

Rating Methodology – Micro Finance Institutions

INTRODUCTION

Bangladesh is considered to be the leader for global conceptualization of the idea of micro finance. The philosophy of poverty alleviation through micro finance has since been accepted globally. The history of MF in Bangladesh dates back to nineteen sixties, when the Nobel Laureate world famous microfinance initiator Prof. Dr. Yunus started a personal approach with the poor at Chittagong by extending collateral free credit. Its immediate success led the way to the formation of Grameen Bank, the pioneering model for MF in Bangladesh and around the world through Grameen Trust. A large number of Micro Finance Institutions (MFIs) are now organizing wholesale fund from various sources including donor agencies that are providing fund on social objectives such as poverty alleviation, employment generation etc. However, the donor assistance fund has been depleting and no longer available to maintain sustainable growth. The government encouraged its own banks and agencies to run MF operation by replicating models practiced successfully by Grameen, BRAC and other NGOs. The Government went further ahead in setting up of Palli Karma-Sahayak Foundation (PKSF) in 1990 to provide low-cost fund to the NGOs. Under the above backdrop, Bangladesh now boasts of having the largest micro finance industry in the world. Now microfinancing has been proved as a powerful tool to poverty alleviation and empowerment of poor people especially for women.

The objective of CRISL's analysis is to form an independent opinion on the type of risks that may affect the relative ability of MFIs to sustain in the long run. These would help the MFI in capacity build-up process towards the best practices. There are eight areas of Assessment which we called "GISPRACEF" as acronym are given below:

- Governance and Regulatory Compliance
- Information System and infrastructure
- Supervisory System
- Program Effectiveness
- Risk Analysis and Control mechanism
- Asset Quality
- Capital Adequacy
- Earnings and Sustainability
- Funding and Liquidity
- Impact study

1. Governance and Regulatory Compliance

Governance carries the philosophy of running an organization through a set of governance policy which ultimately establishes trust among the related parties, provides reliable information for the stakeholders, establishes professionalism, builds capacity to operate program efficiently and creates a congenial working environment, which is inevitable to face the challenges of the present competitive environment. The most important factor in the governance aspect is to analyze the composition of General Body and evaluating their responsibilities & functioning and identifying ultimate beneficiary if the organization dissolves. It also considers the internal reporting as well as the effectiveness of information flows.

For good governance practices, management personnel have a great role. So, management evaluation is vital to determine the capability of the Management team, its functional & financial delegation and organization policy towards human resources.

Regulatory compliance and legal structure builds reputation among donors and others regulators. So MFI's experiences in compliance with its Donors and other regulators are also analyzed.

2. Information Systems and Infrastructure

A sound management information system can be proved to be a very effective control tool and provide management with the desired timely feedback. Information system and the infrastructure to generate information are separately considered. Effectiveness of information system is judged on the basis of its quality, and usability in management decision making. Again infrastructure includes technical human resources as well as their capability in report designing. In an MFI, prime information source is Accounts & Finance department. So effectiveness of accounting system and software should be judged. In this regard CRISL considers Quality of chart of accounts, savings & loan data consolidated in general ledger, cash as well as accrual basis accounting, standard financial reporting, compliance with international accounting standards.

Again portfolio and clients information are another vital factors for decision maker. So for best practices an MFI should maintains all basic members' information as well as integrating it with accounting system and deposit – lending system. System should

be clients – centric and reporting format should be standard as CGAP, Micro-banking bulletin or PKSF recommended.

3. Program Effectiveness

MFI's are operating different program with different objectives. So evaluating performance of the programs in respect of client level is an important factor. Program effectiveness is judged on what extent the program improves their members' standing on various social & economic issues and building their clients toward entrepreneurs.

4. Risk Analysis and Control Mechanism

In the risk analysis phase, there are a number of key areas that must be covered. One of the most important is to understand probable threats and protect the organization against all threats to ensure that operation continues to survive. This requires an extensive scan of the organization to identify vulnerabilities and then analyze to understand those vulnerabilities, which would have the greatest impact on organizational operation.

Risk analysis covers different areas of risk e.g. credit risk, liquidity and interest rate risk, operational risk, delinquency risk, currency risk, collateral issues vs credit mechanism for recovery, legal systems for recovery etc. Concentration of credit risk in any form - by region, by product or by sector (business activity), is evaluated thoroughly. Credit experience is assessed through non-performance indicators, including portfolio at risk and loan loss reserves. Market risk, including interest rate risk is also a prime risk factor. The degree of matching of assets and liabilities is taken into account. Operational risk arises from the possible leakages, weaknesses, flaws, etc. of existing practices of the organization.

For each strategic risk that is identified, consideration should be given to any management control or business process that may mitigate the risk. It is also to identify the internal processes or controls that are most likely to be used by management to mitigate the potential threat. Overall, the goal is to ensure that control should be in a cost-effective way with a reasonable and prudent judgment.

