Women's World Banking

Women's World Banking Capital Markets Guide for Microfinance Institutions (MFIs)

November 2006

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- **Women's World Banking** is a leading non-profit microfinance organization that works to expand the assets, participation and power of low-income women and their families by opening their access to financial services and information. WWB's global team based in New York City, works hand-in-hand with the WWB network of over 50 microfinance partners to help low-income women start small, sustainable businesses to escape poverty. The WWB network reaches close to 23 million clients in more than 30 countries.

- **Lehman Brothers**, an innovator in global finance, serves the financial needs of corporations, governments and municipalities, institutional clients, and high net worth individuals worldwide. Founded in 1850, Lehman Brothers maintains leadership positions in equity and fixed income sales, trading and research, investment banking, private investment management, asset management and private equity. The Firm is headquartered in New York, with regional headquarters in London and Tokyo, and operates in a network of offices around the world.

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WWB's Financial Management Publications Series

Women's World Banking

- Recognizing the growth potential of successfully managed microfinance institutions (MFIs), Women's World Banking has developed tools and trainings to help MFIs build sophisticated financial management structures and systems vital to tapping new forms of capital and negotiating better financing terms.

- WWB's leadership in this area is reflected in additional publications and tools in its Financial Management Series, including:
  - Foreign Exchange Risk Management in Microfinance
  - Strategies for Financial Integration: Access to Commercial Debt
  - Toolkit for Developing a Financial Risk Management Policy
  - e-Course: Developing and Using Financial Risk Management Tools

- These and other microfinance publications and tools can be found at WWB's website: www.womensworldbanking.org.

Introduction

- **Objective:** This guide aims to provide microfinance institution (MFI) general managers, finance managers, and other important decision-makers with an overview of the capital markets. As the capital markets in emerging economies deepen, MFIs are increasingly able to access them. This access enables MFIs to diversify funding sources, reduce FX risk (via sources of local, rather than foreign, capital), and support growth and loan product diversification (ex: housing loans) through longer-term funding. In addition, capital market access increases public awareness of microfinance and MFIs, and results in capacity building of MFIs as they adapt to satisfy the demands of the capital markets for greater transparency.

- **Background:** Understanding the capital markets—how they work, the main players, the instruments available, how to screen financial advisers and investment banks, and how to prepare and access these markets—is critical for MFIs that are interested in expanding and diversifying their client product offerings. With the objective of helping MFIs develop a vision of accessing the capital markets and understanding the elements above, Women's World Banking (WWB) has managed annual workshops on capital markets. As MFIs increasingly expand their access to various capital markets instruments (including recent MFI transactions of bonds, CDOs, securitizations, FX hedges), WWB identified the need to develop a basic guide to assist MFI managers in understanding and distinguishing between these market offerings. The attached guide was developed in partnership with Lehman Brothers, a leading investment bank with significant capital markets expertise, as part of the Firm's Community Service program. The hope is that MFIs will develop a solid grounding in these concepts and seek opportunities to tap their capital markets locally, or internationally.

- **Structure:** The guide provides an overview of the capital markets and includes basic insights into the key capital markets players, instruments, private versus public issues and the rating process. It also contains a checklist for screening investment bank or financial advisers, advice on packaging the institution's success for raters and investors and numerous appendices which expand upon these core concepts and instruments.

Section 1

Introduction to Capital Markets

Capital Markets Introduction

What are Capital Markets?

- Markets where financial instruments such as debt (financial borrowings) or equity (ownership interests in corporations) are bought and sold
- Includes both primary offerings (securities issued for the first time to investors) and secondary offerings (resale of securities already issued)
- Participants include issuing firms, governments and municipalities, institutional & retail investors, broker-dealers and banks
- Generally regulated by local regulatory authority such as the U.S. Securities and Exchange Commission (SEC), Financial Services Authority (FSA, U.K), Securities and Exchange Board of India (SEBI), Comissão de Valores Mobiliários (CVM, Brazil) and Comisión Nacional Bancaria y de Valores (CNBV, Mexico)

Examples of the Size of Key Markets:

	Outstanding Domestic Debt (USD)[1]		Equity Market Cap (USD)[2]
US	20,311B Total	14,386B Non-Government	15,364B
Japan	8,371B Total	1,766 Non-Government	4,504B
Brazil	523B Total	113B Non-Government	533B
India	279B Total	11B Non-Government	583B
Malaysia	124B Total	72B Non-Government	189B
Indonesia	50B Total	6B Non-Government	96.5B

1. As of December 2005
2. As of end of July 16 2006

Capital Markets Introduction

Advantages of Capital Markets Access for Issuers

- What Capital Markets offer
- Diversification of funding through new capital sources
- Access to large sources of funds
- Financing rates that may be more favorable than those available through bank loans, private funding, or other sources of capital.
- Longer tenors than are usually available from banks and many specialized investors
- Advertising to a large audience and boosting the issuer's image
- Valuable information about the market's perception of the appropriateness of a certain course of action by the issuer through movements in security prices (if there is an active secondary market, which is not the case in many local emerging markets)

Disadvantages of Capital Markets Access for Issuers

- Need to demonstrate accountability to outside investors, requiring additional relationship and transactional management attention
- Potential restrictions on use of funding (bond covenants)
- Greater transparency requirements which means increased reporting
- Potentially high administrative costs

Section 2

Basic Requirements for Accessing the Capital Markets

Capital Markets: Definitions

- **Auditor**
  - Accounting firm that examines and verifies a company's financial records and supporting documents against local accounting standards and procedures and confirms that MFI is in compliance with such procedures
- **Comfort letter**
  - Auditor's statement provided to a company preparing for a public offering of securities, confirming that financial data in the prospectus follows financial reporting guidelines.
- **Issuer**
  - A legal entity that develops, registers and sells securities for the purpose of financing its operations. Issuers may be governments, corporations, investment trusts or other legal entities such as NGOs (where permitted)
- **Primary offering**
  - Defined as making a new securities issue available to the public through an underwriting. After the original issue, trading in these securities between investors takes place in the secondary market.
- **Prospectus** *
  - A legal document offering securities for sale that explains the offer, including the terms, issuer, planned use of the funds, historical financial statements, and other information that could help an investor decide whether the investment is appropriate. The initial version of the prospectus produced before pricing of the securities is also called a red herring. The final prospectus includes the final terms and pricing information of the issue.
- **Roadshow** *
  - A series of meetings with potential investors conducted by a company and its underwriter, prior to an offering.
- **Securitization** *
  - The process of gathering a group of debt obligations, such as mortgages, into a pool that can then be sold as securities to investors.
- **Trustee**
  - An individual or agent (such as an attorney or bank) who administers entities that are specifically set up as issuance vehicles (often required for securitizations).
  - Trustees manage the assets and liabilities of the issuing entity for the use and benefit of investors in the entity.
- **Underwriter**
  - An intermediary between an issuer of a security and the investing public, usually an investment bank.

* Additional information on this topic is available in the appendix.

Capital Markets: Illustrative Timeline

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Financing through Capital Markets:

Transaction Planning
- Identify funding needs and market options
- Select Advisors (Underwriter, Legal, Audit)

Initiation of Due Diligence Process
- Initiate Audit and begin Data Preparation
- Prepare Rating Agency Presentation
- Compile and Review Required Documentation
- Prepare Draft Offering Materials

Structuring, Audit, Legal & Documentation Completion
- Design Deal Structure
- Conduct Cashflow Analysis & Risk Modeling
- Finalize Rating Agency Presentations
- Obtain Appropriate Regulatory and Government Approvals
- Finalize Deal Terms & Covenants

Marketing

Pricing

Closing

Time

Capital Markets: Overview

MFIs seeking to finance via the capital markets will generally have to work through the following processes:

- In-depth **transaction planning** prior to **execution of the transaction**:
  - Seek relevant third party support (Underwriters, auditors, legal counsel, board members or trustees) in order to determine appropriate financing options:
    - Debt, equity, securitization*
    - Timing and size
    - Public vs. private offering**
  - Conduct internal preparation to meet rating agency, investor or underwriting needs[1]
    - This will cover business, legal, documentation and accounting issues
  - Update or obtain issuer or "institutional" ratings (in certain cases the finance structure may have to be rated separately)

- **Legal and documentation** requirements that meet local and/or international standards, including:
  - Most recent audited financials
  - Prospectus (please see next slide)
  - Board resolution authorizing issuance
  - Legal opinion from issuer's and underwriter's counsel
  - Auditor's comfort letter
  - Regulatory approvals

1. Regardless of whether the MFI is seeking debt or equity, significant due diligence will be required by underwriters, lawyers, auditors, rating agencies and potential investors

* Further information on securitization is available in the appendix.

** Descriptions of Public and Private offerings are covered in Section 4.

Capital Markets:
Legal & Marketing Documentation

- While the requirements of each country's regulatory agency are different, in general, the prospectus that is used for a capital markets transaction is drafted by lawyers, auditors, underwriters and representatives of the company (MFI) and includes the following components: an explanation of the offering (including the terms); issuer; planned use of the money; historical financial statements, and other information that could help an investor decide whether the investment is appropriate.

- The initial version is also called a red herring

- The prospectus typically includes the following sections:
  - Notice to investors (typically to consult legal counsel before any purchase or resale)
  - Summary of offering
  - Risk factors
  - Use of proceeds
  - Ratings
  - Description of offering
  - Description of issuer
  - Financial condition of issuer (minimum 3 years of financial statements)
  - Tax and legal matters
  - Plan of distribution
  - Purchase and transfer restrictions
  - Index of defined terms
  - Sample purchase letter (investors attest that they meet buyer qualifications)

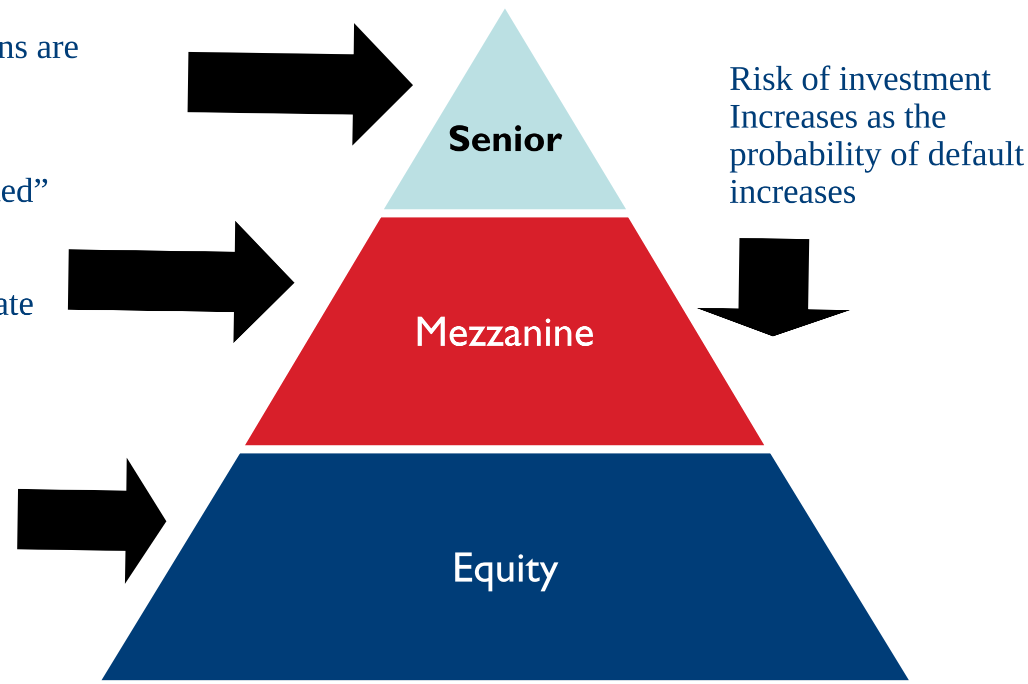
Capital Markets Overview

Capital markets transactions involve securities with varying risk-return profiles

Senior Debt is the highest priority debt. Senior obligations are the first to be repaid in the event of default.

Mezzanine financing is a form of "junior" or "subordinated" debt that fills the gap between senior loans and equity issuance. Mezzanine financing, which is repayable only after senior debt has been paid, carries a higher interest rate to compensate lenders for assuming greater risk.

Equity financing represents an ownership stake in a company or an SPV. The presence of equity provides a buffer to senior and mezzanine investors. Payments to equity holders are always secondary to those due to debt providers.



- In structuring capital markets transactions, the mix of senior, mezzanine and equity capital will affect the rating assigned to the securities as well as the cost of funds. As will be discussed later, the higher the rating, the lower the risk assumed by investors, and therefore, the lower the required return.
- In the case of securitization transactions, a special purpose vehicle (SPV) is created to sell assets with varying degrees of risk, according to the mix of senior, mezzanine, and equity securities.

Capital Markets: Overview

- **Marketing** through management roadshows is an integral part of the capital raising process:

Methodology	Benefits	Considerations
In-person presentations (one-on-one or group)	Live presentation allows for closer investor contact	Limited reach
One-on-one conference calls	Lowers cost of marketing while reaching a wider audience	Somewhat limits investor interaction
Global investor conference call	Lowers cost of promotion while reaching a wider audience More consistent message	Limits investor interaction
"Online" presentations	Lowers cost of promotion while reaching a wider audience More consistent message	Potential technology constraints Uncertain regulatory treatment[1] Limits investor interaction

1. Information given to potential investors on primary offerings is often subject to regulatory constraints. However, appropriate restrictions on the use of web-based technology are still being debated in most jurisdictions.

Capital Markets: Overview

- **Pricing** mechanisms and methodology are dependent on a number of factors:
  - Type of financing
    - Debt vs. equity
    - Secured or unsecured
    - Public vs. private
  - Underwriter agreement
    - The underwriter usually agrees to a “best efforts” approach where the MFI bears the risk if all the new securities are not sold (such as a shortfall of MFI desired financing)
    - In more competitive and developed markets such as the U.S, an underwriter may offer a firm commitment whereby the issuer is guaranteed to receive a fixed amount of funding even if the underwriter is not able to sell all of the securities
  - Investor base and investor appetite
    - High level of interest from investors can help reduce the cost of financing
    - In general, investor interest is highly dependent on their comfort with the issuing entity
  - Private versus public
    - Private deals can sometimes be less expensive as they avoid more onerous registration and filing requirements
    - Public deals may allow for better development of a wider investor base
    - Public registration may allow for less expensive interest rate pricing, whereas private placement transaction costs may be lower
  - Sale mechanism
    - The sale price for an equity ownership stake is established by the underwriters, who generally develop a valuation range based upon a due diligence review, pro-forma earnings, and the price/earnings multiples of similar publicly traded companies
    - Traditional auction process involves selling to highest bidder. In a Dutch auction the winning bid is the lowest price necessary to sell all securities issued (U.S. Treasuries are also sold under this mechanism)

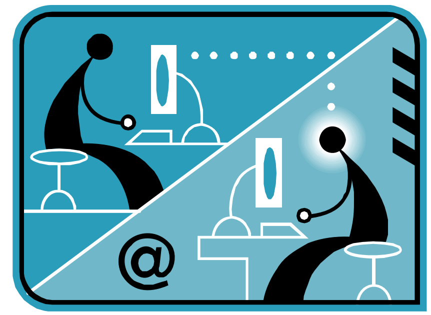
Section 3

Key Players in Capital Markets Transactions

Key players in a Capital Markets Transaction

Issuer (MFI)

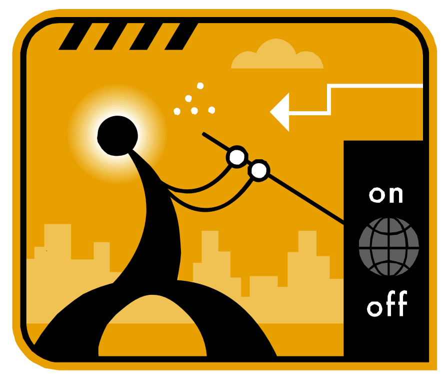
Stock Exchange



Underwriter

Rating Agency

Investor



Regulator

Key players in Capital Markets Transactions

Issuer	- A legal entity that develops, registers and sells securities for the purpose of financing its operations - Issuers are legally responsible for the obligations of the issue and for reporting financial conditions, material developments and any other operational activities as required by the regulations of their jurisdictions - The most common types of securities issued are bonds (notes, debentures, bills) and common and preferred stocks
Underwriter	- A company or other entity (investment bank, commercial bank or other financial institution) that administers the issuance and distribution of securities from a corporation or other issuer - An underwriter works closely with the issuer to determine the offering price of the securities, buys them from the issuer, and sells them to investors via the underwriter's distribution network
Rating Agency	- A company that assesses the credit-worthiness of corporations and countries and assigns credit ratings. This company also provides a transaction rating of the finance structure - The credit rating is a financial indicator to potential investors of debt securities such as bonds
Exchange	- An exchange organization which provides facilities for brokers to trade company stocks and other securities - Stock exchanges also provide facilities for the issue and redemption of securities, as well as other financial instruments and capital events including the payment of income and dividends
Investors	- Banks, Mutual Funds, Pension Funds, Insurance Companies, Asset Managers, Governments, and Individual Investors
Regulator	- A regulator provides supervision which subjects financial institutions and issuers to certain requirements, restrictions and guidelines that aim to maintain the integrity of the financial system

Section 4

Description of the Ratings Process

Why Secure a Rating?

