

Criteria Report

Microfinance Institutions — Factors in Risk Assessment

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Summary

This report aims to highlight those elements of a microfinance institution's (MFI) risk profile that Fitch Ratings evaluates when assigning international and national credit ratings to MFIs, and how these may differ from those of a conventional bank.

MFI demand for credit ratings has increased in recent years, driven by their growing funding needs to support rapid expansion. Although the microfinance sector is populated by a large number of relatively small MFIs, some "top-tier" MFIs have emerged and become internationally active. These "top-tier" MFIs, the capital market investors interested in microfinance investments, and increased regulatory requirements in some countries, have driven an increase in demand for credit ratings.

Fitch does not believe that a separate rating methodology or rating scale is needed for MFIs. Although important differences exist between MFIs and conventional banks that must be understood, these can be incorporated within the existing rating framework.

When assigning ratings to MFIs, the same process is followed as outlined in Fitch's Bank Rating Methodology. The analytical process for MFIs and conventional banks consider broadly the same factors. However, due to the specialised scope of MFI activities, their specific ownership profiles, legal structures and operating and regulatory environments, certain risks are of different significance, as reflected, in the case of international ratings, in Fitch's Individual and Support ratings. These include close analysis of risk management - with particular focus on credit and operational risks in MFIs- and consideration of an MFI's specific funding and liquidity profile, its asset size and portfolio diversification, and capital adequacy. In addition, management quality, corporate governance, transparency/disclosure and the likelihood of support are given particular consideration.

Although absolute size, a relatively short track record and a lack of diversification are important and would weigh negatively on ratings, MFIs do display certain positive features from a rating perspective, in particular: good asset quality and loan book diversification by customer; stable financial performance supported by wide interest margins; and some evidence of resilience to wider macro-economic shocks.

Transformation risk is an important area of focus, and depending where the MFI is in its evolution, can be a significant risk factor. This evolution affects an MFI's legal/organisational structure and funding/capital profile, and how the risks in these areas need to be managed. Funding high growth rates is pushing MFIs to change their legal structures to become banks, expand their product ranges and become increasingly leveraged, compete directly with conventional banks for customers and skills, and as a result become potentially more correlated with the wider economy. How this process is managed and whether there are committed shareholders or stakeholders to support this process are important rating considerations.

In emerging markets there are also the added uncertainties relating to the potential for outside intervention (political) and exposure to regulatory risks.

Assessing support for financial institutions is an important feature of Fitch's rating process. In this respect there are additional dimensions that need to be considered

for MFIs given their “double bottom-line” goals - giving equal weight to developmental aims and the need to generate a sustainable profit. If successfully managed, funding (capital and debt) is likely to be accessible from specialised microfinance lenders, particularly from international financial institutions (IFIs) which have shown to be supportive, while significant moves away could see certain funding markets closing.

Introduction

For an introduction to microfinance and the microfinance sector, see Fitch’s Special Report *The Microfinance Sector*, available at www.fitchratings.com.

This report highlights those elements of an MFI’s risk profile that are characteristic of “top-tier” MFIs, if not the sector as a whole, and which merit particular attention when carrying out a rating analysis of an MFI, compared with a conventional bank. In particular, it considers:

- The “double bottom-line” nature of MFIs, which aims to provide both a developmental result and a positive financial return for shareholders, to varying degrees depending on the MFI’s profile and mission;
- MFIs’ access to funding and technical assistance from international microfinance networks and/or shareholders and socially responsible investors;
- MFIs’ small asset size, although diversified by customer;
- Their high growth rates, partly reflecting the often relatively short track records of operation; and
- Their good asset quality, which in many cases has proved resilient through systemic pressures.

This rating methodology and the key risks highlighted within it are particularly relevant when analysing this “top-tier” layer of MFIs, but is applicable to the broader and growing universe of MFIs.

The Rating Process

The rating process for MFIs is carried out in the same way as for conventional banks (see *Bank Rating Methodology* available at www.fitchratings.com), and similar risks are considered for both institutions.

Nevertheless, there are certain defining characteristics that shape the risk profile of MFIs. Although these (risk) characteristics can also be typical of many emerging market banks they do not necessarily carry the same significance in terms of defining an institution’s risk profile, or sector wide.

MFIs are particularly sensitive to idiosyncratic risks - those linked to the MFI itself - and therefore the stand-alone analysis of the MFI is particularly relevant. However, external factors are also key in that they “test” the internal strengths of an MFI and its processes.

When assessing the credit risks of financial institutions, in broad terms Fitch analyses two components: the intrinsic credit quality (ie the stand-alone strength) of the institution, and then the impact of support. The Individual Rating represents Fitch’s view on the likelihood that an MFI would fail and therefore require support to prevent it from defaulting. Support ratings are the product of Fitch’s assessment of a potential supporter’s (either a sovereign state or an institutional owner) propensity to support the MFI in question and of its ability to provide support (See Annex 1 for more detail).

