


**The Rating Fund**  
The Microfinance Rating and Assessment Fund

**Microfinance ratings/assessments and the Microfinance Rating and Assessment Fund**

Asia Microfinance Forum – Beijing- March 23rd, 2006



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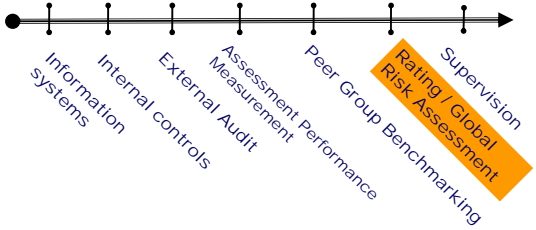
As a kick-off, a little game....

- What are the benefits of being financially transparent?
- What are the benefits of not being transparent?
- In your opinion, why can MFIs be reluctant to get rated?

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**What is a rating?**





- Part of an MFI's transparency sequence



Collect the data	Verify the reliability of the data	Compare	Analyze and understand reality behind figures	Synthesize the analysis in one note
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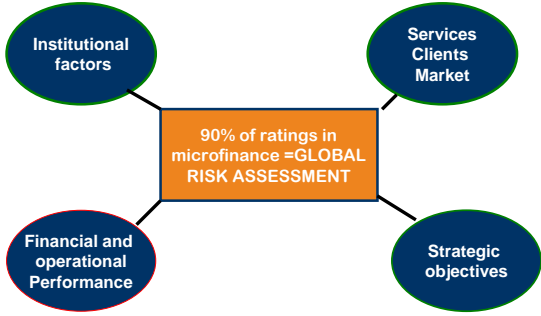
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**Transparency CGAP Programmes**

- IS Fund 
- MFI Audit Information Center
- Rating Fund  Le Fonds de notation et d'évaluation pour la microfinance
- MIX 
- Financial Transparency Awards 
- Capital Markets update

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**What is a rating in microfinance?**



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**What a rating is NOT**

- A financial audit
- A consultancy mission

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## A few performance evaluation notions

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## Performance evaluation definition

- Analysis based on standard indicators to assess the level of performance and risk of a microfinance institution (MFI)
- Ratios must be:
  - Analyzed together, (interdependency)
  - Consistently and periodically tracked over a period of time= trend analysis
  - Geographically and by peer group tracked
- Helpful when preparing financial projections.

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## Adjustment principles

- **Adjustments** are necessary
  - to allow comparisons among institutions
  - to measure the sustainability without external support.
- Principles:
  - Standardization of accounting rules
  - put the MFI in a non subsidized commercial context.
- Limits:
  - Which reference/rate to use?
  - What calculation formula does the rater use?
- Types of adjustments
  - Adjustments linked to the portfolio quality
  - Adjustment for inflation;
  - Adjustment linked to subsidies

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## Adjustments linked to the portfolio quality

- **Adjustments:**
  - To loan loss provisions (especially for refinanced and rescheduled loans);
  - To write-offs
- **Objective** : Reflect additional charge corresponding to charges non accounted at a « a minimum reasonable level » by the MFI.
- **The most affected MFIs**: Those with lenient loan loss provisioning policies, high portfolio at risk and don't write off non-performing loans aggressively

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## Adjustment for inflation

- **Objective**: take into account the effects of inflation
  - The value of net fixed assets increases
  - The value of Equity decreases
- **Adjustment** : additional charge of (Average Equity – Average fixed assets) \* Inflation rate
- **The most affected**: MFIs funded more by equity than by liabilities.

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## Adjustments for in-kind donations and operating subsidies

- **Objective**: include the cost of services not paid by the MFI
- **Adjustment** : additional charge, which equals what the MFI would have paid
- **The most affected**: MFIs with expatriate staff supported by third-party donors; MFIs using goods or services for which they are not paying market rates.

