Securitization of Microloans: An Indian Perspective of the Innovation in Microfinance Industry

Prasad Pole*, Anurag Asawa and Deepak Shah*****

Though securitization of microloans started in 2009, it has been growing in size and numbers. It is an innovative way of supporting microfinance which has come under pressure for want of capital. With priority sector lending norms remaining unchanged and direct lending to microfinance institutions seen as risky by banks, securitization is seen as a viable option to banks. This paper discusses the securitization deals in Indian market.

Introduction

Microfinance in India started to pick up in the 1990s, though it has been in place for many centuries. Nobel Laureate Professor Mohammed Yunus made microfinance famous with his Grameen bank concept. His concept of lending to poor without any collateral, hitherto considered as impossible by many, was in fact a great success. Yunus started off with his own funds, but the demand was too huge for his funds to sustain. Yunus had to convince the Central Bank of Bangladesh to fund his project. The demand for microfinance is too huge to be financed by donor funds alone. The large unmet demand of microfinance is a matter of concern to the Government of India. According to CRISIL (2009), ₹1.2 tn is demanded by 120 million households in India. Microfinance Institutions (MFIs) in India have been able to cover 27 million borrowers by the end of March 2010 (MCRIL, 2010). After having learned lessons from Grameen bank experience, the government, researchers and microfinance industry are mulling on improving the depth and width of the outreach of microfinance. By depth we mean how poor people are served, and by width we mean how many regions and people across geographies are benefitting from microfinance. As per the poverty audit commissioned by Small Industries Development Bank of India (SIDBI), 5 MFIs out of 8 give loans to non-poor (Srinivasan, 2009, pp. 2-3). This is because of higher cost of smaller loans and hence the tendency of skipping poor from lending mechanism. Thus, achieving depth remains a challenge to all the practitioners of microfinance. It is easier to spread the limited donor funds across non-poor than having a high cost lending on smaller loans.

Sriram (2010) observes that development of MFIs had gone through three distinct waves: The first wave involved primarily donor fund-driven activities; the second wave kicked off

* Ph.D. Student, Gokhale Institute of Politics and Economics, Pune 411004, Maharashtra, India. E-mail: prasadpole@gmail.com

** Assistant Professor, Gokhale Institute of Politics and Economics, Pune 411004, Maharashtra, India. E-mail: anurag@gipe.ac.in

*** Professor, Gokhale Institute of Politics and Economics, Pune 411004, Maharashtra, India. E-mail: deepakshah@gipe.ac.in

© 2014 IUP. All Rights Reserved.

المنارة للاستشارات

www.manaraa.com

the development of for-profit commercial organizations; and in the third wave, the mainstream commercial institutions like Private Equity (PE) fund and commercial banks started looking at microfinance as an interesting business. Though MFIs began with a philanthropic cause with donor funds, they eventually emerged as commercial organizations with social responsibility. This is because at some point of stage in MFIs' operation, donors expect MFIs to be operationally self-sufficient and grow on their own. This forces MFIs to search for commercial capital. Since MFIs cannot accept deposits like banks, their fund-raising capability is inherently limited. According to Swanson (2007), most of the estimated 10,000 existing MFIs are not deposit-taking institutions and are unlikely to become so, given the cost and complexity of complying with regulations. Accepting the deposits and lending out remains mainly a job of commercial bank and this handicaps MFIs in terms of raising capital and redistributing it.

The Government of India (GOI) has had poverty eradication as one of its policy planks since independence. Its continued thrust on poverty alleviation has helped microfinance sector grow faster. Typically, MFIs have been financed by conventional method, i.e., MFIs apply for loans from banks at commercial interest rate and lend it to their clients at higher rate. In India, RBI has laid down Priority Sector Lending (PSL) norms for banks, where banks are required to lend 40% of their loan portfolio to PSL (MFI is also designated as PSL) (RBI, 2011b). As many banks found it unprofitable to lend directly to the poor due to various reasons like information asymmetry and difficulty in setting up branches in inaccessible areas, lending to MFI was seen as a good option. Barring mass default events as reported in recent times in India[1], this sector has seen a very low rate of defaults across the world. Banks saw them as a safe investment. Due to donor fund limitation, MFIs found borrowing from commercial banks as a good option, as under PSL they get interest rate subvention which improves their margins. Therefore, the commercial engagement was a win-win situation for banks and MFIs. This arrangement has changed post the failure of several MFIs in recent times.

