Methodology
Microfinance Institution Rating

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Summary

PACRA's credit rating is a representation of its opinion on the relative credit risk associated with the Microfinance Institution. PACRA arrives at this opinion by conducting, inter-alia, a detailed evaluation of the qualitative and quantitative factors, namely: Profile, Ownership, Governance, Management, Business Risk and Financial Risk. This helps in assessing the future financial performance in various scenarios. While several parameters are used, the relative importance of each of these qualitative and quantitative criteria can vary across microfinance institutions, depending on its potential to change the overall risk profile.

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0. INTRODUCTION

- Scope
- Rating Framework

INTRODUCTION

A sound financial ecosystem is critical for functioning of any economy. It is defined by interaction of providers of funds - savers, users of funds - borrowers, MFIs, and regulators. This system ensures smooth flow of funds between savers and borrowers; wherein, MFIs provide platform for their interaction. Regulatory oversight safeguards the sanctity of this system. Like all systems, financial system has its own set of challenges. The most prominent being "Risk"; the risk that some participant may not be able to meet its commitments. All participants do their best to manage this risk to maximize their return. This is not possible unless we have independent information on this risk. Here comes expertise of rating agencies, providing independent opinion on credit risk. Flow of funds is only possible when the provider of funds has confidence that user of funds will be able to return these in a timely manner and as committed. Ratings help build this confidence. A higher rating means higher likelihood of timely repayment compared to a low rating. Our ratings are forward-looking and reflect our expectations for future financial and operating performance. However, historical results are helpful in understanding patterns and trends of a company's performance as well as for peer comparisons.

0.1 Scope: Micro Finance Institutions (MFIs) in many ways are similar to other MFIs, mainly banks, which primarily operate in lending business. In addition to carrying social objective of meaningful impact on overall society, many MFIs focus on business on self-sustainable basis so as to reduce/eliminate dependence on support i.e. subsidized loans, donations, grants etc. MFIs' primary business is to cater that part of society which is unserved or underserved due to low levels of their income and micro needs, which cannot be satisfied by large MFIs like commercial banks mainly due to capability as well as business considerations. As amounts involved per borrower are significantly small but the volumes are large, MFIs operate in a different risk framework. This criteria document applies to MFIs, mainly Micro Finance Banks (MFB), which have access to commercial sources of funding, inter alia including, customer deposits, bank borrowings, commercial papers, and Term Finance Certificates.

0.2 Rating Framework: PACRA bases its analysis of Microfinance institutions on a number of quantitative and qualitative factors, the most significant of which are: Profile, Ownership, Governance, Management, Business Risk and Financial Risk. No one factor has an overriding importance or is considered in isolation and all the factors are reviewed in conjunction.

0.2.1 The risk assessment process for MFIs comprises comprehensive analysis of the particular segment in which the MFI operates, profile of the MFI, and its relative position in its respective segment. Analyzing the profile of the MFI includes comprehensive coverage of both quantitative and qualitative factors. In its assessment, PACRA's quantitative analysis helps to reach an anchor rating. This rating can then be affected by qualitative factors – the modifiers. After standalone rating is finalized, the MFI's rating is concluded while incorporating sponsor's assessment of financial strength and expected / agreed level of support.

0.2.2 The quantitative factors helps in achieving objectivity in the rating process while the qualitative side helps in establishing the sustainability of the relevant factors in the foreseeable future. Neither all factors can be quantified nor do quantitative values portray the whole story. PACRA, therefore, seeks to employ a best combination of both and would stick to it to ensure comparability on historical as well as synchronic basis.

0.2.3 The basic precepts of this rating methodology is understanding of the business model of the Microfinance institution (and the inherent risks), the strategy of its management, local macro-economic environment, and developments happening in the industry. The relevant positioning of the MFI, established in comparison with relative peers in the industry, is a key consideration under this methodology to reach a final rating for a MFI.

0.2.4 While our rating process does not include an audit of a MFI's financial statements, it does examine the control environment to establish to which extent they accurately reflect a MFI's financial performance and balance sheet integrity. We make adjustments where necessary to make a MFI's financial data comparable with those of its peers. In order to carry out adequate analysis of a particular MFI, it is helpful to establish a "peer group" of comparable MFIs. Short-term and long-term ratings are based on a MFI's fundamental credit characteristics, a correlation exists between them (see PACRA's Criteria document "Correlation between Short-term and Long-term Rating Scale").