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### Adjustment for cost of funds

- **Objective** : approximate the cost of funds at the market rate
- **Adjustment**: application of a commercial rate to all the subsidised liabilities (loans, savings, etc)
- **The most affected**: MFIs with heavily subsidised borrowings

### Performance evaluation

- Ratios can help answer two primary questions that every institution involved in microfinance needs to ask.
  - Is this institution either achieving or progressing towards sustainability?
  - How efficient is it in achieving its given objectives?
- Financial ratios and indicators are usually divided into four groups:
  - Portfolio quality;
  - Efficiency and Productivity;
  - Financial management / Risk management;
  - Profitability and sustainability

### Loan Portfolio Quality

- **Portfolio at Risk n days (PAR<sub>n</sub>)**: What part of my portfolio is at risk?
- **Risk coverage ratio**: What part of my Portfolio at Risk is covered? How to protect myself against losses?
- **Provision expense ratio**: How much does this protection cost?
- **Write-off ratio**: which part of my portfolio has been lost?

### Portfolio at risk

**Outstanding Balance on Arrears over < n > days + Total Gross Outstanding Refinanced (restructured) Portfolio**

$$PAR_n = \frac{\text{Outstanding Balance on Arrears over } \langle n \rangle \text{ days} + \text{Total Gross Outstanding Refinanced (restructured) Portfolio}}{\text{Total Outstanding Gross Portfolio}}$$

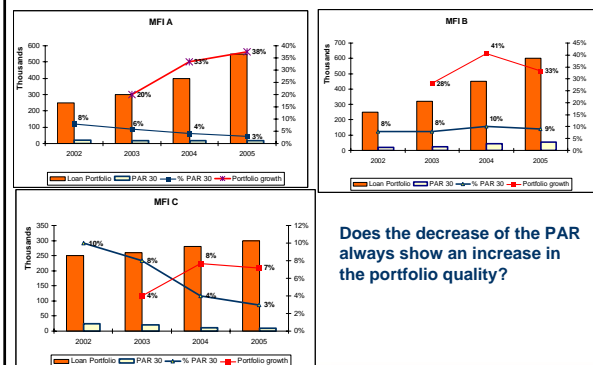
- Specify the number of days
- PAR > 10% is worrying
- Monitor daily if possible
- PAR1 to assess the default risk, especially for loans with high frequency repayments.

### PAR Exercise

X	X	X	0			
X	0	0				
X	X	X				
X	X	0	X			

What is the portfolio at risk? What is the reimbursement rate?

### Observation



Does the decrease of the PAR always show an increase in the portfolio quality?

## Efficiency and productivity

- **Efficiency ratio**
  - Operating expenses / average gross loan portfolio
- **Cost per borrower**
  - Operating expenses / number of borrowers
- **Active clients per staff member**
  - Number of clients / number of staff members
- **Active clients per loan officer**
  - Number of clients / number of loan officers

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## Operating expense ratio: calculation

$$\text{Operating Expense ratio} = \frac{\text{Operating Expenses}}{\text{Average Gross Portfolio}}$$

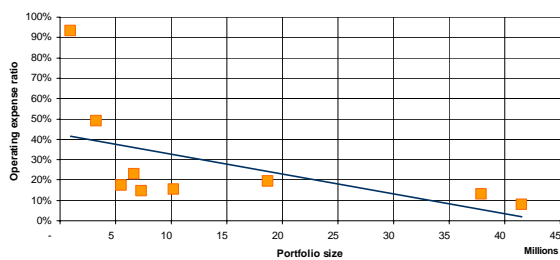
- Downward trend along with the growth of the loan portfolio is a good sign.
- The smaller the ratio, the better it is
- Unfavorable comparison for:
  - MFIs that provide **smaller loans** ( even though they may be serving their target market efficiently).
  - MFIs that offer **savings and other services**
  - MFIs that provide financial services in **rural areas**

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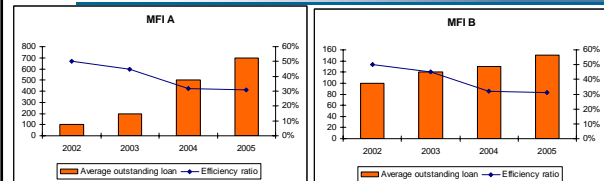
## Economies of scales

Portfolio size vs. Operating expenses (without ACSI)



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- How do you explain the increase or decrease in efficiency?

