Microfinance Credit Guarantee Facility (MCGF)

1. Objective of MCGF

Keeping in view the importance of microfinance in a developing country context, the State Bank of Pakistan (SBP) has been encouraging banks / Development Finance Institutions ("DFIs") to provide funding to viable Microfinance Banks ("MFBs"), to enable them to achieve the outreach targets. It has, however, been observed that apart from few instances, where funds have been provided to few MFBs/ Microfinance Institutions ("MFIs"), the commercial banks are yet to explore the local currency lending opportunities with MFBs/MFIs.

In order to incentivize the channeling of funds to the Microfinance Sector, SBP has designed a Microfinance Credit Guarantee Facility ("MCGF"), henceforth referred to as the "facility" which shall be administered by the SBP, BSC. The facility is expected to facilitate banks/DFIs to play a leading role in easing credit constraints of MFBs/ MFIs in their efforts to maximize outreach by extending credit facilities to them. The facility is expected to achieve the following objectives:

i) The guarantees are expected to help building links between micro borrowers and formal financial institutions. The familiarisation of the bank with the client should eventually lead to the "graduation" of the borrower.

ii) Under the facility, the SBP BSC shall provide Partial Guarantees (pari passu) to cover the principal amount in default or First Loss Default Guarantees to cover the first loss, limited to a certain percentage on the principal amount only, to banks/DFIs to minimize the perceived risk premium by covering part of the losses incurred on funds made available to MFBs/MFIs with the advantage of leveraging the guarantee fund a number of times while keeping the incentive for banks/DFIs to collect the loan.

iii) Banks/DFIs will evaluate the prospective recipient MFBs/MFIs according to the well defined due diligence criteria. This way the credit enhancement facility will serve the banks/DFIs to develop their own sense of the risks involved in microfinance.

iv) The guarantee will facilitate resolution of regulatory issues that limit unsecured lending by banks/DFIs and would bring the loans to MFBs/MFIs under compliance with banking regulations.

2. Details of the Facility

The facility will provide Partial Guarantee or First Loss Default Guarantee up to a certain limit prescribed by the SBP to reduce the credit risk to banks/DFIs entering into lending arrangements with financially and socially sustainable MFBs/MFIs with significant potential to maximize the outreach to poor and marginalized segments of the society. The facility will effectively allow risk sharing, as Partial Guarantees or First Loss Default Guarantees will provide incentives to participating banks/DFIs to monitor these loans. The structure of the guarantees will enable MFBs/MFIs to borrow in local currency.

The facility will be initially started with the help of the UK Department of International Development (DFID) grant amount of GBP10 million to be kept as reserve and used for issuing guarantees to microfinance providers who fit the criteria of the facility. The facility is expected to help raise local currency funds from local sources primarily banks and

DFIs for eligible MFBs/MFIs. The loans portfolio under the guarantee scheme will be administered by banks.

(1) Distribution of tasks and responsibilities

All tasks relating to processing and appraisal of loan applications, evaluation of business plan, loan appraisal, approval, disbursement, recovery, supervision and monitoring, follow up on problem loans, and legal action in case of default will be performed by the lending institution. The SBP BSC will process the guarantee approval and facilitate issuance of NOC to MFBs for availing financing from lending institutions.

(2) Leverage and risk-sharing

The extent of risk coverage under this facility will be either 40% of the loss incurred in case of a Partial Guarantee or 25% of first loss in case of First Loss Default Guarantee, on the principal amount only. With the coverage limited up to 40% or 25% of the expected loss on the principal amount as the case may be the facility will be able to achieve a leverage of up to 4 times.

(3) SLR eligibility

The funds channelized under facility to MFBs /MFIs shall be deductable from Demand and Time Liabilities of the banks/DFIs for the purpose of SLR and CRR calculation. SLR incentive under section 3 shall be withdrawn if partial claim is paid under section 7(ii) upon invocation of the guarantee.

