

10. Microfinance Loan Obligations – Structured Finance for Microfinance Investments

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1. INTRODUCTION TO MICROFINANCE

Microfinance is the provision of financial services to economically active poor populations. By giving access to capital to people excluded from the formal banking sector and economical arena, one opens up an opportunity of virtuous cycles of financial security, savings and growth. Micro and small entrepreneurs can work to stabilize their cash flows, create jobs and improve their living standards. Microfinance replaces neither humanitarian aid nor charitable purpose donation for the world's destitute population and post-conflict areas. It offers poverty alleviation opportunities to small entrepreneurs who aim at sustaining their own needs through various professional activities. Microcredit and microfinance have changed the lives of people and revitalized communities in the world's poorest and also the richest countries. We have seen the enormous power that access to even modest financial services can bring to people. With access to a range of financial tools, families can invest according to their own priorities – school fees, health care, business, nutrition or housing.

However, studies have shown that of the 4 billion people who live on less than USD1,400 a year, only a fraction has access to basic financial services. With this huge unmet demand, the Year of Micro-credit 2005 calls upon us to build inclusive

financial sectors and strengthen ‘the powerful, but often untapped, entrepreneurial spirit existing in impoverished communities.’¹

Microfinance can also be seen as an investment opportunity, with a double bottom line. Microfinance institutions, offering credit and business advisory services to micro- and small enterprises, work to democratize the access to capital. They are both financially sound and profitable institutions and mission driven entities aiming at poverty alleviation. By helping these institutions grow and sustain their micro- and small clients demand, investors achieve both a financial and a social impact down the value chain. Microfinance can thus be seen as a large market, from the investor down to the micro-entrepreneur, with an opportunity for the investor to fill an important existing gap between a large unmet demand and a new emerging supply.

1.1. Capital Markets and Socially Responsible Investors

Globalization and geopolitical events also are increasingly driving capital towards the periphery, opening up new opportunities from previously unattended populations. Emerging markets funds, often theme oriented (sustainable development, environment, water, renewable energy, housing, small enterprise, etc.) are becoming every day more apparent. Whether socially responsible or not, today investors are increasingly looking into low volatility opportunities and/or segments of the market uncorrelated with mainstream global benchmarks. Absolute returns, capital guarantees and value for the money are becoming just as important as relative performance. Microfinance fits all three of these new global trends in the financial arena. As a consequence, the past few years have witnessed the emergence of new microfinance investment vehicles attracting SRI and capital market money. In return, they are bringing yet more professional skills into the industry, increasingly commercializing and rationalizing the value chain, pressuring investment intermediaries into further transparency, risk management tools and competitive market pricing.

1.2. Microfinance Funds and Investment Vehicles

Over 50 global and regional microfinance investment vehicles exist today, and at least as many local ones have been identified. All are expected to grow significantly in the coming few years. Foreign investment in microfinance totals over a USD1 billion, and is growing rapidly (supply is expected to double in 2005 and double again by 2008). These funds are today mostly set for average foreign investments of less than USD1 million in short term hard currency debt. They have

¹ United Nations, ‘International Year of Microcredit 2005’ (available at <www.yearofmicrocredit.org>).

also in the past five years targeted largely the same few dozen institutions, monopolizing much of the attention in the industry. Current policy makers are thus increasingly pressuring investment intermediaries to broaden the scope and geographical outreach of investment products and match adequately the large inflow of funds with the large market demand.

1.3. Microfinance Institutions

Microfinance institutions vary in size and scope. They often start as small NGOs with credit activities being only a part of their focus, and eventually mature into fully-fledged regulated banks. This typical life-cycle gradually pushes them into full commercialization. Today, there are a few dozen banks and financial institutions with balance sheets over USD100 million, profitable and regulated; a few hundred microfinance organizations with balance sheets over USD5 million, commercially sustainable and with high growth rates (>30 per cent on average); and a few thousand micro-credit programs with balance sheets of less than USD5 million, largely donor driven. In recent surveys, the number one growth impediment to microfinance institutions remained access to capital. Today their supply is generally sought to cover 10 to 15 per cent of the potential demand.

