S3IDF

Banking Sector Engagement

The Small-Scale Sustainable Infrastructure Development Fund (S3IDF) is an international development organization that builds inclusive market systems to promote equitable economic and social development.

Challenge and Opportunity: Closing the Credit Gap

Micro-, small- and medium-scale enterprises (MSMEs) are key drivers of economic activity in developing and emerging market countries. However, a 2013 report by the International Finance Corporation (IFC) estimates that between 200 to 245 million formal and informal enterprises need but do not have loans or have loans but still encounter financing constraints.[1] This report also determined that over 90 percent of these unserved or underserved enterprises are formal micro enterprises or informal MSMEs and represent a financing gap between $2.1 to $2.6 trillion.[2]

Despite the opportunity that this financing gap offers to banks and other financial institutions, many banks have been hindered by longstanding imbedded operating models and practices as well as the additional challenges of effectively serving the MSME market. These MSME financing challenges stem largely from banks' cost of capital, specifically risk, loan management and administration expenses, and the cost of initial funds.

Risk**:** Risk assessments of MSMEs by banks often cite a series of risk factors, including lack of collateral, undocumented business track records, little or no formal credit histories, and information asymmetries surrounding business models, market demand for MSME products and services, and lack of familiarity with technologies integral to business operations. These MSME risks, in addition to other external risks such as currency fluctuations and political or regulatory uncertainties, negatively impact bank provision of commercial debt.

Loan Management and Administration Expenses: Loan management and administration costs, which include loan origination and management as well as general administration, tend to be high in developing countries, creating situations, in combination with other high costs of capital, in which the debt service from MSME loans can exceed cash flows.

Cost of Initial Funds**:** The cost of securing funds for its financing products and services and the terms placed on these funds impact interest rates, fees, etc. that banks set, potentially resulting in debt-service claims that exceed MSME cash flows.

1 International Finance Corporation (2013). Closing the credit gap for formal and informal micro, small, and medium enterprises. Retrieved from http://www.ifc.org/wps/wcm/connect/4d6e6400416896c09494b79e78015671/Closing+the+Credit+Gap+Report-FinalLatest.pdf?MOD=AJPERES
2 Ibid.

S3IDF Service Offerings

S3IDF works to address each of these three challenges to facilitate more MSME lending in both urban and rural areas of developing countries while enabling banks to attain an appropriately adjusted return. Bringing our on-the-ground enterprise development and support perspective to our bank engagements, S3IDF also assists banks with developing tailored financial products and services for currently unserved and underserved MSMEs. Specifically, S3IDF provides a range of services to:

Reduce Information Asymmetry

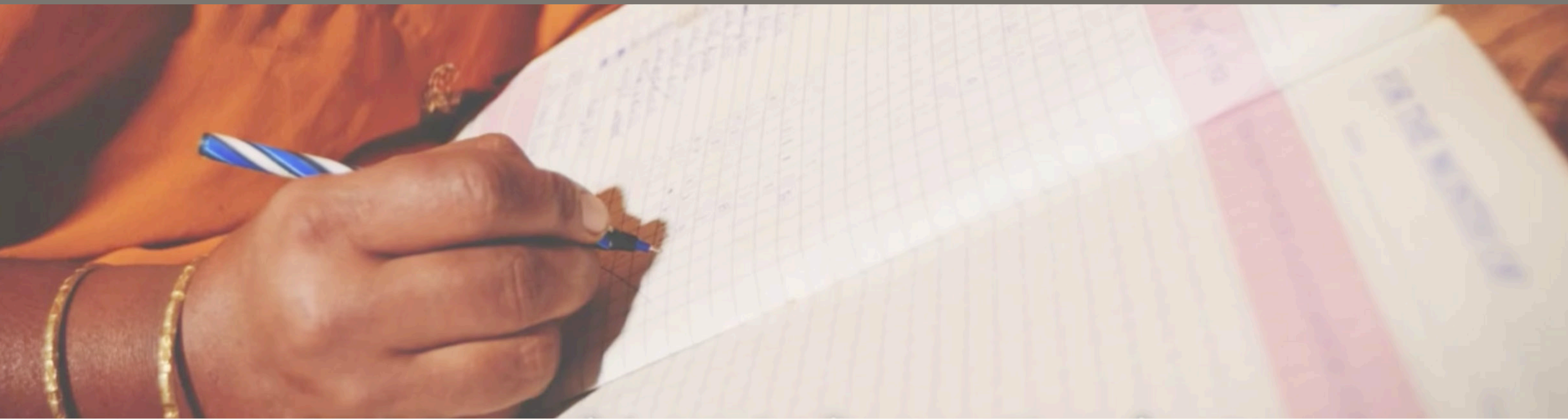
- Conduct in-depth MSME pre-assessments, including MSME business cash-flow analysis, quality of senior MSME management, etc. to facilitate banks' internal evaluations
- Perform market assessments to strengthen banks' understanding of the target consumer, competition, and needs for marketing of MSME products or services
- Offer technology-focused trainings for banks to ensure full understanding of critical MSME inputs and technical issues

