RATING METHODOLOGY

MICROFINANCE INSTITUTIONS RATING

An independent rating opinion on relative ability of a Microfinance Institution to honor financial obligations

Contents

Scope
Ownership
Governance Framework
Management
Risk Management
Business Risk
Financial Risk
Rating Scale

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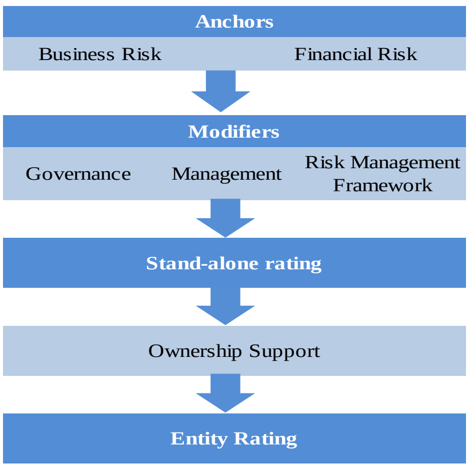
PAKISTAN CREDIT RATING AGENCY

1. Scope

1.1. Micro Finance Institutions (MFIs) in many ways are similar to other financial institutions, mainly banks, which primarily operate in lending business. In addition to carrying social objective of meaningful impact on overall society, many MFIs focus on business on self-sustainable basis so as to reduce/eliminate dependence on support i.e. subsidized loans, donations, grants etc. MFIs' primary business is to cater that part of society which is unserved or underserved due to low levels of their income and micro needs, which cannot be satisfied by large financial institutions like commercial banks mainly due to capability as well as business considerations. As amounts involved per borrower are significantly small but the volumes are large, MFIs operate in a different risk framework. This criteria document applies to MFIs, mainly Micro Finance Banks (MFB), which have access to commercial sources of funding, inter alia including, customer deposits, bank borrowings, commercial papers, and Term Finance Certificates.

1.2. The risk assessment process for MFIs comprises comprehensive analysis of the particular segment in which the entity operates, profile of the entity, and its relative position in its respective segment. Analyzing the profile of the entity includes comprehensive coverage of both quantitative and qualitative factors. In its assessment, PACRA's quantitative analysis helps to reach an anchor rating. This rating can then be affected by qualitative factors – the modifiers. After standalone rating is finalized, the entity's rating is concluded while incorporating sponsor's assessment of financial strength and expected / agreed level of support.



2. Ownership

Factors

- Ability to Support
- Willingness

2.1. Ownership structure and the objective of key shareholders are important to overall ownership assessment. PACRA analyzes the ability and willingness of the major shareholders to support the entity. This factor becomes more important for small size MFIs or MFIs that are facing operational losses, where entity is majorly reliant on key shareholders to meet capital requirements.

2.1.1 PACRA analyzes the ability and willingness of the major shareholders to support the entity both on a continuing basis, and support in times of crisis. Key factors that are considered for this purpose, inter-alia include, shareholding structure, financial strength of major shareholders, operational synergies with the major shareholders' other businesses, and the level of commitment of the major shareholder with the entity in providing capital support. Here, PACRA gives due importance to, i) the behaviour of the major shareholders to provide timely and comprehensive support in times of need in the past, and ii) prospective view of key shareholders, incase such need arises. In case of no explicit commitment, PACRA attempts to form a view on availability of likely support.

Information Required

- Shareholding Pattern
- Details of sponsors' other businesses
- Sponsor's financial information
- Past pattern of equity injection

3. Governance

Factors

- Board Structure
- Members' Profile
- Board Effectiveness
- Financial Transparency

3.1 Corporate governance structure of NBFCs is important to qualitative analysis. While analyzing governance framework, among others, four main factors are looked into, i) board structure, ii) members' profile, iii) board effectiveness, and iv) financial transparency.

3.1.1 Board Structure: This includes assessment of board as a whole. A healthy composition of board includes the presence of independent / non-executive members having limited relationship with the sponsoring group of the MFI. Moreover, diversification in terms of knowledge background and experience is considered positive. However, a fair number of board members should have financial sector experience. Here skills mix is evaluated at board level. Compliance of code of corporate governance is also examined.

