Sa-Dhan

The Association of
Community Development
Finance Institutions

The Rating Exercise of MFIs

A guide for MFI Managers

Guide Series

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Preface

Sa-Dhan, the association of community development finance institutions, strives to provide a facilitative environment for the microfinance sector in India. It also endeavors to contribute in developing a socially responsible and financially accountable microfinance sector.

Today the sector has achieved credible growth in terms of both outreach and sustainability. As of March 2008, Sa-Dhan members have client outreach of approximately fourteen million clients with gross loan outstanding of about Rs.6,000 crores. The growth story is visible across the country with expansion of existing microfinance finance institutions and in form of new microfinance institutions. Clearly, the growth is being led by incremental professionalism in the working of microfinance institutions. Banks and other funders are playing a key role in the growth through their partnership with experienced as well as emerging microfinance institutions across the country in providing funds for expansion of outreach and loan to microfinance clients.

In this context, the rating of microfinance institutions is gaining all the more importance. Rating is traditionally led by the need of banks and other funders to obtain, through a specialized third-party assessment, precise and informed opinion on a microfinance institution. The financial market has witnessed the emergence of specialized rating agencies. The rating agencies provide necessary comfort to banks and other funders in providing funds to microfinance institutions. Microfinance sector in India is fortunate to have a number of rating agencies of international repute and experience. The role of NABARD and SIDBI in increased practice of rating of microfinance institutions is an important new initiative. As microfinance institutions are growing rapidly, rating would therefore become an important process in the growth of funding of microfinance institutions.

This guide on credit rating of microfinance institutions has been prepared to provide a comprehensive understanding of the role and methodologies adopted by rating agencies. We hope the guide would lead microfinance institutions, across legal forms and operational strategies, to develop common understanding on rating issues and mechanisms that would in turn lead to their improved preparedness and better performance.

We are grateful to the Standards Sub-Group for their guidance and comments in the process of developing this monograph. We are thankful to Dr. Satish Bajpai, Mr. Ramesh Arunachalam and Ms. Grace A. Flesher (Welfare Services Ernakulam) for their contribution to the work.

We look forward to your valuable suggestions in improving the guide.

Mathew Titus
Executive Director

1. Credit Rating: Introduction

Rating facilitates financial intermediation, i. e. economic growth

Financial institutions play a very important role in the economy of any country. They aim to facilitate intermediation between savers and lenders/investors thereby promoting economic growth. The work of financial institution revolves around mobilization of resources and their effective allocation that confirms to the goal and objectives of the institution. This underlines the need for reliable information so that the scarce and valuable funds are put appropriately to the most productive use.

Lenders and investors on the other hand, looking for investment avenues need various sources of information, e.g. offer documents of issuers, research reports of market intermediaries, media reports, etc. that would help them to take wise investment decisions. In a number of countries credit rating agencies have been active. Over the years the credit rating agencies have emerged as providers of reliable, independent, objective and well researched information.

Ratings are evaluation reports for lenders and investors in a simple and easily understandable mode. Rating scores are generally expressed in alphabetical or alphanumeric symbols. Such easy to understand symbols assist lenders and investors to comprehend the underlying quality of the rated institution.

Rating as a tool for risk management

Credit rating is a symbolic indicator of the current opinion of the credit rating agency. It is the relative capability of a financial institution to serve its debt obligations. The nature of credit rating is fundamentally of two types.

(1) **Credit instruments such as debentures and bonds of institutions for quality of risk and returns**: The fund has to maintain a certain level of credit quality of the portfolio to uphold the rating at all times. It helps fund investors to identify the scheme with good credit quality portfolio. These are used to assess the MFIs' financial strength based on aspects like repayment performance, asset quality, liquidity and profitability.

(2) **The rating of an institution on risks, returns and prospects:** The assessment exercise includes a review of the MFI's systems, processes and internal controls, asset quality, organizational efficiency, governance, management, financial performance and strengths.

While initially the need for a system of credit rating was born out of defaults, over the last couple of decades its increasing importance has been guided by the following developments:

- Increasing role of capital and credit in economic and industrial development;
- Globalization of the credit market;
- Arrival of financial intermediaries;

- Growth of information technology;
- Securitization of borrowing and lending.

Today, most of the financial market intermediaries including commercial bankers and other funders find rating useful for planning and pricing their lending and investments.

The microfinance sector in India is increasingly moving towards high leverage; the growth in portfolio of microfinance is dominated by borrowed funds from banks and other funders[1]. Rating therefore has taken firm roots in the growth of MFIs.

