MICRO FINANCE INSTITUTIONS

Rating Methodology

Microfinancing has been identified as a powerful means to poverty alleviation as it aims at empowering individuals through the generation of sustainable livelihoods. It caters to micro-entrepreneurs and usually operates within a subset of the local population whose economic status falls below a pre-defined level of poverty. Therefore, many governments in the developing economies encourage setting up of microfinance institutions (MFIs).

Even though the origin of microcredit can be traced to Europe, nearly 76% of the total micro loans today are in Asia, 21% in Latin America and 3% in Africa[1]. The sector has evolved globally from the early days when the credit scene was limited to informal moneylenders. Participation from the formal sector came through the setting up of credit cooperatives, to provide financial services to the lower income groups of the society and replace the informal moneylenders. Along with these credit cooperatives, various commercial banks also ventured into financing this area, through government development programs for the agricultural sector. However, certain considerations including the inability of these institutions to cater to borrowers without physical collateral, limited their reach, and these institutions lost steam to the emerging, specialized MFIs. MFIs have further evolved over the years by shifting from the old paradigm of subsidized credit programs to the new paradigm of sustainable financial intermediation. Two of the well known MFIs in the emerging markets are Grameen Bank in Bangladesh and the unit 'desa' at Bank Rakyat Indonesia (BRI). Various MFIs around the world have learned from their experience and borrowed models to be cloned in their own environment.

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The evolution of Grameen Bank and unit 'desa' at BRI represent the two most dominant paths of development followed by MFIs. Globally, MFIs have usually emerged both as informal sector operators that underwent transformation to formal sector organizations, or as units of formal financial institutions. Grameen Bank, founded in 1976 started from two municipal bodies (thanas) in

Chittagong and Tangail district. It was after almost seven years of experimentation, that the idea took formal shape of a bank in 1983, with its own charter to work exclusively for the poor. In 1983, it had 36,000 members and a portfolio of $3.1 million, which increased to serve 2.3 million members and a portfolio of $260 million by 1997. Similarly in Indonesia, sustainable microfinance (MF) in the formal sector attained nationwide coverage with the 1984 restructuring of the unit 'desa', or local banking system, of the state owned Bank Rakyat Indonesia (BRI). BRI's unit desa system is now the largest financially self-sufficient provider of sustainable MF in the developing world [2]. During the 1997 East Asian economic crisis, the bank contributed in controlling poverty by providing financing to informal enterprises of the poor who had lost their jobs. Various institutions around the world have benefited from these two models operating in emerging economies.

The Local MicroFinance Sector

A vast section of the population in Pakistan is employed in the informal sector with little access to credit from banks and other financial institutions. These micro-entrepreneurs depend on borrowings from the informal sector that are both expensive and scarce. Catering to the financing requirements of these entrepreneurs generally results in cost inefficiencies to conventional financial institutions, bringing to light the need to develop specialized institutions for microlending.

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Non-Government Organizations (NGOs) have been the primary promoters of microfinancing in Pakistan. Participation from financial institutions has been limited, particularly when viewed in the context of resources at their disposal. Amongst formal sector financial institutions that ventured into micro-finance as a part of their lending activities are some private sector enterprises, as well as government sector players that had an express mandate to serve the society's vulnerable groups.

According to some estimates the existing apparatus of micro-financing serves only a minuscule portion of its demand. The Pakistan Microfinance Network is the representative body of MFIs in Pakistan and includes a formal sector financial institution in addition to a number of NGOs. The demand for MF has been quoted as being in the range of 5.6m households while merely 1% of them currently have access to such a facility. Therefore, as financial markets continue to gain sophistication and as larger institutions venture forth in previously unchartered territory, one may expect to see micro-financing taking a bigger part of a traditional institution's loan portfolio, financial institutions setting up micro-financing subsidiaries and the emergence of standalone MFIs. The government initiated support to this sector

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through the promulgation of The Khushhali Bank Ordinance in August 2000 and the establishment of the first MFI 'The Khushhali Bank', owned and controlled by the government. The private sector was allowed to participate in the MF sector through the promulgation of the MicroFinance Ordinance 2001 (MFO), setting the scene for the entrance of new institutions and transformation of existing NGOs into MFIs.