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While a rating may increase the cost of raising capital, it serves as an invaluable method to establish independent credibility

Investor Comfort

- In the debt markets, investors often require that ratings be determined before committing capital
  - Helps investors evaluate the risk of the security being issued
  - Many institutional investors are not allowed to invest in unrated securities
- MFIs may require more preparation to establish a rating due to their more limited track record with mainstream rating agencies (who will also need to understand key differences between MFIs and mainstream finance institutions) and the specialized use of funds

Self Check

- Preparing for the rating agency presentation provides the issuer with a process by which they can ensure they have fully evaluated the business strategy
- Also acts as a mechanism to open the business plan to outside scrutiny, verify assumptions and long term viability

Marketing

- A rating also helps target the appropriate investor audience
- Helps identify the accurate pricing of the security issued

A rating can be a key component of indicating to the market that the security has passed outside scrutiny and will help develop investor confidence in the issuer and the business plan

Ratings Guidelines

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S&P, Moody's, and Fitch publish ratings on entities in order to quantify their ability to meet their financial obligations

Ratings Scale

Investment Grade

Non-Investment Grade (Junk Status)

Moody's	S&P	Examples
Aaa1	AAA+	US / UK Government
Aaa2	AAA	France
Aaa3	AAA-	
Aa1	AA+	
Aa2	AA	
Aa3	AA-	Italy
A1	A+	
A2	A	Chile
A3	A-	China
Baa1	BBB+	South Africa / Mexico
Baa2	BBB	Russia
Baa3	BBB-	
Ba1	BB+	India / Egypt / Morocco
Ba2	BB	Brazil / Columbia
Ba3	BB-	Peru / Vietnam
B1	B+	
B2	B	Pakistan
B3	B-	Dominican Republic
Caa1	CCC+	
Caa2	CCC	
Caa3	CCC-	
D	D	

Explanation

- 'AAA' is the highest rating assigned by ratings agencies and reflects the obligor's capacity to meet its financial commitment on the obligation is extremely strong.
- 'AA' differs only slightly from 'AAA'. The obligor's capacity to meet its financial commitment on the obligation is very strong.
- An 'A' rating is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.
- An obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor.
- A 'BB' ratings faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.
- A 'B' rating is more vulnerable to nonpayment than obligations rated 'BB', but the obligor currently has the capacity to meet its financial commitment on the obligation
- A 'CCC' rating is currently vulnerable to nonpayment, and is dependent upon favorable business, financial and economic conditions for the obligor to meet its financial commitment on the obligation.
- A 'CC' or 'C' rating is highly vulnerable to nonpayment.
- A 'D' rating is a payment in default.

* Ratings as of 19 July 2006

Factors Impacting a Rating

The Issuer must be able to address the following factors when approaching the ratings agency

Profitability

- Trends of Key Measures
- Level of Volatility
- Plan for Growth

Management Financial Policy

- Risk Tolerance and Management
- Funding Viability of Business Plan
- Financial Goals

Cashflow Protection

- Interest Rate Sensitivity
- Capital Investment Requirements
- Timing of Investments

Ratings

Liquidity

- Cash Flow
- Bank Relationships
- Committed Bank Lines
- Monetizations of Assets

Capital Structure

- Asset Quality
- Leverage
- Mix of Funding Sources
- Maturity Structure

Other Items

- Use of Proceeds
- Historical Records
- Corporate Governance
- Macro and Political Risk

Rating Process: Timeline

Week 1

- Make formal request and arrange meeting date
- Sign agreement with rating agency
- Identify key participants
- Start compiling information and begin presentation outline

Weeks 2 - 3

- Finalize written and oral presentations
- Send final written presentation to rating agencies
- Meeting preparation session
- Rating agency meeting

Weeks 4-6[1]

- Ratings agency evaluates material received and carries out its own due diligence on the company and industry
- Credit rating decision

Role of the Financial Advisor or Underwriter

- Services provided as part of the initial rating agency process:
  - Schedule rating agency meetings and enlist appropriate analyst coverage and attendance
  - Guidance and assistance in preparing formal presentation
  - Identify and assist in analysis of key issues and their impact on ratings
  - Prepare client management for oral presentation
  - Attend presentations as observer
  - Solicit feedback and structure follow-up conversations with the agencies
  - Advise on any follow-up responses to questions asked by the rating agencies
- Services provided as part of an ongoing client relationship:
  - Monitor / anticipate rating changes and advise client
  - Advise on impact of strategic and operating events
  - Counsel on dialogue and relationship with agencies
  - Attend annual ratings meetings
  - Provide an informal "bridge" between the agencies and the issuer

1. The above market timetable is for a capital markets transaction. Depending on the rating agency, the amount of field time required by the raters and the MFI's level of institutional performance, the process may be closer to 6 weeks. This 6-week timeline for mainstream raters is similar in length to many of the specialized MFI raters. In the case of Microrate, the pre-analysis phase is followed by a visit to the MFI, then 1-2 weeks of report drafting and rating assignment, followed by 1-2 weeks in which the MFI's comments are integrated into the report, and then a 1 week final approval process at the rating agency.

Specialist Microfinance vs. Mainstream Rating Agencies

	Specialist Microfinance Rating Agencies	Mainstream Rating Agencies[1]
Advantages for MFIs	• Can be less costly • Recognized by specialized investors • Valuable operational and financial assessment; deeper and specialized evaluation which takes a more holistic view of the MFI into account	• Widely recognized ratings are useful to access a broader range of investors. • A high rating can validate financial performance
Advantages for Investors	• Ratings help investors understand origination, financial and operational risks specific to MFIs	• Moody's, S&P, and Fitch are well-known to mainstream investors • For MFIs seeking global, rather than local funding, the methodology for global scale ratings of the mainstream agencies allows for comparisons across industries and geographies
Disadvantages for MFIs	• Ratings must prove themselves over time → many specialist rating agencies face barriers to establishing credibility • Some MFI rating agencies have launched ancillary businesses on the side (consulting), undermining their perceived objectivity	• Obtaining a rating can be costly given that most MFIs are smaller than other financial services companies such as banks
Disadvantages for Investors	• Microfinance ratings are specialized to the sector and may not provide a uniform standard for comparing investment options	• Mainstream rating agencies may not have the expertise to analyze origination, financial and operational risks specific to MFIs
Examples	• MicroRate, MCRIL, PlaNet Rating and Microfinanza are all well-known and well-respected specialist microfinance rating agencies	• Compartamos of Mexico, ProCredit of Germany, FWWB Colombia, and Acleda of Cambodia all have Moody's, Standard and Poor's or Fitch Ratings

1. While the larger rating agencies are often referred to as "mainstream", the key distinction is that they deliver a "credit" rating of the institution's ability to satisfy their obligations, whereas specialized rating agencies focus on the MFI's overall institutional strength and assessment.

Specialist Microfinance Rating Agencies

	Microrate	M-CRIL
Date of Establishment	1996	1998 (established), 1999 (registered)
Geographic Focus	Latin America, Africa	Asia
Number of Ratings	54 in 2005 & over 270 in total for MFIs 1 CDO rating	250 MFI and credit ratings
Reputation	First rating agency specializing in the evaluation of microfinance institutions. Known for being highly credible and scrupulous to the extent that they have lost certain clients over time.	The leader in terms of volume → specialized knowledge of Asia. Rates MFIs of a wide range of organizational forms. The vast majority of M-CRIL's ratings are performed in India.
Methodology	Performance Rating that assesses 5 general areas: microfinance operations, portfolio quality, management and organization (including risk management and controls, MIS, productivity, efficiency and personnel), governance and strategic positioning and special emphasis on financial performance and credit risk.	Assesses external risk, credit risk, market risk, and the risk of fraud; looks at quality of governance, depth and efficacy of management systems, and financial health of the institution
Ancillary Business & Misc.	Special projects, typically macro-overviews (for example, assessment of microfinance industry in specific countries or regions for development organizations)	Sectoral research, social performance monitoring. M-CRIL is a subsidiary of EDA Rural Systems that does training and capacity building in microfinance sector

Specialist Microfinance Rating Agencies

	PlaNet Rating	Microfinanza
Date of Establishment	1999	1996
Geographic Focus	More than 35 countries worldwide	Eastern Europe and the Balkans, Central Asia and Caucasus, Africa and Latin America and the Caribbean (LAC)
Number of Ratings	145	40
Reputation	Reports tend to be longer and more detailed, and seem geared towards a donor audience.	Microfinanza has successfully established itself in LAC and Africa by offering a rating product that is less expensive than MicroRate's.
Methodology	GIRAFE Methodology: Governance and Decision-Making, Information and Systems, Risk Management, Activities and Services, Funding and Liquidity, and Efficiency and Profitability	A Microfinanza rating covers: external context; governance and operational structure; financial products; assets structure and quality; financial structure; operational and financial results; strategic objectives and financial needs with a 50/50 mix of qualitative versus quantitative information
Ancillary Business & Misc.	70% owned by PlaNet Finance which consults for MFIs and has launched its own microfinance funds	Consulting firm specializing in microfinance with specialized division, Microfinanza Rating

Mainstream Rating Agencies

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	S&P	Moody's	Fitch
Date of Establishment	1941	1909	1913
Geographic Focus	Global (The S&P Global 1200 covers 31 markets and approximately 70% of global market capitalization). MFI rating focus on Latin America	Global	Global for Fitch parent 12 ProCredit group MFIs rated, as well as ProCredit Bulgaria CDO rating Also have ratings for 6 FFPs, 6 Mutuales, 1 Cooperative, and 2 banks in Bolivia Additional Duff & Phelps MFI ratings include FWWB Colombia (Cali)
Number of Issuers Rated	$30 trillion of debt, representing nearly 750,000 securities issued by more than 40,000 borrowers 4 MFIs (2 confidential institutional ratings)	70,000 structured finance obligations, 25,000 public finance issuers, 11,000 company issuers, 100 sovereign	Total coverage of 3,100 financial institutions, including 1,600 banks and 1,400 insurance companies, including 20 MFIs
Methodology	S&P assesses the creditworthiness of a debt instrument relative to all other debt issues and issuers worldwide for global scale credit ratings. In addition, S&P will assign national scale ratings where the universe of comparison is limited to debt issues and issuers within a single nation (for a local debt issue). Like Moody's, an S&P rating is 50/50 qualitative vs. quantitative	Moody's ratings place an emphasis on an issuer's credit risk and solvency while benchmarking the institution against the banking sector A Moody's rating covers capital adequacy; profitability; operational efficiency; liquidity risk; foreign exchange risk; credit management, organizational management and ownership; market position; and projected cash flows	Fitch considers both qualitative and quantitative factors in determining a rating that includes balance sheet integrity and profitability and risk management. Fitch factors in: an assessment of the franchise of the financial institution in question; the strategy and quality of its management; the environment in which it operates, and the most likely future development of its business.
Ancillary Business & Misc.	Recently made a 60% stake investment in CRISIL (who has rated some MFIs in Asia)		Duff & Phelps is a subsidiary of Fitch

Section 5

Description of Private Placements versus Public Issues

What are Private Placements?

- A private placement is a direct offering of securities to a limited number of sophisticated institutional investors that has the following characteristics:
  - Can either be stocks or debt securities (bonds)
  - Issue is offered to a small number of investors
  - In the United States, they are exempt from public registration under the Securities Act of 1933
  - Although privately placed debt securities are more liquid than bank loans (because investors may include non-banks, such as pension funds and other institutional investors), the restricted nature of the securities makes them less liquid than public issues and therefore relatively more expensive to the issuer than debt securities that are offered to the public
    - Upfront costs of private placements are lower than public issues, while the interest costs on public issues may be more competitive and/or lower.
    - The trade-off of these two cost elements must be analyzed by the issuer.

Participants

Issuers

- Private placements are suited for small businesses that are looking for growth and expansion.
- A number of countries do not have a private placement market. In those countries, MFIs interested in raising debt in the capital markets would have to raise capital through a public offering.
- Private placements are generally not a feasible alternative for start up MFIs.
- Mexico and Colombia are examples of countries in which private debt markets do not exist.

Investors

- Banks and other financial institutions (such as pension funds and insurance companies)
- Venture funds
- Individual investors

What are Public Offerings?

- A public offering is an issue of securities which is offered to institutional and individual investors through a securities house such as a stock exchange[1]
  - Allows access to a broad range and large number of investors
  - Gives an issuer an opportunity to raise capital at a discount, gain increased market visibility and potentially achieve or attain liquidity of the issued securities—depending on the level of secondary market activity in a particular market
  - Provides exposure to local and/or international capital markets
  - May impose heavy legal compliance and reporting requirements

1. An initial public offering (IPO) is the first sale of a corporation's common shares to public investors. Any later public issuance of shares is referred to as a Secondary Market Offering, or Follow-On Offering.

Participants

Issuers

- Public offerings are best suited for businesses that are looking to raise large amounts of capital at a discount and also want the exposure to the capital markets
- Public offerings are subject to a high level of regulatory requirements compared to private placements
- Possible international exposure through international individual/institutional investors
- The Compartamos, Mibanco and FWWB Colombia (Cali) bonds are public (in certain countries, like Colombia, all securities must be publicly listed)

Investors

- Institutional investors, including banks or other financial institutions
- Individual investors

Steps involved in Public Placements

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There are three main stages in the processing of large public issues.

Origination

- Origination is the first stage in the process for distributing securities on the primary market.
- Origination occurs when a borrower authorizes an investment bank to structure and manage a new issue on its behalf
- The bank purchases the bonds from the borrower and distributes them to investors – a process known as "underwriting"
- In this way, the issuer avoids the risk of being left with unsold securities

Syndication

- The lead manager rarely has the resources to underwrite the entire issue
- For this reason, the lead manager may decide to form a syndicate to share the risk with other investment banks or security houses
- This process is called "syndication"
- On the day the issuer announces the issue, the lead manager invites other banks and security houses to join the syndicate

Distribution

- After closing day, the issue is distributed to syndicate members
- A tombstone advertisement is often published in major financial newspapers after the closing date to advertise the issue for the syndicate
- After the issue has been distributed to the syndicate members, the members begin selling the securities to their clients

Legal Requirements for Public Offerings

- **Registration with the SEC (U.S. Securities and Exchange Commision) or equivalent local securities regulatory body:**
  - Issuers are required to register with the SEC before the firm can offer its securities for sale

- **Prospectus:**
  - Detailed overview of the company's finances, history, operations, risk factors, transaction terms, and other information

- **The issuer is liable for any misstatement or omission in the prospectus**

- **Periodic reporting requirements:**
  - Even after the registration with the SEC, the issuer is also subjected to periodic reporting requirements of local jurisdiction
  - Certain jurisdictions have additional requirements such as an audit committee or election of independent directors on its board, and other such goverance provisions

MFIs View – Advantages and Disadvantages

Private Placements	Public Offerings

Private Placements

Advantages:

- No registration required.
- Reduced disclosure requirements.
  - Transaction costs & staff time (particularly for a public issue) can be high if the level of disclosure required is much greater than what the MFI has produced historically
- Typically carries lower upfront transactional costs (due to fewer regulatory and reporting requirements)
- Flexibility in the amount of financing.
- Quicker form of raising money

Disadvantages:

- Less public exposure as publicity about the offering is restricted.
- Private placement issued securities are less liquid.

Public Offerings

- Public offerings are increasingly becoming a popular means for raising capital among MFIs.
- Public offerings are required to be registered with the securities supervision entity.

Advantages:

- Greater exposure to public as publicity about the offering is less restricted.
  - This exposure may be useful for marketing purposes and may also serve to increase the transparency of the issuer to potential investors, as well as clients and sponsors of MFIs
- Liquidity is greater for publicly offered securities, which also can provide issuer with larger amounts of capital
- Larger potential investor base may translate into lower financing cost for the issuer

Disadvantages:

- Greater disclosure requirements.
  - The combination of rigorous disclosure, regulatory review and other factors can make a registered public offering a time-consuming and expensive process for an MFI.
- Usually involve high transactional costs due to the involvement of Underwriter/Syndication and heavier filing and reporting requirements.

Section 6

Capital Markets Instruments

Overview of Capital Markets Instruments

This section will define and explain the following capital markets instruments:

- Commercial paper
- Bonds (senior & subordinated)
- Securitizations & Collateralized Debt Obligations
- Equity (preferred & common)
- The following financial instruments will be explained in the appendix:
  - A. Currency hedges
  - B. Credit default swaps
  - C. Cash flow loans
  - D. Collateralized Debt Obligations ("CDO") and Collateralized Loan Obligations ("CLOs")
  - E. High-yield debt
  - F. Callable loans
  - G. Public Deposits

Overview of Capital Markets Instruments

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Summary of instruments:

Product	Deal Size	Maturity	Structure Complexity	Administrative Costs	Availability in Emerging Mkts
Commercial Paper	Generally in multiples of USD 1mm	Short term (< 1yr)	Low	Low startup and ongoing costs	Yes
Bonds	Small-Large[1]	Medium-long term[2]	Varies	Servicing costs can be significant	Previously utilized by MFIs: deal sizes generally exceed USD 5 million
Securitizations & Collateralized Debt Obligations (CDOs)	Medium – Large (dependent on collateral)	Varies, but usually medium-long term (dependent on structure)	High	Administered by a separate servicer Structuring costs can be high[3]	Previously utilized by MFIs (example: ProCredit Bulgaria)
Equity	Small – Large [4]	Indefinite	Low	Floatation and ongoing compliance costs can be high	Previously utilized by MFIs (example: BRI)

1. During the first quarter of 2006, the average size of corporate bonds underwritten by regional firms was $460 million.
2. The average life of a US corporate bond in 2005 was 7 years.
3. Securitizations may be administered by the issuers themselves, or by a third party provider depending on the structure.
4. The average of all IPOs priced on the NASDAQ during 2004 was $115 million.

