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Structured finance for small business loans in India: building on the microfinance securitisation experience

by Bama Balakrishnan and Vaibhav Anand, IFMR Capital

Reliable access to financial services at optimum cost to households as well as enterprises is important for economic and social well-being. However, developing countries typically face large classes of financially excluded enterprises and households, owing to various reasons. Around the world microfinance institutions (MFIs) have successfully tried to bring a gamut of financial services to the door-steps of low-income households. However, small entrepreneurs and enterprises, not catered by MFIs, strive to get access to efficient capital to meet their funding requirements. There are however, financial institutions in the small business loan (SBL) segment which cater to such micro, small and medium enterprises (MSMEs) and entrepreneurs. In this chapter, we introduce the fast emerging SBL segment and discuss how the structured finance approach can be used to bridge the gap between MSMEs and capital markets through the SBL segment originators.

SBL sector

SBL can be defined as a working capital or investment capital loan provided to small and microenterprises, including individual entrepreneurs. The enterprises with initial investment in plant and machinery of not more than INR[1]50m (about US$1m) and INR2.5m (about US$50,000) are classified as small and micro enterprises respectively (RBI, 2013). Banks and traditional lending institutions depend mostly on the credit appraisal of the borrower based on financial statements, credit history and business documentation as well as collateral availability. This approach results in the financial exclusion of many MSMEs. Further, the MSME segment is not catered for by MFIs. Even for larger SMEs[2], access to finance is challenging when their borrowing needs exceed the approval authority of local bank branches and the cost of delivering credit to them with further due diligence is perceived by traditional lenders to be significantly higher.

As per the 2007 MSME census, about 92.8% of the MSMEs are excluded from sourcing finance from the institutional and non-institutional sources while they end up looking for

self-financing (Ministry of MSME, India, 2011).
The International Finance Corporation (IFC) had estimated the total financing demand for MSMEs to be INR32.5 trillion (about US$600bn) of which about 38% of the demand can be addressed by the financial sector in the near-term (IFC, 2012).

Sensing this requirement, a number of non-banking financial companies (NBFCs), existing and new, have evolved business models to deliver credit to the MSMEs. These new SBL products are typically meant for MSMEs who have limited or no access to formal channels of financing due to insufficient credit history and/or inability to provide collateral. In the absence of formal financial statements and external ratings, the SBL originators have to rely mainly on their estimation of real cash flows in the business which may not be documented anywhere. Furthermore, the originators need to have deep understanding of the local business and socio-cultural aspects in order to evaluate each loan proposal.

While various SBL lending models have emerged, a generalised description of the business model is discussed. Most of the lenders have a concentrated geographical presence with lending model based on identified business clusters in a particular geography or a generic set of businesses across locations. The SBL lenders build a granular understanding of differing cost and revenue drivers for the same business in different locations, enabling them to arrive at a localised estimate of surplus for each business. Certain SBL lenders finance only one business or product while others aim to leverage existing supply chain linkages to provide short-term working capital financing. Exhibit 1 lists some of the SBL originators operating in India[3].

An independent credit team is often responsible for the detailed credit evaluation. Information provided by the client on revenue, expenses and borrowings is triangulated through reference checks and available informal documentation. Credit bureau checks are used to evaluate the client's credit history. Where security is created on immovable property through a mortgage, a technical and legal evaluation is done. Technology is used intensively in all processes for operating efficiency and cost reduction.

