
Microfinance Institutions Ratings

INTRODUCTION

Micro Finance Institutions (MFIs) have reversed conventional banking practice by removing the need for collateral and created a banking system based on mutual trust, accountability, participation and creativity. MFIs provide credit to the poorest of the poor in rural and urban areas of Bangladesh, without any collateral. This credit program is a cost effective weapon to fight poverty and it serves as a catalyst in the overall development of socio-economic conditions of the poor who have been kept outside the traditional banking orbit.

CRAB's micro-finance capacity assessments (ratings) are intended as a direct service to lenders by providing them with an informed opinion on the creditworthiness of MFIs. This will facilitate the flow of funds to MFIs by providing lenders with detailed information on the MFIs' programmes and linking the flow of funds to the performance of the organisation. This exercise would further provide suggestions for improvements in the MFIs' credit programme through identification of the areas of its strengths and weaknesses. The overall process of rating and its eventual outcome is seen as a process of developing and professionalizing the micro-finance sector.

The rating exercise is done through a quantitative cum qualitative approach following a structured methodology discussed later.

RATING PRINCIPLES

CRAB's rating provides an objective assessment of the performance of institutions providing financial services to Micro Finance Institutions (MFI's). The rating evaluates the MFI's creditworthiness as well as its strengths and weaknesses. It assesses the risk associated with lending to the organization and assigning grade based on the extent of risk. Some of the risks that form the basis of the assessment are external risk, credit risk, market risk, operational risk, model risk, and the risk of fraud and delinquency. With reference to these, the critical aspects covered are, the quality of the governing body, the depth of management systems, financial health and social impact. For the benefit of the donors, ratings also evaluate the MFI's ability to use grant or concession funds efficiently.

BENEFITS OF THE RATING SERVICE

- CRAB ratings would provide professional and standardised assessment of the risk involved in lending to MFIs. This would also help establish a trend for better practices amongst MFIs.
- Rating would provide identification of areas of strengths of MFIs which can be further built upon. Identification also of the areas of weaknesses of MFIs, which can lead to capacity building inputs.
- Rating would lower the appraisal and transaction costs for both lenders and borrowers and ensure more efficient utilisation of funds.



- CRAB rating would facilitate the issuer to effect a high level of credibility among potential investors.
- CRAB opinions would help the MFI to broaden the market for their funding. As 'name recognition' is replaced by objective opinions, the institution may access the international and national fund support more comfortably.
- CRAB rating would facilitate an MFI with fundamental strength an extended level of confidence from the borrowers, depositors, syndication partners, other financing companies, international financial market and regulatory agencies.

RATING ARRANGEMENT

Credit Rating Agency of Bangladesh Ltd (CRAB) would undertake an Initial Rating of the MFI based on the latest Audited Financials available. Under the surveillance contract the MFI would be entitled to a continuous rating service of CRAB. The Initial Rating of the Company would be subject to changes, based on any material developments in the Company. The arrangement for the initial rating and surveillance would be as follows:

Initial Rating: CRAB would perform an initial rating of the MFI based on the latest Audited Financials and the updated financial and company information.

Surveillance: CRAB would provide regular surveillance service of company through out the year. A complete rating review and detailed report would be given every year after completion of the Annual Audited Financial Reports. In case there is any change in the rating award during the year, CRAB would provide a surveillance report indicating the rationale for change in rating award.

RATING FEES

We offer the following fees for the initial rating and subsequent annual surveillance services:

Initial Rating Fee : Tk 5.0 Lac Only

Annual Surveillance Fee: Tk 4.0 Lac Only

Applicable taxes & VAT will be added to the fees.

All the expenses incurred on part of Credit Rating Agency during the rating process will be borne by the Credit Rating Agency of Bangladesh. However, visit to branches, sites etc required by or agreed with the client will be separately billed at agreed rates or at actual.

TIMEFRAME ENVISAGED

4-6 weeks (depending on the timely availability of information)

VALIDITY OF CONTRACT

We propose that the contract be made for a relatively longer period with provisions for extension or cancellation. The validity of the contract would be incorporated in the contract to be finalised after our initial agreement.

RATING METHODOLOGY FOR MICROFINANCE INSTITUTIONS

CRAB uses a comprehensive rating tool consisting of eight categories of indicators. Under each category there are sub parameters to assess and award a grade to any MFI.

