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SECURITIZATION IN MICROFINANCE

CREATING SAVING AND INVESTMENT INSTRUMENTS FOR THE POOR

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INTRODUCTION

For years, the main approach for poverty alleviation was charity. Even today there is an array of institutions and government programs dedicated to this labor. However, philanthropy has not yet proven to be the most effective tool for poverty alleviation. According to the latest revision of the World Bank's 2005 International Comparison Program –ICP– (Chen and Ravallion, 2008: 31-36), the global count of people living under the poverty line of US$2.50/day was of 3.140 million people, equal to 57.6% of the world's population. Almost the third of this population lives with less than a US dollar per day.[1]

The numbers thrown by this survey are not at all encouraging. Nonetheless, there is one of these statistics that shows a plausible way out. The ICP states that China has had a remarkably good rate of poverty reduction when compared to the other countries of the world. The first of the UN Millennium Development Goals (UN, 2008) is to end poverty and hunger, which target is to halve the 1990 index of people living with less than a dollar a day by 2015. China achieved this objective in 2000 with fifteen years to spare!

So what is it about China that lets them have a sustained and overwhelming annual growth year by year for almost three decades now? Mainly, the Chinese boom is owed to the change in the orientation of the economy from the late 70's onward. Two of the cornerstones of the revamped Chinese economy are the promotion of productivity of the non-state sector and the development of the stock markets (CIA, 2008).

Putting together all of the above, maybe charity is not the final solution. Perhaps a more effective way to fight poverty is to give a twist to the old proverb *"Give a man a fish; you have fed him for today. Teach a man to fish; and you have fed him for a lifetime".* Every person –especially those under distress– has conceived an idea to develop. The main issue could not be to train the man (or to show him how to fish), as much as it is to give him a way to get a fishing rod. The promoters of microloans –which visible heads are the Nobel Laureate Muhammad

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1 879 million people or 16.1% of the total world population.

Yunus and the Grameen Foundation– have already covered a big chunk of this aspect. Their project has revolved around the idea of giving access to credit to those that have historically been excluded due to their lack of financial security. It is undisputable that by giving the ideas of the fishermen of the world a space to develop the private productivity will be enhanced, carrying out the first of the elements highlighted from the Chinese experience.

On the other hand, the relation of financial markets and its impact in the overall economy is much more straightforward. A strong, liquid and deep market moves resources faster throughout the economy, reaches further and fills funding deficits swiftly. Yet, the financial markets in developing countries are not robust enough to consummate all these benefits. Part of the problem is the deficient knowledge of common citizens about the market as an investing option, for the most part caused by the lack of interest of the market in their resources. Even the most developed markets exclude the economic agents that have little saving capacity, enabling big actors to take the juiciest piece of the pie, exponentially affecting the distribution of wealth.

In sum, it is reasonable to join the two ends of the line. This means, search for a solution that serves the three-pronged objective of making financial markets truly public, promoting private businesses and widening the reach of the microfinance industry. This paper explores the viability of implementing a scheme that pushes the current microfinance structured finance funding strategies one step further, fulfilling the saving and investing needs of MF customers, while helping the development of the financial markets and the funding issues faced by microlenders. All this process is what I have denominated "the MF Circle" for the purpose of this paper.

The first part of the document presents a short analysis of some microfinance issues that are relevant for the research and proposal such as the narrow view of microfinance industry nowadays, the nuisances experienced for microloan funding and how they had been handled. Secondly, you will find the proposal explained in depth, how it is devised to work along with its pros, risks and implementation issues.

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1. BACKGROUND ISSUES

1.1. Narrow View of Microfinance Nowadays

Much time has passed since the early 1700's when Dean Jonathan Swift, better known for his masterpiece *"Gulliver's Travels"* than for being the forefather of microfinance, lent five-hundred pounds to poor industrious tradesmen giving birth to the Irish Loan Funds (Hollis and Sweetman, 1997: 3). Since then, some individuals and organizations have promoted microcredit initiatives, but none of them has had the strength of the one launched and led by Mr. Muhammad Yunus. In the last few years, microloans have been under the spotlight thanks to the great number of success stories that they have generated. The recent accomplishments of the "microcredit movement" include the declaration by the United Nations making 2005 the International Year of Microcredit (UN, 2005) and – of course – the Nobel Peace Prize that was awarded to Yunus and Grameen Bank in 2006 (NF, 2006). Due to the efforts of its promoters, microfinance activity has gone *deeper* than ever before. It is unavoidable to refer to its development as *"deep"* and not *"broad"* because there still are many financial products that remain unexplored. Indeed, the microfinance boom has mainly – if not solely – focused on microloans, leaving other financial products, such as insurance, savings and investment, untouched.

Microfinance will evolve as a whole. Without denying that loans are a good starting point it is necessary to widen the range of services in order to create an integral system that circles the resources, improving their effective use. So far the asset half of the microlenders' balance sheet is the one that has been developed through microloans. However, the other half –liabilities– has not been examined thoroughly, in spite of the importance savings represents for the low-income population.

As a matter of fact, saving allows poor households *"to afford major acquisitions, smooth consumption over time and self-insure against income shocks"* (BERG, 2008: 19). In a recent research in India, it was proven that the involvement in a microsavings program resulted in an additional 2% of yearly income per capita in each household surveyed. Furthermore, consumption was higher in households involved in the savings program at a rate of 25 basis points for each 1% of additional income. This has to be viewed considering that almost 20% of the income is spent in food consumption (BERG, 2008: 14).

So, why haven't microsaving instruments been developed? One of the main reasons for this limitation are the strict regulations regarding the deposit-taking activity. As most MFIs cannot –or will not– adjust their activity to comply with this regulation; customers do not have a savings alternative available at hand. This happens because the only approximation that micro-borrowers have to the financial system is the microlender.

