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Report No: PAD1211

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED LOAN

TO THE

SMALL INDUSTRIES DEVELOPMENT BANK OF INDIA

WITH

THE GUARANTEE OF INDIA

IN THE AMOUNT OF US$500 MILLION

FOR A

MSME GROWTH INNOVATION AND INCLUSIVE FINANCE PROJECT

February 2, 2015

Finance and Markets Global Practice
South Asia Region

CURRENCY EQUIVALENTS

(Exchange Rate Effective December 31, 2014)

Currency Unit = Indian Rupees (INR)
US$1 = INR 63.3

FISCAL YEAR

April 1 – March 31

ABBREVIATIONS AND ACRONYMS

AC	Audit Committee
ACR	Asset Coverage Ratio
ADB	Asian Development Bank
AFD	French Agency for Development
ALCO	Asset Liability Committee
CART	Credit Appraisal and Rating Tool
CASA	Current Account-Savings Account
CMD	Chairman and Managing Director
CPS	Country Partnership Strategy
DER	Debt to Equity Ratio
DMD	Deputy Managing Director
EC	Executive Committee
EE	Energy Efficiency
ESIF	Early Stage Investment Facility
ESMF	Environmental and Social Risk Management Framework
FAI	Franchising Association of India
FBS	Fixed Budget Selection
FDR	Fixed Deposit Receipts
FM	Financial Management
FY	Fiscal Year
GEMS	Growth Capital & Equity Assistance
GDP	Gross Domestic Product
GiZ	German Agency for Technical Cooperation
GOI	Government of India
IBRD	International Bank for Reconstruction and Development
IDA	International Development Agency
IDBI	Industrial Development Bank of India
IEG	Independent Evaluation Group
IFC	International Financial Corporation
IFL	IBRD Flexible Loan
INR	Indian Rupees
IPF	Investment Project Financing
IRR	Internal Rate of Return
ISP	Implementation Support Plan
IT	Information Technology
IUFR	Interim Unaudited Financial Report
JICA	Japan International Corporation Agency
KfW	German Development Fund

LCS	Least Cost Selection
LES	Loan Extension Services
LIC	Life Insurance Corporation
LIS	Low Income States
MENA	Middle East and North Africa
M&E	Monitoring and Evaluation
MIS	Management Information System
MoF	Ministry of Finance
MOU	Memorandum of Understanding
MSME	Micro, Small and Medium Enterprises
MTR	Mid Term Review
NASSCOM	National Association of Software and Service Companies
NBFC	Non-Bank Finance Company
NIFP	National Innovative Finance Program
NPL	Non-Performing Loans
NPV	Net Present Value
OM	Operations Manual
PAD	Project Appraisal Document
PDO	Project Development Objective
PE	Private Equity
PFIs	Participating Financial Institutions
PIU	Project Implementation Unit
PSIG	Poorest States Inclusive Growth
PSU	Public Sector Undertaking
QBS	Quality Based Selection
QCBS	Quality and Cost Based Selection
RAM	Risk Assessment Model
RMC	Risk Management Committee
RoA	Return on Assets
RBI	Reserve Bank of India
SAS	Startup Assistance Scheme
SEBI	Securities and Exchange Board of India
SBI	State Bank of India
SCBs	Scheduled Commercial Banks
SIDBI	Small Industries Development Bank of India
SME	Small and Medium Enterprises
SMERA	SME Rating Agency
SORT	Systematic Operations Risk Rating
TA	Technical Assistance
TOR	Terms of Reference
VC	Venture Capital
WBG	World Bank Group
WC	Working Capital
WTO	World Trade Organization

Regional Vice President:	Annette Dixon
Country Director:	Onno Ruhl
Senior Global Practice Director:	Gloria M. Grandolini
Practice Manager:	Henry K. Bagazonzya
Task Team Leaders:	Niraj Verma, Mihasonirina Andrianaivo, Rosanna Chan

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India

MSME Growth Innovation and Inclusive Finance Project (P151544)

PROJECT APPRAISAL DOCUMENT

SOUTH ASIA
0000009086

Report No.: PAD1211

Basic Information			
Project ID P151544	EA Category F - Financial Intermediary Assessment	Team Leader Niraj Verma, Mihasonirina Andrianaivo, Rosanna Chan	
Lending Instrument Investment Project Financing	Fragile and/or Capacity Constraints [ ] Financial Intermediaries [X] Series of Projects [ ]		
Project Implementation Start Date 01-April-2015	Project Implementation End Date 31-Mar-2020		
Expected Effectiveness Date 31-Mar- 2015	Expected Closing Date 31-Mar-2020		
Joint IFC No			
Practice Manager/Manager	Senior Global Practice Director	Country Director	Regional Vice President
Henry K. Bagazonzya	Gloria M. Grandolini	Onno Ruhl	Annette Dixon

Borrower: Small Industries Development Bank of India			
Responsible Agency: SIDBI Small Industries Development Bank of India			
Contact:	Harsh Kaul	Title:	Chief General Manager
Telephone No.:	+91 22 26521294	Email:	harshk@sidbi.in

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

Total Project Cost:	550.00	Total Bank Financing:	500.00
Financing Gap:	0.00		

Financing Source	Amount
Borrower	50.00
International Bank for Reconstruction and Development	500.00
Total	550.00

Expected Disbursements (in USD Million)

Fiscal Year	2015	2016	2017	2018	2019	2020	
Annual	1.25	75.00	100.00	125.00	125.00	73.75	
Cumulative	1.25	76.25	176.25	301.25	426.25	500.00	

Institutional Data

Practice Area / Cross Cutting Solution Area

Finance & Markets

Cross Cutting Areas

[ ] Climate Change
[ ] Fragile, Conflict & Violence
[X] Gender
[X] Jobs
[ ] Public Private Partnership

Sectors / Climate Change

Sector (Maximum 5 and total % must equal 100)

Major Sector	Sector	%	Adaptation Co-benefits %	Mitigation Co-benefits %
Finance	SME Finance	100		
Total		100		

☑ I certify that there is no Adaptation and Mitigation Climate Change Co-benefits information applicable to this project.

Themes

Theme (Maximum 5 and total % must equal 100)

Major theme	Theme	%
Financial and private sector development	Micro, Small and Medium Enterprise support	80
Financial and private sector development	Other Financial Sector Development	20
Total		100

Proposed Development Objective(s)
The project development objective is to improve access to finance of MSMEs in manufacturing and service sectors from early to growth stage, including through innovative financial products.

Components

Component Name	**Cost (USD Millions)**
i. Spurring Early Stage and Risk Capital Finance	165.00
ii. Supporting Service Sector Financing Models	220.00
iii. Supporting Finance to Manufacturing Sector	165.00

Systematic Operations Risk-Rating Tool (SORT)

Risk Category	**Rating**
1. Political and Governance	Low
2. Macroeconomic	Low
3. Sector Strategies and Policies	Low
4. Technical Design of Project or Program	Moderate
5. Institutional Capacity for Implementation and Sustainability	Low
6. Fiduciary	Low
7. Environment and Social	Moderate
8. Stakeholders	Low
9. Other	Low
OVERALL	Moderate

Compliance

Policy

Does the project depart from the CAS in content or in other significant respects?	Yes [ ]	No [x]
Does the project require any waivers of Bank policies?	Yes [ ]	No [x]
Have these been approved by Bank management?	Yes [ ]	No [x]
Is approval for any policy waiver sought from the Board?	Yes [ ]	No [x]
Does the project meet the Regional criteria for readiness for implementation?	Yes [x]	No [ ]

Safeguard Policies Triggered by the Project	**Yes**	**No**

Environmental Assessment OP/BP 4.01	Yes	
Natural Habitats OP/BP 4.04		No
Forests OP/BP 4.36		No
Pest Management OP 4.09		No
Physical Cultural Resources OP/BP 4.11		No
Indigenous Peoples OP/BP 4.10		No
Involuntary Resettlement OP/BP 4.12		No
Safety of Dams OP/BP 4.37		No
Projects on International Waterways OP/BP 7.50		No
Projects in Disputed Areas OP/BP 7.60		No

Legal Covenants			
Name:	**Recurrent**	**Due Date**	**Frequency**
Operational Manual	Yes	N/A	Throughout implementation
Description of Covenant			
The Borrower shall ensure that the Project is carried out in accordance with the provisions of the Operations Manual, and shall ensure that the Operations Manual is not materially revised, amended, waived, or abrogated without the prior consent of the Bank.			
Name:	**Recurrent**	**Due Date**	**Frequency**
Sub-loans	Yes	N/A	Throughout implementation
Description of Covenant			
The Borrower shall: (a) (i) appraise and select MSMEs in accordance with the criteria set forth in the Operations Manual; (ii) make Sub-loans to MSMEs under Sub-loan Agreements on the terms and conditions spelled out in the Loan Agreement; and (b) (i) appraise and select PFIs in accordance with the criteria set forth in the Operations Manual; (ii) relend to the PFIs a portion of the proceeds of the Loan under Participation Arrangements on the terms and conditions spelled out in the Loan Agreement.			
Name:	**Recurrent**	**Due Date**	**Frequency**
Safeguards Documents	Yes	N/A	N/A
Description of Covenant			
The Borrower shall, and shall cause each PFI to, carry out the Project in accordance with the ESMF and the relevant instruments to be prepared under the ESMF.			
Reporting of Safeguards Documents	Yes	N/A	N/A
Description of Covenant			

The Borrower shall collect, compile and submit to the Bank on a bi-annual basis (or such other frequency as may be agreed with the Bank) consolidated reports on the status of compliance with the ESMF with respect to all Sub-Loans, including those made by the Borrower and those made by PFIs.

Conditions

Source Of Fund	Name	Type

Description of Condition

Team Composition

Bank Staff

Name	Title	Specialization	Unit
Sita Ramakrishna Addepalli	Senior Environmental Specialist	Senior Environmental Specialist	GENDR
Mihasonirina Andrianaivo	Financial Sector Specialist	Team co-lead	GFMDR
Papia Bhatachaarji	Senior Financial Management Specialist	Sr Financial Management Specialist	GGODR
Rosanna Chan	Economist	Team co-lead	GTIDR
Neeti Katoch	Research Analyst	Research Analyst	GFMDR
Shanker Lal	Senior Procurement Specialist	Senior Procurement Specialist	GGODR
Aza A. Rashid	Program Assistant	Program Assistant	GFMDR
Anuradha Ray	Consultant	Consultant	GFMDR
Swati Sawhney	Operations Officer	Operations Officer	GFMDR
Sangeeta Kumari	Senior Social Development Specialist	Gender Focal Point	GSURR
Varun Singh	Senior Social Development Specialist	Gender and Social Safeguards	GSURR
Saurabh Shome	Economist	Economist	GMFDR
Sumriti Singh	Program Assistant	Program Assistant	SACIN
Ashutosh Tandon	Associate Operations Officer	Associate Operations Officer	GFMDR
Niraj Verma	Lead Financial Sector Specialist	Team Lead	GFMDR
Junxue Chu	Senior Finance Officer	Senior Finance Officer	CTRLN
Jorge Luis Alva-Luperdi	Senior Counsel	Senior Counsel	LEGES

Non Bank Staff

Name	Title	City

Locations

Country	First Administrative Division	Location	Planned	Actual	Comments

I. STRATEGIC CONTEXT

A. Country Context

1. ***India has been amongst the world's fastest growing economies in the last decade.*** In this period, India grew faster than 89 percent of the world's nations. Real GDP expanded at an average annual rate of 8.3 percent between FY2003-04 and FY2011-12. Growth has been accompanied by an impressive reduction in poverty, and, while disparities remain, overall India's growth has been inclusive.[1]

2. ***A key driver of this growth has been the service sector, while the manufacturing and agriculture sector remain important due to their potential to absorb large segments of the labor force.*** The service sector now constitutes over 65 percent[2] of GDP, up from 59 percent a decade ago – an increase that also highlights the transformational changes in the structure of the Indian economy with a marked shift towards this sector. Service sector growth has been broad based in terms of sub-sectors and has had a broad geographic spread across India's states (Figure 1). Several low income states (LIS) such as Bihar, Tripura, Manipur and Chattisgarh outperform many other states in the growth rate of services sector. This statistic also underscores the potential of this sector to contribute to furthering inclusive growth. The manufacturing and agriculture sectors, despite declining shares in GDP composition, remain important as labor intensive sectors and function as key sectors that absorb employment. [3]

Figure 1- Growth Rate of Gross State Domestic Product in Services Sector (at Constant 2004-05 Prices)

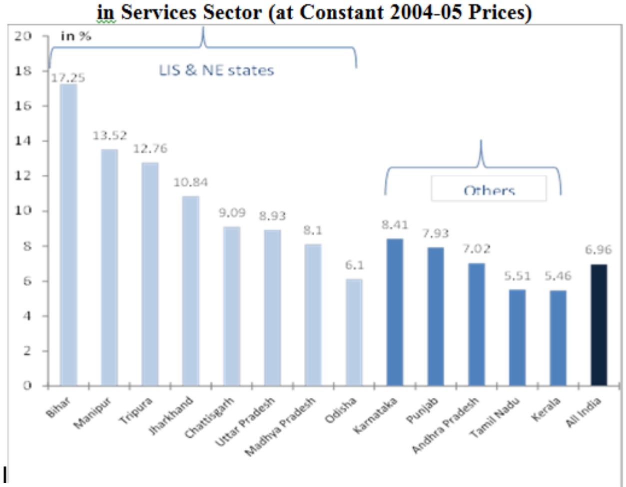
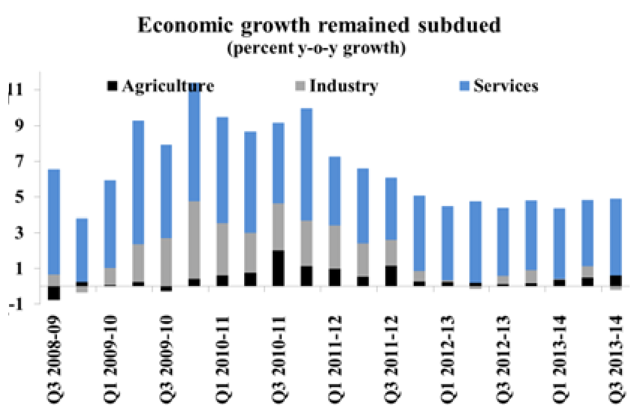


Figure 2- Evolution of economic growth by sector



Source: Central Statistics Office and World Bank Staff estimates

3. ***However, economic growth has slowed down in recent years.*** FY2013 and FY2014 have seen growth reduced to below 5 percent levels (Figure 2), though it has picked up sharply in the first quarter of the current fiscal year.[4] Inflation, which has moderated from double digits, continues to be at an elevated level averaging just above 8 percent since

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[1] Data source: Central Statistics Office (CSO).
[2] Includes construction.
[3] Data source: Central Statistics Office (CSO).
[4] Growth rebounded due to strong industrial recovery aided by growth in investment and exports. Capital flows are back, signaling growing investor confidence

January 2014.[5] The current account deficit has returned to the low pre-global crisis levels, as recovery in India's major export markets and a competitive exchange rate following last year's depreciation, helped stimulate exports.

4. ***For India to retain its high growth trajectory to meet its poverty reduction goals, it needs to address the recent economic slowdown and boost efforts to create jobs and foster entrepreneurship for its burgeoning population.*** Reinvigorating economic growth is a key priority for Government of India (GoI) including through its plan of creating 10-15 million jobs per year for the next decade to provide gainful employment to its growing young population.[6] Rapid job creation, both in terms of formal employment as well as entrepreneurship[7], is key to generating the number of economic opportunities needed. The issue is not just the number of additional jobs (140 million by 2020, Figure 3), but also the type of jobs and the opportunities for young people to create their own jobs, start their own companies, and grow companies that will create more jobs. India needs more productive jobs, with growing labor earnings and the prospect of formalization; jobs that support upward mobility and take households into the ranks of an emerging middle class.

Figure 3 – Employment generation required in India

Source: Planning Commission: Creating a Vibrant Entrepreneurial Ecosystem in India", June 2012

B. Sectoral and Institutional Context

5. ***Central to this challenge of boosting growth and job creation is the micro, small and medium enterprises (MSME) sector,*** which contributes around 45 percent to manufacturing output and about 40 percent of exports (directly and indirectly).[8] As such, entrepreneurship and business creation by MSMEs is crucial for large-scale employment generation and productivity growth. There is widespread recognition in GoI that vibrant MSMEs are a key engine of economic growth, job creation and greater prosperity and that a vibrant entrepreneurial ecosystem fosters innovations and contributes to greater dynamism in the economy. MSMEs are also regarded as the cradle for the Government's "Make in India" vision formulated recently.

6. ***However, the growth of the MSME sector has been constrained by lack of access to finance.*** Financial institutions have limited their exposure to the sector due to a higher risk perception, information asymmetry, high transaction costs and the lack of collateral.[9] Lack of

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[5] Data source: Central Statistics Office (CSO).
[6] India has world's highest population of youth, with about 66 percent of population below the age of 35 according to ILO, March 2013. Given the lack of viable employment opportunities, the majority of Indians opt for self-employment and 85 percent employment tends to be in the informal sector.
[7] Planning Commission June 2012, Creating a Viable Entrepreneurial Ecosystem in India, Mitra Committee report.
[8] Inter-Ministerial Committee for Accelerating Manufacturing in Micro, Small & Medium Enterprises Sector, Ministry of Micro, Small and Medium Enterprises, September 2013.
[9] IFC-Intellecap, October 2012, "Study on Micro, Small and Medium Enterprise Finance in India".

adequate finance is one of the biggest challenges inhibiting MSME growth and MSMEs face a vicious cycle in accessing funding (see Figure 4). It is estimated that about 87 percent of MSMEs do not have any access to finance and are self-financed.[10] Credit towards micro and small enterprises represent around 13-15 percent of formal financial institutions portfolio[11] with only a very small percentage of Indian enterprise loan accounts in commercial banks held by MSMEs (11 percent in 2013, compared to an average of 40 percent in countries with comparable income).[12] An IFC-Intellecap study showed a very large gap between demand and supply for credit for MSMEs (Figure 5).[13] In addition to access to finance constraints, poor investment climate, lack of infrastructure and market linkages, and gaps in financial market infrastructure and legal framework are additional constraints. While these are all important areas, these are the subject of parallel initiatives that seek to address them, and hence are not a focus of this project, which instead aims to complement such other efforts.[14]

Figure 4: MSMEs struggle to access finance

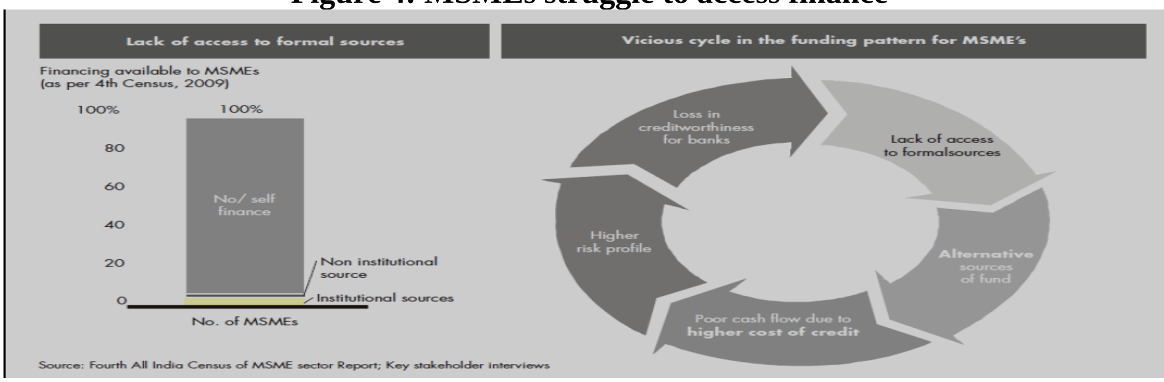

Figure 5: Overall Finance Gap in MSME Sector (in INR Trillion)*

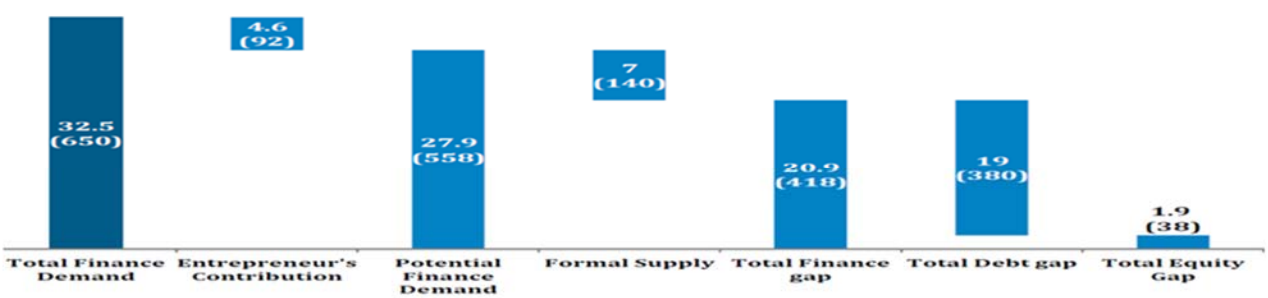

**Figure in brackets is in USD Billion*
Source: MSME Census, RBI, SIDBI, Primary Research, IFC-Intellecap Analysis

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[10] The MSME Census of 2006-07.

[11] Reserve Bank of India Database. A study by Beck, Demeriguc-Kunt, Martinez Peria (World Bank), 2008 shows that India's ratio is below the mean for the countries studied and well below countries like Armenia and Turkey.

[12] IMF Financial Access Survey (2014).

[13] Further around 73 percent of the total demand for finance among women owned businesses in India remains unmet (IFC, 2014).

[14] For instance, Government of India is focusing on this with a renewed effort to rationalize the tax structure (replacing indirect taxes with a rationalized goods and services tax), introducing labor reforms, streamlining business regulations, investing in skills enhancement and supporting infrastructure creation. Financial market infrastructure has been improving with a strong credit bureau industry while technical support from the IFC to the movable collateral registry is contributing to institutional and legal framework strengthening.

7. ***Addressing finance constraints for MSMEs is of utmost importance.*** Financial constraints hamper growth, competitiveness, response to shocks as well as employment and investment decisions at the firm level and thus affect the performance of the economy at large.[15]

8. ***In responding to the challenge of enhancing the provision of financial services to MSMEs, an effort to adapt this response to India's evolving economic structure and focus on spurring key areas within the MSME sector that are particularly relevant for growth and employment, is critical.*** First, accelerating entrepreneurship finance is crucial for generating large-scale employment, but also providing solutions to myriad problems by supporting innovative solutions in sectors such as education, health, climate change, information technology (IT) and financial inclusion.[16] Recent studies have shown that young firms and startups play a critical role in job creation and productivity growth.[17] Second, supporting the services sector which accounts for 67 percent of GDP and encompasses 71 percent of MSMEs[18] would provide an impetus to growth[19] and exports. Sectors such as education, health, entertainment, financial services, are the fastest growing sectors in the India economy, and are not only the drivers of economic growth, but also have the potential to significantly contribute to employment for future generations as India's economic composition continues to shift. Service sector's growth has also propelled growth in several low income states and has therefore contributed to promoting inclusive growth in the country. Third, supporting manufacturing growth is critical given that 75 percent of the MSMEs total output come from the top 10 industries in manufacturing.[20] The manufacturing sector is a priority for GoI which is targeting to increase the share of the manufacturing sector to 25 percent by 2022 from the current 16 percent. Further, enhanced provision of finance to India's manufacturing sector can contribute to maximizing the growing opportunities from the rapidly increasing labor costs in China and help realize the opportunities arising from GoI's recent "Make in India" initiative.

9. ***Rationale: There is a need to bring in institutional interventions to support improved financing to these three vital areas – early stage/start-ups, services and manufacturing – within the MSME sector*. *With regard to the first area, debt financing for early stage companies is virtually non-existent and MSMEs also lack mezzanine risk capital products***. India's startup ecosystem is currently one of the fastest growing in the world.[21] India has the potential to build about 2,500 highly scalable businesses that could generate revenues of INR10 lakh crore (US$158

[15] Chan, Rosanna. 2014. *Financial constraints, working capital and the dynamic behavior of the firm*. Policy Research working paper; no. WPS 6797. Washington, DC: World Bank Group. http://documents.worldbank.org/curated/en/2014/03/19190163/financial-constraints-working-capital-dynamic-behavior-firm

[16] Planning Commission June 2012, Creating a Viable Entrepreneurial Ecosystem in India, Mitra Committee report.

[17] See Eslava, Marcela y Haltiwanger, John. 2012, Young Businesses, Entrepreneurship, and the Dynamics of Employment and Output in Colombia's Manufacturing Industry, CAF Working paper N° 2012/08, http://www.caf.com/media/4220/young_businesses_entrepreneurship_dynamics_employment_colombia_industry.pdf and Javorcik, Beata; Fitriani, Fitria; Iacovone, Leonardo. 2012. Productivity performance in Indonesia's manufacturing sector. Policy note ; no. 5. Washington, DC: World Bank. http://documents.worldbank.org/curated/en/2012/09/16814671/productivity-performance-indonesias-manufacturing-sector-vol-1-1

[18] Compared to an estimated 29 percent of total MSME enterprises being in the manufacturing sector.

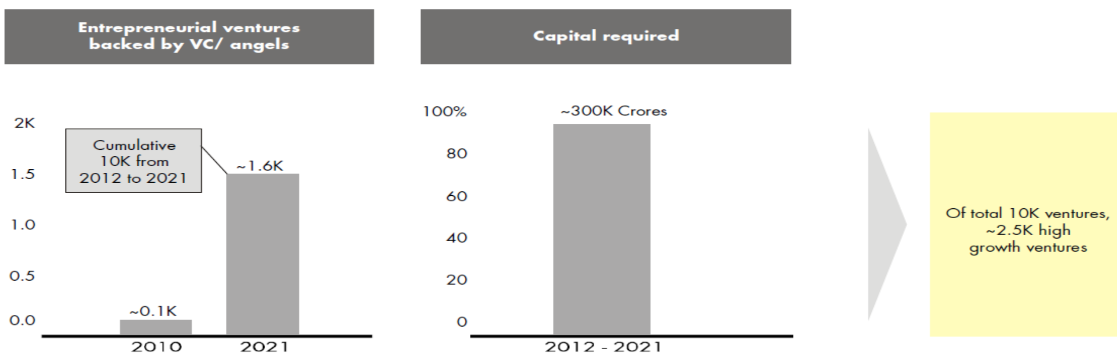
[19] India is also one of the world's largest service exporters and its exports in computer and information makes up over a third of all Indian services exports. World Bank, 2014, "India Development Update-April 2014".

[20] IFC Intellecap, October 2012, "Study on Micro, Small and Medium Enterprise Finance in India".

[21] Oct 2014, NASSCOM, Annual Startup Report. In print.

billion) in the next 10 years.[22] To meet this potential, India needs to build a pipeline of over 10,000 startups. However, the rapid growth in the ecosystem and the demand for financing have not been matched by the supply of financing to early stage entrepreneurs. While India has seen substantive growth of venture capital (VC), the financial market to support the ecosystem has been undeveloped in debt options to startups. The lack of debt financing in the ecosystem has meant that firms grow slower and are less able to take advantage of economic opportunities due to lack of financing[23], and are often forced to turn to equity to finance working capital – which is both an expensive way of financing working capital and reduces entrepreneurial capacity. One of the key findings of the 2012 Mitra Committee Report is the lack of debt financing instruments available to entrepreneurs. It estimates INR3 lakh crores (or around US$47.3 billion) of capital is needed over the next decade to build the pipeline of startups and entrepreneurial activity needed for India to meet its potential (see Figure 6).[24] Half of the capital inflows needed is in the form of debt instruments for working capital needs. In addition to the shortfall in early stage debt finance, MSMEs across various stages of growth lack mezzanine capital – which if provided is a valuable form of capital that can help strengthen balance sheets by providing longer term funding and leverage additional funding.