5. Asset Quality

Asset quality refers primarily to the credit quality of the MFI's earning assets, which comprises its loan portfolio and investment portfolio. Quality in the contest means the degree to which the loans that the MFI has extended are performing (i.e. paid back in accordance with their terms) and the likelihood that they will continue to perform. As asset quality decreases, increased credit cost i.e. the loan loss reserves that the MFIs must set aside, cut into profits and loan write –off may eat MFI's regulatory capital. An MFI with excellent asset quality will normally be able to maintain sufficient profits and capital adequacy.

6. Capital Adequacy

Capital Adequacy which goes beyond the traditional definition of capital i.e. own fund in MFIs. Own fund includes retained earnings and reserves. Capital adequacy refers to the sufficiency of the cushion of equity and other accounts that perform to absorb any shock that an MFI may experience as a result of losses or diminution of its assets.

From an Assessor's perspective, analysis of the capital adequacy focuses on the ability of the lender to absorb future credit losses. It is also imperative to understand the kind of risk an MFI is taking with respect to credit, market, liquidity and operations. The assessment will begin with review of the composition of the own fund. A higher level of core capital is viewed more favorably as it is permanent in nature and would be available to set off credit losses. An MFI's health is typically gauged through capital adequacy measures.

7. Earnings

Earnings refers both profits (Surplus) and profitability, but with an emphasis on the later one. An MFI with strong earnings capacity and high profitability will be able to earn out of trouble by building up capital and continuing to invest in its operation.

CRISL believes that subsidized credit to the poor may be of assistance in the short-term, but the mission is better served if the institution can sustain with profitable operations, enabling it to enhance client outreach over time. To measure the operational viability of the organization, in addition to the usual parameters for measurement of profitability, operational and financial self-sufficiency is assessed. Profitability indicators are therefore adjusted for the cost of inflation and implied cost of equity and/or donations as well as real financial cost, if funds have been borrowed at subsidized rates. Underlying profitability can be affected by many things, amongst recoveries of non performing loans and the level of provisioning. A high level of recoveries would overstate an MFI's profitability while provisioning level above the rational requirement would understate a MFI's profitability.

8. Funding and Liquidity

Assessment of an MFI's funding and liquidity position focuses on the MFI's ability to raise funds to overcome short-term difficulties. A high level of liquidity can help a weak bank to remain funded when in financial stress and provides financial support to optimize on available opportunities. A lack of sufficient liquidity is the proximate cause of most MFIs failure.

Funding is basically being locked at from the deposit structure of an MFI. A large savings to credit portfolio gives stable funding. It is important to evaluate the MFI's position in savings mobilization and also analyzing the reliance on large savers to determine if the movement of funds by these large savers would create a vacuum or render the MFI in illiquid position.

The liquidity of the MFI is dependent on its ability to meet daily expenses and met demands for deposit

withdrawals. On a longer-term basis, this is measured by the degree to which core assets are funded with stable liabilities. Satisfactory liquidity is a characteristic of a healthy MFI. There are primarily three components to an MFI's liquidity: its expected cash flow, capacity to borrow from the market and its stock of readily realizable high quality liquid assets (FDR). Management of liquidity is primarily directed towards ensuring that the asset structure is liquid enough to maneuver to meet short-term demand of depositors and borrowers.

9. Social Impact Study

In order to review the achievement of the institutional objectives it is important to judge the impact of the activities of the MFI. During impact study, CRISL considers impact on sector, society, employment generation, gender inequality, health awareness, children's education, members' education, family planning, sanitation, household decision making, family welfare services, empowering women in the society, economic emancipation that is relevant for the specific institution.

CRISL follows sequential steps in the total assessment process as below:

Client (MFI)		CRISL
Request for Ratings (Time frame for each level)	>	The CRISL team formally asks for primary information through a set questionnaire with a given time frame of one week.
Submits detailed information	>	The team collects, collates and analyzes information from the client and identifies the gaps of further information from market and client.
Interacts with the team, responds to queries, provides any additional data necessary for the analysis	>	<ul style="list-style-type: none"> The team interacts with clients, visit site and analyzes data submitted by the client. Organizes interview with different levels officials of the organization. Team members interact, exchange views among them and prepare report for Internal Review Committee (IRC) and IRC forwards a summary report without rating rationale and symbol.
Reviews the summary report of IRC and suggest revision if any and provides additional information if they consider necessary	>	IRC further reviews the report with the additional information from the client and submits final report to Rating Committee with the indicative rating.