The Fitch Individual Rating

When measured on Fitch’s global Individual Rating scale, ratings for MFIs are generally fairly low (typically ‘D’ or lower). Although this is often a reflection of the operating environment and risk associated with particular MFIs, as outlined in

this report, certain features common to MFIs explain their relatively low Individual ratings.

There is some correlation between a financial institution's size and its rating: bigger financial institutions, in general, receive higher ratings than small institutions because they have greater capacity to absorb financial problems. MFIs are generally small, by both asset size and equity capital, meaning that they have relatively less cushion to absorb unexpected potential losses.

Furthermore, MFIs tend to be fairly concentrated in a single activity - namely, the provision of loans to one target group of customers in one particular region. This also results in a high dependence on interest income from the loan portfolio. However, a mitigating factor of both the typically small size and geographical concentration of MFIs is the fact that their loan books are usually well diversified by individual customer, reflecting the small loan amounts characteristic of the MFI model. Combined with the relative resilience of MFIs' (compared with conventional banks) to macro-economic shocks (see *The Microfinance Sector*), it is arguable that the small size of an MFI may be less of a rating constraint than for a conventional bank.

Many MFIs are experiencing rapid growth, resulting in heightened credit and operational risk. This is particularly true where MFIs are undergoing a transformation (see *The Microfinance Sector*) in their legal or regulatory status. This may have an impact on the financial performance in the short to medium term, due to higher operating expenses, and more expensive commercial funding replacing concessionary funding.

However, MFIs display certain strengths as a sector, which are also factored into their Individual ratings. In particular they have:

- Relative insulation from macro-economic shocks;
- Typically lower leverage (although debt-to-equity ratios have recently been rising due to increasing access to external funding, particularly for regulated MFIs);
- Diversification of loan book by individual customer;
- Good asset quality; and
- Stability of financial performance (for "top-tier" MFIs), ie less volatile profitability indicators.

The key factors that underpin the analysis of an MFI's Individual rating are outlined below.

Operating Environment

MFIs typically operate in emerging-market countries. This is significant in relation to the political and economic volatility that frequently occurs in such markets, but also in terms of specific microfinance sector exposure to potential political interference. The latter can include interest rate ceilings (caps), direct lending programmes at subsidised rates, and measures to protect borrowers from what governments may consider excessively high interest rates. Fitch therefore carefully examines the extent to which MFIs have been, or are likely to be, subject to interference from either local or central government, and the current and expected trends in terms of government policy regarding financial sector regulation or pro-poor policies.

As MFIs tend to have localised or regionalised activities, they are generally sensitive to trends in their domestic - if not their local - operating environment, but less sensitive to international macroeconomic trends. Consequently, it is important to understand the workings of the domestic or local economy and government, and local regulations. Due to the localised nature of MFI activities, many of their

portfolios are concentrated in one particular region: given the lack of insurance for many micro-entrepreneurs or small businesses in developing countries, this exposes the MFI to environmental risks such as landslides or natural disasters, which can severely affect the cash flows of their borrowers.

The level of development of the banking system is also relevant, in that it can bear on such aspects as the depth of the local financial markets, the sophistication of IT systems in the financial sector, the level of product development, the implementation of Basel II, and how integrated the MFI sector is into the banking system. This can also directly affect the level of competition in the market - typically, the more developed the banking system, the more banks are likely to “downscale” into the typical MFI client base, either through dedicated business lines or through consumer loans. The less developed the banking system, the more “un-banked” population there is, and the higher demand there is for microfinance services.

MFIs usually operate in countries with low sovereign credit ratings. The country ceiling may sometimes act as a constraint on the international issuer default ratings (IDRs) of MFIs. On a local currency basis, there should be less of a constraint given that MFIs are less likely to have direct exposure to the sovereign by, for example, holding debt exposures for liquidity purposes (see *Rating Banks Above the Local Currency Sovereign Rating*, available at www.fitchratings.com).

Regulatory and Supervisory Framework

The quality of supervision and regulation is an important consideration when assessing the creditworthiness of any financial institution, and MFIs are no exception. Given that many MFIs operate in emerging markets, the regulatory and supervisory framework is often characterised by certain weaknesses. Furthermore, regulation in microfinance does not provide a level playing field across countries, as, depending on their legal structure, not all MFIs are regulated or subject to prudential regulation.

Accounting Standards and Presentation of Accounts

An increasing number of the larger MFIs produce IFRS or US GAAP accounts, audited by leading international audit firms. This is important in terms of establishing consistency of accounting standards across MFIs. However, the vast majority of MFIs provide accounts under local accounting standards, although they often also prepare financial statements and standard ratios according to Consultative Group to Assist the Poorest (CGAP; a consortium of public and private funding organisations working together to expand poor people’s access to finance, and which acts as a global resource centre for microfinance) disclosure guidelines, which are specific to the microfinance sector and are considered close to international accounting standards, thereby providing greater transparency. If Fitch is unable to get comfortable with the accounting standards used, then the agency will not be able to assign a rating to the MFI.

