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Microfinance & Securitization: A Profitable Partnership for Socioeconomic Development

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Microfinance is the provision of very small loans to individuals in developing nations that possess stable legal systems and honor private property rights. The recipients of these loans ("Microfinance borrowers") generally are economically active small business owners, farmers, or aspiring entrepreneurs who lack access to traditional sources of finance to launch or expand their enterprise. The loans are typically in the range of \$500 to a few thousand dollars and are used to pay start up costs, purchase equipment or inventory, improve business practices, hire employees, or to support other working capital purposes.

Microfinance famously had its start in 1970s Bangladesh with Dr. Mohammad Yunus who, in 1983, was so impressed by the results of his program that he founded Grameen Bank to institutionalize the concept. Dr. Yunus, an economist (and the 2006 Nobel Peace Prize laureate for his lifetime of work in Microfinance), believed that the poor of Bangladesh

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M&A Transactions in China: Managing Legal Risks and Pitfalls

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As an increasingly powerful cylinder of the world's economic engine, China has been going through an extraordinary period of merger and acquisition activities. However, making successful investments and striking good deals in this turbulent market requires more than a gold-rush mentality. Investors doing M&A transactions in China are often faced with a number of unique risks and pitfalls, such as restrictions and limitations on deal structures, unfamiliar customs and practices, difficulty in discovering hidden liabilities and other problems, a "sellers' market" created by a significant influx of investment capital, and a legal and regulatory system that is still in a state of flux. It is therefore essential that dealmakers and their counsel take an informed, balanced, and practical approach and make creative adaptation to the local context.

This article discusses several key areas of risks and pitfalls associated with M&A transactions in China, with the aim of helping dealmakers identify and address important issues at an early stage.

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Microfinance Proves Lucrative within Securitizations

The international microfinance credit market has evolved, with players such as Citigroup, Morgan Stanley and Deutsche Bank. New innovations involving structured finance and securitizations have begun to add to the capital base and are proving to be lucrative. *Page 1*

Managing M&A Transactions in China

ISFR takes a candid look at some of the pitfalls of M&A in China and suggests steps to protect against risk. For example, verification of ownership of assets can be a challenge. One company's assets might have been pledged for another's bank borrowings. Contingent and off-balance-sheet liabilities present another serious area of risk. *Page 1*

EC Publishes White Paper on Breach of Antitrust Rules

The white paper, on damages actions for breach of EC antitrust rules, encourages victims of anti-competitive conduct to seek compensation in national courts and to level the playing field for such actions. *Page 2*

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possessed tremendous entrepreneurial potential that, if tapped in conjunction with sensible aid and development policies, could help significantly bring the poor of Bangladesh a better standard of living. Dr. Yunus reasoned that, if a way was found to provide cheap, safe, and readily available credit in very small amounts, the recipients of this credit would be empowered to invest in their livelihood, provide a better life for their family (particularly their children), hire additional workers, and ultimately become a positive force for change in the fight against poverty.

Almost forty years later, Microfinance has spread from its base in South Asia to every region of the world, including Eastern Europe, Africa, and Latin America. For the Microfinance institutions which lend to Microfinance Borrowers ("MFIs"), which were at first only non-governmental organizations ("NGOs") generally acting on a not-for-profit basis, the institutional benefits of Microfinance are two-fold. First, Microfinance lending is profitable and relatively low risk, allowing the possibility of growth and expansion. With extremely high repayment rates and, conversely, extremely low default rates, Microfinance loans are almost always repaid in full and on time. The interest and fees earned on Microfinance loans allow a steady, reliable cash flow (ideal for securitization) providing the basis to expand an MFI's loan portfolio and encouraging further investment from an MFI's donor base and investors. For example, as of March 2006, less than 25 years after its founding, Grameen Bank reported that it had a customer base of almost six million borrowers, with a loan repayment rate at an astonishing 98% (see www.microfinancealliance.com, visited on April 14, 2008). Grameen Bank further reported that it had an established presence in 63,700 villages in India and Bangladesh, opened 1,900 branches, and employed 17,700 staff (see *id.* (note: numbers were rounded by author)).

