MicroSave India Focus Note 30

Alternative Financing for Indian MFIs

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Introduction

Unlike traditional methods of funding (debt and equity), MFIs can use alternative financing measures that are not reflected on their balance sheets, and are thus referred to as "Off-Balance Sheet Financing" (OBSF). Portfolio buy-out, the "partnership model" and securitisation are some examples of OBSF. Though not evident in the financial statements, these unaccounted-for assets and liabilities have real cash-flow consequences.

This Focus Note analyses different forms of alternative financing, their advantages, disadvantages and feasibility issues with regard to implementation for Indian MFIs.

How Does OBSF Help MFIs and Banks?

- Allows MFIs to package and sell their loan portfolios, reduces dependence on existing investors for fresh equity, and helps secure fresh funding to make more loans.
- Reduces credit risk for the MFI as the portfolio is liquidated before the loan tenure (in true sale model); this also helps in reducing debt thereby improving the asset quality.
- Banks profit from the premium received on the sale of such assets.
- Corporations wanting to enter the microfinance market do so by purchasing portfolio.
- Frees up the regulatory capital for MFIs, and helps in creating more assets by enabling them to lend more with relatively less capital.

Relevance of OBSF

- For banks, OBSF is an easy way of avoiding penalties set on the Priority Sector Lending norms, as microfinance is also considered as Priority Sector.
- Microfinance assets, being of shorter tenure (mostly one year) as compared to traditional term loans, attract greater interest from among the banking community as the assets-to-cash cycle is shorter.
- The microfinance sector has been undergoing a steady transition from donor driven NGO-dominated framework towards an increasing involvement of capital (and corporate) markets. OBSF techniques are all the more relevant now as MFIs need to innovate their approaches to asset-liability management with more stringent capital adequacy requirements.

Microfinance Portfolio Buyout

Under this, an MFI's portfolio is bought by a bank, generally at a discounted rate, and all the receivables are henceforth reflected on the purchaser's (bank's) books. This helps banks to build assets on their books and is generally used to fulfil Priority Sector Lending requirements. The benefits to MFIs from portfolio buyout are: a) liquidity - as future cash flows are liquidated instantly; and b) the capital disengaged can be used for building the portfolio and expanding outreach. In most of the arrangements, the MFI continues to service these loans on behalf of the bank and earns a fee. The "first loss default guarantee" (FLDG) serves as a credit enhancement[1]. This clause makes the MFI financially responsible for any loan losses up to a certain percentage (decided, up front, based on the perception of risk), which typically ranges between 8-20% of the portfolio. This acts as an incentive for an MFI to: a) sell good quality portfolio; and b) ensure proper follow-up for collections. On the flip side, the MFI may become less attractive for other investors as they presume that the best assets have already been sold. This type of OBSF is particularly relevant for MFIs that have an urgent requirement of funds for expansion. Some examples of portfolio buy-out in India are:

MFI	Bank	Asset Size
BISWA	IndusInd	Rs.23.5 Crore
SKS	IndusInd	Rs.100.0 Crore
Bandhan	IndusInd	Rs.75.0 Crore

Growth Guarantee

Grameen Foundation USA (GFUSA) has a US$50 million guarantee programme, under which donor-guarantors provide a guarantee to a bank for an MFI's debt fund, securitisation or bond issue. MFIs use donor assets as guarantees to leverage funds. Some examples of this approach in India are:

MFI (Guarantee)	Deal Size	Bank	Instrument
SKS (USD 2 Million)	USD 44 Million	Citibank	Asset assignment to the Bank
Cashpor (USD 0.11 Million)	USD 1.1 Million	HDFC	Term Loan
Grameen Koota (USD 0.23 Million)	USD 4.4 Million	HDFC	Term Loan
SHARE (USD 0.33 Mn)	USD 4.3 Million	ICICI	On-tap securitisation (GFUSA guaranteed partially for 8% of FLDG)

In the case of SKS-Citibank, assets are assigned to Citibank on a monthly basis and the bank has limited recourse provision for SKS. Client delinquency risk is shared between Citibank, SKS, and the Grameen Foundation; with SKS taking the front position in the

[1] Credit enhancement is the process of reducing credit risk by requiring collateral, insurance, or other agreements.

risk sharing … and thus the first losses, in the eventuality of a default.

