COMMERCIAL BANK AND MFI LINKAGES: TOOLS FOR ASSISTING MFIS IN PARTNERING WITH COMMERCIAL BANKS

A GUIDE FOR ASSISTING MICROFINANCE INSTITUTIONS IN NEGOTIATING SERVICE AGREEMENTS WITH COMMERCIAL BANKS

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INTRODUCTION

The purpose of this Guide is to highlight some of the most common negotiation and documentation issues that microfinance institutions ("MFIs") are likely to encounter when entering into a service agreement with a commercial bank.

INTRODUCING SERVICING ARRANGEMENTS BETWEEN MFIS AND COMMERCIAL BANKS

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 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.

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. Similarly, a servicing arrangement's success also will rise or fall on these factors.

Like other forms of corporate strategic alliances, a MFI considering entering into a formal servicing arrangement should decide where the MFI wants this arrangement to end up before it begins negotiations with any commercial banks. For example, the MFI that hopes to use a servicing arrangement as a means to reach an eventual buy-out or acquisition by a Partner Bank of all or part of the MFI's lending operations will undertake a very different approach to structuring and negotiating a servicing arrangement than a MFI that plans simply to dissolve the servicing arrangement once it no longer serves the MFI's interests or needs.

What are some of the interests, other than a wish to advance an acquisition of its lending operations that might drive a MFI to consider engaging in a servicing arrangement with a commercial bank? Here are five possible motivations:

1) To diversify, expand, and/or lower the cost of funding from commercial banks;

2) To reduce pressure imposed by risk-weighted capital adequacy ratios (likely to be of interest only if the MFI is subject to prudential bank regulation);

3) To encourage downscaling by local banks to reach the microcredit market by demonstrating the viability of targeting such a market;

4) To practice (and gain credibility for) performing a servicing agent role before conducting a securitization of the MFI's own microcredit portfolio; or

5) To 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.

These are not necessarily exclusive motivations, of course, as some MFIs may pursue multiple objectives when entering into servicing arrangements with commercial banks. These motivations are explored in greater detail below.

Source of Funding: Some MFIs will look to a servicing arrangement as a way to diversify, expand and/or lower its cost of funding as servicing arrangements can act as an alternative to borrowing directly from a commercial bank. For MFIs that are finding it difficult to borrow commercially at reasonable terms or that are at risk of exceeding debt/equity covenants in their existing borrowings, servicing arrangements can provide an alternative means of financing a growing microcredit portfolio while generating fee income for the servicing MFI. Other MFIs may be motivated by the opportunity to pass along to their clients cheaper microcredits that benefit from commercial banks' lower cost of funds than that generally available to MFIs.[1] Finally, in some jurisdictions, MFIs may find that government-imposed, priority lending requirements encourage commercial banks to lend directly to poor borrowers rather than through intermediaries like MFIs. Accordingly, a servicing arrangement can ensure an important role for the MFI in helping to allocate credit more efficiently to microfinance clients.

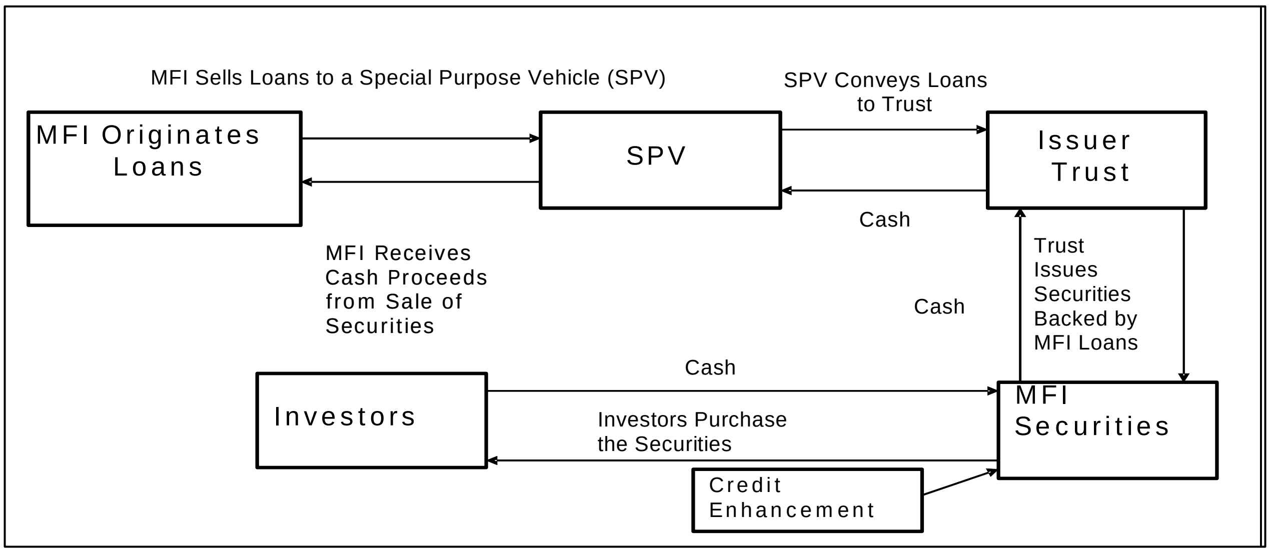
Capital Adequacy Requirements: Other fast growing MFIs that are subject to capital adequacy requirements by their local regulators may see servicing arrangements as a way to meet the growing demand for microcredit in their markets without putting additional pressure on the MFIs to raise capital to support the expansion of their microcredit portfolios. In some countries, the capital adequacy ratios applied to regulated microfinance deposit-taking institutions are much more onerous than that applied to commercial banks. For a MFI that is growing its microcredit portfolio by 30 percent or more a year, a risk-weighted capital adequacy ratio of 10, 15 or even 20 percent can pose a significant challenge as the MFI will need to ensure that its capital base grows in proportion to its microcredit portfolio. One way a MFI can seek to lower the amount of regulatory capital it is required to maintain, without slowing its delivery of microcredit, is to enter into a servicing arrangement so that some or all of the microcredits it originates are not included on the MFI's books for purposes of calculating the adequacy of its capital, but instead are included on the books of the Partner Bank, which presumably can raise capital more easily or find other ways to meet the capital adequacy requirements that attach to the microcredits it funds.

Downscaling Banks: Still other MFIs may see servicing arrangements as a way to introduce commercial banks to the potential profits to be made within the microcredit market so that these commercial banks might one day downscale their operations. Some of these MFIs may hope that their Partner Banks eventually will displace or even acquire the MFIs' lending operations in the microcredit market. Other MFIs may be intent on developing a purely servicing agent role that focuses more exclusively on the

[1] Note that, even where the cost of funds is cheaper for commercial banks than for MFIs, with the addition of servicing fees, loan loss reserves, and other expenses incurred in a servicing arrangement, there may not be any cost-savings left over from a servicing arrangement to be shared with microfinance clients.

client interface, thereby taking pressure off of the MFI to invest in all of the back office operations and talent necessary to fund and support a growing microcredit portfolio.[2]

Precursor to Securitizations: MFIs may see a servicing arrangement as a way to practice acting in a servicing agent role before conducting a securitization of their own microcredit portfolios. Crucial to the success of any securitization is the credibility of the servicing agent as this can impact the rating that is attached to the asset-backed securities created in a securitization, and, related, investor interest in buying such securities. A MFI can establish a positive servicing track record by first engaging in a servicing arrangement with a Partner Bank (or multiple Partner Banks) because many of the responsibilities that the MFI undertakes in a servicing arrangement are comparable to those it would undertake if it were one day to securitize all or part of its microcredit portfolio.



