SOCIAL RATING METHODOLOGY OF MFI & NGO

Social Rating

Social rating is defined as the opinion on how a financial institution performs its financial and social goals (i.e. social performance) and probability of the financial institution to implement and achieve its mission in line of standard social values.

Social value is a part of the society's culture, guidance or standard for social conduct to maintain the stability and uniformity of social order. While social value helps us measure relative importance in the changes experienced throughout one's life, it is neither directly observed in the market price nor measured in the same way the financial value. As a result, social value should be assessed from the perspective of those affected by an organization's work (www.socialvalue uk.org/what-is-social-value/).

For social rating purpose, social values encompass:

- ✓ sustainable access to financial services to underprivileged people in the society for improving their living standard,
- ✓ creating benefits for clients
- ✓ implementing client protection measures
- ✓ responsibility of staff, the community and environment

These values reflect the Social Performance Task Force (SPTF) consensus on social performance as a strategic commitment of all financial institution (Rating Guide, Volume 2: Social Rating Guide, The Rating Initiative, 2013). Thus social ratings come into picture to gauze how a financial institution obliges its social performance in line with its vision, mission and social and financial goals.

Why Social Rating?

Social ratings are developed and growing in demand from MFIs and investors over the last decade (since 2008). They are now globally accepted platform for the investors to scrutinize social performance management in light of the international standard. While the credit rating can only perform financial measurement of credit worthiness, social ratings goes beyond those financial values by quantifying social impact of the financial institutions on the human lives. Social ratings are useful tool for:

- ✓ Assessing the social performance in alignment with mission, vision and goals
- ✓ Analyzing and asserting the social performance management for effectiveness of the MFIs and NGO

- ✓ Evaluating the social performance in comparison with standard, norms, peers in the industry
- ✓ Demonstrating the scope of improvement in social performance
- ✓ Communicating with investor for understanding the policies and procedures of implementing MFIs mission, vision, social development activities
- ✓ Providing objective information on social performance risk profile of the MFI to the investment decision maker
- ✓ Ensuring transparency of the MFIs for capital flow to MFI

Scope & Limitation

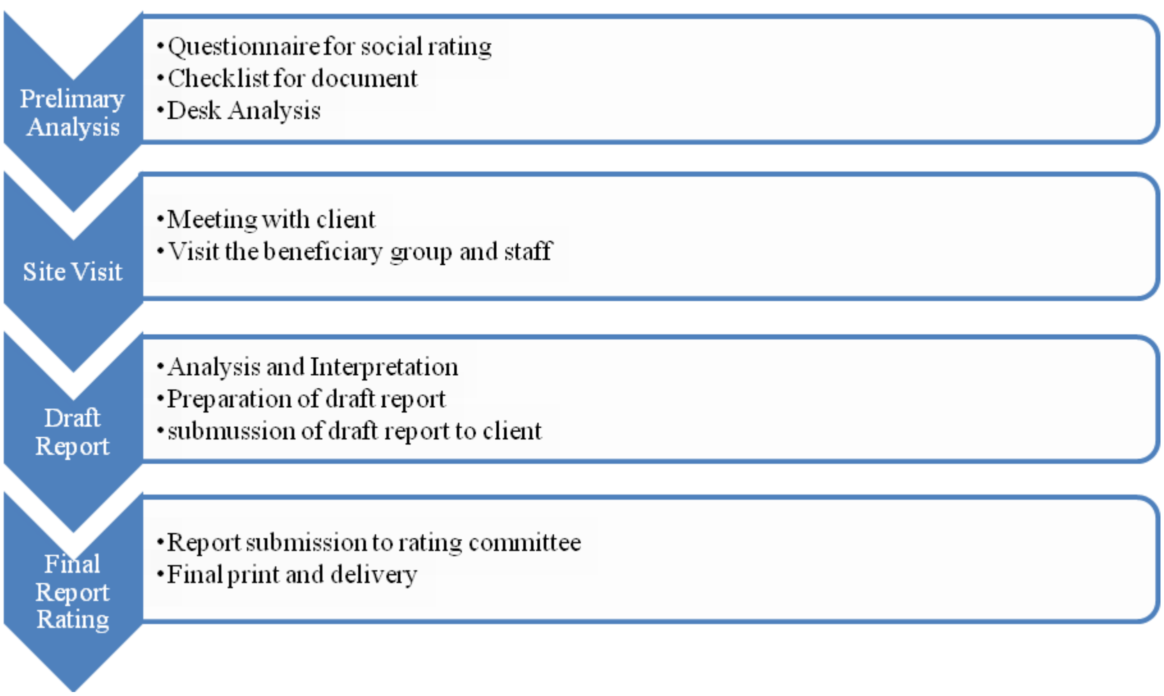
Social rating can be applied to all types of financial institutions and for those entities with double bottom line profitability i.e. financial profit/loss and social return/impact. NCR has developed proprietary social rating methodology based on the guideline provided by The Rating Initiative. This methodology developed by NCR is applicable and used to appraise MFIs and NGOs active in Bangladesh.

The rating agencies require awareness of the international standard for social performance measurement and social performance task force for alignment with social rating methodology. In addition, social rating methodology requires development within country context, which is ignored here. Further, to assess the social impact, client and staff survey need to be conducted. However, NCR may use small sample for client and staff survey, and thus the data sample may be biased.

Social Performance Measurement Factors

Based on the social rating guideline outlined by The Rating Initiative, there are six elements examined for social rating of an entity. They are depicted in the following diagram:

Social Rating Process



Rating Scale Definition

Grade	Social Rating Definition
AAA	**Excellent** social performance and financial practice, highest level of commitment to its mission and highest chance to meet the social mission
AA	**Very strong** social performance and financial practice, very high level of commitment to its mission and very high chance to meet the social mission
A	**Strong** social performance and financial practice, high level of commitment to its mission and high chance to meet the social mission
BBB	**Adequate** social performance and financial practice, moderate level of commitment to its mission and moderate chance to meet the social mission
BB	**Inadequate** social performance and financial practice, low level of commitment to its mission and low chance to meet the social mission
B	**Low** social performance and financial practice, low level of commitment to its mission and low chance to meet the social mission
C	**Very Low** social performance and financial practice, very low level of commitment to its mission and very low chance to meet the social mission
D	**Lowest** social performance and financial practice, minimum level of commitment to its mission and lowest chance to meet the social mission

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 MRA and PKSF.

- **Governance and Infrastructure:**

MFIs' governance practices are crucial as these are the guidance for information flow to stakeholders, policy formulators 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 include evaluation 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.

- **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 of the 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.

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 MFI means own fund of MFI that includes retained earnings and reserves. It also indicates the ability of the MFI 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.

- **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 measure 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, NCR evaluates 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.

Disclaimer:
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