GCR GLOBAL CREDIT RATING CO.
Local Expertise • Global Presence

Rating Methodology

Financial Institutions

Global Criteria for Rating Microfinance Institutions

Updated March 2017

Related Methodologies
Global Master Criteria for Rating Banks and Other Financial Institutions, updated March 2017

Introduction

With social development, financial inclusion, and financial sector deepening on the agendas in many developing economies, the facilitatory role played by microfinance institutions ("MFIs") has increased, and they are increasingly used as conduits for attracting and/or mobilising local, regional or international investor funding. In this regard, investors require clearly defined principles for the credit assessment and performance evaluation of MFIs, which considers both return and development metrics.

Defining characteristics of a MFI
- A financial institution, the primary business of which is to provide loans and financial services to low income and/or underserved individuals; and/or
- A financial organisation with the dual goal of achieving a defined social mission/ developmental result, and a positive financial outcome.

This report details GCR's approach to according ratings to MFIs, which are rated within GCR's financial institutions ratings division, as a similar rating process and analytical framework is applied. This is justified, since the services of MFIs are typically a subset of what larger banks do or could offer. This methodology therefore supplements GCR's Global Master Criteria for Rating Banks and Other Financial Institutions ("Criteria for Rating Banks and Other FIs") which is available on GCR's website, www.globalratings.net, and is to be read in conjunction with this report.

While this methodology focuses largely on assessing a MFI's ability to honour all of its general obligations (ie, borrowings and other liabilities) in a timely manner, it is also relevant to specific debt issues. Moreover, this methodology is intended to be applied globally, and covers institutions with solely domestic/regional operations in a single market, as well as those with a broad franchise operating in multiple countries.

This criteria report ("the Criteria") is an update to the version published in March 2016. There are no significant amendments to the Criteria. The update of this Criteria will not have an impact on any existing ratings. Going forward, this Criteria will be applied to all ratings of MFIs.

GLOBAL CREDIT RATING CO.

Rating methodology

The rating methodology for MFIs is broadly the same as for banks, as similar products/services and risks are common to both types of institutions. However, due to the specialised nature and scope of a MFI's business activities, ownership profile, legal structure, operating and regulatory environment, and scale, the emphasis and weight given to certain risk factors may be different.

In particular, closer evaluation of the following key analytical areas is required:

- Organisational profile (including ownership and the likelihood of support, corporate governance, management quality/strategy, and transparency/ quality of disclosure);
- Operating environment;
- Financial profile (including a MFI's funding and liquidity profiles, and capital composition and structure); and
- Operational profile (including an assessment of asset portfolio structure, credit risk management, and financial performance).

Organisational profile

Ownership and support
As is the case for banks, ownership characteristics impact a MFI from both support (being financial or technical assistance) and governance perspectives.

Considering support, the underlying legal structure of a MFI typically determines whether relief will be forthcoming/can be relied upon if or when needed[1].

Legal basis	Likelihood of timely support (dependent on ability)
NGO status	These MFIs typically have an unclear ownership profile. Donors provide unconditional seed capital for start-ups. Support (apart from non-cash subsidies) is uncommon.
Affiliated	Depending on the network, the collective may have an influential role in brokering financial support to the MFI from third-parties. Support likelihood/success rate is varied.
For-profit	Depending on the MFI's stage of development, shareholders may comprise non-traditional investors (international financial institutions and MFI funds), donors, founding members (private) and other institutions. Likelihood of support is strong (though not permanent).

The impact of ownership on governance comes as a direct result of trying to manage/balance a MFI's double bottom line goals. This is typically a function of investor skill and knowledge, how well the business' social mission is outlined/understood and integrated into the institution's operations, and the extent to which the owners involve themselves in the day-to-day management/evaluation of the MFI. The effect of an institution's owners on the credit evaluation of a MFI is significant, impacting several analytical areas within this Criteria.

Governance and control
In addition to ownership influence, additional external factors also play a decisive role in shaping a MFI's governance structures and practices. These can be split between operational barriers and limitations, and response-induced actions or policies.

