

# Microfinance: An Emerging Asset Class



CONNECTING MICROFINANCE INSTITUTIONS TO CAPITAL MARKETS



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## Background

Microfinance has been defined as the provision of financial services to the global poor.<sup>1</sup> Typically it involves supply of financial products and services (mainly credit, but also savings, insurance, remittance and pensions) in token sizes that are much smaller than those prevailing in the mainstream commercial markets.

MFIs are financially sound and profitable institutions guided by the overarching goal of providing better livelihoods to the poor. Investors supporting MFIs can therefore look to achieve a social impact in addition to commercial returns on their investments. Additionally, microfinance has demonstrated low volatility of returns and low correlation with mainstream global market trends. Another factor that makes it an attractive class is its potential size. As against the estimated three billion people (approximately 600 million households) living below two dollars a day, the estimated outreach of micro-credit worldwide is only 133 million clients,<sup>2</sup> which points to a huge gap between demand and supply.

Worldwide, microfinance institutions have attracted commercial equity as well as debt investments over the last 10-15 years. A survey<sup>3</sup> of 54 microfinance funders conducted by CGAP in 2008 showed that a total amount of USD 11.7 billion had been committed to microfinance. Approximately 63% of this was in the form of debt and another 6% in the form of guarantees. The distribution between the amount contributed by donors and investors was almost equal at 53% and 47% respectively, thus indicating that both commercial and non-profit investors are equally interested in the market.

This paper focuses on the potential of securitisation of microfinance loans in the Indian context and why it makes sense for both Indian and foreign investors to invest in microfinance securities.

## About IFMR Capital

IFMR Capital is a non-banking finance company whose mission is to provide efficient and reliable access to debt capital for institutions that impact low-income households. Utilising its expertise in credit underwriting and structuring, IFMR Capital aims to act as a bridge to mainstream capital markets for microfinance institutions and other institutions providing small enterprise finance, affordable housing finance, and agri-commodity backed financing.

IFMR Capital will develop smooth and efficient access to capital markets by creating transparent criteria for evaluation of these new asset classes, standardizing investment structures, and using financial structuring tools to generate high quality assets leading to price discovery, liquidity and growth in these new markets. This will enable institutions in critically important sectors to reach out to new sets of investors thereby expanding the sources of capital available to them.

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1 <http://www.microcapital.org/what-why-how/>

2 CGAP Global Estimates on Microfinance: <http://www.cgap.org/p/site/c/template.rc/1.11.1792/>

3 CGAP collected data from 54 funders including 33 donors and 21 investors. All data is as of 31 December 2007. Source: <http://www.cgap.org/gm/document-1.9.6303/Regional%20Snapshots%20-%20Global%20-%20Nov08-rev2.pdf>

## Microfinance as an Asset Class

The key distinguishing features of microfinance as an asset class are described below:

**High returns:** In a study of the data from nine leading MFIs from nine different countries (four from Asia, two from African and three from the Americas), it was found that the average return on equity (RoE) for all the MFIs was 26.5%.<sup>4</sup> As per the MIX database, the average RoE for medium sized Asian MFIs was 20.1% based on 2007 data.<sup>5</sup> The same figure for large MFIs was 10.6%.

**High growth:** The study of nine leading MFIs quoted above concluded that the average growth rate of the MFIs in 2005 was 38% in terms of the size of loan portfolio and 33% in terms of the number of borrowers.<sup>6</sup> On an average, Indian MFIs have been growing at 30-50% in terms of number of borrowers and 50-60% in terms of portfolio size.<sup>7</sup>

**High quality:** The average portfolio-at-risk (>30 days)<sup>8</sup> for all MFIs in the MIX Micro Banking Bulletin 2008 was 2.7% (2007 data). The average PAR (>30 days) for three years between 2005 and 2007 has been in the range of 2.5-2.8%. The average PAR (>30 days) for medium-sized and large-sized Asian MFIs was 1.7% and 0.7% respectively in 2007.<sup>9</sup>

Although microfinance loans are not collateralized, there are several factors that contribute to the good portfolio quality of microfinance loans. Some of these are the small ticket size and short repayment tenure of the loans, the 'social collateral' of group pressure, strong credit discipline that is maintained by the MFIs and emphasis on timely repayment of principal together with interest.