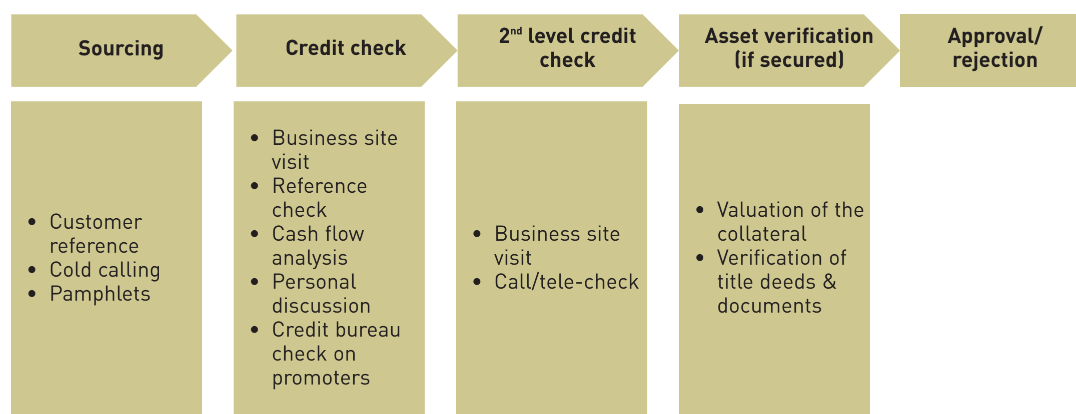
SBL lenders have developed unique lending models based on the in-depth understanding of local industries.
Most originators incorporate the maker-checker process during the loan origination by separating the sourcing and the credit divisions. The SBL lending model utilises both the traditional and innovative measures to ensure quality origination. However due to borrowers' vulnerability to economic cycles and high regional and industrial concentration risk, small SBL lenders face challenges in accessing funds for origination.

Product profile of key SBL originators **Exhibit 1**

Originator	Targeted sector	Ticket size (INRm)	Secured/unsecured
Originator A	MSMEs (dairy, textile, bakery, trading)	0.03 – 20	Both
Originator B	MSMEs in machine tools and small industrial units	3 – 20	Secured
Originator C	Machinery finance for MSMEs	0.30 – 30	Secured
Originator D	Informal sector self-employed	0.10 – 1.5	Secured
Originator E	Informal sector self-employed	<0.1	Unsecured
Originator F	School financing	0.10 – 1	Unsecured
Originator G	MSMEs (agriculture retail and artisan cluster)	0.10 – 3	Both

Source: IFMR Capital

SBL origination model **Exhibit 2**



Source: IFMR Capital

Securitisation for SBL

In a securitisation, the underlying loans are transferred and pooled into a stand-alone bankruptcy remote special purpose vehicle (SPV) which issues securities, backed by the cash flows from the loans, to the investors in return for a consideration which is paid to the originators. The cash flows are typically structured into 'tranches' that differ in default risk. The junior tranche provides credit enhancement to the senior tranche in addition to the credit collateral available. To ensure incentive alignment, IFMR Capital, an India-based NBFC, invests in the junior tranche of all transactions structured and arranged by it. By coming in as a subordinated investor, IFMR Capital has created a mainstream market for microfinance and SBL-backed securitised paper that hereto did not exist in India (Fernandes, 2011).

Microfinance securitisation

Securitisation has provided MFIs the opportunity to diversify their sources of funding by reaching out to previously untapped sources of finance such as mutual funds, private banks, high net worth individuals (HNWIs) and other financial institutions. Though smaller MFIs may find it challenging to participate solely in a securitisation, through multi-originator securitisations (MOSEC™) IFMR Capital has also enabled smaller MFIs to access capital markets (Anand & Fernandes, 2012). The development and implementation of IFMR Capital's structured finance approach to microfinance has been documented in detail in

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a case study by Columbia Business School (Suresh Sundaresan, 2013).

Structured finance can help small businesses and entrepreneurs to get reliable access to credit at reasonable cost by bridging the gap between the MSME borrowers and capital markets through high quality SBL originators.

Key differences between SBL and microfinance loans

Exclusion of MSMEs from the formal financial markets is analogous to that of low-income households that rely on MFIs for financial services. However, there are significant differences between the asset classes that serve these two sectors.

SBL products have higher ticket size (up to INR20m) and longer tenure (up to seven years). Microfinance loans are unsecured, whereas SBLs may be secured with movable or immovable property. Indian MFIs typically follow the Grameen Model where loans are provided to joint liability group (JLG) members only, where all the members in the group are jointly liable for each other's loan.
SBL originators do not follow such model and loans may be provided to individual entrepreneurs and enterprises though guarantees may be required.