Figure 6 – India VC and Angel Investments (Mitra Committee 2012)



Note: Split of capital into various sources to be based on development of different stakeholders and markets – indicative split $20B of VC, $3B of angel, $3B of incubator seed funding and $29B of debt
Successful ventures computed using historic and benchmarked failure rate – 10% for angel and 40% for VC
Source: Thomson Reuters; Bain PE deal database; Expert interviews; Bain analysis

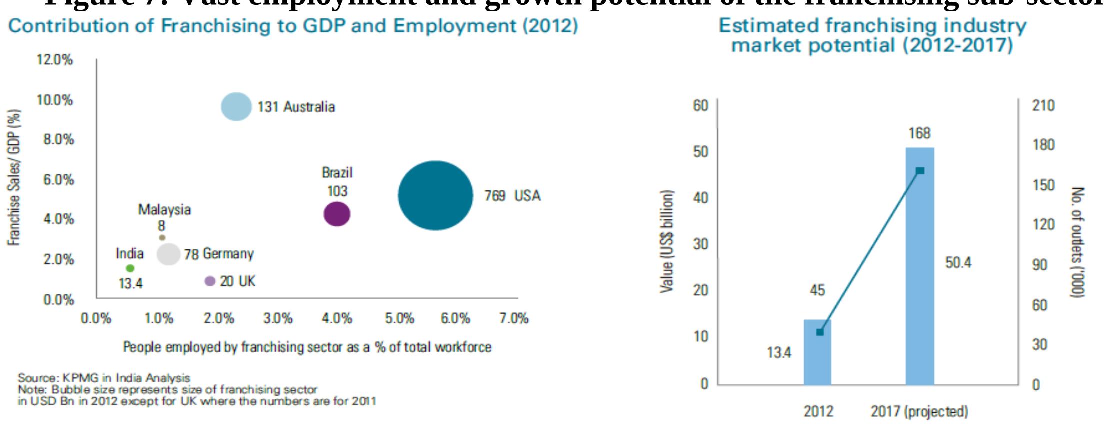
10. ***Second, the service sector lacks the ability to provide physical collateral and this lack of physical assets inherent in service sector activities, and in MSMEs in general, means that they face constraints in accessing bank financing***. Indeed, most businesses in the services sector only create/invest in light assets and operate from leased premises. Therefore, they typically have softer collateral (e.g. fixtures, furnishings, equipment, etc.), with limited access to immovable collateral.[25] All this makes access to formal finance challenging as financial institutions have yet to develop appropriate risk assessment frameworks to assess such enterprises. As a result

[22] Mitra (2012), "Creating a Vibrant Entrepreneurial Ecosystem in India", Report of The Committee on Angel Investment & Early Stage Venture Capital, Government of India, Planning Commission, New Delhi. June 2012.
[23] Financially constrained firms grow much slower and is limited to produce at optimal scale, thus reducing productivity overall. (see Chan 2013). In addition, World Startup Report advises would be investors for Indian Startups to expect everything to be slower by a factor of 2-10 times of Silicon Valley.
[24] See Mitra (2012), "Creating a Vibrant Entrepreneurial Ecosystem in India", Report of The Committee on Angel Investment & Early Stage Venture Capital, Government of India, Planning Commission, New Delhi. June 2012.
[25] Some businesses also operate from a single-purpose commercial building – e.g. bowling lanes, movie theaters and franchises (where customizing the inside and outside is part of the branding) – for such firms, lenders typically further discount the single purpose building collateral by the amount of the renovation cost in the event of default.

traditional banking based on collateral lending does not cater well to these large, innovative and dynamic segments of the Indian economy. Thus, despite the contribution of the sector to GDP, its potential is not fully realized and many firms are unable to grow sufficiently. Financial depth (credit to GDP) for this sector is a mere 25 percent (RBI). The introduction of customized products with innovative financing mechanisms would support the growth of formal debt financing to the service sector and sector growth.

11. ***One striking example in India is the franchising industry***. The demand for franchisee businesses is growing fast with the increased demand for branded goods and services in India.[26] The franchising industry is expected to quadruple between 2012 and 2017 (see Figure 7) and could contribute to almost 4 percent of India's GDP in 2017 from a current estimated 1.4 percent of GDP,[27] and create job opportunities for an additional 11 to 14 million people by 2017. If achieved, the industry will account for almost 10 percent of the targeted growth in workforce.[28] However, the KPMG report concludes that to sustain growth until FY2017 there is a total capital investment (including equity) requirement of INR 37,000 crore (US$5.8 billion) and a total debt requirement of INR 48,000 crore (US$7.6 billion).[29] Most financial institutions in India have used traditional approach with collateral/asset backed lending products to franchisee financing. Innovative financial products to franchisees along the lines of channel financing structures, with adequate support from the franchising ecosystem, in particular from the franchisor could help address financing issues (for example: leveraging the relationship between the franchisor and the franchisor-franchisee to provide additional reassurance to the lending institutions).[30]

Figure 7: Vast employment and growth potential of the franchising sub-sector



Source: KPMG Collaborating for Growth, Report on the Franchising Industry in India, 2013

12. ***Third, lack of adequate finance to manufacturing MSMEs has contributed to constrained growth and limited competitiveness***. The manufacturing sector is more capital

[26] This growth in the number of franchised outlets in India has been also encouraged by increased globalization, relaxation of foreign investment rules, liberalized World Trade Organization (WTO) guidelines and government's incentives among others according to KPMG (2014): "Credit gap, potential and financing of franchising industry in India".

[27] Assuming 6 percent year-on-year GDP growth between 2012 and 2017 as per KPMG 2013 FAI Report on: "Collaborating for Growth".

[28] KPMG 2013 FAI Report on: "Collaborating for Growth".

[29] Total capital investment needs translate to a term loan requirement of INR 18,000 crore (US$2.8 billion). In addition, to sustain sales of INR. 272,000 crore (US$43 billion) by FY2017, working capital of R 29,000 crore (US$4.6 billion) would be required (KPMG, 2014, "Credit gap, potential and financing of franchising industry in India").

[30] The franchisor could provide due-diligence of the franchisee business plans, letters of recommendation, information sharing or even guarantees.

intensive, has longer working capital cycles and has therefore higher working capital requirements than the services sector. It is estimated that working capital accounts for 70 percent of the total debt demand from the manufacturing sector. However, only 50 percent of the average demand of a manufacturing MSME is met in India, suggesting that many manufacturing MSMEs remain financially underserved. Manufacturing enterprises account for 73 percent of the MSME's viable and addressable debt gap.[31] Financing sustainable improvements in the manufacturing MSME sector is one potential way to help strengthen the competitiveness of manufacturing MSMEs, for example through increased cost efficiency but also building competitive advantage beyond cost efficiency, energy saving investments in plant and machinery/production processes, etc.

13. ***The GoI and the Small Industries Development Bank of India (SIDBI)***[32] ***have requested the project which will focus on the financial intermediation to the MSME sector***, and complements other ongoing and parallel efforts by the GoI and industry to address the other constraints that inhibit MSMEs' growth and employment potential. The proposed project also complements other World Bank engagements with the GoI for the MSME sector[33] and builds on previous successful financial sector engagements with SIDBI (2004 and 2009). By focusing on access to finance for strategic sectors, the project will help develop appropriately designed products, mechanisms and initiatives that address the key constraints that inhibit finance for early stage, service and manufacturing MSMEs. Assistance will be provided through SIDBI directly (particularly relevant for early stage financing, service sector financing and manufacturing sector financing linked to better management practices), all areas where interest from other lenders is lacking, as well as through other eligible participating financial institutions (PFIs, refinancing) which are interested. By demonstration, the project will catalyze private sector financing, leveraging SIDBI's role as the apex development bank for MSMEs. Capacity building of the intermediaries in the targeted areas of the project would also contribute to sustainability of the effort and enhanced outcomes.

14. ***The proposed project also supports SIDBI's transition to new focus areas in line with its strategic business plan and therefore contributes to strengthening India's apex development bank for this sector***. The project supports the capacity of SIDBI to deliver and develop financial products to MSMEs in the identified areas. The project supports SIDBI transition as a 'market making' financial institution in line with its recently formulated strategic business plan[34] by enabling it to transition to new focus areas, including creating markets for new and innovative financial products and services for first generation entrepreneurs and new models for service sector financing. The project aims to use innovative channels to address issues around information asymmetry and credit risk by leveraging information from multiple sources (e.g. angel investor networks for early stage debt financing, or franchisers for service sector financing, and credit bureaus), which will be supported by the parallel technical assistance which is designed to support

[31] IFC-Intellecap, October 2012, "Study on Micro, Small and Medium Enterprise Finance in India".
[32] India's development bank for the MSME sector and for microfinance.
[33] Such as the MSME Technology Center Support Project and the technical assistance on the manufacturing sector.
[34] SIDBI has redefined its business plan and has repositioned itself to: (i) align its business operations with the Government of India mandate, (ii) fill in the financing and development related gaps in the MSME ecosystem, and (iii) focus on some of the critical gaps prevailing in the MSME sector based on the feedback received from other stakeholders in the MSME sector and industry. SIDBI has formulated a new strategic business plan that aims to better cater for the changing needs of MSMEs in growing areas of the economy. This will entail expanding credit lines as well as developing new products and services.

implementation, enhance project quality and overall, to facilitate long term sustainable development beyond the term of the project.

C. Higher Level Objectives to which the Project Contributes

15. ***The GoI sees a strong and vibrant MSME sector as crucial to India achieving sustained high growth for the next couple of decades, to stimulate domestic demand and consumption and as a vehicle for inclusive growth,*** The 12th Five Year Plan (2012-17), the National Manufacturing Plan, the recent July 2014 Budget and various recent committee reports and policy announcements, all clearly articulate the critical role early stage, services and manufacturing sector MSMEs to supporting sustained growth and employment. The 12th plan also recognizes the need to improve access to finance including risk capital, for MSMEs. This focus on MSMEs has been echoed by the Reserve Bank of India (RBI) that has advised banks to achieve a 20 percent annual growth in credit to MSMEs.

16. ***Addressing financial constraints of MSMEs can spur greater competitiveness and employment.*** Improving access to finance for MSMEs has the potential to have multiplier effects across the economy by unlocking the inherent growth potential of MSMEs and creating employment opportunities. This is particularly important for the millions of youth and agricultural workforce transitioning into urban areas and for the growing urban population. Through enhancing SIDBI's capacity and channeling finance to MSMEs, the project contributes to these higher level objectives.

17. ***The proposed operation fits with the government program (as discussed above) and is also aligned with the Bank's Country Partnership Strategy*** (CPS, 2013-17) which focuses on inclusive growth, jobs, and private sector development.[35] In particular, the CPS highlights the need to facilitate access to finance for MSMEs especially to boost the manufacturing sector. The CPS cites access to finance for MSMEs as a concern since MSMEs are an important source of wage employment with 8 million people entering the labor force every year. Capturing the employment opportunities that a vibrant MSME ecosystem provides could allow India to reap a substantial demographic dividend. In this context, the project contributes to the CPS first area of engagement on integration through improved infrastructure, by increasing access to finance of MSMEs in the manufacturing sector and contributing to the sector's growth. In addition, the project also directly contributes to the CPS third area of engagement on inclusion by supporting MSMEs and to the achievement of the CPS outcome indicator on additional loans to MSMEs.

[35] The World Bank, "Country Partnership Strategy for India for the period FY2013-2017", Report No. 76176-IN, discussed by the Board on April 11, 2013 .

II. PROJECT DEVELOPMENT OBJECTIVES

A. PDO

18. The project development objective is to improve access to finance of MSMEs in manufacturing and service sectors from early to growth stage, including through innovative financial products.

19. The higher level objective is to support growth and employment creation through unlocking opportunities for firm growth that the financing would provide.

B. Project Beneficiaries

20. Funded MSMEs[36] will be the primary beneficiaries. MSMEs for the purpose of this project will be firms that are considered as MSMEs under the MSME Act.[37] Through supporting activities that are in line with its new business plan, the project specifically benefits SIDBI by enhancing its financial and institutional capacity in the areas of early stage, service and manufacturing sector financing, and also supports other Participating Financial Institutions (PFIs) through project financing and the parallel technical assistance (TA) that will accompany the project.

C. PDO Level Results Indicators

21. **The key results indicators** will include: (a) Outstanding MSME loan portfolio in risk capital financing including startups; (b) Outstanding MSME loan portfolio in the service sector; (c) Outstanding MSME loan portfolio in the manufacturing sector; (d) Turnover of startups supported through the project; and (e) Total number of MSMEs beneficiaries. Additional intermediate outcome indicators are described in Annex 1.

III. PROJECT DESCRIPTION

22. The project supports financing of debt to service and manufacturing sector firms, including early stage firms. In terms of financial products, the project will use debt instruments that could include risk capital (mezzanine/sub-ordinate debt instruments). Parallel financed technical assistance (TA) is proposed to support SIDBI's and PFIs' capacity and other development initiatives (Annex 2).

23. The project financing will be provided through SIDBI directly as well as through other PFIs in market segments and activities where PFIs are interested. Financing will be at market determined rates. Project proceeds will include support to firms with women ownership/management and firms located in a low income state (LIS) which will be tracked in line

[36] These are expected to be primarily formal sector firms, as contrasted to informal micro-enterprises.
[37] At present, this includes manufacturing firms that have plant and machinery of up to INR 10 crores (~US$1.6 million), and service sector firms with equipment of up to INR 5 crores (US$0.8 million). In addition and as per SIDBI policy, service sector firms with a project cost of up to INR75 crores (US$11.8 million) can also be beneficiaries. The definition may be revised over time in discussion and agreement between SIDBI and the Bank.

with indicators in the results framework. Selection of PFIs will be based on clearly defined and transparent eligibility criteria (see Section VI. B and Annex 2 for eligibility criteria).

A. Project Components

Component 1: Spurring Early Stage and Risk Capital Financing (estimated total project cost of US$163.6 million of which US$148.7 million is IBRD loan)

24. Component 1 will support pioneering early stage debt financing (including angel and early stage venture debt) and also support risk capital financing to MSMEs. India's dynamic early stage ecosystem will be supported by debt from SIDBI (and other PFIs that may be interested) to startups and early stage MSMEs.[38] Typically, these enterprises are on the growth stage where they have placed products on the market, have revenue streams even though they may not be making profits or those firms that have already entered early stage venture capital. Firms in these segments are characterized by extreme high growth (startups and early stage) and by business models that are characterized by high non-tangible assets (such as intellectual property). Around a third of the component is expected to be utilized for such financing. Risk capital financing will support innovative products that provide mezzanine debt capital (including sub-ordinate debt) to MSMEs. Such funding, which is higher risk and longer term than typical debt,strengthens the balance sheet of the MSMEs, eases working capital requirements and enables additional leveraging of capital. Two thirds of the component allocation is expected to be utilized for such financing.

Component 2: Supporting Service Sector Financing Models (estimated total project cost of US$220 million of which US$200 million is IBRD loan)

25. This component will support products offered by PFIs and SIDBI which are better tailored for the services sector. These include SIDBI's recently introduced products, which are a small part of SIDBI's balance sheet at present (see Annex 2) but represent products that have the potential to grow. Among them is the introduction and scale up of innovative models of financing with customized appraisal parameters that rely on business viability and cash flow assessment (rather than typical models that rely on collateral as a primary criterion for eligibility). The project will seek to focus on products such as asset light models, and franchisee financing (where the franchisor-franchisee relationship is leveraged) for stand-alone franchisees as well as for a structured arrangement to finance more than one franchisee. In both cases a direct engagement of the franchisor with the PFIs (including SIDBI) to set up the financing scheme would be sought. Key sectors within the Indian franchising industry could be selected to be the focus of the project, for example food chains, logistics and so forth.

Component 3: Supporting Finance to Manufacturing MSMEs (estimated total project cost of US$165 million of which US$150 million is IBRD loan)

26. This activity will support various manufacturing sector financing products, including the introduction of new financial products and/or financing mechanisms for the manufacturing sector.

[38] The term startup is associated with a business that is typically technology oriented and has high growth potential. While the majority of SIDBI's current pilot startup portfolio is technology related, eligibility is not limited to technology focus enterprises but also includes enterprises in other fields that are of high growth potential. For example, the invention of a home *dosa* machine.

The project will also support sustainable improvements in manufacturing MSMEs, through promotion of better management practices that will support their competitiveness in India but also globally. Several activities can be envisaged, such as: (i) Loan Extension Services (LES) to MSMEs: for those MSMEs that are interested (particularly relevant for more energy consuming firms), the parallel TA will support a quick opportunity assessment (for example energy efficiency (EE), audit) for overall improvement of the MSME unit; and (ii) Models of cluster financing (namely credit delivery arrangements with NBFCs, MSMEs associations, machineries manufacturers, dealer financing) where PFIs/SIDBI, could leverage cluster level association/ industry association to help reduce information asymmetries, for example, by obtaining references/credit screening from clusters.

27. ***Parallel TA*** is proposed that will accompany the project implementation. The broad outline of the TA support will be aligned to support the three components of the project and will be designed for a five year period. Support will also be provided for implementation of activities, to SIDBI and also some of their select PFIs. The TA will support capacity building particularly in areas of research and development on early stage financing models and PFI (including SIDBI) capacity building in credit appraisal (especially as early stage debt financing and service sector financing will require differentiated appraisal skills) and new product development. The TA will also support activities that are gender focused/promote women entrepreneurship among MSMEs. A key focus area for capacity building with SIDBI (and PFIs) will be on developing innovative early stage and risk capital products and in developing risk rating and pricing models that appropriately capture the nuances of lending to these sectors. In addition, this would include innovating on processes that can help address information asymmetry issues and keep credit risks to acceptable limits for all three components. Further, support will be provided for other aspects such as products that leverage the use of movable and intangible assets, including light assets, which will be relevant for both early stage as well as service sector firms. For the manufacturing sector, there will be support provided during the initial stages of the project to cover assessments for the Loan Extension Services (LES), Energy Efficiency (EE) audits on selected loans. The TA will also build SIDBI internal capacity for the LES, EE audits and cleaner production. Further, the TA will support a beneficiary survey at the start of the project, mid-term review and closing date and communication/dissemination efforts. Support for consultation with stakeholder and expert panels for providing inputs and industry feedback on particular component activities are also envisaged (see also Annex 2).

28. This TA will be funded through parallel but coordinated development partner funding and/or trust fund resources. Discussions have been initiated with development partners, and trust funds and will be routed through World Bank Group executed trust funds, such as IFC, and/or parallel donor initiatives. Initial funding sufficient for the early project period is anticipated to be available at the start of project implementation. TA activities are expected to be Bank executed and will be closely identified and coordinated with SIDBI.

B. Project Financing

Lending Instrument

29. The project uses the Investment Project Financing instrument (IPF) of IBRD in the amount of US$500 million. Parallel TA supported by trust funds and development partners in an expected

amount of US$5 million is proposed to complement project implementation. After considering the alternative financing products, the Borrower has chosen an IBRD Flexible Loan (IFL) with variable spread. The loan will be guaranteed by the GoI.

30. As a financial intermediation operation, this project complies with the World Bank OP 10.00. SIDBI is the borrower and implementation agency (see Annex 3 for details on implementation arrangements). It has adequate capacity to implement the project as determined through past project experiences and a recent due diligence carried out on SIDBI and a sample of potential representative PFIs that confirmed overall financial performance, management and governance being compliant with the provisions of OP 10.00 (see details in Annex 4). The proposed lending from PFIs (including SIDBI) to early stage and other MSMEs will be undertaken at market determined rates.

Project Cost and Financing

31. The total project cost is US$550 million, of which US$50 million is counterpart funding. The project's allocations to the three components are summarized below.

Project Components	Project cost (US$ million)	IBRD Financing (US$ million)	% Financing
1.Spurring Early Stage and Risk Capital Finance	163.63	148.75	90
2. Supporting service sector financing models	220	200.00	90
3. Supporting finance to manufacturing MSMEs	165	150.00	90
Total Baseline Costs			
Physical contingencies			
Price contingencies			
Total Project Costs	548.63	498.75	90
Front-End Fees	1.25	1.25	100
Total Financing Required	549.88	500.00	

C. Lessons Learned and Reflected in the Project Design

32. The project reflects lessons learned from recent analytical work on MSME development in India including the IFC Intellecap (2012) report, the MSME Census and various government reports referenced above. All these reports highlight inadequate finance to MSMEs as one of the biggest challenges for MSME development and conclude that government support is one of the key elements for an enabling environment for the growth of MSMEs and MSME finance in India (in addition to financial infrastructure support and an enabling legal and regulatory framework). The IFC Intellecap report also advocates financial support through apex sector bodies such as SIDBI to increase penetration of credit rating and the promotion of cluster development, which the project and the accompanying TA will contribute to.

33. The project design also reflects lessons learnt from recent, ongoing and completed World Bank Group and donor projects, international best practices in MSME finance, and also the World

Bank OP 10.00 Guidelines on Financial Intermediary Financing. This includes lessons learnt from similar operations in Egypt, Sri Lanka, Jordan, Morocco, and other countries, from the previous India MSME development and financing projects, and also builds on the conclusions of the 2006 Independent Evaluation Group's (IEG) impact evaluation of World Bank funded line of credit projects. The IEG report outlines that while past experience with financing of credit lines has been mixed, issues mainly stemmed from the following: (i) weak accountability and management capacity of the borrower and implementing entities; (ii) lack of clearly defined and transparent eligibility criteria for commercially-oriented private sector financial intermediaries, namely PFIs, to ensure their financial and operational quality, (iii) poor monitoring of the overall project impact due to inadequate selection of monitoring indicators and inadequate supervision during implementation, and (iv) lack of identification of suitable products for MSMEs and delivery mechanisms and inflexibilities in project design making it difficult to reflect changing circumstances. In addition, the IEG report emphasizes that any foreign exchange risk of sub-loan repayment should be borne by either the end user or the government but not by the PFI. The project is well positioned on all these potential areas of weaknesses found in the IEG study with a strong counterpart in SIDBI and potential PFIs, successful prior experience of MSME financing, clear eligibility criteria, strong monitoring capacity and well defined products/market segments.

34. Further, on early stage financing, the Bank has built up experience through several projects, including through the Regional MENA Early Stage Investment Facility (ESIF), the Egypt and Lebanon SME Projects[39] and work in Morocco on this topic. While there have been lessons and insights gained from Bank's engagement in the startup ecosystem around the world, the design of this project is uniquely customized for India's context. The early stage financing and risk capital and service sector financing components have been informed by lessons learnt from SIDBI's prior engagement with these products, albeit on a smaller scale. During the piloting of such loans, SIDBI has become much more familiar with the business model and growth cycle of firms in these segments, as well as identified constraints. SIDBI has addressed these through strengthening systems, leveraging industry knowledge and expertise in appraisal and development of alternate electronic platforms to facilitate information flows and to increase the speed at which loans can be processed (see also Annex 2 and Annexes 5 and 6).

35. In terms of implementation arrangements, the lessons from past projects have been incorporated in the project design, notably: (i) a PIU in SIDBI has been assigned clear responsibility and accountability for project implementation and reporting (see Section IV); SIDBI is strongly committed to the project and has strong management capacity (see Annex 3 and 4); (ii) PFIs selection and appraisal will be based on clearly defined and transparent eligibility criteria defined in the Operations Manual (OM) for the project (see Annex 2); (iii) measurable target indicators have been identified upfront to monitor the performance/ progress achieved by SIDBI and the PFIs (see results framework in Annex 1); and (iv) commercial banks and MSMEs including early stage firms have expressed strong demand for credit.

[39]Project to encourage early stage investment in SMEs, passed by Parliament and expected effectiveness of February 2015.

IV. IMPLEMENTATION

A. Institutional and Implementation Arrangements

36. SIDBI is the borrower and the implementing agency for this proposed project. SIDBI is the apex institution for MSMEs in India and has a long standing experience in designing financing products and services for MSMEs. It plays a key public policy role in India's MSME sector and therefore benefits from strong support and trust from the GoI, reflected in the responsibilities bestowed on them, including for implementation of key programs for MSMEs. SIDBI has strong credit fundamentals and has AAA rating for its bond issuances in India. It has strong prior experience of working with Bank projects (see Section III. C above) and has implemented these past projects satisfactorily. In addition, SIDBI has partnerships with several other development partners including the Asian Development Bank, KfW, JICA, AFD, etc. It has a strong management team and a risk governance framework commensurate with its size and scale of business.

37. For the project's implementation, no separate department is deemed necessary and SIDBI has identified a multi-vertical core team which will serve as the project implementation unit (PIU). The PIU comprises 13 officers currently and SIDBI has committed to maintaining its size commensurate with project needs. The PIU is headed by the Country Head of the vertical handling the major components of the project, namely Services and Equity Vertical; and includes three General Managers and three Deputy General Managers (in both cases, one each from the Equity and Resources verticals), and seven Assistant General Managers/Managers. The PIU will have representation from all the three concerned verticals. Further, while expertise and human resources exist for both component 1 and 2 within the PIU and Service sector vertical which manages those products (and these resources are deemed sufficient for the initial implementation period), given the project's focus and in anticipation of business growth, it was agreed that SIDBI will strengthen the team and appoint additional staff members to the Risk Capital and Service sector vertical. Half of them will be allocated to the PIU with specific responsibilities for the implementation and monitoring of those components – this will be done from the start of implementation. The PIU members have prior experience of working with the Bank and other multi-lateral and bilateral partners. Staff resources have adequate technical as well as fiduciary and safeguards experience, and SIDBI management has confirmed that additional resources can be drawn upon, if needed.

38. In addition to the PIU, a consultative committee comprising external experts will be supported by the parallel TA. This committee – with an expected membership of around five to seven experts – will serve as a sounding board and will provide feedback on project's activities. The committee will meet at least twice yearly and in the initial years, more frequent interactions are expected. Experts will be drawn from angel and early stage investors, financial institutions with experience in any of the project's components, industry associations and similar stakeholders. In addition to this, more on-going technical support through structured interfaces with industry experts on early stage financing and service sector financing (components 1 and 2) will be available to SIDBI and other PFIs and supported through the TA as described in Section III A above.

39. To facilitate project implementation a detailed OM has been prepared by SIDBI. The OM includes details on the implementation arrangements, including the eligibility criteria for PFIs and

the principles of the appraisal processes that will be followed, fiduciary and safeguards arrangements (which are also defined in the ESMF), project audit requirements including the Terms of Reference (ToRs) for the project audit, disbursement arrangements and the Interim Unaudited Financial Report (IUFR) formats, etc.

40. Funds flow is discussed in Section VI below, but in summary funds will flow to SIDBI and disbursements will be based on IUFRs that reflect on-lending that has been undertaken by SIDBI or PFIs to MSMEs under the project's three components (reimbursement basis). TA funds will be executed by the Bank team (or by the development partner concerned).