Section 6A

Commercial Paper (CP)

Commercial Paper (CP) Market Overview

Commercial Paper Market Characteristics

What is CP?

- Commercial Paper (CP) encompasses short-term debt of maturities between 1 and 365 days.
- Funding that is renewed on a frequent basis (daily, weekly, monthly, etc.)
- U.S. commercial paper is exempt from registration with the SEC

Market Characteristics

- The US commercial paper market is a large and highly liquid market with approximately $1.7 trillion outstanding (US CP accounted for 77% of global capital markets issues outstanding as of 2000)
- Generally, investment grade ratings at a minimum are required to access the CP market.
- Approximately 50% of the market is unsecured and the remaining 50% is secured , or asset-backed commercial paper
- Pricing for Tier I borrowers (issuers with the highest short-term credit rating: P-1 (Moody's), A-1/A-1+ (S&P)) are able to borrow in the commercial paper market at LIBOR
- Current indicative pricing for Tier II borrowers (P-2/A-2 credit ratings) is LIBOR plus 10-15bps.[1]
- Issuers with short term ratings of A-3 or lower often exit the CP market, drawing on bank loans and alternative funding sources
- Most emerging markets do not have significant commercial paper markets

Participants

- 96% of the US market is rated Tier I and 4% is rated Tier II
- Asset backed CP has facilitated funding of many companies that are not rated investment grade.
- Companies with lower credit ratings have also been able to issue commercial paper by means of credit support from a firm with a high credit rating, issuing so-called "credit supported commercial paper" or "letter of credit paper"
- Money market funds, investment advisors, securities lenders, insurance companies, bank trust departments and corporations are the largest investors in the CP market

1. Funding levels are as of Q1 2006.

Commercial Paper Market Overview

Commercial Paper Market Characteristics

Benefits of CP or Commercial Paper

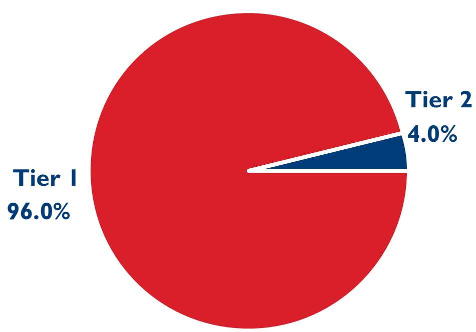
- CP provides issuers with a relatively cheap source of funding when compared to bank loans
- CP programs provide issuers with flexibility with regard to maturity dates (Maturities range from overnight to 365 days).
- A CP program can be easily established with minimal start-up costs. Once the program is up and running, it is extremely easy to issue new commercial paper
  - Establishment and administration is often done by a financial organization acting in the roles of custodian, issuing and paying agent, collateral agent and security trustee

Commercial Paper Market Overview

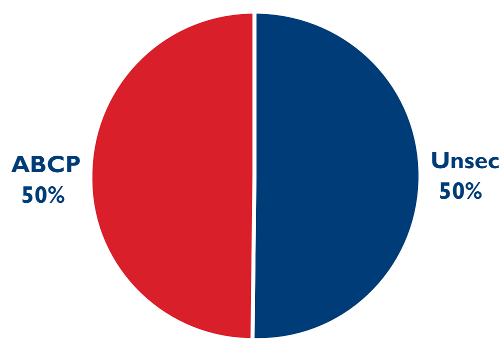
- **Presents a relatively cheap source of funding for highly rated issuers:**
  - Investment Grade ratings are a minimum requirement to issue Commercial paper
  - Liquidity is much higher for A and higher credit ratings, limited for “BBB” rated issuers
  - The high credit rating of the issuers combined with the short maturity periods (average 30-35 days) make CP a very low-risk, low-yield instrument for investors, resulting in lower borrowing costs for the issuer

- **CP was largely unsecured paper until the 1990s when Asset-backed CP was introduced (ABCP)**
  - ABCP has grown at roughly 26% CAGR[1] since 1994, and now represents 50% of the US market

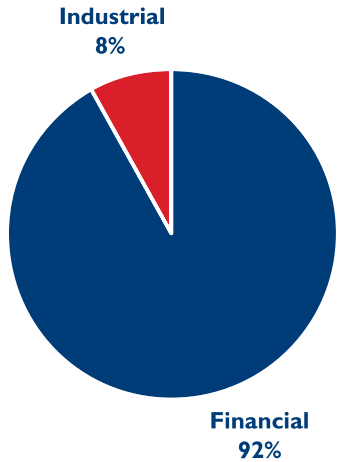
Market Composition by Rating



Market Composition by Collateral



Market Composition by Issuer Type



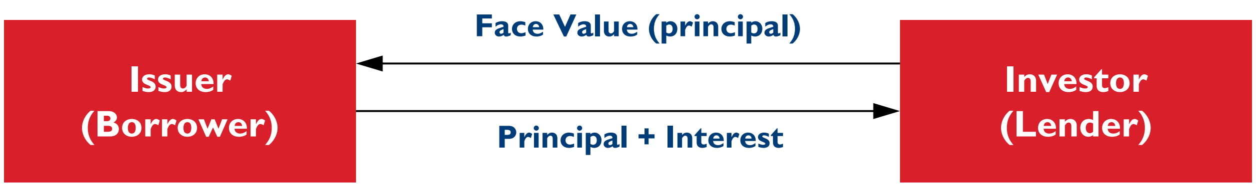
1. Compound annual growth rate. The year over year growth rate applied to an investment or other part of a company's activities over a multiple-year period.

Section 6B

Senior and Subordinated Bonds

Definitions

- **Bond**
  - A debt instrument requiring an issuer (borrower) to repay an investor (lender) the amount borrowed plus interest over a specified period of time.



- **Coupon**
  - Annual interest rate on a bond that may be fixed or floating and payable periodically throughout the year. The coupon on floating rate bonds is equal to an interest rate benchmark (e.g. LIBOR) plus a spread.
- **Par (Face) Value**
  - The value of a bond at maturity. The issuer agrees to repay the bondholder this principal amount at maturity. A bond trading at a price below par is said to be a **discount** bond, while a bond trading at a price above par is said to be a **premium** bond.
- **Senior or Subordinated Bonds**
  - In a credit event such as bankruptcy and liquidation, holders of senior bonds are repaid before holders of subordinated bonds. By creating this order of priority, subordination is a form of **credit enhancement** (the senior bond will typically receive a high rating, catering to investors averse to credit risk).
- **Put and Call Provisions**
  - The issuer of a callable bond has the right to redeem or call (**buy**) the security on a set date before maturity, and might do this in a declining interest rate environment. The investor of a putable bond has the right to put (**sell**) the bond back to the issuer before maturity, and might do this in a rising interest rate environment.
- **Convertible Bonds**
  - Bonds that can be exchanged for a specified amount of a different security, usually the common stock of the issuing company. The value of a convertible bond increases when the stock price increases, but still pays the investor interest when the stock price declines, and therefore offers downside protection.

Debt Markets

Characteristics

- Bonds represent medium to long-term borrowing, typically 12 months to 30 years. Debt obligations that are shorter than 12 months are known as "bills."
- Bonds are a non-permanent source of funding because the borrowed amount is repaid to the lender. Interest paid to the lender represents the cost of borrowing.
- Unlike equity, there is no dilution of issuer's ownership when bonds are issued because the investor does not acquire an ownership stake in the issuer itself.

Risks for MFIs[1]

- **Liquidity risk**
  - Potential difficulty in repaying obligations as they come due or under stress conditions. MFIs must make their interest and principal payments on issued bonds despite any volatility in MFI earnings.

Risks for investors[1]

- **Interest rate risk**
  - The value of a typical bond will change in the opposite direction from a change in prevailing interest rates. A rise in interest rates could reduce the value of a fixed-rate bond (or portfolio of such bonds).
- **Credit risk**
  - Risk that the bond issuer may default (fail to make timely principal and interest payments on the issue). This can be mitigated using credit enhancement methods, such as issuing bonds in senior or subordinated form, or obtaining external guarantors, for example USAID or The World Bank's IFC, to secure the bonds.

1. See Appendix for details

Past Bond Issuances by MFIs

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Many MFIs have successfully accessed the debt capital markets

- **BancoSol**, Bolivian MFI
  - March 1996: USD 5MM USD-denominated 2-year bonds, 13% coupon, credit-enhanced by a 50% guarantee provided by USAID
- **Compartamos**, Mexican MFI
  - July 2002: USD 10MM Mexican peso-denominated, unsecured 3-year floating rate senior bond, 13.6% initial coupon, rated mxA+
  - November 2002: USD 5MM Mexican peso-denominated, unsecured 3¼-year floating rate bond, 13.02% initial coupon, rated mxA+
  - April 2003: USD 5MM Mexican peso-denominated, unsecured 3-year floating rate bond, 11.17% initial coupon, rated mxA+
  - July 2004: USD 17MM Mexican peso-denominated 5-year floating rate bond, 9.0% initial coupon, rated AA(mex)/mxAA and guaranteed 34% of principal by IFC
  - October 2005: USD 29MM Mexican peso-denominated 5-year floating rate bond, 10.7% initial coupon, rated AA(mex)/mxAA and guaranteed 34% of principal by IFC
- **Mibanco**, Peruvian MFI
  - December 2002: USD 6MM Peruvian sol-denominated 2-year fixed rate bond, 12% coupon, rated AA/AA and guaranteed 50% of principal by USAID
  - September 2003: USD 6MM Peruvian sol-denominated 2¼-year fixed rate bond, 5.75% coupon, rated AA/AA and guaranteed 50% of the principal by CAF
  - October 2003: USD 3MM Peruvian sol-denominated, unsecured 1½-year fixed rate bond, 5.75% coupon, rated AA-/AA+
- **Bank Rakyat Indonesia**, Indonesian MFI
  - November 2003: USD 150MM, 10-year 7.75% subordinated note, recently upgraded to idA+ rating (B3 from Moody's)
- **Fundación WWB Colombia**, Colombian MFI
  - 1st tranche - February 2005: USD 30MM Colombian peso-denominated unsecured two-class issue (one 3-year 10.78% fixed rate and the other 5-year floating rate at CPI+5.5%), rated AA+
  - 2nd tranche - November 2005: USD 22MM Colombian peso-denominated, unsecured 6-year floating rate bond (CPI+3.4%), rated AA+

Faulu Kenya, Kenyan MFI
- April 2005: USD 6.5MM Kenyan shilling-denominated 5-year floating rate bond, 9.13% initial coupon, not rated and guaranteed 75% of principal and interest by the French Development Agency (Agence Française de Développement, or AFD)

Section 6C

Women's World Banking

Equity, Common and Preferred

Definitions

- **Stock**
  - A security signifying ownership in an organization and its assets. A share of stock represents one unit of such ownership.
- **Common and Preferred**
  - Two types of stock with differing characteristics (described later). Common stock represents the majority of stock held by the public.
- **Dividends**
  - Portion of profit paid out to shareholders, as approved by the company's board of directors.
  - May be in the form of cash or stock (pro-rata distribution of additional shares of stock paid to common shareholders).
- **Voting Rights**
  - The right of a common shareholder to vote for members of the company's board of directors and other matters of corporate policy.
- **Cumulative Stock**
  - Preferred stock on which dividends accrue if the issuer does not make timely dividend payments. Most preferred stock is cumulative. Non-cumulative preferred stock does not accrue unpaid dividends.
- **Participating Stock**
  - Preferred stock that under certain conditions gives its holders the right to receive company earnings payouts above the specified dividend rate.

Equities: Common vs. Preferred Stock

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Common and preferred stock differ in four crucial ways.

	Common	Preferred
Voting rights	Yes	No
Dividends	Variable	Fixed
Cumulative	No	Yes
Participating	No	Yes (Potentially)

Equity: Characteristics and Challenges for MFIs

Characteristics

- Equity markets represent indefinite term funding through the issuance of shares, each of which represents a unit of ownership in the issuing company
- Stock issuance is a form of permanent funding; unlike bonds, there is no contractual obligation to return the capital to the investor
- Interest is not paid to investors, but dividends may be paid
- Liability is considered “limited” because an investors’ loss can not exceed the amount of the original investment
- Equity can be categorized as private or public:
  - Private equity may be used by start-up companies to raise capital. This is achieved when an individual or organization is offered the opportunity and does buy shares in the company as an investment (venture capital)
  - Public equity is represented by shares of the issuing company listed on a stock exchange. Public equity gives the issuer wider access to capital but could also expose it to market conditions. In addition, regulatory matters, such as the need to audit and disclose company financials and other important company information, in addition to the cost of equity issuance, could be challenging

Challenges of MFIs accessing the equity markets

- Scarcity of local venture capital and lack of development of local venture capital markets
- Few publicly traded microfinance shares. Currently very few MFIs are public (examples are: Bank Rakyat Indonesia, Network Microfinance Bank in Pakistan, Equity Bank Limited in Kenya and BancoSol in Bolivia); others have only had private equity investments
- Valuation of the issuer may be difficult due to lack of any single conventional valuation tool for MFIs
- Country risk for the investor (international investors have been the primary private investors for regulated MFIs to date)
- For investors, potential liquidity may be unclear (exit options are limited)

Trends in Microfinance Equity

- The emphasis of capital markets access by MFIs has been on debt financing; commercial interest in equity has to date been negligible by comparison
- Access to the equity markets is important to MFIs for the following reasons:
  - Equities can not only enhance an MFI's growth, but also fulfill its liquidity and capital adequacy requirements
  - Equities represent a diversification of funding sources for the traditionally debt-oriented MFI. Tapping into the equity markets mitigates some of the risks of debt financing (presented earlier)
  - Equity increases an MFI's capacity to raise debt funding well beyond the amount of the equity itself (leveraging the equity)
  - Public equity distributes ownership of an MFI across shareholders who then assume an active role in defining an MFI's strategy as well as assessing its performance – which carries the potential for improved governance
- Of the current major trends in the development of MFIs, two increase the need to access equity markets:
  - The **transformation** of MFIs: their conversion from non-profit organizations into private, regulated for-profit financial institutions
  - The **green fielding** of MFIs**:** the setting up of regulated, for-profit MFIs in countries and regions that do not yet have an appropriate financial system to support micro-, and small- and medium-sized enterprises (SMEs). For start-ups, private equity is an important means of raising capital
- In recent years there has been a marked increase in the number of microfinance investment funds, with some investing in equity
- The successful IPO of Bank Rakyat Indonesia (BRI) in November 2003 represents the first case of a commercial bank with a significant MF portfolio having issued equity shares to the public. Previously. a government-owned bank, 40% of BRI's shares were sold to the public (privatized) in a transaction that raised over $450 million

Section 6D

Securitizations

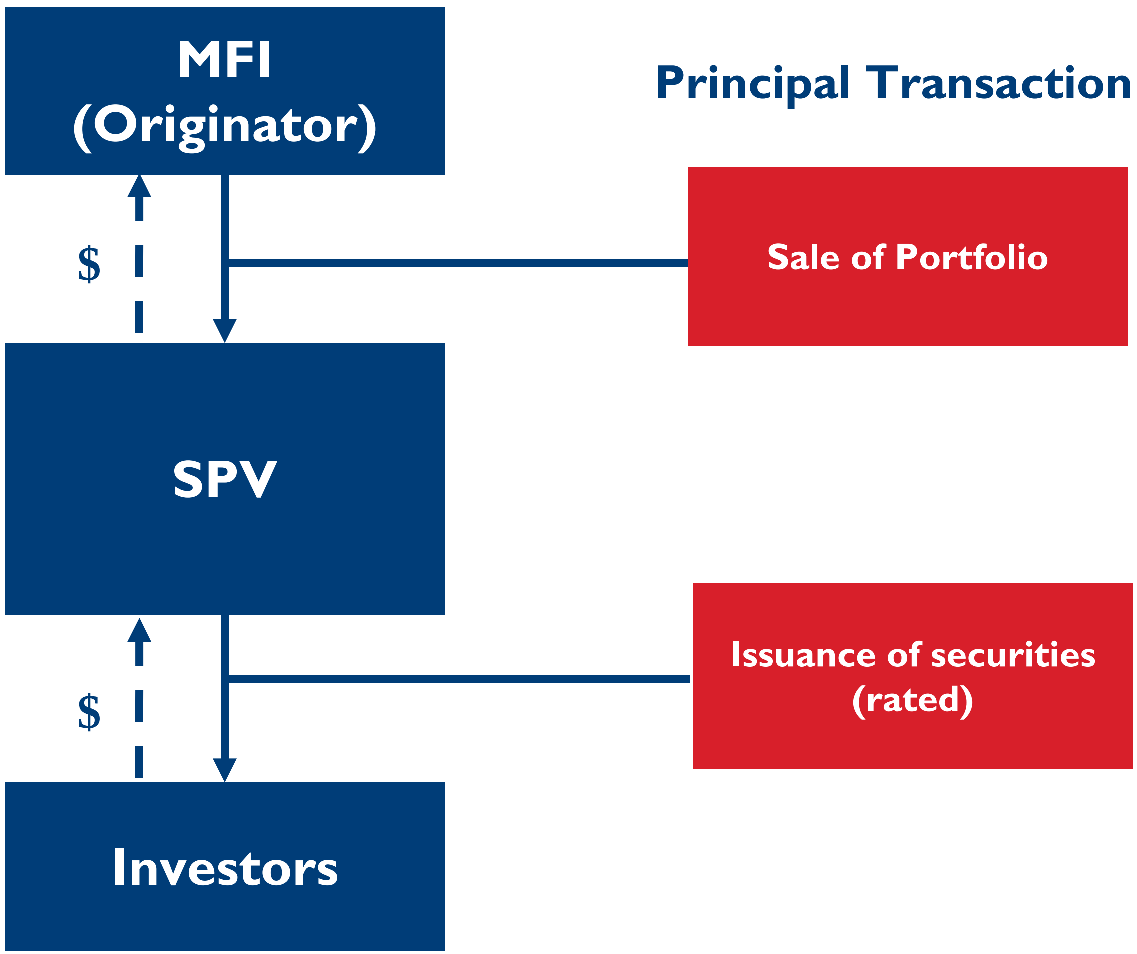
What is Securitization?