So far the NGOs operating in the MF sector of Pakistan have relied primarily on donations and/or subsidized loans. Availability of commercial funds from banks had been limited primarily due to the absence of a common yardstick to compare the relative risk among these institutions. JCR-VIS has initiated ratings of both NGOs and MFIs in Pakistan. Whereas NGOs will be rated on the corporate governance rating scale, the framework developed for the credit ratings of MFIs, as presented in this paper will apply to institutions which have been authorized access to commercial sources of funds. Credit ratings will play their traditional role of alleviating the information asymmetry between borrowers and lenders, and serve as an instrument for MFIs to access commercial funding sources.

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The objective of credit ratings for deposit taking institutions such as the MFIs, would remain the assessment of an institution's ability to repay its obligations. This paper aims to elaborate the credit rating methodology for MFIs and discusses key points of difference with conventional financial institutions[3] as well as their impact on ratings. The analysis incorporates both qualitative and quantitative factors relating to the institution. However, the weightage given to the various rating factors may differ from that assigned, while rating conventional commercial banks.

Fundamental Distinctions-Financial Appraisal

Donor Support

At JCR-VIS, while the long-term self-sufficiency of an institution is being assessed without consideration for the potential of donor support, access to donor assistance, whether in cash or in kind, favorably impacts the ratings and constitutes a fundamental difference from conventional financial institutions. Donations may either be accepted as funds to be lent out or for an MFI's infrastructure development. As such, they not only serve as a cost free means of institutional development but may also assist an MFI to tide over business downturns. Access to donor funds is dependent on the institution's franchise value or reputation and reflects donor confidence in its performance.

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Deployment Strategy

As specialized institutions, the mandate restricts MFIs from lending to any business other than a micro-enterprise. At present, MFIs in Pakistan are restricted from lending an amount exceeding Rs. 100,000 to a single borrower while also ensuring that total borrowings of an individual credit recipient from any number of financial institutions do not exceed Rs. 100,000. The target market has been further confined by the MFO to individuals with a total annual income less than the minimum taxable limit set out in the law related to income tax (Rs. 80,000). These regulations serve to ensure that MFIs serve their mandate and funds are channeled to the poor. MFIs are also restricted from foreign exchange operations, which precludes their handling any foreign trade related transactions.

Most institutions with MF operations function on a localized scale. Depending on the area being serviced by MFIs, their risk profile may be significantly different from each other. The MFO prescribes a three-tiered approach to capital which is linked to the area covered by an MFI. The paid-up capital requirement increases from Rs. 100m to Rs. 250m and then to Rs. 500m to operate at district, provincial or countrywide level respectively. For each location that the MFI caters to, the borrower market may differ on the basis of factors including seasonality of the area's main occupation, extent of dependence on natural resources and general economic conditions. The nature of an MFI's target market is therefore an important consideration and the choice of geographical diversification available to provincial or countrywide MFIs is a positive rating factor.

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Risks related to client and sectoral exposure, are mitigated due to the small size of each loan and exposure to businesses that are generally not as sensitive to economic swings. The level of risk undertaken by an MFI is also affected by the type of loan product. Group loans for instance help in diversifying risk associated with a particular business and mitigate the problems of adverse selection. Such loan structures also raise moral pressure and are used by some MFIs as an effective monitoring tactic, encouraging the group to work in its combined interest. At the same time appraisal and interaction with a group of borrowers, rather than individuals also leads to cost efficiencies for an MFI. Most MFIs do not employ sophisticated methods of credit appraisal as micro-entrepreneurs can rarely supply, formally prepared and comprehensive information regarding their businesses. The situation is rendered riskier by the usual absence of tangible collateral. Therefore, the management's capability to determine the risks associated with each product and mitigating it through product design becomes a key rating factor.

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The appraisal process constitutes enquiries conducted by the MFI personnel from family members and acquaintances of the prospective borrowers. Loan officers visit workplaces and/or personal dwellings to enquire about the applicant. Such informal interaction is an excellent source of firsthand information critical to arriving at the disbursement decision. Personal contact usually continues during the loan period and allows loan officers to keep themselves updated of the repayment potential of loans extended.

