Methodology- Microfinance Institution (MFI)

WCRCL's credit rating is a representation of its opinion on the relative credit risk associated with the Microfinance Institution. WCRCL arrives at this opinion by conducting, inter-alia, a detailed evaluation of the qualitative and quantitative factors, namely: Profile, Ownership, Governance, Management, Business Risk and Financial Risk. This helps in assessing the future financial performance in various scenarios. While several parameters are used, the relative importance of each of these qualitative and quantitative criteria can vary across microfinance institutions, depending on its potential to change the overall risk profile.

Scope: Micro Finance Institutions (MFIs) in many ways are similar to other MFIs, 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 MFIs 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.

Rating Framework: WCRCL bases its analysis of Microfinance institutions on a number of quantitative and qualitative factors, the most significant of which are:

- Profile
- Ownership
- Governance
- Management
- Business Risk
- Financial Risk.

No one factor has an overriding importance or is considered in isolation and all the factors are reviewed in conjunction. The risk assessment process for MFIs comprises comprehensive analysis of the particular segment in which the MFI operates, profile of the MFI, and its relative position in its respective segment. Analyzing the profile of the MFI includes comprehensive coverage of both quantitative and qualitative factors. In its assessment, WCRCL'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 MFI's rating is concluded while incorporating sponsor's assessment of financial strength and expected / agreed level of support.

While our rating process does not include an audit of a MFI's financial statements, it does examine the control environment to establish to which extent they accurately reflect a MFI's financial performance and balance sheet integrity. We make adjustments where necessary to make a MFI's financial data comparable with those of its peers. In order to carry out adequate analysis of a particular MFI, it is helpful to establish a "peer group" of comparable MFIs. Short-term and long-term ratings are based on a MFI's fundamental credit characteristics, a correlation exists between them (see WCRCL's Criteria document "Correlation between Short-term and Long-term Rating Scale").

GOVERNANCE

WCRCL's assessment of governance involves both systematic analyses of governance data and information, and the more contextual reviews of a MFI's governance practices. WCRCL considers four main factors while assessing the board structure of a MFI: (i) board structure, (ii) members profile, (iii) board effectiveness, and (iv) financial transparency.

Board Structure: This comprises assessment of board on various criteria including overall size, presence of independent members, and duration of board members' association with the MFI, overall skill mix and structure of board committees. Size of the board may vary as per the scope and complexity of the operations of the MFI. Compliance with the code of corporate governance is also examined. WCRCL also examines the independence of governance from major shareholders. Lastly, WCRCL evaluates number of board committees, their structure, and how these committees provide support to the board. A board with higher number of members should have higher number of committees in place to assist in performing its role.

Members' Profile: WCRCL collects information regarding profile and experience of each board member. This helps in forming an opinion about the quality of overall board. Moreover, diversification in terms of knowledge background and experience is considered positive. However, a fair number of board members should have related experience.

Board Effectiveness: In WCRCL's view, the role of the board is to work with management in steering the MFI to its performance objectives and to provide critical and impartial oversight of management performance. WCRCL analyzes the type and extent of information shared with board members, and quality of discussions taking place at board and committee levels. Effective oversight requires frequent sharing of detailed information covering various aspects of business and market development.

Transparency: Quality of governance framework is also assessed by the procedures designed by the board to ensure transparent disclosures of financial and other information.

MANAGEMENT

Good quality management, effective systems and controls, and well-defined strategy are essential ingredients for a successful MFI. The assessment of management starts with WCRCL conducting an in-depth analysis of organizational structure of the MFI. On a standalone basis, WCRCL looks into the hierarchal structure, reporting line and coherence of the team. However, WCRCL also places the organizational structure in the MFI's relative universe for comparison in order to form opinion of optimal structure within the sector in context of its complexity. Number of management committees are established to monitor performance and assure adherence to the policies and procedures. WCRCL measures the effectiveness of the MFI by forming an opinion on the quality of management committees. WCRCL conducts a qualitative review of management systems and technology infrastructure to assess management effectiveness. A key measure of management effectiveness is its track record of delivering on past projections and sticking to strategies. One of the key tools available to management to effectively run an organization is the information provided to it. It is critical that information available to management be concise, clear and timely, so it can be interpreted and understood, and the management can respond accordingly.

RISK MANAGEMENT FRAMEWORK

This includes an analysis of the MFI's appetite for risks and the systems in place to manage these risks. WCRCL 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. WCRCL endeavors to assess senior management's understanding of and involvement in risk management issues and examine the reporting lines in place.

Credit Risk: 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 and volatility of asset quality indicators will be viewed in the context of returns achieved and the adequacy of risk management to determine how the risk return equation may evolve in different phases of the business cycle. Indications of poor asset quality or credit risk management will typically lead to lower ratings, whereas strong asset quality and credit quality are positively factored into a rating decision.

Market Risk: WCRCL's analysis of market risk incorporates structural risks (such as interest-rate risk management) and/or trading risks when present. The vast majority of MFIs are subject to structural interest-rate risks due to the shorter nature of their liabilities compared with the duration of their assets. Many MFIs are also exposed to structural foreign exchange risk. WCRCL 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. Market risk on its own may not be a rating driver; however, poor market risk management or aggressive market risk-taking without mitigants would likely pressure a MFI's ratings.

Operational Risk: Operational risk has historically been defined as all other risks other than market, credit and liquidity risk. In the context of Basel II and Basel III, definition of operational risk is: "the risk of loss resulting from inadequate or failed internal processes, people and systems or external events".

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.

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, WCRCL takes comfort from stringent regulatory requirements. Post-delinquency, the level of reserves maintained for provisioning requirements is considered important.

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.

Funding Risk: MFIs finance their assets mainly through deposits – micro savings as well as corporate deposits, in addition to other funding sources, where available. WCRCL 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.

Liquidity Risk: Another most important risk is liquidity management. WCRCL analyses short-term vs long-term mix; the maturity profile of liabilities is seen in tandem with related asset base to analyze liquidity profile. WCRCL believes higher asset turnover as compared to liabilities is good for liquidity management. The MFI's compliance to regulatory reserve requirements is a minimum. The presence of Asset Liability Committee is essential to ensure effective monitoring of liquidity mismatches.

Capitalization Risk: 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, WCRCL considers MFIs capitalization

Social Impact Study: In order to review the achievement of the institutional objectives it is important to judge the impact of the activities of the MFI. During impact study, CRISL considers impact on sector, society, employment generation, gender inequality, health awareness, children's education, members' education, family planning, sanitation, household decision making, family welfare services, empowering women in the society, economic emancipation that is relevant for the specific institution.

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