2. Who uses Credit Rating?

Sector Perspective

Ultimately, credit rating increases systemic efficiency of the sector, in this context: Microfinance. This means, if risks are better mitigated, more clients can be reached at more affordable costs. At the same time, MFIs will be more profitable as inefficiencies of systems and operations are eliminated. Thus, the Microfinance sector as a whole profits because:

- In competitive environments regulators view ratings and standards as a way to separate ‘mediocre’ from ‘star’ performing institutions.
- Common performance standards and benchmarks raise the quality and efficiency of MFIs. They provide confidence and security for banks and investors.
- Investors and donors are interested in ratings and standards as these provide benchmarks and guidelines to determine future funding for MFIs.
- Ratings are also useful in promoting independent and transparent review of MFIs as they enhance prospects for the growth and capacities of MFIs.

Potential uses of credit rating by banks

From the point of view of the bank, the credit rating performs a part of the credit appraisal. For loan applications from MFIs, most Indian banks are now moving towards making a credit rating a mandatory condition. From the credit rating, the bank may

- Establish a baseline measure of the existing capabilities of an MFI on several crucial facets;
- Complement financial audits and program impact reports to provide a comprehensive evaluation of the viability and potential for growth with regard to an MFI;
- Obtain an assessment or 'snapshot' of an MFI’s operations.

[1] The Sa-Dhan ‘Side by Side’ – Maturing Microfinance - Emerging Challenges 2007 and ‘The Bharat Microfinance’ - Quick Data 2008 highlight the aspect of high leverage in microfinance institutions in India.

Potential uses of credit rating by investors

Investors' ultimate vehicle is the injection of equity. Being a long-term relationship, investors will, beyond the bank's perspective, use credit rating to establish the following:

- Choose appropriate MFI partner for implementing micro-finance projects
- Determine the level of performance achieved by an MFI and also identify the specific changes needed to strengthen an MFI's capacity
- Monitor and evaluate an MFI’s progress towards its institutional objectives

Potential use of credit rating by MFI leadership (board and management)

Usually, an impulse for a credit rating comes from banks and investors that the MFI approaches for financial resources. However, the most relevant benefits from the credit rating can be reaped by the MFI's own leadership. The rating report lays out in a clear and well framed manner the strengths and weaknesses of the MFI. It is the responsibility of the leadership of an organization to build on strengths and turn weaknesses into the same. So what kind of document to do this is more relevant to them? As one MFI manager puts it: *"I look at our rating report every couple of weeks. It reminds of what needs to be done next."* Some of the uses of the credit rating are the following:

- Assess training needs of the staff of an MFI and provide a framework for a training curriculum
- Serve as a means to educate NGO/MFI staff about the components and attributes of an effective MFI
- Create a strong and shared commitment to address the internal requirements of an MFI
- Serve as a basis to design improved systems and procedures.
- Facilitate preparation of a strategic business plan for the MFI.

3. Credit rating – scope and limitations

A Credit Rating is a thorough evaluation of all important aspects of an organization or of a loan product. The evaluation is summarised into a brief paragraph of judgment on the credit-worthiness of the organization. This judgment is ranked as an alpha-numerical score.

However, it must be understood that any compressing of information also entails narrowing of perspective. Yet, this compressed information has enabled an enormous expansion of institutional credit. At the same time, it has also wielded enormous powers in the hands of rating agencies. A rating agency has thus a huge responsibility.

If the rating is not carried out prudently, an organization may have to forego growth opportunities. That is, the rating mission does not take into account the specifics of the organization and its market, and applies restrictive judgment inappropriate to situation and context; and ‘underrates’ the MFI. Such fear is common for an MFI; however it can be said that the rating agencies named in this paper are not prone to such mistakes. They have all developed experience and approaches in the areas of small and medium enterprises, and usually have a team of experienced microfinance experts. Moreover, the rating and grading products offered to MFIs are already aligned to the sector, and, forthrightly, are usually somewhat laxed – taking into account specifics of developmental mission and operational context as compared to the ratings of companies in "strictly commercial" sectors.

Indeed, if more often do rating agencies rather lax too much there can be an undeniable conflict of interest. On the one hand the systemic perspective relies on strict, impartial and unbending judgment and scoring so as to make organizations and their risks comparable. On the other hand the rating agencies are private companies who want to expand their market share and profit. At times, the business-perspective has compromised the systemic perspective, in particular when rating agencies are HR or capital-wise intersected with their clients.

Flaws of rating – "overrating", downplaying of risks – played a major role in the two major financial crises and eventual economic downturns of the US during the past decade. Less dramatic, but a factor of inconvenience for MFIs are the different scoring scales, which mirror different rating methodologies and ultimately mean that a CRISIL and a M-CRIL and a PLANET-Rating are not comparable – yet comparability is at the heart of rating agencies' service.

