

Underwriting Guidelines



CONNECTING MICROFINANCE INSTITUTIONS TO CAPITAL MARKETS

Eligibility Criteria and Underwriting Guidelines

Draft for Discussion Purposes only

The mission of IFMR Capital is to act as a bridge to mainstream capital markets for under-served asset classes relevant to low income households. IFMR Capital aims to reduce the cost of capital for the end borrower by developing access to debt capital markets, creating transparent criteria for evaluation of these new asset classes and using sophisticated financial structuring tools to generate high quality assets leading to price discovery, liquidity and growth in these new markets. We invite your comments and feedback on the first draft of the underwriting guidelines.

Eligibility Criteria

CRITERIA	STANDARD
Quality of Management and Organization Structure	The promoters must have a credible reputation and have a past track record proving their ability to raise financial resources in the form of equity, debt or grants from the markets
	The originator must have an incentive plan for its field staff, motivating them to achieve their business objectives and encourage employee retention. This should be aligned with training programmes for new recruits. Field staff must not have differential incentives based on the category of loans they make, for example Agricultural loans versus Non Agricultural loans.
	The originator must have up-to-date audited financial statements within 3 months of closing. The accounts should be audited by a firm of repute.
Loan Data Collection	Client information and supporting proofs must be filed and recorded in the systems
	<p>Details on each loan must be recorded in the systems of the originator</p> <ul style="list-style-type: none"> ● Name, address of borrower ● Unique client identification number ● Group and centre number, where applicable ● Initial loan amount ● Loan Purpose ● Current outstanding balance ● Effective interest rate ● Any other fees and charges collected ● Due and actual installment payments and dates ● Amortization type/term oMaturity Date ● Late payments : amount and dates ● Defaults: amount and dates ● Additional cash deposit amounts ● Collateral amount & type ● Name, address of 3rd party guarantor, if applicable ● Name of originating loan officer

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CRITERIA**STANDARD****Financial and Operating Performance**

Historical defaults as measured by the Weighted Average Annual Default Rate of the combined loan portfolio must not exceed 5% for any fiscal year during the past 3 years. A loan is considered in default if the borrower has not made any payments for that loan for a period greater than 30 days for weekly instalment loans and 90 days for fortnightly and monthly instalment loans. Weighted Average Annual Default Rate is the combined outstanding balance at time of default for all loans that had fallen into default at any time during the fiscal year (excluding loans that were already in default at the start of the fiscal year) divided by the sum of all scheduled principal payments due during the fiscal year

Portfolio at Risk as measured by the ratio of amount of loans overdue to the total loan amount outstanding must be less than 10%

Operating Efficiency: Each field officer must be responsible for a reasonable number of clients. This must be in keeping with the business model of the originator, the lending model (group lending, individual lending), collection methodology, disbursement methodology, time required for the field officer to travel and conduct business.

Each new client must be adequately educated and trained to know the company, the loan product, and their risks and responsibilities under the loan via processes like the compulsory group test and the group recognition test, where applicable. Clients must be made aware of the stipulations under any power of attorney that they sign.

Each loan must be recorded in a loan agreement that sets out the borrower's and, if applicable, the group's obligations and the ability to transfer the loan to a third party

Loan agreements must clearly state the following:

- Loan amount
- Loan term
- Declining interest rate, upfront fees and other charges
- Required deposit, collateral, guaranty
- Complete Repayment schedule with repayment dates and corresponding amounts
- Rights to cross-sell other financial products
- Bundled products and charges, if any

The field staff must physically verify each client's details by visiting their home, supported by interviews with group members, family and neighbours. They must collect the following information on these visits:

- Name and address
- Occupation and income of the household

The field staff must collect proof of name and address from each client and this proof must be admissible under the RBI "Know Your Client" guidelines. The relevant RBI guidelines are available at http://rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=4354.

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CRITERIA	STANDARD
Systems	<p>All customer level and loan level information must be stored in an electronic format</p> <hr/> <p>In particular, the system must be able to track and isolate portfolios that have been sold/hypothecated/charged to 3rd parties in order to eliminate commingling risk</p> <hr/> <p>The originator must have systems in place to monitor and manage different types of risk</p>
Risk Management	<p>Operational Risk: All documents must be transported in a secure manner.</p> <hr/> <p>Operational Risk: Cash at the branch must be held in a secure manner and deposited in a bank account as soon as is reasonably practicable.</p> <hr/> <p>Operational Risk: The originator must have a credit and collection policy that includes internal audit mechanisms and verification of loan utilization</p> <hr/> <p>Operational Risk: The originator must have a well-defined process to handle defaults; this should be reflected in a low volatility of default rates, measured quarterly, for the life of the originator. Volatility of default rates will also be measured across branches and geographical areas.</p> <hr/> <p>Regulatory Risk: The originator must operate in compliance with the laws of the land. The originator must also comply with regulations mandated by the RBI such as those pertaining to deposit taking and insurance.</p> <hr/> <p>Reputation Risk: The originator must not use external personnel to recover outstanding loans and must not in any case use strong arm tactics for these purposes.</p>

CRITERIA**STANDARD****Underwriting Guidelines**

In addition to the Eligibility Criteria laid out above, IFMR Capital will undertake a more detailed study of the originator's business as per the underwriting guidelines below.

