Paving the Way Forward for Rural Finance
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Case Study

Risk Management: Information Technology

How M-CRIL Supports the Provision of Financial Services to Low Income Clients

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1 Introduction

1.1 The Genesis of M-CRIL

The sustainability issue has become particularly important in microfinance – in recent years. This has happened as microfinance portfolios have started to shift from being almost exclusively donor-funded to significantly debt-financed. Loan funds are sourced increasingly from apex-level NGOs, development banks and even, increasingly, from commercial banks. Prominent amongst the institutions lending to MFIs in Asia are the Palli Karma Sahayak Foundation (PKSF) and Sonali Bank in Bangladesh, the Rural Development Bank of Cambodia, the Rural Microfinance Development Centre in Nepal, PNM in Indonesia, PCFC in the Philippines, Friends of Women's World Banking, India (FWWB) and the Small Industries Development Bank of India (SIDBI). The encouraging experience of these institutions in revolving wholesale funds for microfinance has led to growing interest in this activity and more apex institutions (as wholesale lenders) and commercial banks are starting to become involved.

Since lending activity inevitably generates concerns about the borrower's cash flows, viability and sustainability, the availability of skills for MFI appraisal and risk analysis has, increasingly, become an issue. The response of the apex NGOs wholesaling development funds in microfinance has been to attempt to develop the skills internally. Banks with large portfolios but relatively miniscule outstandings to the microfinance sector have been more reluctant to undertake appraisals as purely internal exercises.

There are two reasons for this. Firstly, as custodians of commercial rather than development funds they need a quality of risk analysis that is more sophisticated than is customary in the development sector. Secondly, it is difficult for a bank with a loan portfolio worth a billion dollars or more, invested in a diverse range of industrial and agricultural activities to persuade many of its staff to specialize in MFI appraisals when the microfinance portfolio is likely to be no larger than $10-20 million in the immediate future. Yet, the potential for microfinance lending in India alone is estimated to be in the range of $6-8 billion if only the substantial (and liquid) resources of the banking system could be channeled in its direction.

Thus, the microfinance funding situation in the region can be characterized as one of information asymmetry between banks that have funds but not the skills and experience to understand microfinance operations, on the one hand, and MFIs that have a high demand for funds but many of which have doubtful records on issues like sustainability and viability. It is in this context that EDA Rural Systems Private Limited (EDA) – an organization with the reputation of a highly professional and competent provider of technical services to the development sector in South Asia – decided to develop a service for the rating of MFIs.

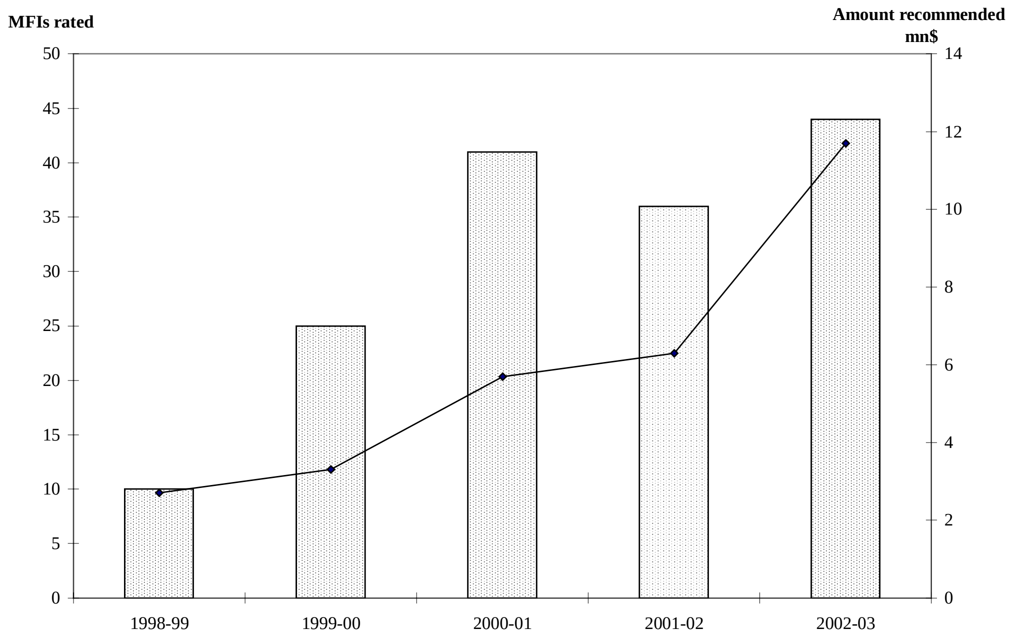
After around 18 months of research and field-testing, a credit rating service for MFIs was introduced in South Asia – virtually for the first time globally – by Micro-Credit Ratings & Guarantees India Limited (M-CRIL, later renamed Micro-Credit Ratings International Limited in line with its international workflow and evolving profile), a subsidiary company established by EDA specifically for this purpose.

In the four and a half years since the launch of its rating service in late 1998, M-CRIL has built up a rating team consisting of 10 professionals. It has an active Board of Directors made up of professionals and academics with an intimate knowledge and experience of Asian microfinance and also uses the services of professionals as part of its Rating Committee to provide independent oversight of the ratings undertaken by the organization. This vetting mechanism has served to ensure that no issues of prejudice, conflicts of interest or sins of omission arise to cloud the judgements made by M-CRIL's rating analysts. As a result, M-CRIL's MFI rating service has come to be accepted in Asia as a highly reliable assessment of the creditworthiness of institutions engaged substantially in providing financial services to low income clients.

Ratings – based on intensive visits by a team of at least two analysts to MFI head offices, branches and clients in the field – have provided the detailed, independently verified information on MFI operations that financial institutions need in order to make lending/investing decisions and judgements of creditworthiness. Until end-March 2003, M-CRIL had undertaken 156 MFI ratings in Asia resulting in a cumulative lending recommendation of around US$30 million. The progress of M-CRIL's rating service – on an annual basis – over the past five years is depicted in **Figure 1.1**

Figure 1.1

<u>MFI Ratings undertaken by M-CRIL & lending recommendations (annual)</u>



The opinions of M-CRIL as a professional institution engaged in the capacity assessment of MFIs have served as a key factor in enabling the lending decisions of wholesale lenders to them. In doing so, M-CRIL's innovative service has greatly accelerated the rate at which lending has emerged as a means of funding MFIs – particularly in India.

