The Pakistan Credit Rating Agency Limited

Social Impact & Performance Rating Criteria

Assessment Framework

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Summary

This methodology describes PACRA's approach to assigning Social Impact and Performance (SIP) Rating to Microfinance Providers (MFP), including Non-Bank MFCs, NGOs, MFBs, NBFCs & banks with microfinance portfolios. SIP rating focuses on the double-bottom-line objective of MFPs, and is an independent opinion on the ability of an entity to create intended social impact and achieve sustainable performance. The aim of this rating is to enhance focus and transparency concerning social goals and objectives against the backdrop of an ever-increasing focus on socially responsible corporate practices. In developing this methodology, PACRA has identified factors that are fully aligned with international social performance standards – as defined by Global Initiatives – and in line with our Microfinance Institution Rating methodology. PACRA arrives at this opinion by conducting, inter-alia, a detailed evaluation of qualitative and quantitative factors, namely: Profile, Ownership/Members, Governance, Management, Social Impact, Business Sustainability and Financial Sustainability.

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1. Introduction

1.1 Background: Micro Finance Providers (MFPs) in many ways are similar to Financial Institutions, which primarily operate in the lending business. There are two types of MFPs in Pakistan: (i) Non-banking Microfinance Companies (Non-bank MFCs) regulated by Securities and Exchange Commission of Pakistan (SECP), and (ii) Microfinance Banks (MFBs) regulated by State Bank of Pakistan (SBP). While these MFPs vary in their legal structures, missions and approaches, they all share the common characteristic of providing financial services to borrowers at the bottom of the pyramid, a clientele that is considerably more vulnerable than traditional banking clients. Unlike other financial institutions where profitability is the prime objective, MFPs have dual objectives: a social objective, that is to serve the strata of the population which is excluded from the traditional financial system, and a financial objective, that is to perform their mission on a financially sustainable basis.

1.2 Social Impact and Performance Rating: Evaluating MFPs' dual objective – social Impact and sustainable performance – is the essence of the SIP rating, a first of its kind rating product in Pakistan pioneered by PACRA. Through this product, PACRA aims to enhance focus on the social objectives of MFPs, improve transparency in social goals and layout best practices benchmarks for MFPs across the board in line with international social performance standards as defined by Global Initiatives. PACRA also aims to bridge the gap that exists in MFPs' access to capital markets by providing valuable information to potential donors and investors. This will allow them to distinguish between MFPs and incorporate their double-bottom-line objective into their decision making.

1.3 Scope: SIP rating can be conducted for all types of Non-Bank MFCs, NGOs, MFBs, NBFCs & Banks with microfinance portfolios.

1.4 Rating Framework: The basic precept of this rating methodology is understanding of the business model of the MFP and the inherent risks. This includes analyzing prevailing macro-economic environment, industry developments, the management's strategy, assessment of social objectives and alignment, and sustainability of its operations. The relevant positioning of the MFP, established in comparison with peers in the industry, is a key consideration under this methodology to reach the final rating opinion.

1.5 Our rating methodology incorporates all material credit considerations, along with social impact, into rating and takes a forward-looking perspective. PACRA bases its SIP analysis of a MFP on a number of quantitative and qualitative factors. These are: **Profile, Ownership/Members, Governance, Management, Social Impact, Business Sustainability and Financial Sustainability**. No one factor has an overriding importance or is considered in isolation as all factors are reviewed in conjunction. Neither all factors can be quantified nor do quantitative values portray the whole story. Therefore, PACRA employs a combination of both qualitative and quantitative factors to ensure comprehension and comparability.

1.6 Rating Scale: SIP Rating has five rating categories from "SIP1" to "SIP5" with SIP1 being the highest. In addition, the scale will be appended with "+" and "++" signs to denote relative status within a category except for "SIP1" and "SIP5".

2. Profile

Background: Evolution and past strategy

2.1 Background: PACRA reviews the background of the MFP to understand its evolution from where it started and where it currently stands. We analyze how and through what means the MFP has achieved its scale. PACRA looks at the progress of the MFP to determine the ability of the MFP to successfully realize its strategy. The significant factor here for PACRA is to assess how the MFP has achieved the intended growth (organic vs acquisition, gradual vs rapid expansion). Meanwhile, the source of funding and resources deployed remain critical.