Secondly, microfinance loan pools typically have less correlation with the mainstream markets. The main reason for this, as argued by Prof Mohammad Yunus, the Nobel Laureate and founder of Grameen Bank, is that microfinance loans are used to finance very basic economic activities (such as agriculture, animal husbandry, grocery and provision stores, roadside hotels, fruit & vegetable vending as well as small-scale artisanship) that have a reasonably stable demand in the local markets (in and around the location of the business itself).

**Low prepayment risk:** Microfinance loans in most cases are linked to the cash flows of the clients' business and involve regular weekly, fortnightly or monthly repayment of fixed small amounts. Businesses that generate regular, periodic cash flows are preferred to those that generate lumpy cash flows. This minimizes the proportion of pre-payments and pre-closures.

The above inherent advantages of microfinance assets make them an attractive investment option for both equity and debt investors.

4 Marco Coppoolse (2007). "Microfinance: An Emerging Asset Class for Equity and Debt Investors". [www.microcapital.org](http://www.microcapital.org) Based on 2005 data.

5 MIX (Autumn 2008). "The Micro Banking Bulletin". [www.mixmarket.org](http://www.mixmarket.org). Medium sized MFIs: Loan portfolio size between USD 2mn to 8mn. Large sized MFIs: Loan portfolio size greater than USD 8mn.

6 Marco Coppoolse (2007). Ibid.

7 Sanjay Sinha (2007). "Efficiency with Growth: The Emerging Face of Indian Microfinance". Published in 'Finance for the Poor' a quarterly newsletter of the Asian Development Bank.

8 Portfolio-at-risk (>30 days): Total amount of loan outstanding against loans that are more than 30 days overdue, expressed as a percentage of the total outstanding portfolio of the MFI.

9 MIX (Autumn 2008). Op Cit.

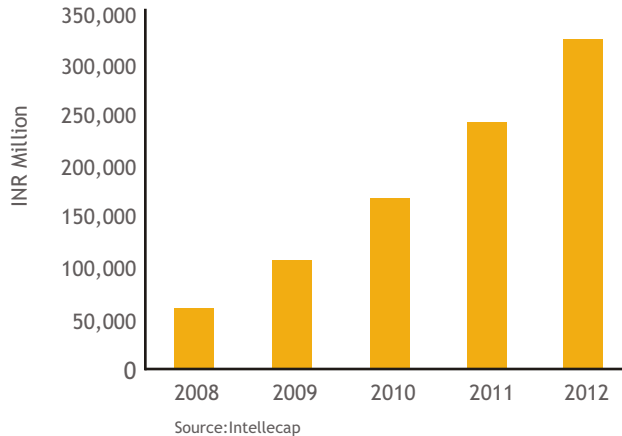
## Microfinance in India

The Indian microfinance sector is expected to grow nearly ten times by 2011 to a size of about Rs 250 billion from the current market size of Rs 27 billion, at a compounded annual growth rate of 76%.<sup>10</sup> With about 42% of the population living below \$1.25 a day in the country<sup>11</sup>, the total demand for micro-credit in the country is Rs 550 billion at an average annual loan size of Rs 6,000. Thus, even by 2011 only about 50% of the market demand may be covered.

Operationally, the microfinance industry in India has borrowed largely from the Grameen Bank and similar institutions in neighbouring Bangladesh, in terms of the methodology, processes and systems. Most of the leading Indian MFIs started out as NGOs during 1985-1999, adopting the Grameen Bank model of group-based lending to women in rural areas. Over the years, they have grown significantly in size and have transformed into commercial, for-profit Non Banking Finance Companies (NBFCs), thus moving towards a more regulated legal setup.