CRISL RATING SCALES AND DEFINITIONS

LONGTERM – MICRO FINANCE INSTITUTIONS

RATING	DEFINITION
AAA Triple A (Highest Safety)	INVESTMENT GRADE Micro Finance Institutions rated in this category are adjudged to be of best quality, offer highest safety and have highest credit quality. Risk factors are negligible and risk free, nearest to risk free Government bonds and securities. Changing economic circumstances are unlikely to have any serious impact on this category of MFIs.
AA+, AA, AA- (Double A) (High Safety)	Micro Finance Institutions rated in this category are adjudged to be of high quality, offer higher safety and have high credit quality. This level of rating indicates a corporate entity with a sound credit profile and without significant problems. Risks are modest and may vary slightly from time to time because of economic conditions.
A+, A, A- Single A (Adequate Safety)	Micro Finance Institutions rated in this category are adjudged to offer adequate safety for timely repayment of financial obligations. This level of rating indicates a corporate entity with an adequate credit profile. Risk factors are more variable and greater in periods of economic stress than those rated in the higher categories.
BBB+, BBB, BBB- Triple B (Moderate Safety)	Micro Finance Institutions rated in this category are adjudged to offer moderate degree of safety for timely repayment of financial obligations. This level of rating indicates that a MFI is under-performing in some areas. Risk factors are more variable in periods of economic stress than those rated in the higher categories. These entities are however considered to have the capability to overcome the above-mentioned limitations.
BB+, BB, BB- Double B (Inadequate Safety)	SPECULATIVE GRADE Micro Finance Institutions rated in this category are adjudged to lack key protection factors, which results in an inadequate safety. This level of rating indicates a MFI as below investment grade but deemed likely to meet obligations when due. Overall quality may move up or down frequently within this category.
B+, B, B- Single B (High Risk)	Micro Finance Institutions rated in this category are adjudged to be with high risk. Timely repayment of financial obligations is impaired by serious problems which the entity is faced with. Whilst an entity rated in this category might be currently meeting obligations in time, continuance of this would depend upon favorable economic conditions or on some degree of external support.
CCC+, CCC, CCC- Triple C (Vulnerable)	MFIs rated in this category are adjudged to be with vulnerable protection factors. This rating indicates that the degree of certainty regarding timely payment of financial obligations is doubtful unless circumstances are favourable.
CC+, CC, CC- Double C (High vulnerable)	MFIs rated in this category are adjudged to be with high vulnerable position. This rating indicates that the degree of certainty regarding timely payment of financial obligations is not possible unless overall circumstances are favourable or high degree of external support.
C+, C, C- (Very High Risk)	Micro Finance Institutions rated in this category are adjudged to be with very high risk of timely repayment of financial obligations. This level of rating indicates entities with very serious problems and unless external support is provided, they would be unable to meet obligations in a timely fashion.
D (Default)	Micro Finance Institutions rated in this category are adjudged to be either currently in default or expected to be in default. This level of rating indicates that the entities are unlikely to meet maturing financial obligations and calls for immediate external support of a high order.

SHORT TERM – MICRO FINANCE INSTITUTIONS

ST-1	Highest Grade Highest certainty of timely payment. Short-term liquidity including internal fund generation is very strong and access to alternative sources of funds is outstanding. Safety is almost like risk free Government short-term obligations.
ST-2	High Grade High certainty of timely payment. Liquidity factors are strong and supported by good fundamental protection factors. Risk factors are very small.
ST-3	Good Grade Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Although ongoing funding needs may enlarge total financing requirements, access to capital markets is good. Risk factors are small.
ST-4	Satisfactory Grade Satisfactory liquidity and other protection factors qualify issues as to invest grade. Risk factors are larger and subject to more variation.
ST-5	Non-Investment Grade Speculative investment characteristics. Liquidity is not sufficient to insure against disruption in debt service. Operating factors and market access may be subject to a high degree of variation.
ST-6	Default Institution failed to meet financial obligations

SOCIAL IMPACT RATING

SI-1	Highest Grade Highest social impact in terms of change in the quality of life of the poor and hard - core people of the society. Having exceptionally strong and sustainable wide network of service delivery system, the MFI achieved highest social objectives.
SI-2	Higher Grade Higher social impact in terms of change in the quality of life of the poor and hard - core people of the society. Having very strong and sustainable wide network of service delivery system, the MFI achieved higher social objectives.
SI-3	High Grade High social impact in terms of change in the quality of life of the poor and hard - core people of the society. Having strong and sustainable wide network of service delivery system, the MFI achieved high social objectives
SI-4	Good Grade Good social impact in terms of change in the quality of life of the poor and hard - core people of the society. Having reasonably strong and sustainable wide network of service delivery system, the MFI achieved good social objectives.
SI-5	Satisfactory Grade Satisfactory social impact in terms of change in the quality of life of the poor and hard - core people of the society. Having sustainable wide network of service delivery system, the MFI achieved satisfactory social objectives.
SI-6	Average Grade Average social impact in terms of change in the quality of life of the poor and hard - core people of the society. Having small network of service delivery system, the MFI achieved average social objectives.
SI-7	Below Average Below social impact in terms of change in the quality of life of the poor and hard -core people of the society. Having non-sustainable wide network of service delivery system, achieved below average social objectives.
SI-8	Poor Grade Poor social impact in terms of change in the quality of life of the poor and hard - core people of the society. Having non effective service delivery system, the MFI could not achieve any social objectives.