It can also be argued that the average microfinance customer does not have savings capability due to its limited amount of resources and income. However, some facts can easily disprove this notion. The Bank Rakyat Indonesia (BRI, 2008) serves 3.5 million borrowers and over 33 million savers!! Besides showing that savers vastly outnumber borrowers, this shows that the poor can and do save when a proper instrument is offered. Moreover, it has been shown that the poor do not borrow because they cannot afford the loans, but because they are averse to debt. And pushing this thought further, it is possible to state that saving instruments are probably more efficient tools to increase outreach than loans (Johnston and Morduch, 2007: 14).

At present, it is not feasible for an individual micro client to acquire any of the existing investment products, though this fact should not close the door of efficient saving and investing to the low-income population. It is possible to either create a vehicle that pools the liquid assets of microsavers so they can get access to the capital markets, or come up with a new investment product that fits their needs.

In conclusion, there are a lot of areas that should be developed before we can properly refer to microfinance as such and not just microcredit. The fact that we are not dealing with the wealthy part of the society should not be a hurdle to innovation in the creation of financial instruments for the poor. Hopefully, the implementation of a truly microfinance structure can help with poverty reduction and the establishment of a more robust economy.

1.2. Self-sufficiency of Microfinance Institutions

At first glance, there is a trade-off between the task of "outreaching" that must be done by microfinance institutions (MFI) and profitability. A microloan involves a much more strict observation by the lender without the reward of a higher yield. In spite of the fact that microloans do generally have a higher interest rate, serving the poor involves a plethora of elements that make the microloan industry a very costly one for lenders. High costs involved in physically accessing rural areas, the small volume of the loans, a lack of collateral and the constant following after its generation, together with the entrepreneurship training that lenders sometimes provide to the debtors, are just a few of the many issues that increase the costs in microlending. This situation has raised many criticisms over the Institutional Financial Self-Sufficiency (IFS) of MFIs without the underpinning provided by donors.[2]

None of these arguments is unfounded. The MFIs –Banks, Non-bank Financial Institutions, Cooperatives, Non-profit Institutions, NGOs or any other form they take– have a two-fold mission. The first one is to provide financial services to the low-income population. The other, a much more complex one to comply with, is to do that in a financially viable way. It is fine to receive donations in the early stages to cover initial costs. However, the MFIs should always aim to achieve self-sustainability by creating economies of scale and a balance between its costs (funding, originating and tracking the loans) and its revenues.

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[2] For more information on the importance of IFS and arguments against the apparent trade-off, see Gibbons and Meehan (2000).

The demand for microloans overwhelmingly exceeds the supply. Some estimates indicate that only around 4% of the potential USD 300 billion MF market is covered (Kostigen, 2007). Moreover, the loans serve roughly 100 million of the one billion people who need financing (Dieckmann, 2007: 10). With a reasonable lineup of self-sustained entities, it is easier to create a greater supply of loans that respond to the need for credit. Rosenberg (USAID, 1995: 1-2) searched for the reasons why, despite the success of microloans, the outreach of MFIs was still short. One of the main causes for this was the lack of leverage capacity of the institutions. The paper defined five levels of leverage for MFIs:

a.) Level one: a microfinance program does not break even on a cash-flow basis. At this level, for one dollar from a donor today, there will be less than a dollar still available to provide ongoing finance for poor people.

b.) Level two: the institution does break even and may be self-sufficient; however, most of its portfolio is financed through loans from donors. Because the institution has little or no equity, it cannot leverage its donor funds by borrowing from commercial sources. For every dollar put in by donors today, the program will have about one dollar available for microfinance in later years.

c.) Level three: describes an institution that has managed to break even or marginally profit but has substantial equity funding built through grants from donors rather than loans. Because it has a positive net worth, the program can expand its portfolio by borrowing from commercial sources. In this case, a dollar of donor money leads to about two dollars of resources available for poor clients.

d.) Level four: is reached when the program has not only a self-sufficient cash flow and a significant equity base, but also a license as a formal financial institution. Because the program meets the requirements of a regulatory authority, outside parties are willing

to loan or deposit money into the institution in amounts up to 11 times the institution's equity base.

e.) Level five: has not yet been reached. It refers to a situation in which programs make such high profits at level four that other investors start their own microfinance programs for purely financial motives.

Even though the preceding analysis is aimed to describe the steps for an MFI to become a formal financial intermediary, it shows that the linchpin for extending the reach of microfinance is access to resources. Until not long ago the vision of those looking for funds was limited to equity and debt instruments. Nowadays there are several means by which to acquire fresh funds –such as sale of assets– that have to be explored in order to provide MFIs with a constant source of funds needed to satisfy the increasing demand for microloans.

1.3. STRUCTURED FINANCE SCHEMES IMPLEMENTED SO FAR

The banking regulation has always been one of the more strict and complex of the legal universe. In order to be chartered as a financial intermediary, legislation requires a certain amount of initial capital that is quite high. Additionally, there are innumerable rules to comply with, corporate governance, prudential ratios, etc., all of which boost the costs of intermediation activity.

These considerations are the main obstacles for the creation of financial companies solely dedicated to the promotion of MF. Indeed, traditional investors do not see microlending as a profitable activity, taking into account the risks involved. This makes the labor of obtaining the initial capital for a MF company very strenuous. Furthermore, the profit margin left by MF activities may not cover all the costs caused by compliance. Thus, microfinance institutions and promoters have been compelled to look for alternative sources to fund their activities, the most popular being private investing initiatives and true-sale securitizations.

1.3.1.Private Investing Initiatives

The idea of looking for new resources in capital markets is not a new one. The Omidyar Network has worked on this front through a series of investments and grants to increase the “Access to Finance”. According to their website more than $115 million US dollars had been given so far (ON, 2008). For our purposes we will focus on two of their multiple investing schemes: KIVA and MicroPlace.

a.) KIVA (www.kiva.org)

KIVA is a non-for-profit organization that develops a peer-to-peer lending model. They serve as link between the lenders and micro-entrepreneurs in need of credit. The lender logs into their website, browse the profiles of the entrepreneurs and chooses one to lend to. Loans can be of as little as USD $25, and are payable through major credit cards and PayPal. Afterwards, KIVA collects the money, bundle the individual loans up to the amount needed by the borrower and then transfers it to the partners, which are MFIs that have direct contact with the borrower. They also provide assistance to the borrower to increase the chance of success. KIVA provides periodical information of the loan until its term is done. When the loan is fully repaid the lender receives back its money and decides whether to lend it again, donate it to KIVA or withdraw it.

