Project Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 16-Sep-2020 | Report No: PIDA29589

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Lao People's Democratic Republic	P174169	Micro, Small, and Medium Enterprise Access to Finance Emergency Support and Recovery Project	
Region	**Estimated Appraisal Date**	**Estimated Board Date**	**Practice Area (Lead)**
EAST ASIA AND PACIFIC	14-Sep-2020	30-Sep-2020	Finance, Competitiveness and Innovation
Financing Instrument	**Borrower(s)**	**Implementing Agency**	
Investment Project Financing	Lao People's Democratic Republic	Lao People's Democratic Republic	

Proposed Development Objective(s)

The project aims to enhance access to finance for MSMEs in the context of the COVID-19 emergency and recovery

Components

Component 1: Emergency and Recovery Line of Credit to MSMEs
Component 2: Establishment of a Partial Credit Guarantee facility
Component 3: Technical Assistance and Project Management

The processing of this project is applying the policy requirements exceptions for situations of urgent need of assistance or capacity constraints that are outlined in OP 10.00, paragraph 12.
Yes

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Project Cost	40.00
Total Financing	40.00
of which IBRD/IDA	40.00
Financing Gap	0.00

DETAILS

World Bank Group Financing

International Development Association (IDA)	40.00
IDA Credit	40.00

Environmental and Social Risk Classification

Substantial

Decision

The review did authorize the team to appraise and negotiate

Other Decision (as needed)

B. Introduction and Context

Country Context

1. Lao PDR is a land-locked lower-middle-income country that shares borders with countries affected with outbreaks of COVID-19, such as Thailand, Vietnam, Cambodia, Myanmar and especially China. The majority of its population of 7.1 million live in rural and remote areas with challenges in communications, transport, and service provision. Lao PDR's gross domestic product (GDP) grew over 7 percent per year over the past decade but experienced a historical low of 5.7 percent in 2019, owing mainly to natural disasters (floods, droughts, a caterpillar infestation) which mainly affected the agricultural sector. Economic growth has been heavily concentrated in urban areas while in rural areas and among ethnic minorities, high levels of poverty and inequality prevail. According to the latest survey results, 18.3 percent of the total population are living below poverty.

2. The pandemic affected mostly labor-intensive sectors and those linked to global and regional value chains, with growth is estimated to decline to between -1.8 and 1 percent in 2020. Tourism-related sectors, including transport, food and accommodation services and retail trade – and which account for 11 percent of total employment – have been hit particularly hard. Supply chain disruptions have caused delays in delivering inputs to export-oriented industries and the construction sector. Economic disruptions to business activity also arise due to a significant depreciation of the exchange rate in the parallel market and a higher inflation rate, which has increased in recent months from an average of 3.3 percent in 2019 to 6 percent in the first half of 2020. Most Lao businesses are small and medium-sized enterprises, which are especially vulnerable to these economic disruptions. Given that the COVID-19 outbreak has negatively affected the growth prospects of Lao PDR's most important trading partners, this is having an adverse consequence on Lao PDR's export performance. A prolonged, severe and pervasive outbreak will also have

a significant adverse impact on the agriculture, manufacturing and the service sectors through trade and investment channels, with a high risk of damage to financial markets. COVID-19 also eroded some earlier gains on poverty reduction.

3. The impact of COVID-19 has worsened the long-standing structural vulnerabilities of Lao PDR, stemming from a growth model reliant on debt-funded, large infrastructure investments with generous tax concessions, unfavorable trading arrangements and limited forex earning capacity. The fiscal deficit is projected to increase to 7.5-8.8 percent of GDP, from 5.1 percent of GDP in 2019. Debt levels are expected to increase to 65-68 percent of GDP, from 59 percent of GDP in 2019. With rising external debt service payments (approximately US$ 1.2 billion in 2020) and low forex reserves (just under one month of import cover expected in 2020), Lao PDR has insufficient buffers to absorb shocks. The parallel foreign exchange market premium is higher than historical norms at close to 10 percent. GOL issued an international sovereign bond in December 2019, an indication that traditional sources of financing may no longer be available. According to the IMF, this would result in a total financing gap for 2020 estimated at US$ 1 billion, which comprises of a balance of payments gap of US$ 800 million and a fiscal gap of US$ 200 million. The health of the banking sector remains fragile, with the non-performing loans significantly higher than the East Asia average. The extent of macroeconomic effects of COVID-19 will depend on the duration, pervasiveness and severity of the outbreak. Consequently, the ability of GOL to mitigate the impact of COVID-19 is limited with policy space to support households and SMEs highly constrained.