B. Results Monitoring and Evaluation

41. A strong monitoring and evaluation (M&E) framework to track inputs, outputs, and outcomes in a systematic and timely fashion has been developed and agreed with SIDBI (see Annex 1). Project outcomes and outputs will be monitored through periodic reporting by SIDBI—which has developed considerable capacity in monitoring through implementing the earlier World Bank project—and via project supervision using data from several sources, including (i) reported data from SIDBI; (ii) auditors; (iii) PFIs, and (iv) Bank staff implementation support missions. Further, a survey of MSMEs beneficiaries of the project will be designed and supported by the parallel TA. It will include a baseline survey, mid-term survey and end term survey to monitor the final outcomes of the project in particular on financial access and on MSME growth and employment creation. Qualitative focus group discussions with MSMEs, lenders and other project stakeholders will also be undertaken alongside the survey. PFIs will be required, under the terms of on-lending financial agreement (specified in a side letter), to submit periodic updates to SIDBI. This could comprise of disbursement of credit line to borrowers (by growth stage, product and location) and borrower outreach (number of MSMEs supported, including an indicator on MSMEs that are women owned or managed). PFIs will need to comply with the eligibility criteria which will be appraised and determined by SIDBI (see Annex 2).

C. Sustainability

42. All three components of the project have been developed by SIDBI and in discussions with other PFIs, which reflects strong demand and ownership by both implementing agency and industry participants. The project request is led and fully owned by SIDBI and signals SIDBI's commitment to the project's objectives and strengthens sustainability of project outcomes beyond the term of the project. In addition, the project incorporates activities that are part of SIDBI's long term strategy as articulated in SIDBI's own recently formulated business plan. As such, incentives are aligned between the project's objectives and SIDBI to ensure implementation during the project period and continuing beyond. Furthermore, financing under the project will be undertaken on market principles to ensure sustainability in the long run and in developing financial products for market segments beyond the term of the project. In addition, the project's accompanying TA and implementation arrangements (safeguards and fiduciary), support the MSME sector in undertaking commercial activities in a sustainable and efficient manner. The project activities also strongly support GoI priorities of supporting MSME sector growth and development, as discussed above. This again contributes to ensuring sustainability of project outcomes.

43. Sustainability beyond the project period is incorporated also into the project design in that the engagement in new areas is expected to yield important sets of demonstration effects for the financial system. By doing so, it would encourage adoption by others in the system and thereby help catalyze nascent product/market segments and create sustained deepening of the financial system in the long run.

V. **KEY RISKS AND MITIGATION MEASURES**

A. Overall Risk Rating and Explanation of Key Risks

44. Key risks have been identified and rated in the Systematic Operations Risk-Rating Tool (SORT) presented above in the Data Sheet. Overall risks are Moderate given past experience and strong collaboration between SIDBI and the Bank over the last 10 years and given SIDBI's demonstrated capacity to implement projects that foray into new domains while keeping to Bank implementation arrangements (including fiduciary and safeguards) in a satisfactory manner. Many of the project implementation arrangements used previously will be used.

45. One risk could be that SIDBI and PFIs may not fully absorb the financing from the credit line, particularly on Component 1 given that the perceived risks of startup and risk capital financing are high and experience of such financing amongst financial institutions is limited. This risk is mitigated by the approach to credit appraisal already being piloted successfully by SIDBI and draws from their extensive experience with SIDBI Ventures in assessing risk in similar ventures. In addition, new approaches will leverage information from other stakeholders in the eco-system, including angel financing networks, early stage funds and accelerators that can help address information asymmetry issues and keep credit risks to acceptable limits. The parallel TA will help support further strengthening of capacity of SIDBI and related departments of the PFIs, as required. This will include developing SIDBI's credit risk appraisal system and other PFIs' ability to appraise and manage MSME loans; and conducting training programs with the SIDBI branches and PFIs on the new products/processes. Another risk to be noted here relates to the level of human resources allocated to project implementation activities. This risk is mitigated by the fact that SIDBI has identified a multi-vertical core team which will serve as the project implementation unit (PIU). As discussed above the PIU is adequately staffed and SIDBI has committed to expanding this team and then maintaining its size commensurate with project needs and covering key dimensions of technical skills, gender activities, safeguards and fiduciary capacities. In addition to this, the TA will also support SIDBI with the operational aspects of pipeline development, disbursements and monitoring of the credit line – through an expert set of consultants, who would work closely with the PIU, and also support SIDBI with the collection and reporting of data/MIS. Also, all the three components reflect expressed demand by SIDBI and discussions with other PFIs indicate their interest as well. In addition, careful analysis of SIDBI's current and projected lending portfolio and of potential PFIs past and projected MSME loan portfolios shows that the amount allocated for project activities is appropriate, will be absorbed and will support building financing in new market segments and expanding access to finance for MSMEs.

46. Another risk could be that implementation is not in line with agreed implementation arrangements (including on safeguards and fiduciary aspects). However, there is comfort from the fact that SIDBI has managed the previous credit lines well and the institution's engagement with the Bank in the past reflects their capacity and ability to intermediate Bank funds appropriately in

line with project implementation arrangements (see also Annex 3) and efficiently. Training and capacity building of credit officers and PFIs will also help mitigate risks of non-compliance. Sufficient resources will be allocated to implementation support (Annex 7).

47. Taken into account the likelihood of materialization of each risk category detailed in the SORT and their respective expected impact on the PDO, overall risk is rated as Moderate.

VI. APPRAISAL SUMMARY

A. Economic and Financial Analyses

48. Significant economic benefit is expected to be derived from the project. The project will provide timely and essential financing (including working capital) to MSMEs which will help them start, sustain and grow their businesses. This will contribute to MSMEs' competitiveness, unlock the vast economic growth potential of the MSME sector, and promote employment. Financing would be provided on market terms, factoring in credit risks and other costs. It will enhance profitable lending to viable MSMEs while managing NPLs to the segment.

49. An economic analysis was carried out to estimate the project's benefits for MSMEs (see Annex 8) relative to the counterfactual without the project. The project effect case is where the easing of financial constraints contributes to faster rates of turnover growth of firms.[40] As the project funds are deployed across growth stages in services and manufacturing, different rates of turnover growth is assumed for different sectors. The counterfactual case used for comparison is defined as firms' turnover growth under financial constraints, without the project's credit line. Plausible assumptions are made as to the lower turnover growth under financial constraints. On an overall basis, and with conservative assumptions, the project is expected to yield an Internal Rate of Return (IRR) of 26 percent in the project case and significantly higher Net Present Value (NPV) of cash flows due to the project (see details on the results and methodology in Annex 8). The benefits for firms outweigh costs (which are expected to be between 12-15 percent).

50. In addition to growth benefits at the MSME level, by strengthening SIDBI's/PFIs' credit appraisal system (including through demonstrated models of cash-flow based lending), the project will enhance lending to viable MSMEs and help reduce banks' MSME-related NPLs. Safeguard practices promoted under the project will increase the MSMEs' ability to comply with environmental and social standards and PFIs' capacity to promote and manage these issues better. SIDBI's new products for women entrepreneurs will support financing to women owned/managed firms and parallel TA activities will support communication and capacity building efforts focused on women enterprises. Further, by introducing and mainstreaming new financial vehicles to the market such as venture capital debt, franchisee financing and cluster financing, this operation is expected to provide an important set of demonstration efforts to the financial system. Enhanced market credibility through SIDBI's demonstrated performance in these new lending segments would help crowd in other banks, institutions, NBFCs and the private sector in general. This will enable the project to contribute to improving MSME credit market efficiency and developing the ability of banks to appraise and manage MSME loans with limited collateral. Furthermore, PFIs will be selected on transparent eligibility criteria (which will include factors related to asset quality,

[40] See also Chan 2014 that shows the easing of financial constraints results in faster rates of growth, and greater productivity as firms can reach optimal scale faster.

capital adequacy, credit appraisal capacity and management systems and profitability; these will be closely monitored and verified on an on-going basis) and will be those that have transparent and sound MSME appraisal capacity. This arrangement will support the demonstration of good lending practices and results.

51. Through its demonstration effect, the project is also likely to generate benefits for a much larger number of intermediaries and MSMEs. It will help contribute to a change in the perception of the bankability of start-ups and service and manufacturing sector MSMEs, which could lead to expanded and sustainable credit to these segments by PFIs. This could result in a wider outreach of the program, thereby enhancing the leverage effect of the project.

52. Overall, these innovative financing instruments and improved MSME credit market efficiency will positively contribute to the creation of a vibrant ecosystem with greater entrepreneurial activity. At a higher level, with its employment potential, MSMEs growth and development will also foster inclusive economic growth and contribute to creation of productive and sustainable employment.

53. The financial analysis, which included a financial review of SIDBI and several commercial banks and participating institutions, indicated that these (potential) PFIs met the eligibility criteria on profitability, capital adequacy, asset quality and liquidity, under Bank policy OP10.00. The reliability of financial information reports is high and the overall quality and independence of banks' and SIDBI's management capacity is strong. All institutions reviewed as part of the sample have well developed internal practices and overall performance is in line with the requirements of World Bank lending. Banks report quarterly financial results apart from detailed annual audits. The quality of audited statements is good for all institutions. In terms of financial reporting to the project, no issues are foreseen though for some monitoring indicators, PFIs may need to develop/adapt their internal systems somewhat (see Annex 4), an aspect that the TA can provide support for.

Rationale for public sector provision/financing

54. There is strong rationale for public provision in deepening access to finance for MSMEs due to lack of private provision, and due to the presence of positive externalities. Section I has outlined the financing market for MSMEs and illustrated that financial constraints continue to restrict MSME growth and competitiveness. Thus, there is demand for financing by eligible bankable firms, yet supply has not been matched by the market, and private provision. This distortion could be attributed to information asymmetries, perceived risk by the private sector, transaction costs (that is processing lots of small loans is less profitable than processing large loans as transactional burden is similar) or simply the opportunity cost of scarce liquidity coupled with the vast size and growth opportunities of the Indian economy that offers better, more profitable, less risk market segments than lending to MSMEs. While lending to MSMEs is a sustainable and profitable market, the private provision of debt to MSMEs, for a multitude of reasons, falls short of meeting demand of eligible MSMEs.

55. Part of the problem is the banking sector's assessment of eligibility. MSMEs in service sectors and startups have been financially constrained mainly due to lower ability to provide physical collateral that financial institutions typically require. Information gaps exist between

perception of risk by private financing institutes and actual risk of the MSMEs. This leads to lower private provision of debt than what is market optimal. Furthermore, given that MSMEs also generate societal benefits such as employment, innovation and foster entrepreneurial activity, it is likely that the private provision of debt to MSMEs is also below societal optimal levels. As such this provides a strong rational for public provision/financing.

56. The project, through supporting SIDBI, an apex financing institute, on the scaling up of innovative products for reaching new market segments and strengthening of new appraisal processes, contributes to the provision of public goods for the financial sector. Through demonstrative effects, and knowledge sharing, and partnerships with PFIs, the project serves to catalyze private provision into nascent market segments. Project experiences will also likely be relevant to GoI efforts – announced in the July 2014 budget – to focus on early stage enterprises through a new fund for MSMEs.

Value added of Bank's support

57. The World Bank has played a leading role in the development of the MSME and microfinance sectors in India. The World Bank will leverage its broad and deep international experience on credit lines throughout the world (for instance from projects in Morocco, Egypt and Lebanon which have dealt with early stage financing) in addition to its experience in India, through the previous MSME and microfinance projects (see Section III. C above). The World Bank is also a key player in the area of access to finance and MSME finance having provided support to many countries on improving MSMEs access to finance and developing innovative financial instruments. The World Bank will draw internally on relevant Global Practices as well as play a convening role in sourcing global knowledge from external industry and think tanks as needed and work closely with country management in implementation, and also maintain technical collaboration and coordination with the IFC. The World Bank's engagement and the project components and allocations, will also support sustained focus on, and reduce chances of drift from the development of new business/market segments within SIDBI.

B. Technical

58. The project financing channeled through SIDBI and other PFIs to MSMEs and implemented in parallel with TA, will help unlock the market for lending to MSMEs at all stages of growth. SIDBI will directly provide funding including risk capital (mezzanine/sub-ordinate debt instruments) to MSMEs in services, manufacturing including early stage firms. SIDBI will also on-lend to participating financial institutions (PFIs) that will then lend to these end-beneficiaries. PFIs will have to meet a set of eligibility criteria in order to participate.

59. These criteria are detailed in the project's OM. Criteria include factors related to asset quality, capital adequacy, credit appraisal capacity, management systems and profitability. Compliance to these criteria will be closely monitored by SIDBI and tracked on an on-going basis. This arrangement supports the demonstration of good lending practices and results. In addition, the quality of the proposals from candidate PFIs will be assessed by SIDBI based on 'additionality' in financing MSMEs—for example, introducing new products including targeting women entrepreneurs, developing innovative delivery channels and financing mechanisms and reaching particularly underserved regions, including Low Income States (LIS). Among the project's focus

will be the development and piloting of tailored credit appraisal and credit scoring methods in particular for asset light models, franchisee financing and cluster-centric financing (see Annex 6). In that light, the project will test multiple/alternative sources of information that can be used to address information asymmetry and assess credit risk in lending to MSMEs. Through demonstration effects, it will encourage the introduction of such new due diligence/borrower risk assessment approaches into PFIs' practices, expand product offerings and modalities to MSMEs beyond traditional lending, increase MSMEs' access to finance by catalyzing private sector financing.

60. Nonetheless, the disbursement and allocation of funds among various financial products (of SIDBI and PFIs) will be demand driven, based on market needs, and will depend on the performance of the various financial intermediaries. On-lending rates reflect the cost of intermediating the funds including an appropriate credit risk margin in compliance with World Bank OP10.00 policy that covers financial intermediation aspects and in line with market rates.

C. Financial Management (FM)

61. Considering SIDBI's long-standing partnership with the World Bank in the last 10 years and its demonstrated capacity to implement agreed financial management arrangements in a satisfactory manner, the FM risk for the proposed operation is rated as Low. This is also evidenced by the entity audit reports as well as the audit reports of the previous World Bank financed projects which do not report any accountability issues. The financial arrangements of the proposed project (see also Annex 3) will be similar to that of the earlier Bank financed projects implemented by SIDBI and would be predicated on SIDBI's own FM systems. The agreed project FM arrangements have been detailed in the OM prepared by SIDBI.

62. All project expenditures under the three Components will be paid for and recorded in the books of SIDBI in accordance with its existing accounting policies and procedures. Each credit line is allocated a separate account code in SIDBIs accounting system. This helps in tracking progress under each credit line of resources raised by SIDBI (liabilities) and assets (loans) created there-under. The Bank financed line of credit under the project would be allocated a separate account code to help distinguish sub-loans under this line from those under other lines of credit. SIDBI will also have appropriate classification for the purpose of reporting expenditures under each of the three project components. SIDBI will furnish quarterly interim unaudited financial reports (IUFRs) to the Bank in agreed formats.

63. **External Audit**: The project financial statements will be audited by independent auditors acceptable to the Bank in accordance with terms of reference agreed with the Bank and included in the OM. The audit report will be due for submission to the Bank within nine months from the end of the financial year.

64. The following audit reports will be monitored in the World Bank's system:

Agency	Audit Report	Audited by	Due Date
SIDBI	Annual Entity Audit Report	SIDBI's statutory auditors	December 31
SIDBI	Project Financial Statements	Chartered Accountant Firm acceptable to the Bank	December 31

65. The World Bank requires that the borrower disclose the audited financial statements in a manner acceptable to the World Bank; following the World Bank's formal receipt of these statements from the borrower, the World Bank makes them available to the public in accordance with The World Bank Policy on Access to Information.

66. **Internal Audit**: SIDBI's internal auditors would retain responsibility for conducting an internal audit of the Bank-financed project, as part of their audit of the Credit Department and individual branch offices.

Disbursements

67. **Fund Flow & Disbursements:** IBRD funds would flow directly to a bank account designated by SIDBI for receiving funds from the World Bank-without being routed through the Controller of Aid Accounts and Audit in the Department of Economic Affairs. The applicable disbursement method will be Reimbursement. Under the three Components "actual expenditures" will be defined as the actual amount of loans advanced by SIDBI directly to eligible MSMEs or through the eligible PFIs. In case of working capital (WC) loans, reimbursements to SIDBI should be based on the maximum (peak) outstanding in the MSME WC loan account during the period covered in an IUFR and in case of subsequent IUFR, the incremental outstanding over the previous outstanding already claimed should be the eligible expenditure, subject to an overall cap of the sanctioned limit. Retroactive financing will be allowed for eligible expenditures incurred between April 1, 2014 and a day prior to signing the loan agreement in an amount not to exceed 20 percent of the loan proceeds. Front-end fees and caps/collar fees (if the cap/collar option is selected) will be financed out of the loan proceeds.

D. Procurement

68. Most of the contracts issued under the project will follow private sector commercial practices, as described in the project OM, which has been reviewed and accepted by the Bank. SIDBI has successfully implemented many Bank financed projects in the past and has adequate capacity to supervise the procurement under sub-loans and refinancing extended by it. Based on this, a "Low" procurement risk rating has been assigned to this Project.

E. Social and Gender (including Safeguards)

69. Women comprise 20.5 percent of the labor force and 13.7 percent of entrepreneurs in the registered MSME sector (4th MSME Census which had a base year 2006-07). Women entrepreneurs in the country are significantly underfinanced and underserved (business training, knowledge, networks, etc.)[41]. Around 73 percent of the total demand for finance among women owned businesses in India remains unmet (IFC, 2014). Leveraging SIDBI's institutional experience and the parallel TA, some specific gender focused activities will be supported. These would include: (a) incentivizing financing for women managed, owned or led MSMEs under components 1-3; (b) exploring products and innovative delivery methods customized for women entrepreneurs, developing gender sensitization (including on issues related to women worker

[41] The Global Entrepreneurship and Development Institute ranks India in the bottom 5 of 30 countries surveyed for conditions that foster 'high potential' women entrepreneurship.

health and safety) through industry associations including efforts at knowledge sharing and capacity building modules and communication/outreach programs supported by the TA; and (c) monitoring progress on key gender indicators and actions (see Annex 1 and Annex 9).

70. With regard to social safeguards, the project will on-lend to MSMEs (manufacturing and service sectors) largely located in designated industrial zones or commercial areas/buildings and will not support any MSME operations that would result in: (i) compulsory land acquisition and displacement of people (loss of assets, loss of livelihoods); (ii) impacts on indigenous people (Scheduled Tribes); and (iii) forced and/or child labor. Hence, land acquisition, physical and economic displacement as well as impacts on indigenous peoples (scheduled tribes) are not anticipated. SIDBI has updated and streamlined the Environmental and Social Management Framework (ESMF) and incorporated screening checklist, appraisal and due diligence criteria, staffing, capacity building and monitoring measures to screen and track any potential risks/issues related to social safeguards (see Annex 3).

E. Environment (including Safeguards)

71. The proposed project will finance the MSME sector through lending operations covering manufacturing and service sectors. In the manufacturing sector, lending activities will be mostly supporting the brownfield units, though a few limited cases of greenfield units could also happen. The environmental issues to be addressed include: (a) in case of brownfield units, the current status of target sectors vis-à-vis environmental performance would be important from the regulatory and reputational risks point of view; (b) the environmental impacts of proposed investments in the form of production scaling up or technology up-gradation; and (c) environmental impacts in case of greenfield projects – although the new manufacturing units under MSME sector can only be established in prior-recognized industrial estates. Thus, SIDBI and the PFIs under the project need to integrate safeguards mechanism as part of sub-loan appraisal mechanism. Considering the MSME sector operations under the project and the type of investments, the environmental issues/risks could vary from low to significant intensity. These are not amenable for upfront identification for designing a particular or set of environmental mitigation/management measures.

72. Given the foregoing, as mentioned above, in the previous World Bank project SIDBI developed an ESMF which it streamlined into its lending processes to address the safeguards related risks. In addition, SIDBI has streamlined the environmental credit risk management mechanism in its lending programs. Through the previous project, SIDBI had also taken credible initiatives to build the capacity of loan officers. As part of the project preparation, the current safeguards management processes at SIDBI was reviewed and the applicability of ESMF with relevant updates has been established. The ESMF establishing the safeguards implementation mechanism, was updated by SIDBI, and covers the following: (a) regulatory framework; (b) SIDBI's institutional mechanisms especially in the context of credit risk management and loan processing mechanisms; (c) approach to environmental due diligence for the proposed project components; and (d) focused Monitoring and Evaluation mechanism which will ensure compliance with environmental safeguards.

Annex 1: Results Framework and Monitoring
INDIA: MSME Growth Innovation and Inclusive Finance Project

Project Development Objective: “to improve access to finance of MSMEs in manufacturing and service sectors, from early to growth stage firms, including through innovative financial products”.

PDO LEVEL RESULT INDICATORS

PDO Level Results Indicators	Core	Unit of Measure	Baseline March 31, 2014	Cumulative Target Values					Frequency	Data Source/ Methodology	Responsibility for Data Collection
				YR 1	YR 2	YR3	YR 4	YR 5			
Outstanding MSME loan portfolio in risk capital financing including startups	☒	US$ million	136	170	200	235	260	300	Bi- Annual	SIDBI	SIDBI
Outstanding MSME loan portfolio in the manufacturing sector	☒	US$ million	1,114	1,200	1,275	1,400	1,650	1,900	Bi- Annual	SIDBI	SIDBI
Outstanding MSME loan portfolio in the service sector	☒	US$ million	365	560	675	865	900	945	Bi-Annual	SIDBI	SIDBI
Turnover of startups supported through the project	☐	US$ million	0	9	25	40	65	100	Baseline, Midterm and End of Line	SIDBI MIS	SIDBI
Total number of MSMEs beneficiaries under the credit line	☐	Number	0	330	660	990	1,320	1,650	Bi-Annual	SIDBI	SIDBI

INTERMEDIATE OUTCOME INDICATORS

Intermediate Outcome Indicators	Core	Unit of Measure	Baseline March 31, 2014	Cumulative Target Values					Frequency	Data Source/ Methodology	Responsibility for Data Collection
				YR 1	YR 2	YR3	YR 4	YR 5			
1.Non-performing loans (NPLs) of PFIs' MSME portfolio	☒	%	TBD	<8	<8	<8	<8	<8	Annual	SIDBI	SIDBI
2. Total number PFIs supported under the credit line	☐	Number	0	2	4	6	8	8	Annual	SIDBI	SIDBI
3.Number of MSMEs extended risk capital under the credit line	☐	Number	0	65	130	190	260	330	Annual	SIDBI	SIDBI
4.Average time for processing credit for startups	☐	Months	6	5	3	2	1	1	Annual	SIDBI	SIDBI
5.Volume of loans extended to MSMEs using innovative methods including franchising finance under the credit line	☐	US$ million	0	4	15	25	40	60	Annual	SIDBI	SIDBI
6.Number of service sector MSMEs reached under the credit line	☐	Number	0	100	200	300	400	480	Annual	SIDBI	SIDBI
7.Strengthened credit appraisal methods for service sector loans	☐		Sufficient	Moderately improved	Moderately improved	Enhanced further	Strong	Strong	Annual	SIDBI	SIDBI
8.Number of MSMEs benefitting from loan extension services	☐	Number	0	30	60	90	120	150	Annual	SIDBI	SIDBI
9.Number of new schemes/products introduced and piloted for the manufacturing sector	☐	Number	0	0	2	3	4	4	Annual	SIDBI	SIDBI
10.Improved collaboration for information sharing with	☐		Sufficient	Moderately	Moderately	Enhance	Strong	Strong	Annual	SIDBI	SIDBI

external partners				improved	improved	d further					
11. Number of women-owned/managed MSME beneficiaries under the credit line	☐	Number	0	50	125	225	325	400	Annual	SIDBI	SIDBI
12. Number of new schemes introduced and dedicated for women-owned/managed MSMEs	☐	Number	0	0	1	2	2	2	Annual	SIDBI	SIDBI
13.Number of SIDBI and PFI officials trained (cumulative and by gender)	☐	Number	0	15	45	100	150	250	Annual	SIDBI	SIDBI
14. Number of MSMEs (other than early stage) in Low Income States benefitting from the line of credit	☐	Number	0	80	160	240	320	400	Annual	SIDBI	SIDBI
15. Volume of Bank Support: Line of credit MSME	☒	US$ million	0	75	175	300	425	500	Bi-Annual	SIDBI	SIDBI

DESCRIPTION OF INDICATORS

Project Development Objective Indicators	
Indicator Name	**Description (indicator definition, etc.)**
Outstanding MSME loan portfolio in risk capital financing including startups	This indicator measures the total outstanding (i.e. not yet repaid or written off) amount of MSME loan portfolio in risk capital financing including startups for SIDBI.
Outstanding MSME loan portfolio in the manufacturing sector	This indicator measures the total outstanding (i.e. not yet repaid or written off) amount of MSME loan portfolio in in the manufacturing sector for SIDBI
Outstanding MSME loan portfolio in the service sector	This indicator measures the total outstanding (i.e. not yet repaid or written off) amount of MSME loan portfolio in in the service sector for SIDBI
Turnover of startups supported through the project	This indicator measures the turnover of startups supported through the project
Total number of MSMEs beneficiaries under the credit line	This indicator measures the total number of MSMEs beneficiaries of loans under the credit line
Intermediate Results Indicators	
Indicator Name	**Description (indicator definition, etc.)**
1. Non-performing loans (NPLs) of PFIs' MSME portfolio	This indicator measures portfolio quality of the PFIs' sub-loans funded by the Line of Credit
2. Total number PFIs supported under the credit line	This indicator measures the total number of PFIs under the credit line
3.Number of MSMEs extended risk capital under the credit line	This indicator measures the total number of MSMEs extended risk capital under the credit line
4.Average time for processing credit for startups	This indicator measures the average time for processing credit for startups: estimated from the date of loan application in branch offices to the date of sanction.
5.Volume of loans extended to MSMEs using innovative methods including franchisee finance under the credit line	This indicator measures the total amount of loans extended to MSMEs using innovative methods including franchisee finance under the credit line
6.Number of service sector MSMEs reached under the credit line	This indicator measures the total number of MSMEs in the service sector that benefitted from loans under the credit line
7.Strengthened credit appraisal methods for service sector loans	This indicator assesses the quality of credit appraisal methods for service sector loans

8.Number of MSMEs benefitting from loan extension services	This indicator measures the total number of MSMEs benefiting from loan extension services line
9.Number of new products introduced and piloted for the manufacturing sector	This indicator measures the total number of new products introduced and piloted for the manufacturing sector
10.Improved collaboration for information sharing with external partners	This indicator assesses the quality of collaboration for information sharing between SIDBI and external partners
11.Number of women owned/managed MSMEs beneficiaries of the credit line	This indicator measures the total number (cumulative) of women owned/ managed MSMEs benefitting from the line of credit
12. Number of schemes introduced and dedicated for women-owned/managed MSME	This indicator measures the total number of new schemes dedicated for women-owned/ managed MSME introduced
13.Number of SIDBI and PFI officials trained (cumulative)	This indicator measures the total number (cumulative) of SIDBI and other PFI officials trained including by gender
14. Number of MSMEs (other than early stage) in Low Income States benefitting from the line of credit	This indicator measures the total number (cumulative) of MSMEs (other than early stage) in Low Income States benefitting from the line of credit
15. Volume of Bank Support: Line of credit MSME	Lines of credit and other funding for retail MSME sub-loans by Participating Financial Institutions

Annex 2: Detailed Project Description
INDIA: *MSME Growth Innovation and Inclusive Finance Project*

1. The project is a five-year Financial Intermediary Loan (as per OP 10.00) in the amount of US$500 million consisting of an IBRD credit line to MSMEs, from early to growth stage firms, in manufacturing and services sectors, in addition to US$50 million counterpart funds by SIDBI. Parallel technical assistance (TA) through grants will be provided – the expected amount being around US$5 million.