## Financial /Risk management

- A few examples of ratios:
  - The Funding expense ratio
  - Cost of funds ratio
  - Debt/Equity ratio

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## Funding expense ratio

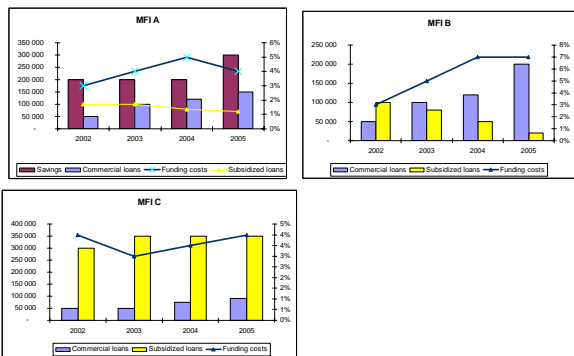
$$\text{Funding Expense ratio} = \frac{\text{Interest and Fee Expenses on funding liabilities}}{\text{Average Gross Portfolio}}$$

- This ratio measures the total interest expense incurred by the MFI on debt and deposit to fund its financial asset, the loan portfolio.
- The ratio depends much on the funding resources: debt (higher ratio), savings or donations (lower ratio).
- This ratio tends to increase as the MFI becomes less dependant on donations
- For MFIs collecting savings, this ratio will probably be lower, but the operating expense ratio will be most likely higher.

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## Graph examples



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## Profitability

- Return on Assets (ROA)
- Return on Equity (ROE)
- Portfolio yield

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## Portfolio yield

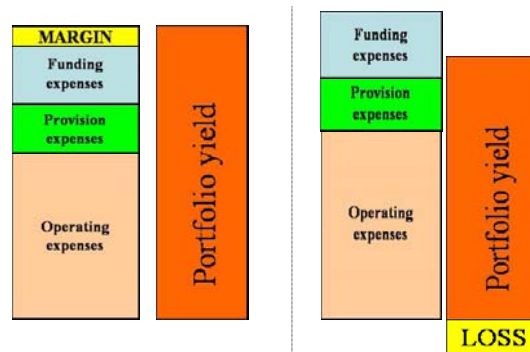
$$\text{Portfolio yield} = \frac{\text{Cash Financial Revenue}}{\text{Average Gross Loan portfolio}}$$

- This accounts for the amounts effectively received in cash from interest, fees and commissions by the institution from the clients. = actual rate obtained
- It indicates the MFI's efficiency in collecting repayments from its clients (compare with effective lending rate)
- Insight into portfolio quality since portfolio yield does not include the accrued income that delinquent loans should have generated but did not

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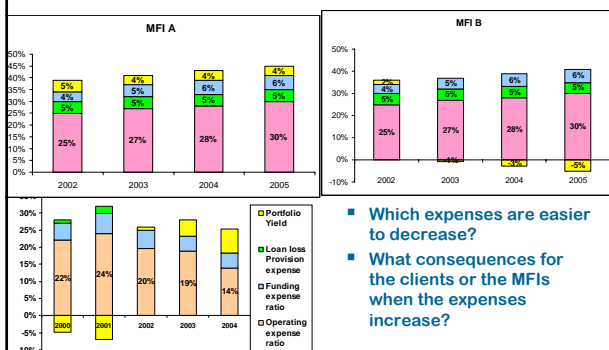
## Portfolio yield composition



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## Graph examples



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- Which expenses are easier to decrease?
- What consequences for the clients or the MFIs when the expenses increase?