Sectoral and Institutional Context

4. **Micro, Small and Medium Enterprises (MSMEs) play an important role in the Lao economy, accounting for around 99 percent of registered firms, and the bulk of the informal economy, estimated to account for 30 percent of the economy.** The contribution of MSMEs to GDP, estimated at under 20 percent, however, lagging that of SMEs in Thailand (40 percent), or Malaysia (32 percent). Most MSMEs are micro enterprises with fewer than 5 employees. Reinforcing the importance of MSMEs in the country, the 2013 Economic Census conducted by the Lao Statistics Bureau found that MSMEs accounted for 82 percent of total employment. MSMEs are therefore critically important for the livelihoods of the Lao people, and improving the performance and prospects of the sector will be critical to minimizing socio-economic disruptions.

5. **MSMEs have been greatly impacted by economic disruptions resulting from the ongoing COVID-19 crisis**. MSMEs face a sharp reduction in demand and income, as well as disruptions in supply chains, while future investments to ensure social distancing at the work place will put additional strain on company finances. Tourism has basically come to a standstill in the second quarter of 2020, while a lockdown in April and May limited demand for other services and brought production in many firms to a standstill. According to a survey by the Lao National Chamber Lao National Chamber of Commerce and Industry (LNCCI) in May 2020[1] a significant percentage of firms expect to suffer large decreases in revenue, with 50 percent of firms seeing a more than 80 percent chance to permanently cease operations. Across the board, firms expect to lay off a large percentage of their workforce-see Figure 1. Among the hardest hit sectors are ‘accommodation and food service’, entertainment and recreation, and the education

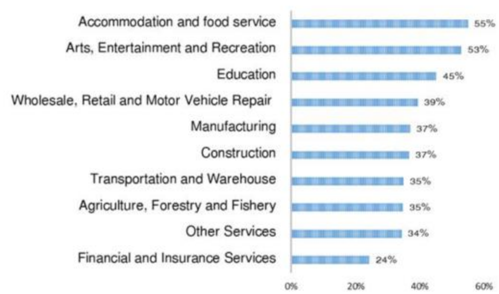
[1] Data was collected via online survey embedded on LNCCI’s website. LNCCI attracted survey respondents through its networks of provincial chambers of commerce and industry, business associations, in conjunction with deploying advertisements on Lao LNCCI’s website and Facebook page, newspapers and various online channels. The timeframe for data gathering was from April 6, 2020 to April 27, 2020, which attracted a total amount of respondents of 474.

sector. In contrast, less than half of respondents from 'Financial and Insurance Services' industry' expect a business failure.

6. **Government has undertaken actions to support firms but its ability to do so has been severely limited by pre-existing fiscal challenges.** As a result, the primary government intervention has aimed at making it easier for the banking sector to extend loans and reduce interest payments. However, such support from commercial banks will need to be carefully managed to avoid exacerbating pre-existing financial sector vulnerabilities over the medium-term.

Figure 1: LNCCI survey on Impact of COVID-19 on Firms (estimate revenue loss-LHS, and Expected Job Loss-RHS)

Sector	Revenue/Estimated Revenue for 2019 (in millions of USD)	Estimated Revenue for one Quarter in 2019 (in millions of USD)	Estimated Impact on Q1 2020 (estimated % decrease compared with Q1 2019)	Impact on Revenue for Q1 2020 (in millions of USD)
Agriculture, Forestry and Fishery	2,856.21	714.05	41%	292.76
Wholesale, Retail and Motor Repair	2,232.32	558.08	51%	284.62
Manufacturing	1,421.40	355.35	52%	184.78
Construction	1,534.06	383.52	43%	164.91
Tourism	934.71	233.67	56%	129.69
Financial and Insurance Services	603.44	150.86	46%	69.40
Education	432.56	108.14	30%	32.44
Other Services	307.53	76.88	26%	19.99
Total Estimated Impact on Business Revenue for Q1 2020				**1,178.59***



