

MICROFINANCE INSTITUTIONS RATING METHODOLOGY

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BACKGROUND

As institutions which provide financial services and products (thrift and credit of relatively small amounts) to low income earners to enable them raise income levels and improve living standards, microfinance has become accepted as a socially motivated means of development. Impressive track record of microfinance programs in some parts of the world, have sparked the imagination of public policymakers, donors, new investors and the recipients of microfinance services thus spurring increasing demand for the sustainable livelihood and development that microfinance can offer. As a result, microfinance investments have been on the rise in the last few years, with an increase in both private and public sector funding.

An **Agusto & Co. Microfinance Institution (MFI) Rating** is an independent assessment of the credit worthiness of an MFI. We give an objective opinion concerning the ability of the MFI to meet its obligations in a timely manner. While we recognise that microfinance institutions may also incorporate a social mission, we also understand that these missions may not be comparable across board. Thus, our ratings focus on credit worthiness, while incorporating a limited view of how the MFI has fulfilled any social objective (if any) under our review of management and governance.

An Agusto & Co rating is not an audit or an equity opinion and therefore does not assess the ability of the MFI to create value for its shareholders. It is merely a forward-looking evaluation of the ability of the MFI to meet its obligations as and when due. We are therefore not liable to any third party who relies on our opinion.

Our track record in providing independent ratings dates back to 1993, when we commenced risk rating on Nigerian banks. Initially we rated all 129 banks in existence in Nigeria at that time on an unsolicited basis. In 1997, we discontinued our unsolicited ratings of banks and requested Nigerian banks to solicit an independent rating from Agusto & Co. Limited. From 1998, the scope of our ratings expanded to include Discount Houses, Insurance Companies, Finance & Leasing Companies, Primary Mortgage Institutions, Asset Managers, Mutual Funds and Industrial Companies. We also rate municipal bonds, corporate bonds, and financial institution bonds.

Agusto & Co. ratings are acceptable locally and internationally. Users of and subscribers to our rating publications include major international banks such as International Finance Corporation, The World Bank, FMO Holland, HSBC, Standard Chartered Bank, Barclays Bank, Credit Suisse, US EXIM Bank, Bank of Japan, Reserve Bank of South Africa, European Investment Bank, Commonwealth Development Corporation, African Development bank, French development Bank, JP Morgan Chase, ING, BNP Paribas, Citigroup etc. as well as major reinsurance companies and insurance brokers such as, Munich Re, Swiss Re, African Re, J. B, Borda, Alexander Forbes e.t.c. This is in addition to all the Treasurers of major companies, Treasurers of banks, reinsurance companies, as well as a diverse spectrum of local and foreign investors and Issuing Houses

Over the years, these institutions have relied on the high quality of our credit reports and our opinions to take decisions.

RATING OBJECTIVES

Our principal objectives in analyzing and rating the MFI are to:

- assist the MFI's investors and other stakeholders better understand the risks attributable to investing in the institution
- contribute to the development of the financial markets by providing independent risk assessment for the purpose of determining the pricing of financial instruments and
- support the regulatory authorities in their objective of achieving a sound financial system and the sustained confidence of depositors in the system

RATING PHILOSOPHY

Agusto & Co. ratings are based on both quantitative and qualitative criteria. Our analysis is premised on audited financial statements, un-audited quarterly management accounts, regulatory filings and other information provided by the MFI. Typically, a rating analyst would require three years of audited financial statements, but under certain circumstances, we will accept to analyse the financial condition of the microfinance institution over a minimum period of two years, using the current year as the focal period. We will also assess other issues (both qualitative and quantitative), which we consider necessary, before arriving at a rating.

We recognize that it is difficult to arrive at a meaningful rating without discussing with management and obtaining additional information that is not ordinarily available publicly. Therefore, we seek both historical and forward-looking information from management on issues, which are relevant for arriving at a rating for the MFI concerned. All confidential information, which we obtain through this process, is used solely for the purpose of arriving at the rating and will not be published or otherwise disclosed to third parties without the prior consent of the MFI.

