected to reduce their lending spreads in-line with the reduced credit risk of borrowers with first-loss guarantees.

Annex 3: Implementation Arrangements

FEDERAL REPUBLIC OF NIGERIA: Nigeria Development Finance Project

Project Institutional and Implementation Arrangements

Project Administration Mechanisms

1. **The FMOF will be responsible for monitoring project implementation and assuming the policy and advocacy role**. This will be achieved with the FMOF's appointment of staff dedicated to development finance policy and the DFI reform agenda for the duration of the project, with capacity-building support being provided by the project. This unit will interface with relevant government entities and the financial sector to ensure a coordinated approach to development finance, the smooth functioning of the new DFI, and achievement of the project's development objectives, as well as overall high-level project promotion. In addition, the FMOF will oversee the work of an existing project implementation unit (PIU) **-** housed in the FMOF and responsible for the World Bank-funded Public-Private Partnership project - which will be tasked to oversee administrative aspects of project implementation. The new project will therefore benefit from the expertise and capacity of the existing PIU, which, in addition to the head of the PIU, currently includes ten staff: two project development specialists, two procurement specialists, a monitoring and evaluation specialist, an environmental safeguard specialist, a social safeguard specialist, two accountants, and an internal auditor.

2. **The PIU will be an administrative interface between the FMOF and the DFI, tasked with ensuring project compliance with all relevant World Bank requirements.** These include fiduciary requirements such as procurement, financial management, withdrawal and disbursement requests, as well as program outreach, communication and reporting, monitoring and evaluation, supporting the DFI with implementing environmental and social safeguards requirements, and impact assessment. In this capacity the PIU will be responsible for implementation of the technical assistance and project-management components of the project, working alongside the new DFI. Throughout the duration of the project, the PIU will be adequately staffed and funded and will cooperate closely with the DFI staff.

3. **Implementation of the facilities funded by the project (i.e., lines of credit, the credit guarantee facility) will be entrusted to the new DFI.** Once all key staff is in place in the DFI and the financial instruments are ready for rollout, the DFI will be responsible for managing all aspects of line of credit and CGF implementation and will also be responsible for monitoring, reporting, and, with the PIU support, ensuring compliance with environmental and social requirements mandated by the World Bank in line with the ESOM.

Financial Management, Disbursements, and Procurement

Financial Management

4. **An updated financial management assessment of the implementing entity in line with the Financial Management Manual (March 1, 2010) and the AFTFM Financial Management Assessment and Risk Rating Principles (October 2010) was conducted on**

August 22, 2014. The objective was to determine whether the implementing entity had acceptable financial management arrangements, which would ensure (i) that all transactions and balances relating to the project are correctly and completely recorded; (ii) the preparation of regular, timely, and reliable financial statements; (iii) safeguarding of the entity's assets; and (iv) existence of auditing arrangements acceptable to the Bank.

5. **The overall FM risk of the Bank's funding contribution to the project is assessed as substantial.** This is mainly because of the challenging environment in which the new DFI will be established and not because of the control risks associated with the basic elements of the project FM arrangements. The identified FM risks are well mitigated by the use of the FAS-PPPP which features established internal and external controls and some mitigating measures. The mitigation measures include use of computerized accounting system, professionally qualified FM staff with appropriate expertise, and independent and effective internal audits that will adopt risk-based internal audit methodology. The Financial Procedures Manual (FPM) in use at the FAS-PPPP will apply to the project with some modifications. Regular reporting arrangements and a supervision plan will also ensure that the implementation of the project is closely monitored and that appropriate remedial actions are taken. The FM risks will be reviewed during project implementation and updated as appropriate.

6. **The FAS-PPPP is presently involved in the implementation of a Bank funded PPP Project.** The FAS-PPPP features, among other things, the following: (i) all the key elements of FM, including budgeting, funds flow, accounting, internal control, reporting, and audit; (ii) computerized system and robust FM procedures manual; (iii) qualified staff that are well trained in relevant Bank procedures and requirements, including procurement; (iv) robust segregation of functions/duties; and (v) control environment, which is required to mitigate fiduciary risks.

7. **The Bank's recent reviews showed that the FAS-PPPP is performing moderately satisfactorily.** Key issues noted within the FAS-PPPP are those of unretired advances and inadequate documentation for incurred eligible expenditures. These are mainly the result of inadequate understanding of Bank's FM requirements. To mitigate the risk arising from these issues, adequate procedures for the handling of advances, including remedial actions in the event of default, development of indicative checklist of appropriate supporting documents for incurred eligible expenditures for inclusion in the FPM will be elaborated in the FPM. Additional capacity building support for the project FM staff will be provided as necessary.

8. ***Planning and budgeting:* a budget committee will be established to coordinate budget preparation and tracking of financial performance.** On an annual basis, the project accountant (in consultation with key members of the implementing unit) will prepare the budget for the fiscal year, based on the work program. The budget will be submitted to the task team leader at least two months before the beginning of the client's fiscal year. Detailed procedures for planning and budgeting will be documented in the FPM.

9. ***Funds flow:* project funding will consist of an IBRD loan. A hybrid form of funds flow and disbursement arrangement will apply to the project, based on respective components.** Disbursement for Components 1 and 4 will follow standard Bank procedures. In regards to Components 2 and 3, the proceeds will be channeled to the FMOF in US dollars. The

FMOF will convert US dollars into Nigerian Naira prior to making them available to the new DFI, in line with the Bank approved subsidiary agreement. The FMOF will bear the cost of the exchange rate risk. IBRD will disburse the loan through Designated Accounts (DA) opened with reputable commercial banks acceptable to IBRD which will be managed by the PIU. The specific banking arrangements are as follows:

- A US$ DA to which initial deposit and replenishments from IBRD funds will be lodged for Components 1 and 4.
- One current (draw-down) account in Naira to which draw-downs from the DA will be credited in respect of incurred eligible expenditures, maintaining balances on this account as close to zero as possible after payments.
- A US$ DA to which the initial disbursements for the DFI will be lodged under Components 2 and 3. After converting the US$ into Nigerian Naira, the FMOF will on-lend the funds to the DFI.
- Disbursement for Components 2 and 3 will be linked to achievement of specific milestones. Disbursements under tranches IV, V, and VI will be after independent verification of the achievements of the DLIs.

10. ***Accounting:*** **IBRD funds will be accounted for by the project on a cash basis.** Computerized accounting system will be used, utilizing existing accounting software currently in use at the FAS-PPPP. The multi-project software will be set up to handle new project activities. The software will be configured in line with the agreed reporting formats for financial reports, i.e., unaudited interim financial reports and annual financial statements. Annual financial statements will be prepared in accordance with relevant International Public Sector Accounting Standards (IPSAS). A comprehensive chart of accounts suitable to the project that encompass the total project as described in the PAD and Loan Agreement, and it reflects all project activities, financing, and expenditures that will be developed. All accounting and control procedures will be documented in the FPM, a living document that will be subject to review as appropriate.

11. ***Financial reporting:*** **calendar semester interim financial reports (IFRs) will be prepared by the PIU.** PIU will submit IFRs to IBRD not later than 45 days after the semester. Annual project financial statements will be prepared and submitted to IBRD within six months of the end of the government fiscal year by the PIU. The DFI shall have its financial statement audited by independent auditors acceptable to the Bank, in accordance with consistently applied auditing standards acceptable to the Bank. The audited financial statement shall be submitted to the Bank after the end of each fiscal year not later than six months after the period. The audited financial statement shall be made publicly available in a timely fashion and in a manner acceptable to the Bank.

12. ***External audit:*** **the project will be audited by an independent external auditor appointed based on terms of reference acceptable to IBRD to audit the project and certify the financial statements for the project.** The auditor will express an opinion on the annual financial statements in compliance with International Standards on Auditing (ISA). In addition to the audit report, the external auditors will prepare a Management Letter (ML). A copy of the audited financial statements along with the ML will be submitted to IBRD not later than six months after the end of each financial year.

13. ***Internal control:*** **adequate internal controls are in place at the FAS-PPPP.** The control features include a robust FM procedures manual; relevantly qualified staff that are trained in relevant Bank procedures and requirements, including procurement; and a robust segregation of functions/duties and highly independent and well-trained internal auditors—the FM staff were competitively recruited by the PIU. To further strengthen the internal controls, capacity of the internal auditors will be built to adopt risk-based internal audit methodology.

Disbursements

14. **Disbursement under Components 2 and 3, to be independently verified, will constitute the eligible expenditures for financing under the loan.**

15. **Issues of inadequate documentation for incurred expenditures and poor-quality IFRs are flagged in the FM report of FAS-PPPP.** Accordingly, the project will use the transaction-based disbursement procedures and not report-based disbursements at effectiveness. When project implementation begins, the calendar semester IFRs produced by the project will be reviewed. Where the reports are found adequate and produced on a timely basis and the borrower requests conversion to report-based disbursements, a review will be undertaken by the World Bank project team to determine if the project is eligible for report-based disbursement. Details of the disbursement arrangement will be in the Disbursement Letter.

Financial Management Action Plan

16. **Actions to be taken for the project to further strengthen its financial management system are listed in following table:**

Table 1: FM Action Plan

No.	Action	Date due by	Responsible
1	Train staff in Bank FM procedures and Disbursement Guidelines.	Within 60 days after effectiveness	PIU
2	Appoint external auditor	Within 90 days after effectiveness	PIU
3	Train Internal Auditor on Risk Based Internal Audit	Within 90 days after effectiveness	PIU
4	Provide office space for FM staff in FAS-PPPP within the FMOF	Within 30 day after effectiveness	PIU
5	Furnish Bank with the remedial actions taken on Suspected Fraudulent Expenses (SFEs) and ineligible expenses identified in the PPP project	Within 60 days after effectiveness	PIU
6	Update existing computerized accounting system to incorporate project activities	Within 90 days after effectiveness	PIU
7	Update Generic FPM as a part of POM	Within 30 days after effectiveness	PIU

Financial Management Implementation Support Plan

17. **FM supervision will be consistent with a risk-based approach and will involve collaboration with the Bank's project team, LOA, and procurement.** The supervision intensity will be based initially on the PAD FM risk rating and subsequently on the updated FM risk rating during implementation. Given the substantial residual risk rating, on-site supervision will be carried out at least twice a year. On-site review will cover all aspects of FM, including internal control systems, the overall fiduciary control environment, and tracing transactions from the bidding process to disbursements as well as SOE review. Additional supervision activities will include desk review of semester IFRs, quarterly internal audit reports, audited annual financial statements, and management letters as well as timely follow up of issues that arise and updating the FM rating in the Implementation Status Report (ISR) and the Portfolio and Risk Management (PRIMA) system. The Bank's project team will support in monitoring the timely implementation of the action plan.

Disbursement Categories

18. **The following table sets out the expenditure categories and percentages to be financed out of the credit proceeds.**

Table 2: Allocation of Loan Proceeds to be Financed for Eligible Expenditures in Each Category (IBRD)

Category	Amount of the Credit Allocated	Percentage of Expenditures to be Financed (inclusive of Taxes)
Component 1: Technical Assistance and Capacity Building	US$12 million	100 percent
Component 2: Line of Credit Facility	US$445 million	100 percent
Component 3: Credit Guarantee Facility	US$35 million	100 percent
Component 4: Project Management	US$6.75 million	100 percent
Front-end Fee	US$1.25 million	100 percent
TOTAL AMOUNT	US$500 million	

Conclusion

19. **The financial management assessment conclusion is that, subject to the mitigation measures and the action plan being implemented as per agreed timeframe, the project has met the minimum FM requirement in accordance with OP/BP 10.00.** Further, this objective

will be sustained by ensuring that strong and robust financial management arrangements are maintained for the project throughout its duration. Detailed financial management reviews will also be carried out regularly, either within the regular proposed supervision plan or a more frequent schedule if needed to ensure that expenditures incurred by the project remain eligible.

Procurement

General

20. **Country environment: Nigeria has been implementing a procurement-reform program based on the recommendations of the 2000 Country Procurement Assessment Review (CPAR).** A review of the progress made on the 2000 CPAR recommendations as reflected in the 2007 PEMFAR shows that implementation of the procurement-reform program has brought about substantial improvements in obtaining value for money in the public sector expenditure. The reform has introduced some level of transparency into the country's procurement process, which has led to substantial reduction of contract prices. The Public Procurement Act was promulgated in Nigeria in June 2007 to further sanitize the public procurement system, which often has been the subject of abuse and corruption. The regulatory agency, the Bureau of Public Procurement (BPP), was established, and the procurement professionals' cadre was created at the federal level in 2006. These measures have significantly improved the procurement system in the public service and enhanced transparency. The Act adheres to the principles of the United Nations Commission on International Trade Law (UNCITRAL) model law. The Act outlines the principles of open competition, transparent procurement procedures, clear evaluation criteria, award of contract to the lowest evaluated tender, and contract signature. The legal framework is applicable to all procurement categories (suppliers, contractors, consultants) and applied to all public funds regardless of value. The Act has provisions for exceptions to competitive tendering. The government has already prepared relevant implementation regulations, standard bidding documents (SBD), and manuals for the procurement of goods, works, and consulting services, which describe the minimum contents of the tender and proposal documents. The essential elements are in line with internationally acceptable procurement standards. The Procurement Act provides for a complaints and appeals mechanism to be established to enhance accountability. The Bank, with the support of DFID, conducted a value-chain analysis of government procurement activities to identify bottlenecks in implementation and disbursement of allocated resources to procurement activities. The resulting report, along with the recommendations, has been sent to the government. The achievement of the procurement reforms at the federal level has encouraged the state governments to also embrace it, with a lot of progress already recorded.

21. **Procurement risk at country level:** With the substantial progress in procurement reforms described, procurement risk such as capacity, fraud, and corruption are being addressed. The BPP has organized a series of trainings and awareness workshops, and the capacity of the procurement professionals, CSOs, and private sector are being built on a continuous basis. These achievements were made possible as a result of the IDA Credit-Economic Reform and Governance Program (ERGP), which had a substantial component focusing on procurement reforms. There are currently three IDA Credits with procurement reform components supporting reform activities at the federal and state levels. These include the Public Sector Governance and

Development Project, the State Employment and Expenditure Project, and the State and Local Government Governance Reform Project. There have also been three IDF Grants that assisted the Federal Government in addressing the weak procurement capacity in the public sector and building appropriate partnerships with the private sector. These vehicles have been used by the government to prepare the relevant procurement tools previously mentioned.

22. **Procurement risk at project level:** The DFI will be a new institution to be established by the government and other shareholders such as AfDB, and it is expected to be managed by competitively recruited, qualified, and experienced professionals. As a majority government-owned institution, its procurement will be based on the Public Procurement Act, and it will also use the regulations, manuals, and standard documents of the Bureau of Public Procurement. DFI will therefore prepare its procurement plans and carry out its procurement activities line with the procedures set forth by the BPP. Relevant consultants including a procurement advisor in the project implementation unit will provide necessary support to DFI to minimize any envisage risk.

23. **Procurement arrangements:** As stated earlier, procurement activities upstream in the project are few, because most of the funds will be passed to the new DFI. Therefore, the remaining few procurement activities will be handled by the PIU in the FMOF. The PIU shall prepare the work plans and the procurement plan, which will include technical assistance and capacity building and project management activities under Components 1 and 4. The PIU will handle the bidding and supervision processes in an effective, efficient, and transparent manner to ensure value for money. Downstream - Component 2, at DFI level; Clause 3.13 (Procurement in Loans to Financial Intermediaries) of the Guidelines on Procurement of Goods, Works, and Non-Consulting Services, January 2011 edition, will apply.

Guidelines

24. **Procurement under the proposed project will be carried out in accordance with the World Bank's rules: "**Guidelines: Procurement of Goods, Works, and Non-Consulting Services under IBRD Loans and IDA Credits and Grants by World Bank Borrowers,**"** dated January 2011; **"**Guidelines: Selection and Employment of Consultants under IBRD Loans and IDA Credits and Grants by World Bank Borrowers,**"** dated January 2011; **"**Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credits and Grants,**"** dated October 15, 2006, and revised in January 2011; and the provisions stipulated in the Legal Agreements. The various items under different expenditure categories are described in general as follows. For each contract to be financed by the credit, the different procurement methods or consultant selection methods, estimated costs, prior review requirements, and timeframe are agreed between the Recipient and the World 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.

25. **Procurement of goods and non-consulting services.** Procurement of goods will be carried out using the National Standard Bidding Documents (SBD) agreed with the Bank for NCB and shopping. Contracts with cost estimate within the International Competitive Bidding (ICB) threshold are not envisaged. Procurement for readily available off-the-shelf goods that cannot be grouped or standard-specification commodities for individual contracts of less than

US$100,000 equivalent may be procured under shopping procedures as detailed in paragraph 3.5 of the "Guidelines: Procurement under IBRD Loans and IDA Credits," dated January 2011 and the "Guidance on Shopping Memorandum," issued by IDA on June 9, 2000.

26. **Selection of consultants:** Consultancy services will be provided under the project and include the following categories: TA, financial audit, and M&E. These consultants shall be selected using Request for Expressions of Interest, short-list, and the National Standard Request for Proposal. 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– 2.8 of the Consultant Guidelines.

27. **Procurement in loans to financial intermediaries:** The line of credit of US$445 million to be made available to FMOF for on-lending to DFI would be advanced to eligible PFIs by the DFI. Therefore, the procurement of works, goods, and non-consulting services will be undertaken by the respective beneficiaries in accordance with well-established private sector procurement methods or commercial practices that shall be acceptable to the Bank. Details will be provided in the Project Operations Manual.

28. **Operating costs**: The operating costs will include equipment, fuel, office supplies, bank charges, advertising expenses, travels, and per diems. Operating costs financed by the project will be procured using the implementing agency's administrative procedures that shall be acceptable to the Bank.

29. **Assessment of the PIU's capacity to implement procurement requirements:** procurement risk assessment of the existing PPP PIU in the FMOF,[32] which will also serve as the PIU for the development finance project, was conducted, and its procurement capacity was found to be satisfactory. The assessment reviewed the organizational structure for implementing the project and the roles of the key actors in project implementation. The key issues and risks that may affect the project's procurement activities include (i) potential delays due to several approval levels at the FMOF; and (ii) potential political interference. An action plan to address and mitigate these risks was agreed with the government during the appraisal. The necessary corrective measures to be put in place to address the issues and risks are reflected in Tables 3; however, it is important to note that these measures are already underway and are expected to be addressed in the context of PIU's role in the World Bank-funded PPP project. In addition, the DFI staff will require procurement-related training. The PIU's senior procurement specialist has relevant qualifications, with several years of experience working in different Bank funded projects. In addition, the PIU has two other qualified procurement specialists. Since the procurement activities at the PIU will be relatively small, the designated specialists will be able to handle the procurement activities of the two Bank-funded projects as well as provide procurement guidance and build capacity at the DFI level.
The risk rating is *substantial.*

[32] For World Bank funded Public Private Partnership Project.

Table 3: Procurement Action Plan

#	Action	Responsibility	Due Date
1	Establish procurement complaint online database and/or hotline	PIU/FMOF	90 days after effectiveness
2	Approval levels to be reduced to the minimum	PIU/FMOF	60 days after effectiveness
3	Prepare Procurement Manual as part of the Project Operations Manual (POM)	PIU/FMOF	By effectiveness
4	Train DFI staff procurement tracking system	WB/PIU	Continuous, upon establishment of the DFI

Procurement Plan

30. **The 18-month procurement plan for project implementation has been finalized and agreed.** The plan will also be available in the project's database and in the Bank's external website. The procurement plan will be updated in agreement with the project team annually or as required to reflect the actual project implementation needs and improvements in institutional capacity.

31. **Fraud, coercion, collusion, and corruption:** all procuring entities, as well as bidders, contractors, suppliers, and consultants, must observe the highest standard of ethics during the procurement and execution of contracts financed under the project in accordance with paragraphs 1.14 & 1.15 of the Procurement Guidelines and paragraph 1.22 & 1.23 of the Consultants' Guidelines.

Procurement Reviews and Thresholds

Table 4: Thresholds for Procurement Methods and Prior Review

No	Expenditure Category	Contract Value Threshold* (US$)	Procurement Method	Contracts Subject to Prior Review (US$)
1	Works	C>=10,000,000	ICB	All contracts
		10,000,000 <C < 10,000,000	NCB	none
		C<200,000	Shopping	none
		All values	Direct Contracting	All contracts
2	Goods, and Services (other than Non-Consulting Services	C>=1,000,000	ICB	All contracts
		100,000= <C < 1,000,000 C=<1,000,000	NCB	none
		C<100,000	Shopping	none
		All values	Direct Contracting	All contracts

3	Consulting Services	C>= 300,000 firms	Quality- and Cost-Based Selection (QCBS) (International)	All contracts. For TA that may require the engagement of a firm
		C<300,000 firms	QCBS (National)	none
		C<300,000	Consultants' Qualifications (CQS)	Only TORs
		C>=100,000 individuals	Individual Consultant (IC)	TTL and PS for procurement consultant only
		C < 100,000 individuals	IC	TTL
		All values	Single Source Selection	All contracts

Note: *These thresholds are for the purposes of the initial procurement plan. The thresholds will be revised periodically based on reassessment of risks.

Frequency of Procurement Supervision

32. **In addition to the prior review supervision to be carried out from Bank offices, based on the capacity assessment of the implementing agency, at least one supervision mission a year is recommended to carry out post-review of procurement actions.** The procurement post-reviews should cover at least 10 percent of contracts subject to post-review.

Table 5: Details of the Procurement Arrangements Involving International Competition

Ref No.	Description of TA	Selection Method	Review by Bank (prior/post)	Expected Proposals Submission Date
1	TA to PFIs on MSME lending	QCBS	Prior	3 months after effectiveness
2	Corporate governance TA for the DFI	QCBS	Prior	3 months after effectiveness
3	Information technology platform and TA for the DFI	QCBS	Prior	3 months after effectiveness
4	Auction and first-loss facility TA for the DFI	QCBS	Prior	6 months after effectiveness
5	CGF product development	QCBS	Prior	1 year after effectiveness

Note: These are key procurement contracts under the project.

Publication of Results and Debriefing

33. **On-line (UN Development Business, and/or Client Connection) publication of contract awards will be required for all, NCB, Direct Contracting, and the Selection of Consultants for contracts that exceed a value of US$200,000.** With regard to large-value consulting contracts, the Recipient will be required to ensure publication of contract awards as soon as the World Bank has issued its "no objection" notice to the recommended award. With regard to Direct Contracting and NCB, publication of contract awards can be in aggregate form on a quarterly basis and in local newspapers.

Environmental and Social (including safeguards)

34. **The project is categorized as a Financial Intermediary (FI) project and the appropriate FI category is FI-2.** This is based on the assumption that the sub-loan portfolio may potentially comprise subprojects that have limited adverse environmental and social risks or impacts that are few in number - generally site-specific, largely reversible, and readily addressed through mitigation measures - or that it may include a very limited number of subprojects with potential significant adverse environmental or social risks or impacts that are diverse, irreversible, or unprecedented.

35. **While the project is not expected to have adverse social risks or long-term or large-scale negative environmental impacts, adequate measures will be taken to mitigate potential environmental and social risks, in line with the World Bank Group (WBG) Performance Standards.** Specifically, an Environmental and Social Operations Manual (ESOM) will be applied by the DFI and all PFIs. The capacity of DFI and PFIs to assess and mitigate environmental and social risks will also be developed and funded under Component 1.

36. **In terms of the proposed sub-project activities, while they are not limited to specific sectors, they are expected to include small-scale manufacturing, light industry, transport, trade, hospitality, agriculture, and similar activities.** It is important to note that these activities will be limited in scope due to the fact that the loan sizes are relatively small and capped and given that the MSME and small corporates sector is either not, or is only to a limited extent, engaged in larger-scale manufacturing or agriculture. It is therefore expected that these activities will have a limited negative environmental and social footprint. Nevertheless, adequate measures will be taken to screen any project that may potentially have a more significant adverse impact.

37. **Through explicit review of social issues at the implementation level and the overall attention to the market gaps in finance that impact MSMEs, the project design reflects safeguards and elements to support sustainable livelihoods.** Social risk screening will review particularly i) commitment to the fair treatment, nondiscrimination, and equal opportunity of employees, maintenance of employee-management relationships, and compliance with national employment and labor laws (Performance Standard 2 on Labor and Working Conditions); and ii) application of all applicable national and state laws and regulations pertaining to home ownership, occupancy, and land tenure (Performance Standard 5 on Land Acquisition and Involuntary Resettlement).

38. **The project is fully consistent with the World Bank requirements for all PFIs whose portfolio and/or proposed business activities present moderate to high social or environmental risks** (i.e., Category FI-1 and some FI-2) to ensure that any such activities supported by the Bank are operated in a manner consistent with the World Bank Group Performance Standards.

39. **Consequently, the World Bank will apply the relevant World Bank Group Performance Standards (as seen in Table 6) to DFI operations in lieu of the World Bank Safeguard Policies.** While, Performance Standards 1, 2, and 5 are expected to be the only applicable standards for this project, each PFI will assess environmental and social risks of transactions according to Performance Standards 1 through 8 and will require its borrowers/investees to meet the requirements of these Performance Standards in their operations. The program components will be subject to application of relevant national laws and regulations. In addition the Policy requires the financial intermediaries to develop an Environmental and Social Management System (ESMS) acceptable to the Bank, which the intermediary applies in identifying, assessing and managing environmental and social risks and impacts under its Bank-supported portfolio of subprojects. The ESMS requirements for this FI-2 will adhere to the practices established by the WBG.

40. **The ESMS that is established by each participating financial institution (PFI) should meet the requirement of the World Bank Group that a financial intermediary has established an appropriate ESMS**. PFIs are required to establish or arrange for proper capacities to duly implement their ESMS in a manner consistent with the guidance provided in this manual. The capacity of PFIs to establish and implement the ESMS will be enhanced through technical assistance provided under Component 1.

41. **In agreeing to participate in the project, each PFI accepts responsibility to the World Bank Group for mandatory screening, assessment, and management of the environmental and social risks and impacts of proposed transactions it takes under the project in a manner that is consistent with WBG Performance Standards as well as the financial institution's corporate practices and policies for corporate responsibility.** In order to effectively adapt the principals of the ESOM as guidance to staff for managing environmental and social risk, each financial institution will develop their internal ESMS. The ESMS should describe key features such as social and environment policies and procedures; current organizational structure and staffing for managing environmental and social risk; skills and competencies in social and environmental areas; training awareness of the institution's investment, legal, and credit officers on the organization's ESMS; reporting systems to managers; and performance monitoring procedures.

42. **The following WBG Performance Standards triggered are seen in Table 6.**

Table 6: Applicable WBG Performance Standards

WBG Performance Standards	**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**

Monitoring & Evaluation

43. **Key PDO indicators include the following:**

- Volume of sub-loans facilitated by the Line of Credit Facility
- Volume of sub-loans facilitated by the Credit Guarantee Facility
- PFI Sub-loan portfolio at risk

44. **Key Intermediate Results indicators include the following:**

- Volume of DFI's wholesale loans
- Volume of guarantees issued
- DFI portfolio at risk
- DFI return on assets
- Number of PFIs reporting on lending to women sub-borrowers

45. **Additional indicators will be monitored under the project for analytical purposes.** The responsibility for reporting will rest with the PFIs, the DFI, and the PIU. These include the following:

Indicator Name	**Frequency***	**Data Source/ Methodology**	**Responsibility for Data Collection**
Number of PFIs	Quarterly	Project reports	PFIs, DFI, PIU
Outstanding PFI MSME, agricultural MSME, and small corporate loan portfolio (amount US$)	Quarterly	Project reports	PFIs, DFI, PIU
Volume/Number of MSME, agricultural MSME, and small corporate Sub-Loans	Quarterly	Project reports	PFIs, DFI, PIU
Percentage of sub-loans to women	Quarterly	Project reports	PFIs, DFI, PIU

Volume of sub-loans to women	Quarterly	Project reports	PFIs, DFI, PIU
PFI sub-loans to women portfolio at risk	Quarterly	Project reports	PFIs, DFI, PIU
PFI MSME, agricultural MSME, and small corporate portfolio at risk	Quarterly	Project reports	PFIs, DFI, PIU
PFI MSME, agricultural MSME, and small corporate write-off ratio	Quarterly	Project reports	PFIs, DFI, PIU
Share of PFI MSME and agricultural MSME portfolio in total PFI assets	Quarterly	Project reports	PFIs, DFI, PIU
Size of MSME, agricultural MSME, and small corporate sub-loans	Quarterly	Project reports	PFIs, DFI, PIU
Maturity of MSME, agricultural MSME, and small corporate sub-loans	Quarterly	Project reports	PFIs, DFI, PIU
Interest rate for MSME, agricultural MSME, and small corporate sub-loans	Quarterly	Project reports	PFIs, DFI, PIU
CGF - administrative cost as percentage of total guaranteed amount	Quarterly	Project reports	PFIs, DFI, PIU
CGF - claim payout as percentage of total guaranteed amount	Quarterly	Project reports	PFIs, DFI, PIU
CGF - leverage achieved	Quarterly	Project reports	PFIs, DFI, PIU
Economic sector in which MSME/ agricultural MSME/small corporate operates	Quarterly	Project reports	PFIs, DFI, PIU
Geographic location of MSME/ agricultural MSME/small corporate beneficiaries	Quarterly	Project reports	PFIs, DFI, PIU
Number of banks that open dedicated window for women entrepreneurs	Annual	Project reports	PFIs, DFI, PIU
DFI mobilization of external capital (debt or equity)	Annual	Project reports	PFIs, DFI, PIU
Increase PFIs interest income	Annual	Project reports, surveys	PFIs, DFI, PIU
Increase in sales of beneficiary MSME/ agricultural MSME/small corporate	Annual	Project reports, surveys	PFIs, DFI, PIU
Increase in employment of beneficiary MSME/agricultural MSME/small corporate	Annual	Project reports, surveys	PFIs, DFI, PIU
DFI return on equity (ROE)	Annual	Project reports	PFIs, DFI, PIU

46. **All reporting under the project will be based on standardized reporting templates, which will be included in the Project Operations Manual.** Finally, a survey of sub-borrowers will be conducted during the last year of project implementation to gauge project impact.