1.4. Micro- and Small Enterprises

There are 4 billion people who live with less than USD4 per day, about 2.7 billion with less than USD2 per day and 1.1 billion with less than USD1 per day. There are at least 500 million economically active poor or micro-entrepreneurs worldwide, the vast majority of whom lack access to capital to sustain and grow their professional activities. The average financing need worldwide is estimated at USD500 per micro-entrepreneur, suggesting a potential market demand of USD250 billion. Microfinance services bring three essential features to a micro-enterprise and its owners: security, growth and empowerment. The economically active poor evolve in cash flows of survival and economics of emergency; they cannot afford to save, and the slightest shock on their revenues, whether due to exogenous factors (hurricanes, earthquakes, strikes, social strife, etc.) or endogenous factors (sickness, weddings, funerals, migration, etc.), might ruin their cash flow and sustainability. If existent, their only alternative is often to finance themselves with local loan sharks, charging up to 10 per cent a day, as is the case from time to time in, for instance, Bolivia or the Philippines. On the contrary, access to adequate financial services works as a security buffer for them, offering liquidity in times of turmoil. Similarly, access to capital allows them to invest in the future, buy fixed assets or hire new staff. In the end, contact with their micro-banker works to integrate them back into cycles of opportunities and increase their self-esteem, independence and social networking. Stabilized and sustainable business cycles in turn increase the micro-entrepreneurs' household disposable income.

This affects their family consumption and life patterns, allowing them an array of choice from more education for their children, to better nutrition or housing facilities, access to health services, etc. Multiplied at the scale of a neighbourhood or city, these hundreds of new opportunities stimulate social capital and community development.

1.5. Current Trends in Microfinance

Everyone agrees that a well-functioning financial sector is the foundation for individuals to better contribute to their country's economic activity. Still, the vast majority of people do not yet have access to sound financial sectors. In many countries the financial infrastructure is designed to reach only a fraction of the wealthiest population. Public money and donations to establish and fund microfinance have therefore had a clear case. In the past, many microfinance institutions have significantly benefited from public and soft funding. However, the focus is now on promoting *sustainable* access to financial services and therefore integrating microfinance more into mainstream finance, knowing that public money cannot support all future refinancing needs and that true sustainability can only be achieved by refinancing in the capital market. A key objective is therefore to generate more commercial investments in microfinance, i.e. to leverage public money with commercial investments. The case for commercial investments is clear: Established and successful microfinance institutions grow significantly, produce consistent and significant profits, own assets (micro-loans) that have relatively low default and loss rates, are sometimes rated and have track records with lenders.

2. STRUCTURED MICROFINANCE INVESTMENTS

2.1. Setting the Stage

The key for a new generation of microfinance investment is to structure microfinance investments that provide microfinance institutions with an efficient access to a broadened investor base. Criteria for such types of investment structures are:

- Broadening and combining the investor base: Broadening the investor base to more commercial and financially motivated investors and matching the various type of investors' risk/return profile.
- Volume thresholds – absorption capacity: More complex financing techniques often need minimal volume thresholds. This means addressing the absorption capacity of financed microfinance institutions and the increasing complexity of involving a multiple of microfinance institutions in one transaction.
- Economies of scale: The structure allows for easy replication of transactions, further capitalizing the economies of scale and the market impact.

2.2. The MFLO Platform

The European Investment Fund (EIF) and Symbiotics SA, Information, Consulting & Services have jointly set up a platform for structured microfinance investments which aims at providing such type of new generation microfinance financing. This platform, called 'Microfinance Loan Obligations (MFLO) Platform' provides a generic transaction structure and facilitates pooled financing for groups of microfinance institutions. In such a structure, a pool of term loans is granted to microfinance institutions and such term loans are financed by issuing asset-backed notes in the capital market. Such notes are structured in different layers of seniority, i.e. offer different risk/return profiles. Senior notes, benefiting from a wrap by the EIF are placed in the capital markets, junior notes and first loss notes are placed with specialized microfinance investors. Lender (of the term loans) and issuer (of the asset-backed notes) is a Special Purpose Vehicle, which is the core of the platform. This type of transaction is generally referred to as Collateralized Loan Obligations (CLOs).

