Libranzas as an Asset Class

A white paper on payroll deductible consumer loans in Colombia

By Steven Rosenblum

July 2016

INTRODUCTION

Créditos de Libranzas ("Libranzas") are the primary unsecured consumer credit product in Colombia. Libranzas are payroll-deductible loans that are repaid directly by the borrower's employer to the lender. They were created in the mid-1990s to offer access to credit for individuals without borrowing histories and, in many cases, bank accounts. The Libranza program is widely regarded as one of the more successful credit-based social impact programs in the world and continues to facilitate financial inclusion for Colombia's rapidly rising middle class.

This white paper outlines the primary characteristics of Libranza loans. Its contents are based on knowledge gained from completing various Libranza transactions over the past few years. The purpose of this document is to provide institutional investors with an openly available overview of Libranzas as an asset class. This document does not make reference to any specific past or prospective transaction. The information is offered solely as a means to provide transparency into the consumer lending industry in Colombia. Please see disclaimer at the end of this document for important details about its content.

CRÉDITOS DE LIBRANZAS

Libranzas are offered by banks, which include regulated financial institutions that are permitted to accept deposits (collectively, "Banks") as well as non-bank Libranza originators, which are entities that originate and service Libranza loans (collectively, "Originators"). Originators must be registered with the Superintendencia de Sociedades (www.supersociedades.gov.co) and have a RUNEOL license with the Ministerio de Hacienda de Colombia (www.minhacienda.gov.co) to transact in and service Libranzas. There is a national registry of Libranza loans overseen by the Superintendencia Financiera de Colombia (www.superfinanciera.gov.co), which provides a centralized data repository for the Libranza system.

Libranza loans are granted to employees, social security recipients and pensioners through pre-established commercial agreements or *convenios* between lenders and large companies / public sector entities and pensions funds. The *convenios* govern the processes that allow for the direct repayment of the loan by the employer. Originators and Banks must have *convenios* in place with employers in order to offer loans to their employees.

Libranzas are typically used by borrowers to purchase big-ticket retail items and vacations as well as to pay for large one-time expenses such as medical procedures and education. Points of contact for borrowers seeking Libranza loans include:

- Human resources departments where Libranzas are offered on internal platforms as an employee perquisite
- At big box retailers, doctors' offices or travel agencies in order to finance a specific purchase
- At bank branches for borrowers with banking relationships
- At the offices or kiosks of smaller Originators, which typically have partnerships (both exclusive and non-exclusive) with larger Originators for the credit approval process and funding
- At the local offices of larger Originators that compete based on brand recognition and proximity to the borrower
- Online/mobile channels, offered by Banks and larger Originators, which are relatively new mediums that are becoming more common

The maximum interest rate lenders can charge is set by the Superintendencia de Financiera and varies with the Colombian overnight rate. Today, the maximum rate is approximately 30% p.a. with rates from 12% to 30%. Lower interest rates are offered by Banks to Bank clients who are likely repeat borrowers and employed by government or government-linked agencies. Higher interest rates are likely offered to first time borrowers employed in the private sector in connection with loans longer than 5 years.

The amount of credit offered is tied to the borrower's monthly wages. The ratio of monthly Libranza payments (for all Libranzas issued to the borrower) to the borrower's monthly income must be less than 0.5x. This helps control the social impact of lower income borrowers becoming excessively leveraged. Therefore, where w = monthly wages of the borrower, t = number of months of the Libranza and i = applicable interest rate per month, the maximum amount of credit offered equals PV (0.5*w, i, t). Lower interest rates, longer term loans and higher monthly wages all increase the amount of Libranza based credit the borrower has access to. Most Libranza loans are COP$ 5,000,000 – 10,000,000 (USD$ 1,500 - 3,500).