Annex 4: Operational Risk Assessment Framework (ORAF)

FEDERAL REPUBLIC OF NIGERIA: Development Finance Project (P146319)

<table>
<tr><th colspan="7">1. Project Stakeholder Risks</th></tr>
<tr><td>Stakeholder Risk</td><td>Rating</td><td colspan="5">High</td></tr>
<tr><td rowspan="2">Description:
Public sector stakeholders may not have the same vision of development finance as the financial industry and donors. While stakeholders are also unanimous that the current schemes are not sustainable, perceptions of the need for such (subsidized) schemes vary. For example, even though it is a monetary authority, the CBN is funding and administering various development finance schemes.</td><td colspan="6">Risk Management: The key stakeholder risk relates to potential lack of public sector consensus about the design, mandate, governance, and programs of the new DFI. The risks are mitigated with FMOF's strong commitment to restructure and privatize or wind down the existing DFIs (and thus dismantle current inefficient support models) and to channel all future support through the new DFI, which will be designed to be financially fully sustainable. Going forward, the roles and responsibilities of the CBN will be focused on its core supervisory mandate of ensuring the stability of the financial system, including regulation and supervision of the new DFI to be established under this operation. However, the CBN has indicated that it intends to remain engaged in development finance with much more targeted interventions to be conducted in parallel with the new DFI. The Bank team has already conducted one technical workshop with all project stakeholders, focusing on market gaps and potential instruments of the new DFI, and will continue to engage with the stakeholders on a regular basis during project preparation to build a consensus about the future of development finance in Nigeria.</td></tr>
<tr><td>Resp:
Borrower, CBN</td><td>Stage:
Implementation</td><td>Recurrent:
x</td><td>Due Date:</td><td>Frequency:
Ongoing</td><td>Status:
In progress</td></tr>
</table>

<table>
<tr><th colspan="7">2. Implementing Agency Risks (including fiduciary)</th></tr>
<tr><td>Capacity</td><td>Rating</td><td colspan="5">High</td></tr>
<tr><td rowspan="2">Description: The biggest potential risks include political interference in the process of establishment and management of the new DFI.</td><td colspan="6">Risk Management: The new DFI will be established according to the guidance provided by the project and managed by professionals recruited in a competitive selection process. The project will provide technical assistance and capacity building to the new DFI as well as the relevant departments in the FMOF and CBN to ensure adequate technical oversight and supervision capability. Finally, unlike existing DFIs, the new institution will operate on a wholesale-only basis, which will reduce the complexity and risks associated with its operations.</td></tr>
<tr><td>Resp:
Borrower, PIU, DFI</td><td>Stage:
Implementation</td><td>Recurrent:
x</td><td>Due Date:</td><td>Frequency:
Ongoing</td><td>Status:
In progress</td></tr>
<tr><td>Governance</td><td>Rating</td><td colspan="5">High</td></tr>
<tr><td rowspan="2">Description: The biggest risk to governance of new DFI includes potential political capture of the new institution, as was the case with the existing DFIs, which incurred significant losses and failed to achieve sustainability as a result.</td><td colspan="6">Risk Management: This risk is primarily managed with an innovative governance structure. While the new DFI will be majority government-owned and managed in partnership with other shareholders (such as the AfDB), the articles of agreement establishing the new DFI will stipulate the business model and strategic direction of the institution. The Memorandum and Articles of Association will also stipulate that a majority of directors are independent and competitively selected and will constitute a majority of the Board at all times. The project envisages an innovative governance structure whereby compliance with the DFI's strategic mandate is ensured both by the majority of DFI Board members being competitively selected independent directors, and through the Bank's participation as an observer on the Board of the DFI. Cognizant that governance failures contributed to thwarting the effectiveness of existing DFIs, the authorities are fully committed to establishing a robust governance structure for the new institution. In addition to providing comfort as regards the strategic direction of the new institution the Memorandum and Articles of Association will stipulate a process of appointing independent Board members that requires candidates to live up to specific professional and technical qualifications. To reflect local ownership, the government wishes to ensure that the majority of directors are Nigerian citizens, selected based on a shortlist of qualified candidates recruited by an independent search firm. The DFI will also be subject to regulation, licensing, and supervision by the CBN, thus further strengthening the governance arrangements, as well as due diligence as regards the DFI's operational and financial capacity. Finally, the project team will ensure continuous supervision of all key operational aspects to ensure good governance.</td></tr>
<tr><td>Resp:
Borrower, CBN, Shareholders, PFIs</td><td>Stage:
Implementation</td><td>Recurrent:
x</td><td>Due Date:</td><td>Frequency:
Ongoing</td><td>Status:
In progress</td></tr>
</table>

<table>
<tr><th colspan="7">3. Project Risks</th></tr>
<tr><td>Design</td><td>Rating</td><td colspan="5">Substantial</td></tr>
<tr><td rowspan="2">Description: The design risk of establishing a brand new financial institution in a challenging environment is substantial. The restructuring and privatization of exiting DFIs, ensuring the role of CBN as the supervisor, and limiting any potentially competing schemes will have a crucial impact on the performance of the new DFI.</td><td colspan="6">Risk Management: These risks will be primarily managed through the FGN's clear commitment to establishing a financially sustainable, wholesale-only DFI, which will not be subject to political interference or thwarted by subsidized finance schemes directly interfering with the DFI.</td></tr>
<tr><td>Resp:
Borrower, CBN</td><td>Stage:
Implementation</td><td>Recurrent:
x</td><td>Due Date:</td><td>Frequency:
Ongoing</td><td>Status:
In progress</td></tr>
<tr><td>Social and Environmental</td><td>Rating</td><td colspan="5">Moderate</td></tr>
<tr><td rowspan="2">Description: The new DFI will fund a variety of projects, and while the project is not expected to have adverse risks, risk mitigation measures have been developed as safeguards against any potentially adverse environmental and social impact. The project's safeguard rating is FI-2.</td><td colspan="6">Risk Management: The project will provide TA and financial support to financial intermediaries to ensure full compliance with the World Bank Group Performance Standards. The risks will be mitigated with the implementation of Environmental and Social Operations Manual (ESOM), in line with World Bank Group Performance Standards, which will spell out the relevant procedures and mitigation measures. PFIs (e.g., banks, MFBs, etc.) will be responsible for identifying, assessing, and managing environmental and social risks and impacts associated with the project, consistent with the World Bank Group Performance Standards. Furthermore, both the new DFI and PFIs will have to develop an acceptable Environmental and Social Management System (ESMS) that guides the intermediary in assessing and managing environmental and social risks in its Bank-financed lending portfolio of subprojects</td></tr>
<tr><td>Resp:
Borrower, PIU, DFI, PFIs</td><td>Stage:
Implementation</td><td>Recurrent:
x</td><td>Due Date:</td><td>Frequency:
Ongoing</td><td>Status:
To commence at implementation stage</td></tr>
</table>

<table>
<tr><td>Program and Donor</td><td>Rating</td><td colspan="5">Substantial</td></tr>
<tr><td rowspan="2">Description: AfDB has expressed interest in providing equity to the new DFI, while other donors (AFD and KFW) have indicated interest to provide debt financing. The risk exists that these expressions of interest do not materialize in the form of binding commitments.</td><td colspan="6">Risk Management: With a view to attracting additional donor and international financial institution investment in the equity and debt of the new DFI an Information Memorandum is being prepared. The FGN is already actively engaged in equity- and debt-raising discussions with multilateral and bilateral donors.</td></tr>
<tr><td>Resp:
Borrower</td><td>Stage:
Implementation</td><td>Recurrent:
x</td><td>Due Date:</td><td>Frequency:</td><td>Status:
In progress</td></tr>
<tr><td>Delivery Monitoring and Sustainability</td><td>Rating</td><td colspan="5">Substantial</td></tr>
<tr><td rowspan="2">Description: The bulk of the project funds will be managed by the new DFI, while policy oversight will be provided by the FMOF, and the DFI will be regulated and supervised by the CBN.</td><td colspan="6">Risk Management: The DFI and FMOF will benefit from technical assistance to ensure effective performance of their respective roles.</td></tr>
<tr><td>Resp:
Borrower, CBN, DFI</td><td>Stage:
Implementation</td><td>Recurrent:
x</td><td>Due Date:</td><td>Frequency:
Ongoing</td><td>Status:
To commence at implementation stage</td></tr>
<tr><td colspan="7">4. Overall Risk</td></tr>
<tr><td colspan="7">Implementation Risk Rating: High</td></tr>
<tr><td colspan="7">Comments: The overall implementation risk is high, because the project will require building a new DFI from scratch in a challenging political and economic environment. The success of the implementation phase will primarily depend on the FGN’s continued commitment to the design and principles for establishment, management, and supervision of the new DFI spelled out in the project documents.</td></tr>
</table>

Annex 5: Implementation Support Plan

FEDERAL REPUBLIC OF NIGERIA: Development Finance Project

Strategy and Approach for Implementation Support

Implementation Support Plan

Time	Focus	Skills Needed	Number of Trips	Resource Estimate
Year 1	Task management	Project management (HQ based)	4	12 staff weeks (SWs)
	Board Observer	Attending DFI Board Meetings	4	2 SWs
	Implementation support and Monitoring	Financial Sector Spec. (Abuja based)		8 SWs
	Procurement support	Procurement Specialist (Abuja based)		3 SWs
	FM supervision	FM Specialist (Abuja based)		3 SWs
	Performance Standards	Environmental/ Social specialists (Abuja based)		3 SWs
Year 2-5	Task management	Project management (HQ based)	3	10 SWs per year
	Board Observer	Attending DFI Board Meetings	4	2 SWs
	Implementation support and Monitoring	Financial Sector Spec. (Abuja based)		6 SWs per year
	Procurement support	Procurement Specialist (Abuja based)		2 SWs per year
	FM supervision	FM Specialist (Abuja based)		3 SWs per year
	Safeguards	Environmental/ Social specialists (Abuja based)		3 SWs per year

Partners

Name	***Institution/Country***	***Role***
African Development Bank	International Financial Institution	Potential DFI Shareholder and Lender
French Agency for Development	France	Potential DFI Lender
KFW	Germany	Potential DFI Lender

Annex 6: Financial Analysis

FEDERAL REPUBLIC OF NIGERIA: Development Finance Project

1. **The balance sheet of the DFI is driven by the PFIs' demand for DFI's lending and guarantee products.** In the base-case scenario, by year seven the DFI is expected to finance 15 percent of the market for MSME finance. Lending operations constitute 13.1 percent and the CGF constitutes 1.9 percent. It is expected that the DFI, through its lending, partial risk guarantee, and TA operations, will demonstrate to the banking industry that MSME financing is a profitable business and thereby increase the proportion of PFI lending to MSMEs.

2. **Due to continued fiscal consolidation and falling inflation, government bond rates are expected to fall from 13.5 percent (2014) to 11 percent (2021).** In line with reduced inflation (forecast to fall moderately from 8 percent in 2014 to 7 percent in 2021) and reduced credit spreads (anticipated to fall from 9.5 percent to 7 percent in 2021), it is envisaged that interest rates to end-borrowers will fall moderately. Falling credit spreads are a consequence of greater familiarity on the part of PFIs with new MSME lending techniques. Reduced interest rate levels and spreads are also expected to increase MSME's demand for bank funding. As a result, the industry-wide share of MSME lending as a percentage of total bank assets is simulated to increase from 2 percent (2013) to 4 percent (2021).

3. **It is assumed that economic growth is sustained at 6 percent and** is accompanied by financial deepening measured by the increase of bank assets to real GDP, from 35 percent (2014) to 38 percent (2021). The growth of assets will provide the banks with additional funds to be used for MSME financing.

Table 1: MSME Market and Demand for DFI Financing

	2013	2014 Base	2015 Period 1	2016 Period 2	2017 Period 3	2018 Period 4	2019 Period 5	2020 Period 6	2021 Period 7
($ millions)									
BASE CASE ASSUMPTIONS									
Macroeconomy									
Real GDP Growth	7,1%	7,1%	6,5%	6,0%	6,0%	6,0%	6,0%	6,0%	**6,0%**
Deposit Money Bank Assets / Real GDP	35,0%	35,0%	35,0%	35,5%	36,0%	36,5%	37,0%	37,5%	**38,0%**
Nominal Government Bond Rate	13,5%	13,5%	13,0%	12,5%	12,0%	11,5%	11,0%	11%	**11%**
Inflation	8,0%	8,0%	7,5%	7,0%	7,0%	7,0%	7,0%	7,0%	**7,0%**
SME Finance Market									
SME Lending Portfolio / DMB Assets	2,0%	2,2%	2,4%	2,6%	2,8%	3,0%	3,3%	3,6%	**4,0%**
SME Lending Portfolio / Total Lending Portfolio (rough ap	4,0%	4,4%	4,8%	5,2%	5,6%	6,0%	6,6%	7,2%	**8,0%**
Default Rate End-Borrower (only relevant for Guarantee	5,0%	5,0%	5,0%	5,0%	5,0%	5,0%	5,0%	5,0%	**5,0%**
Credit Spread to SMEs (over bond rate)	9,5%	9,5%	9,0%	8,5%	8,0%	7,5%	7,0%	7,0%	**7,0%**
PFI's Demand for DFI Financing									
Proportion of SME lending financed by DFI (Lending + Guarantee)			1,0%	3,0%	5,0%	7,5%	10,0%	12,5%	**15,0%**
Proportion of SME lending financed by DFI Lending			1,0%	3,0%	4,4%	6,4%	8,4%	10,6%	**13,1%**
Proportion of SME lending financed by DFI Guarantees			0,0%	0,0%	0,6%	1,1%	1,6%	1,9%	**1,9%**
BASE CASE OUTPUTS									
Macroeconomy									
Real GDP	414.846	444.300	473.180	501.571	531.665	563.565	597.379	633.221	**671.215**
Deposit Money Bank (DMB) Assets	145.196	155.505	165.613	178.058	191.399	205.701	221.030	237.458	**255.062**
SME Finance Market									
Total SME Lending	2.904	3.421	3.975	4.629	5.359	6.171	7.294	8.548	**10.202**
Growth of SME Lending	12%	18%	16%	16%	16%	15%	18%	17%	**19%**
PFI's Demand for DFI Financing									
Value of financed Loans (=DFI Loans and Guarantees)			40	139	268	463	729	1.069	**1.530**
Value of financed Loans through DFI Lending			40	139	238	393	611	909	**1335**
Value of finance Loans through DFI Guarantees			0	0	30	70	118	160	**195**

4. **In servicing 15 percent of the market for MSME finance, the DFI will provide approximately US$1.3 billion for on-lending and guarantees of US$0.2 billion.** As loans comprise 70 percent of the DFI's balance sheet, total assets will be around US$1.8 billion. The remaining assets are invested in cash and securities. The base case has been chosen to model relatively modest loan growth that still reaches sizeable impact. So as to fund this level of increase in its asset base, the DFI will need to issue a bond in year seven of the project, thereby providing a market test of its sustainability.

5. **It is envisaged that the initial equity capital of the DFI will be provided by the government and AfDB in addition to funds provided by donors.** It is assumed that the FGN will provide US$250 million in the base year and year one as equity. AfDB is expected to inject US$50 million of equity in year one. In addition, World Bank and AfDB loans of US$445 million and US$450 million will be on-lent by the FMOF in a series of tranches from the base period until year four (2018) of the project. While the Government has the option to on-lend the World Bank's funds to the DFI or provided them to the DFI as equity, the use of these funds for on-lending to MSMEs and the guarantee facility will remain as stipulated in this project document. In the base case the DFI will need to additionally borrow US$100 million on the domestic bond market to fund its loan book. The bond issue will be FGN-guaranteed, making them attractive for institutional investors, such as Pension Fund Administrators (PFAs).

6. **It is envisaged that the World Bank and AfDB resources will be disbursed to the FMOF for on-lending to the DFI gradually over the life of the project in a series of tranches.** Initially, prior to disbursing the funds at its disposal for their designated purposes the DFI will invest the funds mainly in FGN securities to generate income to cover administrative expenses and contribute to increasing the DFI's capital base. Over time, the DFI will increasingly deploy the funds at its disposal to provide to eligible PFIs for funding and risk-sharing of their MSME exposures.

7. **The CGF aims to provide partial (50 percent) credit risk coverage for 3.8 percent or US$390 million of MSME lending.** The capital fund for the CGF (which will be a wholly owned subsidiary of the DFI) will be provided by an initial capital injection of US$35 million and through the retained earnings of the CGF. Retained earnings - fees and income on security investments - will be reinvested in the fund in order to allow for higher leverage over the years. Initially, PFIs may require a full cash reserve for each guarantee issued. However, far from every loan for which a guarantee is issued will default, and hence, over time - once banks gain more confidence - less than a 100 percent cash reserve to back each guarantee will be needed. The financial model assumes that for every dollar guaranteed only 12.5 cents will need to be reserved in cash. This translates into a so-called leverage factor of 8. For each US$12.5 reserved in cash, the DFI can issue 100 in guarantees, resulting in 200 in loans (assuming that the guarantees provide 50 percent loan coverage). The simulation assumes that the DFI guarantees five-year loans with a one-year grace period. Defaults will occur annually (starting from the year after the grace period). If, for instance, a default takes place in year two, the amount due plus the remaining outstanding balance will be paid out. With an assumed annual default rate of 5 percent, over the five-years, 23.8 percent will be written off from the initial guarantee amount issued.

8. **The following table shows the balance sheet of the DFI.** The equity and investments of the CGF are included as part of the assets and equity of the DFI. In addition, the financial guarantees of the CGF are shown as off-balance sheet items.

Table 2: DFI Balance Sheet Base Case

Periods	Base (0)	Period 1	Period 2	Period 3	Period 4	Period 5	Period 6	Period 7
Dates	31-Dec-14	31-Dec-15	30-Dec-16	30-Dec-17	30-Dec-18	30-Dec-19	29-Dec-20	29-Dec-21
BALANCE SHEET								
Cash and Central Bank	2	12	19	25	29	30	32	34
Due From Banks	0	0	0	0	0	0	0	0
Securities, and Investments	98	526	804	972	1.027	906	719	523
Loans (Net)	0	40	138	238	392	611	909	1.335
Performing Loans	0	40	139	240	396	616	917	1.346
Non-performing Loans	0	0	0	1	2	4	8	12
Provisions (-)	0	0	2	3	6	10	15	23
Other Assets	0	0	0	0	0	0	0	0
Total Assets	**100**	**577**	**961**	**1.235**	**1.448**	**1.547**	**1.660**	**1.892**
Deposits	0	0	0	0	0	0	0	0
Central Bank	0	0	0	0	0	0	0	0
Due to Banks	0	0	0	0	0	0	0	0
ELA	0	0	0	0	0	0	0	0
Borrowings and Subordinate Debt	0	270	570	770	895	895	895	995
Other Liabilities	0	0	0	0	0	0	0	0
Total Liabilities & Equity	0	270	570	770	895	895	895	995
Net Total Equity	100	307	391	465	553	652	765	897
Total Liabilities & Equity	**100**	**577**	**961**	**1.235**	**1.448**	**1.547**	**1.660**	**1.892**
Financial Guarantees (off balance sheet)	0	0	0	30	70	118	160	195

9. **The DFI's initial average cost of funding is expected to be relatively low, because it will have access to concessional subordinated loans** priced at LIBOR plus a 100 basis points IBRD spread, resulting in a naira cost of IBRD and AfDB funding estimated at 4.6 percent (under the assumption that the Government provides a dollar/naira swap and takes the exchange rate risk).

10. **The faster the DFI is able to increase its lending, the sooner it will need to issue more expensive corporate bonds.** In the base case, the first bond will be issued in year seven. It is assumed that government bond rates decrease slightly from 13.5 percent in year one to 11 percent in year seven due to continued fiscal consolidation. In addition to meeting its funding costs, the DFI will need to cover operating expenditures. These are set initially at US$5 million, growing to approximately US$16 million. These operating expenditures are based on cost estimates for staff, consultants, rent, and information technology.

11. **Based on current market conditions, it is assumed that the DFI will charge 11 percent on its loans, thereby partly passing on the concessional terms of the subordinated loans while still enabling the DFI to generate income and a return on equity (ROE).** Over the project period, the margin earned by the DFI decreases in-line with the increase in its funding costs. The DFI is expected to charge an annual guarantee fee of 3 percent on average guaranteed amounts outstanding and an up-front fee on guarantees issued of 1 percent. Pricing by PFIs to their borrowers will be determined by the PFIs themselves.

Table 3: DFI Income Statement Base Case

Periods	Base (0)	Period 1	Period 2	Period 3	Period 4	Period 5	Period 6	Period 7
Dates	31-Dec-14	31-Dec-15	30-Dec-16	30-Dec-17	30-Dec-18	30-Dec-19	29-Dec-20	29-Dec-21
PROFIT & LOSS ACCOUNT								
Interest Incomes	0	13	70	112	139	157	174	198
Interest Expenses (-)	0	0	-12	-26	-35	-41	-41	-41
Net Fee & Commission Incomes (+/-)	0	0	0	1	2	4	6	7
Provisions (-)	0	0	-1	-2	-3	-4	-6	-8
Other Incomes (Expenses) (+/-)	0	-5	-8	-12	-13	-14	-15	-16
Claims Paid	0	0	0	0	-2	-3	-6	-8
Net Profit before Taxes (+-)	0	7	49	74	89	99	112	133
Net Profit After Taxes (+-)	0	7	49	74	89	99	112	133
Net Profit After Dividends (+-)	**0**	**7**	**49**	**74**	**89**	**99**	**112**	**133**

12. **CAMEL analysis of the base case shows that the DFI is profitable and well capitalized**. After the ramp-up period of year three, the return on average equity (RoAE) ranges between 14.5 percent and 17.4 percent, which is slightly below typical returns available in Nigeria, but in line with the mandate of a DFI. The return on average assets (RoAA) ranges between 6.6 percent and 6.7 percent. Income in year seven is generated in the following proportions: 58 percent from interest on loans, 38 percent from investment in government bonds, and 3 percent from guarantee fees. After the ramp-up period, the DFI has a high capital-adequacy ratio (CAR) due to its large Tier 1 and Tier 2 capital base. CAR remains well above the minimum regulatory capital requirement of 15 percent. The profitability and CAR of the DFI decreases with the increasing size of its loan book, because the DFI increasingly needs to fund itself through bond issuance.

13. **As a wholesale institution, the DFI will lend to PFIs rather than end-borrowers, thereby preserving the quality of the DFI's assets.** The DFI faces lesser credit risk as a wholesale institution, whereby it is shielded from credit risk by PFIs, and due to the eligibility criteria applied to PFIs as well as security in the form of recourse to the PFIs' assets. While concentrating on lending to MSMEs, the DFI's exposure will be broadly diversified among different sectors. In addition, the DFI will be subject to limited liquidity risk, because it funds itself through long-term debt and not through savings, and it will impose a ceiling of 8 on the leverage factor of the CGF.

Table 4: DFI Financial Ratios Base Case

Periods	Base (0)	Period 1	Period 2	Period 3	Period 4	Period 5	Period 6	Period 7
Dates	31-Dec-14	31-Dec-15	30-Dec-16	30-Dec-17	30-Dec-18	30-Dec-19	29-Dec-20	29-Dec-21
PERFORMANCE INDICATORS								
CAPITAL								
% Capital Adequacy Ratio (CAR)	0.0%	1105.9%	485.4%	354.1%	252.6%	178.3%	132.3%	99.7%
ASSET QUALITY								
% NPLs to Gross Loans	0.0%	0.0%	0.2%	0.4%	0.6%	0.7%	0.8%	0.9%
EARNINGS								
% ROAA (Net Income after Tax-to-Total Asse	0.0%	2.2%	6.4%	6.7%	6.6%	6.6%	6.6%	6.7%
% ROAE (Net Income after Tax-to-Equity)	0.0%	3.6%	14.0%	17.2%	17.4%	16.4%	15.1%	14.5%

14. **In addition to the base-case scenario presented, a low and a high case scenario were established to stress test the business model of the DFI. Results of the scenario analysis demonstrate that the DFI stays profitable and well capitalized in all cases.** After the ramp-up period of year three, the RoAE ranges between 16.9 percent and 21.1 percent for the low case and between 14.6 percent and 16 percent for the high case. In both cases the DFI has a high, although decreasing, CAR that stays well above the minimum capital requirements. The total value of financed SME loans differs strongly across the scenarios**.** In year seven of the low case, the DFI only funds US$0.7 billion through its lending and guarantee activities, while in the high case it funds US$2.9 billion. It can again be assumed that the asset quality will be high. As in the base case, the liquidity risk in the low and high cases is limited.

Annex 7: Economic Analysis

FEDERAL REPUBLIC OF NIGERIA: Development Finance Project

1. **The strategic focus of the project is to broaden access to finance for MSMEs.** Finance is a critical element for the development of MSMEs, and several studies have highlighted the negative consequences on MSME growth and development of limited access to financial resources compared to larger organizations (See Levy, 1993; Saito and Villanueva, 1981; Peel and Wilson, 1996).[33] According to the Nigerian MSME finance study undertaken by the World Bank in 2011–2012,[34] more than half of all firms interviewed reported that access to finance was either a severe or a major constraint. Access to finance was also the second biggest obstacle faced by firms after power supplies. The situation is challenging, as only about 9.5 percent of firms had a line of credit, and 4 percent had an outstanding loan.[35] This is relatively low, given that in sub-Saharan Africa an average of 17 percent of small-size firms and 33 percent of medium-size firms have a bank loan or a line of credit. An update of the Enterprise Survey for 2014 confirms these results: only 12.5 percent of enterprises in Nigeria report having a loan or active line of credit compared to the global Enterprise Survey average of 36.5 percent. A mere 8 percent of micro-firms (with less than 5 employees) have a loan or line of credit; among SMEs (with more than five and fewer than 250 employees) this rate is 12 percent, whereas among large firms (more than 250 employees), 40 percent have access to a loan or a line of credit. Moreover, while the utilization of loans by large firms is in line with rates in comparator economies, this rate among SMEs lags well behind other countries like Brazil (63 percent), Ghana (36 percent), China (30 percent), Kenya (24 percent), and South Africa (21 percent).

2. **The DFI will contribute to alleviating specific financing constraints that hamper the growth of enterprises.** The DFI will be set up as a second-tier institution, providing guarantees and wholesale funding to financial institutions with the aim of enhancing access to finance and term lending to MSMEs. Given that smaller businesses are potentially one of Nigeria's most powerful sources of economic growth, comprising the lion's share of employment and GDP,[36] the DFI, will promote more diversified and inclusive growth[37] as well as sustained poverty alleviation.[38] This underlines the rationale for public intervention and funding, as the financial system has not been able to adequately address gaps in the provision of finance to MSMEs.

---

[33] Levy B (1993) "Obstacles to Developing Indigenous Small and Medium Enterprises: An Empirical Assessment," The World Bank Economic Review; Saito K and Villanueva D (1981) "Transactions costs of credit to the small-scale sector in the Philippines," Economic Development and Cultural Change; Peel M & Wilson N (1996) "Working Capital and Financial Management Practices in the Small Form Sector," International Small Business Journal

[34] Data from Enterprise Survey 2011 completed for "Financing Small- and Medium-Sized Enterprises in Nigeria"; G. Berg, M. Fuchs, L. Iacovone, T. Jaeggi, A. Lovegrove, and C. Villegas Sanchez, July 2012 .

[35] Ibid.

