RATING GUIDE

The
Rating Initiative
Microfinance and Transparency

Rating Guide

Volume 1: The Microfinance Institutional Rating

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Rating Guide prepared by:

Co-ordination: Adrian Marti, Elora Finance Sàrl, www.elora-finance.ch
Layout, design & cover photo: Jürgen Müller, 1world.ch

Foreword

It is a good governance practice of investors to use ratings as a second independent opinion in their investment decision-making processes. Furthermore, ratings increase the efficiency of the investment process by providing transparent and objective information on the performance and risk profile of potential investees. Ratings reduce due diligence costs for both borrowers and lenders, and minimize default risk or reputation risk for lenders. These efficiencies can only be reached, however, if potential users have a clear understanding of what ratings rate and how ratings are produced. This guide is designed to help ensure that clarity. It was put together by the Rating Initiative with contributions from microfinance raters (M-CRIL, MicroRate, MicroFinanza Rating and Planet Rating), users of ratings and the Social Performance Task Force.

Introduction

In Microfinance, ratings have been available since 1996. They have been mostly provided by specialized Microfinance Rating Agencies that have been created to bridge a market and technical gap left by traditional credit rating agencies.

Their rating methodologies are backed by thorough field assessments, with a strong focus on governance, credit operations, operational risk as well as a long term perspective. These methodologies have been tested and refined over the past 15 years, as the microfinance industry has matured and gone through different waves of development. The evolution from microcredit to microfinance to financial inclusion has led to changes in the analysis of credit risk; the gradual replacement of donor funding by local and international debt, private equity or savings collection has led to changes in the funding and liquidity risks analysis; the evolution from non-profit to commercialization to double bottom-line has led to a deeper analysis of how governance structures manage to find the right balance between the MFI's financial and social goals. The most recent of these evolutions has taken stock of the crises experienced by several microfinance markets in the past years and integrated the review of Responsible Practices when rating the long term viability of Microfinance Institutions.

During 2012, the four leading Microfinance Rating Agencies also agreed on a common name for their core rating product: the Microfinance Institutional Rating. This guide focuses on the Microfinance Institutional Rating, while a second edition will be dedicated to the Social Rating.

The guide provides information on Microfinance Institutional Rating methodologies and processes; clarifies the difference between Microfinance Institutional Ratings and other ratings or evaluations available for MFIs and their investors (credit rating, social rating, certification, label, or assessments); and indicates uses that can be made of these ratings. Users of ratings will find technical information in the appendices that will be useful for those that integrate ratings in their investment process (comparability tables of rating scales).

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Microfinance Institutional Rating: An opinion on the long term viability and creditworthiness of MFIs

Microfinance Institutional Ratings provide an opinion on long-term institutional viability and creditworthiness. It measures the probability that an MFI will continue to operate and remain a "going concern", even if there are unexpected developments.

This opinion is provided after a comprehensive assessment of risks and performance on the following categories. Microfinance Institutional Ratings can be conducted for regulated and non-regulated institutions.

Governance and Management

Rating parameters	Due Diligence carried out by raters
Corporate Governance Strategy Management Responsible decision making Mission Alignment	**Interviews** are conducted with Board Members, Shareholders, Management Team members, as well as Field Staff. **Documents** such as Board minutes, Business Plans, Budgets and Human Resources Manuals or Training Materials are also reviewed.

What is specific to Microfinance when analyzing "Governance and Management"?

Microfinance is built on the premise that a strong motivation for a positive social change can be put at the heart of financial institutions that otherwise operate mostly according to mainstream best practices defined for enterprises that aim at creating value for their shareholders. Balancing this goal (improvement of the socio-economic situation of clients) with profitability or viability creates a complex endeavor for governance structures, and one that is constantly challenged by internal or external evolutions (transformation of legal structures, introduction of new shareholders, rising competition, market saturation, regulation, etc.). Understanding the tensions in the boardroom and the capacity of Management teams, Board members or Shareholders to manage that double bottom line has led microfinance raters to develop an evaluation of governance that incorporates ideas of responsible finance and the balancing of these tensions.

Financial Profile

Rating parameters	Due Diligence carried out by raters tools
Financial Performance Funding Asset Liability Management Solvency	Interviews with the MFI managers are conducted to complement the financial analysis. Operational and financial indicators are compiled and adjusted if needed notably in case of underestimation or lack of reliability of NPL ratios.

