

BRAC, the largest national Non-Government Organization (NGO) in the world serving more than 5 million mostly women members in Bangladesh, is one of the most respected microfinance institutions (MFIs) globally. It has branches in all 64 districts of the country covering 170,277 village organizations, each having 30–40 members. These groups serve as forums where members can collectively address the principal structural impediments to their development, receive credit, and open savings accounts. Micro-loans average balance per borrower is US\$165 in local currency. From its inception in 1972, BRAC has reached scale and diversity in its operations with over 42,263 regular staff and 53,205 BRAC teachers; and focusing on the issue of poverty alleviation and empowerment of the poor, especially women, in Bangladesh's rural areas.

In a deal engineered by Citigroup, RSA Capital (Bangladesh), FMO (Netherlands) and KfW (Germany), BRAC completed the first ever AAA-rated local currency microcredit securitization in 2006. This landmark deal gave BRAC access to US\$180 million of funding in local currency — Bangladesh Taka (BDT) — over a six year period, enabling it to provide more financing to more micro-entrepreneurs than ever before, and has paved the way of alternate financing sources for MFIs around the world. This was a unique securitization for the microfinance industry with the potential of being replicated in other markets.

Milestones

- The First local currency AAA rated microcredit securitization
- First AAA rated securitization transaction in Bangladesh capital markets, rated by The Credit Rating Agency of Bangladesh
- 150% collateralized by micro-loans, at the beginning of the transaction (approx. 400,000 loans to cover each US\$15 million issue)

- Reduced funding costs for BRAC over alternative market borrowings
- Participation from multilateral agencies (FMO, KfW), Citibank N.A. Bangladesh (Citibank, N.A. is the banking arm of Citigroup) and two local banks (Pubali Bank Limited, The City Bank Limited), thereby providing diversification of investor base. It is expected that a broader range of investors will participate in future issuances.

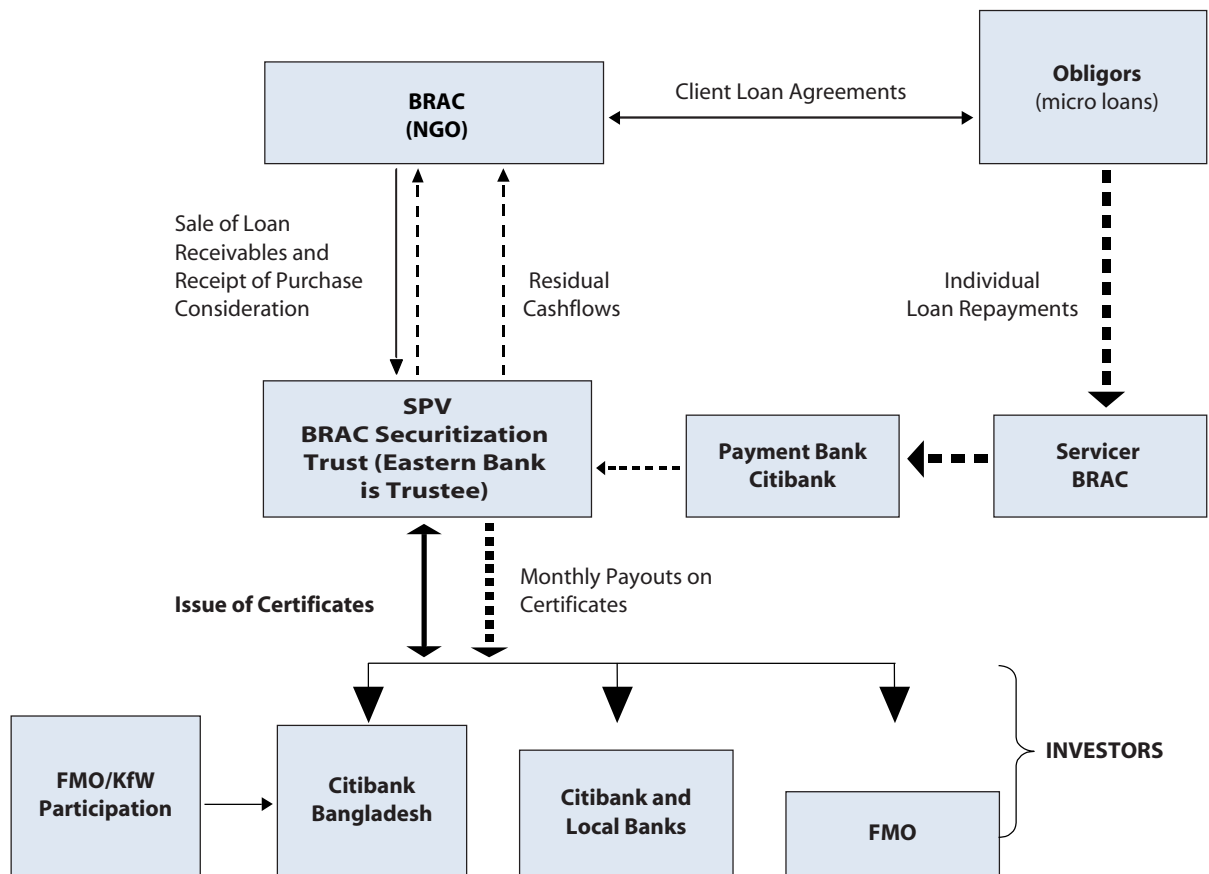
Objective

BRAC's key objectives included establishing a term funding platform through securitization of individual micro loans averaging about US\$165 and diversifying existing sources of financing at lower than currently available interest rates and longer tenors. This structure has essentially offered BRAC higher level of financial flexibility through access to a broader investor base, while reducing on-balance sheet assets, thus freeing-up capital.