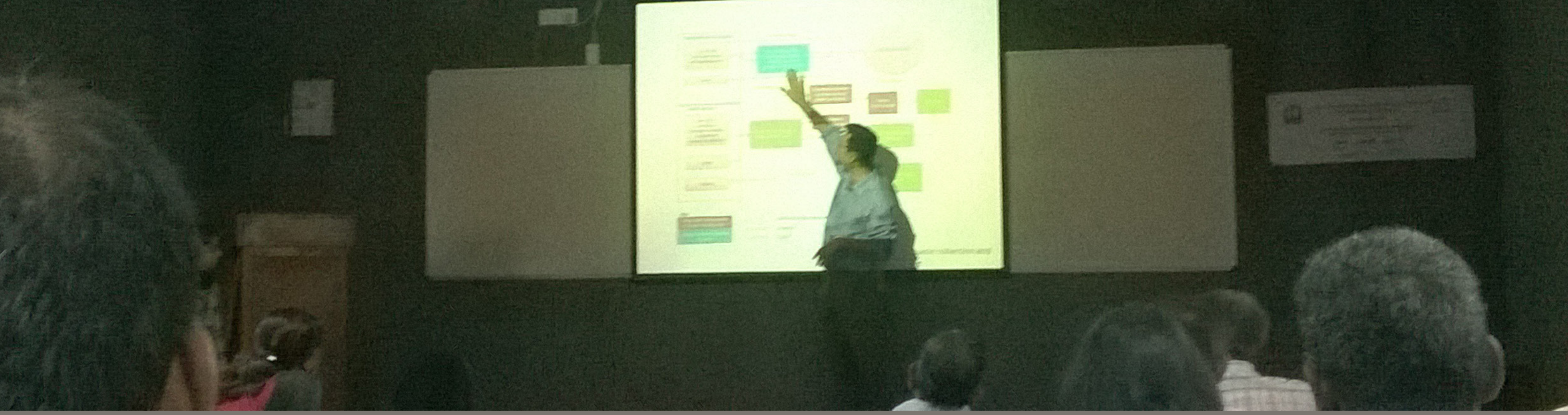
Mitigate Risk

- Provide partial loan guarantees or take first loss positions to protect banks from full exposure to downside risk
- Create financing structures to ensure that required debt-service claims align with MSME cash flows, often involving innovations on commercial financing structures
- Secure technology and equipment buy-back agreements with suppliers of movable assets, eliminating the need for banks to be involved in secondary market transactions in the event of loan defaults
- Provide post-loan MSME supervision and, if necessary, operational adjustments through on-going direct business development support and coordinate related MSME support to strengthen the supply chain

Lowering the Cost of Capital and Buying Down Transaction Costs

- Develop blended finance structures that combine grant funding and smart subsidies with concessional and market rate financing to lower the original costs of funds
- Facilitate loan repayment collection through partner channels or payment platforms when banks do not have an extensive geographic presence, addressing issues of high travel transaction costs relative to low revenue per MSME client





Selected Examples of S3IDF Banking Sector Engagements

Bank Financing Mobilization for S3IDF-Supported MSMEs

S3IDF has over a decade of on-the-ground experience developing, implementing, and managing a portfolio of small-scale infrastructure projects and enterprise investments in India. We have partnered with 12 banks and numerous bank branches to extend financing to these MSMEs by leveraging a blend of grant finance, commercial debt, local equity, and credit-conditioning instruments (for example, loan guarantees, technology buy-back agreements, etc.). S3IDF has assisted banks with entering the MSME financing market.

Design of a Bank-Hosted Revolving Fund for Microenterprise Financing

Through a contract with the Asian Development Bank (ADB) in Nepal to expand financing for small-scale enterprises using micro-hydropower systems for agro-processing and household electrification, S3IDF vetted a series of banks and selected the Clean Energy Development Bank to host a revolving fund to finance the technology through both direct debt and wholesale financing to microfinance and nonbank financing entities. S3IDF subsequently worked to develop investment criteria for pilot transactions, a menu of financing options, and the terms and conditions of financing as well as sources of seed capital.

Training Modules for Financial Institutions on Small-Scale Technology Financing; Capacity Building Workshop

S3IDF, under contract with USAID, created a training program framework to assist financial institutions as well as renewable energy service and technology enterprises. The training was designed to increase financing from local financial institutions to end-users and small enterprises in India. Additionally, we conducted a capacity building workshop for several dozen senior and mid-level banking sector professionals. The objectives of the training were to increase participants' familiarity with specific types of renewable energy technologies and improve understanding MSME business models and the implications for appropriately structured financing products.

Energy Access Facility for East Africa

For GVEP/International (now Energy4Impact), S3IDF designed a regional energy access fund that would target increasing modern energy access for MSMEs. We worked on alternative organizational models based on local conditions and funding sources and identified possible financial institution hosts in Uganda and Kenya for a revolving fund or analogous structure. In addition, S3IDF assessed the feasibility of various projects and conducted a review of regional commercial banks. Work included consultations with the IFC/World Bank.