In one of its most simple forms, a "securitization" of a microcredit portfolio involves a process whereby microcredits are sold to a special purpose vehicle ("SPV"), which conveys these microcredits to a trust. The trust holds the microcredits that it buys, and then issues its own securities, which are backed by the acquired microcredits. Investors buy the trust's securities, and the sales proceeds from these purchases of securities are used, in turn, to pay for the microcredits the SPV and trust are buying from the originating MFI.[3]

[2] Some transformation models pose a variation on this theme by having the NGO MFI retain front office (servicing and client interaction) functions for the transformed (and regulated) MFI, which then retains control of back office and funding functions.

[3] For a discussion of the rationales and challenges that MFIs are likely to face when considering a securitization of a microcredit portfolio, see "Is Securitization Right for Microfinance?" by Sharon Stieber (Innovations, Vol. 2, Issue ½, Winter/Spring 2007). The above chart was taken from that article.

In the first two "true sale" securitizations of microcredit portfolios, which took place in Bulgaria and Bangladesh,[4] the MFI that transferred the microcredits is the same entity that originated the microcredits. Similarly the MFI that originated the microcredits also is acting as the service agent for the securitization.[5] It should be noted that a key responsibility of the servicing agent in securitization transactions like these is managing the debt collection process for securitized microcredits, even though the MFI no longer owns those microcredits.

Economies of Scale: Finally, MFIs may see a servicing arrangement as a way to take advantage of the efficiency, expertise and economies of scale enjoyed by commercial banks. Partner Banks can share sophisticated back-end systems, provide access to national and international payment networks, train MFI staff and absorb much of the market efforts at a relatively low marginal cost.

DOCUMENTING A SERVICING ARRANGEMENT

A servicing arrangement is a complex transaction that can reflect multiple business terms and objectives. As a general rule, a formal servicing arrangement is likely to be more complex than many debt funding arrangements but less complex than equity investments. Hence, the documentation used to reflect a servicing arrangement often borrows provisions from both loan agreements and shareholder agreements.

PURPOSE OF THIS GUIDE

The purpose of this Guide is to highlight some of the most common negotiation and documentation issues that MFIs are likely to encounter when entering into a service agreement with a commercial bank. While the business terms of these service agreements can vary widely, it is assumed, for purposes of this Guide, that under the terms of the service agreement the MFI will act as a service agent and handle the up-front, microcredit origination-related responsibilities and, in some cases, the debt collection functions for the Partner Bank. This Partner Bank will act as a funder for some or all of these MFI-originated microcredits by assuming the back-office, funding-related responsibilities and holding such microcredits on its books.

This Guide does not attempt to provide a full summary of all the provisions that might be found in a service agreement because service agreements vary enormously from agreement to agreement depending on a number of factors, including, for example, the business objectives of the MFI/Partner Bank linkage, the risk allocation and revenue sharing arrangements agreed by the MFI and its Partner Bank, and the laws of the country in which the Partner Bank and MFI are located. This Guide, therefore, offers only general guidance for MFIs that are preparing to negotiate service agreements with potential Partner Banks.

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4 In May 2006, the first "true sale" securitization took place in microfinance when ProCredit Bank Bulgaria securitized €47.8 million of its Euro-denominated microcredit's. Two months later, in July of 2006, the Bangladesh Rural Advancement Committee (BRAC) closed a deal to securitize $180 million equivalent of local currency-denominated microcredits over a six year period. Both of these transactions are "true sale" securitizations, meaning that the assets (here microcredit's) backing the securities issued in the securitization are no longer counted on the books of the MFI originators (ProCredit Bulgaria and BRAC), but instead receive off-balance sheet treatment.

5 One can imagine a transaction, perhaps not long from now, where a MFI seeks to securitize microcredit's that it did not wholly originate. Rather, the MFI may bundle together the microcredits of several MFIs in order to reach the critical mass necessary for a financially viable securitization. If this MFI were to be able to demonstrate a track record of successfully engaging in a servicing arrangement with one or more Partner Banks, that MFI may find investors (and raters) more amenable to and comfortable with such a securitization structure.

ROLE OF A TERM SHEET

Most complex negotiations (debt, equity, or other) begin with the negotiation of a document that is called a "term sheet."[6] The function of a term sheet is to memorialize the parties' agreement on the most important business, financial, and legal terms of the proposed transaction. As a result, the terms set forth in a term sheet often dictate much of the contents of the final documentation–in this case, the service agreement. For illustrative purposes only, Attachment A provides a sample form of the types of issues that might be addressed in a term sheet for a MFI/Partner Bank servicing arrangement.

Whether or not a term sheet is used to jumpstart the negotiation of a linkage arrangement, the Partner Bank typically will expect to take the lead in developing the documentation that will be used to evidence the arrangement. It would be unusual, but not unheard of, for a MFI to assume this lead drafting role. More often the MFI's role will be limited to commenting on draft documentation provided by the Partner Bank. One exception to this rule might be where the MFI has more experience than the Partner Bank in engaging in servicing arrangements. While rare, MFIs could have multiple servicing arrangements with several Partner Banks serving different geographic areas.

> **WARNING!** MFIs should not assume that terms agreed in a term sheet will be open for later discussion because commercial banks often use term sheets to secure necessary internal approvals based on the contents of the agreed term sheet. If the final documentation deviates in a material way from the previously agreed term sheet, the Partner Bank's negotiators may need to solicit new internal approvals and, in doing so, risk a possible rejection of or unwelcome delay in consummating the proposed servicing arrangement.

ROLE OF A SERVICE AGREEMENT

The documentation that evidences a formal servicing arrangement of the type discussed here will include, at a minimum, a form of service agreement between the MFI acting in its role as service agent and the Partner Bank acting in its role as a funder of microcredits.[7]

As with loan agreements, some of the clauses found in a service agreement will be standard (so called "boilerplate") provisions. Banks often are reluctant to make changes to these standard or boilerplate provisions, although no provision ever should be treated as off-limits for discussion and possible negotiation. Many other provisions in a service agreement, however, will be transaction-specific, so these provisions will need to be customized to reflect the business and financial terms of the servicing arrangement in question.

Finally, the business and financial terms underlying MFI/Partner Bank servicing arrangements may change over time to reflect new economic or strategic objectives and circumstances of the parties. It is not unusual, for example, for the negotiating position of MFIs to improve vis-à-vis their Partner Banks once the Partner Banks better understand the risks and rewards of engaging in microfinance activities. Accordingly, affected provisions of the service agreement also should change over time to reflect the changes in business and financial terms of the overall servicing arrangement.

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[6] Sometimes this document will be called a "mandate" or "engagement" letter. Irrespective of its name, the purpose of the document is the same, e.g., to spell out the parties' agreements on key business, financial, and legal terms.