What is more interesting about this NGO is that it does not provide investment options, nor collect donations. In fact, the amount of money given is the amount of money returned with no interest payment, so there is no actual investing going on. Evidently, lenders are not donating their resources because they are getting them back over time. This scheme has been copied by *Babyloan*[3] that focuses on channeling microloans to Tajikistan and Benin.

So, what is the big contribution of KIVA-like models to the microfinance industry? Mr. Matthew Flannery, Co-Founder and CEO of KIVA, argues that:

> *“…many of the most commercial MFIs had relied on donations during their early years. It is difficult for MFIs to move from donor dependence*

[3] http://www.babyloan.org

> *to the capital markets all at once. We began to see person-to-person debt capital as a bridge for MFIs on a journey from donor dependence to tapping into the capital markets."* (Flannery, 2007: 31-56).

This step is essential for the future of microfinance funding through capital markets. MFIs have to accept that they cannot be held as charity institutions forever and KIVA came up with a very clever way to make that transition. The structure of KIVA also helps in the creation of incentives for the population, by allowing them to know exactly how their money is being used and to have the possibility of getting it back, rather than putting it in a blind fund and never seeing it again. Thanks to this initiative two of the main barriers that represent problems for MFIs are removed, they are: the dependency of MFIs on donations and the conception of microloans solely as a philanthropic cause.

b.) MicroPlace (www.microplace.com)

This subsidiary of eBay took KIVA's idea a step further. The potential lender that logs into MicroPlace actually invests by purchasing securities. The money gathered by the sales of these securities is given to the MFIs, who finally lend the money to the micro-borrowers. With the revenue produced by the repayment of the loans, MFIs pay the principal and interest to investors through MicroPlace.

This option is not as personal as KIVA but it is certainly more appealing. Not only does the investor get the satisfaction of helping others, as they also make a profit. Nevertheless, there are additional differences between KIVA and MicroPlace. Their legal natures are different. KIVA is an NGO whereas MicroPlace is a registered Broker-Dealer. This circumstance allows MicroPlace to give return on the investments. When money is channeled through KIVA it goes specifically to one particular project. On the other hand, MicroPlace relays the resources to an institution (MFI). MicroPlace deals with securities instead of cash, in contrast to KIVA's system. Finally, KIVA does nothing more than receive and give money between lenders and borrowers, while MicroPlace issues securities, aggregates the cash and lends it to MFIs.

MicroPlace's business model is demonstrating that it is possible to create schemes that report benefits to all parties involved. Yet, there is still some struggle around the idea of making money off of low-income populations, and eventually this idea may block the advancement of similar structures. It is up to the promoters of such systems to find solutions to this argument, mainly by recommending the reinvestment of the principal and interest, creating a sort of *"snowball effect"* circling and augmenting the available resources within the same system. Certainly, if the lender invests the principal and proceeds to repeat this behavior throughout, the availability of resources will grow exponentially and consequently the gap between supply and demand for MF will be narrowed.

1.3.2. True-Sale Securitizations

Before discussing how securitization has been implemented in the MF industry, it is required to shortly refer to what securitization is:

> *"In a basic securitization structure, an entity, often a financial institution and commonly known as a "sponsor," originates or otherwise acquires a pool of financial assets, such as mortgage loans, either directly or through an affiliate. It then sells the financial assets, again either directly or through an affiliate, to a specially created investment vehicle that issues securities "backed" or supported by those financial assets, which securities are "asset-backed securities." Payment on the asset-backed securities depends primarily on the cash flows generated by the assets in the underlying pool and other rights designed to assure timely payment, such as liquidity facilities, guarantees or other features generally known as credit enhancements. The structure of asset-backed securities is intended, among other things, to insulate ABS investors from the corporate credit risk of the sponsor that originated or acquired the financial assets."* (SEC, 2004: 10).

In the early years of the 2000's, amid the mortgage backed securities frenzy, MF industry took interest in this funding strategy. Indeed, securitization solved main issues faced by both deposit and non-deposit taking MFIs:

- The loan-financing shifts from the traditional philanthropists to the capital markets (Stieber, 2007: 207-211);

- The risks of the loans are transferred to the Special Purpose Vehicle (SPV), especially the credit, interest rate and prepayment risks (Stieber, 2007: 207-211);
- For regulated MFIs that have the capability to take deposits, securitization enables them to reduce reserves and free capital so they can use the surplus to leverage more credits. For the institutions that are not allowed to take deposits, the sale of the receivables raise their liquidity, proportionally augmenting their capacity of lending (Stieber, 2007: 207-211);
- Profits increase due to the markup in the selling price of the loan and for the fees collected from the servicing of the loan, if the MFI retains this task after the deal (Stieber, 2007: 207-211);
- For non-regulated MFIs the implementation of securitization lets them get the liquidity of the deposit-taking activity without the regulatory burden of a formal financial institution;
- The rating of the securities will not be attached to the credit-worthiness of the MFI, especially if the notes can get credit enhancements.
- When looking for investors a full disclosure has to be made regarding the assets of the pool and the main issues of the security. On the other hand, when dealing with donors not only disclosure but also some showing of results after the money is disbursed is necessary. This means a higher burden for the MFIs involved.

As it will be explained below, securitization has proven to be a successful instrument for MFIs that target different sectors of the population. Moreover, the securities issued under this scheme were attractive to investors because of their high rating and particular characteristics.

a.) ProCredit Bank Bulgaria

A landmark transaction was structured in May 2006 by the securitization of €47.8 million of the loan portfolio of ProCredit Bank Bulgaria –PCB–, both internationally and within Bulgaria.[4] It not only was the first true-sale securitization in Bulgaria, but also the first microloan-backed securitization worldwide (Hagen and Hüttenrauch, 2006).