What is specific to Microfinance when analyzing "Financial Profile"?

The financial profile of Microfinance Institutions is reviewed based on an analysis of standard financial indicators, taking into account historical trends, outlook and comparison with benchmarks. Benchmarks include other MFIs operating in the country or region and more generally all financial institutions that are direct competitors of the rated institution. Benchmarks of best practices of MFIs from other comparable countries are also used, notably when rating MFIs that operate in relatively immature markets. Specific indicators are used to assess the operating efficiency, given that operating costs represent a major share of an MFI's total cost base. Specific attention is also given to the loan loss provisioning methods, in order to identify potential situations of under-provisioning and apply the necessary adjustments. Given the usually (very) short term nature of an MFI loan portfolio, the financial profile can rapidly evolve. The capacity of an MFI to swiftly identify changes in its financial performance and to adjust its strategy accordingly are taken into account in the rating.

Operations and Organization

Rating parameters	Due Diligence carried out by raters
Loan Portfolio Quality Human Resources MIS Internal Control and Audit	**Interviews** are conducted with Credit Managers and representatives of all levels involved in the credit process (Loan Officers and Cashiers, Supervisors, Branch Managers). Rating teams test the internal control system for key operations (disbursements, repayments, data entry). Field visits also include interactions with clients to get their perspective. **Documents** such as Credit Procedures, Management reports, Audit and Accounting procedures and Audit Reports are also analyzed. Data accuracy is tested with a sample of credit files and client level records.

What is specific to Microfinance when analyzing "Operations"?

The key difference between microcredit and traditional banking is that the credit decision is primarily based on the clients' repayment capacity and is less often backed by collateral requirements. The assessment of repayment capacity often cannot be based on formal documentation of resources or assets, since microcredit clients mostly derive their income from informal activities, and might lack proper identification documents, or documentation of their properties. The manner in which this repayment capacity is determined by loan officers in the field is thus crucial to a microcredit loan portfolio. Microfinance raters have to check the loan portfolio quality by reviewing credit methodologies, as well as their implementation, and thus visit field offices, interview loan officers, and interact with clients. The evaluation of the loan portfolio quality also implies a detailed review of the loan portfolio credit risk, per branches, regions or sectors.

> Bamboo Finance encourages MFIs to undergo a third party rating. Our proprietary social performance scorecard ASPIRE includes a (scored) question on the existence of social and financial ratings. Additionally, we use third party ratings in assessing MFIs in our due diligences and monitoring processes and we value the reports as a source of additional information to help us form investment/ divestment decisions
>
> Ximena Escobar de Nogales, Bamboo Finance

Because of the nature of their activities, Microfinance institutions are particularly vulnerable to operational risks: credit decisions are heavily decentralized and the loan officer usually has an exclusive knowledge of key information about the clients; MFIs often operate in areas where communication infrastructure, energy supply or IT skills might be a challenge; MFIs are usually relatively young institutions, and they are also often fast growing; external audits of their accounts do not always include a review of internal controls; etc. Microfinance raters have to check that internal control systems are well defined and enforced. This is done through visits of field offices during which routine operations are observed (disbursements, repayments, client appraisal visits, etc.), and key control points are tested (data reconciliation, separation of incompatible tasks, etc.).

Responsible Practices

Rating parameters	Due Diligence carried out by raters
Client Protection Responsible Performance	Questions related to these topics are added to the **interviews** conducted in the framework of the analysis of Governance & Management, Operations and Financial profile. Interaction with clients on their perception of client protection is important. **Documents** such as Code of Ethics, Client protection policies, and board minutes.

What is specific to Microfinance when analyzing "Responsible Practices"?

If a client's situation badly deteriorates when using the service of an MFI or if clients do not trust the MFI to serve them in the long run, the value of microfinance assets can quickly drop: MFI loans are indeed mostly un-collateralized and when they are collateralized, legal collection processes are usually slow or inefficient; MFI deposits are mostly demand deposits. Client protection practices are thus evaluated and tested to ensure that MFIs do not undermine their long term viability with practices that put their clients at risk.