[7] The service agreement can go by many names and its provisions may be divided among several agreements. For example, the documentation used to evidence at least one servicing arrangement includes both a "Credit Arrangement Letter" and "Memorandum of Understanding."

NEGOTIATING PERSPECTIVES

GENERAL OVERVIEW

A MFI that is determined to act as a service agent in a MFI/Bank servicing arrangement is likely to exhibit, among other key motivations, a strong desire to:

- Define the MFI's role and responsibilities as a service agent for the Partner Bank, including an articulation of what the MFI will not do in its role as a service agent;
- Allocate revenue sharing between the MFI and its Partner Bank in a manner commensurate with their risk sharing arrangements;
- Protect the MFI's proprietary information and human resources from inappropriate use or solicitation by the Partner Bank and, in some cases, allow the MFI to operate independently of the Partner Bank in providing microfinance products or engage in servicing or funding arrangements with other banks;
- Limit the MFI's liabilities to the Partner Bank should there be a deterioration in the quality of the microcredit portfolio originated by the MFI; and
- Set a fixed term or establish the conditions that will trigger an expiration of the servicing arrangement, at which time the arrangement may be extended and possibly modified if the parties agree.

A Partner Bank that is determined to engage in a MFI/Bank servicing arrangement is likely to exhibit, among other key motivations, a strong desire to:

- Define the Partner Bank's role and responsibilities, including, importantly, its funding role by setting out clearly the circumstances under which the Partner Bank will be obligated to disburse funds in the form of microcredits under the service agreement;
- Allocate revenue sharing between the MFI and its Partner Bank in a manner commensurate with their risk sharing arrangements;
- Define clearly the underwriting criteria to be used by the MFI in originating microcredits;
- Enable the Partner Bank, on an ongoing basis, 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

Defining roles and responsibilities in a servicing arrangement

Who defines the microfinance market segment to be served and products to be offered?

- Microfinance customer eligibility: Who is target customer–nationality, age limits, location, level of poverty, gender, type of business, other?
- Products/types of loans: Working capital, housing or home improvement, personal, consumer financing, fixed assets, other?
- Financial and other terms of products/loans: Size, pricing, duration, other?

Who defines the underwriting criteria?

What is included in criteria?

—Cash flow of customer?

—Available credit enhancements for microcredit?

—Existing level of indebtedness of customer?

—Credit history of customer?

—Business experience of customer?

—Other?

- Provide the Partner Bank with a legally-enforceable claim for the recovery of its money or other desired remedies should something go wrong, and to give the Partner Bank an exit strategy for terminating the servicing arrangement.

There are other motivations, of course, that will drive parties as they negotiate a servicing arrangement. For a MFI that is about to engage in such a negotiation, mapping key motivations–both its own and those likely to influence its proposed Partner Bank - can strengthen the MFI's negotiating hand and also save valuable time in forging solutions likely to bridge competing interests of the MFI and its Partner Bank.

PRELIMINARY CONSIDERATIONS

Among the threshold questions that will confront a MFI that is intent on entering into a servicing arrangement with a commercial bank are:

- Why link? (Is a servicing arrangement the best alternative for the MFI?)
- When to link? (Is the MFI ready to engage in a servicing arrangement?)
- Who to link with? (Which commercial bank (or banks) is best for the proposed servicing arrangement?)
- How to link? (What might be included in defining the duties, obligations and functions of the parties to a servicing arrangement?)

For a fuller checklist for responding to these and related questions, see Attachment B: Checklist of Questions for MFIs Contemplating Funding Partnerships/Servicing Arrangements with Commercial Banks.

WHY LINK?

How important is proposed servicing arrangement to the MFI's overall success/mission? Does it support the MFI's strategy and vision? In the short-term? In the long-term?

What are the cost implications of linking? What are the likely savings and costs (financial, human, operational, and other) to the MFI of linking with a commercial bank for proposed services (funding or otherwise) compared to developing the proposed Bank services inhouse?

What is the alternative (next best solution) to proposed servicing arrangement? What is the "value-add" of the proposed servicing arrangement relative to alternative solutions?

What is likely to happen to the MFI if servicing arrangement doesn't work? What is likely to happen to the MFI if servicing arrangement does work? (short and long-term; financial and operational) How dependent is MFI's ongoing success likely to be linked to the proposed servicing arrangement?

SERVICE AGREEMENT PROVISIONS

INTRODUCTORY PROVISIONS

Contractual agreements often contain two types of introductory provisions - *recitals* (which are easy to spot because they are placed at the very beginning of the agreement and often start with the word "Whereas"), and *definitions* (which can be centralized in one section of the agreement (often called "Definitions") or, as is the case with this Guide, sprinkled throughout the body of the agreement and identifiable by the use of quotation marks, parenthetical and capitalized initial letters).

Recitals describe the general business understanding between the parties to the agreement, the purpose of the transaction, and, in some cases, provide background information about how the transaction came to pass. Recitals in service agreements are likely to describe the interest of the Partner Bank in advancing microcredits to microentrepreneurs, and the MFI's skill and experience in originating and servicing such microcredits. In some cases, these recitals will establish whether the servicing arrangement is founded on an exclusive or non-exclusive basis. The recitals also may describe (and possibly cap) the amount of funding that the Partner Bank is expected to provide for microcredits. Accordingly, for a MFI that is about to enter a service agreement containing introductory recitals, the MFI should confirm that the contents of these recitals accurately reflect its understanding of the background, operation, and purpose of the proposed servicing arrangement.

SAMPLE LANGUAGE—RECITALS

RECITALS:

Whereas, the [Partner Bank] is interested in funding up to [100%] of approved microcredits for a total outstanding principal loan balance of no more than [$XXX];

Whereas, the [MFI] has represented that it has the requisite skill, knowledge, experience and capacity to originate microcredits, assist the [Partner Bank] in verifying and evaluating credit applications made by poor or near poor microentrepreneurs to secure such loans, and to manage the debt collection of payments owed in respect of any and all microcredits the MFI originates under this Agreement; and

Whereas, …

Whereas, …

Now, therefore, in consideration of the conditions, premises and mutual agreements herein contained, the parties agree to enter into the following arrangement, which is intended to increase poor and near poor microentrepreneurs' access to financial services.

Definitions usually are used to avoid the repetition of wordy or complex terms, and to ensure consistency in the use of such terms throughout any document(s) where such terms are used. MFIs should <u>not</u>

presume that terms commonly used in the microfinance industry will be assigned the same common meaning in the service agreement. Indeed, it is very likely that these defined terms actually will be assigned a different meaning. See, for example, the sample language below, which purposefully distorts some of the common understandings of what constitutes a "Village Bank."

SAMPLE LANGUAGE—DEFINITIONS

DEFINITIONS:

"Village Bank" shall mean a group of at least 30 men and women who are living within an urban or rural community with household incomes at or below the poverty line, who have agreed to borrow as a group for the purpose of using such microcredits as working capital and consumer financing, and who have agreed to mutually guarantee all such group borrowings. For the purpose of this definition, it is understood that any single group borrowing shall not exceed [$XXX] in the aggregate unless formal collateral is pledged to secure such borrowing. It is also understood that the term of any microcredit made to such groups of men and women will not exceed 36 months.

