ADB

Major Change and Additional Financing

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Microfinance Risk Participation and Guarantee Program

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

ABBREVIATIONS

ADB	–	Asian Development Bank
DMC	–	developing member country
LCL	–	local currency lender
MFI	–	microfinance institution
MSMEs	–	micro, small, and medium-sized enterprises
PFI	–	partner financial institution

NOTE

In this report, "$" refers to US dollars.

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I. PROPOSED MAJOR CHANGE AND ADDITIONAL FINANCING

1. A major change and additional financing for the Microfinance Risk Participation and Guarantee Program are proposed for Board consideration.

2. Under this proposal, the Asian Development Bank (ADB) would provide up to $50 million in additional financing for the program, increasing the program limit to $240 million.[1] In addition, the program's expiration date for the 2015 availability period would be removed, subject to reviews by ADB's Board of Directors every 3 years. The revised design and monitoring framework is in Appendix 1.

II. BACKGROUND

3. Access to finance is often cited as one of the primary obstacles for micro, small, and medium-sized enterprises (MSMEs). An International Finance Corporation report found that MSMEs in developing countries face a financing gap of about $2.1 trillion–$2.6 trillion, which is equivalent to 30%–36% of current outstanding MSME credit. An estimated 200 million–245 million formal and informal enterprises do not have access to finance or find access to finance a constraint.[2]

4. The impact of the Andhra Pradesh crisis[3] in the microfinance industry in 2010 created an acute liquidity scarcity for microfinance institutions (MFIs) throughout India. In response, ADB developed the Microfinance Risk Participation and Guarantee Program to encourage international and domestic financial institutions to increase their lending volumes to microfinance through risk participation and guarantee arrangements.

5. The Board approved the program on 13 December 2010 with a $250 million limit.[4] In 2012, $60 million was canceled and program limit was reduced to $190 million in order to create lending capacity for other nonsovereign approvals that year.[5] The program facilitates the expansion of lending volumes of partner financial institutions (PFIs) to MFIs. The availability period of the program was set at 5 years or until 13 December 2015. Since the underlying risk-participated loans to MFIs have a maximum tenor of 3 years, ADB's exposure could extend to 2018. The program has been implemented through risk participations and guarantees.[6] Under the program, ADB selects PFIs to provide local currency loans to ADB-approved MFIs in its developing member countries (DMCs).[7] ADB risk participates or guarantees the default risk of these MFIs, thereby catalyzing private sector participation and mobilizing additional funds for the MFIs.

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1 ADB. 2010. *Additional Financing: Enhancing Development Effectiveness*. Manila.
2 International Finance Corporation. 2013. *Closing the Credit Gap for Formal and Informal Micro, Small, and Medium Enterprises.* Washington, DC.
3 Caused primarily by the State of Andhra Pradesh, India, whereby it outlawed the repayment of microfinance loans by individual borrowers, resulting in huge defaults at the MFI level and rescheduling of debt from commercial banks.
4 ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Microfinance Risk Participation Program.* Manila.
5 The reduction of the original program limit by $60 million was reported to the Board through a deduction to the total amount of approvals in the year that it was canceled (2012). The reduction was also reported to the Board through the annual portfolio performance review circulated by the Independent Evaluation Department.
6 Through a minor change in scope, approved on 6 May 2011, the program was expanded to include the issuance of guarantees.
7 Partner Financial Institution Criteria (accessible from the list of linked documents in Appendix 2).

6. Under the risk participation structure, ADB shares (e.g., on a 50:50 basis) the default risk of ADB-approved MFIs. In the guarantee structure, however, the PFI role is split between two entities—one to perform as an arranger[8] and the other as the local currency lender (LCL). Similarly, the default risk is shared on a pro-rata basis between arranger (typically at 10%), the LCL (35%), and ADB (50%). The remaining 5% is represented as a first loss and is provided by the MFI as cash collateral placed with the LCL.[9] The program is available to international and local financial institutions supporting and funding microfinance in Asia and the Pacific.