Microfinance Environment

Rating parameters	Due Diligence carried out by raters
Political, economic and financial context	Regulators and Supervisory Authorities are **consulted** when necessary.
Legal and regulatory environment Competitive environment	**Documents** such as Laws and Regulations, Country Political and Economic Outlook are reviewed.

What is specific to Microfinance when analyzing the Environment?

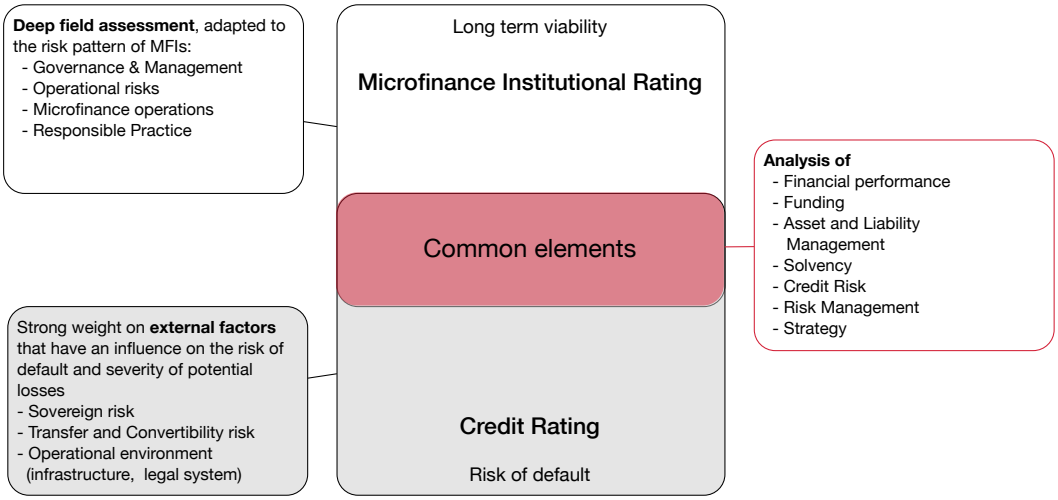
Even if the performance of microfinance has a lower correlation to local or international economic conditions than the rest of the financial system, the performance of Microfinance Institutions has to adapt to, and can be influenced by the political, economic or financial situation in the country or region where it operates. These factors are thus integrated in the Microfinance Institutional Ratings.

Because the existence of a sound market infrastructure and an enabling regulatory framework enhances the capacity of MFIs to develop adequate financial services, and prevent the emergence of certain risks such as market saturation or multiple lending, the following elements are taken into account in Microfinance Institutional Ratings: sound regulation and supervision; transparency on risk levels and performance of all actors; status and enforcement of customer protection norms; existence and operational effectiveness of credit bureaus; etc.

Microfinance is a relatively young and high growth industry. This means that the competitive landscape is changing much more rapidly than that of the traditional banking sector in most countries. The existing competitive environment is assessed as part of a Microfinance Institutional Rating, as well as the potential changes that could affect the microfinance landscape (changes in regulation, downscaling programs of banks, subsidized programs supported by donors or the government, etc.).

What is the Difference between a Microfinance Institutional Rating and a Credit Rating?

Microfinance Institutional Ratings and Credit Rating both provide information on the creditworthiness of an MFI. However, while Microfinance Institutional Ratings look at various dimensions of an MFI with the aim of providing an opinion on the probability that an MFI will remain a viable business in the long run, Credit ratings are focused on providing an opinion on its likelihood of default, or its ability and willingness to meet its financials and in the short term. This difference of focus (i.e. one on the institution itself, and the other on its financial obligations only) leads to a different analytical approach and a different on-site rating process. This also corresponds to differences in the intended use that can be made of the rating.



Country / external risks

Elements of country risk that have an influence on the efficiency of the recourse mechanisms in case of default (i.e. legal and regulatory environment, level of corruption) have a strong weight in credit ratings. Risks arising from sovereign actions that might interfere with a financial institution's capacity to honor its financial obligations (Sovereign risk) are also factored in the credit rating.

By contrast, Microfinance Institutional Ratings only include country factors that have an influence on the long term performance of an MFI: 1) Quality of the regulation and supervision of the Microfinance sector, 2) Level of competition and risk of market saturation, and 3) Economic stability.