Where there are shortcomings, they are regularly more on the side of the clients – MFIs, banks, investors – than on the side of the raters. At times, MFIs are reluctant to take up the opportunities of rating, and rather complain about interference with their ways. The danger is they may not take measures to improve weaknesses observed by the rating. At times, banks and investors may not read the rating report and use it to build their relationship with the MFI. Rather, they "tick" presentation of the rating report, assign an amount based on peruse over the score, and file it. Where such an attitude shows, willingness to claim and pay for a thorough institutional assessment – which is the real and core service of any rating agency – is restrained; and eventually laxity may loom.

Box 1: Assumptions to be kept in mind in using credit rating

- Credit rating is an advisory recommendation to the lender / investor.
- A rating does not create any fiduciary relationship between a rating agency and the user of a rating, as there is no legal basis for such a relationship.
- A credit rating agency does not perform an audit. It is an evaluation mechanism.
- The primary objective of rating is to provide guidance to banks / investors in determining a credit risk associated with a credit obligation.

- In determining a rating, both quantitative and qualitative analysis is employed. While the judgment is qualitative in nature quantitative analysis helps make the best possible overall qualitative judgment because, ultimately rating is an opinion.

To summarize, the limitations of ratings should be carefully understood; and the exercise should be brought into play wisely. However, it should not be forgotten that rating agencies have evolved as till now there has been no better mechanism of transparency designed. Particular in low-income countries and developing markets, both governments and MFIs have proved to be incapable to establish the degree of systemic efficiency that the private owned motivated, competitive interventions of rating agencies offer.

4. Rating Agencies for MFIs in India

Microfinance institutions are increasingly accessing commercial financial markets. To succeed in their efforts for mobilizing source of funds MFIs need to be assessed and evaluated by independent agencies. As per financial year 2007-08, most credit ratings of MFIs have been carried out by M-CRIL and CRISIL (**table 1**). Other Indian and international agencies are APMAS, CARE, Planet Rating and ICRA. Below, we introduce them in alphabetical order.

Table 1: MFI-ratings in India, 2007-08

Portfolio Size	**M-CRIL**	**CRISIL**	**CARE**	**APMAS**	**Access Development**	**Total**
> 50 Crore	15	20	------	------	-----	**35**
5 – 50 Crore	28	13	02	01	------	**44**
< 5 Crore	01	02	03	01	02	**09**
Total	**44**	**35**	**05**	**02**	**02**	**88**

Source: The Bharat Microfinance – Quick Data 2008, Sa-Dhan, New Delhi (Out of 233 data sheet collected by Sa-Dhan during 2008, 88 MFIs have been rated by above Rating Agencies)

APMAS

APMAS (www.apmas.org), a capacity building organisation, based in Hyderabad (A.P.), is working towards a common acceptance and wide use of quality as well as organisational capacity assessment processes for SHG Federations and MACS. APMAS has developed a Quality Assessment (QA) system called GRADES (Governance & Strategy, Resources, Asset Quality, Development & Impact, Efficiency & Profitability, Systems & Operating Processes, and SHG Performance) in collaboration with

M-CRIL. To enhance the internal quality consciousness, APMAS is developing a self-assessment tool for SHG Federations. APMAS was involved in the development of NABARD Critical Rating Index, which is being used to rate SHGs. APMAS has assessed MACS in several districts of Andhra Pradesh.

Credit Analysis & Research Ltd (CARE Rating)

CARE (www.careratings.com) is a full service rating company that offers a wide range of rating and grading across sectors. CARE is one of the pioneer rating agencies of micro-finance institutions in India. CARE rating methodologies are in line with the best international practices. It has been recognized by statuary authorities and other agencies in India for rating services.

CRISIL

CRISIL (www.crisil.com) adopts the MICROS methodology for undertaking the grading of microfinance institutions (MFIs) and non-government organisations that have microfinance programmes in their key activities. This is a comprehensive framework to assess the ability of MFIs to scale up and sustain their operations. The acronym MICROS stands for Management, Institutional arrangement, Capital adequacy and asset quality, Resources and asset-liability management, Operational effectiveness and Scalability and sustainability. The MICROS framework includes a traditional creditworthiness analysis using the CRAMEL approach, modified as applicable to the microfinance sector. The acronym CRAMEL stands for Capital adequacy, Resource raising ability, Asset quality, Management and systems evaluation, Earnings potential and Liquidity/Asset liability management, the focus being on credit worthiness, scalability and sustainability.

