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CASE STUDY

Improving Credit Access for Entrepreneurs at the Bottom of the Pyramid

Here's how using credit enhancements and working with commercial banks can increase access to finance for micro and small businesses.

Overview

Providing financial services to traditionally underserved populations is critical to reducing poverty and achieving inclusive economic growth. This includes giving micro and small entrepreneurs the capital they need to sustain and grow their livelihood.

In 2010, the Asian Development Bank (ADB) started a credit enhancement program with commercial banks to mobilize funding for the bottom of the pyramid in Asia and the Pacific. This involves supporting the portfolio growth of microfinance institutions by making it easier for them to get commercial financing.

Project snapshot

Dates	• **13 December 2010:** Approval date • **Every 3 years:** Program review
Cost	• **US$ 340 million: :** Overall program limit

Institutions and Stakeholders	**Financing** • Asian Development Bank: risk participation or guarantee **Partner** • International: Standard Chartered Bank, Citibank NA, Malayan Banking Berhad • India: Northern Arc Capital (formerly, IFMR Capital), RBL Bank, Kotak Mahindra Bank, IndusInd Bank • Sri Lanka: Hatton National Bank **Others** • Borrowers: Microfinance institutions in ADB's developing member countries

Challenges

Across Asia and the Pacific, many micro and small entrepreneurs struggle to find loans for their business. Institutions targeting this market segment are mostly microfinance institutions and even they have difficulties in gaining access to commercial financing.

Small and medium-sized enterprises (SMEs) are the backbone of the Asian economy. An ADB survey of 20 countries in Central Asia, East Asia, South Asia, Southeast Asia, and the Pacific shows that these enterprises make up more than 96% of businesses in the region and provide two out of three jobs in the private sector. They also contribute an average of 42% of the gross domestic product or manufacturing value added in these countries.

However, many banks prefer to lend to large enterprises, rather than micro and small enterprises because of the perceived higher risks, small loan amounts, and absence of credit history and collateral. The survey report notes a downward trend in bank lending to small businesses in the region since the 2008/09 global financial crisis. This leaves approximately 52% to 64% of the 60 million to 70 million microenterprises in Asia and the Pacific unserved or underserved, translating to an estimated credit gap of $400 billion to $500 billion.

Microfinance institutions play a critical role in financing micro and small businesses, such as trade stores, roadside food stalls, and market vendors. However, microfinance institutions are often small in scale, and banks are reluctant to lend to them for the reasons mentioned above.

For example, when the microfinance crisis hit the southern Indian state of Andhra Pradesh in 2010, liquidity dried up and it was difficult for microfinance institutions to get funding.

Solutions

ADB designed a regional credit enhancement program that fills these market gaps by sharing risks with commercial banks to increase local currency lending to the microfinance sector.

The Microfinance Risk Participation and Guarantee Program shares up to 50% of the default risk of banks that provide wholesale loans in local currency to microfinance institutions with a maximum tenor of 5 years. This helps to lessen microfinance institutions' exposure to foreign exchange risks and improve access to commercial financing.

The program is open to international and domestic financial institutions that are able to meet ADB's eligibility criteria and due diligence requirements, which include the following:

- Credit rating of BB or higher (or equivalent) from at least one international credit rating agency or industry recognition as a key player in microfinance sector;
- Reputable and sound ownership, management and governance standards;
- Status as a duly registered, regulated, and licensed entity in ADB's developing member countries;
- Acceptable underwriting systems and servicing platforms in place
- At least 3 years of lending experience to the sector with nonperforming loans of less than 5%.

Once accredited, the partner financial institution submits microfinance institutions to be included in the program. ADB will approve a limit for each microfinance institution subject to the result of its own institutional review.