1.2 Criteria used for the assessment of MFIs

The M-CRIL rating evaluates the strengths and weaknesses of the operations of the financial service provider to low income clients – bank or MFI – as well as its creditworthiness. It assesses the risks associated with lending to the organization and assigns a grade based on the extent of risk. Some categories of risk that form the basis of the assessment are external risk, credit risk, market risk and the risk of fraud. With reference to these, the critical aspects covered are – the quality of governance, the depth and efficacy of management systems and the financial health of the institution.

M-CRIL's methodology utilizes the extensive experience of its parent company, EDA, in the monitoring and evaluation of programmes to promote the livelihoods of low income families. It combines this experience with the results of research to identify determinants of credit-worthiness – based on a rating literature review, discussions with rating experts, bankers, academics and MFI leaders. M-CRIL indicators are categorized into three broad areas

1 **Governance** that assesses the quality and appropriateness of the composition of the MFI's board, its role, experience with microfinance, the MFI's outreach and its overall strategy for fulfilling its mission and goals. The major indicators used include
   - Role of the Board: relevant experience and technical knowledge of board members, interest and extent of involvement of board members in governance
   - Strategy: appropriateness of operational strategy in the context of the operating environment, focus/specialisation in financial services, suitability of loan products, presence/concentration in the operational area.

2 **Management systems:** the quality of human resources, their productivity, the strength of critical systems like accounting, management information and management planning as well as internal control and policy compliance are assessed.
   - Human resources: adequacy and qualifications of staff, their understanding of crucial microfinance issues, staff productivity, incentive systems and management stability
   - Systems: appropriateness and efficacy of systems for managing portfolio information, accounts and internal audit through various indicators like rigour, accuracy and timeliness
   - Strength of clients: Most MFI clients in Asia are illiterate and poor with little or no access to financial services. In this context, M-CRIL feels that it is important for an MFI to have an informed, disciplined and engaged client base with some sense of loyalty to the institution. This is assessed as part of the rating.

3 **Financial strength** is evaluated on the basis of information from financial statements specially prepared (or re-drafted, if necessary) using internationally accepted accounting practices and prudential norms to present a fair picture of the MFI's operations. In case the institution is engaged in more than one activity, the costs of the financial operation are carefully separated, the allocations being based on a field assessment of resource utilization – human and material. The segregated and reformatted financial statements are used to assess the MFI's financial strength based on indicators like portfolio quality, liquidity, asset-liability management (ALM) and profitability. Indicators used include

   - Portfolio quality: The quality of an MFI's loan assets based on an age statement of overdues, portfolio at risk (more than 60 days) and portfolio diversification over a range of activities.
   - Credit discipline of both the MFI clients as well as the MFI itself in relation to its lenders by analyzing their repayment history.
   - Repayment ability: For a lender it is very important to get an objective sense of a borrower's repayment ability; M-CRIL assesses this by examining the rated MFI's liquidity, capital adequacy and ability to service debt from operations.
   - Profitability and sustainability: The microfinance sector is fast moving away from a donor-driven charity oriented paradigm to a sustainability oriented commercial one and the focus of M-CRIL's initiative has been on facilitating this process. An MFI's profitability is assessed through ratios like Return on Assets (ROA), Operational Self Sufficiency, Financial Self Sufficiency, Subsidy

Dependence and Operating Expenses as a proportion of portfolio. This profitability/sustainability analysis forms an important part of M-CRIL's risk assessment.
- External risks affecting operations: Every organization is exposed to risks arising out of its environment and no risk assessment would be complete without this. M-CRIL assesses external risk on parameters related to the macro-economic strength of the MFI's operational area and other factors like economic infrastructure, institutional development of the region and political stability.

A more detailed note on M-CRIL's rating methodology is presented in **Annex 1**.

1.3 M-CRIL's approach versus that of formal sector ratings

M-CRIL's ratings differ from formal sector ratings in their institution-wide focus and enabling intent. Formal sector ratings tend to be solely focused on assessing the risk associated with a particular credit product of an organization based on its present situation, systems and industry outlook and using pre-specified indicators bearing proven historical correlation to credit risk emerging from experience.

However much the utility of these methodologies, M-CRIL believes that taking such an approach would be a disservice to the microfinance industry. Firstly, most MFIs do not make market offerings so there is virtually no scope for an offering-specific approach. Secondly, given the still relatively early stage of debt-finance based microfinance, the correlation between indicators and performance is still being tested. Thirdly, the systems employed by most MFIs are relatively unsophisticated and, not only is the availability of data inadequate, its reliability is often also open to question. In the context of a nascent activity, the typical commercial rating could be somewhat regressive, condemning the lack of performance and poor systems of the rated institution without providing any systematic feedback for improvement. M-CRIL's approach to rating MFIs, by contrast, incorporates the following features

- Data collection and authentication as a key element of the rating exercise to ensure the use of authentic and reliable data for the assessment. This means that the authenticity of an MFI's reporting system is first determined by a snap system audit and, if its reliability is found to be unsatisfactory, data is physically reconciled from base level records. In an average, small-medium Asian MFI with 3-4,000 loan accounts, this could entail examining all the loan ledgers to get accurate portfolio information.

- An analysis of strengths and weaknesses of the organization on key parameters as a critical part of M-CRIL's rating reports. This includes detailed comments on the appropriateness of strategy, the strength of accounting and management information and portfolio tracking systems, credit performance and profitability. Based on specific requests, M-CRIL also provides capacity building needs assessment reports. It is an indication of M-CRIL's concern for this aspect of the rating exercise, that it covers the strength of systems up-front rather than just specifying the risk grade (**Annex 2**).