7. **Consistency with ADB strategy.** Poverty reduction and inclusive economic growth is one of the 10 strategic priorities of ADB set forth in the Midterm Review of Strategy 2020.[10] ADB will continue to pursue its vision of an Asia and Pacific free of poverty by expanding its support for achieving and sustaining rapid and inclusive economic growth. In its approach to inclusive economic growth, ADB will emphasize financial inclusion by improving and expanding support for microfinance and finance for small and medium-sized enterprises, as well as by using innovative information and communication technology to improve access to finance. The program was well-timed and in line with supporting the financial and institutional development of the microfinance industry and expansion of access to finance for small entrepreneurs, particularly poor households and women. The expansion of access to finance for women supports ADB's Gender Equality and Women's Empowerment Operational Plan, 2013–2020.[11]

8. **Impacts.** The program has supported the increase of PFI lending volumes to MFIs. MFIs provide the unbanked low-income segments with wider access to financial services. Within strict and acceptable guidelines, loans provided to individuals living below or at the poverty line are deployed to sustain business and livelihoods, and are not for consumption. As such, this is consistent with inclusive business models.

9. One of the expected broader impacts of the program has been increased economic contribution to Asia and the Pacific by micro borrowers. A 10% increase in employment and productive output was expected. Data collected from the annual report of the Government of India's Ministry of Micro, Small and Medium Enterprises show 44% growth in the number of registered microenterprises and a 21% increase in employment in this sub-sector from 2011 to 2014.[12] The program was also expected to provide greater financial access for the underserved poor. A 25% increase in the number of registered microfinance customers was targeted. Following ADB's intervention in this industry, smaller MFIs were expected to be able to access funding from commercial banks, which had been scarce. Under the program, ADB has supported 12 such institutions (considered small or medium-sized MFIs) of the 50 MFIs operating in India.[13] During the 5 years of the program, all impact criteria have far exceeded what had been envisioned (para. 10).

10. **Outcome.** Following the implementation of the program in 2012, the outcomes have been as follows:

(i) Through a combination of guarantees and risk participation, ADB has provided support to $207 million of local currency loans. This covers more than 30 MFIs in

[8] The role of the arranger in the guarantee structure includes identifying LCLs acceptable to ADB, as well as MFIs that will receive the funding. Acceptable criteria also require that the arranger have a financial relationship with the MFIs.

[9] Implementation arrangements and illustration of the two structures are accessible through the list of linked documents in Appendix 2.

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

[11] ADB. 2013. *Gender Equality and Women's Empowerment Operational Plan, 2013–2020*. Manila.

[12] Government of India, Ministry of Micro, Small and Medium Enterprises. 2015. *Annual Report 2014–2015*. New Delhi.

[13] Ranking is based on the Microfinance Institutions Network, India Micrometer report as of 31 March 2015.

India and Indonesia where utilization under the program has taken place.[14] In addition, the program has catalyzed private sector direct support totaling $100 million through cofinancing.

(ii) The number of borrowers under the program increased more than 200% to 1.23 million from 2012 to March 2015, and they were almost exclusively women.

(iii) MFIs approved by ADB disclosed increased loan portfolios of almost $2.0 billion, while commercial funding available to them increased by $1.2 billion from 2012 to March 2015.

(iv) Following ADB's support, fresh equity infusions to the same MFIs totaled $53 million.

(v) Asset quality has been excellent. Nonperforming loans continue to be below 5%, as required in the design and monitoring framework. As of March 2015, nonperforming loans were 0.16%.

11. **Output.** Since 2012, local currency loans totaling $207 million have been disbursed.

III. IMPLEMENTATION PROGRESS

12. The program has been successfully implemented and has achieved its objectives (paras. 10–11). It is therefore proposed that it continue unchanged, subject to the modifications set forth in paras. 13 and 15.

