



RATING METHODOLOGY

MICROFINANCE INSTITUTIONS RATING

An independent rating opinion on relative ability of a Microfinance Institution to honor financial obligations

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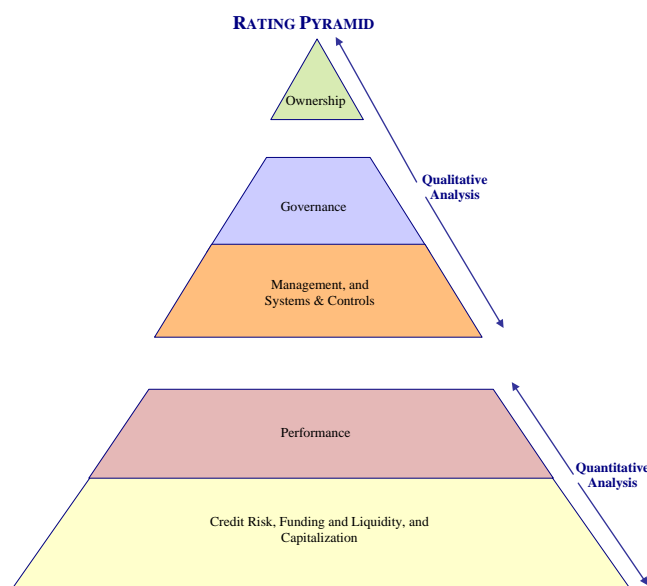
PAKISTAN CREDIT RATING AGENCY

1. SCOPE

- MFIs serve micro needs
- Applicability on MFIs mobilizing commercial funding

1.1 MicroFinance Institutions (MFIs) in many ways are similar to other financial institutions, 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 financial institutions 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 MicroFinance Banks (MFB), which have access to commercial sources of funding, inter alia including, customer deposits, bank borrowings, commercial papers, and Term Finance Certificates.

1.2 The rating process for MFIs is driven by analysis of both qualitative and quantitative factors. In addition, relative position of the MFI is considered important to reach at a particular rating opinion.



2. OWNERSHIP

- Ability to support
- Willingness

2.1 Ownership structure and the objective of key shareholders are important to overall ownership assessment. PACRA analyzes the ability and willingness of the major shareholders to support the entity. Key factors that are considered for analysis purpose, inter-alia, include shareholding structure, financial strength of major shareholders, operational synergies with the owner's other businesses, if any, and the level of commitment of the owner with the entity in providing capital support. Here, PACRA gives due importance to the behavior of the sponsors to provide timely and comprehensive support in times of need in the past.

3. GOVERNANCE FRAMEWORK

- Structure of board
- Experience profile of BoD members
- Compliance with code

3.1 Corporate governance structure of MFIs is important to qualitative analysis. While analyzing governance framework, among others, three main factors are looked into,

- Board Structure:** This includes assessment of board as a whole. A healthy composition of board includes the presence of independent / non-executive members having limited relationship with the sponsoring group of the MFI. Moreover, diversification in terms of knowledge background and experience is considered positive. However, a fair number of board members should have financial sector experience. Here skills mix is evaluated at board level. Compliance of code of corporate governance is also examined.
- 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.
- iii) **Board Effectiveness:** PACRA analysis the conduct of board meetings, the type and extent of information shared with the board members, and quality of discussions taking place at board and committee level. PACRA considers that the role of the board is to work with management in steering the entity to its performance objectives and to provide critical and impartial oversight of management performance.
 - iv) **Financial Transparency:** Effective oversight requires frequent and detailed information sharing than required by statute. This requires transparency in financial disclosures. Quality of audit function is very important to achieve financial data integrity.

4. MANAGEMENT, AND SYSTEMS AND CONTROLS

- Quality of both top management and on-field staff
- Staffing policies and trainings
- Effectiveness of control mechanism

4.1 Good quality management, effective systems and controls, and well-defined strategy are essential ingredients for a successful entity. PACRA looks at the organizational structure, experience profile of key individuals, stability and management's past track record.

4.2 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.

