responsAbility

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Draft concept note for discussion purposes

THE COVID-19 MSME EMERGENCY LIQUIDITY FACILITY

I. Context

We currently are facing an unprecedented situation: A global health crisis where all countries at the same time must fight the same challenge: a pandemic which rapidly brings health systems to their limits and which currently can only be counterbalanced by extreme restrictions on social and economic activity. The preventive measures which are or will be implemented by all countries at this moment are a severe shock to the real economy due to the far-reaching lockdowns across many or all industries and all their trickle-down effects. In most countries the economically most effected part of those measures will be self-employed people, microenterprises as well as small and medium-sized enterprises ("MSME"). A backbone of most economies world-wide.

It is therefore not at all surprising that all developed countries are quickly coming up with very large support packages for employees but also all types of companies, including the MSME segment. Supportive funding must get out to those millions of small companies very fast to prevent a major, lasting disaster on the economies.

It is also not a surprise that currently each country is focused on its own situation. It is unprecedented and certainly the most severe challenge global community has been facing since World War II.

The problem is that there are many developing countries —currently still a few weeks later in the cycle— who have even much more limited health care capacity and who therefore also have to take drastic measures to prevent the worst. However, at the same time those countries will struggle much more to come up with meaningful direct support to all type of companies as they will depend in many cases on the international community (IMF, World Bank, etc) to counterbalance this extreme situation. Though there certainly will be support via different channels, it is under the current circumstances all a matter of volumes and timing. There currently is a relatively simple rule: more targeted financing volume and faster availability is better for the MSMEs, their families, the financial institutions ("FIs") and the local economies.

A very effective way to reach out to millions of MSMEs in a very short time period is to use the existing channels, the financial sector which has pre-established contacts with millions of MSMEs. These channels can and should be used now to get out emergency liquidity to MSME who are directly economically impacted by this crisis.

This crisis will hit MSMEs in developing countries even stronger than most entrepreneurs in any developed country as in most cases no safety net is around. Often these MSME already belong to the most vulnerable group of people before the crisis.

II. Key idea

Establishing an Emergency Liquidity Facility with the purpose to support MSME in developing countries who are directly affected by COVID-19 prevention measures with a highly effective and efficient one-time delivery mechanism.

The primary objective of the Facility is to financially support millions of MSME which face the risk to run out of business during country lockdowns. The ultimate objective of the Facility is to secure millions of jobs in these MSMEs, not even to speak about the impact on the related employees' families. Differently said, as COVID-19 has the potential to destroy millions of small companies and jobs, this Facility strives to preserve the development impact (particularly job creation) which the development finance industry has achieved in the past. In order to do that, the development finance industry needs to pragmatically collaborate to deliver a speedy reaction now.

The funding for this Facility would not be based on grants but on equity with the expectations to achieve capital preservation for Funders. The Facility builds on sustainable companies which just have been adversely affected by the COVID-19 crisis circumstances but do otherwise represent a reliable client base. As a one-time delivery mechanism, its design is all about (a) effective, targeted out-reach with (b) highest level of efficiency, (c) acceptable risk levels and (d) affordable for the targeted FIs.

III. Key facts

Objective	Secure Jobs and secure MSME businesses
Approach	Liquidity financing to MSME through well-known local FIs with a [80/20]% risk sharing between the Facility and the FIs
Size	USD 1bn (min USD 300m, max USD 3bn)
Inception	May 2020
Lifetime	4 years (MAY 2020 – MAY 2024)
Investment period	6 months (MAY 2020 – OCT 2020)
Geographical coverage	Global (approx. 50 developing countries & emerging markets)
Instrument	Senior loans
Currency	USD (all Facility loans will be in USD, loans from FIs to MSMEs will be in local currency)
Borrowers	FIs (with existing responsAbility or other MIV)
Loan tenor	12-40 months
Maximum loan exposure to a single FI	up to maximum 5% of the facility
End clients	MSMEs affected by COVID-19
Sub-loan tenors	12-36 months (potentially with grace period)
Sub-loan size	Max USD 50k
Return to Funders	Capital preservation
Management Fee	Cost coverage (approx. 0.5% p.a. in case of a USD 1bn Facility)

IV. Key operating principles

Focus on trusted well-known FIs: The Facility will only be partnering with existing counterparties, i.e. with FIs that have a current funding relationship with responsAbility, or any other eligible MIV. The FI must have been checked during an onsite Due Diligence visit by the Manager in the past, still needs to be in good standing now (i.e. not in default vis-à-vis the Manager) and must have solid recent annual financial statements.

a. How to be effective and efficient?

The Facility builds on existing relationships between FIs and MSMEs. In order to be eligible for the COVID-19 loan book, MSMEs must fulfil simple and clear criteria: their business must go out of operation due to a lockdown or it must be strongly affected due to lockdown. The offering to MSME must also be strictly standardized: Each MSME is eligible for one loan with an amount equivalent to 2 months of USD-revenues of that specific MSME (based on last credit approval data of the FI). The maximum loan amount is USD 50k. The loan must be paid back by the MSME to the FI over a period of a 12-36 months (with the FI's standard repayment schedule e.g. weekly, monthly repayment). Interest rates of all loans are in line with standard loans of the executing FI and must be pre-agreed with the Facility. No additional fees (as disbursement fees etc.) can be charged by the FI.

b. How to counterbalance moral hazard?