FINANCIAL TERMS

There are at least four financial terms that are likely to be the subject of much negotiation in a servicing arrangement: (i) the terms under which the Partner Bank is willing to fund its agreed share of the microcredit portfolio, (ii) the financial terms of the microcredits being originated by the MFI for the Partner Bank, (iii) the terms under which the risks of the microcredit portfolio are allocated between the MFI and Partner Bank, and (iv) the terms under which revenue from these microcredits is shared between the MFI and Partner Bank.

FUNDING COMMITMENTS

The terms under which the Partner Bank is willing or required to fund the microcredit portfolio can vary significantly from deal to deal, and, like any condition precedent to disburse under a loan agreement, are likely to be highly negotiated. Four topics that will be at the forefront of any discussion of the Partner Bank's funding commitment are:

1. How much is the funding commitment,
2. When is this funding commitment triggered,
3. Under what conditions, if any, may the Partner Bank decide not to fulfill its funding commitment, and
4. What are the consequences, if any, of not performing on a funding commitment?

If the MFI has any funding commitments under the servicing arrangement, then the same questions would apply to it as well.

FINANCIAL TERMS OF THE MICROCREDITS

In some service agreements (or related documentation), the parties attempt to establish not only the rate of interest to be charged in connection with each microcredit, but also all other fees and other charges and the manner by which interest and any such fees and charges are to be calculated. These agreed microcredit financial terms also can include the maximum duration of the microcredit, and the minimum and maximum amount of any such microcredit.

RISK SHARING ARRANGEMENTS

The risk sharing arrangements described in service agreements are highly tailored to the particular transaction at hand. Although highly customized, risk sharing arrangements often address common questions in order to determine how to allocate risk between the two parties. At the heart of these risks sharing arrangements is a decision by the Partner Bank as to the maximum exposure amount it is willing to take with respect to the microcredits it funds. But the complicated answer to this simple question will be driven by a myriad of other details involving highly negotiated definitions of the covered risks, loan loss allocations, processes for sharing risk, debt collection responsibilities, and management of regulatory issues raised by the servicing arrangements, to name a few.

For example, one issue that is sure to be discussed among parties negotiating a service agreement is whether the MFI that originates the microcredits will assume any risk of nonpayment of those microcredits. A Partner Bank is likely to ask for some kind of risk sharing in order to ensure that the originating MFI has some "skin in the game," that is, to ensure that the MFI will have a financial interest in selecting microcredits that are likely to be repaid on time and in full. If the MFI agrees to assume some of this repayment risk, there are many issues left to discuss. One issue is whether the MFI will share in losses on a pro rata basis with the Partner Bank. Or whether the MFI will take a "first loss position." The financial consequences of these two options can be significant for both parties concerned so this is likely to be highly negotiated.

Look at the two very different financial consequences of a pro rata risk sharing arrangement versus a first loss risk sharing arrangement. Imagine a scenario where the MFI agrees to assume 20 percent of the risk of any

Risk Sharing Arrangements

What risks are covered (nonpayment of interest, principal, both), who bears, and at what point? (What if nonpayment is due to loss or delay by Bank and/or MFI in handling repayment made by customer?)

How are loan losses to be shared?

- Will the MFI assume any losses? If so, for what?
- Are losses from principal defaults allocated differently than losses arising from interest payment defaults?
- Will the MFI assume any first loss position (and if so, for how much)?
- How will subsequent losses (after the first losses) be shared between the MFI and Partner Bank?

What is the process for risk allocation? (Can the Bank sell all or part of its interest in defaulting microcredits to MFI? If so, is the MFI contractually obligated to purchase all such impaired microcredits–price, timing, amount? What customer/borrower consents, if any, are required by local law to facilitate a sale of microcredits?)

Who is responsible for debt collection? How are related costs (and related recoveries) of debt collection to be allocated between the MFI and Partner Bank?

How do bank regulatory requirements (such as bad loan reserve requirements) shape these risk sharing arrangements if at all?

What are the tax implications and accounting implications of risk sharing arrangements?

What kind of record-keeping of risk sharing arrangements is required by the Bank and MFI to satisfy regulatory authorities (bank and tax), auditors, accountants, and other stakeholders?

microcredit it originates. (So for every $100 of microcredits, the MFI has $20 of credit exposure.) In scenario one, the MFI has agreed to assume, on a first loss basis, all losses up to this 20 percent limit. Under this scenario one, if a micro entrepreneur fails to make a $20 payment on its $100 microcredit, the MFI will assume the entire amount of this loss, and the Partner Bank will be insulated from taking any loss until (or if) the microentrepreneur defaults on the remaining $80 of the microcredit. In scenario two, the MFI has agreed to share losses with the Partner Bank on a pro rata basis up to this 20 percent limit. Under scenario two, if the same microentrepreneur fails to make a $20 payment on its $100 microcredit, the MFI will assume $10 of the loss and the Partner Bank will assume the remaining $10 of loss. This sharing of loss will continue until/if the microentrepreneur defaults on over $40 of the microcredit (at which point the MFI's ceiling of risk sharing of $20 will kick in (and the Partner Bank will assume all remaining credit risk of the defaulting microentrepreneur). Imagine these two scenarios played out over a large microcredit portfolio of, say, $20,000,000 and suddenly these risk sharing arrangements, which share the same goal of sharing risk 20/80 but use different processes for allocating the timing and apportioning of this shared risk, and it is clear that the two scenarios pose significantly different financial issues for a MFI, not only in respect of its credit exposure, but also with respect to its cash flows, reserve provisions, etc.

REVENUE SHARING ARRANGEMENTS

The revenue sharing arrangements found in service agreements are similarly tailored to particular transactions. As a general rule, revenue sharing arrangements should reflect the allocation of risk as agreed by the parties. So, for example, in principle the party that is funding 90% of the microcredit portfolio should enjoy 90% of the revenue from that portfolio. This simple concept can be complicated, however, by the introduction of first loss positions and other credit enhancements that may be provided, directly or indirectly, by the MFI.

Revenue Sharing Arrangements

- What revenue is shared (interest, penalty interest, fees, other)? And how is revenue to be allocated between the Bank and MFI?
- To what extent, if any, can the Bank or MFI "cross-sell" other financial services to the customer base being served by servicing arrangements without subjecting revenue generated from such "cross-sells" to these revenue sharing arrangements?
- What are the tax and accounting implications of the revenue sharing arrangements? (Do deductible business expenses track revenue generation?)
- What kind of record-keeping of revenue sharing arrangements is required by the Bank and MFI to satisfy regulatory authorities (bank and tax), auditors, accountants, and other stakeholders?

REPRESENTATIONS AND WARRANTIES

Representations and warranties are found in nearly every kind of financing documentation–debt and equity. The purpose of representations and warranties is to offer assurances to lenders and investors that the legal, financial and regulatory affairs of all key parties, particularly the borrower or investee, are in order before any loan is disbursed or investment is made.

Not surprisingly, parties with a funding commitment, such as the Partner Bank in the context of a servicing arrangement, are most likely to demand that customary representations and warranties are made by the parties prior to the disbursement or investment of any funds. However, in a transaction, like a servicing arrangement that depends so heavily on each party's legal, financial and operational capacity to perform its respective obligations, both parties–the MFI and the Partner Bank - may be required to offer customary representations and warranties irrespective of the existence of any funding commitments.