- For the purpose of standardization and comparison across MFIs, the presentation of adjusted financial statements and detailed explanations of the adjustments made in the construction of financial statements. For the financial statements, these adjustments range from the allocation of assets and staff time in a multi-service organization to determining adequate loan loss provisioning (and write off of defaults) for the institution based on portfolio ageing. Besides these, various other adjustments like subsidy calculations are done for specific indicators. This process serves as a guide to the MFI enabling it to improve its accounting practices at the same time as facilitating M-CRIL's analysis.

- Within M-CRIL an institutionalized process of ongoing instrument review for verifying the rating outlook with the actual credit performance and modifying the instrument accordingly. M-CRIL reviews the instrument based on ongoing experience and revises it periodically (roughly at two year intervals). The revisions of its methodology and instrument are based on advice from its board comprising technical experts in the field of microfinance. In the past, such reviews have led to the strengthening of the minimum conditions for various rating grades, capital adequacy norms, redistribution of weights across indicators, and the relative weights between the governance, management and financial sections of the instrument.

- The regular sharing of information on good practice in microfinance as an "externality" resulting from M-CRIL's work. This has been done in two ways

    - By providing critical inputs to SA-DHAN, the premier association of Indian MFIs, particularly on standards. SA-DHAN regularly disseminates information through workshops, papers and technical documents.

    - Through its own publications and workshops. In 2002, M-CRIL conducted an all India study documenting the best practices followed by India's leading MFIs on critical functions like governance, strategy, products and delivery mechanisms, management information systems, accounting practices, financial management, internal audit and personnel issues. The findings were published in the form of a book and discussed and publicized at a national-level workshop including the leading stakeholders in microfinance.

1.4 How the methodology adapts to different situations: the urban-rural divide and other considerations

M-CRIL believes that the credit risk profile of any entity is partly a function of the environment it operates in. However, to make any rating useful, it has to be set in a paradigm that allows comparison across institutions and these two factors form the basis of all rating decisions.

M-CRIL's rating instrument has been designed to capture the critical aspects of MFI performance across operational models and geographical regions without biasing the results in relation to any particular type of institution. The focus of the instrument is on capturing those aspects of the MFI's operations that are critical to performance and assessing them against benchmarks that represent good systems/processes/policies. To obtain a comprehensive assessment, all indicators are clubbed into small sub-groups, which include a range of parameters. For example, the management information systems sub-group includes

- Quality of repayment schedules
- Information on borrower profile and loan disbursed
- The system's ability to generate and track the amount due and the amount recovered
- Timeliness of information availability

These are the generic requirements of a good information system and, therefore, are able to assess all types of information systems employed by MFIs.

M-CRIL has developed a comprehensive user manual, which incorporates guidelines for assessing different types of institutions. The rating analysts are sensitized and trained to use their judgement as objectively as possible, especially in the case of indicators such as the quality of accounts, MIS and the client-MFI relationship where some subjective assessment is necessary. Individual biases are curbed through the organisation's policy of undertaking all assignments in teams of at least two analysts and then subjecting draft reports to a rigorous process of validation.
However, M-CRIL is conscious of the fact that no instrument/methodology can be applied in a blanket form and, therefore, adjustments are made whenever necessary. One such instance is in the recent pilot rating of BPRs (Bank Perkreditan Rakyat) in Indonesia. BPRs are locally owned financial institutions funded by private money, public deposits or borrowings from commercial banks that are on-lent to the public – usually small enterprises or consumers – in a competitive (mainly urban) environment. The instrument used for rating the BPRs provides more weight to the suitability of products, liquidity management and market share than it would to a donor driven institution in a remote rural area. But, virtually all the aspects included in M-CRIL's base instrument are assessed to get a sense of the underlying risk, which exists with varying intensity for all MFIs.

The major difference between urban and rural microfinance is related to governance, strategy and the suitability of products in terms of the end-use of loans. Pure reliance on group collateral for managing delinquency in an urban MFI, where populations have a high proportion of migrants, will fetch lower marks than an approach where systems have been put in place for tracking delinquency on an ongoing basis. Similarly, portfolio diversification is much more important in an urban setting where clients have a more limited number of income sources (usually 1-2) than in rural areas where low income clients diversify risk at the micro-level by following multi-activity survival strategies.

Apart from their area of operation, in the Asian context, the major differences in MFIs arise from the models they follow. The models, mostly Self Help Group (SHG), Grameen replications, village banks, solidarity groups have their own unique differences which give rise to specific risks. The Grameen model for example is usually quite investment intensive to begin with and starts to pay back only after a few years. Therefore, it becomes critical to assess the client drop-out rate in a Grameen type MFI – an aspect which could critically affect the payback potential of the institution. In SHG type organizations, where each group manages financial services on its own, the capacity of the group members to manage finances becomes much more important than in Grameen replicators where accounts are usually kept by the MFI's staff. Similarly, for an MFI following the individual banking model, client appraisal and collateral recovery (or the functionality of quasi-collateral mechanisms such as joint liability groups) assume great importance in undertaking the assessment.

1.5 Clients: Who uses M-CRIL's rating service?

M-CRIL's microfinance rating methodology was developed with support from the Ford Foundation, a well-known US-based foundation with a record of promoting innovation in development. With the launch of M-CRIL's rating service in September 1998, its initial clients were the Swiss Agency for Development and Co-operation (SDC) and the Small Industries Development Bank of India (SIDBI). SDC (in Bangladesh) decided to experiment with M-CRIL's fledgling service, as part of an innovation designed to promote commercial bank lending to MFIs in that country. Thus, the rating of the Shakti Foundation – a leading urban MFI in

Bangladesh – became M-CRIL's first commercial (fee-paid) assignment.[1] This rating was used by SDC as an input to its decision on whether or not to guarantee a loan from Bangladesh's Sonali Bank to the Shakti Foundation. Soon afterwards, SIDBI also decided to try out the M-CRIL service preliminary to the establishment of the SIDBI Foundation for Micro-Credit (SFMC) – its microfinance division which focuses on wholesale lending to MFIs.

