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microNOTE 42

Why Are Microfinance Institutions Acting as Service Agents for Commercial Banks?[1]

There are many ways that microfinance providers can link with a commercial bank. These linkages can range from informal information exchanges to formal contractual or even ownership relationships. The linkage analyzed in this NOTE is a servicing arrangement, which involves a MFI that acts as a service agent for a commercial bank.

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When microfinance institutions ("MFIs") act as "service companies" to commercial banks ("Partner Banks"), they build a strategic alliance that can offer a means of delivering microcredit services more efficiently and effectively than if either party were to operate on its own. A "servicing arrangement" (or contract) between a MFI and Partner Bank allows these two stakeholders to differentiate the various roles and functions necessary in the making and managing of microcredits, and to allocate among the MFI or its Partner Bank responsibility for these roles to draw on the comparative advantages of each. In other words, a servicing arrangement allows MFIs and their Partner Banks to "disintermediate" or separate into various components the credit function to ensure that access to credit is distributed most efficiently to the unbanked. This microNOTE examines how servicing arrangements can be structured to benefit all stakeholders in the arrangement—the MFI, it's Partner Bank, and, most importantly, the microcredit borrower who should share in the efficiencies gained from such an arrangement.

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The linkage analyzed here is a servicing arrangement, which involves a MFI that acts as a service agent for a commercial bank ("Partner Bank"). The MFI, often for a servicing fee, undertakes microcredit origination responsibilities and, in some cases, microcredit collection functions for the Partner Bank. The Partner Bank, in turn, acts as a funder for some or all of these MFI-originated microcredits, and holds on its books the microcredits that it funds.

When a MFI and a Partner Bank enter into a servicing arrangement, they essentially are entering into a form of strategic alliance. Like other corporate strategic alliances, servicing arrangements are most likely to succeed only if both parties (the MFI and Partner Bank) derive benefits from the alliance. Accordingly, there are likely to be few, if any, servicing arrangements that will end in failure for one partner, but success for the other. In short, the parties to a servicing arrangement need to be committed to achieving a win/win relationship that offers observable and quantifiable benefits to both parties.

For example, the MFI might be able to identify and reach microentrepreneurs that are good credit risks more efficiently and effectively than the Partner Bank. The MFI might also have a distribution channel and methodology that allows it to monitor the use of microcredit proceeds and encourage borrowers to make timely repayments of their microcredits. The Partner Bank, on the other hand, might be able to tap cheaper and larger sources of capital than the MFI, which capital then can be used to fund more microcredits more efficiently than the MFI. The relative size and scope of the Partner Bank's operations also may allow it to enjoy economies of scale, not available to the MFI, that would enable the MFI to tap into the Partner Bank's more sophisticated back-end systems, access national and international payment systems, and take advantage of other human and physical resources at a relatively low marginal cost.

WHAT IS THE STRUCTURE OF A TYPICAL SERVICING ARRANGEMENT BETWEEN AN MFI AND COMMERCIAL BANK?

Embedded in any credit decision are several questions. Among the most common questions are:

- Who is lending the money?
- Who is borrowing the money?
- How is the borrowed money to be used?
- Who is responsible for ensuring that the borrower:
  - uses the borrowed money for the agreed purpose; and
  - pays the borrowed money back?
- Who will bear the loss if the borrower does not pay the borrowed money back?

A servicing arrangement pulls apart these questions, which underpin any credit decision, and asks, "Which party to the servicing arrangement will take responsibility for these various components of a credit decision?"

In most arrangements where a MFI agrees to act as a service agent for a Partner Bank, the MFI typically undertakes microcredit origination responsibilities, and, in some cases, microcredit collection functions for the Partner Bank. The Partner Bank, in turn, acts as a funder for some or all of these MFI-originated microcredits, and holds on its books the microcredits that the Partner Bank funds.

WHY WOULD A MFI CONSIDER ACTING AS A SERVICE AGENT FOR A COMMERCIAL BANK?

There are many reasons why a servicing arrangement might appeal to an MFI. Here are five possible motivations. MFIs may agree to act as service agents in order to:

1) Diversify, expand, and/or lower cost of funding from commercial banks;
2) Reduce pressure imposed by risk-weighted capital adequacy ratios (most likely to be of interest to regulated MFIs that are subject to such ratios);
3) Encourage downscaling by local banks to reach the microcredit market by demonstrating the viability of targeting such a market;
4) Practice (and gain credibility for) performing a servicing agent role before conducting a securitization of the MFIs' own microcredit portfolios; or
5) Tap into economies of scale enjoyed by commercial banks in order to access sophisticated back-end systems and other human and physical resources at a relatively low marginal cost.

WHAT STRUCTURAL AND FINANCIAL ISSUES ARE LIKELY TO ARISE IN THE NEGOTIATION OF A SERVICING ARRANGEMENT BETWEEN A MFI AND ITS PARTNER BANK?

There is no standard servicing arrangement. Rather, servicing arrangements should reflect the unique strengths, weaknesses, and objectives of each party. However, there are several common structural issues that appear to come up in the negotiation of most servicing arrangements between MFIs and their respective Partner Banks.