1. **PROFILE**

- Background
- Operations

PROFILE

1.1 Background: PACRA reviews the background of the MFI to understand its evolution from where it started to where it currently stands. We analyze how and through what means the MFI has achieved the desired expansion. PACRA looks at the progress of the MFI from its historical past. The progress of the MFI helps PACRA in determining the ability of the MFI to successfully realize its strategy. The significant factor here for PACRA is to assess whether the MFI has achieved the desired expansion through organic growth or acquisitions. Meanwhile, the source of funding for desired growth is also critical.

1.2 Operations: The assessment of operations of a MFI depends on the exposure of business segments and the stage the business is in. Here PACRA reviews the diversity, geographic spread of operations, risk management framework, product offering, asset mix, borrower profile, size of the franchise/portfolio and track record of operations. Size may be an important factor if it confers major advantages in terms of operating efficiency and competitive position.

2. **OWNERSHIP**

- Structure
- Stability
- Business Acumen
- Financial Strength

OWNERSHIP

2.1 Ownership Structure: The assessment of ownership begins by looking at the legal status of the MFI. Legal status determines the level of expected stability of a MFI. The level of perceived stability gradually increases from a sole proprietor to a listed MFI. This is followed by an in-depth study of the shareholding mix in order to disentangle structure of ownership. Key factors that are considered for this purpose, inter-alia, include: i) shareholding structure which includes whether the individual(s) own the MFI directly or indirectly, ii) foreign or local shareholders, iii) whether the MFI is owned by a single group or through a combination of entities and individuals, and iv) whether it is part of a group or a standalone MFI. All these deliberations are done to identify the man of the last mile. PACRA further considers how a MFI is actually run, as, at times, entities are run as family concerns despite being legally structured as companies.

Complex shareholding/ownership structures: *In cases where a MFI has a complex ownership structure, there are unique challenges in evaluating the decision making process, lines of hierarchy and financial obligations and liabilities. In analyzing these MFI's the fundamental issue is to explore the underlying reason or motivation for the complexity of the structure.*

Microfinance Institutions which are owned by private individuals and families: *On the one hand, the concentration of equity ownership might indicate that the majority shareholders have a strong vested interest in creating long-term value and closely monitoring management behavior. On the other hand, a potential concern in such cases is that the owners might rely heavily on extracting* *funds from the MFI as source of income or to fund other business activities, potentially undermining the financial stability of the MFI.*

2.2 Stability: In order to analyze the stability of the ownership, a particularly important factor to be taken into account is the succession planning. A very important part of our background analytical work is an attempt to assess whether, and under right of succession, a MFI future prospects would be supported, and by whom. A stable ownership with clarity in succession, perhaps major stakes residing with one family or group, is considered positive for ratings. On the contrary, high free float (in case of listed concerns) leads to risk of take over and may anchor lower ratings.

2.3 Business Acumen: PACRA gauge the Sponsor's business acumen. Having a strong business acumen set has been critical for the sustainable success of the MFI. PACRA analyze the business acumen through two primary areas; i) Industry-specific working knowledge and ii) Strategic thinking capability. Meanwhile, a deep and applicable understanding of the system is critical in order to determine how a business achieves its goals and objectives. The scope includes the assessment and understanding of how the sponsors of the MFI think about and successfully make the right business decisions.

2.4 Financial Strength: We analyze the ability and willingness of owners to support the MFI in case of need. Particularly in case of small MFI, where capitalization requirements are yet to meet by the MFI, PACRA critically analyses the willingness and ability of the major shareholder to support the MFI to comply with regulatory requirements within required timeframe. Thus ongoing support is considered more likely in these cases. However, for large MFIs, external support from government / regulatory becomes more important. Here, PACRA gives due importance to, i) the behavior of the major shareholders to provide timely and comprehensive support in times of need in the past, ii) prospective view of key shareholders, incase such need arises, iii) other businesses of sponsors, and iv) the level of commitment of the major shareholder with the MFI in providing capital support. In case of no explicit commitment, PACRA attempts to form a view on availability of likely support. The scope for other business of sponsors includes overall profiling of the key sponsor in the context of identifying the resources they have, outside the MFI.

Table 1. Information Required on Ownership

- Shareholding pattern
- Details of sponsors' other businesses
- Sponsors' financial information
- Past pattern of sponsor support

3. GOVERNANCE

- Board Structure
- Members' Profile
- Board Effectiveness
- Transparency

GOVERNANCE

3.0 PACRA's assessment of governance involves both systematic analyses of governance data and information, and the more contextual reviews of a MFI's governance practices. PACRA considers four main factors while assessing the board structure of a MFI: (i) board structure, (ii) members profile, (iii) board effectiveness, and (iv) financial transparency.

