



Report and Recommendation of the President to the Board of Directors

Project Number: 51195-001
November 2017

Proposed Debt Financing Cholamandalam Investment and Finance Company Limited Expanding Credit Delivery for Micro-, Small-, and Medium-Sized Enterprises Project (India)

This is an abbreviated version of the document approved by ADB's Board of Directors that excludes information that is subject to exceptions to disclosure set forth in ADB's Public Communications Policy 2011.

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 31 October 2017)

| | | |
|---------------|---|------------------|
| Currency unit | – | Indian rupee (₹) |
| ₹1.00 | = | \$0.015 |
| \$1.00 | = | ₹64.93 |

ABBREVIATIONS

| | | |
|------|---|--|
| ADB | – | Asian Development Bank |
| CAGR | – | compound annual growth rate |
| CAR | – | capital adequacy ratio |
| FYE | – | fiscal year-end |
| GDP | – | gross domestic product |
| IFC | – | International Finance Corporation |
| LAP | – | loan against property |
| LCV | – | light commercial vehicle |
| LTV | – | loan to value |
| MSME | – | micro-, small-, and medium-sized enterprises |
| NBFC | – | nonbank financial company |
| NCD | – | nonconvertible debenture |
| NIM | – | net interest margin |
| NPA | – | nonperforming asset |
| NPL | – | nonperforming loan |
| RBI | – | Reserve Bank of India |
| SME | – | small- and medium-sized enterprises |

NOTES

- (i) The fiscal year (FY) of the Government of India and Cholamandalam Investment and Finance Company Limited ends on 31 March. “FY” mentioned before a calendar year denotes the year in which the fiscal year ends, e.g., FY2014 ends on 31 March 2014.
- (ii) In this report, “\$” refers to United States dollars.

| | |
|-------------------------|--|
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In preparing any country program or strategy, financing any project, or by making any designation of or reference to a particular territory or geographic area in this document, the Asian Development Bank does not intend to make any judgments as to the legal or other status of any territory or area.

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PROJECT AT A GLANCE

| | | | |
|--|--|--|---------------------------------|
| 1. Basic Data | | Project Number: 51195-001 | |
| Project Name | Expanding Credit Delivery for Micro-, Small-, and Medium-Sized Enterprises Project | Department /Division | PSOD/PSFI |
| Country | India | | |
| Borrower | Cholamandalam Investment and Finance Company Limited | | |
| 2. Sector | | Subsector(s) | |
| ✓ Finance | Inclusive finance | ADB Financing (\$ million) | |
| | | 150.00 | |
| | | Total | |
| | | 150.00 | |
| 3. Strategic Agenda | | Subcomponents | |
| Inclusive economic growth (IEG) | Pillar 2: Access to economic opportunities, including jobs, made more inclusive | Climate Change Information | |
| | | Climate Change impact on the Project | Low |
| 4. Drivers of Change | | Components | |
| Private sector development (PSD) | Promotion of private sector investment | Gender Equity and Mainstreaming | |
| | | Some gender elements (SGE) | ✓ |
| 5. Poverty and SDG Targeting | | Location Impact | |
| Geographic Targeting | Yes | Rural | High |
| Household Targeting | No | Urban | Low |
| SDG Targeting | Yes | | |
| SDG Goals | SDG1, SDG8 | | |
| 6. Nonsovereign Operation Risk Rating | | | |
| Obligor Name | | Obligor Risk Rating | Facility Risk Rating |
| Cholamandalam Investment and Finance Company Limited | | | |
| 7. Safeguard Categorization | | | |
| Environment: FI-C | | Involuntary Resettlement: | Indigenous Peoples: FI-C |
| | | FI-C | |
| 8. Financing | | | |
| Modality and Sources | | Amount (\$ million) | |
| ADB | | 150.00 | |
| Nonsovereign LIBOR Based Loan (Regular Loan): Ordinary capital resources | | 150.00 | |
| B-Loans | | 0.00 | |
| None | | 0.00 | |
| Official Cofinancing^a | | 0.00 | |
| None | | 0.00 | |
| Others^b | | 0.00 | |
| Total | | 150.00 | |

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on proposed debt financing through senior secured nonconvertible debentures (NCDs) of up to \$150,000,000, in Indian rupee equivalent, to Cholamandalam Investment and Finance Company Limited (Chola) for the Expanding Credit Delivery for Micro-, Small-, and Medium-Sized Enterprises Project in India.