2. The project development objective to improve access to finance of MSMEs in manufacturing and service sectors from early to growth stage, including through innovative financial products.

3. The project will support MSMEs[42] through direct financing by SIDBI as also lending through PFIs[43], across all three components. Direct financing by SIDBI is particularly relevant for early stage financing, service sector financing and manufacturing sector financing linked to better management practices, all areas where interest from other lenders is lacking. Nonetheless, some PFI interest is expected to be generated for these as the project progresses and hence PFI financing is provided for in the project design.

4. A due diligence of SIDBI (and sample PFIs) conducted by the World Bank in accordance with OP10.00 in November 2014 and summarized in <u>Annex 4</u>, confirmed: (a) SIDBI's eligibility (and PFIs') to act as the Tier 1 (Tier II for PFIs) Financial Institution (FI) for the project; and (b) the robustness of SIDBI's (PFIs') MSME loan appraisal criteria and procedures in providing direct financing to start ups and MSMEs. For its direct financing, SIDBI will use loan appraisal criteria and procedures agreed with the Bank and detailed in the Operations Manual (OM). These criteria are robust and mitigate SIDBI's credit risk.[44] Interest rates will be set on market terms, fully reflecting SIDBI's costs and risks and market conditions (which will prevent any market distortions).

5. SIDBI on-lending pricing will include a positive price differentiation to further incentivize lending to underserved (sub) segments of the market and support inclusion. These segments are defined and detailed in the OM and currently include gender (firms with women ownership/management) and origination of the loan and/or location of the project in a low income state (LIS). Progress on this will be tracked by SIDBI and reported during implementation support missions.

6. In the refinancing model, SIDBI is the wholesaler and participating financial institutions (PFIs) are intermediaries (see fund flows in <u>Annex 3</u>). The PFIs will extend sub-loans to eligible MSMEs and startups, which will include both investment and working capital loans and will need to adhere to the project implementation arrangements fully. PFIs' eligibility to receive refinancing support will be determined through a due diligence based on clearly defined eligibility criteria and procedures agreed by SIDBI and the World Bank; and in accordance with OP 10.00 as be captured in the OM. The eligibility criteria will include capital adequacy (regulatory prescribed levels), profitability (positive profit in last three years or return on assets greater than 0.5 percent in current year), NPLs (less than 10 percent), adequate financial accounting and internal controls, management quality and business focus

[42] MSMEs for the purpose of this project are firms recognized as MSMEs under the MSME Act. At present, this includes those manufacturing firms that have plant and machinery of up to INR10 crores (~US$1.6 million), and service sector firms with equipment of INR5 crores (US$0.8 million). In addition, given the significant potential of service sector enterprises to contribute to jobs and growth, firms with a project cost of up to INR75 crores (US$11.8 million) will be considered. The definition can be changed based on the evolution of the MSME sector and proposed updates will be discussed and agreed between the World Bank and SIDBI and reflected in the OM.

[43] PFIs can include banks, NBFCs, financial institutions regulated by RBI and Venture Capital Companies regulated by SEBI.

[44] In its current direct lending portfolio the credit appraisal methodology is fairly comprehensive covering project, business, financial and management risk assessment (see <u>Annex 4</u>).

on MSME lending and/or interests in startup or other innovative financing. SIDBI will also execute a side letter with each eligible PFI which will amongst other things capture the salient features of the refinancing.[45] As in the direct financing model, on-lending will be on market–terms both for SIDBI's wholesale funds to PFIs and for sub-loans from the PFIs (including SIDBI) to MSMEs. With regard to the pricing of wholesale funds versus direct operations by SIDBI, the markup over cost of funds will reflect: (i) the difference in credit risk on lending to PFIs versus directly lending to MSMEs; and (ii) transactions costs of bulk versus retail lending. The pricing of the SIDBI refinancing to the PFIs will be determined by SIDBI in accordance with its appraisal of the PFI and its refinancing policies as described in the OM. The PFIs will be required to report to SIDBI on their sub-loan portfolio and key financial and performance indicators on an annual basis in line with the results framework including regional and sectoral distribution of loans to MSMEs (Annex 1) apart from furnishing data for the quarterly IUFRs. SIDBI will also periodically monitor the performance of PFIs with respect to the eligibility criteria throughout the refinancing period.

Component 1: Startup debt financing and Risk Capital (US$148.75 million)

7. India's startup ecosystem is currently one of the fastest growing in the world.[46] In the last 3 years, India's start-up ecosystem has attracted 300 Venture Capital (VC)/Private Equity (PE) and 225 angel investment deals worth over US$2.3 billion and over 20 mergers and acquisitions worth US$1 billion. It is currently the third largest startup base in the world with 3,100 startups (next to the United States' 41,500 start-ups, and the United Kingdom's 4,000).[47] India has the potential to build around 2,500 highly scalable businesses that could generate revenues of INR10 lakh crore (US$158 billion) in the next 10 years.[48]

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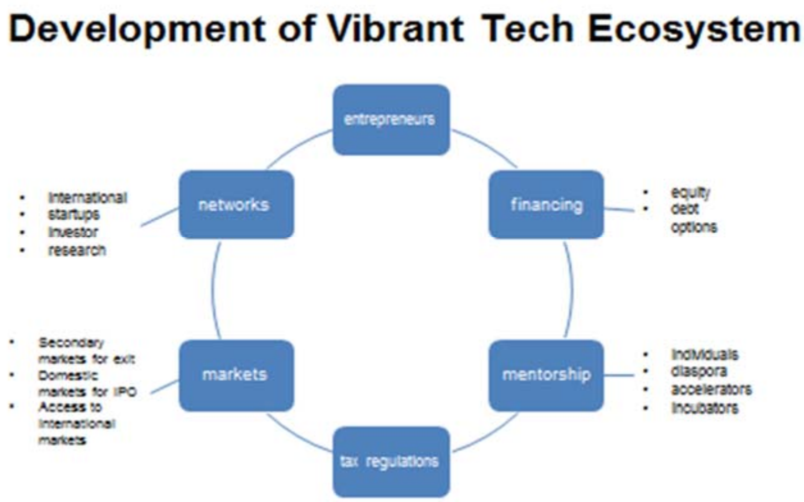
[45] For instance, it will specify the maximum limit of refinancing that SIDBI will provide to the PFI and will require that the PFI continues to meet the eligibility criteria throughout the period over which refinancing is made available, as also complies with project implementation arrangements, and specify the duration of the loan, interest rate and repayment schedule, etc.

[46] Oct 2014, NASSCOM, Annual Startup Report. In print.

[47] Numbers from NASSCOM Annual Startup Report, cited from Hindu Business Times http://www.thehindubusinessline.com/features/smartbuy/tech-news/india-3rd-largest-base-for-startups-in-the-world/article6545415.ece

[48] 2012 Mitra Report "Creating a Vibrant Entrepreneurial Ecosystem in India" etc.

Figure 1: Development of a vibrant ecosystem requires development in multiple segments

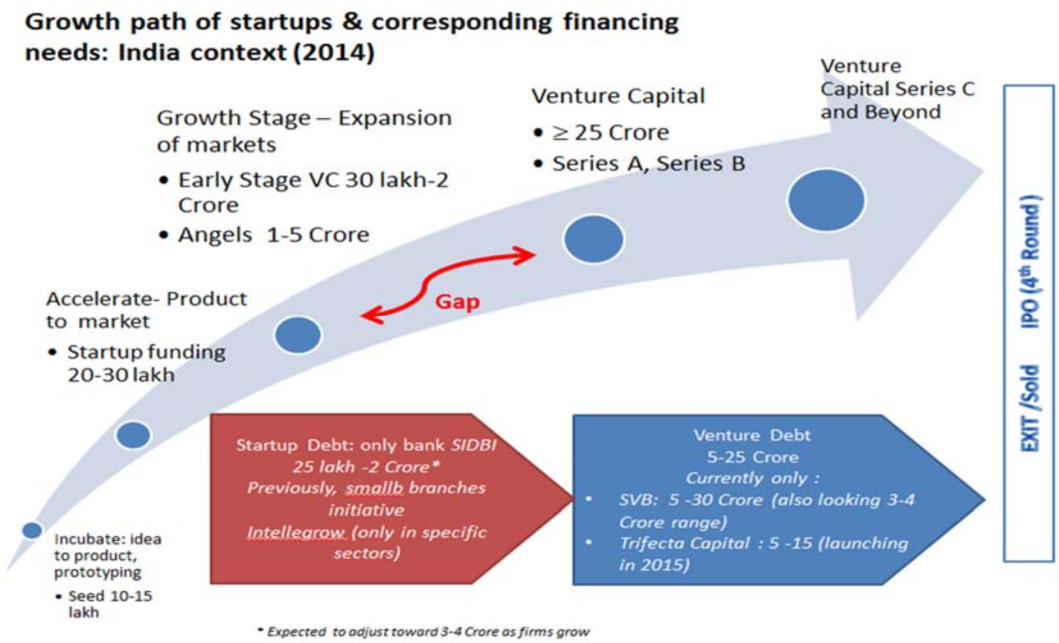


8. However, the rapid growth of India's vibrant startup ecosystem and the demand for financing has not been matched by the availability of financing for startup and early stage entrepreneurs. Figure 1 illustrates the multiple segments needed to create a vibrant ecosystem. While India has dominated in segments such as networks, markets and entrepreneurs, the financial market to support the ecosystem has been undeveloped in debt options to startups. One of the key findings of the 2012 Mitra Report is the lack of debt financing instruments available to entrepreneurs, and estimates that around INR3 lakh crores (or around US$47.3 billion) of capital would be needed over the next decade to build the pipeline of startups and entrepreneurial activity needed for India to meet its potential.

9. Debt is crucial to the development of the ecosystem in addition to the availability of equity, as financing is needed to improve the company's cash flow runway, allow more time to achieve better milestones, improve product, expand markets, hire and strengthen startup team or even acquire a potential target. The valuation of the company improves with these activities without the need for diluting equity. The Mitra Committee report states that half of the capital inflows needed for fostering early stage entrepreneurship is in form of debt instruments for working capital needs.

10. Component 1 targets early stage debt financing and developing SIDBI's ability to further develop and scale up debt financing. The component will include: (i) Financing to startups; and (ii) Risk capital financing through mezzanine debt instruments to address financial market development to cater for these segments. In addition, the parallel TA will support further development of SIDBI's products and enhance SIDBI's capability in scaling up access to finance to startups and risk financing to MSMEs.

Figure 2: Growth Path of start ups



11. ***Financing to startups***, the first part of component 1, will target early stage entrepreneurs (see Figure 2 Growth Path of Startups & Corresponding Financing Stage in the current Indian context). This component aims to address the financing gap below VC stage (also at early VC stage). Around a third of component 1 will support scaling up of lending to startups (including non-collateralized loans), and this ratio could be adjusted depending on market growth and deepening industry experience with structure debt products offerings. The focus is to support early stage enterprises that focus on innovation and/or technology businesses, as well as to support bonafide business expenses for growth expansion. Businesses targeted will typically include: business models that have evolved and revenues have commenced for 1-2 years, carry no prototype risk, have confirmed orders in hand or growth potential and preferably have equity investment from reputed VC/Angel/incubator for technology validation. Such firms would have typically placed product to market, have revenue streams, may or may not be making profits, may or may not have equity investments, and are in acceleration stage, or have already entered early venture capital, and where the nature of their business are generally based on non-tangible asset. Firms in these segments are characterized by extreme high growth (startups and early stage) and by business models that are characterized by high non-tangible assets (such as intellectual property) and low capital assets, lack of collateral or require financing against future cash flows (contractual and non-contractual).

12. SIDBI's existing startup pilot portfolio stands to date at 30 loans and total amount of INR28.5 Crore (~ US$4.5 million) (see Box 1 for further details on current pilot portfolio). The portfolio leverages both SIDBI banking and SIDBI ventures experience. The portfolio has been accumulated over the past three to four years under the Startup Assistance Scheme (SAS) which started in 2010 under SIDBI's Risk Capital Products. The startup portfolio has five applications under processing stage, thirteen calls for detailed application information, and thirteen under preliminary enquiries stage. SIDBI intends to scale up lending to startups and increase the size of this lending portfolio tenfold over the next five to seven years. It will achieve this through direct lending to startups as well as facilitating the nascent growth of PFIs that lend to this segment. Current market conditions allow for both direct lending and other PFIs

as there is massive unmet demand from the enormous growth in India's startup base, along with severely limited supply.[49] SIDBI is currently the only financial institution that is lending to startups.[50]

13. Furthermore, SIDBI has in place a comprehensive appraisal process for lending to startups, developed over the past three years in the growth of their startup portfolio that also minimize risk. The appraisal process involves several stages (See Box 2 SIDBI Startup Application Process and Criteria). SIDBI will leverage its existing experience and processes to scale up the Startup Assistance Scheme into a national program under the project, and at the same time, innovate and enhance capacity to increase the pipeline, develop robust partnerships for pipeline, delivery and monitoring, source additional development funds from government initiatives, and other multilateral and bilateral agencies, and develop a market making electronic platform to converge the entire eco-system.

Box 1 Current Pilot Startup Portfolio

The current portfolio, while too small a sample size to make significant inferences, shows an impressive range of firms supported and portfolio performance.

- The majority (24 out of the 30) are technology related, including software development, e-commerce, IT enabled solutions in health, education, and logistics as well as hardware development such as chip design and gaming consoles.
- Two firms focus on clean energy and energy efficient solutions.
- Diversification across industries: 6 startups in non-technology high growth areas: vocational training, tourism and hospitality, quick service restaurants as well as childcare.
- Overall IRR is around 14 percent per annum.
- One successful exit "Inkfruit.com" 52% IRR.
- 3-4 accounts in "Stressed category"
- Revenues of firms at the time of loan sanction ranges from zero to 5.6 Crore (~US$ 885,000), with average revenue at 1.32 Crore (~US$ 208,530).

Box 2: SIDBI Startup Application Process and Criteria

Process and Criteria

Startups begin by completing a comprehensive application form that assesses key financials, risks and management. This includes detailed information of the business (company and founders profile, product details, market and industry structure, management system), financial position and projected financials, funding proposal details, SWOT analysis, and accompanying due diligence certificate from chartered accountant, and any applicable certifications and compliances. The application has a checklist of over 20 documents that is submitted along with the application document. Applications are filtered, and further detailed technical reports are sought if necessary. If applicable, a technical evaluation is conducted by industry experts and leaders, in partnership with industry associations, iSpirit, NASSCOM and Department of Science and Technology and other relevant bodies. For angel or VC invested companies, the opinion and due diligence information from the investors are also sought and factored into the appraisal note. Site visits, and presentations by the company are conducted before a board decides on loans approved, terms offered, or whether the application has been declined.

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[49] As such, the first few years of the project, PFI participation may be limited.

[50] Only around 12 cases were assisted under the SmallB Innovation bank branches initiative that started in October 2012. This was a Startup Finance Programme coordinated by SIDBI for funding innovative Start-ups. 10 bank branches were associated with SIDBI in this program: Dena Bank, OBC, Indian Bank, Corpn. Bank, SBoP, BoB, IDBI Bank, UCO, Andhra. SIDBI provided full scheme and operational manual based on SAS for these branches. The only other entity that lends to this segment is Intellegrow (part of Intellecap).

14. In implementing this component, SIDBI will be innovating approaches to meet its objectives for scale up and product development (see Annex 5 for further details on innovating approaches to be explored).

15. ***Risk capital financing through mezzanine debt instruments***, the second part of component 1, will support innovative products that provide mezzanine debt capital (including sub-ordinate debt) to MSMEs. SIDBI has built up experience in providing support to MSMEs through their risk capital products. To date, they have assisted more than 400 MSMEs in risk capital under the Growth Capital and Equity Assistance Scheme (GEMs) launched in Sept 2011, with an aggregate assistance of US$140 million. SIDBI plans to further enhance their risk capital offerings to increase access to finance for growth stage MSMEs by strengthening the appraisal and diligence process and at the same time giving more flexibility in delivery of assistance.

16. Through the risk capital financing, the focus is to enhance access to finance for growth stage MSMEs who are unable to get bank finance due to business models that do not fit into traditional banking requirements such as tangible asset coverage, debt equity ratio and collateral requirements. Large and growing segments of MSMEs have business models that maybe inherently without assets ie intellectual property, services, technology, or require financing against future cash flows (contractual and non-contractual). Through such funding, which is higher risk and longer term than typical debt, it strengthens the balance sheet of the MSMEs, eases working capital requirements and enables additional leveraging of capital. Two thirds of the component allocation is expected to be utilized for activities to support risk capital financing. The parallel TA will support the development of robust assessment models and risk capital products to assist MSMEs and to enhance capability to carry out diligence and assessment both within SIDBI and other PFIs that may come forward on this product.

Component 2: Supporting service sector financing models (US$ 200 million)

17. **Component 2 will provide financing support for MSMEs in the service sector through SIDBI and other PFIs.** Despite the increasing importance of the service sector for the Indian economy, which has shifted from being agriculture-based to being service-based (see section I); service sector enterprises continue to face challenges in accessing formal finance.[51] SIDBI introduced four new products for the sector in 2013 as an attempt to address this issue.[52] These include: the Secured Business Loans for MSMEs, the Scheme for Asset Backed assistance to service sector entities, the Scheme for Facilitating Payments to MSMEs in Construction sector, all introduced in August 2013, and the Scheme for Asset Light assistance to service sector entities, introduced in October 2013.[53] Although, these products currently represent a small part of SIDBI's balance sheet[54], they have the potential to grow.

    Component 2 will support the scale up of similar products for MSMEs in the service sector, with terms and conditions detailed in the PAD and in compliance with OP 10.00 guidelines.

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[51] IFC Intellecap (2012) estimated the viable debt gap that can be addressed by financial institutions in the near term in the services sector at INR. 0.78 trillion (US$($12.3 billion).
[52] Previous SIDBI service sector schemes included asset backed loans and cash-flow based lending.
[53] The scheme for secured business loans for MSMEs provides business loan (open term loan) to MSMEs secured by immovable property; the Scheme for Asset Backed assistance provides Capex, movable assets and working capital backed by collateral (collateral includes immovable assets and equipment -such as hospital/diagnostic equipment, construction equipment-, vehicles as well as interiors and furniture - installed in immovable property owned by the borrower and mortgaged to SIDBI); the Scheme for Facilitating Payments to MSMEs in Construction Sector provides loans for Commercial Real Estate (CRE) exposures in construction sector, excluding solely residential projects, with collateral including movable and immovable assets including personal guarantees; and the Asset Light Scheme requires minimum financial collateral and/or immovable security (and possibly guarantees) and provides Capex including investment in light assets (like interiors, equipment, furniture and fixtures, project related intangibles, etc.) and working capital.
[54] As of September 30, 2014 SIDBI outstanding loans for the service sector stood at INR 2,260 Crore (US$357 million) for 977 loans.

18. Given that access to finance of MSMEs in the service sector is constrained mainly because of firms' limited access to immovable collateral and also because these firms primarily create and /or invest only in light assets and operate from leased premises due to the nature of their businesses, this component will seek to focus on asset light models. In addition, it will look at innovative new products such as franchisee financing, even while supporting other service sector products that have potential to support the needs of this sector and can be scaled up. Allocation of funds will be determined by market factors and will be demand driven.

    - For asset light models, component 2 will also seek to support the scaling up of SIDBI's "asset lite" product and the refinancing of loans provided through innovative financial products that have appraised light or movable assets as collateral. SIDBI launched an "asset light scheme for service sector entities", [55] which although currently accounting for a marginal proportion of SIDBI portfolio in the service sector (0.4 percent) has encouraging prospects. Alongside with the funding, streamlining of the credit and appraisal process including developing and piloting a credit scoring/rating tool specific to light assets will be supported as needed through the parallel technical assistance provided. The scaling up of this product will build on SIDBI's previous experience; take into account the features of SIDBI potentially competing schemes and incorporate international best practices as well as feedback from stakeholders' consultations and awareness activities. SIDBI has developed an elaborate appraisal framework for its "asset light" scheme. Existing rating tools such as the Credit Appraisal and Rating Tool (CART) and the Risk Assessment Model (RAM) (that were supported in the previous Bank project with SIDBI) are used as applicable, with working capital assistance being provided on the basis of a detailed gap assessment and a quick due diligence exercise may be undertaken for assistance exceeding INR 500 lakh (US$790,000).[56] Asset coverage for this scheme, however, still includes a minimum financial collateral (or immovable security) of up to 40 percent of the proposed assistance for units with more than five year existence and three year profits. In addition, for other units the collateral requirement is at least 50 percent of the proposed assistance, although this norm (on financial collateral/immovable security) could be lowered on few instances as detailed in SIDBI credit manual.[57] With regard to refinancing, through a corresponding appraisal framework of PFIs, component 2 will support PFIs' loans that have appraised light or movable assets as collateral for the MSMEs in the service sector.[58]

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[55] Service sector entities include: (i) Restaurant chains, budget hotel chains, diagnostic/specialty clinic chains, gyms/ fitness centers, media, entertainment companies, and other service businesses which invest in tangible but light assets like interiors, equipment, computers etc, and (ii) organized retail outlets, which invest primarily in interiors and stock etc.

[56] In addition, depending on the case, specific aspects are also looked into during appraisal, for example, (i) if the borrowers have institutional equity investors, (ii) the financing is for service enterprise chains, (iii) the financing is for franchisees on a standalone basis (i.e. with no structured arrangements or exposure limits to franchisors) or (iv) for financing organized retail outlets. Lease or Rental Agreements for borrowers or for projects where assets are on leased or rental premises and the related compliances are also specifically examined. Furthermore, detailed guidelines are provided on disbursement and on verification and monitoring of the end-use.

[57]These instances include: borrowers: (i) having institutional equity investors, (ii) those covered under CGTMSE for term loan up to INR 100 lakh (US$ 158,000), (iii) borrowers with external credit rating with top two rating grades of SME or Bank Loan Rating of BB+ [stable] or higher, (iv) borrowers having credit facilities for similar projects from commercial banks without or with lower collateral and with more than two years of relationship. Furthermore, since these businesses generally invest in tangible but light assets and operate in leased premises, SIDBI eligibility criteria on beneficiaries are more stringent (in terms of borrowers' eligibility) and promoters' contribution is differentiated whether assistance is requested for working capital or for term loan. A lower Debt to Equity Ratio (DER) is also needed. In addition, other debt service comforts for instance through cash flow streams or an Escrow/Trust and Retention Account is required in case there is no financial collateral or immovable property as security. The following securities can be taken for Asset Coverage Ratio (ACR): (i) immovable security, (ii) other including equipment, interiors, (iii) book debts and stocks, (iv) any other unencumbered assets of the borrower, (v) Financial collaterals such as Fixed Deposit Receipts (FDR), and) (vi) any other security available and acceptable as per SIDBI existing guidelines.

[58] The OM provides the detailed framework for appraising PFIs.

- With regard to franchisee financing, component 2 will seek to support the introduction and piloting of structured financial assistance to franchisees by SIDBI but also by other PFIs. In that light, the line of credit for SIDBI will be available to pilot appropriate products for franchisee financing along the lines of dealer financing or channel financing structures, where the strength of the franchisor and the franchisor-franchisee relationship could be leveraged.[59] The arrangements under this financing model, where the franchisor-franchisee relationship is leveraged, are intended for financial assistance for stand-alone franchisees as well as for a structured arrangement to finance more than one franchisee. Currently, stand-alone franchisees can approach SIDBI for assistance under any of SIDBI service sector schemes (e.g. under asset light scheme) while a structured arrangement to finance more than one franchisees could also be considered. In both cases a direct engagement of the franchisor with SIDBI to set up the financing scheme would be sought. SIDBI has in fact taken several initiatives to cater to the promising and fast-growing franchising industry in India. Among them, the drafting of a scheme for franchisee financing, the signature of an MOU with the Franchising Association of India (FAI) and the completion of a KPMG study on the "credit gap, potential and financing of franchising industry in India" commissioned by FAI and SIDBI in 2014 are good steps forward (see Box 1). To ensure relevance, adoption and take up of such initiatives in the franchising ecosystem, the design of such products specific to franchise financing will be supported through the parallel technical assistance as needed, and building on CRISIL SME rating of franchisees, domestic banks' current practices and international best practices. In addition, to align the incentives of the franchisor, the franchisee and the bank in a well-designed product, the design will build on stakeholders' feedbacks provided during preparatory technical meetings. In the refinancing model, component 2 will seek to support the refinancing of loans provided to franchisees and/or provided under a structured financial assistance to franchisees, through a corresponding appraisal framework of the PFIs. In these loans a direct engagement of the franchisor with the PFIs in the financing scheme will also be sought. Annex 6 provides a summary of how this financing model could be structured. Key sectors within the franchising industry may be selected to be the focus of the project for example food chains, logistics etc.[60] Efforts towards increasing awareness about franchise financing and about the designed products will also be made. Once the model scales up further through the support of the project, a downstream possibility that might exist would be to use the franchisee financing model to lower financing costs and lower risks based on transactions and on other firm data (through the channel characteristics).

[59] For example, where the franchisor could provide greater reassurance to the lending institutions through services like due-diligence of the franchisee business plan, credit screenings, provision of ratings on franchisees – including based on information on the outlets opening and closing- letters of recommendations, first loss guarantee arrangements and so forth.

[60] KPMG (2013 and 2014) estimated the sector wise franchising growth in India. Services sector is expected to contribute to majority of the growth in franchising in the next half decade, expected to form around 55 percent of total estimated franchisees in 2017. Among the key industries that were identified to possess high prospects for successful franchise opportunities in India, are (i) education and training, (i) food and beverages, (iii) health, beauty, and wellness, (iv) retail franchising, and (v) consumer services. Franchising in Health and Wellness sub-segment is expected to grow almost six times the current penetration.

Box 1: SIDBI latest initiatives to support franchisee financing

They comprise the following:

- Draft scheme for structured arrangement to finance more than one franchisees
- MOU between SIDBI and the FAI: In a nutshell, the MOU envisages that FAI screens eligible borrowers within its pool of members and provides SIDBI with references. FAI would facilitate the mentoring of MSMEs assisted by SIDBI under the arrangement. In addition, FAI would organize meetings, workshops and dissemination of SIDBI schemes. SIDBI would in turn respond to FAI references within a reasonable time while keeping the right to decline/reject any application. Both FAI and SIDBI would work on policy advocacy and structuring of credit products to create an enabling ecosystem for entrepreneurship and MSME development; and
- Commission of a study on the "credit gap, potential and financing of franchising industry in India": The Franchising Association of India (FAI) and SIDBI commissioned a study by KPMG released in November 2014 which reviewed the franchising industry in India and the funding requirements. The report also provides a gap analysis on franchise financing based on global experience and suggests possible product structures for franchise financing along the lines of channel financing and based on a proposed risk assessment framework of the franchise business.