(4) Interest Rate payable by the borrowing institutions

The interest rate charged from borrowing institutions under the guarantee facility shall not exceed 2 (two) per cent over and above the prevailing SBP Policy Discount Rate.

(5) Responsibilities of lending institution under the facility

i) The lending institution shall provide financing after carrying out proper due diligence of the MFB/MFI, keeping in view the risk profile of the borrower and in light of policy developed, duly approved by its Board of Directors, for providing financing under the MCGF. In case, the microfinance lending policy duly approved from the Board of Director is not in existence, such policy shall be made within two years of the first disbursement under the facility; however, it shall be mandatory if the funding under the facility exceeds 20 percent of the lending bank's equity, prior to disbursement under the facility.

ii) The lending institution shall closely monitor the borrower's account.

iii) The lending institution shall ensure that the guarantee claim in respect of the credit facility and borrower is lodged with the SBP BSC under the facility in the form and manner and within such time as may be specified under the facility in this behalf. Any delay on the part of the lending institution to notify the default within the time period specified shall render the lending institution ineligible for the guarantee claims.

iv) The payment of guarantee claim by the SBP BSC to the lending institution shall not in any way affect the right of the lending institution to recover the defaulted amount from the MFB/MFI. The lending institution shall exercise all the necessary precautions and initiate such actions as deem necessary for recovery of the defaulted amount, including such action as may be advised by the SBP BSC.

v) The lending institution shall comply with such directions as may be issued by the State Bank or the SBP BSC, from time to time, for effecting or facilitating recoveries in the guaranteed account, or safeguarding interest of the SBP BSC as a guarantor, as the SBP BSC may deem fit and the lending institution shall be bound to comply with such directions.

vi) The lending institution shall, in respect of any guaranteed account, exercise the same diligence in recovering the dues, and safeguarding the interest of the facility in all possible manners as it might have exercised in the normal course if no guarantee had been furnished under the facility.

vii) The lending institutions shall promptly repay the SBP-BSC amounts received from the SBP-BSC under the guarantee and subsequently recovered from the borrower.

(6) Extent of the guarantee

Under the facility, the SBP BSC shall provide guarantee cover of up to 40% (Forty percent) of the amount in default in case of Partial Guarantee or 25% of first loss in case of First Loss Default Guarantee, of the credit facility extended by the lending institution to an eligible borrower institution, subject to a maximum guarantee cover of GBP 2.5 million per borrower. The guarantee cover shall commence from the date of first disbursement to the borrowing institution and shall run through the agreed tenure of the credit facility which shall not exceed five years.

(7) Conditions and procedures for calling on guarantee

i) The lending institution may invoke the guarantee in respect of eligible credit facility if the following conditions are satisfied: -
   a) the guarantee in respect of that credit facility is in force;
   b) the amount due and payable to the lending institution in respect of the credit facility has not been paid and the dues have been classified by the lending institution as Non Performing Loans (“NPLs”).
      “NPL” means a loan classified as a non-performing loan based on the instructions and guidelines issued by the State Bank of Pakistan from time to time
   c) the loan facility has been recalled and the recovery proceedings have been initiated as per bank’s policy and loan agreement;
   d) Provided that the lending institution has performed all its responsibilities as defined in section 5.

ii) The SBP BSC shall pay ninety per cent of the claim covered under the guarantee on submission of eligible claim by the lending institution, within thirty days, subject to the claim being otherwise found in order and complete in all respects. The balance ten per cent of the guaranteed amount if not recovered by the lending institution from the borrower, will be paid on conclusion of recovery proceedings and final settlement of the loan On a claim being paid, the SBP BSC shall be discharged from all its liabilities on account of the guarantee in force in respect of the borrower concerned.

iii) In the event of default, the lending institution shall exercise its rights, if any, to take over the assets of the borrowers and the amount realised, if any, from the sale of such assets or otherwise shall first be credited in full by the lending institutions to the facility before it claims the remaining ten per cent of the guaranteed amount.

iv) The lending institution shall be liable to refund the amount of the claim released under the facility together with penal interest at the rate of 4% (four percent) above the prevailing SBP Policy Discount Rate, if in the opinion of SBP BSC serious deficiencies existed or where dual claims are lodged for the settlement of claims.