2. The project entails ADB providing longer-term financing to Chola, a leading nonbank finance company, for onlending to micro, small and medium-sized enterprises (MSMEs), half of which will be from the lagging states in India. ADB's financing will meet Chola's requirements for medium-term funds, which will help fund longer-tenor MSME loans and diversify Chola's funding mix. Given the slowdown in credit growth from banks in India in FYE 2018, ADB's funding will also have a countercyclical benefit on MSMEs' access to finance, translating into economic growth and employment.

II. THE FINANCIAL INTERMEDIARY

A. Investment Identification and Description

3. **Finance sector overview.** India's finance sector is evolving, with commercial banks dominating the sector. There were 216 banks as of fiscal year-end 2017 (FYE2017), including 149 scheduled commercial banks registered with the Reserve Bank of India (RBI). Total deposits of all banks stood at ₹107.0 trillion and total loans amounted to ₹78.0 trillion.¹ The excessive exposure of certain banks to high-risk sectors, such as power and metals and mining, and RBI's stricter provisioning and disclosure policies on distressed loans; resulted in a deterioration in asset quality for the banking sector. Nonperforming asset (NPA) ratios increased from 3.5% in FY2013 to 7.6% in FY2016 and to 9.6% in FY2017. The decline in asset quality and limited access to new capital have pushed the sector's capital adequacy ratio (CAR) down from 14.0% at FYE2013 to 13.6% at FYE2017. Profitability also declined. Consequently, commercial banks have severely curtailed their lending operations, with credit growth slowing to its lowest level; 4.6% at FYE2017 against an average of 12.5% in the period FY2008 to FY2016.² Furthermore, credit offtake has been focussed on retail and consumer financing, which further constricted access to formal financing for underserved micro-, small-, and medium-sized enterprises (MSMEs).

4. **Nonbank financial companies.** Nonbank financial companies (NBFCs) complement the banking sector in targeting under or unbanked segments of the population with tailored approaches and products. Also, given RBI's policy for extending credit to priority sectors, some banks partially fulfil their mandated requirements by extending credit through NBFCs, benefitting from the latter's client reach, geographic coverage, and adaptability of products, which generate loans in priority sectors.³ At FYE2017, 11,517 NBFCs had total loans outstanding of ₹13 trillion (equivalent to 17% of total financial system assets).⁴ While the overall asset quality of NBFCs is better than that of the banking sector, there has been an increase in gross NPAs. NBFCs' CAR

¹ RBI. Database on Indian Economy. <https://dbie.rbi.org.in> (Business of Schedule Banks) (accessed 15 September 2017)

² CARE Ratings. 2017. *Indian Banking Sector: Update FY17 & Outlook*. 26 July 2017. <http://www.careratings.com/upload/NewsFiles/SplAnalysis/Indian%20Banking%20Update%20FY17%20and%20Outlook.pdf>.

³ RBI. 2015. Policy RBI/2015-16/53 FIDD.CO.Plan.BC.4/04.09.01/2015-16. As per the policy, 40% of adjusted net bank loans must be for priority sectors, including agriculture, MSMEs, export credit, education, housing, social infrastructure, and renewable energy.

⁴ RBI. Financial Stability Report. <https://www.rbi.org.in/Scripts/FsReports.aspx> (accessed September 2017).

declined from 24.3% as of FYE2016 to 22.0% as of FYE2017 (the regulatory requirement is 15.0%). Profitability also declined moderately in the same period as net interest margins narrowed.⁵ While both commercial banks and NBFCs can provide much-needed financing for MSMEs, NBFCs are well-placed in terms of their capitalization, and benefit from manageable NPAs and maintain their focus on growth.