[36] MSMEs accounted for over 25 percent of total employment in Nigeria in 2007 and contributed 46.5 percent of GDP in 2010. Source: Enterprise Baseline Survey 2012 by SEDIN and SMEDAN

[37] World Bank, "Finance for all, policies and pitfalls in expanding access," 2008; DEG Atrium dialogue, "Promoting small and medium Enterprises, Their importance and the role of Development Finance Institutions in supporting them," November 2010

[38] Singh, Raju and Y. Huang, 2011, "Financial Deepening and Property Rights: Evidence from Sub-Saharan Africa," IMF Working Paper No. 11/196. Authors demonstrate that financial deepening is associated with less poverty and income disparities in SSA countries and that this is most important in early stages of financial development. Using different measures of poverty and a sample of SSA countries, poverty is inversely related to financial deepening.

3. This economic analysis aims to assess the benefits associated with increased availability and access to finance for MSMEs. The project will increase availability of funding through technical assistance, lines of credits, and partial credit guarantees to enable banks to build up high-quality MSME loan portfolios. The DFI will be a sustainable institution that will refinance itself on the capital market by issuing corporate bonds. The financial intermediation supported by the DFI will contribute to increasing the income of Participating Financial Institutions (PFIs).

4. In addition to its impact on the financial sector, the project has a broader benefit that will be captured through improved MSME performance. The products provided by the new DFI (e.g., term finance, risk sharing facilities) are currently not broadly available, and it is thus assumed that provision of DFI loans and guarantees will have an impact similar to removing credit constraints, resulting in an increase in sales made by MSMEs.

5. The economic analysis captures the cost of the project, currently estimated at US$1.3 billion (NGN208 billion). It encompasses US$950 million as debt financing (on-lending of US$500 million including TA sourced from the World Bank, plus parallel financing of US$450 million from other donors) and US$300 million equity provided by the FGN and donors. The costs and benefits of the project are computed and compared to a counterfactual to derive the net present value (NPV) using a discount rate of 10 percent[39] to calculate the economic rate of return (ERR) of this investment. Outcomes are considered over alternative lifetimes of ten and seven years.

Impact of the Project on the MSME Lending Market

I. Reference Scenario (Base Case):

6. The economic analysis, while based on a financial analysis of the DFI, aims to quantify the larger economic impact of the project. The project is expected to impact the MSME credit market as a whole through a **catalytic effect on MSME lending. In addition to the proportion of the market directly affected by the DFI through PFIs** (see base case in the Financial Analysis section)**,** the project is expected to increase lending to MSMEs by promoting institutional capacity building as well as enhancing the lending environment. The technical assistance component will instill knowledge about new lending techniques, strengthen the capacity of businesses to prepare bankable projects, and provide support for institutional development geared toward enhancing MSME finance. As a result of improved market conditions on both the supply and demand sides, it is expected that banks will scale up their MSME lending beyond the facilities (funds and partial guarantees) provided by the DFI.[40]

Thorsten Beck & Asli Demirguc-Kunt & Ross Levine, 2005. "SMEs, Growth, and Poverty," NBER Working Papers 11224, National Bureau of Economic Research, Inc. The paper examines a broad cross country sample of 58 developing countries and finds that financial development (measured by the ratio of financial intermediation to the private sector to GDP) reduces income inequality by disproportionately raising income of the poor.

[39] This rate is in-line with DFID Nigeria's standard discount rate used for Financial Sector Development Projects. (see DFID Business Case—Financial Sector Development in Nigeria—Extension and Scale-Up).

[40] This amount will be sensitive to the disbursement profile of the project. An early disbursement of funds, in particular of the TA component, is expected to result in greater participation of the private sector by year five.

Baseline - Size of Current MSMEs Lending Market Size:

7. **The current MSME market size has been estimated using the World Bank's MSME Finance study.** The study indicates that volume of loans allocated to MSMEs represented about 2 percent of banks' total assets and about 4 percent of their lending in 2011[41]. Although banks that provided data represented only about 32 percent of the banking sector assets, these findings are assumed to be representative of the whole industry. Based on these assumptions the MSME loan market is estimated to be around NGN547 billion (US$3.4 billion) by the end of 2014, representing 2.2 percent of total banking system assets.

Counterfactual

8. **Without the project, over the five year period under consideration, it is assumed that the ratio of MSME loans to total banking assets is expected to grow from 2.2 percent to 2.6 percent over seven years,**[42] while the ratio volume of MSME loans to total lending is expected to grow from 4.4 percent to 5.1 percent. As the economy grows, banks are expected to gradually increase their lending to MSMEs, but at a relatively slow pace.

Volume of Loans (size of the MSMEs lending market) – under the base case

9. **In the base case the volume of lending is expected to grow from 2.2 percent of banks' balance sheet and 4.4 percent of total lending to about 3.6 percent of total banking system assets and 7.2 percent of total loans after seven years.**

- With the project, MSME lending is projected to cumulatively grow to NGN2 trillion (US$10.2 billion).
- Without the project, under the counterfactual assumptions, MSME lending will grow to NGN1.1 trillion (US$6.6 billion) by year seven. Thus, the project results in net addition lending to MSMEs of NGN575 billion (US$3.6 billion) over a seven-year period.
- Over ten years, the net addition in the base case is expected to be NGN1.4 trillion (US$8.6 billion), with a MSME lending market projected to be NGN2.8 trillion (US$17.4 billion) compared to NGN1.4 billion (US$8.8 billion) under the counterfactual. This rapid increase reflects the assumption that, once the DFI reaches scale, PFIs will leverage the support provided by the new DFI, having learned from and adopted the techniques and funding modalities piloted by the new DFI. Simultaneously, parallel activities aimed at improving the lending environment will yield results, as PFI will be taking more risks and scaling up lending.

---

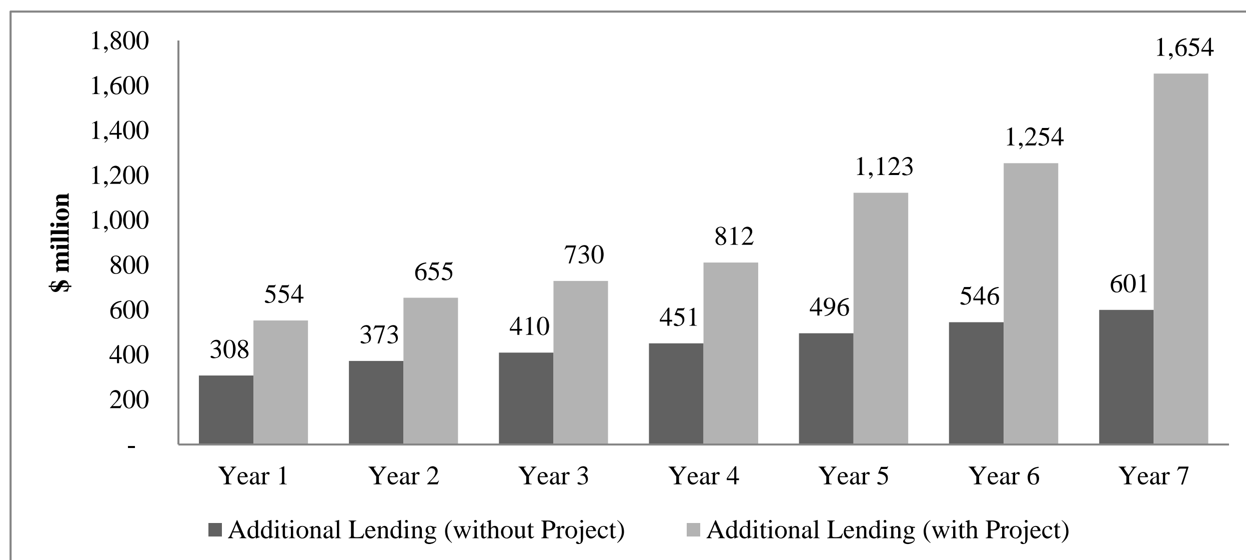
[41] Financing Small- and Medium-Sized Enterprises in Nigeria; Gunhild Berg, Michael Fuchs, Leonardo Iacovone, Thomas Jaeggi, Andrew Lovegrove, and Carolina Villegas Sanchez, July 2012. The lack of a single definition of MSMEs makes comparison between bank lending practices difficult. Thus, the heterogeneity of ranges observed in the definition of MSMEs is dealt with using the classification as described by each bank surveyed.

[42] This is based on the assumption that the market growth is expected to be in-line with the average recorded over the last five years.

Volume of MSME lending (with and without the project), seven years

Items	Unit		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Real GDP	million USD	yearly	444,300	473,180	501,571	531,665	563,565	597,379	633,221	671,215	711,487	754,177	799,427
Total Lending by Banks	million USD	Yearly	77,753	82,806	89,029	95,700	102,851	110,515	118,729	127,531	136,961	147,064	157,887
Deposit Money Bank (DMB) Asset	million USD	yearly	155,505	165,613	178,058	191,399	205,701	221,030	237,458	255,062	273,923	294,129	315,774
Counterfactual - MSMEs Lending Market Without Project													
Total MSMEs lending without Project	million USD	Yearly	3,421	3,729	4,102	4,512	4,963	5,460	6,006	6,606	7,267	7,993	8,793
Volume / Real GDP	%	Yearly	0.77%	0.79%	0.82%	0.85%	0.88%	0.91%	0.95%	0.98%	1.02%	1.06%	1.10%
Volume of MSMEs Lending / Total lending	%	Yearly	4.40%	4.50%	4.61%	4.71%	4.83%	4.94%	5.06%	5.18%	5.31%	5.44%	5.57%
Volume of MSMEs Lending / Total Bank balance sheet	%	Yearly	2.20%	2.25%	2.30%	2.36%	2.41%	2.47%	2.53%	2.59%	2.65%	2.72%	2.78%
Base Case Scenario - MSMEs Lending Market With Project													
Total MSMEs lending with Project	million USD	Yearly	3,421	3,975	4,629	5,359	6,171	7,294	8,548	10,202	12,327	14,706	17,368
Volume /GDP	%	Yearly	0.77%	0.84%	0.92%	1.01%	1.10%	1.22%	1.35%	1.52%	1.73%	1.95%	2.17%
Volume of MSMEs Lending / Total Lending	%	Yearly	4.40%	4.80%	5.20%	5.60%	6.00%	6.60%	7.20%	8.00%	9.00%	10.00%	11.00%
Volume of MSMEs Lending / Total Bank balance sheet	%	Yearly	2.20%	2.40%	2.60%	2.80%	3.00%	3.30%	3.60%	4.00%	4.50%	5.00%	5.50%

Volume of Additional Lending, per annum, over seven years



Illustrative Impact on the Nigerian Economy

Impact at the PFI Level

10. The increased volume of loans generated through the project is expected to provide value added to the PFIs. The increased value added is a reflection of the increase in the volume of loans to MSMEs that more than compensates for downward pressure on PFI lending spreads.

Impact on MSME Activities

a) *Expected increase in MSME sales*

11. Increased access to finance will increase firm-level growth (i.e., increased sales). The impact of removing credit constraints on sales has been confirmed by several studies.[43] According to the 2010 Enterprise Survey data for Nigeria, annual sales of credit-constrained firms are 3.5 percent lower in real terms than for firms with access to credit. There are other benefits associated with increased access to finance, such as increased firm-level productivity and spillovers on other firms and the economy as a whole. These can generate additional income and employment; however, due to difficulties in quantifying them, they are excluded from the analysis.

b) *Distribution of benefits across different factors of production*

12. Given the heterogeneity of firms targeted under the project, a representative firm is defined using the Enterprise Survey data to illustrate the factors underpinning the growth in sales presented previously.[44]

Firm-Level Assumptions	
Average sales in year zero	US$ 726,097
Cost-to-sales ratio	83%
Annual real growth without the project	12%
Additional annual real growth with the project	3.5%
Average loan requirement, year zero	US$ 267,674

13. The ratio of these cost items to sales is expected to remain constant and proportional to sales. It is expected that loans provided through the DFI or within the improved environment resulting from the project will be extended at an estimated interest rate of 23 percent (nominal terms) with an amortization period of up to ten years. The analysis compares the benefits associated with lending by the DFI with the counterfactual case, where it is assumes that equivalent annual savings would be needed to finance a similar investment. After comparing the different outcomes, the yearly real increase in sales resulting from obtaining a loan can be disaggregated as follows:

[43] Several papers assess the impact of removing credit constraints at the SME level. See Thorsten Beck, Financing Constraints of SMEs in Developing Countries: Evidence, Determinants and Solutions; 2007; Banerjee, Abhijit V. and Esther Duflo. 2004. "Do Firms Want to Borrow More? Testing Credit Constraints Using a Directed Lending Program." CEPR Discussion Paper 4681.

[44] Technical data on sales and underpinning factors such as the cost structure are derived from Enterprise Survey data as collected in 2010, which has been adjusted by the yearly real growth rate of firms as computed from the same source.

Cost Structure (percentage of incremental sales)	
Cost of input (raw material) and external supplies	52%
Cost (fixed cost, rent, overhead, etc.)/Sales	13%
Profit/Sales	12%
Labor cost/Sales	12%
Tax/Sales	5%
Cost of finance/Sales[45]	6%

14. From the given cost structure, the net economic benefits of the project arise as increased demand for inputs as well as additional household income and profits. These benefits are expected to give rise to multiplier effects and will thereby further contribute to aggregate consumption, investment, and possibly government spending*:*

i. Cost of inputs (raw material, etc.) and external supplies are not assessed to be adding value. Given the structure of the Nigerian economy, which is heavily reliant on imports of raw materials and spare parts,[46] any increase in sales will be accompanied by increased imports of raw materials and intermediate goods. Only fixed costs (land, rent, overheads), representing 13 percent of increased sales, are expected to boost the local economy and therefore count toward value added created by the project.
ii. Household income and gross profits represent 24 percent of sales. These elements are analyzed together, as MSMEs are very often owned by households, and profits will be used to supplement households' income or consumption.

c) Firms' performance in relation to total lending

15. Under the base case, the increased sales of an average firm are a result of loans obtained as a result of the project. Thus, based on given assumptions, for every NGN1.00 lent, sales are expected to increase cumulatively and over ten years, by NGN1.71; and based on the cost structure estimates given, the value added created corresponds to 37 percent of the increase in sales.

Aggregate Benefits

16. By year seven the project is expected to increase total lending to MSMEs by about NGN575 billion (US$3.6 billion) compared to the counterfactual. This increase will have a positive impact on Nigerian GDP:

a) The cumulative value added, generated from the increase in MSMEs' sales, is estimated to be **US$2.6 billion** over a seven-year period and US$6.1 billion over ten years. This increased impact after year seven is driven by the rapid market growth as PFIs become more conversant with the MSME market and scale up their MSME lending.

[45] This is not captured as part of the value added at the MSME levels as it has already been captured by the interest rate paid to PFIs.
[46] See Eme and Al. "Determinants Of Nigeria's Non-Oil Import Demand," South-Eastern Europe Journal of Economics 1 (2013) 79–100

b) PFI income will cumulatively increase by US$374 million over seven years and by US$878 million over ten years.

(in $ million)	Value Added After 7 years	Value Added After 10 Years
Incremental Value Added	2,947	7,013
- Interest paid	374	878
- Return on fixed costs	819	1,952
-Return to households (owners and other workers)	1,754	4,182
Of which		
- Labor costs	*720*	*1,716*
-Profit	*1,034*	*2,465*

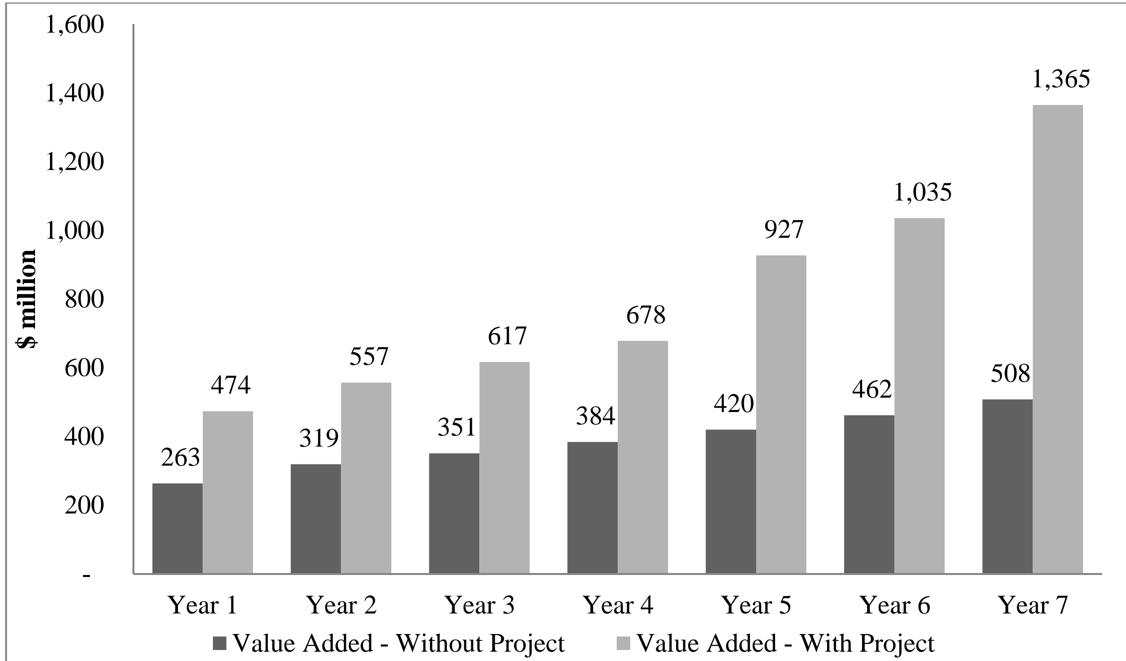
c) To further illustrate these benefits, the volume of loans generated through the project can be converted into the number of firms reached, assuming that average loans requirement is about US$250,000. Similarly, assuming that the average annual wage of the representative firm is about US$1,500 and using the illustrative cost structure presented previously, 13 percent of the incremental sales will go to workers. These are summarized as follows:

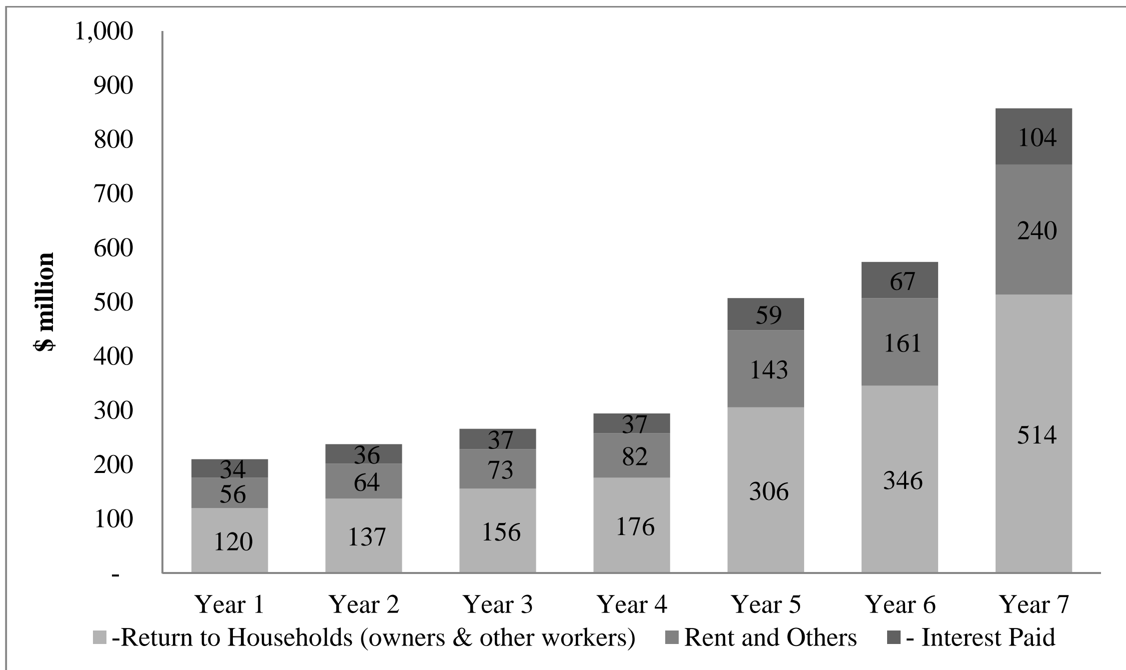
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Number of loans	983	1,128	1,278	1,443	2,507	2,834	4,214
Number of job created	31,227	35,826	40,606	45,836	79,641	90,051	133,884

Economic Rate of Return

17. The project is expected to yield benefits of US$2.9 billion over seven years and US$7 billion after ten years, distributed to entrepreneurs, wage earners, and financial institutions. These benefits are financed at an estimated cost of US$1.3 billion. For every dollar invested in the project, about US$2.23 of benefits is created after seven years. Assuming that benefits are proportional to cost, the US$500 million invested by the World Bank will yield benefits estimated at US$1.11 billion after seven years. At a discount rate of 10 percent, the project represents a net present value of US$1.6 billion after seven years (US$2.1 billion after ten years) and an ERR of 26 percent after seven years (and 38 percent after ten years).

Summary of Annual Benefits



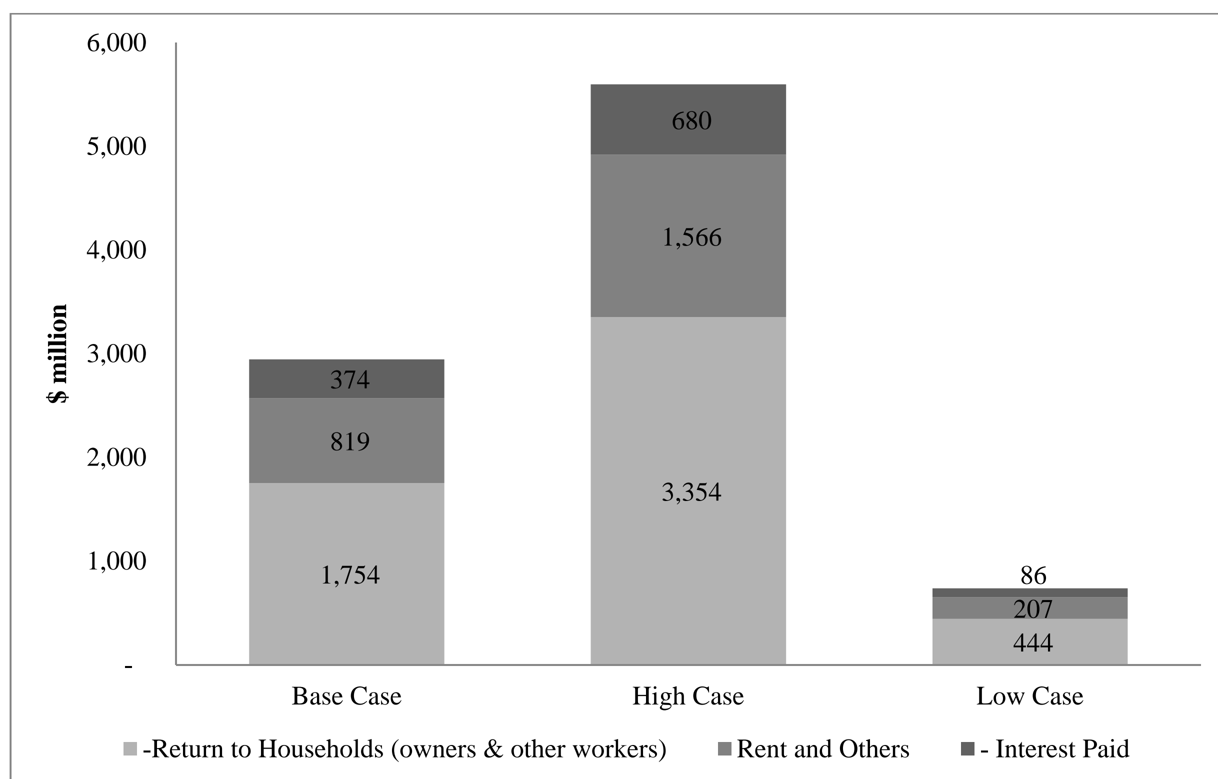


Sensitivity Analysis

18. To test the robustness of these results, we present the impact on the project of changing some key assumptions. The economic impact of the *low case scenario* (low market growth, low uptake of DFI, high interest rates) and *high case scenario* (high market growth, high uptake of DFI funding, low interest rates) described in the financial analysis are presented as follows:

Scenarios	MSME Lending (% of Banks' Assets)		MSME Lending (% of total Lending)		NPV ($ millions)		ERR	
	7 Years	*10 Years*	*7 Years*	*10 Years*	*7 Years*	*10 Years*	*7 Years*	*10 Years*
Base case	4.00%	5.50%	8.00%	11.00%	$1,647	$2,185	25.91%	37.8%
High Case	5.00%	6.50%	10.00%	13.00%	$4,300	$4,308	71.78%	75.65%
Low Case	3.00%	3.60%	6.00%	7.20%	($563)	($270)	-13.1%	4.6%

Benefits Associated with Each Scenario[47]



[47] Compared to the counterfactual over a seven-year period.

Summary Table—Increased MSME Lending

Items	Unit		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Real GDP	million Naira	yearly	71,088,045	75,708,768	80,251,295	85,066,372	90,170,355	95,580,576	101,315,410	107,394,335	113,837,995	120,668,275	127,908,371
Real GDP	million USD	yearly	444,300	473,180	501,571	531,665	563,565	597,379	633,221	671,215	711,487	754,177	799,427
Total Lending by Banks	million Naira	yearly	12,440,408	13,249,034	14,244,605	15,311,947	16,456,090	17,682,407	18,996,639	20,404,924	21,913,814	23,530,314	25,261,903
Total Lending by Banks	million USD	Yearly	77,753	82,806	89,029	95,700	102,851	110,515	118,729	127,531	136,961	147,064	157,887
Deposit Money Bank (DMB) Asset	million Naira	yearly	24,880,816	26,498,069	28,489,210	30,623,894	32,912,179	35,364,813	37,993,279	40,809,847	43,827,628	47,060,627	50,523,807
Deposit Money Bank (DMB) Asset	million USD	yearly	155,505	165,613	178,058	191,399	205,701	221,030	237,458	255,062	273,923	294,129	315,774
Counterfactual - MSMEs Lending Market Without Project													
Total MSMEs lending without Pro	million Naira	Yearly	547,378	596,642	656,306	721,937	794,130	873,544	960,898	1,056,988	1,162,686	1,278,955	1,406,851
Total MSMEs lending without Project	million USD	Yearly	3,421	3,729	4,102	4,512	4,963	5,460	6,006	6,606	7,267	7,993	8,793
Volume / Real GDP	%	Yearly	0.77%	0.79%	0.82%	0.85%	0.88%	0.91%	0.95%	0.98%	1.02%	1.06%	1.10%
Volume of MSMEs Lending / Total lending	%	Yearly	4.40%	4.50%	4.61%	4.71%	4.83%	4.94%	5.06%	5.18%	5.31%	5.44%	5.57%
Volume of MSMEs Lending / Total Bank balance sheet	%	Yearly	2.20%	2.25%	2.30%	2.36%	2.41%	2.47%	2.53%	2.59%	2.65%	2.72%	2.78%
Additional Lending (without Proje	million Naira	Yearly	-	49,264	59,664	65,631	72,194	79,413	87,354	96,090	105,699	116,269	127,896
Additional Lending (without Proje	million USD	Yearly	-	308	373	410	451	496	546	601	661	727	799
Base Case Scenario - MSMEs Lending Market With Project													
Total MSMEs lending with Project	million Naira	Yearly	547,378	635,954	740,719	857,469	987,365	1,167,039	1,367,758	1,632,394	1,972,243	2,353,031	2,778,809
Total MSMEs lending with Project	million USD	Yearly	3,421	3,975	4,629	5,359	6,171	7,294	8,548	10,202	12,327	14,706	17,368
Volume /GDP	%	Yearly	0.77%	0.84%	0.92%	1.01%	1.10%	1.22%	1.35%	1.52%	1.73%	1.95%	2.17%
Volume of MSMEs Lending / Total Lending	%	Yearly	4.40%	4.80%	5.20%	5.60%	6.00%	6.60%	7.20%	8.00%	9.00%	10.00%	11.00%
Volume of MSMEs Lending / Total Bank balance sheet	%	Yearly	2.20%	2.40%	2.60%	2.80%	3.00%	3.30%	3.60%	4.00%	4.50%	5.00%	5.50%
Additional Lending (with Project)	million Naira	Yearly	-	88,576	104,766	116,750	129,896	179,673	200,719	264,636	339,849	380,788	425,778
Additional Lending (with Project)	million USD	Yearly	-	554	655	730	812	1,123	1,254	1,654	2,124	2,380	2,661
Net Addition MSMEs Lending (with Project - without Project)	million Naira	Yearly	-	39,312	45,102	51,119	57,703	100,260	113,365	168,546	234,151	264,519	297,883
Net Addition MSMEs Lending (with Project - without Project)	million USD	Yearly	-	246	282	319	361	627	709	1,053	1,463	1,653	1,862

Annex 8: Detailed Sectoral Analysis[48]

FEDERAL REPUBLIC OF NIGERIA: Development Finance Project

1. This Annex provides: (A) a summary of analytical work regarding the Nigerian MSME (including agricultural MSMEs) sectors; (B) an analysis of the availability of SME financial services in Nigeria; (C) an analysis of obstacles to MSME finance in Nigeria; (D) a description of existing Nigerian government MSME financing programs; and (E) institutional weaknesses that undermine the contribution of existing DFIs.