3.1 Board Structure: This comprises assessment of board on various criteria including overall size, presence of independent members, and duration of board members' association with the MFI, overall skill mix and structure of board committees. Size of the board may vary as per the scope and complexity of the operations of the MFI. While a very small board is not considered good, similarly, reaching a decision in an effective and efficient manner may not be possible in case of a large board. A healthy composition of board includes the presence of independent/non-executive members having limited relationship with the sponsoring group of the MFI. Meanwhile, same individual holding chairman and CEO positions is considered weak governance practice. The chairman is expected to have a non-executive role. Compliance with the code of corporate governance is also examined. PACRA also examines the independence of governance from major shareholders. Lastly, PACRA evaluates number of board committees, their structure, and how these committees provide support to the board. A board with higher number of members should have higher number of committees in place to assist in performing its role.

3.2 Members' Profile: PACRA collects information regarding profile and experience of each board member. This helps in forming an opinion about the quality of overall board. Moreover, diversification in terms of knowledge background and experience is considered positive. However, a fair number of board members should have related experience.

3.3 Board Effectiveness: In PACRA's view, the role of the board is to work with management in steering the MFI to its performance objectives and to provide critical and impartial oversight of management performance. PACRA analyzes the type and extent of information shared with board members, and quality of discussions taking place at board and committee levels. Effective oversight requires frequent sharing of detailed information covering various aspects of business and market development. Meanwhile, PACRA also reviews the number of board meetings held during the year as these should be justified with the number of issues/matters arising. Board members' attendance and participation in meetings is important, and is gauged by viewing board meeting minutes.

3.4 Transparency: Quality of governance framework is also assessed by the procedures designed by the board to ensure transparent disclosures of financial and other information. This can be achieved through: i) ensuring independence of the audit committee, ii) strengthening the quality of internal audit function, which may be in-house or outsourced, and iii) improving quality of external audit by engaging auditors which are included in the State Bank of Pakistan's panel of auditors and/or have a satisfactory QCR rating.

***Accounting Quality**: PACRA reviews the quality of a MFI's accounting policies as reflected in its notes to accounts, auditors' comments and other disclosures which are part of its financial statements. Adherence to accounting standards is assessed, particularly for unlisted concerns.*

***Quality of disclosures:** A well-established information system is required for adequate disclosures. The characteristics of quality information includes timeliness, disclosures beyond the minimum regulatory requirements to improve transparency and consistency of such disclosures.*

Table 2. Information Required on Governance

- Profile of BoD members
- Details of committees including TORs
- Minutes of the board meetings
- Information packs for the Board (MIS)
- External auditor detail

4. MANAGEMENT

- Organizational Structure
- Management Team
- Management Effectiveness
- Risk Management framework
- Technology Infrastructure

MANAGEMENT

4.0 Good quality management, effective systems and controls, and well-defined strategy are essential ingredients for a successful MFI.

4.1 Organizational Structure: The assessment of management starts with PACRA conducting an in-depth analysis of organizational structure of the MFI. On a standalone basis, PACRA looks into the hierarchal structure, reporting line and coherence of the team. However, PACRA also places the organizational structure in the MFI's relative universe for comparison in order to form opinion of optimal structure within the sector in context of its complexity. Number of management committees are established to monitor performance and assure adherence to the policies and procedures. PACRA measures the effectiveness of the MFI by forming an opinion on the quality of management committees.

4.2 Management Team: Analysis of management includes evaluating experience profile of key individuals, management's track record to date, in terms of building up sound business mix, maintaining operating efficiency and strengthening the MFI's market position. Although judgment about management is subjective, performance of MFI over time provides a more objective measure. PACRA analyses the quality and credibility of management's strategy, examining plans for internal or external growth. When evaluating future plans, significant credit is given for delivering on past projections and sticking to strategies. Loss of key personnel, particularly members of senior management, can have potentially adverse effects on overall standing of the MFI relative to peers. Hence, HR turnover is reviewed to determine the stability of critical staff, with particular focus on key departments. In addition, MFI's human resource policies are also reviewed to gauge its emphasis on retaining and recruiting vital staff.