5. **Micro-, small-, and medium-sized enterprise subsector.** It is estimated that about 48.8 million MSMEs operated across all industries in India, employing more than 111 million people as of 2014.⁶ Also, MSMEs accounted for 45% of the Indian industrial output in 2012⁷, and the Ministry of Micro, Small and Medium Enterprises estimated that MSMEs accounted for 50% of exports in 2015–2016.⁸ About 94% of MSMEs are unregistered, making statistical estimation difficult; nonetheless, MSMEs' contribution to the country's gross domestic product (GDP) is estimated to grow at 11.5% per year, outpacing total GDP growth. An important segment of MSMEs is the logistics, distribution, warehousing, and transportation business, in which MSMEs with fleets of three to five vehicles on average are active, and related to it is the commercial vehicle financing activity. The commercial vehicle financing market potential as of FYE2017 was estimated at ₹4.1 trillion, of which about 54% is for pre-owned vehicles.⁹

6. Evidence suggests that MSMEs' contribution to India's GDP falls below the potential for this sector. Most MSMEs in India are micro and small enterprises; unlike similarly sized enterprises in many other countries, however, most of these firms never grow out of the informal sector in which they start or may even diminish in size over time.¹⁰ This lack of enterprise development and growth has severe implications for employment, per capita GDP growth, and the development of India's middle-income segment.

7. **Access to finance and credit.** Despite the size of the finance sector and the significant strides the government has been making, including the successful Pradhan Mantri Jan Dhan Yojana (Prime Minister's People Money Scheme), access to finance remains a key issue,¹¹ with fewer than 15.71% of men and 11.42% of women accessing credit through formal channels (based on the percentage of people borrowing money).¹² MSMEs' lack of adequate access to finance is seen as a major obstacle to growth, with 78.2% of MSMEs self-financing and only 2.0% obtaining funds from financial institutions (footnote 7). This is the reason why most micro and small enterprises do not graduate to formal employment-making small- and medium-sized

⁵ RBI. 2017. *Financial Stability Report*. Issue No. 15. Delhi (June 2017).

⁶ ADB. 2015. *Asia SME Finance Monitor 2014*. Manila.

<https://www.adb.org/sites/default/files/publication/173205/asia-sme-finance-monitor2014.pdf>.

⁷ IFC. 2012. *Micro, Small and Medium Enterprise Finance in India: A Research Study on Needs, Gaps and Way Forward*. Delhi. <http://www.ifc.org/wps/wcm/connect/4760ee004ec65f44a165bd45b400a808/MSME+Report-03-01-2013.pdf?MOD=AJPERES>.

⁸ Government of India, Press Information Bureau, Ministry of Micro, Small and Medium Enterprises. 2016. 4th All India Census of MSME. News release. 1 August. <http://pib.nic.in/newsite/PrintRelease.aspx?relid=149436>.

⁹ Shriram Transport Finance Company Ltd. 2017. *Corporate Presentation—March 31, 2017*. <http://www.stfc.in/pdf/investor-presentation/STFC-Corporate-Presentation-March-2017.pdf>.

¹⁰ V.A. Nageswaran and G. Natarajan. 2016. *Can India Grow? Challenges, Opportunities, and the Way Forward*. Carnegie Endowment for International Peace: Washington, DC. A statistical update on employment in the informal sector published by the International Labour Organization in 2012 showed that India has one of the world's largest informal sectors, representing 83.6% of nonagricultural employment.

¹¹ Government of India, Pradhan Mantri Jan Dhan Yojana (PMJDY). <https://www.pmjdy.gov.in/account>. The proportion of unbanked people in India has declined from 65% in 2011 following the launch by the Government of India of the Pradhan Mantri Jan Dhan Yojana, which aims to open 100 million bank accounts for poor families. As of 4 October 2017, more than 300 million accounts have been opened under the program.