Between financial year 2004-05 and 2005-06, the combined loan portfolio of Share Microfin Ltd, SKS Microfinance Pvt Ltd and Spandana Sphoorty Innovative Financial Services Ltd, three of the largest NBFC MFIs in the country, showed a growth rate of 102%. Similarly, their combined outreach (number of active borrowers) showed a growth rate of 114% over the same period. All the three MFIs mentioned above now have much more than a million active borrowers each.<sup>12</sup>

### Projected MFI Portfolio Growth



Many of the new MFIs are set up by professionals from related backgrounds, who are convinced of the potential of the 'bottom-of-the-pyramid' market. These are typically MFIs that have also been setup with significant promoter equity as well as investment by commercial or social investors. These MFIs typically have an urban focus, mainly on account of the urban background of the promoters. This trend, combined with the interest shown by traditional MFIs also in the urban space, has resulted in an increase in outreach of microfinance to urban slums and wholesale market places (usually fruit and vegetable mandis).

<sup>10</sup> Cygnus (2008). "Microfinance in India". Cygnus Business Consulting & Research.

<sup>11</sup> World Bank estimates based on 2005 data. Source: <http://www.thehindu.com/2008/08/28/stories/2008082856061300.htm>

<sup>12</sup> Source: [www.mixmarket.org](http://www.mixmarket.org)

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	Tier 1	Tier 2	Tier 3	New-Age MFIs
<b>Description</b>	5-6 large NBFC MFIs that have been in operation as NBFC for 6-10 years and previously as an NGO for several years	10-15 mid-sized MFIs that have recently transformed into NBFCs	500-800 NGO MFIs that have been growing steadily and face difficulty in borrowing from banks	5- 10 MFIs promoted recently by professionals who are convinced of the opportunity at the 'bottom of the pyramid'. Most of them are for-profit NBFCs.
<b>Legal form</b>	For-profit NBFCs	For-profit NBFCs, Section 25 companies or NGOs	Mostly NGOs	Mostly for-profit NBFCs
<b>Total outreach</b>	> 10 million	2-5 million	< 1 million	< 0.5 million
<b>Source of equity</b>	Most have availed of commercial equity capital	Have availed or are looking for commercial equity capital	Dependent on donated equity and 'social' investors	Have availed of commercial equity capital
<b>Source of debt funds</b>	Institutional loans + buyout	Institutional loans + buyout	Institutional loans, soft loans, grants	Institutional loans + buyout
<b>Leverage</b>	Moderate	Moderate	High - Very high	Low - Moderate

Another interesting aspect of the microfinance industry in India is the involvement of the government and government-sponsored agencies, under the Self-Help Group (SHG)-Bank linkage programme, that operates parallel to the MFI space described above. The SHG-Bank linkage programme in India, sponsored by state-owned National Bank for Agriculture and Rural Development (NABARD), is much larger in size and scope than the largely private sector MFI space. The programme contributes to about 2/3rd of the total number of clients and 3/4th of the total estimated microfinance loan portfolio of Rs 22,000 crore as on 31 March 2008.<sup>13</sup>

Under the SHG model, typically, an SHG (Self-Help Group) consisting of 20 members (generally women) is promoted by an NGO (known as Self-Help Promoting Institution or SHPI). The NGO staff train the SHG members in meeting regularly and maintaining minutes, record-keeping, saving small amounts regularly and lending among themselves using the pooled savings. After a period of 3-6 months, the SHG is 'linked' to a neighbouring bank by opening a Savings Bank account for the SHG. The NGO facilitates the bank to lend to the SHG, based on the quality of the SHG. The NGO gets a grant from NABARD while NABARD also refinances the loans provided to SHGs by the bank, at rates that are lower than the prevailing prime lending rate.

Due to the involvement of NGOs and NABARD, the interest rate paid by the SHG borrowers is typically much lower than that paid by their MFI counterparts. However, one major weakness of this model is that the follow-up by the NGO or banks post linkage is generally weak, raising doubts about the quality of loan portfolio and sustainability of groups.<sup>14</sup>

The key difference between the MFI model and the SHG-Bank Linkage model is the involvement of a privately-owned institution (i.e., the MFI) in the former case. In the MFI model, it is the privately-owned MFI that borrows from banks on its balance sheet and then lends onward to its 'clients'. In the SHG model, the SHG is technically only an association of the clients, who have come together for 'self help' or mutual benefit.