Component 3: Supporting finance to manufacturing MSMEs (US$ 150 million)

19. **Component 3 will support financing MSMEs in the manufacturing sector through SIDBI and other PFIs.** The growth and competitiveness of the Indian manufacturing sector have been hampered by lack of credit.[61]

20. This activity will support various manufacturing sector financing products, including the introduction of new financial products and/or financing mechanisms for the manufacturing sector. The project will also support sustainable improvements in manufacturing MSMEs, through promotion of better management practices that will support their competitiveness in India but also globally. Several activities can be envisaged, for instance, such as: (i) Loan Extension Services (LES) to MSMEs: for those MSMEs that are interested (particularly relevant for more energy consuming firms), the loan will undergo a quick opportunity assessment (for example energy audit) for overall improvement of the MSME unit. Services could include energy efficiency, cleaner production, lean management and so forth. The MSMEs' decisions to invest in these improvements will be on a voluntary basis while the cost of the assessment will be covered through grant funds to be raised from various donors through the parallel technical assistance; and (ii) Piloting cluster financing (namely credit delivery arrangements with NBFCs, MSMEs associations, machineries manufacturers, dealers financing and so forth). In this model PFIs including SIDBI, could leverage cluster level association (including women – led clusters) and/or industry associations to help reduce information asymmetries for example by obtaining references/credit screening from clusters. The project will aim to focus on few sectors (five or six) within the MSME segment in order to better serve the needs on a cluster basis. Technical assistance will, in parallel, support the identification of these sectors through a stock taking of the various studies on MSME clusters in India followed by an informed identification of the sectors on which the project will seek to focus. SIDBI has had various experience leveraging industry/cluster associations through various financing models (see Table 1), which will further help develop customized program depending on the cluster.

21. Particular attention will be to expand manufacturing activity in financially underserved areas, including low income states (LIS) especially through refinancing, as banks and other PFIs have a deeper network

[61] IFC Intellecap (2012) estimated that only 50 percent of the average demand for finance of a manufacturing enterprise is met, suggesting that many manufacturing enterprises remain underserved. The viable debt gap that can be addressed by financial institutions in the near term in the manufacturing sector is estimated at INR. 2.15 trillion ($(US$34 billion).

in these states. In that light, one or two clusters operating in LIS may also be a focus of the project after careful identification of those clusters.

Table 1 - Some examples of SIDBI arrangements with industry associations and financing models

	Assistance against future lease rentals of movable asset	***Credit Delivery Arrangement with Mumbai Taximen's Union (MTU)/ Mumbai Taxi Association (MTA) for providing assistance to Taxi drivers of Mumbai***	***Credit Delivery Arrangement with Faridabad Small Industries Association (FSIA) for providing assistance to its MSME members***	***Structured arrangement with Sahjanand Laser Technology Ltd (SLTL)***
Product requirement	SMEs suppliers providing equipment (computers, office equipment, fixtures etc.) that large corporates rent (instead of outright purchase).	The taxi drivers associations (Mumbai Taximen's Union (MTU)/ Mumbai Taxi Association (MTA)) approached SIDBI to provide financial assistance to taxi drivers to replace their vehicles and benefit for example from special schemes from car dealers, as regulation requires to phase out old taxi vehicles within one year.	FSIA is a representative body for nearly 1000 MSMEs in Faridabad. FSIA approached SIDBI for considering sanction of pre-approved loan limits up to INR.50 lakh (US$79,000) to its MSME members which could be used by them for small capital expenditure at a short notice during the year.	SLTL, a leading laser cutting machine manufacturing company had approached SIDBI for having a structured arrangement under which assistance will be provided to MSME units for purchasing machinery / equipment from SLTL.
Product details	A pilot scheme for providing assistance to SME suppliers against their future rent receivables from large corporates. Security: notional (hardware/ office equipment, etc) Assistance is provided on : - The strength of the rental/lease contract (contract is analyzed in detail to understand the obligations of both the parties, maintenance issues, termination clauses, etc.) - The financial strength of the lessee	A special Scheme for providing assistance to the affected taxi drivers using a simplified credit delivery arrangement two Taxi Associations - Under the arrangement, assistance 90 percent of the cost of vehicles at concessional rate is offered under JICA Scheme and CGTMSE coverage. - The Taxi Associations assist their members in filling the loan applications and execution of documents. - The Associations are forwarding the Application with their recommendation to SIDBI.	- SIDBI entered into a MoU with FSIA on December 20, 2008 for the credit delivery arrangement. - FSIA agreed to assist SIDBI in the arrangement by carrying out various tasks to reduce the delivery time for SIDBI and to enable smooth flow of assistance to MSMEs without taking any financial obligation/ liability in respect of the loans dispensed by SIDBI. - A simplified credit delivery arrangement has been devised: Simplified Application form, Appraisal form and other process documents - Under the arrangement, FSIA recommends the MSME customers and forwards the application along with the related information/enclosures.	- Under the arrangement, SLTL has agreed to provide comfort in the form of Corporate Guarantee, Security deposit and buy back arrangement in case of default by the borrowers. - SLTL would scout customers to SIDBI based on the credit screen stipulated by SIDBI. - It would also source application forms in SIDBI format along with all enclosures. - The customers would be provided assistance on customized financial terms

	- The financial strength of the lessor and its abilities to fulfill the obligations under the rental contract	- Further, the Associations are also actively involved in collection and recovery of dues (coordinated monitoring)	- FSIA is closely associated with SIDBI as also the MSME borrower under the arrangement at the Disbursement stage and in Monitoring of the loan accounts. - SIDBI has agreed to compensate FSIA for various costs incurred by FSIA under the arrangement.	
Details of assistance	- The assistance is provided to the lessor in the form of loan released after the equipment has been received by the lessee and the lessee would make direct payment to SIDBI in respect of the rentals. - No leverage of equity and asset coverage required. - 3 SME beneficiaries	163 accounts (Sanction amount : INR. 3.64 cr, US$575,000) till March 31, 2009		4 customers have been sanctioned assistance under the product at Ahmedabad Branch Office. Note: PIC has approved similar arrangements with Sahajanand Technologies Pvt. Ltd. and Jyoti CNC Automation Pvt Ltd

Source: SIDBI

Parallel technical assistance to Implementation Support and PFIs (indicatively US$5 million)[62]

22. The TA program that accompanies financing under the project is designed to support implementation, enhance project quality and overall, to facilitate long term sustainable development beyond the term of the project. The TA support will be provided to SIDBI during the course of the project period of five years. Broadly, three main themes have been identified: (i) Knowledge sharing and strategy development; (ii) Implementation of strategy and capacity building support; and (iii) Dissemination and outreach. These broad themes cut across the project's three components although it is expected that a significant portion of this parallel TA will be focused on component 1. Knowledge sharing and strategy development assistance will support SIDBI's further development of innovative products and processes across early stage, services and manufacturing as well as enhancing existing products and processes. Implementation of strategy and capacity building support strengthens both existing systems of operation as well as help establish new modes of operations to implement new products and processes. Included under this thematic area is monitoring and evaluation, and the development of feedback loops for implementation. Dissemination and outreach facilitates communication and reaching end MSME beneficiaries. The key objective of the technical assistance program is to facilitate enhanced outcomes of the project.

23. More specifically the TA will support the development of customized credit appraisal/evaluation framework for all the three components as needed- including template credit scoring tools (potentially use of the psychometric credit-scoring parameter) to build objectivity across segments. A key focus area for capacity building with SIDBI (and PFIs) will be on developing innovative early stage and risk capital products and in developing risk rating and pricing models that appropriately capture the nuances

[62] Subject to funding being mobilized.

of lending to these sectors. In addition, this would include innovating on processes that can help address information asymmetry issues and keep credit risks to acceptable limits for all three components. For instance, for early stage financing, such measures could include leveraging information from other stakeholders in the entrepreneur ecosystem such as the venture capital industry, angel networks, accelerators, industry associations as well as industry experts, etc. and using that information in the appraisal of the financing proposal.[63] Such a model could facilitate faster application processing even while enhancing the appraisal quality. In addition, the customized appraisal tools (building from SIDBI's current experience and supported through the TA) could be used for both early stage and risk capital financing. Further, support will be provided for other aspects such as products that leverage the use of movable and intangible assets, including light assets, which will be relevant for both early stage as well as service sector firms. Furthermore, support is envisaged to develop products for franchisee financing along the lines of dealer financing or channel financing structures, where the strength of the franchisor and the franchisor-franchisee relationship could be leveraged.

24. The TA will also support the development of new and innovative products exploring the design of gender-specific product(s) or process guidelines (latter, particularly for the service sector). Similarly, for the manufacturing sector, there will be support provided during the initial stages of the project to cover assessments for the Loan Extension Services (LES), Energy Efficiency (EE) audits on selected loans. The TA will also build SIDBI internal capacity for the LES, EE audits and cleaner production.

25. Further, the TA will support a beneficiary survey at the start of the project, mid-term review and closing date and communication/dissemination efforts. Support for consultation with stakeholder and expert panels for providing inputs and industry feedback on particular component activities are also envisaged.

26. Technical assistance will be funded through parallel but coordinated development partner funding from partners – discussions have been initiated with partners such as GiZ (German agency for technical cooperation that was part of the Bank led previous SME financing project with SIDBI and currently has an existing TA engagement with SIDBI) and IFC. The TA activities have been designed, based on discussions with SIDBI; and will be adaptive over the course of the project, and any changes to the same will be made based on joint agreement between the WBG/IFC (or other development partner) and SIDBI teams. Consultations with banks, industry associations, financing institutions and other stakeholders will be conducted regularly to ensure stakeholder inputs to the project and applicability, as well as to leverage partnerships to maximize scale up.

27. Broadly, the technical assistance can be generalized in the following table as a framework for the project.

[63] SIDBI plans to collaborate closely with angel networks and early stage VCs to develop fast track to near automatic loan processing for enterprises which have been funded by recognized angel networks or early stage VCs, so as to offer matching loans to committed angel/VC investments. This could offer greater financial access and options for vetted early stage MSMEs as well as developing new products and services.

	CROSS CUTTING ACTIVITIES	COMPONENT 1: Early Stage and Risk Capital Finance	COMPONENT 2: Services Sector Finance	COMPONENT 3: Manufacturing Sector Finance
Knowledge Sharing and Strategy Development	• Support for development of gender focused programs and promote SIDBI's brand as preferred financier for women entrepreneurs • Knowledge sharing and thought leadership through research reports and workshops to promote innovation in SME finance in India • Knowledge visits of SIDBI to other institutions within India and globally • Conduct a baseline data study/analysis, a mid-term data review, and an end of project evaluation to assess the impact of project activities (e.g. through beneficiary surveys, focus group discussions, including on gender activities)	• Facilitate partnerships with FIs in early stage and risk capital finance space • Explore options for on-lending models to promote Risk capital finance to MSMEs, with focus on start-ups • Knowledge sharing with qualified local and international institutions, with regard to risk capital finance • Awareness/training programs on the NIFP platform to promote greater use • Articulate success stories on SIDBI funded entrepreneurs • Develop strategy & institutional framework for Risk Capital Finance	• Market assessment to determine gaps in financial products available to the services sector in India and strategy for implementation of innovative service sector products • Feasibility study on a franchise registry building on existing research (including analysis of legal and regulatory framework) ▪ Support an implementation focused road-map for the design and set-up of a national franchise registry led by SIDBI or another institution	• Market assessment of financing products for manufacturing MSMEs in India and global comparisons • Work with Credit Rating Agencies (SMERA, others) and other stakeholders to incentivize the use of Green Ratings
Implementation of Strategy and Capacity Building Support	• Review and streamline existing processes across all components • Map product gaps relative to market demand • Internal staff capacity building: training, greater exposure to relevant industry conferences and other countries' experiences, and for implementing new products • Support with project's Monitoring and evaluation (including gender data), data management, analysis and feedback loops • Support to strengthen the PIU through resident advisors as needed	• Additional/new loan structures for startups and early stage MSMEs; Mezzanine debt products for risk capital financing • Develop incentives/targets to encourage sourcing • Support marketing & outreach (including women, LIS) • Training of staff for applicant identification and screening • Streamline origination/ documentation process, - for accurate data capture and a reduction in TAT	• Design and launch of innovative products, including franchisee finance, asset-lite products (including gender specific products) • Development of relevant sales incentive schemes • Credit Process streamlining • Training of relevant SIDBI staff in new product features and new credit process	• Design and launch appropriate products, • Strengthen credit processes, and design credit scoring/rating tools for manufacturing sector products, as required • Support training of relevant staff in use of new and gender – friendly products • Support EE audits at SMEs being financed by SIDBI

<table>
<tr><th></th><th>CROSS CUTTING ACTIVITIES</th><th>COMPONENT 1: Early Stage and Risk Capital Finance</th><th>COMPONENT 2: Services Sector Finance</th><th>COMPONENT 3: Manufacturing Sector Finance</th></tr>
<tr><td></td><td></td><td>• Establish advisory panel of specialists to support credit decisions on potential start-up clients
• Support scale-up of National Innovations Finance Platform (NIFP)</td><td></td><td>• Build capacity of relevant SIDBI & ISTSL staff on delivery of Loan Extension Services for EE& cleaner production
• Support training of trainers in LES</td></tr>
<tr><td>Outreach and dissemination</td><td colspan="4">• Facilitate and support regular discussions with key stakeholder and industry experts to ensure a feedback loop is in place for SIDBI on the different components of the project, including with nationally recognised networks of women MSME entrepreneurs
• Actively support outreach and promotion activities related to all new products and services offered by SIDBI
• Marketing and outreach campaigns specifically targeted to women and low income states (e.g. road shows, demonstrations of online applications); support development of SIDBI’s brand as a preferred financier for women entrepreneurs
• Promote greater knowledge on successful gender finance programs through sharing global case-studies on successful models (e.g. RBS, Westpac) and, as appropriate, facilitation of knowledge visits
• Research reports and analysis on SIDBI’s success stories, products and market positioning
• Roundtables and workshops with key stakeholders in the sector on a range of issues to promote greater innovation in SME finance in India</td></tr>
</table>

28. The proposed TA would be implemented by the World Bank/IFC (or other development partners, where they are contributing through parallel funding to the project), in close coordination with SIDBI. For the World Bank/IFC funded component, SIDBI would contribute through in-kind (or parallel) contribution. In addition to this, SIDBI will be provided support to the PIU for ensuring that utilization of the project proceeds moves in line with projections and planned activities.

Annex 3: Implementation Arrangements

INDIA: *MSME Growth Innovation and Inclusive Finance Project*

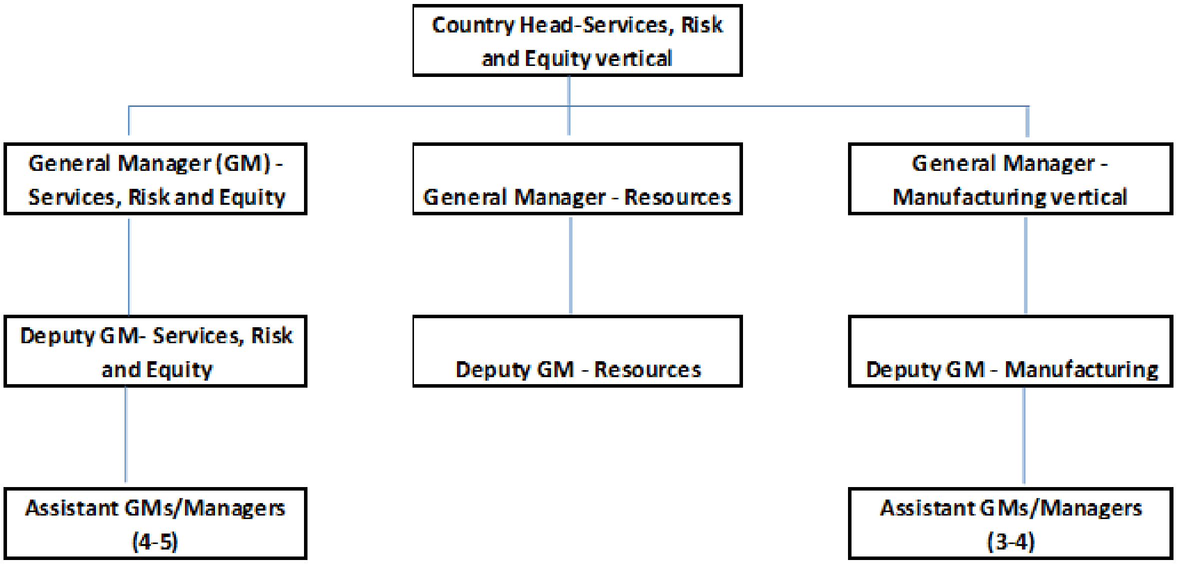
Project Institutional and Implementation Arrangements

1. SIDBI is the borrower and the implementing agency for this proposed project. SIDBI was established in 1990 pursuant to an Act being introduced to form SIDBI, with a mandate to promote the growth and development of the MSME sector in India through playing the role of the main development bank. As the apex institution for MSMEs in India it has long standing experience in designing financing products and services for MSMEs. It plays a key public policy role in India's MSME sector and therefore benefits from strong support and trust from the Government of India (GoI), reflected in the responsibilities bestowed by GoI on SIDBI, including for implementation of key programs for the MSME sector.

2. SIDBI has strong credit fundamentals and has AAA rating for its bond issuances in India. It has strong prior experience of working with Bank projects and has implemented these past projects satisfactorily. In addition, SIDBI has partnerships with several other development partners including the Asian Development Bank, KfW, JICA, AFD, etc. It has a strong management team and a risk governance framework commensurate with its size and scale of business. In addition, since some financing is expected to be channeled through PFIs that are eligible, a sample review was undertaken. This review covered a set of PFIs that were considered representative of the kinds of institutions that may ultimately participate in the project. The review found the governance, management and financials of the reviewed PFIs, consistent with the requirements of OP10.0 (see details in Annex 4); the review also draws comfort from the fact that previous projects with SIDBI have involved similar arrangements of channeling through PFIs, and have worked well in terms of identification of eligible PFIs but also implementation experiences have been positive.

3. For the project's administration and implementation, no separate department is deemed necessary and SIDBI has identified a multi-vertical core team which will serve as the project implementation unit (PIU). The PIU comprises 13 officers currently and SIDBI has committed to maintaining its size commensurate to project needs. The PIU is headed by the Country Head of the Services vertical, and includes three General Managers and three Deputy General Managers (in both cases, one each from the Services and Resources verticals), and seven Assistant General Managers/Managers (see Figure 1). Further, while expertise and human resources exist for both component1 and 2 within the PIU and Service sector vertical which manages those products (and these resources are deemed sufficient for the initial implementation period), given the project's focus and in anticipation of business growth, SIDBI has committed to appointing six additional staff members to the Service sector vertical. Half of them will be allocated to the PIU with specific responsibilities for the implementation and monitoring of those components – this will be done from the start of implementation. The PIU members have prior experience of working with the Bank and other multi-lateral and bilateral partners. SIDBI management has confirmed that additional resources can be drawn upon to meet such requirements. Further, staff experience and roles will be matched with the key responsibilities that are required under the project – for example, a clearly designated person will be responsible for safeguards, as for other roles.

Figure 1: Core team comprising the PIU

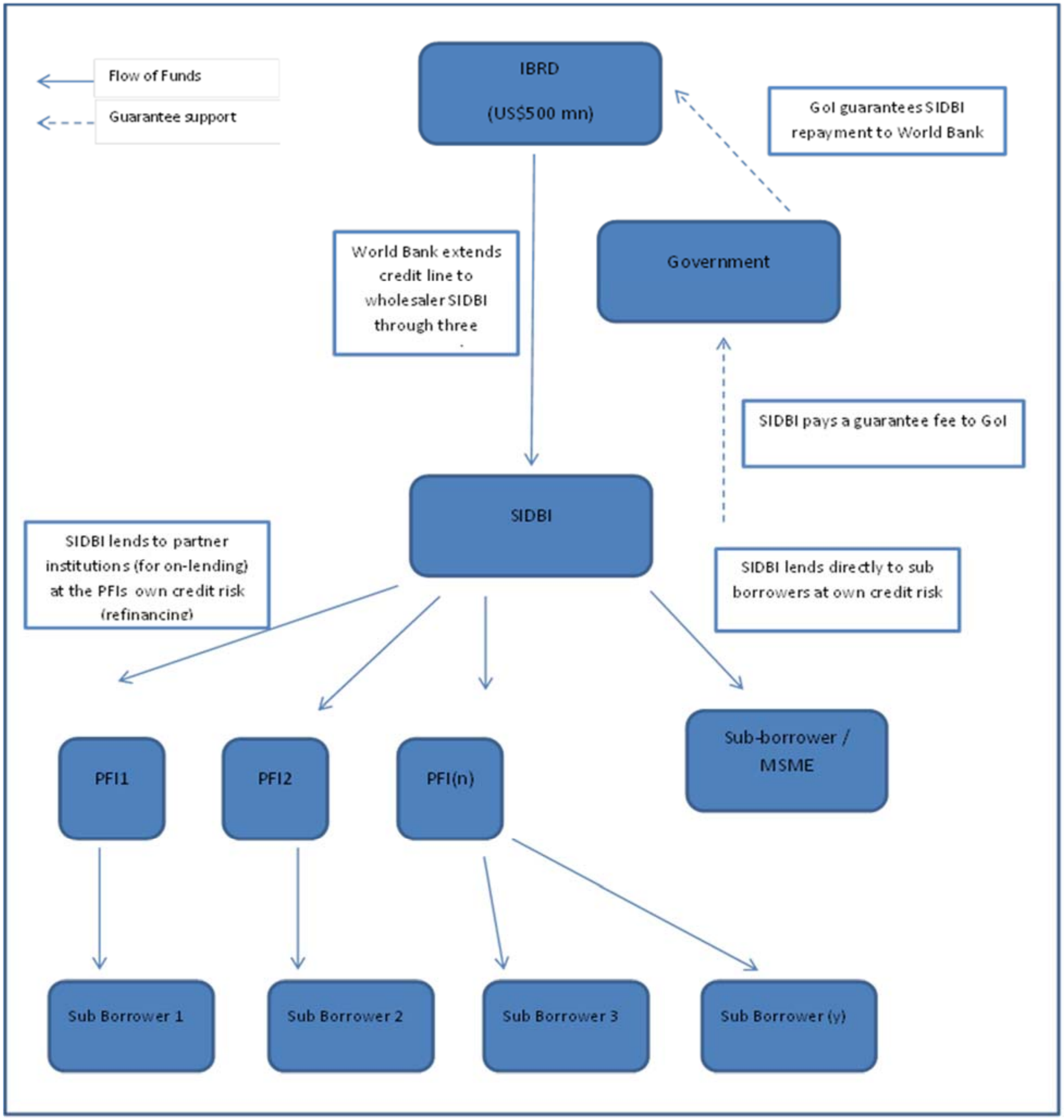


4. In addition to the PIU, a consultative committee comprising external experts will be supported by the parallel TA. This committee – with an expected membership of around five to seven experts – will serve as a sounding board and will provide feedback on project's activities and initiatives. The committee will meet at least twice yearly and in the initial years, more frequent interactions are expected. Experts will be drawn from angel and early stage investors, financial institutions with experience in any of the project's components, and industry associations and similar stakeholders. In addition to this, more on-going technical support through structured interfaces with industry experts on early stage financing and service sector financing (components 1 and 2) will be available to SIDBI and other PFIs supported through the parallel TA.

5. To facilitate project implementation a detailed Operations Manual (OM) has been prepared by SIDBI. The OM includes details on the implementation arrangements, including the eligibility criteria for PFIs and the principles of the appraisal processes that will be followed, fiduciary and safeguards arrangements (which are also defined in the ESMF), project audit requirements including the draft Terms of Reference (ToRs) for the project audit, disbursement arrangements including the Interim Unaudited Financial Report (IUFR) formats, etc. For financing through PFIs, a side letter will be executed between SIDBI and PFIs to ensure compliance with the project's implementation framework.

6. Funds will flow to SIDBI and disbursements (Figure 2) will be based on IUFRs that reflect on-lending that has been undertaken by SIDBI or PFIs to MSMEs under the project's first three components (reimbursement basis). TA expenses will be executed by the World Bank/IFC/development partner/s concerned.

Figure 2: Credit Facility flow of funds



7. In terms of grievance redressal and disclosure, SIDBI has strong internal arrangements already in place. On grievance redressal it has an elaborate mechanism in place that relies on web based and branch based mechanisms for channeling complaints. A detailed system of handling, reporting and tracking such complaints is also in place and is reflected in the Operations Manual. On disclosure, SIDBI is compliant with the far reaching provisions of the Indian Right to Information Act. In addition on-demand disclosure of information, SIDBI has proposed *suo moto* disclosure of information related to the project including through including key information related to the project, on its website.

8. World Bank implementation support missions will be planned at six monthly intervals. The implementation support teams will include representation from various Global Practices within the World Bank, including fiduciary and safeguards staff. In addition, external experts will be part of

implementation support missions, as needed. Such implementation missions will typically include discussions with SIDBI, but also other key stakeholders who could include PFIs, MSMEs, industry associations, etc. Close coordination with development partners will also be sought to be maintained during implementation.

9. Further, SIDBI has regular consultations with key stakeholders and this will continue during implementation. This was evidenced during project preparation where SIDBI engaged with key stakeholders in the MSME ecosystem such as startups, venture capital firms, angel networks, accelerators, industry associations, and banks and financing institutions.[64] Such a process would be particularly relevant for the development of new credit products and appraisal models that may evolve. With the support from the parallel TA, SIDBI will also upgrade and expand its outreach and communication efforts with a special focus on women entrepreneurs and MSMEs in low income states.

Managing Implementation Risks

S. No.	Identified Risks	Mitigation
A.	Technical Design of Project or Program	
1	SIDBI and PFIs may not fully absorb the financing from the credit line, particularly on Component 1 given that the perceived risks of start up financing are high and experience of such financing amongst financial institutions is limited.	This risk is mitigated by the approach to credit appraisal already being piloted successfully by SIDBI and which design will be supported through the parallel TA as needed. This approach will leverage information from other stakeholders in the angel financing eco-system that can help address information asymmetry issues and keep credit risks to acceptable limits (see Annex 5). SIDBI has managed the previous credit lines well, and benefits from experience with SIDBI Ventures. Furthermore, the institution's engagement with the Bank in the past reflects their capacity and ability to intermediate Bank funds appropriately and efficiently, including projects which supported initiatives that were new to the financial market at the time. Also, all the three components reflect expressed demand by SIDBI and discussions with other PFIs indicate their interest as well. In addition, careful analysis of SIDBI's current and projected lending portfolio and of potential PFIs past and projected MSME loan portfolios was carried out during project preparation to confirm the amount to be allocated to the credit line.
B.	Institutional Capacity for Implementation and Sustainability	
1	Entrepreneur investment is inherently a higher risk profile - SIDBI has to evaluate the risk, business decision. Not having enough expertise and man-power within the team, to deal	The SIDBI team has already made 34 loans to start-up enterprises, of which they have had successful exits from two. While the SIDBI team is building up internal expertise to appraise start-ups and firms taking risk-capital products; one of the aspects of the parallel TA will be to streamline existing processes and support in the design of a formal credit

[64] For instance, on component1 and 2, several rounds of discussions were held with key market participants on product market appetite, product design features, etc. Or on safeguards, SIDBI disclosed the draft ESMF on its website, distributed it across its 13 regional offices in the country, displayed it locally through notice boards and sought consultations with small groups of industry representatives and local associations to inform the ESMF.

	with the in-flow of new cases, which could serve as a bottle-neck for disbursement of loans.	assessment scorecard for these early stage enterprises. There will also be further support provided on pipeline development of start-ups and risk-capital finance for MSMEs. In addition, the World Bank has developed significant experience on financing early stage firms including startups. Several recently approved projects, including in Egypt, Lebanon and also in Latin America, have incorporated startups financing. The Project design fully reflects lessons learnt from these projects (see section III-C).
2	For the Service sector vertical, SIDBI has launched the Asset-lite scheme. However, at the SIDBI branches, there appears to be hesitation to promote these products, given that they are perceived as risker, and the mindset of the branch staff is still to secure their product by taking as much collateral as possible from the client. Since potential focus of the project includes scaling up asset light models and exploring franchisee financing the branch buy-in to market these products can be a concern.	Given the project's focus and in anticipation of business growth, SIDBI has committed to appointing additional staff members to the Service sector vertical, half of whom will be allocated to the PIU with specific responsibilities for the implementation and monitoring of those components – this will be done from the start of implementation. Staff resources have adequate technical as well as fiduciary and safeguards experience, and SIDBI management has confirmed that additional resources can be drawn upon, if needs were to arise (see Annex 3). Further, the parallel TA will help support further strengthening of capacity of SIDBI and related departments of the PFIs, as required. This will include developing SIDBI's credit risk appraisal system and other intermediaries' (such as commercial banks and NBFCs) ability to appraise and manage MSME loans (including through cash-flow based lending); and conducting training programs with the SIDBI branches and PFIs on the new products /processes.