PCB is a bank focused in loans to Small and Medium-Sized Enterprises (SME). Its shareholders include, besides ProCredit Holding AG, a leader in microfinance lending in the world, the European Bank for Reconstruction (EBRD) and Internationale Projekt Consult (IPC) GmbH, a front-runner in microfinance consultancy services. The commercial paper issued had a rating of BBB by Fitch Ratings, with further guarantee enhancements provided by the European Investment Fund (EIF) and German KfW (PH and DB, 2006).

The favorable outcome of this issuance has demonstrated that capital markets can be accessed for MF funding and that international organizations are willing to provide support in order to lower the risk of the securities.

b.) Bangladesh Rural Advancement Committee –BRAC–

With RSA Capital acting as the leading arranger, and Citibank, N.A. Bangladesh (Citigroup), FMO (Netherlands), and KfW (Germany) as co-arrangers, BRAC securitization was a groundbreaking deal. BRAC is the world largest NGO and focuses in empowering the poor and poverty alleviation. As opposed to PCB, whose borrowers have a relatively stable source of income, BRAC serves low-income communities with little or no collateral availability.

Not withstanding their target market, the structure used for the issuance of the securities allowed them to be rated AAA by the Credit Rating Agency of Bangladesh. BRAC's issuance involves a special purpose trust that has the burden of purchasing the receivables from the originator and issuing the certificates for investors every six months, over a six-year period, with a maturity of a year each.

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[4] For a complete diagram of the transaction, see Annex 1.

The total amount raised will be of 12.6 BN Bangladesh Taka (BDT) equivalent to US$180 MM. A third of the first series of the issuing was acquired by FMO, another third by Citibank, N.A backed by guarantee of FMO and counter guarantee of KfW and Citibank, N.A. Bangladesh, along with two local banks purchased the remaining one third of the certificates (BRAC, 2006). The structure implemented had the clear intention of giving the securities a higher level of liquidity and protection for investors.

2. CLOSING THE CIRCLE

After a quick scan through some of the problems and issues that MF is facing today, and the way they are being managed, one can speculate about the possibility of creating some sort of synergy that connects the two ends of the microfinance industry. In other words, the big challenge is to match the need for savings instruments of the micro clients, with the constant feed of resources that MFIs require to satisfy their loan demand. If one of the parties needs to find a secure way of saving for unexpected events or for future spending, whereas its counterparty is always looking for liquid assets, why not supply their needs with one solution?

This proposal uses the experience that MFIs have been acquiring in their funding strategies as a mean to offer low-income citizens a safe and liquid instrument that gives them the opportunity to save money while investing. At the same time, the structure will be useful to the deepening of capital markets in developing economies.

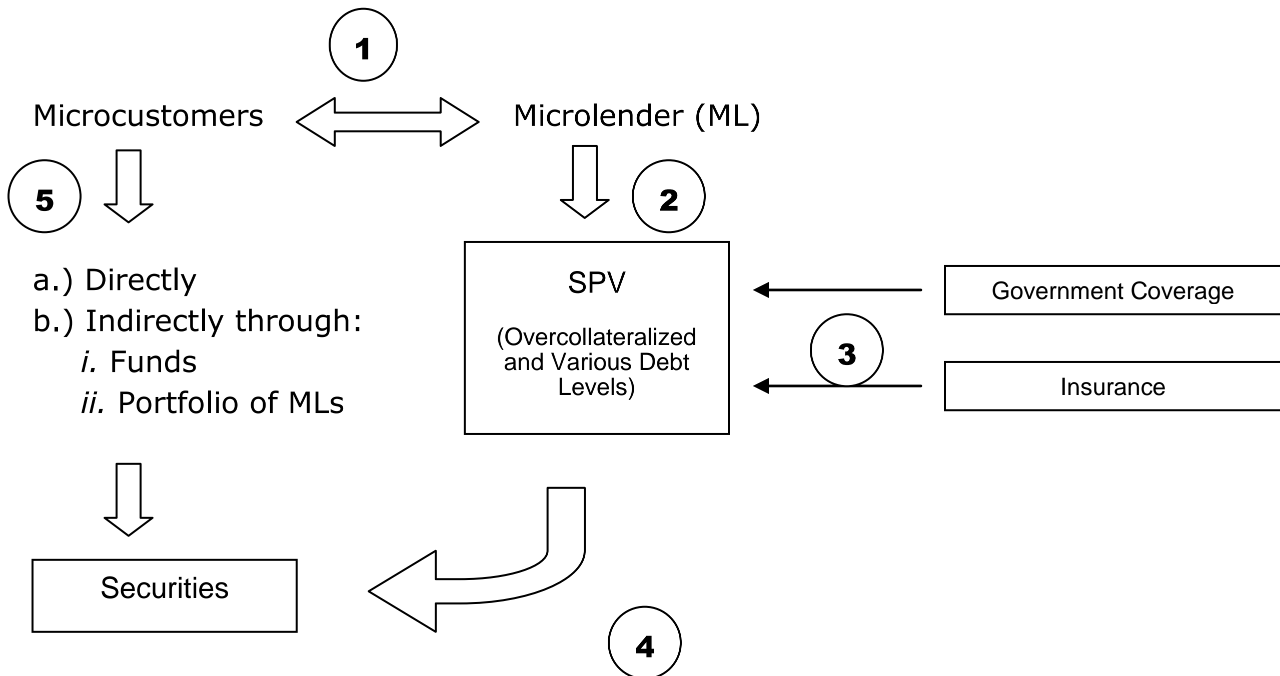
2.1. THE PROPOSAL

As it was stated previously, the idea is to use a traditional securitization as the starting point and take it a step further. As shown in the analysis, steps 1 to 4 in the below diagram resemble the examples of true-sale securitizations explained.