As a result, BRAC has developed a strong balance sheet – evolving from donor based and secured financing to unsecured commercial lines — by finally taping the capital markets through this innovative securitization structure. BRAC will use the funding to expand customer reach, while the transaction helps develop local capital markets and introduces microfinance as a new asset class.

Structuring Securitization Transaction for an MFI

The structure involves the assignment of BRAC's micro-credit receivables to a special purpose trust, which issues certificates representing undivided beneficial interest in the underlying receivables. It is denominated in Bangladesh Taka (BDT) and will provide an aggregate of BDT12.6 billion (US\$180 million equivalent) of financing for BRAC over a period of six years. Under the program, BDT1 billion (US\$15



million equivalent) will be disbursed every six months to BRAC, with a maturity of one year.

In the initial tranche of US\$15 million in equivalent BDT, (a) FMO has directly invested US\$5 million, (b) Citibank has funded US\$5 million against FMO guarantee, and (c) the remaining US\$5 million has been syndicated (participated by Citibank and two other local banks).

The certificates are AAA rated, and the rating was performed by Credit Rating Agency of Bangladesh. These are floating rate notes and tranche-specific pricing of which are pegged with Bangladesh Government six-month Treasury Bill rates. Clifford Chance (Hong Kong) and Lee, Khan & Partners (Bangladesh) provided legal counsel and documentation.

The initial pool selection has been done using software developed by MF Analytics (U.S.), which generates a pool similar in key parameters to the total loan portfolio of BRAC. The securitized pool is a "sub-portfolio," which reproduces characteristics of BRAC's total loan book and hence it is diversified across product type and geography. The overall

delinquency rate of BRAC's portfolio is less than 2%. The transaction has no direct credit enhancements, but it is over collateralized with micro-loans to achieve a higher credit rating.

Due Diligence

In a transaction of such operational complexity, due diligence is extremely important. This process assessed BRAC's credit policies and procedures and included meeting various key members of BRAC management and staff, visiting regional offices, field operations and village organizations. Portfolio analysis was completed and credit & collections policies, credit underwriting & collections processes, backend systems, branch operations, HR systems and policies, audit & controls and MIS reporting were reviewed. Due diligence was supported by the fact that BRAC has received "The CGAP Award for Financial Transparency" demonstrating high level of MIS reporting systems, Audit and Controls, and data available in various segments that facilitate analysis and decision-making.

The detailed assessment proved the organization to be very robust:

- BRAC has an extensively documented credit policy and procedures manual with the required processes and formats to set up a village organization. The manual also discusses the details of the three credit products and the selection criteria for each — Dabi, Progoti and Unnati. The borrowers migrate from product to product as they progress through the income curve.
- Reconciliation of cash positions is done at the branch level on a daily basis, including disbursements, collection of repayments and savings from village meetings and office expenses. This reconciliation along with field visits by area and regional managers constitutes the second level checks on the collections made from borrowers for repayments and savings. BRAC monitors its sales and repayment performance regularly against targets.
- BRAC has strong focus on building human capital, which includes staff development, creating a talent pool for future leadership, a formal performance appraisal system, a compensation structure and policy formation and monitoring. Also, there is a separate team of personnel responsible for carrying out investigations into ethics and fraud issues. A detailed manual and checklist of internal audits on every aspect of branch operations are in place.

In addition to these aspects, the standard of data integrity, sufficiency of information available with field and head office, security, and system's ability to tag loan accounts for identification purposes were also reviewed and found to be strong.

Cooperation and Support from the Stakeholders

The transaction passed through the detail scrutiny of various departments of Bangladesh Bank (central bank of Bangladesh) as well as the Securities and Exchange Commission of Bangladesh. The regulators

in Bangladesh provided guidance and full cooperation on this innovative microfinance transaction. The different players brought together to complete this structure (BRAC, Citigroup, FMO, KfW, RSA, Clifford Chance, local banks, auditors, tax and legal counsels, credit rating agency) were all fundamental to its completion.

Recommendations

For MFI's such as BRAC, it is important to maintain their development focus, while demonstrating the ability to reach scale on a financially sustainable basis. Institutions and specific facilities need to be rated, and these ratings will often differ. Portfolio size, credit performance, strong management information systems and diversification of the underlying assets are important factors for securitizations, as are a demonstrated robust credit appraisal, monitoring and recovery process. Institutions, depending upon their needs, size and local market context, are not likely to first access their domestic capital markets through a securitization, but by initially doing asset sales, private placements, local bank syndications and bond issues. Most MFI's require local currency funding and seek diversification of domestic funding sources, so most such transactions will be local currency denominated, requiring access to domestic investors and liquidity, and structured under local law and regulations.

Once an MFI has a well developed funding and business plan, supported by strong institutional policies, procedures, documentation, financials and MIS, it should work closely with innovative banks that will review with the MFI's management possible capital market alternatives. Citibank Bangladesh, for example, worked closely with its partner institutions on the BRAC securitization, and it mobilized its microfinance expertise, local and global capital markets and securitization structuring and sales teams, its local business presence and relationship with regulators, and access to domestic currency financing to support this successful and pioneering transaction for Bangladesh and the wider microfinance sector.

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Awards

BRAC's micro-credit receivables Securitization transaction has been selected as (i) Securitization Deal of the Year 2006 by IFR (International Financing Review), (ii) Best Domestic Securitization Deal of the year 2006 by The Asset Magazine, and (iii) only Securitization Deal amongst the 10 most outstanding deals of 2006 compiled by CFO Asia.