MFIs are likely to make sure that:

- The MFI's role and responsibilities as a service agent for the Partner Bank are well defined, including an articulation of what the MFI will <u>not</u> do in its role as a service agent;
- The MFI's proprietary information and human resources are protected from inappropriate use or solicitation by the Partner Bank and, in some cases, the MFI is allowed to operate independently of the Partner Bank in providing microfinance products or engaging in servicing or funding arrangements with other banks;
- The MFI's liabilities and losses are limited to a previously agreed amount should there be a deterioration in the quality of the microcredit portfolio originated by the MFI; and
- There is a fixed term or clearly defined conditions that could trigger an expiration of the servicing arrangement, at which time the arrangement may be extended and possibly modified but only if both the parties agree.

Partner Banks, on the other hand, are likely to ensure that:

- The Partner Bank's role and responsibilities, including, most importantly, its funding role, also are well defined, including the circumstances under which the Partner Bank will be obligated to disburse funds in the form of microcredits;
- There is agreement between the MFI and Partner Bank as to the underwriting criteria (gender of borrower, poverty level of borrower, type of business being funded, use to which microcredit proceeds are to be put, maximum size of microcredit, etc.) to be used by the MFI in originating microcredits;

- The Partner Bank, on an ongoing basis, is able to monitor the resulting microcredit portfolio's performance, and, when necessary, to take remedial action before the microcredit portfolio it is funding gets into serious financial trouble; and
- The Partner Bank has a legally-enforceable claim for the recovery of its money or other desired remedies should something go wrong, and, the Partner Bank has a workable exit strategy for terminating the servicing arrangement should it no longer serve the interests of the Partner Bank.

In addition to these structural issues, there also are at least four financial issues that are likely to be the subject of much negotiation in a servicing arrangement:

- The terms under which the Partner Bank is willing to fund its agreed share of the microcredit portfolio,
- The financial terms (maturity, interest rate, other charges, etc.) of the microcredits being originated by the MFI for the Partner Bank,
- The terms under which the risks of the microcredit portfolio are allocated between the MFI the and Partner Bank, and
- The terms under which revenue from the microcredit portfolio is shared between the MFI and the Partner Bank.

With respect to these last two issues of risk and revenue, both the MFI and its Partner Bank will be keen to ensure that revenue is shared in a manner that is commensurate with the way risk is shared in their servicing arrangements.

CONCLUSIONS: FUTURE CHALLENGES AND OPPORTUNITIES

Servicing arrangements allow MFIs and commercial banks to build a strategic alliance that plays to their respective strengths as they extend the reach of credit to microentrepreneurs. Like any strategic alliance in the corporate world, the most successful strategic alliances marry partners that have strong existing positions in different markets. Strategic alliances can help partners to expand core and non-core activities, fill functional gaps, and share costs. Strategic alliances most typically fail when partners are weak, lack required functional strengths, or have incompatible corporate cultures and strategic goals. So, too, the success of a MFI/Partner Bank servicing arrangement will also rise or fall on these factors.

Similarly, the health of servicing arrangements will turn on bank regulators' perceptions of the rewards and risks of these arrangements. As with any "agency" function, some bank regulators will be very reluctant to see credit decisions outsourced to unregulated MFIs. Servicing arrangements will need to address not only prudential banking concerns, such as worries about putting the general public's deposits at risk or concerns about bank failures that might weaken the entire banking sector, but also other regulatory concerns ranging from anti-money laundering (AML) and combating the financing of terrorism (CFT) concerns to market regulation concerns, such as consumer protection practices in marketing and debt collection. Accordingly,

> Until recently, Indian commercial banks and MFIs led the world in the number and size of MFI/Partner Bank servicing arrangements. Now, however, most Indian banks are no longer funding microcredit portfolios through such servicing arrangements. This is in large part due to regulatory concerns, particularly "know your customer" concerns, voiced by the Reserve Bank of India.
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> As a result, many of these Indian commercial banks and MFIs now are creating a "next generation" of off-balance sheet funding mechanisms. For example, some Indian MFIs are conducting microcredit portfolio sales to commercial banks where the commercial banks first fund the origination of the microcredits with a term loan to the MFI, and then, once the microcedits are funded from the proceeds of this loan, the commercial banks buy from the MFI the microcredit portfolio that their term loan funded. And the MFI then uses the sale proceeds to repay the commercial banks' original term loan.
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> In these Indian transactions, the MFI typically takes a first loss position in portfolio sales—which often ranges from 3 percent to 8 percent—thus there is risk sharing between the commercial bank and Indian MFI.

servicing arrangements will need to demonstrate to these concerned regulators that Partner Banks are exerting appropriate judgment in funding microcredits that are subject to servicing arrangements.

As lines blur between the strengths and weaknesses of MFIs and commercial banks, the rationale for servicing arrangements also could become fuzzy. However, for markets where commercial banks are reluctant to develop expertise in microcredit lending methodologies and where MFIs find funding overly expensive or structured in ways that inhibit scale, servicing arrangements can offer a means of delivering microcredit services more efficiently and effectively to customers than if either party were to operate on its own.

Disintermediation of the credit function through servicing arrangements is but one step in building strategic alliances between MFIs and more formal providers of financial services. Lessons learned from today's servicing arrangements can be applied to the extension of other financial products including savings, remittances, and insurance.

Additionally, just as servicing arrangements can be extended to other financial products, so too could servicing arrangements be extended to new kinds of funders beyond commercial banks. For example, as the range of funders of microcredits expands via online lending platforms, some MFIs may find that engaging in a servicing arrangement with these online lending platforms is a more transparent and less risky way to connect online funders directly with microentrepreneurs, while generating sizeable servicing income for the MFIs, without putting the MFIs' balance sheets at risk from foreign exchange exposure or unexpected funding interruptions from these new online lending platforms.