Field Staff: *In case of MFIs, the mid- and low-tier staff is critical in maintaining a strong asset quality as they hold the relationship with the borrower and any misconduct on their part may cost deterioration to the institution's asset quality. Thus their ability to retain good field staff is considered important while assessing human resource management. Moreover, PACRA attempts to understand the client's staffing policies, local language ability of staff dealing with borrower, and their training on social aspects, particularly important to the area of their operations.*
Key-man Risk*: Key-man risk occurs when a MFI is heavily reliant on an individual, or a limited number of individuals, who are accepted as the key holder(s) of important intellectual capital, knowledge or relationships. While this type of risk is more commonly identified in small to medium-sized entities, it can also exist in larger entities and is relatively challenging to benchmark, and hence, mitigate. PACRA attempts to identify the extent to which a MFI is dependent on the expertise of such individual(s) and to ensure policies exist for managerial succession to limit the adverse impact of such a person unexpectedly leaving, on the MFI.*

4.3 Management Effectiveness: PACRA conducts a qualitative review of management systems and technology infrastructure to assess management effectiveness. A key measure of management effectiveness is its track record of delivering on past projections and sticking to strategies. One of the key tools available to management to effectively run an organization is the information provided to it. It is critical that information available to management be concise, clear and timely, so it can be interpreted and understood, and the management can respond accordingly. An important part of this analysis is looking at the MFI's MIS. PACRA further assesses whether management has developed any critical success factors to evaluate performance of various business segments, and their efficacy. Management meeting minutes are also reviewed, wherever available, to assess the quality of discussion.

MIS: *System generated – real-time based – MIS reports add more efficiency in decision making whether related to operational, financial or strategic issues. PACRA evaluates the quality and frequency of the MIS reports used by the management team to ascertain that decision-making within the MFI is information-based.*

4.4 Risk Management Framework: This includes an analysis of the MFI's appetite for risks and the systems in place to manage these risks. PACRA examines the independence and effectiveness of the risk management function, the procedures and limits that have been implemented, limits setting authority and the degree to which these procedures are adhered to. PACRA endeavors to assess senior management's understanding of and involvement in risk management issues and examine the reporting lines in place. In recent years, there has been a noticeable upgradation in the risk management systems of the MFIs, in the face of increasing guidance and supervision from the SBP and SECP.

4.4.1 Regulatory framework particularly for MFBs is considered strong. MFBs come under the purview of State Bank of Pakistan - the regulator. SBP monitors MFBs through separate regulations. In addition, SBP supports small entities in microfinance business in funds mobilization by issuing microfinance credit guarantee scheme (MCGF).

Credit Risk: *A key attribute of a well-run institution is that it establishes clear parameters around risk appetite and expected returns (profit) for risks being taken. Asset quality indicators are a primary tool to assess the level of risk being taken. The level and volatility of asset quality indicators will be viewed in the context of returns achieved and the adequacy of risk management to determine how the risk return equation may evolve in different phases of the business cycle. Indications of poor asset quality or credit risk management will typically lead to lower ratings, whereas strong asset quality and credit quality are positively factored into a rating decision.*

Market Risk: *PACRA's analysis of market risk incorporates structural risks (such as interest-rate risk management) and/or trading risks when present. The vast majority of MFIs are subject to structural interest-rate risks due to the shorter nature of their liabilities compared with the duration of their assets. Many MFIs are also exposed to structural foreign exchange risk. PACRA reviews the asset and liability management strategy to assess the risk appetite of the institution. Board and management policy limits are typically expressed as earnings at risk limits. These are usually evaluated along with reports from management systems. Market risk on its own may not be a rating driver; however, poor market risk management or aggressive market risk-taking without mitigants would likely pressure a MFI's ratings.*

Operational Risk: *Operational risk has historically been defined as all other risks other than market, credit and liquidity risk. In the context of Basel II and Basel III, definition of operational risk is: "the risk of loss resulting from inadequate or failed internal processes, people and systems or external events".*

Our analysis of operational risk focuses on a number of issues, including (a) MFI's definition of such risk (b) the quality of its organizational structure (c) operational risk culture (c) the development of its approach to the identification and assessment of key risks (d) data collection efforts; and (e) overall approach to operational risk quantification and management.

Reputation and Other Risks: *Reputation risk may emanate from operational problems or failure in any risk management systems. It may be difficult to evaluate but could adversely affect an* *institution's rating in cases where it is significant. In addition to reputation risk, any regulatory non-compliance may lead to legal risk with potential ramifications as well.*

4.5 Technology Infrastructure: With the growth of technology-based opportunities to enhance service standards and delivery processes, technology has to be an important part of any forward-thinking MFI's strategy. The advent of technology in microfinance sector is needed to not only scale up the access to finance but also attempt to ensure provision of financial services to the remotest and far-flung areas, hence increasing the outreach. PACRA evaluates the efforts of MFIs to not only constantly examine options for technology-based solutions, but also subject them all too rigorous cost/benefit and risk analysis. Digitalization of banking procedures is very critical for the future growth of MFIs.