Operations: Review of scope of operations based on license, size and stage of business

2.2 Operations: The scope of operations assessment comprises general overview of the MFP's intended social mission, portfolio composition and the stage the business is in. Here, PACRA reviews the diversity, geographic spread of operations, product offering, asset mix, and track record of operations to understand the overall operations of the underlying entity.

3. Ownership/Members

Structure: Identification of the person at the last mile.

3.1 Structure: The assessment of ownership begins by looking at the legal status of the entity to form a view on its expected stability. This is followed by an in-depth study of the shareholding mix in order to disentangle structure of ownership. Key factors that are considered for this purpose, inter-alia, include: i) shareholding structure which includes whether the individual(s) own the entity directly or indirectly, ii) foreign or local shareholders, iii) whether the entity is owned by a single group or through a combination of entities and individuals, and iv) whether it is part of a group or a standalone entity. All these deliberations are done to identify the person at the last mile. PACRA further considers how an entity is actually run, as, at times, entities are run as family concerns despite being legally structured as companies.

3.1.1 Non-Bank MFCs structure is relatively different from other entities. As they are usually incorporated as public companies limited by guarantee under Section 42 of the Companies Ordinance, 1984 (now Companies Act, 2017).

Stability: Succession planning at shareholder / member level

3.2 Stability: In order to analyze the stability of ownership, a key criterion for PACRA is existence and form of shareholding agreement. In case of multiple owners, a well-documented shareholding agreement is considered to bring stability in the long-run compared to verbal agreement. Another particularly important factor to be taken into account is succession planning. Well defined shareholding agreement and succession plan also complements our criteria to identify the person at the last mile and eventual successor. In case of Non-Bank MFCs, PACRA assesses the entity's ability to identify a pool of members who can contribute in carrying the mission and operations beyond founding members. Here, an entity's dependence or over reliance on a single person (owner/member), especially in terms of decision making, can pose risks.

Business Acumen: Knowledge, skills and experience of

3.3 Acumen: PACRA gauges the owners'/members' understanding of microfinance industry dynamics and business skills. Having a strong skill set is considered critical for the sustainable success of the entity through business cycles. PACRA analyzes the business acumen through two primary areas; i) Industry-specific working knowledge and ii) Strategic thinking capability. Meanwhile, a deep and applicable understanding of the financial system is critical in order to determine how a business achieves its goals and objectives. Meanwhile, entities backed by strong institutions and/or foreign key shareholders / members

institutions as strategic investors are expected to have strong institutional acumen and provide higher comfort. Moreover, the scope includes the assessment and understanding of the owner's/member's thought process and decision making.

Financial Strength: Willingness and ability of key shareholders / members to provide extra-ordinary financial support or arrange funding through donations

3.4 Financial Strength: PACRA reviews the owners' track record and support provided to the business in normal circumstance. The owners' prior track record, commitment to the business along with the financial support extended to the venture in distressful times, is also considered. Thus, ongoing support is considered more likely in these cases. For entities, the most usual source of support is from the owners (institutional support), when a corporate parent has a financial sector subsidiary. However, for large financial institutions, external support from government / regulatory becomes more important. Here, PACRA gives due importance to, i) the behavior of the owners to provide timely and comprehensive support in times of need in the past, ii) prospective view of key shareholders, incase such need arises, iii) other businesses of shareholders, and iv) the level of commitment of the major shareholder. In case of no explicit commitment, PACRA attempts to form a view on availability of likely support. The scope for other businesses of owners includes overall profiling of the key owner in the context of identifying financial resources they have, outside the entity.

3.4.1 In case of Non-Bank MFCs, the members are not taking any monetary benefit from the entity's available funds. Hence, financial support in the form of members backing, will be from other sources, if needed. As an alternative to equity funding, the Non-Bank MFC can raise donations or funding from different institutions/multilaterals/individuals in Pakistan and abroad. Herein, ability of key member/s to get external support from government, regulators, international and local donors/ lenders become more important.