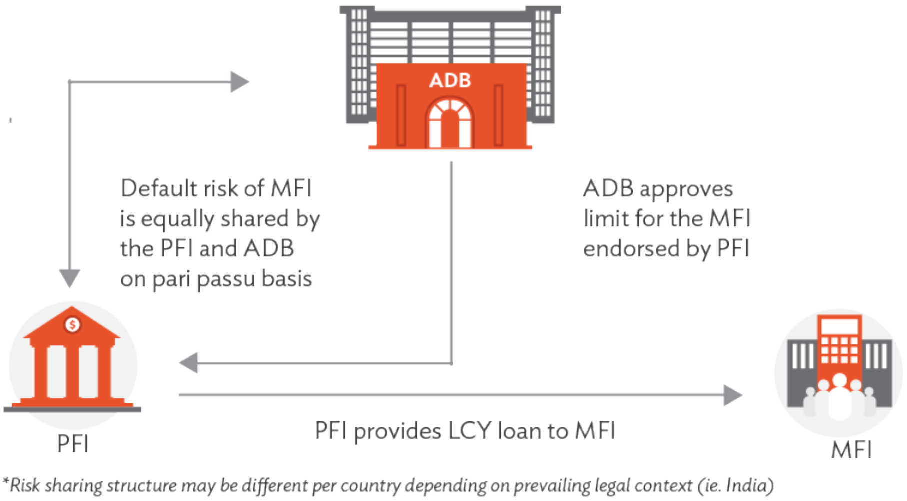
The program offers two structures through which ADB works with partner financial institutions.

Risk Participation

Under the risk participation structure, ADB shares on a pro rata basis the default risk of ADB-approved microfinance institutions. This structure is often more suitable for financial institutions that have a regional network. The structure is valid in various countries and only one agreement needs to be executed.

Guarantee Structure

The guarantee structure may differ in each country according to the local context, but the obligations of ADB are the same. For example, in India, the partner financial institution's role is split between two entities – one to perform as an arranger and the other as local currency lender. Similar to the risk participation structure, the guarantee structure shares the default risk on a pro rata basis between arranger, local currency lender and ADB. This structure is used in India to meet certain regulatory requirements.

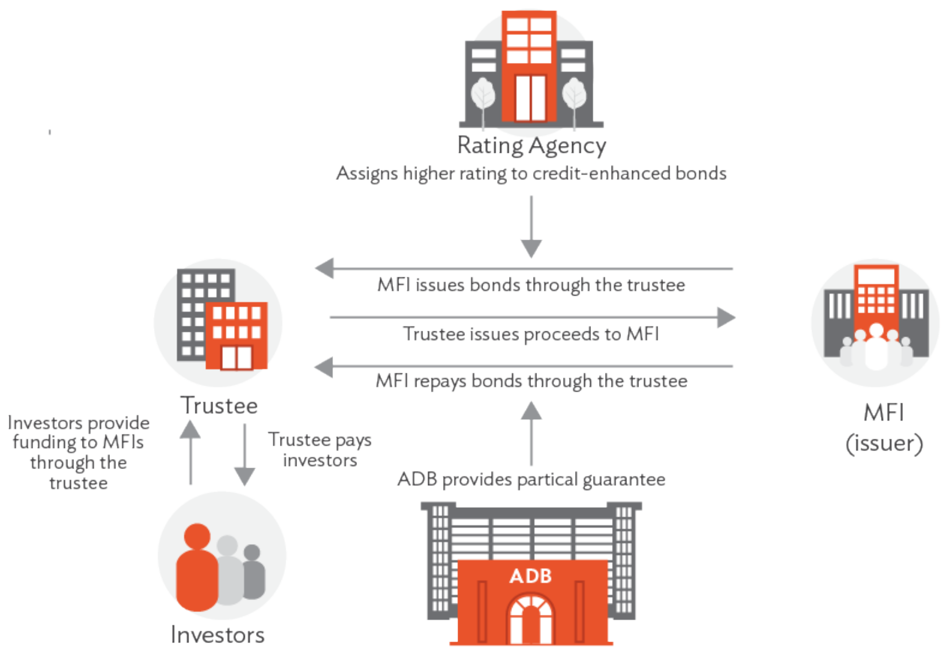


LCY = local currency; MFI = microfinance institution; PFI = partner financial institution.

At the end of 2017, the program expanded its scope to include partial credit enhancements for capital market instruments, such as bonds and securitization, issued by microfinance institutions. This will support the microfinance institutions to broaden their funding source.