ICRA

ICRA Limited (www.icra.in) - formerly Investment Information and Credit Rating Agency of India Limited was set up in 1991 by leading financial/investments, commercial banks and financial services companies as an independent and professional Investment Information and Credit Rating Agency. Now ICRA, along with National Small Industries Corporation Limited (NSIC), has launched a Performance and Credit Rating Scheme for Small Scale Enterprises in India. The service is aimed at enabling Small and Medium Enterprises (SMEs) to improve their access to institutional credit, increase their competitiveness, and raise their market standing.

M-CRIL

As a specialized micro-finance rating and research agency Micro-Credit Ratings International Limited (www.m-cril.com) pioneered rating of micro-finance institutions in Asia. MFIs using a wide range of organizational forms, from NGOs to cooperatives, non-bank companies and banks have been rated by M-CRIL.

M-CRIL ratings differ from corporate ratings (undertaken by rating agencies) in their focus and enabling intent. The focus is on assessing the risk associated with a particular credit product of an organization based on the situation, system and industry outlook and using pre-specified indicators bearing proven historical correlations emerging from experience. Recognizing the developmental nature of the micro-finance sector, M-CRIL as and when requested, identifies the strengths and weaknesses of rated institutions and makes recommendations for improvement of operations.

PLANET FINANCE

‘Planet Rating’ an initiative of ‘Planet Finance’ (www.planetfinance.org) carries out independent evaluation and rating missions of Microfinance Institutions (MFIs), disseminates the results of these missions, provides customized evaluation and training sessions. These services are based on the GIRAFE methodology: a comprehensive evaluation and rating methodology designed to meet MFIs' characteristics. The focus of rating is on parameters like governance and decision making process, information and management tools, risk analysis and control, assets including loan portfolio, funding, efficiency and profitability.

Prominent MFI Rating Agencies:-

Name	Year of Inception
M-CRIL	1998
CRISIL	1987
APMAS	2001
PlaNet Finance	1999
CARE	1993
ICRA	1991

5. Rating Parameters

The objective of conducting credit rating a MFI is to determine the institutional robustness in providing microfinance services.

Box 2: What factors are usually considered in a Credit Rating?

All organizational factors that have an impact on the working of the MFI are considered and this should include the external environment as well. Examples of such factors include - Governance, Financial Management, Human Resources, Key Performance Indicators (Qualitative and Quantitative Ratios), External Environmental Aspects and the like. These factors are usually weighted and scored to yield a composite "final score" that is converted to a grade like A, B, C etc.

The analytical framework of rating deals with evaluation of financial and also business risks associated with the MFI.

Financial risks involve evaluation of the financial management, cash flow adequacy, earnings forecasts and the accounting policies.

Business risks involve evaluation of industry characteristics, performance, outlook and operating efficiencies of the MFI. In addition to business and financial risks in determining a rating, the role of qualitative aspects like management capabilities also has a considerable say. However, the role of each of these factors varies from case to case.

The following are the broad parameters for rating of micro finance institutions.

Governance & Management

Governance is process by which a board of director through management guides an MFI in fulfilling its missions and protects the assets of the MFI. Fundamental to good governance is the ability of individual directors to work in partnership to balance strategic and operational responsibilities. The interplay between management centers on the relationship between strategy and operations are essential for the successful evaluation of the MFIs.

Assessment of governance depends on the quality and appropriateness of the board composition, roles & responsibilities and the overall organizational structure.

Management systems are rated on the quality of human resources, the strength of critical systems like accounting and management information. The performance of the MFIs on staff production and ensuring compliance are also assessed.

The board is responsible for setting policy and providing strategic directions to the MFI. The board must work closely with management in carrying out this role to ensure congruence between the MFI’s strategic thinking and its operations.

Structure & line of authority:- There are three mechanisms that a board establishes to operate effectively.

1. The separation in the role of the board chair and that of the managing director or chief executive officer.
2. The role of the board chair in relation to other board members and
3. The use of board committee.

Accounting

To ensure that the comparisons between different microfinance institutions are meaningful, the accounting is adjusted for provisions on account of loan loss and valuation of securities.

Asset Liability Management

The assets of a microfinance institution comprises mainly of its loans to clients and of investments made in securities / bank term deposits. On the liability side, microfinance institutions have bulk loans from banks and other funders. MFIs also have owned funds in the form of corpus capital.