Branchless Banking: *With recent growth in branchless banking (BB) segment by microfinance banks (MFBs), PACRA evaluates BB operations in detail. In addition to surveilling its profitability, PACRA gives importance to, i) Agent networks, ii) Regulatory reporting, and iii) related Systems and controls. Besides adding diversity to the revenue stream, it has been observed that BB operations can generate low-cost deposits; thus further strengthening the profitability.*

Table 3. Information Required on Management

- Latest organogram
- Profile of senior management
- Redundancy pattern
- MIS reports
- Management meeting minutes
- MFI's policies and SOP

5. BUSINESS RISK

- Industry Dynamics
- Relative Position
- Revenue
- Profitability
- Sustainability

BUSINESS RISK

5.1 Industry Dynamics: The process for anchoring credit rating of a MFI builds on PACRA's understanding of the industry dynamics. This understanding, following an in-depth research approach, is documented as a sector study. The analysis captures the placement of the local industry in the international context to see the points of identity and distinction. In points of identity, the risks and challenges identified for the international players are re-evaluated for the local players, with a view to see whether the local players have established effective mitigant's against those risks and taken due measures to meet the challenges. At the same time, we identify the risks and challenges specific to the local context of the industry. While conducting the analysis, PACRA takes a view on the industry alone, independent of the market players. This exercise helps PACRA to form a view on industry's significance in the economic environment of the country, its attractiveness to entrepreneurs, barriers to entry, and the power of suppliers and customers.

5.1.1 PACRA explores the possible risks and opportunities in a MFI resulting from social, demographic, regulatory and technological changes. It considers the effects of geographical diversification and trends in industry expansion or consolidation required to maintain a competitive position. The analysis includes the role of the supervisory authority, its supervision of regulated entities, reporting requirements and regulations relating to specific type of MFIs and to specific financial products.

5.1.2 PACRA determines a MFI's rating within the context of its industry fundamentals. Segments that are in decline, highly competitive, capital intensive, cyclical or volatile are inherently riskier than stable with oligopolistic structures, high barriers to entry, national rather than international competition and predictable demand levels. Major industry developments are considered in relation to their likely effect on future performance. The inherent riskiness and/or cyclicality of an industry may result in an absolute ceiling for ratings within that industry. Therefore, a MFI in such an industry is unlikely to receive the highest rating possible ('AAA') despite having a conservative financial profile, while not all entities in low-risk segments can expect high ratings. Instead, many credit issues are weighed in conjunction with the risk characteristics of the industry to arrive at an accurate evaluation of credit quality.

Economic Risk: *While analyzing economy, PACRA evaluates economic policies, GDP growth, performance of important sectors in the economy and potential credit demand. An important part of economic analysis is positioning of industry and impact assessment of economic risk factors on the industry.*

Regulatory Environment: *A well-regulated and supervised system is pivotal for credibility and stability of MFIs even when the operating environment is unfavorable. PACRA's evaluation of the regulatory system involves evaluation of criterion related to capital and other countercyclical measures to absorb risk and the extent of regulatory supervision and changes in response to the macro environment; key norms (such as Non-Performing Asset (NPA) recognition, provisioning, capital adequacy, liquidity, benchmark lending rate and expansion) and prospective regulatory changes.*

5.2 Relative Position: Relative position reflects the standing of the MFI in the related market. The stronger this standing is, the stronger is the MFI's ability to sustain pressures on its business volumes and profit margins. This standing takes support from two major factors including a) market share, b) growth trend.