Moreover, a microfinance loan is generally repaid during the regular centre meetings which are mandatory for all borrowers to attend. However, in SBL segment the repayments are typically made through post-dated cheques (PDCs), electronic payment instructions or direct debit mandates (DDM) provided by the borrower. In many cases the SBL borrowers are new to these payment channels which results in inadvertent delays in repayments. It has been observed that typically SBL portfolios show high overdue in 0-30 days past due (DPD) bucket, with DPDs tapering in subsequent monthly buckets, and significantly lower write-offs. Other key differences between the two asset classes are discussed later in the risk management section.

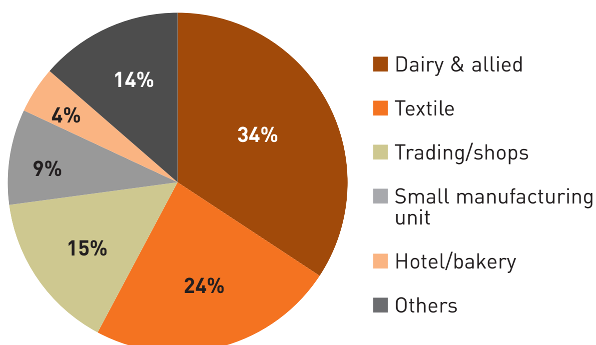
SBL securitisation – case study

Eximius-SBL

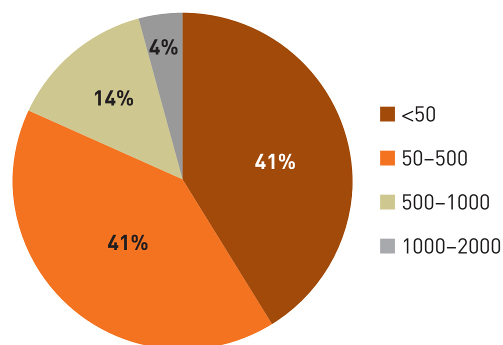
Structured finance transactions in SBL segment in India have traditionally been dominated by large originators having significant vintage and high fund raising capability. The first SBL securitisation with a new and relatively small originator was structured and arranged by IFMR Capital in May 2012. Six months later, IFMR Capital completed

Eximius-SBL pool break-up by industry and loan amount **Exhibit 3**

Pool break-up by industry exposure



Pool break-up by loan amount (in INR '000)



Source: ICRA Rating Services, 2012

another SBL securitisation, Eximius-SBL IFMR Capital 2012 (Eximius-SBL), which had 3,193 small business loans worth INR175m underlying it. The originator was Vistaar Financial Services (Vistaar), a Bangalore-based NBFC established in 2010. The underlying pool had borrowers from various businesses and industries. The loans were originated from nine districts across the two southern states of India – Karnataka and Tamil Nadu. The ticket size of underlying loans ranged from INR25,000 to INR1m. Around 47% of the pool principal was secured by the mortgage on property.

Structure and investors

Eximius-SBL was structured as turbo-par securitisation where the purchase consideration from the investors was equal to the underlying pool principal. Further, in a turbo-par structure, the excess interest spread (EIS) is passed to the investors as principal repayment. This results in fast amortisation with residual cash flows from the pool which act as credit enhancement. The structure had three tranches: A1, A2 and A3. The A1 and A2 tranches were promised a monthly interest; however the principal payment to A2 was subordinated to A1. The payments to A3 tranche were subordinated to both A1 and A2 tranches. The subordination of junior tranches provided credit enhancement in addition to the cash collateral, provided by the originator, and the residual cash flows. Vistaar, which continued to service the pool, provided a cash collateral of INR20.6m. The total credit enhancement in the transaction, excluding the subordination of A2 and A3 tranches, was roughly 34% of the pool size which includes nearly 22.35% of residual cash flows (ICRA Rating Services, 2012).

The A1 tranche was subscribed by a private bank and a large NBFC. The A2 was solely subscribed by the NBFC. IFMR Capital invested in the A3 tranche and provided additional credit enhancement to the senior investors. The transaction was rated by ICRA Limited, an associate of Moody's Investor Services.