Financial Management, Disbursements and Procurement

10. The project fiduciary implementation arrangements will draw significantly on the arrangements used in past lending projects with SIDBI that worked well. The key arrangements are described below.

Financial Management

11. Considering SIDBI's long-standing partnership with the Bank in last ten years and its demonstrated capacity to implement agreed financial management arrangements in a satisfactory manner, the FM risk for the proposed operation is rated as Low. This is also evidenced by the entity audit reports as well as the audit reports of the previous Bank financed Projects which do not report any accountability issues. The financial arrangements of the proposed project are expected to be similar to that of the earlier Bank financed projects implemented by SIDBI and would be predicated on SIDBI's own FM systems. The agreed project FM arrangements have been detailed in a project Operations Manual (OM) prepared by SIDBI.

12. SIDBI has a credit policy for financing to MSMEs containing the appraisal methodology including minimum eligibility criteria and loan approval delegation and post sanction monitoring of loans. MSMEs who avail financing from SIDBI are expected to have a satisfactory and transparent

accounting, MIS (for reporting end use of the project funds), and internal control systems, and have their accounts audited by an external auditor annually. Maintaining satisfactory FM arrangements by the MSMEs will be a condition for SIDBI's on-lending to MSMEs (as also referenced in the OM).

13. **Accounting and financial reporting:** All project expenditures under the three Components will be paid for and recorded in the books of SIDBI in accordance with its existing accounting policies and procedures. Each credit line under the project will be allocated a separate account code within its books of account. This will help in tracking progress under each credit line including (liabilities) and assets (sub-borrowers, loans, and advances) created there-under and will help distinguish transactions under this line from those under other existing credit lines. SIDBI will create subheads in its accounting system for the purpose of tracking financial progress against the three Project components. SIDBI will furnish quarterly interim unaudited financial reports to the Bank in agreed formats provided in the Operations Manual.

14. **Recycling of Loans:** SIDBI has other lines of business like microfinance, venture capital, direct-retail credit, and treasury operations and there is a possibility that funds on account of repayments of loans availed by MSMEs under the project could be used for purposes other than MSME lending. SIDBI will provide assurance that such funds would be re-lent to MSMEs and not diverted for any other purpose. This aspect would be monitored as part of the monitoring and evaluation process by watching the growth of the overall portfolio of MSME loans advanced by SIDBI during the project period. It would also be ensured by SIDBI that the outstanding amount of MSME loans at any moment is higher than the amounts disbursed from the IBRD loan under the three components during the project's life. This will also be tracked through SIDBI's financial statements.

15. **External Audit**: Audit of project financial statements will be carried out by auditors with independence and capacity acceptable to the Bank, under terms of reference acceptable to the Bank. The Terms of Reference of External audit has been agreed with SIDBI and included in the OM. In particular, the TORs includes verification of the end use of funds under each of the project components including review of a sample of loans advanced to MSME beneficiaries under the three components, either directly or through PFIs. The audit ToR also covers requirements related to compliance with agreed procurement arrangements.

16. The following audit reports will be monitored in the World Bank's system:

Agency	Audit Report	Audited by	Due Date
SIDBI	Annual Entity Audit Report	SIDBI's statutory auditors	December 31
SIDBI	Project Financial Statements	Chartered Accountant firm acceptable to the Bank	December 31

17. World Bank requires that the borrower disclose the audited financial statements in a manner acceptable to the World Bank; following the World Bank's formal receipt of these statements from the borrower, the World Bank makes them available to the public in accordance with The World Bank Policy on Access to Information.

18. **Internal Audit**: SIDBI's internal auditors would retain responsibility for conducting an internal audit of the Bank-financed project, as part of their audit of the Credit Department and individual branch offices. They will review a sample of loans advanced by SIDBI to the MSME beneficiaries under the project (either directly by SIDBI or through PFIs), and verify that the funds have been used as per the relevant agreements between SIDBI and the beneficiary/PFI and for the purposes for which they have been advanced. They will also review at the compliance with the internal control framework as laid

down in the Operations Manual and report on the performance and adequacy of the control framework including compliance with selection criteria of PFIs and system of periodic monitoring by SIDBI, appraisal of MSMEs etc. The internal audit reports will be shared with the World Bank during implementation support missions. SIDBI shall ensure adequate and timely compliance with the audit observations.

Disbursements

19. **Fund Flow & Disbursements:** IBRD funds would flow directly to a bank account designated by SIDBI for receiving funds from the World Bank-without being routed through the Controller of Aids Accounts and Audit in the Department of Economic Affairs.

20. The World Bank will disburse funds to the designated account of the SIDBI on the basis of eligible project expenditures pre-financed by SIDBI and reported by quarterly Interim Unaudited Financial Reports submitted by SIDBI. The applicable disbursement method will be Reimbursement. Under the three Components "actual expenditures" will be defined as the actual amount of loans advanced by SIDBI directly to the MSMEs or through the PFIs. Any "interim disbursement" made by SIDBI to the PFIs will not be considered eligible expenditure under the project. In case of Working Capital (WC) loans, reimbursements to SIDBI should be based on the maximum (peak) outstanding in the MSME WC loan account during the period covered in an IUFR and in case of subsequent IUFR, the incremental outstanding over the previous outstanding already claimed should be the eligible expenditure, subject to an overall cap of the sanctioned limit.

21. Retroactive financing of up to 20 percent of approved loan will be allowed for eligible expenditures made during the period of retroactivity, from April 1, 2014 and up to the day prior to the date of signing the loan agreement. This will be claimed through stand alone interim unaudited financial report/s and the audit of this retroactive financing will be covered in the audit for the first year of the project post effectiveness. Front-end fees and caps/collar fees (if the cap/collar option is selected) will be financed out of the loan proceeds.

22. The project financing will be across the following categories as indicated below:

Category	**Percentage of expenditures (%)**
Loans to MSMEs	90
Front-end Fee	100
Interest Rate Cap or Interest Rate Collar premium	100

Procurement

23. The proposed loan of US$500 Million will finance the direct lending by SIDBI as well as refinancing of other PFIs under three components namely Spurring Early Stage and Risk Capital Finance (US$148.75 million); Supporting Service Sector Financing Models (US$200 million) and Supporting Finance to Manufacturing MSMEs (US$150 million).

24. Procurement for the project will be carried out in accordance with the World Bank's "Guidelines: Procurement of goods, works and non-consulting services under IBRD loans and IDA credits & grants by World Bank borrowers" dated January 2011, as revised in July 2014 ("Procurement Guidelines") and "Guidelines: Selection and employment of consultants under IBRD loans and IDA credits & grants by World Bank borrowers" dated January 2011, as revised in July 2014 "(Consultant Guidelines)" and the additional provisions mentioned in legal agreement.

25. Procurement capacity of SIDBI: Established in April 2, 1990, SIDBI is the principal development financial institution for promotion, financing and development of Industries in the small scale sector and coordinating the functions of other institutions engaged in similar activities. SIDBI is already involved in execution of many World Bank funded Projects and is aware of the World Bank Procurement Guidelines. Under the present loan, SIDBI will not directly handle any procurement and the main role of SIDBI will be to monitor the procurement under direct lending by it as well as those refinanced to other PFIs.

26. Procurement risk assessment. The table below describes major procurement-related risks and the mitigation plan. The risk ratings have been decided based on both the probability of occurrence of various events as well as their likely impact. Based on the risk factors and mitigation measures, the overall residual procurement risk rating for the project is determined as "Low". The residual rating on procurement will be reviewed and updated periodically by the World Bank.

Assessed Procurement Risks and Mitigation Measures

Risk Factor	*Initial Risk*	*Mitigation Measure*	*Completion Date*	*Residual Risk*
Non-compliance with agreed procurement arrangements by borrowers of SIDBI and PFIs	Moderate	- Prior and post reviews by SIDBI - Capacity building of PFIs and borrowers by SIDBI	Continuous from year 1	Low
Overall Risk	**Moderate**			**Low**

27. Procurement methods. Procurement by borrowers of SIDBI and PFIs financed by SIDBI will be governed by paragraph 3.13 of the Procurement Guidelines; namely procurement of goods, works, consulting and non-consulting services will be undertaken by the beneficiaries in accordance with well-established private sector procurement methods or commercial practices that shall be acceptable to the World Bank. However, for large value contracts, following methods will apply. Domestic preference will not be applicable.

Procurement Methods

Category	*Method of Procurement*	*Threshold (US$ Equivalent)*
Goods, Works and non-consultant services	International Competitive Bidding (ICB)	> 3,000,000
	Commercial practices acceptable to the Bank (as defined in Operations Manual)	For remaining contracts
Consultants' Services	Firms: Quality- and Cost-Based Selection (QCBS)/Quality-Based Selection (QBS)/Selection under a Fixed Budget (FBS)/Least-Cost Selection (LCS)	> 800,000
	Individuals: Comparative Selection	>100,000
	Commercial practices acceptable to the Bank (as defined in Operations Manual)	For remaining contracts

28. Operations Manual. The Project Operations Manual describes the basic guiding principles and acceptable procedures applicable to the loan. These principles, inter alia, include mandatory provisions

that beneficiaries of the loan shall not award contracts to their parent or affiliate companies unless there is an established arms-length arrangement. The Manual also defines the main responsibilities of SIDBI such as: (a) assessing the capacity of the beneficiaries to carry out procurement efficiently; (b) approving acceptable plans for the procurement of goods, works, and non-consulting services, and the selection of consultants as may be applicable; (c) agreeing to supervision and oversight arrangements under each sub-loan (consistently with the provisions under the World Bank loan) for the procurement to be carried out by the beneficiaries so as to ensure compliance with the agreed private sector methods and commercial practices under the sub-loans; (d) maintaining all relevant records for the World Bank's post review and audits when requested; and (e) satisfying itself with the reasonableness of the price of contracts awarded by the beneficiaries in the particular market through the hiring of an independent entity or auditors, if necessary.

29. World Bank review of procurement. The World Bank will prior review the following contracts:
- Goods, Works, Services (other than consultancies) and IT system: All contracts more than US$ 3.0 million equivalent;
- Consultancy services: > US$ 800,000 for firms; and
- Consultancy services: > US$ 100,000 equivalent for individuals.

30. The above thresholds are for the initial 18 month implementation period; based on the procurement performance of the project these thresholds may be subsequently modified. The auditor of SIDBI shall also conduct procurement audit of sub-loans and share the findings with the Bank. The World Bank however reserves the right to carry out ex-post procurement review of the procurement falling below the prior review thresholds provided above.

31. Implementation support. The World Bank will normally carry out implementation support missions, including review and support on procurement, on a semi-annual basis. Mission frequency may be increased or decreased based on the procurement performance of the project.

Environmental and Social (including safeguards)

32. Women comprise 20.5 percent of the labor force and 13.7 percent of entrepreneurs in the registered MSME sector (4th MSME Census which had a base year 2006-07). Significant number of women owned MSMEs remain smaller sized, informal and unregistered microenterprises with minimal access to credit, business and capacity development policy/schemes. Women entrepreneurs in the country are significantly underfinanced and underserved (business training, knowledge, networks, etc.)[65]. Around 73 percent of the total demand for finance among women owned businesses in India remains unmet (IFC, 2014). Leveraging SIDBI's institutional experience and the parallel TA, some specific gender focused activities will be supported under the project. These would include: (a) incentivizing financing for women managed, owned or led MSMEs under components 1-3; (b) exploring products and innovative delivery methods customized for women entrepreneurs, developing gender sensitization (including on issues related to women worker health and safety) through industry associations including efforts at knowledge sharing and capacity building modules and communication/outreach programs supported by the TA; and (c) monitoring progress on key gender indicators and actions.

33. The project will on-lend to MSMEs (manufacturing and service sectors) largely located in designated industrial zones or commercial areas/buildings. The project will not support any MSME operations that would result in: (i) compulsory land acquisition and displacement of people (loss of assets, loss of

[65] The Global Entreprenuership and Development Institute ranks India in the bottom 5 of 30 countries surveyed for conditions that foster 'high potential' women entrepreneurship.

livelihoods); (ii) impacts on indigenous people (Scheduled Tribes); and (iii) forced and/or child labor. Hence, land acquisition, physical and economic displacement as well as impacts on indigenous peoples (scheduled tribes) are not anticipated. SIDBI has updated and streamlined the Environmental and Social Management Framework (ESMF) and incorporated screening checklist, appraisal and due diligence criteria, staffing, capacity building and monitoring measures to screen and track any potential risks/issues related to social safeguards

34. In terms of environmental safeguards, the proposed project will finance the MSME sector through lending operations covering manufacturing and service sectors. While the lending activities will be by and large supporting the brownfield units, financing of greenfield units could also happen. The environmental issues to be addressed include: (a) in case of brownfield units, the current status of target sectors vis-à-vis environmental performance would be important from the regulatory and reputational risks point of view; (b) the environmental impacts of proposed investments in the form of production scaling up or technology up-gradation; and (c) environmental impacts in case of greenfield projects – although the new manufacturing units under MSME sector can only be established in prior-recognized industrial estates. Thus, SIDBI and the PFIs under the project need to integrate safeguards mechanism as part of sub-loan appraisal mechanism. Considering the MSME sector operations under the project and the type of investments, the environmental issues/risks could vary from low to significant intensity. These are not amenable for upfront identification for designing a particular or set of environmental mitigation/management measures.

35. Given the foregoing, as mentioned above, in the previous Bank project, SIDBI had developed an ESMF and had adopted for streamlining its lending processes for addressing the safeguards related risks. In addition, SIDBI has streamlined the environmental credit risk management mechanism in its lending programs. Through the previous project, SIDBI had also taken credible initiatives to build the capacity of loan officers. As part of the project preparation, the current safeguards management processes at SIDBI was reviewed and the applicability of ESMF with relevant updates has been established. The ESMF, establishing the safeguards implementation mechanism, was updated by SIDBI and covers the following: (a) regulatory framework; (b) SIDBI's institutional mechanisms especially in the context of credit risk management and loan processing mechanisms; (c) approach to environmental due diligence for the proposed project components; and (d) focused Monitoring and Evaluation mechanism which will ensure compliance with environmental safeguards.

Monitoring & Evaluation

36. A strong M&E framework to track inputs, outputs, and outcomes in a systematic and timely fashion was developed and agreed with SIDBI. Project outcomes and outputs will be monitored through periodic reporting by SIDBI, which has considerable capacity in monitoring given its role as a key financial institution in India, in addition to its experience of handling previous World Bank and donor projects. Data will be collated by the SIDBI which in turn will collect mainly from the PFIs. Some of the data will be generated through independent beneficiary surveys to be undertaken. In addition data sources for project monitoring will include supervision efforts of the PIU as well as implementation support missions undertaken by the World Bank team. The midterm review (MTR) of the Project will review project performance and identify if any mid-course corrections are needed.

Annex 4: Financial Analysis and Intermediary Assessment
INDIA: *MSME Growth Innovation and Inclusive Finance Project*

Financial analysis

1. A financial review of SIDBI and several commercial banks and financial institutions[66] that are potential candidates for participation in the credit facility was undertaken to determine compliance with the eligibility criteria under OP10.00 and which are in line with the project's eligibility criteria for PFIs (see Annex 2).

2. The eligibility criteria are as follows:
   - Adequate profitability, capital adequacy, asset quality and liquidity in accordance with accounting and auditing principles acceptable to the World Bank
   - Acceptable levels of loan collections
   - Appropriate capacity including staffing for sub-project appraisal and implementation
   - Capacity to mobilize resources
   - Adequate managerial autonomy and commercially oriented governance
   - Appropriate prudential policies, administrative structure and business procedures.

3. The result of the review showed that all institutions reviewed meet the basic eligibility criteria. Select key financial parameters[67] for a representative list of PFIs are displayed in the Table below.

TABLE 1: SELECT FINANCIAL PARAMETERS FOR REPRESENTATIVE LIST OF PFIS

March 31, 2014; in Rs bn

	SIDBI	SBI	BoB	Canara Bank	Dena Bank	IDBI Bank	ICICI Bank	HDFC Bank
Total Income	58	1549	434	435	109	296	546	491
Net Interest Income	23	493	120	89	25	60	165	185
PAT	11	109	45	24	6	11	197	85
Total Assets	678	17922	6595	4919	1249	3290	5946	4916
NII/ATA	3.5%	3.2%	2.9%	2.3%	2.5%	2.2%	3.3%	4.4%
Return on assets (PAT/ATA)	1.7%	0.7%	0.8%	0.5%	0.5%	0.4%	1.8%	2.0%
Provision Cover	88%	63%	65%	59%	56%	52%	69%	73%
Gross NPL to Gross Advances	1.9%	5.0%	2.9%	2.5%	3.3%	4.9%	n.a.	1.0%
Net NPL to Net Advances	0.5%	2.6%	1.5%	2.0%	2.4%	2.5%	1.0%	0.3%
Capital to RWA (total)	30.8%	13.0%	12.9%	10.6%*	11.9%	11.7%*	19.1%	16.1%
Leverage (Total Borr+Dep/TNW)	6.2	13.3	16.8	15.1	16.1	12.5	6.6	9.4
PLR	12.75%	10.00%	10.25%	10.20%	10.25%	10.25%	10.00%	10.00%
Credit Rating (Long term Debt)	AAA	AAA	AAA	AAA	AA+	AA+	AAA	AAA

** Basel III*

4. Net Interest margins for institutions range between 2 percent to 4.5 percent and capital adequacy position is well above the 9 percent prudential requirement. While overall asset quality is within acceptable limits and provisioning cover is largely adequate, public sector banks' portfolios need improvement as do monitoring and control systems as banks' in general embrace inclusive[68] growth. Liquidity position for the domestic financial system has improved and is now comfortable.

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[66]Additional reviews were carried out for representative NBFCs and Venture Capital Funds dedicated to financing MSMEs.
[67] As of March 31, 2014
[68] More inclusive loan portfolios mean smaller ticket sizes, increased monitoring, untested and more variable risk profiles because of the evolving nature of the segment.

5. Some of the larger banks have robust low cost current account-savings account (CASA) profiles and have also been substituting expensive, volatile bulk deposits with more stable sources like retail term deposits. Overall deposit and credit growth are expected to be balanced at 15-16 percent in the near term and perhaps move higher if investment and growth outlook improves. Liquidity conditions have improved on the back of lower deficits on both fiscal and current account, arrested diversion of financial savings into non-financial assets[69] and a stable, consistent policy environment. Deposits (which form the bulk of bank funding) when stable augur well for their financial profiles given that their operations primarily entail maturity transformation *i.e.* borrowing short term to lend long term. Given the generally steady growth rates in deposits over long periods of time, banks regard this to effectively mean that deposits are in practice long term. The preferred tenure profile of liabilities for a financial institution is derived from the asset side such that interest rate risks are minimized and the ability to meet repayment obligations is not compromised. In the event of hardening of interest rates, unless assets and liabilities are both on floating rates and therefore re-priced, banks would need longer term debt to sustain the longer term asset deployment objectives.

6. SIDBI's overall position with respect to the financial parameters in OP10.00 was found to be sound. A recent update using March 31, 2014 figures on SIDBI's financial performance showed that SIDBI is a viable financial institution (a) with good performance on profitability (return on assets, 1.7 percent compared to 0.8 percent for Scheduled Commercial Banks), (b) strong capital adequacy (30.75 percent vs 13 percent for SBI, the largest bank in the country), (c) has acceptable credit quality (gross NPLs at 1.86 percent vs 4.1 percent for SCBs), (d) has the capacity to mobilize domestic resources and has a cost advantage over comparable apex financial institutions (SIDBI average cost of funds at 7.6 percent vs others[70] at 8.5 percent for FY2013[71], and (e) has adequate institutional capacity and systems and thus is qualified to act as conduit for on-lending the World Bank's funds to the MSME sector as required under OP10.00. SIDBI's capital adequacy position is very strong (>30 percent) and it enjoys the policy support of Government of India given its public policy role in promotion and development of MSMEs and the microfinance sector.

7. SIDBI has robust net interest margins at 3.5% which has held steady in recent years despite rate cycles which points to an active and effective asset liability and interest rate management. SIDBI has a comfortable, matched position in all time brackets and has a sound position on liquidity. SIDBIs favorable liquidity profile and competitive cost of borrowings allow it to make use of increased arbitrage opportunities in financial markets. Its return on assets (RoA) has been on the rise from 1% in FY12 to 1.7% in FY14 (and contrasts with average RoA clocked by SCBs which declined from 1.1% in FY12 to 0.8% in FY14). This is largely explained by lower incremental provisions. SIDBI's NPL performance has been benign with a gross NPL% of 1.86%. Though yearly additions to non-performing loans have been significant compared to the opening balance of NPLs resulting from its relatively more risky segments of operation like lending to SFCs, MFIs and new direct lending lines like service sector and receivables financing, they reflect a cautious approach to growth while being responsive and innovative in line with market demand. That said, the possible impact of the poor performance of State Financial/Industrial Development Corporations on its asset quality will continue to be an area that merits attention, although adequate provisions have already been made for the legacy portfolio in this segment.

[69] Like Gold and Real Estate
[70] NABARD, NHB, Exim Bank
[71] Cost of funds includes debt and equity; Trends and Progress in Banking, RBI 2013.

TABLE 2: SIDBI'S FINANCIALS (IN INR MILLION)

	2013-14	2012-13	2011-12
Net Interest Income	22,819	20,949	18,987
PAT	11,183	8,374	5,669
Total Assets	678,103	618,482	593,851
Interest/ATA*	8.7%	8.5%	8.0%
Interest expenses/ATA	5.1%	5.0%	4.6%
NII/ATA	3.5%	3.5%	3.4%
Return on assets (PAT/ATA)	1.7%	1.4%	1.0%
Provision Cover	88%	84%	88%
Gross NPL to Gross Advances	1.86%	0.98%	0.69%
Net NPL to Net Advances	0.45%	0.53%	0.34%
Capital to RWA (total)	30.75%	28.14%	30.09%
Leverage (Total Borrowings/TNW)	6.25	6.39	6.81

**ATA: Average Total Assets of last two Balance Sheets. All figures from Balance Sheet.*

8. On the qualitative criteria specified in OP10.00, information from SIDBI (as also other banks) was found to be reliable and the overall quality and independence of SIDBI's management, acceptable. SIDBI (and other reviewed banks) has well developed practices related to internal controls, lending and investment policies, human resource management and overall operations – performance on these fronts is acceptable and in line with the basic requirements of Bank lending. Refinance operations are on commercial terms that reflect that business and market conditions at the time of transaction, and intended to be non- distortionary. An example of a non-distortionary lending practice is that only loans by PFIs *at or above PLR* are eligible for refinance by SIDBI. For effective monetary policy transmission this works well too as the absence of subsidies ensures the transmission 'link' is not broken. For entities like Venture Capital Funds, SIDBI refinances through investment in a fund corpus for on-lending to investee MSMEs in startups or for risk capital. Here SIDBI's due diligence covers the Asset Manager's performance record, compliance with regulatory (RBI and SEBI) guidelines and SIDBI's own policies with regard to serving the MSME segment through this channel. It also ensures terms and conditions are in place that keeps its credit risks manageable e.g. through seniority of claims; a matching hurdle rate reflecting SIDBI's lower risk appetite.

9. Overall, the financial review showed that, prima facie, despite challenges for improvements facing all the institutions reviewed and scope for improvement, all these institutions meet the basic eligibility parameters specified in OP10.00. SIDBI will report progress and provide accounting and monitoring information according to the financial reporting arrangements.

Intermediary Assessment

10. The Department of Financial Services, MoF (GoI) is the line department responsible to oversee the project and will provide overall guidance and monitoring, while SIDBI as the Borrower and implementing agency will be responsible for implementation, coordination and management of the overall project (all three components). Due diligence of SIDBI was completed in November 2014 and for partner PFIs, due diligence of representative candidates was carried out in November 2014 (see above). During implementation, the wholesaler (SIDBI) would assess PFIs against pre-established criteria, confirm compliance and apply performance criteria through ongoing monitoring.

11. SIDBI is the apex institution for MSMEs in India and has long standing experience in designing financing products and services for MSMEs. It plays a key public policy role in India's MSME sector

and therefore benefits from strong support from Government of India (GoI). The World Bank has also had a long and successful engagement with SIDBI in support of previous projects including: the SME Financing and Development Project in 2004 (which benefitted from Additional Financing in 2009), the ongoing India: Scaling Up Sustainable and Responsible Microfinance which commenced in 2009 and more recently, the Partial Risk Sharing Facility in Energy Efficiency. SIDBI was set up as a wholly owned subsidiary of Industrial Development Bank of India (IDBI) in 1990 under an Act of Parliament as the principal financial institution for promotion, financing, development of industry in the small scale sector and co-ordinating the functions of other institutions engaged in similar activities. In order to provide greater flexibility, the SIDBI Act was amended in 2000 and SIDBI was delinked from IDBI effective March 27, 2000. The SIDBI Act provides for a 15 member Board of Directors of which eight are from the Government of India, including the Chairman and Managing Director. There are nine Directors on the SIDBI Board currently, including three representing the largest shareholders and one MSME Entrepreneur. Currently, SIDBI has 33 shareholders with the top three being IDBI Bank, SBI and LIC. Its shareholding pattern as on March 31, 2014 is as follows: Financial Institutions (5.3%), Insurance Companies (21.9%), PSU Banks (72.8%).

12. The Board approves all policy including loan, investment and non-performing asset management policies. Periodic reviews on important aspects of the business like strategic and annual business plans, annual resource mobilization plan, review of operations, asset liability management, fixing of concentration limits, review of exposures under money market operations, review of quarterly and annual financials and review of non-performing assets are placed before the Board at set frequencies. SIDBI has issued detailed guidelines on fair practices code for lenders. Right to Information Act (RTI) is implemented in SIDBI.

13. SIDBI has 10 Sub Committees of the Board which meet at different frequencies. Of these, key from an operations perspective are the Executive Committee (EC), Audit Committee (AC) and Risk Management Committee (RMC). Sanctions related to credit proposals above a threshold limit are considered by the EC. The AC in addition to overseeing the Audit vertical and reviewing its major observations also provides guidance on finalization of accounts and observations from RBI Inspection. The RMC lays down policy and guidelines for Integrated Risk Management for the Bank. Additionally Committees such as the one for Supervision of State Finance Corporations remains key from the overall performance management perspective of this important but credit sensitive lending channel.

14. The Chairman and Managing Director (CMD) is the Chief Executive Officer, who is vested with the overall management of SIDBI. He is assisted by two Dy. Managing Directors (DMD) under whom all the Head Office departments except Vigilance Department function. The Vigilance Department is headed by an Executive Director, who reports directly to the CMD. SIDBI's head office functions are managed from three locations viz., Delhi, Lucknow and Mumbai. Head Office Departments are organized on functional lines like Business Planning, Resource Management, Credit, Development Financing Institutions (Refinance), Asset Recovery, Risk Management, Corporate Accounts, Human Resources Development, IT Services, Legal, MIS and Internal Audit. A nodal office functions at Delhi to oversee project management. The key departments are headed by Chief General Managers. For SIDBI's business operations, the Asset Liability Committee (ALCO), Investment Committee and the use of delegated powers for Credit and NPL management are key to manage performance and risk.