- Securitization is the process by which relatively homogenous pools of loans, originally made by a bank or other financial intermediary, are sold and converted into tradable securities.[1]
- The object of securitization is to raise funding, reduce the financial intermediary's capital requirements, and increase the issuer's liquidity so that they can originate new loans.
- Securitization transactions involve the creation and issuance of debt securities whose payments of principal and interest come from cash flows generated by separate pools of assets. These separate pools of assets are organized into a Special Purpose Vehicle (SPV), which is a separate entity from the MFI and carries a distinct rating.
- MFIs may also securitize their assets in order to:
  - Meet capital adequacy regulations
  - Improve financial ratios
  - Lower leverage and boost return ratios
  - Lower the cost and diversify the sources of funding
  - Improve asset/liability management
  - Manage credit risk exposure
  - Free up MFI management time from fundraising
- Although the upfront time and expenses involved in a first-time securitization transaction may seem high (relatively higher than a first time bond issue for example), subsequent securitization issues tend to be less onerous and repeat programs can be much easier to execute

As the originator of a securitized loan portfolio, an MFI gives up legal claim to the ownership of its client cash flows, while retaining the client and responsibility for collecting the loan from that client. In other words, securitization affects an MFI's balance sheet while client outreach stays the same

1. It may be interesting to note that the securitization industry has emerged in the past 30 years, and now includes a wide array of cash-producing assets. The first securitizations were done with mortgage loans, and eventually auto loans, credit card receivables, home equity loans, manufactured housing loans, student loans and future entertainment royalties. Even lottery receivables have been securitized!

What does a Securitization Look Like?

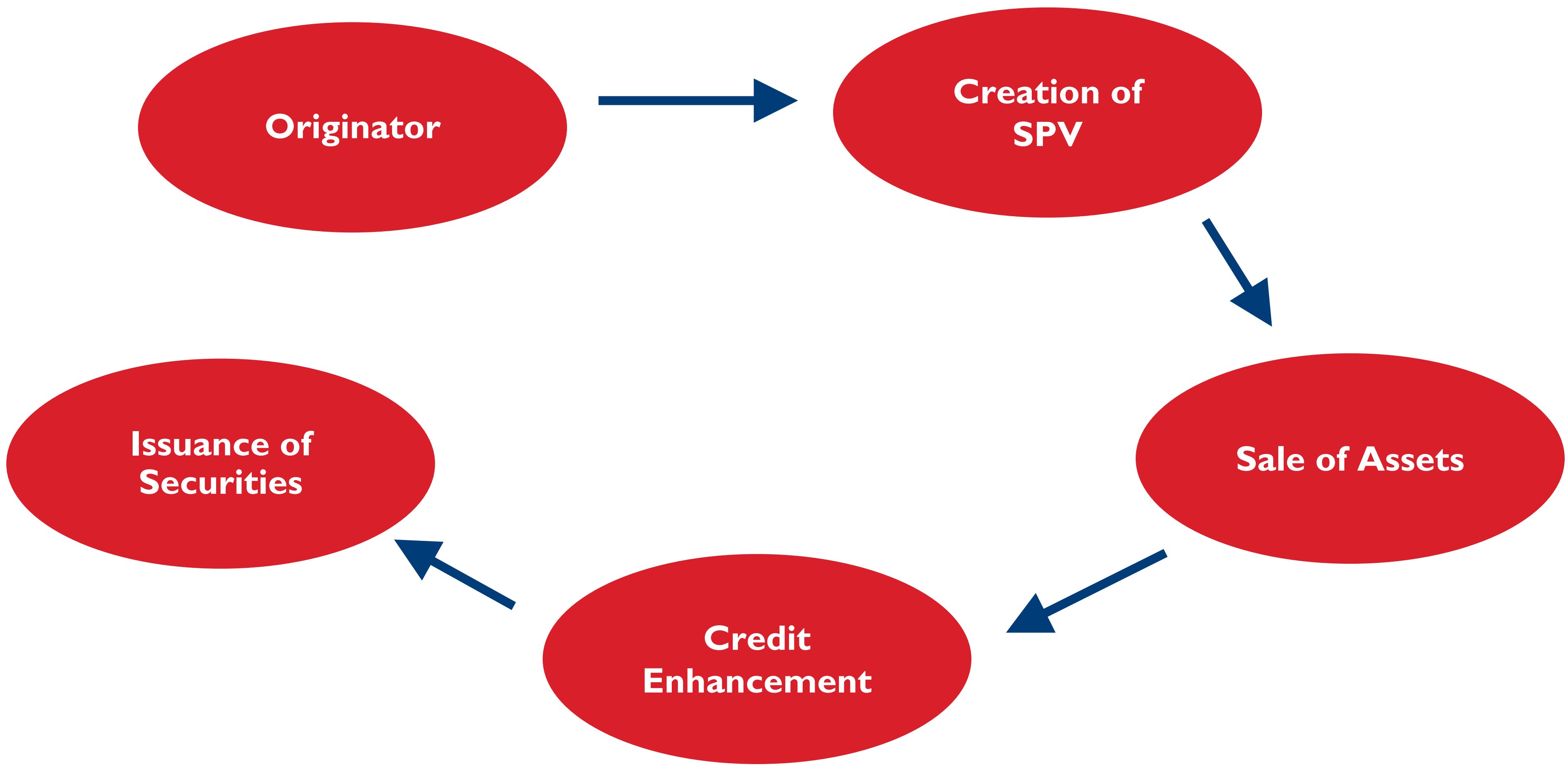


Key Players in Securitization Process

- **Borrowers**
  - Borrowing creates the assets that will underlie the securitization (ex: microfinance clients)
- **Originator**
  - The entity for originating the assets to be securitized (the MFI). The originator will typically be a top-quality financial institution or other corporation.
- **Special Purpose Vehicle**
  - Set up by the originator, the SPV will purchase the assets from the originator and issue securities to the investors.
  - The SPV is a “bankruptcy remote” entity, which means that even if the Originator (the MFI) were to go bankrupt, or get into other financial difficulties, the rights of the investors on the assets held by the SPV are not affected.
- **Credit Enhancement Providers**
  - These will take up some of the risks associated with the assets.
- **Rating Agencies**
  - Rating agencies analyze the risks associated with the transaction and award a credit rating to the issue.
- **Investors**
  - The investors ultimately purchase the issue and receive periodic payments of interest and principal over the security's life.
- **Structurer and Placement Agent**
  - The structurer and placement agent create securities based on underlying assets and markets them to investors

Process of Securitization

Steps involved in the process of securitization



Additional details about this process can be found in the appendix on slide 70.

Process of Securitization

- Securitized structures typically involve a special purpose vehicle (SPV) acquiring pools of either loans or bonds, and funding this purchase by issuing notes to investors
  - Multiple classes of debt and equity are issued to capitalize the SPV and provide funding for this asset purchase. These capital classes vary with respect to seniority in bankruptcy and timing of repayment.
  - The equity class is the highest risk class in the structure
    - It is the first to sustain the risk of payment delays and credit losses
    - Equity holders may be entitled to receive excess cash flows after the satisfaction of all senior and mezzanine claims
- Investors' returns are directly related to the performance of the pool of underlying assets.

- A simple securitization involves the following:
  - A seller sells a pool of assets, say USD 100M of MF loans, to the SPV. The SPV issues USD 95M of highly-rated securities to investors. This over-collateralization (USD 100M of loans sold to SPV for USD 95M) is designed to provide investors with a cushion for repayment
  - The SPV uses the proceeds to make an upfront payment to the seller of 95% of the purchase price for the assets purchased and agrees with the seller to pay the balance of the purchase price over time, using collections from the assets, but only after ensuring that high-rated securities holders are repaid
  - A credit enhancement or liquidity facility is often obtained to provide investors with greater comfort around the probability of receiving principal and interest payments from the securitization
    - This often has the added benefit of reducing over-collateralization requirements

Securitization Advantages and Disadvantages

Advantages

- **Issuer**
  - New sources of funding
    - Securitization opens up new alternative sources of capital and increases the participation of the MFI in the financial markets
  - Creation of a marketable security
    - Securitization allows an issuer to create a tradable security out of a relatively illiquid asset
  - May help a borrowing institution lower its cost of funds, in that the rating of the structured securitization is generally better than the borrower's institutional rating
- **Investor**
  - Higher returns
  - Portfolio diversification

Disadvantages

- **Issuer**
  - Securitization costs[1]
    - Securitization can be expensive to operate, as they are highly structured. Typical securitization costs include
      - Issuance costs
      - Structuring costs
      - Rating agency fees
      - Operating and servicing fees (SPV or trustee administration)
  - Credit Risk Retention (depending on structure and whether the securitization is on a recourse basis)
- **Investor**
  - Early amortization Risk (prepayment on the underlying assets or loan portfolio purchased)
    - Early amortization may require the originator to transfer additional assets or to remove deteriorated assets, which replenishes the pool of assets sold

1. The cost disadvantage of securitization only applies to smaller issuers; by contrast, large issuers benefit from economies of scale (due to the scalability of the costs).

Basic types of securitizations and accounting impact

Type	Accounting Impact
Off-balance sheet securitization	▸ Loan assets removed from balance sheet ▸ Realization of "gain on sale" income ▸ Indicators: leverage decline (off-balance sheet financing) • Return on Assets (ROA) improves (income gain and lower asset base) ▸ Other: may have to pay special/increased taxes on asset sales/gains.
On-balance sheet securitization[1]	▸ Sale of assets to separate subsidiary or company owned SPV resulting in retaining assets on the balance sheet ▸ Securitization proceeds show up on consolidated statements as "debt" (since the subsidiary– or SPV– issues notes to third parties to purchase the assets) ▸ Avoids earnings swings (no "gains on sale") ▸ Might minimize taxes paid on asset sales and gains ▸ Depending on level of recourse back to the company, a securitization may be classified as on-balance sheet

1. The vast majority of securitization transactions receive "off-balance sheet" accounting treatment. Only in selective cases, usually in the United States, is the securitized portfolio kept "on-balance sheet". Because the creation of an SPV is designed to transfer assets and liabilities from the balance sheet of an issuer to a separate entity, on-balance sheet financing largely defeats the purpose of the SPV and would be particularly unusual in the case of MFI securitizations.

Key Takeaways of Securitization Transactions

There are several key aspects of securitization transactions which affect an MFI's balance sheet and income statement

- The securitization process affects the assets side of the balance sheet in two ways:
  - Cash balance increases (cash income generated from sale of assets)
  - MF portfolio decreases (assets transferred to off-balance sheet SPV)
- It is also important to note that through a securitization, an MFI is able to grow its portfolio without taking on new debt
- While the MFI's portfolio may initially decline, the MF portfolio will be quickly replenished as the proceeds of the securitization will be reinvested in MF loans
- On the income statement, an MFI's income will generally increase from the realization on the sale of the portfolio
- Combined, the increased earnings and relatively constant asset base should result in a higher Return on Assets (ROA) for the MFI

Recent Securitizations

Below are some of the recent securitizations involving MFIs

- BRAC Bangladesh, Taka Denominated Microcredit Loan Portfolio Securitization
  - In July 2006, BRAC completed the first microcredit securitization. Denominated in Bangladesh Taka (BDT), the transaction will provide an aggregate of BDT 12.6 BN (USD180mm equivalent) of financing for BRAC over six years. Under the program, BDT 1 BN (USD 15mm equivalent), with a maturity of one year, will be disbursed every six months to BRAC. The transaction was rated AAA by the Credit Rating Agency of Bangladesh, and the first program was priced at 200 basis points below BRAC's current cost of funds. RSA Capital acted as lead arranger; Citibank, N.A. Bangladesh (Citigroup), FMO (Netherlands), and KfW (Germany) were co-lead arrangers. FMO purchased one-third of the certificates, Citibank, N.A purchased another one-third of the certificates, (backed by a guarantee of FMO and counter guarantee of Kfw) and Citibank, N.A. Bangladesh, with two other local banks purchased the remaining one third of the certificates.

- ProCredit Bank Bulgaria, Euro-Denominated SME Loan Portfolio Securitization
  - In November 2005, Deutsche Bank acted as lead structurer of the ProCredit Bulgaria securitization and arranged the financing through the commercial paper market. ProCredit Bulgaria will use proceeds of the securitization to finance its lending activities to micro, small and medium-sized enterprises. The initial securitized portfolio amounted to €47.8 million, which is intended to increase to €100 million over the next 12-15 months. Fitch Ratings gave the note facility used to finance the securitization a 'BBB' rating, which was further enhanced by guarantees provided by the European Investment Fund (EIF) and Germany's KfW.

- ICICI Bank's Securitization of SHARE's Loan Portfolio
  - In early 2004, ICICI Bank (India) paid India-based SHARE USD 4.3MM for 25% of SHARE's loan portfolio, which covered approximately 42,000 loans from 26 different branches. ICICI discounted the future value (FV) of the principal and interest of these receivables at 8.75%. While there was no placement of securities with investors, the transaction was structured in securitization style and it was a step towards a full securitization.
  - It should be noted that this portfolio purchase helped ICICI to meet the "priority sector" lending target requirements imposed by the Reserve Bank of India on private banks. ICICI subsequently sold the assets to another Indian bank at a premium, netting over 400 basis points (approximately USD 4MM) in the process.

Section 6E

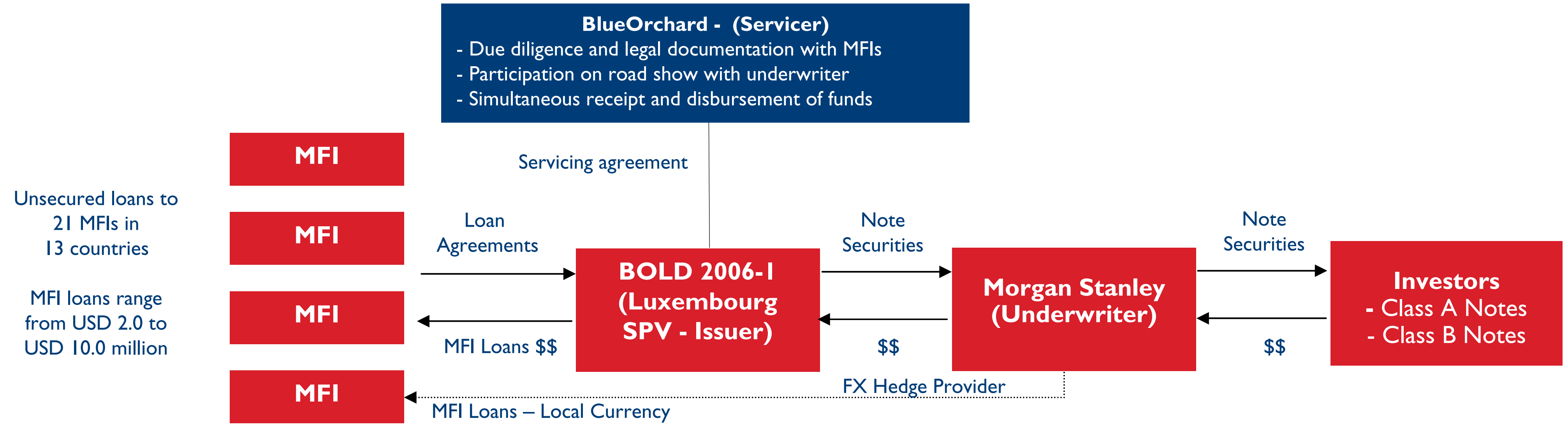
Collateralized Debt Obligations and Collateralized Loan Obligations

What are CDOs?

