

Primer on Securitization

After the subsidy and soft loan era which initiated NGO MFIs in India, commercial lending by banks to MFIs has led the second round of expansion. However, already the conventional debt space is handicapped with issues of insufficient capital base, (resultant) high leverage, and the rising cost of debt. So how do the MFIs address these issues? The answer to some of the questions is in the dire need for MFIs to attract capital in other than conventional ways and, as a result, access mainstream capital markets and broader set of investors including mutual funds, pension funds, insurance companies etc. Various off-balance sheet structures are possible which serve the twin purpose of generating funding from portfolio cash flows as well as freeing up regulatory capital, if structured appropriately.

We are halfway through what has been declared as the year of the “bottom billion” by United Nations Secretary General Ban Ki Moon. With a country where roughly 40% of the world’s poor live, India seems to be (and rightly so) at the focus of global financial inclusion initiatives.

First, let us get the percentages out of the way- National poverty line estimates about 28% poor in the country, while a look at other (often debated) measures by the World Bank put the numbers much higher, at over 34% of the population living below \$1 a day and over 80% below \$2 a day!

The total of all outreach of microfinance initiatives (both by state as well as private sector) is widely estimated to be nearly 50 million poor in 2007, though this appears to be an overstated figure, risking multiple counting. Of these, microfinance institutions across India are estimated to reach out to nearly 9 million households with an INR 60-80 billion portfolio (US\$ 1.5-1.9 billion), a fraction of the total demand which is anywhere between INR 0.75-1.50 trillion (US\$ 18-36 billion). Compare this with Bangladesh, where the largest five MFIs each reach out to over 5 million clients. To put this in perspective though, Bangladeshi MFIs have a much greater history spanning over 3 decades compared to MFIs in India which are of much lesser vintage. However, with India’s fantastic growth rates (MFIs in India are witnessing arguably the fastest growth rates in the world!), we will very soon see MFIs of that size in India as well.

Together, the top five MFIs in the country are expected to disburse between INR 120-150 billion (US\$2.8-3.6 billion) during the current year. The sector as a whole is expected to continue the 80% growth it has experienced over the past several years.

Why Securitization?

One of the most critical issues here is the ability of the MFIs to be able to raise the necessary debt and equity capital to fuel their growth and this within the costs estimated in their Business Plans.

It is in this context, that certain off-balance sheet structures become useful by enabling access to a larger investor class given the limited, often seasonal, appetite of banks, and also in freeing up the regulatory capital.

Securitization and Portfolio Buy-outs

Portfolio buy-outs and securitization structures have been actively executed in the past in other industries in India. The year 1991 saw the first securitization transaction in India when Citibank securitized a pool from its auto loans portfolio and placed it with GIC Mutual fund. Since then, securitization of assets has begun to emerge as a clear option of fund-raising by corporates and a few transactions of well-rated companies have taken place in the country. As per the regulatory definition, securitization is the process of pooling and repackaging homogenous illiquid financial assets into marketable securities that can be sold to investors.

The Concept of Securitization

Securitization is the process of conversion of existing assets or future cash flows into marketable securities. In other words, securitization deals with the conversion of assets which are not marketable into marketable ones.

Securitization primarily involves sale of assets to a bankruptcy remote special purpose vehicle (SPV) in return for an immediate cash payment. The cash flow from the underlying pool of assets is used to service the securities issued by the SPV.

Securitization issuance can include Asset Backed Securities, Mortgage Backed Securities, Single Loan Sell Downs, Collateralized Loan Obligation and Direct Assignment of loans.