Step 1. Microlending

Microcredit institutions (MFI) lend money to their customers according to their credit policies. This step is the base of the deal because the receivables generated by the loans are the source of the cash flow of the securities. The certainty in the payments of the loans will be transferred to the securities in the

form of a higher rating. Thus, it is pivotal that MFIs evaluate thoroughly the borrowers so that the credit risk is mitigated.



Step 2. True-Sale Transfer

From the regulatory and supervisory standpoint it is very important that this step is carried out as a true-sale of assets, as opposed to a guarantee/pledge agreement, so that the loans are truly transferred to the Special Purpose Vehicle (SPV). Some rulings could possibly forbid MFIs to place or underwrite securities. In this case, if the loans are not properly transferred to the SPV and the MFI is somehow left related with the pool of assets, in a quality different from originator or servicer if that is the case, there could be legal consequences as a result of non-compliance to the regulatory frame. However, there is still some discussion on whether the originator is an issuer. We will briefly comment on this when examining the implementation issues of the proposal.

At this stage, even before, the MFI and the group of arrangers must have determined whether the Originator/MFI[5] is going to be the servicer of the loans. It is considered favorable that this happens for three reasons:

a.) MFIs and borrowers already have an established relationship;
b.) MFIs have extra profits for developing this labor;
c.) Logistically it is very difficult for the SPV to track each and every one of the loans.

Step 3. Enhancements

Investors perceive a higher risk from microborrowers, notwithstanding that historically the delinquency[6] and repayment rates of microloans are favorable. To enhance the rating of such securities it is necessary that the governments provide some kind of protection and the usage of any other kind of insurance available.

Step 4. Issuing of Securities[7]

The SPV issues securities. To have an extra protection, the total value of the securities issued by the SPV will be less than the value of the bulk of the loans (Overcollateralization). Additionally, the issuance can consider multiple subordination levels, so each of them can be targeted to a specific investing group. As subordination is included, "cash waterfall" provisions are necessary.

Step 5. Distribution of Securities

Once all of the steps are cleared and a traditional securitization is performed, securities will be acquired by investors and mainly by the same borrowers of the underlying loans or the low-income part of the population. This acquisition can be either directly, through collective investing schemes or by way of deposit-taking MFIs portfolio.

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[5] For the purposes of this paper the terms MFI and Originator are used interchangeably. The proposal only considers MFIs that securitize the loans they originate, instead of other assets acquired in the secondary market.
[6] A *delinquent loan* is the one that is 30 to 60 days past due with no payments being made.
[7] For details on the characteristics of the securities refer to 2.2. Main Objective.

It would be really difficult to find the complete demand for these securities in the low-income population. Thereby, it is more effective to create different levels of securities, each of them aimed at a different kind of investor.

2.2. Main Objective

When microborrowers or low-income individuals purchase the securities issued by the SPV an option for saving/investing, formerly not available, is given to them. The challenge is to structure the securities in a way that will suit the needs of the microborrowers. Evidently, to do this we have to explore the reasons that motivate low-income citizens to save. These motivations do not differ much from those effecting the rest of the population. Through saving, poor households can build capital either to self-finance investments or to leverage themselves by getting credit backed by such capital. Furthermore, seasonal consumption needs will be fulfilled more smoothly, and what is saved can be used as self-insurance against major shocks (Johnston and Morduch, 2007: 15).

Keeping these characteristics in mind, the securities have to comply with two basic requirements: They have to be safe and liquid. Indeed, as these savings are probably going to be used as the seed capital of some investment or enterprise, safetyness is essential. If those moneys are lost, households will lose not only the cash invested, but also the opportunity to create a stable source of income. Secondly, the investors have to be capable of selling the securities fast and with the minimum possible loss of value when unexpected episodes or crises occur. To achieve this, it is necessary to use market makers (or third market makers, subject to the market the securities are traded in – OTC or an Exchange, respectively) that give those securities a good level of liquidity. Also, a proper structuring of the insurance and guarantees of the issued papers is pivotal for both, lowering the risk of the securities and making them attractive to investors.

The term of the securities, or at least the ones destined to the target population, also have to be carefully settled. As stated, some of those savings are

used to cover "seasonal consumption " needs (e.g. holidays, religious ceremonies – first holy communion– or beginning of school). This means that the securities shall expire before those peaks of consumption so that the investors can satisfy their needs with this income and not be obliged to sell before the expiration date, probably loosing some profit margin. Indeed, if the seasonality is not considered the price of the securities will be affected because of the increase in the offer of the instruments before high spending seasons. The latter observation implies that we are dealing with short-term securities, a feature that –at least in theory– will lower their risk.

2.3. Benefits of the Proposal

2.3.1. For Savers/Investors

The main benefit of this scheme is the offering of a financial product that enables the poor to save/invest with a reasonable rate of return. As it was said before, microsaving products are truly undeveloped, not to speak of the "microinvesting" ones. There is no empirical evidence that shows that low-income populations are not active in saving. On the contrary, as it was shown previously, research has demonstrated that they save when an appropriate product is offered.

The benefits for the low-income customers do not stop with the option of saving. Clearly by investing in short-term papers they will get a much better return than in a savings account. Additionally, due to the government insurance and other enhancements, their investment would not be exposed to a high risk.

There is also a greater certainty in the use of the investor's funds, as opposed to the "obscurity" of deposit-taking institutions. Indeed, the investor has some information about the assets that are providing the cash flow to pay for the installments. On the other hand, when money is deposited in a traditional financial institution the depositor has no idea of what is the destination of his resources.

Finally, the customers will get a glance at financial markets and have a first approach to them. This is helpful as a tool for making the markets truly public, following the ideas developed by the promoters of *bancarization*[8]. The knowledge that user can get in this process would be useful if eventually he/she develops a SME. As a previous user of the capital markets the former investor will see this forum as an option without the fear that this alternative can arise in a first-time user. In the same way, this experience will help with the educating mission of the financial customer, which has been largely discussed (OECD, 2004).