¹² World Bank. Gender Statistics Databank. http://databank.worldbank.org/data/reports.aspx?source=gender-statistics#selectedDimension_GS_Ctry (accessed 20 September 2017).

enterprises (SMEs).¹³ MSMEs in logistics and distribution services and manufacturing get further excluded from the mainstream finance sector because of their small finance requirements, insufficient proof of income, longer processing time for loans, and high access costs.¹⁴ While financing needs vary, financial institutions typically have limited exposure to MSMEs compared with larger commercial enterprises because MSMEs are seen as being higher risk and have limited access to immovable collateral. There are estimates that the MSME subsector's total financing requirement is about ₹32.5 trillion, of which ₹26.0 trillion is for debt financing (footnote 7).

8. **Investment rationale.** Given the continued need to address access to finance for the underserved customer segments in India, nonsovereign operations of the Asian Development Bank (ADB) has supported financial institution partners that have demonstrated the ability to reach under-banked segments of the population on a commercial and sustainable basis. ADB has supported projects to address (i) access to credit for women borrowers in self-help groups and access to funding for small farmers;¹⁵ (ii) affordable housing finance;¹⁶ (iii) funding for micro and small entrepreneurs, including women, in lagging states and rural areas through bank and NBFC lending; and (iv) sanitation finance.¹⁷ In addition to its direct funding to banks and microfinance institutions for onlending to under-banked segments, ADB has supported financial inclusion in India through the Microfinance Risk Participation Program and an equity investment in a credit rating agency.¹⁸ To build on these initiatives and promote financial inclusion in India, ADB is targeting partnerships with financial institutions involved in the MSMEs subsector to support job creation and the development of India's "missing middle" (SMEs and the lower middle-income segment). NBFCs such as Capital First Limited, for which ADB approved a \$150 million debt investment in September 2017,¹⁹ are playing a critical role in addressing MSME financing needs with low turnaround time and last mile capital delivery, based on better adapted loan products, customized credit models and delivery processes, and reliance on market information and empirical data.

9. Based in Chennai, Chola is a pan-Indian NBFC selected by ADB for its track record in providing finance to MSMEs in logistics and distribution services, which are critical for job creation and overall economic growth. With more than 700 branches, 90% in tier-2 and tier-3 cities and

¹³ Harvard University, Center for International Development, Entrepreneurial Finance Lab Research Initiative. The Missing Middle. <https://wayback.archive-it.org/8983/20170629160523/https://www.hks.harvard.edu/centers/cid/programs/entrepreneurial-finance-lab-research-initiative/the-missing-middle>.

¹⁴ Government of India, Development Commissioner, Ministry of Micro, Small and Medium Enterprises. What are Micro, Small & Medium Enterprises?. http://www.dcmsme.gov.in/ssiindia/defination_msme.htm.

¹⁵ ADB. 2014. *Report and Recommendation of the President to the Board of Directors: Proposed Loans and Technical Assistance Grant to Axis Bank Limited and YES Bank Limited for the Strengthening Rural Financial Inclusion and Farmer Access to Markets Project in India*. Manila.

¹⁶ ADB. 2014. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Dewan Housing Finance Corporation for Low-Cost Affordable Housing Finance in India*.

¹⁷ ADB. 2015. *Report and Recommendation of the President to the Board of Directors: Proposed Equity Investment and Loan to RBL Bank for the Supporting Financial Inclusion Project in India*. Manila; ADB. 2016. *Report and Recommendation of the President to the Board of Directors: Proposed Debt Financing to Janalakshmi Financial Services Private Limited in India*. Manila; ADB. 2016. *Report and Recommendation of the President to the Board of Directors: Proposed Debt Investment in Au Financiers (India) Limited for the Expanding Micro and SME Lending in Semi-Urban Rural Areas Project in India*. Manila; and ADB. 2016. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to IndusInd Bank Limited for the Supporting Access to Finance for Women in Less-Developed States Project in India*. Manila.

¹⁸ ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Microfinance Risk Participation Program*. Manila; and ADB. 2016. *FAST Report: Equity Investment in Micro-Credit Ratings International Limited for the Strengthening the Microfinance Ecosystem Project*. Manila.