In 1999, M-CRIL obtained its first bulk-contract with the SFMC, now India's leading wholesaler in microfinance, for rating its MFI customers. Since then, SFMC has become M-CRIL's major client in terms of the number of ratings commissioned. M-CRIL's ratings have become an integral part of SFMC's process of appraising loan applications from MFIs all over India. M-CRIL has rated 30-40 MFIs a year over the past three years on behalf of SFMC. During this time, the relationship with SFMC has evolved as MFIs have been asked to share with the lender a higher – though still relatively small 20% – of the total cost. In recent weeks, it has become likely that another of India's public sector bulk lenders to MFIs – the Rashtriya Mahila Kosh (RMK, the National Women's Fund) – will become another large client like SFMC.

Internationally, the demand for M-CRIL's services has grown slowly but steadily as an increasing number of ratings has been commissioned by a variety of clients including both donors (HIVOS, DFID, CGAP) and lenders (Blue Orchard Finance) in the following way

- MFIs interested in raising funds internationally use the opportunity offered by the CGAP Rating Fund to obtain a rating from M-CRIL – paying 20% of the total cost from their own resources and obtaining the rest from the CGAP Fund. The rating report provided by M-CRIL is then used as an independent assessment report for attracting investors – whether donors or lenders – to provide funds to the MFIs. MFIs/banks in Indonesia (Bank Dagang Bali), the Philippines (NWTF and TSKI) and Cambodia (EMT) as well as in India have used M-CRIL's ratings in this way. Blue Orchard Finance, the Deutsche Bank, Citibank and a number of private Indian banks are known to have accepted M-CRIL's rating reports as part of their appraisal for lending to these MFIs. Currently, Cambodia Community Building – another MFI – has obtained the support of its long term funder the Mekong Project Development Facility (a programme of the World Bank affiliated IFC) – to commission an M-CRIL rating for similar reasons.
- HIVOS has gone further and used M-CRIL's rating for determining the capitalization levels for two MFIs – one in Kazakhstan, another in East Timor. After the rating, M-CRIL was asked to undertake quarterly desk reviews based on information provided by the MFI. This programme of rating and reviews is now being extended into its second year.
- In Myanmar, M-CRIL's rating methodology was used to recommend the future capitalization of three UN-funded microfinance initiatives. At the request of the UNOPS,[2] no specific rating was assigned but detailed projections were made to determine the capitalization requirements of the three projects. In addition, the analysis of performance identified areas for capacity building and institutional development of the projects.
- A couple of large MFIs in Sri Lanka and India, have used M-CRIL's ratings to benchmark their own performance and to identify and accelerate institutional development initiatives.
- In Nepal, on the other hand, the technical support network, the Centre for Microfinance commissioned four ratings by M-CRIL to determine the utility of the rating exercise for the local microfinance industry.

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[1] As opposed to the 14 complimentary ratings undertaken earlier for MFIs in different parts of India as part of M-CRIL's methodology development process.

[2] United Nations Office for Project Services – the executing agency for the UNDP-funded programme.

- More recently, a Bank Indonesia supported (USAID/Asia Foundation-funded) initiative has resulted in the pilot rating of three BPRs for determining the suitability of M-CRIL's rating methodology to facilitating lending by commercial banks to BPRs in that country. It is possible that this will lead to the establishment of a joint venture in Indonesia focused on the rating of BPRs. The revenue model for this joint venture is based on the expectation that the lending commercial banks and the borrowing BPRs will jointly bear the cost of the rating.

Thus, it is apparent that the ratings undertaken by M-CRIL are largely not donor driven. Most of M-CRIL's activities have fallen within the framework of financial market deepening with apex lending agencies (such as SIDBI and RMK), international lenders and commercial banks using the rating service to inform their lending decisions. Much of the rest of the work – whether through the CGAP Rating Fund, or the Center for Microfinance, Nepal or the BPR ratings in Indonesia – has also been for the purpose of promoting or experimenting with the promotion of commercial relationships between commercial banks and MFIs. To the significant extent that these efforts augment the flow of on-lending funds to MFIs, these initiatives also have a clear effect on deepening financial markets for low income clients.

2 Results and impact – contributing to financial market deepening

The **mission** of M-CRIL is to *facilitate the flow of commercial capital into microfinance by minimizing the information asymmetry and experiential gap between the formal financial sector and microfinance practitioners.*

In the short span of a little over four years, M-CRIL has made substantial progress in its endeavor to become a premier microfinance rating agency that undertakes high quality assessments and enhances the flow of funds to microfinance. A total of 156 ratings had been completed by the end of March 2003. **Table 2.1** (following page) provides a country-wise breakup of the ratings undertaken.

The grade distribution resulting from these rating assignments is contained in **Figure 2.1** below. M-CRIL's rating symbols range from α+++ (the highest grade) to γ (the lowest grade awarded). All institutions achieving β+ or above qualify as credit-worthy and, for these, a lending recommendation is made. Institutions achieving a β grade usually – but not always – also receive a lending recommendation. This is the cut-off point between investment grade and high risk institutions. As the figure shows, as many as 76% of the MFIs rated achieved the investment grade but, as expected on account of the relative nascence of the industry, a large number of the investment grade (credit-worthy) MFIs fall on the margins in the β grade. At the other end of the range, none of the MFIs rated by M-CRIL so far have achieved the highest two grades, α++ and α+++.
Not only has the service been successful in terms of the number of ratings undertaken, it has also made a substantial contribution to the actual flow of funds to MFIs. Though the cumulative value of the recommendations made is close to US$30 million, the actual investment resulting from these recommendations are much higher. Most lenders/donors appear to be willing to support investment grade institutions in excess of M-CRIL's (perhaps relatively conservative) recommendations. The foremost objective of the rating service is, therefore, being substantially fulfilled.