Focus on Governance & Management, and Operations & Organization

With their longer term perspective and adaptation to the specific risk pattern of MFIs, Microfinance Institutional Ratings have a strong focus on factors that might not have a

direct impact on the current financial strength, but weigh heavily on the probability that the MFI can remain a viable business in the long run: corporate governance, management, internal controls, responsible lending practices, deep knowledge of the clientele, etc. This focus is only made possible by relatively long on-site rating missions (3 to 7 days), that include deep field assessments to have a good vision of these important characteristics of the risk profile of MFIs.

Comparability

Unlike Microfinance Institutional Ratings, credit ratings can be used to compare the creditworthiness of an MFI with that of other potential investees or investments. Credit ratings are indeed available for all types of financial instruments, and credit ratings provided to microfinance institutions can be compared to credit ratings of other asset classes. Regulated MFI or Microfinance Institutions who want to issue financial instruments in the capital markets (bonds, shares, etc.), are usually required to get a credit rating from a rating agency that is recognized by its local financial market authority.

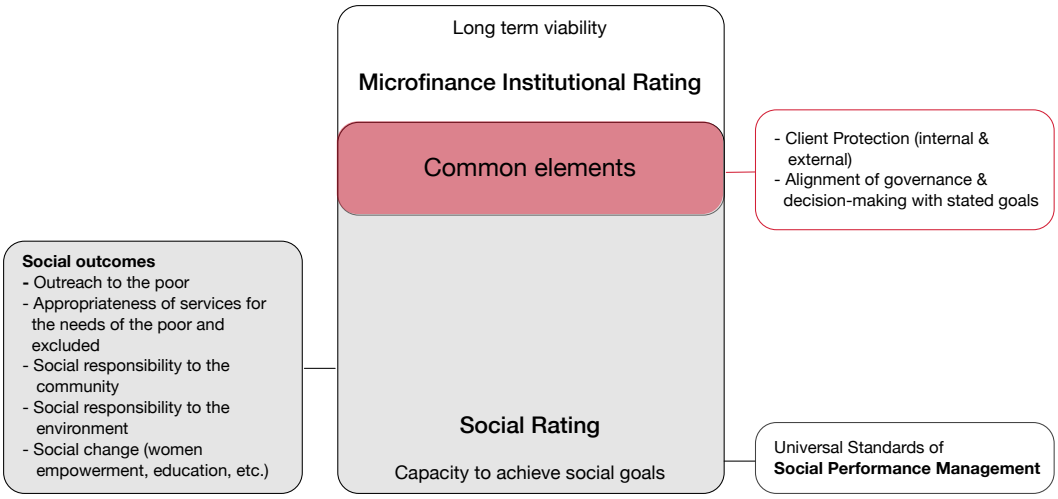
AfD, as a bilateral funder, provides grants, loans and guarantees to MFIs. Although we carry out our own financial and social evaluation before any investment, we are frequent users of rating reports at all stages of the project: identification, appraisal and monitoring. During the execution period, we actually encourage our partner MFIs to undergo a social and financial rating within two years after the signature of the loan agreement. The bottom line for us is that raters can provide (i) much more information and analysis than we can in a typical due diligence, (ii) an external, objective, comparable view and grade of the MFI through a proven methodology, (iii) a sense of the willingness of the target MFI to be transparent. The rating process is as important as the rating result.

Philippe Serres, AFD

What is the difference between a microfinance institutional rating and a social rating?

While Microfinance Institutional Ratings provide an opinion on the long term viability and creditworthiness of MFIs, Social Ratings assess the MFIs' capacity to translate the social mission into practice. It is evident, though, that the microfinance rating methodology has been notably improved with the integration of some social rating criteria like the analysis of the client protection principles and social responsibility towards staff. Lack of attention to either or both of these could lead to reputation risk and affect the viability of the MFI. However, social ratings answer crucial questions not tackled by the Microfinance Institutional Rating, such as:

- How much are MFI's products, systems (internal control, MIS) and policies (HR) aligned to the mission?
  Microfinance Institutional Ratings assess only some selected aspects of mission alignment, which are most relevant for the level of reputational risk exposure of the MFI. These are the alignment of governance and decision-making to the mission.
  Social Ratings assess, with specific details, the social performance management of the MFI, that is the alignment of policies, procedures, systems and products to the mission.
- What is the risk of mission drift incurred by the MFI?
- What proportion of the MFI's clientele is poor?
- What is the social profile of MFI clients in terms of access to basic services, educational level, access to financial services, financial education?
- What is the quality of financial services provided by the MFI?
- What is the extent of the corporate social responsibility towards internal staff, community and environment?



