PUBLIC DISCLOSURE AUTHORISED

CARIBBEAN DEVELOPMENT BANK

EXECUTIVE SUMMARY WITH MANAGEMENT RESPONSE

PROJECT COMPLETION VALIDATION REPORT

THIRD CONSOLIDATED LINE OF CREDIT
CARIBBEAN FINANCIAL SERVICES CORPORATION
REGIONAL

OFFICE OF INDEPENDENT EVALUATION

MARCH 2016

Any designation or demarcation of, or reference to, a particular territory or geographic area in this Document is not intended to imply any opinion or judgment on the part of the Bank as to the legal or other status of any territory or area or as to the delimitation of frontiers or boundaries.

PUBLIC DISCLOSURE AUTHORISED

CARIBBEAN DEVELOPMENT BANK

EXECUTIVE SUMMARY

PROJECT COMPLETION VALIDATION REPORT

THIRD CONSOLIDATED LINE OF CREDIT
CARIBBEAN FINANCIAL SERVICES CORPORATION
REGIONAL

MARCH 2016

EXECUTIVE SUMMARY

1. BASIC PROJECT DATA

Project Title:	Third Consolidated Line of Credit – Caribbean Financial Services Corporation – Regional
Country:	Regional
Sector:	Finance
Loan No.:	06/OR-REG
Borrower:	Caribbean Financial Services Corporation (CFSC)
Implementing/Executing Agency:	CFSC

	CARIBBEAN DEVELOPMENT BANK (CDB) LOAN (USD mn)		
Disbursements ($mn)	**OCR**	**SFR**	**Total**
Loan Amount	5.00	-	5.0
Total Loan Disbursed	3.06	-	3.06
Cancelled	1.94	-	1.94
Project Milestones	**At Appraisal**	**Actual**	**Variance (months)**
Board Approval	2005-05-16	2005-05-16	-
Loan Agreement signed	2005-07-22	2005-06-15	1.19
Loan Effectiveness[1]	2005-08-12	2005-08-24	(0.39)
CDB Loan	**At Appraisal**	**Actual**	**Variance (months)**
First Disbursement Date	2005-12-31	2006-02-08	(2.26)
Terminal Disbursement Date (TDD)	2009-03-31	2010-06-30	9.19
TDD Extensions (number)	-	1	-
Project Cost & Financing ($mn)	**At Appraisal**	**Actual**	**Variance**
CDB Loan	5.00	5.00	-
CDB Grant	-	-	-
Counterpart (GOB)	-	-	-
Total	5.00	5.00	-
Terms	**Interest Rate**	**Repayment**	**Grace Period**
CDB Loan (SFR)	-	-	-
CDB Loan (OCR)	5.75 (variable)	13 years (including grace period)	3 years
Implementation	**At Appraisal**	**Actual**	**Variance**
Start Date[2]	2005-08-12	2005-08-24	(0.39) months
Completion Date	2009-03-31	2010-03-31	(12) months
Implementation Period	3.6 years	4.7 years	(1.1) years
Economic Rate of Return (%)			
At Appraisal	Not Applicable		

[1] Date conditions to First Disbursement satisfied
[2] Implementation begins with satisfaction of conditions precedent

2. PROJECT DESCRIPTION

2.01 CDB has enjoyed a lending relationship with the Caribbean Financial Services Corporation (CFSC), headquartered in Barbados, since 1994, and as at 2005 had provided two loans of USD5 mn each.

2.02 As a regional private sector Development Finance Institution (DFI), CFSC seeks to fill a gap in the provision of development finance to small and medium-scale export-oriented enterprises. CFSC's core business areas are loan and equity investments to commercially viable, employment generating projects in the Organisation of Eastern Caribbean States (OECS) member countries, Barbados, Belize, Guyana and Trinidad and Tobago. CFSC's loan and equity portfolios are heavily skewed towards tourism and related activities, but attempts were made to diversify across geographical locations in which it operates. CFSC has created a niche in financing tourism activities, especially within OECS member countries.