Any MFI asked to give representations and warranties should consult with counsel to ensure that it is able to make accurate statements as to the facts articulated in these provisions. Failure to provide accurate representations and warranties might give the Partner Bank reason to withhold funding for microcredits and, thus, could jeopardize the entire servicing arrangement.

Another drafting concern that arises in this context is the question of how often such representations and warranties should be made. From the point of view of the party giving the representations and warranties, the less often representations and warranties are to be made the better, for this provides fewer opportunities for the party to make an inadvertent material misstatement.

The following are examples of some of the representations and warranties that might be asked of a MFI and Partner Bank in a service agreement. These are nearly identical to many of those that would be asked of a borrower under a commercial loan agreement.[8]

SAMPLE LANGUAGE

Representations and Warranties. Each party hereto [the MFI and Partner Bank] hereby represents and warrants, as of [the date of this agreement], that:

(a) Organization. It is a company duly organized and validly existing under the law of [the country in which it is incorporated] and has the power and authority to own its property, to conduct its business as currently conducted, and to consummate the transactions contemplated in this Agreement.

(b) Authorization. It has taken all necessary action to authorize the execution and delivery of this Agreement and all other documents to be executed and delivered by it in connection with this Agreement, the performance of its obligations under this Agreement, and the consummation of the transactions contemplated in this Agreement.

(c) Legal, Valid and Binding. This Agreement has been duly executed and delivered by the parties and constitutes a legal, valid and binding obligation of the parties, enforceable against them in accordance with the terms thereof.

(d) Governmental Authorizations. All governmental authorizations and actions of any kind necessary to authorize this transaction or required for the validity or enforceability against the parties of this Agreement have been obtained or performed and are valid and subsisting in full force and effect.

(e) No Actions. There are no actions, proceedings or claims pending or, to the knowledge of the parties, threatened, the adverse determination of which might have a materially adverse effect on the financial condition of the parties or impair their ability to perform their obligations under, or affect the validity or enforceability of, this Agreement.

[8] See "Commercial Loan Agreements: A Technical Guide for Microfinance Institutions," (prepared for CGAP by Cleary, Gottlieb, Steen & Hamilton (2006)), which provides these and many other standard representations and warranties found in loan agreements, together with useful drafting tips. (This technical guide has been translated into several languages and is downloadable from the CGAP website, www.cgap.org.)

COVENANTS

While representations and warranties address the question of whether each of the parties currently is prepared to consummate the proposed servicing arrangements, covenants address the party's future capacity to continue to meet its duties and obligations under the service agreement. Covenants can be affirmative (promises to perform certain undertakings) or negative (promises to refrain from taking certain actions).

Examples of mutual, affirmative covenants that are sometimes found in service agreements include promises by both parties to:

- Develop a joint marketing plan and promotion policy for the delivery of microcredits;
- Meet their respective duties, obligations and functions as set out in the service agreement, and such other duties as the parties may agree in writing from time to time; and
- Act prudently in accordance with the terms of the service agreement and to exercise due diligence in carrying out their duties and obligations under the service agreement.

Examples of mutual, negative covenants that are sometimes found in service agreements include promises by both parties not to:

- Use each other's name or logo for any purpose, unless specifically authorized in writing by the other party; or
- Disclose (or permit any employee to disclose) to any third party confidential information concerning the business of each party.

Of course service agreements also will provide for covenants that are not mutual but rather are tailored to reflect the varying duties and responsibilities of each of the parties. Examples of some of these more party-specific covenants can include promises by the MFI acting in its service agent role to:

- Ensure, on a best efforts basis, that the target clientele covered under the service agreement shall access finance only from the Partner Bank;[9]
- Cause all employees of the MFI to conduct themselves within the parameters of the law, and assume all liability should such employees commit or abet an illegal act;
- Certify each microfinance borrower as fit for funding by the Partner Bank;
- Implement MIS systems on a decentralized basis for maintaining and monitoring the outstanding microcredit portfolio funded by the Partner Bank;
- Provide monthly reports to the Partner Bank on the status of the microcredit portfolio funded by the Partner Bank and allow the Partner Bank to have visitation rights to the MFI's offices; and
- Ensure that all microfinance borrowers execute all appropriate loan documentation as agreed with the Partner Bank.

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[9] This type of covenant should be found only in service agreements that provide the Partner Bank with some degree of exclusive rights to fund microcredit's loans originated by the MFI. If the service agreement provides for a non-exclusive arrangement, then such a covenant would be inappropriate.

In addition to these more service agreement-oriented covenants, the parties also may agree to more standard covenants such as those that closely resemble the representations and warranties described above. This can include the following promises, for example.

SAMPLE LANGUAGE

Covenants. Each party hereto commits to:

(a) Obtain, make and keep in full force and effect all authorizations from and registrations with governmental authorities that may be required for the validity or enforceability against the party of this Agreement;

(b) Maintain its good standing and valid existence under the law of [the country in which it is incorporated];

(c) Give prompt notice to the other party of each event that has or might have a materially adverse affect on its ability to perform its obligations under this Agreement;

(d) ….

Key to negotiating any covenant should be the twin goal of preserving flexibility for the MFI while allowing the MFI to engage, as much as possible, in its normal business practices. So, for example, MFIs likely will want to try to assume only those duties, functions and responsibilities that are closely aligned with their existing methods of identifying, training, managing, and tracking microfinance borrowers.

WARNING! After a service agreement is executed, it is always possible for a MFI to request an amendment or waiver of an overly restrictive covenant. This request, however, might be treated by its Partner Bank as an opportunity to revise, in its favor, the revenue sharing arrangements or to impose other charges or reciprocal concessions on the requesting MFI in return for the applicable Partner Bank's favorable response to the requested waiver.

TERMINATION/EXPIRATION PROVISIONS

Loan agreements come to a natural conclusion with the repayment of all amounts due and owed to the lender. By contrast, it is much harder to forecast the expiration of a service agreement.

The right to terminate a service agreement and its related linkage arrangement is usually a mutual right enjoyed by both parties. Typically, either party has the right to terminate the Service Agreement if the other party's performances of its responsibilities are unsatisfactory. In some cases, the service agreement will provide that a party may terminate the agreement if:

a) Any representations or warranties made by the other party prove to be false or incorrect in any material respect;

b) The other party fails to observe or perform any covenant or obligation under the service agreement; or

c) Extraordinary circumstances make it improbable that the parties (or a party) shall fulfill the obligations specified in the service agreement.

In some transactions, service agreements require prior written notice to be given by the requesting party before a termination goes into effect. In other transactions, service agreements allow the party to call for the immediate termination of the agreements without the giving of notice, provided that such termination is with cause (for example, one of the above three trigger events has occurred).

Irrespective of why a termination takes place, service agreements typically will provide guidance and direction for how the duties and obligations of the parties under the service agreement should be unwound. This is easier said than done and so service agreements can take different approaches to addressing this issue.