When a customer applies for a loan, the application is vetted to ensure conformity to a lender's eligibility requirements. Supporting the application review process is a national credit scoring system owned by Experian as well as various proprietary metrics that are utilized by the Originators and Banks. The borrower must also take out a life insurance policy endorsed for the benefit of the lender in the amount of the Libranza. The application is checked against the national Libranza registry to ensure that, among other things, the monthly payment amount is below the legal limits. Approval times vary by the point of contact and can be as short as 5 minutes or as long as several days. Originator approval times are significantly shorter than Banks, which is a competitive advantage in attracting borrowers. Once approved, the proceeds are given to the borrower within approximately 24 hours.

Libranzas are repaid via equal monthly payments with varying interest and principal components. Once proceeds have been disbursed, the loans are repaid by the borrower's employer via an automatic deduction from his or her paycheck and funds are sent directly to a master collection trust according to the *convenio* with the Originator. The trust manager then automatically routes the payment to the lender's trust. This eliminates any involvement of the borrower in connection with repaying the loan. Should the borrower change employers, the payment obligation follows the borrower to the new employer via an automatic notification process to the loan servicer, lender, trust manager and new employer. The new employer is required by law to comply with the payroll deduction. Any severance from the prior employer is directed toward repayment of the loan.

Thus, by removing the borrower from the repayment process, credit quality becomes largely a function of the employer, the quality of the servicer and the overall integrity of the Libranza system in Colombia. This is how the Libranza program has de-risked unsecured consumer lending in Colombia and facilitated access to credit for millions of first-time borrowers who would otherwise have been unacceptable credit risks for most lenders.

LIBRANZAS AS AN ASSET CLASS

There are approximately USD$11.5bn of Libranza loans outstanding in Colombia. Approximately 95% are owned by Colombian banks and the rest by local asset managers and individuals. Of the 95% held by banks, more than half were originated in-house (i.e. not purchased from an Originator). Today, Banks are originating approximately 90% of all the new loans in-house and directly competing with, instead of funding, the Originators.

Loans and loan portfolios are not traded on formal exchanges however small portfolios often trade bilaterally, providing some measure of liquidity. Loans directly originated by Banks are typically not offered for sale. The primary channels that investors can get exposure to Libranzas as an asset class are:

I. *Via owning shares of an Originator*
   No Originators are publicly traded yet many of the larger ones have financial sponsors. Establishing a new origination/servicing platform is difficult and time consuming as it requires multiple licenses and *convenios*.
II. *Via participations in sales / securitizations of Libranza portfolios offered by Originators*
   There are very few USD denominated securitizations of Libranza portfolios and only one multi-tranche financing with institutional size completed to-date.
III. *Via investment funds that invest in Libranzas*
   Citi, Itau, BTG, most major Colombian banks and Colombian asset managers offer these products to individuals. The target return is typically 10-12% p.a. in Colombian Pesos, net of all fees.

LIBRANZA PORTFOLIO TRANSACTIONS

Process/Structure

Originators typically sell new loans to banks or asset managers within 0-4 weeks of origination, outlaying funds for borrower proceeds then aggregating loans into portfolios over short periods of time. Originators benefit from a sale premium and often retain servicing contracts for the loans. The banks/asset managers become the lender and hold title to the loans in local trusts or *fideicomisos*, which are administered by independent trust agents. The loans are sold both with and without recourse, the existence and quality of which is reflected in the economics of the transaction. Prior to the purchase, the buyer is offered the opportunity to perform due diligence on the loans either directly or via independent due diligence agents, which are also responsible for the endorsement and custody of the loans.