Target audience

More commercially oriented investors use the Microfinance Institutional Rating while double-bottom line investors tend to use social rating as well.

What is the difference between rating, assessment and certification?

The differences between rating, assessment and certification do not lie in the criteria they rely upon, but in the use that is made of them:

- Ratings compare performance relative to other actors in order to be able to choose an investment allocation
- Assessments seek to understand weaknesses to allow improvement of performance
- Certifications check and communicate on compliance with norms.

> EIF is the European Investment Bank (EIB) subsidiary for SME financing in Europe. Complementary to our internal risk assessment, EIF makes use of microfinance rating research on a regular basis, in particular assessment reports and rating reports. Such reports are seen as particularly important in a European context where there is limited information available for benchmarking purposes in the non-bank market segment.
>
> Per Erik Eriksson, European Investment Fund (EIF)

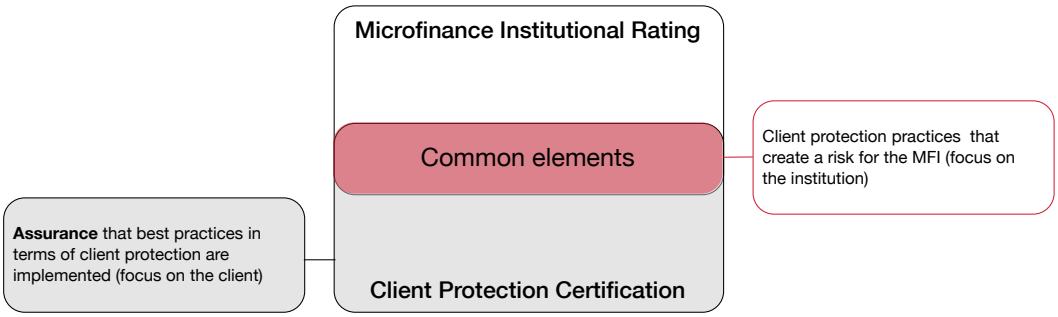
These differences lead to different focuses for the on-site missions (cross-checking of opinion, experience sharing, check-list verification) and to different outputs (public grade, private assessment report, certification label). There is however significant overlap in terms of document reviews, interviews, checks to be done during the on-site missions and these different tools can be combined for more efficiency.

Characteristics	Rating	Assessment	Certification
Main purpose	Compare performance with other actors / decide on investment allocation	Understand weaknesses and improve performance	Recognize compliance with standards
Reference	Industry benchmarks and best practices	Best practices	Recognized standards
Communication	Grade communicated to the market in all cases	Internally or to selected third parties	Certification is public
Focus of the on-site mission	Systematic review of main risks; cross-verification of opinion	Interactivity, experience sharing	Detailed check-list; verification; detailed documentation

How do the Microfinance Institutional Rating and the Client Protection Certification work together?

Client Protection Certifications promoted by the Smart Campaign focus on whether or not an institution has met **adequate standards of care** in implementing the widely accepted Client Protection Principles. A Microfinance Institutional Rating has a section on client protection, but its focus is on whether an MFI's client protection practices create risk for **institutional viability**. Smart Campaign Certification involves a more detailed review of specific client protection practices, and answers the question as to whether clients can be confident that the institution takes **adequate care** in its treatment of clients. For example the Smart Campaign Certification program's standards around "Privacy of Client Data" focus on whether customers know how their personal information will be used internally and externally by the financial institution; given that this area is not integral to an institution's viability, it will not be weighted heavily by a Microfinance Institutional Rating.

While a Microfinance Institutional Rating and Client Protection Certification highlight different aspects of an institution, they are complementary and cost-effective in implementation. When carried out in tandem the overall time and cost will be significantly lower than if each is pursued alone.



Providing a quality rating: what is the rating process?

The opinion expressed in a rating is the result of a thorough desk and a deep field analysis of both quantitative and qualitative information related to the performance and organizational features of the rated MFI. That information has to be collected from the appropriate source, verified and cross-checked many times at different levels during the visit of the institution to be consistent and reliable, measured through standard units and compared with industry reference benchmarks.