7. **Even prior to the COVID-19 crisis, access to finance stood out as one of the top three prominent obstacles facing MSMEs according to 2018 Enterprise Survey.** Comparing Enterprise Survey data over time indicates that access to finance has become a more prominent issue for firms over the past two years, and this trend has been broad-based across different firm sizes and sectors. It was most frequently cited as the biggest constraint facing registered MSME firms in the 2018 Enterprise Survey, with 36 percent of firms reporting it as such compared to only 6 percent in 2016. In line with this, access to finance was the second most cited serious obstacle facing businesses, with around 18 percent of firms reporting it to be so. Using the Doing Business Getting Credit score as a benchmark, Lao PDR's credit environment was less favorable than those of Cambodia, Vietnam, Malaysia, Thailand and Indonesia. According to the 2020 Dong Business report, only 19.8 percent of adults are covered by the public credit registry, lower than the EAP average of 16.9 percent. There is no private credit bureau coverage (% of adults), however in December 2019 the Bank of Lao launched an initiative to significantly upgrade the public credit information system by establishing the Credit Information Corporation as a state-owned entity and increasing its coverage and depth of credit information by including information from insurance, utilities and telecommunication companies[2]. The Government adopted a new insolvency law in 2019, which benefitted from World Bank support, but has yet to draft implementing regulations[3]. Since 2015, Lao has had a modern, unified, notice-based collateral registry.

8. **The financial sector is critical to help mitigate the economic impact of the devastating consequences of the COVID-19 pandemic by providing the most extensive and capillary network to**

[2] The improvements to the credit information system benefitted from IFC support through the Doing Business reform initiative.
[3] IFC, with World Bank financial support, is supporting GoL in the design and adoption of secondary regulations of the enterprise insolvency regime, specifically regarding the selection, supervision and remuneration of insolvency administrators, which is a new concept in Lao, introduced by the 2020 Enterprise Bankruptcy Law.

channel financial flows to the real economy. Several regulatory and supervisory measures have been taken by many countries across different regions to facilitate banks' counter-cyclical role while avoiding financial instability. Like many regional countries, the Government of Lao policy responses for the financial sector have included easing of reserve requirements and reducing policy interest rates (see Table 1). In addition, through Bank of Lao (BOL) Decision No. 238, BOL also adopted other extraordinary measures aimed at facilitating banks' counter-cyclical role, through regulatory forbearance comprising credit moratorium on principal and interest rate payments and flexibility in classification of problem loans. The Decision encourages banks to provide new working capital loans to firms, even those with delinquent loans prior to the onset of the crisis. BOL has also authorized reclassification of loans (including NPLs) with corresponding reductions in loan provisioning, which could pose a serious risk for banking systems.

9. **In response to COVID-19 crisis**, **Government is scaling up programs to stimulate access to finance for MSMEs.** The government's Small and Medium Enterprises (SMEs) Promotion Fund (SME PF) has injected 100 billion kip in financing for SMEs via commercial banks in the form of long-term low-interest loans (currently 3%). The fund focuses on productive enterprises in rural areas. The financing will be provided to the SMEs via four commercial banks. Targeted sectors include: (i) Farming and livestock; (ii) Agriculture processing (iii) Handicrafts; and (iv) Tourism. The Government announced plans to increase funding for the SME PF to 200 billion kip a year and also to finance technical assistance projects to help SMEs gain access to finance. BOL has also signed a US$300 million loan agreement with China to promote SME access to finance, which has yet to disburse due to restrictive conditions of the loan. BOL is reportedly engaged in renegotiating these terms with China Development Bank. Due to delays in rolling out the China SME facility, and in response to the COVID-19 crisis, BOL also announced a new SME loan program funded by BOL which aims to offer low interest rates to MSMEs.