Table 1. Information Required on Owners/Members

- Shareholding structure (if applicable)
- Shareholding agreement (if applicable)
- Succession plan (documented or otherwise)
- Current and historical structure of members/ownership
- Details of members/owners
- Member's/owner's resourcefulness and acumen

4. Governance

Board Structure: Composition of board in terms of size, independence and committees

4.1 Board Structure: This comprises assessment of board on various criteria including overall size, presence of independent members and gender diversity, duration of board members' association with the MFP, overall skill mix of board members and structure of board committees. Size of the board may vary as per the scope and complexity of the operations of the MFP. While a very small board may not possess the desired diversity in terms of member skills and areas of expertise, similarly, reaching a decision in an effective and efficient manner may not be possible in case of a large board. A healthy composition of board includes the presence of independent/non-executive members having limited relationship with members and management of the MFP. Meanwhile, same individual holding chairperson and CEO positions is considered weak governance practice. The chairperson is expected to have a non-executive role. Compliance with the code of corporate governance and international best practices is also examined. PACRA evaluates number of board committees, their structure and how these committees provide support to the board. A board with higher number of board members should have higher number of committees in place to assist in performing its role. Lastly, PACRA also takes into account voting rights reserved for female and independent directors.

Social Impact Monitoring: *PACRA reviews structure through which the social impact indicators are set, the means deployed for attaining these objectives, and benchmarks identified to monitor progress. Here, special emphasis is given to the board's approach towards determining effectiveness of social impact. PACRA analyzes the quality and frequency of board agenda, board packs, and MIS shared with the board and how social impact and other parameters are discussed.*

Board Profile: Relevance and diversity of board skills and experience

4.2 Board Profile: PACRA collects information regarding profile and experience of each board member. This helps in forming an opinion about the overall quality of the board. A fair number of board members are expected to have relevant experience. However, diversity in terms of knowledge, background, experience, gender and perspective is also viewed positively. Certain board committees may require specialized expertise, such as audit committees. Greater proportion of Board members who have received directorship trainings is viewed positively.

Board Effectiveness: Extent to which board properly discharges its responsibilities

4.3 Board Effectiveness: In PACRA's view, the role of the board is to work with management in steering the MFP to meet its objectives (both social impact and sustainability) and to provide critical and impartial oversight of management's performance. PACRA analyzes the type and extent of information shared with board members and quality of discussions at board and committee levels. Effective oversight requires frequent sharing of precise information covering various aspects of business and market development. Meanwhile, PACRA also reviews the number of board meetings held during the year as these should be justified with the number of issues/matters arising. Board members' attendance, participation and deliberations in meetings is important. These are gauged by viewing board meeting minutes.

Transparency: Quality and extent of financial and non-financial information disclosure to stake holders

4.4 Transparency: Quality of governance framework is also assessed by the procedures designed by the board to ensure transparent disclosures of financial and other information. This can be achieved through: i) ensuring independence of the audit committee, ii) strengthening the quality of internal audit function, which may be in-house or outsourced, and iii) improving quality of external audit by engaging auditors which are included in the State Bank of Pakistan's panel of auditors and/or have a satisfactory QCR rating.

Accounting Quality*: PACRA reviews the quality of a MFP's accounting policies as reflected in its notes to accounts, auditors' comments and other disclosures which are part of its financial statements. Adherence to accounting standards is assessed, particularly for unlisted concerns. As part of the regulatory framework, Pakistan is transitioning to IFRS 9 reporting for financial institutions. SBP has issued detailed guidelines and timeframe for financial institutions, including MFBs, to adopt the new reporting standards. Similar guidelines are issued by SECP for NBFCs. This shift entails that the financial institutions would adopt and report under the new expected credit loss model (ECL) method. This is expected to enhance transparency in classification of financial assets (loans, investments, etc.) and certain other disclosures by financial institutions. PACRA will incorporate these changes in its evaluation of MFP's once they are implemented.*

Quality of disclosures: *A well-established information system is required for adequate disclosures. The characteristics of quality information includes timeliness, disclosures beyond the minimum regulatory requirements to improve transparency and consistency of such disclosures.*

Table 2. Information Required on Governance

- Profile of BoD members
- Details of committees including TORs
- Minutes of the board meetings
- Information packs for the Board (MIS)
- External and Internal auditors' detail

5. Management

Organizational Structure: Alignment of organogram with size and business requirements

5.1 Organizational Structure: The assessment of management starts with PACRA conducting an in-depth analysis of organizational structure of the MFP. On a standalone basis, PACRA looks into the hierarchal structure, reporting lines and coherence of the team. However, PACRA also places the organizational structure of the MFP's relative universe for comparison in order to form an opinion on the optimal structure within the sector in context of its complexity. Number of management committees established and their roles to monitor performance and assure adherence to the policies and procedures are looked at to ascertain effectiveness of the structure.