Risk management and reporting

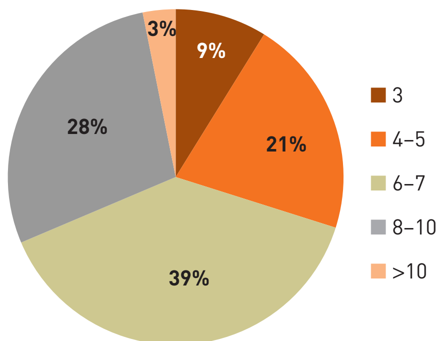
Risk management and periodic monitoring is critical for the success of any structured finance transaction. This section discusses the key risk factors present in the segment and leading practices that could help in managing these risks.

High ticket size

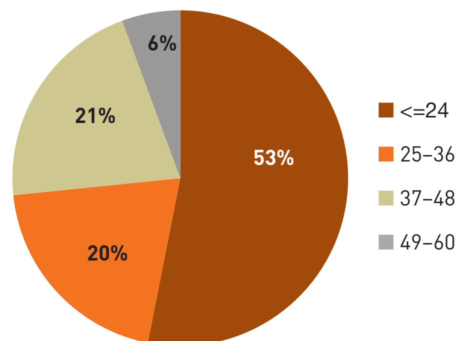
One of the key differences in the SBL and the microfinance sector is the ticket size of the underlying loans. Exhibit 7

Eximius-SBL pool break-up by seasoning and tenure **Exhibit 4**

Pool break-up by seasoning (in months)



Pool break-up by tenure (in months)



Source: ICRA Rating Services, 2012

Eximius-SBL structure **Exhibit 5**

Tranche	Amount (INRm)	Tenure (years)	Credit enhancement (% of pool principal)	Rating
A1	149.1	3.34	49.10%	A-(SO)
A2	14.9	3.26	40.60%	BBB(SO)
A3	11.4	4.00	34.10%	BB+(SO)

Source: ICRA Rating Services, 2012

Performance of SBL securitisations by IFMR Capital **Exhibit 6**

Transaction	Originator/servicer	Pool principal (INRm)	Transaction date	Collection defficiency (March 2013)[4]
Abeona-SBL IFMR Capital 2012	Vistaar Financial Services Pvt Ltd	77.2	May 2012	99.58%
Eximius-SBL IFMR Capital 2012	Vistaar Financial Services Pvt Ltd	175.4	November 2012	99.62%
Aurora-SBL IFMR Capital 2012	Au Financiers (India) Pvt Ltd	281.3	January 2013	94.43%[5]

Source: ICRA Rating Services, 2012

compares the 'proportion of pool principal accounted by a given proportion of borrowers' for the Eximius-SBL and Alpha-MF, a microfinance securitisation. A concave curve for SBL-Eximius shows that a small number of loans, roughly 10%, accounted for nearly 50% of the pool principal. A default by a handful of the largest loans in the pool could potentially wipe out the complete cash collateral. In order to mitigate this risk one should ensure that all large sized loans are not concentrated in a single geography or industry. Also, estimated cash collateral should be able to cover a certain per cent of large sized loan defaults. On top of that, the largest loans may be modelled individually to arrive at a prudent estimation of the credit enhancement required.

