A Primer on Debt Financing for Microfinance in Pakistan

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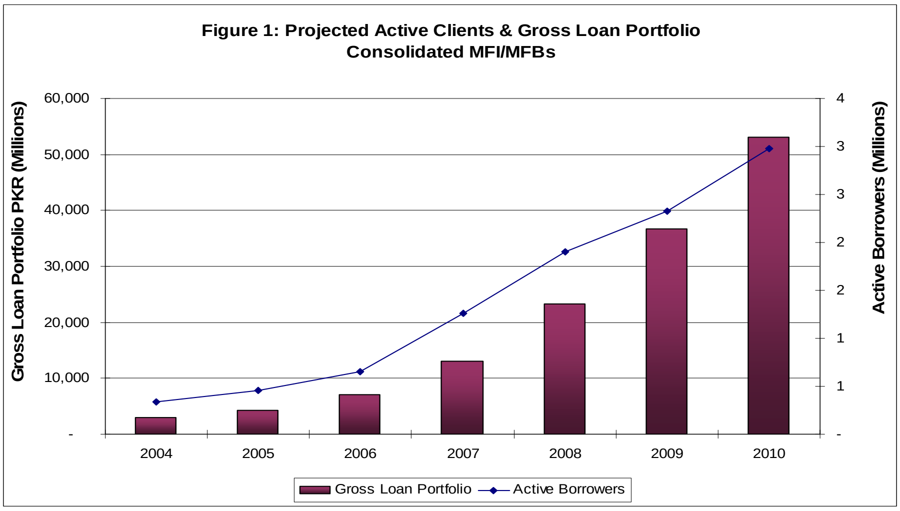
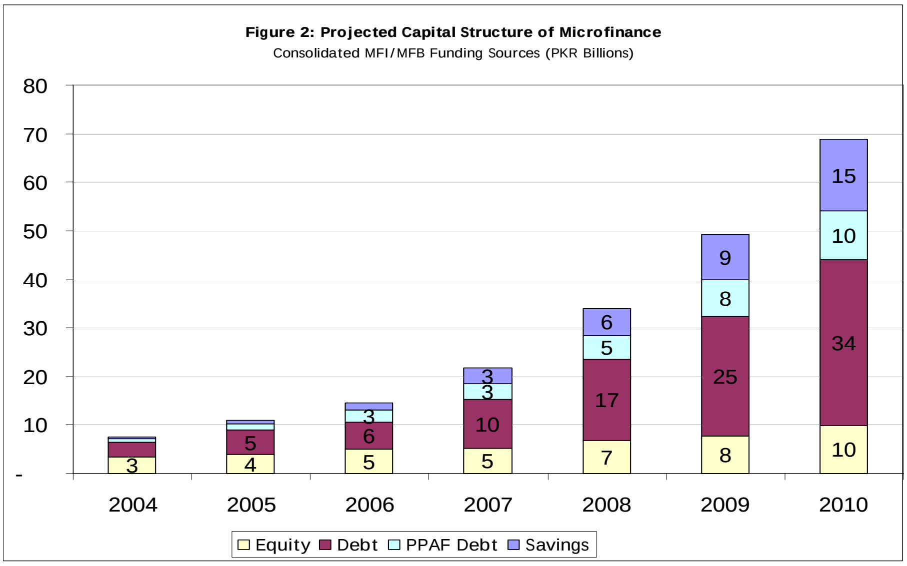
Debt financing will be a critical element of the expansion of microfinance (and particularly microcredit) in the next few years. This Note outlines the basic rules and regulations which affect the overall environment for raising debt financing for microfinance in Pakistan. The goal is to provide an introduction to the issues in order to stimulate further discussion and investigation. It is critical to highlight, however, the limitations of this note – this is not an exhaustive in-depth review of the legal and regulatory issues and lenders and borrowers are encouraged to seek legal opinions as they seek to execute transactions.

