

Securitisation: A funding alternative
for Microfinance Institutions?

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I. What is securitisation?

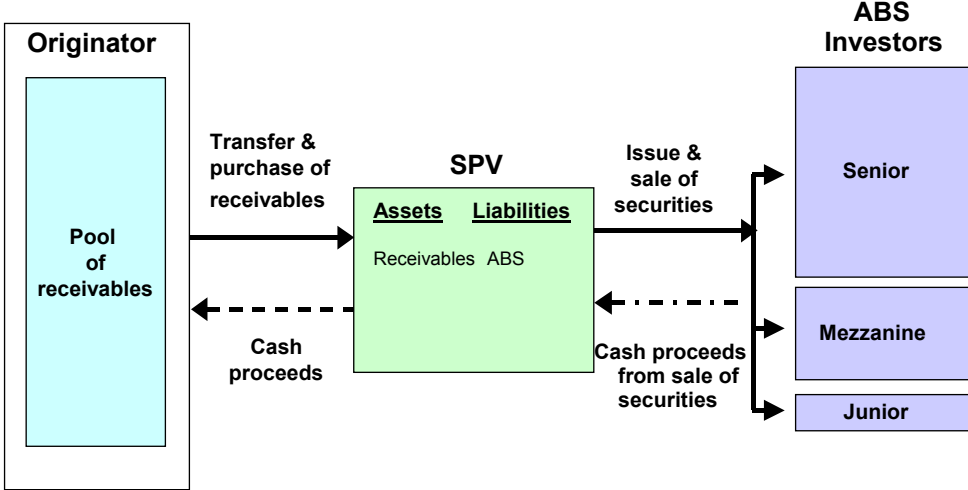
Securitisation, in its most common understanding, is a financing technique whereby a set of stable and predictable future cash flows (often referred to as the “receivables pool”) forms the basis for issuing securities into the debt markets. The technique of securitisation enables the owners of financial assets (the “originators”) that generate stable cash flows to convert such assets into a lump sum liquidity advance. The funding raised by issuance of the securities compensates the owner of the receivables for surrendering the corresponding cash flows to the securities holders. The cash flows generated by the receivables are directed towards the payment of interest and principal on the securities. In doing so, the investors assume the credit risk of the receivables. With securitisation formerly immobile assets of (financial) institutions are transformed into tradable instruments.

Normally, such securities are either placed privately or publicly in the capital markets with institutional investors like banks, insurance companies or investment and pension funds that have a profound knowledge of this rather sophisticated security type. Since the payments of interest and principal on these securities depend exclusively on the cash flow emanating from securitised (or “underlying”) assets, these instruments are known as asset-backed securities (or “ABS”). Frequently, the securitised financial assets found in the markets consist of some form of loan receivables, but the spectrum of assets qualifying for securitisation is very broad. In developed structured finance markets it is possible to securitise any financial asset generating predictable cash flows. Among others, one might encounter securitisations of tax revenues, social security payments, corporate revenues or lease payments.

At the centre of each transaction is a stand-alone legal entity, referred to as Special Purpose Vehicle (SPV). Administrated by a trustee, the activities of the SPV are contractually limited to the purchase of financial assets from the originator and to the issuance of the corresponding ABS. The intent of these arrangements is to prevent a future bankruptcy of the originator from affecting the legal and financial standing of the SPV, a status referred to as “insolvency-remote”. In addition, the payment obligations of the SPV on the securities are secured only by the underlying receivables,

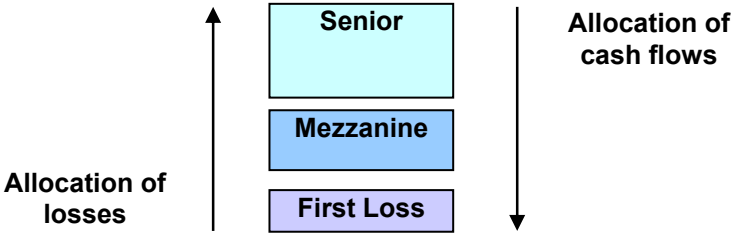
and the ABS-investors have no recourse on the originator.¹ Thus, the ABS-investors only bear the risk of the underlying receivables.

Figure 1: Basic scheme of a securitisation transaction



Since the SPV transfers the cash proceeds from the ABS issuance to the originator by purchasing the assets, the originator can access funding at costs that depend on the quality of the underlying assets. In order to optimise the cost of funding, the ABS are “structured”. This can be accomplished by dividing the securities into separate classes (“tranches”) subordinated to each other. The cash flow from the underlying asset pool is firstly used for the payment of interest and principal on the most senior tranche, and then, sequentially, on the subordinated mezzanine and junior tranches. Reversely, initial losses occurring in the asset pool lead to an interest (and principal) shortfall of the security class with the highest risk, the junior tranche (often referred to as the “first-loss tranche”), followed by mezzanine and senior tranches.

Figure 2: Structure of ABS



¹ If there was a recourse of the investors on the originating bank, such a transaction had the character of a secured loan but not of securitisation.

Due to the credit enhancement resulting from tranching, the most senior security class is expected to be insulated from default risk of the underlying asset pool. Therefore, this security class may obtain a “AAA” rating, while the mezzanine tranches are more riskier and may not be investment grade at all. The pricing of the securities reflects the different risk-return profiles. While the senior tranches are priced at relatively attractive levels the risk premiums increase the more subordinated the respective tranches are. The overall funding cost is equal to the weighted average of the interest rates to be paid on the various tranches. Obviously, the smaller the junior and mezzanine tranches the more cost effective the structure gets.

From a development perspective it is expected that pricing of risk on ABS issued into liquid and active secondary markets can have an impact on risk premiums charged in the primary markets. For example, interest rates for loans to SME should tend to decrease over time once the asset class “SME loans” has been securitised repeatedly and at attractive risk premiums.

Due to the change in ownership of the assets, the aforementioned form of securitisation is also known as “cash” or “true sale” securitisation. Very common and increasingly used in the US and some European markets, is another securitisation type, the so-called “synthetic securitisation”. In synthetic securitisations, the originator seeks protection against default deriving from a specified pool of receivables. By using credit derivatives like credit default swaps, only the credit risk of a portfolio is transferred to investors in the capital markets. Similar to guarantees, the use of credit default swaps provides for risk reduction / risk diversification and regulatory or economic capital relief. Synthetic securitisations do not constitute a funding alternative for originators, since the assets remain on their balance sheets. Therefore, in the following, we only refer to cash securitisations.