4.3 An MFI's internal systems and policies are vital to establish a strong control mechanism. Thus PACRA conducts a qualitative review of policies and procedures, technology infrastructure including management MIS to assess the strength and comprehensiveness of these. Robustness of control systems is considered a reflection of strong management.

5. INDUSTRY RISK

- Key part of credit risk analysis
- Strong regulatory framework

5.1 Industry analysis is a key component of credit risk analysis, as entities do not operate in a vacuum. Economic environment, regulatory policies, business dynamics, energy situation, security threats, and so on, all play a significant role that can impact the entity's performance. Hence, it is paramount to be fully cognizant of the industry behavior.

5.2 Industry analysis includes an assessment of overall operating environment, general ownership structure of the industry, governance and regulatory structure in place. In addition risks generated by competition levels in the industry are analyzed so that an MFI's strengths and weaknesses can be seen in comparison to other market players.

5.3 Analysis of market share is an important factor in establishing relative position of the institution. PACRA analyzes the institution's proximity to its key areas of operations, outreach (e.g. no. of districts covered), number of customers it serves and market share in overall customers of the industry, potential customer base that is yet to tap, no. and type of products on offer, and pricing policy vis-à-vis other players operating in the same markets.

5.4 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).

6. PERFORMANCE

- High net interest margins
- High business acquisition/servicing cost
- Quality and stability in earnings
- Diversification in earnings – an important area to analyze

6.1 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.

6.2 PACRA evaluates an entity'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.

6.2.1 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.

6.3 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.

6.4 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.

7. RISK MANAGEMENT

- Micro-lending requires a separate risk monitoring framework
- Collateralized loans vs clean portfolio
- Asset quality
- Market risk
- Operational risk – a

7.1 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.

7.1.2 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

key focus area

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.

7.2 ASSET QUALITY: Assessing asset quality is an important pillar of credit risk. In this regard, an MFI's over due, 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.

7.2.1 MFIs' asset quality remains exposed to risk of undocumented earning streams viz-a viz the amount of loans obtained by the borrowers from different financial institutions. 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.

7.3 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.

7.4 OPERATIONAL RISK: MFIs internal systems and procedures are important to manage operational risk. PACRA attempts to measure the adequacy of these and whether these are implemented with a perspective to manage potential operational risks that may cause due to relatively high human involvement in case of MFIs versus other financial institutions. Moreover, PACRA understands that oversight of top-management, the procedures they have employed to avoid staff collusions with the customers, and design and implementation of related management information systems (MIS) are important factors in managing operational risk.

8. FUNDING AND LIQUIDITY

- Micro-savings
- Liquidity management

8.1 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. The most important one is liquidity management. PACRA believes higher asset turnover as compared to liabilities is good for liquidity management. The bank's compliance to regulatory reserve requirements is a minimum.

9. CAPITALIZATION

- Regulatory requirements
- Capital is seen as a cushion for unforeseen losses

9.1 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.

9.2 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. Where necessary in such cases, PACRA requires comfort from sponsors of the

entity as to ability and willingness to provide support, if the need arises.

9.3 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.

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ENTITY RATING SCALE & DEFINITIONS

Entity rating reflects forward-looking opinion on credit worthiness of underlying entity; 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 RATINGS		SHORT TERM RATINGS
AAA	Highest credit quality. Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments.	A1+: The highest capacity for timely repayment.
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.	A1: A strong capacity for timely repayment.
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.	A2: A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial 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.	A3: An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.
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: The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.
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.	C: An inadequate capacity to ensure timely repayment.
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.	

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, a) some material identifiable event and/or b) deviation from expected trend. 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 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) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, e) the entity/issuer defaults, or/and f) PACRA finds it impractical to surveil the opinion due to lack of requisite information

Disclaimer: PACRA's ratings are an assessment of the credit standing of entities/issue in Pakistan. They do not take into account the potential transfer / convertibility risk that may exist for foreign currency creditors. PACRA's opinion is not a recommendation to purchase, sell or hold a security, in as much as it does not comment on the security's market price or suitability for a particular investor.