Legal Form	<p>The legal structure of the originator should preferably be an NBFC or Bank, as the structures provides for :</p> <ul style="list-style-type: none"> ● Regulation ● Incentive structures due to the presence of shareholders ● Capital adequacy ● Ability to raise additional capital <p>While the NBFC or Bank is the preferred structure, IFMR Capital will look at buying loan portfolios from originators organized in other legal forms such as a society, trust or a section 25 company.</p>
Quality of Management and Organisation Structure	<p>The organization should have an experienced board with at least one independent director. The board should have an active role in guiding management</p> <p>The organization should have a business plan including financial projections</p> <p>The organization should have created a strong second level of management, below the promoters, ensuring that the business is sustainable</p> <p>The organization should have appropriate training for loan officers</p> <p>The organization should have support functions such as finance, accounting, HR, IT, internal audit and credit</p> <p>The organization must have clear delegations of authority, and oversight mechanisms to insure these are properly adhered to</p>
Origination Process	<p>The field staff should collect the following information: Education, Occupation of household members, including age & school status of each child</p> <p>Household income and expenditure including nature of income (daily wages, salary, agricultural income), income volatility measured by data on the range of incomes (average, low and high) during the year</p> <p>Infrastructure including availability of electricity and access to healthcare and sanitation</p> <p>Assets including type of dwelling, ownership of land and house, ownership of agricultural land, milch animals, poultry, TV, radio, agricultural implements, tractor, bicycle, jewellery, bed, utensil Liabilities including prior loans, repayment history and loans with other sources</p>
Capital Structure	<p>Originator should preferably maintain multiple and diverse sources of funding</p>

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CRITERIA	STANDARD
Systems	<p>All customer level and loan level information should be stored in an electronic format with periodic back ups, and should be regularly updated to a centralized location (i.e. up-to-date regional data should be available at HQ)</p> <hr/> <p>The system should be able to retrieve accurate information in a timely manner and have restricted access as per the company hierarchy, i.e. employees at each level must have access to only the information that they need</p> <hr/> <p>The system should be able to track historical loan information for each individual client</p> <hr/> <p>All data such as client asset information, late payments, defaults, additional deposit amounts should be recorded in the centralized electronic system</p> <hr/> <p>Adequate process controls should be in place to ensure data integrity during transfer of data from manual to electronic format</p> <hr/> <p>The system should be able to generate reports such as collections, disbursements by branch/hub, client history, product summaries, hypothecated portfolios, portfolios by loan purpose /tenor/client profile/loan officer, portfolio at risk, defaults. Timely access to such reports should facilitate business and operational decisions</p> <hr/> <p>The system should be able to monitor and track portfolios to manage risk</p>
Financial and Operating Performance	<p>Loan loss provisions should be no less than:</p> <hr/> <ul style="list-style-type: none"> ● 20% for 1-30 days in default ● 40% for 31-90 days in default ● 60% for 91-180 days in default ● 100% for over 180 days in default <hr/> <p>Capital Adequacy Ratio as measured by the ratio of Total Equity (including Share Capital, General Reserve, Capital Reserve, Statutory Reserve, Loan Loss Reserve, Subordinated Loans) less retained first loss default guarantees) to Total Assets should be at least 10%</p>
Risk Management	<p>The originator should have adequate insurance cover to protect it against the risk of fraud, natural disasters and other unanticipated damage</p> <hr/> <p>Interest Rate Risk: The originator should use appropriate interest rate risk management techniques, including interest rate hedges as needed. The originator should maintain a low Equity Duration which is a measure of interest rate risk/sensitivity and is calculated as the ratio of the weighted average duration of assets and the weighted average duration of liabilities</p>

CRITERIA	STANDARD
	<p>Liquidity Risk: The originator should maintain a robust liquidity position, as measured by the Quick Ratio which is defined as the ratio of current assets to current liabilities</p> <hr/> <p>Currency Risk: Originator should use appropriate currency/exchange rate risk, if applicable.</p> <hr/> <p>Reputation Risk: The organization should have a process in place to address customer grievances.</p> <hr/> <p>De-risking portfolio: The originator should aim for a diversified loan portfolio by geography, type of location (rural/urban), purpose of loan to mitigate concentration risk</p> <hr/> <p>Originator should demonstrate ability to continue operations in the following stress scenarios:</p> <ul style="list-style-type: none"> ● Inability to access additional funding for a period of 6 months ● Increase/decline in benchmark interest rates of 2% ● Increase in default rates of 3% for a period of 12 months ● Decline/increase in currency value of 20%
Definitions	
Default	A loan is considered in default if the borrower has not made any payments for that loan for a period greater than 30 days for weekly instalment loans and 90 days for fortnightly and monthly instalment loans.
Weighted Average Annual Default Rate	Combined outstanding balance at time of default for all loans that had fallen into default at any time during the fiscal year (excluding loans that were already in default at the start of the fiscal year) divided by the sum of all scheduled principal payments due during the fiscal year.
Portfolio at Risk	Ratio of loan amounts overdue to total loan balance outstanding.
Capital Adequacy	Ratio of Total Equity (including Share Capital, General Reserve, Capital Reserve, Statutory Reserve, Loan Loss Reserve, Subordinated Loans less retained first loss default guarantees) to Total Assets
Equity Duration	Ratio of the weighted average duration of assets and the weighted average duration of liabilities
Quick Ratio	Ratio of current assets to current liabilities

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