Projections show that the demand for debt capital in microfinance is likely to expand rapidly from 2007 to 2010 as many existing organizations leverage up to meet growth targets. Consolidated projections of seven organizations likely to grow the most quickly over this time span show the following credit expansion (Figure 1) and the corresponding financing requirements (Figure 2). These carefully calibrated projections are based on realistic expansion of the number of borrowers and their corresponding loan balances to derive the required funding levels. These projections are on the conservative end given the known internal management capabilities and risks inherent in expansion. Even under this conservative scenario the projections show a need for debt financing of 44 billion rupees by 2010.



DISCLAIMER: Readers should be aware that this note provides a policy-level overview of emerging legal and regulatory issues. Readers are cautioned that the content should not be interpreted as a legal opinion and is not a substitute for in-depth due diligence or legal advice.



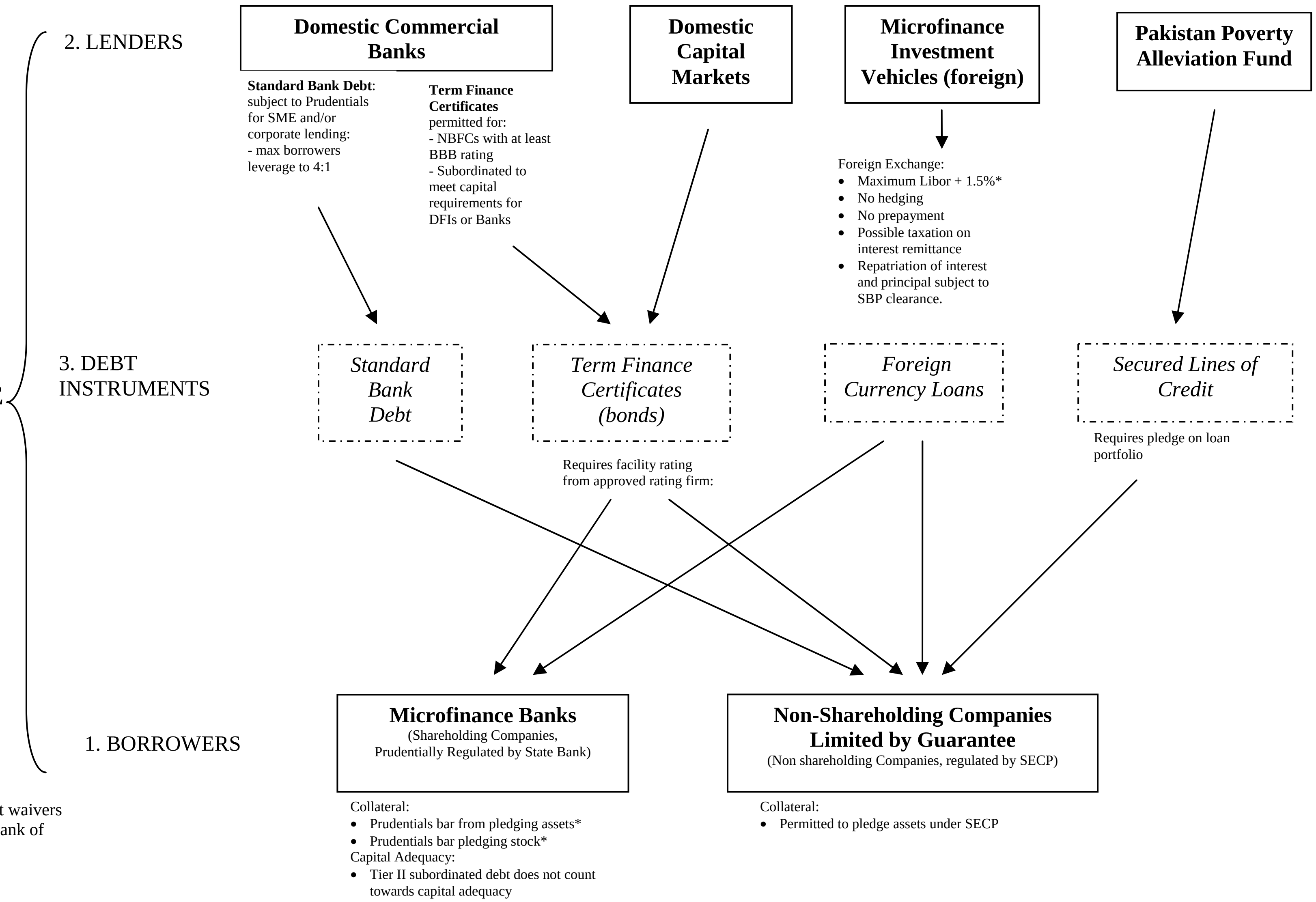
In order to help policy makers, practitioners and investors begin to chart the road ahead for raising the necessary financing, this note provides an initial exploration of the legal and regulatory issues which will assist microfinance providers and potential lenders to microfinance to facilitate future transactions for raising debt. The discussion is separated into three categories to highlight the key legal and regulatory issues in each:

1. **Borrowers:**
   Microfinance Banks (MFBs) and Non-Shareholding Companies (NSCs)

2. **Lenders:**
   Commercial Banks, Capital Markets, International Specialized Funds and the Pakistan Poverty Alleviation Fund.

3. **Debt Instruments:**
   Standard Bank Debt, Term Finance Certificates, Foreign Currency Loans and PPAF's Secured One Year Lines of Credit.

FIGURE 3: WHOLESALE MARKETS FOR DEBT FUNDING



* Potential to get waivers from the State Bank of Pakistan

1. BORROWERS

The provision of microfinance comes from providers which operate under one of two legal forms.

- Microfinance Banks (MFBs) – First MicroFinanceBank, Khushhali Bank, Pak-Oman Microfinance Bank, Tameer Microfinance Bank
- Non-Shareholding Companies (NSCs) Limited by Guarantee – Asasah, Kashf Foundation, National Rural Support Programme

There are other legal forms which include commercial banks, leasing companies and other non-profit organizations which are classified as Welfare Societies. However, it is the MFB and NSC categories which are and will hold the overwhelming market share and therefore this note focuses on these two categories for analysis.

1.1 Borrowers: Microfinance Banks (MFBs)

Legal space was originally created for MFBs under Presidentially sponsored legislation the Microfinance Institution Ordinance 2001. The underlying legal structure of an MFB is as shareholding companies under the Companies Ordinance 1984. However, as financial institutions they are regulated under special Prudential Regulations for MFBs issued by and periodically updated by the State Bank of Pakistan (Central Bank and primarily financial sector regulatory authority).

Table 1. Legal Status Microfinance Banks

Licensing Authority	State Bank of Pakistan (SBP)	www.sbp.org.pk
Registering Authority	Securities & Exchange Commission Pakistan (SECP)	www.secp.gov.pk
Regulating Authority	State Bank of Pakistan	www.sbp.org.pk
Major guidelines followed	Microfinance Institutions Ordinance 2001 Prudential Regulations for Microfinance Banks	http://www.sbp.org.pk/l_frame/MF_Inst_Ord_2001.pdf http://www.sbp.org.pk/publications/prudential/micro_prs.pdf

There is a significant legal and regulatory distinction between MFBs and Commercial Banks. Mainstream Commercial Banks are legally formed under the Banking Companies Ordinance 1962 and are prudentially regulated by the SBP under specific regulations for Commercial Banks. MFBs are therefore seen differently under the law and are regulated differently in comparison to Commercial Banks.

While these distinctions exist, MFBs must still meet nearly all of the same quality and control standards that are required of deposit taking banks and are subject to many of the similar prudential regulatory norms as banks. For instance, MFBs:

- Can accept deposits from the general public
- Must comply with stringent weekly, monthly and quarterly reporting requirements
- Are subject to off-site and on-site examinations by the SBP
- Must meet minimum capital, liquidity and reserve requirements

- Must develop sound systems and meet the “fit and proper” requirements for managers
- And various other standards typically applied to deposit taking institutions

Within these legal structures and regulations there are 4 key areas which affect MFBs generalized capabilities to raise debt. These are outlined in Table 1 below.