2.03 In 2005, CFSC, applied to CDB for a third Line of Credit (LOC) of USD5 mn to assist with the financing of its medium to long-term lending programme to export-oriented enterprises involved in agriculture, industry, tourism and service sectors.

EXPECTED OUTCOMES AND STRUCTURE

2.04 The objective of the loan was to enhance CFSC's capacity to provide resources to assist in increasing the financial strength and competitiveness of the productive sectors, by providing resources on competitive terms that facilitate industry expansion and improvements in the quality and the delivery of goods and services. The project comprised disbursements to CFSC to a maximum of USD5 mn as sub-loans were approved.

2.05 The LOC was to be used for making loans (sub-loans) for agricultural, industrial, tourism and agro-industry purposes in any of CDB's BMCs in which CFSC is authorised to carry on business, on CDB's standard terms and conditions. Not more than 70% of the cost of a project financed by a sub-loan would be disbursed by CDB; not more than 60% of the Loan would be disbursed for sub-projects for tourism purposes; and not more than 20% of the Loan would be disbursed to any single borrower.

EVALUATION OF PERFORMANCE

2.06 The Project Completion Report (PCR) was prepared in 2013 and validated by the Office of Independent Evaluation (OIE) in 2015. The Evaluator rates the overall performance of the project as *Unsatisfactory*. The PCR provided contradictory and inconsistent ratings in the summary page and the body of the PCR. With respect to individual criteria, the Evaluator assigned *Unsatisfactory* to all core criteria with the exception of Relevance, which was rated as *Marginally Unsatisfactory*. The Evaluator emphasises that the *Unsatisfactory* performance of the Borrower and the *Marginally Unsatisfactory* performance of CDB contributed to the poor performance of the project. OIE is of the opinion that warning signs about the financial health of CFSC were not addressed with sufficient urgency. CFSC did not meet the targets set in the logical framework and CDB did not pay adequate attention to monitoring the sub-loans securing the LOC.

BORROWER AND EXECUTING AGENCY PERFORMANCE

2.07 The *Unsatisfactory* performance of this project is due to the poor financial performance of CFSC as an institution, poor project selection leading to over-concentration in the tourism sector, protracted inability to reduce its non-performing loan (NPL) portfolio, the paucity of and delay in providing information to CDB, and the apparent weak corporate governance which resulted in the entity becoming insolvent.

THE CARIBBEAN DEVELOPMENT BANK'S PERFORMANCE

2.08 The Evaluator rates CDB's performance as *Marginally Unsatisfactory*. CDB fell short of its oversight role in a number of areas. CDB had an equal responsibility for assessing the quality of the loan applications and could equally be held responsible for "poor project selection". There is no evidence of CDB engaging with CFSC to better market its loan products to new clients, or in raising the alarm that CFSC concentrated in one sector and in its client base for that sector. The monitoring of the sub-loan portfolio by CDB was unsatisfactory and failed to prevent the overconcentration of loans under the LOC in tourism. While CDB raised concerns as early as 2005 about the level of CFSC's capitalisation, CDB did not act decisively to, for example, reduce its exposure for this project, insist on more robust measures by CFSC, use its influence to press more strongly for changes in management of its NPLs portfolio. In addition, there is a two-year gap in the registry file for this Third Line of Credit.

LESSONS LEARNED

2.09 In addition to the lessons cited in the PCR, the Evaluator adds the following:

(a) CDB should have more actively monitored the conditions for borrowing that were established at appraisal, particularly the concentration in tourism loans and have taken a more involved role in project selection.

(b) The fundamental assumptions and regional context for small medium-sized enterprise (SME) lending should have been more thoroughly and independently assessed by CDB at appraisal. "SMEs" should have been defined and a more robust analysis of the constraints to SME lending in the Region undertaken.

(c) CDB overlooked the significance of CFSC's lack of capital and dependence on a few donors, including CDB itself, and did not exert significant pressure on CFSC to diversify its financing sources.

(d) The importance of due diligence and internal capacity (of both the Borrower and CDB in its oversight role) to assess investment projects and assess risk adequately cannot be overstated.