The presence of the MFI (which in many cases is for-profit) is the key factor that attracts investors and lending institutions to the MFI space, as they are much more comfortable dealing with a legally registered entity, with tested systems and processes, audited financial results and represented by its promoters (who are generally educated and articulate), rather than an informal association of borrowers (who are mostly illiterate and inexperienced).

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13 Sa-dhan (2008). "A Snapshot of Microfinance in India". Data for MFIs from Sa-dhan's 223 member MFIs.

14 EDA Rural Systems Pvt Ltd (2006). "Self Help Groups in India: A study of the lights & shades".

## Microfinance Regulation

India is one of the few countries in South Asia that are yet to give formal recognition to for-profit MFIs in their regulations. At present, MFIs see the Non-Banking Finance Company as the best legal setup to operate in, once they have achieved significant size. Banks are also more comfortable dealing with NBFCs as they are seen as better regulated entities. However, MFIs looking to set themselves up as NBFCs face stringent barriers in terms of initial capitalization required and restrictions on accessing foreign debt and equity.

Another key area where the Indian microfinance regulatory environment is different is in terms of access to client savings. MFIs in many developing countries are permitted to collect deposits.<sup>15</sup> However, in India, even the not-for-profit MFIs registered as Trust or Society are not permitted to collect deposits on a large scale. Only those MFIs operating as Co-operative Societies are permitted to collect savings from members. However, as member-owned institutions that are not strictly regulated, co-operatives are not seen as a preferred entity for microfinance operations.<sup>16</sup> This inability of the larger MFIs to collect savings from their clients makes them dependent to a large extent on debt funds from banks.

One regulatory initiative that has been the primary reason behind the growth of microfinance in the country is the introduction of 'priority sector' lending requirements for banks in India in 1985. Banks in India are required to have at least 40% (32% for foreign banks) of their total advances lent to the 'priority sector', which includes sectors such as agriculture, small-scale industries, small business and advances to 'weaker sections' of society including small farmers, artisans and cottage industries etc. The Reserve Bank of India, the country's central bank, monitors the 'priority sector' exposure of banks on a periodic basis (generally annual basis) and in case of non-fulfillment, banks are required to invest the shortfall amount in earmarked long-term government securities with yields that are much lower than the market rates.

Advances given for microfinance qualify as loans to the 'priority sector'. Banks are therefore particularly interested in microfinance loans due to the relatively high safety of such loans and the possibility of market rate returns.

Indian legislators have also realized that microfinance needs a separate legal framework, and the Micro Financial Sector (Development and Regulation) Bill, 2007 was introduced in the Parliament on 20 March 2007. It has been referred to the Lok Sabha Standing Committee on Finance for review. The Bill is expected to ease the entry barriers for microfinance and also make it easier for registered MFIs to collect savings. However, it has been criticized for looking to exclude for-profit NBFC-MFIs from its purview.

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<sup>15</sup> M-CRIL (2005). "A Study of the Regulatory Environment and its Implications for Choice of Legal Form by Microfinance Institutions in India". Published by Sa-dhan.

<sup>16</sup> Ibid.

## Off-Balance Sheet Funding in Microfinance in India

The Indian microfinance industry has seen the usage of off-balance sheet funding over the last few years. ICICI Bank initiated an innovative off-balance sheet funding model for microfinance in 2004. The model called the “partnership model” enabled the bank to finance the end-client directly as the loans remained on the bank’s balance sheet, while the MFI acted as a service provider, providing loan origination, monitoring and collection services for a fee.<sup>17</sup>

The “partnership model” allowed much faster growth of MFIs as it effectively bypassed the equity constraint of MFIs had the loans been on the MFI’s balance sheet, the MFI would have to increase its equity levels<sup>18</sup> proportionately to maintain prescribed capital adequacy ratios and reasonable leverage levels. The fast growth under the model led to a lack of incentives for MFIs to develop robust origination practices and to invest in MIS and monitoring systems of high quality; yet, the “partnership model” has played an important role in the growth of the industry in India.