3.1.2 Members' Profile: PACRA collects information regarding profile and experience of each board member. This helps in forming an opinion about the quality of overall board.

3.1.3 Board Effectiveness: An MFI's internal systems and policies are vital to establish a strong control mechanism. Thus PACRA conducts a qualitative review of policies and procedures, technology infrastructure including management MIS to assess the strength and comprehensiveness of these. System generated – real time based – MIS reports add more efficiency in performance monitoring. Robustness of control systems is considered a reflection of strong management. Number of management committees are established to monitor performance and assure the adherence to the policies and procedures.

3.1.4 Financial Transparency: Quality of governance framework is also assessed by the procedures designed by the board to ensure transparent disclosures of financial information. The board may establish controls to ensure transparency through strengthening the role of audit committee, the quality of internal audit function, and effectiveness of external audit.

Information Required

- Profile of board of directors
- Board meetings participation details
- Minutes of the board meetings
- Information packs for the boards (MIS)
- Compliance Report
- Audit Report

4. Management

Factors

- Organizational Structure
- Management Team
- Field Staff
- Effectiveness

4.1 Organizational Structure: Good quality management, effective systems and controls, and well-defined strategy are essential ingredients for a successful entity. As part of its assessment of management, PACRA conducts an in-depth analysis of organizational structure of the entity. PACRA looks into the hierarchal structure, reporting line, dependence of the management team on one or more persons, coherence of the team, and the independence of management from major shareholders.

4.2 Management Team: Analysis of management includes evaluating experience profile of key individuals, management's track record to date, in terms of building up sound business mix, maintaining operating efficiency and strengthening the entity's market position. 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 sticking to strategies. Although judgment about management is subjective, financial performance over time provides a more objective measure.

4.3 Field Staff: In case of MFIs, the mid- and low-tier staff is critical in maintaining a strong asset quality as they hold the relationship with the borrower and any misconduct on their part may cost deterioration to the institution's asset quality. Thus their ability to retain good field staff 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.

4.4 Effectiveness: An MFI's internal systems and policies are vital to establish a strong control mechanism. Thus PACRA conducts a qualitative review of policies and procedures, technology infrastructure including management MIS to assess the strength and comprehensiveness of these. System generated – real time based – MIS reports add more efficiency in performance monitoring. PACRA evaluates the quality and frequency of the MIS reports used by the department heads. Robustness of control systems is considered a reflection of strong management. Number of management committees are established to monitor performance and assure the adherence to the policies and procedures.

Information Required

- Latest Organogram
- Profile of senior management
- HR & Remuneration policies for all tiers
- Training details
- Redundancy pattern
- MIS reports
- Management meeting minutes

5. Risk Management

Factors

- Risk Management Framework
- Operational Risk
- Code of Conduct
- Technology Infrastructure
- Branchless Banking
- Credit Risk

5.1 Risk Management Framework: This includes an analysis of the entity's appetite for risk and the framework it has in place for managing risk. PACRA examines the independence and effectiveness of the risk management function, the procedures and limits employed, and the degree to which these procedures and limits are abided by. While evaluating the risk management framework, PACAR also evaluates adherence of the entity with the applicable code of conduct, fulfilling all the regulatory requirements. We assess the senior management's understanding of and involvement in risk management issues, and examine the reporting lines in place. Key risks that can affect the profile of the entity include credit, market, and liquidity risks.

5.1.1 Operational Risk: MFIs internal systems and procedures are important to manage operational risk. PACRA attempts to measure the adequacy of these and whether these are implemented with a perspective to manage potential operational risks that may cause due to relatively high human involvement in case of MFIs versus other financial institutions. Moreover, PACRA understands that oversight of top- management, the procedures they have employed to avoid staff collusions with the customers, and design and implementation of related management information systems (MIS) are important factors in managing operational risk.

5.1.2 Code of Conduct: Regulatory framework particularly for MFBs is considered strong. MFBs come under the purview of State Bank of Pakistan - the regulator. SBP monitors MFBs through separate regulations. In addition, SBP supports small entities in microfinance business in funds mobilization by issuing microfinance credit guarantee scheme (MCGF).