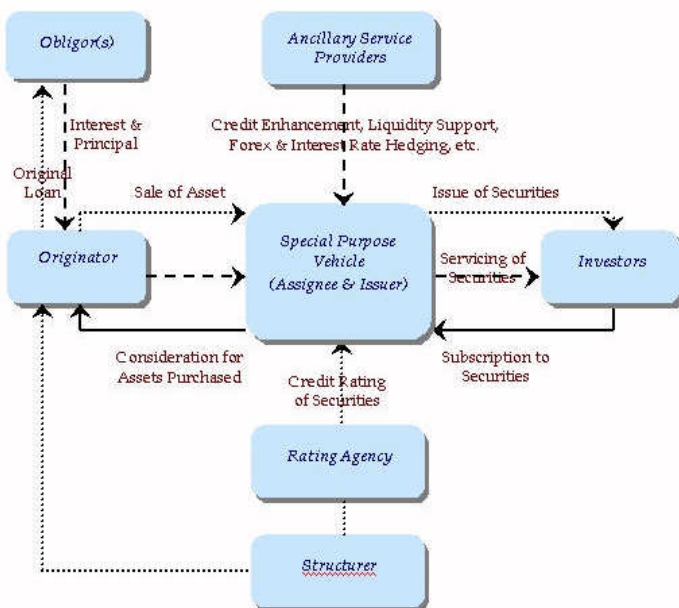
The Role of the Rating Agency

An external rating agency rates the pool of assets earmarked for securitization, thus ensuring that the credit risk of the pool is independent of the

credit risk of the originator (entity selling the assets). In India, The Central Bank's guidelines¹ mandate that securities issued by the SPV shall compulsorily be rated by a rating agency registered with the Securities and Exchange Board of India (SEBI) and such rating at any time shall not be more than 6 months old (it is important to note that, commonly, there are some unrated securities within a transaction as well). The rating requirement is to ensure that the repayment of securities subscribed by the investors is not impacted by insolvency of the originator.

Securitization transactions have largely taken place in asset classes like automobile loans (ICICI Bank, India's second largest bank, undertook the largest securitization transaction ever for old car loans last year, for INR 19.3 Bln) (US\$ 0.5 billion), personal loans, credit card receivables, real estate, etc. The microfinance sector in India though, has yet to see a true securitization transaction.

Fig 1: Securitization: A typical transaction structure



What Steps does Securitization Involve?

A true securitization structure comprises the following key stages and indicative timelines:

How does Securitization free up the 'regulatory' capital?

Globally, regulations require lending companies (Banks, financial institutions and other forms) to maintain minimum capital adequacy depending upon their asset size. Typically, this is governed by way of Capital to Risk Weighted Assets ratio (CRAR or CAR) and calculated as below:

$$CAR \text{ or } CRAR = \frac{\text{Capital}}{\text{Risk weighted assets}}$$

Assume for instance, a MFI has INR 10 of capital and INR 100 of Risk weighted assets. The CAR or CRAR for this MFI will then be 10 divided by 100 or 10%. Assume now that the MFI securitizes INR 20 from its assets and so is left with INR 80 worth of risk weighted assets. The CAR or CRAR now rises to 12.5%. As a result, assuming the capital at INR 10, now the MFI can disburse further INR 20 while maintaining its capital adequacy at 10%. Also, in the Indian context, provision of credit enhancement by originator (MFIs in this case) requires them to earmark capital to a certain extent. This can be further overcome through third party credit enhancers.

In India, the central bank has, on 30 May 2008, issued draft guidelines to increase the capital adequacy requirements for non-deposit taking Non-Banking Financial Companies with >INR 100 crore or US\$ 25 million asset book from 10% to 12% and further to 15% from 2009. Almost all of the for-profit microfinance companies are registered as NBFCs and as such, this move is set to further put stress on capital.

Securitization is a process by which a company (originator in this case) can sell off its assets for immediate cash-flow, thereby freeing up the regulatory capital earmarked to the asset. While raising capital is an expensive exercise, securitization can work an effective balance sheet management tool on an ongoing basis.

undertaken in the Indian microfinance context, yet a key opportunity is in portfolio sale transactions

with banks. 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.