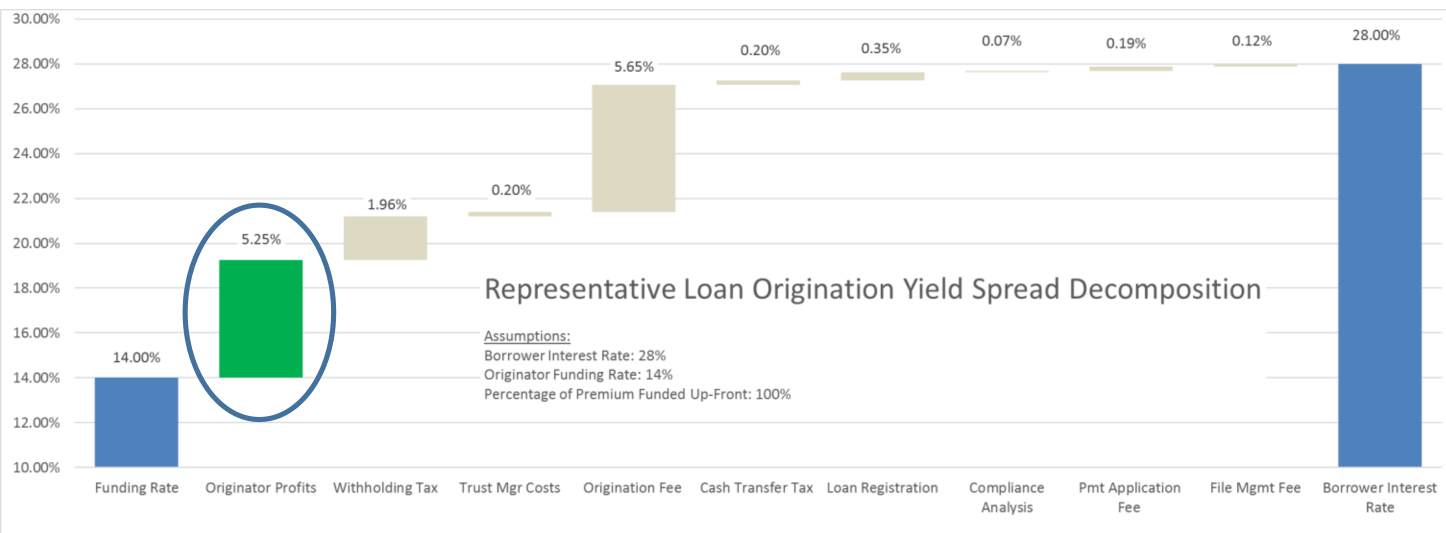
A Colombia law documentation package consisting of a sale/purchase agreement, guarantee agreement, pledge agreement and buyer trust management agreement typically governs the sale. For international counterparties, US or UK law loan documents between the buyer and its local trust, which the originator can be a party to, can be used to efficiently bring the funds into Colombia.

Portfolio Pricing

At the time of the sale, loan portfolios typically have 4-5 year tenors and 2-2.5 year weighted average lives. The sale price is calculated as the present value of the remaining loan payments discounted at the funding rate. The funding rate is equivalent to the buyer's IRR. This pricing convention is also used in secondary market transactions. Funding rates range from 10-20% in COP (see below for USD / COP Yield Differential).

The lowest funding rates are typically associated with government subsidized financing of certain borrower demographics (i.e. social programs), which larger Originators often take advantage of. The highest funding rates are typically offered to smaller Originators or for sales without recourse to the seller. Loan seasoning also influences portfolio pricing – pricing breakpoints are typically 0 payments (no rate reduction), 1-5 payments (-50bps) and > 6 payments (-100bps). Borrower specific factors that influence pricing include, among other things, Government employee/pensioner vs. private sector employee, type of Government employer, employment tenure (relevant due to severance and job stability), and credit scores.

As the funding rate is higher than the borrower (loan) interest rate, portfolios are sold at a premium to the principal balances of the loans. The Originator's profit from the portfolio sale equals the difference between the loan portfolio sale price and all of the origination costs including the proceeds provided to the borrower. The profit embedded within the premium have historically been paid up front at the time of the sale. An example of the yield spreads of a representative portfolio sale are below:



Over the past year, the industry has moved away from funding portfolio premiums, however. This is primarily due to insufficient resources of Originators to support sales with recourse in combination with increasing prepayment rates (see prepayment section below). Without corporate level revolving credit facilities and the commensurate equity required to support them, it is extremely challenging for Originators to access funding in the current market environment. Furthermore, notwithstanding access to 3rd party financing, Originators' cost of capital is still 2-3x higher than Banks, which are funded by deposits.