As many MFIs are in the process of transformation, particularly from NGO into for-profit entities, due attention should be given to the accounting of both legacy and new entities, and to the transfer of asset and liability processes.

Risk Management

On the whole, MFI risk monitoring and control systems are unsophisticated, reflecting the small scale of and the simple products they offer. However, this is counterbalanced by MFIs’ typically conservative appetite for risk. Exceptions to this general statement include the larger microfinance banks: these MFIs benefit from strong parent companies through access to centralised risk management functions and access to technical assistance funding. Fitch will be looking to assess how appropriate the risk management framework and the management structure is, and whether sufficient investment is being made in this area as the business evolves.

Credit Risk

The main risk facing MFIs is credit risk, given the predominance of loans in the balance sheet, and the developmental goal of MFIs to provide financing to unbanked, low-income populations.

Unlike customers of most conventional banks, MFI borrowers usually work largely in the informal sector and do not produce accounts or have any banking history. Lending to microfinance borrowers is frequently unsecured; if provided, collateral is limited in value and is often in the form of guarantees from friends and relatives. In many countries where MFIs operate, the situation is further complicated by the absence of credit bureaux. As a result, MFIs apply specialised lending processes and technologies. While traditional security for lending may be limited, practices such as “solidarity lending” have in some cases allowed MFI asset quality to prove quite resilient when compared to that of more traditional financial institutions (eg. Bolivia, Peru). As MFI financing is often the primary source for small/micro business investment, the incentive to keep this source available is a powerful one.

Fitch’s analysis of credit risk for MFIs includes investigation into, and an understanding of, the key trends affecting the informal economic sector in that region - in particular, the volumes and flows of foreign worker remittances, the main trade flow patterns, and trends in formal employment.

It is important to gain a full understanding of an MFI’s day-to-day credit risk processes, including credit approval processes and credit committees, maximum exposure limits and industry limits, in order to form a view of the robustness of an MFI’s credit risk management. Consideration is also given to loan officer incentive systems, and which weight they assign to portfolio quality: incentive systems which are biased towards increasing loan volumes as opposed to maintaining loan portfolio quality, may lead in the medium-term to credit risk for the MFI.

Concentration risk in the loan portfolio is also an important rating consideration for MFIs. Given that the main products offered by MFIs are micro- and small business loans, there is little diversification by client profile. However, this is mitigated by the large numbers of clients, and the diversification of activities and sub-sectors of industries within that client group. Nevertheless, aggregate exposures to particular industries (notably trade) can be large. Although MFI portfolios are highly granular, given the low average loan amounts, single-name exposure can still be significant relative to equity, reflecting the small capital bases of many microfinance institutions. This is particularly relevant for MFIs that also provide SME loans.

As MFIs tend to operate in a single country, and typically only in one or several regions of that country, many are exposed to geographical concentration in their loan book. This makes them particularly vulnerable to economic, political and legal changes in their local operating environment. For example, an MFI’s loan portfolio may be concentrated in a single branch, or loans concentrated to borrowers trading in one local market.

Rapid loan growth is a particular characteristic of the MFI sector and is an important factor to consider when establishing the level of credit risk, as future asset quality problems can be concealed by asset quality numbers and ratios at any point in time.

Furthermore, many MFIs disburse loans in foreign rather than local currency, reflecting the fact that their funding is frequently provided in foreign currency, and that they sometimes operate in economies with high levels of dollarisation (for example Bolivia or Nicaragua). The high percentage of MFI loans denominated in foreign currency entails the risk of a significant devaluation of the local currency being passed on to the borrower, which results in additional credit risk for MFIs. It is important to establish how an MFI assesses the ability of a borrower to repay a foreign currency loan and whether its policy is to shift towards a greater proportion of local currency lending, which would result in lower credit risk overall.

The quality of an MFI's loan portfolio is a highly important consideration, including the level of past-due loans, restructured loans and written-off loans, and the loan provisioning policies underpinning them.

Fitch considers specific indicators for microfinance portfolios including portfolio-at-risk 30 days, 90 and 180 days. Portfolio-at-risk refers to the outstanding balance of past-due loans over 30, 90 and 180 days divided by the average outstanding gross loan portfolio. MFI loan portfolio quality is typically good, with portfolio-at-risk 30 days expected to be in the low single-digits, although this typically varies across regions. Fitch also considers past-due loans as they are defined under local regulation or practice. Fitch's analysis, however, considers quality trends starting from portfolio-at-risk 1 day because MFI portfolios usually consist of short-term loans with frequent repayment schedules, which allow the early flagging of potential repayment issues. In this context, it is important to analyse the related procedures in place to deal with overdue loans, and the extent to which portfolio information is readily available to management and staff.

MFI's usually apply conservative loan-loss provisioning policies, which underpin high coverage ratios, with loan loss reserves covering at least 100% of portfolio-at-risk 30 days, generally providing an adequate cushion to absorb existing problem loans.