This type of OBSF is especially useful for MFIs that are registered as NGOs or Section 25 Companies and thus cannot leverage their capital any further.

Partnership Model

The RBI allowed banks to partner with MFIs which originate and manage the loans on behalf of the bank. This was known as the "partnership model". In this model, pioneered by ICICI bank, banks use the expertise of MFIs/NGOs, their existing rural infrastructure and micro credit distribution channels, to save the initial costs of catering to a new market segment. MFIs on the other hand, benefit by having a large back-up source of capital on which they can build outreach.

The RBI has asked the banks and partner MFIs to have higher degree of KYC collection for the clients due to the risks associated with the model and thus has made it a very complicated procedure. Some MFIs (such as Cashpor or Asomi) attribute tremendous growth (among other things) to the partnership model, as it allowed them to grow their assets quickly without commensurate growth in equity.

Securitisation

Under this OBSF structure, the MFI transfers, sells or assigns its portfolio to an independent legal entity called a "Special Purpose Vehicle" (SPV). The SPV issues securitised debt receipts or securities, equity or certificates entitling the holder to the receipt of monies on account of the assets held by the SPV. Some form of credit enhancement or liquidity facility can be obtained by the SPV and generally includes, amongst others, a first loss default guarantee from the MFI which has assigned assets to the SPV. This ensures timely collection from the MFI, which are transferred back to the investors via the SPV. This process basically repackages risks in a manner that suits the investment concerns of lenders and the growth objective of MFIs.

Securitisation has several advantages in that it:

- Allows the MFIs to liquidate the loans before they actually mature. For the investor, securitised microfinance loans mature much faster (six months to three years) than other sector or industry portfolio.
- Securitisation helps the MFI churn its portfolio and make room for fresh asset creation.
- It typically allows the MFI to obtain better pricing than through a direct debt-financing route.
- Investors benefit by achieving priority-sector lending targets.
- Securitisation allows investors to improve their yields and offers an opportunity to diversify and improve the quality of investment portfolios.
- Investors save on the initial cost of serving a new market segment that also opens up avenues for other products such as insurance, remittances etc.

Examples of securitisation deals in India include:

MFI	Deal Size	Investor
SHARE	USD 4.3 Million	ICICI
Equitas	USD 3.5 Million	Several institutional investors
SKS	USD 22.22 Million	Yes Bank

Securitisation is different from portfolio buy-out, even though both can help banks fulfil priority sector lending requirements. In securitisation, securities can be traded on the market while in portfolio buyout banks have to hold securities till maturity.

Preparing for OBSF measures

In order for an MFI to get into a securitisation deal with an investor, it must develop:

- A robust information system so that frequent reports regarding repayment status and general portfolio health (in any format required by the investor) can be presented on a timely basis;
- An efficient staff with a professional outlook towards the business, so that investors are assured of repayments being collected as per schedule; and
- A sizeable marketable portfolio, to cover the costs of being credit-rated and of setting up an MIS and SPV.

A Word of Caution: Legal Issues

Although OBSF measures are being steadily implemented in the Indian microfinance industry, there have been debates over the legal authenticity of securitisation[2]. There have also been differences of opinion expressed by government authorities regarding the legal status of the microfinance loans themselves, as most loans are not supported by stringent policies and regulations that are needed to establish credit-worthiness.

International Financial Reporting Standards (IFRS)

OBSF allows an MFI to borrow, but in the process can mask the level of indebtedness and obscure related ratios such as the leverage. Any form of non-disclosure/ inadequate disclosure slows the development of a viable market for this type of security.

[2] In January 2009, the Gujarat high court has ruled that banks can not engage in trading of debts and are not entitled to transfer debts from one bank to another. This is in conflict to the provisions of the Securitisation Act, 2002.

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