USD / COP Yield Differential

For non-Colombian investors, the withholding tax rate for interest payments paid outside of Colombia for loans longer than 1 year is 14% for most jurisdictions (notable exceptions are Canada, Mexico, Peru, Panama and Spain). The cost of hedging the COP/USD using generic forwards is approximately 6% per annum in yield terms for 5 years of equal monthly cash flows (this has varied from 4.5-6.5% over the past year). Thus the base-case USD equivalent yield of a COP 15% annualized loan portfolio return equals 15% X (1-14%) – 6% or ~USD 7% p.a. Issuers and investors have devised various solutions that minimize this return differential, however.

DELINQUENCY AND DEFAULT RISK

Delinquencies are not necessarily indicators that a loan is impaired. Delinquencies frequently arise as a result of clerical errors on the part of the employer or the servicer, which occur most often with new *convenios*. A delinquency will typically lead to a default through the following confluence of events:

i. The borrower is terminated (or resigns), <u>and</u>
ii. any severance given is not sufficient to cover the outstanding balance, <u>and</u>
iii. the borrower leaves the 'formal' employment sector (i.e. remains unemployed or employed in an informal capacity not connected into Colombia's formal credit system), <u>and</u>
iv. the borrower elects not to pay the loan, despite the negative effect on his or her credit.

Following a loan default, a loan loss will occur subsequent to typical collection agency attempts to collect the debt (~3 months) and subsequent to judicial processes if pursued (~6 months). Collections agencies do not accept partial settlements of principal however the recovered principal is often re-termed and paid over time. Collections agencies typically charge 5% of recovered funds prior to judicial processes and 20% post judicial processes.

For a hypothetical portfolio of Colombian Government and Government linked agency employee borrowers, delinquency risk can be approximated as follows:

<u>*Approximately 2% of the portfolio will have at least one late payment per year*</u>

Approximately 50% of these single late payments will be automatically corrected in the following month from resolving a portfolio reconciliation issue or, in instances when the payment was actually not made, a double payment in the following month.

<u>*Thus, approximately 1% of the portfolio will have at least two late payments per year*</u>

Approximately 75% of the loans with two late payments are also delinquent due to clerical errors. Once the error is identified and corrected, the servicer typically extends the term of the loan by two (or however many) extra months and the loan is no longer considered delinquent (Note - most Libranza portfolio sales include contractual obligations for the Originator to repurchase and/or substitute loans that are 2 or more months delinquent)

<u>*Thus, approximately 0.25% of the portfolio will default per year*</u>

Of the 0.25% of defaulted loans, approximately 60% of loans are recovered (usually prior to judicial processes – i.e. within 3-6 months). However, even though successful collections result in 100% of the principal balance of the loan recovered, this is still a principal loss if the investor that funded / purchased the Libranza with a premium (see Prepayment Risk section below).

Thus, approximately 0.10% of the portfolio is expected to be lost per year

Therefore, an investor in a portfolio of 5 year Libranzas will expect to lose 0.50% (0.10% X 5 years) of the number loans during the investment period. In addition, approximately 5% of the loans will have a 1-month longer duration and approximately 4% of the loans will have a 2 + month longer duration. The effect of this on the investment IRR will be driven by the timing of the delinquencies, defaults and loan losses with instances early on in the investment period having a larger negative effect.