Management Team: Relevance and diversity of skills, knowledge and experience of top management

5.2 Management Team: Analysis of management includes evaluating experience profile of key individuals, management's track record in terms of building up sound business mix, maintaining operating efficiency and strengthening the MFP's market position. Although judgment about management is subjective, performance of MFP over time provides a more objective measure. PACRA analyses the quality and credibility of management's strategy, examining plans for internal or external growth. When evaluating future plans, significant credit is given for delivering on past projections and envisioned results. Loss of key personnel, particularly members of senior management, can have potentially adverse effects on overall standing of the MFP relative to peers. Hence, HR turnover is reviewed to determine the stability of critical staff, with particular focus on key departments. In addition, MFP's human resource policies are also reviewed to gauge its emphasis on retaining and recruiting vital staff.

Field Staff: *In case of MFPs, the mid- and low-tier staff is critical in maintaining a strong asset quality as they hold the relationships with borrowers and any misconduct on their part may cost deterioration to the institution's asset quality. Thus, their ability to retain good field staff and aligning their individual goals with entities social mission 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.*

Key-person Risk*: Key-person risk emanates when an MFP is heavily reliant on an individual, or a limited number of individuals, who are accepted as the key holder(s) of important intellectual capital, knowledge or relationships. PACRA attempts to identify the extent to which an MFP is dependent on the expertise of such individual(s) and how succession is ensured within the management team.*

Management Effectiveness: Systems and tools in place to measure and monitor business

5.3 Management Effectiveness: PACRA conducts a qualitative review of management systems and technology infrastructure to assess management effectiveness. One of the key tools available to management to effectively run an organization is the information it gathers and uses for decision making. It is critical that information available to management be concise, clear and timely, so it can performance, internal KPIs and track record of management

be interpreted and understood it and respond accordingly. An important part of this analysis is looking at the MFP's MIS. PACRA further assesses whether management has developed any critical success factors to evaluate performance of various business segments, and their efficacy. Management meeting minutes are also reviewed, wherever available, to assess the quality of discussion.

MIS: *System generated – real-time based – MIS reports add more efficiency in decision making whether related to operational, financial, social or strategic issues. PACRA evaluates the quality and frequency of the MIS reports used by the management team to ascertain that decision-making within the MFP is information-based.*

Risk Management Framework: Management of credit, market, operational and other risks

5.4 Risk Management Framework:

This includes an analysis of the MFP's appetite for risks and the systems in place to manage these risks. PACRA examines the independence and effectiveness of the risk management function, the procedures and limits that have been implemented, limits setting authority and the degree to which these procedures are adhered to. PACRA endeavors to assess senior management's understanding of and involvement in risk management issues and examines the reporting lines in place.

Credit Risk Management: *A key attribute of a well-run institution is that it establishes clear parameters around risk appetite and expected returns (profit) for risks being taken. Asset quality indicators are a primary tool to assess the level of risk being taken. The level of asset quality indicators will be viewed and the adequacy of risk management to determine how the risk return equation may evolve in different phases of the business cycle.*

Market Risk Management: *The vast majority of MFPs are subject to structural interest-rate risks due to the longer nature of their liabilities compared with the duration of their assets. PACRA reviews the asset and liability management strategy to assess the risk appetite of the institution. Board and management policy limits are typically expressed as earnings at risk limits. These are usually evaluated along with reports from management systems. Moreover, MFP's investment policy is reviewed. When viewing the investment policy, PACRA analyzes the management plans on managing its investments/placements. Here, exposure limits for each investment type – in relation to sectors, institutions – is considered important. PACRA also reviews relevant guidelines i.e., how well they are documented and their level of clarity and transparency. Clearly defined investment guidelines which offer long-term visibility of business profile are viewed positively*

Operational Risk Management: *Our analysis of operational risk focuses on a number of issues, including (a) MFP's definition of such risks (b) operational risk culture (c) the development of its approach to the identification and assessment of key risks (d) data collection efforts; and (e) overall approach to operational risk quantification and management.*

Reputation and Other Risks: *Reputation risk may emanate from operational problems or failure in any risk management systems. It may be difficult to evaluate but could adversely affect an institution's rating in cases where it is significant. In addition to reputation risk, any regulatory non-compliance may lead to legal risk with potential ramifications as well.*

Technology Infrastructure: Extent of technological integration essential to

5.5 Technology Infrastructure:

With the growth of technology-based solutions to enhance service standards and delivery processes, technology has to be an important part of any forward-thinking MFP's strategy. The advent of technology in microfinance sector is needed to not only scale up the access to finance but also attempt to ensure provision of financial services to the remotest and far-flung areas, hence increasing the outreach. PACRA analyses the adequacy of technology maintain efficiency and controls

infrastructure in place and its effectiveness in terms of efficiency and controls. Disaster recovery and business continuity plan and system to provide strong back up are considered. PACRA evaluates the efforts of MFPs to inculcate technology-based solutions to remain competitive and enhance risk controls.