II. A glance at the securitisation markets

Since the 1970s, securitisation markets have grown exponentially and today constitute an important segment of the global fixed income and credit markets. The total volume of the global securitisation market exceeds US\$ 3 trillion.² For many years, the US has been by far the most important market with a market share of roughly 85

% to 95 %. Although the European market has taken-off impressively during the past decade, it has still not surpassed 10 % of the global securitisation market. As to the relative importance of securitised asset classes, Residential Mortgage Backed Securities (RMBS), which are linked to an asset pool consisting of either residential mortgage loans, account for over two thirds of the ABS issuance in the US and Europe,

Table 1: Global Securitisation Issuance in 2004 in US\$ billion

Country	Total Securitisation	Market Share
US	2,668.3	85,7%
Europe	303.2	9,7%
Australia	74.3	2,4%
Asia	57.3	1,9%
Latin America	8.7	0,3%
South Africa	1.2	0,0%

Sources: FitchRatings Reports, International Financing Review, International Financial Services

In emerging markets, securitisation is still in its early stage and cross-border deals have dominated the market development during the last years. In cross-border structures, the SPV is located “off-shore”, i.e. outside the country of the originator, mainly in industrialised countries or off-shore financial centres with a legal and regulatory environment conducive for highly rated international ABS issuance. Typically, the underlying assets of such deals are receivables owned by domestic banks or large corporates and denominated in foreign currency (FC), e.g. export or credit card receivables.³ In some cross-border transactions the receivables never become an asset owned by an emerging market originator since, legally, the assets are originated directly on behalf of the off-shore SPV.⁴ Other cases require the foreign debtors to make their payments on collection accounts outside the originator’s country. In structuring a deal that way, the transfer and convertibility risk for the investors can be reduced significantly. Prominent examples of such structures in the market are the securitisation of tourism related receipts and worker remittances in Turkey or the securitisation of gas export receivables in Russia and Peru (see table 2). For originators possessing FC assets, cross-border securitisation can be an interesting instrument

² International Financial Services, City Business Series, Securitisation, April 2005, p. 1
³ FitchRatings, “EEMEA: Evolution of Securitisation Through 2004 and Outlook for 2005”, March 2005, p. 1
⁴ Known as „future flow transactions“

for leveraging such assets and for achieving stable refinancing in FC at both attractive rates and longer terms.⁵

Cross-border securitisation is a less appropriate refinancing technique for institutions that are originating receivables mainly denominated in local currency (LC). By securitising LC assets cross-border, the originator would increase the dependency on international capital markets financing with all risks stemming from maturity and currency mismatches. The same concern is valid for institutions that originate assets in hard currency, but whose domestic customers are still exposed to transfer and convertibility risk. Obviously, this rationale applies for many microfinance institutions (MFIs) located in dollarised economies in Latin America or Eastern Europe.

However, cross-border securitisation can be an interim solution for financial institutions located in countries with a legal and regulatory framework not yet conducive to domestic securitisation, a weak domestic investor base and a significantly reduced convertibility and transfer risk. Such a profile can be found in some of the Central and Eastern European countries being EU-members or accession countries.⁶ Furthermore, one cross-border securitisation of loans to MFIs has been concluded successfully („Blue Orchard Microfinance Securities I, LLC“). We will present this case in further detail in Chapter V.

In order to assess the potential for securitisation of assets originated by MFIs, the experience from domestic securitisations in emerging markets is more relevant. In such “on-shore” transactions, assets denominated in LC are sold to a domestic SPV that, in turn, issues LC denominated ABS placed with investors in the local capital markets. On-shore securitisations dominate the South African and several Asian markets and are now also significantly increasing in Latin American markets, in which for the first time in 2004, on-shore issuance not only surpassed off-shore issuance but also amounted to double the volume issued cross-border.⁷

⁵ Standard & Poors, “The Three Building Blocks of an Emerging Markets Future Flow Transaction Rating”, Nov 2004, p. 1

⁶ *ibid.*, p. 2, in 2004 cross border securitisation of LC assets were completed in Poland and Romania.

⁷ FitchRatings: “Structured Finance in Latin America’s Local Markets, 2004 Year in Review and 2005 Outlook”, March 2005, p. 3

Mainly two factors account for the impressive take-off of local ABS issuance during 2003 and 2004 in countries like Argentina, Brazil, South Africa, Mexico and Peru: (i) appropriate legal and regulatory reforms, and (ii) increasing liquidity and activity in the local bond markets. Given the fact that both factors can also be observed in China, most structured finance experts expect the Chinese securitisation market to grow significantly in the near future.⁸

Table 2: Securitisations in selected emerging markets (volumes in US\$ billion)⁹

	2003	2004	No of deals	Most deals On-shore / Offshore	Important asset classes (% of issuance volume)
<i>Latin America</i>					
Mexico	1.200	4.100	53	Onshore	Tax revenues (50 %), Residential mortgages (11%)
Colombia	690	1.100	15	Onshore	Bonds & Residential mortgages
Brazil	902	1.060	55	Onshore	Residential mortgages (18%), Trade receivables (8%)
Argentina	190	480	62	Onshore	Personal and Consumer Loans (62%)
Peru	250	634	22	Onshore	Revenues of Energy Companies (> 50 %)
Chile	461	315	12	Onshore	Residential Mortgages (40%)
Ecuador	13	24	3	Onshore	Residential Mortgages (58 %)
Bolivia	-	3	1	Onshore	Municipal Tax Revenues (100 %)
<i>Europe</i>					
Russia	-	6.270	-	Offshore	Export Receivables (> 25 %)
Turkey	875	1.475	4	Offshore	Diversified Payment Rights (90 %)
<i>Asia</i>					
India	1.600	2.000	-	Onshore	-
China	4.420	1.400	2	Onshore	Non-performing Loans (100 %)
Kazakhstan	-	103	3	Offshore	Diversified Payment Rights (97 %)
<i>Africa</i>					
South Africa	1.500	1.200	-	Onshore	Autoloans, residential mortgages

Sources: FitchRatings Reports, S&P Reports, International Financing Review, Structured Finance International, International Financial Services.

Most of the local securitisation issuance in emerging markets was backed by residential mortgages, followed by securitisations of tax revenues. Except for a few MFIs issuing mortgage bonds (like ProCredit Bank, Bulgaria), no on-shore securitisation of portfolios of microloans has been reported so far.

From an originators' perspective, on-shore securitisation offers an appealing alternative to cross-border refinancing, since the institution can access LC funding at match-

⁸ HSBC Global Research: "Asian Securitisation – A new ABS market ready to unfold", May 2005, p. 16.

⁹ Some countries with securitisation activity are missing in the table due to the lack of available data.(e. g. Romania)

ing maturities.¹⁰ On the other side, the cost of securitising into local markets has to be calculated on a case by case basis. It will be influenced by various factors like size of the transaction, overhead cost of the deal, investor appetite for a specific asset class, and the interest rates charged in the past by the originator on the receivables to be securitised. We believe that for the originator, in most cases, on-shore securitisations may be more economic and less risky than cross-border transactions. Due to the high overhead cost of international deals (with international rating agencies and law firms involved), the average deal size of such off-shore securitisations is well above US\$100 to 200 millions. In turn, local securitisations can in some cases be worthwhile for the originator even with deal sizes around US\$10 to 20 millions.