IV. RATIONALE FOR THE PROPOSED CHANGES

13. **Additional financing.** The additional financing of up to $50 million will contribute to maximizing the potential of the program and achieving its objectives. The maximum overall exposure that the program can assume at any time is limited to $190 million (para. 5). The current facility allocations ($175 million) leave minimal room to accommodate higher demand by the MFIs (most recently, PRASAC Microfinance Institution in Cambodia and SV Creditline Private in India). Furthermore, additional PFIs have been added to the program, including IndusInd Bank, Kotak Mahindra Bank, and Federal Bank in India.[15] Given the success of the program (para. 10), the Board is requested to approve additional financing of up to $50 million, which will increase the overall limit of the program to $240 million, and to confirm that the program is on a revolving basis.

14. Currently, 81% of the program is allocated in India, followed by Bangladesh (13%), Cambodia (4%), and Indonesia (2%).[16] Plans are in place to extend the program to the People's Republic of China, Pakistan, the Philippines, Sri Lanka, Thailand, and Viet Nam.[17] The program is expected to be implemented in 2016 and 2017 in these new countries, and they will utilize 5% of the proposed limit of $240 million.

15. **Removal of program expiration date.** The program has broadened financial access for MFIs, thereby increasing funding for low-income entrepreneurs in several of ADB's DMCs. Poverty is a complex and multidimensional problem, and the program directly supports ADB's mission to eliminate poverty in Asia and the Pacific. The program's success in expanding financial access for the poor must be sustained and replicated. Therefore, it is recommended that the program be mainstreamed into ADB's operations by removing the expiration date. The Board will review the

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[14] Eight microfinance institutions are common under the guarantee and risk participation structures.
[15] Approved by ADB's Investment Committee on 8 February 2015.
[16] Based on approved limits by ADB's Office of Risk Management as of 30 June 2015.
[17] The program has obtained no objections from these DMCs.

program every 3 years through an informal board seminar. This will ensure that the program will continue to provide greater financial access for the bottom of the pyramid in a sustainable manner.

16. Removing the program expiration date will also enable ADB to enter new markets, adjust the program in some countries and regions, and continue a dialogue with several DMCs. Peak utilization is expected in the second quarter of 2016 as new PFIs and LCLs are added. During the initial stage (first 2 years from Board approval), significant time was spent developing the nonbank financial institution rating model (used for approving MFIs), negotiating the terms of the guarantee and risk participation agreements, and approving the PFIs and MFIs.

17. **Risks and mitigation measures.** The 2010 report and recommendation of the President (footnote 4) addressed these issues in detail and remain unchanged.[18]

18. **Currency risk.** As these are all local currency loans that ADB is supporting through a guarantee or risk participation structure, ADB will be liable to pay in dollars or in local currency (if available) if an MFI defaults. ADB would therefore carry the liability on its books in local currency, which would expose it to foreign exchange fluctuations. The 2010 Board approval allowed the issuance of guarantees and risk participations against local currency loans extended to the MFIs. This was done to reduce the financing cost to the MFI through elimination of foreign exchange hedging costs. The program's largest sub-limits are in India ($97.1 million) followed by Bangladesh ($16.0 million), Cambodia ($5.0 million), and Indonesia ($2.5 million).

19. The exposure under this program is, in general, not expected to lead to substantial consumption of the 1% limit of ADB's total equity for unhedged local currency guarantee operations, as established in the recent review of ADB's local currency operations.[19] This is because, in line with provisions in this policy paper, most of the major countries where this program will be operational already have regulatory approvals for funding claims from a local currency source. In India, for example, regulatory approvals for raising $500 million are already in place and can be used to raise local currency resources to make payments on any future rupee guarantee claims under this program. In the Philippines, ADB already has standing regulatory approvals under the Asian Currency Note Program. In addition, ADB has access to its in-country equity (reserves) and possibly equity (paid-in) for local currency guarantees and local currency lending. These resources could also be used for funding guarantee claims under the program. In Pakistan, ADB has successfully applied for and received project-specific approvals for use of its local currency capital[20] to support local currency guarantee operations.