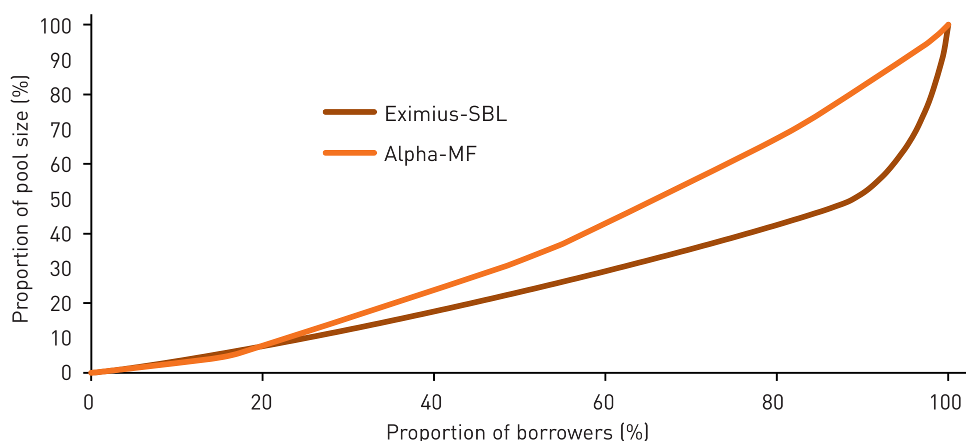
Pool audit

The lumpy nature of individual loans makes it essential for the investors in a securitisation transaction to assess the credit quality of the pool in detail. The adherence to origination processes and documentation requirements is a key determinant of the credit quality of the loans and existence of underlying collateral. So, a pre-transaction audit of the underlying pool plays an important role in the pool assessment. Under a pool audit typically a sample of loans is selected and each loan in the sample is assessed for the financial strength, collateral valuation and verification, credit history, legal documentation and the credit analysis done by the originator at the time of loan disbursement. The sample is selected in such a way that it represents the largest exposures in the pool as well as the loans across industry and geography.

Concentration risk

In a microfinance securitisation, selecting a well-diversified portfolio across geographies often suffices from a risk management perspective. In the MSME sector however, most small enterprises are typically located in clusters. High industry concentration in a single geography may increase the risk significantly. In such a scenario, a good risk mitigation approach is to develop a deeper

Distribution of loan size – SBL and microfinance **Exhibit 7**



Source: IFMR Capital

understanding of these risk factors and estimate their potential impact. Maintaining risk registers for underlying industries helps in managing this risk. Risk register is a risk management tool and act as a repository of all the identified risk factors along with their probability, severity and mitigation as well as management measures.

Eximius-SBL pool had a concentration of power loom operators from a few districts which had experienced unreliable power supply with frequent power outages. The cluster risk was analysed by categorising loans into mortgage loans secured by collateral which had a lower propensity to default and unsecured loans. The cluster was further analysed to categorise borrowers based on their access to alternate power sources, secondary livelihoods, and other sources of income.

Collateral estimation and verification

Typically, the high ticket size small business loans are secured by a collateral agreement. However, the ease, economics and feasibility of the agreement enforceability may vary and depend on the type of collateral. The verification of the physical security and title documents may form a part of the pool audit.

Another structural challenge in SBL securitisation in India is the transfer of the mortgage security interest from the originator to the investors. The federal nature of stamp duty laws and the registration requirements make it economically unviable to transfer the security interest to the investors. In Eximius-SBL, the mortgage securities are kept in trust by the originator for the benefit of the investors, which means that investors have beneficial interest in the security (ICRA Rating Services, 2012).

Monitoring and reporting

The long tenure of SBLs makes the pools more vulnerable to the economic, political and environmental events across the industry and geography. However, continuous monitoring of the key performance and risk indicators helps in identifying early warning signals. Further, a timely reporting of these indicators could help in risk management and minimising the losses on account of idiosyncratic as well as external factors. A few originators in this segment are moving to risk-based post-disbursement monitoring of the clients. Investors should tap into such information to gain granular credit information on the pool.

Road ahead

The structured finance approach has enabled the capital market access to smaller and niche players in the SBL segment. However, these smaller and niche SBL originators may find it difficult to set aside an unencumbered pool that is large enough to make the securitisation economically viable. In addition, high geography and industry concentration could make the single originator securitisations cost ineffective due to high credit collateral requirements. We believe that the MOSEC™ that has enabled smaller MFIs to tap into capital markets would be equally relevant in the SBL segment. IFMR Capital has structured, arranged and invested in 33 multi-originator transactions using pools originated by 20 MFIs spread across the country. One such transaction was listed on the Bombay Stock Exchange earlier in 2013, creating opportunities of higher transparency and liquidity in these products (IFMR Capital, 2013). Going forward, such MOSEC™ transactions could allow multiple SBL originators to pool their loans to reach critical size as well as attain efficient geographic and industry diversification.

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Notes:

1 Indian rupee
2 Small and medium-sized enterprises.
3 Originator names are masked as the information presented in the Exhibit may not be publicly available.
4 Source: IFMR Capital.
5 Aurora-SBL shows low collection efficiency on account of frequent delays in repayment as most of the borrowers are not familiar with payment channels like electronic clearance service (ECS) and post-dated cheques (PDCs). Overdue is high in 0-30 day bucket and declines sharply in higher buckets.

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