¹⁹ ADB. 2017. *Report and Recommendation of the President to the Board of Directors: Proposed Debt Investment in Capital First Limited for Expanding Micro, Small and Medium Enterprise Lending Project in India*. Manila.

towns where the MSMEs are predominately domiciled, and about 70% of its total portfolio in states with a lower level of penetration by banks and formal financing institutions, Chola is an attractive partner for ADB. Additionally, 40–50% of its total loans qualify as priority sector lending. In contrast to trends across the finance sector, Chola has maintained asset growth, lowered its NPA levels, and broadly sustained its profitability and strong capital base in FY2017.

B. Business Overview and Strategy

10. **Overview.** Founded in 1979 by the Murugappa Group, Chola has consistently maintained its leadership in the market and is among the top three in its specialized segment. Founded in 1900, the Murugappa Group operates 28 businesses, including nine listed entities. Chola had total assets under management of ₹369 billion as of FYE2017 and a customer base of over 750,000 clients. It offers a diversified suite of loan products to MSMEs through two main lines: commercial vehicle finance (69% of the total portfolio) and loans against property (LAPs) (28% of the total portfolio). It is an industry leader in vehicle finance, focusing on smaller fleet operators (three to five vehicles). The commercial vehicle finance portfolio is diversified along eight main product lines: light commercial vehicles (LCV), cars and multi-utility vehicles, heavy commercial vehicles, vehicle refinance, used vehicles, tractors, 3-wheelers and small commercial vehicles, and construction equipment. LAPs are generally business loans backed by property. Chola was one of the first movers into the market in 2006 and has since focused on a segment consisting mostly of small self-employed nonprofessional entrepreneurs in manufacturing, retail, trading, textiles, and small-scale industries, which are often excluded from the SME financing offered by commercial banks.

11. **Business strategy.** To support its future growth, Chola is arranging for incremental funding. Its commercial vehicle financing business is expected to drive portfolio growth, while LAP is projected to grow at a slower pace. Chola moderated the growth of its LAP portfolio as it mitigates the rising risks in this segment from a decline in property prices and fall in yields driven by increasing competition. The balance of growth will come from newly pilot-tested products such as mortgage loans and agribusiness loans. Improved profitability is expected from larger volumes delivered under Chola's established products, efficiency gains, and a selective focus on higher-yielding asset classes. To support its growth strategy, Chola will add new branches during FY2017 and FY2018, mostly in smaller cities and townships in remote parts of India, where there is limited presence of banks and formal financial institutions.

C. Ownership, Management, and Governance

12. **Ownership.** Chola is listed on the Bombay Stock Exchange and the National Stock Exchange and has about 23,000 shareholders. The shareholding structure consists of promoters (53.1%); financial institutional investors (36.6%)²⁰, and noninstitutional investors (10.3%). The promoter's stake is primarily held by TI Financial Holdings Ltd, which is also a listed Murugappa Group entity, operating as an investment holding company. Integrity due diligence was conducted and identified no significant or potentially significant integrity risks.²¹ ADB's review of the entity does not give ADB cause to believe that such entity has been established or is being used for money laundering or terrorism financing in the jurisdictions involved in the project.

²⁰ Of which mutual funds (13.8%) and foreign portfolio investors (22.6%), including IFC, held the largest stakes.

²¹ ADB. 2003. *Enhancing the Asian Development Bank's Role in Combating Money Laundering and the Financing of Terrorism*. Manila.

13. **Management.** Vellayan Subbiah was Chola's managing director from August 2010 to August 2017. Currently he has moved to Tube Investments as Managing Director (Designate). N. Srinivasan, who was the vice chairman and non-executive director on Chola's board, replaced Subbiah and is now the Executive Vice Chairman and Managing Director of the Company. Srinivasan is a Murugappa Group veteran and has served as a member of the Murugappa corporate board as well as several group companies. He was lead director of the Financial Services Group within the Murugappa Corporate Advisory Board and was instrumental in leading a strategic realignment of the company during 2008–2010. Chola's senior management has solid experience in financial services and has grown from within company ranks.