A. Summary of Analytical Work

2. **The World Bank and other donors have undertaken extensive work since 2010 to assess the availability of MSME finance and undertook further analytical work and demand- and supply-side interviews while preparing the proposed operation**. In this regard comprehensive surveys of both supply and demand sides of MSME finance in Nigeria were carried out between 2010 and 2014.[49]

- On the demand side, in 2011 a sample of 511 SMEs were surveyed drawn from a pool of 1,154 SMEs that had been previously surveyed in 2007 to assess their access to financial services and impact of the financial crisis (as part of the World Bank Enterprise Survey in six Nigerian states - Anambra, Abuja, Cross Rivers, Kaduna, Kano, and Lagos). In addition, the 2014 access to finance survey was administered covering 480 MSMEs in four states: Lagos, Kano, Abuja, and Abia.
- On the supply side, the 2011 survey covered 18 financial institutions, representing approximately 60 percent of banking-sector assets in 2011. These institutions included 13 commercial banks, one development finance institution, and four microfinance banks. The 2011 survey data has been supplemented[50] by (i) an analysis of CBN-administered credit programs (both on-lending facilities and credit guarantees) carried out by a World Bank team in early 2014; (ii) demand- and supply-side interviews and further analysis carried out by the World Bank team in late 2013; (iii) an MSME finance supply-side survey of six commercial banks, carried out in early 2014; and (iv) analysis of the need for financial services in the agricultural sector carried out in 2013–2014.

---

[48] This Annex summarizes and draws from seven main sources: (i) "Financing Small and Medium Enterprises in Nigeria" (World Bank, 2011); (ii) "Feasibility Study for a New DFI in Nigeria—Agriculture" (RIAS, 2013); (iii) World Bank analysis of CBN-administered development finance schemes carried out in 2014; (iv) a survey of six commercial banks carried out in early 2014, carried out by the World Bank; (v) "Cooperation Framework to Support the New Alliance for Food Security and Nutrition in Nigeria" (New Alliance for Food Security & Nutrition, 2013); and (vi) "Private Sector Survey Results" (Federal Ministry of Agriculture and Rural Development, 2013).

[49] "Financing Small and Medium Enterprises in Nigeria" (World Bank, 2011); 2014 MSME Demand Survey; 2014 Bank questionnaire.

[50] The 2011 survey also analyzed CBN-administered credit programs, but less extensively than the 2014 analysis.

B. Availability of MSME Financing

MSME Finance - Demand Side Analysis

2011 Survey Results

3. **The 2011 survey found that while the percentage of SMEs with a loan or line of credit outstanding had roughly doubled since 2007, access to finance for SMEs remained at a low overall level**. Only 9.5 percent of surveyed SMEs had a loan or line of credit from a financial institution in 2010, whereas in 2007, this percentage was 5.1 percent. This reflected a statistically significant increase in firms' access to finance, albeit from a very low base. Interestingly, very few of the same firms had a loan or line of credit in 2007 as well as in 2010. While 8 percent of SMEs had no loan or line of credit in 2007, but had one in 2010, 4 percent of SMEs had a loan or credit line in 2007, but not in 2010. This suggests that most loans and lines of credit observed in 2010 were indeed new credits. The percentage of firms with an overdraft facility decreased from 8 percent in 2007 to 4 percent in 2010, however. This difference is statistically significant.

4. **The increase in firms' access to finance is also reflected in how SMEs finance their working capital and fixed assets, with bank financing of working capital increasing slightly from 1 percent in 2007 to 3 percent in 2010.** Bank financing of fixed assets was on an even lower level. The comparison of these figures to the sub-Saharan average of 8.4 percent of working capital and 10 percent of investments financed by banks illustrates the very low level of SME access to finance in Nigeria.[51]

5. **Purchases on credit (supplier financing) as a financing method for working capital decreased significantly between 2007 and 2010 and were replaced by financing provided by internal funds**. Possible reasons for this finding could be either high costs of customer and supplier credit or worse economic conditions making it more difficult for customers and suppliers to provide credit. This finding is in line with the observation that the percentage of purchases paid for before delivery had significantly increased from 38 percent to 51 percent during the period. At the same time, the percentage of sales paid for before delivery had significantly increased as well (from 38 percent to 44 percent), indicating that firms were obliged to tighten their own credit terms in response to the tightening of supplier credit. The remaining mismatch seems to have been absorbed by internal funds. A similar drop in customer and supplier financing was observed in the World Bank South Africa survey in 2010. There, however, firms switched from purchases on credit to bank financing, while this has happened in Nigeria to only a very limited degree.

6. **The percentage of SMEs that applied for a loan or line of credit in 2010 was 12.1 percent**.[52] This is a slight increase compared to 2007 (10 percent). The main reasons for not applying for loans were described as: no need, unfavorable interest rates, high collateral requirements, and complicated application procedures (see Table A8.1). Although the main reason not to apply for a loan or line of credit was "no need", this percentage is only 34 percent,

---

[51] Source: World Bank Enterprise Surveys.

[52] This compares to 17 percent in South Africa.

implying that the remaining 66 percent would have considered applying for a loan if the conditions had been more favorable. In South Africa, the percentage of firms reporting no need for loans was greater than 60 percent suggesting a considerably lower mismatch between potential demand and actual supply.

Table A8.1: 2011 Survey—Reasons for SMEs Not Applying for Loans (percentage)

Reasons	2007	2010
No need for a loan	26.4	34.5
Application procedures for loans/lines	21.6	16.2
Interest rates not favorable	24.2	18.3
Collateral requirements too high	18.3	17.8
Size of loan and maturity are insufficient	1.3	1.4
Did not think it would be approved	7.4	6.5
Other	0.9	5.3

Note: 432 observations.

7. **The percentage of credit applications rejected decreased from a very high level of 69 percent in 2007 to 60 percent in 2010.** Even though this reflects fewer credit rejections, the percentage is still high (the comparable figure for South Africa is 22 percent). The most common reasons for rejections according to the interviewed SMEs were related to insufficient collateral or unacceptable cosigners (see Table A8.2).

Table A8.2: 2011 Survey - Reasons Given by SMEs for Rejected Loan Applications (percentage)

Reasons	2007	2010
Collateral or cosigners unacceptable	51.5	41.9
Insufficient profitability	18.2	6.5
Problems with credit history/report	9.1	9.7
Incompleteness of loan application	12.1	12.9
Other objections	9.1	29.0

Note: 31 observations.

8. **Loans that were taken out in 2010 had an average interest rate of 32 percent and an average maturity of 13 months**. This is consistent with the supply-side survey results, which show an average maturity offered by the surveyed financial institutions of 12 months. Close to 80 percent of the loans received by SMEs required collateral.

9. **According to the survey responses, collateral requirements are a major impediment to SMEs' access to finance**. Land, machinery, and equipment are the most frequent collateral assets required by financial institutions. Collateral requirements were one of the main reasons for SMEs not to apply for loans and also the predominant reason for rejecting loan applications. Several banks indicated that they are required by regulation to collateralize all loans above N50,000, but this requirement is not stipulated in CBN regulations, and a few banks indicated that they are offering uncollateralized loans above this threshold and are using cash-flow–based lending techniques to overcome the risks associated with unsecured lending.

10. **The 2014 demand-side finance (DSF) survey that was undertaken between March 2014 and June 2014 provides an update on key aspects of the 2011 survey.** Similar to the 2011 survey, the 2014 demand-side survey is based on adapted questions and methods from the World Bank Group's Enterprise Surveys and includes specific design aspects and questions to address both the constraints on and demand for finance among private sector enterprises in Nigeria. Interviews were conducted in four states: Lagos, Abuja, Abia, and Kano. Five key sectors of economic activity were targeted: agriculture and fisheries, agriculture-related (or light) manufacturing,[53] non-agriculture-related (or heavy) manufacturing,[54] retail and wholesale, and other (select) services. Table A8.3 shows the final distribution of the 477 completed surveys.[55]

Table A8.3: Distribution of Completed Interviews

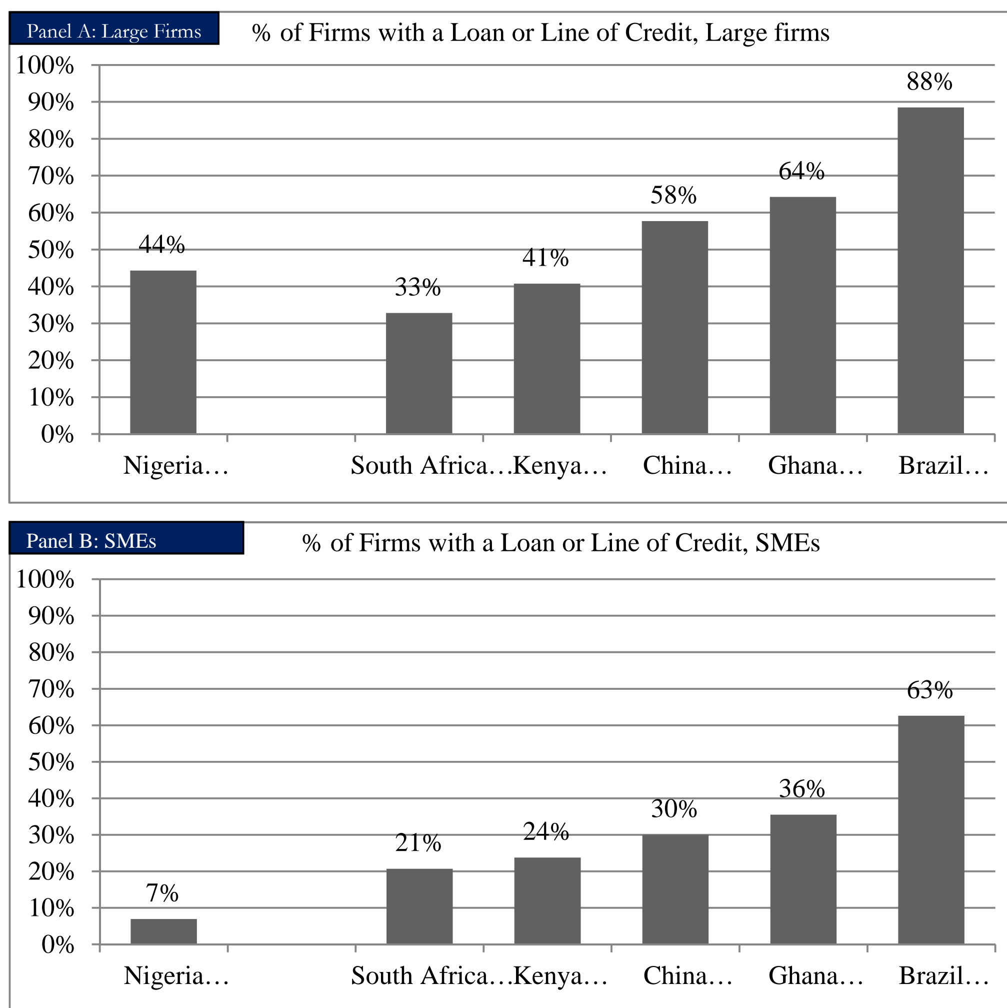
Sector			Location			Size (by emp.)[56]	
Agriculture & Fisheries	97		Lagos	141		Micro (<5)	66
Ag.-related (light) Manuf.	57		Abuja	105		SME (5-249)	358
Non-ag.-related (heavy) Manuf.	69		Kano	124		Large (250+)	14
Retail & Wholesale	140		Abia	107		Refusal	39
Other Services	114						

Results

11. **Utilization of loan-based financing varies strongly by size; among SMEs this rate lags behind comparable economies.** Only 6.7 percent of enterprises report having a loan or active line of credit (compared to the global ES average of 36.5 percent).[57] A mere 3 percent of micro (with less than 5 employees) firms report having a loan or line of credit; among SMEs (with between. 5-249 employees) this rate is 7 percent, while large firms (with more than 250 employees) report a rate of 44%. Among sectors, over 9 percent of agriculture and fisheries report having a loan or line of credit; just under 9 percent of manufacturers have a loan or line of credit. Other services firms have the lowest rate of firms with a loan, at under 4 percent. Moreover, while the utilization of loans by large firms is in line with rates in comparator economies, this rate among SMEs lags well behind countries (see Panel B of Figure A8.1).

[53] Agriculture-related (light) manufacturing includes food/beverages, tobacco, textiles, garments, leather, wood products, furniture.
[54] Non-agriculture-related (heavy) manufacturing includes paper, publishing, coke/refined petroleum products, chemicals, rubber/plastics, minerals, basic metals, fabricated metals, machinery and equipment, computing/office machinery, electrical machinery, radio/communication equipment, precision equipment, motor vehicles, transport equipment, recycling.
[55] All results presented here are survey-weighted.
[56] Note that these size categories are utilized for analysis purposes. Survey design was stratified based on size classifications available in the sample frame, including <10 emp., 10–49 emp., 50–199 emp., 200+ emp.
[57] Care needs to be taken in comparing data across surveys. However, it is noteworthy that in 2014 only 6.7% of SMEs have access to bank loans compared to 9.5% in 2011. This may reflect the aftermath of the 2009 banking crisis that led to tighter supervision of banks and more cautious approach to risk by the banks.

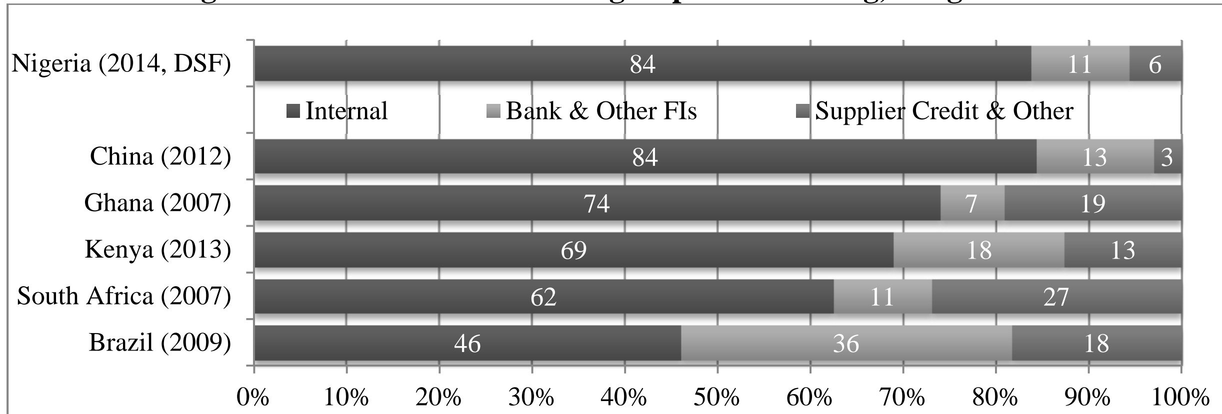
Figure A8.1: Percentage of Firms with a Loan or Line of Credit (by size category)



Source: Enterprise Surveys and Nigeria DSF

12. **Large firms rely more on working capital financing from banks, while SMEs utilize credit from customers and suppliers.** Across various comparable economies, firms predominantly finance their day-to-day operations with internal funds. Large firms in the Nigeria DSF receive 11 percent of their financing for working capital from banks and other financial institutions (FIs), roughly in line with most comparator averages, though falling well behind the average of Brazilian firms at 36 percent and Kenyan firms at 18 percent. Figure A8.2 shows the distribution of firms' reported sources of working capital.

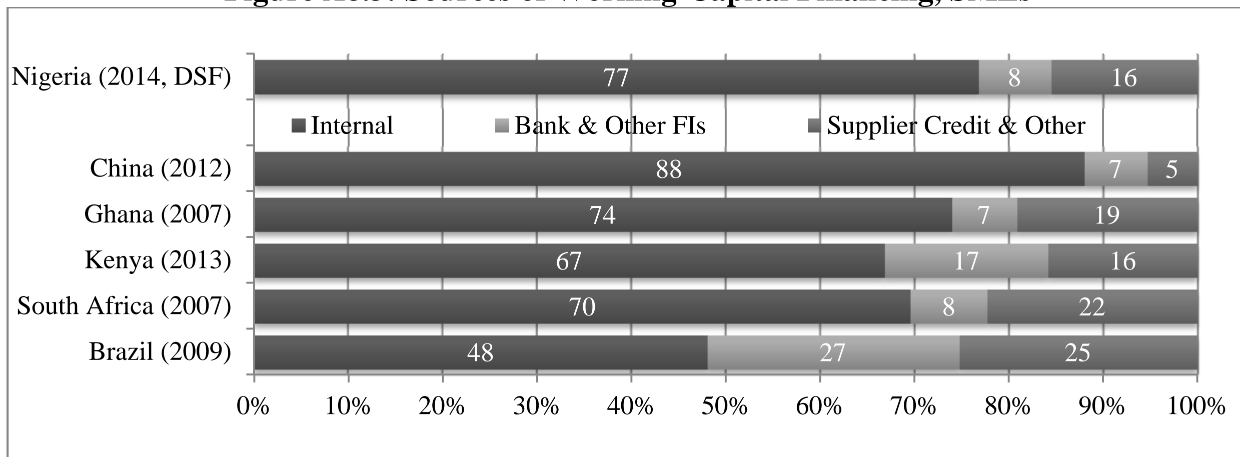
Figure A8.2: Sources of Working Capital Financing, Large Firms



Source: Enterprise Surveys and Nigeria DSF

13. **Figure A8.3 shows that similar to like-sized firms in other economies, SMEs in Nigeria utilize working-capital funds from banks and other FIs at a rate lower than that of large firms.** Likewise, SME firms are much more reliant on day-to-day financing from supplier credit, friends, family, and other informal sources, compared to large firms. Together, the percentage of SME working-capital financing from banks (8 percent) and other sources (16 percent) are in line with SME firms in comparator countries like Ghana and South Africa. These rates differ notably from Brazil and Kenya - where SMEs rely more on external, formalized funding at a higher rate - and China where SMEs predominantly utilize their own retained earnings to finance their operations.

Figure A8.3: Sources of Working-Capital Financing, SMEs



Source: Enterprise Surveys and Nigeria DSF

14. **Figures A8.4 and A8.5 show the sources of firms' financing when they do purchase fixed assets, showing a pattern similar to the sources of working capital.** Across size categories, the use of internal funds predominates (with the exception of Brazil). Yet large firms in Nigeria obtain a third of their financing for fixed asset investments from banks and FIs, a rate only surpassed by large firms in Brazil. By contrast, SMEs in Nigeria turn to banks and FIs for an appreciably lower portion of their investment financing (at 10 percent, this rate is closer to

SMEs in China and Ghana). Perhaps reflecting a need for alternate sourcing of investment financing, SMEs in Nigeria obtain 11 percent of these funds from supplier credit and other sources, a rate second only to Brazil.

Figure A8.4: Sources of Investment Financing, Large Firms

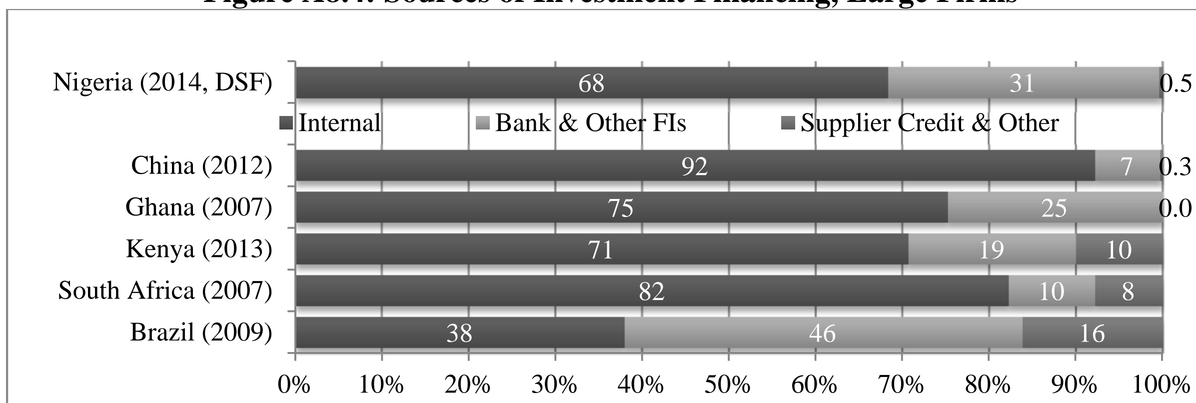
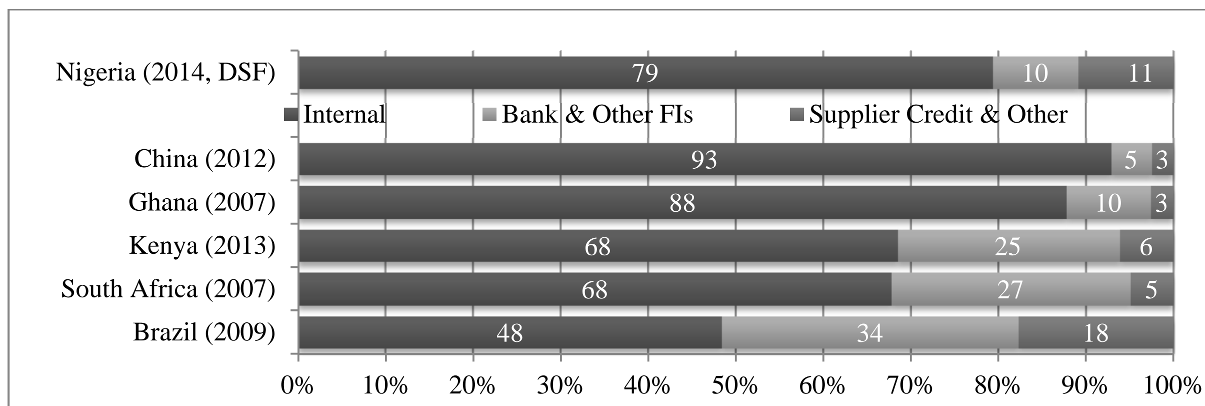


Figure A8.5: Sources of Investment Financing, SMEs



Source: Enterprise Surveys and Nigeria DSF

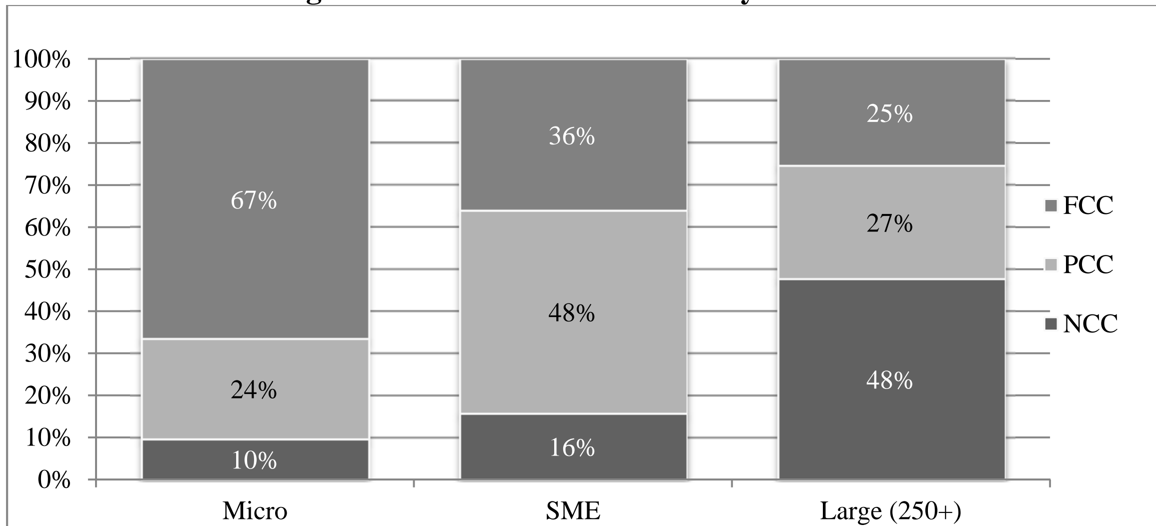
15. **Across all categories, a notably high percentage (41 percent) of firms are fully credit constrained; likewise, a substantial portion of firms (44 percent) report some level of credit constraint**. Utilizing categories based on firms' reported use and need for financing, three broad credit constraint categories are identified.[58] Fully credit-constrained (FCC) firms are either dissuaded from applying for external sources of credit (self-segregated firms) or are outright denied access to credit through rejected applications for loans and/or lines of credit. Partially credit-constrained firms (PCC) have some form of external financing but are self-segregated from applying for additional credit or are only able to receive partial amounts of their desired credit (credit rationed). Finally, non-credit-constrained (NCC) firms report being sufficiently capitalized or having full access to desired credit.

---

[58] Based on Kuntchev et al. (2013), *What Have We Learned from the Enterprise Surveys Regarding Access to Credit by SMEs?* Accessible at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2344038

16. **Notably, the proportion of firms with full access to credit increases over size categories, with only 10 percent of micro firms and 16 percent of SMEs in this category.** Across all size categories, there is a notable *middle* portion of PCC firms that, while having some access to credit services, have either been dissuaded by the terms and conditions of the credit market from applying for a loan or have been fully or partially denied further credit. This middle financing gap is largest for SMEs: 48 percent of SMEs report some level of un-met credit demand, compared to 27 percent of large firms and 24 percent of micro firms. In the third category – those firms that are fully credit constrained (FCC) – micro firms have the highest proportion of FCC firms (a notably high 67 percent), followed by SMEs (36 percent), and lastly large firms (25 percent).

Figure A8.6: Credit Constraints by Firm Size



17. **Among SMEs specifically, the vast majority of firms report having not applied for a loan due to unfavorable terms and conditions; only 4.5 percent of SMEs surveyed report applying for and receiving full approval of their loan application.** Table A8.4 shows the breakdown of the outcome of SME loan applications. Nearly 64 percent were discouraged from applying for a loan due to unfavorable terms and conditions. Meanwhile, only 11 percent of all SMEs even applied for a loan in the last fiscal year; more than half of those (6.4 percent of the overall SME sample) report having applied for a loan but facing a partial or full rejection of their application. Only 4.5 percent of all SMEs in the sample report having received full access to a requested loan. Combined with 14.1 percent of SMEs that report no need for a loan, this translates into a portion of SMEs that do not face some credit constraint of only 19 percent. Put differently, more than 80% of SMEs are constrained by un-met credit demand.

Table A8.4: Credit Rationing among SMEs

No need for a loan	14.1
Did not apply due to terms and conditions	63.8
Did not apply, thought application would be rejected	11.2
Applied and approved	4.5
Applied and rejected, partially or fully	6.4

MSME Finance - Supply-Side Analysis

2011 Survey Results

18. **SME lending constitutes a relatively low proportion of total lending by commercial banks**. For the five banks that supplied appropriately disaggregated data, the weighted average proportion of SME loans to the total lending book of the bank was only 5 percent. However, it should be noted that this may well be an overestimate of the true proportion of SME loans in Nigeria because banks with more commitment to the segment appeared to be more likely to provide disaggregated data (most likely because they are segregating SME data to measure the performance of their own SME business). This level is also low when compared to the share of SME lending in total lending internationally, as shown in Figure A8.7.[59] This finding matches with results from the 2010 survey's demand-side analysis in so far as only a very low percentage of surveyed SMEs reported having had a loan or line of credit from a financial institution in 2010.

19. **The average bank loan to SMEs in 2010 was about N6 million (approximately US$40 thousand), and the average interest rate for the lowest-risk SME customers was around 20 percent in 2010** (although conditions and other fees vary between banks). The average maturity of SME loans is less than 12 months, considerably shorter than that observed among commercial banks in South Africa (where the average maturity was approximately three years).[60] On average, 60 percent of loans are to finance working capital, and the remainder is used for investment financing or other purposes. There appear to be large variations in the quality of SME portfolios across institutions as determined by the nonperforming loan (NPL) ratio. This averaged 16 percent in 2010.

20. **The survey data shows that from 2008 to 2010, the SME lending books of banks expanded** (excluding distressed banks that were intervened by the state), with an increase in the average value and number of loans to SMEs of 13 percent and 24 percent respectively. Some institutions did, however, report declines in both metrics, signaling divided views and commitment to this market segment on the part of the banks. Corresponding to their plans to increase net income from SMEs over three years, a number of banks had plans in place to double or triple the size of their SME lending portfolios. Furthermore, when asked to assess the prospects of the SME market, 9 out of 13 respondents took a positive view, stating that they believed the market to be big and with good prospects. However, the remaining four institutions replied that they viewed the market to be big but with bleak prospects. Some insight into this more negative view can be gained through the discussion of obstacles to lending to SMEs that follows.