15. The institution had outstanding assets of INR678 billion (US$10.7 billion) on March 31, 2014 with net NPA to net advances at 0.45%, attesting to its capabilities in delivering financial intermediary financing in a viable manner. In addition to Investments, its Business Operations largely consist of *Indirect Credit / Refinance* (80%) to Banks, State Finance Corporations, Microfinance Institutions and NBFCs, and *Direct Credit* (20%) as Term Loans and Receivable Finance. Recognizing a need in recent years, SIDBI re-oriented its business strategy to address financial and non-financial gaps of *early stage*, *service*

sector and manufacturing MSMEs through a combination of financial products and capacity building measures. Lending products include among others, risk/equity finance products that support and foster entrepreneurship, growth capital, factoring and receivable financing services to improve working capital cycles, and financing schemes for energy efficiency.

16. As part of its MSME refinance operations, SIDBI lends to 57 participating financial institutions (PFIs) consisting of Banks, State Finance/Industrial Development Corporations, NBFCs and to a limited degree Venture Capital firms which meet eligibility criteria. The top 20 borrower groups constitute 55% of the portfolio, down from 70% a year ago suggesting increasing portfolio diversification. This augurs well both from a 'crowding in' and risk management perspective. PFIs for refinance operations have moderate to superior risk profiles with capital adequacy above minimum regulatory requirements of 9 percent[72]. Rated PFIs, typically Scheduled Commercial Banks and NBFCs, are in investment grade range of BBB to AAA, with a greater share of refinancing being routed through higher rated institutions. As per strategy, counterparty limits (individual and group) in line with the Loan Policy are stringently used to manage risk exposure. A representative list is given below:

Activity/Industry	***Aggregate exposure limit***
All Nationalised Banks	300% of capital funds of SIDBI
State Bank and Associate Banks	200% of capital funds of SIDBI
Private Sector Banks	200% of capital funds of SIDBI
Foreign Banks	100% of capital funds of SIDBI
All State Industrial Development Corporations	5% of capital funds of SIDBI
All State Finance Corporations	Rs 31 billion
Venture Capital Funds*	5% of outstanding portfolio of SIDBI
Industry#	5-10% of outstanding portfolio of SIDBI
Services Sector	15% of outstanding portfolio of SIDBI
NBFCs	20% of outstanding portfolio of SIDBI

** subject to capital market exposure limit*
 # varies industry-wise

17. ISRs of previous projects has noted effective monitoring and management of PFI financing by SIDBI, including in its ability to crowd in commercial financing in a non-distortionary manner and meet project objectives.

18. **Quality of financial intermediary**: SIDBI has strong credit fundamentals being a AAA rated entity, with a risk governance framework commensurate with its size and scale of business. Though SIDBI's mandate entails directing credit to specific sectors like MSME and MFIs, it follows commercial principles in lending and has the autonomy to do so. A summary of SIDBI's financial results is as follows:

INR million

[72] Basel III parallel runs have begun from 2013-14 and over the next five years, minimum CRAR for SCBs would need to be 11.5percent5 percent.

TABLE 3: SIDBI'S FINANCIAL RESULTS

	2013-14	2012-13	2011-12
Net Interest Income	22,819	20,949	18,987
PAT	11,183	8,374	5,669
Total Assets	678,103	618,482	593,851
Interest/ATA*	8.7%	8.5%	8.0%
Interest expenses/ATA	5.1%	5.0%	4.6%
NII/ATA	3.5%	3.5%	3.4%
Return on assets (PAT/ATA)	1.7%	1.4%	1.0%
Provision Cover	88%	84%	88%
Gross NPL to Gross Advances	1.86%	0.98%	0.69%
Net NPL to Net Advances	0.45%	0.53%	0.34%
Capital to RWA** (total)	30.75%	28.14%	30.09%
Leverage (Total Borrowings/TNW)	6.25	6.39	6.81

**ATA: Average Total Assets; **RWA: Risk Weighted Assets*

19. **Loan administration process:** SIDBI has documented loan, investment, and risk management policies which are amended from time to time, as required. Its organizational structure has checks and balances to originate and manage loan and investment portfolios including through separate and independent units for origination and risk management. SIDBI adopts a Committee system for exercise of delegated powers by executives in respect of sanction of credit lines (TABLE 7), settlement of impaired assets and other promotion and developmental activities at Head Office, Zonal Office and branch levels. There is also a post-sanction reporting system to the next higher level.

TABLE 4: DELEGATION OF POWER

Rs million

Risk Category		Branch Credit Committee		Regional CC	Central Credit Committee			Executive Committee
		AGM	DGM		CGM	ED	DMD	
Secured Exposure - Sanctioning Powers		20	50	150	350	450	550	>550
Where external ratings are the primary determinant of risk	Benchmark rating AA and above	No delegation			100	200	250	>250
	Benchmark rating below AA	No delegation				200	250	>250
Where internal ratings are the primary determinant of risk	Benchmark rating CR3 and above	No delegation			100	200	250	>250
	Benchmark rating below CR3	No delegation				200	250	>250

20. **Appraisal methodology**: SIDBI uses a combination of internal and external rating models depending on the category of lending. For internal ratings, it uses Credit Appraisal and Rating Tool (CART), for loans up to INR20 million (US$316,000). Fresh proposals from existing customers are typically assessed using CART. For fresh proposals, it uses a customized version of CRISIL's Risk Assessment Model (RAM). The RAM generates an Obligor rating (reflecting the Probability of Default) and a Facility rating (reflecting the Loss Given Default) are carried out separately and a final combined rating derived. SIDBI undertakes periodical review of the efficacy of the rating system and upgrades the models as necessary. Currently, it is considering increasing the number of rating grades in the model to allow for more differentiation in risk pricing.

21. Credit appraisal for borrowers in its direct lending portfolio is fairly comprehensive covering project, business, financial and management risk assessment. In financial risk assessment, sustainability of financial performance and credit history of promoters/company are key. On business risk analysis, the analytical approach is sectoral which makes competitive analysis of firms in an industry a key feature. The composition of Credit Committees differs and SIDBI brings in external experts as required depending on sectors/segments for which sanctions are being considered. Institutional knowledge of a particular credit has significant weightage in lending decisions and explains the higher degree of comfort in repeat lending to firms where there has been prior favorable experience. To provide credit comfort and enable lending in new asset classes or underserved segments, credible sources of (third party), as explored by the project (see Annexes 2, 5 and 6), data on credit histories could be beneficial as also support through distributed appraisal protocols through credible industry associations (who will carry significant reputational risk by lending their name).

22. **Operational capacity to manage, especially the new funding lines**: SIDBI manages a INR610 billion (US$9.6 billion) portfolio of wholesale and direct lending operations with a staff strength of 1060, bulk of which is in direct lending. It has established verticals for credit lines being considered under the project (namely early stage and risk capital, service sector and manufacturing sector). Processes and staffing are therefore in place to allow implementation from an early stage of the project. The parallel TA will also assess improvements as required in processes (e.g. enhanced credit scoring tools) including through incorporation of industry good practices and as the project progresses, SIDBI may be required to reflect these.

23. **Application of Commercial Principles, Managing Business Risk and Conflict of Interest**: In the conduct of its public policy role, SIDBI uses the 1) wholesale channel to crowd in institutions in established credit markets by providing access to cost effective refinance and 2) direct lending channel to cater to under-served segments or where credit markets may be less developed. Its very design enables management of conflicts, if any. This is also supported by:
    a) Its *Loan Policy* which articulates the focus on crowding in institutions through building strong alliances with intermediaries, developing new channels for credit delivery, strengthening operations of State Financial Corporations (SFC) including through support in risk management practices to ensure good quality growth and encouraging expansion and diversification of the portfolio.
    b) Following *clear policies on lending rates based on commercial principles*, for wholesale vs direct operations with the markup over cost of funds reflecting i) the difference in credit risk on lending to PFIs vs direct MSMEs and ii) transactions costs of bulk vs retail lending. Distortions, if any, are also minimized through distributing the lending portfolio across a large number of entities. (see details in the OM).
    c) *Selection of PFIs follow a transparent and standardized process described in details in the OM*; funding channels are open to those that meet the transparent eligibility criteria and clear due diligence.

24. **Design for Sustainability:** A risk of SIDBI lending to PFIs (refinanced by a Bank credit line) is the possible disruption in lending operations should the World Bank line through SIDBI not be available in future. This risk is mitigated on several counts: (a) the World Bank line constitutes a relative small less than 6 percent of total borrowings; (b) SIDBI liabilities originate from a range of sources namely RBI, Government of India (though part of this includes IDA funds), Banks and FIs, five Development Financial Institutions and Retail Deposits ensuring non-disruptive lending operations; (c) the rate of lending by SIDBI is not subsidized to distort and create dependencies in the lending market that can disrupt credit offtake should the Bank line not be available; (d) though the World Bank line confers a

tenor advantage to SIDBI’s liability profile, the borrowing rate (inclusive of GoI guarantee fees) is broadly at market rates and in line with SIDBI’s average borrowing costs.

Annex 5: Early Stage Financing: Innovating Approaches
INDIA: *MSME Growth Innovation and Inclusive Finance Project*

1. This annex follows from component description of Component 1 early stage financing that seeks to develop and scale up debt products to early stage firms. This area of lending is on the frontiers of innovative financial development not just for developing economies, but globally. SIDBI has identified three key potential areas where innovating their existing approach, can allow them to reach their objective to scale up their pilot portfolio. First, to develop faster appraisals model that leverages industry assessments to reduce risk so to process more loans in shorter time. Second, to leverage digital technology by developing a financing electronic platform as a backbone to facilitate processing, sourcing and appraisal.[73] Third, to actively seek out partnerships and potential PFIs interested in entering this segment and to develop incentive compatible models to onlend.

2. First, models of appraisal are being considered that leverages industry information and signals as means to facilitate faster and lighter appraisal processes for startups. The Indian startup ecosystem are characterized by active industry associations (such as NASSCOM, iSpirit), who have insights to industry and technological developments, established angel networks (such as India Angels Network, Mumbai Angels, etc) and active VCs that regularly collect information, appraise and assess startups, and a large growing number of accelerator programs (such as 10,000 startups, Microsoft Accelerators, Target Accelerator Program) that filter startups for innovative ideas and viable commercial viability. These entities have access to a richer set of information on startups that differ from the information sets banks have access to. SIDBI will develop and innovate on appraisal models that leverage the information from those within the ecosystem to overcome information asymmetries, reduce risk and to facilitate greater efficiency in appraisal processing. SIDBI is already currently working with industry entities to develop these models (see Box 1 on innovating appraisal models for startups).

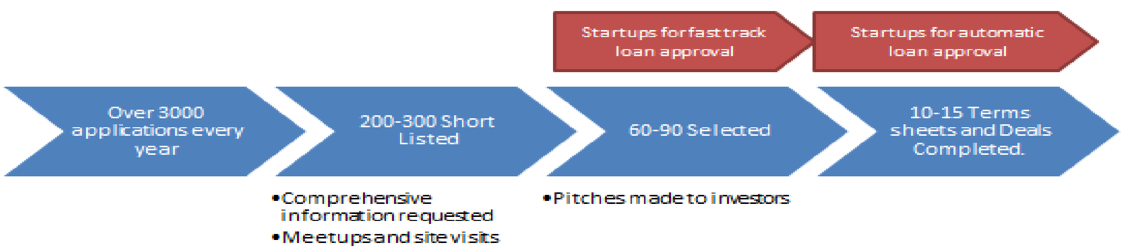
[73] This has begun with initiative developed within NIFP, which is being supported through a parallel initiative by GiZ and Centre for Innovation, Incubation and Entrepreneurship (CIIE).

Box 1 SIDBI Innovating on Appraisal Processes to facilitate lending to Startups.

While, SIDBI has already recently set up formal MOUs with Nasscom and iSpirit for technology assessment inputs to their appraisal process, as well as plan to build a wider panel of experts across different fields for similar inputs, SIDBI envisages to go further by developing innovative appraisal models that will leverage India's vast angel networks as well as fast track to automatic loan matching to early stage firms that have been invested. That is, to move toward matching loans with equity investments at angel stage, or angel matching loans.

SIDBI hopes to develop fast track to automatic loan processing as a means to lower information asymmetries in screening startups through streamlining the financial appraisal processes with angel networks. Not only is this the first of its kind, and could potentially revolutionize access to finance to startups, but the appraisal model is a viable mechanism to leverage information signals of bankable enteprises. Firms that have successfully obtained angel investments have had undergone not only a rigorous vetting process, but need to have been chosen by leading angel investors – who are often industry experts in the field. As such, invested firms are positive signals for viable startups.

The Figure below illustrates an example of the number of startups reviewed and vetted by the India Angel Network – the largest angel network in India. From over 3000 applications a year, 200-300 are shortlisted for indepth information, site visits and vetting. From these, only 60-90 are chosen each year to pitch to investors, and the enterprise needs to attract an angel investor willing to lead an investor round within the angel network. From that, only around 30 enterprises are backed each year. Those who are backed, should be eligible to almost automatic appraisal and decision (provided a viable revenue stream within the term of the loan). Startups within the category that were chosen to pitch to investors (the 60-90 or so in the example), have also undergone the same process as those who may have received investments, however, these vetted companies may not have attracted angels due to idiosyncratic variations in investor taste, experience needed to mentor and/or appetite for particular products. Likewise, these startups should be considered eligible for fast track appraisal processing given the appraisal process they already have undergone through the angel network.



INDIAN ANGELS NETWORK ASSESSMENT OF STARTUPS

Currently, the assessments and signals of angels and vcs are taken into account in SIDBI's appraisal of loans on a case to case basis. This means that a startup has to undergo several long and lengthy appraisal processes that often require very similar requirements but each one requiring a separate process. The aim would be to get as close to streamlining appraisal across entities, fully automating the process via use of electronic backbone platform, and aim towards matching loan approvals to equity investment commitments.

3. The second area of focus is to look at ways that electronic platforms can bring together the market place for early stage financing and further market development in this nascent segment. SIDBI has developed a comprehensive plan, called the National Innovative Finance Program (NIFP), that aims to address the underdeveloped market for the financing of startups by utilizing digital technology to develop bring together market players in one centralized virtual market meeting place (see Figure 1). The platform can facilitate a virtual meeting place for the ecosystem that connects not just SIDBI to the startups that need financing, but also facilitate other financiers and sources of finance including angels, VC and government schemes and investors (with the flexibility for future expansion into new forms of lending such as facilitating peer to peer lending, crowdsourcing and other investing/fund raising options).[74] Such leveraging of digital technology facilitates market development through increasing efficiency of information flows, processing time as well as provide the platform from which SIDBI can develop, and introduce new products and models of appraisal outlined in previous paragraphs. This platform could be a major game changer for the development of early stage financing not only in India, but also one of the first entrants in the world to be developed. Figure 2 illustrates the components within the planned NIFP. The development of the platform will be in close collaboration and participation by key industry leaders and associations. The electronic platform will be undertaken in several phases, with the first phase prioritizing the facilitation for SIDBI to improving processing time of loans to startups.

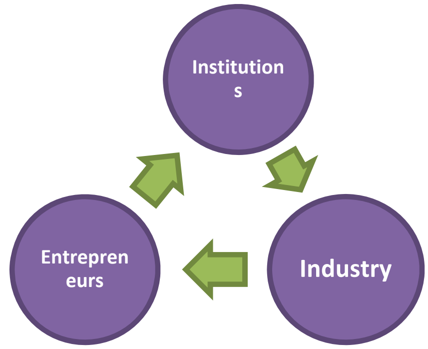


FIGURE 1 VIRTUAL FINANCING MARKET PLACE FOR STARTUPS

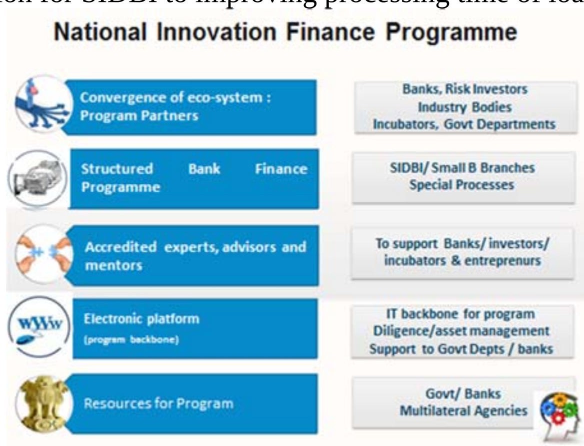


FIGURE 2 NIFP

4. The third area where innovative approaches are being developed is in developing incentive compatible models of on-lending to PFIs who will offer debt instruments to early stage MSMEs. In contrast to traditional banking, this area of financing is entering product combinations of equity and debt that have different risks, payoffs and incentives by the on-lender. The approach thus requires some piloting as there is no established model for such on-lending. While SIDBI is an experienced on-lender to PFIs, in the area of early stage financing not only is this a new product, but at present, venture debt is non-

[74] It is envisioned, that the platform will facilitate startup's loan applications electronically to different institutions and bodies, build profile pages, connect with angel networks, investors, venture capital firms, accelerators and incubators, as well as resources and services (such as legal, accounting and intellectual property). For financing institutions and investors, the platform offers a centralized place to peruse startups and faster access to up to date information on financials, and performance data of the startups.

existent in the ecosystem save for three entities: Intellegrow, Sillion Valley Bank[75] and a new entrant Trifecta Capital launching in 2015. Both SVB and Trifecta look at a larger loan size, at the INR5-25 Crore (US$790,000-US$3.9million) loan amount. However, given the financing gap, SVB have expressed interested in reaching the INR3-4 Crore (US$474,000-US$632,000) range. There are also other potential PFIs, such as Intellegrow who are closer to target segments, as well as new funds that are emerging in the India ecosystem.[76]

5. SIDBI is interested in exploring partnering with early stage venture funds[77], or angel funds as intermediary to lending to startups. Potentially, the vetting and assessment could be undertaken by the fund – in line with SIDBI's requirements – backed by equity investments by them. The debt risk could be borne by SIDBI, but the implementation and monitoring of the debt could be undertaken by the fund.

6. This area of innovating approach seeks to facilitate private sector provision of venture and startup debt by engaging with PFIs that have experience with equity and venture capital, and thereby also achieving greater scale and reach of startups in the ecosystem.

[75] SVB is a California subsidiary, which will be selling their India portfolio in coming months to new management.
[76] Recent LiveMint article: http://www.livemint.com/Specials/F7DNMHhU2wRYQxQ7OyDu6H/When-angel-investors-start-their-own-funds.html
[77] Early-stage VC funds, such as Blume Ventures, Inventus Capital Partners and Nexus Venture Partners, provides seed funding in the range of US$50K – US$300K to early-stage tech-focused and tech-enabled ventures.

Annex 6: Possible Product Structure for Franchisee Financing
INDIA: *MSME Growth Innovation and Inclusive Finance Project*

1. While the franchising industry is expected to quadruple between 2012 and 2017,[78] the funding ecosystem for franchising in India remains at a nascent stage compared to other countries (see section I A and annex 2). This lack of bank credit is constraining entrepreneurial opportunities and growth.[79]
2. One approach that could be pursued to improve franchisees' access to bank credit is to build on the relationship between the franchisor and the franchisee. In that light, the introduction of a collaborative approach involving franchisees, franchisors and financial institutions (FI) , where the FI will actively engage the franchisor for example in assessing the franchisees and mitigating credit risk, is one possibility. The contours of such arrangement could be designed along the lines of channel financing structures. SIDBI is keen to support such structured financial assistance to franchisees, notwithstanding the fact that improving the entire franchise financing ecosystem in India warrants supplementary actions on the regulatory front as well as changes in practices towards franchisee financing within lending institutions and by the franchising industry (including franchisors and industry associations). This annex provides an overview of a potential product structure for franchisee financing which is leveraging the franchisor –franchisee relationship and that SIDBI or other PFIs could adopt in India. Initial feedback from stakeholders has shown interest in such a structure.

Franchise financing along the lines of channel financing structures

1. Deriving the parallels between channel financing operating model and franchise financing (Source: KPMG "Study on credit gaps, potential and financing of franchising industry in India", 2014)

3. *Channel Financing* relates to integrated financial and commercial solutions to the entire supply and distribution chain to ensure the health of the firm, financed by the bank. In channel financing, banks are also concerned as to how the suppliers of the firm and the dealers of the products are financing their activities. For a manufacturing firm for example the suppliers (vendors) of raw materials, who provide inputs for production, are equally important as the distributors (dealers) who sell the manufactured products to the end-consumers, through retailers.
4. *Equivalence with channel financing*. Table 1 describes the parallels that exist between channel financing operating model and franchisee financing.

[78] with among others, shifting consumer trends including growing preference for branded products and increasing awareness of franchising as a business opportunity.

[79] Franchising industry has indeed a huge potential to provide entrepreneurial opportunities to a large number of aspiring young people/graduates or even to salaried workers, who may lack entrepreneurial expertise and therefore opt for the franchise model (where the franchisor provides the brand, the business model and support such as mentoring, monitoring, operating process and so forth). Over the years in India many consumers of franchising brands have indeed ventured into setting up their own franchised outlets and the potential for growth is immense considering that in India only 15 per cent of the sales are currently through franchised outlets, compared to for example 60 percent in the USA. (KPMG, 2014,"Credit gap, potential and financing of franchising industry in India").

Table 1- Equivalence between Channel Financing and Franchise financing

Channel Financing	Franchisee Financing
Corporate/Anchor (OEM for auto companies)	Franchisor
Dealer	Franchisee
Bank	Bank

Source: KPMG (2014).

2. Challenges in Franchise financing and possible product structure.

5. Financial institutions may have well developed products for channel financing (typically for the automobile sector) and with some adjustments (for example for the services sector) the same structure can be tailored for franchise financing. However, challenges remain for franchise financing in this model. Among them is the creation of a working partnership between the franchisor and the bank. The bank can be deterred by the small ticket size of the loans to franchisees and as opposed to channel financing where the corporate provides a guarantee, the franchisor can be wary of providing a guarantee to the bank.

6. Several avenues could be explored to design an appropriate product that will align all incentives. For instance working at the "master franchisee"[80] level (who can be assimilated as the "anchor" or the "corporate" in channel financing) because the latter has growth targets to meet and has a clear incentive/mandate to expand the penetration of the brand (therefore opening additional outlets). In that light, the master franchisee could be more willing to provide support to its sub-franchisees' loan applications that ranges from information sharing, on past and ongoing performance, to financial comfort to lenders. This could for instance include first loss guarantees for selected sub-franchisees that the master franchisee would recommend. The partial guarantees could be funded by a "loss pool account" that has pooled aside part of royalties paid by all its sub franchisees.

7. Further, lenders may also find enough financial comfort in accessing detailed information on the franchisees if the brand value has been sufficiently demonstrated in the country and the franchisor's strength as well as the strength of its relationship with the franchisee (including the contractual agreement) have been established (for example through a detailed analysis of the contract to understand the obligations of both the parties and to estimate the franchisee's abilities to fulfill its obligations under the franchise agreement). KPMG (2014) has for instance provided a risk assessment framework that could be used by lenders (see Figure 1).

8. Figure 2 provides a possible structure for franchise financing. The parallel technical assistance would support the design of such a product for SIDBI and through technical meetings with stakeholders it will also support the design of such a product for other financial institutions. This will build on current practices (e.g. CRISIL SME rating of franchisees, domestic banks' current practices and international best practices) but also on stakeholders' feedbacks provided during preparatory technical meetings.

Figure 1- Illustrative risk assessment process flow (Source: KPMG, 2014)

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[80] As defined by KPMG (2014), the master franchisee is typically appointed by the franchisor with the responsibility of opening and supporting franchisees within a broad geographical area. The master franchisee is expected to own and operate some of their own outlets and has certain sales and growth targets, set. The franchisees within this area, often referred to as "sub franchisees", enter into a tri- partite agreement with the master franchisee and the main franchisor. Typically, the master franchisee will command royalties from the sub-franchisees and will pay a percentage of these royalties to the franchisor. The master franchisee route is typically used by foreign brands to enter international markets as they seldom have any regional knowledge and cultural acumen to successfully carry out business and franchising operations.