We also recognize that changing circumstances may quickly invalidate a rating which was previously valid. We will therefore review our ratings in instances where there are significant subsequent events, which may warrant a change in a previous rating. These reviews will be based on both published financial statements and possibly un-audited interim financial statements. The rating may be changed, suspended, or withdrawn at any time. However, the reason for the change, withdrawal or suspension will be communicated to the MFI in advance.

OUR RESPONSIBILITY

The relationship between the rated MFI and Agusto & Co is contained in a standard letter of engagement, which is addressed to Agusto & Co. by the MFI. The letter sets out the contractual relationship between the MFI being rated and the rating agency.

THE RATING PROCESS

A rating programme is put in place for every microfinance institution that solicits a rating. This covers a period of one year and includes a detailed annual review of each institution as well as quarterly reviews once the rating is concluded.

Our rating exercise commences with information gathering using our standard questionnaire and a preliminary analysis of the financial statements of the microfinance institution. This continues with a pre-rating meeting with the principal officers of the MFI. Well in advance of the pre-rating meeting, the

MFI is asked to submit the documentation from the questionnaire allowing the analyst sufficient time to review them. Following the preliminary review, the MFI is informed of any additional requirements prior to the pre-rating meeting. After meeting with the principal officers of the microfinance institution, reviewing market focus, strategies, performance and post reporting date events, a **Draft Rating Report** is then prepared on the microfinance institution being reviewed.

The Draft Rating Report will include

- Background information on the MFI
- Industry Information and obligor profile
- Analysis of balance sheet and income statements over the past three years
- Key indicators of financial condition- profitability, quality of earnings, asset quality, liquidity & funding and capital adequacy
- Comments on management expertise, business structure and governance

The Draft Rating Report is sent to the management of the microfinance institution. This is done for the MFI management team to review the report and:

- Correct factual errors
- exclude any information which the microfinance institution may consider confidential
- note any opinion(s) expressed in the report which they disagree with and reason(s) for the disagreement.

Upon receipt of the MFI's comments on the Draft Rating Report, amendments are made (where applicable) and the corrected Rating Report is then presented to our Rating Committee. The Rating Committee will also be informed of any areas of disagreement with the MFIs management during the draft Rating Report review.

The Rating Committee is provided with the scores of the MFI and any other qualitative information that may be relevant to the approval of a rating. The analyst also includes a rating recommendation.

The Rating Committee then assigns a rating to the MFI bearing in mind that the rating is forward looking and assessing financial condition and the ability of the microfinance institution to meet its obligations as and when due. It also takes into account macroeconomic and industry information at its disposal.

The Rating Report (with a rating) is then sent to the MFI's management. Our analyst(s) will once again meet with the management of the institution to discuss the report and justify the rating if required.

The MFI may disagree with its rating even after a justification meeting. There is the opportunity for one appeal to the Rating Committee. It is expected that the appeal will be accompanied with new/additional information that will assist the Rating Committee in arriving at a decision on the appeal. The decision of the Rating Committee on the appeal shall not be subject to another appeal.

Monitoring

The rating assigned to the MFI is monitored throughout its life. Changes in macroeconomics, regulatory, politics, the industry and/or the microfinance institution may warrant a change in the rating. The reason for the change is usually communicated to the microfinance institution's management.

RATING METHODOLOGY

Agusto & Co employs a top down approach in carrying out a rating, as outlined below.

Macroeconomic Analysis

As an integral part of our macroeconomic analysis, we review macroeconomic trends over the most recent five years. We also review political issues and how they affect the economy. At the end of the analysis we:

- Prepare macroeconomic projections over the next 5years
- Explore alternative political scenarios
- Form an opinion on the economic outlook and its economic impact on the microfinance sub-sector

Industry Analysis

The key areas we review are:

- Size and strategic importance of the industry
- Regulatory environment
- Industry characteristics
- Industry financial condition
- Key success factors
- Industry challenges and major risk areas
- Industry outlook

We then assign an Industry Risk Rating to the industry. Our analysis also enables us form an opinion over the performance of the industry over the short to medium term; determine the degree of operating risk faced by the rated MFI; establish industry trends and thus facilitate peer and company to industry comparison.

