Introduction

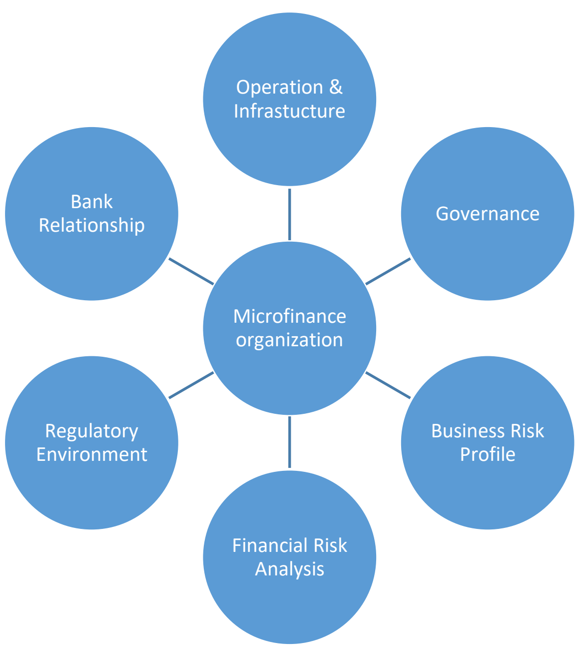
Microfinance institutions (MFIs) are financial organizations that provide small loans, savings and other financial services to low-income individuals and small businesses who are often excluded from access to traditional banking services. The primary goal of microfinance is to provide financial support to help them create income-generating opportunities and improve their standard of living. Microfinance has proven to be a successful tool for reducing poverty and promoting economic development, as it provides access to financial services for those who would otherwise be excluded from the formal financial sector, and enables them to start and grow businesses, invest in their education, and build assets.

Micro Finance Institutions (MFIs) are in many ways similar to other financial institutions, which primarily operate in lending business. MFIs' primary business is to cater to unserved or underserved part of the society due to low levels of their income and micro needs. These cannot be satisfied by large financial institutions like commercial banks mainly due to capability as well as business considerations. MFIs focus on business on self-sustainable basis so as to reduce/eliminate dependence on support (subsidized loans, donations, grants etc.). As amounts involved per borrower are significantly small but the volumes are large, MFIs operate under a different risk framework. This methodology applies to Micro Finance Institutions, which will be referred to collectively as MFIs.

AlphaRating's Credit rating methodology for microfinance institutions (MFIs) is a process used to evaluate the creditworthiness of these organizations, based on their financial performance, operations, management, governance, and other factors. The main objective of credit rating is to provide investors, lenders, and other stakeholders with a comprehensive and impartial assessment of an NGO or MFI's ability to repay its debt obligations.

Rating Framework

AlphaRating's microfinance institution rating is a representation of creditworthiness on the relative credit risk associated with a microfinance institution. AlphaRating arrives at this opinion by conducting a detailed evaluation of several qualitative and quantitative factors, namely: infrastructure, Governance, Bank Relationship, regulatory environment, Business Risk and Financial performance. The relative importance of each of these qualitative and quantitative criteria can vary across microfinance institutions, depending on its potential to change the overall risk profile & surrounding environment. While standalone credit quality is addressed, AlphaRating incorporates the relative positioning of a microfinance institution within the industry to arrive at the final rating.



A. Operation & Infrastructure

- Profile:

  AlphaRating reviews the profile of the MFI to understand its evolution from where it started to where it currently stands. We analyze how and through what means the MFI has achieved the desired expansion progress from its historical past. Understanding of the progress of the MFI helps AlphaRating in determining the ability of the MFI to successfully realize its strategy & success score in implementing its strategy. The significant factor here for AlphaRating is to assess whether the MFI has achieved the desired expansion through organic growth. The profile assessment also includes conducting an in-depth analysis of organizational structure of the MFI. This assessment also comprises general overview of the diversity, geographic spread and track record of operations to understand the overall operations of the underlying entity.

  AlphaRating conducts a qualitative evaluation of management systems and technology infrastructure to assess management effectiveness. One of the key tools available to management to effectively run an organization is the information provided to it. It is critical that information available to management be concise, clear and timely, so it can be interpreted and understood, and the management can respond accordingly.