Often service agreements provide that the party who was been responsible for servicing and collecting payments owed in respect of the microcredits will remain in place throughout the life of those microcredits, notwithstanding any termination of the service agreement. This approach attempts to ensure that the servicing and debt collection processes for outstanding microcredits remain intact beyond the term of the service agreement, thereby maximizing for the Partner Bank (and, to the extent that losses are shared, for the MFI too) the recovery of all amounts outstanding under the microcredits still remaining on the books of the Partner Bank.

Termination Procedures

- What are the procedures for terminating servicing arrangements–notice requirements, with or without cause, mutual or individual?
- What are causes for termination without notice? Failure by a party to perform significant covenant, obligation or undertaking? Material misrepresentation by a party? Other?
- Is there a “run-off” or unwinding period once termination notice is given? If so, what are responsibilities of the Bank and MFI during this period? If not, what are responsibilities of the Bank and MFI for immediately terminating arrangement?
- What are financial implications (risk sharing, revenue sharing, costs sharing) during termination process?

ATTACHMENT A: SAMPLE FORM OF TERM SHEET FOR A SERVICE AGREEMENT

Parties: [XXX Microfinance Institution, as Servicing Agent]

[XXX Commercial Bank, as Partner Bank]

Purpose of Service Agreement:

Maximum Aggregate Amount of Partner Bank's Funding Commitment:

Microcredit Lending Terms:

a) Minimum/maximum principal amount per microfinance borrower
b) Interest rate:
c) Other fees and charges:
d) Maximum term:
e) Collateral (informal or formal) required, if any:
f) Other?

Underwriting Criteria:

a) Microfinance Borrower eligibility: [gender, age, geographic distribution, poverty level, meets "know your customer (KYC)" rules, other?]
b) Use of microcredits: [working capital, consumer finances, other?]
c) Other criteria?

Risk Sharing Arrangements:

Revenue Sharing Arrangements:

Covenants/Undertakings of MFI/Servicing Agent:

Covenants/Undertakings of Partner Bank:

Marketing Restrictions and Cost Sharing:

Indemnifications:

Confidentiality Requirements:

Non-solicitation of Employees:

Exclusivity [or Non-exclusivity]:

Expiration/Termination Date and Wind-up Procedures:

Governing Law:

Submission to Jurisdiction:

Dispute Resolution Procedures and Forum:

Miscellaneous (customary representations and warranties, notice requirements, amendments and waivers, assignability of interests, etc.):

ATTACHMENT B: CHECKLIST OF QUESTIONS FOR MFIS CONTEMPLATING FUNDING PARTNERSHIPS/SERVICING ARRANGEMENTS WITH COMMERCIAL BANKS

WHY LINK? (IS A SERVICING ARRANGEMENT THE BEST ALTERNATIVE FOR MFI?)

How important is proposed servicing arrangement to MFI's overall success/mission? Does it support the MFI's strategy and vision? In the short-term? In the long-term?

> What are the cost implications of linking? What are the likely savings and costs (financial, human, operational, and other) to the MFI of linking with a commercial bank for proposed services (funding or otherwise) compared to developing the proposed Bank services in-house?
>
> What are the likely tax consequences of proposed servicing arrangement? (to MFI, to Partner Bank)

What is the alternative (next best solution) to proposed servicing arrangement? What is the "value-add" of the proposed servicing arrangement relative to alternative solutions?

What is likely to happen to MFI if servicing arrangement doesn't work? What is likely to happen to MFI if servicing arrangement does work? (short and long-term; financial and operational) How dependent is MFI's ongoing success likely to be linked to the proposed servicing arrangement?

WHEN TO LINK? (IS THE MFI READY TO ENGAGE IN A SERVICING ARRANGEMENT?)

What are the current legal and operational authorizations and capacities of MFI?

- Does MFI have sufficient legal authority to conduct business activity contemplated by servicing arrangement?
- Does MFI have sufficient operational capacity to conduct business activity contemplated by servicing arrangement?
- (MIS, Human Resources, Management Expertise and Capacity, Funding, Track Record in related activities, Branch Network, other?)

What are the current human resource/managerial capacity of MFI?

- Who within the MFI needs to be involved to make servicing arrangement work?
- Who within the MFI wants to be involved? Who within MFI has time to be involved? (Any disconnect between the three?)

Where is leadership housed within the MFI to support servicing arrangements? Who has ultimate authority to approve servicing arrangement? Who has ultimate authority to determine whether to extend or terminate servicing arrangement?

Does MFI have suitable talent and expertise to engage in?

- Finding Bank partner?
- Negotiating business terms of servicing arrangement with Bank?
- Managing ongoing relationship with Bank?
- Evaluating success of servicing arrangement?

Does MFI have competent legal counsel and other external advisors (as appropriate) to represent/support it in negotiation and documentation of servicing arrangement?

Does MFI have any pre-existing contractual relationships (with donors, investors, lenders, others) that will be impacted by or possibly shape scope or nature of proposed servicing arrangement? If so, how will these relationships be managed (who, when, how)?

WHO TO LINK WITH? (WHICH COMMERCIAL BANK (OR BANKS) IS BEST FOR THE PROPOSED SERVICING ARRANGEMENT?)

What are Bank's likely motivations for entering into proposed servicing arrangement?

- Why "does" Bank think it needs MFI? Why "should" Bank think it needs MFI? (Any disconnect between the two?)
- What is relative strength and weakness of Bank with respect to proposed servicing arrangement? What is relative strength and weakness of MFI with respect to proposed servicing arrangement? (Where is there overlap?)
- How and when is Bank likely to evaluate success of servicing arrangement? What are the most important criteria? Who within the Bank will evaluate the success of the servicing arrangement?
- What are the Bank's expectations for the servicing arrangement (duration, exit strategy, success, etc.)? Are these likely to change and, if so, what would be triggering events? Where do the Bank's expectations match the MFI's expectations? Where are there mismatches of expectations?

What are the legal and operational authorizations and capacities of Bank?

- What is the Bank's legal authority to conduct business activity contemplated by linkage arrangement?
- What limitations, if any, will bank regulators impose on servicing arrangement (e.g. require Bank to review and approve issuance of microcredits, apply additional reserve requirements to funding

provided by Bank, impose constraints on MFI operations, limit type of product offered to customers under servicing arrangement, require Bank to demonstrate compliance with "know your customer" rules, other?)

- What is Bank's operational capacity to conduct business activity contemplated by servicing arrangement?
- (MIS, Human Resources, Management Expertise and Capacity, Funding, Track Record in related activities, Branch Network, other?)

What human resources and managerial support of Bank are being mobilized to support the servicing arrangement?

- Has Bank fully "costed out" nonfinancial expenses it will incur in undertaking the servicing arrangement?
- Does the Bank have sufficient buy-in or support from those who will be involved in the servicing arrangement? Who within the Bank needs to be involved to make servicing arrangement work? Who within Bank wants to be involved? (Any disconnect between the two?)
- Where is leadership housed within Bank to support servicing arrangement?
- Who within Bank will negotiate terms of servicing arrangement with MFI?
- Who within Bank will manage servicing arrangement once put in place?
  - Managing ongoing relationship with MFI?
  - Evaluating success of servicing arrangement?
  - Determining to extend or terminate servicing arrangement?

HOW TO LINK? (WHAT MIGHT BE INCLUDED IN DEFINING THE DUTIES, OBLIGATIONS AND FUNCTIONS OF THE PARTIES TO A SERVICING ARRANGEMENT?)