Rating Criteria

In arriving at a rating, we consider both quantitative and qualitative criteria. We have specific benchmarks in the following broad areas which we apply across board:

1. Capital Adequacy & Leverage

Capital plays a key role in the MFIs ability to grow business volumes, absorb possible losses and remain a going concern. Our criteria for determining the adequacy of capital focuses on the institution's ability to meet regulatory capital requirements to support its business and the rate of internal capital generation. Our analysis also includes stress testing capital ratios to examine the impact of erosion of capital from additional provisioning for nonperforming assets on the MFIs solvency. In recognition of the importance of external funding sources to microfinance institutions globally, our leverage analysis includes a review of the MFI's ability to meet its interest and principal obligations.

- Capital unimpaired by losses
- Adjusted capital to risk weighted assets ratio
- Earnings retention and the ability to generate additional capital from internal operations
- Gearing ratio – Debt to equity

2. Asset Quality

Agusto & Co considers asset quality to be a key rating concern when analysing microfinance institutions. In forming an opinion on asset quality, we consider the MFIs asset mix, risk management framework and the quality of its loan portfolio. Our analysis also factors any political, social or regulatory changes that may affect ability to collect on receivables.

- Volume and trend of classified assets and recoveries
- Loan loss rates
- Level and adequacy of provisioning
- Write-off trends
- Concentration by geography and customer types

3. Liquidity & Funding

A strong liquidity profile remains a key success factor in financial institutions and accordingly, Agusto & co places significant emphasis on the MFIs liquidity policies, adherence to regulatory liquidity requirements and contingency plans. In analyzing the liquidity profile of the MFI, we consider the liability generation capacity of the institution as well as its access to external funding sources. We consider funding mix, stability of funding and cost of the institutions deposit and resource base. We also review the MFIs asset & liability management (ALM) framework.

Our criteria may include:

- Liquid assets/deposit liabilities
- Weighted average cost of funds
- Ability to refinance
- Contingent sources of liquidity
- Stability of funding

4. Performance & Earnings

Our performance analysis seeks to determine the MFIs operating profitability and sustainability of earnings. Earnings breakdown aids in ascertaining the strength of core earnings as well as diversification of earnings. Given the relative underdevelopment of the industry, we consider product innovation and the ability to broaden both business scope and customer base key to sustainability of earnings. The effect of the interest rate environment and competition on the MFI is reflected in its interest margin. Expense management is also critical in our analysis due to the relatively narrow income streams of MFIs and the impact of the institutions' cost structure on equity in more adverse conditions. Ratios of operating efficiency are used to form an opinion on expense profile, while Profitability analysis includes traditional measures of profitability. Our ratios are analysed on a level and trend basis. We may also compare to peers where applicable.

- Net interest Margin
- Operating expenses/ adjusted average loan portfolio
- Cost-to-income
- Staff expenses –to-income
- Pre-tax return on average equity
- Pre-tax return on average assets

5. Business Structure, Ownership, Management & Staff

Our review of the MFI's organisational structure seeks to determine the institution's ability to exercise timely and organised control over the activities involved in meeting its obligations. Given the larger than life role of ownership on MFIs, we also consider ownership breadth and the ability to support the business. Our review of management seeks to determine expertise and quality of management. We also review the MFIs governance structure, quality and adequacy of staffing, staff productivity and the ability of the institution to retain its staff.

Our review of management may also incorporate a limited review of how the MFI has fulfilled its stated social objectives (where applicable)

- Ownership breadth
- Independence and quality of Board of Directors
- Quality of executive management
- Organisational structure
- Management independence
- Track record of senior management
- Compliance with regulation
- Reporting standards - transparency
- Stability of key staff
- Staff productivity
- Level and quality of automation
- MFIs experience/years of profitable business

6. Risk Management

We lay considerable emphasis on risk management, as we recognize that risk management practice is indicative of future asset quality. This includes a review of the MFIs risk management structure, risk management culture, loan origination and monitoring processes as well policies concerning provisioning and loan recovery. In examining the MFI's risk management structure, we focus on the practices and processes the MFI adopts to manage its business risks. This includes tools and processes used to assess and monitor operational, credit and market risk. Our analysis is also aimed at determining the MFIs risk appetite and approach to risk taking with a view to how this may impact future asset quality and performance in different economic scenarios.

