

Microfinance Institution (MFI) Grading Criteria

OVERVIEW

Microfinance involves providing thrift, credit and other financial services and products to the economically challenged to enable them to raise their income levels and living standards. Typically, customers of Microfinance institutions (MFIs) do not have access to banking services, and depend on informal sources (such as friends and money lenders) for their credit requirements.

MFIs fulfil the critical objective of providing financial services to the economically challenged; such services enable clients to meet their credit requirements, fulfil their entrepreneurial ambitions and enhance their economic status. However, microfinance can create a lasting impact in society only if it is provided on a sustainable basis. To make this happen, CRISIL offers risk assessment (including MFI grading) and diagnostic services to help MFIs and other constituents in the microfinance industry to measure, mitigate and manage their business and financial risks. Lenders, donors and investors also benefit substantially from CRISIL's inputs because their growing microfinance portfolios demand an intensive, sustained assessment of key monitorables.

Traditional credit rating services that are used to rate banks, financial institutions and finance companies do not address the needs of the lending fraternity. While a number of specialised agencies emerged to cater to the needs of donors/social investors and sector-specific lenders, their inexperience in the finance industry was a major constraint. Investors, multilaterals, development financial institutions and other lenders, therefore, sought an appropriate evaluation service from CRISIL given its credibility, track record, analytical rigour and experience in the developing markets. The evaluation methodology that CRISIL employs to assess MFIs ensures optimal differentiation for the microfinance industry. CRISIL took account of the following characteristics of MFIs and requirements of investors/donors/lenders in launching its methodology and definition:

- The nascent state of the microfinance industry, the world over, and the limited size of MFIs
- Most MFIs either began as non-governmental organisations (NGOs) or were nurtured by NGOs, resulting in a non-commercial orientation
- Most MFIs are not regulated and do not adhere to prudential norms, unlike banks and financial institutions
- Most MFIs have a governance structure of their own
- A number of MFIs are characterised by an absence of capital/equity
- MFIs have distinct lending models that help them maintain asset quality despite the inherently weak profile of clients
- MFIs have high operating costs and are, therefore, not the lowest cost providers of finance

- Very few MFIs have access to public debt markets for funding; credit rating was, therefore, not a practical solution
- Analysis that assess the MFIs' strengths, weaknesses, opportunities and limitations, and enables donors/lenders to appropriately provide a mix of capacity-building support and loans/revolving funds would be highly appreciated
- Reports that provide lenders/donors details on MFI performance and allow ranking of a portfolio of MFIs inter se would be useful
- Lenders look for reports that benchmark MFIs against other MFIs and not banks and financial institutions
- Lenders look for reports that provide views on management, governance and loan/asset administration

PRODUCT OFFERINGS

To help investors, lenders and MFIs manage risks better, CRISIL Ratings offers risk assessments (with or without gradings) and diagnostic services globally.

MFI Grading/Risk Assessment Services

CRISIL Ratings offers risk assessment services, which expresses its current opinion on the ability of an MFI to conduct its operations in a scalable and sustainable manner. CRISIL's risk assessment service can be offered with or without an MFI grading.

Definition

CRISIL's MFI grading is a measure of the overall performance of an MFI on a broad range of parameters under CRISIL's MICROS framework (explained later in this note). An MFI grading is CRISIL's current opinion on the ability of the MFI to conduct its operations in a scalable and sustainable manner. MFI grading is assigned on an eight-point scale, mFR1 being the highest, and mFR8 the lowest grading; a high grading denotes a greater degree of scalability and sustainability. The universe for evaluating institutions under the MFI grading service consists of MFIs operating across the world. MFI grading is not a comment on debt repayment capability.

The risk assessment exercise includes a review of the MFI's systems, processes and internal controls, asset quality, organisational efficiency, governance, management, financial performance and strengths. CRISIL's MFI risk assessment service is not a credit rating and does not indicate the credit worthiness of an MFI.

No surveillance

CRISIL's MFI gradings are one-time assessments based on the information provided by MFIs; CRISIL does not monitor the grading on an ongoing basis. These are non-issuance based gradings and reviews are done only at the request of the MFI or a prospective investor/donor/lender on a point-in-time basis.

Diagnostic services

CRISIL Ratings offers customised diagnostic services that cater to the requirements of donors and social investors proposing to invest in or provide grants to MFIs, or microfinance programmes of NGOs. These studies, apart from carrying out a SWOT (Strengths, Weaknesses, Opportunities and Threats) analysis, may be customised to indicate actions that the MFIs can explore to scale up and sustain their microfinance operations while minimising risks. CRISIL also offers customised services, such as a review of the business plan, and periodic monitoring of microfinance programmes with an option of an MFI grading under this service.