Delinquency Management

The asset quality of an MFI is a direct reflection of the appraisal mechanism, internal controls and the management's understanding of the micro-finance sector. While examining the level of delinquency, it is essential to keep in mind the fact that micro-loans are usually extended for shorter tenors and repayment dates are therefore more frequent. Moreover, microloans are often allowed prepayment. Signs of delinquency therefore tend to become apparent at an earlier stage and classification schedules prescribed by the MFO are stricter than those applicable to conventional forms of financing.

Micro-loans are classified as non-performing with only a 30-day delay in payment and are classified loss in a year resulting in a stepped up provisioning requirement vis-à-vis those applicable to conventional loans. However, loan losses are sometimes triggered due to temporary business losses or personal crisis and there remains a fair chance of eventual repayment. It is therefore considered important at JCR-VIS to track the pattern of classification against the various loan types and track eventual recovery, to form an opinion as to the probability of actual loan loss. These trends are considered in addition to the usual ratios employed for the analysis of a conventional bank, relating NPLs to outstanding exposure and provisions held against them. For the purpose of consistency between credit ratings of MFIs and conventional institutions, it is helpful to equate the classification criteria for the two types of institutions to arrive at a comparative number.

The MFO requires a general provision equal to 2% of outstanding exposure compulsory, developing a cushion for MFIs, which has a positive impact on ratings. Moreover, to protect the institution from seasonal cycles of loss or appraisal failures, the minimum capital adequacy ratio requirement is higher for MFIs at 15% of risk-weighted assets. To estimate the probability of future loss, the loan portfolio is assessed for the proportion of repeat loans, where chances of delinquency are lower. Policy guidelines limiting exposure to a new client and extent of conformance to these is an important rating consideration.

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Liquidity Management

The most important distinction marking an MFI's transition

from the informal sector to the status of a commercial bank is the institution's ability to access deposits. Although an MFI can access all types of commercial funds, the profile of depositors typically includes the savers who also benefit from micro-loans extended by the MFI. Savings from the borrowers' pool are perceived as an important benchmark of an MFI's success as it is indicative of borrowers' empowerment, which is the primary objective of microfinancing. An institution's deposit mix, average deposit size and the proportion of deposits maintained by the bank's borrowers, is considered while evaluating stability of the deposit base. JCR-VIS believes that, as an MFI's average deposit size tends to be smaller, it faces considerably lower chances of a run. The statutory liquidity reserve requirement for MFIs is therefore lower at 15% against its demand and time liabilities as compared to 20% for a conventional bank. Availability of liquid reserves is viewed favorably as a shield against maturing liabilities and future stress.

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Financial Sustainability

Another important aspect in the financial appraisal of an MFI is the management's approach to profitability. JCR-VIS believes that subsidizing markup on loans may assist the poor only in the short-term, and that the mission is better served if the institution can sustain profitable operations, enabling it to enhance client outreach over time.

Apart from the usual parameters employed for benchmarking earning potential, an MFI's profitability is also evaluated for financial self-sufficiency. Financial self-sufficiency adjusts for the implied cost of equity and/or donations as well as the real financial cost if funds have been borrowed at subsidized rates. We use this indicator to assess the commercial viability of an institution and its ability to enhance its outreach continuously through an internally generated increase in financial resources. The pay-out policy of the institution is also considered while evaluating the entity's growth potential. A steady growth in population being served is better ensured if the MFI sustains real growth in terms of it being able to generate economic profits.

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MFIs do enjoy a degree of latitude in charging markup rates and generally price loans considerably higher than market lending rates on conventional forms of financing. This becomes important in consideration of the fact that MFIs tend to run higher transaction costs. Profitability may be adversely affected if an MFI accepts prepayments. The effect of prepayments is worked into computation of yields. Risks mitigating tools employed by MFIs to counter such trends including charging markup on initial disbursement rather than diminishing balances, are viewed favorably, while assigning ratings.

Fundamental Distinctions- Institutional Factors

The most critical factors in a rating review are the quality of management, internal reporting procedures and auditing systems of an MFI. Central to an MFI's viability is the management's conviction to the organization's mandate and the vision propelling the institution. Other institutional factors considered include its legal structure, quality of leadership and human resource. The management should preferably comprise a mix of individuals with banking experience and technical expertise of the MF sector. JCR-VIS believes that an institution's sustainability is dependant on the fact that operations are streamlined on a commercial basis, while being attuned to the specific requirements of operating in the MF sector. This requires specialized human resource and thus emphasis is placed on how the institution recruits, develops and retains staff. Further, for assessing the long term sustainability of any institution, the comprehensiveness of a succession plan is evaluated.