[59] The developing country average is based on analysis of data on 45 countries included in the Beck et al (2008) study.
[60] The development finance institution in the sample was able to offer loans of considerably longer maturity.

Figure A8.7: International Comparisons of SME Share of Total Bank Lending

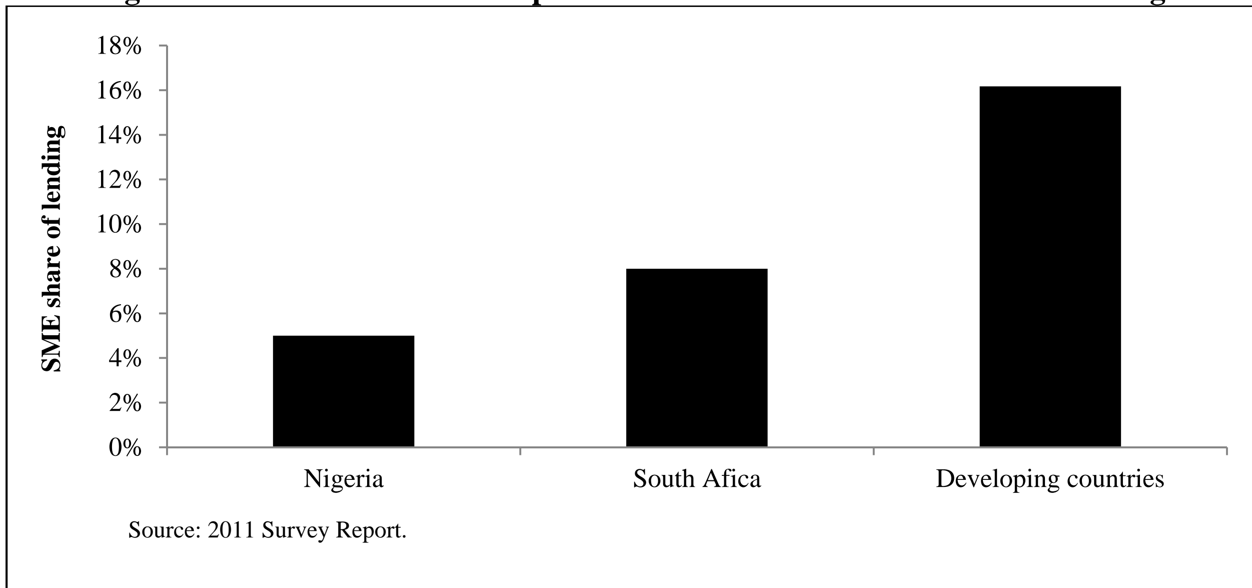
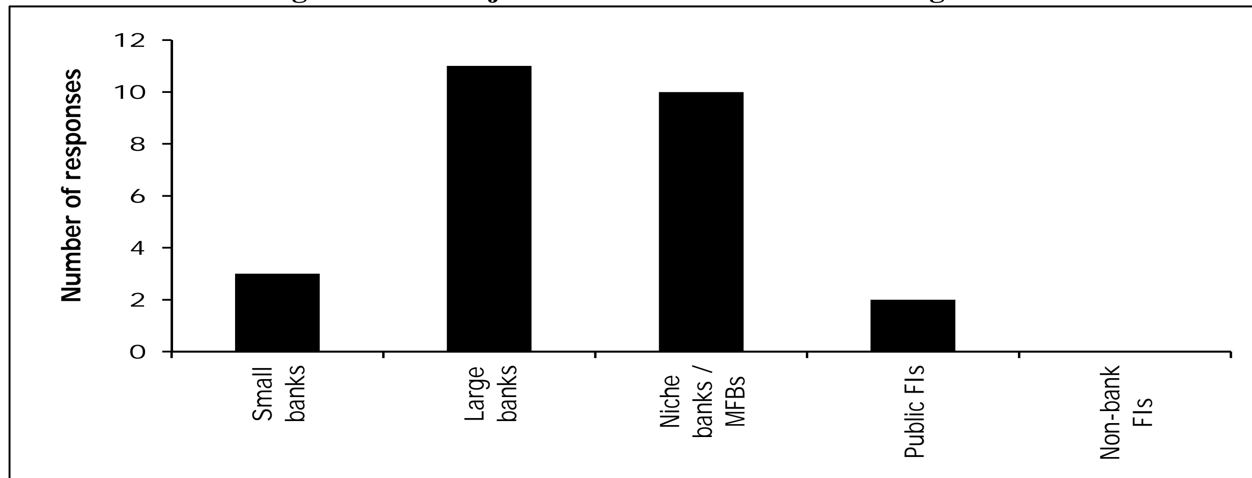


Figure A8.8: Major Sources of SME Credit in Nigeria



Source: 2011 Survey

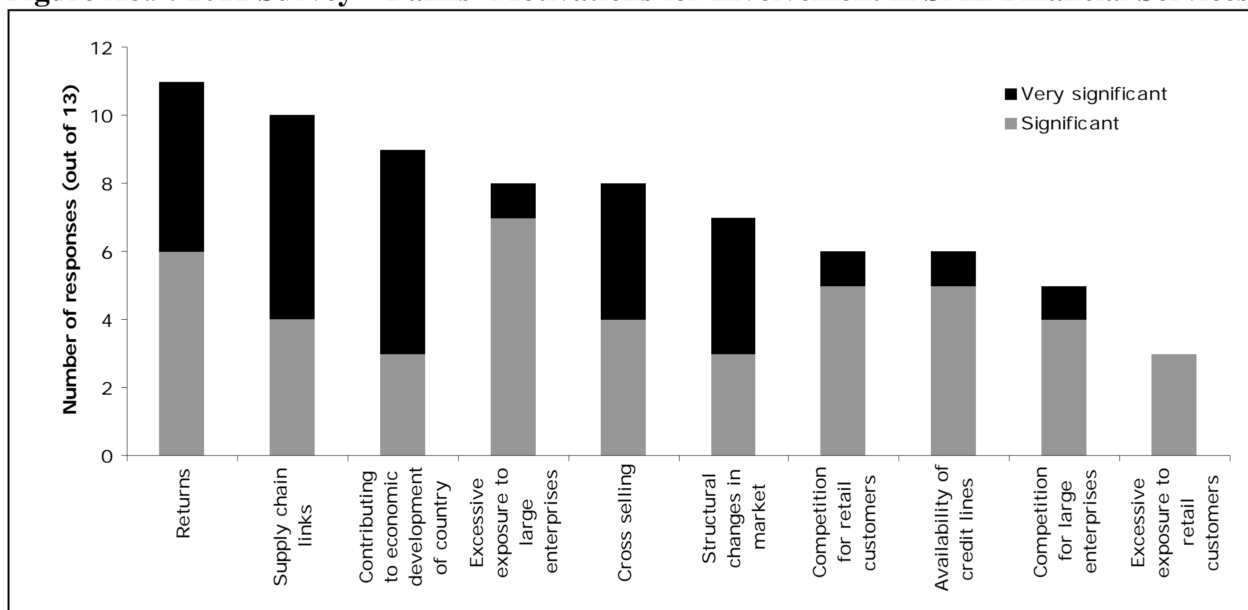
21. **Microfinance banks also were active in lending to the segment**, but were limited by CBN regulations to lending only 20 percent of their total loan books to SMEs, with SME loans being defined as all loans above N500,000. Additionally, microfinance banks typically are licensed to operate only in specific regions and as a result have a targeted geographic focus and branch network. Therefore, at an institutional level, the scale of microfinance bank lending to SMEs is considerably smaller than that of the main commercial banks (based on available data, the average microfinance bank lends approximately 2-3 percent the volumes of the average commercial bank).

22. **According to banks (see Figure A8.9), their involvement in SME lending is driven by risk-adjusted returns on investment**. Indeed, banks did see a large profit opportunity in targeting SMEs, particularly given high levels of competition between banks for "blue chip"

business and the resulting squeeze on margins in the large corporate segment, the potential for increased diversification when making many smaller loans, and the potential growth opportunity in the SME segment given the large number of currently underserved SMEs. Excessive exposure to large enterprises was also named as an important factor for targeting SMEs.

23. **The importance of supply chain links also came out strongly in the survey**. The business model of certain banks was particularly focused on building business along supply chains and using the informational advantage gained from having existing banking relationships with large firms on the supply chain as well as the reduced business and credit risks posed by SMEs that are integrated into a larger firm's supply chain.

Figure A8.9: 2011 Survey – Banks' Motivations for Involvement in SME Financial Services



24. **Overall, the banks in the 2011 survey sample, and especially those actively targeting the SME segment, acknowledged that while SME loans may be both more costly and risky than loans to large enterprises, there was also the potential for greater profitability in this segment**. In terms of contribution to banks' net income, it appears that SME clients are contributing more than the size of their borrowing would suggest. As of December 2010, the average contribution of SMEs to banks' net income for those same institutions for which disaggregated lending data was available was 11 percent, over double the proportion of SME loans in total loans, and is indicative of the importance of income from fees generated by SME accounts. A number of banks that participated in the 2011 survey had aggressive growth targets with respect to the contribution of SMEs to net income, looking to double the proportion over three years. A number of banks highlighted the squeeze on margins in the large corporate segment and potential for high revenue growth given the number of SMEs in Nigeria. Indeed, for the five Nigerian banks actively targeting SMEs, just 22 percent of revenues from SMEs related to credit, with the remainder generated by deposits and account management and by other transaction and fee-based services. By contrast, microfinance banks generated a far higher proportion of their revenues from credit products, with an average of 90 percent from credit and 5 percent for both deposit and account management and other transaction and fee-based services.

Consistent with the low share of income from credit is the finding that the average ratio of loans to deposits for SMEs at commercial banks is 37 percent (indicating potentially significant intermediation of liquidity by banks from SMEs to other borrowers).

25. **In terms of market competition, the majority of survey respondents viewed large banks and niche banks, including microfinance banks, to be the major players in SME finance** (11 and 10 of 13 responses to this question, respectively). Small banks and public financial institutions were named by few institutions. Furthermore, 90 percent of respondents viewed the SME lending market to be 'atomized' in the sense that many institutions were active, targeting similar potential clients.

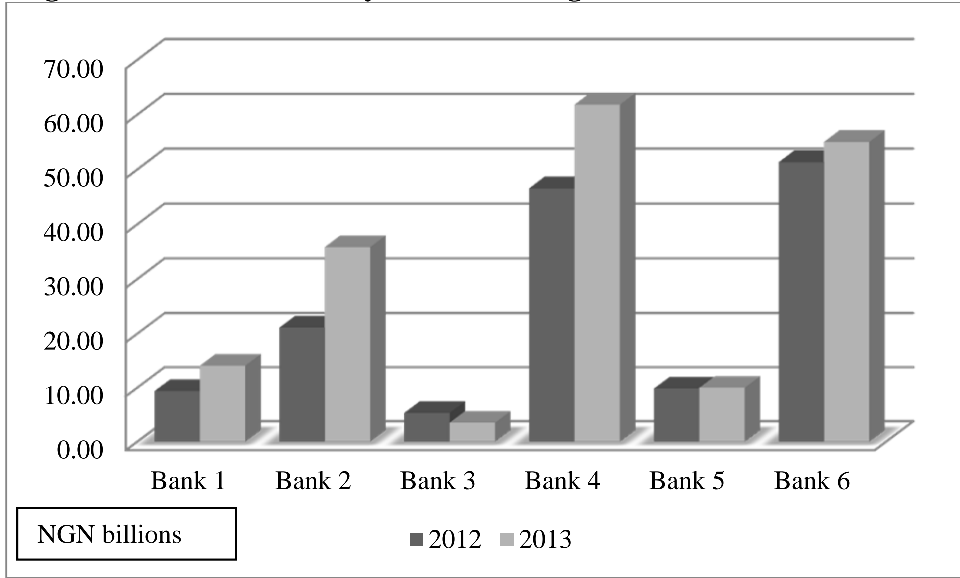
2014 Survey Results

26. **A total of six Nigerian commercial banks with MSME loan portfolios were surveyed in early 2014 to assess current trends in MSME finance**. Results were generally consistent with those in the 2011 survey:

- From 2011 to 2012, lending to SMEs grew by 25.11 percent[61].
- The main credit instrument used for lending to SMEs is loans (71 percent) with the balance being provided by overdrafts.
- The average size of SME loans increased from NGN9 million in 2011 to NGN11 million in 2012.
- The average maturity of SME loans was reduced, falling slightly from 610 days to 600 days in 2011–2012.
- Nonperforming loan ratios for SMEs are high and have increased quite sharply, rising from 11.24 percent in 2011 to 14.74 percent in 2012, an increase of 31.2 percent.
- SMEs were generally unable to secure loans for investment. Only one bank (representing only 1.4 percent of total credit to SMEs extended by the six banks) reported extending investment loans. The majority of lending to SMEs is for working capital (70.8 percent), with "Other" (e.g., for trade) being the second largest category (21.4 percent).

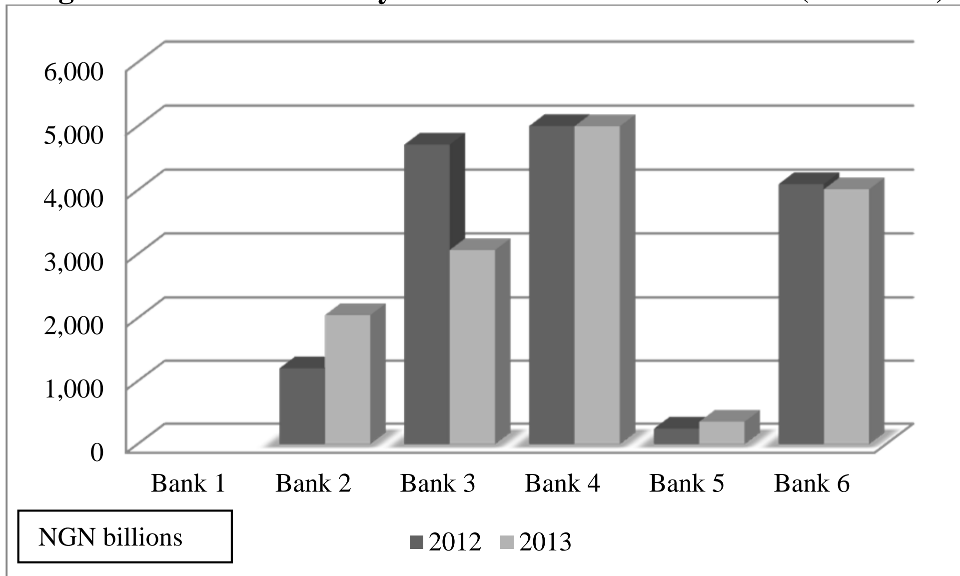
[61] Data reported by five of six banks showed a decrease (5.1 percent) in the number of loans to SMEs. However, the bank that did not report the number of its SME loans is one of the fastest growing lenders to SMEs. Accordingly, it is possible that the number of loans in fact increased.

Figure A8.10: 2014 Survey – Outstanding Credit to SMEs (six banks)



- SMEs are charged high interest rates, and the banks have a very large interest spread between SME loans and deposits. In 2012, the average interest rate charged on SME loans was 22.4 percent (increased from 20.6 percent in 2011), while SME deposits received 1.6 to 2 percent interest (a spread of more than 20 percent).

Figure A8.11: 2014 Survey – Number of Loans to SMEs (six banks)



Agricultural MSME Finance Analysis

27. **The main financing challenges in agriculture lie with primary processors and primary agriculture, which generally lack access to affordable finance**. Currently, 17 banks finance agricultural processing, and recent initiatives, such as CBN mandating that agricultural lending must be at least 5 percent of a bank's loan portfolio (backed by credit guarantees), has led to increased interest in and focus on agriculture.

28. **A 2013 survey of the agricultural sector cited access to finance as the second largest obstacle to agricultural investment after physical infrastructure.[62]** Survey respondents cited the unfavorable terms of loans, high costs, and lack of availability of financing as major problems, with domestic agricultural investors more affected by financing problems than international ones:

- Lack of access to financing is a major barrier for small investors.
- Even when financing is available, high local currency interest rates and short payback periods make it difficult to justify new investments.
- Some investors noted that banks often perceive agriculture as more risky than other sectors and suggested that credit-risk officers and investment managers may not have enough background knowledge of the sector to make informed judgments about risk.
- Financial investors in agriculture thought increased bank guarantees and longer loan terms should remain policy priorities, while operational investors recommended lower interest rates on agricultural loans.

29. **Total financing required for smallholder agriculture has been estimated at US$7.75 billion** (NGN1.28 trillion). Rabo International Advisory Services (RIAS) estimated that this amount could be broken down as follows:

- US$4.3 billion (NGN710 billion) for the inputs (e.g., seed and fertilizer) of the 20 most important crops.[63]
- USD 600 million (NGN 99 billion) would be required to warehouse 20 percent of the grain crop for later sale.
- USD1.35 billion (NGN223 billion) of financing would be needed to develop storage capacity for 20.6 million metric tons of grains.
- USD1.5 billion to finance machinery and equipment for about three million farmers (5 percent of the total number).

30. **The existing agriculture portfolios of banks can roughly be divided into four categories**:

- *Processors and distributors*: Processors and distributors currently represent the main recipients of bank financing, except for larger foreign-affiliated companies that may secure a significant part of their financing in foreign currency. Financing in this segment,

[62] This paragraph summarizes the results of "Private Sector Survey Results" (Federal Ministry of Agriculture and Rural Development, 2013).

especially for medium- and long-term financing, will continue to represent the bulk of funding requirements from banks and the proposed DFI because this segment has a manageable risk profile.

- *Traders and processors financing*: Financing working-capital requirements of agri-traders, especially larger ones, is provided by banks, particularly if they are able to provide adequate security in the form of buildings and inventories. Financing of assets requiring tenors in excess of 18–24 months remains a challenge due to the limited availability of term funding. As a result, even for longer term investments, banks tend to provide financing in the form of short-term loans. The availability of medium- or long-term funding for banks would significantly improve financing possibilities in this segment. Some banks also offer warehouse-receipt financing for commodities such as maize, soya, coffee, and cocoa. This kind of financing is still very limited because no regulatory infrastructure exists for it. The infrastructure for warehouse-receipt financing is also lacking, with banks relying on their customer's own facilities or warehouses being rented by the bank for the storage of the financed commodities. The financing bank must therefore engage trustworthy collateral managers in addition to having an efficient back office and trading desk to manage the exposure and risk of such transactions

- *Larger commercial farmers:* Banks are providing financing for the acquisition of equipment such as poultry cages, tractors and implements, and on-farm processing equipment. The financing is generally for tenors of up to two years and secured partly with the assets being financed and partly with other fixed assets belonging to the borrower. Based on limited examples seen, the pricing of such financing ranges between 23 percent and 30 percent p.a., excluding fees related to establishing the facilities, in particular with respect to mortgage registration. However, little financing seems to be granted to this type of farmer for inputs such as seeds, fertilizers, or chemicals, except under government scheme guarantees. The need for input finance is, however, very high (estimated at US$4.3 billion, based on FAO production figures for the 20 most important crops in 2012) and is a major factor in limiting primary agricultural production. Farm asset financing is more attractive to banks than input finance because collateral is available to offset credit risks.

- *Smallholders:* Only MFIs and the Bank of Agriculture (BOA) offer financing to smaller producers in the agribusiness sector, making as much use as possible of the existing schemes such as NIRSAL. Financing tenors of MFIs are generally short (up to 12 months) and expensive with rates of 2.5 to 4 percent per month. While the majority of these small loans are taken up by small agri-traders, some financing with risk sharing from government schemes also goes to small and medium primary producers for inputs. The main limiting factors in this kind of financing are short tenors, high costs, and lack of available collateral. BOA offers loans at much lower interest rates than other banks (12 percent to 14 percent per annum with a 20 percent cash collateral requirement), and 90 percent of its loans are made in the micro segment (maximum loan size of NGN 250 thousand/US$1,500). BOA loans are normally for a maximum of 12 months, with an exception for cassava growers due to the longer crop cycle.

31. **The main financing challenge for agriculture lies with primary processors and primary agriculture, which generally lack access to affordable finance**. However, development of these upstream value-chain operators is only possible if a reliable market is available and the link between primary production and market can be adequately organized. Emerging farmers (who produce a small surplus from a primarily subsistence farm for sale) and commercial smallholders are the two segments exposed to the greatest gaps in terms of financing access, costs, and tenors. Subsistence farmers, who represent the largest number of agricultural producers, have no access to finance and generally no significant “commercial” revenues. Their banking relationship is generally limited to small savings, if any, and without significant technical assistance, such farmers are unlikely to make the step to commercial farming activities.

32. **Existing government financing schemes for agriculture (such as CACS, GES, NIRSAL—see Section D) have been largely mopped up by larger agribusiness corporates rather than helping the primary agriculture sector**. This is mainly because of lack of farmer organization into groups or cooperatives and lack of collateral. Initially, the NIRSAL pilot was targeting smallholders more specifically; however, this led to high NPLs due to the high level of guarantees and the perception that funding was grant money rather than loans. The new version of NIRSAL is no longer targeting smallholders but still supports farming through interest subsidies. The agribusiness value chain must be developed as a whole, and while the market end is a crucial driver of this sector, adequate support must be given to the upstream operators (agricultural producers and small primary processors).

33. **The FGN has made a number of policy commitments to support the growth of agricultural lending**. These include commitments to strengthen the BOA by divesting control to a new investor that would recapitalize it, develop new credit instruments for agriculture (most likely via the new DFI), liberalization of the agricultural insurance market, and adjustment of the regulatory framework.[64] These reforms would be complemented by reforms to the agricultural business environment, which would make lending to agricultural firms and smallholders more attractive for commercial banks.

C. Obstacles to MSME Access to Finance

Obstacles to MSME Finance - 2011 Survey Results

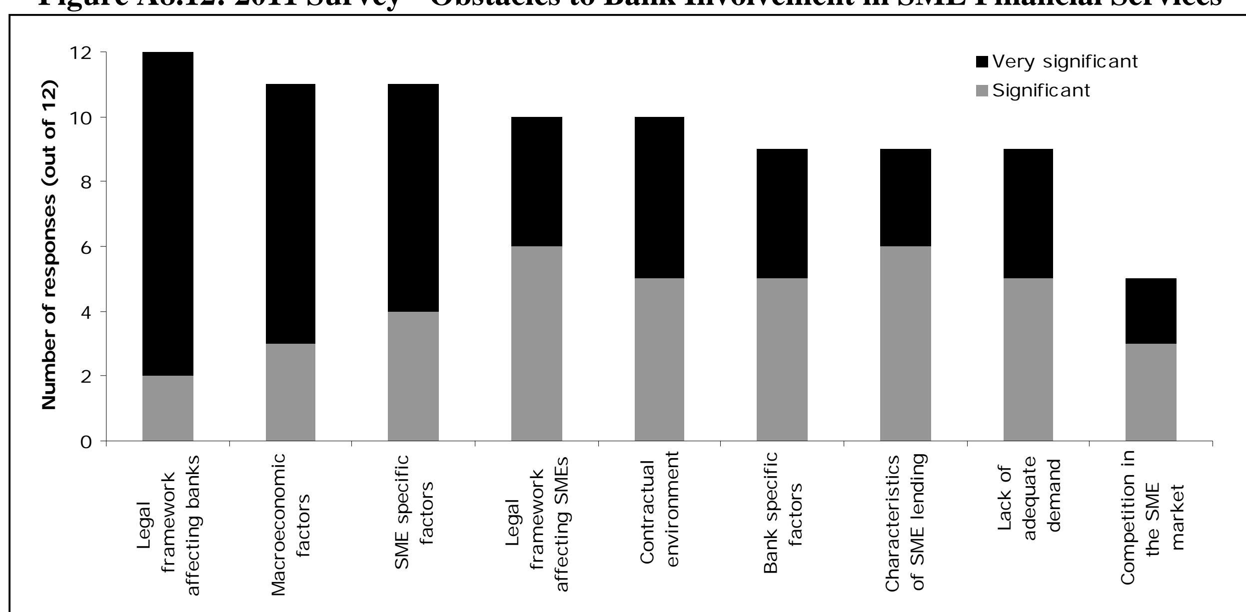
34. **A major focus of the 2011 supply-side survey was on the obstacles to financial institutions’ involvement with SMEs** (see Figure 13). Financial institutions were asked to rank a set of potential obstacles as either not significant, significant, or very significant and to provide a rationale for their responses. Additionally, this topic formed a central focus for face-to-face discussions with the project team. The legal and regulatory framework affecting banks, macroeconomic factors, SME-specific factors, and the contractual environment were obstacles particularly highlighted in the written responses and during the discussions with the institutions.

---

[64] “The Government of Nigeria intends to focus its efforts on increasing private sector involvement in production and distribution of inputs; increasing farmer and agro-businesses access to private sector financial services, improving food security and nutrition, and improving the business environment for private sector investment.” “Cooperation Framework to Support the New Alliance for Food Security and Nutrition in Nigeria” (New Alliance for Food Security & Nutrition, 2013).

35. **Regarding the legal and regulatory framework affecting banks, the issues cited included the law on collateral, security registration, documentation requirements for borrowers, loan classification and provisioning requirements, and required cash reserves and liquidity requirements** (however, it should be noted that there were differences of opinion regarding the impact of certain CBN regulations). For example, some institutions highlighted the impact of regulatory requirements to only lend against collateral in an environment where many potential borrowers may not have sufficient collateral or, importantly, not have the documentation required to prove that they owned the required collateral, whereas other institutions did not believe that this was a limitation. The high costs and delays in realizing collateral in the case of default were also highlighted as particular challenges for banks to be able to manage their risks effectively.

Figure A8.12: 2011 Survey - Obstacles to Bank Involvement in SME Financial Services



Note: Number of institutions citing obstacle as significant or very significant.

36. **Prudential regulations on SME lending and burdens posed by regulator-required documentation were not shown by the 2011 survey to pose any specific problems with respect to commercial banks' SME lending**. Ten out of thirteen responding institutions replied either that prudential regulations had a positive effect on their involvement with SMEs or that prudential regulations were inconsequential to their involvement, while only three of eleven responding institutions felt that the burden of regulatory documentation was excessive. However, microfinance banks faced additional obstacles relating to the regulatory framework. In particular, microfinance banks are limited to making only 20 percent of their loans to SMEs (defined as loans above N500,000), and have policy guidelines in place limiting loan size, face regulatory uncertainty (for example, relating to proposed maximum daily cash withdrawals and disbursement), and face various constraints on expansion. The microfinance banks were typically operating on a regional license and required a national license to expand to other regions, which would involve a major increase in their minimum capital. Additionally, there is a limit on the ratio of investment in fixed assets to capital of 20 percent, which was felt to be too low when an institution is expanding its operations.

37. **SME-specific factors that were identified by banks as posing obstacles to expanding SME access to financial services identified were, in general, familiar issues such as the lack of collateral of potential entrepreneurs, low levels of business skills and training, and the poor quality of financial statements and information relating to SMEs**. However, one factor appeared to be particularly important in Nigeria: the lack of physical infrastructure, such as a reliable electricity supply, which leads to an increased cost base for SMEs and increased business risks, both increasing the challenge of providing finance.

Obstacles to Agricultural MSME Finance

38. **Constraints to smallholder access to credit are similar to those faced by nonagricultural MSMEs**:

- All agricultural value-chain participants indicate the need for lower interest rates in order to support the development of the agribusiness sector in Nigeria. However, interest rate subsidies are probably not an efficient way to promote the development of the agribusiness sector. Subsidies are needed, at least in the early stages of agricultural development, to ensure access to adequate inputs, infrastructure, and market; however, those should be given for specific purposes rather than a blanket interest rate benefit.
- Available funding is generally short term (12 months), which is suitable only for basic working capital needs. Short-term financing is not suitable for agribusiness sectors with a production cycle of several years (palm oil, fruit, animal production), equipment, or processing investments. Longer term financing is, however, needed throughout the value chain, not only for primary agriculture.
- Bank collateral policies are generally not realistic for primary farming activities, and, when available, perfection of security is long and expensive. Financial intermediaries must be helped in gradually moving away from collateral lending to alternative security solutions such as warehouse receipts, value-chain financing, portfolio approach, and groupings such as joint liability structures for part of the risk coverage.

39. **Most banks have established agricultural lending desks as required by the CBN, but in many cases knowledge of the agribusiness sector is limited and bank policies are not suited to the sector**. Sector knowledge and client proximity are essential components for effective and successful agricultural finance. Banks must be supported in developing specific policies, products, and procedures for the agribusiness sector. Besides knowledge, banks will only be able to provide adequate services to the primary agriculture and processing players in the value chain with a close physical presence, requiring an adequate network.