PURPOSE OF LINKAGE:

Defining overall objectives of servicing arrangement

NATURE OF LINKAGE:

- Defining market segment to be served and products to be offered: (Who, where, what, how?)
  - Microfinance customer eligibility: Who is target customer–nationality, age limits, location, level of poverty, gender, type of business, other?
  - Products/types of loans: Working capital, housing or home improvement, personal, consumer financing, fixed assets, other? (Any other products–savings, insurance, other?)
  - Financial and other terms of products/loans: Size, pricing, duration, other?
  - Underwriting criteria: Who applies criteria? What is included in criteria?

- Cash flow of customer?
- Available credit enhancements?
- Existing level of indebtedness?
- Credit history?
- Business experience?
- Other?

- Defining role and composition of "credit" committee: What respective roles do Bank and MFI play? How are decisions made? Unanimous consent required? Any bank regulatory requirements that are likely to shape role, veto authority, and composition of credit committee?
- Defining risk/revenue share: Is risk allocation aligned with revenue sharing arrangements?

DURATION AND EVALUATION OF SERVICING ARRANGEMENTS:

- What duration (short, medium or long) most benefits the MFI?

Factors to consider:

- How long is current arrangement likely to be favorable/acceptable to MFI?
- What performance benchmarks might trigger systematic re-evaluation of servicing arrangement (and negotiation of terms more favorable to MFI)?
- Does MFI have opportunity to conduct "competitive servicing arrangement" with another Bank that could be used as leverage in renegotiating terms of this servicing arrangement?
- How dependent is MFI on existence of servicing arrangement? (How comfortable is MFI with that dependency?)

Funding Arrangements:

- What is the funding commitment of Bank? Of the MFI, if any?
  - How much and when?
- Under what conditions, if any, may the Bank or the MFI not fund its commitment?
  - Poor debt collection or recovery rates
  - Significant deterioration of microcredit portfolio
  - Use of improper loan documentation for microcredits
  - Inappropriate or abusive marketing or debt collection practices
  - Significant delays in providing required reports
  - Other?

- What are the consequences, if any, of not performing on funding commitments if for reasons other than those elaborated above?

Risk Sharing Arrangements

- What risks are covered (nonpayment of interest, principal, both), who bears, and at what point?
  - What if nonpayment is due to loss or delay by Bank and/or MFI in handling repayment made by customer?
- How are loan losses shared?
  - Are losses from principal default allocated differently than losses arising from interest payment defaults?
- What is process for risk allocation?
  - Can Bank sell all or part of its interest in defaulting microcredits to MFI? If so, is MFI contractually obligated to purchase all such impaired microcredits–price, timing, and amount?
  - Are there any conditions under which MFI is not required to purchase impaired microcredits—e.g. where nonperformance is due to political risk (e.g. war, insurrection, civil strife) or acts of God (natural disasters), etc.?
  - What customer/borrower approvals, if any, are required by local law to facilitate a sale of microcredits to the MFI?
- Who is responsible for debt collection?
- How are related costs (and related recoveries) of debt collection to be allocated?
  - Are these costs (and recoveries, if any) to be shared between Bank and MFI?
  - If so, how much and at what point?
  - Are there any limits to amount of debt collection costs that can be incurred (and shared)?
- How do bank regulatory requirements (such as bad loan reserve requirements) shape these risk sharing arrangements if at all?
  - Who bears costs of bank regulatory compliance?
- What are tax implications and accounting implications of risk sharing arrangements?
  - Which losses and debt collection costs, if any, is tax deductible?
  - By whom–Bank or MFI?
  - How are sales of impaired loans between Bank and MFI treated for tax and accounting purposes?
  - How is cost sharing treated?
- What kind of record-keeping of risk sharing arrangements is required by Bank and MFI to satisfy regulatory authorities (bank and tax), auditors, accountants, and other stakeholders?

Revenue Sharing Arrangements

- What revenue is shared (interest, penalty interest, fees, other)?
  - And how is revenue to be allocated between Bank and MFI?
- To what extent, if any, can the Bank or MFI "cross-sell" other financial services to customer base being served by linkage arrangements without subjecting revenue generated from such "cross-sells" to these revenue sharing arrangements?
- What are tax and accounting implications of revenue sharing arrangements?
  - Do deductible business expenses track revenue generation?
- What kind of record-keeping of revenue sharing arrangements is required by Bank and MFI to satisfy regulatory authorities (bank and tax), auditors, accountants, and other stakeholders?

LENDING PROCESSES AND RESPONSIBILITIES

General:

- What requirements, if any, are there on the maintenance of branch networks of the Bank and/or MFI to facilitate lending arrangements?
  - Any requirement to obtain other party's consent before a branch closure of MFI or of Bank?
- What requirements, if any, are there to maintain existing operations, processes and controls?
  - Any requirement to obtain other party's consent to make material change in operations?
- Any additional training/experience required for staff of Bank and/or MFI engaged in servicing arrangement?
- What reporting requirements are agreed by the parties in respect of monitoring amount and quality of products/services sold in connection with servicing arrangement?
  - Frequency of report
  - Scope of report
  - Verification by outside auditors

Loan Originations (need to define respective roles of Bank and MFI):

- How are loan applications to be processed, what information is required for application, who is responsible for ensuring that complete applications are submitted, who is responsible for verifying information on application, etc?
- What kind of credit review is being conducted?
  - By whom–Bank and/or MFI or Credit Committee?
  - Within what period of time should a credit decision to be made?
- Who manages documentation and execution of loan agreement–Bank or MFI?

- Are there any requirements/standards for loan documentation (including any credit enhancements) to be met?
- Other?

Loan Servicing: (need to define respective roles of Bank and MFI):

- When are payments due and who is responsible for collecting?
- Who manages books to track borrowers' payments?
  - What processes/procedures/systems are to be used in such tracking?
- Who develops reports (frequency and content) regarding performance of individual loans, overall portfolio, delinquencies, defaults, etc?
  - Who receives such reports?
- Who receives and responds to customer complaints?
  - Is Bank or MFI subject to any formal or informal consumer protection regulation?
  - If so, how will such requirements impact propose servicing arrangement?

Debt Collection Procedures: (need to define respective roles of Bank and MFI):

- Who undertakes?
- What is notification procedure to customer?
- What are permissible enforcement actions and when can such actions is resorted to?
- If agents are used as debt collectors, what are rules of engagement for such agents?
- Who monitors and responds to customer complaints regarding alleged inappropriate debt collection practices?
- How are costs of debt collection shared between Bank and MFI?

TERMINATION; UNWINDING PROCEDURES

- What are procedures for terminating servicing arrangements–notice requirements, with or without cause, mutual or individual?
- What are causes for termination without notice? Failure by a party to perform significant covenant, obligation or undertaking? Material misrepresentation by a party? Other?
- Is there a "run-off" or unwinding period once termination notice is given?
  - If so, what are responsibilities of Bank and MFI during this period?
  - If not, what are responsibilities of Bank and MFI for immediately terminating arrangement?
- What are financial implications (risk sharing, revenue sharing, costs sharing) during termination process?