ELIGIBILITY

CRISIL's MFI grading methodology may be applied to MFIs of varying types and lending methodologies. The MFI grading is offered to institutions that meet all of the following criteria:

- Direct or indirect exposure to microfinance activity. Direct exposure institutions are those that have a loan portfolio and/or manage loan portfolios for banks/financial institutions. Institutions with indirect exposure are primarily NGOs that organise prospective clients (usually women) in the form of groups (in India these are called self-help groups), which are then linked to banks for accessing credit. Such NGOs do not undertake financial intermediation on their own¹.

¹ For institutions with indirect exposure, criterion #(ii) will not be applicable

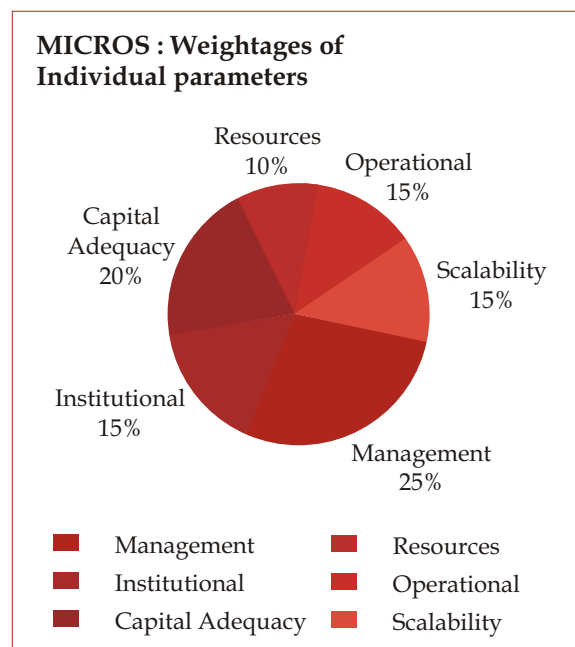
- A substantial proportion of the loan portfolio and disbursements should be dedicated to microfinance and micro enterprise loans.
- Have a loan product orientation towards microfinance and micro enterprise activity that are generally of an income-generating nature.
- Loan product orientation, rather than average loan size, is an eligibility criteria.

MICROS - MFI EVALUATION FRAMEWORK

The broad analytical framework adopted by CRISIL to evaluate MFIs is, to a large extent, similar to the one used for banks, financial institutions and other financial intermediaries. CRISIL employs the CRAMEL methodology in the credit rating of financial entities (refer Table 1); this methodology has been modified to address issues that are specific to MFIs, after taking account of the fact that the microfinance sector is still in its infancy.

CRAMEL - Credit rating of entities in financial sector	MICROS - MFI grading of MFIs
Capital adequacy	Management
Resource raising ability	Institutional arrangement
Asset quality	Capital adequacy and Asset quality
Management and systems evaluation	Resources and Asset liability management
Earnings potential	Operational effectiveness
Liquid/ Asset liability management	Scalability and sustainability

The focus of MICROS is on management/ institutional analysis to assess the sustainability and scalability of the MFIs' operations. Weightage for the main parameters in the MICROS methodology are highlighted in Chart1:



MANAGEMENT

CRISIL's management analysis focuses on evaluating the practices and systems of the MFI vis-à-vis the best practices among financial intermediaries. It is imperative for MFIs to have formalised processes for identification of client segments, loan disbursements, and monitoring of loan accounts and collections. Formalised processes and systems are key to achieving a sustainable and scalable business model. This parameter is analysed using the following sub-parameters:

- Track record in microfinance, alliances and networks with other agencies (donors, associations, tie-ups)
- Documentation levels and adherence to them
- Systems for client identification, group formation, credit appraisal, loan overdue monitoring, cash flow management and fraud control

- Processes, controls and audit; nature of internal audit, quality of accounting practices and reporting
- Use of information technology: hardware and software infrastructure, adequacy of systems and degree of computerisation, perceived benefits from IT implementation, security and disaster recovery management
- Human resources management
- **Social/local impact:** Findings of impact assessment studies, local/social impact observed by CRISIL team during interactions/observations on field
- Capital position with respect to domestic capital requirements (for banks and non-bank finance companies)

CRISIL evaluates asset quality by assessing the MFI's ability to manage credit risks. The analysis is based on information provided by the MFI, or obtained at meetings with management or on visits to the field for interactions with branch staff and customers, or a random review of documentation and experiences of other MFIs. The analysis is based on the following:

INSTITUTIONAL ARRANGEMENT

CRISIL assesses institutional arrangement by examining the quality, track record and inter-relations among the MFI's management, promoters and board. It also evaluates the articulated vision of the management/board to the stakeholders. Institutional arrangement is scored on the following sub-parameters:

- Quality of management, ownership and governing board – pedigree of promoters, experience/recognition in field, structure of the board, independence of the board from management, organisation structure, experience of senior management personnel and their understanding of the sector
- Governance practices
- Goals and strategies – Articulation of vision, goals and strategies, quality of planning
- Profile of clients and quality of lending, loan conditions, alternatives to collateral (group guarantee), quality of groups formed by the MFI, purpose of loan (economic or consumption), adverse selection risks
- Seasoning of loan portfolio
- Concentration of credit risk – diversity in end-use of loans, exposure to disaster prone regions, geographical concentration of operations
- Loan loss levels and movement of provisions and write-offs – portfolio at risk (PAR) greater than 30, 90, 180, 360 day levels, on-time repayment rates, provisioning and write-off policies of the MFI, proportion of write-offs and provisions (after CRISIL's adjustments, in case the MFI does not have an adequate policy), loan provision and write-off policies vis-à-vis prudential norms (for companies and banks)

CAPITAL ADEQUACY AND ASSET QUALITY

CRISIL's assessment of an MFI's capital adequacy level is based on the perception of relative profitability, and the institution's risk profile and asset quality. The analysis encompasses the following factors:

- Size of capital
- Quality of capital, internal accretions, access to capital grants/donations (for non-corporate/cooperative legal forms)

RESOURCES AND ASSET LIABILITY MANAGEMENT

CRISIL analyses the resource position of MFIs on the basis of their ability to maintain a stable resource base and obtain borrowings at competitive rates. CRISIL's analysis factors in the legal status of the MFI (which imposes restrictions on the acceptance of savings/deposits) and the regulatory environment in the country in which the MFI operates. In other words, CRISIL does not penalise the MFI for the constraints imposed by its legal status and operating/regulatory environment under this parameter. Constraints of legal status and operating environment are considered under scalability and sustainability.

Moreover, regulatory risks, if any, are considered separately. The key factors analysed under this parameter include:

- Composition of borrowings
- Diversity in borrowing profile – banks, apex MFIs/financial institutions, overseas borrowings, money markets, etc.
- Cost of borrowings – trend and comparison with other MFIs
- Other details – ability to securitise portfolio from impact of foreign exchange currency risks
- Asset liability maturity profile of the MFI, liquidity risk and interest rate risk

OPERATIONAL EFFECTIVENESS

In measuring operational effectiveness, the key considerations are operational efficiency and profitability. MFIs are incorporated under different legal forms; in most countries they are not regulated and do not need to follow standard accounting practices. CRISIL, therefore, performs appropriate analytical adjustments, which are in line with the practices adopted worldwide in evaluating MFIs. The factors analysed under this parameter include:

- Office outreach and quality of infrastructure
- Operational efficiency – productivity measured through several indicators such as loans/borrowers to loan officer, loans/borrowers per branch and staff allocation ratio. Efficiency is measured through indicators such as operating expenses to average funds deployed, and operating expenses to disbursements
- Diversity of income sources – composition of fund and fee-based income
- Profitability – loan pricing, impact of pre-payments, operational self-sufficiency (OSS) ratio, net profitability margin (NPM), return on equity (RoE), return on funds deployed/earning assets (RoA)
- Impact of inflation on earnings (used in countries that have experienced high inflation in the past)

SCALABILITY AND SUSTAINABILITY

An MFI needs to create a sustainable and scalable business model; its products and processes need to be evolved so as to attain institutional and financial resilience. To assess an MFI's ability to attain institutional and financial resilience, the following sub-parameters are analysed:

- Fund and resource base sustainability – sustainability of capital with respect to growth in the MFI's loans, plans to raise capital, and resource diversification strategies in place
- Organisational sustainability – legal structure, governance, succession, human resource issues
- Programme sustainability – sectoral expertise, ability to diversify product mix, enter new regions, retain market share in existing operational areas, long term strategy of the MFI/NGO-MFI in microfinance activity

ADJUSTMENTS TO FINANCIAL STATEMENTS

CRISIL makes appropriate adjustments to financial statements in analysing an MFI's financial performance in order to improve comparability. Adjustments are also necessitated because MFIs, with their varied legal structures, seldom follow uniform accounting and provisioning norms even within one country. The adjustments relate to factors such as revenue and expense recognition, segregation of capital and revenue grants, loan loss provisions and write-offs and depreciation.

FACTORING IN REGULATORY RISKS

Local and national regulatory and legislative policies impact three actions of MFIs – interest rate settings, mobilisation of savings/deposits, and offering insurance by undertaking underwriting. CRISIL's analysis examines whether the MFI contravenes the law with respect to these actions. It also factors in the views/past actions of governments on these issues and appropriately takes account of them in the overall grading.

EVALUATION PROCESS

CRISIL begins its evaluation process by reviewing the MFI's documentation. The team of analysts request a detailed list of information requirements from the MFI. Thereafter, a CRISIL team visits the MFI for two-four days of management meetings, and branch and field visits for on-site review. The duration of visit depends upon the size of the MFI,

the geographical reach, number of lending models adopted, the reporting quality and quality of information provided. The team interviews board members, senior management, line managers (branch managers and loan officers) and clients. The grading is assigned by CRISIL's rating committee.

Chart 2 illustrates the sequence of steps involved in the rating process:

The sequence of steps in the rating process