Table 3. Information Required on Management

- Latest organogram
- Profile of senior management
- Redundancy pattern
- MIS reports and write-up on technological infrastructure
- Management committee minutes
- MFP's policies and SOPs

6. Social Impact

Social Performance Management System: Clarity in social mission, efforts to achieve it, alignment of decision-making and policies with social mission, measures to benchmark and capture social performance

6.1 Social Performance Management System: Social performance management system refers to the degree of robustness an MFP demonstrates in implementing its identified social mission. Analyzing social performance management is a key element of our rating approach. Effective Social Performance Management (SPM) is a continual process of translating social mission into practice. The assessment of social impact starts from PACRAs deliberation on strategy and systems in place to achieve its social mission. Further, our assessment includes a review of how the MFP defines and communicates its social mission to all stakeholders, internal and external. It includes how well the mission are communicated and documented within the entity through its policies and procedures. Herein, PACRA also reviews whether social considerations influence the decision-making process. Another key factor to determine social performance management system is training of field staff and alignment of staff recruitment and incentives with its social mission. PACRA also reviews the MIS and systems that the management has put in place to monitor and capture its social performance.

Client Protection & Social Responsibility: Design and communication of product features to clients, compliant resolution, client feedback

6.2 Client Protection & Social Responsibility: Client Protection is a central focus for the microfinance sector that aims to work with low income, poor, and more vulnerable people who are particularly at risk. Here, PACRA reviews the design of products and services and whether these are structured to meet targeted customer's need. Herein, ease of access, due diligence and transparency of program is pivotal to our assessment. PACRA also reviews steps taken by the MFP to ensure that terms and conditions of the loans are clearly stated and understood by the customer, especially loan pricing. This prevents misleading or mis-selling by the MFP to its customers. In this regard, PACRA reviews the contract/application signed by the customers, information disclosed to customers and to what extent MFP educates it customers regarding the terms and pricing being charged. Meanwhile, MFP's criteria for over-indebtedness a key assessment factor for us. Thus, an MFP's risk evaluation systems should be able to appraise the ability of such borrowers to repay on time. Lastly, PACRA evaluates how effectively an MFP monitors customer complaints and resolution approach towards the same. Relevant documentation of mechanisms to monitor client feedback is reviewed for quality, appropriate frequency, and use of findings by the management to improve products and services.

Outreach: Focus on vulnerable clientele by gender and geographic location, client retention

6.3 Outreach: PACRA analyzes outreach by reviewing breadth and depth of MFPs operations and coverage. Our approach towards portfolio analysis covers outreach to vulnerable communities, mix of women clientele, loan and saving size offered by an MFP and diversification of product slate. The

Quality of Services: Mix of financial and non-financial product offerings, product design adaptation and suitability

analysis uses MIS reports that show distribution of the clients by gender, by economic activity or socio-economic status and by rural or urban geographical area. The analysis may also use details on the distribution of the portfolio according to the type of business financed.

6.4 Quality of Services: Social impact is also assessed by quality of services provided by an MFP. Here, PACRA analyzes the MFP's ability to develop and adapt product offerings to different client segments, their financial needs and opportunities. A mix of non-financial products and services offered by an MFP is also an important consideration to assess quality of services. Furthermore, PACRA reviews the capacity of the MFP to reference relevant market intelligence, and provide convenient services with flexibility in terms of repayment, term and amount at a reasonable cost. The analysis includes the extent of client uptake of different types of products and services.