Key elements of the rating process are:

- **Preparation**: in order to optimize the time spent in the field during the rating visit, the rating agency sends the rated MFI, well in advance, the complete list of documents and information needed for the analysis plus a standard questionnaire with specific questions on loan and savings portfolio reporting standards, accounting norms, etc.. The rating analysts team normally leave

for the rating field visit having already studied the main policy manuals, strategic planning documents and having analyzed accounting and portfolio data and input them into the analysis software for elaboration.

- **Field visit**: typically, interviews with BoD members and of all the top and middle managers are conducted. Visits to the operational branches are systematically made, representing a crucial activity to directly observe the operational model and to cross-check the information included in the manuals and the one provided by the managers. The rating analysts also interview external stakeholders such as regulators, external auditors, microfinance associations, local and international investors and main competitors of the rated institution. The goal of the rating field visit is to cross-check and validate the information and data provided by the rated MFI and to directly observe the operations at head office as well as at branch level. Five full working days, for a team of two analysts, is the standard minimum time spent in the field for a specialized microfinance rating agency. A debriefing at the end of the field visit is conducted
- **Draft rating report**: a draft report is confidentially transmitted to the rated institution for comments before report finalization and publication. Rated institution and external stakeholders can easily access the rating methodology (rating agency's web site and info materials) and the quantitative and qualitative indicators definitions are disclosed within the rating report.
- **Rating report finalization**: an objective and independent rating decision process is assured by the work of the Rating Committee within the rating agency, whose members are the most senior and expert analysts and/or external independent professionals. The Rating Committee members are not involved in the first phases of the rating process (desk analysis, field visit and draft report production) and perform a deep analysis and screening of the draft report presented by the analysts and the subsequent comments from the rated institution. All rating reports are officially and publicly issued only by the Rating Committee.

> BlueOrchard uses third party ratings in its due diligence procedures and actively encourages MFIs to go through a ratings process. Ratings are a valuable complement to our on-site visits and desktop research: Analysts routinely check ratings reports against their own analysis and review them as part of active ongoing monitoring to highlight areas of potential concern. Whether or not an MFI has had a rating is also a component of our internal credit scoring system, as we believe that undertaking a rating demonstrates transparency and openness by the MFI's board and management, and a desire to adhere to best practices.
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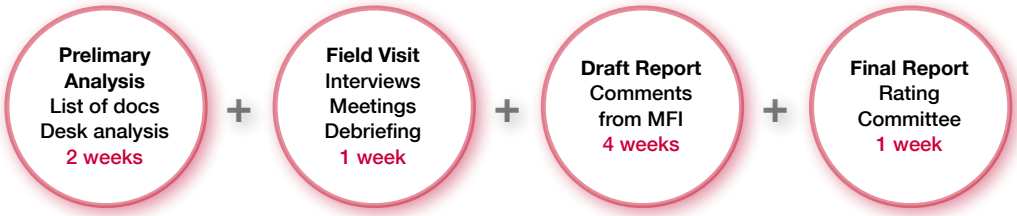
> Blue Orchard



Key characteristics of Rating Agencies: ensuring objectivity and independence of ratings

Rating agencies need to be independent third parties, in order to be as objective as possible and thus credible for all actors. They derive their independence from:

- Governance structures that reduce potential conflicts of interests to minimal levels: controlling shareholders and managers of rating agencies do not have vested interests in the entities they rate.
- Procedures to manage conflicts of interests if and when they arise.

Microfinance Rating Agencies have signed a Code of Conduct whose goal is to ensure and promote the integrity and quality of ratings of microfinance institutions (MFIs). The Code has been signed by Microrate, MicroFinanza Rating, Planet Rating and M-CRIL.

Code of Conduct of Microfinance Rating Agencies

Signatories to this Code of Conduct will conduct annual self-certifications of their compliance with the Code. These will be cross-checked by a qualified, independent, third party institution. Each rating agency will publicize its annual self-certification and compliance assessment. Below are excerpts of the main commitments taken by the signatories of the Code.

Ratings that are characterized by integrity are objective, independent and transparent.

