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Tier II Capital Allowance for Microfinance Banks (MFBs) by State Bank of Pakistan

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INTRODUCTION

The purpose of this note is to analyze the assessed impact of recent allowance to Microfinance Banks (MFBs) by the State Bank of Pakistan (SBP) to raise Tier-II capital, with specific reference to subordinated debt, in order to help MFBs to leverage Tier I capital and maintain a minimum capital adequacy ratio at 15%.

However, it is felt that to place the allowance of Tier-II capital by SBP, in its proper perspective, it is essential to interlink the above, with a corresponding amendment in SBP regulation which requires MFBs to maintain the already prescribed minimum paid up capital, *free of losses, at all times*. Specifically, all MFBs to meet specific minimum paid up capital requirements i.e. free of losses, latest by Dec 31, 08, according to the operational scope of the MFB, i.e.

MFBs licensed to operate in a specified district	PKR 100M
MFBs licensed to operate in a specific region	PKR 150M
MFBs licensed to operate in a specific province	PKR 250M
MFBs licensed to operate at the national level	PKR 500M

The paper has therefore been divided into three sections:

Section I, discusses the repercussions that might follow by the imposition of maintenance of minimum paid up capital, at all times by MFBs.

Section II, discusses the assessed impact of allowance of Tier-II capital for MFB's (specifically subordinated debt)

Section III, discusses the reasoning behind restriction of subordinated debt in local currency.

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SECTION I

MAINTENANCE OF MINIMUM PAID UP CAPITAL REQUIREMENT

State Bank of Pakistan (SBP), in its role as a regulator, has prescribed the maintenance of minimum paid up capital level free of losses for MFBs, in a bid to safeguard public funds i.e. depositor funds.

The SBP has gone a step further i.e. from previously prescribing the minimum levels of paid up capital required to commence operations to the recent requirement that the paid up capital be maintained, free of losses, at all times.

The primary objective behind the above mentioned amendment in paid up capital regulation is to consolidate the equity base of the MFBs thereby safeguarding depositors' long term interests through ensuring that the MFB's suffering from operational losses constantly replenish their equity base.

The above resultantly reduces the probability of erosion of the deposit base due to operational losses, ensuring that at all times; the equity base does not fall below a certain benchmark.

IMPLICATIONS FOR THE SECTOR

Current Sector Scenario: Amongst the MFBs (operating on a nationwide mandate) the predominant players have the following paid up capital levels:

MFB	Gross Paid up Capital (PKR M)	Net Paid up Capital (PKR M)
Khushhali Bank	PKR 1,705M,	PKR 1,875.258 M
The First MicroFinanceBank Ltd.	PKR 660M	PKR 687.440 M
Tameer Microfinance Bank Ltd.	PKR 600M	PKR 335.342 M
Pak-Oman Microfinance Bank Ltd.	PKR 500M	PKR 463.554 M
Total	PKR 3,465 M	PKR 3,361.594M

Gross paid up capital includes the aggregate share capital (equity) of the MFB. The Microfinance Ordinance entails that at least 51% of the paid up capital of the MFB shall be subscribed by the promoters or the sponsor members.

Equity of the MFB means Tier I Capital or core capital and includes paid up capital, general reserves, balance in share premium account, reserve for issue of bonus shares, and retained earnings / accumulated losses as disclosed in annual audited financial statements.

Therefore net paid up capital constitutes the net-worth / equity position of the MFB after accounting for equity erosion caused by losses or equity build up caused by reserve accumulation and retained profit as may be the case.

It is evident from the above equity table, that the recent revision in SBP regulation will have an impact on some MFBs, because while all meet the minimum paid up capital requirement to commence operations, a couple of the MFBs have suffered losses over the years that has led to equity erosion, thereby necessitating the need for further equity injection (Tier I).

SHORT TERM IMPLICATIONS

1. High Pressure on Start-Up Organisations Leading to a Slow Down of Sector Growth:

By requiring MFBs to maintain minimum paid up capital at all times, the SBP has ensured equity injection (for those MFBs not meeting this requirement), albeit on a no-choice basis in the short run.

It is anticipated that the move will put immense pressure on start-up organizations, which suffer start up losses, to raise additional equity within a narrow time frame. This will shift the pressure from expansion of credit to consolidation of the equity base. As a result, anticipated initial measures are raising additional equity by the MFB's, and curbing operational losses - primarily through cost cutting, thereby slowing down the immediate branch expansion network.