14. **Governance structure.** Four independent directors, one executive director, and one managing director make up Chola's board. M.B.N. Rao, an independent director who has been on Chola's board since 2010 and has over 42 years of banking experience, chairs the board. Two of the other three independent directors also possess extensive banking experience, having held top executive and director positions at banks and financial institutions. The audit, stakeholders' relationship, corporate social responsibility, nomination and remuneration, risk management, and business subcommittees support the board. Chola is well-regarded for its management quality²² and maintains strong corporate governance practices and good disclosure and oversight practices, as seen in its adoption of stringent RBI norms, over one year ahead of the allowed timeline.

15. **Risk management.** Chola has institutionalized a formal risk reporting framework with specifically identified risk parameters, monitored to prescribed levels. This framework, developed in-house, calculates the Chola Composite Risk Index, which highlights the level, movement, and direction of defined critical risks. These key risk indicators are aligned with the company's overall risk appetite framework, which is approved by the board. The framework includes daily monitoring with help from data analytics and algorithmic models that were also developed in-house by its risk management team and reviewed closely by the internal audit unit. The credit appraisal process includes a detailed risk assessment of the borrowers and ongoing monitoring to identify portfolio trends and implement necessary credit policy changes. Chola's credit process is strictly defined, while standards and permissible deviations are well specified. Decision-making is done online using an in-house application platform which is decentralized, with segregation of authority and responsibility across business teams. The credit process is implemented through the sales, credit underwriting, independent risk, operations, collection, monitoring, and internal audit teams, and a separate frauds-control unit.

III. THE PROPOSED ADB ASSISTANCE

A. The Assistance

16. ADB will provide debt financing to Chola by subscribing to up to \$150 million, in Indian rupee equivalent, of senior secured NCDs, in three tranches of \$50 million each, of tenors of 3,4, and 5 years; with full recourse to Chola's balance sheet.²³

²² CRISIL Ratings. 2016. *Cholamandalam Investment and Finance Company*. Credit Rating Report. Mumbai.

²³ NCDs are a form of fixed maturity debt security that cannot be converted to company equity or stock and are regulated by RBI and the Securities and Exchange Board of India. Upon issuance, the NCDs will be listed on the Bombay Stock Exchange and/or the National Stock Exchange.

B. Implementation Arrangements

17. **Use of proceeds.** Chola will use the proceeds of ADB's debt financing to finance loans to MSMEs in semi-urban and rural areas in India, with up to 30% of ADB's funding for the LAP segment, and at least 50% of the funding targeting lagging states.²⁴

18. **Reporting arrangements.** ADB's Private Sector Operations Department will monitor the project. Chola will provide ADB with financial reports at predetermined regular intervals and as requested. These will include (i) unaudited financial statements on a quarterly basis, (ii) audited financial statements on an annual basis, (iii) compliance certificates for financial covenants on a quarterly basis, (iv) reporting on the MSME loan portfolio on an annual basis, and (v) annual reporting on selected development indicators agreed by ADB and the borrower.

19. **Evaluation.** Chola will prepare and submit monitoring reports to ADB regularly, and at least annually. The Company will submit the first report no later than 12 months after the first disbursement.

C. Value Added by ADB Assistance

20. **Support micro-, small-, and medium-sized enterprise growth and development of logistics, distribution, and transport-related industries.** ADB funding will support growth and job creation in India's MSME segments through improved access to finance and at a period where commercial banks have decreased lending. Through the funding, MSMEs engaged in logistics, distribution, and transportation activities, and MSMEs seeking loans for investment and working capital will benefit from access to term financing. This lending would be focused primarily on lagging states and on rural and semi-urban areas, where access to finance is even more limited.