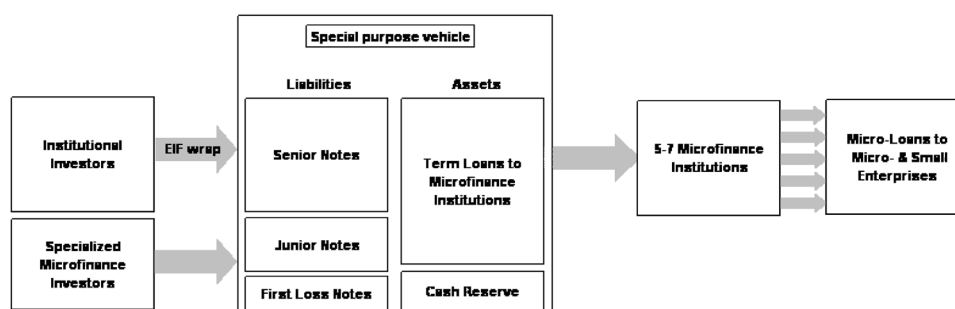


Figure 1: Special Purpose Vehicle

2.3. Elements of the MFLO platform

2.3.1. Special Purpose Vehicle

The core element of the platform transaction structure is a Special Purpose Vehicle ('SPV'), which has been established as a *société anonyme (Microfinance Loan Obligation S.A.)* in Luxembourg in November 2005, having the legal form of a securitisation company within the meaning of the Luxembourg securitisation law. The Luxembourg securitisation law provides for a multiple of compartments within a securitisation company, which are legally segregated from each other, and which can therefore facilitate different transactions by using the same entity. This allows carrying out the simple execution of repeat deals in the microfinance market out of segregated compartments established within the securitisation company, thus eliminating any risk of cross-contamination between transactions. Such a SPV will act both as lender to the microfinance institutions and as issuer of asset-backed notes.

2.3.2. Pool of Term Loans

The transaction pools a multiple of term loans, which will be granted to a multiple of microfinance institutions ('MFIs'). Involved, i.e. financed, MFIs can be registered in different jurisdictions and can have diverse legal forms (e.g. banks, non-bank financial institutions, NGOs etc.). The minimum number of MFIs in such pool is determined by a trade-off between: (i) increasing volume and diversification; and (ii) increasing complexity. The optimal number is expected to be around 5–8 MFIs. The credit risk analysis of the MFI counterparty risk is being provided by Symbiotics.

2.3.3. Loan Servicing

The servicing and monitoring of the pool of term loans, i.e. of the financed MFIs, will be based on an online-reporting tool, providing for high transparency and efficiency in loan servicing and acting as an early warning system. This system is being provided by Symbiotics, which acts as loan servicer.

2.3.4. Joint Commitment

All financed microfinance institutions, being involved in the same transaction, will be asked to assume a joint first loss position, in order to enhance the credit risk and to mitigate moral hazard.

2.3.5. Multiple of Closings

As the absorption capacity of such MFIs is a binding constraint, the transaction structure foresees a multiple of closings, i.e. each term loan granted to an MFI features a multiple of disbursements at pre-set points in time. Such disbursement schedule is mirrored in the issuance of asset-backed notes, i.e. such asset-backed notes feature a multiple of series.

2.3.6. Structured Asset-Backed Notes (CLOs)

The SPV will issue asset-backed notes, which are backed by the pool of term loans of the specific transaction (compartment). Such asset-backed notes (or Collateralized Loan Obligations) will be issued in different layers of seniority. The generic structure will include three levels of seniority (Class A, B and C, in descending order of seniority).

2.3.7. Credit Enhancement

The most senior Class A note will benefit from an irrevocable, unconditional guarantee (wrap) by the European Investment Fund (rated AAA/Aaa/AAA), further broadening the investor base to institutional investors which could otherwise not invest in such kind of securities. The guarantee will be commercially priced

according to the credit risk of the Class A note and placed by the European Investment Fund in the capital market.

2.3.8. Advisory Committee

Whereas such a structure will typically not involve an active management, it may occur that, in unforeseen situations, outside advice is required. For such a scenario, the structure provides for an advisory committee, in which key participants of the transaction are empowered to vote and give advice to facilitate decision-making within the structure.

2.4. First Facilitated Transaction

The first transaction facilitated by the MFLO platform is the first series of a transaction called Microfinance Loan Obligations – Opportunity Eastern Europe 2005-1, which closed in November 2005. In this transaction, a pool of MFIs in the Balkans, all belonging to the Opportunity International, a worldwide micro-finance network, secure long-term funding on flexible terms to support continued growth in their micro-lending activity. For the first closing (first series), EIF and Symbiotics have sourced assets in emerging markets in Albania, Montenegro, Romania and Russia. A second and third closing is scheduled for April and October 2006, which would bring total notes issuance up to approximately EUR30 million and would include assets in Bulgaria, Macedonia and Serbia. All underlying assets are senior unsecured term loans to MFIs.