Table 2. MFB Rules and Regulations Affecting Debt Financing

Source	***Reference***	***Comment***
Microfinance Institutions Ordinance 2001	Clause 3, Section 2: “Microfinance Institution shall not be deemed to be a banking company for the purposes of the said Ordinance”.	MFBs are considered a separate class of bank from mainstream Commercial Banks. Notably MFBs do not appear eligible to borrow on the interbank market nor are they members of the clearing house system.
	Clause 7, Section 4: “No microfinance institution shall create a floating charge on the undertaking or any of its assets or part thereof, unless the creation of such floating charge is certified in writing by the State Bank as not being detrimental to the interest of the depositors of such institution”.	MFBs will find it difficult to raise secured financing and may be left only with unsecured debt financing options. It is important to note that Commercial Banks cannot lend significant funds without security.
	Clause 10, Section 2: “…paid up capital of a microfinance institution….. shall neither be transferable nor encumbrance of any kind shall be created thereon without prior permission, in writing, of the State Bank”.	MFBs will also find it difficult to offer their shares as security for debt; may be left only with unsecured debt financing options.
Prudential Regulations for MFBs	The calculation of “capital” for the purposes of meeting the minimum 15% capital adequacy against risk weighted assets does not include mezzanine Tier II capital.	Mezzanine or subordinated debt would not help alleviate capital adequacy pressures.

1.2 Borrowers: Non-Shareholding Companies

Non-profits working in microfinance are most commonly registered as Non-Shareholding Companies Limited by Guarantee registered under section 42 of the Companies Ordinance 1984. NSCs are companies under the law but cannot pay dividends and must apply their profits for public or mutual benefit. NSCs are also not permitted to raise deposits from the public. NSCs are lightly regulated by the Securities and Exchange Commission with certain minimum reporting requirements, annual general body meetings and quarterly board meetings.

Table 3. Legal Status of Non Shareholding Companies

Licensing Authority	Securities & Exchange Commission Pakistan (SECP)	www.secp.gov.pk
Registering Authority	Securities & Exchange Commission Pakistan (SECP)	www.secp.gov.pk
Regulating Authority	Securities & Exchange Commission Pakistan (SECP)	www.secp.gov.pk

Major guidelines followed	Companies Ordinance 1984 Associations Not-For-Profit Guide	 http://www.secp.gov.pk/Guides/AssociationsNotForProfitGuide.pdf

Table 4. NSC Rules and Regulations Affecting Deb Financing

Source	***Reference***	***Comment***
Associations Not For Profit Guide - SECP	Conditions 3, 4 and 5 of clause IV of the sample Memorandum of Association given in the Association not for Profit Guide allow pledging assets through Registrar of Companies. Mortgages and charges are created on security offered under the sections 121 through sections 136 of the Companies Ordinance 1984 and based on the directions given in SECP	Allowed to pledge assets to raise secured debt financing. Options include Term Finance Certificates, Bank Debt and PPAF lines of credit.
	Section 4.2: "The Company shall not appeal, solicit, receive or accept funds, grants, contributions, donations or gifts, in cash or in kind, from foreign sources except with the prior permission, clearance or approval from the relevant public authorities as may be required under any relevant statutory regulations and laws".	Rules on NSC raising foreign currency debt are ambiguous. Apparently need waiver on foreign currency loans, however not clear of requirements for foreign lenders making local currency loans.

2.0 LENDERS

The potential sources of debt financing for microfinance are grouped into 4 categories: Commercial Banks, Capital Markets, Microfinance Investment Vehicles (Foreign) and the Pakistan Poverty Alleviation Fund. The overall rules and regulations for each of these four sources are highlighted in each of four sections.