RECOMMENDATIONS

2.10 A detailed analysis of the reasons for the failure of this project was beyond the scope of a validation report. There is scope for assessing a number of inconsistencies and deficiencies especially in supervision. CDB should consider extending such a review to other intermediary Development Finance Institutions (DFIs) supported by CDB to ascertain whether this experience is an outlier or points to systematic weaknesses in CDB's lending approach to DFIs.

TABLE 1: SUMMARY RATINGS OF CORE EVALUATION CRITERIA AND OVERALL PERFORMANCE ASSESSMENT OF THE PROJECT

Criteria	PCR[3]	OIE Review	Justification
Relevance	Marginally Unsatisfactory (2)	Marginally Unsatisfactory (2)	Based on the historical demand for CFSC financing and its reliance on CDB funding as a source, the third LOC appeared relevant at appraisal with respect to the assessed demand for financing in the countries and sectors in which CFSC was active. This assessed demand did not materialise. This was evidenced by the poor quality and poor volume of applications, as well as the continued concentration in tourism, and on existing clients. While there was evidence in the files of applications from at least three non-tourism enterprises, these were assessed as unsuitable. It was not clear whether there was sufficient effort on the part of CFSC to market its services outside of the tourism sector, or whether the demand from SMEs simply did not exist.
Effectiveness	Unsatisfactory (1)	Unsatisfactory (1)	The project did not attain the results expected with respect to the disbursed value, number of SMEs supported and the range of industries to be financed by the loan. The disbursed value from the third LOC was USD3,059,209, (61% of the approved LOC) to four firms (of a target of 10), only one of which was not involved in tourism. CFSC made investments to existing clients rather than new clients and the concentration of the loans in the tourism sector was higher than CFSC's overall portfolio, despite the recognised risk.
Efficiency	Unsatisfactory (1)	Unsatisfactory (1)	The project disbursed only 61% of the targeted amount by 2009 and disbursed to only 40% (4 out of 10) of the number of firms targeted. The institutional challenges of CFSC required significant resources of CDB with respect to monitoring and ongoing consultation with CFSC and other partners to address the capitalisation and restructuring of CFSC; as well as recovery action for NPLs.
Sustainability	Unsatisfactory (1)	Unsatisfactory (1)	The sustainability of the project was unsatisfactory. Of the four loans financed by the third LOC, two were non-performing. At the time of PCR preparation, CDB was advised that CFSC was virtually insolvent, due to persistent losses and erosion of its capital and was operating with only a minimum Board and losing staff. As at 2013 when the PCR was prepared, CFSC still had no access to funding for its lending activities and had been unsuccessful in securing a strategic partner to capitalise the institution.
Composite (Aggregate) Performance Rating	Unsatisfactory (1.25)	Unsatisfactory (1.25)	The project was compromised by the poor performance of CFSC in identifying suitable projects that met CDB's criteria, and by the overall financial weaknesses of the institution, particularly its lack of capital and poor management of its loan portfolio.
Borrower & EA Performance	Marginally Unsatisfactory	Unsatisfactory	The Unsatisfactory performance of this project is due to the very poor financial performance of CFSC as an institution, poor project selection leading to over-concentration in the tourism sector, protracted inability to reduce its NPL portfolio, the paucity of and delay in providing information to CDB, and the apparent weak corporate governance which resulted in the entity becoming insolvent.
CDB Performance	Satisfactory	Marginally Unsatisfactory	CDB oversight of the project was mixed. There was regular monitoring of CFSC's financial performance but lax monitoring of the loan portfolio securing the LOC. There is no evidence of CDB recognising the concentration of the loans to tourism and existing clients. The result was a higher concentration in tourism lending with funds from the third LOC than was considered prudent. In the face of early warning signs of CFSC's deterioration in 2007, CDB seemed unable to take a hard decision to reduce their exposure for this project or to insist on more robust mitigation measures by CFSC. The issue was only formally escalated in December 2010. CDB allowed CFSC too much latitude to delay taking the necessary steps to better manage its debt portfolio.
Quality of PCR		Marginally Unsatisfactory	The PCR was not completed using the required PPES rating format and provided limited justification for its ratings.