Market Share: *Market size represents the MFI's penetration in the chosen market. Size is advantageous as it provides ability to acquire larger business, pricing power and better expense management. There is a positive correlation between a MFI's absolute and relative size and its market position and brand value. The large entities exercise greater power over the pricing, while ensuring commensurate profits. Small entities struggle to obtain business; and with less flexibility in the cost structure, their profits remain low. While absolute size is important, it is basically the relative proportion which provides a clear yardstick to analyze the comparative strength of the market players. The more distant a player is from the average on the positive side, the stronger is its ability to reflect the characteristics just mentioned. In a dynamic industry, which is not characterized by concentration, PACRA believes that relative size would better capture the strength of the MFI's standing in the related market.*

Growth Trend: *While evaluating the size, PACRA looks at the rate of growth. Growth is important as it ensures that the MFI continues to have the ability to meet the industry's benchmarks. As the industry grows, it uplifts the scale of its operational context. This reflects in the ability of the players to invest in human resource, upgrade the control environment, enhance the product slate, increase the outreach and improve the quality of product/service. To lag the industry's growth trend means to remain short on these avenues, putting pressure on the market position.*

Franchise / Brand Value: *The strength of a franchise determines its capacity to grow while maintaining a reasonable cost to income ratio and profitability, thus providing resilience of earnings. PACRA evaluates the franchise strength in terms of scale of operations and market share* *for various activities, performance and strengths relative to competition, complexity of key segments, diversification across various performance metrics like branches, advances, liabilities, sources of other income etc and access to special Government support or privileges relative to other MFIs. A strong franchise is expected to result in a granular asset and liability base. PACRA also considers the brand recognition and life of institution for its franchise strength analysis.*

5.3 Revenues: In measuring earning's quality of a MFI, diversification and stability are very important factors. A MFI with a diverse product slate with more than one revenue streams is considered better than a MFI with a concentrated earning profile. PACRA sees concentration at both product and customer levels. In addition, the analysis of target markets to which a MFI serve s forms a part of the assessment. Stability is measured through historical trend analysis of the MFI's revenues.

5.3.1 **Diversification:** Diversification is a holistic perspective. It encompasses many aspects which govern the business model of the MFI. Multiple array of product provider against mono-line product provider is perceived to have less business risk. Diversification is utmost desirable. The rationale for this is that diversification enhances the ability to meet challenges, both present and upcoming. The lack of diversification gives rise to concentration risk, reflecting vulnerability of the MFI to few elements. Concentration is considered a major negative because it limits the MFI's ability to ensure sustainability in its business let alone expand it. At the same time, it enhances the risk of disruption in the operations if the area of concentration goes wrong. This does not entail that a company specializing in a certain product/segment would be put at a disadvantage. The disadvantage would only arise, if the company's business gives rise to concentration risk.

Segments
Products
Customers
Geography

5.3.2 **Non Mark-Up Income:** A MFI's revenue comes from interest and non-interest sources. In most MFIs, interest income from advances and investments makes up much of the revenue base. However, non-interest income from, e.g, fees, service charges, commissions and foreign exchange income also represent an important and growing source of revenue. PACRA views earnings profiles comprised primarily of interest income favorably given the relative stability of this income stream. However, PACRA also assesses the MFI's ability to complement its interest income with fee income. A large fee income allows greater diversification which can improve MFI's resilience of earnings and earning profile.

5.4 Cost Structure: Cost structure is analyzed for the amount of flexibility provided when market conditions are less favorable. In this regard, PACRA considers how much of the cost base is variable. PACRA also evaluates the Microfinance Institution's performance ratios relative to those of its peers to understand whether costs have been contained while growing assets and revenue. If expense ratios are high, it could be an indicator that the MFI has a significant fixed cost burden. In this context, key measure that PACRA looks at is the (Non-Mark-Up Expenses / Total Income) ratio. Non-mark-up expenses are also compared where possible with earning assets, to the number of branches and to the number of employees. Performance measures are not assessed in isolation as there may be variations that are caused by business model differences and the importance of ongoing investment in the MFI's franchise. A low-cost base relative to peers offers the MFI greater flexibility to deal with competitive pricing pressures. PACRA also considers Provisioning levels, together with the capacity of the MFI's earnings to absorb provisions.

Margins: *MFIs carry high credit risk on their balance sheet due to the nature of their operations. Moreover, due to certain limitations, inter-alia including, small size, and limited outreach, their ability to mobilize low cost deposits remains weak. Thus in addition to risk profile, their cost* *structure is high. These institutions serve a large pool of client base with small loan size. This results in high operational including staff costs for MFIs. Therefore, MFIs charge fairly high price to their customers. Although their interest margins seem high as compared to other FIs; once loaded with business acquisition and servicing cost, their pre-provision profit margins are comparable to other FIs.*

5.4.1 PACRA evaluates a MFI's ability to convert its earnings into profits as well as efficiency ratios, e.g. operational self-sufficiency. Moreover, the quality and stability of the earning streams are assessed. An adequately diversified product slate is considered good as compared to concentration in a single loan product. In case MFI can generate revenue from some business other than lending, it is seen positively. But its contribution towards bottom-line is measured to incorporate its impact on overall performance. In addition, the drag of provisioning expense is incorporated to see the level of pre-tax profitability for the current as well as future periods.