10. **Government is keen to pursue additional programs to support the ability of MSMEs to survive and recover from COVID-19**. Interventions need to address banks' risk-averseness to lend to MSMEs given that economic disruptions have reduced cash flows, account for economic uncertainty and its impact on MSME performance, and avoid increasing financial sector vulnerabilities that could contribute to a crisis. A well-designed line of credit and credit guarantee facility could achieve government's objectives to preserve MSMEs while upholding commitment to financial stability. Leveraging the existing SME A2F project offers an opportunity to build on a well-performing project to deliver relevant support to MSMEs while ensuring that banks are able to charge a sustainable interest rate and have access to a partial credit guarantee facility.

C. Proposed Development Objective(s)

Development Objective(s) (From PAD)

The project aims to enhance access to finance for MSMEs in the context of the COVID-19 emergency and recovery

Key Results

The key results expected for the project will be measured by following PDO indicators:

(a) Volume of sub-loans disbursed to MSMEs under the project (direct project beneficiaries, of which female)

(b) Share of MSMEs benefitting from line of credit that survive COVID-19 crisis
(c) Number of MSMEs benefitting from TA that obtain credit for first time (Number)

D. Project Description

11. The project will achieve the PDO through a combination of lines of credit to MSMEs (for emergency and recovery phases of the crisis), intermediated through select eligible financial institutions, and technical assitance to support the establishment of a Partial Credit Guarantee (PCG) facility to backstop bank lending to MSMEs. The project will also invest in strengthening the capacity of financial institutions to implement crisis management strategies and develop MSME finance business strategies, technical assistance to support MSMEs obtain access to finance, and capacity building to DOSMEP to strengthen its ability to formulate and implement policies to promote MSME development. While the project is focusing on emergency response to the crisis, it will also have a longer-term impact on the economic recovery by providing a flexible approach to addressing financial needs of the MSMEs during the crisis and in the recovery phase.

12. The project will adopt a flexible pricing approach to the lines of credit in order to respond the crisis and recovery. Under normal market circumstances, the Bank policy for financial intermediation (as per the Bank Policy and Bank Directive: Investment Project Financing (formerly OP/BP 10)) is to avoid interest rate and other subsidies. However, World Bank has used a more flexible approach to the normal strict commercial approach to credit lines after natural disasters, so this is appropriate for countries and financial sector markets facing pandemics. The objective is to help to preserve financial institutions, markets, and businesses during the emergency stage – and return when possible to normal market-driven commercial approaches to financial intermediation. The pricing strategy will conform with the following principles: 1) World Bank will coordinate with IFC on the overall design to ensure that each insitution’s interventions are complementary and help maximize the development impact of the World Bank Group; 2) commercial banks must be able to charge a sustainable interest rate, which covers cost of funds, administrative cost, risk, and profit; 3) any subsidies will benefit MSMEs; 4) design will aim to ensure that any divergence from market pricing is temporary and transparent with a clear path back to the market. The credit decisions and pricing for the MSME loans are left to PFIs, based on their own credit assessment.The proposed project consists of four main components:

Component 1: Emergency and Recovery Line of Credit to MSMEs (US$34 million)

13. This component will provide lines of credit to eligible PFIs, which will onlend funds to MSMEs and bear the credit risk. Department of SME Promotion (DOSMEP) will serve as the apex entity, as it has done under the original SME Access to Finance project where it has developed the requisite experience to manage and monitor loan funds prudently and to allocate them in line with agreed selection criteria. BOL, which is represented on the project Steering Committee, will provide support as needed, particulaly related to monitoring of PFIs financial performance.

14. The project will offer two windows: i) emergency; and ii) recovery, with separate pricing arrangements for each. The emergency window aims to address MSMEs liquidity challenges and will strive to offer below market interest rates to final borrowers during the emergency phase. The project will achieve this by extending financing to DOSMEP for onlending to PFIs at the cost of IDA financing or lower, with