Given the expected increase in liquidity (owing to equity injection), it is anticipated that the expansion of credit will initially be undertaken in areas where the MFB is already operating (minimizing operational branch development costs) and constraining the MFBs from expansion in areas where returns on investment are considered high.

In view of the sector target to increase outreach from the current level of 1.2M clients to 3.0M clients by 2010, the above minimum equity requirement (free of losses), will to some extent act as a decelerating force to overall sector momentum and sector balance sheet growth rate.

2. Pressure on MFB Profitability

In order to meet the equity requirement, MFBs will face pressures to gear up profitability which would probably be met in the short run through the following measures:

a) Increased asset (micro-finance) pricing:

In order to gain access to higher margins, required to bolster retained earnings and hence equity of the MFB the asset (micro-financing) pricing is increased. The above would lead to a portion of the burden, if not all, being shared by the client. The above would lead to asset pricing at levels that ensure institution sustainability, with no initial built in subsidies- thereby building foundations for a sustainable institution.
However, the net result would depend on how crucial the built in subsidy in pricing is for initial client outreach and whether the more expensive loan, can render the newer MFBs competitive to other established MFBs.

b) Increase in stringency of risk appraisal criteria:

On the positive side, the above would promote better credit appraisal procedures, thereby once again laying the foundations for a more stable institution with limited provisioning losses.

Given the pressure on the MFB to reduce loan loss provisioning it is anticipated that it would result in greater stringency of the risk criteria for applicants, thereby reducing fund flow to riskier clients and may be a slow down on the advance side. The above might lead to a loss in focus and slow down the growth trajectory of the industry, which is the prime aim of allowing MFBs to access sub debt to leverage their growth. However, some might dis agree with this argument citing factors like huge untapped market with limited institutions that are providing financial services.

3. No Forecasted Mergers and Acquisitions

In view of the limited number of players in the sector, the infancy of the sector, and the current fragility of the balance sheets, no player seems to be ready to incur additional costs of an acquisition, and no player appears to be extraordinarily small relative to other players to require to be merged into another entity for survival.

LONG TERM IMPLICATIONS

1. Establishment of Sector Credibility

With the sector having attained the milestones of conforming to SBP minimum benchmarks, depositor confidence will increase significantly.

2. Survival of the Fittest Player

Following conformity to the above requirement, only players who are able to effectively streamline operations, optimize on pricing versus risk, control loss provision and/or have deep pockets will be able to survive. Therefore while it is anticipated that the short run spells hardships for the sector in the long run the move will help MFBs gear up and streamline operations thereby achieving optimal results, and help achieve efficiency at both the institution level and the sector level.

CURRENT SCENARIO

As evident from the above mentioned paid up capital levels, a couple of MFBs fall short of the minimum paid up capital requirement laid down by the SBP - thereby creating an urgent need for these institutions to recapitalize their equity structure.

In the short run, the gap will have to be bridged through owner equity injection or third party/ public equity injection, through IPO of the MFBs.

While third party public equity injection would be the ideal scenario in the longer run, however at present it is anticipated that limited interest might be expressed by public investors. Financial pressures on the MFB income statement, market liquidity constraints, combined with the limited operational time span of the MFBs are the major factors behind the assessment of limited saleability/interest in the subordinated debt investment.

Therefore the current scenario spells out a restrictive growth phase for the MFBs specifically those not meeting the requisite criteria, with greater pressure on consolidation of branch network systems to reduce loss provisioning requirements, greater pressure to focus on higher loan volumes to take advantage of economies of scale, and pressure on pricing to improve bottom line profitability.

However, the above challenge also represents an opportunity for the MFBs to utilize the time period to build systems that can effectively sustain future growth and profitability that is bound to be exponential once the barrier of minimum paid up capital has been achieved.

The emphasis on systems and finding the optimum loan size/pricing mix, the MFBs would effectively set sound foundations for future growth whilst providing stability within the system.

On the asset side, the minimum paid up capital requirement, is bound to lead to investment of some portion of the equity in secure long term asset instruments such as treasury bonds, bank deposits, etc, thereby providing the MFBs with a stable long term asset base.

The above portfolio could also be leveraged by the MFBs to gain access to funds for lending portfolio growth.

To conclude, while in the short run, certain MFBs will face restrictive growth as a result of the recent SBP regulation, however, the phase can be used to set up solid foundations to gear up for future exponential growth

SECTION II: TIER-II CAPITAL ALLOWANCE BY SBP

This section deals with the assessed impact of the allowance by SBP to MFBs to take on Tier II capital within its equity calculation.