As per mixmarket.org data, India's microloan borrowers are increasing at a Compounded Annual Growth Rate (CAGR) of 70%, while its gross loan portfolio CAGR was 85% during 2004-10. The state of Andhra Pradesh had accounted for 27.93% of country's borrowers and 7.28% of country's population (Srinivasan, 2009, p. 39). Andhra Pradesh (AP) had a share of 36.4% in Self-Help Group (SHG) linkage program (Srinivasan, 2009, p. 25). The country's growth story was clearly visible in AP. Borrowers were benefitting from good services, as AP was home to many MFIs. Andhra Pradesh topped the Microfinance Penetration Index (MPI) with a score of 3.64 and Microfinance Poverty Penetration Index (MPPI) with a score of 6.35 in 2010 (Srinivasan, 2011, p. 16). High levels of penetration are also a cause for concern as they indicate that the debt levels could exceed the repayment capacity of the poor households (Srinivasan, 2009). Andhra Pradesh had 9.63 loan accounts per household (Srinivasan, 2010, p. 4). Microfinance in AP was not used primarily to facilitate productive investment but, rather, to pay back existing loans, cover healthcare expenditures and meet immediate consumption needs (Taylor, 2011). A bubble was brewing in Indian microfinance, as the logic

[1] Andhra Pradesh, Eastern Maharashtra and Northern Karnataka recorded maximum defaults.

المنارة للاستشارات
www.manaraa.com

of competitive provisioning had led to a gross oversaturation of the market (Rozas, 2009). This is what precisely happened later: the media was carrying stories of harassment of borrowers and public humiliation leading to suicides. A report by the government-run program, Indira Kranti Pratham (IKP), had documented more than 40 cases of suicides attributed to overindebtedness from MFI (Sriram, 2012). In October 2010, the Government of AP promulgated an ordinance against MFIs. The ordinance made it mandatory for MFIs to register in each district, collect repayments only from specified locations; it also imposed restrictions on recovery agents (State Government of Andhra Pradesh, 2010). The effect of ordinance was immediate on recoveries which is sure to result in MFIs facing liquidity problems. The borrowers used this ordinance to default and loans started becoming delinquent. MFIs were handicapped due to this ordinance and were struggling to sustain their businesses.

Methods of Funding

Equity

Equity is one of the principal sources of funding, whereby an MFI mobilizes resources from primary market through Initial Public Offerings (IPOs). In fact, such method of funding became popular among the MFIs with the success of the IPO of SKS, which was oversubscribed by 13 times in a price band of ₹850-985 per share.

Besides taking direct recourse to equity market, MFIs can approach PE as well. One of the major PE investments—to the tune of ₹16 mn—was made by International Finance Corporation (IFC) in Bandhan Financial Services. There were many capital market deals prior to October 2010 (before AP crisis). According to Srinivasan (2010 and 2011), there had been a steady growth in equity deals till 2009-10. With the AP crisis in October 2010, PE showed little interest in MFIs (see Table 1).

Table 1: Private Equity Deals in India

Year	$ mn	No. of Deals
2007-08	52	3
2008-09	178	11
2009-10	209	29
2010-11	75	7
2011-12	69	4

Source: Puhazhendhi (2012)

But there are a few PE deals post this crisis like Incofin's investment in Hope Microcredit Finance. This shows the commercial interest of investors in microfinance sector. Many social investing funds have been set up like Dia Vikas Capital (a subsidiary of Opportunity International, Australia) to fund various MFIs in India. Therefore, the commercial engagements are helping MFIs to grow. Some research papers state that MFIs start drifting away from their mission as they grow and mature (Ditchter and Harper, 2007). Mission drift occurs when MFIs move away from serving poor clients in pursuit of commercial viability (Cull *et al.*, 2007). However, there are also some researches like Downey and Conroy (2010) which shows that not-for-profit MFIs have superior financial performance than for-profit MFIs. Another paper states that profit motives help MFIs to

المنارة للاستشارات
www.manaraa.com

become more efficient and tap newer markets (Rhyne, 1998). Post-AP crisis, the Government of India (GOI) has stepped in to allay the fears of investors by setting up its own equity fund, called India Microfinance Equity Fund. This has been set up by GOI along with SIDBI in the Union Budget 2011-12. The purpose of this fund is to support smaller MFIs to achieve growth and efficiency in their operations (SIDBI, 2012). Though small in size (about ₹1 bn), it shows the government's interest in developing microfinance sector through equity funding.

Non-Convertible Debentures

Non-Convertible Debentures (NCDs) are another way that MFIs have found to finance. In this avenue, there have been many deals and MFIs have been able to secure funding for their short-term requirements. NCDs have to be rated by a SEBI-approved credit rating agency and should carry a minimum rating of P-2 or equivalent. Some of the major deals in NCDs include Ujjivan Financial Services raising ₹230 mn (Contify, 2011) and Sahayata Microfinance raising ₹195 mn (Microfinance Focus, 2011).