## Recommended readings

- Measuring Performance of Microfinance Institutions (FRAME), SEEP Network, 2005
- Definition of selected financial terms, ratios and adjustments for microfinance, CGAP, 2003
- Disclosure Guidelines for Financial Reporting by Microfinance Institutions, CGAP, 2003
- Performance Indicators for Microfinance Institutions: TECHNICAL GUIDE. MicroRate and IADB, 2003

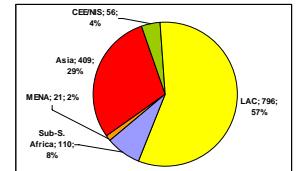
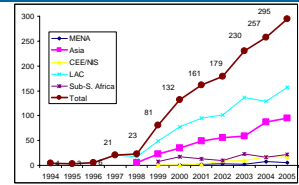
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## The microfinance rating market

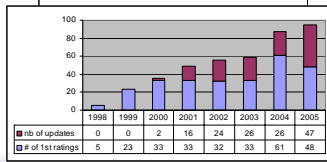
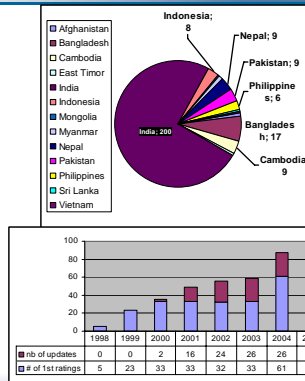
## The world microfinance rating market

- Around 1400 rating exercises since 1994, among 683 MFIs in 74 countries – around ¼ of existing MFIs.
- More than 50% are located in only 4 countries: India, Peru, Bolivia and Colombia
- The market growth is globally constant since 1997 (257 ratings in 2004 and 295 ratings in 2005) but is irregular regionally speaking.
- In the top 10 countries, 8 from Latin America and 2 from Asia (India and Bangladesh)



## The rating market in Asia

- 409 rating exercises since 1997 in 13 countries where India accounts for 78% of the total number of ratings.
- One third of Asian MFIs have taken a rating update (39% worldwide)
- 268 MFIs rated including 200 in India BUT 5 countries have only one or two rated MFIs

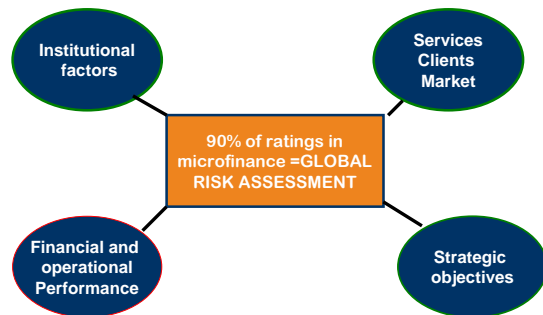


## The rating market: South Asia vs. East Asia

Sub-region	Country	Total number of ratings	Nb of MFIs rated
EAP	Cambodia	12	9
	East Timor	4	2
	Indonesia	9	8
	Mongolia	1	1
	Philippines	7	6
	Vietnam	1	1
	<b>Total EAP</b>		<b>34</b>
South Asia	Afghanistan	2	2
	Bangladesh	25	17
	India	319	200
	Myanmar	4	3
	Nepal	11	9
	Pakistan	13	9
	Sri Lanka	1	1
<b>Total South Asia</b>		<b>375</b>	<b>241</b>
<b>Total</b>		<b>409</b>	<b>268</b>

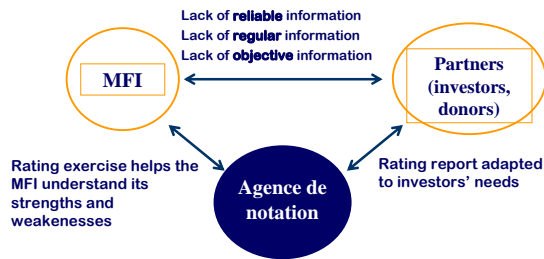
## Objectives and benefits of ratings

## What is a rating in microfinance?



## The objective of the rating in microfinance

**Primary objective: facilitate the relationship with partners**



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## The benefits of ratings for MFIs

### Improving Performance

Managers can use the evaluation process to:

- focus on how and where to improve
- compare their performance with peers
- evaluate their standing in the microfinance industry and set performance targets

### Attracting Funders

Third party verification of MFI performance information and risk management assessment allows

- Investors and donors to judge the relative quality of MFIs
- MFIs to earn a higher transparency ranking on the MIX Market, which links investors with MFIs.