Primarily Tier II capital has been defined to include both subordinated debt and revaluation surplus. However, for the purpose of this section the emphasis has been placed on the impact of the subordinated debt, since it has been assumed that MFBs would have minimal investment in fixed assets and therefore impact of the revaluation surplus would be negligible.

- Subordinated debt is primarily defined as an unsecured, plain vanilla debt that may be raised from any person or entity, preferably from sponsors[1], in local currency only; entitled to profit payments, as decided by the MFB (with SBP's consent).

Other features of the sub-loan include:

- The principal and profit payments of the debt remain subordinate to all other indebtedness of the MFB including deposits.
- The loan has a fixed term to maturity of minimum five years, and the loan is not repayable before the agreed repayment date, without the prior SBP approval. Principal repayment commences after the five year period and may be structured either as a balloon payment at the end of the tenor or repayment in installments. However, the entire debt is required to be maintained for a period of five years. Neither interest nor principal may be paid even at maturity if such payments mean that the MFB falls below the capital adequacy ratio, and any other restrictions imposed by the SBP.

[1] Other sources of subordinated debt could be third party institutional investors, such as pension funds, insurance companies, mutual funds all of which require asset placement opportunities. Furthermore, investment banks and commercial banks could also be valuable potential sources for arranging and funding of subordinated debt.

The purpose of the allowance by SBP to MFBs to take on subordinated debt, and its eligibility to be included in capital adequacy requirement appears to be to introduce Tier II capital, within the balance sheet of the MFB, thereby adding depth to the capital equity structure of the MFB.

Furthermore the cap on inclusion of supplementary capital for calculating Capital Adequacy Ratio (CAR) to be limited to 50% of core capital[2], signals that the mode of financing is primarily envisaged as a means to supplement MFB's balance sheet growth.

The advantage of the allowance is two-fold i.e.

a) to offer sponsors/investors the incentive to earn regular fixed profit amounts on their investment, as opposed to the varying dividend amounts, and
b) to provide sponsors/investors with the option to retract their financing in sub debt from the MFB after a period of five years (provided all SBP pre-conditions are met).

The minimum tenor of five years, specified by SBP, is aimed at providing medium term stability to the balance sheet of the MFB a requisite to safeguard depositor interests.

SHORT TERM IMPLICATIONS

Limited impact expected, owing to the high probability that the subordinated debt would come in from sponsors/and associated sources. The current relative lack of interest by potential independent third party sources of subordinated debt injection such as private institutional investors, commercial banks, investment banks, etc (reinforced in the current scenario of restricted liquidity) implies that the potential advantage of equity base diversification, and the resulting quasi equity entry by the above mentioned third party into the sector, hence creating possibilities for greater future inter-linkages and access to commercial funds for the sector, would not be realizable within the current scenario.

However, as discussed above, the longer term efficiency impact foreseen of the minimum paid up capital requirement, leading to improved margins within the sector, might lead to a situation in the future, wherein the sector returns are adequately attractive to attract inter-linkages partnerships with the more formalized and established capital markets of the country.

LONG TERM IMPLICATIONS

Deepening of MFB Equity Structure

Addition of the Tier-II capital would result in a deepening of the MFB equity structure, which in the long run could potentially provide an opportunity for investment by third party agents, as mentioned above.

In addition, upon the removal of the tax exempt status of MFBs, the tax deductible nature of the debt, could result in tax savings for the MFB, thereby increasing attractiveness of the investment tool for sponsors and equity stakeholders.

[2] MFBs can raise subordinated debt more than 50%, but it would not be counted towards CAR.

SECTION III:

ALLOWANCE OF SUBORDINATED DEBT ONLY IN LOCAL CURRENCY

The requirement to raise subordinated debt only in local currency is a move by the SBP, to avoid taking on long term foreign exchange exposure both on its own books and those of the MFB.

Given the volatility of the foreign exchange, further exacerbated by the current balance of payments deficit, taking on additional foreign exchange exposure, and that too long term, would be a fairly risky move for the SBP at this juncture.

It is, therefore, in light of the above that the SBP has restricted raising of subordinated debt to local currency only.

The above move might be a blessing in disguise for MFBs, given the relative infancy of sector, the exposure of the balance sheets to foreign exchange fluctuations at this juncture, would increase the fluctuation and unpredictability of the balance sheet and income statement, and therefore not constitute a prudent approach to capital management.

Some practitioners however do believe that in the presence of international Microfinance Investment Vehicles (MIVs) – specialized investment funds for microfinance – willing to provide sub-debt, there is a case for allowing those institutions to take subordination positions, given that attracting domestic players is almost impossible.

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