the expectation that lower cost of funds will be passed on to MSMEs in the form of below market interest rate. To enforce this (without establishing an interest rate cap), DOSMEP will review proposed loan terms by PFIs and compare against each PFIs overall average interest rate on market sourced funds[4]. Participating Financial Institutions (PFIs), which meet eligbility criteria, will submit proposals to DOSMEP/World Bank that include target interest rates to MSMEs, cost of funds and average interest rates/terms offered under market conditions. DOSMEP will evaluate the proposals against selection criteria to ensure proposed pricing approach complies with the requirement that the low cost of funds is passed on to the borrower. Funds will be disbursed on a back-to-back basis[5], with other disbursement approaches included fixed term and advances available on an exceptional basis (see Annex I for further details), with subsequent funding dependent on performance in previous round in terms of compliance to criteria. Final details will be included in the Project Operations Manual. The Project Steering Committee, which includes MOIC, MOF and BOL, will assess through its semi-annual meetings when to close the emergency window based on agreed upon criteria related to economic and financial sector performance. The second window for the recovery phase will function similar to current project with funds onlent to PFIs at market or near market rates based on analysis of market conditions, and PFIs will determine interest rates to final borrowers according to market principles. In this manner, the project builds in a path back to market rates, consistent with best practice for WB financial intermediary financing.

Component 2: Establishment of a Partial Credit Guarantee facility (US$1.0 million)

15. The project will provide technical assistance to Bank of Lao to support its efforts to establish a PCG to support continued access to finance for MSMEs by reducing credit risk for participating financial institutions, thereby addressing current issues of risk aversion. The technical assistance will draw on “Principles for Public Credit Guarantee Schemes for SMEs”, tailored to the Lao context. The report outlines 16 key principles in the areas of legal and regulatory environment, corporate governance and risk management, operational framework and monitoring and evaluation. The institutional set-up of the new facility, whether public or public-private partnership, will be determined by the Government during project implementation, and will be informed by recommendations of the feasibility study, which will be financed under current SME A2F project.

16. The following activities will be supported amongst others: i) design the component of the World Bank project (conduct a market scoping study); (ii) preparation and development of a business plan and financial model, including governance arrangements; iii) preparation of operational policies and procedures for the PCG. The business plan will set out key parameters of the PCG to ensure its long term sustainability.

Component 3: Technical Assistance and Project Management (US$5 million)

17. This component will provide technical assistance (TA) to strengthen capacity of commercial banks, SMEs, DOSMEP, as well as project implementation and monitoring and evaluation, including of the Ministry of Industry and Commerce (MOIC). Given the emergency nature of the project, the technical assistance component will have a narrow focus on supporting implementation of components one and

[4] Market sourced funds generally mean customer deposits, and exclude government directed credit initiatives which are sourced by government and impose interest rate caps.
[5] Financing or refinancing of an eligible sub-loan portfolio which has been initially approved by the PFI’s credit committee.

two, building off previous TA and allow for a minimal amount of new technical assistance to support DOSMEP policies and programs. The main areas of technical assistance include the following:

- **TA to Participating Financial Institutions** - The technical assistance to commercial banks program, launched under the SME A2F project, will be continued and expanded to additional banks and aim to promote changes in banks' business models and capacity to better serve MSMEs. The TA will incorporate lessons learned from existing TA including the need to obtain senior management commitment and to provide longer term support to PFIs to ensure transfer of knowledge. The TA will be offered to additional banks (the current project only supported 4 banks). The TA will go beyond strategy development and focus on actions (i.e implementation), including the following:
  - Portfolio management and re-structuring (recovery phase)
  - Establishing overall Risk Management policy and procedure and accountability at all levels (eg, governance, independent internal audit etc)
  - Developing Business Continuity Plans - a critical missing piece in all PFIs - to meet future shocks such as COVID-19
- **TA to MSMEs** – Building on the successful activity carried out under SME A2F, the new project will leverage BDS providers trained under initial project (11 total) and contract several to provide tailored technical assistance to MSMEs designed to facilitate access to finance. The assistance will not overlap or crowd out other support that is already being provided by other donor institutions to MSMEs.
- **TA to DOSMEP** – will support strengthening DOSMEP capabilities to formulate and implement an updated SME development strategy and to implement and monitor the project including ensuring compliance with World Bank's social and environmental operational policies and PCG's operating cost and performance standards. The design and scope of this component will be kept flexible so as to cover the needs as they arise.
- **Monitoring and Evaluation**: The project will enhance the existing M&E framework by conducting WB COVID-19 Business Pulse Surveys, which is a rapid survey to collect high frequency data from enterprises to better understand the impact of the COVID-19 pandemic on businesses across countries, with a particular focus on MSMEs. The results of the survey will be used to inform government responses aiming to support businesses during the crisis, as well as tracking the recovery process.