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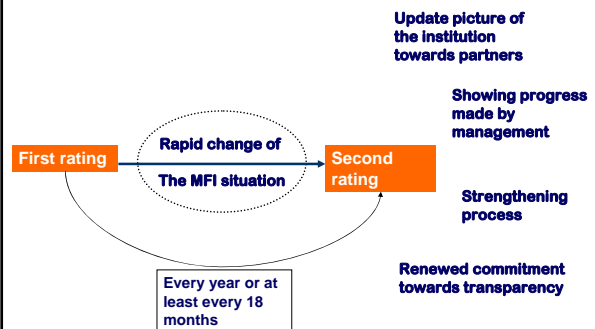
## Usefulness of rating reports for funders

- The rating report contains complete, accurate, reliable, and standardized information about the MFIs' global performance and operating risk.
- It might be a tool for a **donor** or a supporting **NGO**
  - to better know the performance / level of sustainability of its partner
  - to better understand the kind of support its partner is asking for
  - to easily follow-up the evolution of its partner
- It might be a tool for **investors**
  - To identify potential investments (powerful initial source for filtering through prospects)
  - To complement their own due-diligence analysis
  - To assess risk and return and monitor their investments
  - To follow-up the MFIs they are investing into

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## Update of the rating / assessment: Fundamental!!



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## How to get prepared for a rating exercise

- **Select the rating agency and the rating product** that best suits your needs and expectations.
- Define the terms of contract (negotiate the price!) and the mission schedule
- Prepare all the **documentation** and information required by the analysts and provide them to the agency prior to the filed visit.
- Appoint someone to **coordinator** or focal point.
- Inform and **sensitize staff members**.

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## During and after the rating exercise

- **Remain transparent**
- **Accept the external look of the evaluator on your work**
- **Adjust the global strategies**

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## MFI feedback

## Investor Feedback : Oikocredit

## How to finance a rating

## The Microfinance Rating and Assessment Fund



A joint initiative of the IDB, CGAP and the UE launched in 2001 to improve the **quality, reliability, and availability** of information on the risk and performance of MFIs.

### Objectives

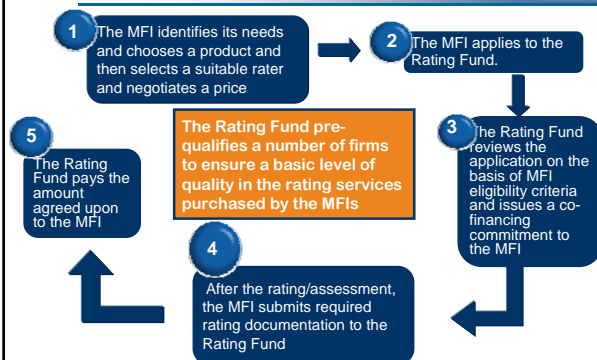
- Build a **market** for rating and assessment services
- Improve **transparency** by increasing the availability of third-party-verified MFI performance information

### Services:

- **Co-financing for MFIs** for professional rating and assessment services
- **Over 210 rating reports** on MFIs worldwide
- **Rating agencies' profiles** engaged in MF ratings

- **Over 250 rating reports co-funded since 2001**
- **16 qualified rating agencies**
- **All funded MFIs consented to publicly disclose their performance information**
- **Social investors like Blue Orchard, ResponsAbility and Dexia Microcredit now require ratings as part of their pre-investment due diligence**
- **Many MFIs reported significant improvement in the internal management and increased ability to access funding after their rating**

## The Rating Fund process



## Step 1: Select a rating agency

- ➔ Contact already rated MFIs to get their feedback as well as recommendations from donors/investors
- ➔ Contact different rating agencies and compare their services
- ➔ Obtain technical and financial proposals from two or three raters
- ➔ Select the final rating agency according to the methodology most suited to the needs of the MFI.