Industry-wide delinquency statistics and their calculation methodologies are published on a monthly basis by the Superintendencia Financiera de Colombia. The link to the datasets and the research methodology is:

https://www.superfinanciera.gov.co/jsp/loader.jsf?lServicio=Publicaciones&lTipo=publicaciones&lFuncion=loadContenidoPublicacion&id=61032

Prepayment Risk

For the purposes of this discussion, if Pi = initial principal balance of a portfolio of Libranzas at the time of origination; and Pp = The amount of principal balance prepaid during the life of the portfolio; then the "prepayment rate" = Pp / Pi. Prepayment rates were approximately 15%-20% prior to 2015. In late 2015, prepayment rates began to rise and today are 20%-25% for most borrower categories. This is primarily due to:

- The lagging effects of significant industry legislation (Ley 1527) introduced in late 2012 that opened up all employers to all Originators. Prior to this, Originators often had exclusive *convenios* with employers hence borrowers were captive to the Originator that their employer chose.
- Industry convention of paying origination fees upfront that are non-refundable in the event of prepayment. This encourages loan churning. Note – the origination fee is different from the Originator profit and is akin to a broker's commission rather than net interest margin. Although prepayment penalties are permitted by the regulators, they are not customary and borrowers have highly negative reactions to them.
- Interest rates for repeat and higher quality borrowers are declining significantly and Banks have become a direct source of new loans for most banking profile customers.
- Better pricing transparency for borrowers and the availability/ease of online loan applications

Today, the most effective strategy for lenders to mitigate prepayment risk is a combination of (i) keeping in close contact with customers, (ii) offering the lowest interest rates and (iii) having sufficient capital readily available for new loans. Banks currently have significant advantages over Originators in (ii) and (iii).

For Banks, the effects of higher prepayments manifest via a decline in the yield of their Libranza loan books. When considering the small percentage of balance sheet allocated to this product across the industry and the high comparative yield relative to the risk, the effects of prepayment on Banks are not significant. This assumes the prepayment is a refinancing and not a loss of a customer, as is typically the case.

For Originators, higher prepayment rates are a systemic problem. Historically, Originators have sold loans to Banks and asset managers at a premium (discussed above) and guaranteed the performance of the loans – i.e. a portfolio sale with recourse to the seller. In doing so, the Originators guarantee the amount and timing of the loan cash flows, which in turn guarantees the IRR for the investor. Without this, prepayment would result in a principal loss to the owner of the loan, which would be either unacceptable or lead to extremely onerous funding terms for Originators.

Assuming a recourse sale, when a loan is prepaid the Originator first uses the prepayment proceeds to provide a substitution loan to the investor. However, the initial principal balance of the substitution loan will be lower than the initial principal balance of the original loan. This is because the initial loan will have amortized prior to being prepaid. Therefore, relative to the prepaid loan, the substitution loan will have lower monthly cash flows, a longer term and the same principal balance. Next, the Originator is required to contribute cash to "top up" the monthly cash flow deficiency for the remaining term of the original loan in order to fulfill the terms of the guarantee.

Most Originators are asset light businesses, acting as intermediaries between the borrowers and the holder of the title to the loan (the investor/lender). As prepayment rates increased, many Originators have not been able to fulfill their obligation to gross up portfolio cash flows. Smaller Originators, which no longer have access to new origination funding and are burdened with significant ongoing payment obligations for the loans that they have guaranteed, are rapidly becoming insolvent. The effect on larger Originators manifests in the way they are financed. Neither local nor international funding sources will finance premiums to principal balance anymore. This requires that the Originators contribute all of the up-front origination costs into the funding structure, which typically equal 8-10% of the initial principal balance of the loan. Additional cash or other collateral contributions to the funding structure are now also a common feature of recourse portfolio sales.

The difference over the past two years is stark. In 2014, Originators could finance all up-front origination costs. They were also able to take out 10-12% of the amount of the funding up-front as profit. In 2016, Originators needs to outlay all origination costs and contribute additional cash as a cushion for non-performing or prepaid loans. Profit can only be taken on the back-end over the life of the loan portfolio, assuming there are residual cash flows. This changes the entire business model of Originators and their future is becoming increasingly unclear.