Component 4: CERC

18. In the event of an Eligible Crisis or Emergency, the project will contribute to providing immediate and effective response to said crisis or emergency. The allocation to this component is to minimize time spent on a reallocation of funds from programmed activities. The unused amount can be reallocated to other components if the CERC component is not triggered a year prior to project closing.

Legal Operational Policies

	Triggered?
Projects on International Waterways OP 7.50	No

Projects in Disputed Areas OP 7.60	No

Summary of Assessment of Environmental and Social Risks and Impacts

19. The project is a financial Intermediary project and ESS9 is triggered. The Project will provide financing to eligible MSMEs through Participating Financial Intermediaries (PFIs). The potential negative impacts are likely to be minor, localized, and reversible and can be mitigated with simple measures and environmental good practice. High and substantial risk type of subprojects are not foreseen because of the type of activities and threshold limit of sub-loan (200,000 USD). The average loan size under the existing project is USD 83,000. No significant environmental and social impact sub-projects will be financed under this project. However, due diligence of the current activities will be conducted to ensure no significant environmental and social impacts from the sub-projects will occur.

20. The environmental risk and social rating of the project is Substantial, given the nature and magnitude of the potential environmental and social risks and impacts associated with the proposed sub-projects with capacity on the safeguard of participating commercial Banks. The implementing agencies have demonstrated good performance in a similar current WB-funded project, where they have shown E&S capacity to implement low to medium risk small loans. Currently there are four safeguard staff under DOSMEP team and around 11 safeguard staff working with PFIs under the current SME A2F project (3 with SACOM, 3 with Lao Viet Bank and 5 with Lao-China Bank) of which sufficient to implement the ESF. New participating commercial banks will need to be assessed their capacity as per ESMS and follow ESCP and get approval from the Bank prior to project participation.

21. It is expected that this project will require special attention to monitor and enforce compliance in the application of ESS9 (Financial Intermediaries -FI) since this will be the first FI project supported in the country under the new ESF. Other relevant standards applying to this project from a social risk management perspective are ESS1 (Assessment and Management of Environmental and Social Risks and Impacts), ESS2 (Labor and Working Conditions), ESS 4 (Community Health and Safety), ESS7 (Indigenous Peoples) and ESS10 (Stakeholder Engagement and Information Disclosure). Land acquisition and resettlement will not be supported, and loans that would result in either will be comprised as part of the exclusion list included at the project's Environmental and Social Management System (ESMS).

E. Implementation

Institutional and Implementation Arrangements

1. **The Department of SME Promotion (DOSMEP) at the Ministry of Industry and Commerce (MOIC) will be the Executing Agency for the project; other agencies involved in project implementation include PFIs, and BOL.** DOSMEP already manages an existing Government line of credit program that is similar to the one proposed under the project and was the Implementation Agency for the Access to Finance Project. However, all fiduciary activities for this Project, were carried out by the National Implementation Unit (NIU) within the Department of Planning and Cooperation of the MoIC. Therefore, DOSMEP will engage appropriate fiduciary expertise to implement and monitor the project including international advisors on Project Management, PFI assessment, and project implementation, as well as safeguards and M&E experts. It has set up a Project Management Unit (PMU) headed by the Director General of DOSMEP,

as the Project Director. For its day to day operations, the PMU will hire a Project Manager and adequate staff, external consultants and other resources necessary for the successful implementation of the project. This arrangement will be reviewed by the Bank prior to Project Effectiveness.

2. As part of alignment with overall aid effective governance structure and ensures coherence and coordination across development assistance in the areas of trade and private sector development, the Project Executive Committee (PEC), chaired by the Minister of Industry and Commerce (or designee), will function as the Steering Committee for the project. The PEC will meet every 12 months but will review and endorse work plans for implementation of this project every 6 months following recommendation by the technical level Project Review Committee (PRC) for this project (approvals will be through email every 6 months). Other key stakeholders may be invited to participate in meetings of the PEC as observers

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APPROVAL

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