OTHER

Marketing:

- What is intended purpose of marketing (how is linkage being presented–or not–to outside world)?
- What limitations are there on use of each other's logo or name in marketing materials?
- What consents, if any, are required of Bank and MFI of content of each other's marketing materials?
- Who pays for marketing and product promotion arising out of servicing arrangements?
- Are any marketing costs shared between Bank and MFI?
  - If so, how allocated?
    - Any caps on amounts?

Indemnification:

- Are Bank and MFI willing to indemnify the other for losses due to the misconduct/criminal actions of their respective employees?
  - Is this indemnity mutual or is it one-sided (e.g. indemnity only goes from MFI to Bank and not vice versa)?

Employees:

- When employees of Bank or MFI are located at other's physical premises, what liability, if any, do Bank and MFI assume for health and welfare of other's employees–e.g. bodily injury, etc.?
  - Does local law impose any further liability beyond what has been agreed contractually between the parties?
- What are the parties' responsibilities for handling termination/firing of employees to protect servicing arrangements and related proprietary information?

Confidentiality:

- To whom does confidentiality provision apply?
- What information is protected?
- For how long?
- Do requirements of confidentiality provision apply equally to Bank and MFI?

Bank Secrecy:

- Does Bank operate under any bank secrecy legal requirements?
  - If so, how does the bank secrecy law impact the proposed servicing arrangement?
- Does microcredit documentation need to be amended to permit sharing of customer information among parties to servicing arrangement?

- Do employees of Bank and MFI need to pledge to abide by bank secrecy legal requirements?
  - What are legal penalties of a violation?

Anti-Money Laundering/Anti-Terrorist Financing:

- Are the Bank and/or MFI subject to any anti-money laundering/ anti-terrorist financing legal requirements?
  - If so, how does such requirements impact propose servicing arrangement?
  - How will compliance with such requirements be enforced (and recorded/demonstrated to regulators)?

Non-solicitation of employees:

- Are there to be any limitations on Bank or MFI's hiring of each other's staff during the servicing arrangement and for a to-be-determined period afterwards?
- Any possibility of a waiver, if parties consent?
  - Need written permission?

Non-exclusivity:

- Can MFI engage in similar servicing arrangements with other Banks?
- Can Bank engage in similar servicing arrangements with other MFIs?
  - If not, what are the programmatic and geographic restrictions and duration?

Audit:

- Does either party have a right to call for an audit of the other party with respect to performance of obligations under the servicing arrangement (for example, to assess revenue stream, or cost-sharing, or evaluate quality of microcredit portfolio)?
- Or are audit reports routinely required as part of arrangement?

Modification:

- Are there any provisions that would require only one party (either the MFI or Bank) to agree for a modification to be effective or are all modifications to be agreed by both parties?

Dispute Resolution:

- What are appropriate choices of governing law, process and forum (court or arbitration) for dispute resolution between the Bank and MFI arising out of the servicing arrangement?

ATTACHMENT C: ROLE OF COUNSEL: WHY AND HOW TO ENGAGE LEGAL COUNSEL

Some MFIs may choose to consult outside legal counsel to represent them when negotiating servicing arrangements with Partner Banks. While the costs of retaining a lawyer to advise a MFI in the negotiation of the terms of a servicing arrangement as memorialized in the Term Sheet (and the drafting of the related Service Agreement) may seem like a large, initial investment that increases the overall costs of the arrangement for the MFI, retention of good legal counsel often can be a very worthwhile investment for the MFI over the medium to long term.

Key Initial Questions to Ask Local Counsel

1. What country (or state/region)'s law is likely to govern the servicing arrangement? Is legal counsel competent and in good standing to give advice on matters arising under this law?
2. Which areas of expertise does legal counsel have (or have ready access to):

Corporations Law, Contracts Law, Banking Law, Tax Law, or Not-for-Profit/Charitable Law (if MFI is organized as a not-for-profit), other?

3. Is legal counsel comfortable with giving an enforceability opinion with respect to the transactions contemplated by the Service Agreement? If so, what kinds of qualifications does it typically make in such opinions? (This will be relevant if the Partner Bank requires the MFI to give an opinion of counsel regarding the validity and enforceability of the MFI's obligations under the Service Agreement.)
4. Does legal counsel have any dealings with the Partner Bank that might present a conflict of interest (or appearance of a conflict) in its representation of the MFI?
5. What are legal counsel's fee and billing arrangements? To what extent (and at what rates) are reimbursable expenses of counsel billed to clients (photocopying, word processing, delivery services, travel, phone calls, other?) Note: Some law firms view these services as profit centers and charge for these services accordingly.

HIRING COUNSEL

Hiring the "right" legal counsel is the first step. Given the variety of laws and regulations that are likely to impact the structure of a servicing arrangement, such as contract law, tax law and banking law, it is important to make sure that legal counsel is competent to give legal advice (or solicit advice from others more expert) in all laws and regulations that are pertinent to the servicing arrangement. It also is important to make sure that legal counsel does not have any conflicts of interest that could jeopardize or impair its ability to give the MFI impartial advice.

For example, when interviewing prospective legal counsel, the MFI should ascertain whether this counsel has represented (or currently represents) the proposed Partner Bank in any other transactions or capacity. Such representation may not necessarily disqualify counsel from advising the MFI on its servicing transaction with the Partner Bank. However, if counsel has represented (or is representing) the Partner Bank in other transactions, the MFI should discuss with its counsel what steps counsel is taking to minimize the likelihood of any conflict of interest.

EMPOWERING COUNSEL

Once legal counsel is hired, it is the MFI's responsibility to make sure that its counsel understands the MFI's business objectives and, equally important, any concerns that the MFI may have about the proposed servicing arrangement. This knowledge should help its legal counsel to spot issues in the draft Service Agreement (or other related documentation) that may be inconsistent with the MFI's business goals and, where necessary, to propose solutions for addressing the MFI's concerns about the servicing arrangement. In short, the MFI that decides to hire outside legal counsel will likely need to make a sizeable financial and time investment in its counsel in order to ensure that its counsel is empowered to represent the MFI's interests well in its negotiations with the Partner Bank. This is an investment, however, that can have a lasting impact and help to level the playing field, at least in part, during initial negotiations between the MFI and its prospective Partner Bank.

SOLICITING ONGOING ADVICE OF COUNSEL

A last but critical role of legal counsel is to continue to advise the MFI of the parties' respective duties and obligations under the Service Agreement during the life of the servicing arrangement. It should be obvious that counsel that has been at the table throughout the negotiation of the servicing arrangement will be much more able to perform this ongoing advisory role than counsel that is brought in to advise the MFI long after the negotiations have been completed and the Service Agreement has been executed.

As well intentioned as parties to a servicing arrangement may be, such a partnership can go badly awry. Having legal counsel ready to support and advise the MFI's management about the MFI's contractual obligations and duties can help to avoid any inadvertent missteps by the MFI and also to protect the MFI from inappropriate conduct by its Partner Bank.

Finally, should the parties decide to extend the servicing arrangement, involving the same legal counsel as used in negotiating the initial transaction should help the MFI negotiate more favorable terms going forward since such counsel presumably will understand the objectives and concerns of both parties to the transaction given his/her participation in the original negotiations.