Source	Description of possible impact on governance
Governance structure	Attracting, retaining and replacing members of the Board of Directors ("board") is typically a problem. Consequently, MFIs are regularly found to lack the required array of board committees, and the independence and talent of board members may be limited. A weak leadership, in turn, affects the business on many levels, for example: planning and review of the MFI's strategy will be poor, leading to problems in execution, resulting in difficulty retaining funders and shareholders (also fraud and/or exploitation may persist unnoticed).
Regulation	As most MFIs operate in emerging markets, not all MFIs are regulated or subject to prudential regulations and supervision. MFIs which are authorised to take deposits are usually regulated, while those not authorised to take deposits are usually subject to limited regulation. Thus, transparency and 'good business' practices are usually poor compared to banks. However, the sector is prone to political intervention (which makes doing business more difficult/expensive) including interest rate ceilings, fee caps, direct/subsidised lending and legal steps/redress to protect borrowers. Consequently, it is critical that a MFI's policies and procedures are aligned with prevailing legislation.

In GCR's experience, most MFIs struggle to overcome or adjust to the governance and regulatory challenges they face, constraining credit ratings early in the assessment/review process.

Management and strategy
An efficient and experienced management team is a further prerequisite for the successful running of any financial institution[2]. GCR considers management's ability to contribute to, as well as interpret and execute, the business' strategy and objectives[3] (as

[1] Government support is considered unlikely as most MFIs are too small to be systemically important. Nonetheless, the state may be willing to step in when the failure of a MFI could jeopardise the deposits of unemployed or low-income individuals (particularly if there is no deposit insurance scheme).

[2] Key person risk (or being heavily dependent on a single person and/or group) is a feature in most emerging market MFIs. As such, succession planning and division of responsibilities are very important. Moreover, a capable management team can, in some cases, offset the risks associated with having a weak and/or lacking governance/board structure.

[3] Internal policies and procedures (being management's responsibility) are also tested for comprehensiveness, adequacy, and/or success (and must be clearly documented and sufficiently thorough, so as to avoid misunderstanding, and facilitate ongoing implementation).

well as the platforms/mechanisms put in place to monitor performance, and executive adaptability).

Furthermore, management's ability to communicate the business' strategy and/or objectives to its employees is assessed. In addition, performance measurement (and any links to incentivised pay schemes), training and/or staff retention initiatives are considered.

Reporting and transparency
Another critical factor in assessing a MFI (either stand alone or as part of a wider financial system) is how reliable, accurate and comparable the financial information is (both internal and external reporting).

Source	Description of possible impact on reporting
Protocols	Consideration is given to which reporting standards were used to prepare the MFI's accounts, as well as the disclosure guidelines and rules issued by the relevant authorities (which should be consistent with banking sector regulations).
Technology	A MFI's existing management systems and information risk management are assessed for accuracy, thoroughness, and timeliness. Connectivity and security issues are also considered (as data quality is crucial for executive decision making).
Structures	The integrity of the audit process is also profiled, including confirmation of whether the MFI has internal audit and compliance teams in place, the relevant experience of team members, and relevant reporting channels.

Operating environment

An assessment of historical and forward looking economic, industry and other socio-demographic indicators provides a framework for analysing each MFI. The specific analytical processes in relation to evaluation of the operating environment are well covered in GCR's Criteria for Rating Banks and Other FIs, and as such, are not repeated in this Criteria.

Financial profile (risks and outcome)

Liability funding (solvency and liquidity)
Seen as the foundation of GCR's financial risk analysis, the process starts with understanding/ evaluating how a MFI funds itself (source, diversification and cost of funds), when the related liabilities must be paid (maturity profile), and also the ease at which a MFI is able to replace or renew maturing liabilities (refinancing in both normal and stressed conditions). Nevertheless, it must be noted that these factors vary according to the legal structure of the MFI.

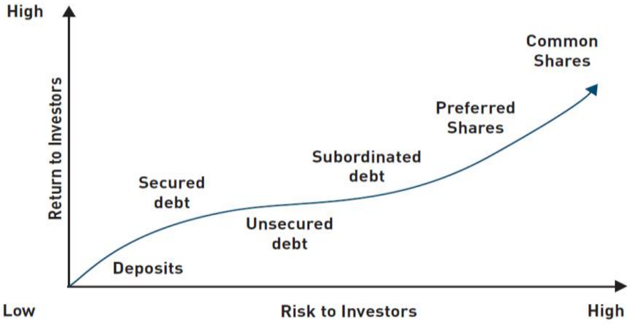
Legal basis	Description of usual funding sources/types
Regulated	Can be deposit taking or credit only (country specific), reliant mainly on private wholesale funds and capital (bonds and structured vehicles are frequently seen).
Unregulated	Mostly credit-only businesses, funding profile comprises public and/or private funding, at concessionary and/or market rates (donor funds and subsidies are common).