[3] PPES scores and ratings used in PCR and PSRs to be converted to PAS 2013 scores and ratings, using the equivalence matrix in the relevant PAS 2013 Manual (Public Sector Investment Lending and TA; PBL; CSP).

PUBLIC DISCLOSURE AUTHORISED

CARIBBEAN DEVELOPMENT BANK

MANAGEMENT RESPONSE

PROJECT COMPLETION VALIDATION REPORT

THIRD CONSOLIDATED LINE OF CREDIT
CARIBBEAN FINANCIAL SERVICES CORPORATION
REGIONAL

MARCH 2016

MANAGEMENT RESPONSE

INTRODUCTION

1.01 The Executive summary of the Project Completion Validation Report provides valuable lessons that can be used to inform future design for similar interventions, especially in relation to our private sector financial intermediaries, and for early corrective measures where such a financial institution might be significantly exposed to one sector. However, we do not fully endorse all of the conclusions reached within the Report and we have sought to provide alternative responses where appropriate.

FINDINGS

2.01 We accept that a valuable lesson from this experience is the need for better assessment and oversight of subloans, which forms part of the underlying security for the CDB Loan, a situation made worse by the failure of CFSC to maintain and provide adequate supervision and monitoring of its portfolio on a timely basis.

3.01 Neither the PCR nor the Validation Report highlighted in their assessment of the Borrower's performance, the debilitating effects which CFSC's change of ownership had on its operating and financial performance, as well as deficient governance arrangements. Such information is critical to explaining the challenges related to CFSC's access to additional capital and deterioration in performance. ECIC Holdings (ECIC), which acquired majority shareholding of CFSC in 2006, did not demonstrate commitment to the institution and in several respects sent mixed signals with respect to CFSC's business model. Once CFSC's financial fortunes deteriorated, ECIC did not demonstrate an ability to provide much needed capital and liquidity support to CFSC despite requests from CDB. CFSC encountered difficult times from 2009 onwards, and it was during 2009 that ECIC gave an undertaking to provide $3 mn in additional equity to CFSC, which never materialised. A working capital loan in the amount of $2.5 mn approved by the National Bank of Dominica in 2009 (one of the shareholders of ECIC) was not taken up, due to onerous conditions. Further, ECIC had the option to convert $1.6 mn in convertible debentures to equity, which was not exercised. Such factors are critical to the assessment of CFSC's borrower performance and to lay the foundation for why CFSC failed to meet expected outcomes under the Loan.

4.01 The Report seems to place significant emphasis on CFSC's heavy concentration in tourism lending and raised concerns with respect to such portfolio concentration and our due diligence process. We recognised and accepted that inherent risks were associated with this strategy, and sought to exert controls on CFSC to diversify its heavy concentration in tourism investments, but admittedly these did not have the desired results. Part of the challenge was that CFSC had developed and articulated being a niche market financier for tourism projects, while showing a limited appetite for exposures to other sectors. In addition, CFSC failed to employ adequate supervision and monitoring of its investment portfolio and this situation was made worse by CFSC's inability to retain qualified and experienced staff post-2008.

5.01 It is important to note that CFSC's portfolio also comprised equity investments, primarily funded from the resources of the European Investment Bank (EIB) that were subsequently impacted by the financial and economic crisis of 2008. This contributed to CFSC's poor performance, including its capital erosion. Also, there is need to recognise that CFSC had a significant portion of its portfolio in Grenada, which suffered major devastation from hurricane Ivan in 2004 and Emily in 2005, thus severely impacting infrastructure, the economy and performance of the tourism sector. While accelerating recovery of non-performing projects has been a key area of focus for CFSC, progress has been slow and exacerbated by a slow Court litigation process, as well as challenges with the continued loss of key staff. Further, CFSC along with other financial institutions [including the International Finance Corporation (IFC) and EIB] have encountered significant challenges in disposal of assets held as security for failed projects in Grenada, given its prolonged macroeconomic difficulties.