A. Management System

- **History & Track Record.** CRAB evaluates the MFI on the basis of its number of years in micro credit, associate entities and their performance, growth of MFI in the past with respect to program, geography, clients, branches and portfolio.
- **Alliances & Network.** MFIs gain through the relationship with strategic alliances (national & international), partners' contribution, donor agencies support and appreciation etc.
- **Documentation Level.** It includes the appraisal of extent of documentation in terms of manuals on MFI's products, policies, processes, authorisations etc.; adherence of the documented policies, procedures etc in day-to-day operations.
- **Management Information System.** The credit delivery system, method of action, loan and overdue monitoring system, cash flow management system and fraud control, delinquency management system, use of IT in operation etc are examined.
- **Human Resources Development.** Selection and recruitment process, training need assessment and training arrangements, role definition, accountability and responsibility of staff, career development, retention rates etc are assessed.
- **Processes, Control & Audit.** Critically analyse the loan approving and disbursing authority at head office, group, centre, zone and branch level, controlling mechanism, appointment of independent auditors and scope of audit (financial & management), internal audit department and its function as well as efficiency of internal audit system.

B. Institutional Arrangement

- **Management, Ownership & Governing Body.** Pedigree of promoters, their experiences, recognition in the field and years of experience; involvement in day to day operations; structure of the Board,; diversity of the technical expertise on the Board; professional reputation of the board member(s); independence of the management from the board, organization structure; experiences of key management personnel; management's understanding of issues in MFI sector are looked in the process of rating.
- **Governance practices.** Governance practices in the operations and overall assessment in terms of practices, processes and people.
- **Goals and Strategies.** Articulation of vision, mission and objectives into the project document and its reflection in the operation. Strategic planning and budgeting process are also evaluated.

C. Capital Adequacy & Asset Quality

- **Asset Quality.** CRAB evaluates the quality of the assets and portfolios, the risk inherent into the assets and portfolios, loan recovery system and its effectiveness, diversification of product and services etc.
- **Capital Adequacy.** Existing capital adequacy and ability to raise capital are also analysed.
- **Provision against delinquent assets.**

D. Resources

- **Ability to Raise Resources.** Current funding sources and its adequacy, diversity in funding sources, impact of MFI's legal structure in raising resources current relationship with the donors and ability to attract new donors.
- **Cost of Funds.** Average cost of funds and percentage of funds tied up with grant, subsidized fund and hard fund.

- **Liquidity and Asset Liability Management.** Loan as percentage of total asset, asset liability mismatch etc.

E. Operational Effectiveness

- **Office outreach and quality of infrastructure.** Geographical areas covered, employee productivity and client targeting practices are covered under this parameter.
- **Efficiency Ratios.** Various types of ratios are computed to analyse the efficiency of the MFIs in terms of operation, portfolio, profitability, financial and economical sustainability.

F. Scalability & Sustainability

- **Resources base sustainability.** Evaluating the existing fundraising strategies in practice, current level of efficiency and profitability to test the sustainability level in case of large scale of operation and diversity.
- **Organizational sustainability.** Ability to develop into a mainstream financial institution.
- **Program sustainability.** Ability to sustain operations on a larger scale.

G. Accounting Policies

Accounting policies and practices of the MFI's.

H. Social Performance of MFI's

- **Social Mission.** Explicit or implicit statement, alignment with wider development objectives, strategic/systems adherence and methods to track.
- **Outreach.** Depth and width analysis of operations in underdeveloped areas, socio-economic profile of (recent) client households, marginal groups, poor and very poor families and impact on the target group through increase of income level, empowerment of women, social mobility, creation of job opportunity, reduction in rural-out migration.
- **Client Feedback.** Understanding of microfinance services, satisfaction with delivery systems, and products; drop-out rates and reasons for drop-out.

F. Regulatory Compliance

- **Registration with Micro Credit Regulatory Authority**
- **Compliance with the regulations of MRA**

RATING PROCESS

CRAB's microfinance rating service is aimed at providing a professional and rigorous opinion on the relative ability of an MFI to make timely and complete payments on loan obligations to lenders. CRAB's rating provides a credit risk outlook of the rated MFI and an assessment of the areas of strength and weakness in its operations. This assessment is also a tool for MFIs and their funding partners to work together to build the MFI's capacity.