Table 1: Key Figures of the Transaction

Sponsor:	Opportunity International Network
Co-Arrangers:	Symbiotics SA, Information, Consulting & Services/European Investment Fund (EIF)
Loan servicer:	Symbiotics
Expected volume (all closings):	approx. EUR30 million
Number of closings:	3
Volume of first closing:	~ EUR8.4 million
Pool of term loans:	Four MFIs (first closing), up to 7 expected for future closings
Asset location:	Albania, Montenegro, Romania and Russia
WAL of term loans ² :	~3.5/4/4.5 years
Asset/liability structure:	See Figure 2 below

² Weighted Average Life (in years) of term loan disbursements extended at first, second and third closing.

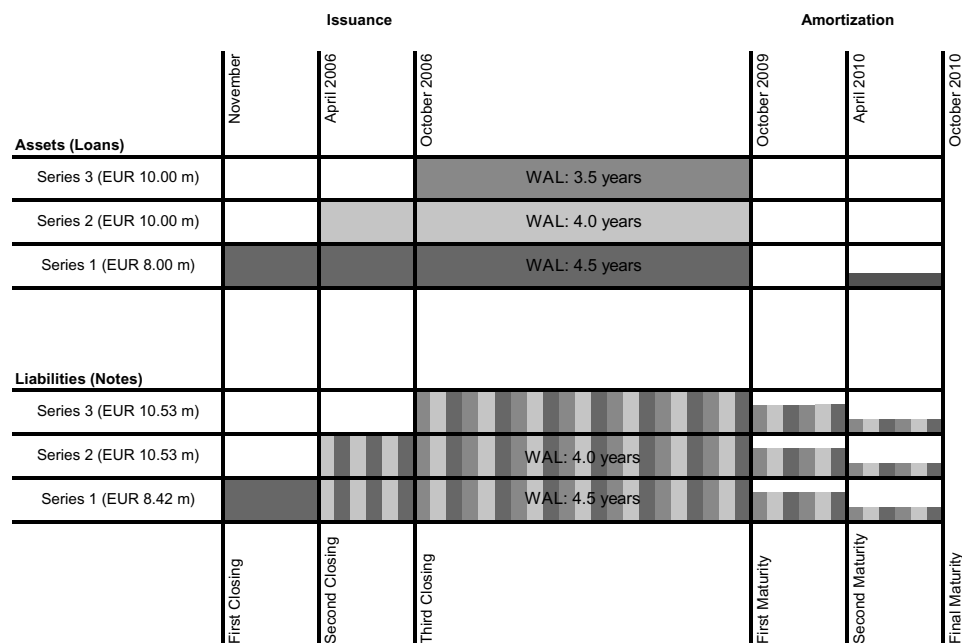


Figure 2: Asset/liability structure

2.4.1. Asset-backed Notes

The tranching of the asset-backed notes has been determined as a senior note of approximately 76 per cent (of total notes face volume), a junior note of approximately 21 per cent and a First Loss tranche of approximately 3 per cent. Additional enhancement is provided in the form of a fee payment, which is made by all financed microfinance institutions. A performance premium, which is granted to all financed microfinance institutions in case of no default occurring among the group of refinanced microfinance institutions, serves as additional risk mitigant.

The interest rate margins on the various notes reflect the underlying risk profile. The Class C notes do not receive any fixed coupon but rather trap any excess spread in the structure in case of a performing underlying loan pool. The resulting return is commensurate with an equity risk exposure. The Class B notes are compensated for assuming subordinated non-investment grade risk, also considering that the risk cushion provided by the Class C notes is relatively small given the high obligor concentrations in the underlying loan pool. The Class A notes are compensated for assuming an EIF exposure, i.e. a triple A risk with 20 per cent risk-weighting under Basel I and 0 per cent risk-weighting under Basel II. For its undertaking to guarantee timely payment of interest and principal repayment according to schedule for the Class A notes, EIF receives a fixed guarantee premium, commercially priced. Such premium reflects the risk cushion provided to EIF, eliminating the risk of credit deterioration for a single underlying loan

Table 2: Key Figures of the Asset-Backed Notes

<i>Note</i>	<i>Volume</i> ³	<i>WAL (y)</i> ⁴	<i>Reference rate</i>	<i>Shadow rating</i> ⁵
Class A Notes	~76.4%	~3.5/4/4.5	WAL EUR SWAP	BBB ⁶ /AAA ⁷
Class B Notes	~20.4%	~3.5/4/4.5	WAL EUR SWAP	B
Class C Notes	~3.2%	~3.5/4/4.5	WAL EUR SWAP	N/A

exposure, and the margin to generate sufficient cash for Class A notes interest payments already inherent in the structure.