Due to the fact that a typical MFI portfolio consists either of LC receivables or foreign currency assets owed by local debtors, in the following we will focus on criteria for domestic securitisations. The requirements for cross border securitisation will be discussed in less detail. Once a set of prerequisites for on-shore securitisations in emerging markets is defined, the paper will focus on the question whether MFIs can meet such criteria.

III. Requirements for securitisation in emerging markets

III.1 Country specific issues

Depth of local capital markets

Significant securitisation activity in a specific country will only develop to the extent that local securities and debt markets have reached a certain level of diversification and maturity.¹¹ For instance, some securitisation structures require interest rate swaps, while others need sufficient investor demand for medium to long-term securities. Most domestic securitisation markets started with an increasing demand from local pension funds, mutual funds and insurance companies for fixed-income instruments denominated in LC with medium maturities. Before institutional investors can develop a meaningful appetite for investing in such instruments they need to have available excess liquidity not yet invested in domestic high quality paper and gov-

¹⁰ FitchRatings: "Structured Finance in Latin America's Local Markets, 2004 Year in Review and 2005 Outlook", March 2005, p. 2.

¹¹ Moody's Investor Service: "Securitisation in New Markets: Moody's Perspective", May 2003, p. 2

ernment bonds, as is often required by their local regulators.¹² On the other side, the formation of monetary assets depends highly on the stability of the domestic currency and the sovereign credit outlook.¹³ Therefore, a reasonable degree of overall macro-economic and political stability is required for the development of a local bond and ABS market.¹⁴

Since most institutional investors (are required to) prefer high quality assets, they first examine mortgage bonds as an investment alternative to government and large corporate bonds. Given their collateralisation, mortgage bonds are considered less risky. Therefore, in many countries the securitisation market started with Residential-Mortgage-Backed-Securities (RMBS). In some cases, institutional investors actively approached potential originators suggesting them a mortgage bond issuance (e.g. South Africa). In other cases, lobbying of investor groups paved the way for legal changes. Once an ABS market has taken-off with RMBS, it is only a question of time when investors will also buy into other asset classes considered to be riskier. In addition to sufficient investor demand, an adequate financial market infrastructure (e. g. arrangers, clearing agents, exchanges) is required for building up a securitisation market.¹⁵ Furthermore, in most cases a (local) credit rating agency acceptable to the investors needs to be involved.

Legal and regulatory framework

It is important to fully understand if, and under which conditions, the legal environment of a given jurisdiction allows for on-shore securitisation. Many countries have promulgated specific securitisation laws, thereby giving strong impetus for the development of domestic securitisation markets (e. g. in Brazil, South Africa).¹⁶ In other countries, securitisation developed after existing capital market laws were amended (e. g. Mexico). Unfortunately, some countries introduced specific securitisation laws

¹² Maddin, Lee, International Finance Corporation (IFC): "Structured Finance in emerging markets", in: Global Securitisation Review 2004/05, Euromoney Yearbooks, p. 3.

¹³ DeSanctis, Gabriel: „Guaranteeing progress“, in: International Financing Review, IMF/World Bank Special Report, September 2004.

¹⁴ FitchRatings: "Structured Finance in Latin America's Local Markets, 2004 Year in Review and 2005 Outlook", March 2005, p. 3

¹⁵ Maddin, Lee, International Finance Corporation (IFC): "Structured Finance in emerging markets", in: Global Securitisation Review 2004/05, Euromoney Yearbook, p. 4.

¹⁶ Currently, securitisation laws are under preparation in Honduras, Nicaragua, El Salvador & Romania.

but securitisation is still not developing since the scope of the laws was too narrow (e.g. Poland, Ecuador).¹⁷

The main issues to be examined in order to determine whether the legal and regulatory framework in a given country is conducive to securitisation are:¹⁸

Transferability of assets: It must be legally permitted to transfer loans from the original lender to a third party (the SPV). Furthermore, the loan agreements of the respective loans must allow for such a transfer. In addition, it must be impossible to challenge the new ownership of the receivables in the event of the originator's bankruptcy.¹⁹ Potential pitfalls to be found in the respective domestic legislation are, for example, loan agreement provisions that deny the transfer of assets or of the corresponding collateral, require the borrower's consent to the transfer or require the explicit notification of the borrower. Finally, there might be bank regulations that only allow for licensed banks to hold loans originated by a bank.

Insolvency remoteness of the SPV: The legislation must provide for the establishment of an insolvency-remote entity, whose purpose can be strictly limited. The idea is to limit both the purpose of the SPV and the decision power of its management in such a way, that under normal circumstances no cash shortfall can arise in the SPV.²⁰ Around the globe SPVs are set up in different legal forms, ranging from trusts and limited liability companies to foundations.

Tax issues: Potential tax liabilities of the SPV (including taxes on profits, stamp and value-added tax) have to be assessed. Most jurisdictions allow the SPVs to be deemed tax-neutral, since their sole purpose is to administer the ABS and to channel the cash flows related to the transaction on a non-profit-basis.

¹⁷ FitchRatings: "Structured Finance in Latin America's Local Markets, 2004 Year in Review and 2005 Outlook", March 2005, p. 9

¹⁸ For a comprehensive list of legal and regulatory issues to be addressed for a (first time) securitisation in emerging markets refer to Moody's Investor Service: "Securitisation in New Markets: Moody's Perspective", May 2003, p. 10.

¹⁹ FitchRatings: "Securitisation in Emerging Markets: Preparing for the Rating Process", January 2004, p. 3

²⁰ Apart from fraud.

Regulation of the issued securities: It has to be determined which type of security is most appropriate for the envisaged securitisation. In most cases, there will be a choice of different securities each of which might be regulated differently. Some jurisdictions limit the ability of institutional investors to invest in certain types of securities and accounting and tax regulations will also have to be taken into account.²¹

Regulation of securitisation: It has to be taken into account whether domestic bank regulations require the regulator to approve the securitisation transaction, which is the case in several jurisdictions.²² Furthermore, the originator will have to determine with its auditors whether a potential securitisation structure is complying with national accounting rules and whether that particular transaction achieves the envisaged funding or equity targets. For example, accounting rules (and bank regulation) in many countries only accept assets as “truly sold” in case a real risk transfer has taken place and that the originator does not retain too much of the asset’s risk.²³

Sovereign risk

In cross-border transactions, the SPV risks default on the payment of interest and principal to the ABS investors in the event that the national government imposes a moratorium on all FC debts. Therefore, sovereign risk in the form of convertibility, transferability and expropriation risk has to be assessed and mitigated, for example through political risk insurances, liquidity lines or guarantees provided by (highly rated) foreign entities (e. g. insurance companies, development agencies).²⁴ Without mitigation of sovereign risk, the issued securities of cross border transactions can generally not achieve a credit rating superior to the sovereign rating of the respective country.²⁵

²¹ Lambe, Geraldine: “Securitisation gives food for thought”, in: The Banker, 04 August, 2003, p. 30

²² An overview on the legal and regulatory framework of securitisation in various countries can be found in: Global Legal Group: „The International Comparative Legal Guide to: Securitisation 2005“, London 2005, see also: www.vinodkothari.com/seclaw.htm, www.globalsecuritisation.com, and http://www.ifc.org/ifcext/home.nsf/Content/Securitisation_in_Russia

²³ Also Basel II stipulates many criteria for approving securitised assets as truly sold.