(8) Subrogation of rights and recoveries on account of claims paid

i) The lending institution shall furnish to the facility, the details of its efforts for recovery, realizations and such other information as may be demanded or required from time to time. The lending institution will hold lien on assets created out of the credit facility extended to the borrowing institution, on its own behalf and on behalf of the SBP BSC. The SBP BSC shall not be bound to exercise any subrogation rights and that the responsibility of the recovery of dues including takeover of assets, sale of assets, etc., shall rest with the lending institution;

ii) any amount recovered and due to be paid to the SBP BSC under the Facility shall be paid without delay, and if any amount due to the Facility remains unpaid beyond a period of 7 (seven) days from the date on which it was first recovered, interest shall be payable to the Facility by the lending institution at the rate, which is 4% (four percent) above SBP Policy Discount Rate for the period for which payment remains outstanding after the expiry of the said period of 7 (seven) days.

(9) Modifications and exemptions

i) The State Bank or the SBP BSC reserve the right to modify, cancel or replace guidelines, however, the rights or obligations arising out of, or accruing under a guarantee issued under the facility up to the date on which such modification, cancellation or replacement comes into effect, shall not be affected.

(10) Interpretation

i) If any question arises in regard to the interpretation of any of the provisions of the facility or of any directions or instructions or clarifications given in connection therewith, the decision of the State Bank shall be final.

(11) Supplementary and general provisions

In respect of any matter not specifically provided for in the guidelines, the facility may make such supplementary or additional provisions or issue such instructions or clarifications as may be necessary for the purpose of the facility.

3. Administration of the Guarantee Fund

SBP Banking Services Corporation (SBP BSC) will administer the guarantee fund. The fund will be invested partly in government securities and partly shall be put in remunerative deposit account, which will serve as a first-call account for claims or, such other investment(s) as may be approved by the SBP BSC from time to time.

Banks / DFIs will lodge their claims against the facility to SBP BSC. A detailed procedure for lodgment of claims and the supporting documents required for processing of claims, has been communicated vide DFSD Circular No.1 of 2009. . SBP or SBP BSC shall ensure that the total exposure under the facility does not go beyond the funds available in the Guarantee Fund.

4. NOC to MFBs

Only those MFBs will be eligible to avail financing under MCFG from the banks/DFIs that have been issued NOC. For the purpose, MFBs shall approach SBP BSC for seeking

NOC necessary for bank financing under the MFI Ordinance 2001, which will be subject to observance by the concerned MFB of all formalities as advised, from time to time, by SBP or the SBP BSC.

5. Eligibility criteria for Microfinance Providers

The eligibility criteria shall include financial and social indicators to measure the potential of the MFBs / MFIs for achieving the objectives of the guarantee facility. A broad criteria for assessing the eligibility of MFBs / MFIs is given at Annexure-A.

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Annexure-A

Selection Criteria for Microfinance Providers

Background

The aim of Microfinance Credit Guarantee Facility for Microfinance Providers ("MFPs") is to help the existing MFPs to become large, innovative, and sound institutions by easing their funding constraints. The funding through the facility shall be used by MFPs for onward lending to poor borrowers. A partner organization may be supported until it has attained the possibility of accessing the desired level of commercial loans. The funding under the facility shall not exceed five years from the date of its first release.