2.1 Commercial Banks

Commercial banks can lend to MFBs and NSCs using a variety of instruments, but subject to several different prudential regulations which apply to Commercial Banks.

Table 5. Commercial Bank Rules and Regulations Affecting Lending

Source	***Reference***	***Comment***
SME Prudential Regulations	Can only lend unsecured up to Rs. 2 million funded exposure.	These unsecured loan sizes are too small to be relevant to the large debt needs in microfinance.
	Can lend on secured basis up to Rs. 75 million.	Potentially allows small scale lending to NSCs on secured basis if the NSCs is treated as an SME. Probably not relevant for larger NSCs.
Commercial and Corporate	Unsecured exposure is limited to facilities under Rs. 500,000	Amout not relevant to MFBs/ NSCs

	Borrowers must generally keep a current ratio of at least 1:1	Not a major issue since most MFBs/NSCs have substantial current assets in their loan portfolios
	Can place interbank funds with Non Bank Finance Companies (NBFCs) that have achieved a minimum 'A-' long term rating and a minimum 'A2' for short term rating.	MFBs and NSCs are not categorized as NBFCs thus they can not raise funds from the inter-bank market.
	Can only lend up to four times the equity of the borrower on a funded basis (though unfunded exposure can rise to 10 times equity). Subordinated debt can contribute to the equity amount.	Caps the leverage level for NSC's at 4 times which is low considering NSCs have small equity bases (no access to share capital) and can have the potential to leverage to higher multiples. Subordinated debt does provide opportunity for greater leveraging for NSCs.
	Commercial Banks do appear to have leeway to invest in TFCs which are not listed, unsecured, but they would generally need a strong facility rating.	The rules and regulations for TFC funding by Commercial Banks is ambiguous, though there would appear to be significant scope for this kind of debt financing for both MFBs and NSCs.

2.2 Capital Markets

The capital markets in Pakistan are expanding with the recent entrance of more fixed income and mutual fund options. The lead regulatory authority for capital markets transactions is the Securities and Exchange Commission of Pakistan. The complexity of capital markets regulations affecting debt transactions are beyond the scope of this note to cover in detail. The specific regulations or issues affecting certain capital markets instruments (e.g. Term Finance Certificates) are noted in section 3.0 below.

2.3 Microfinance Investment Vehicles (Foreign)

In the past 3 years there has been a rapid proliferation of MIVs globally and several are actively looking at lending in Pakistan. These organizations are based in a multitude of international jurisdictions with specific funding guidelines and regulatory requirements that are beyond the scope of this note. As these organizations are designed for lending internationally, they typically are structured to permit lending to countries like Pakistan. MIVs most often provide foreign currency funding, but a few are beginning to offer loans in local currency.

2.4 Pakistan Poverty Alleviation Fund (PPAF)

PPAF is an apex funding organization founded in 1997 which is legally registered as NSC under the Companies Ordinance 1984. A large majority of PPAF's funding has come from World Bank loans to the Government of Pakistan which are on lent to PPAF. PPAF on its balance sheet an estimated Rs. 14 billion designated for wholesale lending for microcredit organizations.

PPAF offers a standard secured line of credit with some of these facilities reaching Rs. 1 billion in size. These loans come with certain restrictions which includes a cap on the onlending loan size of Rs. 30,000. PPAF has a per party exposure rule which restricted funds to any one borrowing organization of not more than 25% of its total funds available (Rs. 14 billion) which effectively caps exposure at Rs. 3.5 billion. All PPAF loan facilities are required to be fully secured with a pledge on the borrowers loan portfolio receivables. This rule effectively bars PPAF from making loans to MFBs (which are unable to pledge their assets).

3.0 DEBT INSTRUMENTS

There are four primary instruments currently available to facilitate transactions between lenders and borrowers in the wholesale market.[i]

3.1 Standard Bank Debt

A full range of debt offerings are feasible including lines of credit, term loans and syndications. Until recently most of the bank debt flowing into microfinance was cash secured lines of credit with NSC's putting up investments to secure the debt. In the future more debt would need to be raised against the loan portfolio assets of NSCs. MFBs face tighter restrictions to this market since the Commercial Banks offering standard bank debt are not permitted to lend unsecured.