Table 2.1

Country wise ratings and recommendation as on March 31, 2002

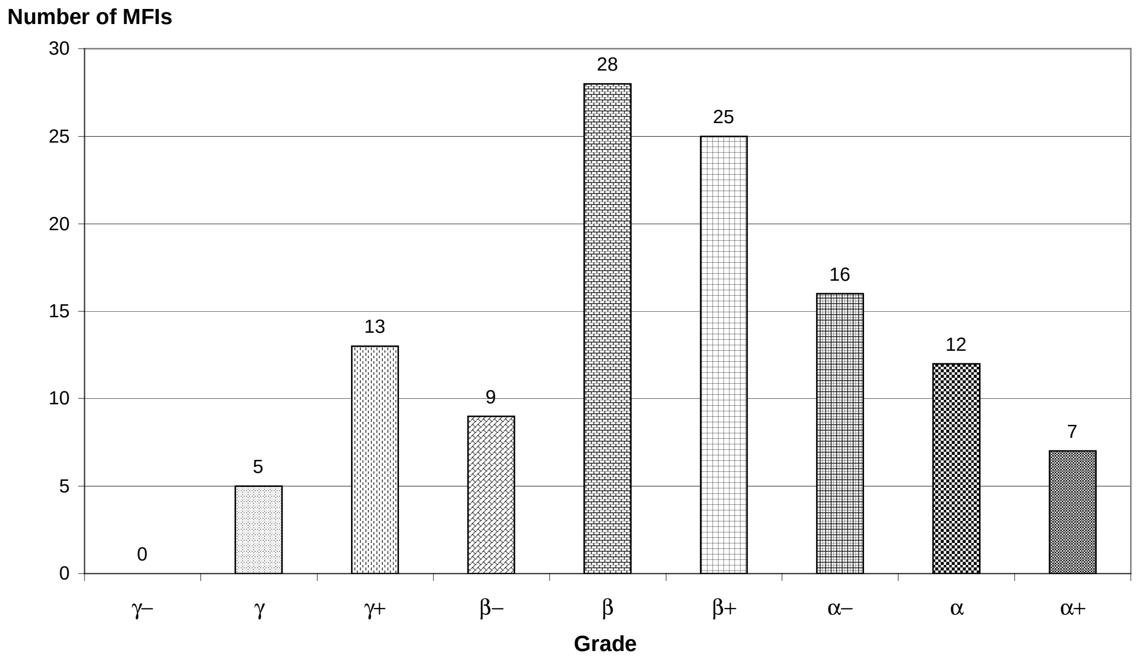
Country	**Number of**	**Amount recommended**

	ratings	(in US$ million)
India	129	20.10
Bangladesh	9	2.10
Cambodia	2	1.70
East Timor	1	0.05
Kazakhstan	1	0.20
Nepal	4	0.50
Philippines	2	1.20
Sri Lanka	1	1.25
Indonesia	4	1.35
Myanmar*	3	1.20
	156	**29.65**

* the assignments in Myanmar were capitalization reviews based on M-CRIL's rating methodology

Figure 2.1

Distribution of grades awarded



Though this was not originally part of M-CRIL's purpose, contributing to an improvement in the performance of the industry has become a major secondary goal of the organization. Partly because of the historical association of EDA with management support to development programmes, M-CRIL's rating reports have, from the start, provided not only more description of products, programmes and systems than a more conventional rating, they have also provided the reader with a SWOT analysis of the MFI's operations. This has enabled progressive MFI managements to treat M-CRIL rating reports as management consultancy inputs providing substantive pointers to improvements that can be made in their operations for greater efficiency and efficacy. Some of the leading institutions that have used M-CRIL reports in this way are BURO Tangail in Bangladesh, Spandana and SIFFS in India and EMT in Cambodia. The utilization of the rating process and report for capacity building purposes is, indeed, gathering momentum and, in recent months, M-CRIL has even been approached by MFIs wanting to be rated purely for the purpose of this type of internal learning.

To reinforce these benefits, M-CRIL has also taken the initiative to aggregate and present the MFI level information in its database. An analysis of the performance of the first 50 MFIs rated was presented in The M-CRIL Report, 2000 and a second analysis – being completed now – is to be published soon. The M-CRIL Report has played an important role in setting benchmarks not only for the rating process in the region, it has also been used by networks (particularly Sa-Dhan in India) to make their members more aware of industry standards. More specifically, the comparison of performance indicators like portfolio at risk, operating expense ratio and return on assets with averages for the best performers from M-CRIL's database has increased the awareness of standards in the industry as a whole. This has reinforced the impact of the SWOT analysis in encouraging and enabling the design of capacity building and systems improvement programmes by the MFIs themselves and their donors/investors.

Going further, during 2002, M-CRIL expanded and documented its accumulated knowledge on systems and best practices in microfinance (to begin with) in India. This was undertaken through a systems study of a selection of the country's leading MFIs incorporating good practice on various aspects of microfinance operations.[3] The practices covered include governance and institutional linkages, operational strategy, products and delivery mechanisms, management information systems, internal control for risk management, financial management and accounting policies and human resource management. The document that emerged was published in a user-friendly format and disseminated/distributed through a national-level workshop attended by a large number of MFIs and followed by extensive mailing. Feedback from readers indicates that the report has been well received and is making a significant contribution to learning in the industry about good practices in microfinance operations.

Thus, M-CRIL believes it has made an important contribution to the deepening of the rural financial sector by

- providing investors with a professional appraisal tool that facilitates the flow of funds to MFIs, and by
- enabling MFIs to improve their performance by benchmarking, identifying areas of weakness and improving awareness of standards and best practices.

3 Challenges in contributing to financial market deepening

Most analysts agree that the microfinance sector is at a critical stage in its evolution. It is in the process of deepening financial markets by making available formal financial services to un-banked low income clients through

- The provision of a wide range of competitively designed and priced financial products for a variety of client needs through the better managed MFIs
- The financing of this activity increasingly via investment channels that value efficiency and allow investors to get reasonable returns.