21. **Provide access to local currency longer-tenor debt.** In general, NBFCs have historically extended relatively shorter-tenor loans, given the funding constraints and the need to maintain a matched asset–liability profile. This adversely affects borrowers who service debt over a shorter period, lesser than the economic life of the underlying financed **asset**. Chola is addressing this issue by diversifying its funding base and reducing its dependence on shorter-maturity bank funding. Access to capital markets is still constrained, particularly for longer-tenor funds for NBFCs, as about 78.5% of the bonds and/or debentures raised by financial institutions during September–February 2017 had tenors of less than 2 years.²⁵ Debt financing from ADB, of tenors ranging from 3 to 5 years, will provide Chola the scarce medium-term funds it needs to diversify its liability mix and fund longer-tenor MSME loan products.

²⁴ Lagging states include low-income states with high poverty incidence and special category states. These include Assam, Bihar, Chhattisgarh, Himachal Pradesh, Jharkhand, Madhya Pradesh, Manipur, Meghalaya, Mizoram, Nagaland, Odisha, Rajasthan, Sikkim, Tripura, Uttar Pradesh, Uttarakhand, and West Bengal.

²⁵ S. Niyogi. 2017. Bond Issuances Gain Traction; Market Conditions a Key to Sustenance. News release. 3 April. <https://www.indiaratings.co.in/PressRelease?pressReleaseID=26901&title=Bond-Issuances-Gain-Traction%3B-Market-Conditions-a-Key-to-Sustenance>.

IV. DEVELOPMENT IMPACT AND STRATEGIC ALIGNMENT

A. Development Impact, Outcome, and Output

22. **Impact.** The project is aligned with the following impact: access to finance for the underserved enhanced, contributing to finance sector development in alignment with the government's financial inclusion agenda.

23. **Outcome.** The project will have the following outcome: sustainability of Chola's lending activities to MSME in India demonstrated.

24. **Output.** The output will be Chola's increased capacity to finance underserved MSMEs, including MSMEs led by women and in lagging states in India.

B. Alignment with ADB Strategy and Operations

25. ADB's Midterm Review of Strategy 2020 emphasizes ADB's support for the finance sector by helping to develop financial infrastructure, institutions, products, and services. The proposed transaction contributes to finance sector development by supporting the growth of an NBFC, which is an important component of the finance sector in India.²⁶ ADB's Midterm Review also seeks to promote inclusive growth. Without access to formal financial services, lower-income people or underserved segments of the population will be excluded from the growth process and its benefits. According to ADB's country partnership strategy for India, 2018–2022²⁷ and the country operations business plan, 2017–2019, ADB's nonsovereign operations will continue to support the finance sector and MSME development in India, which is also a high priority for the government.

V. POLICY COMPLIANCE

A. Safeguards and Social Dimensions

26. The proposed ADB debt financing is classified *category FI treated as C* for impacts on the environment, involuntary resettlement, and indigenous peoples. The financial intermediary's business activities have minimal or no adverse environmental impacts and are unlikely to entail impacts on involuntary resettlement and indigenous peoples. The financial intermediary will apply ADB's prohibited investment activities list, exclude all projects that will have adverse environmental and social safeguards impacts, ensure that investments using ADB funds abide by applicable national laws and regulations, and comply with the ADB Safeguard Policy Statement (2009). The financial intermediary will confirm this in its periodic report to ADB and need not apply any other specific safeguard requirements.

27. Chola will comply with national labor laws and, pursuant to ADB's Social Protection Strategy (2001), will take measures to comply with the internationally recognized core labor standards. Chola will report regularly to ADB on (i) its compliance with such laws and (ii) the measures taken. Information disclosure and consultation with affected people will be conducted following ADB requirements. The transaction is classified as *some gender elements*.

²⁶ ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.

²⁷ ADB. 2017. *Country Partnership Strategy: India, 2018–2022*. Manila.

B. Anticorruption Policy

28. Chola was advised of ADB's policy of implementing best international practice relating to combating corruption, money laundering, and the financing of terrorism. Chola's know-your-customer and anti-money laundering policies, in addition to the requirements placed by RBI, mitigate the risks of money laundering and terrorist financing. ADB will ensure that the investment documentation includes (i) appropriate provisions prohibiting corruption, money laundering, and the financing of terrorism; and (ii) remedies for ADB in the event of noncompliance.