The funds flow in a MFI comprise of two separate streams of transactions. On the assets side, loans are recovered and new loans are disbursed. On the liability side, bulk loans are repaid by the MFI and new bulk loans are sourced. The inflow and outflow of funds in each of the streams may not match. Therefore these two separate streams of financial transactions in a MFI have to be managed in a manner that would balance the overall funds flow in the MFI. This is the function of asset liability management in a MFI.

The analysis of adequacy of control over the funds flow within asset and liability therefore focuses on management mechanism that deals with mismatches between maturity of assets and liabilities as well as on the adequacy of reporting and control systems.

Liquidity

Liquidity of micro finance institutions is derived from their ability to manage cash flows on a consistent basis. Cash flows are analyzed through business plan, regularity of repayments on loans provided to clients and on managing the sources of funds for the MFI. Management of idle cash over a period is another important indicator of optimal use of liquidity.

Financial Sustainability

Recovery of costs is a crucial factor in determining the sustainability of a microfinance institution. Sources of income particularly from on-lending, investments and other income are analyzed in detail. Another important indicator of profitability is the level and trend of net margins on interest.

In assessing financial sustainability, various financial ratios including the ratio of earnings to total assets are computed and compared with sectoral benchmarks. Financial performance over various periods are analyzed to understand reasons for periodic variations and to determine the future trends in financial sustainability of the MFI.

Asset Quality

This is the prime factor that differentiates microfinance institutions operating within the same or similar environments. The primary areas of concern are the diversification of the portfolio and the concentration of risk.

To measure asset quality, an assessment of the procedures for evaluating, authorizing and servicing loans is carried out. A review is done of the history of loan losses, write-offs and provisions, collection efficiencies and the policies with regard to reschedulement of loans. The extent of NPAs (non-performing assets) is an important indicator[2].

Future Developments

In the process of determination of any rating, past performance is one of the indicators of the future. Discussions with senior management are as important an input as statistical forecasts of expected levels of profitability. Discussions with the senior management involve economic conditions, current and expected business and operating environment, expected changes in regulations. The review includes how profitability levels will be maintained, required levels of capital and liquidity will be financed and the management's outlook and preparedness in these areas.

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[2] NPAs are those on which interest and principal repayments have been overdue over a period laid down by the regulatory authority. Internationally the norm for NPAs is overdue for a period of two quarters beyond the due date of repayment. The assets are classified as standard, sub-standard, doubtful or loss assets depending on the period for which they have continued to be NPA.

Maintained, required levels of capital and liquidity that has to be financed and the management's and preparedness in these areas.

Table 2: Focus areas of aspects that ratings agencies generally look at

Focus Areas	Sub Area
GOVERNANCE	• Board composition • Board members' background/qualifications • Board member compensation • Board roles • Board responsibilities • Board functioning and • Board meetings etc
LEGAL ISSUES	• Legal form • Legal compliances of regulatory requirements • Laws etc.
MANAGEMENT AND SYSTEMS	• Senior management team's power and decision making authority • Organizational structure including lines of authority and responsibility • Strategic business planning – formulation and implementation of plan and Control and management of strategic business plan • Implementation of Delinquency and portfolio systems and policies • Administrative procedures, operational manuals and workflow organization • Risk management systems • MIS (Management Information Systems) • Polices documented/written (cash control, risk control, information security etc.)
HUMAN RESOURCES	• Staffing, job descriptions and positions • Personnel administration and management recruitment and employment systems • Performance based appraisals • Promotions and rewards (incentive schemes)
FINANCIAL MANAGEMENT	• Basic financial and accounting systems • Cost allocation • Accounting standards, in particular provisioning for loan losses, loan collections/defaults • Internal audit systems and procedures • Internal control mechanisms and related aspects • External audits and their administration

Focus Areas	Sub Area
PRODUCTS AND DELIVERY	• Products and description • Distribution/Delivery mechanisms • Pricing of micro-finance services
PERFORMANCE	• Growth and analysis • Capital structure analysis • Self-sufficiency and profitability analysis (financial and organizational) • Efficiency and cost structure analysis • Portfolio quality and management • Transformation to regulated MFIs • Social impact assessment (social audits), portfolio at risk
ENVIRONMENT	• Managing growth • Political insulation of MFIs/MF programs • Market areas opportunities/challenges

Source: Drawing on "Life at Bottom of Pyramid" by Aruanchalam et al (2007), VBDT Publications, Chennai, with additions by Sa-Dhan.

