Securitization in Microfinance

Securitization is a financing process in which a company moves assets to an ostensibly bankruptcy-remote vehicle to obtain lower interest rates from potential lenders. This article explains how securitization works for Microfinance Institutions.

As microfinance claims its place alongside other asset classes in institutional investment portfolios, securitization is gaining attention because it provides a means of packaging microfinance risk in a way that is both attractive to investors and suits the needs of growing microfinance institutions (MFIs).

For the investors, securitization provides a direct risk on a granular, diversified pool of financial assets. As a "pure play", a securitization credit is easier to analyze than a typical corporation with its multiple lines of business and exposure to variable and uncontrollable operating risks. Moreover, securitization simplifies asset allocation, enabling portfolio manager to more easily conduct their diversification strategies.

For the asset originator, securitization - which typically involves purchasing assets off the originator's balance sheet – enables an organization to expand its business without constantly bringing in new equity to underpin growing liabilities. New equity not only dilutes existing owners' control but is usually the most expensive (and time-consuming) form of capital to raise.

Before we look at the rise of microfinance securitization, we need to define terms. "Securitization" in the international capital markets generally means a transaction in which a special purpose legal vehicle (SPV) is created, issues securities to fund itself, and uses the proceeds to purchase financial assets, such as loans, bonds or receivables. The SPV has a sole purpose: to deliver a defined, limited pool of risk to investors. Most securitizations apportion the risk of the assets among several classes, or "tranches", of securities in order to accommodate investors along a spectrum of desired risk-return levels. More on this later!

In India, however, "securitization" has been used to describe the purchase, typically by a bank, of microloans from an MFI. The bank typically does not house the purchased assets in an SPV, nor does it issue securities which are solely dependent on the microloans for repayment. It may be helpful to consider these transactions as "microloan purchases" rather than "securitizations" strictly speaking. Therefore, in the sense in which the word is used in international capital markets, "securitization" has not yet arrived in microfinance in India.

There have been at least 9 microfinance securitization transactions in international capital markets, totaling approximately $375 million. Of these, only two, accounting for approximately $75 million, have been direct securitizations of microloans purchased from MFI balance sheets. The remainder of the deals has been a specific form of securitization called collateralized debt obligation (CDO).

CDOs are securitizations in which corporate loans or corporate bonds comprise the asset pool -- as distinguished from loans to consumers, such as mortgages, car loans or credit card receivables, which usually are termed simply "securitizations". MFIs that participate in CDOs do not sell microloans off their balance sheets – in this form of securitization, each MFI simply takes a loan from the SPV which then securitizes a pool of loans to multiple MFIs.

Let's look at CDOs first, and then direct microloan securitizations. Finally, we will make some observations on the prospects for microloan securitization in India.

Collateralized Debt Obligations

The first CDO based on microfinance risk and sold in the international capital markets was BlueOrchard Microfinance Securities I (BOMSI), co-sponsored by DWM and BlueOrchard. The first closing of $40 million occurred in July 2004 and a subsequent closing of $47 million was held in April 2005.

In both offerings, investors purchased seven-year notes, the proceeds of which were used, simultaneous with the note issuance, to fund loans to MFIs - 14 MFIs, in nine countries. Both the notes and the loans mature with a single repayment of principal seven years after closing.

BOMSI's funding is stratified in five levels of risk – senior, three classes of subordinated, and, at the bottom, equity. The cashflow from BOMSI's loans to MFIs is applied according to a strict order of precedence, known in structured finance as the "cash waterfall".

Senior investors are paid completely first, then the other classes in order of precedence. Equity investors do not get a current return on their investment -- but if there is residual cash left in the BOMSI SPV, after all MFI loans have reached maturity and all other investors have been repaid, it will be allocated to the equity investors.

The tiered capital structure enabled BOMSI to offer high returns to the higher-risk tranche investors, while providing the lower-risk investors with a substantial degree of collateralization, enabling them to accept a relatively low credit spread because their notes had the highest priority of repayment.

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Investors were not asked to discount their return expectations in view of the presumed social value of microfinance. With a variety of securities offering different risk and return parameters, BOMSI was able to segment the international investor base and thus appeal to a wide spectrum of potential investors.

Since the inception of BOMSI, both DWM and BlueOrchard have sponsored additional CDOs, as has the specialized microfinance lender Global Partnerships. In total, including BOMSI, approximately $300 million has been raised in CDOs so far.