2.3.2.For MFIs

Why is it better to promote saving through the access to financial instruments and not by the conversion of non-deposit taking MFIs into traditional financial institutions? There are several reasons for this. The most evident is the burden that this step represents for MFIs at the moment of the transformation. Regulation for deposit taking is very strict and in the early stages it requires the MFIs a big amount of initial capital in order to get authorization for performing that activity. Once chartered, institutions incur in several costs of compliance with the rules for safe and sound banking. Moreover, there are other charges that significantly reduce the potential use of resources, such as the LLR (Loan Loss Reserve), and certain capital ratios to be maintained.

On the other hand, implementing true-sale securitizations allows MFIs to steer clear of the burdensome regulation of banking institutions because they are not taking deposits. This enables them to focus on expanding the outreach of their activity, rather than spending time and money in compliance issues. Furthermore, administratively it is much easier to handle only the asset side of the balance sheet than to manage, in addition, liabilities with depositors as formal financial institutions do.

Through securitizations MFIs also have the opportunity to share the risk of the loan portfolio with other investors while maintaining -or even increasing- their profits. From a risk management stance, the originator passes credit, interest rate

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[8] For more on *bancarization*, see Anastasi et al (2006).

and prepayment risks to the SPV and ultimately to the purchasing investors. In spite of the discount price that is applied to the loans in the sale process, MFIs are still going to get an earning out of the transaction. In addition to this profit, when the originating MFI holds on to the labor of servicing the loans, an extra fee is paid by the SPV for this matter. Thus, the institution will have an income to cover its costs without bearing the normal risks of the loan portfolio and, more importantly, it will get enough liquidity to keep generating loans.

By implementing funding through this structure, MFIs reduce the uncertainty of their liabilities in a more effective way than deposit-taking institutions. The latter only have statistical approaches regarding the amount of withdrawals in an established time frame. Conversely, MFIs that use securitization have a more precise estimate of their liabilities. This increases the effectiveness in the use of resources, thus reducing the interest rate for microborrowers.

2.3.3.For Markets and General Economy

Without wanting to make a detailed exposition of all the benefits of financial markets, it is relevant to highlight once more their role in modern economies:

> *"Indeed, the advantages of sound financial markets are well known. These markets play a critical role in mobilizing savings and in allocating them to productive investment. Moreover, strong local markets can also provide a more stable source of financing for the public and the private sectors, insulating them to some extent against volatile global capital flows. We have recently seen some practical demonstrations of the positive effects of sound financial markets. In several industrial countries, such as the United States and the United Kingdom, financial markets over the past decade have substantially improved economic performance, through the development a wide array of products that allow for a more efficient allocation of savings. This rapid financial development has helped boost growth in both countries. For example, since the mid-1990s, productivity has grown by about 1 percent a year more in the United States than in the euro area. And almost half of this difference is accounted for by differences in productivity in the financial sector. Similarly, several countries in Latin America have made good progress in developing their financial markets. Pension and mutual funds in Chile have helped lengthen maturities and deepen financial*

markets. Similarly, both Brazil and Chile have developed foreign exchange derivatives markets which are among the most sophisticated and transparent in the world. These developments are helping to enhance stability and economic growth.

"Indeed, it is no coincidence that the countries—in Latin America and elsewhere—where financial market development has been the most advanced are also those that have been among the most successful economies. The causality runs both ways. As macroeconomic policies have become more credible, and confidence grows that inflation will remain low, demand for financial services increases. As financial markets grow, the availability of credit increases, spurring faster noninflationary growth. And as financial markets become more sophisticated, and risk management and hedging become easier, economies become better able to manage volatility. In this context, I should mention that the (International Monetary) *Fund has recently completed a study on what countries need to do to maximize the gains from financial globalization. We find that countries that have more developed financial sectors, stronger institutions, sound macroeconomic policies, and more open trade systems are better placed to benefit from financial globalization and are considerably less likely to suffer the instability that greater openness to global capital flows could entail."* (De Rato, 2007).

Markets should not be seen as a development goal, but as a tool to develop. The countries that need stronger financial markets are those that have difficulties in allocating resources: these countries are indeed the ones that have the smallest and least effective market structure. So the logical way to go is to first build a solid market to contribute to economic development, rather than to build a market when development has been reached.

In this order, creating an inclusive market that attracts the greatest possible amount of saving surplus within the population will certainly foster economic growth. And right in this place is where the proposal makes its contribution. The saving capability of the poor has been rarely included in this asset allocation task. Currently, low-income households do not deposit in bank accounts, do not participate in pension plans due to the informality of their jobs, do not invest in securities transactions because of the ignorance of this topic and low amounts saved, etc. To create a financial instrument to attract these resources will improve

the flow of liquidity throughout the market, giving an impulse to the overall performance of the economy.

2.3.4.For Microloans/Microlenders

One of the first things that Dr. Yunus noticed when he started lending to the poor was the importance of peer-pressure in repayment. Poor are not in a privileged position when it comes to second chances. *"They* (are) *in no position to delay a default on their loans because if they did so they would be cut off from access to funds in the future and this will destroy their earning capacity"* (Husain, 2006). Applying this idea to the proposed structure, it is possible to affirm that the person who purchases the securities and at the same time is a microborrower understands that the return on its investment relies ultimately in the compliance of its own loan contract. In fact, if borrowers do not pay in a timely manner, they are going to be affected by this breach because they would not get as much return on its investment as they expected. Evidently for this to work the way it should, a thorough labor of education has to be developed so that the investor/borrower understand the importance of the opportune payments and how it fits in the overall scheme.

Another advantage is the exponential augmentation of the capital dedicated to microfinance. When dealing with the low-income population some would not feel so comfortable in making a profit out of it. What can be done in these cases is giving the option to the purchasers of the securities to reinvest the profits at maturity. If this behavior repeats itself throughout the system the capital will enlarge progressively, at the same time that the demand for the securities is created.