20. The likelihood of the entire program portfolio defaulting is low as it is a regional program, and the impact of foreign exchange risk on ADB's books is insignificant and well within prudential norms (on average, the ADB share of the risk is less than $5 million per MFI). Furthermore, the events following the Andhra Pradesh crisis in India in 2010 show that, despite such large defaults in the state's microfinance portfolio, the regulator (Reserve Bank of India) was able to restrict defaults to Andhra Pradesh. The program has been active since 2012, reviewed more than 30 MFIs (including annual reviews), issued 25 guarantees (supporting $70 million of local currency loans), and risk participated in 63 transactions (totaling $137 million of local currency loans). There has been no delays in payments and/or defaults.

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[18] Risk and Mitigation Measures (accessible from the list of linked documents in Appendix 2).

[19] ADB. 2014. *Review of the Asian Development Bank's Local Currency Operations.* Manila.

[20] ADB. 1966. *Agreement Establishing the Asian Development Bank.* Manila. Refers to 50% of ADB's paid-in capital in currency of the member country as stated in ADB's Charter Article 6, Section 2, subsection b.

21. **Revised design and monitoring framework.** The program will continue to foster inclusive finance in ADB's DMCs by supporting the expansion of PFI lending to MFIs. By 2018, the program's outcome will be $500 million in increased lending volume by MFIs in the program and access provided to about 2 million micro entrepreneurs, largely women (95%), while maintaining sound portfolio quality with an overall nonperforming loan ratio of less than 5%.

22. The output will be increased access to finance for MFIs in ADB's DMCs.

V. DUE DILIGENCE

23. Each underlying PFI, LCL, and arranger that joins the program is subject to a separate due diligence process to confirm compliance with ADB policies.

24. **Environmental and social safeguards.** The program will continue to be classified as financial intermediary and will be treated as category C for the environment, involuntary resettlement, and indigenous peoples under ADB's Safeguard Policy Statement (2009). The business activities of PFIs and LCLs have minimal or no adverse environmental impacts, and are unlikely to have any impacts on involuntary resettlement and indigenous peoples. The program will apply ADB's prohibited investment activities list, exclude all projects that will have adverse environment and social safeguard impacts, ensure that investments using ADB funds abide by applicable national laws and regulations, and comply with the Safeguard Policy Statement. The PFIs and LCLs will confirm that they are compliant with the environmental and the safeguard policies in their periodic reports to ADB and need not apply any other specific safeguard requirements.[21] Given the nature of microfinance operations, environmental impacts are expected to be negligible and no involuntary resettlement or impact on indigenous people is foreseen.

25. **Exposure limits.** The program remains within the medium-term, country, industry, group, and single investment exposure limits for nonsovereign investments.

26. **Anticorruption policy.** All PFIs and LCLs have been or will be advised of ADB's Anticorruption Policy (1998, as amended to date) and Policy on Combating Money Laundering and the Financing of Terrorism (2003). Consistent with its commitment to good governance, accountability, and transparency, ADB will require the PFIs to institute, maintain, and comply with internal procedures and controls following international best practice standards for the purpose of preventing corruption or money laundering activities or the financing of terrorism, and covenant with ADB to refrain from engaging in such activities.

A. Assurances

27. Consistent with the Agreement Establishing the Asian Development Bank (the Charter),[22] ADB will only proceed with the proposed assistance under the program upon establishing that a DMC has no objection. ADB has obtained no objection from all countries in which the program operates today.

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[21] Summary Poverty Reduction and Social Strategy (accessible from the list of linked documents in Appendix 2).
[22] ADB. 1966. *Agreement Establishing the Asian Development Bank.* Manila.

VI. THE PRESIDENT'S RECOMMENDATION

28. The President recommends that the Board approve the additional financing and related changes for the Microfinance Risk Participation and Guarantee Program, as described in paras. 13 and 15.