GCR considers how the MFI plans for, measures, monitors, and controls its liquidity and solvency (funding and/or trading). However, contrary to banks, effective and efficient cash optimisation is considered much more arduous (and hence riskier).

Source	Description of status and/or impact on liquidity
Reserve pool	Liquid assets mainly held as cash or bank placements (constrained by choice of securities in each country, and generally not significant in relation to total assets).
A/L mismatch	Usually well managed, as most MFIs fund short-dated assets with longer-term funding (albeit, deposit taking MFIs balance withdrawals with loan book cash flows).

Finally, GCR considers the likely impact of a MFI's funding profile on the lending side of its business (be it through product development and/or pricing), as well as on overall profitability.

Capital (composition and structure)
Moving from short- to long-term sustainability (and the ability to absorb unanticipated obligations), GCR's analysis depends on the nature and structure of a MFI's capital base (tangible and total capital).



Procedurally, the method of analysis does not discriminate between institution types (MFIs or banks), covering the same features.

Operational profile

Managing credit related risks
A further key area of consideration relates to a MFI's intermediation function (being the conversion of commercial funding and/or grants into loans).

GCR evaluates the evolution of the lending portfolio (and the associated growth pressure). This provides valuable insight into a MFI's strategy and the suitability of management's policies and actions.

Source	Description of individual/collective portfolio items
Composition performance	Consideration of the growth trends (past and current) in the number of loans and number of borrowers, the value of loans granted (acquisition and overall/total), and the term structure of loans granted (by remaining and original term). Consideration of trends in collections, pre-payments and bad debts impact the portfolio makeup and asset quality.

GCR obtains an understanding of the MFI's business model, and also the mechanics of how the loan book is managed and quality maintained (from both a pre and post origination point of view).

Source	Description of loan portfolio inputs (as reviewed)
Assessment	Consideration of a MFI's credit protocols and policies, being: the loan approval processes (client identification, selection and loan appraisal) and management filters (branch/board credit committees, approval matrices, maximum exposure/ industry limits, utilisation checks and disbursement and collection policies/strategies).
Measurement	Evaluation of the loan book's actual performance (focusing on the level of past-due, restructured and written-off loans, collections and recovery rates) and the policies in place to deal with overdue/bad debts (tiered follow up system, loan provisioning policies, definition/classification of arrears, legal recourse).

Earnings and performance

GCR analyses how a MFI's operations/business facets impact operational sustainability (being the extent to which interest and other financial revenue covers operational and administrative costs) and financial sustainability (being the ability to also cover the cost of funds and grants at market prices), and *vice versa* (being policy responses to achieve a specific target).

Source	Description of key differences between banks and MFIs
Earnings	MFIs usually charge higher interest on loans to cover the higher perceived risk of default. This leads to a higher net portfolio yield and interest margins.
Expenses	Operating costs are also typically higher for MFIs. This is mainly driven by infrastructure (large branch needs) and employee costs (business is very labour intensive).
Provisions	The chosen target market of MFIs predisposes them to higher arrears rates with little/no collateral on loans. As such, MFIs need to provide more aggressively for bad debts.

To assist in distinguishing between conventional banks and MFIs, several supplementary, industry specific ratios (which may provide additional insights in assessing MFIs) are set out in Annexure 1.

Conclusion

While thorough quantitative analysis is important, the qualitative characteristics of GCR's analysis cannot be overemphasised. It is critically important to look "beyond the numbers" and to evaluate the intangible strengths and weaknesses of an entity. At the core of GCR's analysis is the understanding of the strategic characteristics of an organisation and the quality of management. Our emphasis is on determining how these strategic aspects will affect an organisation's flexibility and capacity to withstand adverse market circumstances.