Table 4. Information Required on Social Impact

- Social mission and defined goals
- Details of products and services offered
- Sample contract/application signed by the customers
- Information disclosed to customers
- Customer Awareness Campaigns and framework
- Quality monitoring mechanism
- Client satisfaction surveys and compliant resolution
- Social audit report

7. Business Sustainability

Operating Environment: Extent to which economy, industry dynamics, regulatory regime and unforeseen events can impact core business

7.1 Operating Environment: The process for anchoring rating of an MFP builds on PACRA's understanding of operating environment. A key component of our analysis is the extent to which external conditions can have a meaningful influence on MFP's social and credit profile. We identify the risks and challenges identified by the local players and further see whether the local players have established effective mitigant's against those risks and taken due measures to meet the challenges. This exercise helps PACRA to form a view on industry's significance in the operating environment of the country, its attractiveness to entrepreneurs, barriers to entry, and the power of suppliers and customers.

7.1.1 The Operating Environment sub-component captures relevant economic strength, industry dynamics, regulatory environment, relative position. In some cases, these conditions can over time have as much, if not more, of a bearing on MFP's long-term sustainability of their own operations. A competitive environment can have a profound impact on its financial and operating strategy as well as on current and future profitability.

Economic Strength: *Economic strength of an economy provides critical indications of a sovereign's resilience to external shocks. While analyzing economy, PACRA evaluates economic policies, GDP growth, ability to generate sufficient revenue to service debt, performance of important sectors in the economy and potential credit demand.*

Industry Dynamics: *While conducting the analysis, PACRA takes a view on the industry alone, independent of the market players. PACRA explores the possible risks and opportunities in an MFP resulting from social, demographic, regulatory and technological changes. It considers the effects of geographical diversification and trends in industry expansion or consolidation required to maintain a competitive position. PACRA determines a MFP's rating within the context of its industry fundamentals.*

Regulatory Environment: *PACRA's evaluation of the regulatory system involves evaluation of criterion related to capital and other countercyclical measures to absorb risk and the extent of regulatory supervision and changes in response to the macro environment; key norms (such as Non-Performing Asset (NPA) recognition, provisioning, capital adequacy, liquidity, benchmark lending rate and expansion) and prospective regulatory changes.*

Market Share: *There is a positive correlation between a MFP's absolute and relative size and its market position and brand value. The large entities exercise greater power over the pricing, while ensuring commensurate profits. Small entities struggle to obtain business; and with less flexibility in the cost structure, their profits remain low.*

Growth Trend: *While evaluating the size, PACRA looks at the rate of growth. Growth is important as it ensures that the MFP continues to have the ability to meet the industry's benchmarks. As the industry grows, it uplifts the scale of its operational context. To lag the industry's growth trend means to remain short on these avenues, putting pressure on the market position.*

Sustainability:
Operational cost control, provisioning, profitability, ability to scale

7.2 Sustainability: MFPs 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 funding 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 MFPs. Therefore, MFPs 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.

7.2.1 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 MFP 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.

7.2.2 Where necessary in its rating analysis, PACRA makes adjustments to the MFP's reported income statement figures, so that financial performance indicators are comparable across similar entities.

Franchise / Brand Value: *The strength of a franchise determines its capacity to grow while maintaining a reasonable cost to income ratio and profitability, thus providing resilience of earnings. PACRA evaluates the franchise strength in terms of scale of operations and market share for various activities, performance and strengths relative to competition, complexity of key segments, diversification across various performance metrics like branches, advances, liabilities, sources of other income etc and access to special Government support or privileges relative to other MFPs. A strong franchise is expected to result in a granular asset and liability base. PACRA also considers the brand recognition and life of institution for its franchise strength analysis.*

Strategy:
Management's long-term plans and projections, and their viability

7.3 Strategy: PACRA evaluates the strategy of the management and the viability of designed path to reach to the goal. 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.

Table 5. Information Required on Business Risk

- Industry information for Loan portfolio, number of borrowers
- Projection of two years, with details of underlying assumptions
- Type of License
- Outreach, Market share, details pertaining to operations within a particular districts, target market, strategy for future, key figures (agents, number of transactions)
- Branchless Banking Operations

***Event Risk**: Incorporating the risk of unforeseen events into a MFP's rating opinion is challenging, given their unpredictable nature. These events may be external (e.g., M&As, regulatory changes or a natural disaster) or may be internally driven (e.g., unrelated diversification or strategic restructuring) and can lead to substantial rating changes. PACRA applies its analytical judgment in assessing the likelihood of such occurrences, insofar as may be possible, and assesses the MFP's track record, expertise of management team and level of financial discipline to incorporate the same into its ratings.*

8. Financial Sustainability

Asset Quality:
Average loan size, Concentration in borrower base, PAR30, write-offs,

8.1 Asset Quality: Assessing asset quality is an important pillar of our assessment. Asset quality refers primarily to the credit quality of the MFP's earning assets, which comprises its advances and investments. In this regard, an MFP's overdue, 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.