### Specialized MF raters:

**M-CRIL,  
Microfinanza,  
PlanetRating,  
Microrate**

**Mainstream raters  
(outside Latin America):  
CRISIL,  
JCR-VIS**

## Step 1 (continued): Select a product

Product	Definition
Global risk assessment	Measures <b>TRUSTWORTHINESS</b> by analyzing institutional capacity and performance Evaluates operational and financial performance Evaluates management's capability to meet objectives and fulfill the contractual obligations
Mini-assessment	Shorter global risk assessment designed for smaller and/or younger MFIs.
Credit Risk Rating	Measures <b>CREDITWORTHINESS</b> An opinion of the ability and willingness of an institution to pay its debt obligations on time
Joint ratings	Joint completion of a global risk assessment and of a credit risk rating. Meets the needs for bond issuance without neglecting the microfinance specificities analysis

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## Step 2: Apply to the Rating Fund

MFI's Eligibility criteria (for all products except mini-assessments):

- Over **3 years** of financial operations
- Total assets between **US\$300,000** and **US\$30m**
- Average outstanding loan size less than **\$2,000 (Exceptions)**
- **No mandatory** rating exercise required by local regulation

MFI's Eligibility criteria for mini-assessments:

- Over **2 years** of financial operations
- Total assets between **US\$200,000** and **US\$ 1 million**.
- Average outstanding loan size under **US\$2,000**

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## Step 3: RF's co-financing scales in Asia

- **Average price in Asia:** US\$ 10,000 in East Asia and USD 8,500 in South Asia, ranging from US\$4,500 to US\$ 23650!!
- **Cost sharing:** the Rating Fund will cover a portion of the costs of a rating or assessment for an MFI, not the entire amount.

Co-financing Table	First Rating	Second Rating	Third Rating
Global risk assessments	80% max \$8,000	60% max \$6,000	40% max \$4,000
Mini-assessment	50% max \$2,500	-	-
Joint ratings	80% max \$13,000	60% max \$9,500	-

**Amount of Rating Fund Contribution =**  
(Total cost of rating – Funding from other sources) X Co-financing %

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## Step 4: Reimbursement process

1. Rating report is added to the Rating Fund website (only the executive summary is compulsory for the mini-assessment) and you are encouraged to post your profile on the MIX.
2. The MFI pays the rating agency directly.
3. The Rating Fund transfer funds to the MFI (not to the rating agency)

- An electronic copy of the final rating report
- A copy of all invoices from the rating agency
- An invoice from the MFI to the Rating Fund for the amount of the co-financing
- Proof of full or partial payment made to the rating agency.
- A short feedback form about your experience with the rating agency and the Rating Fund.
- The MFI's bank account information for direct wire transfer

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## The Rating Fund Website

[Home Page](#) | [Microsoft Internet Explorer](#)  
[Home](#) | [About the Fund](#) | [MFI Application](#) | [Rating and Assessment Agencies](#) | [Rating Reports](#) | [Other Resources](#)

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 The Microfinance Rating and Assessment Fund

Welcome to the Rating Fund website. The Rating Fund provides the following services:

- Rating/Assessment product definitions
- Eligibility criteria
- MFI and Rater application instructions
- Comparable information on qualified agencies
- Agencies' methodologies and pricing
- Completed rating reports
- Market information, news and resources

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## Conclusion

- **About ten years ago...**
  - MFI follow-up was based on:
    - cumulative number of disbursed loans, members, clients,...
    - repayment rate, average loan size,...
    - net income
  - Each entity (donor, NGO or investor) needed to assess the sustainability of its partners through its own method which was time consuming for it and for the MFI as well.
- **Today**
  - There is a set of standard indicators (non exhaustive)
  - There is a consensus about terms and definitions to be used within the microfinance industry
  - There are several agencies specialized in MFIs performance evaluation
  - MFIs may use one evaluation report internally as well as for several of their partners (from donors up to investors)
  - The Rating Fund may co-finance a performance evaluation

## Reluctances and MFIs feedback

- **Lack of information about:**
  - The **benefits** and impact for the institution
  - The different types of **services**
  - Who the **rating agencies** are
- **Disclosure** of the MFIs data to the public
- Get a bad **grade**, and thus get excluded from potential funding
- **Cost is high**
- **Competency of the rating agencies** to understand the MFI context
- **Time consumed**