MFIs were required to provide a “credit enhancement” or First Loss Default Guarantee (FLDG) to the bank, usually as an upfront fixed deposit to be placed with the bank. The FLDG was between 6-10% of the amount availed from the bank, depending on the risk profile of the MFI. In cases where the MFI was not able to place fixed deposits, the bank provided an overdraft facility to the extent of the FLDG. This overdraft would be invoked if the MFI defaulted on its payments and the overdraft would attract penal charges.

Over the last few years, portfolio buyouts have also emerged as a popular tool for off balance sheet financing. In 2004, Share Microfin completed the first portfolio buyout in Indian microfinance by selling a portfolio of Rs 174 crore to ICICI Bank. Grameen Foundation, USA provided a guarantee to ICICI Bank on behalf of Share Microfin. Since then, several innovative structures have been tested, including an “on-tap securitisation” mechanism between Citibank and BSFL (BASIX) in which new loans generated by BSFL are bought by Citibank on a monthly basis. More recently, in August 2008, IndusInd Bank provided SKS Microfinance with a Rs 100 crore loan to originate microfinance receivables, which was to be assigned to the bank over a period of time.

Following the trend set by the above transactions, several other banks in the country have been active in portfolio buyout deals with MFIs. These transactions also set the stage for the first rated securitisation of microloan portfolios in India.

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<sup>17</sup> Prabhu Ghate (2006 & 2007). “Microfinance in India: State of the Sector Report”. Access Development Services, India

<sup>18</sup> Ibid.

## The First Rated Securitisation in Indian Microfinance

The first formal securitisation of assets in India took place in 1991, when Citibank securitised a pool from its auto loan portfolio and placed the paper with GIC Mutual Fund. The transaction was rated by CRISIL. Since then, securitisation of assets has emerged as an attractive option for fund raising by corporates.