However, the outreach of microfinance is still relatively low in much of Asia – other than in Bangladesh and Indonesia. If the microfinance industry is to cover a substantial proportion of the un-banked low income families in the region it must be able to put into place systems and processes required for a dramatic expansion. M-CRIL's contribution to this process – both in facilitating the financing of the activity and in improving MFI performance – was discussed in

[3] Supported by the End Poverty Foundation, California.

the previous section. This section covers some of the key challenges arising in enhancing this contribution.

3.1 Donor orientation vis-à-vis market strengthening

Since much of microfinance is still driven by donors, it is important for the donor community to appreciate the challenges in mainstreaming microfinance. Donors like HIVOS, SDC and the Ford Foundation have a generally clear understanding of the eventual commercial route that microfinance must take and, therefore, have put into place a strategy that commits the MFIs to sustainability and encourages them to raise funds on a commercial basis. M-CRIL works with a range of donor institutions and can be an important channel for controlling any anomalies in this process. In some countries like Bangladesh, M-CRIL has been playing this role effectively, but the challenge ahead is to replicate the experience with more donors and in other Asian countries. The positive experiences are described in **Box 1** (following page).

Unfortunately, some donor institutions – even different parts of the same institutions that are otherwise quite enlightened – work at cross-purposes and end up distorting the market. There are a number of instances of donors playing a quasi-regulatory role vis-à-vis the institutions they support; insisting on policies like interest rate caps and failing to implement effective phase-out strategies. Thus, for instance, a large NGO in Bangladesh focused on social development continues to receive donor support for microfinance despite failing to understand, over an extended period of time, the basics of sustainable microfinance. Similarly, a handicrafts-promotion institution in India has received repeat grants in spite of its very ineffective and market-ignorant approach to livelihood promotion. Such instances have the negative effect of encouraging unsustainable methods of service delivery and reinforce potential investors' wariness of the microfinance sector.

Box 1: Positive experiences of facilitating donor support to MFIs

HIVOS' strategy for m-f support in Asia	**Donor support in Bangladesh**
HIVOS – a Dutch support institution – works in collaboration with the Triodos Bank, a commercial bank with an interest in promoting viable microfinance. The m-f strategy of HIVOS revolves around identifying promising m-f start-ups and supporting them for a limited period through its 'seed capital' support. After the MFI evolves into a viable entity, HIVOS links it with the commercial HIVOS-Triodos Fund (HTF) managed by the Triodos Bank and other commercial investors/lenders. This mechanism ensures that the MFI develops capacities to handle its operations in a commercially viable manner in a limited timeframe. M-CRIL is contracted to support HIVOS through the rating and monitoring of two such institutions in Kazakhstan and East Timor.	M-CRIL works closely with the Swiss Agency for Development and Cooperation (SDC) in Bangladesh to identify suitable MFI candidates for mainstreaming. Under the arrangement, commercial banks in Bangladesh are encouraged to provide a shortlist of MFIs to M-CRIL for rating. M-CRIL's ratings contribute to the lending decisions of the banks, and the donor also provides some short-term capacity building support, if necessary. The process involves convincing the banks about the utility of the credit rating service, to begin with, and to cover the costs of the ratings (subsidised at present by SDC) on an incremental basis. This arrangement is picking up slowly, partly because of the availability of subsidized loan funds in Bangladesh that make borrowing from commercial banks unattractive for MFIs.

3.2 Creating an investment climate for m-f

In addition to the standard rating services, dissemination of verified information for the m-f industry can play an important role in improving the understanding of banking and other corporations that might want to invest in socially relevant, yet remunerative activities. Sectoral research and dissemination of consolidated results – through The M-CRIL Report amongst other means – has had some impact in India, where private banks are lending to the reputed MFIs in the country. However, this is still driven partly by government policy that specifies a minimum exposure level to what is referred to as the 'priority sector' (for ensuring credit outreach to farmers and the poor) and is only gradually being transformed into a genuine desire to invest in microfinance.

In order to strengthen this (still weak) trend in the financial sector towards investment in microfinance, there is a clear case for M-CRIL (and other independent institutions in the sector) to contribute to the investment climate through further effective dissemination of industry information in order to highlight the ability of MFIs to provide attractive returns. However, while recognizing the potential of such *pro bono* activities not only to encourage more investment in MFIs but also eventually to increase the demand for M-CRIL's services, the immediate pressure to deliver revenue-generating rating services to clients has acted as a serious constraint. As a result, such efforts have been limited and have not, therefore, had impact that fulfils the potential. This is a challenge that M-CRIL must address in the near future.

3.3 Important link in setting standards for disclosure and accountability

In the absence of a significant coverage in most Asian countries, the microfinance industry is still largely self-regulated in the region. Disclosure requirements for MFIs are minimal (and poorly enforced) so that the information available in the public domain is mostly self-reported by individual MFIs. This is true even for the most widely circulated and used documents relating to the industry, such as the MicroBanking Bulletin (MBB).

In this situation, the role of rating agencies in bringing about a qualitative change on disclosure and accountability issues is paramount. Some efforts in this regard have been made with M-CRIL's support. Sa-Dhan (the association of Indian MFIs) and the CGAP-IDB Rating Fund have made progress on setting disclosure standards, but much still needs to be done. While the CGAP-IDB Fund insists on disclosure as a minimum condition for its support to a rating exercise, the nature of the activity is such that in all other cases the availability of M-CRIL's reports for public use is still dependent on the client. Besides, in the absence of mandatory requirements in most Asian countries the large majority of MFIs remain unrated and the available information about their operations has no credible independent verification.

This is a challenge that the microfinance industry as a whole needs to address. M-CRIL's role in this is to foster a common appreciation of this challenge among MFIs and investors – lending institutions and donors – alike.

3.4 Internal quality control

Finally, like any other professional institution, quality maintenance and control is an inherent challenge for M-CRIL. Its importance is particularly underlined by the pioneering nature of M-CRIL's initiative in undertaking microfinance rating in Asia. The task of maintaining and enhancing quality is, therefore, a function of the evolution in the industry and M-CRIL's ability to learn from evolving trends. As discussed earlier, the rating is derived not just from a structured mapping and understanding of elements of risk (as in the formal sector), but also from M-CRIL's specialist understanding of critical safety concerns in a relatively new industry that does not have authentic historical data to fall back upon.