²⁴ Moody’s Investor Service: “Securitisation in New Markets: Moody’s Perspective”, May 2003, p. 4

²⁵ The international rating agencies define different “country ceilings” or “Local currency ratings” as rating caps. In some cases they deviate from the rating of the respective sovereign.

III.2 Originator and servicer requirements

Originator motivation

From the perspective of the originator, a potential securitisation must offer a positive trade-off between costs and benefits. In emerging markets, the primary benefit consists in access to asset-based funding and equity. Depending on the profile of the originator's balance sheet, additional benefits could be improved risk management as well as better asset-liability management. Secondary benefits, such as access to the domestic capital markets and diversification of funding sources, can also play an important role. Whether the benefits of a securitisation exceed its expenses will depend on factors like the direct cost of securitisation, the availability of alternative and cost-efficient funding and/or equity sources, and on the indirect costs the originator will incur due to ongoing transaction related reporting and disclosure requirements. Moreover, the quantification of regulatory (and economic) capital relief achieved by the originator is becoming an increasingly complex exercise with the Basel II regulations ahead and – in some cases - the revision of national accounting rules. Although preparation and implementation of a securitisation transaction can constitute a big challenge for an originator, especially for a first time issuer, such effort will be well compensated as long as the originator can offer a sufficiently large and well diversified asset pool and is able to issue ABS on an on-going basis.

Originator and Servicer issues

In any securitisation, the investors (and rating agencies, if involved) want to understand the objectives of the transaction and appraise the quality of both the originator and the servicer of the receivables. Their main concern is that a situation might arise in which the servicer would be unable to properly administer the securitised receivables any more. In most cases, the originator and servicer are the same entity. Thus, the originator continues to service the loans on behalf of the SPV. When revolving asset pools are securitised, investors will also assess the strength of the institution selling the loans with regard to origination of new loans.

During due diligence, investors (and rating agencies) normally require the originator/servicer to demonstrate at least.²⁶

²⁶ FitchRatings: "Securitisation in Emerging Markets: Preparing for the Rating Process", January 2004, p. 3

- A convincing financial track record and governance / ownership structure;
- A clear definition of core markets and a good understanding of its competition;
- A sound corporate strategy for sustaining the current market position and for achieving the growth objectives;
- A qualified management team and skilled staff;
- A rational organisational structure and an appropriate and powerful management information system (MIS);
- Appropriate policies and procedures for the underwriting, management and monitoring of loans, as well as procedures for the resolution of problem loans;
- A convincing motivation for the securitisation transaction.

The investors may also consider the availability of back-up servicers, able to step in if the servicer defaults. Often, potential back-up servicers are similar companies operating in the same industry. As the case may be, investors (or rating agencies) could also require both the originator and the back-up servicer to be rated, at least on a national scale.²⁷ Although unrated emerging market originators, especially capital market debutants, might have difficulties in presenting a sustained track record in some of the key areas mentioned above, securitisation is still possible for such institutions. If servicer risk cannot be otherwise reduced, investors and rating agencies would simply factor in additional risk into the securitisation structure, resulting in higher cost for the originator. Besides back-up servicers, potential government support to a defaulted servicer can also be a mitigant to servicer risk.²⁸ However, rating agencies would only give credit, if potential government support is highly likely, for instance, due to the systemic importance of the originator.

Another requirement servicers have to meet is more of a technical nature. The servicer of a securitisation transaction must technically be able to separate each securitised loan portfolio from others and from unsecuritised loans as well. This is not only important with regard to transaction reporting but also for the originator's accounting. In essence, the originator has to qualify as a third party servicer. Although being no longer part of the originator's balance sheet, the securitised loans still have to be administered - risk and datawise - as if they were loans for its own account.

²⁷ *ibid*, p. 3

III.3 Loan characteristics and data requirements

Diversification and standardization

The more homogeneous and diversified a loan portfolio is, the easier it is to securitise. Asset pools are considered homogeneous, if their receivables are similar in contractual terms and interest rates, as well as in probabilities of prepayment, default and recoveries.²⁹ Therefore, standardised loans are much more suitable for securitisation than other loans. For example, the cash flow of a pool is easier to predict if loans are originated in accordance with standardised underwriting criteria and standardised loan documentation. Also, regional and sectoral diversification of the borrowers in the asset pool reduces the probability of high defaults. Furthermore, granularity of assets in the pool decreases the probability of high losses. The smaller the (uncorrelated) individual loans in a pool are - the better.

Data requirements

In order to successfully place ABS with local or international investors, the originator has to provide the investors (and rating agencies) with a complete set of data illustrating the characteristics of the underlying assets and demonstrating their performance under certain recession and stress scenarios. According to the experience of FitchRatings, the provision of data constitutes the major impediment for the risk assessment or rating of an emerging market transaction.³⁰ Often, the data (format) used by the originator to administer a loan portfolio differs from the data and the formats that are needed for a securitisation transaction. Once the data are available and data formats have been adjusted originators find repeated securitisation very efficient, and the cost incurred in the process of initial data collection usually amortises across various transactions.

The objective of the data analysis is to predict future defaults and losses (“expected loss”) of the receivables in the securitisation portfolio. The data requirements usually comprise:

- *Historical data:* (at least 3 to 5 years) on default and delinquency ratios, recoveries and prepayments of the relevant loan book;

²⁸ Lambe, Geraldine: “Securitisation gives food for thought”, in: The Banker, 04 August, 2003, p. 31

²⁹ FitchRatings: “Securitisation in Emerging Markets: Preparing for the Rating Process”, January 2004, p. 6

- *Borrower data*: ideally some kind of credit score in addition to geographic location, industry type, payment history, and financial data;
- *Loan data*: original amount, outstanding balance, maturity, seasoning, interest rate, collateral, repayment schedule on a loan by loan basis.³¹

If an originator cannot provide all of the data, securitisation may still be feasible.

Again, the investors (and rating agencies) will make conservative assumptions for those features with limited or no data available. The resulting increase in the size of the junior or mezzanine tranches will be reflected in a higher cost to the originator. Hence, additional efforts of the originator as to data collection normally pay off in lower transaction cost.