2.4. RISKS AND BARRIERS

2.4.1. Reckless Lending

The main concern that the implementation of the proposal raises, is the same matter that investors deal with. For the latter, the main issue is the creditworthiness of the borrowers because they are the ones providing the cash flow for the securities. The only ones that can truly qualify this credit risk are the MFIs that originate the loans. So the nuisance here is how to guarantee that the MFIs are not going to lend recklessly, given the fact that they are not the ones bearing the risk of these loans. In other words, something must be done to avoid a second sub-prime crisis-like catastrophe, this time affecting the most vulnerable part of the population.

The issue has to be treated from the regulatory perspective. First of all, the law must provide for a minimum of characteristics for the MFIs to be eligible to securitize their loan portfolio, as well as requisites regarding the loans itself. On top of that, there has to be a legal structure that allows investors or other interested parties –such as government agencies, exchanges or the market– to take legal action against the MFIs that originate loans "just for the sake of it". Moreover, with regards to the last two provisions, a ruling concerning the level of responsibility of managers, administrators or stockholders/promoters of the MFIs is necessary, especially taking into consideration that there will be no capital requirements for originating MFIs.

Finally, as in every other investment product, a detailed regulation about full-and-fair disclosure of the bulk of loans is always a good protection for both, investors and originators. However, it is important that the information is comprehensible for the low-income investors/savers, given its level of experience and knowledge of the market.

2.4.2. Lack of Regulation and Justice Structure

Although one of the cornerstones for the success of the proposal lies in the coherence of the legal rules and the means for enforcement, there are few laws

enacted in countries in which the scheme would have more application. In fact, for some countries of Latin America, Africa or Asia, there are hardly any bills regulating rating agencies and complex SPV structures. Thus, it is important that before enacting a whole set of rules, there is a first implementation on a case-by-case basis within a meticulous contractual structure. Once the scheme is digested and some experience has been acquired in developing a functional structure, laws can be issued, rather than "importing" foreign regulation that most certainly will not fit the specific national context.

In developing countries the justice system is often lacking in effectiveness and promptness. This issue can be analyzed extensively and it falls away from the focus of this paper, nonetheless it is important to highlight it here because part of the promotion of investor confidence is closely connected to it. Consequently, any advance on this topic goes hand-in-hand with the proposal.

2.4.3.Moral Risk

A risk common to every loan agreement is having the borrower use the loan for something other than what was initially intended. This is commonly known as "moral risk" and for our purpose MFIs are responsible for monitoring it. There is additional risk when looking at an investor who is also a borrower. Indeed, if the cash flow of the securities is secured by government insurance and other enhancements, individuals will have no motivation to pay for their loans because they will receive the return on their investment anyway. This certainly negates the advantage mentioned in 2.3.4 above. If this is the case, we must rely on the pressure exerted by societal norms that enforce responsible borrowing practices and have historically helped to account for high repayment rates on microloans.

There is also some of this moral risk in MFIs, closely related to the first issue mentioned above (Reckless Lending). If the government and other insurers pay the investors regardless how bad the loans being securitized are, MFIs will continue to originate deficient loans and will still get the incoming flow of capital because the investors' confidence will not be affected. The plausible solution to this was already analyzed earlier in section 2.4.1.

2.4.4. Regulatory Barriers

Because of their structure, it is hard for MFIs to go directly to the financial markets and in some countries these institutions are forbidden to issue securities under any circumstance. The way MFIs work is very unsteady, especially when it comes to corporate governance issues. This is one of the main obstacles for the implementation of the scheme due to the strict market regulation in this area.

The creation of an SPV that outsources the issuance may help, though some regulations, for example the US Securities Act of 1933 §2(a)(4), have established that the originator/depositor is deemed to be the issuer in Asset-Backed Securities (ABS) transactions. The fundamental point of this rule is very simple: regulators want to have a person that is liable for the quality of the assets and avoid securitization schemes that might become a means by which to side-step issuers' rulings.

The proposed solution is to leave an exception within new regulations that allows MFIs to sell their loans for securitization purposes. However, this has to happen concurrently with the reckless lending and disclosure rules mentioned above. The purpose is to give MFIs enough legal security so that they feel safe with the scheme, but also keeping their responsibility in generating good quality and enforceable loans.

2.4.5. Mental Barriers

This point is probably the most difficult one for the implementation of new securitizations in the microloan industry. Today the financial world is in total commotion because of the crisis caused by the subprime mortgages, ergo every investor is afraid to provide capital to similar deals. In spite of the fact that some of the demand is fulfilled by the acquisition of the securities by the microborrowers and microinvestors, to raise the level of impact of the scheme it is important that wealthy investors, such as institutional investors, participate in order to get more funds in circulation.

The only way to promote investor confidence in these kinds of securities is by giving peace of mind. This process has to be carried from the origination of every loan –a topic that without question is in hands of the MFIs– and by clear regulation regarding the quality of the loans in the pool. Thankfully not every aspect of the crisis is bad. The current debate around new rules for the rating agencies will help in the process of re-building investor confidence in the financial instruments.

In the initial phases of implementation, the enhancements that the issuance gets are pivotal. Not only investors will see these securities as a safer option, but also psychologically it is soothing to see that a well-known institution has already trusted those instruments.

3. CONCLUSIONS

It is important to broaden the view of what is usually understood as Microfinance. Lending and savings instruments have been covered by MFIs – although much more the former than the latter. However, no investment products have been conceived, and the insurance ones have not been widely expanded, in spite of their relevance for the targeted communities.

A lot of changes are needed in order to allow microfinance to be the primary tool for empowering the poor and building those bridges that would guarantee MFIs to get access to funds. Yet before any "tangible" change is introduced, there has to be a switch in everyone's mind. The investors have to move away from the traditional view of risk so to invest in Microfinance projects with confidence. Nowadays, before giving the money the investor looks at what the debtor has done so far that can build up an acceptable level of trust, so he knows that the money is safe: what kind of assets does the payer has, who has trusted this individual before, how much is the current provable cash- flow of the debtor, etc. Microfinance requires a different approach to risk analysis which is not based on the past, but on the future. The main question that the investor must have in mind is: how is the debtor going to use my money to pay me back?