6. Rating Process

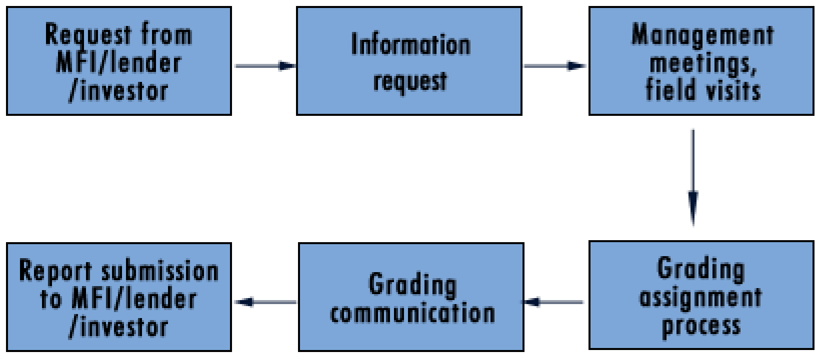
Overview

Every rating agency adopts certain practices and follows certain procedures to gather information that is necessary and helps in the evaluation of credit risk of the microfinance institution. The rating agencies adopt practices and procedures to analyze the information and arrive at a conclusion on the appropriate rating to monitor the credit quality of the rated institution from time to time. It helps to decide on timely changes in the ratings as institutional fundamentals change and to keep the users of ratings duly informed.

All these processes are not only inter-related but also ongoing. The general principles of the process of rating are the same the world over. The procedures followed by the rating agencies in India are modeled on those of the major international credit rating agencies.

Rating agencies begin its evaluation process by reviewing the MFI's documentation. The team of analysts requests for a detailed list of information from the MFI. Thereafter, a rating team visits the MFI for **two-four days of management meetings, and branch and field visits for on-site review**. Chart 1 illustrates the sequence of steps involved in the rating process. The duration of visit depends upon the size of the MFI, the geographical reach, number of lending models adopted and quality of reporting and information provided. The team interviews board members, senior management, line managers (branch managers and loan officers) and clients. In case ratings are being assigned for the first time, it normally takes **two to four weeks after the information flow is complete** to arrive at a final rating opinion. However, the time taken to arrive at a rating opinion is also dependent on the complexity and diversity of the operations of the MFI. The rating score is assigned by the agency's rating committee.

Rating process Chart:-



The main and important procedures involved in rating are as below:-

Rating Teams

Analysts are organised along sectoral lines. These teams make the analytical process efficient and consistent. The analytical teams are formed so as to draw on the analytical and sectoral skills of the organisation.

For basic research, analysts obtain credit related data (both statistical as well as qualitative) from a variety of sources including annual reports, prospectus, industry, sectoral or economic data, government reports, industry association reports, news reports, regulatory and other sources that may have knowledge of the rated institution and the industry it works in. Over a period of time these teams of analysts develop statistical database, which enables comparability across major issuer categories.

Meetings with Management

Meetings are held with key operating personnel of the MFI. These meetings broadly cover the background, history, organizational structure, operating performance, financial management and topics of special relevance to the future strategies of the MFI. At these meetings the analysts of the rating agency look for information that will help them understand the MFIs ability to generate cash from operations to meet debt obligations in future. The meetings also provide an opportunity to the management of the MFI to explain their work and financial strategies to the representatives of the rating agency. Finally a meeting of the analysts is also held with the top management where apart from corporate strategy and philosophy, key issues relevant to the rating are discussed.

The rating team may also undertake a visit to the operational sites of the MFI.

As part of the rating process, MFIs would provide information that is not placed in the public domain. This information is helpful in conveying to the users of ratings an accurate assessment of the working of the MFI. However, strict **confidentiality** of the specific nature of the information is maintained by the rating agency.

Report Preparation

After a thorough analysis of all the information collected by the rating teams, a detailed report setting out all the parameters in the rating is prepared. A list of key issues pertinent to the rating is also prepared. The rating report is submitted by the rating agency to the bank / investor that engaged the rating agency to rate a MFI. This report is a confidential document between the rating agency and the bank / investor.[3]

Major elements of the report are:

- **Rating score**: Rating agencies provide the banks / investors, along with its rating report, a rating score. The rating score is a composite score for the rated MFI. The validity of the score is for tenure of six months to a year; more importantly on the continuation of the existing conditions of working of the MFI. The rating score is derived by the rating agency through its proprietary mechanism that gives relative weights to different components of its assessment of the MFI. The components range from governance, management to financial performance and various elements of risks involved in operations of the MFI.
- **Rationale**: A rationale setting out the key issues in the rating assigned to an MFI is given in the rating report. The rationale is also disseminated to the users by the rating agency through its own publications.

Rating Meetings

The report prepared by the team of analysts is previewed and then placed before the Rating Committee of the rating agency. The composition of the Rating Committee is such that it would ensure objectivity and impartiality to the ratings. The Rating Committees consists of independent and external members who are distinguished people with varied experience.

