UN Capital Development Fund

De-risking Lending to MSMEs in Bhutan

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Unlocking Public and Private Finance for the Poor

Taking Credit into the CSI space

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- In subsistence economies, initiatives to build livelihood systems and finance small producers often use grants
- Moral hazard issues and limited potential for scale-up are challenges in taking grant based financing to scale
- Structural transformation of economies and shift to market oriented production call for debt based financing
- Risks are encountered in the demand and supply side
- Financial institutions are being called in to work in spaces they had avoided due to risks & transaction costs
- Beneficiaries with limited financial literacy and assets called upon to use debt as an instrument

CSI and PSL in Bhutan

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- About 20,000 licensed and operational CSIs accounting for more than 90% of total industries in Bhutan
- Ease of access to credit from financial institutions a challenge for CSIs: geography, network & preparedness
- Credit risk seen as a key constraint for lending to CSIs by financial institutions - calls for collateral and guarantees

→ Priority Sector Lending (PSL): Directed lending initiative offered by RMA to improve access to CSIs

- PSL offered borrower insurance backed lending in place of addresses collateral & guarantor based credit

Managing Risk: two recent examples

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- Bangladesh: women led MSMEs faced severe supply side barriers to access concessional credit facility
- Key constraint was unwillingness of financial institutions to lend in cases of inadequate collateral or guarantee

→ Partial credit guarantee offered to partner financial institutions to finance women owned SMEs to scale up

- Nepal: milk producers couldn't secure working capital credit during long payment cycles
- Digitized history of quantity and quality of milk sold used to establish algorithm for payment strategy

→ Factoring services introduced whereby a bank stepped in to provide major part of payment due, in 24 hours

Stakeholders and Risk

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- Investments & innovations in livelihood improvement are often viable & impactful, but vulnerable to risks & shocks
- Poor households have severe impacts when new crops fail or bigger cows die; even when funded by grants
- Financing through debt adds to the burden in such cases
- Along with capital for debt financing, there is need to set up systems to share between stakeholders:
  - Promoters: Govt. & development partners
  - Lenders: Financial institutions
  - Borrowers: Households & CSI

Balanced Risk Sharing to promote CSIs

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- Operating in the market always comes with an element of risk for all stakeholders
- Overwhelming capacity constraints and information asymmetries made past case for grant financing
- The perspective of structural transformation and market maturity models offers the case for blended finance
- Probabilities of failures are more measurable now, and contribute to design of insurance products in Bhutan
- Instead of using grants to finance a few individual investments, development agencies could incentivize institutions to finance bankable CSIs by giving risk cover

Sharing the Risk

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- When borrowers take the complete risk, insurance offers some recourse to borrowers, and indirectly for lenders
- Subsidizing the insurance is seen as a simple step to mitigate risk, but vulnerable to moral hazard
- The alternative is to subsidize risk taken by the financial institutions to work with the higher risk target segments, and reduce adverse selection by these institutions
- Lenders usually have capacity to measure risks for classes of borrowers using evidence from lending experience
- Hence, additional risks related to CSIs with inadequate collateral could be supported by development partners and government who hitherto made investment grants

Fintech and Access to Finance for CSIs

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- Inadequate information often adds to perception of risk and thereby cost of capital
- Financial statements/ projections, stakeholders profiles, and collateral traditionally drove investment decisions
- FinTech offers lenders a dynamic framework for making credit decision by:
  - Leveraging related financial actions to rate the entity
  - Using transaction data beyond financial statements
  - Using blockchain data to define additional credit need
- FinTech allows borrowers explore multiple options
- FinTech depends heavily on the technology and institutional ecosystem, to enable such access to credit

THANK YOU

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