Class B and Class C notes have been subscribed by specialized microfinance investment funds and an emerging market investment promotion agency, all placed by Symbiotics. The main rationale for such investors is the combination of an attractive return and the benefit of getting leverage on their investments in socially responsible areas. Class A notes have been placed in the capital market by the EIF.

Obviously, such a structured finance transaction is associated with higher transaction costs than other, more basic kind of financing. Main elements of transaction costs are: (i) set-up fees, i.e. legal fees and structuring fees; and (ii) ongoing fees, i.e. servicing fees, account bank, paying agent's fees and trustee fees. As it is the goal of the MFLO Platform to facilitate replications of such transactions, the economic rationale will be further enhanced over time.

3. OUTLOOK

Another application of structured finance to microfinance may be the use of securitisation mechanisms to microfinance institutions, i.e. securitising micro-loans. Whereas the MFLO Platform is based on pooled debt transactions (CDO methodology), bringing into the equation the micro-loans credit risk directly could offer five additional advantages:

- Capital relief effect: Many microfinance institutions are, like other more conventional lending institutions, bound by capital adequacy ratios. As

³ As a percentage of the aggregate face value of the notes.

⁴ Weighted Average Life (in years) of notes issued at first, second and third closing.

⁵ Estimated shadow rating on an international scale (combined country rating and counterparty risk rating).

⁶ Naked, i.e. without EIF guarantee.

⁷ Wrapped, i.e. including EIF guarantee.

micro-loans tend to have a relatively low loss rate, the capital relieve effect of a micro-loan securitisation transaction can be significant.

- Lending restrictions: In some legislation, lending restrictions can be a constraint for microfinance institutions, and a transfer of micro-loans can be a potential mitigant to such constraint.
- Funding costs: A micro-loan securitisation transaction could capitalize on low default and loss rates, on a relatively low correlation of the micro-loan credit risk with macroeconomic factors and on a high diversification of micro-loan portfolios, thereby potentially yield in lower refinancing costs for originators of such transactions.
- Asset/liability match: A securitisation of micro-loans could contribute to a better match of the term structure for assets and liabilities of the microfinance institutions.
- Investment opportunities: Especially institutional investors and hedge funds are attracted by the diversification and correlation properties of the micro-loan credit risk (rather than microfinance institutional risk).

Ultimately, the goal is to establish micro-loans as an additional underlying asset class for securitisation transactions and provide microfinance institutions access to the multi-billion asset-backed securities (ABS) financing market.

In order for such transactions to work, several issues need to be addressed:

- Micro-loan servicing risk: The credit risk of micro-loans is closely linked with the servicer of such micro-loans. In other words, an isolation of the micro-loan credit risk (from the originator/servicer counterparty risk) is difficult to achieve. The concept of a back-up servicer needs adjustment in case of securitized micro-loans.
- Country risk: The benefit of a potentially low asset risk (micro-loan credit risk) is often impeded by the country risk of a MFI's country of origin. This may be addressed by a multi-country transaction (diversification), which would however tremendously increase complexity.
- Legal framework. A cash securitisation transaction would most probably need to be structured with an on-shore SPV. Many MFIs operate in emerging markets, which may raise legal issues such as availability of a functioning securitisation framework. Main legal issues to be addressed are notification requirements (if any) for a huge number of assets to transfer and the bankruptcy-remoteness of the securitisation vehicle.
- Tax issues: Servicing costs for micro-loans are much higher than for traditionally securitised assets. If such servicing cost (which would be a fee paid to the servicer once such assets are securitised) becomes subject to VAT, the transaction economics may be materially affected

A possible structure to address such issues may be a combination of a conventional debt financing, combined with a synthetic micro-loan securitisation mechanism. We are convinced that micro-loan assets offer a strong potential to become established as a new underlying asset class, this being subject to an appropriate structure for this purpose.