Another concept that potential investors must rethink is the market size of microfinance. Microfinance works just as hypermarket-type businesses: the profit of a single contract might not be so attractive, but if we realize that the potential market for these products is above USD 300 billion, then there is something to think about.

Nonetheless, not only the investors must change their attitudes. The MFIs also have to realize the importance of standardizing procedures and come up with relevant and clear information. Up to now MFIs have been very focused on doing what traditional banks have not done, while overlooking banking practices that actually comply with the objectives of microfinance: having clear documentation

between for the clients, or statistics regarding the portfolio performance, or rules that establish credit analysis processes, just to name a few, are all very helpful tools to monitor the operations of an MFI, while making easier to "sell the idea" to potential investors. Indeed, if the relevant data is provided to investors in a comprehensible and standardized manner, it will spare the latter the burden of checking the entity to understand its operations.

Notwithstanding the MFIs and investors' role, there are still many things that remain to be done: governments have to enact laws and regulations that make things easier – though safe – for investors to invest, for MFIs to widen their services and enough for protecting the interests of the serviced communities. International foundations and organizations have to support microfinance, not only by donations to specific MFIs, but also by financing projects that promote integration between the actors of society that can play an active role in poverty-fighting. Finally, also the entrepreneurial world can be a part of microfinance through Corporate Social Responsibility plans. One way to do this is by providing guarantees to the obligations of the microborrowers to build up the required confidence in the market so that investing in microfinance becomes a reality.

Admittedly, we will find many more elements that require action along the way, but these conclusions can serve as a general checklist for a series of things that need to be addressed now. As long as what is currently done has the purpose of integrating microfinance into the formal financial markets, mainly by building trust and confidence around it, it is safe to say that we are on the right path.

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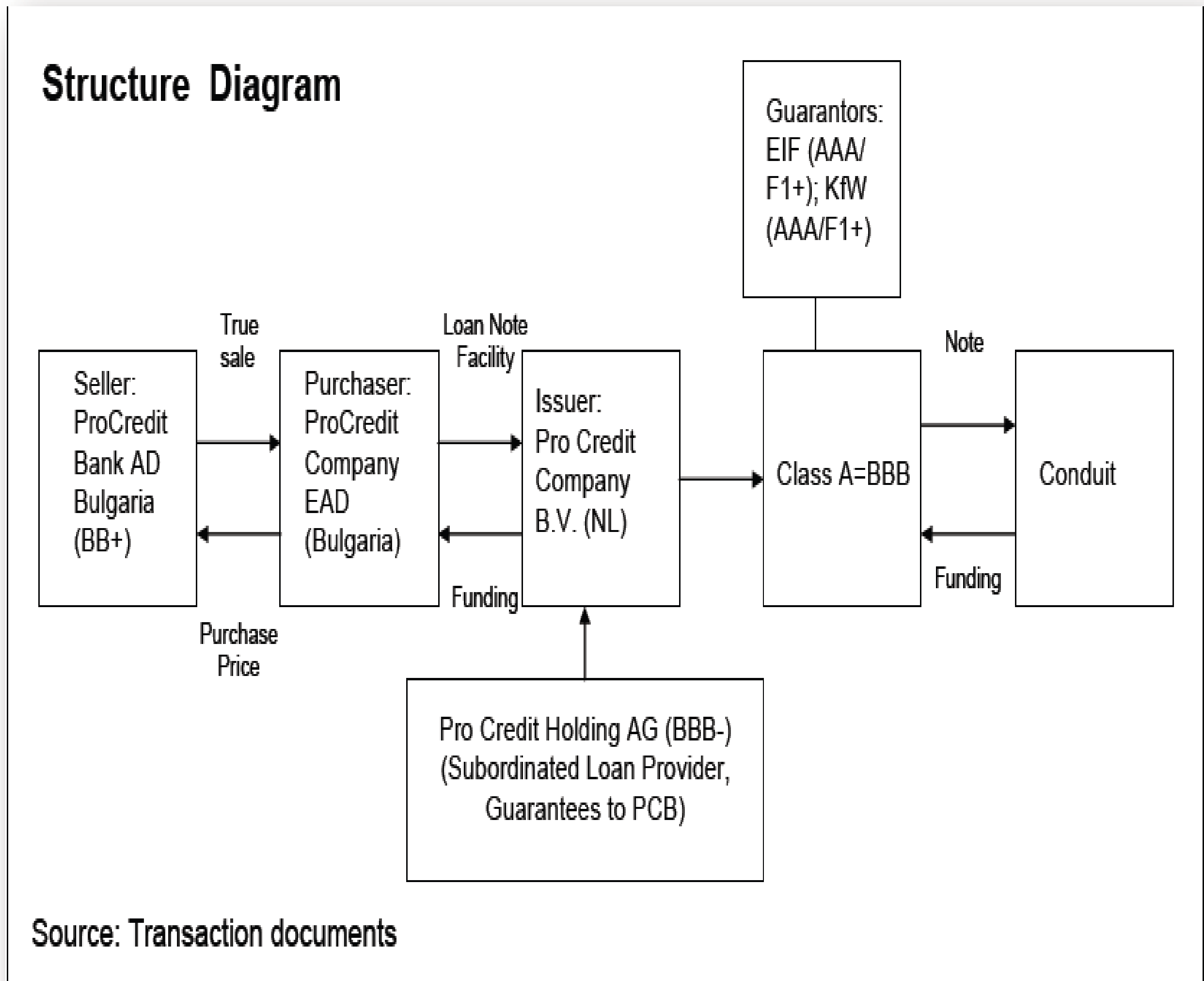
5. ANNEX 1



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