5.2 Technology Infrastructure: With the growth of technology-based opportunities to enhance service standards and delivery processes, technology has to be an important part of any forward-thinking MFI'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 evaluates the efforts of MFIs to not only constantly examine options for technology-based solutions, but also subject them all to rigorous cost/benefit and risk analysis. Digitalization of banking procedures is very critical for the future growth of MFIs.

5.2.1 Branchless Banking: With recent growth in branchless banking (BB) segment by microfinance banks (MFBs), PACRA evaluates BB operations in detail. In addition to surveilling its profitability, PACRA gives importance to, i) Agent networks, ii) Regulatory reporting, and iii) related Systems and controls. Besides adding diversity to the revenue stream, it has been observed that BB operations can generate low-cost deposits; thus further strengthening the profitability.

5.3 Credit Risk: Importance of credit risk is significant to any lending institution. As MFI's type of customers is different i.e. micro-borrowers, it entails different approach towards credit risk assessment. Micro-borrowers tend to have little or no documentation. Moreover, the tenor of loans is usually short, one year or less. Thus an MFI's risk evaluation systems should be able to appraise the ability of such borrowers to repay on time. The relationship of MFI's loan staff with the borrower himself or with the people around him is critical to assess the means of the borrower for repayment of loans.

5.3.1 The review of credit risk involves assessment of policies and procedures before taking an exposure, post-disbursement monitoring mechanism, criteria for ongoing surveillance, and recovery process. 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.

Information Required

- Policies of Risk management department
- Internal control SoPs
- Importance of technology in the strategy, quality and use of current technology infrastructure and associated risks
- Lending process – controls implemented, levels of approvals
- Applicable regulations for MFIs and adherence with all the requirements
- Branchless Banking operations, outreach, market share, target market, strategy for future, key figures (agents, deposits in amount and volume, number of transactions)

6. Risk Management

Factors

- Asset Quality
- Market Risk

6.1 **Asset Quality:** Assessing asset quality is an important pillar of credit risk. In this regard, an MFI'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.

6.1.1 MFIs' asset quality remains exposed to risk of undocumented earning streams viz-a viz the amount of loans obtained by the borrowers from different financial institutions. 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 MFIs in this regard.

6.2 **Market Risk:** Microfinance institutions in normal circumstances only invest in government securities to meet regulatory statutory liquidity and cash reserve requirements. Moreover, regarding equity investments, microfinance institutions are only allowed investment in limited sectors. This limits overall exposure of MFIs to market risk.

Key Parameters

- Percentage of Secured Loan Book
- Concentration – Top 20 borrowers / total borrowers
- Product concentration (highest product portfolio as percentage of total loan portfolio)
- Loan Size (Average Industry Loan Size compared to Entity's loan size)
- Infection Ratio
- NPL Coverage Ratio
- Net NPL / Equity
- Percentage of investment in Government Securities,
- Bank Deposits and Placements / total deposits
- Net Non-Earning Assets / Equity

Information Required

- Outstanding exposures amount along with segment-wise/product-wise details of the classified advances portfolio
- Industry-wise concentration of exposures of entity
- Party wise detail of classified advances portfolio (Top 20)
- Industry loan portfolio

7. Business Risk

Factors

- Industry
- Performance
- Sustainability

7.1 **Industry:** Industry analysis is a key component of credit risk analysis, as entities do not operate in a vacuum. Economic environment, regulatory policies, business dynamics, energy situation, security threats, and so on, all play a significant role that can impact the entity's performance. Hence, it is paramount to be fully cognizant of the industry behavior. It also includes analyzing risks generated by competition levels in the industry so that an MFI's strengths and weaknesses can be seen in comparison to other market players.

7.1.1 7.1.1 Analysis of market share is an important factor in establishing relative position of the institution. PACRA analyzes the institution's proximity to its key areas of operations, outreach (e.g. no. of districts covered), number of customers it serves and market share in overall customers of the industry, potential customer base that is yet to tap, no. and type of products on offer, and pricing policy vis-à-vis other players operating in the same markets.