40. **Smallholders generally do not have enough or adequate collateral available to access traditional banking finance**. When available, agricultural assets are generally in the form of land (which is not necessarily owned by the farmer), farm buildings (generally of limited commercial value), and machinery (movable assets not favoured by banks). Commercial banks generally require collateral in the form of real estate assets located in "suitable" areas and will not accept farm or even residential buildings located in remote areas with uncertain market potential. When available, registration of fixed collateral is a lengthy and costly process that is not cost effective for small loans. A significant cost element in the registration process is reported to be stamp duty (a tax on transactions), which can vary significantly from state to state.

41. **Nigerian Naira ("NGN") currency lending is generally only available for relatively short-term tenors, the majority of which do not exceed 12 months**. Furthermore, financing is expensive because benchmark treasury bills currently bear interest of about 12 percent and even short-term deposits can receive in excess of 12 percent interest. As a result of high funding costs, borrowing rates easily reach 20-25 percent for secured lending. Large agribusiness firms are generally able to access financing through offshore entities in foreign currency at much more favourable rates (5 percent to 6 percent in US dollars), giving these players very significant competitive advantages compared to smaller firms that only have access to short-term domestic funding at high rates.

42. **The business culture in agribusiness is strongly influenced by its dependence on imports for the vast majority of inputs, raw materials, and even consumer products**. Business is driven by the need for a rapid return on investments and focus on short-term profit maximisation rather than long-term business development. In general, contractual arrangements are considered to be of limited value because of the quickly changing environment and lack of enforceability of contractual obligations. Enforcing obligations, including those related to bank finance, can easily be stalled for extended periods of time, which has led to a general disdain for documented arrangements. Business culture changes will only occur as a result of more appropriate legal and regulatory frameworks that are effectively implemented and recognition of mutually beneficial long-term goals among the various players in the value chain, which will depend on adequate training and guidance.

43. **As with other sectors of the economy, a lack of physical infrastructure is one of the main constraints to developing the agribusiness sector in Nigeria**. There is a general shortage of suitable and accessible crop storage space, in particular for smaller agricultural players. The lack of adequate storage results in high levels of post-harvest losses, reported to range between 30 percent and 40 percent. Transport infrastructure is also lacking, especially for fresh products such as dairy, vegetables and meat, all of which require refrigerated transport and storage in transit, making it difficult and costly for farmers to reach the main markets and compete with imported products. Electrical supply in rural areas is either unavailable or unreliable. Most operators are more or less obliged to invest in backup power generators, which in some cases serve as main power supply, to run their operations. The significant costs and investments required to compensate for poor or absent infrastructure put a further strain on the competitiveness of agribusiness (particularly with reference to import competition) and thus contributes to the credit risk of agricultural lending.

Weaknesses in Financial Infrastructure

44. **Despite some progress over the recent years, credit infrastructure in Nigeria remains underdeveloped**. Weaknesses in credit infrastructure significantly inhibit the growth of lending to MSMEs in Nigeria. In 2008 the CBN issued the guidelines governing licensing, operations, and regulation of credit bureaus, which facilitated establishment of three private credit bureaus; in 2010 the guidelines were expanded to include a requirement for banks to consult at least two credit bureaus prior to lending, which in turn facilitated expansion of their records. The credit bureau industry remains nascent, and the key priorities in the short to medium term include enforcing the requirements for submitting data and consulting credit bureaus for all

credit institutions (e.g., MFBs) and broadening the scope of credit reporting to select nonfinancial institutions extending credit (e.g., utilities, telecoms, etc.). In addition, an immovable property registry was established, but it requires modernization and automation. At the same time, a movable collateral registry has not yet been established, and the law regulating secured transactions, drafted in 2012, has not yet been adopted, though the government indicted interest in pursuing this reform agenda.

45. **While there are three licensed private credit bureaus in Nigeria, coverage and utilization is limited.** The total number of records of the three credit bureaus is around 14 million, of which the large majority relate to records for individuals. The credit bureaus generate a total of approximately 20,000 reports per month, primarily for the use of commercial banks. Credit bureaus collect both positive and negative credit information, but data from nonfinancial institutions, such utilities and telecommunication companies, is not included. All credit bureaus primarily offer two types of reports - basic and detailed - with a price ranging from NGN700 to NGN2,000, respectively, while a special price of approximately NGN250–500 per report applies to MFBs due to the specific nature of their business and their large number of very small loans. In addition, the credit bureaus generate quarterly portfolio reports mandated by the CBN and limited customized reports. To date, the existence of the bureaus has resulted in more discipline in the financial system, as borrowers become more aware of the importance of their credit histories. Also, banks have started to develop new consumer products based on credit reports.

46. **Despite a large nominal number of subscribers, only commercial banks actively use credit bureau services.** Credit bureau subscribers include commercial banks, primary mortgage institutions, microfinance banks, and very few, mostly inactive, nonfinancial institutions. Of approximately 150–200 credit bureau subscribers, only slightly over 50 percent are active, and these are primarily commercial banks. In addition, despite the fact that regulations require MFBs to use credit bureaus, in practice very few do so (mostly those operating in urban areas), due to various reasons such as a lack of technical capacity to pull reports and submit data, inadequate IT capacity, belief that credit bureau information is not needed for their business, high costs (despite lower prices for MFBs), etc. It is interesting to note that the use of credit bureaus by existing DFIs is apparently marginal.

47. **The 2011 survey found that credit bureaus had been building up their credit records considerably since 2010** (when the CBN issued guidelines that banks should check with at least two bureaus prior to lending). In general, this appears to have improved the information set available to banks. Seven out of nine surveyed commercial banks used a credit bureau in loan analysis, and of these seven banks, five found the bureau to be effective. Some banks did, however, note that there could be improvement in the quality of the data, especially through timely updates of the information on the system. This problem appears to be caused by the irregularity of submission of credit information from financial institutions to the credit bureaus, which reduces the completeness and timeliness of credit data. Additionally, the credit bureaus could offer further value-added services such as scoring and proactive monitoring.

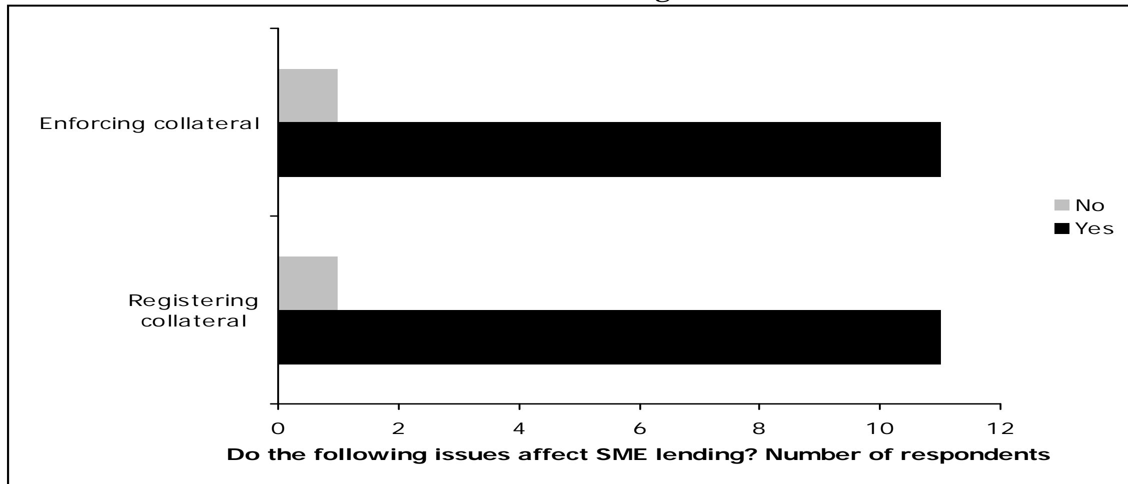
48. **Despite improvements since 2010, the volume and quality of supplied data to credit bureaus remains inadequate**. While most commercial banks are in compliance with regulations when it comes to meeting requirements for supplying data to credit bureaus, the quality of their

reports could be improved. For example, approximately 8 percent of received data is dropped due to incomplete or inaccurate information. As previously noted, very few MFBs are reporting to credit bureaus. Also, on the rare occasions when existing DFIs do supply credit data, the quality of the data is reported to be inadequate.

49. **Under the Nigeria MSME project (that closed in December 2012), the World Bank supported the diagnostic of the legal and regulatory framework for secured transactions**. This review identified the following issues with the current regime: (i) the system is fragmented, with different and conflicting pieces of legislation and serious gaps in certain areas; (ii) the system is only applicable to companies that are registered in the company registry, therefore excluding the majority of the business sector composed of SMEs; (iii) certain types of transactions are in practice transactions secured with movable property, such as sale of an account, conditional sales contract, consignments, hire-purchase contract, and a long-term leases, but are not encompassed by the legal/regulatory framework; (iv) the current system restricts businesses to accessing credit from only one borrower, thus effectively limiting competition in the market; (v) the existing system fails to establish priority among secured creditors, as only the security interests of corporates are registered, thus excluding the majority of the SME businesses; and finally, (vi) the cost and operation of the registry are high due to the use of obsolete systems. While a draft secured-transactions law and the design of a reformed collateral registry have been prepared, no progress was recorded until recently. In 2013 the IFC re-engaged with the authorities to reach consensus on the (i) draft law, (ii) the establishment of the registry, and (iii) the capacity building of the involved stakeholders. This is a work in progress.

50. **Discussions with banks of the contractual environment brought up clear issues relating to the difficulty of enforcing contracts and enforcing collateral and to long delays in the judicial process**. The general view was that financial institutions could not rely on timely and reliable court enforcement of contracts, with legal proceedings potentially taking many years to complete. The absence of efficient commercial courts was highlighted by some respondents as an obstacle to their involvement with SMEs. As illustrated in Figure A8.13, the responding institutions were almost unanimous in their views of the difficulty of both registering and enforcing collateral.

Figure A8.13: 2011 Survey – Impact of Collateral Registration and Enforcement Issues on SME Lending



51. **Leasing or asset-based financing offers an alternative channel through which SMEs lacking hard collateral can access financing**. By using the leased asset as security, the transaction focuses less on the balance sheet of the lessee but more on the firms' ability to generate sufficient cash flow to service the lease payment. Even though the leasing market in Nigeria has been expanding, the lack of a specific law clarifying the legal nature of leasing is hampering the development of the sector as an alternative to bank financing for SMEs. This problem is reinforced by a lack of clarity in the tax treatment of leases; presently, leases are subject to both value-added tax (VAT) and withholding tax. Subjecting leases to VAT results in double taxation, as VAT is due when the asset is purchased as well as when it is leased out, making leasing more expensive than other financial products.

D. Government Financial Support for MSMEs[65]

52. **Given the risk aversion and lack of capacity of the banks with regard to SME and agricultural lending, the government has intervened in the market for MSME financial services for many years to increase the volume of credit flowing to these sectors**. A total of seven major credit schemes are active:

- ***Small and Medium Enterprise Credit Guarantee Fund (SMECGS)***. Established in April 2010, this CBN-administered fund provides N200 billion for 80 percent guarantees of principal and interest on loans to SMEs. SMEs are defined as having N5 million to N500 million in assets (excluding land) and 11 to 300 employees. The maximum loan amount is N100 million, with a maturity of up to seven years and a two-year grace period. Loans must be collateralized, and the bank making the loan must confirm to the CBN that the collateral is adequate and realizable. The guarantee is callable when a loan is declared nonperforming as defined by CBN regulations. Interest rates are fixed at the prime lending rate. As of end-2013, 25 projects had been guaranteed, with the face value of projects guaranteed since inception amounting to N3.1 billion.

[65] Findings from the 2011 survey on government credit schemes have been updated with data collected by a World Bank mission in early 2014.

- ***Intervention Fund for Refinancing and Restructuring of Banks' Loans to the Manufacturing Sector (RFF)***. Established in 2010, this revolving fund is implemented by the Bank of Industry (BoI) using N300 billion raised by selling debentures to the CBN. The fund has two purposes: (i) to allow banks to refinance or restructure nonperforming loans to manufacturing companies, with a maximum loan size of N1 billion; and (ii) to provide a loan of N35 billion to one fertilizer company. Manufacturing SMEs are eligible to apply. Loan maturities may be up to 15 years for investment and one year for working capital. Interest rates are fixed, with BoI lending to banks at 1 percent and banks allowed to charge 7 percent on on-lent funds. By end-2013, the fund had disbursed N264 billion for 573 projects (285 new projects and 288 refinancing operations).

- ***Power & Aviation Intervention Fund (PAIF)***. An N300 billion intervention fund for on-lending by banks to power companies and for the restructuring of airline companies was established in 2010. As of January 2012, N178 billion had been provided by the CBN through the purchase of BoI debentures, and the BoI had on-lent N145 billion to 10 power companies and 11 airline operators (the difference between these amounts reflects projects approved but not yet disbursed by BoI). Loan maturities may be up to 15 years for investment and five years for working capital. The size of individual loans is unlimited. Interest rates are fixed, with BoI lending to banks at 1 percent and banks allowed to charge 7 percent on on-lent funds. The Africa Finance Corporation has been selected to be the technical adviser to BoI to review applications to the fund.

- ***Entrepreneurship Centers.*** The CBN sponsors the operation of entrepreneurship centers to provide training and capacity building. The centers are administered by service providers working under contract to the CBN. As of February 2012, three centers were in operation (in Lagos, Abuja, and Kano), with a further three expected to open in the future.

- ***Agricultural Credit Guarantee Scheme Fund (ACGS)***. First established in 1977, the fund now has NGN3 billion of capital, provided 60 percent from the FGN and 40 percent from the CBN. The fund provides guarantees of 75 percent of principal and interest on loans to farmers, with the guarantee effective after the CBN has completed due diligence on a bank's loss claim. By mid-2010 the scheme had supported loans to about 63,000 borrowers. The scheme has a subcomponent directed to self-help groups: for this component, the level of guarantee is increased to 87.5 percent as a result of additional collateral provided by oil companies and state governments, and borrowers are required to have savings equivalent to 25 percent of the amount borrowed. The scheme has no fixed lending rate, but borrowers are able to get a rebate of 40 percent of the interest paid after they have repaid their loans in full.

- ***Commercial Agriculture Credit Scheme (CACS)***. Launched in 2009, the scheme is a N200 billion CBN-administered fund designed to support large-scale commercial agriculture and lending to state government-sponsored farming schemes. As of end-2013, the scheme had disbursed N151 billion to 190 borrowers. Banks are able to borrow from the scheme at 0 percent interest to finance loans of up to seven years maturity with an

interest rate capped at 9 percent. Single loans are limited to no more than N2 billion. The on-lending banks bear all the risk. In addition, the scheme has an NGN1 billion per state subcomponent for on-lending to smallholder cooperatives on the same terms as large borrowers. This part of the scheme is administered by eight state-level agencies, which act as an intermediary between cooperatives and banks.

- ***Agricultural Credit Support Scheme (ACSS)***. The scheme was launched in 2006 as an N50 billion commitment by the participants to provide credit to agriculture. The scheme was superseded by the commercial Agriculture Credit Scheme (see above) and is in the process of being wound down. Loans under the scheme are provided by commercial banks, state governments, and other sources. Participating institutions receive funds at 6 percent from the CBN and on-lend to farmers at 14 percent, with a six percentage point quarterly interest rebate so long as the borrowers remain current. Large borrowers were eligible to approach banks directly for loans, whereas smallholders were required to approach banks via farmers' associations and state implementation committees. The scheme had no maximum loan size or duration. Borrowing from the scheme peaked at N17 billion of loans for 42 projects in 2008 and, as of January 2012, one project application remained pending CBN approval.

- ***Nigeria Incentive-Based Risk-Sharing System for Agricultural Lending (NIRSAL)***. NIRSAL was developed with the Alliance for a Green Revolution in Africa (AGRA) providing technical advice to the CBN. The facility is targeted on providing term and working-capital loans to participants in agribusiness value chains, with an emphasis on smaller borrowers. However, guarantees issued so far indicate that the primary beneficiaries have been large agribusinesses, apparently with the intention that the benefits will be passed down to the large firms' smaller suppliers. NIRSAL is an N75 billion guarantee fund providing first-lost credit guarantees to PFIs of up to 10 percent of principal and accrued interest, with PFIs paying a guarantee premium of 3 percent per annum of the guaranteed amount. The entire amount of the loan must be covered by bankable collateral. In addition, there is an interest drawback, with NIRSAL refunding 20-40 percent of the interest paid by fully performing borrowers (the legal basis for this subsidy is not clear). Since its inception in 2012, the scheme has guaranteed N14.3 billion and paid out N67.5 billion in interest subsidies for a total of 43 borrowers.

- ***Bank of Industry (BOI) administered schemes***. In addition to the schemes administered by the CBN, BOI is active in SME lending as well, approving 1,470 SME loans, amounting to N165 billion, from 2008 to 2011. The average tenor of these loans is five years, and the NPL rate was at 16 percent at end-2011. BOI administers an array of credit lines at below market interest rates: loans to cooperatives (N4.5 billion); cotton loans (N100 billion); and a rice processing facility (N10 billion) among others. BOI also partners with state governments to organize development forums for entrepreneurs. These activities are partly funded from UNIDO and the US Commerce Department. The purpose is to provide business development services including training on business plans and credit assessments.

53. **Analysis of the existing CBN schemes shows that they primarily benefited large enterprises**. Average loan sizes are close to N500 million for the Intervention Fund for Refinancing and Restructuring of Banks' Loans to the Manufacturing Sector (RRF) and N6.9 billion for the Power & Aviation Intervention Fund (PAIF), indicating that these schemes are not, in fact, targeted at SMEs. The SME guarantee scheme (SMECGS) is underutilized because of the modalities of the scheme: (i) commercial banks are required to lend at prime rate, which is unlikely to cover all costs and risks of SME lending; and (ii) loans have to be collateralized, and banks have to confirm that the collateral is adequate and realizable (as a result, banks described themselves as having to guarantee the CBN's guarantee).

E. Institutional Weakness Undermines Contribution of Existing DFIs

54. **Accounting information regarding the performance and financial situation of the existing DFIs is generally available only sporadically and with considerable delay.** However, available data documents show insuperable problems relating to the non-performance of their loan portfolios, with NPLs ranging from 30% to 68%. All DFIs have direct lending to the private sector on subsidized terms as part of their mandates, and—as has been the experience elsewhere—they are heavily dependent on funding using fiscal resources. According to the government's *Ad Hoc Sub-Committee on Development Finance in Nigeria*, which recently reviewed the DFIs' performance, the cumulative losses of the three main DFIs (BOI, BOA, and FMB) in the past five years have reached approximately NGN43 billion, eroding their capital to a net negative position despite combined capital injections of approximately NGN25 billion.

55. **Independent and effective regulation and supervision is a basic condition for the sound governance of DFIs and to ensure good performance.** The current ownership structure of development banks is generally shared between the Ministry of Finance (about 60 percent) and the CBN (about 40 percent) with the respective line ministry as the regulator. The exception is the Bank of Infrastructure, which, since being restructured in 2011, is in majority private ownership and regulated by the CBN. The line ministries generally regulate their respective DFIs as their own subsidiaries, without any other independent financial sector oversight. Furthermore, agent/principal relationships are further blurred because the line ministries appoint all key personnel of their respective DFIs, from Board members to senior staff. For example, in the case of BOA, the shareholders (CBN and FMOF) have little control over the bank's operations, as all board decisions and senior staff appointments are approved by the line ministry, the Federal Ministry of Agriculture.

56. **The absence of transparent financial and performance management data and of public accountability acts as a disincentive for existing DFI performance.** The lack of published financial statements, including rigorous performance reporting similar to requirements for public limited companies registered with the SEC, has enabled DFIs to operate without effective oversight and transparency. The impact of this distorted performance framework is further compounded when fresh resources are allocated to DFIs that have been very poor performers.

57. **The schemes launched by the CBN were largely motivated by the need to compensate for weakness in the development finance framework.** In the absence of a sound development finance framework, the CBN launched a number of development finance schemes—largely in the form of lines of credit and guarantees - aimed at intervening in various sectors on a short- to medium-term basis. The three largest schemes are the NGN300 billion Power and Airline Intervention Fund (PAIF), NGN200 billion intervention fund for re-financing and restructuring of banks' loans to the manufacturing sector (RRF), and NGN200 billion Commercial Agriculture Credit Scheme CACS). In addition, the CBN has recently launched a NGN200 billion Small and Medium Enterprises Credit Guarantee Scheme (SMECGS). In recent years the redesign of the schemes by the CBN has focused on enhancing their impact in order to encourage greater risk sharing by the private sector.

Annex 9: Letter of Sector Policy

FEDERAL REPUBLIC OF NIGERIA: Development Finance Project

FEDERAL MINISTRY OF FINANCE

Office of the Co-ordinating Minister for the Economy / Hon. Minister

Ahmadu Bello Way,
Central Business District,
P.M.B. 14 Garki, Abuja.
Nigeria.

☎: 09-6702444
08180147408

F.11373/S.34/C.1606/I

23rd May, 2014

Ms Marie Francoise Marie-Nelly
Country Director, The World Bank
102 Yakubu Gowon Crescent
Abuja, Nigeria

Dear Madame,

LETTER OF DEVELOPMENT POLICY

Nigeria's transformational agenda and vision aim to create sustainable jobs, and improved prosperity and living standards for all Nigerians. The Federal Government of Nigeria (FGN) is pursuing a series of sectoral policies covering the macro-economy, business environment, trade, as well as financial system development to achieve these objectives. As part of this transformation process the FGN recognizes that the financial sector could play a more significant role in reaching out to micro-, small-, and medium enterprises (MSMEs) and thereby contributing to economic diversification while also allocating scarce financial resources more efficiently. While efforts undertaken by development finance institutions or in the form of CBN schemes have been well-intentioned, they have not provided adequate scale and sustainability in lending required by the Nigerian economy. The FGN is therefore implementing a new approach that will significantly strengthen sustainable access to finance by MSMEs in all sectors of the economy.

Macro policies

Nigeria is implementing an economic policy of fiscal consolidation, building fiscal buffers aimed at underpinning low levels of inflation. Strong efforts in budgetary consolidation led by the FGN have reduced the General Government deficit from an estimated 5.7 percent of GDP in 2010 to 1.9 percent in 2012. The FGN will continue these policies as reflected in the 2014 budget. Such continuing fiscal consolidation will be important not only in providing the basis for sound macroeconomic management, but also in building the foundation for financial inclusion. In addition, the FGN is in the process of strengthening the public sector's cash management through the establishment of a Treasury Single Account (TSA) to sterilize the liquidity

1

impact of public sector deposits. While the TSA is still being implemented the Central Bank of Nigeria (CBN) – aware of the detrimental incentive impact associated with allowing banks to host large albeit temporary government funds – has over the past year gradually tightened the Cash Reserve Ratio to 100 percent of such deposits.

For the past decade, the FGN has introduced an oil-price based fiscal rule in its budgeting to de-link government expenditures from international oil price movements. Under this rule, government revenues accruing above a reference benchmark oil price are saved in a designated, special account, called the *Excess Crude Account*. The adoption of this fiscal rule has greatly improved the macroeconomic environment in Nigeria, providing a stable platform for private sector investments. In addition, the FGN recently established the Nigeria Sovereign Investment Agency (NSIA) to oversee the country's sovereign wealth fund which currently manages about US$1.55 billion in total investments.

Focus on strengthening financial inclusion

The FGN continues to implement policies to reform the financial sector following the banking crisis in 2009. Substantial liquidity was injected; a blanket guarantee for depositors, as well as for interbank and foreign credit lines of banks (extended for six-monthly periods until end–2011), was provided; AMCON was established to purchase banks' nonperforming loans (NPLs) in exchange for zero coupon bonds and inject funds to bring capital to zero; regulations and supervision were strengthened and corporate governance enhanced; and the universal banking model was abandoned and banks were instructed to establish holding companies or to divest their non-bank activities.

Building on its success in stabilizing the financial system since 2009 the FGN now intends to focus on enhancing financial inclusion. While bank lending to the private sector has recovered since the 2009 crisis, the FGN recognizes that banks still face a difficult environment for lending and, with a relatively high 12 percent monetary policy rate coupled with a stable nominal exchange rate to the US dollar, enterprises face challenges both in meeting their borrowing costs and in competing with importers.

Establishing a new, financially self-sustainable Development Finance Institution

The FGN intends to establish a self-sustaining, wholesale development finance institution (DFI) to alleviate financing constraints faced by MSMEs. The new DFI will focus on providing support to participating financial intermediaries on a market-conforming and fully sustainable basis. It is envisaged that the new wholesale DFI will provide credit lines and partial credit guarantees to financial intermediaries, predominantly banks and microfinance banks, as long as they observe a pre-specified set of eligibility requirements providing assurance as regards the prudence and soundness of the on-lending intermediaries. The emphasis on market-conformity reflects the dual policy objectives of (a) reaching scale, whereby the new DFI will need to source capital

market funding, predominantly through the issuance of longer term Naira-denominated securities, and (b) encouraging banks to engage in lending to MSMEs on their own account by adopting similar products and practices to those deployed by the DFI.

Strong emphasis is to be placed on independent, professional corporate governance. Drawing on experience from development finance institutions in Nigeria and elsewhere, a key parameter determining the success of the new institution will be strong corporate governance. As such, the FGN has approved the incorporation of the institution as a PLC under the Companies and Allied Matters Act (CAMA) of Nigeria. This provides a strong signal of the FGN's commitment to good corporate governance of this institution. It is envisaged that the institution, while FGN-sponsored, will be managed by a Board of Directors comprising a minority of directors appointed by Government and a majority of independent directors. Independent directors, as well as the executive management team of the institution, will be recruited through an open and transparent process.

Addressing weaknesses in the business environment

The Government will enhance efforts to improve the legal, regulatory and institutional environment for MSME lending recognizing that in the medium term these improvements will be crucial to more substantial engagement by private sector financial intermediaries. Constraints arising from the legal and regulatory framework result in banks perceiving MSMEs as being difficult and costly to service. MSMEs often lack formal collateral and documentation. The absence of a functioning personal identification system, and the high costs of verifying and obtaining official documentation present challenges for banks in financing MSMEs, both in satisfying legal and regulatory requirements and in managing their risks effectively. Credit history information, while under development, as yet encompasses only negative and often only partial information from banks. In addition, the cost and difficulty of registering and enforcing contracts and collateral, as well as delays in the judicial process hamper banks' willingness to lend.

To strengthen the capacity of banks and MSMEs the Government, working in collaboration with donors, intends to complement funding provided by the new DFI with a comprehensive technical assistance program. Factors that severely constrain the ability of financial intermediaries in augmenting the provision of MSME finance relate to the lack of appropriate lending methodologies, and limited understanding of how to assess the potential viability of MSMEs and to mitigate the associated credit risks. On the part of the MSMEs, constraints arise in being able to prepare bankable projects. Overall, these hurdles, coupled with comfortable returns on safe investment in Government securities, result in a situation where banks have been reluctant to expand into this new market segment. Reflecting international experience, the funding/guarantee instruments offered by the new DFI will be

complemented with provision of a comprehensive package of technical assistance services to both intermediary banks and MSME borrowers.

Strengthening regulatory oversight and enforcement

The oversight and regulatory role of the CBN as regards development finance institutions will be strengthened and apply in full to the new development finance framework from inception. Hitherto the mandate of the CBN vis-à-vis existing DFIs has been limited. The supervision of DFIs has been conducted on a voluntary basis, allowing the existing DFIs to underperform. The absence of a sound DFI framework has led the CBN itself to develop a series of schemes, an activity which lies outside its core mandates. As part of the envisaged reforms the CBN will assume a much stronger mandate in supervising the sector. Specific licensing and prudential regulations to be applied to the new DFI are currently being developed by the CBN, and will be reviewed by the Federal Ministry of Finance and other financial sector stakeholders.

Paradigm shift in development finance policy

In parallel with the establishment of the new DFI the FGN is committed to undertaking a comprehensive reform of the DFI sector. The FGN recognizes that current development finance institutions and schemes work on the basis of subsidies or interest rate drawbacks, and that benefits arising from such arrangements are limited to few entrepreneurs and compromise the development of market-based finance. The FGN has established an ad-hoc committee on development banking whose mandate is the restructuring and divestiture of the Bank of Agriculture and the Bank of Industry. Transactions advisors are being hired to advise the Bureau of Public Enterprises in restructuring and partially privatizing these institutions. In parallel the FGN has agreed with the CBN to undertake an evaluation of existing CBN schemes with a view to winding them down or possibly transferring viable schemes to the new DFI.

The FGN is committed to a fully sustainable development finance framework. Cognizant of the fact that interest rates subsidies, ceilings and/or draw-backs distort the decision-making of financial intermediaries and provide a disincentive for these intermediaries to engage in expanding their exposure to groups targeted by such market interventions, the FGN will refrain from intervening both in the pricing of products financed by the DFI and in the pricing of products delivered by participating financial intermediaries to the enterprise beneficiaries of DFI funding. If the FGN nonetheless deems it necessary to provide subsidies to underserved regions and/or sectors, such subsidies will be fully costed and funded as part of the Federal budget or budgets of participating State Governments. Subsidies could take the form of tax rebates that would also serve the purpose of encouraging enterprises to become formal and at the same time increase the potential client base of the DFI.