INVESTMENT THEMES

The number of Colombians actively engaging in the formal credit system is growing rapidly. Demand for mortgages, credit cards, and Libranzas has slowed despite the economic challenges of the past few years. The Libranza business is changing rapidly and loan profitability is decreasing for both Banks and Originators. Banks are increasing their origination efforts, moving down-market into new borrower categories and directly competing with Originators. Regulatory requirements for Originators are becoming more onerous and costly to comply with. These industry themes should run their course over the next few years. After this, a more standardized and consolidated landscape will likely emerge. How this will ultimately affect the investment prospects for the sector is unclear. However, today, the general investment opportunities categorically are:

The Credit Play

Colombia is an investment grade jurisdiction. Libranzas are repaid directly by Government agencies and there has never been a systemic default on these obligations. In USD, Libranza securitization yield spreads are 600-800bps over comparable unsecured consumer loan securitizations in the U.S. and Europe, which also lack the payroll deduction feature. This compares favorably to Colombia / US sovereign spreads, which are 200-300bps. This investment can be expressed in several ways, the most common of which are via participations in bank securitizations and via a bilaterally negotiated structured credit instruments issued by Originators. The most challenging components of these transactions are their structural intricacies as well as coming to terms on pricing with large, privately held Originators that must be willing to contribute significant assets into the structure.

The Equity Play

Despite a 20-year track record, the Libranza system in Colombia (and banking more broadly) has not adopted most of the financial technology innovations deployed in many developed economies. Mobile and web based banking, the digital integration of employer networks and the integration of the Libranza system into credit cards and other consumer products all present new channels to interact with borrowers and increase borrower profitability. Set against growing demand for credit, this presents an opportunity to build a best-in-class specialty finance business by partnering with one of the larger Originators. The combination of low-cost international funding, innovative financial technologies and local know-how should resonate well with hands-on financial sponsors and strategics seeking toeholds in Colombia.

The Distressed / Consolidation Play

There are over 2,000 Originators however less than 20 have commercial scale. Of these 20, most are unable to obtain sufficient financing to maintain monthly origination volumes and several have fallen into distress. The distress is mostly a result of failing to fulfill recourse-sale obligations that require them to top up prepaid loan cash flows and repurchase delinquent loans, many of which are not even in default. Most recourse sale agreements have seller repurchase options embedded in them. The concept here is straightforward – First, establish a partnership with or create a servicing platform. Second, purchase or option smaller portfolios at highly advantaged pricing from distressed Originators (potentially purchasing Originators as well in order to acquire their *convenios*). Third, do everything outlined in “The Equity Play” above. With significant effort, the amount of loans that could be acquired could surpass USD$200M.

DISCLAIMER:

The information herein (the “Information”) provided by Steven Rosenblum (the “Author”). The Information is for your internal use only and does not constitute research or investment advice. The Information and any opinions presented herein have been obtained and derived from sources believed by the Author to be accurate, but the Author cannot and does not make any representation or warranty with respect to it or its accuracy, completeness, sufficiency, appropriateness for your purposes or timeliness. All Information is subject to change at any time without notification. The Author disclaims, to the extent permitted by applicable law or regulation, all liability for any use you or your advisers make of the contents of this Presentation.

The document containing the Information (the “Document”) is not an offer to enter into any transaction. In particular, the Document is not intended to constitute a solicitation or offer to sell or to purchase any securities. Unless otherwise stated herein, any securities described herein have not been and will not be registered under the U.S. Securities Act of 1933, as amended (the “Securities Act”) and may not be offered or sold, directly or indirectly, in or within the United States or to, or for the account or benefit of, any U.S. person, except pursuant to an exemption from or in a transaction not subject to the Securities Act and applicable U.S. state securities laws.

The Document and the Information are the property of the Author. You may not use any portion of the Document except for your personal use, and you may not otherwise distribute any portion of this Document or the Information to a third party without the prior written Authorization of the Author.