It is essential to have a clear understanding of the definition of each past-due category, and the policy and procedures for its classification, as this can vary across countries.

As with conventional banks, Fitch also considers trends in asset quality, both intrinsic to individual MFI's and relative to the financial systems which they inhabit. Historical recovery rates can be a good indicator of the robustness of an MFI's loan monitoring and loan collection systems, particularly where borrowers are widely and remotely dispersed. Continued recovery efforts are essential for MFI's, in order to uphold financial discipline among borrowers: if expectations settle within the community that an MFI is a soft lender, borrower discipline and loan portfolio quality can quickly erode.

MFI's are also exposed to credit risk on inter-bank placements. Given the typically limited nature of inter-bank operations, control systems tend to be quite basic. However, limits for domestic banks are generally fairly small, and those for international banks and their subsidiaries, although larger, tend to be reasonable.

Operational Risk

Operational risk is another key risk for MFI's. Given the working-capital needs of most MFI borrowers, MFI's manage highly granular portfolios of small loans, with short maturities and frequent amortisations. The credit processes that underpin these loan books are highly labour intensive, and typically do not involve automated processes such as credit scoring.

Operational risk is heightened by the central role of loan officers, whose strong relationship with borrowers and local communities plays a crucial role in ensuring good repayment behaviour. As a result, MFI's are particularly vulnerable to staff turnover: competition and the lure of higher salaries can also make staff retention a challenge for many MFI's. The significant human element in the MFI model also makes it susceptible to "human error" and fraud.

The MFI business model makes it very reliant on staff, and human resources are often mentioned as a major constraint on MFI development. This makes human resources management a key consideration in the analysis of an MFI. Training, notably of loan officers and middle management, is essential for MFI's to be able to deal with rising business volumes, but also to overcome the general lack of suitably qualified staff, which is often typical of developing countries experiencing a net

brain drain or with a small educated population. Attracting and retaining a capable team of staff is a major challenge, particularly as many MFIs operate partly in remote rural areas.

For most MFIs, a key element in the financial package of MFI lending staff is a performance-related pay scheme, which often links individual lending results and portfolio quality indicators to the monthly take-home pay of loan officers. Careful analysis should be made of these schemes, and whether they are suited to the MFI's overall business goals. Consideration should be given to whether the schemes are adequate in directing lending staff to the right balance between loan disbursement and maintaining loan quality standards. An incentive scheme which is biased in favour of loan volumes as opposed to loan quality, can lead to such key operational risks as staff burn-out, breaches of policy and procedures, and "phantom loans" as loan officers try and reach excessively aggressive disbursement targets; all of which then directly feed into heightened credit risk.

Rapid loan growth is a particular feature of MFIs. Growth and the accompanying rise in branch and staff numbers pose a challenge for MFIs in terms of pressure on systems and processes. The logistical challenges posed by the local operating environment, the often wide geographic dispersion of branches and weak inter-branch communication and connectivity, and the predominance of cash-based lending are all factors that pose significant operational risk challenges for MFIs.

In this context Fitch considers the adequacy of the Management Information Systems (MIS) and software systems in place at the MFI, given the size and scope of activities (lending only or multi-product offerings), and connectivity and security issues.

Political interference represents an important risk for MFIs: although difficult to foresee and quantify, its likelihood and the nature of the intervention (eg interest rate caps and subsidised government lending to MFI target groups) are taken into consideration during Fitch's assessment of an MFI's operational risk.

The integrity of the audit process is another weakness of many MFIs, with the development of a well-functioning audit process often lagging behind rapid growth rates.

Although money laundering is a risk, particularly for non-regulated MFIs, balances are typically small, and therefore not conducive to cross-border money laundering. Although not all MFIs will have Know-Your-Client (KYC) procedures in place, the fact that MFIs themselves are generally integrated into the local community, and conduct intensive client screening, generally indicates a sound level of knowledge about their client base.

Reputation Risk

MFIs usually have a high commitment to ethically and environmentally sound policies, and have a social mission integrated into their *raison d'être*. The extent to which an MFI fulfils its stated "double bottom line" mission - which gives equal weight to both financial and social performance - and its ability to document its social performance, are important considerations for many of the international investors who represent an important source of MFIs' external debt funding. Consequently, MFIs are sensitive to reputation risk, and need to prove that they are fulfilling their stated social and developmental targets to ensure continued funding from their international sources. The disillusionment of the main funders of MFIs could have a knock-on effect for the sector as a whole, resulting in refinancing risk for many MFIs, which, if severe enough, could theoretically result in something akin to systemic risk.

Other issues where MFIs could be drawn into disrepute and lose the support of their international donors and funders, are, for example, if they were seen to be charging excessively high interest rates, applying lax underwriting standards leading

to over-indebtedness among microfinance borrowers or applying unethical loan recovery practices.