Furthermore, the originator has to provide data on the securitised portfolio on an ongoing basis (monthly or quarterly) during the lifetime of the securitisation transaction. Investors and rating agencies want to monitor the performance of the pool on the basis of a regular standardised pool reporting. The regular pool reporting serves also the monitoring of specific pool ratios, such as certain level of delinquencies or default rates, which once reaching predefined benchmarks often trigger certain actions in the securitisation.

Any MFI considering a potential securitisation need to find answers to the issues raised in this chapter. In depth analysis of the country specific issues has to be carried out at local level in cooperation with lawyers, regulators and, as the case may be, also accountants/auditors. In the following, we will discuss criteria related to MFIs as originators and microloans as asset class.

IV Can MFIs securitise their assets?

IV.1 MFIs as originators and servicers

Over the last decades, the development of microfinance has been anything but a uniform process across countries and regions. As a result, a highly fragmented market place has evolved. The divide between a small group of leading MFIs and thousands of MFIs with limited growth potential may deepen even further. Today, it is estimated that more than 10,000 MFIs are operating worldwide, from tiny little microloan pro-

³⁰ *ibid.*, p. 5

grammes through sophisticated Non-Governmental-Organisations (NGOs) specialised in microfinance to commercial banks delivering microfinance alongside traditional financial products. The majority of MFIs can be characterised as institutionally weak and heavily donor-dependent with little chance to achieve the operational scale needed to gain independence from grant funding.³²

Given the sophistication of securitisation instruments and the related data requirements, in the following we will refer exclusively to the so-called “leading MFIs”. In our view, this is a peer group made up by approximately 100 to 200 MFIs considered economically viable. Furthermore, these MFIs are professionally managed, in the market for more than 3 to 5 years, originate microloans according to proven underwriting and servicing principles, and many of them are able to reliably generate very healthy profits. Finally, many of the leading MFIs are evaluated externally or even carry a rating by (specialised) rating agencies.

MFIs’ motivation for potential securitisation

Many leading MFIs operate in markets with high demand pressure. Various sources estimate the total market demand for microloans to be more than US\$ 300 billion, while current market supply is below US\$ 4 billion.³³ A further indicator for the enormous supply gap are the extremely low microloan penetration rates, which still have not exceeded 1 % of the total (poor) population in many developing countries and transition economies.³⁴

³¹ *ibid.*, p. 6

³² Littefield, Elizabeth, and Rosenberg, Richard. “Microfinance and the Poor. Breaking down walls between microfinance and formal finance.” In : *Finance & Development* (2004): 38-40, p. 39.

³³ Meehan, Jennifer. *Tapping Financial Markets for Microfinance*. Grameen Foundation USA Fostering This Emerging Trend. Grameen Foundation USA Publication Series. (February 2005), p.1

³⁴ Honohan, Patrick (2004). *Financial Sector Policy and the Poor. Selected Findings and Issues*. World Bank Working Paper No. 43. The World Bank. Washington, p.4

Table 3: Microloan penetration rates

MFI Penetration Rates - Top Countries (borrowing clients as % of population)					
Bangladesh	13,1	Togo	1,7	Honduras	1,2
Indonesia	6,7	Gambia, The	1,7	El Salvador	1,2
Thailand	6,5	Benin	1,7	Nicaragua	1,1
Sri Lanka	4,3	Senegal	1,6	India	1,1
Vietnam	3,0	Nepal	1,5	Bolivia	1,1
Cambodia	2,6	Mali	1,5	Ethiopia	0,9
Malawi	2,4	Niger	1,4		

Source: Honohan (2004) p.4, based on Daley-Harris (2003)

This growth potential translates into growth objectives of leading MFIs ranging from roughly 10% to 30 % per year, with big variations according to the respective market conditions.³⁵ Research on MFI funding assumes that micro-lending could grow at rates between 15% and 30% annually, provided that funding was available. The volumes of financing required to sustain such pace in portfolio growth are quite challenging: Yearly funding requirements for the origination of new microloans are estimated to be between US\$ 2.5 million and US\$ 5 billion. This corresponds with a need in additional equity of around US\$ 300 million to US\$ 400 million.³⁶

Access to funding as well as the cost of debt and equity of the leading MFIs varies according to their legal form, financial strength and geographical location. The institutional, organisational and legal structures of the leading MFIs are very heterogeneous, ranging from foundations (e. g., NGOs like the affiliate of WWB in Cali, Colombia), through commercial banks specialised in microfinance (e. g. Banco Solidario S.A. in Bolivia) to commercial banks delivering microfinance alongside their traditional products (e.g. Banco del Trabajo in Perú). However, to overcome growth restrictions and tap the market for deposits, a trend can be observed in which more micro-lending businesses are converted into licensed financial institutions.

For deposit-taking MFIs, generally the cheapest source of funding is their deposit base. Such MFIs would only consider a potential securitisation of microloans if their deposit base became unstable. However, non-deposit-taking MFIs might be taking a different view. They are many times lacking interesting alternatives of commercial

³⁵ In some cases growth may even be higher, achieving levels over 40 %.

funding and sometimes even have to come back to development agencies in order to achieve funding.³⁷

When studying examples of MFIs funding themselves by issuing debt instruments, the frequent application of a third party guaranty is drawing attention.³⁸ Bond guarantees permit MFIs to issue term bonds and attract new local and, sometimes also, international investors. With partial guarantees issued by IFC, USAID or FMO, banks like Mibanco in Peru or Financiera Compartamos in Mexico, were able to issue bonds with better ratings and at lower prices. Among the few examples of local capital market access on a stand-alone basis are bonds issued by ProCredit Bank in Bulgaria, FinAmérica in Colombia and Financiera Compartamos in Mexico.³⁹ Furthermore, recent developments suggest that some international banks are beginning to view microfinance as a business opportunity.

Analogous to the diversification of MFIs' funding sources, increasingly commercial equity investors can be found besides the traditional shareholders of MFIs, such as development agencies or foundations. For instance, ABN AMRO and Citibank started to cooperate with selected MFIs through equity investments, guarantees and funding.⁴⁰ However, in our view, it remains to be seen whether this trend will be sustained when the international capital market environment changes. On the one hand, commercial equity investors are attracted by the healthy return-on-equity rates of MFIs.⁴¹ But, on the other hand, it was only the sustained global low interest rate environment and the lack of high return investment opportunities that has lead many of these investors to open up for relatively risky emerging market investments.

³⁶ de Sousa-Shields, M., Miamidian, E., Steeren, J., King, B. & Frankiewicz, C. (2004) : Financing Microfinance Institutions: The Context for Transitions to Private Capital. USAID (December 2004)P..4ff.

³⁷ Borrowing from development agencies is also incentiviced through their rates.

³⁸ *ibid.*; p.6, The amount of loan guarantees outstanding to support MFIs is approximately US\$ 300 million to US\$ 500 millions.

