MICRO FINANCE INSTITUTIONS RATING METHODOLOGY

Micro finance institutions have been in action in Bangladesh for more than three decades. These institutes are non-government organizations that are supporting welfare of the country in grass root level voluntarily alongside the government. The model of micro finance was developed by the Dr. Yunus who implemented in Grameen Bank through providing free credit to the people in rural under developed area. Micro Financing Institutions has proven to be a powerful tool for poverty reduction and Bangladesh is now a role model for other countries that have acknowledged and introduced this model of Micro Finance in their program for the betterment of society. However, these institutions is going through lots of changes and challenges like outreach, portfolio size, new regulatory reign, institutional capacity and quality etc. In support of the Micro Finance Institutions and their sustainable development, Bangladesh government has set up Palli Karma Sahayak Foundation and Micro Credit Regulatory Authority to oversee and regulate these institutions and their activities.

NCR forms independent opinion on MFIs in light of their overall institutional strength, their clients' sustainability and MFIs' financial and economic viability with focus given to MFI's ability to attract and use funds from external sources. In addition, NCR bases its analysis of MFI on a number of quantitative and qualitative factors which includes regulatory environment, role of the supervisory authority, reporting requirements.

1. QUALITATIVE FACTORS

- **Regulatory Compliance:**

MFIs require abiding by an extensive regulatory process to register and to maintain relationship with donors. NCR examines the past record of a MFI in complying with norms and practices as specified by the PKSF and MRA.

- **Governance and Infrastructure:**

MFIs' governance practices are crucial as they are the guidance for information flow to stakeholders, policy formulation and have impact on financial capacity and sustainability. In assessing governance, NCR analyses governance data and information systematically and review an individual entity's governance practices. The important aspects of governance which are analyzed includeevaluation of composition of governance body, their qualities and responsibilities and their eventual beneficiaries.Development of proper infrastructure of MFIs is also analyzed to evaluate their human resources and ability to incorporate with reporting system within the institution. Proper management and executive body are required to maintain relationship with stakeholders and portfolio management.

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- **Information System and Supervisory System:**

A sound information system is necessary to supervise and control the management and its activities. As a result, proper accounting system and practices of MFIs need to be evaluated.Rating depends profoundly on accounting system, usage of software, compliance with accounting standard, revelation of client information and integration of clients' information with accounting system etc.

- **Program Effectiveness:**

MFI runs different programs with different intended objectives. It is necessary to understand the development programs (like employment generation, education and training of children and members, raised awareness of health and hygiene, empowerment of women, family planning, sanitation) so that NCR can judge to what extend these programs has affected the welfare society and to what extend the intended objectives are achieved.

- **Risk Analysis:**

Risk analysis comprises of factors like operational risk, market risk or industry risk. NCR covers the probable threats and vulnerabilities of MFIs regarding recovery system, credit facilities, collateral issue, members' credit quality, regulations and interest rate risk etc.

2. QUANTITATIVE FACTORS

- **Asset Quality:**

Asset quality is the measure of MFIs' ability of managing credit quality of their assets, consisting loan portfolio and investment portfolio. In reviewing the asset quality, NCR places due importance to structure of the assets in terms of performing and nonperforming assets and their likelihood of future performance aspects. Maintenance of good asset quality in MFIs' asset portfolio ensures lower loss provision that causes higher profitability of MFI and minimum capital adequacy requirement with regulatory body.

- **Capital Adequacy:**

Capital adequacy of MFIs means own fund of MFI that includes retained earnings and reserves. It also indicates the ability of the bank to absorb any future financial shocks i.e. credit losses resulting in deterioration in assets. NCR examines the capital adequacy through gauging the size and the composition of own fund and their nature for future absorption of credit losses.

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- **Profitability:**

MFIs' solvency is reflected from its profitability and is therefore an important area for analysis. While MFIs are benefited from the subsidized borrowing cost provided by the government of Bangladesh, it is important that MFI should have permanent and sustainable investment programs to consistently generate profit through increased client outreach over time.To gauge the profitability of MFIs, NCR looks at the historical trend of MFIs' earnings, the stability and quality of its earnings and the capacity to generate profits via different parameters of operational and financial self-sufficiency. During analyzing the profitability indicators, NCR looks at the nonperforming loans and their prospect of recovery and level of provision maintained to evaluate the level of profit and underlying profitability of MFIs.

- **Funding and Liquidity:**

Analysis of funding and liquidity position of MFIs is a measure of MFIs' ability raise funds in short notice to meet the short term expenses. MFIs require maintaining fixed deposit with the banks as security collateral which cannot be withdrawn to support daily expenses and sudden rush of withdrawals from the saviors. Therefore, NCR analyzes the structure and diversification of a MFIs' funding base, concentration of deposit and savings, significant trends in funding sources.

As far as liquidity is concerned, NCRevaluates both in short term and long term perspective i.e. the sources of liquidity (expected cash flow, capacity to borrow from financial market and maintenance of own FDR) and the proportion of liquid asset to total asset (asset structure) and the extent to which core asset are fund by stable liabilities. NCR also judge the management of liquidity position in consideration with management of asset structure that can meet short term demand of depositors and of borrowers.

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