External Commercial Borrowings

External Commercial Borrowings (ECBs) are another route wherein for-profit MFIs could tap the non-resident lender's fund for a minimum maturity of three years. However, as per the conditions laid down by RBI (2011a), MFIs should have been operating in the field for at least 3 years and have been working with a bank authorized to deal in foreign exchange. The limit for ECBs is $10 mn for a year.

Commercial Papers

Commercial Papers (CP) are unsecured, short-term debt instruments issued by an organization. SKS raised $4.8 mn through this method as reported by Microcapital.org (2009). CPs are used to finance short-term liabilities. Maturities on commercial paper rarely range any longer than 270 days. The debt is usually issued at a discount, reflecting prevailing market interest rates. CPs have to be rated by SEBI-approved rating agency. Since CPs are not backed by any collateral, institutions with strong ratings are able to raise money through CPs.

Securitization: New Saga in MFI Funding

The conventional method of MFI lending is when MFIs lend to borrowers and keep these loans on their balance sheet. MFIs own these loans and retain their credit risk. If the loans are transferred to other client/trust along with the future cash flows, then these loans can be taken off from the MFIs' balance sheet. One way of doing this is by setting up SPV (Special Purpose Vehicle) and transferring these loans to it. Then SPV collects the interest on these loans and pays out to investors. This is Securitization, one of the techniques which can help in microfinance sector capitalization.

Securitization is pooling all cash flow-generating assets, structuring them into tranches and selling particular tranche to investors as per their risk appetite. Typically, any kind of cash receivables can be securitized to issue a transfer certificate after which the cash flow is transferred to the investor.

المنارة للاستشارات
www.manaraa.com

In microfinance context, securitization is an asset-backed transaction, wherein microloans receivables are pooled and repackaged to sell them to investors (banks or funds). In this way, investors are funding the micro borrowers of MFIs who remain as the servicer of these loans.

The world's first microfinance securitization deal took place in 2006 when the Bangladesh Rural Advancement Committee (BRAC) received 12.6 bn Bangladesh Taka (US$180 mn) in financing over six years, through a microcredit securitization structured by RSA Capital, Citigroup, the Netherlands Development Finance Company (FMO), and KfW Entwicklungsbank (KfW). One billion Bangladesh Taka (US$15 mn) was disbursed to BRAC every 6 months, with a maturity of 1 year (Microcapital, 2006).

Securitization has been a source of debate and has raised a lot of doubts about its viability for successful implementation, especially after credit crisis. Securitization was blamed for the world economy debacle and was seen as an evil financial innovation. Its Originate-to-Distribute (OTD) model was criticized heavily. Many banks started to disburse loans just to securitize; this is called as OTD model. Banks were actively looking for clients to whom they could lend. After that they would securitize and sell it to some investors. This triggered predatory lending wherein people were offered attractive schemes so that they could borrow money (in many cases even if not needed). Many thought that using this OTD model, banks were giving out loans to not-so-creditworthy people. Opposing views state that banks have their reputation at stake and cannot offload risky loans from their balance sheets. A paper by Bank for International Settlements (BIS, 2011) argues that securitization can work provided there are certain changes made to the framework. The paper concludes that the securitization of prime mortgages is a soundly functioning market and should not be excessively penalized. The OTD model per se cannot be blamed for having induced reckless risk-taking (BIS, 2011). Dodd-Frank Act has been laid down to tackle the issue of OTD and moral hazard, and required originators of the loans to have "skin in the game". This meant that originators of the loans were asked to maintain 5% of their securitized portfolio in their balance sheet. Originators will have more due diligence as bad loans will affect their balance sheet as well. By retaining these loans on their balance sheet, Dodd Frank Act did a better job by addressing the problem of OTD model (Thompson, 2011). Securitization can work provided there are certain changes in loan production processes, improving transparency and monitoring at both security and financial system levels (Riddiough, 2010). Keys *et al.* (2008) conclude that market forces are better in mitigating moral hazards than stricter regulations.

There have been many classical reasons for development of securitization. Though there is a controversy surrounding securitization, there are certain advantages. Kalani (2009) states that securitization increases MFI size and capital available for funding, and concludes that it increases the average amount lent to borrowers along with the reduction in the portfolio at risk. There have been several papers on commercial microfinance and securitization, but research papers combining these two are rare. Kalani (2009) is unique in terms of combination of commercial microfinance and securitization.

www.manaraa.com

Bystrom (2008) explains microfinance Collateralized Debt Obligation (CDO) by taking a hypothetical example and building the implications from it. The paper uses the assumption laid down by Consultative Group for Assisting Poor (CGAP) regarding the costs incurred by MFIs and creates a hypothetical portfolio of MFIs in multiple countries. It concludes that growth of microcredit supply can speed up by the use of CDO. The microfinance CDO can be tailor-made to provide various risk-return profiles for different risk appetite and investment mandates. By retaining the most risky tranche, the originator of the microfinance CDO can get high risk-adjusted return and take care of asymmetric information problem in any securitization deal.

