



GRAMEEN CAPITAL INDIA LIMITED

Alternative financing structures for Microfinance Institutions (MFIs)

Portfolio sale

Outright sale of Microfinance assets

Portfolio sale is a type of off-balance sheet transaction which serves the twin purpose of generating funding from portfolio cash flows as well as freeing up regulatory capital, if structured appropriately.

It involves an outright sale of microfinance assets to Banks and is one of the simplest structures being used, albeit by a handful of larger MFIs in the Indian microfinance sector. In this structure, the buyer (bank) purchases microfinance assets from the originator (MFI), thereby bringing all the assets (individual receivables) on the buyer's books. The originator may continue to service these loans on behalf of the buyer.

Participants in the structure

A typical portfolio sale transaction involves the following entities:

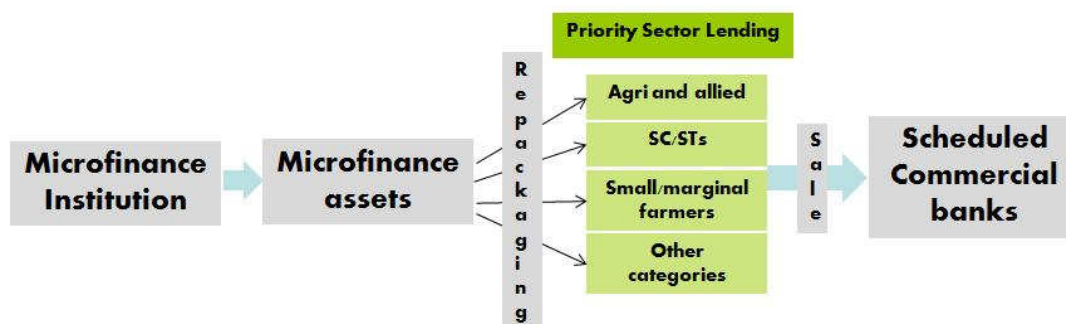
- a. Originator: This is the entity on whose books the assets that need to be sold exist. In the given context, MFI acts as the originator
- b. Investor: Investors buy a participating interest in the pool of receivables (assets to be sold) and receive their payment periodically in the form of principal and interest. Given the priority sector lending requirement in the Indian context, Banks are the key investors in microfinance portfolio sale structures, by which they (banks) hold/record the assets directly in their own books.
- c. Obligors: The obligor is the Originator's debtor (borrower of the original loan). The amount outstanding from the Obligor is the asset transferred to the Investor. The credit standing of the obligor is of paramount importance in the portfolio sale transaction.
- d. Administrator or Servicer: It collects payments from the Obligors and passes them on to the Investor and also follows up with delinquent borrowers. Typically, the originator also acts as the administrator/servicer.
- e. Structurer: A third party agency (like Grameen Capital India) is responsible as structurer for bringing together the Originator, Investor, Credit enhancer and other partners to a portfolio sale deal. It also works with the Originator and structures the transaction.

Demand side

The market for such assets has developed primarily owing to prevailing regulatory environment in the banking sector in India. As per the existing regulatory framework, banks have priority sector lending (PSL) targets (the Reserve Bank of India mandates that banks must lend a certain percentage of funds to certain sectors: 40% for domestic banks and 32% for foreign scheduled commercial banks). Within the overall figure, sub-targets are set for banks: for domestic banks, 18% agricultural loans (of which 13.5% is direct-agri) plus 10% lending to weaker sections, for domestic banks; for foreign banks, the requirement of specific relevance to this context is the 10% sub-target for micro, small and medium enterprises. Since microfinance assets qualify as PSL and the bulk of it falls under lending for direct-agri, weaker section and micro-enterprise, there is immense value for MFIs in doing such bilateral transactions with banks. Term lending by Banks to MFIs qualifies under indirect category, while a sale/securitization allows the bank to categorise the assets under the all important direct lending segment.

Considering the shorter tenor of microfinance assets (about one year), there is keen interest in the banking community for such structures to be "on tap" all year round, given the need for reporting of PSL compliance every quarter, especially at the March-end "reporting Friday," i.e. end of the financial year for India, when penalties for bank's non-compliance on priority sector lending targets get computed.

Structure



Role of credit enhancement

Why credit enhancement

Credit enhancement is needed to mitigate the inherent risks of servicing the portfolio and bring the security to an acceptable level as far as investors are concerned. Credit rating of the pool of assets determines the levels of additional credit enhancement required to bring the securities issued to a rating which would attract investors. However, portfolio sale transactions have been done without a rating of pool as well.

Levels of credit enhancement

Considering the relative newness of microfinance as an attractive asset class, Banks require significant credit enhancement to provide additional comfort (to mitigate the risk of taking up borrowers directly on their books). Typical credit enhancement levels for portfolio sale transaction have been in the range of 15%-20%, seemingly higher than levels than those seen in conventional term loan facilities. However, it is expected that over time, these requirements will come down (improvisations of the guarantees are already being evaluated in one structure by Grameen Capital India, wherein the MFI commits to buyback future non-performing assets in the pool sole to the investor).

Mitigants

Typical structures undertaken by Grameen Capital India have been to get the MFI place a 2-5% FLDG component basis the historical loss levels and arrange SLDG component from a third party depending upon the buyer's requirement. This provides additional comfort to third party credit enhancement agencies which are giving second loss guarantees, with a sufficient cushion provided by the first loss piece.

This note is prepared by Grameen Capital India and is for information purposes only. Grameen Capital India focuses on reducing the cost of capital for MFIs through debt and equity investment advisory and structuring, and facilitating capital markets access to MFIs. It is also involved in structuring and arranging securitization and buy-out transactions and in arranging credit enhancement. Grameen Capital India (www.grameencapital.in) is a collaboration of Grameen Foundation, IFMR Trust and Citi. To know more, please contact Royston Braganza (Chief Executive Officer, Grameen Capital India) at royston.braganza@grameencapital.in or Shashi Shrivastava (Vice-President, Grameen Capital India) at shashi.shrivastava@grameencapital.in