M-CRIL is conscious of this challenge and tries to respond to it through appropriate human resource management practices, including recruitment, training and induction processes. Further, as the rating methodology note shows, the rating process is fully geared towards eliminating bias and in ensuring a fair representation and understanding of the facts and issues relating to an individual MFI's situation.

4 Policy and donor recommendations

Key recommendations emerging from the above discussion – particularly in relation to the task of deepening rural financial markets to serve more low income clients include

4.1 Greater rigour and discipline in the donors' and governments' approach to development finance

Donors should not give programme officers without both formal training and experience in microfinance responsibility for decision making and management of development finance portfolios. Organisational objectives should reinforce the concept of a time-bound movement towards sustainability and failure by MFIs to achieve targets towards this end should be sympathetically but rigorously reviewed before additional grants are provided. More effort should be made to base decisions on assessments of impact rather than on nebulous judgements resulting from brief field visits.

Governments too need to be encouraged to resist the temptation to populism, and to support development finance activities that are likely to be sustainable rather than to subsidise the provision of such services based on their presumed impact on poverty. By paradoxically reducing (rather than enhancing) the outreach of development finance to low income families, the inefficient application of subsidies is less beneficial in making a socially beneficial impact than the full cost provision of such services.

4.2 More of a focus on capacity building of MFIs and other development finance institutions

The increasing trend of donors to focus on providing on-lending funds to MFIs to the exclusion of capacity building funds needs to be reversed. It should be apparent that improving the capacity of MFIs would enable a larger number of them to generate commercial funds more quickly than the unfortunately prevalent strategy of throwing good money after bad into poorly managed and unsustainable portfolios.

4.3 Provide greater recognition and support to the work of specialist rating agencies and MFI networks

This would entail providing greater sponsorship to the agencies/networks efforts to disseminate the lessons learned from their analytical work and standard setting activities. It would lead to better information and understanding about microfinance entering the domain of commercial investors and would gradually reduce the need for the donors/governments themselves to act as quasi-investors in a field that has significant potential to become a real commercial market if it is given a chance.

4.4 Emphasise the need for MFIs to attain better professional standards by insisting on the use of professional assessment services such as rating for grant as well as loan funding

This, in itself, would focus the thinking of MFI managements on attaining standards that would soon improve operations and enable them to become attractive options for commercial investors.

4.5 Stop drawing the best personnel away from the implementation of microfinance services into the less productive role of facilitating donor decision making

Most donor and international funding organizations complain of the lack of high quality personnel in the development sector in Asia. Yet, in establishing local offices (that pay relatively high salaries) they invariably draw away the best personnel from local development organizations. This only aggravates the shortage of capable and professional staff in local MFIs and local technical service providers including rating agencies and networks. The donor organizations, with their well-trained international staff should, on the contrary, be in a position to recruit fresh graduates from the better universities and provide them with on-the-job training, a relevant work experience and a grounding in a professional work culture. The seeding of this work culture into development finance organizations – after completion by these recruits of a time bound (say, three year) contract period – would often go even further in improving resource utilization for the benefit of low income families than substantial sums of money invested by donors in poorly managed, unprofessional institutions by way of grants and loans.

5 Conclusions

This paper has discussed the role that M-CRIL has played in recent years in enabling the flow of funds – mainly loan funds – into financial institutions (both MFIs and banking institutions) that work primarily with low income clients. It has emphasized the additional contribution that M-CRIL's activities have made to the improvement of microfinance operations by drawing attention to weaknesses in individual MFIs, fostering knowledge and understanding of standards to be achieved and dissemination information about the best practices followed in the sector. In doing this, the paper shows how organizations such as M-CRIL can make a significant contribution to the deepening of financial markets the better to serve the needs of low income families.

The major issues emerging from the discussion are

- The sometimes counter-productive role of donors and governments in limiting the growth of the microfinance sector through support to ineffective MFIs and programmes and through inappropriate "socially beneficial" measures such as interest rate caps, and
- The need for an increased focus on enhancing the efficiency of the microfinance sector through measures such as the capacity building of MFIs and the utilization of professional services such as rating by agencies like M-CRIL that specialize in understanding the sector. To this end donors/governments should also reinforce the supply of good personnel to MFIs and reverse the current tendency to draw the best staff away from them.

Above all, for financial services to reach a large proportion of low income families in developing countries, an increasing focus on professionalisation and efficiency is a precondition for fostering the links with commercial markets needed to release the vast resources required for this purpose. M-CRIL's pioneering effort in providing rating services for microfinance has made a substantive contribution to this process.

[SS/Draft2: 5 May 2003]

Annex 2

M-CRIL's Microfinance Rating Symbols

M-CRIL Grade	Description
α+++ alpha triple plus	Highest safety, excellent systems ➢ most highly recommended
α++ alpha double plus	Highest safety, very good systems ➢ most highly recommended
α+ alpha single plus	Very high safety, good systems ➢ highly recommended
α alpha	High safety, good systems ➢ highly recommended
α– alpha minus	Reasonable safety, good systems ➢ recommended
β+ beta plus	Reasonable safety, reasonable systems ➢ recommended, needs monitoring
β beta	Moderate safety, moderate systems ➢ acceptable, needs improvement to handle large volumes
β– beta minus	Significant risk, poor to moderate systems ➢ acceptable only after improvement
γ+ gamma plus	Substantial risk, poor systems ➢ needs considerable improvement
γ gamma	Highest risk, poor systems ➢ not worth considering

M-CRIL's Credit Rating Service

Rating Principles

M-CRIL's rating provides an objective assessment of the performance of institutions providing financial services to low income families – microfinance institutions (MFIs), NBFCs, rural and cooperative banks as well as commercial banks with a focus microfinance.