C. Assurances

29. Consistent with the Agreement Establishing the Asian Development Bank (the Charter),²⁸ ADB will proceed with the proposed assistance upon establishing that the Government of India has no objection to the proposed assistance to Chola. ADB will enter into suitable finance documentation, in a form and substance satisfactory to ADB, following approval of the proposed assistance by the ADB Board of Directors.

VI. RECOMMENDATION

30. I am satisfied that the proposed debt financing would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the debt financing through senior secured nonconvertible debentures of up to \$150,000,000, in Indian rupee equivalent, from ADB's ordinary capital resources to Cholamandalam Investment and Finance Company Limited for the Expanding Credit Delivery for Micro-, Small-, and Medium-Sized Enterprises Project in India, with such terms and conditions as are substantially in accordance with those set forth in this report, and as may be reported to the Board.

Takehiko Nakao
President

16 November 2017

²⁸ ADB. 1966. *Agreement Establishing the Asian Development Bank*. Manila.

DESIGN AND MONITORING FRAMEWORK

| Impact the Project is Aligned with Access to finance for the underserved enhanced, contributing to finance sector development in alignment with the government's financial inclusion agenda. ^a | | | |
|--|--|---|---|
| Results Chain | Performance Indicators with Targets and Baselines | Data and Reporting Mechanisms | Risks |
| Outcome Sustainability of Chola's lending activities to MSME in India demonstrated | <p>By 2023</p> <p>a. Number of outstanding MSME loans increased to 1.015,000 (Q2-FYE2018 baseline: 780,000)</p> <p>b. Percentage of outstanding MSME loans in lagging states increased to 70% (Q2-FYE2018 baseline: 65%)</p> <p>c. NPA (90 days past due) maintained below 5% (Q2-FYE2018 baseline: 4.5%)</p> <p>d. Percentage of loans to MSMEs led by women increase to 8% (Q2-FYE2018 baseline: 6%)</p> | <p>a–b, d. Annual development effectiveness monitoring reports from Chola</p> <p>c. Data from Chola Annual Reports and Quarterly Investor Presentations</p> | <p>Chola's asset quality deteriorates significantly.</p> <p>Demand for MSME loans is lower than expected.</p> |
| Output Chola's capacity to finance underserved MSMEs, including MSMEs led by women and in lagging states in India, increased | <p>By 2023</p> <p>a. MSME loans disbursed totaled at least ₹450 billion (Q2-FYE2018 baseline: ₹352billion)</p> <p>b. Share of MSME loans disbursed in lagging areas reached 70% (Q2-FYE2018 baseline: 65%)</p> <p>c. Share of new loans disbursed to MSMEs led by women reached 8% (Q2-FYE2018 baseline: 6%)</p> | <p>a–c. Annual development effectiveness monitoring reports from Chola</p> | <p>Interest rates and inflation increase to high levels.</p> <p>Chola does not grow as expected.</p> |
| <p>Key Activities with Milestones</p> <p>Output: Chola's capacity to finance underserved MSMEs increased</p> <p>1.1 ADB executes legal agreements in Q4 FYE 2018.</p> <p>1.2 ADB loan is fully disbursed by Q1 FYE 2019</p> <p>1.3 Chola onlends the proceeds of the ADB debt financing to MSME clients by Q2 -FYE 2019.</p> | | | |

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| Inputs ADB: \$150 million (debt financing) |
| Assumptions for Partner Financing Not applicable. |

ADB = Asian Development Bank; Chola = Cholamandalam Investment and Finance Company Limited; FY = fiscal year; MSMEs = micro-, small-, and medium-sized enterprises; NPA = nonperforming asset; Q = quarter; TBD = to be determined.

^a Government of India, NITI Aayog (National Institution for Transforming India). 2017. *India Three Year Action Agenda, 2017–18 to 2019–20*. Delhi.

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RRPs/?id=51195-001-4>

1. Contribution to the ADB Results Framework
2. Country Economic Indicators