Collateralized debt obligations (CDOs) are securitization transactions (in the sense of selling assets) backed by the following types of assets:

- Loans (loans to MFIs)
- Structured Products (Asset Backed Securities - ABS, Mortgage Backed Securities - MBS)
- CDS (Credit Default Swaps)
- Other
  - Emerging market debt securities
  - Commercial and industrial loans
  - High-grade and high-yield bonds

The diagram below illustrates the 2006 BOLD transaction[1]



1. Please see page 52 for more details on this transaction.

Types of CDOs

There are two basic types of CDOs

Balance Sheet

- Reduce the size of the balance sheet
- Allows banks to manage regulatory and economic capital
- MFI CDOs would fall into this category

Arbitrage

- Allows equity investors to buy high-yielding collateral through the issuance of significantly lower yielding debt (most of which is rated AAA or AA)

CDOs: Who invests?

Investors vary by class of security.

Class of investment	Types of Investors
Senior Securities • Typically rated AAA • Conservative – Low risk-return strategy • Last class to be affected by asset defaults	• Non-U.S. Commercial banks • Money managers • Hedge funds
Mezzanine Securities • Typically rated from AA to B • Moderate risk – Medium risk profile • Junior to AAA but senior to equity	• Insurance companies • Money managers • Commercial banks
Equity Securities • Unrated class • Aggressive – High risk-return strategy • First class to be affected by asset defaults	• Affiliates of asset manager • High net worth individuals • “Alternate investment” investors

Recent CDOs

Below are a few of the recent CDO transactions involving MFIs

- BlueOrchard Microfinance Securities (BOMFS)
  - In July 2004, BlueOrchard Finance and Developing World Markets co-structured a USD 40MM securitization of 7-year fixed rate notes against cross-border loans to microfinance institutions (MFIs) in a transaction that was referred to as BOMFS I. JPMorgan Securities acted as the Senior Placement Agent for the Senior Notes.
  - In May 2005, BlueOrchard Finance and Developing World Markets co-structured a second closing of BOMFS I with a USD 47MM securitization ("CDO"). JPMorgan Securities again acted as the senior placement agent.
- BlueOrchard CDO (BOLD 2006 I)
  - In March 2006, BlueOrchard Finance, a microfinance specialist investment company, issued a landmark USD 99.1m unrated Collateralized loan obligation (CLO) tranche available to investors worldwide, with the sale managed by Morgan Stanley. It is backed by loans to 22 MFIs. Morgan Stanley is also providing currency swaps for around 25% of the proceeds to provide local currency finance in Colombia, Mexico and Russia.
  - In total, ten investors participated in the senior tranches, which had average lives of 4.7 years and were split into euro, sterling and dollar notes. The Class A1 Notes bear interest at a floating rate of three-month LIBOR + 0.75%. The Class A2 Notes bear interest at a fixed rate of 5.59% per annum. The Class A3 Notes bear interest at a fixed rate of 6.02% per annum . Interest on the Class B Notes will be calculated by the cash manager and were purchased 100% by FMO. The average return amongst the tranches is 6.14%.
  - This deal represents a major step to generate funding for MFIs by accessing the structured credit markets. It offers a new way to channel private capital from global sources to small-scale borrowers who have little access to credit, providing several participating MFIs with local currency funding, thus eliminating any foreign exchange (FX) risk.
  - BlueOrchard has been arranging capital for MFIs for five years, and manages other MFI funds including the USD 90m Dexia Microcredit Fund and the ResponsAbility Global Microfinance Fund. In 2004 BlueOrchard with Developing World Markets also launched a USD 40m US CLO wrapped by the Overseas Private Investment Corp, and followed with another USD 47m deal later in the year.

Recent CDOs

Below are a few of the recent CDO transactions involving MFIs

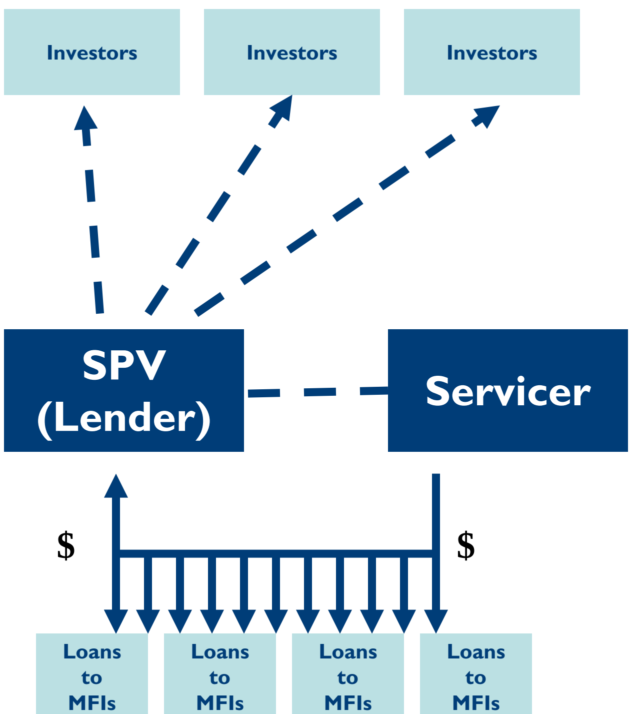
- MicroFinance Securities XXEB (MFS):
  - In July 2006, Developing World Markets completed the structuring of a USD 60MM 5-year fixed and floating rate securitization of cross-border loans to 30 microfinance institutions (MFIs) in 15 countries that encompasses nearly 1 million clients. This transaction, referred to as MFS, included Symbiotics (a Geneva-based provider of microfinance investment intermediation services) and Global Partnerships (a Seattle-based non-profit) as co-servicers in this transaction. DWM sponsored the transaction and acted as Master Servicer.
  - The transaction consisted of multiple currencies including USD, EUR and GBP with debt and equity tranches. The senior notes were rated A1 (on a Moody's scale) by MicroRate, making MFS the first microfinance CDO to be rated. The equity investors in MFS include Morley Fund Management, a leading UK-based socially responsible investment (SRI) fund management company, Civic Capital, a Boston-based SRI hedge fund and DWM.

CLOs and CDOs vs. Securitizations

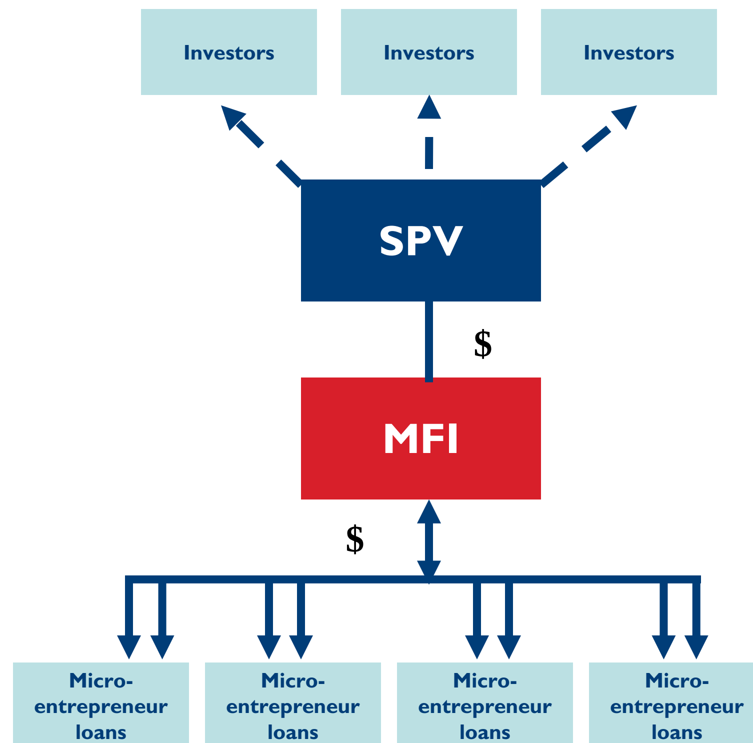
How do CDOs and CLOs differ from Securitizations?

- Securitization is the process of creating structured financial instruments around many kinds of assets. CDOs and CLOs are also structured financial instruments, but the assets underlying them are specifically limited to loans or debt obligations (bonds). Therefore, a CDO or a CLO is just another form of securitization.

CDO/ CLO



Securitization



- Limited number of obligors
- Loans grouped to provide portfolio diversification
- “Lender” may also act as “servicer”
- SPV pledges loans to MFIs to lender

- Thousands of obligors
- MFI acts as the servicer for the collection of the loans
- In a securitization, the MFI “sells” assets to the SPV

Section 7

Credit Enhancements

What are Credit Enhancements?

- A credit enhancement reduces the risk of a transaction to achieve a higher rating. Essentially, it improves the creditworthiness of a borrower or transaction. Credit enhancements take many different forms, including financial guarantees
- Such instruments or guarantees can improve the feasibility of an issuer accessing their local capital markets and may lower the ultimate cost of the transaction financing
- Concepts to evaluate when considering credit enhancement options include: size, maturity, structure complexity, direct and administrative costs and availability in the respective emerging markets

Section 7A

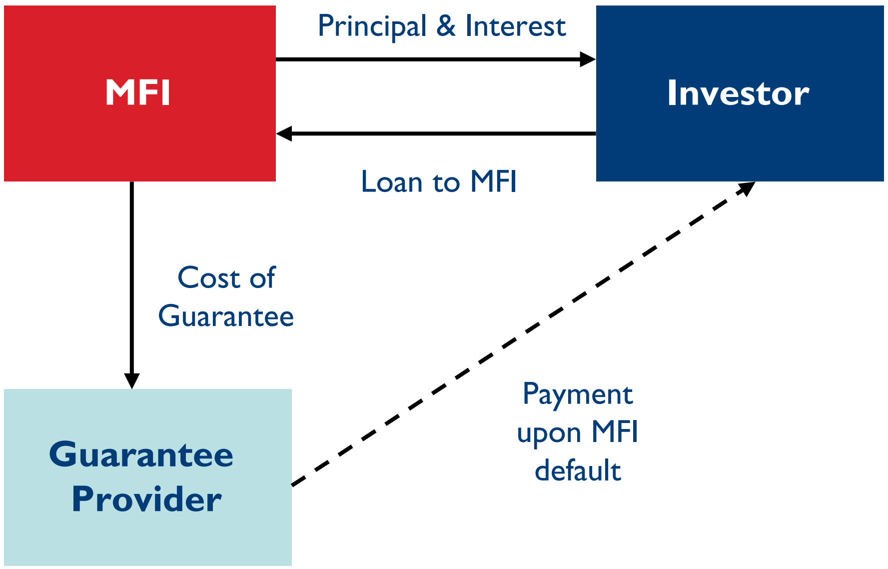
Financial Guarantees

Financial Guarantees

Financial guarantees are used to ensure timely payment

Definition:

- A guarantee ensures that interest and principal will be paid on time and in full for the financial instrument in question.
  - The guarantee provider accepts responsibility for the obligation if the entity (MFI) with primary responsibility for the obligation does not meet it



Financial Guarantees

Financial guarantees are used to ensure timely payment

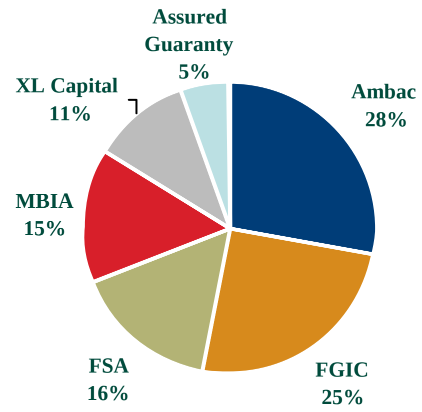
Transaction Considerations

- Viability of guarantee programs depends on the perceived credit-worthiness of the guarantor to meet payment claims (the assigned rating)
    - In developed financial markets, credit ratings by major rating agencies greatly influence investor perception of the guarantor and/or issuer
- Since comprehensive guarantees may prove to be too expensive or infeasible, there are alternatives:
    - Partial guarantees are structured such that there is risk sharing between the lender and the guarantor that mitigates borrower risk to a level absorbable by the lender
    - Debt subordination acts as a credit enhancer, in which the subordinate lender (MFI donor or development agency) takes a junior lien versus senior lenders

U.S. Bond Insurer Overview

- AFGI's[1] members had insured bonds with a principal value of USD 466.6 billion in 2004 - including U.S. municipal and international public sector bonds and asset- backed securities (ABS).[2]
- Internationally, the principal value of bonds insured totaled USD 58.5 billion. International asset-backed bonds insured increased by 4% from 2003 to $46.8 billion in 2004.

Guarantors of US ABS/MBS in 2004 (3)



1. Source: www.afgi.owrg. AFGI (Association of Financial Guaranty Insurers) is the trade association representing U.S. insurers and reinsurers of municipal bonds and asset-backed securities. These guarantors are financial institutions (primarily insurance companies) that are regulated and tend to have AAA ratings.
2. Source: Asset Backed Alert, January 2005

Section 7B

Women's World Banking

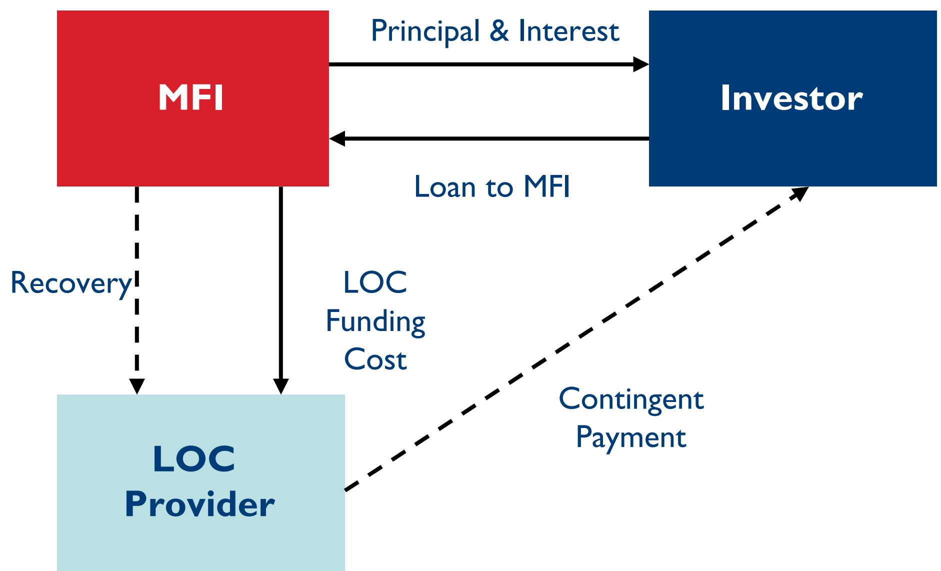
Standby Letters of Credit

Standby Letters of Credit (SBLC)

Standby letters of credit may be used to increase funding liquidity

Definition:

- **A letter of credit (LOC)** is an agreement issued by a financial institution (typically a bank) stating that a borrower (the MFI) has established a line of credit in the lender's (the Investor's) favor and confirming that payment will be made according to the provisions of the letter of credit.
- **A standby letter of credit ("SBLC")** is a LOC designed to be used only when the applicant defaults on payment
  - The standby letter of credit assures the lender of the performance of the borrower's obligation
  - Generally, the SBLC is issued by a highly rated bank and essentially helps to substitute the bank's risk for the issuer's risk – providing investors with greater protection



Standby Letters of Credit

Standby letters of credit may be used to increase repayment liquidity. Transaction considerations are described below:

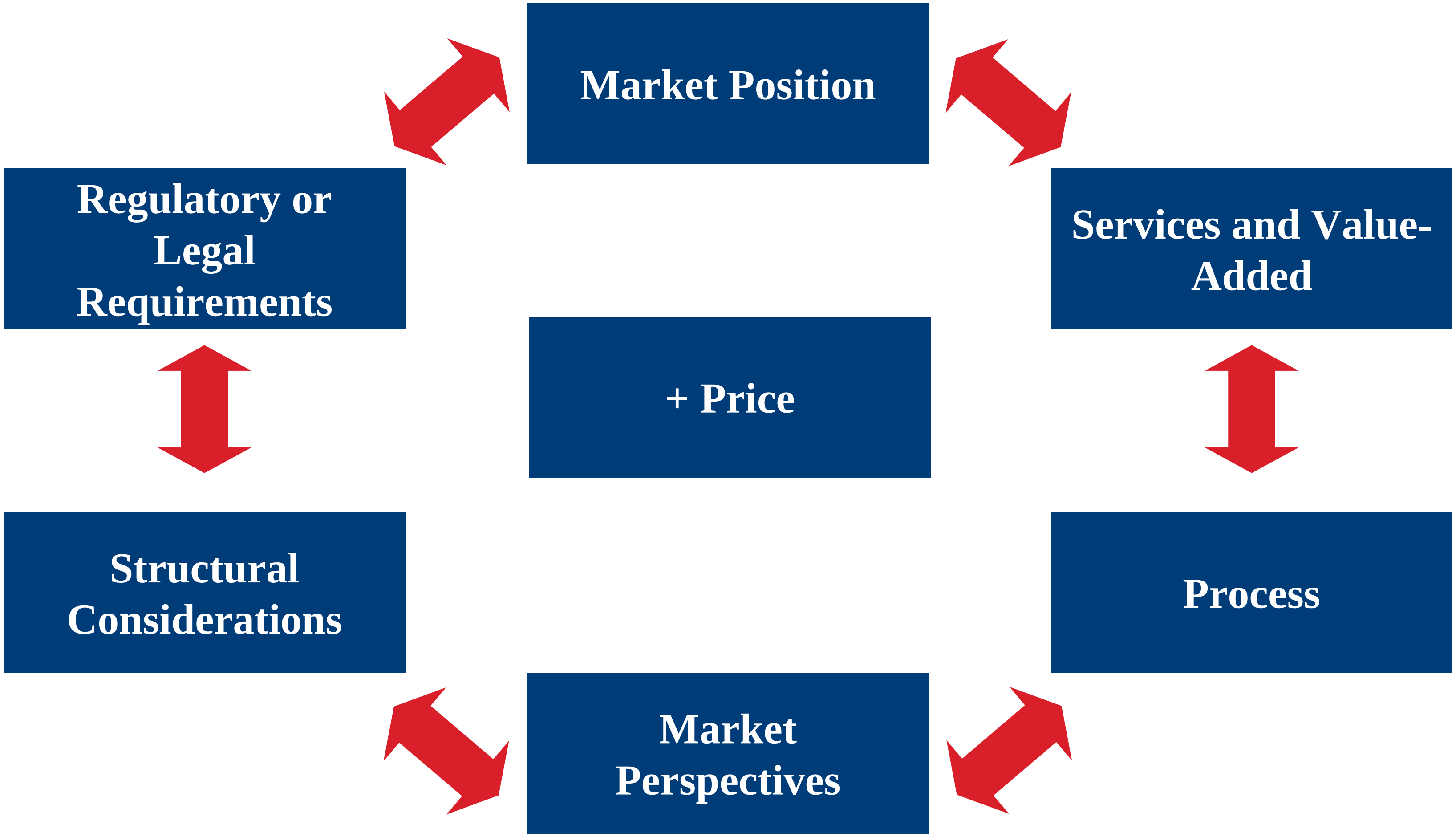
- Three basic types of risks
  - Credit risk
    - Provider is exposed to credit risk of the borrower and the cost of providing the SBLC which can significantly affect pricing in higher risk transactions
    - Option may not be available to entities who cannot satisfy the LOC provider's credit requirements
  - Documentation risk
    - Legally enforceable contract but depends on pre-defined "default" triggers
    - Documentation that fails to comply with the requirements of the LOC may invalidate a contract
  - Political risk
    - Cross border transactions may create unwanted exposure to political or event risk for investors, however, the presence of a SBLC from a global bank could help mitigate this risk.
- Since 1979, Standard & Poor's has rated over 9,000 transactions in the US that are credit-enhanced with the full support of a letter of credit (LOC).
  - The rating assigned to an LOC-backed transaction typically is the provider's certificate of deposit (CD) or issuer credit rating.