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The loan officers' credentials are of key importance as the incumbent should be appropriate for the MFI work environment and well adapted to the market being served. In addition to the quality of human resource, emphasis on training is factored into the ratings as developing the required expertise is important in the long-term. JCR-VIS believes that management of an MFI like any other institution should invest a suitable sum towards retaining and training its human resource in line with its growth requirement.

The background of board members, their familiarity with the sector and the extent to which the mission is shared among the management and the board is an important consideration. Degree and quality of participation by the board of directors in the affairs of an MFI is also taken into account.

The need for developing an effective management information system is accentuated due to the volume of business that an MFI is required to monitor. The capacity of the system is determined with a view on its ability to manage future business volumes and its flexibility in handling new products. Utilization of MIS is gauged through the effectiveness and reliability of reports generated by the system facilitating the management in decision-making.

Another critical aspect for the rating of MFIs is the internal supervisory framework as these institutions are exposed to higher levels of operational risks. JCR-VIS believes that companies with weak internal systems are more vulnerable to changes in the environment and policies and procedures ought to be standardized across the institution with emphasis on risk management. An organization's structure should promote a high level of transparency with clear lines of authority and responsibili-

ty. Further the quality and adequacy of internal and external audits has to be assessed. The rating review forms an opinion on the risk management ability of the institution by assessing the quality of its appraisal systems, written policy guidelines and the reports generated by both internal as well as external auditors. The controls exerted by external regulatory agencies in ensuring that the policy framework is adhered to, also takes on a great deal of significance and an effective regulatory environment constitutes a positive rating factor.

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Impact Assessment

The concept of micro finance is not confined to the extension of micro loans but encompasses the full range of financial and structural support services extended to the poor. Its central theme is the economic revival at grassroot level and therefore another aspect of an MFI's strength is its impact on the population at large. It is important for an MFI to develop impact assessment tools to gauge its contribution to the society, either through skill development or general economic uplift. Though this does not impact the institution's credit worthiness directly, it does have a bearing on the institution's franchise value and financial access. It therefore becomes an area of interest for the rating agency, and the presence of an impact assessing system is a positive influence on ratings. JCR-VIS

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[1] *Fighting Poverty with Microcredit- Shahidur R. Khandker*

[2] *The Microfinance Revolution: Marguerite S. Robinson*

[3] *JCR-VIS Primer - Commercial Banks (December 2001); JCR-VIS Primer - Leasing Companies (April 2002)*

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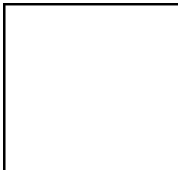

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The edifice of the Jahangir Kothari Parade has stood proudly through the years and is a symbol of our heritage. Its 'Dome' as the most stable of building structures, exemplifies architectural perfection. Committed to excellence, JCR-VIS continues its endeavor to remain an emblem of trust.

Jahangir Kothari Parade (Lady LLoyd Pier)
Inspired by Her Excellency, The Honorable Lady Lloyd, this promenade pier and pavillion was constructed at a cost of 3 Lakhs and donated to the public of Karachi by Jahangir Kothari to whose genrosity and public spirit the gift is due. Foundation stone laid on January 5, 1920. Opened by Her Excellency, The Honorable Lady Lloyd on March 21, 1921.

Dome: A roof or vault, usually hemispherical in form. Until the 19th century, domes were constructed of masonry, of wood, or of combinations of the two, frequently reinforced with iron chains around the base to counteract the outward thrust of the structure.

Origins: The dome seems to have developed as roofing for circular mud-brick huts in ancient Mesopotamia about 6000 years ago. In the 14th century B.C. the Mycenaean Greeks built tombs roofed with steep corbeled domes in the shape of pointed beehives (tholos tombs). Otherwise, the dome was not important in ancient Greek architecture. The Romans developed the masonry dome in its purest form, culminating in a temple built by the emperor Hadrian. Set on a massive circular drum the coffered dome forms a perfect hemisphere on the interior, with a large oculus (eye) in its center to admit light.

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