Market Risk

In general terms, market risk is not a significant risk for MFIs, as they do not typically take proprietary positions. Market risk predominantly arises from structural FX and interest rate positions. Correspondingly, procedures for the management of market risk are often basic.

Structural FX risk results from the fact that assets are typically denominated in local currency, whilst funding is predominantly provided in hard currencies, particularly US dollars or euros (see “Funding” below). Hedging is not usually a possibility for the currencies of MFI’s countries of operations. Consequently, MFIs either pass on some or all of the risk to borrowers by offering hard currency loans or indexed loans, or they maintain a short structural FX position, which makes them vulnerable to exchange rate movements and bottom-line volatility. Certain lenders to MFIs may provide access to forward foreign exchange contracts that provide some protection to the MFIs from exchange rate volatility.

Interest rate risk typically arises because asset rates are fixed, whilst those for liabilities may be floating. Funding is often priced based on market rates such as LIBOR. Unlike for many conventional banks, however, the resulting risk is mitigated to some extent by MFIs’ usually high net interest margins (in part reflecting the fact that some of their funding is at preferential rates), the short tenor of MFI loans, which allows for frequent re-pricing, and, for non-regulated non-deposit-taking MFIs, relatively low leverage.

Funding and Liquidity

As for conventional banks, it is important to understand MFIs’ diversification and maturity funding profiles, and their refinancing risk. These factors will vary according to whether the MFI is a regulated bank or a deposit-taking non-bank financial institution, or whether it is a regulated or unregulated credit-only MFI. Regulated full-service MFIs usually have better access to funding, and tend to have higher leverage, which has increased in recent years. Unregulated MFIs that do not mobilise savings have greater funding constraints.

For both types of MFI, the funding profile is usually a mix of public and private funding, and of concessionary and market-rate funding. Fitch analyses these breakdowns to assess an MFI’s ability to renew or refinance maturing liabilities, and at what cost.

Many MFIs source a significant level of funding from IFIs, international donors, international microfinance networks and specialised microfinance investment vehicles (MIVs) - all of whom are interested in the “double bottom line” nature of microfinance (see *The Microfinance Sector*). Although such funding sources can be regarded as fairly stable in the short to medium term, over the longer term many IFIs and donors are likely to look for some sort of exit strategy. Furthermore, specialised microfinance debt funds are subject to individual counterparty and country exposure limits, which can act as a constraint given the relatively small asset size of those investment funds.

Many MFIs are taking steps to diversify their funding bases, to reduce their reliance on large individual shareholders or networks, by attracting customer deposits and commercial funding sources from the international or domestic capital markets (through bond issues and CDOs or CLOs, which are usually able to attract more commercially motivated investors). However, for most MFIs, such funding is not usually significant relative to total liabilities, though typically their importance rises as the entity grows and matures. Only a handful of MFIs issue securities, but many attract bilateral or syndicated debt funding from international commercial investors and MIVs.

Access to a diversified and local currency funding base is one of the major reasons why MFIs are taking, or have taken, steps to transform into deposit-taking institutions (see *The Microfinance Sector*). This also fulfils their social goal of mobilising “mattress money” and further integrating the customer base into the formal financial system. Although growth in deposits is positive for diversification of funding, until the MFI has an established track record of retaining those deposits, it can be difficult to establish the “stickiness” of those deposits. However, many deposit-taking MFIs take steps to extend the maturity of their deposit base by offering fixed-term deposits.

As for all banks, liquidity is a key issue for MFIs. The level of liquid assets relative to the balance sheet can vary across MFIs, but will tend to be fairly tight for non-deposit taking MFIs. Owing to a lack of marketable securities in many markets in which MFIs operate, liquid assets are mainly held in cash or inter-bank placements, but are not generally significant relative to total assets. Furthermore, MFIs generally do not have easy access to bank credit lines for funding unforeseen liquidity gaps. However, liquidity is supported by cash flows from the loan portfolio, which can generally be freed up fairly quickly if required, thanks to the short maturities and frequent repayment schedules of most customer loans (typically one month or less).

As a general rule, MFIs do not generally rely on money market funding. They are however reliant on wholesale funding from IFIs, MIVs or their shareholders. As with conventional banks, MFIs often face some sort of funding mismatch, although this is less likely in non-deposit-taking MFIs that fund short-term assets with long-term liabilities. This maturity gap can increase as MFIs become larger and move up the lending scale toward SME customers, as the latter’s financing needs are usually for investment in fixed assets, which are slightly longer term, and not just for working capital.

Although some microfinance banks may have access to “last resort” lenders in the form of the central bank of their country of operation, this is not an option available to the vast majority of MFIs. Access to standby credit lines is generally limited. The most likely sources of liquidity support for MFIs are the IFIs, international microfinance networks, or international microfinance funds that already provide financing to MFIs. Fitch analyses the likelihood of this support case by case through discussion with the MFI and its partner or parent.