a. Bond Issuance

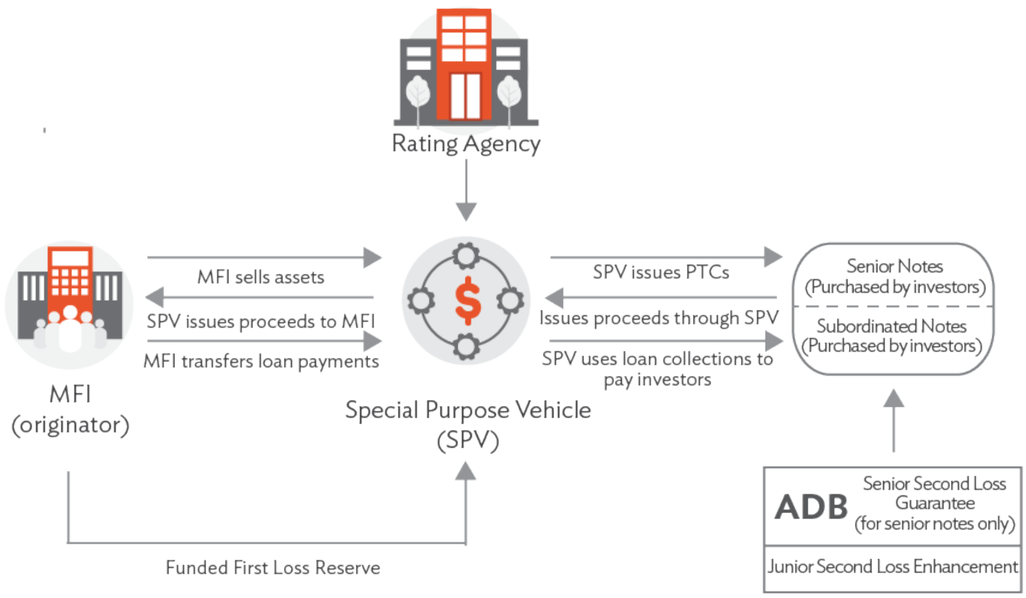
ADB offers partial credit guarantees on bonds issued by microfinance institutions through a trustee to support access to diversified funding in capital markets. ADB takes credit exposure on the microfinance institution issuing the bond and guarantees up to 50% of the principal bond amount. Bond issuances usually have a tenor of three to five years, and ADB's credit enhancements would thus need to be able to cover this period.



MFI = microfinance institution.

b. Securitization

For securitization where a pool of microfinance loans are sold without recourse to investors, ADB partially credit enhances the senior notes portion of the securitization structure held by an arranger or accredited partner financial institution. This option requires that ADB provides credit enhancement (senior second loss guarantee) on the portion of a specific microfinance institution loan portfolio.



MFI = microfinance institution; PTC = pass-through certificate.

Results

Because of the program's success, its expiration date was removed and brought into ADB's mainstream operations in 2015. The program currently works in India, Bangladesh, Myanmar, Indonesia, and Sri Lanka through eight partners and will further expand regionally to ensure more low-income clients can get access to financial services. It has approved so far 31 microfinance institutions.

From inception to August 2018, the program has supported $846.17 million in new local currency loans, which went to 4.47 million micro-borrowers, mostly women.

One of the program's strongest attributes is its ability to support microfinance institutions through various stages of growth. For example, some Indian partner microfinance institutions have grown significantly and are now converting into small finance banks and exiting the program. Several of the larger microfinance institutions are now being funded directly by ADB outside of the program through long-term debt and equity.

In addition, some of the banks that perceived microfinance institutions as too high a credit risk in the beginning are now much more comfortable with this asset class and require proportionately less risk sharing or guarantees from ADB.

Key statistics

$846.17 million	New loans supported (until August 2018)
$440.74 million	Cofinancing (until August 2018)
31	Number of microfinance institutions approved from 2010–August 2018
4.47 million, mostly women	Borrowers supported from 2010–August 2018
3 international, 5 local	partner financial institutions from 2010- August 2018
India, Bangladesh, Myanmar, Indonesia, Sri Lanka	Countries covered

Lessons

The partnership between ADB and financial institutions demonstrates how mobilizing finance from the private sector using ADB products can increase access to financial services for the bottom of the pyramid and help advance the Sustainable Development Goals.

The program has had no default or guarantee claims to date. This was partly the result of efforts to select good partner financial institutions that have strong underwriting standards and are familiar with and monitor the microfinance sector in a country. It also shows the importance of well-regulated microfinance markets, such as India.

Going forward, the ADB will expand further throughout the region and support microfinance institutions in diversifying their funding sources and product offerings in order to reach more of the unbanked population in Asia and the Pacific.

Resources

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Catalysts for Financial Inclusion: Remittance and Digital Finance

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Sabine Spohn is primarily responsible for managing the Microfinance Risk participation and Guarantee Program. Prior to ADB, she worked as Deputy Head in Frankfurt School of Finance and Management, responsible for its Asian project portfolio. She has a commercial banking background and holds a PhD in Development Studies from the University of Melbourne.

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