REVISED DESIGN AND MONITORING FRAMEWORK

Impacts the program is aligned with:

Current program

1) Increased economic contribution to the Asia and Pacific region by micro-borrowers
2) Greater financial access for underserved poor customers
3) Expansion of private capital flows in the Asian microfinance sector

Overall program

1) Increased inclusive finance in ADB DMCs.[a]

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
Outcome			
Current program Expanded and improved access to finance for MFIs in ADB DMCs	**Current program** a. MFIs funded under the program increase their balance sheet funding and loan portfolios by 30% from 2011 to 2015 b. Portfolio credit quality remains high among MFIs supported under the program, with average NPLs of less than 5%	a. MFI annual reports and financial statements b. Reports requested from PFIs	Stability of the regional economic and political landscape
Overall program Financial inclusion by MFIs under the program sustained	**Overall program** By 2019: a. Loan portfolio of MFIs under the program increased by at least \$500 million (2015 baseline: \$207 million) b. Average nonperforming loan ratio of MFIs under the program is maintained at less than 5.00% (2015 baseline: 0.16%)[b] c. Aggregate number of microfinance customers of MFIs supported under the program increases by 10% year on year and at a minimum 95% are women entrepreneurs (2015 baseline: 1.23 million customers that benefitted from microfinance loans supported under this program, of which 99% are women)	a–c. MFIs' annual reports and audited financial statements a–c. Quarterly reports provided by PFIs and LCLs a–c. Quarterly financial and qualitative monitoring reports provided by IFMRC	Microfinance is no longer a priority sector of growth. Regulatory changes that could affect the microfinance industry.

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
Outputs			
Current program Risk Participation program is implemented	**Current program** $250 million is made available for Asian microfinance customers up to 2015	Reports requested from PFIs	Insufficient number of PFIs to fully utilize the program.
Overall program Finance for MFIs in ADB DMCs increases	**Overall program** By 2018: Participating PFIs and LCLs' lending to MFIs under the program increased by $500 million (2015 baseline: $207 million)	PFI and LCL quarterly and annual monitoring reports	Nonutilization of limits due to pricing, reduced limits, and deterioration of ADB risk rating, making ADB's credit enhancement products irrelevant.

Key Activities with Milestones

1. Completed
   1.1 Standardize risk participation and guarantee program agreements
   1.2 Agree on MFI eligibility criteria with PFIs and LCLs

2. Continue and unchanged
   2.1 Engage potential PFIs and LCLs and promote utilization of the risk participation and guarantee program
   2.2 Conduct due diligence on PFIs and LCLs, including review of microfinance portfolio, business plan, credit underwriting standards, and monitoring procedures
   2.3 Execute appropriate documentation with PFIs and LCLs under risk participation and guarantee agreements
   2.4 Monitor and manage the underlying risk exposure on an ongoing basis

3. Added
   3.1 Process transactions (i.e., issuance of guarantees and acceptance of referenced loans)
   3.2 Execute appropriate documentation with other PFIs and LCLs.

Inputs

ADB	
$190,000,000	current
$ 50,000,000	additional
$240,000,000	**overall**

Assumptions for Partner Financing

Not applicable.

ADB = Asian Development Bank, DMC = developing member country, IFMRC = IFMR Capital, LCL = local currency lender, MFI = microfinance institution, NA = not applicable, PFI = partner financial institution.

[a] Program defined.

[b] Data includes India and Indonesia only since no loans referenced yet from Bangladesh and Cambodia.

Source: ADB.

LIST OF LINKED DOCUMENTS
http://www.adb.org/Documents/MC/?id=44934-014-4

1. Partner Financial Institution Criteria
2. Implementation Arrangements
3. Guarantee Structure
4. Risk Participation Structure
5. Risks and Mitigation Measures
6. Program Milestones
7. Summary Poverty Reduction and Social Strategy