Annexure 1: Financial Ratios and Indicators

Term	Formula	Explanation
	Sustainability and Profitability	
Operational Self-Sufficiency	Finance Income / (Finance Costs + Impairment Losses + Operating Costs)	Measures how well a MFI can cover its costs through operating revenues.
Financial Self-Sufficiency	Finance Income *(Adj.)* / (Finance Costs *(Adj.)* + Impairment Losses *(Adj.)* + Operating Costs *(Adj.)*)	Measures how well a MFI can cover its costs, taking into account adjustments.
Adjusted Return on Assets	(Net Operating Income *(Adj.)* - Taxes)/ Average Assets *(Adj.)*	Measures how well a MFI uses its assets to generate returns (ratio is net of taxes and excludes non-operating items).
Adjusted Return on Equity	(Net Operating Income *(Adj.)* - Taxes) / Average Equity *(Adj.)*	Calculates the rate of return on equity (used as a proxy for commercial viability).
	Asset and Liability Management	
Yield on Gross Portfolio	Cash Received From Interest, Fees and Commissions on Loan Portfolio / Average Gross Loan Portfolio	Indicates an MFI's ability to generate cash from interest, fees and commissions on its gross loan book. Unpaid accrued income is not included here.
Adjusted Cost of Funds	Finance Costs on Funding Liabilities *(Adj.)* / (Average Deposits + Average Borrowings)	Calculates a blended interest rate for all a MFI's funding liabilities (adjusted to either include or exclude subsidies).
Adjusted Debt to Equity	Total Funding Liabilities / Adjusted Equity	Measures the overall leverage of a MFI and how much cushion it has to absorb losses after all funding liabilities are paid.
Liquidity Cover	Cash + Trading Investments / (Demand Deposits + Short-Term Time Deposits + Short-Term Borrowings + Interest Payable on Funding + Accounts Payable and Other Short-Term Liabilities)	Indicates the level of cash and cash equivalents a MFI maintains to cover short-term liabilities (12-month term).
	Portfolio Quality	
Portfolio-at-Risk (PAR)	(PAR > x days + Value of Renegotiated Loan)s / Gross Loan Portfolio	The most accepted measure of portfolio quality (adjusted for write-offs).
Adjusted Write-off Ratio	(Value of Loans Written Off + Write-off Adjustment) / Average Gross Loan Portfolio *(Adj.)*	Represents the percentage of a MFI's loans that have been removed from the balance of the gross loan portfolio because they are unlikely to be repaid.
Adjusted Risk Coverage Ratio	Impairment Loss Allowance *(Adj.)* / (PAR > x days *(Adj.)* - Write-off Adjustment)	Shows how much of the portfolio at risk is covered by a MFI's impairment loss allowance (adjusted for write-offs).
	Efficiency and Productivity	
Adjusted Cost Ratio	Operating Expenses *(Adj.)* / Average Gross Loan Portfolio *(Adj.)*	Highlights personnel and administrative expenses relative to the loan portfolio (adjusted for subsidies and hidden grants).
Cost per Active Client	Operating Expenses *(Adj.)* / Average Number of Active Clients	Provides a meaningful measure of efficiency (average cost to maintain a client, adjusted for subsidies/grants).
Client Turnover	(Number of Active Clients (End of Period) + Number of New Clients (During Period) - Number of Active Clients (Beginning of Period)) / Average Number of Active Clients	Measures the net number of clients continuing to access services during the review period (used as a measure of client satisfaction).
Active Clients per Employee	Number of Active Clients / Total Number of Personnel	Measures the overall productivity of a MFI's staff in terms of managing clients, including borrowers, savers and other.