With the establishment of the new DFI, the restructuring/partial privatization of existing DFIs and the restructuring/winding down of existing CBN schemes, significant changes are envisaged in the structure of development finance in Nigeria. Going forward, greater focus will be placed on the design of development finance policies and monitoring of outcomes. Responsibility for implementation of these policies will reside with the Federal Ministry of Finance. Thus the Ministry intends to build its internal capacity to undertake the formulation, design, implementation and outcome monitoring of development finance initiatives and to assess the scope, cost, efficiency of possible new policy initiatives.

As Co-ordinating Minister of the Economy, and Chair of the President's *Ad Hoc Committee on Development Finance*, I have worked with the relevant Government Departments to develop our plan for Nigeria's wholesale development finance institution. Moreover, in a letter dated 25th April 2014 (Ref: PRES/87/MF/-2/269), President Goodluck Jonathan granted formal approval for the incorporation and capitalization of this institution. With the support of our development partners, the Nigerian Government will continue to work to establish and build this important financial institution.

With best personal regards,

Dr. Ngozi Okonjo-Iweala
Coordinating Minister for the Economy/
Honourable Minister of Finance
Federal Republic of Nigeria

Annex 10: Key Macroeconomic Indicators and Projections

FEDERAL REPUBLIC OF NIGERIA: Development Finance Project

	2012	2013	2014	2015	2016	2017	2018
	Actual	Projections					
National income and prices							
Real GDP (at 1990 basic prices)	6.6	6.4	7.3	7.0	6.8	6.9	6.6
Oil and Gas GDP	-0.2	-1.8	6.8	3.4	2.2	2.3	1.6
Non-oil GDP	7.8	7.7	7.4	7.5	7.5	7.5	7.2
Production of crude oil (million barrels per day)	2.339	2.300	2.388	2.463	2.505	2.561	2.594
Nominal GDP at market prices (trillions of naira)	41.1	44.8	49.7	54.8	60.4	67.2	74.8
Nominal non-oil GDP (trillions of naira)	26.1	30.3	34.7	39.8	45.5	52.1	59.5
Nominal GDP per capita (US$)	1,589	1,702	1,813	1,899	1,993	2,106	2,228
GDP deflator	2.0	2.5	3.4	3.0	3.3	4.0	4.5
Non-oil GDP deflator	7.6	8.0	6.7	6.5	6.5	6.6	6.6
Consumer price index (annual average)	12.2	8.5	7.3	7.0	7.0	7.0	7.0
Consumer price index (end of period)	12.0	7.9	7.0	7.0	7.0	7.0	7.0
FGN gross debt (percent of GDP)	18.4	19.1	20.0	20.3	20.2	20.5	20.8
Investment and savings							
Gross national savings	30.2	26.7	26.9	26.1	25.2	25.1	23.9
Public	7.2	2.2	3.9	5.1	4.4	3.5	2.9
Private	23.1	24.5	23.0	20.9	20.8	21.6	21.0
Investment	22.4	23.6	23.2	23.3	23.0	22.9	22.8
Public	6.2	6.3	6.2	6.4	6.1	6.1	6.0
Private	16.2	17.3	17.0	16.9	16.9	16.8	16.8
Current account balance [1]	7.8	3.1	3.7	2.8	2.2	2.2	1.1
Consolidated government operations [2]							
Total revenues and grants	25.3	20.0	21.1	22.3	20.5	19.2	18.3
Of which: oil and gas revenue	18.5	12.9	13.8	14.7	12.7	11.1	10.0
Total expenditure and net lending	25.7	24.6	24.0	24.2	22.9	22.4	22.0
Of which : fuel subsidies [3]	3.8	1.6	1.5	1.3	1.2	1.1	0.9
Overall balance	-0.4	-4.7	-2.9	-1.9	-2.4	-3.2	-3.7
Non-oil primary balance (percent of non-oil GDP)	-26.9	-23.5	-21.6	-20.5	-17.8	-16.5	-15.4
ECA/SWF (US$ billions)	11.0	3.0	6.3	11.3	13.6	16.4	18.3
Money and credit							
Broad money (percent change; end of period)	16.4	-5.2	14.3	15.6	14.5	14.5	14.2
Net foreign assets	14.3	-3.4	1.3	1.4	2.1	2.6	1.1
Net domestic assets	2.1	-1.7	13.0	14.3	12.3	11.9	13.1
Credit to consolidated government	-13.6	0.8	3.3	2.7	2.1	1.7	1.6
Credit to the rest of the economy	6.1	7.8	11.1	12.8	11.4	11.3	12.4
Velocity of broad money (ratio; end of period)	1.6	2.0	2.0	2.0	2.0	2.0	2.0
Treasury bill rate (percent; end of period)	13.2	11.9	...	...	...	...	...
External sector							
Exports of goods and services	1.8	-2.1	2.4	-0.2	-1.1	0.4	0.1
Imports of goods and services	-10.6	13.8	4.6	4.6	3.7	2.4	4.7
Terms of trade	1.4	-0.1	-0.4	-1.9	-2.2	-1.8	-1.6
Price of Nigerian oil (US dollar per barrel)	110.0	109.0	104.0	98.5	93.7	90.3	88.0
Nominal effective exchange rate (end of period)	81.4	83.1	...	...	...	...	...
Real effective exchange rate (end of period)	135.6	150.1	...	...	...	...	...
External debt outstanding (US$ billions)	6.5	8.2	10.0	11.5	12.9	14.2	15.5
Gross international reserves (US$ billions)	44.2	43.6	44.5	44.3	45.1	46.5	46.6
(equivalent months of imports of G&Ss)	6.0	5.7	5.5	5.3	5.3	5.2	4.8

Sources: Nigerian authorities; and IMF staff estimates and projections.

[1] Large errors and omissions in the balance of payments suggest that the current account surplus is overestimated by a significant (but

[2] The budget oil price is US$72 a barrel for 2012, US$79 thereafter.

[3] For 2012, includes one-off payment of about 1 percent of GDP to settle arrears accrued in 2011.

*Projections

Sources: National Bureau of Statistics, Ministry of Finance, Central Bank of Nigeria, World Bank projections

Annex 11: Sample Technical Cooperation Agreement

FEDERAL REPUBLIC OF NIGERIA: Development Finance Project

1. **This sample Technical Cooperation Agreement (TCA):** (i) describes the technical cooperation package that the project will make available to the participating bank and the decision-making process for sub-loans; and (ii) sets forth the procedures under which the participating bank shall enter into MSME loan agreements with sub-borrowers.

2. **This is only an illustrative example subject to modification to reflect the needs of individual PFIs based on the diagnostic review of each institution**.

Operation through Regional Offices and Local Branches

3. **The participating bank will create streamlined internal banking procedures conducive to MSME lending and incorporate such procedures into the participating bank's normal business strategy at the level of its regional and local branches**. The participating bank will provide all regional offices and local branches with all necessary instructions and documents and take such steps as may be necessary to ensure successful and smooth project implementation.

The Project's Technical Cooperation Package for the Participating Bank

4. **In preparing the technical assistance to be provided to prospective participating banks, the project will recruit expertise to undertake diagnostic reviews of the individual banks to identify technical-assistance needs and benchmarks for technical-assistance programs outcomes tailored to the needs of each bank**. These technical-assistance diagnostic reviews will form the basis for designing the technical assistance to be delivered in agreement with prospective participating bank management. They will also provide benchmarks for evaluating the outcomes of the Technical Cooperation Agreements, as described in the following.

5. **The advisory assistance provided to the participating bank will be carried out by competitively selected external advisor(s) with a track record in similar projects and comprising a qualified team of long-term advisor(s) and various short-term experts, as well as the project coordinator**. The senior specialists and project coordinator will have the authority to make decisions on most important issues concerning the implementation of technical assistance. Responsibility for overseeing technical assistance delivery will reside with the PIU.

6. **As an integral part of the advisory assistance to be provided by external advisors, the participating bank will receive support in the following areas**: training of local loan officers, credit extension and monitoring procedures appropriate for high volume micro- and small lending, and establishing management information systems designed to support the credit extension, monitoring, and reporting processes.

7. **The following specific services will be provided**:

a) Suitable loan officers will be selected by the external advisor(s) in consultation with the participating bank and trained for small enterprise operations. It will generally be the case that new loan officers are selected. However, it may also be agreed that existing staff are selected, but only if they are devoted full time to the project. The training will include courses and on-the-job training of up to 12 months.

b) The loan officers will work on a full-time basis with the external advisor(s), and the project will bear all costs associated with their training, including a stipend for a period of up to six months to cover their salaries, after which time they will be provided with an adequate salary by the participating bank, consisting of a base salary and a bonus as appropriate. The amount of the bonus will be determined monthly on the basis of the number of loans disbursed, the volume of loans outstanding, and the arrears on such loans. Loan officers trained by the project will be expected (contingent upon satisfactory performance) to remain engaged for a minimum of two (2) years following the end of their training.

c) Using a specialized software package, a credit-monitoring program will be implemented and modified to meet the specific needs of the participating bank.

d) The implementation of the technical cooperation package may be terminated if it is determined that (i) the participating bank does not comply with the actions in the Technical Co-operation Agreement, (e.g., to appropriately streamline procedures, including those necessary for timely disbursement, and to acquire the credit technology); (ii) the target MSMEs that are the focus of the project are not being reached; (iii) the emphasis on rigorous credit analyses in lieu of overly strict loan-security requirements, which is an integral part of the credit technology, has not been adopted by the participating bank and incorporated to an appropriate degree in its lending methodology; or (iv) suitable loan officers are not committed full time for a sufficient period.

Role of External Advisors; Facilities of the Participating Bank; Credit Committee and Small-Loan Approval Process

8. **In order to provide the necessary on-the-job training and know-how transfer to the participating bank's management and staff, the external advisor(s) will assist in effective screening of applications for MSME loans**, conducting credit analysis, evaluating projects, and making recommendations for financing of creditworthy projects.

9. **The external advisor(s) will work with the participating bank on the participating bank's premises (the external advisor(s) may also work in parallel with other banks participating in the project)**. The participating bank will allocate for the external advisors(s), free of charge and within a reasonable period of time, an appropriate office space, including secure storage facilities for storage of legal documents relating to MSME loans, office supplies, furniture, telephone, and computer equipment to enable them to carry out the project. As necessary, the participating bank will arrange necessary storage facilities for storage of clients' collateral.

10. **The participating bank will designate at least one high-ranking member of the management staff to work in close cooperation with the external advisor(s)**. This person will act as head of the MSME division, which will be established during the first six months of the period during which technical cooperation activities are carried out. Furthermore, at least one member of each department of relevance for the implementation of the project (e.g., legal, marketing, property valuation, foreign exchange, or loan-security departments) will be assigned by the participating bank to work in close cooperation with the external advisor(s) and the loan officers in the process of developing standardized documentation, including appropriate collateral agreements and local loan agreements.

11. **In cooperation with the external advisor(s), the participating bank will prepare a promotion campaign for the project, and the participating bank will provide the necessary funds to execute this campaign in each of the regions participating in the project**.

Identification, Screening, and Appraisal of Loans to MSMEs

12. **The participating bank and the external advisor(s) will evaluate the participating bank's existing loan application and disbursement procedures and documentation**. These procedures will be developed, amended, changed, and standardized under the guidance of the external advisor(s) to closely follow prudent banking practice for the extension of MSME loans. The participating bank will provide all needed assistance to facilitate the introduction of standardized MSME loan agreements and standardized security agreements in its credit process, along with all other closing documentation.

13. **Working under the guidance of, and in close cooperation with, the external advisor(s), the loan officers will identify MSMEs that appear to be potential candidates for loans, and they will draw up loan applications with them on the basis of the financing requirements that they have identified**. Loan applications that meet the eligibility criteria set forth as follows and that are considered feasible by loan officers and the external advisor(s) will be presented by the loan officer to the participating bank's credit committee. Recommendations will be prepared based on a format recommended by the external advisor(s).

Decision-Making Process

14. **All MSME loan applications meeting the set criteria will be presented for approval of a MSME credit committee of the participating bank (the "credit committee")**. This committee will meet as often as reasonably necessary and at least twice a month. The credit committee is the sole decision-making authority regarding the extension of MSME Loans. Extraordinary meetings may be convened upon reasonable notice at any time at the request of the management of the participating bank or of the external advisor(s).

15. **The credit committee is composed of the external advisor(s) and the head of the participating bank's MSME division as well as a maximum of two additional high-ranking staff members of departments directly involved in the lending process**. The project coordinator will have observer status on the credit committee and will participate in its meeting at his/her discretion in a nonvoting capacity.

16. **Credit decisions will be taken at the local level, with each branch or regional office setting up its own credit committee**. With respect to regional offices and branches, the head of the participating bank's MSME division may be substituted for by the head of the regional or branch MSME division.

17. **The credit committee will review and discuss the loan applications and make credit decisions on the basis of the quality of the loan applications, as evidenced by the written proposals submitted by the loan officer(s) and by further information presented by them at the meetings**. When assessing the applications, it is the duty of the credit committee to accord a special significance to the credit analysis of the real financial situation of the borrower and not to reduce the loan-approval decision to one based primarily on collateral criteria. While collateral will be taken on each loan, the participating bank will be expected to be flexible with respect to types of collateral taken and in the valuation of collateral.

18. **The participating bank, its management, and its employees shall disclose to the external advisor(s) and the loan officers the existence of prior loans or other financial arrangements made by the participating bank to or in respect of any proposed MSME borrower**. The participating bank, its management, and its employees shall also disclose to the external advisor any guarantee arrangements it may have with respect to the proposed MSME loan.

19. **The external advisor(s) and the participating bank's management representatives on the credit committee will each have a veto over each loan application submitted to the committee for consideration**.

Disbursement Process

20. **Once a loan application has been approved, the participating bank will undertake to ensure speedy disbursement of the credit to the client**. The disbursement procedures shall be mutually agreed upon between the participating bank and the external advisor(s), and individual disbursements shall be made within five (5) business days, provided that the MSME borrower has satisfied all conditions precedent under and is not in breach of the MSME loan agreement and has not otherwise been negligent.

21. **The participating bank will provide to the external advisor(s) an original executed copy of each MSME loan agreement signed by the external advisor unless such decision authority is delegated by the external advisor(s) to the participating bank**.

MSME Loan Agreements

22. **MSME loans extended under the bank's loan will comply with the following conditions**:

(a) Disbursement arrangements: Each MSME loan may be disbursed by bank transfer or in cash, taking into consideration the recommendations of the external advisor.

(b) Amount: Each MSME loan will be for an amount of up to US$500 thousand equivalent with no minimal limit. After a large portfolio has been built up in MSME loans, and depending on market demand, consideration may be given to increasing maximum size.

(c) Loan tenor: The tenor of MSME loans will up to ten years.

(d) Interest rates: The interest rate for each MSME loan will be determined on a case-by-case basis at the branch level by the credit committee on the basis of recommendations made by the loan officers and the external advisor(s). Such recommendations will take into account the cost of funds to the participating bank, commercial risk of the MSME loan, the quality of the proposed security, the loan amount, the administrative costs involved in the preparation of the loan, and the competitive conditions of the local banking market. The credit committee is free to set any interest rate that it deems appropriate for MSME loans.

(e) Interest payments and repayment schemes: As a general rule, payments of equal instalments of principal and interest will be used. Under special circumstances, and only if the external advisor(s) has given his or her approval, other interest payment and repayment options may also be selected.

(f) Changes in terms and conditions: All material changes in terms and conditions of MSME loan agreements—such as an increase/decrease of approved loan amount, extension of grace periods, and changes to the repayment schedule, release of collateral, and/or co-signers or guarantors or extension of maturity—will require a decision of the credit committee. Recommendations to the credit committee on such changes will be prepared by the loan officers and the external advisor(s) based upon the MSME borrower's request. The decision-making process of the credit committee in such cases will be the same as provided herein for the approval of the MSME loans.

(g) Security: Security of a type that is available to and appropriate for MSMEs will be taken. The participating bank shall not require loan insurance and shall be prohibited from being named as beneficiary under any such loan insurance policies.

Eligibility of MSME Borrowers and Projects (the "Eligibility Conditions")

23. **MSME borrowers must be firms, businesses, sole proprietorships, or other legal entities formed under the laws of Nigeria, as well as individuals registered as entrepreneurs in accordance with such laws, which meet the following criteria**:

Enterprise Type	# Employees	Annual Turnover	Total Assets	Max. Loan Size
MSMEs	< 250	< $3.125mn (N500mn)	<$3.125mn(N500mn)	< $500k(N80mn)

24. **Eligible projects and terms: Sub-loans will be extended to eligible MSMEs for investment and working-capital loans in amounts of up to US$500 thousand or equivalent**. Sub-loan maturity is expected to be up to ten years with a grace period of up to 18 months. Specifically:

a) Investment loans: The maximum available sub-loan amount will be US$500 thousand. Maximum maturity will be ten years with a grace period of up to 18 months.
b) Working capital loans**:** The maximum available sub-loan amount will be US$200 thousand. Maximum maturity will be three years with a grace period of up to six months.

25. **The MSME borrowers will have majority private ownership and control**. The total percentage of state ownership in a borrower cannot be greater than forty-nine percent (49%), and the state cannot be directly or indirectly involved in day-to-day management and cannot have any majority authority in directing the local borrower's affairs.

26. **Startup local borrowers must have at least thirty percent (30%) contributions in cash or in kind from their shareholders**.

27. **The MSME borrower receiving a loan shall not utilize the proceeds of MSME loans to finance any activity that is included on the WBG exclusion list**.

28. **The participating bank may allow local borrowers who have built up a favorable credit history under the project to take out more than one loan at a time, with the consent of the external advisor**.

Environmental and Social Standards

29. **All activities under the project must comply with the Project's Environmental and Social Operations Manual**.

Monitoring of Local Loans

30. **Loan officers, under the guidance of and following the recommendations of the external advisor(s), will establish and implement procedures for monitoring of MSME loans**. Procedures will provide for regular on-site visits to the borrowers.

31. **Monitoring of the MSME loans will be the responsibility of loan officers**. They will prepare monthly monitoring reports on the loans to be presented to the external advisor(s) and the participating bank's management and as input to the evaluation of the technical cooperation agreements (see diagnostic reviews described in paragraph 4).

Problem Loans

32. **Problem loans will be reviewed at least monthly by the credit committee**. The loan officers will prepare a report (the "problem asset report"), which will be updated and reviewed by the external advisor(s) monthly and presented to the credit committee. The external advisor(s) have a right to request that any individual problem loan be reviewed by the credit committee at its next meeting.

33. The MSME loans to be included in the problem asset report will include the following:

i. Loans on which borrowers are more than 15 days behind in their payments
ii. Loans where there has occurred marked deterioration of the borrower's financial condition
iii. Any occurrence or occurrences under the loans that may lead the participating bank to believe the loan has developed a higher risk
iv. Loans classified as substandard or worse by examining authorities or outside auditors
v. Loans placed on nonaccrual
vi. Loans classified as watch or problem by a loan review
vii. Any other loans as determined by the external advisor(s)

34. **During the review of the problem loans, the credit committee will make decisions on acceleration of the loans and exercising security**. The external advisor(s) will have the right to require the participating bank to undertake any of the given actions in cases when the other members of the credit committee will be opposed to this. All applications for moratoria and refinancing must be presented to and approved by the credit committee.

Reporting Requirements

35. **The participating bank shall provide the external advisor(s) with regular operations reports ("Operations Reports")**. Such reports will be presented on a branch-by-branch basis to the external advisor(s) on a monthly basis. These reports will also be shared with the experts undertaking the diagnostic review of the bank at inception, so as to provide input to the monitoring and evaluation process. The operations reports will be prepared under the guidance of the external advisor(s), and will, among other things, cover the volume and numbers of MSME loans disbursed, the numbers and amounts of small loans and microloans outstanding, and the arrears levels (1–15 days, 15–30 days, 30–60 days, and over 60 days). With respect to small loans, the following will be covered: enterprise name, amount, purpose, and term. In addition, participating banks will be obliged to report on other indicators, as set out in the project appraisal document and/or as identified by the diagnostic review undertaken in designing the appropriate technical assistance for each participating bank.

36. **The participating bank shall use its best efforts to furnish to the external advisor(s) information that is reasonably requested related to the participating bank's operations as they may affect the project, including expenses incurred by the participating bank in relation to the project**.

Annex 12: Draft Memorandum and Articles of Association

FEDERAL REPUBLIC OF NIGERIA: Development Finance Project

THE FEDERAL REPUBLIC OF NIGERIA

COMPANIES AND ALLIED MATTERS ACT 1990

COMPANY LIMITED BY SHARES

MEMORANDUM OF ASSOCIATION

OF

DEVELOPMENT BANK OF NIGERIAPLC

The Shareholders hereby establish the Development Bank of Nigeria. The purpose of the Development Bank of Nigeria (Company) is to increase availability and access to finance on a wholesale basis only through eligible financial intermediaries.

1. The name of the Company is Development Bank of Nigeria Plc.

2. The registered office of the Company will be situated in Nigeria.

3. The objectives for which the Company is established are:

a. To alleviate financing constraints faced by MSMEs and other small and medium corporates in Nigeria through providing financing, partial credit guarantees and technical assistance to eligible financial intermediaries on a market-conforming and fully financially sustainable basis.

b. To acquire licenses, privileges and powers necessary or desirable to carry out the objectives of the company.

c. To do all such things as may be considered incidental or conducive to the attainment of the above objectives.

4. The company is a Public Limited Company, and has a development finance mandate.

5. The liability of the members is limited by shares.

6. The share capital of the Company is Ten Million Nigerian Naira (NGN 10,000,000) divided into Ten Million (10,000,000) shares of One Nigerian Naira (NGN 1) each.

We, the several persons whose names and addresses are subscribed, are desirous of being formed into a company in pursuance of this Memorandum of Association and we respectively agree to take the number of shares in the capital of the Company set opposite our respective names.

NAMES, ADDRESSES AND DESCRIPTIONS OF SUBSCRIBERS	**NUMBER OF SHARES BY EACH SUBSCRIBER**	**SIGNATURES**
Ministry of Finance Incorporated Ahmadu Bello Way, Central Business District Abuja, Nigeria	9,999,999	
Nigerian Sovereign Investment Authority The Clan Place, 4th floor, Plot 1386A, Tigris Crescent Maitama Abuja, Nigeria	1	

Dated this day of 2014

Witness to the above signatures:

Signature:

Name:

Address:

Occupation:

THE FEDERAL REPUBLIC OF NIGERIA

COMPANIES AND ALLIED MATTERS ACT 1990

COMPANY LIMITED BY SHARES

ARTICLES OF ASSOCIATION

OF

DEVELOPMENT BANK OF NIGERIAPLC

---

1. INTERPRETATION

a. In these Articles, the Act means the "Companies and Allied Matters Act, 1990".

b. Unless the context otherwise required, words or expressions contained in these Articles shall bear the same meaning as in the Act.

c. The Company is a public limited company.

2. SHAREHOLDERS

(1) PRE-EMPTIVE RIGHTS OF SHAREHOLDERS

a) The Company shall not allot any new or unissued shares unless the same are offered in the first instance to all the shareholders or to all the shareholders of the class or classes being issued in proportion as nearly as may be to their existing holdings in accordance with Article 2 (1) (b) below.

b) The offer to existing shareholders shall be by notice specifying the number of shares to which the shareholder is entitled to subscribe and limiting a time, not being less than Twenty-Eight (28) days after the service of the notice, after the expiration of which the offer, if not accepted, will be deemed to be declined. On the receipt of an intimation from the shareholder that it declines to accept the shares offered or after the expiration of the stipulated time, as the case may be, the Board of Directors may, subject to the terms of any resolution of the Company, dispose of the shares at a price not less than that specified in the offer, in such manner as they think most beneficial to the Company.

c) Where a Shareholder seeks to dispose of some or all of its Shares, it must first give to the Directors of the Company, written notice that it wishes to do so **(Transfer Notice).**
The Transfer Notice must state:

i. the total number of Shares for sale by the Selling Shareholder (**Sale Shares**);
ii. the price per Sale Share;
iii. whether the sale is conditional or not and, if conditional, the conditions;
iv. the period during which the invitation to the other Shareholders (**Remaining Shareholders**) to make an offer to purchase the shares is open (**Offer Period**), which (unless otherwise agreed by all Shareholders) must not be less than Twenty-Eight (28) Days; and
v. if applicable, the name of any proposed buyer of the Sale Shares;

d) Subject to Article 2 (1) (c), when the Directors receive a Transfer Notice, the Directors should give written notice (Board Offer Notice) to all Shareholders offering the Sale Shares as follows:

i. If the Sale Shares comprise all the shares in a Class, they must be offered to the holders of the shares in all other Classes in proportion to their existing holdings in that Class or Classes.
ii. If the Sale Shares are only part of the shares in a Class of Shares, they will first be offered to the holders of the remaining shares in that Class in proportion to

their existing holding in that Class. If any of the Sale Shares remain unallocated, they will be offered to the holders of Shares in all other Classes, in each case, in proportion to their existing holdings in the other Class or Classes.

e) Each Remaining Shareholder may, during the Offer Period, accept the offer for it to buy some or all of the Sale Shares on the terms of the Board Offer Notice by giving to the Directors, at its registered office, an acceptance notice **(Acceptance Notice).**

f) An Acceptance Notice given by a Remaining Shareholder constitutes an acceptance by the Remaining Shareholder of the offer by the Selling Shareholder to buy Sale Shares as set out in the Acceptance Notice.

(2) VARIATION OF RIGHTS

a) If the share capital of the Company is increased or new classes of shares are issued, the provisions of Article 2 (1) (a) and(b) shall apply; provided, that no member shall be obliged to subscribe to any part of an increase in the share capital.

b) Subject to the Act, any preference shares may, with the approval of an ordinary resolution be issued on terms that they are, or at the option of the Company are, liable to be redeemed.

c) If at any time the share capital is divided into different classes of shares, the rights attached to any class issued with preferred or other special rights (unless otherwise provided by the terms of issue of the shares of that class) may, whether or not the company is being wound up, be varied only with the consent in writing of the holders of not less than 85% (Eighty-Five per cent) of the issued shares of that class, or with the approval of a special resolution passed at a separate general meeting of the holders of the shares of the class.

d) The rights conferred upon the holders of the shares of any class issued with preferred or other special rights shall, unless otherwise expressly provided by the terms of issue of the shares of that class, be deemed to be varied by the creation, issue or allotment of further shares ranking equally therewith.

3. SHARES

a) The share capital of the Company is Ten Million Nigerian Naira (NGN 10,000,000) divided into Ten Million (10,000,000) shares of One Nigerian Naira (NGN 1) each.

b) The Company shall not give, directly and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares in the Company; and the Company shall not make a loan for any purpose whatsoever on the security of its shares.

c) Without prejudice to any special rights previously conferred to the holders of any existing shares or class of shares, the Company may from time to time increase or decrease the share capital of the Company and/or issue shares or classes of shares with such preferred, deferred, qualified or special rights, privileges or conditions or restrictions, whether in regard to dividend, voting, return of capital or otherwise, as the Company may from time to time, as approved by a vote representing at least 85% (eighty-five per cent) of the total voting power of members, determine in accordance with Article 4 (4) (i) .

d) It shall be the responsibility of the Company to determine the classes of shares to be issued. All the rights or restrictions attached to each particular class of shares shall be specified in the terms of issue but such rights may at any time be varied in accordance with the provisions of section 114 of the Act and these Articles.

e) Subject to and in accordance with the provisions of the Act, the Investments and Securities Act 2009 ("ISA"), the Rules and Regulations made pursuant to the ISA and without prejudice to any relevant special rights attached to any class of shares, the Company may purchase any of its own shares of any class (including without limitation redeemable shares) in any way and at any price (whether at par or above or below par) and may hold such shares as treasury shares.

f) The Company may exercise the powers of paying commissions conferred by section 131 of the Act, provided that the rate per cent or the amount of the commission paid or agreed to be paid shall be disclosed in the manner required by the Act. Such commission may be satisfied by the payment of cash or the allotment of fully or partly paid shares or partly in one way and partly in the other.

(1) SHARE CERTIFICATES

a) Every person whose name is entered as a member in the register of members shall be entitled without payment to receive, within 2 (two) months after allotment or within 3 (three) months after lodgment of transfer or within such other period as the conditions of issue shall provide, 1 (one) certificate in respect of each class of shares held by him or, with the consent of the Directors, several certificates each for one or more of his shares upon payment of such fee as the directors shall from time to time determine.

b) Every certificate shall be under the Company's seal and shall specify the shares to which it relates and the amount paid up thereon. In respect of a share or shares held jointly by several persons, the Company shall not be bound to issue more than one certificate and delivery of a certificate for a share to one of several joint holders shall be sufficient delivery to all such holders.

c) If a share certificate is worn out, defaced, lost or destroyed, it may be renewed without charge on such terms [if any] as to evidence and indemnity as the Board of Directors thinks fit, and in the case of defacement and wearing out, on delivery up to the Company of the old certificate. The person availing himself of the provisions of these Articles shall pay to the Company all out-of pocket expenses incident to the investigation of evidence and the preparation of the requisite form of indemnity.