To counter-balance moral hazard a [80/20] risk-sharing rule will apply. As an example: A FI receives a USD 10m loan from the Facility in order to establish an explicitly ringfenced “COVID-19 loan book” worth USD 10m. The default risk of this USD 10m COVID-19 loan book will be split between the Facility (80%) and the FI (20%). Differently said, the 80% risk coverage serves like a funded guarantee for the FI and thus is a strong incentive to build up a reasonable sizable loan book. This has several very positive effects as the FI can issue USD 10m loans during these difficult times to good MSMEs without having to use their often scarce liquidity and without putting too much additional burden on capital requirements (as 80% of the risk on the USD 10m is covered by the Facility).

c. How to counterbalance adverse selection?

Loans can only be issued to MSMEs whose outstanding loan performance as of the local lockdown day was of very high quality (the last instalment overdue maximum 7 days before lockdown).

d. How to ensure that MSMEs only access one financing from the Facility?

responsAbility will provide a simple “COVID-19-loan-tracking tool” to the FIs. This tool is an adaptation of responsAbility’s existing “CO2-loan-tracking tool” used in our climate finance funds. All FIs must report all their sub-loans (MSME name, address, etc) of their COVID-19-loan book to the Manager via this reporting tool. This allows to daily verify and detect double bookings to a MSME.

e. How to avoid that the FIs misuse the funding?

As loans will be tracked individually, an external auditing process of the loan book in 2021 (donor financing for local audits and audits of the Facility manager to be put in place) will counter-balance the risk. Misuse, such as loans to non-eligible MSMEs, multiple loans from the Facility to one MSME or loan amounts above the pre-agreed maximum) will lead to full repayment of the credit line by the intermediary at 5% p.a. plus penalty of 5% p.a on the total credit line. Such misuse and the Facility’s consequential acceleration rights will be fixed in the loan agreement between the Facility and the FIs.

V. Key financials

With a targeted Facility size of USD 1bn and an average sub-loan size of USD 2’000 the Facility targets to support 500’000 MSMEs in more than 50 countries.

The Facility charges 5% p.a. in USD to each FI, independently of the country and counterparty risk. Respective “equivalent” rates for local currency would be put into place where hedging is available.

The total operating expense ratio of the Facility is approx. 1% which is composed of administrative expense of 0.3% p.a. and a cost-covering management fee of 0.5-0.8% (depending on the size of the Facility). With the assumption that the defaults are approx. 4% p.a., capital preservation for the Funders would be achieved.

It goes without saying that the 4% default p.a. is an assumption. However, as FIs share 20% of the risk and will put the money to work with clients which do have a realistic chance to continue operating it seems to be not unrealistic.

VI. Implementation schedule

When	What	Comment
Until end April 2020	Establishment of the most appropriate vehicle/SPV to host the Facility according to best practices	responsAbility has practical experience with most of the relevant structures for this type of Facility
Until end of April 2020	Fine tuning of required loan tracking tool	
Until end of April 2020	Identification of interested Funders	Target Facility size: USD 1bn Min Facility size: USD 300m Max Facility size: USD 3bn
Until end of April 2020	Pre-selection of FIs in the target countries	
End of April 2020	Subscription documents ready	
Mai – October 2020	Investment Period	The Facility invests its entire funding volume to FIs and FIs disburse the equivalent amount to MSMEs
2Q – 3Q 2021	External audits on FIs and Facility Manager	
May 2024	Termination of Facility	The Facility will only disburse the available capital once; cash is paid back to Funders on a quarterly basis starting end of 1Q 2021

VII. Q&A

On Facility concept

- Why does the Facility finance 2x monthly revenue?

From today's perspective most MSME will be either confronted with strongly reduced revenue or loss of revenue for around six weeks to three months. The Facility intends to reduce that liquidity crunch effect short term and stretch the impact over a period of several years. Under the assumption that countries get back into business during 2H of 2020, this should allow MSME to cope with the circumstances.

- Why does the Facility not put the full risk on the intermediary?

It is an unprecedented situation, also for the FIs. To reach out to many MSME effectively and efficiently the required risk restrictions which FIs will have to put into place would undermine the purpose. A too small number of MSMEs would be reached. Additionally, many FIs will face the challenge to deleverage to still be compliant with regulatory requirements. The 80% risk coverage of the Facility allows the FIs —under the proposed risk sharing framework— to act while at the same time managing their balance sheet adequately.

- Why does the Facility not allow a more flexible design of loans by FIs?

The design must be as simple and standardized as possible to allow to act fast. It is of course understood that this might lead to a degree of sub-optimal allocation of capital. Speed and efficiency in this case, however, are more important.