As discussed earlier, MFIs do have restrictions on capital building as they are not allowed to accept deposits and even if they are allowed to accept deposits, there is a huge risk of moral hazard. MFIs are large in number and regulating them for accepting deposits will be a daunting task for any regulatory authority. So MFIs will naturally explore alternate avenues for raising capital. Securitization involves only MFIs and investors to raise capital, therefore this makes it easier for any MFI to adopt this route of financing. Unlike other areas where there are restrictions from regulators inhibiting their usage, this is a good option from the point of view of investors and originators of loans.

Table 2 shows a few of the securitization deals in India, which are compiled from various sources like the website of Institute of Finance and Management Research (IFMR), and Indian Credit Ratings Agency (ICRA) rating releases of various structures.

Securitization of Microloans in India

Though the first securitization deal in India took place in as early as 1990, microloan securitization took a substantial time to materialize. It was only in 2009 that Equitas Microfinance (MFI based in Chennai) securitized its microloan portfolio with the help of IFMR Capital (Chennai-based NBFC) to launch India's first rated securitization deal. Since then there have been multiple microloan securitization deals. This deal was classified as single originator deal like IFMR Capital Pioneer I (Table 3) wherein only one MFI was involved; in this case Equitas Microfinance's loans were securitized into various tranches. The size of the deal was ₹157 mn which was divided into two tranches, A1 and A2, with the principal amounting to 80% and 20%, respectively. The CRISIL rated its top tranche (A1) as AA (SO) having high degree of safety in timely servicing of its financial obligations, depicting low credit risk, and mezzanine tranche (A2) as BBB (SO) having moderate degree of safety and moderate credit risk. In this structure, there is a stipulated cash collateral of 11.7% of the principal. This cash collateral acts as internal credit enhancement giving stability to the structure; the first loss is taken up by this collateral and hence there is no rating given to this. This first-loss guarantee protects the upper tranches. If the default losses are 11.7%, the cash collateral is used for the defaults and cash flows to Series A2 and Series A1 continue. If the default exceeds 11.7%, then the default is absorbed by Series A2 tranche protecting the most senior tranche. This way Series A1 is protected till Series A2 principal has not defaulted.

المنارة للاستشارات
www.manaraa.com

Table 2: Summary of a Few Microfinance Deals in India

S. No.	Name	Originator	SPV	Size (₹)	No. of Microloans	Tranches	Remarks
1.	Delta Pioneer IFMR Capital 2010	Janalakshmi Financial Services	IFMR Capital	250 mn	35,560	AA and unrated	Unrated held by IFMR.
2.	KRIOS Pioneer IFMR Capital	Ujjivan Financial 2011	IFMR Capital Services	401 mn	45,954	(89.5%) A1 and (10.5%) subordinated junior	Unrated held by IFMR.
3.	Beta IFMR Capital 2011	Grama Vidiyal	IFMR Capital	108 mn	11,304	84% senior tranche rated A1 and 16% subordinated junior tranche rated A3	Unrated held by IFMR.
4.	Aether IFMR Capital 2011	Grameen Financial Services Pvt. Ltd. (Grameen Koota)	IFMR Capital	239 mn	23,108	A-rated tranche and IFMR Capital invested in the subordinated ICRA BB+	Grameen Koota provides cash collateral of 10% of the pool principal. Avendus Capital invested in 84% of loan receivables.
5.	MOSEC 7	Asirvad Microfinance Pvt. Ltd., Disha Microfinance Pvt. Ltd., Mimoza Enterprises Finance Pvt. Ltd., Satin Creditcare Network Ltd., Suryoday Microfinance Pvt. Ltd., SV Creditline Pvt. Ltd. and Utkarsh Microfinance Pvt. Ltd.	IFMR Capital	511 mn	49,881	85% senior tranche rated A1-LBBB+ (SO) and Series A2 unrated	Senior tranche has been subscribed by a Bank and HNI's Junior Tranche by IFMR Capital. Originators and servicers provide cash collateral as first loss.

www.manaraa.com

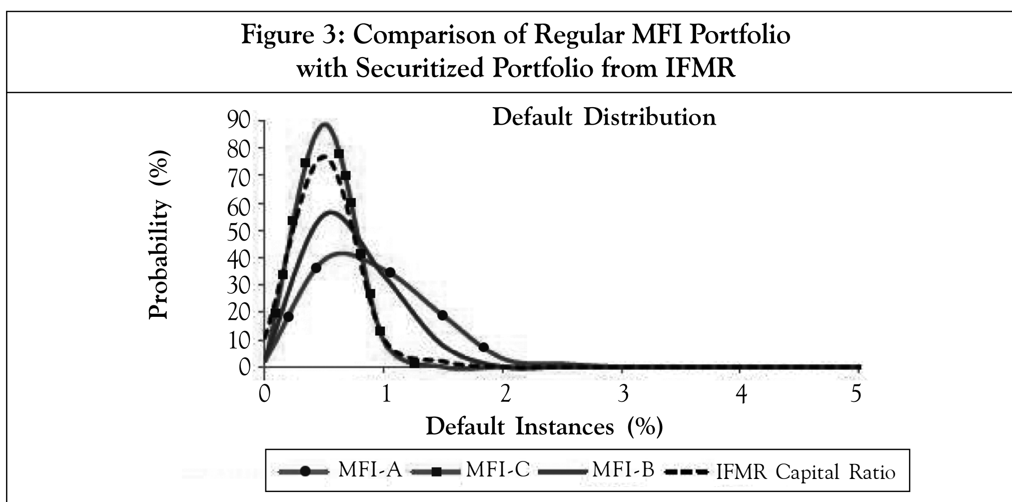
Table 3: IFMR Capital Pioneer Trust I				
PTC	**Yield Terms**	**Principal (₹ mn)**	**Principal (%)**	**Ratings**
Series A1	Fixed	125.4	80.00	AA (SO)
Series A2	Residual	31.3	20.00	BBB (SO)
Cash Collateral	–	18.3	11.70	Unrated

Other type of securitization is where there are many originators (MFIs) whose microloans are securitized. These are called Multi-Originator Securitization deals like IFMR Capital MOSEC I wherein IFMR clubs microloans from many MFIs. Because of MOSEC type of deals, many small MFIs have been able to get access to this new financing. Table 4 shows an example of IFMR MOSEC I structure in which Asirvad Microfinance Pvt. Ltd., Sahayata Microfinance Pvt. Ltd., Satin Creditcare Network Ltd., and Sonata Finance Pvt. Ltd. are contributing to the pool of assets. The first loss guarantee is given by these four MFIs in terms of cash collateral and second loss guarantee is given by IFMR Capital by investing in junior tranche. This means that if there is any default, it is absorbed by all the MFIs involved and second default is absorbed by IFMR Capital.

Table 4: IFMR Capital MOSEC I				
PTC	**Yield Terms**	**Principal (₹ mn)**	**Principal (%)**	**Ratings**
Series A1	Fixed	233.3	76	AA(SO)
Series A2	Residual	75.2	24	Unrated
Cash Collateral	–	41.3	13	Unrated

This multi-originator structure has also helped investors to reduce the risk by diversifying the loan portfolio across various geographical areas, servicers and originators. Sahasaranaman (n.d.) mentioned that MOSEC resulted in diversification hence default distribution of IFMR Capital portfolio of various securitized pools has thin tail (low probability of high defaults) as shown in Figure 3. This implies that multi-originator structure may have loans from various

Figure 3: Comparison of Regular MFI Portfolio with Securitized Portfolio from IFMR



www.manaraa.com

states and probability of default in one state affecting the other may be low. Hence, this will help the investors to protect their investments.

Risks of Securitization

Now that we have discussed the securitization deals in detail, we may have to take a look at inherent risks associated with securitization. This is important even if there are credit enhancement, overcollateralization and first-loss protection from originators.

Credit Risk

Credit risk remains the most important risk for any bank/investor. There are many modeling techniques which are used by banks for modeling credit risk, but models are based on historical events which are limited in case of microfinance industry and moreover no model can predict event risk like mass defaults. The only relief that securitization structure gets is overcollateralization and first loss guarantee which is limited. There is an information asymmetry problem which is difficult to be addressed. India's first credit bureau High Mark Credit Information for microfinance sectors was launched in 2011. The purpose of credit bureau is to collect information of all the borrowers. Currently, it has 80 million loan records and profiles of 45 million customers (Puhazhendhi, 2012, p. 8). Equifax is another credit bureau. RBI has made it mandatory for NBFC-MFIs to register in at least one bureau. In the long run, these bureaus can build credit histories and get integrated to main financial system. But currently, information on borrowers still remains a challenge to gauge the level of risk.

Prepayment Risk

All the loans taken by the borrower can be paid off early. This means that all the future cash flows of securitized structure are paid off before maturity and so the securitization structure will collapse. The regulation in India does not permit any prepayment penalty for prepayments. This is not a major risk in microfinance as the economic status of the borrower is low (Ray, n.d.).

Commingling Risk

This risk occurs because servicer handles all transactions related to recovery. So there is a possibility that the funds received as recoveries may not be distributed to investors in case of bankruptcy. Microfinance securitization is more prone to this risk as MFIs are small and Management Information System (MIS) is not in place to monitor the loan recoveries. This risk can be minimized by reducing the time of collection and distribution to investors, but it is difficult and location of MFIs make it even more difficult. This risk is exacerbated due to lack of back strategy for loan servicing. For other asset classes in developed countries, there are backups ready for reducing this risk. But in the case of microfinance in India, it is difficult to achieve it in the near future.

Political Risk

This risk occurs due to political intervention. Porteus (2009) points out that credit markets are fragile, both because they risk political meddling, and because borrowers themselves

المنارة للاستشارات
www.manaraa.com

exhibit systematic vulnerabilities which compromise their decision making. In AP, the government had intervened in the operations of MFIs hurting their business; this type of political risk will always remain with the securitization. Also, the AP type crisis will always remain a factor in the business for the microfinance industry.

Legal Risk

This risk is due to the nature of the structure. Even if the structure boasts of bankruptcy-remote model, borrowers are from rural areas and if originator/servicer goes bankrupt, there is an inclination of default by the borrowers as they are more connected to the original servicer and may oppose servicer replacements.

"In several countries including India it has been noticed that the microfinance borrowers fail to understand the migration of the servicer from the originator to the third party and mostly stop repaying loans" (Ray, n.d.).

Benefits of Securitization in the Microfinance Context

There are multiple benefits of securitization to investors and originators (primarily MFIs). The most significant benefit is freeing up regulatory minimum capital. Originators have to maintain minimum capital-to-risk weighted assets ratio. In the microfinance context, banks lend to MFIs who in turn lend to their clients. It is mandatory for both the organizations to maintain this minimum ratio. However, securitization can provide capital relief to the industry and free-up capital.

The availability of funds throughout the period is also an important benefit. It is because typically MFIs receive the funds from banks around last quarter of the financial year, as during this period banks try to fulfill their PSL targets. By securitization, timing of the income is changed and MFIs do not have cash flows only during the end of the financial year.

The higher tranche is always protected by stipulated cash collateral and junior tranches; this is of much interest to banks that have started avoiding funding to MFIs. If banks buy the senior tranche, they will have credit protection from any default arising from lower tranches. This can help banks to monitor the loan performances in a much better way. We analyze two scenarios: first, banks lend directly to the poor or MFIs, and second, where they buy senior tranche notes from a MOSEC securitized structure. Now consider a case where there are some defaults or delays occurring due to some reason. In the first scenario, banks take the bad loans on their balance sheet. There was no early trigger mechanism for banks to have foreseen this circumstance. This situation can easily spin out of control and banks will be left with nothing much to control. In the second scenario, banks have invested in MOSEC senior tranche which has diversified loan portfolio through various geographies. The default is taken up by lower tranches protecting the bank's investment in senior tranche. The losses absorbed by lower tranches will give an early warning to banks on deteriorating loans. The banks can put in more efforts to avoid further escalation of defaults by monitoring MFIs and analyzing the situation closely.

المنارة للاستشارات
www.manaraa.com

Conclusion

MFIs may never be accepting deposits in the near future, so their funding will remain inherently limited. Therefore, MFIs will always have to find newer avenues of financing. One such innovation is securitization of microloans, and this being easier than other methods of raising capital, will become more popular.

In the current scenario wherein the MFIs are not able to get funding from banks to lend to poor, GOI has stepped in to allay the fears by setting up microfinance fund, but this will not solve the supply side problems. This fund is of meager, and moreover, even if the current situation improves the supply deficit will stay. The banks tend to take the route of securitization for satisfying the PSL requirements. This innovative financing can help both banks as well as MFIs which are reeling under pressure from lack of funds. In this situation, banks can buy senior tranche which is protected by overcollateralization and first loss guarantee by junior tranches (mainly equity tranche and cash collateral). The stipulated cash collateral absorbs the first loss and second loss is absorbed by the holders of equity tranche. All these will help to gain confidence in banks that due diligence is taken care of. This is an important lesson learnt from credit crisis in which originators lent just to securitize (OTD model) causing loan screening lapses. Now RBI has put a condition of "skin in the game" wherein originators cannot just get away with poor quality loans as they need to keep certain amount of loans on their balance sheet. Of course, these measures will not help banks in the event of recurrence of AP crisis. The AP crisis has led to a loss of ₹60 to 70 bn (Srinivasan, 2011, p. 56). Though there has been a regulation that RBI is the sole regulator for microfinance industry, risk of AP type of crisis still remains unchanged.