Earnings and Performance

MFI income is derived mainly from interest income from lending, making MFIs particularly vulnerable to margin pressure. This is an increasing issue in many markets due to competition from other MFIs, but also from local banks moving down the lending scale to reach smaller and in some cases “micro” borrowers (eg through the provision of consumer loans), and in some cases from new entrants to the market. Some MFIs are taking steps to diversify their income by offering fee-generating services such as money transfer or remittances. However, this is usually fairly limited relative to total revenue, reflecting the small-ticket nature of microfinance business, but also the fact that microfinance customers generally require a fairly basic product range.

The lack of revenue diversification is, however, counterbalanced by the following features of microfinance lending:

- High nominal portfolio yield;
- High net interest margin, although this is coming under pressure for many MFIs due to competition and increased use of commercial sources of funding; and
- Diversified lending by customer and high granularity of loan portfolio.

Although MFIs usually benefit from a higher net interest margin than conventional banks, to a large extent this is necessary to cover the high operating costs associated with the microfinance model. MFI processes are labour intensive, while the average loan amount is low, resulting in cost-income ratios (in the range of 70 to 90%) that are often much higher than in the mainstream banking sector. Furthermore, MFIs usually maintain large branch networks, as closeness to the client is a core component of the microfinance lending methodology. As MFIs usually operate in under-served markets, rapid growth often occurs, and this can require both human and capital investments. Nevertheless, it is necessary to establish that MFIs are being as cost efficient as possible and that investments in developing the business are resulting in higher business volume. In order to assess the “adequacy” of an MFI’s cost and revenue structure, Fitch considers some additional microfinance specific indicators, such as operational self-sustainability, operating expense ratios and productivity ratios for loan officers. These are then analysed within the context of the MFI’s age and lending methodology.

Operational self-sustainability considers the extent to which interest and other financial revenue covers financial expenses, loan impairment charges and operating expenses. It is used to establish the extent to which operating revenue from the portfolio covers the main MFI expense items. It provides a useful snapshot of an MFI’s ability to cover its main costs, without taking into account non-lending activities or other income such as donations or grants. The operating expense ratio, defined as operating expenses divided by average earning assets, allows us to analyse operating expenses in relation to the outstanding loan portfolio which typically represents the majority of an MFI’s earning assets, and to establish how efficient an MFI is in terms of managing its expenses in relation to the size and scope of its activities. Productivity ratios - in particular number and volume of outstanding loans per loan officer - are useful to understand how well the MFI is utilizing its main productive resources, the loan officers. They are analysed within the context of the lending methodology applied by the MFI (group or individual lending) and of the scope of MFI activities (urban or rural lending). Low ratios would indicate scope for additional efficiency gains from existing resources, whereas high ratios would signal potential issues linked to excessive case-loads for loan officers.

As for all banks, profitability trends need to be assessed. Whereas MFIs frequently take a number of years to break even after their initial establishment, the growth of MFI portfolios usually ensures yoy growth in net interest income. It is therefore important to see positive trends in net interest income, although bottom-line profitability can vary depending on operating and loan impairment charges. When considering profitability trends and consistency, Fitch aims to assess the extent to which an MFI is able to generate sufficient capital internally to support future growth. In this context, Fitch looks at retained earnings and plans for grant or donation capitalisation, both of which support internal capital generation; and consider the extent to which this is sufficient to cover the costs of investments as the entity evolves.

Profitability figures are typically good for the “top-tier” MFIs, although this is not representative of the entire sector (see *The Microfinance Sector*). Given the extent of concessionary or subsidised funding, and of grants and donations on MFI balance sheets, both actual and adjusted performance indicators should ideally be analysed. It is also important to establish the presence of any “hidden grants”, such as rent-free premises, shared staff not on the MFI’s payroll and technical assistance, that could be distorting an MFI’s cost ratios. For MFIs that provide social services in addition or in parallel to micro loans, attention must be given to the accounting treatment of these additional non-financial services.

Capital

As for all banks, the absolute size of an MFI's equity capital and its capital adequacy are important considerations. Although the nature of capital can vary among MFIs depending on their legal structure (eg for MFIs that operate as NGOs or foundations, equity consists of capitalised donations and retained earnings; for credit cooperatives, paid-in membership fees and retained earnings; for for-profit companies, equity capital), the main rating question is whether capital is there to absorb unreserved losses. Some MFIs also issue Tier 2 capital to support their capital ratios (especially subordinated debt, often with limited equity content), although the amount of Tier 2 capital relative to Tier 1 equity is generally limited by local regulations, internal guidelines or the availability of such funding. The source of such funding is typically limited to the MFI's shareholder or main donor, which thereby express their intention to support MFI capital ratios in the medium- to long-term.

Management's policies with regard to minimum capital ratio objectives and dividend payouts are taken into account, as is the ability of an MFI to raise new capital and generate capital internally.