Microloan Securitizations

Direct securitization of microloans has attracted a great deal of interest, as microloans are relatively homogenous and vastly diversified, in line with other consumer obligations such as mortgages and car loans that have been successfully securitized.

However, several important challenges need to be overcome to structure a microloan securitization:

- Short maturity of microloans: As opposed to longer-term assets such as mortgages, which may endure 30 years, most microloans mature in less than a year and feature frequent amortization. This means that all but the shortest-term microloan securitizations will need to incorporate a mechanism to roll over or substitute the underlying assets, which greatly increases the structuring complexity, administrative cost and non-financial risk (see below).
- Origination risk. Because the portfolio of underlying microloans needs constant replenishment, the ability of the MFIs continually to originate a sufficient volume of microloans is a significant additional risk.
- Important role of servicer: Successful MFIs cultivate intimate relationships with borrowers. Thus the MFI role in servicing securitized microloans is a critical element in the performance of the securitized portfolio. This makes it difficult to portray microloan securitizations as pure borrower risk. In effect the performance risk of the MFI servicer is a key component in the overall risk profile – and a difficult one to quantify in the pricing of the risk.
- Difficulty of rating: Institutional investors typically require, or at least favor, credit ratings on investment products. In the case of securitizations, since there is no corporate balance sheet to support the credit, the rating agencies rely on extensive data on the assets being securitized to model the outcomes of various risk and maturity structures. For more developed asset classes such as mortgages this data is easily obtainable going back many years. But microfinance is still a new industry and data on microloan performance is both difficult to obtain and not standardized across the industry. However, it is promising to note that SKS here in India recently successfully underwent a static pool analysis of its loan portfolio in order to demonstrate that certain MFIs do have sufficient data available to support a rigorous analysis.

Given these constraints, there have been only two case of microloan securitization in international capital markets.

- In May 2006, ProCredit Bank Bulgaria, a subsidiary of ProCredit Holding AG, sold €48 million of its loan portfolio to institutional investors
- Four months later, BRAC, a large Bangladeshi MFI, held the first close of a program, backed by microloans, which will issue $15 million (local currency equivalent) of 6-month maturity notes twice a year for 6 years. (Note that while the deal has been advertised as $180 million in size, total risk outstanding at any one time is $15 million, which is effectively rolled over 12 times)

Neither of these transactions could be viewed as "market standard" and thus neither provides a model for replication with commercial capital market investors.

In the ProCredit case, the European Investment Fund and the German development agency KfW each provided substantial guarantees, enabling Fitch Ratings to grant an investment grade (BBB) rating. Thus it is difficult to make the case that investors accepted the risk of the assets on their own merits. Moreover, in most commercial securitization transactions, fees charged by substantial guarantors would lower investor returns to unacceptable levels.

In the BRAC case, the issue was rated AAA by a local rating agency, but this was based on an overcollateralization level of 50% (i.e. for every $15 million of microloans sold to the SPV, BRAC earmarks another $7.5 million from its microloan portfolio as credit support for the securities). Most asset sellers would not agree to take on this level of liability; moreover, the liability would remain on the balance sheet, thus vitiating one of the principal reasons for doing a securitization in the first place. But for BRAC, with its $380 million balance sheet, the incremental risk was not material and apparently was outweighed by the value to its reputation of being the "first sponsor of an AAA-rated securitization".

Microloan securitization in India

Most Indian MFIs have been able to grow equity, through retained earnings and founders' capital, in line with their liabilities. However, that situation is now changing. With the continued increase in their microloan portfolios, MFIs are starting to look for outside capital. In addition, RBI's 10x debt-equity capital adequacy rule for non-bank financial companies (NBFCs) is putting pressure on the most-leveraged MFIs to grow their equity.

In principle, this context should favor the emergence of microloan securitization. However, the constraints mentioned above are daunting, in India as elsewhere. Moreover, the relatively rigid capital controls regime impedes the financing of microloan securitizations by offshore investors that could bring their expertise in this asset class into India.

Priority Sector Lending rules also may discourage microloan securitization in India. Banks eager to satisfy their PSL requirements compete for MFI exposure, thus driving down MFI borrowing rates to levels below those that institutions normally would require.

Over time, however, it is likely that the success of the microfinance industry in India will create such a demand for capital that new forms of funding will arise, among them securitization. India is not alone in this regard. Despite the inherent difficulties, securitization projects are underway in several countries and it is probable that truly commercial, replicable, models will emerge within a short period. ■

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