(2) CALL ON SHARES

a) The directors may from time to time make calls upon the members in respect of any moneys unpaid on their shares as stipulated in the Act particularly in Section 133 of the Act.

(3) TRANSFER OF SHARES

a) The instrument of transfer of any share shall be executed by or on behalf of both the transferee and the transferor, and the transferor shall be deemed to remain the holder of the share until the name of the transferee is entered in the register of members in respect thereof.

b) Shares in the Company shall be transferred in writing in any usual or common form, or in any other form, which the Directors shall approve. Any document which records the name of the transferor, the name of the transferee, the class and number of shares agreed to be transferred and the date of the agreement to transfer the shares, shall once executed by the transferor and the transferee, be deemed to be a proper instrument of transfer.

c) Without prejudice to the power of the Company to register as Shareholder any person to whom the right to any Shares in the Company has been transmitted by operation of law, no transfer of Shares would be deemed to have been delivered to the Company until a proper instrument of transfer has been delivered to the Company.

d) The Directors may decline to recognize any instrument of transfer unless the instrument of transfer is accompanied by the certificate of the Shares to which it relates and such other evidence as the Directors may reasonably require to establish the right of the transferor to make the transfer.

e) If the Directors refuse to register a transfer they shall, within 2 (two) months after the date on which the transfer was lodged with the Company, send to the transferee a notice of the refusal.

f) The registration of transfers may be suspended at such times and for such periods as the Directors may from time to time determine, provided always that such registration shall not be suspended for more than 30(thirty) days in any year.

4. GENERAL MEETINGS

(1) COMPOSITION

a) The Company shall in each year hold a general meeting as its annual general meeting in addition to any other meetings in that year and shall specify the meeting as such in the notices calling it. Not more than fifteen (15) months shall elapse between the date of one annual general meeting of the Company and that of the next. All annual general meetings shall be held at such time and place in Nigeria, as the Company shall appoint.

b) The General Meetings shall be composed of all shareholders of the Company. Each Shareholder shall appoint one representative to represent it at the General Meetings. Each representative shall be person(s) with recognized qualifications and extensive practical experience in the fields of development and/or finance.

c) The chairman of the Board of Directors shall preside as chairman at the general meetings of the Company, unless he or she is not present or is unwilling to act, in which case the attending Directors present shall elect one of their number to be chairman of the meeting.

(2) FUNCTIONS

a) Subject to the provisions of this Memorandum and Articles of Association, all the powers of the Company shall be vested in the General Meeting.

b) In addition to the other functions and powers set out and conferred upon it by this Memorandum and Articles of Association, the General Meeting shall have the power to:

i. Determine the remuneration of the Directors;
ii. Consider, approve or reject the annual accounts of the Company;
iii. Determine and authorize, on the recommendation of the Board of Directors, the allocation and distribution of net income;
iv. Suspend or terminate the operations of the Company and determine the distribution of the assets of the Company in the event of dissolution;
v. Consider and determine any matter which the Board of Directors may refer to it; and
vi. Generally provide guidance to the Board of Directors in the discharge of its functions.

c) All general meetings other than annual general meetings shall be called extraordinary general meetings.

d) The Directors may convene an extraordinary general meeting whenever they think fit, and shall convene an extraordinary general meeting on the requisition of members as provided in section 215 of the Act.

e) Except as otherwise provided by law, at any extraordinary general meeting only such business shall be conducted as is set forth in the notice thereof or otherwise properly brought before the meeting or at the direction of the Board.

(3) QUORUM AND PROCEEDINGS AT GENERAL MEETINGS

a) No business shall be transacted at any general meeting unless a quorum is present at the time which the meeting proceeds to business. Shareholders holding at least 50 % (fifty per cent) of the issued and outstanding shares present in person or by proxy and entitled to vote shall be a quorum for all purposes; provided, however, that if the Company or a class of shareholders shall have only one shareholder, one shareholder present in person or by

proxy shall constitute the necessary quorum; provided further however, that in the event that the Federal Republic of Nigeria (FRN) and entities acting for or on its behalf, cumulatively, hold at least fifty per cent (50%)of the issued and outstanding shares but are not the sole shareholders of the Company, the necessary quorum shall require the presence, in person or by proxy, of FRN plus one additional shareholder that does not act for or on behalf of FRN.

b) At any general meeting, a resolution put to a vote at the meeting shall be decided on a show of hands, unless a poll is (before or on the declaration of the result of the show of hands) demanded in accordance with section 224 of the Act.

c) Unless a poll is demanded, a declaration by the chairman of the meeting that a resolution has been carried, or carried unanimously, or by a particular majority, or lost, or not carried by a particular majority, and an entry to that effect in the minute books, shall be conclusive evidence of the fact, without proof of the number or proportion of the votes recorded in favor of or against such resolution.

d) If a poll is duly demanded, it shall be taken in such manner and either at once or after an interval or adjournment or otherwise as the chairman of the meeting may direct, and the result of such poll shall be deemed to be the resolution of the meeting at which the poll was demanded. The chairman of the meeting may appoint scrutineers (who need not be members) and fix a time and place for declaring the result of a poll.

e) In the case of an equality of votes, whether by show of hands or on a poll, the chairman of the meeting at which the show of hands takes place or at which the poll is demanded shall not be entitled to a second or casting vote.

f) Subject to the provisions of the Act, a resolution in writing signed by all the members for the time being entitled to receive notice of and to attend and vote at general meetings [or being corporations, by their duly authorized representatives], shall be as valid and effective as if the same had been passed at a general meeting of the Company.

g) All the members of the Company and every other person entitled to notice of meeting of the Company may elect to attend the Company's meeting either personally or by proxy or teleconference or any other acceptable technological means of attending a meeting.

(4) VOTING OF MEMBERS

a) Subject to any rights or restrictions attached to any class or classes of shares, except as otherwise herein provided every member shall be entitled to attend and vote at general meetings and the provisions of the Act as it relates to the procedure of voting shall apply to the Company.

b) No member shall be entitled to vote at any general meeting or at a separate meeting of the holders of any class of shares in the Company, either in person or by proxy, in respect of any shares held by him unless all calls or other sums presently payable by him in respect of shares in the Company have been paid.

c) A member of the Company may appoint a proxy whether or not such person is a member of the Company, to attend, speak and vote on his behalf at any general meeting of the Company; provided, that where a member appoints more than one proxy in relation to a general meeting, each proxy must be appointed to exercise rights attached to a different share or shares held by him. The proxy shall have the same right as the member who appointed him to speak at the meeting and to vote on a poll, and shall be entitled to vote when the vote is taken by show of hands.

d) An instrument appointing a proxy and the power of attorney or other authority, if any, under which it is signed or a notarized certified copy of that power or authority shall be deposited at the registered office of the Company or at such place within Nigeria as is specified for that purpose in the notice convening the meeting, not less than 48(forty-eight) hours before the time of holding the meeting or adjourned meeting at which the person named in the instrument proposes to vote, or in the case of a poll, not less than 24(twenty-four) hours before the time appointed for the taking of the poll, and in default, the instrument of proxy shall not be treated as valid.

e) An instrument appointing a proxy shall be in the following form or as near thereto as circumstances admit or in any other form which the Directors shall approve:

"I/We of Limited, being a Member/Members of the above-named Company, hereby appoint ……………. Or failing him …………………… of as my/our proxy to vote for me/us on my/our behalf at the Annual [Extraordinary] General Meeting of the Company to be held on the ………….. day of …………….. 20………

Signed this day of 20………

Signed, sealed and delivered
by the within-named Member
xxxxxxxxxxxxxxxxxxxxxxxxxxx

In the presence of:

Name: ……………………………………

Address: ………………………………….

Occupation: ………………………………

Date: …………………………………….

Signature: ………………………………

f) The instrument appointing a proxy shall be deemed to confer authority to demand or join in demanding a poll.

g) Receipt by the Company of an appointment of a proxy in respect of a meeting shall not preclude a member from attending and voting at the meeting or any adjournment thereof.

h) Except as otherwise specifically provided in this Memorandum and Articles of Association, or as required by law, matters referred to the General Meeting for decision shall be decided by Ordinary Resolution passed by a simple majority of shareholders present and voting in person or by proxy.

i) Without prejudice to other functions and powers set out and conferred upon it by this Memorandum and Articles of Association, the following matters shall be regarded as "Reserved Matters" and shall be referred to the General Meeting by the Board of Directors. Decisions regarding Reserved Matters shall be by Special Resolution requiring approval by a vote representing at least eighty-five per cent (85%) of the total voting power of members.

The Reserved Matters shall be as follows:

i. Any change to this Memorandum and Articles of Association;
ii. Any change to the nature and purpose of the business of the Company, its lending policy and or its general strategy;
iii. Any amalgamation, merger, consolidation, reconstitution, restructuring, or similar transaction that results in a change in control of the Company;
iv. Any termination of operations, or liquidation, of the Company;
v. Any alteration of share capital or share re-purchase; and
vi. Any declaration of dividends.

5. BOARD OF DIRECTORS

(1) COMPOSITION

(a) The business of the Company shall be managed by the Board of Directors, and the Board may exercise all such powers of the Company as are not by the Act or by these Articles required to be exercised by the Company in a general meeting.

b) The Directors of the Company shall not be less than 3 (three) and not more than 13 (thirteen) unless and until otherwise determined by the Company in a General Meeting. Post incorporation, there shall be a majority of Independent Directors who shall be jointly appointed by all the shareholders, the majority of Independent Directors shall be Nigerians. The Chief Executive Officer of the Company shall participate in the board of directors' meeting but shall have no voting rights at the board of directors' meeting.

(2) FUNCTIONS

a) In addition to the other functions and powers set out and conferred upon it by this Memorandum and Articles of Association, the Board of Directors shall have the power to:

(i) Review and guide corporate strategy, major plans of actions, risk policy, annual budgets and business plan;
(ii) Set performance objectives, monitor implementation and corporate performance;
(iii) Oversee major capital expenditures, acquisitions and divestitures;
(iv) Monitor the effectiveness of the Company's corporate practices and make changes as needed;
(v) Select, compensate, monitor and when necessary replace key executives and oversee succession planning;
(vi) Align key executive and board remuneration with the longer term interests of the Company and its shareholders, keeping in mind the obligation of the Company to remain financially sustainable;
(vii) Ensure a formal and transparent board nomination and election process;
(viii) Monitor and manage potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions;
(ix) Ensure the integrity of the Company's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular systems for risk management, financial and operational control, and compliance with the law and relevant standards.

b) The Directors of the Company, in carrying out their duties shall exercise independent decision making, and shall serve on a part-time basis as required to carry out their functions.

c) The right of signing on behalf of the Company shall be vested severally in the Chief Executive Officer and in any other member of senior management team of the Company delegated by the Board for this purpose.

(3) DUTIES OF DIRECTOR

a) In the discharge of their responsibilities, the Directors shall act in utmost good faith, with care, skill and diligence and shall adhere to all duties and obligations applicable to directors under the Act, CBN Code and other applicable laws and regulations.

b) Directors owe fiduciary duties of care and loyalty to the Company and shall not act in any circumstances where their personal interests conflict with the interest of the Company. For this reason, if a Director has pecuniary or other beneficial interest in, and material to, a matter that is before the Board for consideration, he or she shall:

(i) disclose to the other Directors the nature of his or her interest in advance of any consideration of the matter;
(ii) not influence or seek to influence a decision to be made in relation to the matter;
(iii) take not part in any consideration of the matter; and
(iv) excuse himself or herself from the meeting or that part of the meeting during which the matter is discussed.

(4) BORROWING POWERS OF THE DIRECTORS

a) The Directors may exercise all the powers of the Company to borrow or raise money and to mortgage or charge its undertaking, property and uncalled capital or any part thereof and to issue debentures, debenture stock and other securities whether outright or as security for any debt, liability or obligations of the Company; provided, that the remaining undischarged amount of monies borrowed or secured shall not at any time, without the prior approval of the Company at a general meeting, exceed the nominal amount of the share capital of the Company for the time being issued.

(5) APPOINTMENT OF DIRECTORS

a) Without prejudice to the provisions of the Act and other applicable laws, regulations and codes, the each Directors of the Company shall fulfill certain minimum qualification criteria for appointment to the Board, which will be agreed among the shareholders.

b) For the purpose of registering the Company at the Corporate Affairs Commission, the initial Board of Directors of the Company shall consist of 3 (three) Directors who shall be appointed by the shareholders.

c) Post incorporation, the Board of Directors shall be increased to 5 (five) Directors who shall replace the initial 3 (Three) Directors. Each shareholder shall be entitled to appoint one Director as its representative on the Board subject to the approval of the relevant regulatory body (ies) and the shareholders shall thereafter jointly appoint three (3) Independent Directors.

d) The procedure for appointing the Independent Directors shall be as follows:

i. There shall be established an Initial Nominations Committee **("Committee")** consisting of 5 (five) high-caliber professional and technical experts which shall have the responsibility of supervising the process of selecting the Directors.
ii. The minimum professional qualification requirements for the Committee members shall be jointly agreed upon by the shareholders.
iii. The shareholders shall have the responsibility of jointly appointing the Committee members and the Committee members will not be considered for Board positions.
iv. The Committee shall appoint an Independent Professional International Firm ("**Firm**") subject to the written consent of the shareholders. The Firm shall have the responsibility of short-listing eligible candidates for the position of Director.

v. The Firm shall shortlist up to 9 (nine) qualified prospective Directors with at least 3 (three) shortlisted for each Board position. The names of the qualified prospective Directors shall be forwarded to the relevant regulatory body (ies) for screening.

vi. The Committee shall forward the short-list of up to three qualified prospective Directors who have been approved by the regulators to the shareholders.

vii. The shareholders shall interview the prospective directors and shall thereafter jointly appoint 3 (three) Independent Directors for the respective Board positions.

viii. The Committee shall be dissolved upon the completion of the selection process.

(e) Post appointment, each Director will be designated with terms of reference in specialized areas which shall include the following: MSME financing, risk management, accounting, audit matters, financial inclusion, performance management and human resources. The terms of reference for the Directors shall be mutually agreed upon by the shareholders.

(6) REPLACEMENTOF DIRECTORS

(a) The Board of Directors shall constitute a Board Nomination Committee ("**Nomination Committee**") comprising of 3 (three) Directors.

(b) The chairman of the Nomination Committee shall be the Director in charge of human resources and the other 2 (two) members of the Nomination Committee shall be selected by the Board of Directors 1 (one) of which must be an Independent Director.

(c) The Nomination Committee shall appoint an Independent International Search Firm who shall shortlist 3 (three) prospective Directors for each vacant Independent Director position in accordance with the terms of reference agreed on by the Nomination Committee and the Shareholders.

(d) The Firm shall forward the list of qualified prospective Directors to the relevant regulatory body (ies) for screening.

(e) The Nomination Committee shall forward the shortlist of 3 (three) qualified prospective Directors who have been approved by the regulators to the shareholders.

(f) The shareholders shall interview the short-listed prospective Directors who have been approved by the regulators. The shareholders shall jointly appoint the Director or Directors where the vacant position(s) is that of an Independent Director.

(g) With regard to a Director representing a shareholder, the Shareholder who appointed such Director shall have the right to appoint another Director in his place, subject in each case, to the approval of the relevant regulatory body (ies).

(7) APPOINTMENT OF ADDITIONAL DIRECTORS

(a) The number of Directors shall be increased by one (1) Director upon the Initial Additional Shareholder becoming a member of the Company. The Initial Additional Shareholder shall be entitled to appoint one (1) Director as its representative on the Board of Directors. The appointment of the additional Director by the Initial Additional Shareholder shall be subject to the approval of the relevant regulatory body (ies). For the purposes of this Memorandum and Articles of Association, the Initial Additional Shareholder shall mean the initial international financial institution that subscribes for shares in the Company with a subscription price as determined by the shareholders and which is given the right to appoint a director in a shareholders or investors agreement to which the Company is a party.

(b) Notwithstanding Article 5 (7) (a) above, the number of the Directors on the Board may be further increased when an additional shareholder or new additional Shareholders makes an equity investment in the Company.

(c) In considering such an increase as contemplated in Article 5 (7) (b) above, the existing Shareholders may consider offering the new additional Shareholder or new additional Shareholders Board position but must take into consideration the requirement that the size of the Board shall not exceed 13 (thirteen) Directors with the majority at all times being Independent Directors. In offering the Board position, the existing Shareholders shall consider whether the Board position will need to be shared among several of the new additional shareholders, depending on their number, the size of their investments and the recommendations of the Board. The appointment of any such additional Director shall be subject to the approval of the relevant regulator body or bodies.

(d) Each Shareholder shall be entitled at any time to remove any member of the Board so appointed by it and to appoint another or others in his or their place(s). In the event of the resignation, retirement or vacating of office by a Director appointed by a Shareholder, the Shareholder who appointed such Director shall have the right to appoint another or others in his or their place(s). In each case, subject to the approval of the relevant regulatory body (ies).

(e) For the avoidance of doubt, the recruitment and appointment process outlined in Article 5(6) shall apply to the appointment of additional Independent Directors.

(8) APPOINTMENT OF CHAIRMAN

(a) There shall be a Chairman of the Board who shall be appointed by the Federal Government of Nigeria as the majority Shareholder.

(b) The Chairman of the Board shall chair the meetings of the Board, unless he or she is absent, in which case, the Directors present may choose one of their number to be chairman of the meeting.

(9) REMUNERATION OF THE DIRECTORS

(a) The remuneration of the Directors, which shall be deemed to accrue from day to day, shall from time to time be determined by the Company in a general meeting. The Directors may also be paid all travelling, hotel and other expenses properly incurred by them in attending and returning from meetings of the Directors or any committee of the Directors or general meetings of the Company or in connection with the business of the Company.

(10) PROCEEDINGS OF THE BOARD OF DIRECTORS

a) BOARD MEETINGS

(i) The Board of Directors may make rules as it deems fit for regulating its proceedings.
(ii) The Directors may meet together for the dispatch of business, adjourn and otherwise regulate their meetings as they think fit, provided that the first meeting of the Directors shall be held not later than six months after the incorporation of the Company. Thereafter, the Board shall meet at least once in each calendar quarter.
(iii) The Board of Directors may invite observers to attend its meetings without the right to vote.

(11) QUORUM

(a) The Board of Directors shall have a quorum if at least two-thirds (67%) of its members are present. A meeting of Directors at which a quorum is present may exercise all powers exercisable by the Board of Directors. No decision - other than to call another meeting of the Board – may be taken without the quorum.

(b) Subject to there being a quorum, any question arising at any meeting shall be decided by majority of votes of all Directors present. In case of an equality of votes, the Chairman of the meeting shall have a second or casting vote. Directors are not allowed to vote by means of a proxy.

(c) Directors may participate in meetings by means of a telephone conference, video conferencing or similar communications equipment allowing all persons participating in the meeting to hear and be heard at the same time and participation at such a meeting shall constitute presence in person at such meeting.

(d) A resolution in writing signed by all the Directors entitled to receive notice of and vote at a meeting of the Board or of a committee of the Board shall, provided they constitute a quorum, be as effective as a resolution passed at a meeting of the Board of Directors or, as the **case may be, a committee of the Board duly convened and held.**

(12) DIRECTORS' TENURE

(a) A Director shall hold office for a term of three (3) years from the date of his appointment and he shall hold office for the whole of the term unless he is removed before the expiration of his term in accordance with the Act, the provisions of the Memorandum and these Articles of Association, or any Shareholders or Investors Agreement to which the Company is a party.

(b) A Director, upon the expiration of his term aforesaid, shall be eligible for re-appointment for one additional term on the Board for a total maximum tenure of six(6) years.

(c) To ensure continuity in the work of the Board, at each annual General Meeting of the Company at least one-third of the Directors shall retire by rotation and may submit themselves for re-appointment.

(d) The Board shall, irrespective of the tenure of the Directors stated above, be entitled to take appropriate action including removal of a Director, if the Board determines that a Director is in material breach of his duties, including fiduciary duties, to the company or the Director is disqualified under the Act or other applicable Codes from serving as a Director (on account of inter alia conviction in the court of law for an offence involving fraud or dishonesty or being adjudged bankrupt), subject to the conditions of the Act, the Memorandum **and these Articles of Association.**

(13) ALTERNATE DIRECTORS

a) Each Director shall be entitled to appoint an alternate director who shall attend and vote at meetings of the Board. The alternate director shall possess comparable professional qualifications with the Director by whom he is appointed.

6 BOARD COMMITTEES

(a) The Board shall establish such Board Committees as it deems necessary for the proper and efficient conduct of its business. The Board shall determine the composition and mandate of such Committees.

(b) The Board may delegate any of its powers, functions and discretions to committees, consisting of such Directors of its body as it think fit. Any committee so formed shall, in the exercise of the powers and functions so delegated, conform to any regulations that may be imposed on it by the Board.

(c) At the minimum, the Board shall constitute the finance, audit committee, remunerations committee, Nominations Committee and risk management committee. Audit and remunerations committees shall each be solely constituted by Independent Directors.

(d) The meetings and proceedings of such committees consisting of two or more Directors shall be governed by the provisions of these Articles regulating the meetings and proceedings of the Board, so far as the same are applicable and are not superseded by any regulations made by the Board under the preceding Article.

(e) A committee may elect a chairman of its meetings; if no such chairman is elected, or if at any meeting the chairman is not present within ten (10) minutes after the time appointed for the holding of the meeting, the Directors present may choose one of their number to be chairman of the meeting.

(f) Performance of the Board and Board committees shall be evaluated annually, facilitated by an external consultant, and it shall cover in the minimum the following areas: Board/Committee composition, dynamics, experience and knowledge; and communication between the Board and Board Committees and Management.

7. MANAGEMENT

(a) The day-to-day operative business of the Company shall be directed by a management team, which shall consist of a Chief Executive Officer (CEO), Chief Financial Officer (CFO) ,Chief Risk Officer (CRO) and a Chief Legal Officer (CLO). All members of the management team shall be competitively selected, appointed and removed only by the Board of Directors. The Chief Executive Officer and the other members of the management team shall be appointed by the Board for such terms and at such remunerations and upon such conditions as the Directors think fit. The number and composition of the management team can be changed by the Board of Directors.

(b) The CEO, CFO, CRO and CLO as well as other key members of the management team, shall report periodically to the Board of Directors and, at every General Meeting, to the shareholders.

8. SECRETARY

a) The Secretary shall be appointed by the directors for such term, at such remuneration and upon such conditions, as they may think fit; and any secretary so appointed may be removed by them.

9. FINANCIAL PROVISIONS

(1) DIVIDENDS AND RESERVES

(a) The Company in general meeting may declare dividends, but no dividends shall exceed the amount recommended by the Directors.

(b) No dividend shall be paid otherwise than out of the profits. The recommendation of the Directors, corroborated by financial statements duly audited by external auditors, as to the amount of profits of the Company shall be conclusive.

(c) Subject to the rights of persons, if any, entitled to shares with special rights as to dividend, all dividends shall be declared and paid according to the amounts paid or credited as paid on the shares. An amount paid or credited as paid on a share in advance of calls shall be treated for the purpose of these Articles as paid on the share. All

dividends shall be apportioned and paid proportionately to the amounts paid or credited as paid on the shares during any portion or portions of the period in respect of which the dividend is paid; but if any share is issued on terms providing that it shall rank for dividend as from a particular date, such share shall rank for dividend accordingly.

(d) All dividends unclaimed for six (6) months after having been declared may be invested or otherwise made use of by the Directors for the benefit of the Company until claimed and so that the Company shall not be thereby be constituted as a trustee in respect thereof. All dividends unclaimed for a period of twelve (12) years after having been declared shall be forfeited and shall revert to the Company.

(e) No dividend shall bear interest against the Company.

(2) CAPITALISATION OF PROFITS

a) The Company may in a general meeting upon the recommendation of the Directors, resolve that it is desirable to capitalize any part of the amount for the time being standing to the credit of any of the company's reserve accounts or to the credit of the profit and loss account or otherwise available for distribution and accordingly that the Directors be authorized and directed to appropriate the profits so resolved to be capitalized to members on the record date specified in the relevant resolution who would have been entitled thereto if distributed by way of dividend and in the same proportions.

(3) ACCOUNTS

a) The Directors shall cause proper accounting and other records to be kept and shall distribute copies of balance sheets and other documents as required by the Act and the provisions of the Act shall be complied with.

(4) AUDITS

a) External auditors shall be appointed and their duties regulated in accordance with this Memorandum and Articles of Association and the Act. Audit of the Company's financial statements shall be made in conformity with generally accepted auditing guidelines and standards by independent auditors.

10. ETHICS AND BUSINESS CONDUCT

(a) The Company, its Board and Management undertake to establish a Code of Ethics and Business Conduct to ensure compliance with the highest standards of honesty, integrity and impartiality for Directors, senior management, officers and employees and shall provide guidance on the avoidance of conflicts of interest, self-dealing and other types of impropriety as specified in the Banks and Other Financial Institutions Act (BOFIA) or the Act or by the Central Bank of Nigeria Code as amended.

(b) The Company, its Board and Management undertake to conform to the highest standards of professional ethics, business conduct and sustainable business practices in accordance with its Code of Ethics and Business Conduct.

(c) In accordance with the Code of Ethics and Business Conduct of the Company, all Directors, key executives and senior management of the Company shall act honestly in good faith and in the best interest of the Company and shall make full declaration of all their personal assets to the Company at the commencement of their appointment.

(d) The Company shall, on an annual basis, procure external independent evaluation consultant tasked with assessing the Company's strategies, policies, and projects in order to improve its development results. The consultant will report its findings to the Company's Board of Directors and shall be independent of the Company's management.

11. FINAL PROVISIONS

(1) ALTERATION OF MEMORANDUM AND ARTICLES OF ASSOCIATION

a) Subject to the provisions of the Act, the alteration of the Memorandum and Articles of Association shall be by special resolution approved by a vote representing 85 percent (eighty-five percent) of the total voting power of members. Any such alteration shall, before being passed by a resolution of the Shareholders, be referred to the General Meeting by the Board of Directors of the Company.

(2) WINDING UP

a) If the Company shall be wound up, the liquidator may, with the sanction of special resolution of the Company to that effect, and any other sanction provided in the Act, divide amongst the members in specie the whole or any part of the assets of the Company [whether they shall consist of property of the same kind or not], and may, for such purpose set such value as the liquidator may deem fair upon any property to be divided as aforesaid, and may determine how such division shall be carried out as between the members or different classes of members. The liquidator may, with like sanction, vest the whole or any part of such assets in trustees upon such trusts for the benefit of the contributories as he shall think fit, but so that no member shall be compelled to accept any share or other securities whereon there is any liability.

(3) MINUTES

a) The Board shall cause minutes to be recorded for the purpose:

i. of all appointments of officers made by the Board;
ii. of the name of the Directors present at each meeting of the Board and of any committee of the Board; and
iii. of all resolutions and proceedings at all meetings of the Company and of the holders of any class of shares in the Company and of the Board and of committees of the Board.

(4) THE SEAL

a) Directors shall provide for the safe custody of the seal, which shall be used on the authority of the Directors or a committee of the Directors authorised by the Directors in that regard, and every instrument to which the seal shall be affixed shall be signed by two Directors or shall be signed by a Director and the Secretary or by some other persons appointed by the Directors for the purpose.

(5) INDEMNITY

a) Every Director officer, secretary or auditor for the time being of the Company shall in the execution of his duties be indemnified out of the funds of the Company against any liability incurred by him in defending any proceedings, whether civil or criminal, in which judgment is given in his favour or in which he is acquitted by the court under the provisions of the Act

(6) NOTICES

a) Any notice to be sent to or by any person pursuant to these Articles (other than a notice calling a meeting of the Board of Directors or any committee of the Board) shall be in writing.

b) Any notice or other document (including a share certificate) may be served on or delivered to any member by the Company either personally or by sending it by post (by airmail or courier service where applicable) in a pre-paid letter addressed to such member or to his address as appearing in the Register. Where a notice is sent by post, service of the notice shall be deemed to be effected by properly addressing, pre-paying and posting a letter containing the notice, and to have been effected at the expiration of seven (7) days after same is posted if to an address in Nigeria and or if to an address outside of Nigeria at the expiration of seven (7) days after same is sent by courier service.

NAMES, ADDRESSES AND DESCRIPTIONS OF SUBSCRIBERS	SIGNATURES

Dated this day of 2014

Witness to the above signatures:

Name:

Address:

Occupation: