Microfinance Industry Funding Facility

A Concept Note by the

Pakistan Microfinance Network

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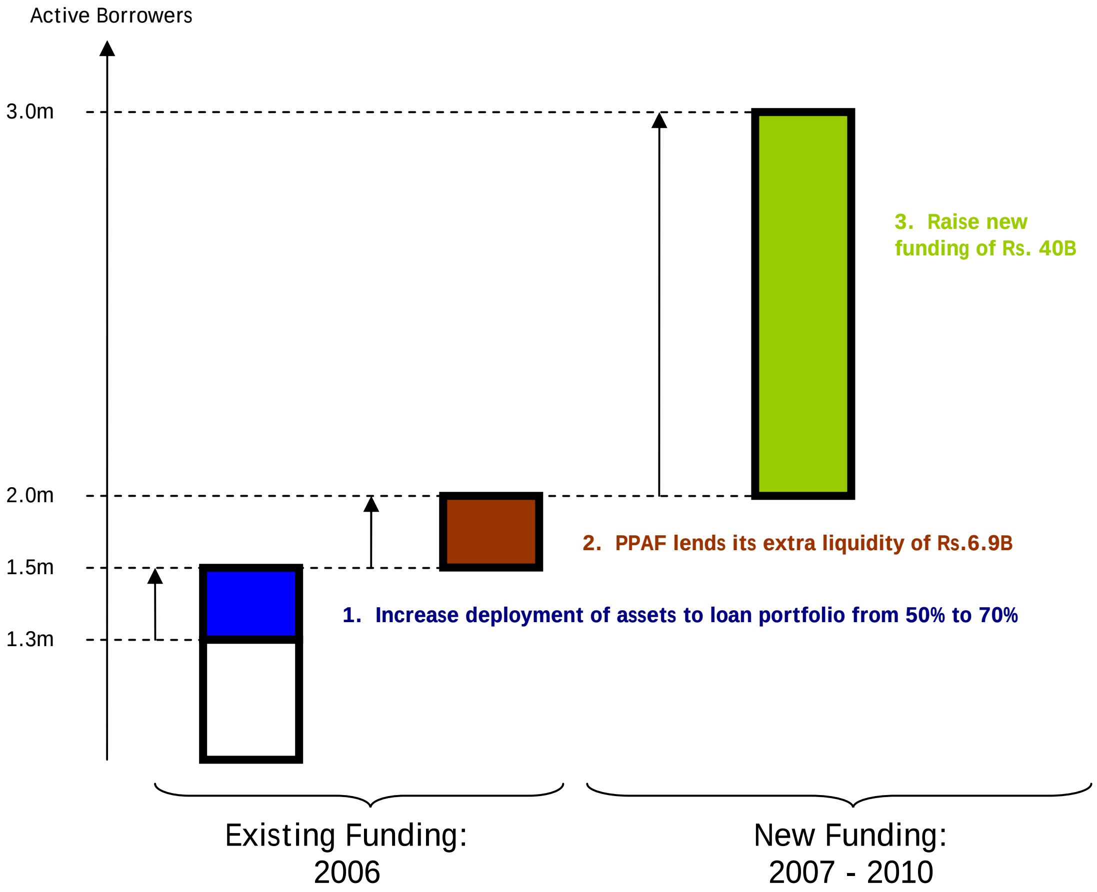
The Pakistan Microfinance Network proposes to create a new facility to help raise funding to support the growth of low income focused financial services - the Microfinance Industry Funding Facility (MIFF). The MIFF, under the umbrella sponsorship of the Pakistan Microfinance Network, will provide three key services which expand and diversify access to funding: investment promotion and referral services, support for technical assistance to prepare microfinance providers (MFPs) to raise funding and a credit enhancement facility.

The PMN believes the sponsorship of MIFF will be critical to fuel the growth and expansion goals of low income focused services across Pakistan. Close analysis of the growth trajectory of the microfinance shows that the industry could reach 3.0 million active borrowers by 2010. (Eventually the number of savers is expected to outpace borrowers, but savings is expected to lag behind credit expansion in the next 2-3 years.)



To fund growth there are existing funding resources that can be more efficiently employed:

(1) Increasing the proportion of assets on MFI/MFB balance sheets deployed in loans (currently at only 50%) which is a management decision which can be taken by MFI/MFBs to become more aggressive in their efforts to expand lending operations, and

(2) Deploying the available funds with PPAF of Rs.7 billion[1] through more loans to MFB/MFIs. For PPAF to take this step they would need to increase their lending appetite to MFIs and open up their policies to allow uncollateralized cashflow based lending to MFBs.

While these two measures would bring a significant injection of funding into the sector, the projections indicate that there would still be a need for incremental funding of Rs.40 billion to fund growth to 2010.

To raise the necessary new funding from 2007 to 2010 is a surmountable challenge – but one which will require focused efforts. Unlike India which has government mandated priority sector lending requirements, the financial markets in Pakistan are under no policy obligation to allocate funding to microfinance. It will take more focused attention to raise the necessary growth funding in Pakistan.

There is also the risk that the rush to fund rapid growth loses sight of the longer term objective of building a balanced and healthy financial sector capable of serving the poor over the long run. In particular, the push to raise debt risks displacing savings mobilization and this could have long-term adverse effects stunting savings service expansion. One objective of the MIFF is to raise interim debt funding to meet early growth needs, but which does not reduce incentives to mobilize deposits over the long-term as the primary source of long-term funding.

In addition to savings mobilization, the wholesale market for funding needs to be strengthened through diversification. The PMN expects that more diverse sources of funds will make pricing and terms more competitive. Microfinance providers will be better able to shop around to find the terms, tenor and pricing options that best meet their preferences. There is also the need to develop the local financial markets and to avoid an over-dependence on foreign currency funding. The MIFF's goal is to take a holistic view of the market for funding and to work towards a more diverse range of providers, emphasize savings mobilization and emphasize mobilizing local sources of funding. With these priorities, the MIFF will help develop a more sustainable long-term solution for the funding requirements of microfinance.

Overview of Microfinance in Pakistan

Microfinance in Pakistan is evolving at a rapid pace with new entrants, new products and practices and a fast growing client base. Most of the growth is expected to be driven by 7 existing institutions which have stronger track records and/or strong management backgrounds which will enable them to expand. These seven organizations include 4 microfinance banks with national licenses and three non-profit MFIs (though two of these MFIs will be

[1] The excess liquidity figure is derived from PPAF's website which shows a short term investment portfolio for 2006.

moving some of their operations into newly created microfinance banks over the next two years).

Table 1: Statistics of top market players (June 2007)

	Institution	Active Borrowers	Active Savers
Microfinance Banks	First MicroFinanceBank	82,018	55,910
	Khushhali Bank Limited	324,471	-
	Tameer Microfinance Bank	30,118	34,861
	Pak Oman Microfinance Bank	16,452	6,469
Microfinance Institutions	Asasah	38,257	26,609
	Kashf Foundation	208,316	-
	National Rural Support Programme	319,729	704,318
	TOTAL	**1,019,361**	**828,167**

The expansion of these seven organizations could be complemented by the entry of additional international players such as BRAC and ASA from Bangladesh. It is also possible that a number of commercial banks and other commercial players will enter the low income markets more aggressively. However, the pace of entry of any of these new players is difficult to predict and therefore the analysis in this note focuses on the top seven fastest growing providers whose futures are easier to anticipate. It could be that the actual funding growth needs are higher than what is projected here if some of these new players enter and accelerate their expansion quickly.

Funding Needs for 2007 - 2010

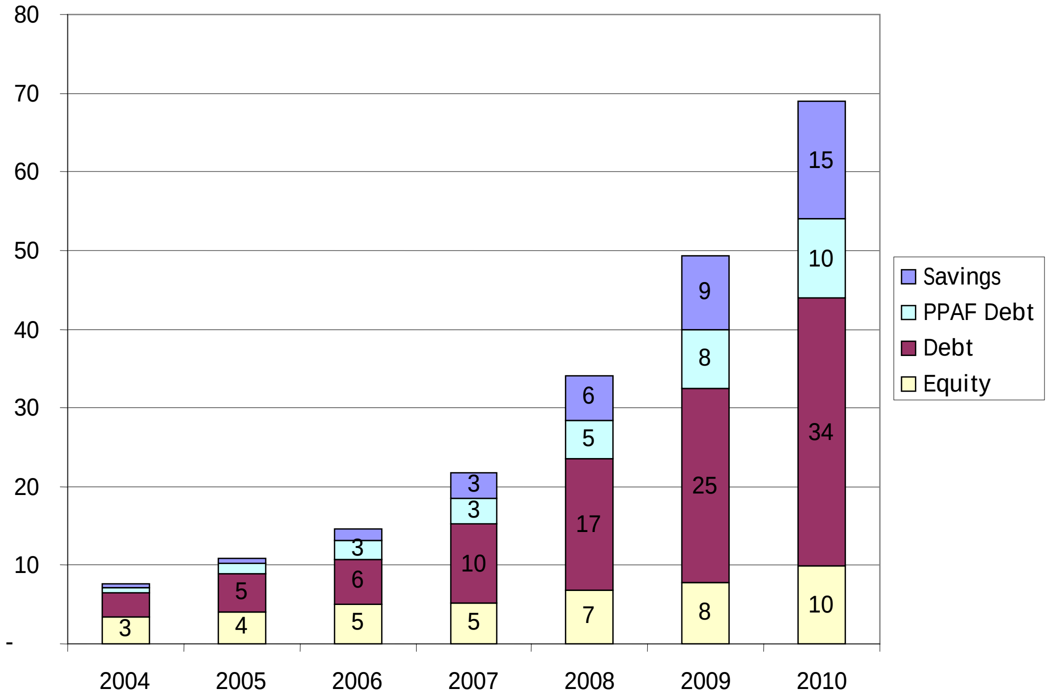
The PMN and SBI undertook a more detailed analysis of likely future growth for seven MFIs who provided their projections. These projections were consolidated and certain adjustments made to account for changes including greater deployment of PPAF's funds as well as the creation of microfinance banks by NRSP and Kashf Foundation.

Based on these projections, the PMN and SBI estimate that by 2010 the total active borrowers collectively of these seven main players will just reach 3 million borrowers (with a collection of other smaller players pushing the number up slightly higher). The average loan balance is expected to rise to Rs.17,862 compared to Rs. 10,781 in 2006 due to the addition of larger loan size products, the effects of inflation and organic loan size growth. This rise of the average loan balance and the rise in total borrowers will result in a seven fold increase in gross outstanding loans by 2010 and a six fold increase in total assets.

Consolidated figure for MFBs & MFIs								
		2004	2005	2006	2007	2008	2009	2010
1	Active Borrowers	0.3	0.5	0.7	1.3	1.9	2.3	2.9
2	Average Loan Balance (PKR)	8,701	9,559	10,781	10,355	12,211	15,811	17,862
3	Gross Loan Portfolio (PKR billions)	2.9	4.3	7.0	13.0	23.3	36.8	53.1
4	Total Assets (PKR billions)	7.8	10.6	14.8	23.3	34.6	52.4	72.1

With the assets available in the sector equivalent to roughly Rs. 30 Billion in 2007 (23 billion already on the balance sheets of MFIs/MFBs and another addition Rs. 7 Billion of available funds with PPAF), there would be an incremental additional requirement of Rs. 40 Billion by 2010. The expansion is projected to proceed as per Figure 1 below which breaks funding sources into 4 broad categories. It is important to note that these are consolidated figures for these seven organizations which combines the balance sheets for both MFBs and MFIs. The use of different sources of capital will vary, however. For instance, only MFBs can mobilize savings. Despite these variances among the seven organizations, the consolidated picture which emerges provides a clear indication of the future needs for funding.

Figure 1: Projected Capital Structure of Microfinance Consolidated MFI/MFB Assets (PKR Billions)



Consolidated for MFBs & MFIs								
(PKR Billions)		2004	2005	2006	2007	2008	2009	2010
1	Savings	0.5	0.7	1.4	3.3	5.6	9.4	14.9
4	PPAF Debt	0.6	1.4	2.5	3.2	5.0	7.5	10.0
2	Debt	3.1	4.9	5.7	10.0	16.6	24.5	34.1
3	Equity	3.4	4.0	5.0	5.2	6.9	7.8	9.9

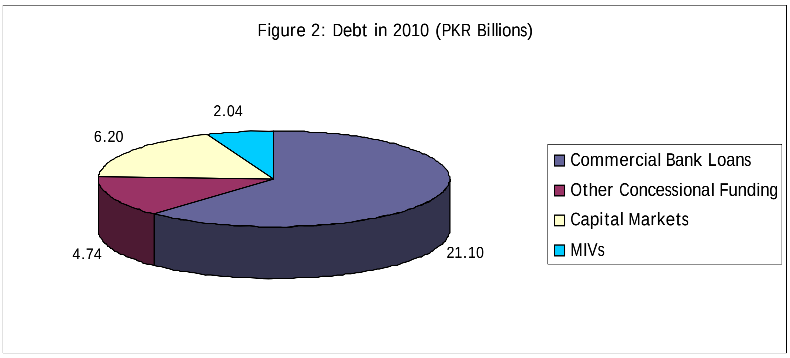
The projected scenario from Figure 1 raises several key issues in the expected expansion scenario, including the following 3 factors driving capital structures:

Savings are a priority for most MFBs, but total volumes are likely to lag. Most prioritize savings as a more stable low cost source of funds, but savings deposits will take some time to accumulate even with a major investment in market research and product development. The MFBs are still relatively new to their markets (on the whole), clients are becoming more aware gradually and the internal systems for savings product delivery are being refined. Therefore, the near term pressure will be on alternative forms of funding.

Debt will be the major initial source of growth funding. By 2007 the overall industry remains under-leveraged against its equity base with just under one quarter of assets financed by equity. There is room to grow by leveraging liabilities in the near term. The deployment of additional available funds of PPAF would be an important contribution to the growth projections, but even this would not be sufficient. Additional debt would need to be raised from a combination of sources:

- Commercial Bank Loans
- Debt from Capital Markets
- Funds from specialized microfinance investment vehicles (MIVs)

The projections suggest the following breakdown of new debt sources by 2010, though this scenario is subject to a certain contextual factors – particularly with respect to pledging of assets by microfinance banks and the restrictions on borrowing in foreign currency.[2] These various sources of additional debt financing are easy substitutes for one



[2] See forthcoming PMN/SBI note on legal and regulatory issues affecting debt raising due for completion in October 2007.

another and therefore the important figure is the total projected debt funding requirement of Rs. 34 billion.

The need for more equity capital will become more pressing by 2009-10 later in the projections. The likely expansion scenario shows an early reliance on debt but that later in the projections the leverage will begin to push against the equity available and the priority will shift to equity capital and particularly meeting capital requirements in the later years of these projections. The capital adequacy requirement for MFBs is 15% and projections show that this will be a constraining as early as 2009. There would be the need for more equity capital by this point in time which could be partly met by retained earnings (if MFI/MFBs substantially improve their financial performance over this time period) and would be further contributed by share capital or possibly mezzanine financing (if the rules change to allow subordinated debt to contribute towards capital adequacy in the future).

Sources of New Funding

Capital	Sources	Key Issues
Savings	Public Deposits	• Market research, product design and market education lag the credit markets, but should be prioritized • Will be a lower cost and more stable source of long term funds.
Concessional Credit Facilities	PPAF from World Bank/IFAD multilateral loans	• Underutilize existing capital – need to expand and better leverage existing capital. Available funds with PPAF are Rs.6.9 billion • Can provide funding at lower cost than other debt sources • May leverage PPAF capital with additional commercial debt and capital markets – possible use of PPAF guarantees
Commercial Debt	Commercial Banks	• Key source of funding in near term • Some regulatory restrictions for commercial bank lending and microfinance bank borrowing • MFBs and MFIs need to strengthen their financial performance
Capital Markets	Institutional investors and general public	• Term Finance Certificates (bonds) are attractive to banks and institutional investors if they are rated • Likely will require credit enhancement in the early stages but could decrease in time • Too early for securitization
Microfinance Investment Vehicles (MIVs)	Social and institutional investors (e.g. MicroVest, Unitus, ShoreCap)	• Interest in Pakistan increasing • Large availability of funds globally, but require stronger financial performance by MFBs/MFIs • Forex regulations require investors to bear forex risk
Equity	Investors, Retained Earnings, Private Individuals	• Near term sufficient capital, but leverage to put pressure over medium to long term • Need more diverse private domestic and international investors over time

The priority for the MIFF in the near term will be to mobilize significant debt resources with a particular focus on capital markets (term finance certificates), commercial banks and MIVs. This will be aided by greater coordination in the use of guarantees which leverage concessional funds to raise commercial sources of funding.

Over time, if the debt raising is successful and growth targets are achieved, leverage will increase substantially across the sector and for some MFI/MFBs push up against capital adequacy requirements. Due to this pressure the PMN anticipates the need to raise equity financing will be more pressing by 2009 and 2010. Equity injections could come in the form of common shares, but it could also be complemented by alternative preferred shares or mezzanine capital. Some of these options will be affected by the regulatory environment for microfinance banks (i.e. currently Tier II capital does not count towards capital adequacy).

Design of MIFF

Given the projected scenarios for growth, there is a need for an entity that is agile and can move flexibly to meet the fast changing demands in the microfinance sector. As the projections show, the funding needs are likely to shift even over a short 3 year time frame. In the immediate future there will be a significant need for commercial debt to leverage up the equity base; particularly as savings deposits are expected to lag. In 2-3 years organizations may reach leverage limits which will place more pressure on raising equity and savings may become more plentiful. The MIFF may be able to contribute more if it can retain the flexibility to adapt quickly to dynamic changes. In this context, and bearing in mind the need to build a healthy holistic market for funding in microfinance, the design is sketched out below.

MIFF Services

In order to achieve the holistic industry objectives the MIFF, under the umbrella of the PMN, will provide three primary services:

1. **Investment Promotion and Referral Resource**. Access to timely and credible information is a key to expanding investment in microfinance. The PMN is already the focal point for the MIX on collecting transparent financial reporting. The core purpose of the information sharing function will be to target investor groups such as commercial banks, investment banks and international investors to provide key information on specific institutions as well as the environment for investing. Specific contributions under this service include:

    - Regular updates on transactions in microfinance and information on the funding flows into low income financial services.

- Updated briefs on the regulatory environment for investors including changes in debt or foreign exchange regulations.
- The MIFF will actively cultivate investors through access to information and periodic “roadshows” targeting domestic and international investors.
- Central introduction and referral source for investors and MFI/MFBs.
- Organizing and streamlining due diligence information gathering and visits for investors.
- Expert guidance on legal and regulatory environment and references to legal advisors for investors and investees.
- Providing models for appropriate transactions including debt offerings, term finance certificates and other structures suited to the Pakistani environment. This could include templates for standardized financing agreements. (See attached term sheets with possible term finance certificate structures provided by JSBank – a top Pakistani investment bank).

2. **Technical Assistance on Capital Raising and Capital Structuring.** In Pakistan, some MFI/MFBs have a limited track record structuring their capital and attracting investors. Some have grown out of NGO backgrounds and are learning to fully utilize commercial finance instruments. The PMN anticipates that some, though probably not all, MFIs/MFBs will need strengthening and capacity building to attract commercial funding on more favorable terms. Preparing an MFI/MFB for raising commercial funding will require significant periods of technical assistance and discussions with management and the board in budgeting and planning. It will be important to separate this technical assistance from the neutral facilitator functions of the MIFF. The PMN proposes that the technical assistance be supported under the MIFF umbrella, but that specialized technical assistance firm(s) be engaged to provide this support.

3. **Credit Enhancement Facility**. The analysis of funding requirements shows that the amount of funding required will be large and that the environment will be dynamic and fluid over the next three years at least. The MIFF should take on the management responsibilities of a credit enhancement facility which would be funded by grants. This facility would initially focus on credit enhancement to support the large debt funding expansion requirements for microfinance. Three examples of the use of credit enhancement are:
   - First loss default guarantee for term finance certificates (enhancement could generate a stronger facility rating which makes TFCs acceptable to potential buyers and should reduce pricing)
   - First loss default guarantee for the partnership model. As practiced in India, the partnership model allows MFIs to be a service company for the deployment of commercial bank microcredit loans and requires that the MFI place a FLDG with the commercial bank.
   - Credit guarantee of standard bank debt. Loans from commercial banks could be guaranteed on a pro rata basis for 50% or lower.

Over time, the markets for microfinance should be developed as the overall microfinance sector leverages up. This in part may be due to the use of the guarantees but is also likely to happen as a natural process. As leverage across the sector increases there will be greater pressure on capital adequacy. The MIFF should retain sufficient flexibility to begin to redeploy its resources from guarantees towards other options. This would ideally focus on subordinated debt to contribute to the capital base of MFBs (if regulatory rules evolve to allow allow subordinated debt to contribute to capital adequacy). Other (perhaps more complex) alternatives could be investing in common share capital or even to use the funds to invest in MFIs as grant equity if certain criteria were developed and met.

The initial feasibility of using credit guarantees in the market in Pakistan has been floated with several banks including the Investment Bank JS Bank. Based on these discussions JS Bank provided an indicative term sheet for raising Term Finance Certificates with the assistance of credit guarantees and these terms sheets indicate there would be buyers (e.g. mutual funds) in the market for term finance certificates with moderate levels of credit guarantees (perhaps 35% or less, depending on the strength of the issuing MFB/MFB). A copy of an indicative term sheet is attached at the back of this note.

MIFF Performance Targets

Given the industry wide objectives of the MIFF, it will be important to establish appropriate performance objectives. Credit enhancement facilities are often judged on the level of use of their funds and on the leverage of the guarantees deployed (amount of guarantee to the amount of credit extended). The MIFF could be assessed on these measures, but is perhaps better assessed against the overall targets for the industry. Therefore, the MIFF should look to industry wide funding and outreach objectives for each year with progressive targets. A sample of such targets is given below.

For the industry as a whole (consolidated):	2008	2009	2010	Etc.
Savings % of assets				
Unsecured credit % of assets				
Secured credit % of assets				
Equity as % of Assets				
Active Borrowers				
Active Savers				
Savings Accounts Active				
Deposits to Advances Ratio				
Etcetera				

MIFF Management and Staffing

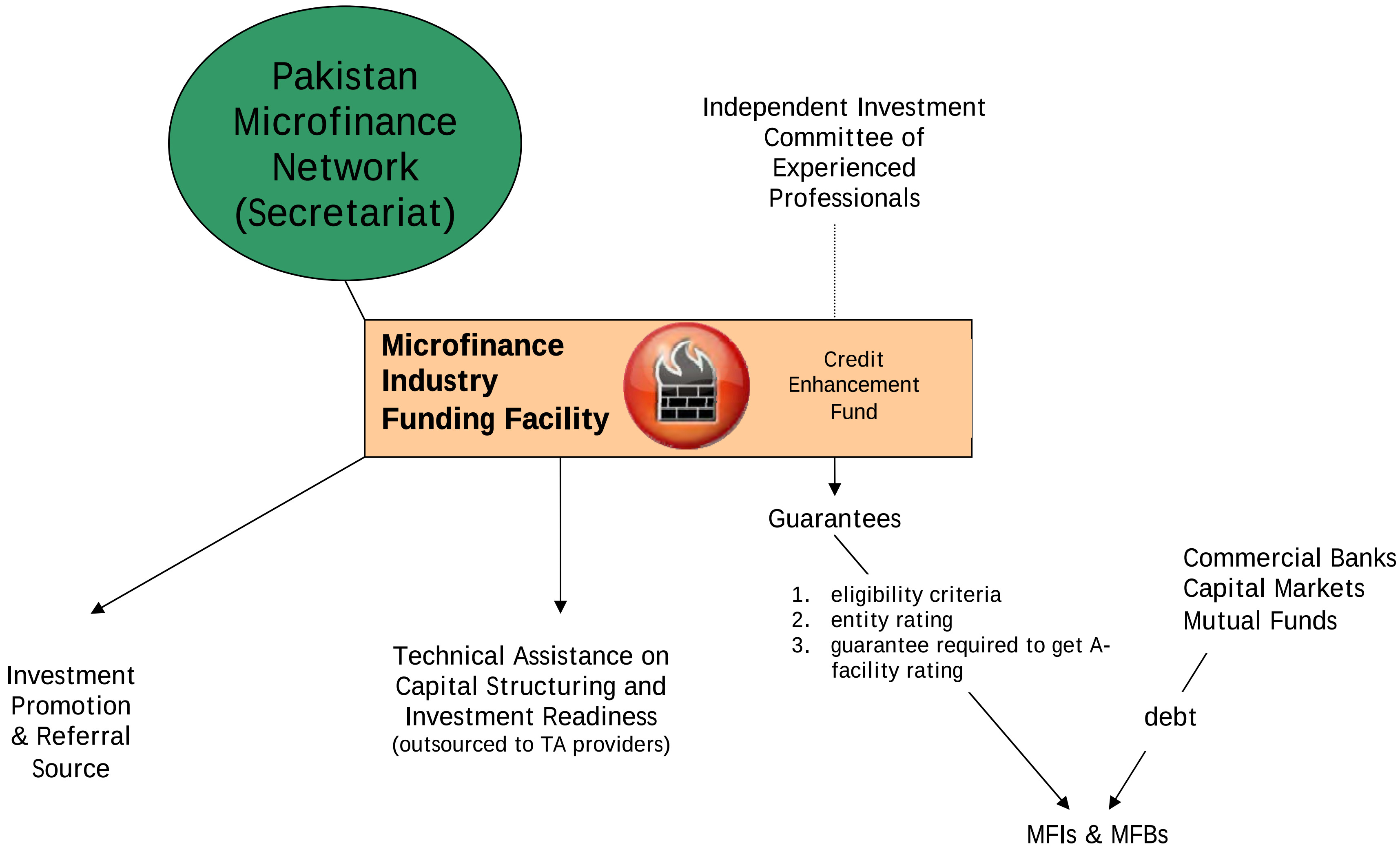
To effectively add capacity and bring value adding expertise will require that a highly skilled and motivated set of professionals be used to support the MIFF. One option is for the PMN to recruit a small team of 2-3 experts sourced from the banking or capital markets of Pakistan. This team would bring the necessary financial sector expertise to complement the existing microfinance knowledge of the PMN. An alternative strategy would be to recruit a smaller team, but to team with an investment bank or another organization to acquire requisite investment banking and finance skills from an established player in the Pakistani market. The successful identification and recruitment of this team is considered the single most important factor for success of the MIFF.

MIFF Organizational Structure

To ensure clarity and purpose to the MIFF, this facility will be designed to be operated separately from the PMN Secretariat. The facility will be managed on a day-to-day basis by a dedicated team; leaving the current PMN staff to focus on their core network management functions. The credit enhancement facility would have an independent Investment Committee which will need to approve investment guidelines, be consulted at different stages of the investment process and make final approval of all allocations of MIFF funding through a set of established investment procedures. The investment committee would be selected based on their technical expertise, independence and objectivity. Their decisions and deliberations will be made confidentially and without reference to the PMN in order to steer clear of any conflicts of interest.

MIFF Sustainability and Sunset Clause

The goal of the MIFF facility is to be a cost-efficient provider of the services noted above to build a more diverse and sustainable wholesale market for capital. It is not necessary for this facility to become self-sustaining from revenues and fees. Indeed, the purpose of the MIFF is to accelerate market development for wholesale finance and to exit. It may be helpful in the MIFF design to establish a sunset clause of 5 years from inception prior to which the MIFF would be evaluated by its primary sponsors and supporters. The assumption should be that the MIFF would close after 5 years of service, unless there are certain functions which justify continuation based on a sound assessment of the projected value of these functions. In particular, the funds in the credit enhancement facility should phase out since one of its fundamental objectives is to bring new capital into the market (the remaining capital may be allocated to an appropriate government agency such as the State Bank). The sunset clause would also remove expectations by MFI/MFBs that the enhancement is permanent and therefore the incentive to mobilize sources of capital, especially savings, would remain during and after the life of the credit enhancement facility. Credit enhancement would be correctly perceived as a temporary measure to overcome early perception and information problems which should go away if the MIFF achieves its goals of bringing other investors and funding into microfinance.


Pakistan Microfinance Network (Secretariat)
Independent Investment Committee of Experienced Professionals
Microfinance Industry Funding Facility
Credit Enhancement Fund
Guarantees
1. eligibility criteria
2. entity rating
3. guarantee required to get A- facility rating
Commercial Banks
Capital Markets
Mutual Funds
debt
MFIs & MFBs
Investment Promotion & Referral Source
Technical Assistance on Capital Structuring and Investment Readiness
(outsourced to TA providers)

Indicative Terms & Conditions for Proposed Rated, Guaranteed and Privately Placed Term Finance Certificate Issue of PKR xxxx million by Microfinance Institution

Issuer	Microfinance Institution ("**MFI**" or the "**Institution**" or the "**Issuer**");
Instrument	Rated Guaranteed and Privately Placed Term Finance Certificate ("**PPTFC**" or Issue");
Purpose	The amount to be raised through the PPTFC issue will be utilized for business expansion as permitted under its Memorandum & Articles of Association
Advisors & Arrangers	JS Bank Limited ("JSBL")
Issue Amount	Up to PKR xxxx million;
Currency	Pak Rupees ("PKR");
Investors	A number of financial and non financial institutions but not limited to Advisors and Arrangers
Tenor	Up to five (5) Years Tenor will be decided with mutual consultation with MFI based upon the preferences of MFI
Grace Period	Up to three (3) Years
Credit Enhancement by way of Guarantee	Security Structure will be finalized after due diligence; however the Issue is likely to be secured through the following for a **Microfinance Bank**: • First Loss Funded Guarantee upto 35% of the Issue amount • Guarantee on Pro Rata Basis Security for a **Microfinance Institution** could be First ranking pari passu charge by way of hypothecation over all present and future assets of MFI and credit enhancement, with 25% margin.
Guarantor	Pakistan Microfinance Network by way of cash grants to be kept in an escrow account of a reputed financial institution
Principal Repayment	It will be decided with mutual consultation with MFI based upon the preferences of MFI, however the grace period could go up to three (3) years with principal repayment in four equal semi annual payments in the last two (2) years of the issue.
Coupon Type & Frequency	Profit will be payable semi-annually in arrears on the outstanding principal amount and will be calculated on a 365-day year basis. The first such profit payment will fall due 6 months from the Issue date;
Indicative Pricing	Floating rate; Base Rate + Margin **Instrument Rating** — **Margin** AA-/A+ — 1.50% - 1.75% A/A- — 1.75% - 2.25 %
Base Rate	The Base Rate is defined as the six month Karachi Inter-Bank Offered Rate

	("KIBOR") prevailing on the Base Rate setting date. The Base Rate will be set for the first coupon on the last working day prior to the date of Issue Date and subsequently on the immediately preceding day before the start of each semiannual period. The KIBOR rates used for reference will be taken from Reuters page "KIBOR" as published at 11:30 a.m. PST by the Financial Markets Association (FMA). For the purpose of this PPTFC Issue the daily average of the "6 MONTHS ASK" rate will be used. In the event that this rate is not published on Reuters on the rate fixing date, the same would be replaced with a relevant rate of a similar nature or an alternate basis would be agreed upon for determining the Base Rate;
Minimum Expected Entity Rating	A- (Single A minus) by PACRA/JCR-VIS;
Instrument Rating	xxxx by PACRA/JCR-VIS
Financial Closure	Six to Eight weeks from the award of mandate;
Expected Issue Date	To be decided will mutual consultation with the MFI;
Transferability	The Issue will be eligible for induction into the Central Depository system ("**CDS**") of the Central Depository Company of Pakistan Limited ("**CDC**")
Trustee to the Issue	To be appointed in consultation with MFI;
Legal Counsel to the Issue	To be appointed in consultation with MFI;
Issue Documents	Trust Deed, Investor Agreement, Security documents and any other agreements as may deemed appropriate by Legal Counsel of the Issue;

Mandatory Expenses & Outside Services	
Advisory Fee	0.75% of the total issue size; 25% payable on acceptance of Proposal Documents, 50% payable on signing of security and investor documents, balance 25% payable upon disbursement
Arrangement Fee	0.10% of the total issue size payable on signing of the Issue Documents;
CDC Fee	PKR 67,500 p.a. is payable during the tenor of the PPTFC issue.;
Transfer Agent Fee	Estimated at PKR 75,000/- however to be billed at actuals;
Legal Fee	Estimated at PKR 400,000/- however to be billed at actuals;
Printing, Publication & Advertising	Capped at PKR 400,000/- and will be billed at actuals;
Out of Pocket Expenses	Out of pocket expenses (including, inter alia, travel, accommodation, telephone, fax, courier, and tombstones) incurred in connection with the preparation, execution and performance of the PPTFC issue shall be borne by the MFI, regardless of whether or not this transaction is successfully completed. Out of Pocket Expenses are to be capped at PKR 400,000/- and will be billed at actuals.