Second, Microfinance loans spur socioeconomic development and financial independence. Microfinance increases personal income, rewards entrepreneurship, reduces the power of loan sharks, and is a useful long term complement to traditional grants and relief programs. Microfinance has, in particular, had a profoundly positive impact on women and children. It is reported that a substantial majority (96% in the case of Grameen Bank) of all Microfinance borrowers are women. In traditionally patriarchal societies, women have historically been shut out of what local credit market may have existed and, if women were able to gain access to credit at all, such access tended to come

from loan sharks charging prohibitively high rates of interest which served only to compound the problems of poverty, disenfranchisement and dependence. Moreover, today many husbands and fathers have emigrated to find work abroad to support their families at home, and are often able to only send periodic and, unfortunately, sometimes inadequate, support payments home. Microfinance provides women with a means to provide for themselves and their children in the face of these harsh realities.

Securitization of loans made to MFIs may provide the means to satisfy the gaping deficit between supply of and demand for Microfinance capital.

As Microfinance's success has grown, MFIs, both in the NGO space and in the private sector, have proliferated all over the world. Many of the most successful MFIs are operated as professional financial institutions applying first rate risk assessment and portfolio management techniques similar to those used by any other lender in any other industry. The obviously key ingredient to the continued success of these MFIs, as pointed out by the U.S. Agency for International Development, is securing access to ever greater amounts of capital. The biggest challenge to Microfinance is to raise that capital. In 2001, the World Bank reported that only 4% of the potential Microfinance market was being served by MFIs.

Since 2001, an MFI credit market has begun to evolve to provide additional capital. This credit market is served by well-known global banks, such as Citigroup, Morgan Stanley, and Deutsche Bank, among others, and frequently by private funds, such as, for example, Minlam Asset Management, based in New York. Traditional lending structures have, at least so far, been the more common avenue for financing MFIs, although innovations to this structure, principally from structured finance and securitization, have begun to emerge within the past decade. The combination of traditional lending and securitization has the potential to provide much

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of the capital necessary to fuel the Microfinance industry's growth.

Lenders to MFIs typically provide a type of "warehouse" lending in the form of a term loan of less than \$5,000,000. These loans are sometimes secured by a pledge of the MFI's Microfinance loan portfolio and may sometimes benefit from a guarantee by a parent entity of the MFI. The term loan is documented with a standard, short-form loan agreement containing familiar conditions to closing and funding, currency risk provisions, and standard representations and warranties for cross-border lending. The MFI Lender will typically charge at least market-rate interest and additional fees to the MFI. The loan will typically be made in one or multiple drawings, be denominated in U.S. Dollars, British sterling, or Euro and paid to the MFI's account in its home country in the converted local currency equivalent of the loan. The MFI Lender may accept the foreign currency risk by requiring that repayment of the loan be in an amount equal to this local currency equivalent on the funding date (and may offset this risk by entering into foreign exchange hedges). The MFI, in turn, will use the proceeds of the loan to finance its Microfinance portfolio.

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These transactions are subject to the standard assortment of legal, political, and business risks that any cross-border lending transaction is subject to plus additional issues unique to Microfinance. The MFI Lenders typically manage these risks by lending to a diverse group of MFIs (with acceptable minimum credit) located in different countries and various regions of the world, requiring that choice of law be New York, United Kingdom, or another forum familiar to the MFI Lender, and employing careful financial covenant ratios published by the Consultative Group to Assist the Poor (known as "CGAP") in the loan documentation. Strict covenants governing the use of proceeds are also employed.

Legal fees and expenses can often be an issue in these term loan transactions as the size of the loan, and its resulting income for the lender, can be relatively small, but the legal issues presented can often be complex and time consuming, requiring the involvement of experienced and creative legal counsel. Any MFI Lender should retain legal counsel that is sensitive to these issues, may consider offering a fee arrangement, and is capable of working with the MFI Lender to establish an on-going program that standardizes documentation as much as possible across various jurisdictions to capture best practices from deal to deal. As with Henry Ford's Model T cars on the first mass production line, standardization brings familiarity and predictability, resulting in continually lower legal fees over time.