Once the draft rating score is assigned, this is communicated to the rated MFI. The MFI on being communicated the rating has an opportunity to request for a **review** of the rating in case it wants to present fresh facts or clarifications. After considering the request for review, if received, the final rating score is assigned by the rating agency.

[3] The website 'www.ratingfund.org' provides information on select contents of rating reports on MFIs from across the globe.

Continued Surveillance

In addition to the ongoing review of the rated MFIs performance, a detailed annual surveillance exercise may also take place. This reviews the major developments in the MFI during the period and their impact on the rating of the MFI.

Wherever the credit fundamentals of the MFI undergo transitions, the reviews could be more frequent. As a part of continued surveillance, personal meetings with MFIs and a regular flow of periodical and interim reports and other information from MFIs are a continuous process.

The review specifies the potential directions in which existing ratings are likely to change, viz., upgrade, downgrade or uncertain direction. The analysts of the rating agency discuss the situation with the management of the MFI and make a detailed analysis. After the analysts have prepared heir report, the Rating Committee of the rating agency decides whether or not a change in the rating is warranted.

7. Information requirements for Rating Agencies

From the objectives and methodologies of credit rating transpires obviously that the rating team will ask a lot of questions and will look in a lot of documents. A comprehensive list of the information from the microfinance institution is given in **table 3**. The list is indicative of the broad themes. Rating agencies would need information in detail to suit their specific requirements.

Documents required to be submitted to the rating agencies prior to the rating visit are:

1) MFI mission, vision and overview
2) Organizational chart
3) Profiles of Senior staff
4) List of Board members with background, experience and other directorships held.
5) Audited financial statements for the last 5 years
6) 5 year projection, including
    (a) Income & Expenditure
    (b) Balance Sheet
    (c) Cash Flow
    (d) Assumptions
    (e) Strategic Plan document
7) Outreach Summary
8) Donor support details
9) List of all bank borrowing since inception, including
    (a) date of disbursement

(b) Interest rate

(c) Loan outstanding at end of the fiscal year, for which of the last 2 years.

10) Written confirmation from each lender, for each loan, of timely payments.

11) Staffing summary

12) Descriptions of loan and savings products, fees, rates

13) Branch – wise on time % PAR %s(< 30 days, 31-60 days, 61-90 days, 91-180 days, 181-365 days, > 1 year)

14) Product – wise on time % , PAR %s (< 30 days, 31-60 days, 61-90 days, 91-180 days, 181-365 days, > 1 year)

15) Break – up of disbursements and year end portfolio by sector, product and branch

16) Loan disbursement by loan size and borrower type (1^{st} , 2^{nd} time borrowers)

17) Balance Sheet by month

18) Collection efficiency by month

19) Asset & Liability management profile.

Table 3: List of information required by a rating agency from a MFI

Broad theme	Some of the elements of indicative information
Institution framework	How and why the institution was created Brief history of the institution since its creation Composition of the Board Roles and responsibilities of key management people in the institution Legal status of the institution
Current work	Objectives and focus of the institution Donors and funders Geographic and client focus
Working mechanisms	Institutional organogram Funding structure Working strategies Products and services
Systems and processes	Human resources Operational systems Accounting systems Reporting processes Internal monitoring systems
Financial performance	Cost recovery Asset quality Loan loss provisioning Management of funds Adherence to performance standards

Future plans	Growth strategies New initiatives

8. Way Forward

How to prepare for a successful rating?

Rating is costly – Rating agencies' fees vary, depending on scope and stretch of an MFI's operations; the bill may run somewhere between Rs. 2 and 5 lakhs. Naturally, as it is a competitive market, MFIs should compare quotations from several rating agencies. However, the financial cost is not the most important factor. Indeed, there are various opportunities for MFIs to access 50-75% financial support towards their rating bill. Examples are

- The SIDBI[4] initiative to obtain ratings as an annual input for their credit support to MFIs has pioneered the practice of rating of MFIs in India. MFIs that access funds from SIDBI have been undergoing ratings periodically.
- NABARD[5] has instituted rating by CRISIL for MFIs as a condition to access funds from NABARD. The Micro Finance Equity and Development Fund (MFEDF), constituted by the Government in 2005 propose to support rating of MFIs. A couple of MFIs have got themselves rated at one point of time or other on a voluntary basis. During financial year 2007-08, Sa-Dhan recorded approximately 788 MFIs were rated (see table 1).