Section 8

Screening Questions for Evaluating Investment Banks as Underwriters

Screening Investment Banks as Underwriters

Evaluating investment banks as potential underwriters along the 7 dimensions below should help to optimize your planned capital markets transaction.



Please see appendix (6) for specific questions on each of the topics above to be asked of potential underwriters as part of the selection process.

Section 9

Women's World Banking

Packaging Your Institution's Success for Raters and Investors

Marketing Process: Overview

- During the marketing process, an MFI will need to explain the following to investors (also called "positioning"):
  - **MFI's value proposition**, including: target clientele, regional & geographic focus, loan methodology, expansion strategy, product and services offered
  - **Key differentiators** between the MFI and regulated and/or commercial financial institutions
  - **Competitive advantages** of the MFI with microentrepreneurs versus competing programs, such as the qualitative value of MFI brand and appeal to target market
- Investors (equity investors in particular) will look to an MFI's ability to:
  - extend and protect existing product offerings
  - enter new markets and access new customers
  - strengthen its financial performance when assessing whether to proceed with an investment
- In order to help investors make this determination, management should think about the following (sample) investment highlights:
  - **Strong Franchise:** an MFI might include market-share or market-penetration statistics that demonstrate leadership and highlight areas where the MFI has competitive superiority
  - **Loyal Customer Base:** an MFI might point to the number of repeat clients, or other customer retention statistics
  - **Powerful Business Model**: an MFI could feature data on recurring revenues, high operating leverage, strong cash flow generation, high portfolio quality, and sustained performance during economic downturns
  - **Attainable Growth Opportunities:** an MFI might highlight the number of micro-entrepreneurs or low-income families present in the market who are currently "un-banked"
  - **Excellent Management:** an MFI could discuss the experience of its key executives and board of directors to demonstrate management's commitment to the institution and professionalism

Marketing Process

MFIs must be prepared to address investor concerns across a variety of topics

Organizational Structure

- Management experience with microfinance
- Current internal controls, origination, risk and audit
- Executive board or management committee oversight
- "Key man" risk (too much reliance on a single person or group)
- Current capital structure and financial data
  - Ownership
  - Debt-to-capital ratios
  - Balance sheet & income statement
- Direct or indirect lender
  - Lenders that do not make microfinance loans directly to the public will have to explain their relationships with the direct lenders.

Funding Type/Use of Proceeds

- Description of offering:
  - Funding terms (maturity, coupon frequency, amortization)
  - Funding type (debt, securitization or equity)
  - Relative value of offering versus:
    - Relevant government debt
    - Local mortgages or securitizations
- Local currency and convertibility restrictions
  - Likely more important for cross-border deals
- Legal and jurisdictional issues
- Use of proceeds:
  - Estimated returns over next 3 to 5 years
  - Assumptions (for above calculations)

Marketing Process

MFI's must be prepared to address investor concerns across a variety of topics.

Asset Origination and Risk Management

- Loan origination:
  - Underwriting and expansion capabilities
  - Credit evaluation methodology
- Financial and break even point analysis information, including:
  - Default rates
  - Historical performance of portfolio
  - Audit reports
- Risk management:
  - Back-office systems to manage credit risk and cash flow:
    - Collection systems and centers
    - Payment processing
  - Process for defaulted loans
    - Recovery values (estimated and realized)

Third Party Support

- Financial advisor selection
  - Crucial for securitizations
- Provide historical performance of issuing entity
  - Important even for securitizations where a separate entity or SPV is created
- Provide current rating agency reports or credit ratings:
  - Mainstream agency preferable (Fitch, S&P, Moody's) for "credit rating" and more global recognition with investors
  - If specialist agency, describe rating history and methodology. Specialist agency rating would have to be recognized by or acceptable to local capital markets regulatory agencies and local investors

Marketing Process: Investor Relations

The Investor Relations function is an important part of the marketing effort, and will serve as the focal point for communication with investors on an ongoing basis

- As an MFI considers whether to pursue a capital markets transaction, it is essential that the management team bolster its investor relations (IR) function.
- The Investor Relations function is typically responsible for monitoring the ways in which the MFI discloses information to the outside world, with an emphasis on maintaining transparency and consistency
  - After a capital markets transaction is completed, the IR team will usually oversee documentation related to regulatory compliance, and will also act as the primary contact point for existing and potential investors who are seeking information on the MFI
- Overall, the IR function is concentrated on the distribution and dissemination of financial information (audited financial statements and rating reports) relating to the MFI, but IR department duties may also include the transmission of information relating to MFI's corporate governance policy or communication related to changes in an MFI's product offering, new strategic alliances, entrance into new markets, and other such developments (especially if there is no already-existing communications function within the MFI)
- As with most publicly traded companies, an MFI should designate an officer or manager to respond to requests from investors in a prompt fashion
  - The IR officer may also collect information on competitors, disseminate information through press conferences, organize one-on-one briefings, maintain the IR section of an MFI's website and coordinate the production of an annual report
- The IR team should also stay aware of current and upcoming issues that may affect the MFI from a regulatory or operational perspective. The IR manager should work closely with the executive director and finance manager of the MFI, as well as with the chairperson of the board, to ensure that the image of the MFI is maintained in a coherent fashion. The IR department often also has a role in crisis management in the event of an operational disaster.

Appendix 1: Core Description of the Ratings Process

The Ratings Presentation

Below we lay out what information would be found in a typical ratings presentation

Contents

- Executive Summary
  - High level info on background, strategy, business plan
- Management Team
  - Presentation of team who will be operating and implementing this plan and identifying their experience
- Strategy
  - High level strategy and rationale
  - Largely qualitative discussion about strategy
- Business Plan
  - Step-by-step: what do you expect to achieve and how
- Use of Proceeds
  - How will the proceeds be used
- Financial Projections
  - Forecast financials based on the business plan (generally 3 to 5 year forecast, or at the minimum, projections should cover tenor of capital markets issue)
- Sensitivity Analysis
  - Key financial measures at different sensitivities
    - For MFIs, sensitizing of key business variables including client growth, interest rates, operating costs and funding costs)
- Appendices
  - Appendix I
    - Biographies of key operational staff
  - Appendix II
    - Key assumptions to financial projections

Appendix 2: Commercial Paper

Establishing a U.S. Commercial Paper Program

Women's World Banking

DOCUMENT:	RESPONSIBILITY OF:	DOCUMENT IS SUBMITTED TO:
Dealer Agreement: An agreement between Issuer and Investment Bank that specifies the terms under which each dealer will act with regard to the issuance of the commercial paper notes.	Issuer/Investment Bank	Investment Bank/ Issuer/Rating Agencies
Offering Memorandum: A marketing piece outlining the business of the Issuer and the terms of the program.	Issuer/Investment Bank	Investors
Issuing and Paying Agent (IPA) Agreement: Authorizes a bank, acting as an agent for the Issuer, to issue commercial paper notes and pay investors at maturity.	IPA/Issuer	Investment Bank/Rating Agencies
Board Resolution and Certificate of Incumbency: The Issuer's Board of Directors must approve the borrowing of funds and designate officials authorized to arrange borrowings on behalf of the Company.	Issuer	Investment Bank/Rating Agencies
Securities Law Opinion: States that the commercial paper notes are exempt from registration under the Securities Act of 1933 pursuant to Section 3 or Section 4.	Issuer/Legal Counsel	Investment Bank/Rating Agencies
Corporate Opinion: States that the borrower is duly organized, validly existing and in good standing; the Company has the corporate power and authority to execute, deliver and perform its obligations; the notes have been duly authorized, executed and delivered.	Issuer/Legal Counsel	Investment Bank/Rating Agencies
Master Note/DTC[1] Letter of Representation: Provide terms under which the notes are traded under the "Book-Entry" system.	Issuer/DTC/IPA	Investment Bank/Rating Agencies
Evidence of Short-Term Ratings/Copies of Ratings letters.	Rating Agencies/ Issuer	Investment Bank

1. DTC - Depository Trust Company - A central repository through which members electronically transfer stock and bond certificates (a clearinghouse facility).

Establishing a U.S. Commercial Paper Program

Timetable for Establishing a USCP Program – (First Time Issuer)		
Target Date	**Documentation/Action:**	**Responsibility of:**
Week One	Contact rating agencies to advise of new program.	Issuer
	Contact commercial bank to establish back-up facility (generally a line of credit to provide investors with a guarantee of repayment) for the commercial paper program. (if applicable) and select an Issuing and Paying Agent.	
Week One-Two	Provide the Issuer with a draft of the dealer agreement and offering memorandum.	Investment Bank
Week Two-Three	Commence processing the required commercial paper documents: - Dealer Agreement - Board Authorization of Borrowing - Certificate of Incumbency - Legal Opinions - Issuing and Paying Agent Agreement - Physical Note (also Master Note)	Issuer
Week Three-Five	Finalize documentation on bank back-up facilities. Execute the dealer agreement and finalize other commercial paper documents, including the Issuing and Paying Agent Agreement.	Issuer/Investment Bank
	Finalize offering memorandum and authorize distribution to investors. Trader and Issuer discuss market strategy and review procedures for borrowing.	Investment Bank

Appendix 3: Bonds, Senior and Subordinated

Bonds: Key Considerations and Risks for MFIs and Investors

Women's World Banking

	Risks for MFIs	Risks for Investors
Interest Rates	• For floating rate bonds, rise in benchmark index means higher interest payments • For fixed-rate bonds, when interest rates rise, there is no risk of an increase in funding cost	• For floating rate bonds, fall in benchmark index means lower interest payments • For fixed-rate bonds, rise in interest rates decreases bond's value
Liquidity	• Potential difficulty in repaying bonds as they come due under stress conditions. • When MFIs make longer-term client loans, they need funding to match – bonds provide this funding	• An active secondary market may not exist for investors in MFI issued bonds
Credit	• Manage client loan portfolio and MFI liquidity appropriately to ensure timely payment of principal and interest on bonds especially as they may have a bullet or full principal, due at maturity	• Potentially insufficient understanding of microfinance business and risks
Exchange Rates	• "FX" risk exposure: Issuing bonds denominated in foreign currencies creates exposure to foreign exchange rate movements resulting from the mismatch between its loan portfolio (assets) and its funding liabilities that could be dangerous	• When investing in bonds denominated in a foreign currency, the investor will receive cash flows in that currency, whose equivalent value in domestic currency depends on prevailing FX rates
Call and Put Provisions	• For putable bonds, risk that investor may put (sell) the bond back to MFI prior to maturity; the MFI may then need to raise debt at a higher interest rate to refinance these investor obligations	• For callable bonds, cash flows are uncertain. If MFI calls (redeems) bond prior to maturity, the investor could be exposed to reinvestment risk by having to reinvest proceeds at lower, market interest rates

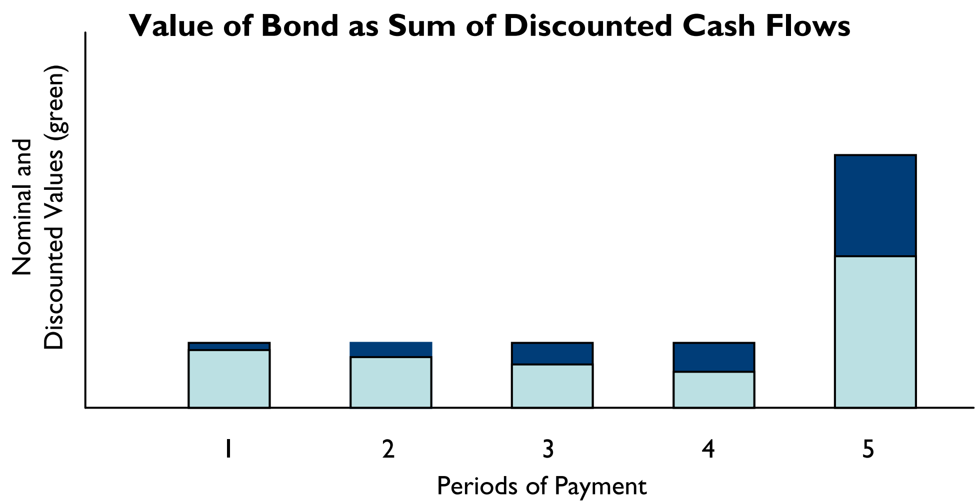
Bonds: Valuation

- The price of a bond can be expressed as the sum of its discounted cash flows:

$$P = \sum_{t=1}^{n} \frac{CF_t}{(1+r)^t}$$

CF_t represents the cash flow at period t and r represents the periodic discount rate. The higher the discount rate for a given set of cash flows, the lower the price of the bond.

- The commonly quoted **yield to maturity** is the discount rate, that when used to discount all cash flows, will make the sum of present values equal to the bond's price. It assumes that the bond is held to maturity (which may not be true in the case of a callable bond) and that coupon interest is reinvested at that yield.



- Conceptually, a rise in market rates decreases the value of a fixed-rate bond because if the market perceives the yield on the bond to be low relative to market expectations, the price of the bond will fall to bring its yield in line with prevailing interest rates. Conversely, when market rates fall, a fixed-rate bond's price will rise. In short, bonds have inherent risk due to their market exposure; future interest rates are not known with certainty, and the value of bonds can rise or fall accordingly.