For this purpose, CRAB employs the following process which is given below:

<p><u>Step 1</u> <i>Receipt of Rating Offer Letter</i></p>
<p><u>Step 2</u> <i>Communication with MFI Information Requisition</i></p>
<p><u>Step 3</u> <i>Information from MFI Visits to Offices & Projects Discussions with management</i></p>
<p><u>Step 4</u> <i>Analysis & Assessment of the Information</i></p>
<p><u>Step 5</u> <i>Draft Report Review by Internal Committee</i></p>
<p><u>Step 6</u> <i>Draft report to Client for Review Modification of report, if required</i></p>
<p><u>Step 7</u> <i>Rating Committee Meeting Finalization & Submission of Rating Report to Client</i></p>



CRAB RATING SCALES AND DEFINITIONS

LONGTERM – MICRO FINANCE ENTITY RATING

RATING	DEFINITION
AAA Triple A (Highest Safety)	Micro Finance Institution (MFI) rated in this category are adjudged to be the best institution, characterized by excellent financials, healthy and sustainable franchises, and a first rate operating environment. This level of rating is the outcome of highest credit quality, and risk factors are negligible. This level of rating indicates exceptionally strong capacity for timely payment of financial commitments, highly unlikely to be adversely affected by foreseeable events.
AA1, AA2, AA3* (Double A) (High Safety)	Micro Finance Institution (MFI) rated in this category are adjudged to be very strong institution, characterized by very good financials, healthy and sustainable franchises, and a first rate operating environment. This level of rating is the outcome of high credit quality, and risk factors are modest and may vary slightly from time to time because of economic conditions. This level of rating indicates strong capacity for timely payment of financial commitments with very low likeliness to be adversely affected by foreseeable events.
A1, A2, A3 Single A (Adequate Safety)	Micro Finance Institution (MFI) rated in this category are adjudged to be strong institution, characterized by good financials, healthy and sustainable franchises, and a first rate operating environment. This level of rating is the outcome of adequate credit quality, and risk factors are more variable and greater in periods of economic stress than those rated in the higher categories. This level of rating indicates adequate safety for timely payment of financial commitments with low likeliness to be adversely affected by foreseeable events.
BBB1, BBB2, BBB3 Triple B (Moderate Safety)	Micro Finance Institution (MFI) rated in this category are adjudged to be moderate institution, characterized by average financials, defensible franchises. This level of rating is the outcome of moderate credit quality, and MFI is under performing in some areas. Risk factors are more variable and greater in periods of economic stress than those rated in the higher categories. This level of rating indicates average capacity and safety for timely payment of financial commitments with moderate likeliness to be adversely affected by foreseeable events.
BB1, BB2, BB3 Double B (Inadequate Safety)	Micro Finance Institution (MFI) rated in this category are adjudged to lack of key protection factors, which results in an inadequate safety. This level of rating is the outcome of below moderate credit quality. This level of rating indicates a MFI as below investment grade but deemed likely to meet obligations when due.
B1, B2, B3 Single B (High Risk)	Micro Finance Institution (MFI) rated in this category are adjudged to be with high risk, which results in low level of safety. This level of rating is the outcome of poor credit quality. Timely repayment of financial obligations is impaired by serious problems which the entity is faced with.
C (Very High Risk)	Micro Finance Institution (MFI) rated in this category are adjudged to be with very high risk, which results in very low level of safety. This level of rating is the outcome of very poor credit quality. Timely repayment of financial obligations is impaired by very serious problems, which the entity is faced with.
D (Default)	Micro Finance Institution (MFI) rated in this category are adjudged to be either currently in default or expected to be in default. This level of rating indicates that the entity is unlikely to meet maturing financial obligations.

* 1,2,3 refers to positive, average, and below average outlook in the short-term



SHORT TERM – MICRO FINANCE ENTITY RATING

ST-1	Highest Grade Highest capacity for timely repayment of obligations. MFI rated in this category are characterized with excellent position in terms of liquidity and internal fund generation. Access to alternative sources of funds is outstanding.
ST-2	High Grade Strong capacity and certainty of timely repayment. MFI rated in this category are characterized with commendable position in terms of liquidity and internal fund generation. Access to alternative sources of funds is strong.
ST-3	Good Grade Good capacity and certainty of timely repayment of obligations, although such capacity may impair by adverse changes in business, economic, or financial conditions. MFI rated in this category are characterized with sound liquidity and internal fund generation. Access to alternative sources of funds is available.
ST-4	Satisfactory Grade Timely repayment capacity of obligations is satisfactory, although such capacity is highly correlated with adverse changes in business, economic, or financial conditions. MFI rated in this category are characterized with low liquidity and internal fund generation. Access to alternative sources of funds is available but limited.
ST-5	Non Investment Grade No certainty and capacity of timely repayment capacity of obligations, and adverse changes in business, economic, or financial conditions, it could not meet obligation. MFI rated in this category are characterized with insufficient liquidity and internal fund generation. Access to alternative sources of funds is limited.
ST-6	Default Institution fails to meet financial obligations.

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