- Operations

  The assessment of operations of a MFI depends on the exposure of business segments and the stage the business is in. Here AlphaRating reviews the diversity, geographic spread of operations, product offering, asset mix, borrower profile, size of the franchise/portfolio and track record of operations. Size may be an important factor if it confers major advantages in terms of operating efficiency and competitive position.

B. Governance & Management

- Executive Committee Structure

  This comprises assessment of the board on various criteria including overall size, presence of members, duration of board members' association with the MFI, overall skill mix and structure of Executive Committee. Size of the board may vary as per the scope and complexity of operations. While a very small board is not considered good, similarly, reaching a decision in an effective and efficient manner may not be possible in case of a large board. A healthy composition of board includes the presence of independent members having limited relationship with the sponsoring group of the MFI. AlphaRating evaluates number of board committees, their structure, and how these committees provide support to the board. A board with higher number of members should have higher number of committees in place to assist in performing its role.

- Members Profile

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

C. Risk management Framework/Control Environment

- Business Risk analysis

  This includes an analysis of the MFI's appetite for risks and the systems in place to manage these risks. A key attribute of a well-run institution is that it establishes clear parameters around risk appetite and expected returns (profit) for risks being taken. AlphaRating examines the independence and effectiveness of the risk management function, the procedures AlphaRating and limits that have been implemented, limits setting authority and the degree to which these procedures are adhered to. Overall, a comprehensive risk assessment of an MFI involves looking at both qualitative and quantitative factors. The objective of this assessment is to identify the key risks facing the MFI and to develop a plan to mitigate or manage these risks. In recent years, there has been a noticeable up gradation in the risk management systems of the MFIs, with the growth of technology-based opportunities to enhance service standards and delivery processes. AlphaRating analyses the impact of technology-based solutions to remain competitive and enhance risk controls.

- Industry Analysis

  The process of deriving credit rating of a MFI builds on AlphaRating's understanding of the industry dynamics. The analysis captures the placement of the industry to evaluate the current state and future potential of a specific industry. This exercise helps AlphaRating to form a view on industry's significance in the economic environment of the country. At the same time, we identify the risks and challenges specific to the local context of the industry.

D. Regulatory Environment

Regulatory compliance is critical for Microfinance Institutions (MFIs) as it helps to ensure the stability, transparency, and sustainability of the MFI, while also protecting the rights of its customers. Compliance with relevant laws and regulations helps to establish trust and credibility with customers, regulators, and stakeholders. It also helps to prevent illegal activities, such as money laundering and financing of terrorism, and to ensure the privacy and security of customer information. In addition, compliance with accounting and financial reporting standards helps to provide a fair representation of the MFI's financial position, allowing stakeholders to make informed decisions about its future. AlphaRating evaluates compliance with regulations by verifying its valid licenses and good standing with the relevant regulatory authority, reviewing its accounting and financial reporting standards. This provides a comprehensive understanding of the MFI's compliance status and assess its ability to operate legally and sustainably. Analysts also thrives to stay informed about latest changes in regulations to evaluate if the MFI meets regulatory requirements.

Among the regulators, Microcredit Regulatory Authority (MRA) plays a crucial role in regulating and supervising the microfinance industry in the country. The MRA was established in 1997 with the aim of promoting the growth of the microfinance sector while ensuring that the sector operates in a responsible and sustainable manner. The main responsibilities of the MRA includes the following:

- Licensing and supervising microfinance institutions
- Developing and enforcing regulations
- Promoting responsible microfinance practices
- Providing technical assistance
- Monitoring and reporting on the microfinance sector

E. Financial Risk Analysis

Financial risk analysis of a Microfinance Institution (MFI) is a systematic evaluation of the potential risks that can impact the financial performance and stability of the organization. Financial risk analysis helps the credit rating of an MFI by providing a comprehensive evaluation of the various financial risks that the MFI faces. In course of doing this, AlphaRating will review the company's financials by evaluating latest three years' Audited financial statements. While our rating process does not include an audit of a MFI's financial statements, it does examine the control environment to establish to which extent they accurately reflect a MFI's financial performance and balance sheet integrity. Financial Risk Analysis is segmented into seven sub categories which are as follows:

- **Uncovered Capital Ratio (Portfolio Quality and Vulnerability)**

  The uncovered Capital Ratio (UCR) provides a more detailed indication of an MFI's portfolio quality. UCR is a more revealing ratio to assess vulnerability and potential loss. Uncovered Capital Ratio (UCR) is calculated by obtaining the Portfolio at Risk (PAR) greater than thirty days minus impairment loss allowance divided by total capital. When considered in conjunction capital adequacy ratio, UCR allows an additional dimension for understanding capital sufficiency. A low ratio suggests better risk management, indicating the MFI is less susceptible to losses above what is already provisioned. As more extensive comparative data is analyzed with the help of more revealing benchmarks, effective use of the rational decision can be made.