Unless the government assures that the AP kind of crisis is not repeated and such type of moral hazard situation does not arise, no one will have confidence in microfinance industry. Investing in top tranches can protect the capital only to the extent that losses do not exceed junior tranches, but whole loans can go delinquent after mass defaults.

RBI's new guidelines (RBI, 2012) have been supportive of microfinance securitization in many ways. These guidelines have Minimum Holding Period (MHP) as the criteria for originating organizations. In this, originators can securitize loans only after these have been held by them for a minimum period in their books (based on maturity and repayment frequency) ensuring that loans are not given out only for the purpose of securitization. The other criterion is Minimum Risk Retention (MRR) which ensures that originators continue their stake in the securitized structure. MHP and MRR are established to help boost securitization and safeguard the investors. Microfinance securitization is definitely an innovation that is here to stay. It is still at a very nascent stage, and RBI is doing its job of protecting the microfinance industry from credit crisis-like situations which happened in other parts of world. ⅄

Acknowledgment: *The author would like to express his gratitude to Dr. Madhusoodanan T P for his guidance and sharing knowledge.*

www.manaraa.com

References

1. BIS (2011), "Securitization is Not that Evil After All", Bank for International Settlements, available at http://www.bis.org. Accessed on May 3, 2012.

2. Bystrom Hans (2008), "The Microfinance Collateralized Debt Obligation: A Modern Robin Hood?", *World Development*, Vol. 36, No. 11, pp. 2109-2126.

3. Chakraborthy Digal (2013), "Securitization in India: A Strategic Tool for Competitiveness", *Indian Journal of Applied Research*, Vol. 3, No. 3, pp. 304-307.

4. Contify (2011), "Ujjivan Financial Services Raises Rs. 230 mln via Issue of Non-Convertible Debentures", available at http://contify.com/story/ujjivan-financial-services-raises-rs-230-mln-via-issue-of-non-convertible-debentures-2011-07-04. Accessed on June 3, 2012.

5. CRISIL (2009), "India's Top 50 Microfinance Institutions", available at http://www.crisil.com/pdf/ratings/CRISIL-ratings_india-top-50-mfis.pdf. Accessed on May 3, 2012.

6. Cull R, Demigfuc-Kunt A and Morduch J (2007), "Financial Performance and Outreach: A Global Analysis of Leading Microbanks", *Economic Journal*, Vol. 117, No. 517, pp. 107-133.

7. Dichter T W and Harper M (Eds.) (2007), *What's Wrong with Microfinance?* Practical Action Publishing, Rugby, UK.

8. Downey Kenneth and Conroy Stephen J (2010), "Microfinance: The Impact of Non-Profit and For-Profit Status on Financial Performance and Outreach", Academy of Economics and Finance, available at http://www.econ-jobs.com/research/35795-Microfinance—The-Impact-of-Nonprofit-and-For-Profit-Status-on-Financial-Performance-and-Outreach.pdf. Accessed on May 3, 2012.

9. Kalani G (2009), "Making Benevolence Profitable: Assessing the Role and Impact of Securitization in the Microfinance Sector", available at https://www.amherst.edu/media/view/190195/original/Kalani09MakingBenevolenceProfitable.pdf. Accessed on June 19, 2012.

10. Keys Benjamin J, Mukherjee Tanmoy, Seru Amit, Vig Vikrant (2009), "Financial Regulation and Securitization: Evidence from Sub-Prime Mortgage Loans", *Journal of Monetary Economics*, Vol. 56, No. 5, pp. 700-720.

11. MCRIL (2010), MCRIL Microfinance Review, available at http://www.m-cril.com/BackEnd/ModulesFiles/Publication/M-CRIL-Microfinance-Review-Nov2010.pdf. Accessed on May 5, 2012.

12. Microcapital (2006), "World's First Microcredit Securitization: $180 Million Deal Between Bangladesh Rural Advancement Committee, RSA Capital, Citigroup, Netherlands Development Finance Company, and KfW Entwicklungsbank", available at http://www.microcapitalmonitor.com/cblog/index.php?/archives/283-Worlds-First-Microcredit-Securitization-180-Million-Deal-Between-Bangladesh-Rural-

المنارة للاستشارات
www.manaraa.com

Advancement-Committee,-RSA-Capital,-Citigroup,-Netherlands-Development-Finance-Company,-and-KfW-Entwicklungsbank.html. Accessed on July 8, 2012.

13. Microcapital.org (2009), "Microcapital Story: Indian SKS Microfinance Issues Bonds and Commercial Notes, and Announces a $963.6m Borrowing Plan to Finance Rapid Growth", available at http://www.microcapital.org/microcapital-story-indian-sks-microfinance-issues-bonds-and-commercial-notes-and-announces-a-9636m-borrowing-plan-to-finance-rapid-growth. Accessed on July 8, 2012.