- Why does the Facility allow FIs to set interest rates?

FIs, target groups and country environments can be very different. To make the process as seamless as possible for FIs a certain degree of freedom to set interest rates is required. Also, it is very important that MSMEs do not understand the support as a "subsidy". It is an extra credit volume in difficult times which allows MSMEs to get their business running again.

- How can be avoided that FIs use the Facility to only let MSMEs payback their still outstanding loan with the financial institution?

Loan contracts will foresee that MSMEs who receive emergency liquidity financing only must serve their interest payments on outstanding loans for three months after reception of the liquidity financing.

- Can the Facility have regional windows e.g. for investments in Africa?

As COVID-19 is a truly global issue, we believe it is important to build a global solution which does not exclude nor focus some countries or regions. It is also important to keep the operational structure of the Facility as pragmatic as possible and to avoid all complexities which do not help to fight COVID-19 as effectively and efficiently. However, we know that there are Funders which have politically earmarked funds for e.g. Africa. For this Facility's approach to be most successful, it would be very useful to seriously explore on Funder-level if these political restrictions could exceptionally be lifted considering COVID-19. The facility however can be structured in such a way that an amount which is earmarked for a region by a funder will also be reflected as an allocation in that region.

- Can the Facility operate in local currencies?

The Facility is set up with the objective to be an effective mechanism with high degree of financial efficiency. Capital of the Facility's Funders should be preserved. Unhedged local currency exposure would not be a controllable risk for the Facility. However, if feasible to establish within the given short timeframe, the Facility will offer its USD financing in local currency equivalent on a fully hedged level. If hedging opportunities are available.

- Can FIs which operate group lending technology participate?

Yes, they can. In group-lending cases it is a requirement that most of the group members have been affected by lockdowns.

- How can the FIs be incentivised to pay back the loan to the Facility once the market is back on its feet (instead of hanging in the emergency Facility funding).

Due to the short maturity of the loans from the Facility to the FIs (12-40 months), we believe that a predefined replacement mechanism is not required per se.

- Does the Facility foresee a reporting on a regular basis?

Yes, the Facility will provide a financial report on a quarterly basis to its Funders. At the same time, we strive to keep the reporting work for the MSMEs and the FIs as limited as possible.

- Does the Facility foresee an impact assessment?

Yes, an impact assessment will be carried out at the end of the Facility's life. A donor agency has still to be identified to cover such additional costs.

- What happens if the capital can't be placed during the investment period?

In such a scenario, the capital will either not be called or, if already called, it will be paid back to Funders while keeping a liquidity buffer to cover running cost for the lifetime of the Facility.

- Why does the Facility take a "soft commercial" approach instead of straight subsidy as in many developed countries these days?

Though from an operational efficiency level and from a beneficiary impact level it would be best to work with straight subsidise, the cost would be enormous and there still would be the very high risk that the hard work which has been put in place over the last decades to implement an adequate business relationship culture between financial sector and the still often informal sector could be undermined. If implemented on a large scale the availability of any emergency financing facility for the most vulnerable people would be a big advantage and positive impactful signal to people who only too often are the last in those extraordinary circumstances.

On the role of responsAbility

- Shouldn't the Facility be operated by an "independent" asset manager?

In an ideal world, with sufficient time, one would set up such a vehicle the way it is typical done: An international competitive procurement process would be run over several months to select the Manager. Given the speed at which COVID-19 spreads and the urgency required to respond, at responsAbility we believe that the current circumstances do not allow for this standard approach. We need to establish something feasible and appropriate under the current circumstances. Speed is essential for the Facility to be relevant and not to come too late. Additionally, responsAbility is of the opinion that the typical conflicts can be managed very well if a specialized private sector player offers support in the current situation.

- Can FIs which do not work with responsAbility make use of the Facility?

Yes, FIs from other MIV can also access the funding. responsAbility is worldwide the MIV with the largest number of FIs (currently around 300) and nearly all of them are shared "clients" with other MIV. This means that even if no other manager would be involved, all other MIVs and DFIs would benefit as there is a high level of overlap on the FI-level.

- Will responsAbility generate a profit from this activity?

No. We believe that the special situation requires a very altruistic approach by all partners including the Manager and all Funders. Therefore, the management fee structure has been designed to only cover cost, not to generate commercial profits for responsAbility. In the base case scenario of a USD 1b Facility, the Mgmt Fee will of the order of 50 bps p.a.. In case the Facility is larger this fee might be slightly lower and in case the Facility is smaller this fee might be slightly higher.

- How can responsAbility ensure the required speed of implementation?

ResponsAbility is bringing its 17-year experience of product development to the table, including our own software system to track loans. Additionally, we plan to build this Facility on a network of currently 300 FIs globally with whom we have current lending operations. Furthermore, we have a large outreach to potential Funders with whom we have been working over many years. Under the current circumstances this initiative can only be brought forward if the involved Funders and FIs can build on already existing trust.