7.2 Performance: MFIs 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 deposits 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 MFIs. Therefore, MFIs 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 MFI 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 MFI's reported income statement figures, so that financial performance indicators are comparable across similar entities.

7.3 Sustainability: 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.

Key Parameters

- Market Share with respect to Gross Loan portfolio
- Market Share with respect to number of Borrowers
- Market Share with respect to total Deposits
- Portfolio Yield compared to Industry portfolio yield
- Investment Yield compared to 6M Treasury bill rate average
- Operational Self Sufficiency (Markup earned and Other income as a % of markup expense, other non-interest markup expenses and provision expense)
- Revenue Diversification (Markup earned on Advances, investments and bank accounts as a % of Customer deposits and Financial Institutions deposits)

Information Required

- Financial Statements (Annual & Quarterly for 3 years)
- Industry information for Loan portfolio, depositors, number of borrowers
- Type of License
- Projections for 3 years

8.Financial Risk

Factors

- Funding
- Liquidity
- Capitalization

8.1 Funding: MFIs finance their assets mainly through deposits – micro savings as well as corporate deposits, in addition to other funding sources, where available. PACRA analyzes funding mix (short-term vs long-term, and retail vs institutional etc.) as well as concentration levels in funding base. A large pool of micro savers is considered stable in comparison to large institutional deposits. Due importance is given to management's strategy to keep risks related to funding at manageable level.

Key Parameters

- Individual Depositor / Total Deposits
- Current Deposit / Total Deposits
- Sponsor Deposit / Total Deposits
- Deposit Size (Average Industry deposit size compared to entity's deposit size)
- Funding Diversification (Deposits / Deposits, Borrowings & Grants)
- Cost of Funding

8.2 Liquidity: 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. PACRA believes higher asset turnover as compared to liabilities is good for liquidity management. The bank's compliance to regulatory reserve requirements is a minimum. The presence of Asset Liability Committee is essential to ensure effective monitoring of liquidity mismatches.

Key Parameters

- Liquid Assets as a % of Deposit & Borrowings
- Liquidity Mismatch (weighted average maturity of liabilities)

8.3 Capitalization: Compliance with minimum capital requirement is key to obtain license. For MFBs, the requirement for capital increases with the operational scale i.e. district, provincial, or national. Like in case of other financial institutions, PACRA considers MFIs 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.

8.3.1 While analyzing capitalization, PACRA sees higher capital adequacy ratio positively. As ratings are not point-in-time, PACRA sees the ability of the institution to generate capital from internal sources. In case of MFBs, dividend payout policy is considered important to evaluate as it may have a significant bearing on potential capital formation rate. Additionally, PACRA considers compliance with regulatory requirements important for MFBs.

Key Parameters

- Equity to Assets
- Free Capital to Adjusted Assets
- Capital Adequacy Ratio
- Internal Capital Generation (Net Income after dividend as % of last years equity)

Information Required

- Total available money market lending and borrowing lines along with the average rates
- SBP returns filed including i) Reserve Ratio Requirements', and ii) Capital Adequacy Statement
- Details of 50 largest depositors along with their maturity profile and profit rates
- Spread Calculations
- Industry information for Deposit portfolio

CREDIT RATING
SCALE & DEFINITIONS

Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

LONG TERM RATINGS

AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments.
AA+ **AA** **AA-**	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ **A** **A-**	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ **BBB** **BBB-**	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ **BB** **BB-**	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ **B** **B-**	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC **CC** **C**	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

SHORT TERM RATINGS

A1+: The highest capacity for timely repayment.

A1:. A strong capacity for timely repayment.

A2: A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.

A3: An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.

B: The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.

C: An inadequate capacity to ensure timely repayment.

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, a) some material identifiable event and/or b) deviation from expected trend. 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 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

Disclaimer: PACRA's ratings are an assessment of the credit standing of entities/issue in Pakistan. They do not take into account the potential transfer / convertibility risk that may exist for foreign currency creditors. PACRA's opinion is not a recommendation to purchase, sell or hold a security, in as much as it does not comment on the security's market price or suitability for a particular investor.