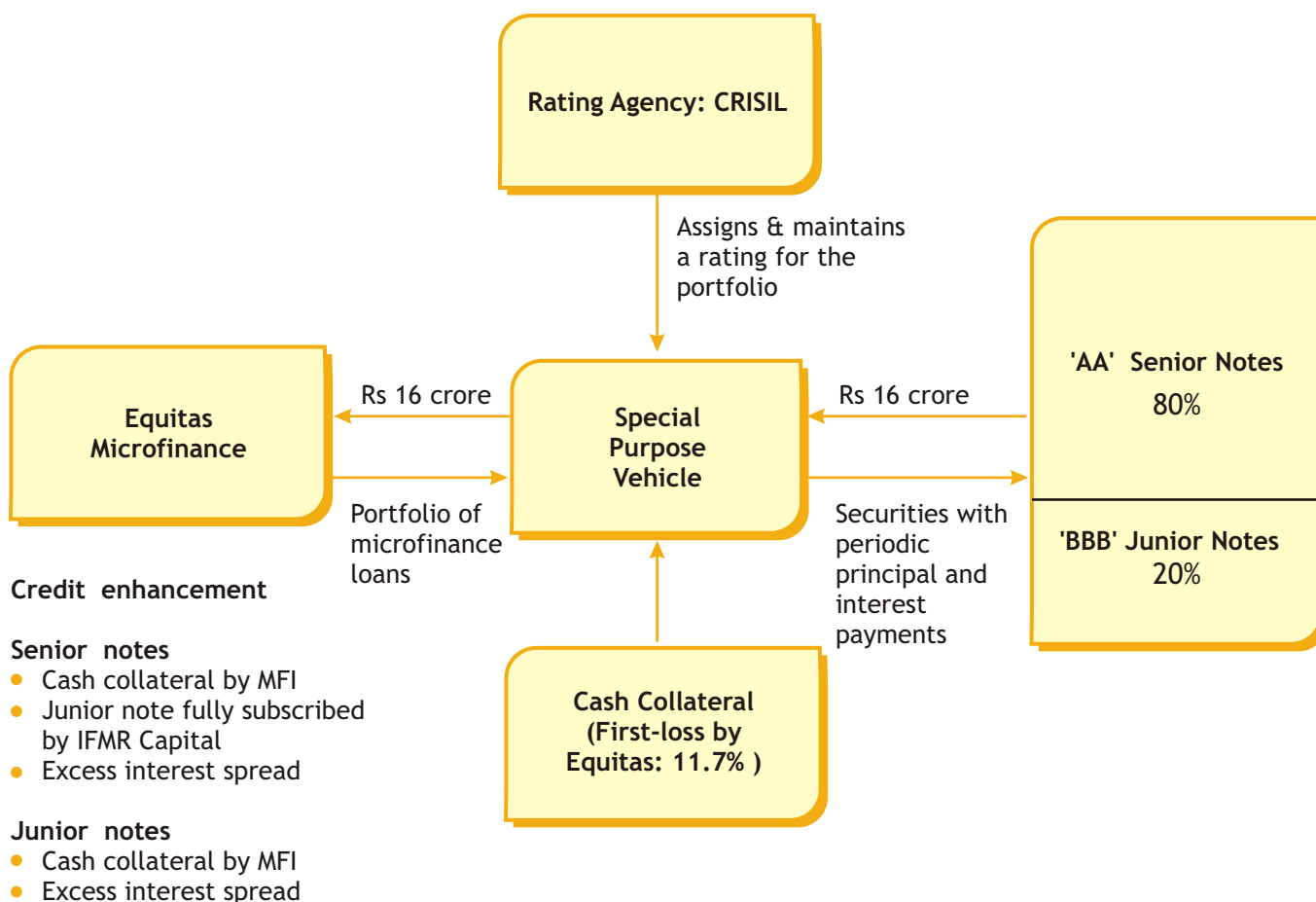
In February 2009, IFMR Capital and Equitas Micro Finance India Private Ltd concluded the first-ever rated securitisation of microfinance loan pools in India. The transaction involved the securitisation of a loan pool of Rs 16 crore originated by Equitas, a leading MFI having operations in the southern state of Tamil Nadu.

The transaction was structured and arranged by IFMR Capital, and the loan pool was purchased from the originator by a bankruptcy-remote Special Purpose Vehicle (SPV) created specifically for this transaction. The SPV then issued “pass through certificates” (PTCs), thus allowing the cash flows from the loan pool to be transferred to the investors through the SPV.

CRISIL has rated the transaction which has two tranches of securities, the Senior Notes being rated 'AA' and the Subordinated Notes rated 'BBB', both ratings being on an 'ultimate' basis. The rating process involved a comprehensive due diligence conducted by CRISIL covering the MFI's performance and quality of the loan pool, the structure of the transaction, the extent of first and second loss provided, legal aspects of the transaction etc. The loan pool was thus securitized into the 'AA' rated Senior Notes (equal to 80% of issue size, i.e. Rs 12.5 crore), which were subscribed to by a bank investor, and 'BBB' rated subordinated notes (equal to 20% of issue size, i.e. Rs 3.1 crore), which were purchased by IFMR Capital. Equitas provided a cash collateral equal to 11.7% of the issue size.

The senior note investor is therefore provided protection to an extent of 31.7% of the issue size, in the form of the cash collateral from Equitas and the 'BBB' rated notes, which are fully subordinated to the senior notes, subscribed to by IFMR Capital. The extent of protection increases as the portfolio runs down.

IFMR Capital structured this securitisation also keeping in mind the learnings from the “sub-prime” crisis. The fallout from the sub-prime mortgage market in the U.S. showed that, when all risks are passed on to end investors, loan originators and financial intermediaries have no incentive to perform the requisite due diligence at the time of originating and buying portfolios of loans. The first-loss risk that Equitas bears is to ensure that the originating MFI maintains high quality of origination and servicing. The second loss piece, in the form of subordinate notes, provided by IFMR Capital ensures that it has an incentive to conduct robust pre-purchase due diligence to ascertain that the originating institution is of high quality. Each party in the transaction thus takes risks that it is best equipped to handle and the structure ensures that the incentives of all parties are aligned



The table below shows how some of the risks in the transaction are mitigated by the above structure.