The rating evaluates the MFI or bank's creditworthiness as well as its strengths and weaknesses. It assesses the risks associated with lending to the organisation and assigns a grade based on the extent of risk. Some of the risks that form the basis of the assessment are external risk, credit risk, market risk and the risk of fraud. With reference to these, the critical aspects covered are – the quality of the governing board, the depth of management systems and financial health.

Although M-CRIL ratings are valid only for one year, the rating recommendations keep in view the long-term prospects of the rated organisation. M-CRIL believes that such an approach is necessary for making the rating process an enabling one.

M-CRIL uses a comprehensive rating tool consisting three categories of indicators

Governance and strategy*:* The assessment depends on the quality and appropriateness of the board composition, its role and overall organizational strategy.

Management systems are rated on the quality of human resources, the strength of critical systems like accounting and management information. The performance of the MFI on staff productivity and ensuring compliance is also assessed.

Financial performance evaluation requires the rating team to construct financial statements, based on internationally accepted prudential norms, to present a fair picture of the operations. In case of organisation's doing more than one activity, the costs are allocated based on a field assessment of usage. These are then used to assess the MFIs financial strength based on aspects like repayment performance, asset quality, liquidity, Asset Liability Management (ALM) and profitability.

The Framework

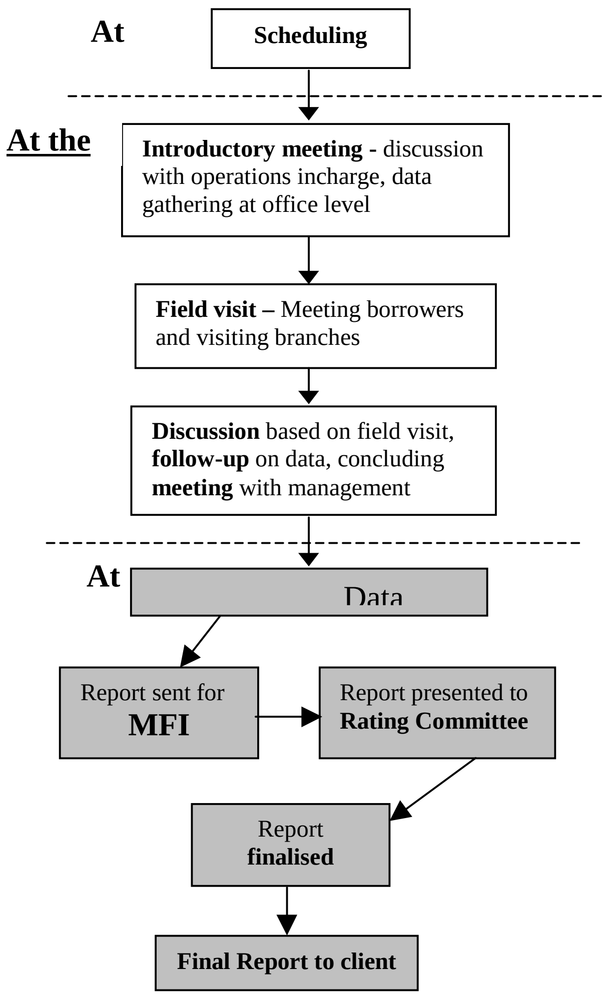
The output

M-CRIL's rating report provides a detailed assessment of the rated organisation on issues of governance, management and financial sustainability. It also identifies key improvement areas for the rated MFI and indicates the type of input that could help to make the improvements. The report includes financial statements, key ratios, graphs and comparisons with any previous rating. Besides these, financial projections based on the assessment of the M-CRIL team are provided.

The rating report provides a detailed analysis, justification of grades assigned and comments on strengths and weaknesses. This is presented to an external rating committee comprising specialists in finance, management and development. The committee critically examines the rating rationale under each of the three assessment areas using **benchmarks and analysis norms**. If it does not agree with the report, suitable changes are effected and only after the endorsement of the committee is the report, with a **specific rating grade**, finalized and submitted to the client. In cases of lending recommendations, the report provides an indicative amount as the MFI's **absorptive capacity**.

M-CRIL ratings have not only facilitated the flow of funds they have also resulted in important systemic changes and enabled the design of capacity building initiatives for MFIs.

The Process



Generally 3-6 days spent – by a team of two or more analysts – at the MFI. The duration varies with the geographical spread and volume of operations of the rated MFI.

Why M-CRIL?

- M-CRIL is **the most widely experienced agency** with experience of over 130 microfinance ratings across Asia
- A **dedicated team of qualified professionals** constantly engaged in the task of delivering and upgrading its rating services
- It maintains a **comprehensive database** of all its rating actions, which is used for developing benchmarks
- MCRIL is in cooperation with MicroRate, the leading microfinance rating agency in Africa and Latin America to standardize microfinance rating practices globally. Provides M-CRIL with a global perspective in microfinance.

What the rating does?

For MFIs

- Provides recognized, objective, high quality assessment that assists in fund-raising
- Identifies areas of strength which can be built upon and areas of weakness that require correction or capacity building
- Enables understanding of better practices

For Investors

- Professional and standardised assessment of the risk involved in lending to MFIs
- Lowers appraisal and transaction costs
- Enables more efficient utilisation of funds

For Regulators/Other stakeholders

- Provides a tool for assessing performance

Raison d'être for the Rating Service

In the late 1990s, most MFIs were still in the nascent stages of evolution and were unable to attract adequate funding for their operations. Lending to MFIs was relatively low on account of the perception that such institutions were risky and there were very few high quality MFIs. Whatever lending did take place was based on insufficiently rigorous appraisal systems. It was to tackle these issues and to facilitate efficient and increased flow of funds into microfinance based on professional assessment of creditworthiness, that this rating service was launched. The service was based on an assessment of parameters developed specially after studying the realities of microfinance operations.

M-CRIL: Evolution and Advantages

M-CRIL started in 1998 - after intensive and rigorous methodology testing and development phase funded by the Ford Foundation – for providing a critically needed evaluation service for microfinance. The aim was both to sensitize the formal financial sector to the microfinance environment, and to assist prospective lenders/ investors by providing a rigorous, standard, objective assessment of MFI creditworthiness.

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