Appendix 4: Equity - Common and Preferred

Detailed Characteristics of Common and Preferred Stock

Common Stock

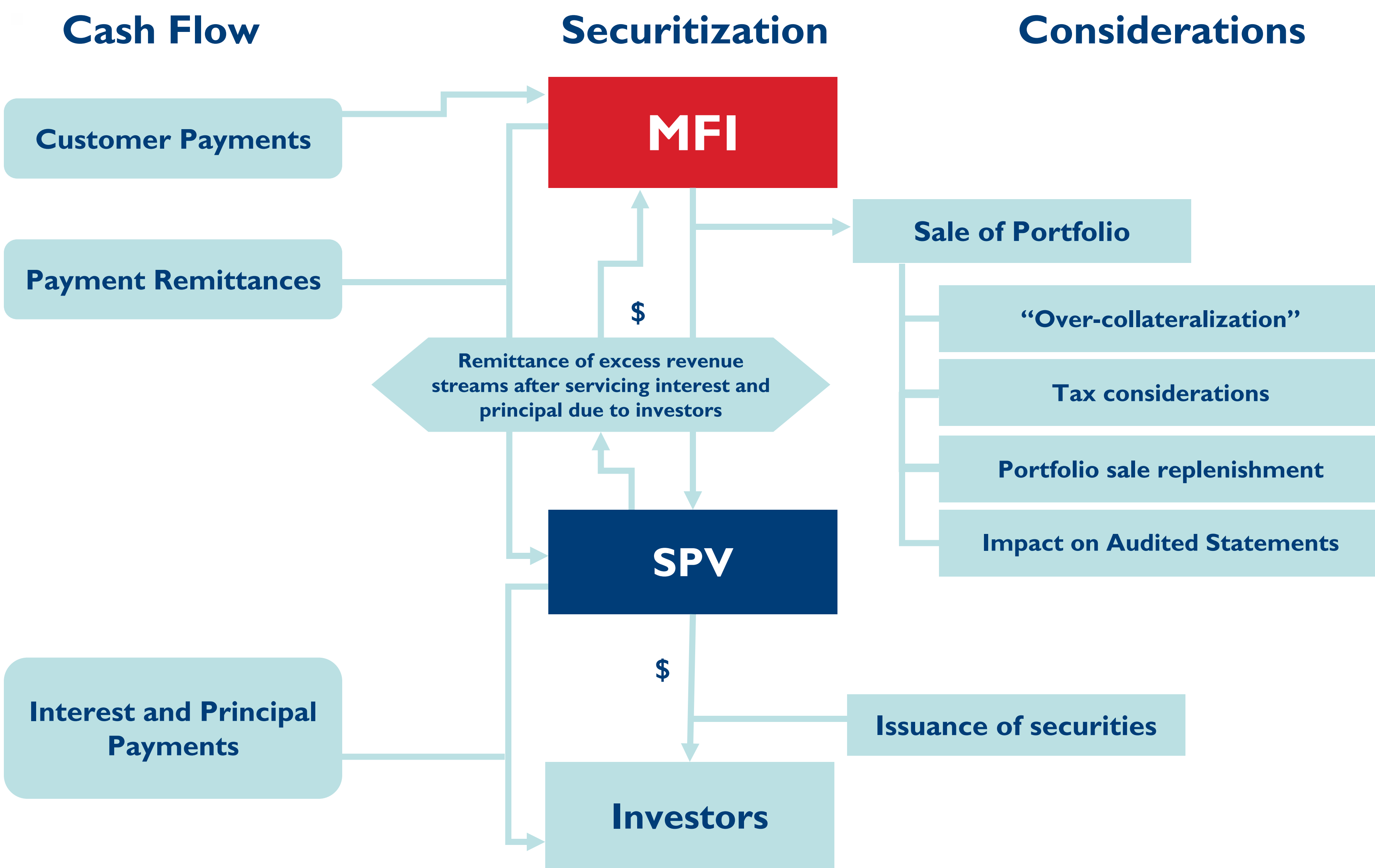
- The majority of stock held by the public
- Offers voting rights in matters of corporate policy, such as elections to the board of directors and stock split decisions
- Gives its shareholders the right to share in dividends, although that dividend may or may not be paid

Preferred Stock

- Entitles its shareholders a higher priority in receiving liquidation proceeds in the event of the issuer's insolvency or bankruptcy (senior to common shareholders)
- Entitles its shareholders to a fixed dividend that is paid at regular intervals
- Is usually cumulative, meaning that unpaid dividends will accrue
- Gives its shareholders a higher priority in receiving dividends than common stock shareholders
- May be participating; participating preferred shareholders have the right to receive "participating" dividends in addition to the fixed amount that non-participating preferred shareholders receive. This additional amount is equal to the common shareholders' dividend that is in excess of the regular preferred dividend, and is a function of earnings.
- May be callable in that the issuer has the right to redeem shares at a certain price and retire them

Appendix 5: Securitizations

What does a Securitization Look Like?



Process of Securitization

Steps involved in the process of securitization

Asset Origination	▸ First step in the securitization process is asset origination. ▸ Assets are originated when an entity makes a loan, for example, a residential mortgage to a borrower (ex: developing an MF loan portfolio).
SPV[I]	▸ The originator (MFI) will select a pool of assets for securitization. ▸ The originator typically sets up a special purpose vehicle (SPV). ▸ The SPV can be a corporation, business trust or partnership, depending on local factors and practice ▸ The SPV will often take the form of a trust as the establishment of a trust is a relatively simple process.
Sale of Assets	▸ The assets are sold to the SPV ▸ The originator must secure a legal opinion that the sale of assets represents a 'true sale' and not in the substance, merely a secured financing, so that the assets will move off the MFI's balance sheet to the SPV
Credit Enhancement	▸ The asset pool may need to be supported by one or more types of credit enhancement and/or liquidity support ▸ This will allow the MFI to achieve the desired credit risk profile for the debt securities being issued ▸ In most securitizations, credit ratings from one or more of the major rating agencies are usually obtained at the time of issuance
Issuance of Securities	▸ The SPV issues tradable securities to fund the purchase of the assets from the originator ▸ The performance of the securities is directly linked to the performance of the assets

Appendix 6: Collateralized Debt Obligations & Collateralized Loan Obligations

Collateralized Debt or Loan Obligations ("CDOs" or "CLOs")

Overview of CDOs and CLOs

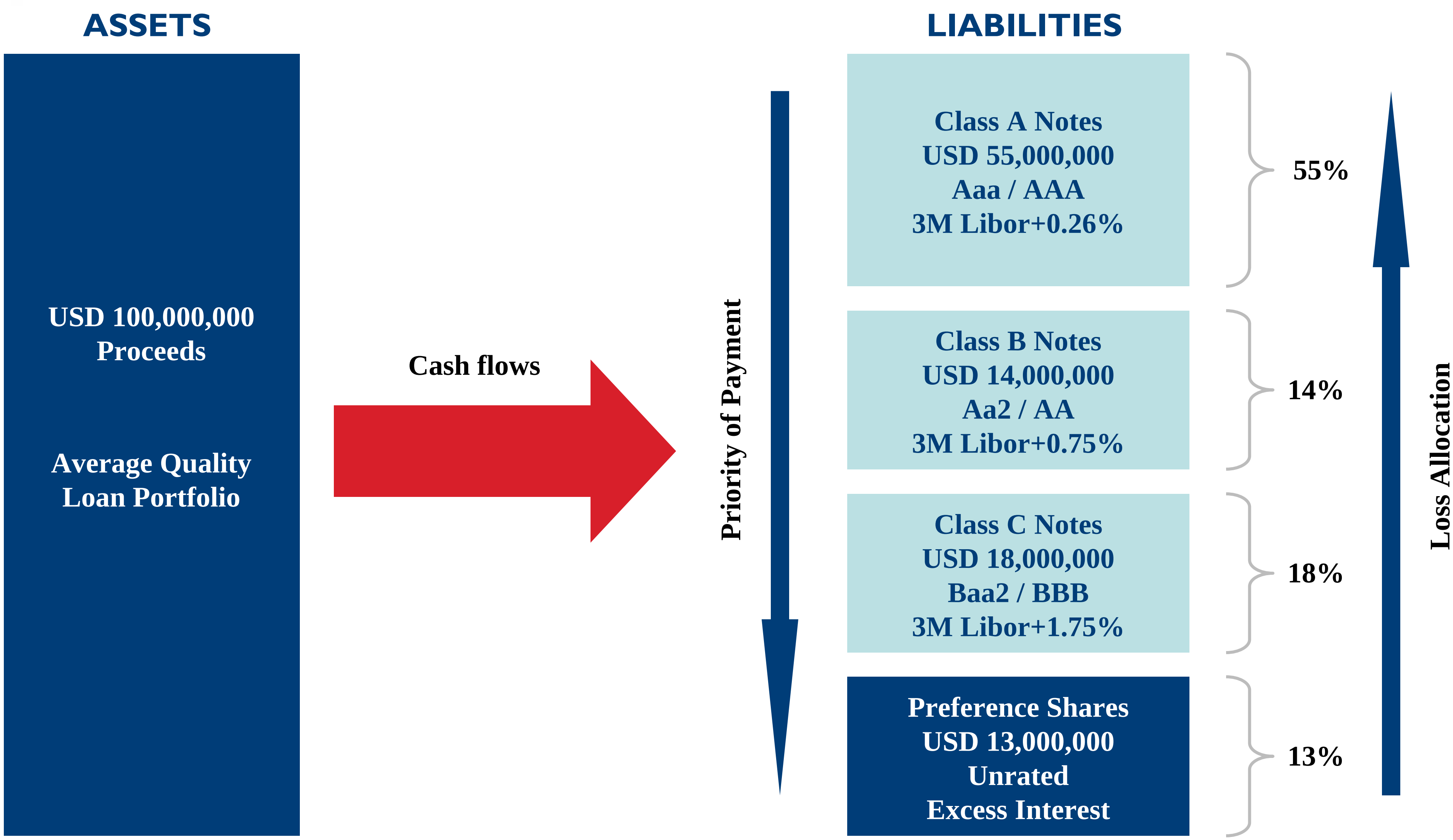
- CDO technology has been applied to a wide range of assets, a large portion of which are bank loans. CDOs backed by pools of bank loans are known as collateralized loan obligations (CLOs). In CLO structures, the cash flows from loan portfolios (assets) are used to repay investors of the CLO's tranches (liabilities).
- The first CLO was issued in 1990, and this asset class has gained popularity over the past 10 years, growing to an issuance volume of approximately USD 210bn in 2005.[1] The asset class continues to grow, and global issuance volume of CLOs and structured finance CDOs jumped 70% from 2004 to 2005.

Advantages of CLOs as a Funding Source for MFIs[2]

- **Increase the number of MFIs tapping the capital markets.** Investors may be more inclined to invest in a diversified pool of loans to MFIs than in a debt issuance by a single MFI, would make the minimum issue size more feasible for MFIs as the total issue amount is allocated among participating MFIs
- **Reduce MFIs' issuance costs** because such costs can be allocated among a number of MFIs participating in a CLO
- Allow MFIs to securitize a large portion of their loan books to investors who do not participate directly in the primary lending markets due to contractual restrictions or market barriers to entry
- **Help improve liquidity** through CLOs or securitization where illiquid bank loans are converted into tradable capital market instruments. Provides new funding to MFIs and liquidity to make new microloans
- **Offer investors access to a portfolio of credit risks** through a single investment. By creating a senior or subordinated structure of tranches with different degrees of risk and return, CLOs enable participants to build customized investments meeting different objectives according to risk appetite

1. Source: Lehman Brothers
2. Disadvantages of CDOs and CLOs as funding sources include the prevalence of triggers and covenants, or restrictions on borrowers.

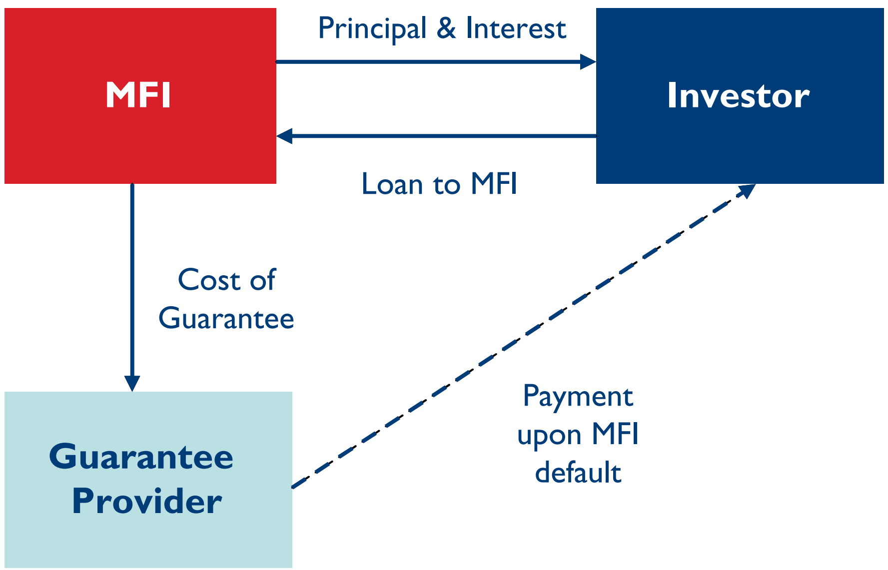
Typical Structure of a CLO



Appendix 7: Credit Enhancements

Financial Guarantees

Financial guarantees are used to ensure timely payment



Benefits:

- Guarantees can create a number of benefits such as lower borrowing costs and greater investor access.
- Appealing to a wider range of investors can increase the marketability of issues for large, well-known entities as well as for smaller, less frequent issuers.
- Investors often rely on the guarantor's credit ratings in their risk analysis.

Definition:

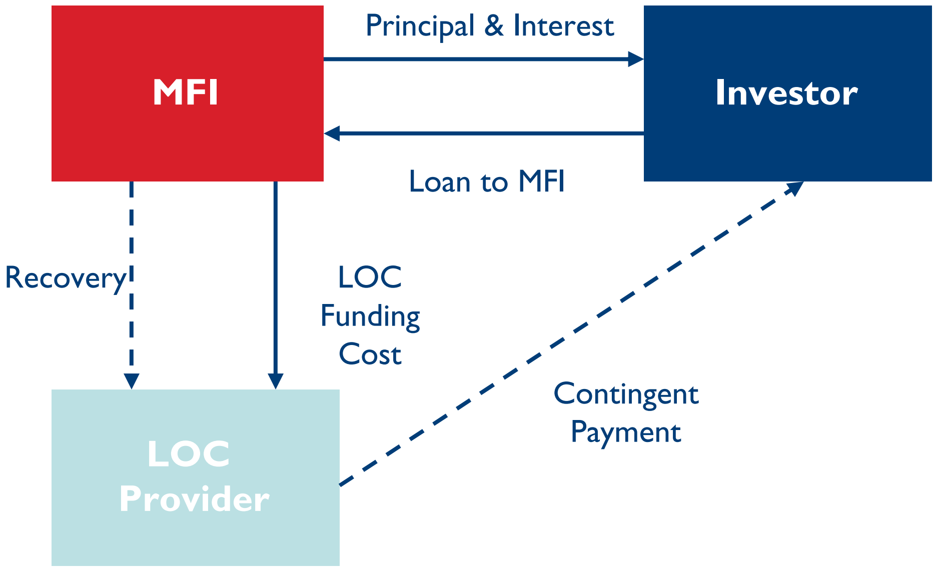
- A guarantee ensures that interest and principal will be paid on time and in full for the financial instrument in question.
  - The guarantee provider accepts responsibility for the obligation if the entity (the MFI) with primary responsibility for the obligation does not meet it.
- Guarantees have been made on: loans, bonds; infrastructure and project financings; local government issues; asset securitizations; structured finance transactions, and sovereign and quasi-sovereign debt
- Guarantee providers have been government agencies, financial development institutions, banks and insurance companies.

Characteristics:

- Financial guarantees have become popular in markets characterized by low probabilities of default and high likelihood of substantial recovery in the rare cases when default occurs.
- Historical focus has been on guaranteeing municipal bonds (in the U.S), asset-backed securities and structured finance instruments, but attention is shifting to opportunities in emerging markets.
- Generally cover principal amount of the debt issued (with the possibility of structuring guarantee to cover interest as well)
- Examples of financial guarantors in the U.S. include highly rated financial institutions, such as large insurance companies, global financial institutions (Citigroup, JPMorgan), or government agencies (Small Business Administration). For MFIs, financial guarantees may come from highly rated development institutions such as the IFC, the Inter-American Development Bank and USAID.

Standby Letters of Credit

Standby letters of credit may be used to increase funding liquidity



Benefits:

- The standby letter of credit is often used to guarantee performance or to strengthen the creditworthiness of a borrower
- Reducing credit risk can also allow borrowers to raise funds outside their typical investor base

Definition:

- A **letter of credit (LOC)** is an agreement issued by a financial institution (typically a bank) stating that a borrower (the MFI) has established a line of credit in the lender's (investor's) favor and confirms that payment will be made according to the provisions of the letter of credit.
- A **standby letter of credit ("SBLC")** is an LOC designed to be used only when the applicant defaults on payment.
  - The standby letter of credit assures the lender of the performance of the borrower's obligation.
  - Generally, the SBLC is issued by a highly rated bank and essentially helps to substitute the bank's risk for the issuer's risk— providing investors with greater protection

Characteristics:

- When a contingent payment is required:
  - The lender is able to draw under the LOC by presenting evidence that the borrower has not performed its obligation.
  - The bank is obligated to make payment if the documents presented comply with the terms of the LOC.