In addition to these criteria, we may also use the following criteria to upgrade or downgrade the rating.

Management/shareholder conflict

A microfinance institution will be downgraded if there is open conflict between members of management and/or shareholders and we believe that this may have (or has had) an adverse effect on the MFI's financial condition.

Significant changes in ownership

We may downgrade the microfinance institution if there is a significant change in ownership and there are uncertainties about

- (1) The character of the new owners, and/or
- (2) The ability of the new owners to sustain a good track record or turn around an ailing institution.

Other factors

A rating is an opinion of the quality of risk presented by a particular microfinance institution. This risk is affected by a variety of factors which no one can predict at a particular point in time. Accordingly, where any issues come to our notice which we believe will significantly affect the financial condition of the microfinance institution or the level of risk inherent in such an institution, we will take such factors into account in arriving at a rating.

BENEFITS

The benefits of a rating include the following:

- Our Rating Report is a ready reference document on the financial condition of each microfinance institution. Subscribers can use the Rating Reports to form quick opinions on each MFI, whilst saving the time that detailed analysis would have taken. It is not a substitute for the decision-maker's own analysis but can be used when an immediate decision is required, or to form a preliminary opinion.
- It provides independent information to treasurers, credit risk managers or other persons who have responsibility for setting risk acceptance criteria, setting and reviewing placement lines and monitoring the financial condition of other financial institutions.
- It provides independent information to investors who would like to know what microfinance institution to select to invest in/to deposit their monies.
- A rating enhances the ability of an institution to access the enlarging local currency money market. This is because discount houses and other key players in the money market rely on our ratings for the purposes of identifying counter-parties and pricing transactions.
- The rating may identify internal strengths that can be built upon and other areas of weaknesses that require attention
- The publication of the rating on our Internet site and national newspapers provides publicity for the rated institution.

RATING DEFINITIONS

Agusto & Co. rating categories conform to internationally recognizable designation for rating categories.

Aaa A microfinance institution of impeccable financial condition and overwhelming capacity to meet obligations as and when they fall due. Adverse changes in the environment (macroeconomic, political, and regulatory) are unlikely to lead to deterioration in financial condition or an impairment of the ability to meet its obligations as and when they fall due.

Aa A microfinance institution of very good financial condition and strong capacity to meet its obligations as and when they fall due. Adverse changes in the environment (macroeconomic, political and regulatory) will result in a slight increase in the risk attributable to an exposure to this financial institution. However, financial condition and ability to meet obligations as and when they fall due should remain strong.

A A microfinance institution of good financial condition and strong capacity to meet its obligations. Adverse changes in the environment (macroeconomic, political, and regulatory) will result in a medium increase in the risk attributable to an exposure to this financial institution. However, financial condition and ability to meet obligations as and when they fall due should remain largely unchanged.

Bbb A microfinance institution of satisfactory financial condition and adequate capacity to meet its obligations as and when they fall due. It may have one *financial, operational or strategic weaknesses that has the potential to threaten their viability* but which if addressed, should not impair its ability to meet obligations as and when due. Adverse changes in the environment (macroeconomic, political and regulatory) will result in a medium increase in the risk attributable to an exposure to this institution.

Bb Financial condition is satisfactory and ability to meet obligations as and when they fall due exists. The microfinance institution may have one or more *financial, operational or strategic weaknesses that have the potential to threaten their viability*. Adverse changes in the environment (macroeconomic, political, and regulatory) will increase risk significantly.

B Financial condition is weak but obligations are still being met as and when they fall due. Has more than one major weakness and may require external support, which, in our opinion, is not assured. Adverse changes in the environment (macroeconomic, political and regulatory) will increase risk significantly.

C Financial condition is very weak. Net worth is likely to be negative and obligations may already be in default.

D In default

The first four categories of ratings are investment grade, while the last four are speculative grade. The ratings from Aa to C may be modified by the addition of a plus or minus sign to show relative standing within the category.