GLOSSARY OF TERMS/ACRONYMS USED IN THIS DOCUMENT AS PER GCR'S FINANCIAL INSTITUTIONS GLOSSARY

Arrears	An overdue debt, liability or obligation. An account is said to be 'in arrears' if one or more payments have been missed in transactions where regular payments are contractually required.
Asset	A resource with economic value that a company owns or controls with the expectation that it will provide future benefit.
Asset Quality	Refers primarily to the credit quality of a bank's earning assets, the bulk of which comprises its loan portfolio, but will also include its investment portfolio as well as off balance sheet items. Quality in this context means the degree to which the loans that the bank has extended are performing (ie, being paid back in accordance with their terms) and the likelihood that they will continue to perform.
Bad Debt	An amount owed by a debtor that is unlikely to be paid due, for example, to a company going into liquidation. There are various technical definitions of what constitutes a bad debt, depending on accounting conventions, regulatory treatment and the individual entity's own provisioning and write-off policies.
Capital	The sum of money that is invested to generate proceeds.
Capital Base	The issued capital of a company, plus reserves and retained profits.
Cash	Funds that can be readily spent or used to meet current obligations.
Cash Flow	The inflow and outflow of cash and cash equivalents. Such flows arise from operating, investing and financing activities.
Collateral	Asset provided to a creditor as security for a loan.
Corporate Governance	Refers to the mechanisms, processes and relations by which corporations are controlled and directed, and is used to ensure the effectiveness, accountability and transparency of an entity to its stakeholders.
Credit Rating	An opinion regarding the creditworthiness of an entity, a security or financial instrument, or an issuer of securities or financial instruments, using an established and defined ranking system of rating categories.
Credit Risk	The possibility that a bond issuer or any other borrowers (including debtors/creditors) will default and fail to pay the principal and/or interest when due.
Debt	An obligation to repay a sum of money. More specifically, it is funds passed from a creditor to a debtor in exchange for interest and a commitment to repay the principal in full on a specified date or over a specified period.
Default	Failure to meet the payment obligation of either interest or principal on a debt or bond. Technically, a borrower does not default, the initiative comes from the lender who declares that the borrower is in default.
Diversification	Spreading risk by constructing a portfolio that contains different investments, whose returns are relatively uncorrelated. The term also refers to companies which move into markets or products that bear little relation to ones they already operate in.
Exposure	Exposure is the amount of risk the holder of an asset or security is faced with as a consequence of holding the security or asset. For a company, its exposure may relate to a particular product class or customer grouping. Exposure may also arise from an overreliance on one source of funding.
Financial Institution	An entity that focuses on dealing with financial transactions, such as investments, loans and deposits.
Interest	Scheduled payments made to a creditor in return for the use of borrowed money. The size of the payments will be determined by the interest rate, the amount borrowed or principal and the duration of the loan.
Interest Rate	The charge or the return on an asset or debt expressed as a percentage of the price or size of the asset or debt. It is usually expressed on an annual basis.
International Scale Rating LC	International local currency (International LC) ratings measure the likelihood of repayment in the currency of the jurisdiction in which the issuer is domiciled. Therefore, the rating does not take into account the possibility that it will not be able to convert local currency into foreign currency or make transfers between sovereign jurisdictions.
Liabilities	All financial claims, debts or potential losses incurred by an individual or an organisation.
Liquid Assets	Assets, generally of a short term, that can be converted into cash.
Liquidity	The speed at which assets can be converted to cash. It can also refer to the ability of a company to service its debt obligations due to the presence of liquid assets such as cash and its equivalents. Market liquidity refers to the ease with which a security can be bought or sold quickly and in large volumes without substantially affecting the market price.
Long-Term	Not current; ordinarily more than one year.
Long-Term Rating	Reflects an issuer's ability to meet its financial obligations over the following three to five year period, including interest payments and debt redemptions. This encompasses an evaluation of the organisation's current financial position, as well as how the position may change in the future with regard to meeting longer term financial obligations.
Margin	The rate taken by the lender over the cost of funds, which effectively represents the entity's profit and remuneration for taking the risk of the loan; also known as spread.
Past Due	Any note or other time instrument of indebtedness that has not been paid on the due date.
Portfolio	A collection of investments held by an individual investor or financial institution. They may include stocks, bonds, futures contracts, options, real estate investments or any item that the holder believes will retain its value.
Provision	The amount set aside or deducted from operating income to cover expected or identified loan losses.
Recourse	The right to demand payment/collect from the maker or endorser of a negotiable instrument.
Risk	The chance of future uncertainty (i.e. deviation from expected earnings or an expected outcome) that will have an impact on objectives.

Risk Management	Process of identifying and monitoring business risks in a manner that offers a risk/return relationship that is acceptable to an entity's operating philosophy.
Securities	Various instruments used in the capital market to raise funds.
Security	An asset deposited or pledged as a guarantee of the fulfilment of an undertaking or the repayment of a loan, to be forfeited in case of default.
Shareholder	An individual, entity or financial institution that holds shares or stock in an organisation or company.
Short-Term	Current; ordinarily less than one year.
Short-Term Rating	An opinion of an issuer’s ability to meet all financial obligations over the upcoming 12 month period, including interest payments and debt redemptions.
Yield	Percentage return on an investment or security, usually calculated at an annual rate.

For a detailed glossary of terms please click here