In addition to the usual bank capital adequacy ratios, Fitch analyses an MFI's leverage on the basis of the debt to equity ratio, particularly for those MFIs which are not banks. For non-regulated non-deposit taking MFIs, the expectation should be to see much more conservative debt to equity ratios than for regulated banks (typically 4x-6x debt to equity).

Size and Franchise

There is some correlation between an entities' size and its rating. Whereas bigger banks generally receive higher ratings than smaller ones because they have greater capacity to absorb financial problems, and they have greater diversification in their operations, MFIs, by the nature of their specialisation in micro loans, tend to be regionalised, and with few exceptions are small and relatively undiversified. The size factor limits an MFI's ability to gain efficiencies through economies of scale, and limits their ability to significantly lower their cost income ratio to levels typical of normal mainstream banks.

Although MFIs are small in absolute terms, they may benefit from a strong local franchise, and from granularity in their loan portfolios and client base (eg low top 20 and insignificant related-party lending). An MFI's franchise, as the sole or leading microfinance provider in a particular region, affords it some advantages in terms of relative "stickiness" of deposit base, its ability to attract third-party funding from IFIs or MIVs, as well as pricing power and a privileged position to generate its business.

In addition, Fitch analyses MFI portfolios and asset size within their regional context, and acknowledges that the size of the country's economy and population have a direct relation to MFI portfolio sizes. The agency also relates its analysis to several factors connected to size, such as the age of the MFI, the lending methodology used, the average disbursed loan amount and the level of access to international technical assistance.

Consequently, although balance-sheet size forms a part of Fitch's analysis, evidence of sustained, well-managed growth and the ability to weather wider economic, political and even natural crises are also an important consideration.

Management and Strategy

An effective management team and a well-defined strategy are essential ingredients for a successful MFI. This is particularly true given that management of MFIs is typically made up of a small dedicated team of staff members, who have often been with the MFI since its early days. This "key person risk" is a fairly

frequent feature in MFIs, and often results in the dependence of the management team on one person (eg the CEO or general manager). Consequently, it is necessary to establish that a capable management team is in place with a clear division of responsibilities, avoiding this over-reliance on a limited number of individuals.

The management of MFIs can frequently suffer from a lack of know-how and weaknesses in financial planning, and this can become even more acute when MFIs take the decision to transform from non-profit to for-profit status, which requires the management to achieve both a profitability target and a social mission. In more competitive markets, management should also be assessed in terms of its “strategic” vision and flexibility as the competitive pressures increase on an MFI’s traditional “niche”. Management quality is therefore assessed in terms of its ability to support a particular MFI’s stage of development, or its preparedness for the next level of institutional growth.

For MFIs with international parent companies or who belong to international microfinance networks, the main strategic lines will tend to be established by a central headquarters function.

Corporate Governance

As is the case for banks, corporate governance practices can have a material impact on the risk profile of MFIs, particularly where that governance is weak. Corporate governance in many MFIs is an area of weakness and is a factor mainly of ownership structure, affiliation to international microfinance networks and access to technical assistance. Ownership by IFIs, and affiliation to international microfinance networks (such as Women’s World Banking, Accion or FINCA) typically ensure a higher minimum level of corporate governance and transparency, which is considered to be positive in Fitch’s analysis.

Nevertheless, MFIs are often lacking in terms of the necessary array of competent board-level committees, and the independence and quality of board members. MFIs that are affiliates of international networks will usually lack independent board members, and are staffed with international directors from within the same network or group. Among NGOs or foundations, board membership tends to be typically non-remunerated, which means MFIs struggle to attract commitment and the best talent. The political connections of board members also need to be assessed.

Corporate governance at MFIs is in a sense more complex than many other conventional banks, given the required balancing of both a social and profit mission and the management of the “double bottom-line”. This requires clear articulation and commitment to a “double bottom-line” mission, in order to minimize potential conflicts between the social and profit goals.

Although typically less relevant for MFIs than for banks, particularly in emerging markets, the existence of related-party activity is also assessed.

The Fitch Support Rating

Support ratings are the product of Fitch’s assessment of a potential supporter’s propensity to support a bank or MFI and of its ability to do so. The likelihood of timely support is therefore an important part of the assessment of whether a particular bank or MFI will default on its obligations.

There are two types of potential supporter - sovereign states, and institutional owners. The propensity to support is a judgement made by Fitch. The ability to support depends on the potential supporter’s own Fitch Long-Term IDR. Details of the potential support available to MFIs are outlined below.

Institutional Support

MFIs exist in various legal forms (see *The Microfinance Sector*). The type of ownership structure will usually also establish whether an MFI is likely to benefit

from any shareholder support (either in terms of liquidity or capital) in case of need.