- **Income Analysis**

  Excess of income over expenditure is a calculation that measures the amount of total income that exceeds total expenses. In other words, it shows how much surplus operating income remaining in a particular year after covering all expenses incurred by a MFI. This ratio is calculated by subtracting total expenses from total revenue.

- **Asset Quality & Composition**

  As a most important perimeter for AlphaRating's analysis, Asset quality refers primarily to the credit quality of the MFI's earning assets, which comprises its advances and investments. In this regard, an MFI's overdue, restructured, and written off loans are taken into account to see the overall performance of the portfolio. This is an important aspect of risk management as it helps to identify potential default risks and allows the MFI to make informed decisions on lending and risk management practices. The following are some of the key factors to consider when conducting an asset quality analysis of an MFI:

  1. Loan Portfolio Composition: This includes understanding the types of loans in the portfolio, their size, and the distribution of loans by sector, geography, and borrower type.
  2. Loan Repayment Performance: Evaluate the MFI's loan repayment history and track any trends in delinquency and default rates. This information can be used to identify potential problem areas and develop strategies to address them.

- **Capital Adequacy (institutional Solvency)**

  Capital Adequacy Ratio (CAR) provides information about the ability to meet long-term expenses and obligations as well as absorb unanticipated future commitments. It is in line with Basel III calculations. CAR uses total capital in the numerator as a complete picture of the MFI/s resources. This includes supplementary capital sources, such as loan loss reserves, asset reserves and subordinated debt. The denominator is a risk-weighted aggregate of assets as riskier assets require the institution to hold higher capital reserves. CAR is particularly informative when compared to regional benchmarks. An appropriate level often depends upon the size and maturity of an MFI, as well as differing socio-political or economic contexts.

- **Sustainability**

  Operating self-sufficiency is a percentage (%), which indicates whether or not enough revenue has been earned to cover the Microfinance Institution's (MFI's) total costs which includes- operational expenses, loan loss provisions and financial costs. It is calculated by obtaining all operating income (loan + investment) and divides them by total expenses incurred (financial expense + loan loss provision +operating expense). While Excess of income over expenditure margins are expressed as a percentage and, in effect, measure how much out of every BDT income of a MFI actually keeps in earnings and it is calculated by excess of income over expenditure divided by total income.

- **Adequacy of Resources**

  The defensive interval (months) is a financial metric that indicates the number of months that a MFI can operate in term of meeting its monthly expenses without needing to access noncurrent assets whose full value cannot be obtained within the current accounting year and additional funds or donation from outside after paying all its short term obligation. To calculate the defensive interval ratio, aggregate the amounts of all liquid assets and then divide by the average amount of monthly expenditures. The liquid funds indicator is similar to the defensive interval in its use but is more conservative in removing assets with restrictions on them from the calculation. The savings indicator measures the increase or decrease in the ability of an organization to add to its net assets. The savings indicator is a simple way to determine if an organization is adding to or using up its net asset base.

- **Foreign Currency Risk (Susceptibility to Shocks for Foreign Exchange)**

  The foreign currency risk ratio measures the relationship between an MFI’s net foreign currency assets and its equity for each foreign currency on the statement of financial position. Foreign exchange risk exposure is more explicitly revealed when relative data is documented with due care and accuracy. The lower the foreign currency risk ratio a MFI maintains, the more limited its vulnerability to changes in foreign currency values. The higher the foreign currency ratio is, the more risk the MFI faces, which may or may not lead to negative performance.

F. Bank Relationship

Analysis of banking relationship is very important in corporate rating process. The analyst team must collect information about the loan repayment history, reason against the delay in payments, utilization performance of the loan limit, security against the loan, control over the security and related risks. Any loan classification will create problem to the respective entity in further borrowing from the bank.