5.4.2 Where necessary in its rating analysis, PACRA makes adjustments to the MFI's reported income statement figures, so that financial performance indicators are comparable across similar entities.

5.5 Sustainability: PACRA evaluates the strategy of the management and the viability of designed path to reach to the goal. Earnings prospects are monitored, based on budgets and forecast prepared by the management. A reality check is performed while analyzing underlying assumption taken by the management as well as management's track record in providing reliable budgets and forecasts.

***Event Risk**: Incorporating the risk of unforeseen events into a MFI's rating opinion is challenging, given their unpredictable nature. These events may be external (e.g. M&As, regulatory changes or a natural disaster) or may be internally driven (e.g. unrelated diversification or strategic restructuring) and can lead to substantial rating changes. PACRA applies its analytical judgment in assessing the likelihood of such occurrences, insofar as may be possible, and assesses the MFI's track record, expertise of management team and level of financial discipline to incorporate the same into its ratings.*

Table 4. Information Required on Business Risk

- Industry information for Loan portfolio, depositors, number of borrowers
- Projection of two years, with details of underlying assumptions
- Type of License
- Branchless Banking operations, outreach, market share, target market, strategy for future, key figures (agents, deposits in amount and volume, number of transactions)

Business Risk – Key Ratios

Revenue

- Advances Yield (%)
- Deposits Costs (%)
- Core Spread (%)
- Net Mark Up Income / Total Income (%)

Earnings

- Return on Average Equity (%)
- Return on Average Assets (%)
- Non-Mark Up Expenses / Total Income (%)
- Personnel Expenses / Total Income (%)

6. FINANCIAL RISK

- Credit Risk
- Market Risk
- Funding
- Liquidity
- Capitalization

FINANCIAL RISK

6.1 Credit Risk: Importance of credit risk is significant to any lending institution. As MFI's type of customers is different i.e. micro-borrowers, it entails different approach towards credit risk assessment. Micro-borrowers tend to have little or no documentation. Moreover, the tenor of loans is usually short, one year or less. Thus an MFI's risk evaluation systems should be able to appraise the ability of such borrowers to repay on time. The relationship of MFI's loan staff with the borrower himself or with the people around him is critical to assess the means of the borrower for repayment of loans.

6.1.1 The review of credit risk involves assessment of policies and procedures before taking an exposure, post-disbursement monitoring mechanism, criteria for ongoing surveillance, and recovery process. Credit risk analysis includes review of credit portfolio at all levels. Portfolio is evaluated with respect to its size to establish market share. PACRA evaluates the size of loan per borrower to get an understanding of the risk profile of the book. Analysis of product mix in terms of secured and unsecured is done. Collateralized loan book is considered superior as compared to non-collateralized portfolio. Loans having staggered repayment structure are considered better vis-à-vis loans with bullet payment at maturity.

6.1.2 **Asset Quality:** Assessing asset quality is an important pillar of credit risk. In this regard, an MFI's overdue, restructured, and written off loans are taken into account to see the overall performance of the portfolio. Regarding provisioning criteria, PACRA takes comfort from stringent regulatory requirements. Post-delinquency, the level of reserves maintained for provisioning requirements is considered important.

6.1.3 MFIs' asset quality remains exposed to risk of undocumented earning streams vis-a vis the amount of loans obtained by the borrowers from different MFIs. Thus assessment of over-indebtedness remains a challenging task. Nevertheless, structuring of in-house evaluation framework and availability of micro finance exclusive credit information reports lend help to MFIs in this regard.

6.2 Market Risk: Microfinance institutions in normal circumstances only invest in government securities to meet regulatory statutory liquidity and cash reserve requirements. Moreover, regarding equity investments, Microfinance institutions are only allowed investment in limited sectors. This limits overall exposure of MFIs to market risk.

6.3 Funding: MFIs finance their assets mainly through deposits – micro savings as well as corporate deposits, in addition to other funding sources, where available. PACRA analyzes funding mix (short-term vs long-term, and retail vs institutional etc.) as well as concentration levels in funding base. A large pool of micro savers is considered stable in comparison to large institutional deposits. Due importance is given to management's strategy to keep risks related to funding at manageable level.