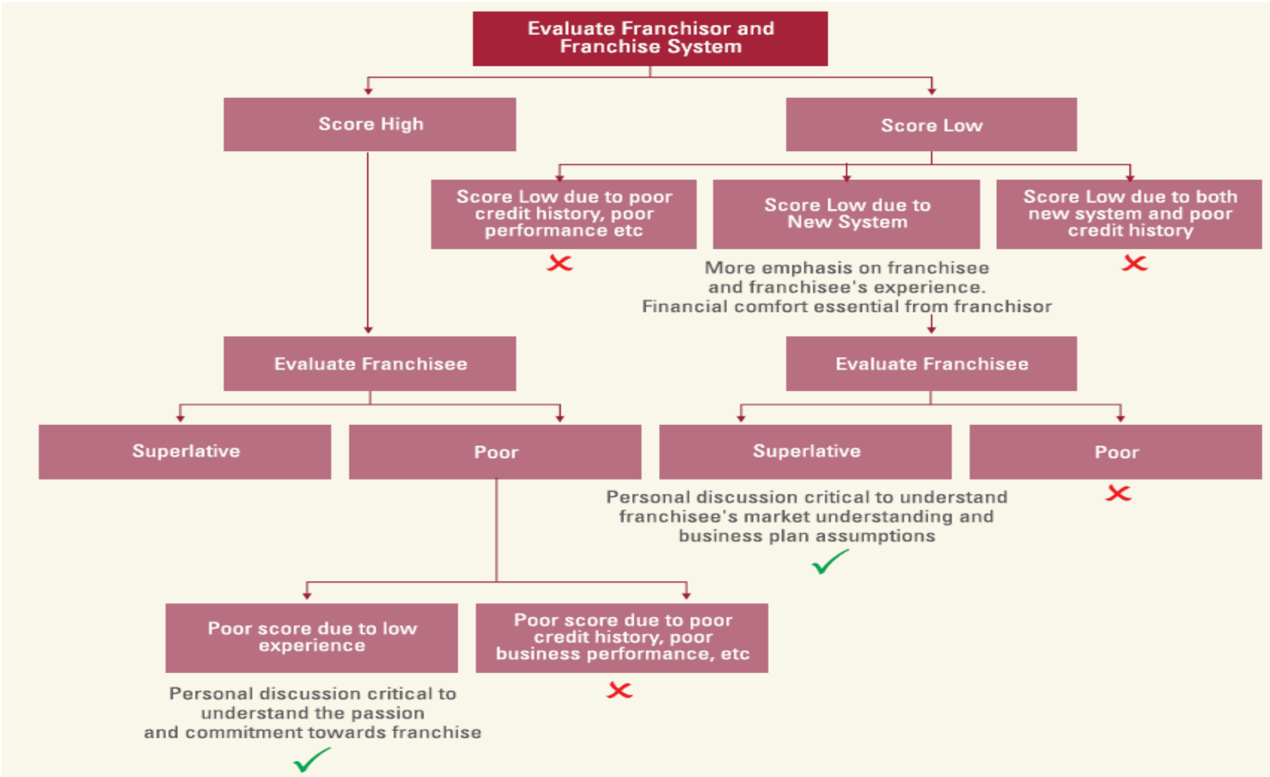
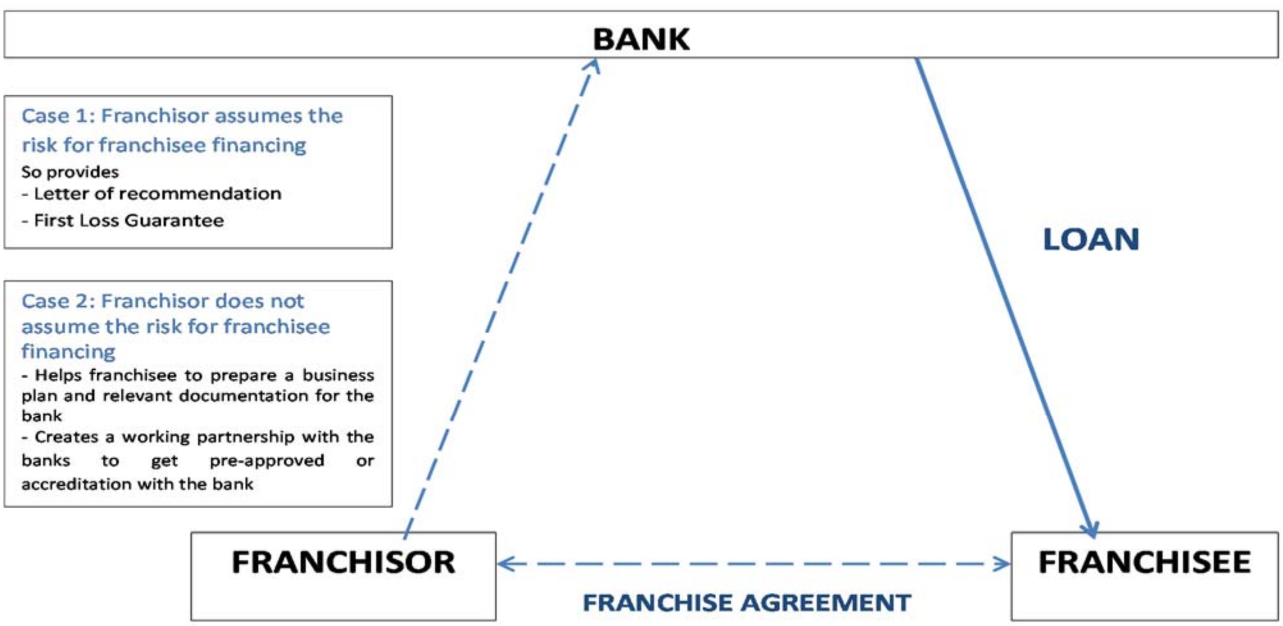


Figure 2- Possible product structure of franchisee financing (Source: World Bank and KPMG, 2014)



Annex 7: Implementation Support Plan
INDIA: MSME Growth Innovation and Inclusive Finance Project

Strategy and Approach for Implementation Support

1. The project supports SIDBI the Apex institution for MSMEs in India. SIDBI has a long standing experience in designing financing products and services for MSMEs. It plays a key public policy role in India's MSME and benefits from strong support from Government of India (GoI). SIDBI has strong credit fundamentals being a AAA rated entity, with a risk governance framework commensurate with its size and scale of business. The World Bank has had a long and successful engagement with SIDBI in support of previous projects including: the SME Financing and Development Project in 2004 (which benefitted from Additional Financing in 2009), the ongoing India: Scaling Up Sustainable and Responsible Microfinance which commenced in 2009 and more recently, the Partial Risk Sharing Facility in Energy Efficiency.

2. With SIDBI having participated in several World Bank projects in the past and implementation arrangements having worked well, it is therefore expected that this track record will simplify implementation support. Two implementation support missions will be carried out annually in addition to follow up visits as deemed necessary. World Bank's implementation support missions will cover financial management, procurement and safeguards management under the project in addition to overall support. The WBG implementation support team is located both in HQ (in Washington DC) and in the field (in Delhi and Mumbai) which will ensure adequate support on a regular basis.

3. Further, while SIDBI is a strong and technically sophisticated partner for the implementation of the project, in particular the innovative parts, it may also need and benefit from additional external technical assistance and advice. This is envisaged in the broad area of the parallel TA as specific support to implementation and capacity building will be provided, including through hiring advisors as needed. While this parallel TA support will largely be provided by consultants, the World Bank team will play a key supervisory role, including by drafting the Terms of Reference of consultants, reviewing their deliverables to ensure quality and relevance, and monitoring the TA performance during implementation support missions.

Implementation Support Plan

4. The Bank implementation support team will consist of technical specialists from the World Bank Finance and Markets Global Practice, Transport and ICT Global Practice and other operations specialists based in New Delhi including gender, procurement, financial management and safeguards specialists.

5. During project implementation, support will be provided as indicated below:

Time	*Focus*	*Skills Needed*	*Resource Estimate*	*Partner Role*
First twelve months	*Capacity building of branches* *Product and strategy development for innovative products of components 1 & 2* *Communications Strategy and Awareness Building including for LES*	*Please refer to the table below.*	*170,000*	
12-60 months	*Project Management, Implementation and Completion*	*Please refer to the table below.*	*170,000 per annum*	
Other				

Skills Mix Required

Skills Needed	*Number of Staff Weeks*	*Number of Trips*	*Comments*
Early stage and MSME finance	*180*	*Minimum of 2 a year per World Bank staff*	*Will need to be adjusted depending upon the skills mix of the India based World Bank staff*
TA coordination with credit line	*15*	*Based in the field*	
LES and Environmental safeguards	*20*	*Based in Delhi, Minimum of 2 a year*	
Gender and Social safeguards	*10*	*Based in Delhi, Minimum of 2 a year*	
Procurement	*15*	*Based in Delhi, Minimum of 2 a year*	
Financial Management	*20*	*Based in Delhi, Minimum of 2 a year*	

Note: Some staff costs will be covered out of the parallel TA funding.

6. The Implementation Support Plan (ISP) may be reviewed to meet the implementation support needs of the project.

Annex 8: Economic Analysis
INDIA: *MSME Growth Innovation and Inclusive Finance Project*

Economic Analysis

1. MSMEs play a pivotal role in economic development by contributing to major shares of industrial production and exports, providing the vehicles for entrepreneurial spirit and innovation, and generating employment. In India, MSMEs account for more than 80% of total industrial enterprises, produce over 8000 value-added products and employ an estimated 60 million people. In addition, over 50% of MSMEs are rural enterprises and widely distributed across low-income states making them potentially conduits for promoting equitable development and poverty reduction.

2. However, the growth of the MSME sector has been constrained by lack of access to finance. Lack of adequate finance is one of the biggest challenges inhibiting MSME growth**.** Financial institutions have limited their exposure to the sector due to a higher risk perception, information asymmetry, high transaction costs and the lack of collateral. The MSME census of 2006-07 estimated that about 87 percent of MSMEs did not have any access to finance and were self-financed. The IFC-Intellecap study shows that demand-supply shortfall in finance to MSMEs is substantial. Credit towards micro and small enterprises represent only around 13-15 percent of formal financial institutions portfolio.[81] In addition, poor investment climate, lack of infrastructure and market linkages, and gaps in financial market infrastructure and legal framework are additional constraints. While these are all important areas, these are the subject of parallel initiatives that seek to address them, and hence are not a focus of this project, which instead aims to complement such other efforts.

3. The project aims to increase formal financing to MSMEs, improve the overall quality of MSME lending and increase access to finance for MSMEs through reaching new market segments and products. Through a combination of both financing instruments and technical assistance, the project seeks to enhance development and delivery of financial products to MSMEs in the areas of early stage debt finance, services and manufacturing sector finance.

Development Impact

4. Significant economic benefit is expected to be derived from the project, both direct and indirectly.

5. Directly, the project will improve the value of beneficiaries MSMEs through the credit line supporting their operations. It would improve MSME credit market efficiency, through the parallel TA and project financing experience which would help develop the ability of banks to appraise and manage MSME loans with limited collateral thereby improving synergies in the financing ecosystem and enhancing profitable lending to viable MSMEs while managing NPLs to the segment. The project will help build up the knowledge and capacity of intermediaries with respect to MSME lending, thus help catalyze an independently sustainable MSME lending market. Enhanced market credibility through SIDBI's demonstrated performance in these new lending segments would help crowd in other banks, institutions, NBFCs and the private sector in general. This would occur through several means including through tapping synergies in the financing ecosystem and distributed credit information on MSMEs in a systematic way. Financial and social sustainability is enhanced by appraising and screening intermediaries, applying strict lending standards and calibrating controls and incentives while crowding in the larger market.

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[81] Reserve Bank of India Database. A study by Beck, Demeriguc-Kunt, Martinez Peria (World Bank), 2008 shows that India's ratio is below the mean for the countries studied and well below countries like Armenia and Turkey.

6. Indirectly, the project would support the structural shifts occurring in the Indian economy towards service oriented activities while seeking to enhance the competitiveness of manufacturing and supporting the growth of innovation, startups and early stage, a key to deepening sustainable access to finance for MSMEs. The project implemented through SIDBI, a key financial institution in India, is likely to induce a demonstration effect, generating benefits for a larger number of banks and MSMEs, with higher level impacts contributing to MSME growth, job creation and poverty reduction.

7. The economic analysis looks at early stage, risk capital, services and manufacturing separately and generates IRRs for each of the components as well as also for the project. This is as the project is targeting a variety of firm types, with different cost structures, employment intensities and potential for value addition. For early stage firms, which register very high growth rates for successful ventures but also have high failure rates, the project is intended to provide risk support at the margin, lower failure rates and improve growth trajectory. The key assumptions and project results are summarized below. The sensitivity analyses under different scenarios (on turnover growth, value added percentage and employment elasticity), show that while results are robust to changes in key assumptions, they are very sensitive to profitability assumptions calling for strategic and efficient use of the project finance.

8. Access to finance is effective at releasing constraints to growth for early stage and risk capital which is reflected in the high returns even under not so robust conditions for turnover growth. The benefits for manufacturing are clearly driven by improved profitability through supporting project interventions. It is expected that this would occur through improved competitiveness. The service sector has the potential to contribute the most through higher number of jobs though early stage firms contribute the most to creation of higher skilled jobs.

Summary of assumptions		**Early Stage**	**Risk Capital**	**Services**	**Manufacturing**	**Total**
Loan component	mill $	50	100	200	150	500
Loan component	Rs mill	3000	6000	12000	9000	30000
Number of firms financed	**no.**	**240**	**330**	**480**	**600**	**1650**
Average loan size	Rs mill	13	18	25	15	18
Compounded annual turnover growth - counterfactual	%	5%	8%	8%	5%	
Compounded annual turnover growth - post project	%	25%	15%	17.5%	10%	
Employment intensity	per mln t/o	0.6	0.3	0.3	0.3	
Employment elasticity	chg in t/o	1.05	1.02	1.02	1	
Averages wage per employee	Rs mill	0.5	0.4	0.3	0.2	
Value added* % counterfactual	% of t/o	10%	10%	12%	6%	
Value added* % post project	% of t/o	45%	25%	22%	8%	
Results		**Early Stage**	**Risk Capital**	**Services**	**Manufacturing**	**Total**
Counterfactual EIRR	%	10%	16%	12%	18%	15%
Project EIRR	%	20%	37%	22%	26%	26%
Turnover of firms financed in terminal disb year	Rs mill	5079	29072	44295	96631	175077
Employment in terminal year - counterfactual	no.	2617	8479	12345	26471	49913
Employment in terminal year - post project	no.	3889	9629	14672	28989	57179
Share of wages in turnover in terminal disb year	%	38%	13%	10%	6%	9%

**Value added=Turnover less material costs incl intermediate goods and services*

9. Overall, the project is expected to yield an IRR of 26% with conservative assumptions relative to the counterfactual where varying degrees of credit constraint results in lower IRRs of 15%. Additional sensitivity tests using different assumptions on turnover, value added and employment, show that the economic benefits outweigh costs (between12-15%) for different scenarios of the project.

10. *Methodology*: The economic analysis is undertaken by comparing the projected value addition to MSMEs under the project to the counterfactual firm performance without the project. The economic model estimates the project direct benefits through increased turnover and value added[82] of MSMEs, and compares it to the case where limited access to finance constraints firm growth.

IRR - Counterfactual							
in Rs mln	Loan	Year 1	Year 2	Year 3	Year 4	Year 5	IRR
Total	***(20,700)***	***1,851***	***4,002***	***6,493***	***9,366***	***12,669***	***15%***
Early Stage	(700)	62	128	196	267	342	10%
Risk Capital	(4,000)	363	791	1,293	1,879	2,560	16%
Services	(8,000)	634	1,381	2,258	3,282	4,473	12%
Manufacturing	(8,000)	792	1,703	2,746	3,938	5,294	18%

IRR - With Project							
in Rs mln	Loan	Year 1	Year 2	Year 3	Year 4	Year 5	IRR
Total	***(30,000)***	***3,405***	***7,636***	***12,853***	***19,243***	***27,029***	***26%***
Early Stage	(3,000)	281	631	1,066	1,609	2,285	20%
Risk Capital	(6,000)	907	2,040	3,443	5,166	7,268	37%
Services	(12,000)	1,162	2,643	4,511	6,846	9,745	22%
Manufacturing	(9,000)	1,056	2,323	3,833	5,622	7,730	26%
NPV (cash flows, 15%) Counterfactual	11,618						
NPV (cash flows, 15%) Project	37,415						
NPV (cash flows, 20%) Counterfactual	9,989						
NPV (cash flows, 20%) Project	32,743						

Sensitivity scenarios	*NPV@15%*			*IRRs*		
	Rs million	Total	Early	Risk	Services	Mfg
Project Case	**37415**	**26%**	20%	37%	22%	26%
Sensitivity 1: growth rate higher	**41916**	**28%**	23%	40%	24%	28%
Sensitivity 2: growth rate lower	**35549**	**25%**	18%	36%	20%	26%
Sensitivity 3: Value add % higher	**58448**	**36%**	23%	45%	29%	42%
Sensitivity 4: Value add % lower	**24284**	**19%**	12%	29%	14%	21%
				Jobs		
Project Case		**57179**	3889	9629	14672	28989
Sensitivity 5: Employment elasticity higher		**64575**	4477	11131	16960	32006

11. The counterfactual case makes different assumptions across different segments as to the extent firms that are financially constrained, leading to sub optimality in capital efficiency and performance metrics. For firms in early stage, it is assumed that they are about 80% financially constrained and therefore particularly severe. For growth stage and service sector, credit constraints are assumed at about 35% and for manufacturing at 10%. For early stage firms, greater access to funding enables them to register higher average growth rates, improve failure rates and significantly improve profitability at the margin (early stage are typically at the borderline of profitability). For growth enterprises and service sector firms, while credit constraints are relatively less severe than early stage firms, they nevertheless operate at sub optimal levels relative to growth potential. The project targets this niche through appropriate and innovative access to finance such that promising firms with strong business

[82] And therefore lower expected NPLs though its quantification has not been attempted here.

models can grow into vibrant enterprises where jobs can be created on a large scale. For manufacturing firms, the project seeks to address key issues of competitiveness and scale, through additionality in financing.

12. The project is expected to contribute to jobs through creation of skilled formal sector employment including high end knowledge capital. As early stage and growth ventures are human capital intensive, these firms are expected to generate greater demand for higher end jobs while services and manufacturing absorb greater amount of labor. In addition to measured benefits captured in the economic model, the project also spurs, increased SME activity that contributes to GDP growth through increased output, value add and profits. The project would directly contribute to formal job creation (as noted above) and indirectly through ancilliary development and tertiary employment.

13. Second order effects of the project include contributing to increase consumption via increased wages to workers. Assuming a marginal propensity to consume of 70%, just wages in the terminal year of the project can generate additional demand for goods and services in future worth INR52.8 billion (US$834 million). ERRs are expected to be higher given the beneficial effects on direct and indirect employment, creation of 'missing middle' opportunities and improving options for accessing health and education through IT enabled services (expected to be a large share of funded early stage ventures) and higher tax payments.

14. Regional inequalities are related to spatial immobility of capital and therefore returns to it would be higher in less wealthy districts provided viable firms in these regions have access to it. This project, through its emphasis on low income states, helps address the constraint of inter-regional capital mobility. Size is a significant predictor of the probability of being credit constrained. By addressing turnover growth and scale through access to finance, firms improve their own chances of survival and future performance contributing to a positive, healthier ecosystem and better asset performance by lending institutions.

15. Other second order effects include improved competitiveness of manufacturing from promoting energy audits and investments for energy efficiency, incentives through green ratings and several other initiatives (funded by parallel TA interventions). This is a priority for India as well as a key area of sensitivity for the project where larger improvements can have a marked impact on IRRs[83]. Project design would lower social costs through responsible and sustainable manufacturing that is by embedding energy efficient practices in manufacturing processes. Overall, the project would yield economic benefits through spurring transformation.

16. Qualitative benefits of the project also include supporting inclusion by moving down the pyramid by funding smaller sized firms with lower average loan sizes. As demonstrated in the literature, funding smaller sized firms, typically more dynamic and innovative, contribute to a positive economic ecosystem. Despite their high failure rate, some grow to become large, successful companies often deploying 'disruptive technologies' or innovative business models. With new successful firms replacing incumbents, it supports structural changes in an economy, leads to productivity gains and adds to resilience by diversifying the domestic economy.[84]

[83] An additional 5% increase in value add can increase manufacturing IRR from 26% to 45%

[84] World Bank's Report, Finance for All: "*If entry, growth, innovation, equilibrium size, and risk reduction are all helped by access to and use of finance, it is almost inescapable that aggregate economic performance will also be improved*".

Public Rationale

17. There is strong rationale for public provision in deepening access to finance for MSMEs due to lack of private provision, and due to the presence of positive externalities.

18. The proposed project supports enhancing the capacity of SIDBI and supports its transition to new focus areas, including creating markets for new financial products and services for first generation entrepreneurs and new models for service sector financing. Credit market constraints in these segments make SIDBIs 'market making' role essential and critical to address the access to finance problems at source which are described section III-A, *i.e.* risk averse supply side given the limitations of credit quality of MSMEs more so if evaluated using conventional, traditional methodologies.

19. Public funding of this intervention through a credit line and parallel TA contributes to the provision of public goods for the financial sector. The project is expected to confer capacity to SIDBI and participating institutions to lend to emerging areas, encourage use of innovative channels of knowledge and risk sharing to address issues around information asymmetry and credit risk by leveraging information from multiple sources (eg. angel investor networks for early stage debt financing, or franchisers for service sector financing, and credit bureaus) and enable 'crowding in' the market by demonstrating the ability to sustainably lend to these segments based on commercial principles (ie. returns have risks priced in). Importantly, given that MSMEs also generate societal benefits such as employment, innovation and foster entrepreneurial activity, it is likely that the private provision of debt to MSMEs is below societal optimal levels. The rationale for public provision/financing is strengthened on this ground.

Bank Value Added

20. World Bank Group's support would lead to increase impact in ways that go beyond what can be realized by alternative sources of support. Added value is derived through i) technical inputs drawing from international experience where relevant ii) innovation in design of instruments or financing models. As described in paragraph 67 of section III-A, the WBG has broad and deep international experience on credit lines throughout the world (for instance from projects in Morocco, Egypt and Lebanon which have dealt with early stage financing) in addition to its experience in India. It has played a leading role in the development of the MSME and microfinance sectors in India. It is also a key player in the area of access to finance and MSME finance, having provided support to many countries on improving MSMEs access to finance and developing innovative financial instruments.

21. In addition, WBG intervention will provide i) support through building institutional capacity during implementation, including training ii) risk management. It will support sustained focus on, and reduce chances of drift from, the development new business/market segments within SIDBI.

22. Further WBG knowledge and experience sharing through leveraging its convening power, from sourcing global knowledge from external industry and think tanks as needed is invaluable.

23. As the model demonstrates, it is such 'additionality' that can potentially translate into robust IRRs for MSMEs relative to the counterfactual (where access to such resources is absent).

Annex 9: Gender, Women Entrepreneurship and MSMEs
INDIA: *MSME Growth Innovation and Inclusive Finance Project*

1. Women comprise 20.5 percent of the labor force and 13.7 percent of entrepreneurs in the registered MSME sector (4th MSME Census). Although considered to be pro-poor and inclusive, women's employment and entrepreneurship in the MSME sector is less than a fifth of the total. Approximately 78 percent of women enterprises belong to the services sector and the vast majority of women entrepreneurs are micro-enterprises that operate in informal sector; thus, women entrepreneurship is largely skewed towards smaller sized firms.

2. **Under-capitalized**. Women entrepreneurs are underfinanced and underserved (business training, knowledge, networks etc.). Access to formal/external finance and business networking is the biggest barrier to growth and development for women-owned MSMEs, as per the Global Entreprenuership and Development Institute's index for 2014.[85] Around 73 percent of the total demand for finance among women owned businesses in India remains unmet (IFC, 2014). Access to finance is the biggest barrier to growth and development for women-owned MSMEs. Therefore, women–owned MSMEs rely heavily on informal sources of finance for seed capital and working capital requirements. Though several financial institutions have taken measures to finance MSMEs, support to women–owned MSMEs remains small, though improving slowly. General lack of awareness and sensitivity in understanding the unique needs of women–owned enterprises, and lower confidence in their entrepreneurial ability have contributed to significant gaps in demand and supply for credit. Lack of property rights reduces women's access to finance and increases their dependence on male family members. Women also face inordinate delays in accessing credit and often have to rely on men to access finance. Additionally access to finance is also affected by unequal access to networks and skills in relationship management.

3. **Under-served**. From a demand–side perspective, women lack knowledge about available finance options, advantages and disadvantages, costs of various options, and benefits of borrowing, etc. This lack of knowledge generates reluctance to access finance from formal channels. Women entrepreneurs also tend to have less experience with banking institutions and may feel reluctant to approach a bank. Only a limited number of public and private sector banks offer customized products for women-owned enterprises, though uptake remains poor due to weak promotion and outreach. There is, however, considerable scope for financial institutions to reach out to a significant market opportunity of women-owned enterprises in India.

4. **SIDBI's experience**. SIDBI has substantial institutional experience in implementing strategies to enhance women's access, to finance, in particular, in in the areas of microfinance, financial services and micro-entreprenership. Under the World Bank-supported 'Scaling up Sustainable and Responsible Micro finance', more than 95 percent of the beneficiaries are women borrowers. This project aims at scaling up access to sustainable micro finance services, including to clients in the underserved areas of the country through, among other things, the introduction of innovative financial products and fostering transparency and responsible finance. The DFID-supported Poorest States Inclusive Growth (PSIG) Program aims to improve access of poor men and women to a variety of financial services in the low income states of Bihar, Odisha, Madhya Pradesh and Uttar Pradesh. SIDBI is also working with KfW for improving access to microfinance products in India among the poor, particularly women. SIDBI is also implementing a project on 'Supporting Micro-entrepreneurship for Women's Empowerment' with ADB support. The key activities taken up are: training of women in financial literacy and enterprise

[85]. India ranks in the bottom 5 of 30 countries surveyed for conditions that foster 'high potential' women entrepreneurship.

management. In addition, personnel of intermediaries like regional rural banks, NBFCs, microfinance institutions, etc. are trained in enterprise financing and gender sensitization for the benefit of enhanced credit flows to the 'missing middle' segment with emphasis on women entrepreneurs in Madhya Pradesh, Maharashtra, Odisha, Rajasthan and Uttar Pradesh. SIDBI has also been up-scaling and widening its outreach and assistance to underserved areas, e.g. North-Eastern region, Rajasthan, Uttar Pradesh, Madhya Pradesh, Uttarakhand, Bihar, West Bengal, Jharkhand, Odisha, and Chhattisgarh etc.

5. At present SIDBI does not have any specific scheme targeting women entrepreneurs as part of their direct financing to MSMEs. SIDBI recognizes that it needs to improve its support for formal sector, women led/managed MSMEs through direct financing, and greater institutional focus and customized interventions are required in this regard.

6. **Key Gender Actions**. The MSME Growth Innovation and Inclusive Finance Project will support MSME firms as primary beneficiaries, including women-owned/managed firms and entrepreneurs. SIDBI will leverage its institutional experience on gender and support specific initiatives that would be implemented under the project and through the parallel TA:

   i) **Targeting women-led/owned/managed MSMEs**. Under the project SIDBI will identify and target MSMEs with women as proprietors, partners or board members. The results framework includes a target of 400 such firms.[86]

   ii) **Customized scheme for women entrepreneurs with price/other incentives**. Under the project, SIDBI will design, pilot and rollout two schemes specifically designed for women entrepreneurs. These schemes will prioritize and target MSMEs with women representing at least 40 percent of partners/directors. Under these schemes, SIDBI would offer a positive price differential of 25-100 basis points and possible other benefits.[87]

   iii) **Gender tracking indicators.** SIDBI would track and report key gender indicators under the project. These indicators are: (a) number of women owned/managed firms supported under the credit line; (b) number of schemes introduced for women. In addition, SIDBI will seek to capture data on the gender of the proprietor/directors of funded MSMEs in its internal credit formats.

7. In addition, through the parallel TA it is proposed to support an information and communication program for women entrepreneurs. With TA support, SIDBI will implement an outreach and communication program that specifically reaches out to women entrepreneurs, their networks, PFIs, cluster associations and other relevant stakeholders. The program could also support SIDBI raise its institutional profile as a growing financer and promoter of women entrepreneurship in the country. Under the TA, consultants/firms would be engaged to assess communication needs of women entrepreneurs and design and implement a tailored communication program (content/messages, media products and delivery formats) that would also support the roll out of the gender specific schemes that are rolled out. The TA will also seek to support awareness, knowledge and capacity building of women entrepreneurship and working conditions. With TA support, awareness building, knowledge dissemination and training programs would be undertaken on promoting women entrepreneurship and, other gender and social issues relevant to MSME clusters, including women's health and safety. It is anticipated, depending on the type of awareness, knowledge and capacity building that is needed, the recipient of capacity building could include: (a) SIDBI's officers in various departments; (b) PFIs/cluster associations; and (c) women entrepreneurs and their networks. If needed, TA support could

[86] Of the 1,650 firms targeted under the project.
[87] SIDBI would still earn a net margin on such products, but this would be lower than for other products.

be provided to update SIDBI's existing training and communication modules. The TA could also support knowledge and learning activities on, promoting and supporting women entrepreneurs and adoption of gender–informed products and procedures in the MSME ecosystem. The activities could include national/international case studies, learning visits, workshops, consultations, depending on applicability and need. The TA could also explore leveraging existing training programs and offering them to women entrepreneurs supported under the project through training providers such as IFC's franchisees for its Business Edge program, the Indian School of Business, the Entrepreneurship Development Institute of India, the Indian Institutes of Management, National Institute of Entrepreneurship and Small Business Development, etc. Opportunities for supporting SIDBI to develop an annual workshop and awards on female entrepreneurship could also be explored. SIDBI also indicated that it could explore initiatives to incentivize staff to promote female entrepreneurs.

8. **Implementation, Monitoring and Reporting**. SIDBI has appointed a gender focal point in the PIU to coordinate activities, under the project. Expert/resource persons on promoting female entrepreneurship are proposed to be engaged under the TA, as necessary. The baseline, mid-term and end-term surveys will track and report on the project impact on entrepreneurs, including women. With support under the TA, a thematic study on women entrepreneurs could possibly be undertaken as well as stocktaking of key gender indicators and impacts as part of the Mid-Term Review.