- Best practice rating agencies actively take steps to mitigate any compromises to the integrity of ratings that might arise out of the "issuer-pays" business model, both in case of first ratings and rating updates.
- Best practice rating agencies ensure that the non-rating services that they offer do not compromise the integrity of their rating services and products.
- Best practice rating agencies minimize the chances that the relationships of their Board members and staff with the staff of MFIs and/or investors in MFIs might influence the integrity of the rating.
- Best practice rating agencies avoid ownership ties to other companies that might pose a conflict of interest or even the appearance of a conflict of interest.
- The governance structures of best practice rating agencies ensure that business interests of the company do not impair the independence and accuracy of the rating process.

Ratings that are characterized by quality are fair, reliable, consistent, complete and easily understood

- Best practice rating agencies are fair and transparent.

- Best practice rating agencies, within the time limitations of a rating mission, conduct fact-driven analyses of their rated MFIs' performance and level of risks.
- Best practice rating agencies use straightforward and clear language in their rating reports to express fact-based opinions.
- Best practice rating agencies ensure that their rating missions are conducted by skilled rating analysts.
- Best practice rating agencies develop internal procedures to ensure that ratings are consistent across rated customers and standardized product-by-product.
- Best practice rating agencies aim for completeness in their ratings.

How can Microfinance Asset Managers use ratings? Integrating ratings in investment processes.

Ratings increase the efficiency of the investment process by providing transparent and objective information on the performance and risk profile of potential investees. Ratings can reduce due diligence costs for both borrowers and lenders, and minimize default risk or reputation risk for lenders. Below are outlined the major sources of efficiencies.

Phase of the investment process	Identification of targets	Due diligence	Credit decision	Monitoring
Potential role of rating	Provide 1st rating of emerging MFIs	Enhanced due diligence on weaknesses identified by ratings	Second opinion to balance Investment Officer's opinion	Enhance or substitute monitoring visits
	Demonstrate commitment to Responsible Lending Practices			
Expected benefits for Microfinance Asset Managers	Higher deal flow	Lower credit risk	Lower credit risk	Decreased cost of monitoring

During the screening process, ratings help identify new investment targets:

- MFIs usually get a rating in order to gain access to potential funding providers.

Before investment decisions are made, ratings supplement due diligence:

- Second opinion: a rating provides an objective second opinion that can back, cross-check, or balance the investment officer's opinion and more generally inform the credit decision. Investors use ratings as a good governance practice for their investment decision-making process.
- Verification of information: Rating on-site missions last from 3 to 7 days. It allows rating analysts to verify the reliability of key data such as portfolio quality indicators which are not always extensively verified by external auditors, and also to have an assessment of the quality of loan-officer/client interactions. The relatively short timeframe of an investor due diligence usually does not allow for such in-depth verifications.

During the life of the investment, ratings enhance or substitute monitoring visits:

- Ratings provide the information that is usually collected during monitoring visits; for some investors they could replace monitoring visits, especially when these visits are not meant to decide on a loan renewal, and if MFIs regularly update their ratings.
- Investors that integrate the update of ratings in their loan covenants can ensure that they receive updated information on strategic developments and evolution of major risks in the operations or environment in which the MFI operates.

Ratings are used to demonstrate a commitment to responsible investment practices:

- Ratings enable direct investors to ensure that public and verified information is available on the performance of the investees on these issues.

Rating Grade Comparability Table for Specialized Microfinance Ratings Agencies

A ratings comparability table can be useful to investors as well as MFIs seeking to compare themselves to other MFIs in local or other markets. The Rating Grade Comparability Table for specialized Microfinance Ratings Agencies segments their rating grades into four categories, numbered 1-4, which correspond to classifications of Excellent, Good, Fair, and Weak. Each of the four rating categories is segmented based on a continuum of performance and risk, and encompasses from two to four rating grades per rater. The table is based on the participating specialized Microfinance Ratings Agencies' respective methodologies as of September 2012. The complete report and details on the methodology used to develop the ratings comparability table may be found at www.fomin.org.