6.4 Liquidity: Another most important risk is liquidity management. PACRA analyses short-term vs long-term mix; the maturity profile of liabilities is seen in tandem with related asset base to analyze liquidity profile. PACRA believes higher asset turnover as compared to liabilities is good for liquidity management. The MFI's compliance to regulatory reserve requirements is a minimum. The presence of Asset Liability Committee is essential to ensure effective monitoring of liquidity mismatches.

6.5 Capitalization: Compliance with minimum capital requirement is key to obtain license. For MFBs, the requirement for capital increases with the operational scale i.e. district, provincial, or national. Like in case of other financial institutions, PACRA considers MFIs capitalization as a cushion to absorb unreserved losses. These include impact of foreseeable future business losses, if any, and expected level of provisioning on bad loans.

6.5.1 While analyzing capitalization, PACRA sees higher capital adequacy ratio positively. As ratings are not point-in-time, PACRA sees the ability of the institution to generate capital from internal sources. In case of MFBs, dividend payout policy is considered important to evaluate as it may have a significant bearing on potential capital formation rate. Additionally, PACRA considers compliance with regulatory requirements important for MFBs.

Credit Enhancement: *The MFI that carry third party commitment to make good an amount obligated to the lenders may provide additional support to its financial risk profile. In this case, in determining the impact on rating, key factors to assess are the financial profile of the third party and the extent of coverage – quantum and duration – it provides.*

Table 5. Information Required on Financial Risk

- Total available money market lending and borrowing lines along with the average rates
- SBP returns filed including i) Reserve Ratio Requirements', and ii) Capital Adequacy Statement
- Details of 50 largest depositors along with their maturity profile and profit rates
- Spread Calculations
- Industry information for Deposit portfolio
- Outstanding exposures amount along with segment wise/product-wise details of the classified advances portfolio
- Industry-wise concentration of exposures of MFI
- Party wise detail of classified advances portfolio (Top 20)
- Industry loan portfolio

Financial Risk – Key Ratios

Credit Risk

- Non-Performing Advances / Gross Advances (%)
- Non-Performing Finances / Gross Finances (%)
- Loan Loss Provisions / Non-Performing Advances (%)

Market Risk

- Government Securities / Investments (%)
- Investments / Equity (%)
- (Investments + Debt Instruments) / Total Assets (%)

Liquidity and Funding

- Liquid Assets / Deposits and Borrowings (%)
- Advances / Deposits (%)
- Finances / Total Assets (%)

Capitalization

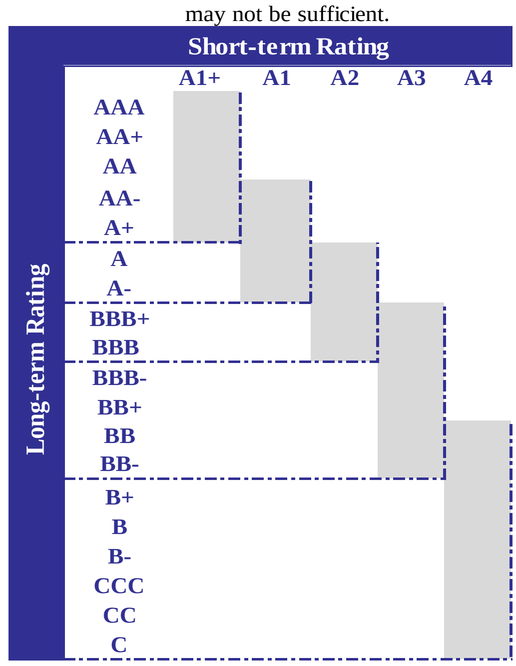
- Equity / Total Assets (%)
- Capital Adequacy Ratio
- Capital Formation Rate (%)

Credit Rating

Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long-term Rating	
Scale	**Definition**
AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ **AA** **AA-**	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ **A** **A-**	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ **BBB** **BBB-**	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ **BB** **BB-**	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ **B** **B-**	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC **CC** **C**	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Short-term Rating	
Scale	**Definition**
A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.



**The correlation shown is indicative and, in certain cases, may not hold.*

Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch Alerts to the possibility of a rating change subsequent to, or, in anticipation of some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating watch may accompany rating outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note. This scale is applicable to the following methodology(s):

Entities

a) Broker Entity Rating
b) Corporate Rating
c) Financial Institution Rating
d) Holding Company Rating
e) Independent Power Producer Rating
f) Microfinance Institution Rating
g) Non-Banking Finance Companies (NBFCs) Rating

Instruments

a) Basel III Compliant Debt Instrument Rating
b) Debt Instrument Rating
c) Sukuk Rating