Appendix 8: Other Capital Markets Instruments

1. High-Yield Bonds

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High-yield bonds are issued by companies that are rated below investment-grade

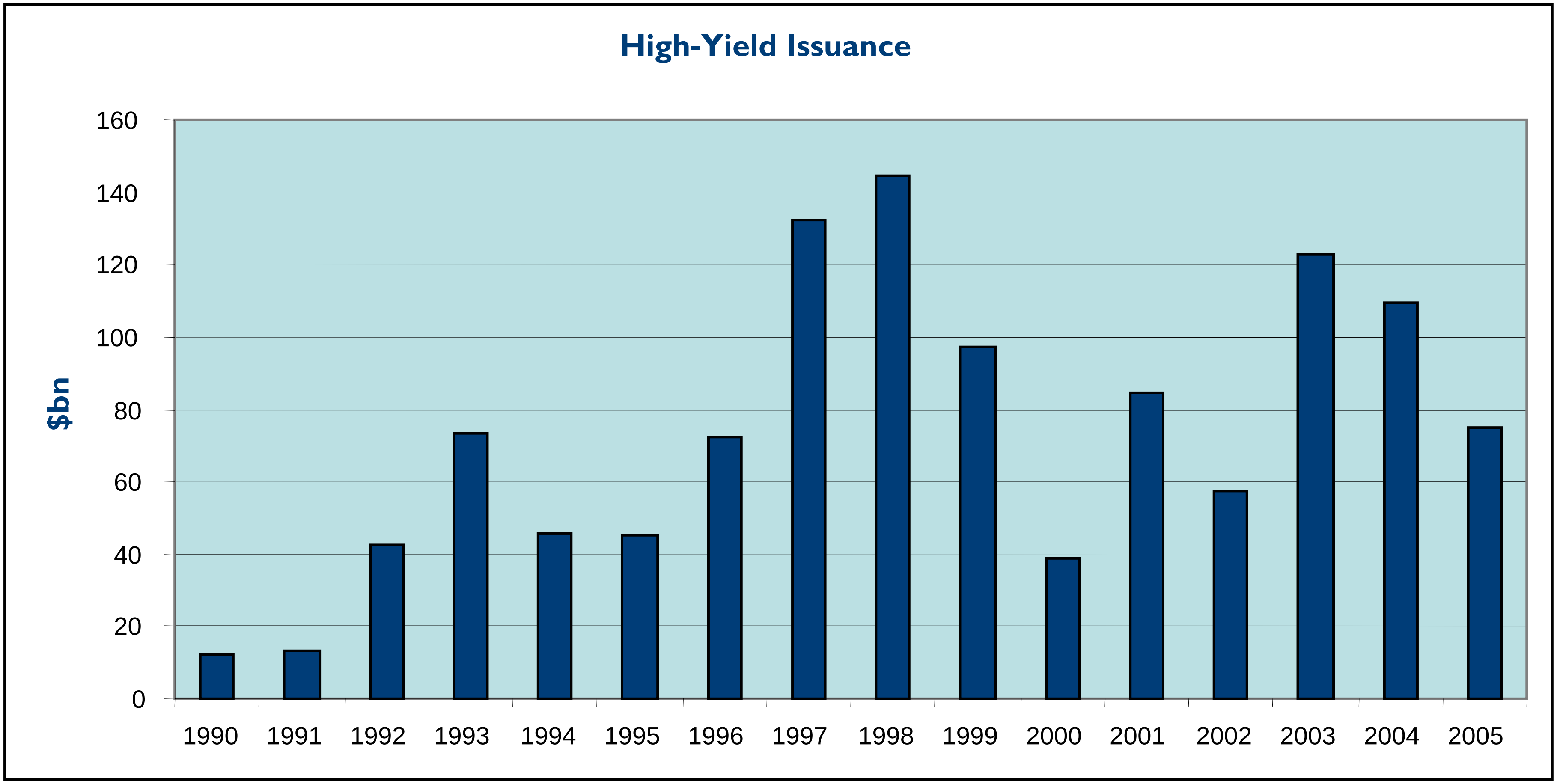
- Rating agencies assign ratings based on their opinions of the issuer's ability to pay interest and principal.
  - Those issuers with a greater risk of default (not paying interest or principal as scheduled) are rated below investment grade
  - Ratings of Ba1/BB+ (for Moody's/S&P) and below are considered to be below investment grade[1]
  - These issuers must pay a higher interest rate to attract investors and to compensate them for the higher risk associated with investing in bonds of lower credit quality
  - Both these issuers and the bonds issued are classified as "High Yield"
- Organizations that issue high-yield debt include many different types of U.S. and non-U.S. corporations and various governments.
  - Companies access the high yield markets for many reasons including:
    - Emerging companies that do not have the operational history, size or strength required to receive an investment-grade rating
    - Companies buy a public corporation from its shareholders, often for the benefit of a private investment group
    - Some governments may rely on high-yield bonds to attract capital as they have some unique risks (such as currency risk and political risk).
    - Companies that cannot completely finance themselves through earnings or bank borrowings
- Factors affecting issuers include:
  - Economic risk: In recessions, high-yield bonds typically lose more principal value than investment-grade bonds. If investors grow anxious they may only want to buy or hold high-quality debt, such as U.S. Treasuries (often called "flight to quality")
  - Industry and single company event risk: Factors that can affect a company's ability to repay its debt obligations on time can include management changes, rising costs, regulations and new competition. Certain events can adversely affect companies in an entire industry
- A variety of investors participate in the high-yield bond market including individuals (either via direct ownership and/or mutual funds); institutions such as insurance companies or pension funds, and investors with an appetite for securitizations may use high-yield bonds as the underlying asset (CBOs)

1. See ratings agency section for more information on ratings classifications.

High-Yield Bonds

Women's World Banking

High-yield bonds are issued by companies that are rated below investment-grade



Source: Bond Markets Association Website and Thomson Financial Securities Data.

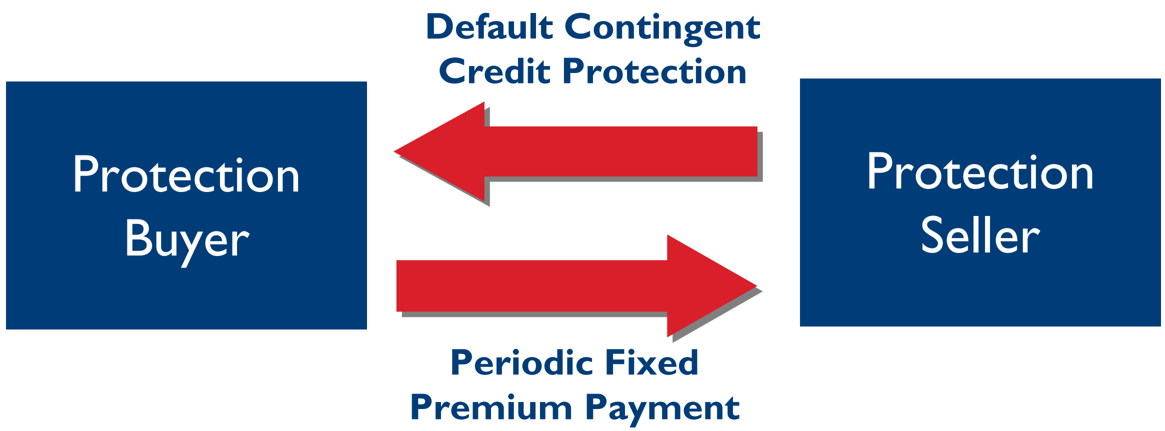
2. Credit Default Swaps (CDS)

Credit Default Swaps are used to buy protection against the risk of default

- A Credit Default Swap (CDS) is a swap designed to transfer the credit exposure of fixed-income debt between parties. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the debt. The risk of default is thereby transferred from the holder of the fixed income security to the seller of the swap.
  - Credit Default Swaps are enacted through ‘synthetic exposures’ to credits called reference entities. Default swaps transfer credit risk without requiring exchange of underlying bonds, loans, or obligations.
  - CDSs are the most widely used credit derivatives. In a CDS, the protection buyer pays a periodic fee to the protection seller in return for a contingent payment from the seller in the case of an occurrence of a credit event (such as a certain default) for the reference entity
  - A CDS is often used as an insurance policy, or hedge, for the holder of a corporate bond or loan. The typical term of a CDS contract is five years, although maturities out to ten years are common.
- Credit Default Swaps are commonly used to create desired exposure, or hedge risk without transferring legal ownership.
  - Banks have used CDS to sell or reduce credit risk in their loan and bond portfolios
- Credit default swaps were initially traded in the late 1990s as global commercial banks sought to hedge their exposure to corporate credits. The markets have evolved since then and CDSs represent the primary mode of trading credits in the United States and Europe. By contrast, volumes are still growing in emerging markets.
- Credit Default Swaps vary by:
  - Tenor or maturity
  - Form of fee payment (upfront or periodic)
  - The nature of credit events, which include events such as bankruptcy, failure to pay, obligation acceleration and restructuring

Credit Default Swaps

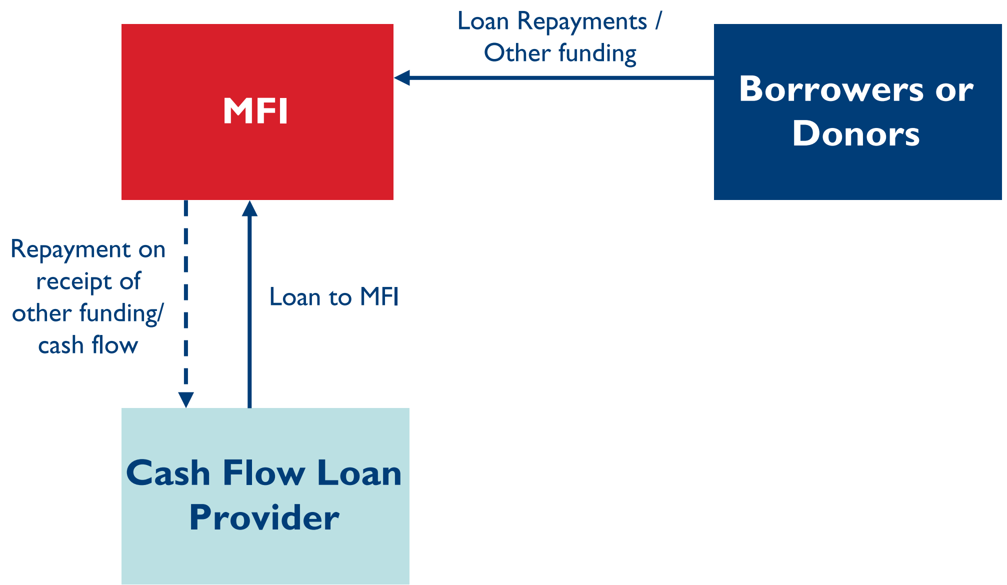
Default Swaps Diagrams



- The trade terminates at the earlier of a “credit event” (or default on underlying asset) or contract maturity.
- Upon a credit event, settlement can be made via:
  - Physical Settlement—buyer delivers defaulted obligations, and seller pays par value, or
  - Cash Settlement—Buyer delivers nothing, but seller pays amount equal to par value less obligation recovery.

3. Cash Flow Loan

Cash Flow loans are useful for bridge financing while awaiting committed funding to materialize



What is a Cash Flow Loan?

- For organizations that depend on funding from external sources to deliver vital services, frequently there might be significant delays in getting access to the funds
- Cash flow loan providers are typically banks

Characteristics:

- Cash flow loans make sense for organizations that have predictable and sustainable cash flows
- Cash flow funding can complement the necessary processes of cash flow management such as improving a business' cash conversion cycle

Benefits:

- A cash flow loan can allow the organization to launch new programs, continue expected services, compensate staff, purchase supplies and pay bills during periods of delays in getting access to regular sources of income and funding
- A cash flow loan can allow the organization to function smoothly and continue operations without disruption of services

4. Currency Hedges

Currency Hedges are used to manage foreign exchange risk exposure

What is a currency hedge?

- A hedge is a protective trading strategy which allows an investor or borrower to guard against adverse price fluctuations of an asset or liability on the balance sheet by taking an opposite position for maturity on a date in the future. In establishing this position, the investor is also foregoing the benefits of positive price fluctuation of the asset or liability
- Changes in the international economic and political landscape cause uncertainty regarding the direction of foreign exchange rates. This uncertainty leads to volatility and the need for an effective way to hedge foreign exchange risk, while at the same time, effectively ensuring a future financial position

Foreign Currency Risks:

- Foreign exchange rate risk exposure
  - Due to foreign funding or foreign Investments
  - As part of conducting international business
- Interest rate risk exposure
  - Due to interest rate differential between the two countries' currencies in a foreign exchange contract

Typical vehicles for meeting the above hedging needs:

- Forward Contracts - A contract to buy or sell a foreign currency at a fixed rate for delivery on a specified future date or period
  - Foreign currency forward contracts are used as a foreign currency hedge when an investor has an obligation to either make or take a foreign currency payment at some point in the future. If the date of the foreign currency payment and the last trading date of the foreign currency forwards contract are matched up, the investor has in effect "locked in" the exchange rate payment amount

Currency Hedges

Currency Hedges are used to manage foreign exchange risk exposure

Typical vehicles for meeting the above hedging needs (continued):

- Foreign Currency Options - A financial foreign currency contract giving the buyer the right, but not the obligation, to purchase or sell a specific foreign currency contract (the underlying) at a specific price (the strike price) on or before a specific date (the expiration date). The amount the option buyer pays to the option seller for the foreign currency option contract rights is called the premium.
  - Typically used in combination with other foreign currency options contracts to create more complex foreign currency hedging strategies
- Foreign Currency Swaps - A foreign currency contract whereby the buyer and seller exchange equal initial principal amounts of two different currencies at the spot rate. The buyer and seller exchange fixed or floating rate interest payments in their respective swapped currencies over the term of the contract. At maturity, the principal amount is effectively re-swapped at a predetermined exchange rate so that the parties end up with their original currencies.
  - Foreign currency swaps are often used as a foreign currency hedging vehicle as the buyer can essentially exchange a foreign currency obligation for a local currency obligation by entering into a swap

Benefits:

- MFIs can face significant foreign currency risk especially when tapping into foreign capital markets. currency hedges allow the MFI to manage this risk.
- If an MFI operates in a country where the local capital markets are not sufficiently developed, currency hedges could allow the MFI to access capital in foreign markets while safe-guarding against foreign currency risk.
- Even when the local capital markets are well developed, currency hedges will make it possible for an MFI to diversify and access international markets for their financing needs.

Appendix 9: Screening Questions for Evaluating Investment Banks and Underwriters

Market Position, Services and Competitive Advantages

1. Market Position

- What is your position in the league tables (competitive ranking among your peers) in the relevant country bond, commercial paper or securitization market [1] (year to date) by:
  - Volume of issues
  - Number of transactions
  - If possible, the MFI should perform its own research on this topic from sources such as stock exchange or the securities supervisory agency's website
- Who are your principal clients for issues (corporate or public/state)— in terms of number of transactions completed in past year?
- What is the profile of your typical client?
  - Are they large corporates or smaller companies? (Consider closely investment banks with proven success in helping smaller issuers reach the market)
- What is your reputation or niche within the markets for this particular funding option?

2. Services and Competitive Advantages

- What support do you provide in terms of helping first time issuers access the bond market?
- How well do you understand the microfinance industry?
- What is your distribution capacity—ability to place our securities?
- Which investor base do you have the best relationship with for selling the securities?
- Do you sell most of the securities to third parties or to institutional affiliates of your financial institution (insurance companies, asset managers, private clients?)
- Do you have a critical mass of socially responsible clients?
- If we were to do a structured transaction with you, who would buy the equity piece?
- Would you be able to help us work with a rating agency? If so, what would that entail?
- Would our transaction be a private placement or is there a way for us to be able to access a broader pool of investors?

1. For this appendix, we are referring to screening for bond transactions, although these questions would pertain to other capital markets instruments as well.

Price and Market Perspectives

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3. Price

- What are the principal costs and fees around bringing a deal to market? Please provide a breakout of the cost categories and estimates.
- Categories should include interest, legal, rating, marketing and transaction fees, potentially including structuring, placement, credit enhancement and other capital market fees.
- What is the fee structure, including payment time horizon? What are we obligated to pay if the transaction fails?
- How do interest rates vary with rating, tenors and guarantees or credit enhancements?

4. Market Perspectives

- Who are the principal investors in the security under consideration? Institutional investors (pension funds, insurance companies and others), private investors, or both?
- Investor Appetite: what type of security structures are most investors interested in?
    - Ratings: do most require or favor rated transactions? Particular raters?
    - Tenor
    - Size (minimum bond amount necessary to reach the market?)
    - Floating vs. fixed interest rate?
- Liquidity (related to size; do investors require a secondary market for bonds?)
- Collateral (are most bonds unsecured? If not, type of collateral generally required?)
- Financial Covenants: Do investors require financial ratio compliance (maximum leverage, minimum liquidity)? Would we need a fiduciary or trust figure?
- How open would investors be to deal terms allowing prepayment or refinancing of debt (callable bond)?
- When is the best time of year to issue bonds (when are markets most liquid?)
- What recent transactions have you done that are comparable or can be a reference point?

Structural Considerations: Regulatory, Legal and Process

5. Structural Considerations

- What would be the best way to structure the issue and why?
- Who do you anticipate would be the most significant buyers of our securities?
- Would your bank take a principal position in our securities?
- Do you think that we need or should be rated? Why or why not?
- What other capital market instruments or finance options would you recommend for us and why?
- Do you think that we could do an unsecured debt issuance? If not, what type of credit enhancement might be required?

6. Regulatory or Legal Requirements

- What are the key requirements for any issuer wishing to access the capital markets in our country?
- Are there any constraints on the issuer's legal structure?
- Particular restraints related to financial institutions (do you need to be regulated? NGOs?)
- Are there any certifications or structures that we would have to implement prior to considering a bond issue?
- Are there any corporate governance requirements that we would need to meet?
- In the case of equity deals, what changes or additions, if any, would be required in our management team prior to a transaction?

7. Process

- How long should it take from selecting the underwriter and beginning the structuring to the closing of the deal?
- Please describe the principal steps involved from the start to finish of the process and provide an indicative timetable.
- Who should be the key contacts at both your bank and our organization and what is the estimated time commitment required for our principal contacts?
- What are the principal documents needed for your bank to conduct its due diligence and review?

Additional Capabilities

8. Foreign Exchange Capabilities

- Would you be able to offer us local currency loans?
- Do you have internal hedging capabilities?
- Do you have experience and relationships in the markets in which we operate? If so, please describe.

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