Category	Classification	Definition	M-CRIL	MicroFinanza Rating	Microrate	Planet Rating
1	Excellent	Excellent performance Low or well-managed short- medium term risk	α+ α	AAA AA A	α+ α	A++ A+ A A-
2	Good	Good performance Modest or well-managed short- medium term risk	α- β+	BBB BB	α- β+	B++ B+ B B-
3	Fair	Fair performance Moderate to medium-high risk	β β-	B CCC	β β-	C++ C+ C C-
4	Weak	Weak or poor performance High to very-high risk	γ+ γ	CC C D	γ+ γ	D E

Glossary

Assessments

- Assessments are usually designed for internal use, or are only shared with selected technical or financial partners.
- They do not have the same comparability as ratings since they can be tailored to the specific needs of the institution at a given moment (for example: review of MIS only, or evaluation of the social performance management systems, audit of portfolio quality).
- Rating agencies are one of the providers of assessment services in microfinance. They might use the same criteria as the ones used during rating missions if the goal of the assessed entity is to have a vision on its overall institutional viability or social performance.

Certification

Certification is the verification that a company complies with a set of norms, at a given point in time. These norms are defined by standard-setting bodies (for example, the International Organization for Standardization, which defines all "ISO" standards). These bodies can either be regulators, or industry associations wishing to provide a tool for the self-regulation of their sector. The standard-setting body delivers licenses to certifiers that will check an entity's level of compliance with standards.

In microfinance, the Smart Campaign has so far played the role of a standard setting body for Client Protection, by gathering experts, proposing draft standards and collating comments from a wide range of industry players. The Code of Conduct for Indian MFIs, created by the two national industry associations (MFIN and Sa-Dhan), is another standard. Certification that MFIs comply with that Code will also be made available.

Certification is meant to guarantee full and complete compliance with the norm. The certification process thus entails very detailed verifications of the procedures and processes. Minor breaches to the norm might be accepted, and lead to a Certification with reservations or qualifications, and a timeframe for correction of the exceptions.

Creditworthiness

Creditworthiness refers to the ability and willingness of an MFI to repay its financial obligations.

Ratings

- A tool to communicate with the market: Ratings are designed to be made available to the public and with all potential partners of an MFI. In particular,

they are a means of communication between MFIs and Investors or Development Finance Institutions (DFIs).

- Ratings, when they are mandated by the regulator, are a means to ensure that all market players have all the information they need to make informed investment decisions; a wide communication of grades is thus a mandatory requirement for regulated rating agencies (rating agency website, press release, etc.).

Short term

A short term credit rating for a financial institution relates to the probability that the institution would be able to repay its financial obligations due within the coming twelve months. Typically the analysis on which a short-term rating is based gives greater weight to factors such as near-term liquidity, financial flexibility and solvency.

Long term

A long-term credit rating assesses the institution‘s ability of repaying its financial obligations beyond the coming twelve months. Therefore, it attributes a higher weight to institutional factors such as corporate governance, management structure and quality, systems, market positioning and competitiveness, performance trends and solidity (profitability, efficiency, productivity).

There is certainly a link between short-term and long-term rating as, typically, the short-term default risks cannot be separated from the long-term risk profile, while a low short-term default risk can coexist with a high long-term risk profile.

Even if microfinance rating validity is normally one year, they carefully consider long term factors for the assessment of the institutions.

Social performance

Social performance is “the effective translation of an institution’s mission into practice in line with accepted social values.” In other words, social performance refers to the institution’s strategy and internal processes which lead to the accomplishment of its mission.

The Rating Initiative was launched by ADA in collaboration with the Government of Luxembourg, the Microfinance Initiative Liechtenstein, the Swiss Agency for Development and Cooperation (SDC), Oxfam Novib, the Oesterreichische Entwicklungsbank (OeEB), ICCO, the Principality of Monaco, the Ford Foundation and Blue Orchard.

The Rating Initiative has collaborated with ResponsAbility, the African Microfinance Transparency Forum (AMT) and the Social Performance Task Force in all aspects related to ratings, including a specific emphasis on social ratings.

The Rating Initiative was driven by the following 3 objectives:

- Promote and contribute to the establishment of a financially viable, sustainable and healthy global microfinance rating market both from the demand and supply side in underserved regions for both financial and social ratings.

- Address in the long term the lack of available, transparent information on MFIs for investors, donors and other microfinance stakeholders, including the MFIs themselves.

- Ensure the availability of market information not just on MFIs but on the microfinance rating sector in general.

This Rating Guide is part of the phasing-out period of the Rating Initiative which is funded by ADA and SDC.