3.2 Term Finance Certificates (i.e. Bonds):

TFCs are bond like instruments which can be issued as either fixed or variable rate instruments. TFCs are regulated by the SECP and must follow certain standard bond like procedures such as requiring and agent and the release of an Information Memorandum issued. There are four primary kinds of TFCs with some of the following characteristics and issues. Microfinance TFCs in the current environment would probably be focused on the Unlisted market, with MFBs only having the option of unsecured and NSCs issuing secured.

Table 6. Four Primary Categories for TFCs

	Listed (Public)	**Unlisted (Privately Placed)**
Secured	NSC potential in future with strong entity ratings. Buyers would be general public.	This option is potentially open to NSCs if they can get strong rating and assisted with credit enhancement. Buyers would be insurance companies, pension funds, mutual funds or commercial banks.
Unsecured	MFBs potential in the future with strong entity ratings. Buyers would be general public.	This option is potentially open today to MFBs if they can get strong rating and assisted with credit enhancement. Buyers would be insurance companies or mutual funds.

[i] In addition to the four instruments noted here, Commercial Paper is an additional option for raising unsecured financing. Generally, Commercial Paper can be raised for short tenors of 3 months and if managed well can constitute a substantial long term source of capital. More investigation is required to determine whether this option might work for either MFBs or NSCs.

3.3 Foreign Currency Loans

Foreign currency borrowing by both MFBs and NSCs is subject to a series of foreign exchange rules detailed in the SBP Foreign Exchange Manual. It is not clear what rules, if any, are required for borrowing from foreign entities in local currency.

Table 7. Certain Foreign Exchange Rules and Regulations

SBP Foreign Exchange Manual *(compiled* under the powers given to SBP under the *Foreign Exchange Regulations Act 1947)*	Chapter XIX, Clause 17, Section B: • Maximum interest LIBOR + 1.5%, • Exchange rate fluctuation will be borne by the borrower • No prepayment is allowed • Remittance of interest is subject to deduction of taxes where applicable. • Repatriation of interest and principal would be permitted as per the repayment schedule approved by SBP	Forex regulations make it difficult to negotiate foreign currency loans, but it is possible to get waivers from the SBP. Ambifuous on loans from foreign entities made in local currency.

3.4 One Year Secured Lines of Credit - PPAF

The Pakistan Poverty Alleviation Fund offers a standard one-year line of credit facility specifically for microfinance providers. This facility currently requires a pledge of loan portfolio to secure the facility which leaves only NSC's eligible for this financing (and other legal forms not covered in this note).

References and Resources

Relevant Documents	**Can be found at**
Microfinance Ordinance 2001	http://www.sbp.org.pk/l_frame/index2.asp
Microfinance Prudential Regulations	http://www.sbp.org.pk/about/micro/index.htm
Commercial Banks Prudential Regulations	http://www.sbp.org.pk/publications/prudential/index.htm
SME Prudential Regulations	http://www.sbp.org.pk/publications/prudential/index.htm
Commercial/ Corporate Prudential Regulations	http://www.sbp.org.pk/publications/prudential/index.htm
Banking Companies Ordinance 1962	http://www.sbp.org.pk/l_frame/index2.asp
Foreign Exchange Act 1947	http://www.sbp.org.pk/fe_manual/appendix%20files/appendix%201/appendix1.htm
Foreign Exchange Manual	http://www.sbp.org.pk/l_frame/index2.asp
Companies Ordinance 1984: Volume I and II	
Guidelines for Commercial Banks to Undertake Microfinance Business	http://www.sbp.org.pk/about/micro/index.htm

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Basir Shamsie	Treasury, Investment Banking & FIG	J.S. Bank Limited
Sabeen Saleem	Group Head	JCR-VIS Credit Rating Co.
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