8.1.1 MFPs' asset quality remains exposed to risk of undocumented earning streams vis-a vis the amount of loans obtained by the borrowers from different MFPs. 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 MFPs in this regard.

***Credit Risk:** Credit risk analysis includes review of credit portfolio at all levels. Portfolio is evaluated with respect to its size to establish market 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.*

***Market Risk:** For any MFP, the most typical form of market risk is interest-rate risk, given an MFP's structural design of its investment portfolio. However, our analysis also includes assessment of foreign exchange risks where these are material. Market risks will be higher for MFPs with sizeable investment portfolio or where cross-border activity or balance sheet structure gives rise to foreign-exchange risk. Generally, MFPs invest in government securities or place funds with financial institutions (mainly banks) to meet regulatory liquidity and other day-to-day requirements, if they have access funds. Herein, another important criterion is assessment of* *duration in conjunction with duration of its funding book.*

Liquidity & Funding: Portfolio maturity profile, availability of liquid assets, coverage against short-term liabilities

8.2 Liquidity & Funding: Another most important risk is liquidity management. PACRA analyses short-term vs long-term mix; the maturity profile of liabilities is seen in tandem with related asset base to analyze liquidity profile. The MFPs recovery of loan installments in a timely manner to ensure availability of funds is critical. The MFP's compliance to regulatory reserve requirements is a minimum. The presence of Asset Liability Committee or any other forum to ensure effective monitoring of liquidity mismatches is considered. MFPs finance their assets mainly through borrowings, grants and donation. PACRA analyzes funding mix as well as concentration levels in funding base. Due importance is given to management's strategy to keep risks related to funding at manageable level.

Capitalization: Equity cushion to absorb losses and remain compliant with regulatory requirements

8.3 Capitalization: Like in case of other financial institutions, PACRA considers MFPs 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. For MFBs, compliance with minimum capital requirement is a key licensing requirement and PACRA ensures that it is met at all times. It is important to note that due to the significance of capitalization as a financial risk parameter, PACRA uses CAR to assess capitalization of non-bank MFCs as well. The CAR is calculated based on financial information provided by the client. Where detailed financial information is not available or not provided, PACRA will strive to reach a proxy as close as possible to complete its assessment. Higher capital adequacy ratio (CAR) is factored positively into the rating opinion as it reflects greater ability to withstand unforeseen losses and withstand shocks in business. PACRA sees the ability of the institution to generate capital from internal sources.

Credit Enhancement: *The MFP that carry third party commitment to make good an amount obligated to the lenders may provide additional support to its financial risk profile. In this case, in determining the impact on rating, key factors to assess are the financial profile of the third party and the extent of coverage – quantum and duration – it provides.*

Table 6. Information Required on Financial Risk

- Total available borrowing lines along with the average rates and repayment schedule
- Projected funds inflows vs projected liabilities
- Committed donor funds and avenues of funds
- Outstanding exposures amount along with segment wise/product-wise details of the classified advances portfolio
- Industry-wise concentration of exposures of MFP
- Top 50 Deposits and Advances
- Loans wise detail of classified advances portfolio (Top 20)
- Spread calculation

Social Impact and Performance Rating (SIP)	
An independent opinion on the ability of an entity to create intended social impact and achieve sustainable performance.	
Scale	**Definition**
SIP1	**Very Strong.** Very strong ability to create intended social impact and very high likelihood of sustaining performance.
SIP2++ **SIP2+** **SIP2**	**Strong.** Strong ability to create intended social impact and high likelihood of sustaining performance.
SIP3++ **SIP3+** **SIP3**	**Adequate.** Adequate ability to create intended social impact and adequate likelihood of sustaining performance.
SIP4++ **SIP4+** **SIP4**	**Inadequate.** Inadequate ability to create intended social impact and low likelihood of sustaining performance.
SIP5	**Weak.** Weak ability to create intended social impact and very low likelihood of sustaining performance.

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 some material identifiable event with indeterminable rating implications. 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 rating 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 surveill the opinion due to lack of requisite information

Harmonization A change in rating due to revision in applicable methodology or underlying scale.