The most important factor of "cost" of a rating is the time involved. Rating teams will visit the MFI headquarters and usually some field operations for 2-4 days. It is important that they are attended by the MFI leadership as it is not uncommon to find that rating missions often run behind their schedules when MFI management does not find ample time to discuss with them and answer questions patiently.

However, the major driver of time is the quality of documentation available from the MFI. If all information as listed in this section is readily available – over 2-3 financial years – then the rating team will work quickly and smoothly. Lack of documentation, or delay in producing documents required is the major impediment to any rating, because even the discussion with management will be hampered by it.

Therefore, an MFI should embark on rating by a conscious decision of management. At least one senior manager must "champion" the project and act as the contact and liaison person. S/he should be supported by 1-3 staff (depending on the size of the MFI) that co-ordinates the visits of the rating team and ensures that the MFI submits documents and schedules meeting with board and management timely and reliably. When the draft report

[4] www.sidbi.com

[5] www.nabard.org

comes, the MFI leadership should embrace it constructively. Rather than being defensive, discuss openly about any weaknesses that the rating team observed; but do not forget to note strengths as well. That way, the MFI will reap valuable internal benefits:

- **Transparency:** Rating helps in improving transparency in governance & Management, Financial aspects, operational levels of MFIs.
- **Staff Efficiency:** Rating helps in creating improved staff productivity as increased value for the clients.
- **Portfolio at Risk:** It has a bearing on the portfolio management and Portfolio at Risk.
- **Profitability:** This is good way to depict the leadership between profits and yield. on loan portfolio as this will present the effective interest rate that the MFI is charging from.

It would be the task of the rated MFI's "champion and her/his team to do follow up action upon the rating report. As the ranking scales of different agencies are incompatible, it is highly advisable to take at least two consecutive ratings from the same agency as to track improvements. Negotiating two ratings in a row could be an argument for better pricing. From bigger MFIs banks and investors will expect annual ratings; for smaller MFIs bi-annual ratings might be appropriate.

Ultimately, for a successful and high rating MFIs should aim and gradually progress towards:

- Scalable operational size in terms of credit portfolio and service delivery network;
- Reliable accounting and information system including regular review of assets and liabilities and objective assessment of their quality and real value;
- Establishment of reliable and effective internal audit function;
- Achieve operational sustainability and financial self-sufficiency through increased cost recovery, efficiency and expanded outreach of services.

A role for Sa-Dhan?

Approximately a third of Sa-Dhan member-MFIs have undertaken a credit rating. As for the emerging SHG-federations and MACS, many of which are not Sa-Dhan members, only very few have been rated.

This observation contrasts to the manifold benefits that rating has for an MFI. It may be argued that the benefits for small and/or young and/or community-based organizations are the more relevant ones, because they provide their management and owners with a solid and straight forward framework for their work, responsibilities and performance.

Moreover, credit rating is a form of applied transparency. Therefore, any Sa-Dhan member should be eager to line up for a rating. It will prove to its stakeholders and the wider public, as well as to its own leadership, the degree of implementation of transparency which is at the core of Sa-Dhan's code of conduct.

Thus, dissemination of information – as through this guide is clearly part of Sa-Dhan's mandate. But as the association works towards raising the bar of quality for services and products in microfinance, it does not end here. Sa-Dhan might in future tie its membership criteria – which are already like a small "rating test run" - closer to the framework of credit ratings. Here, the rating score is of little interest – the important part is that the MFIs take a habit of getting rated, and that they track improvements over time, that is from one rating to the next. To support them in that process with adequate capacity building, Sa-Dhan would need to be intimated with the rating reports. That would in turn strengthen the associations' consolidated sector-reports.

The ultimate beneficiary of the whole exercise is the microfinance client who get better services, and moreover, many of today's unbanked Indians will only be reached if MFIs become stronger and more sustainable organizations.

A Look into the Future

The growth of MFIs would continue to be dominated by borrowed funds that would be provided by institutional sources like banks and investors. The operating scale of even small and of emerging MFIs is moving up. Evaluation of MFIs by these institutions through the rating mechanism would be therefore on the rise. Ratings would become an essential condition in growth of MFIs.

MFIs would need to respond through systemic improvements in operations coupled with attaining the social mission of working with the underprivileged masses. The essential components of the response of MFIs could be:

- That institutional change towards systemic approach to microfinance operations would have to be practices irrespective of legal form and of operating mechanisms. The systemic approach would comprise of adequate operational norms and controls, human resources and financial management.
- Complying with sectoral standards for financial and social norms would be central to building credibility and growth of MFIs
- MFIs would grow through maintaining long term relationship with banks and other funders.