- For example, MFIs with NGO status generally have an unclear ownership structure, as ultimately there are no real owners of the capital once the original donors have left. The propensity of donors to provide support to MFIs while still subsidising them needs to be established with reference to that donor agency's mandate in terms of target countries or activities, and this in itself is typically subject to wider political or foreign policy considerations.
- For stand-alone MFIs affiliated to a network, their affiliation to a network could provide them with greater opportunities to source support. In some instances, the network may have an influential role in brokering financial support to the MFI from shareholders or third parties, such as IFIs. However, in such cases the support rating would be driven by the rating of the ultimate supporters, ie the IFIs, rather than the shareholder or network itself, as is the case for ProCredit Holding AG (rated 'BBB-') and its subsidiaries.
- The typical shareholding structure of a for-profit MFI - which is often licensed and regulated as a bank - includes a group of IFIs and international microfinance funds with considerable experience of co-investment in MFIs (see *The Microfinance Sector*). IFIs usually have investment-grade ratings, and are considered "deep-pocket" investors who may subscribe to future capital injections to support the MFI's asset growth. In terms of size, their investment in an MFI is likely to be small relative to their overall investment portfolios. However, their support cannot be considered unlimited as many such investors are minority shareholders, and have a medium-term exit strategy for when they consider their mandate to be fulfilled. Furthermore, the likelihood of IFIs providing support will also be a factor of the extent to which the MFI's developmental mission is in line with the IFI's regional mandate and scope of activities. The stability of the MFI's shareholding structure is also important.

There are a number of potential obstacles to support factored into MFI's ratings. First, many "supporters" are unlikely to have international Long-Term IDRs assigned by Fitch, and therefore support cannot be taken into account, even if willingness to support is apparently there. Additional considerations regarding support from a network would include a proven track-record of support, whether any cross-guarantee mechanism exists, and whether and how support could and would be coordinated.

Sovereign Support

Most MFIs are too small to be viewed as systemically important, and therefore sovereign support is generally unlikely to be forthcoming in the event of an MFI failing. However, a government may be willing to support a deposit-taking MFI if its failure would mean that a large number of poor or low-income individuals in an otherwise underdeveloped banking system were likely to lose their deposits, particularly in a context where there is no deposit insurance scheme. Nevertheless, this is considered to be an exceptional scenario, and Fitch would only factor this in if an MFI's local deposit franchise was of particular significance, and in the local currency to which the government would have access.

MFIs' small asset size - both individually and as a percentage of the financial and banking sector - and the fact that they do not play a significant role in the supply of, the demand for, and the price of, money makes government support less likely than for banks. Furthermore, many MFIs are non-deposit-taking institutions, placing them off the radar of bank regulators in some countries.

However, due to MFIs' social and developmental role, many governments may view microfinance as a tool for poverty reduction and regard its interaction with a vulnerable low-income part of their electoral base as important. Although such factors have been the main motivation for government interference in the

microfinance sector around the world, they may also mean that sovereign support for some larger MFIs could be forthcoming.

The likelihood of sovereign support for MFIs is therefore considered by Fitch to be small, and is unlikely to be used as a driver for a Fitch MFI rating.

As for many emerging-market banks, uplift to an MFI's international ratings, whether driven by sovereign or institutional support, can be constrained by the Country Ceiling (or the shadow country ceiling where Fitch does not formally rate a sovereign) of the country in question, reflecting the volatility of the wider operating environment, but also such issues as a weak regulatory system, an underdeveloped banking system, and the risk of government interference (eg FX controls, bank deposit freezes, interruption of payments systems and expropriation of assets).

Annex 1 – Fitch MFI Ratings

Fitch has assigned ratings to MFIs in most emerging-market regions. Ratings assigned include both international and national ratings.

International ratings express an opinion on the creditworthiness of an MFI, and its relative ability to meet financial commitments; they are comparable across borders and across asset classes. The function of international ratings is not to provide an assessment of how good or bad an MFI is, but simply to answer the question: “If I lend money to this MFI, how certain is it that I will be repaid in a timely fashion?”

With little or no default history in emerging-market regions in general, and for MFIs in particular, national ratings are designed to indicate relative creditworthiness only within a particular country, and are denoted by a special identifier for that given country. They do not provide an international basis for cross-border comparison of MFIs. As for international ratings, national ratings can be based on shareholder support or an MFI’s standalone strength. By making available a complete range of notches on a separate scale, national ratings permit better credit differentiation than is possible on the international scale, where ratings sometimes bunch around the (often low) sovereign rating.

When assessing the credit risks of financial institutions, in broad terms Fitch analyses two components: the intrinsic credit quality (ie the stand-alone strength) of the institution, and then the impact of support. On Fitch’s international scale, these components are specifically addressed by the “Individual” and “Support” rating scales. Whichever aspect is stronger from a credit perspective will dictate the level of the IDR. Individual and Support ratings are not assigned to financial institutions in the case of national ratings, but these principles are applied in arriving at the national rating.

Individual ratings assess stand-alone creditworthiness and represents Fitch’s view on the likelihood that an MFI would fail and therefore require support to prevent it from defaulting. Support ratings are the product of Fitch’s assessment of a potential supporter’s (either a sovereign state or an institutional owner) propensity to support the MFI in question and of its ability to provide support.

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