³⁹ ProCredit Bank Bulgaria is rated [BB+] by Moody's and placed repeatedly bonds in different currencies (EUR, Bulgarian Leva) in the local market.

⁴⁰ ABN AMRO, has set up a joint venture in Brazil (Real Microcrédito). Citigroup has set up a microfinance unit within its global consumer banking line of business.

⁴¹ For instance, *MicroRate* reported in October 2002 that 12 of the 29 rated leading MFIs in Latin America exceeded the return on equity of Citigroup, see: *MicroRate* (2002): *The Finance of Microfinance*. Washington, D.C.; also: Chu, Micheal, Accion International: "Reflections on assessing capital markets", 2000, www.accion.org/file_download.asp?f=10

The analysis of the growth potential of leading MFIs and their equity and funding structure suggests that a selected group of non-deposit-taking MFIs is in increasing need of tapping alternative funding and equity sources in order to finance their growth targets. Such a need might also emerge for MFIs with fully used credit lines available at development agencies or interested local and international investors. In principle, these MFIs should be motivated to examine the possibility of securitising (parts of) their loan portfolio on an ongoing basis.

MFIs servicing and origination quality

Today, around 100 to 150 MFIs carry either local or international ratings which have been assigned or confirmed recently.⁴² The ratings were carried out either by specialised MFI rating agencies or, in some cases, by international rating agencies such as Moody's or FitchRatings. Statistics on the average rating or credit quality of the leading MFIs cannot be found since the ratings were assigned on the base of various rating scales not comparable to each other. The few international ratings are only meaningful to a limited extent, since they are linked to the respective sovereign rating. However, many of the ratings of large MFIs can be considered as local investment-grade ratings. In principle, at least these MFIs should qualify as servicer or originator for a securitisation transaction.

Difficulties could arise given the fact that most of the specialised MFI rating agencies might not yet be in a position to rate structured securities like ABS. In addition, potential ABS investors might require the securities to be rated by international agencies or at least by their local affiliates. Generally, international rating agencies are more expensive than local rating agencies. Furthermore, they do not accept originator or servicer ratings assigned by other agencies. Thus, international agencies would consider the originator as unrated.

The remaining unrated institutions out of the group of leading MFIs, as far as they are considering securitisation, would have to decide whether to prepare an unrated securitisation transaction (which is more difficult to sell to investors) or to go for a rated transaction. In this case, the unrated MFI would either have to become a rated insti-

⁴² For further information refer to www.ratingfund.org

tution,⁴³ or have to find a rated back-up servicer. Theoretically, also a rated share holder (e.g. commercial bank or consulting company) could step in for the originator in case of default. In principle, back-up servicers should be available and the natural candidates would be large competing MFIs in the same country or even strong MFIs in neighbouring countries with the same language and similar credit underwriting and servicing technology.

The credit techniques applied by the leading MFIs combine mundane but essential virtues of conventional banking, with incentive structures for both the customers (e.g. the gradual increase in loan amounts, more favourable loan terms etc.), and loan officers (e.g. performance-based remuneration, etc.). From a perspective of managing credit risk, the results for most leading MFIs are convincing thus far, as the reported low loan default rates and even lower loan loss rates indicate. However, the impression gets more heterogeneous when looking at the state of information management systems. Frequent (i.e. daily or weekly) default and delinquency tracking seems to be common among most MFIs. However, the group of MFIs that would be in a position to act as third party servicer might be much smaller given the requirement of being able to track delinquencies, defaults, cash balances, prepayments and restructurings for a specified pool of loans that are separated from the non-securitised loan portfolio. Probably, many of the leading MFIs would have to invest in improving their MIS in order to meet the requirements of a securitisation transaction.

IV.2 Characteristics of MFI assets and data requirements

Diversification and standardisation

From a capital market's perspective, in principle the loan portfolios of MFIs carry interesting features. They are highly granular and the correlation between individual borrowers can be relatively low to the extent that the pool is geographically and sectorally diversified. In particular, the large MFIs operating nationwide have such portfolios. When considering a potential securitisation, however, the question raises whether the loan products offered by MFIs are standardised sufficiently. Today, besides unsecured short-term loans, typical instruments in microfinance also comprise

⁴³ Moody's Investor Service: "Securitisation in New Markets: Moody's Perspective", May 2003, p. 2

medium-term loans, longer-term mortgages, leasing finance (hire purchase) and consumer loans.⁴⁴

The majority of loans originated by MFIs are more traditional “microloans” that are defined as short-term, uncollateralized loans to individuals or very small (informal sector) businesses. Depending on the geographical region, maturities of microloans vary between 3 and 12 months and their average loan size ranges from US\$ 50 to US\$ 1.000. As long as a single set of underwriting criteria and collection policies is applied, the pool of microloans might be considered as standardised. However, other loan products originated under different underwriting policies, are less suitable for securitisation in the same pool, unless there are sufficient loans of the same (deviating) type, which together constitute a sizable subpool that merits evaluation in its own rights. Some MFIs might have mortgage loan subpools of significant size which might qualify for a separate securitisation.

Data requirements

The microloans would be viewed by most rating agencies as consumer loans. In some cases, where average loan sizes are higher, rating agencies might also consider to apply risk assessment techniques that are used for trade receivables transactions. Whatever the case, rating agencies (and investors) would model the predicted cash flow of the receivables pool under different stress scenarios. To carry out the modelling exercise the following data are needed, at least on a loan-by-loan basis: (i) the original loan amount, (ii) the current outstanding balance, (iii) maturity, (iv) interest rate, (v) collateral, (vi) repayment record,⁴⁵ (vii) seasoning and (viii) repayment schedule. Normally, an experienced arranger would assist the originator to prepare the data for the rating agencies and the investors.

The rating agencies will try to find out how the cash flow of the pool would evolve in case of harsh recession or other stress scenarios, like natural disaster. For this purpose the rating agencies would ideally want to analyse data on the individual creditworthiness of the borrowers (like credit scorings or credit bureau information) and on

⁴⁴ Despite the fact that microloans are provided explicitly for business purposes, many borrowers employ the funds to cover needs emerging in their household-economy, i.e. the differences to consumer financing are blurring.

historical performance data (optimally, such data would comprise a whole business cycle of the respective economy). Obviously, both data sets are rarely available and the agencies are used to working with a much smaller data base. Usually, when rating a debut transaction of an originator (and maybe also for the country), the assumptions for the default model of the rating agencies will be fairly conservative. The models will be adjusted over time as more data become available from other securitisations of the same asset class and performance data on securitised portfolios. However, given the lack of data, it is strongly recommended to present as many arguments as possible underpinning the high quality of microloan portfolios. For instance, it could be stressed that empirical data seem to indicate the robust reaction of microloans to macroeconomic shocks and catastrophes.⁴⁶ In any case, the first loss or junior piece of a (first time) securitisation of microloans can be expected to be a multiple of the historical losses.