14. Microfinance Focus (2011), "Sahayata Microfinance raises INR 195 MN Through NCDs", available at http://www.microfinancefocus.com/sahayata-microfinance-raises-inr-195-mn-through-ncds. Accessed on July 6, 2012.

15. Porteus David (2009), "Policy Focus Note 1: Consumer Protection in Credit Markets", Financial Access Initiative Framing Note, available at www.financialaccess.org

16. Puhazhendhi V (2012), *Microfinance India State of Sector Report 2012*, Sage Publications, New Delhi.

17. Ray Prantik (n.d.), "Issues in Microfinance Securitization in India: Need for Proper Risk Assessment", available at http://www.wbiconpro.com/315-Prantik.pdf. Accessed on July 2, 2012.

18. RBI (2011a), "A.P. (DIR Series) Circular No. 59, External Commercial Borrowings (ECB) for Microfinance Institutions (MFIs) and Non-Government Organizations (NGOs) Engaged in Microfinance Activities Under Automatic Route", available at http://rbidocs.rbi.org.in/rdocs/notification/PDFs/59APDMFI191211.pdf. Accessed on July 6, 2012.

19. RBI (2011b), "Priority Sector Lending", available at http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/73748.pdf. Accessed on May 28, 2012.

20. RBI (2012), "Revisions to the Guidelines on Securitization Transactions", available at http://rbidocs.rbi.org.in/rdocs/notifications/PDFs/FIGUSE070512.pdf. Accessed on September 3, 2012.

21. Rhyne E (1998), "The Yin and Yang of Microfinance: Reaching the Poor and Sustainability", *MicroBanking Bulletin*, Vol. 2, No. 1, pp. 6-8.

22. Riddiough T (2010), "Can Securitization Work? Economic, Structural and Policy Considerations", *The Journal of Portfolio Management*, Vol. 37, No. 5, pp. 24-38.

23. Rozas D (2009), "Is There a Microfinance Bubble in South India?", Microfinance Focus, available at http://www.microfinancefocus.com/2009/11/10/is-there-a-microfinance-bubble-in-south-india/ Accessed on May 28, 2011.

24. Sahasranaman Anand (n.d.), "Securitization in Microfinance", available at http://www.vinodkothari.com/Session%204_Securitisation%20in%20Micro%20Finance%20sector_Mr.%20Anand%20 Sahasranaman_IFMR.pdf. Accessed on August 15, 2012.

www.manaraa.com

25. SIDBI (2012), “Addressing Gaps in MSME Ecosystem”, Annual Report 2011-2012, available at http://www.sidbi.com/sites/default/files/financials/SIDBI%20ANNUAL%20REPORT%20%202011-12%28ENGLISH%29-Final.pdf. Accessed on May 29, 2013.

26. Srinivasan N (2009), *Microfinance India State of Sector Report 2009*, Sage Publications, New Delhi.

27. Srinivasan N (2010), *Microfinance India State of Sector Report 2010*, Sage Publications, New Delhi.

28. Srinivasan N (2011), *Microfinance India State of Sector Report 2011*, Sage Publications, New Delhi.

29. Sriram M S (2010), “Commercialisation of Microfinance in India: A Discussion on the Emperor’s Apparel”, Indian Institute of Management, Ahmedabad.

30. Sriram M S (2012), “The AP Microfinance Crisis 2010: Discipline or Death?”, *Vikalpa*, Vol. 37, No. 4, pp. 113-127.

31. State Government of Andhra Pradesh (2010), An Ordinance to Protect the Women Self Help Groups from Exploitation by the Microfinance Institutions in the State of Andhra Pradesh and for the Matters Connected Therewith or Incidental Thereto.

32. Swanson Brad (2007), “The Role of International Capital Markets in Microfinance, 2007”, paper presented at a symposium on Credit Markets for the Poor, University Business School, Columbia.

33. Taylor Marcus (2011), “Freedom from Poverty is Not for Free: Rural Development and the Microfinance Crisis in Andhra Pradesh, India”, *Journal of Agrarian Change*, Vol. 11, No. 4, pp. 484-504.

34. Thompson Eric (2011), “Dodd-Frank and Basel III’s Skin in the Game Divergence and Why It Is Good for the International Banking System” , *The Global Business Law Review*, pp. 159-174, available at http://engagedscholarship.csuohio.edu/gblr/vol2/iss2/4

Reference # 01J-2014-01-05-01

المنارة للاستشارات
www.manaraa.com

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

المنارة للاستشارات

www.manaraa.com