The Selection Criteria

The Fund shall work with two specific types of MFPs:

1. Licensed MFBs
2. Microfinance Institutions (MFIs) in transformation to MFBs

MFPs interested in borrowing from banks / DFIs under this facility will have to demonstrate a strong commitment for enhancing its institutional capacity and financial condition to a level, which will ultimately enable it to access funding without any support under this facility. In this regard, MFBs will be required to chalk out a concrete plan for deposit mobilization, deciding a timeline as to when these banks will be able to raise enough deposits required to fund their loan growth. For MFIs/Rural Support Programs ("RSPs"), it will be required that they work out a plan for their transformation to MFBs, leading them to act as self-sustainable institutions providing all range of financial services to poor.

The MFP applying for funding through the facility, shall be assessed on following parameters:

- Clear Business Strategy / financial projections (for next five years) focusing on sustainable growth.
- The focus must be exclusively on reaching out to the poor.
- Satisfactory progress on Financial & Operational performance in last three years.
- Having a concrete plan / commitment to build their institutional capacity to mobilize commercial funds for sustainable microfinance operations.
- The organization must demonstrate commitment through its management decisions to promote initiatives outlined in the existing approved micro-finance strategy to develop the overall sector on sound footing.
- A minimum of two years experience in providing microfinance services

The assessment of the selection criteria will be based on the following indicative benchmarks/standards:

Sr. No.	Areas	Indicators	Indicative Benchmarks / Standards
1	Business planning, & expected performance targets	Growth oriented planning	Growth rate should be in accordance with the age of institution and market conditions. Growth parameters include clients, loans/advances, deposits, branches, new products, human resource development, profitability, capital
		Well diversified growth	
		MFBs to give due focus to savings mobilization.	Range of services with focus on deposits / savings. The strategy for savings mobilization especially from within the target market.
		Availability of Management & operating structure to support envisaged growth	Structure/policies are aligned with organizational mission.
2	Existing financial & operational condition	**<u>Financial Stability*</u>** 1. Equity-to-Assets / CAR 2. **Portfolio at risk (30 days overdue) 3. Gross Loan -to-Total Assets 4. Return on Asset 5. Deposit-to-Loans Ratio	1. > 10% / >15% 2. < 5% 3. subject of age of institution 4. positive 5. subject of age of institution
		* The MFP's compliance with Financial Stability indicators will be determined both on prospective & retrospective basis. In retrospective, the last 3 years' performance of the applicant MFP should provide sufficient evidence of satisfactory progress towards achievement of the targets in the above-mentioned indicators. Despite the progress, if there appears some negative gaps (subject to tolerable limits) in MFPs' current performance and the defined indicators, then management should provide a future plan to overcome the deficit in the indicators within the timelines as given in the loan agreement. ** While determining financial stability indicators, MFPs will follow the Loans Classification & Provisioning criteria being followed by MFBs as per Prudential Regulations issued by SBP for MFBs, from time to time.	
		<u>Operating Efficiency</u> 1. Use of alternate delivery channels 2. Cost per borrower	Branch expansion, geographical diversification, innovative models.

		3. Cost per loan portfolio 4. Borrowers/Staff ratio 5. Borrowers/loan officer ratio	These indicators will be examined on case to case basis keeping in view the factors such as age of institution, area of operations, strategic orientation, and financial performance indicators.
3	Social orientation	i. Urban vs. Rural	Rural penetration > 25%
		ii. Gender	Women > 25%
		The deficit in any of the first 2 indicators can be compensated by the surplus in the other indicator.	
		iii. Avg. Loan size /GNP per capita	< 1
		iv. Poverty Profiling of clients	Poor persons excluded of access to financial services by commercial banks / Poor persons as defined by SBP in Prudential Regulations for MFBs.
		Credit rating (For MFBs only)	Ratings
		Quality of external auditors	Ranking of External auditors

The assessment of MFPs on the above criteria will be used not only for screening the MFPs eligible for funding but also for evaluating the level of funding being requested by the MFP. The initial and/or subsequent funding limits approved by SBP for an MFP may be discounted / declined if the MFP's compliance on some of the indicators does not appear satisfactory.

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