## How the risks are mitigated

Institution	Risks and Mitigants	Protection to Senior Investors
MFI	<p><b>Origination &amp; credit risk</b></p> <ul style="list-style-type: none"> <li>• Credit appraisal</li> <li>• Timely follow-up for repayment</li> <li>• Robust MIS &amp; monitoring systems</li> </ul> <p><b>Asset class risk</b></p> <ul style="list-style-type: none"> <li>• Short-term loans</li> <li>• Group liability</li> <li>• Loan linked to borrower's business cash flows</li> <li>• Emphasis on timely repayment of principal</li> <li>• Transparency in products</li> </ul>	<p>The First Loss Default Guarantee in the form of cash collateral that will stand for the life of the transaction.</p> <p>Any losses will first be absorbed by the FLDG.</p>
IFMR Capital	<p><b>Servicer risk</b></p> <ul style="list-style-type: none"> <li>• Underwriting guidelines</li> <li>• Rigorous due diligence</li> </ul> <p><b>Structuring risk</b></p> <ul style="list-style-type: none"> <li>• Alignment of incentives</li> </ul>	<p>Second Loss position in the capital structure, in the form of 'BBB' rated subordinated notes.</p> <p>This security will be used to cover losses only once the first loss piece has been exhausted.</p>

## Benefits of Securitisation

Securitisation in the context of microfinance offers several benefits both to the MFI and investors such as banks, mutual funds and insurance companies.

Rated securitisations allow for the broadening of universe of investors and bring in mutual funds and insurance companies also as potential investors in this space. As far as MFIs are concerned, this opens up multiple avenues to seek funding.

Appropriately structured securitisations can give such investors access to a new class of assets that are short term and have low correlation to mainstream markets, thereby providing for portfolio diversification. The presence of different types of investors in the market will also serve in increasing the liquidity of microloan backed securities and also lead to a secular reduction of cost of funding for the MFIs over time.

A rating also ensures that the microfinance asset can be compared like-for-like with other asset classes, and investors will therefore have a basis to assess microloan backed securities. This also means that the MFI can access capital markets as and when required and raise debt. It thus enables MFIs to manage their liquidity and get more regular funding throughout the year instead of lumpy inflows towards year-end, when banks are looking to meet the regulatory lending requirements. As institutions build their track record and access the securitisation markets time and again, the structural requirements in terms of credit enhancement will come down and free up more capital for the MFI. At the same time, a track record of successful securitisations will also lead to a progressive reduction in the cost of funding for the MFI.

The implementation of Basel II norms also incentivizes banks to invest in securitized paper. Securitisation can be a more efficient way of funding MFIs since rated securities require lower risk weights under Basel II guidelines and therefore free up more of the bank's capital.

## Conclusion

Microfinance is fast emerging as an attractive asset class for investors across the world, particularly because of the social impact coupled with high returns. India, which currently has about 20% of the world's poor, presents a large market for microfinance, with the unmet demand being close to Rs. 70,000 crore. The Indian microfinance sector is growing at a fast pace, with some of the largest MFIs showing growth rates close to 100% year on year.

Moreover, Indian MFIs are also increasingly becoming more professionalized and regulated, for-profit entities that have begun to attract commercial equity as well as debt investors from domestic and international markets. The growth trend represents that the industry is now maturing and is ready for structured finance products including securitisation.

The foundation for rated securitisation of microfinance loans pools has been laid, with the Equitas transaction structured and arranged by IFMR Capital. With several investors now keenly interested in microfinance as an emerging asset class, it is expected that securitized loans will be a significant source of funding for the Indian microfinance sector in the future, as it offers several benefits to both investors and MFIs. As the market for securitized microfinance loans matures, it will eventually result in much lower cost of borrowing for MFIs, leading to a reduction in cost for the ultimate borrower.





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