6.01 Table 2 below, details responses to key findings in the Report.

TABLE 2: KEY FINDINGS FROM THE PROJECT COMPLETION VALIDATION REPORT AND RESPONSES FROM PROJECTS STAFF

REFERENCE	COMMENTS FROM STAFF
Weak Logical Framework.	We concur with this assessment, but believe that this has been a major challenge at appraisal for financial intermediary loans.
No evidence of CDB engaging with CFSC to better market its loan products to new clients.	CFSC's mandate requires it to provide funding for development activities within a market segment commonly referred to as "the missing middle," representing that market segment not addressed by the national development finance institutions, given their loan ceiling and for which commercial banks have limited appetite. There were several instances where CDB staff referred project sponsors or financing inquiries to CFSC for consideration, given CDB's limited involvement in direct lending. However the marketing of CFSC services is the responsibility of its management team.
No evidence that CDB raised the alarm that CSFC was concentrated in one sector.	Paragraphs 2.21 and 3.04 of the Appraisal Report identified portfolio concentration in tourism as a risk. Paragraph 3.05 of the same Report imposed a limit on tourism lending.
Monitoring of the subloan portfolio by CDB was unsatisfactory.	Agreed and reflects a project and sector specific absence of internal capacity at the time of project appraisal and implementation.
CDB should have more actively monitored the conditions for borrowing that were established at appraisal, particularly the concentration in tourism and be more involved in project selection.	While closer attention to project selection was critical, the underlying sector analysis to inform performance and sector constraints suffered from CDB not having relevant sector specialists on staff. Hence, our due diligence focused on management and financial soundness of the project proposals being requested for financing.

REFERENCE	COMMENTS FROM STAFF
CDB overlooked the significance of CFSC's lack of capital and dependence on few donors, including CDB itself and did not exert significant pressure on CFSC to diversify its funding sources.	We do not agree that CFSC's capital structure was overlooked. CDB identified weak capitalisation at appraisal and during project supervision as early as 2006, which formed part of an ongoing conversation with CFSC and similarly, supported by other senior lenders. CFSC held ongoing discussions with various investor groups, which did not translate into the desired results. However, prior to the change of ownership in 2006, institutional investors (Deutsche Investitions-und Entwicklungsgesellschaft, IFC and the Commonwealth Development Corporation) along with some private sector investors did signal an intention to divest their shareholding in CFSC, on the grounds that their development role had been fulfilled. The decision by ECIC to acquire majority shareholding in CSFC was perceived to be an opportunity for CFSC to get additional capital from among OECS investors which did not materialise. Expanding CFSC's equity capital was an ongoing conversation with CFSC. However, investor appetite was limited. Outside of CFSC's shareholder group, additional avenues for borrowing were either limited or non-existent.
The fundamental assumptions and regional context for SME lending should have been more thoroughly and independently assessed by CDB at appraisal. SMEs should have been defined and a more robust analysis of the constraints to SME lending undertaken.	Agreed. At the time of appraisal, a decision was taken to focus on a review of the financial sector, given that it was a financial intermediary loan. However, in light of CFSC's exposure to tourism, a sector analysis would have been useful. Also, there is need to recognise that SMEs, while having some common features and constraints, will differ across the Region in terms of number of employees, asset size, sales generated and financing needs, which in essence complicates the provision of a standard definition for SMEs.
An inability of CFSC to achieve the output targets as specified at appraisal.	While the Report accurately stated that by 2009 CFSC had an undisbursed balance of $2.8 mn on this loan, CDB took a decision to suspend disbursements due to unacceptable financial performance. Such action was a critical factor in controlling CDB's risk exposure following the deteriorating performance of CFSC and the project not realising its disbursement target.
Early warning signs of CFSC's deteriorating financial health, were not addressed by CDB with sufficient urgency.	While we accept that there was room for enhanced supervision, by the time CFSC's difficulties were manifested in 2008, CDB had already disbursed 60% of the loan resources and had raised its concerns in relation to CFSC's weak management structure, insufficient capital and decline in performance. On three occasions, CFSC advised its senior lenders that negotiations were taking place with potential investors, which contributed to a delay in taking action on debt recovery during CFSC's early stages of difficulties.