Grameen Capital India recently arranged a portfolio sale of nearly US\$6 Million of direct agri assets of BISWA (one of the largest MFIs in East India). With a two-tier credit enhancement piece (amounting to 50% of the pool size), the transaction was discounted at 6% per year by the purchasing bank.

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.

What is the role of 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.

Credit enhancement can be arranged for by the originator or by third parties like credit enhancement providers/investors as first loss, and if required, multiple layers of guarantees. If originators provide the first or second loss guarantee themselves, the existing securitization regulations in India require them to reduce their Tier I and Tier II capital (up to the full extent depending upon the structure). As such, it is useful for originators to have a third party credit enhancer providing the guarantee.

There have been nearly a dozen ‘microfinance’ securitization transactions in the global capital markets. Of these, 2 have been securitization of

microloans (small value loans given by MFIs) while others have been a particular type of securitization called collateralized debt obligation (CDO) wherein the asset pool is more heterogeneous, has smaller number of underlying assets and more innovative (including bonds, leveraged loans, credit default swaps or even sometimes CDOs)².

Transactions involving securitization of microloan receivables of MFIs have been rare (only two reported till date). In 2006, when Citibank arranged a securitization transaction for BRAC, Bangladesh to arrange for US\$ 180 million financing for over 6 years. The first issuance was US\$ 15 million with a AAA rating (bonds were 150% collateralized with BRAC’s microloans) and subscribed by FMO and Citibank among others. Few months before this transaction, Deutsche bank arranged a transaction for ProCredit Bank Bulgaria for securitizing an asset pool of €47.8 million (to put this in context, the average loan size in the initial pool was nearly €15,000- too large to be referred to as a ‘microloan’!). This was also heavily credit enhanced- the issue was rated BBB by Fitch on the back of guarantees by ProCredit holdings, European Investment Fund and KfW.

Securitization and Portfolio Buy-out Market for Indian Microfinance

Value from such off-balance sheet structures for MFIs is manifold:

- Improving access to debt capital, by reaching out to a larger investor class. Typical subscribers to securitized notes could be mutual funds, pension funds, insurance funds, etc.
- With most of the large NBFC MFIs now under the category of systemically important or SI-NBFCs, capital adequacy is a key constraint. Besides, one of the issues with the Indian microfinance sector has been the high leverage (10-15 times). Proper structuring can help MFIs free up their regulatory capital and thus, enable them to borrow more to fund operations.
- There is good appetite for such short-term assets (characterised by high repayments and minimal non performing asset, as per the historical data) in the capital markets.
- Tremendous value for MFIs in selling these assets to banks, from the point of view of priority sector lending requirements for banks. Recent additions by the regulator (in terms of addition of 10% lending to weaker sections under mandatory sub-targets) will only increase the appetite further.

- Smaller MFIs can use securitization to access the capital markets, as well. For Tier II or Tier III MFIs who may not be able to originate portfolios of a certain size, it would make “economic sense” to do such a transaction by pooling portfolios with other MFIs and accessing the markets. Such MFIs can utilize aggregation and credit enhancement arrangement capabilities of specialised firms for accessing capital markets and benefiting from the securitization of their assets.

Net-net, the future looks bright. MFIs have tremendous “locked-up” potential value which is inherent in the very nature of their portfolio. Unleashing this calls for some bold steps – moving beyond the traditional comfort zone of bank financing, and trying out innovative capital market structures. But it’s about time to think differently – especially when there is money “on-tap.”

The regulatory guidelines on the securitization market (2006), specifically the requirements on amortization of profit and treatment of capital on provision of credit enhancement brought a temporary stagnancy in the market. It is expected that introduction of BASEL II norms shall bring in clarity and depth in the securitization market, as will SEBI’s move to create a secondary market for securitized debt through listing of such debt.³

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¹ <http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=2723&Mode=0>

² http://www.nek.lu.se/publications/workpap/Papers/WP06_14.pdf

³ CARE ratings: Securitization market in India

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