V. Selected case studies

As mentioned above, an onshore securitisation of microloans has not yet been reported. However, one large Asian MFI seems to be preparing a local securitisation of microloans involving a guaranty from a development agency. Also other MFIs are evaluating the possibility of securitisation. In the assessment of a potential securitisation MFIs can learn from examples of residential mortgage loan and consumer loan securitisations in developing countries. Relevant examples in our view are the mortgage loan securitisation programme of South African Home Loans Ltd. (“The Thekwini Fund”) and the residential mortgage loan securitisations in Mexico (Su Casita and GMAC Financiera). Also the consumer loan securitisations in South Africa and Mexico (Nedbank’s “Synthesis” programme and the Fonacot programme)⁴⁷ are interesting examples. Among others, the mentioned examples include local securitisations without any guaranty. As to servicers locally rated servicers can be found as well as unrated servicers backed by a rated back-up servicer.

⁴⁵ The borrower’s payment record on loans received previously also would be helpful for the risk assessment

⁴⁶ According to anecdotal evidence, during Indonesia’s banking crisis in 1998, the default rates of Bank Rakyat Indonesia (BRI) microloans did not exceed 6 %, whilst the NPL in the overall banking system averaged 60%. After the Hurricane Mitch, the quality of ProCredit Bank El Salvador’s portfolio shortly deteriorated significantly but NPL could be brought back under 5% within a short period of time.

Furthermore, a number of examples of bank borrowings can be found, where a pool of (mortgage) loans is used as collateral, e. g. Banco Interfin in Costa Rica. Although this is not a real securitisation, since the borrowing is based on the bank's credit, it can be a good starting point to train tranching techniques and data management. Another interesting way of funding for a MFI might be the sale of a microloan portfolio to another bank in the local market. In such portfolio sales many aspects also relevant for securitisation have to be addressed. This is why we deem the following case study of a microloan portfolio sale in India as most relevant for MFIs evaluating a potential securitisation. As second case study we briefly describe a cross border securitisation of loans to MFIs.

V.1 The wholesale models of ICICI Bank, India

ICICI being the second largest commercial bank in India has developed a model in which it offers to Indian MFIs, under certain conditions, to underwrite microloans on behalf of ICICI. As a consequence the MFI is more acting like a distribution agent and concludes loan agreements in the name of ICICI with the borrowers. ICICI funds the microloans underwritten by the MFI on a portfolio basis. In turn the MFI maintains a certain percentage of the portfolio risk. In particular, the MFI will be liable for the first losses in the portfolio up to a specified percentage which, depending on the portfolio quality, range between 5 and 20 % (tranching similar to a securitisation).⁴⁸ As such, the MFIs have a strong incentive to underwrite the microloans according to their own prudent underwriting criteria and to maintain a certain portfolio quality. The MFIs service the microloans originated on behalf of ICICI and receive a servicing charge. In case of the MFI's default ICICI can appoint another MFI (or another entity) as servicer. ICICI has been applying this "wholesale" approach since 2002 and at the end of 2004 around US\$ 150 million microloans originated by more than 30 Indian MFIs were outstanding. ICICI's vision is to cooperate under this partnership model with around 200 Indian MFIs.⁴⁹

⁴⁷ See the respective rating reports of Moodys and FitchRatings. Also: Manuel Calcoa González: "Mortgage-Backed Securitisation: New legal development in Mexico" at <http://www.natlaw.com/pubs/spmxbk8.htm>

⁴⁸ Ananth, Bindu: "Financing microfinance – the ICICI Bank partnership model", in: Small Enterprise Development, Vol. 16 No. 1, March 2005, p. 61

⁴⁹ *ibid*, p. 61

From the MFIs' perspective the partnership model offers attractive funding which is based on the quality of their portfolio (which show default rates consistently under 5 %) and not on their own (inferior) credit standing.⁵⁰ Furthermore, the MFI reduces its capital requirements. Normally, for retained first losses a financial institution has to hold tier one capital. In the partnership model ICICI provides the MFI an overdraft facility equivalent to the first losses retained by the MFI. As such ICICI has to put capital against the portfolio risk (which is credit enhanced via the first loss retention of the MFI up to a local AAA quality) and the overdraft facility granted to the MFI. In that way the MFI and ICICI both can achieve a high leverage on their capital.⁵¹ Since many of the Indian MFIs have significant business in rural areas, through the partnership model ICICI also achieves compliance with the requirements by the Reserve Bank of India for lending in rural areas.

ICICI has further developed this model and in 2003 for the first time bought a complete microloan portfolio from Share, one of the leading Indian MFIs with a good track record, growth rate and scale of operation.⁵² In two transactions ICICI purchased microloan receivables in a combined net present value of US\$ 5.3 million from Share.⁵³ As credit enhancement for the sold receivables, Share provided ICICI a first loss guarantee (8% of the portfolio). Share continues acting as servicer and collection agent, remitting payments to ICICI Bank on a monthly basis. The results of the portfolio sale from the MFI's perspective are similar to those of the partnership model above: the MFI can overcome capital and funding constraints for scaling up its business and built up outreach more rapidly. Also, through the rating arbitrage the MFI achieves cheaper cost of funding than otherwise available.⁵⁴ This allows them to negotiate more favourable terms with borrowers in the future.

With this transaction ICICI has instituted a secondary market for microloans in India. ICICI not only purchased the microloan portfolio from Share but also resold the port-

⁵⁰ *ibid.*, p. 62

⁵¹ *ibid.*, p. 61

⁵² *ibid.*, p. 64

⁵³ The portfolio of the 2nd transaction wasn't an original portfolio of Share, but one acquired from another Indian MFI, Basix. See:

www.businessweek.com/magazine/content/04_39/b3901146_mz035.htm

⁵⁴ Ananth, Bindu: "Financing microfinance – the ICICI Bank partnership model", in: Small Enterprise Development, Vol. 16 No. 1, March 2005, p. 63

folio to another private sector bank in India.⁵⁵ The portfolio sale involves many issues required for a securitisation (tranching, reporting, third party servicing) and therefore only small additional steps are needed for a rated ABS issuance. If demand from banks and other financial institutions as asset buyers is sufficient, there might even be no need for going further and issuing ABS on the sold portfolios in order to raise funds from other investors. Furthermore, ICICI is preparing together with the Grameen Foundation the establishment of an entity who could provide credit enhancement for microfinance portfolios in India. This can be very helpful for both further portfolio sales from MFIs to banks and securitisations of microloan portfolios.