Notwithstanding the role of MFI Lenders in providing term loans, and the continuing role of multi-lateral NGOs, charities, and governments providing additional sources of funding to MFIs, MFIs' demand for credit remains far in excess of the available supply. Studies cited in an article by Phillip Jung and Per-Erik Eriksson have reportedly shown that, as recently as 2005, there may be 500,000,000 or more economically active poor micro-entrepreneurs worldwide. Their average financing need is reported to be \$500 each, resulting in a potential market of \$250,000,000. According to Jung and Eriksson, in 2005 the supply of Microfinance credit was generally thought to only satisfy 10 to 15 percent of the existing demand. Today, CGAP reports the dearth of MFIs as the "key bottleneck" to the future of Microfinance. Clearly, additional sources of capital are needed.

Securitization of loans made to MFIs may provide the means to satisfy the gaping deficit between supply of and demand for Microfinance capital. A typical securitization program may look something like this. A group of investors, being a combination of traditional market participants and specific microfinance investors, create a special purpose vehicle (an "SPV"). To achieve greater economies of scale, the SPV may be formed in Luxembourg to avail of Luxembourg's favorable securitization laws permitting a single SPV to carry out a variety of different transactions by forming multiple, legally segregated, compartments within the same SPV. The SPV will become the lender of record to the MFIs and, when its portfolio is large enough (recent market transactions suggest a portfolio of between \$20,000,000 to \$50,000,000), the issuer of notes in favor of the investors. To provide

sufficient diversity and minimize country risk, multiple MFIs from a variety of countries should be included in the securitization portfolio. To further spread risk, the notes themselves may be, as in any securitization transaction, divided into various tranches, at least some of which can be rated by the ratings agencies as investment grade, offering different returns based on their relative levels of risk. Insurance for the transaction can frequently be provided in the form of a guarantee, such as that provided by the European Investment Fund.

Securitization offers many advantages to the Microfinance industry. It moves loans off of the books of an MFI Lender, insulating it further from risk and recapitalizing it, allowing it to initiate more Microfinance loans, broadening the capital base for the industry. By setting up a transparent process to manage credit risk and monetize returns, it encourages more investors to join the market in the short and long term. Microfinance, moreover, can bring benefits to securitization, particularly during a time when the credit crisis runs rampant, by providing a new market and growth opportunities. With such high repayment records and low default rates, Microfinance borrowers are far from subprime and, with the added virtue that comes from materially helping to roll back the frontiers of poverty, just might give the securitization industry something to smile about in these challenging times. □

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and international syndicated and unsyndicated financings. His practice generally focuses on asset-backed facilities, acquisition facilities, mezzanine and first and second lien facilities, letter of credit facilities, and other senior secured and unsecured transactions. These financings are frequently secured by diverse and complex collateral, including accounts receivable, inventory, other personal property interests and real estate. He also has considerable experience with negotiating participation agreements between institutional lenders and accounts receivable purchase agreements. Mr. Carolan can be reached at +1.212.209.4937 or ccarolan@brownrudnick.com. Madeleine M.L. Tan is a partner in the structured finance group and a member of the climate and energy group. She has extensive financial expertise in the areas of project finance, equity investments, capital markets debt offerings, asset-backed, tax-advantaged and structured finance transactions including securitization, derivatives and leveraged leasing. She has acted as adviser and counsel to equity investors, lenders, project developers, alternative investment funds, special situation funds, issuers and underwriters. Most recently, Ms. Tan has advised corporations, financial institutions, specialized funds and the investment and trading communities on the financing of alternative energy projects, and derivatives and structured products relating to EU emissions allowances as well as certified emission reductions (CERs) under the Kyoto Protocol's CDM regime. She also practices in the area of whole business securitization. Ms. Tan can be reached at +1.212.209.4805 or mtan@brownrudnick.com.

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