V.2 Blue Orchard Microfinance Securities I, LLC

The world's first securitisation of microfinance assets consisted of the cross-border securitisation of a pool of loans to MFIs. The originator of the receivables is the SPV named "Blue Orchard Microfinance Securities I, LLC" (BOMFS I), a limited-liability company established in 2004 under the laws of the state of Delaware (USA). At the closing of the transaction, BOMFS I issued structured ABS to investors in the US capital market and achieved to raise approximately US\$ 40 million to be advanced to the MFIs selected for the pool.⁵⁶

Among others, the following features of the transaction are noteworthy:

Arranger, pool manager: Developing World Markets LLC, an investment advisory group focused on emerging economies structured and arranged the deal. Furthermore, the other sponsor of the SPV, Blue Orchard Finance S.A., a Geneva based microfinance investment advisory company, selected the assets for the pool: 9 leading MFIs operating in 7 countries, most of them in Latin America.

Rating, placement, investors: The unrated issuance of structured ABS with a 7 year maturity was privately placed in the US capital market. Among the investors in the structured securities appear socially oriented individual investors, Foundations (e.g.

⁵⁵ *ibid*, p. 64

⁵⁶For basic information on this privately placed securitisation refer to the Website of Developing World Markets, LLC (<http://www.dwmarkets.com/>). Furthermore, refer to the "MFS Pitch Book" distributed at the 2004 KfW Symposium in Berlin. BlueOrchard MicroFinance Securities I. Helping MicroFinance Institutions Alleviate Poverty. An Introduction & Overview.

Grameen Foundation USA, Omidyar Network) and institutional investors like banks and mutual funds.

Credit enhancement in structure, guarantee of highly rated development agency: The “Senior Notes” comprised about 75% (or USD 29 million) of the total volume issued. JP Morgan placed these notes at a very attractive pricing of 55 bps p.a. over the reference rate. The credit enhancement of the Senior Notes (25 % subordination) would have been insufficient to balance the return with the risk profile inherent to that class of securities. Therefore, OPIC, a development agency of the US government, provided for additional credit enhancement by writing a guaranty covering full and timely payment of interest and principal on the Senior Notes. Without OPIC involvement, the BOMS I transaction would not have materialised.

Mitigation of sovereign risk: BOMFS I is a cross-border transaction providing long-term foreign currency funding to MFIs. There is no specific mitigation of sovereign risk in the structure. Thus, the SPV might default on its payments on the mezzanine and junior notes if one of the countries imposed restrictions like capital or exchange controls.

Interim strategy to access attractive funding alternative: The conditions of the unsecured loans (interest rates, maturities) from the SPV must have compared favourably to the individual MFIs’ alternative funding opportunities. There are even some deposit-taking MFIs in the pool of BOMS I, for whom this long-term funding offered apparently an attractive opportunity to diversify their funding sources. On average, each of the MFI raised roughly USD 4.5 million. This is probably too small of a volume to prepare for an on-shore, stand-alone securitisation in the MFIs’ domestic markets, even if local legislation in some of the countries was conducive to securitisation. The issuance of a straight bond into the local markets secured by the MFI’s own institutional credit probably would have provided a funding alternative either, given the average volume of funding raised.

VI. Conclusions

We strongly believe that securitisation is a useful tool that can help non-deposit taking MFIs to gain access to alternative funding sources and achieve their growth objectives on the base of their existing capital. In addition, securitisation could also help those MFIs to reduce their cost of funding and to better manage their capital base.⁵⁷ Once MFIs use securitisation repeatedly, their borrowers can benefit from reduced interest rates. Given the growth objectives of MFIs and increasing competition in some markets, it is highly likely that MFIs in many countries would pass on the funding advantages gained through a securitisation to their clients.

Given the high complexity of introducing ABS in a MFI and the respective local capital market, we are convinced that any MFI considering a securitisation should do this with the strategic long term objective of becoming a repeat issuer. Otherwise, the MFI risks failing to amortise the initial cost of product creation (e. g. cost of data collection, legal cost, higher risk premiums for first ABS issuances) and not attracting sufficient interest from local investors. To support this strategic approach the MFI also needs to have a sizable loan portfolio that allows for regular ABS issuance and that has the potential to amortise fixed transaction cost quickly.

If local investor demand is sufficient, in our view a local securitisation is always more efficient than a cross border securitisation, which will usually involve issue related to currency risk. As the case may be, the local investor demand still might need development incentives. We highly recommend MFIs to pursue an intensive dialogue with potential local institutional investors (also with other financial institutions and the relevant authorities), in order to learn more about the investors' risk appetite and to educate them on the emerging asset class "microloans".

In principle, from the point of view of a potential ABS investor, a microloan portfolio serviced by a leading MFI has a very appealing risk profile. Granularity, diversification, standardisation, the low prepayment risk and the relatively low default rates are each considered a plus for potential ABS-investors. The challenge is that the MFI will have to deliver data on an ongoing and historical base proving these favourable loan

⁵⁷ The Financial Express: „Crisil Study: Securitisation of Microfinance assets: a winning position“, Dezember 2004, http://www.financialexpress.com/fe_full_story.php?content_id=76655

characteristics. For first time issuers, the collection of historical data and on going transaction data management will normally imply an extraordinary effort which only pays off over the time.

From the perspective of the development agencies, supporting the securitisation of microloans is also strongly linked to several key development policy objectives. First, the creation of a local secondary market for microloans securitisation will deepen and diversify the financial sector in the respective country. In addition, we are convinced that, in the long run, the development of such a liquid secondary market can also contribute to poverty alleviation, since more of the poorer segment of the society could gain access to financial services at lower rates. The instruments development agencies could use to promote microloan securitisation include among others: (i) financing of legal feasibility studies, (ii) technical assistance to governments and regulators in creating the conducive legal and regulatory framework, (iii) technical assistance to MFIs in the area of data, and (iv) credit enhancement for ABS structures through the provision of (partial) guarantees or other risk mitigating instruments in a transaction (e. g. servicer risk).

In our view, partial guarantees from highly rated development agencies can be a very powerful tool for the promotion of local securitisation. From the originator's view partial guarantees are more cost-effective than full guarantees. They assist the originator in establishing the credit risk of the microloan portfolio in the market. Once a partially guaranteed transaction has been placed, the local investors learn to better understand the performance of microloans and the ABS linked to microloans. Over time, more educated investors (and rating agencies) will be interested in investing further down the credit curve so that the guarantors are crowded out subsequently. Ideally, any partial or even full guaranty of a highly rated development agency should be denominated in LC. Otherwise, the originator continues to bear the currency risk. Given the operational restriction and the limited risk appetite of many development agencies, the possibility of providing LC guaranty is limited to a few countries with tradable currencies. Development agencies should work towards overcoming this limitation and MFIs are encouraged to look for alternative local guarantors, like governments or insurance companies.

In sum, we are convinced that the securitisation of microloan portfolios can be feasible in selected cases, even in the near future. To make this happen, a joint effort of the MFIs, local investors, a rating agency, the regulator and maybe also a development agency will be needed.

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