

The Role Of Microfinance Ratings In The Sustainable Development Of China's Financial Inclusion Sector

A joint research publication of
Planet Finance China and Planet Rating

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July 2014

Acknowledgements

We would like to thank all the people who were interviewed for this research or provided comments on the report, with a particular note of gratitude to Lynn Exton, Rui Guo, Lianggang He, Emmanuelle Javoy, Jinchang Lai, Tammy Lam, Hui Li, Aldo Moauro, Edouard Sers, Damien Von Stauffenberg, Paul Tholly, Arnaud Ventura, and Rui Zhang.

Laura Hemrika from the Credit Suisse Microfinance Capacity Building Initiative has been a champion of this project and other sector-level work on building a sustainable financial inclusion sector in China. Her counsel and support have been vital to this project.

Finally, we wanted to thank our team of researchers, who have tirelessly supported us in our exploration of this topic, particularly Aurora Yan, Kel Yang, and Michael Zhang.

About the PlaNet Finance Group

PlaNet Finance is a global leader in positive and responsible economic actions. For nearly 15 years it has worked to help poor populations gain access to financial services, and so improve their living conditions in a sustainable way -- by integrating them into the economic system. The PlaNet Finance Group contributes to the development of the microfinance sector by implementing specific products and services that address the needs of people who suffer, due to their exclusion from the mainstream economic system. With an international presence in more than 80 countries, the PlaNet Finance Group is now recognized as a major force in the fight against poverty. It was founded in 1998 by Jacques Attali and Arnaud Ventura.

www.planetfinancegroup.org

About PlaNet Finance China

Since 2003, the PlaNet Finance Group has been active in over 20 provinces in China. As one of the first and only international microfinance organizations operating on the ground, PlaNet Finance China counts the leading Chinese financial institutions engaged in microfinance and financial inclusion as its clients and partners. Through its Microfinance Plus programs, PlaNet Finance China also links microfinance to social development programs (health, education, and environment). PlaNet Finance Group also operates two microfinance institutions in Sichuan province.

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About Planet Rating

Planet Rating is a worldwide rating agency specialized in microfinance, focused on providing all microfinance stakeholders with the information they need for sound growth of the sector. For more than a decade, it has provided institutional, social and financial ratings of Microfinance Institutions (MFIs), and its work has played a vital role in professionalizing the microfinance sector. Planet Rating has won the confidence of investors through over 600 ratings and a constant attention to quality. Planet Rating's methods and process have evolved over time, but its vision has remained unchanged: to take the best of the techniques and experience of the mainstream world and adapt them to a sector that is defined by its social goals and its specific reach. Planet Rating is a member of the Planet Finance Group.

www.planetrating.com

This paper is part of the ongoing activities of the Microfinance Robustness Program, a PlaNet Finance program aimed at upgrading risk management in the Chinese microfinance sector to drive long-term sustainability. The Microfinance Robustness Program is supported by the Credit Suisse Microfinance Capacity Building Initiative.

www.credit-suisse.com/microfinance

Research Group

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Abbreviations

ADA	Appui au Developpement Autonome
ADB	Asia Development Bank
CAMEL	Banking supervisory rating system used in US banks. Stands for Capital Adequacy, Assets, Management Capability, Earnings, and Liquidity.
CBRC	China Banking and Regulatory Commission
CGAP	Consultative Group to Assist the Poor
CNBS	National Commission of Banking and Securities
CSRC	China Securities Regulatory Commission
EIU	Economist Intelligence Unit
GONGO	Government-run organizations with social missions
ICCO	Inter-Church Organization for Development Cooperation
IDB	Inter-American Development Bank
MCC	Microcredit Company
MFI	Microfinance Institutions
MIF	Multilateral Investment Fund
MSME	Micro-, small-, and medium-sized enterprise
NRSRO	Nationally recognized statistical rating organizations
OeEB	Oesterreichische Entwicklungs Bank
P2P	Person-to-Person
POFAs	Provincial Office of Financial Affairs
PBOC	People's Bank of China
SDC	Swiss Agency for Development and Cooperation
SME	Small- and medium-sized enterprises
SMRAs	Specialized Microfinance Rating Agencies
S&P	Standard & Poor's
VTB	Village and Township Bank

Notes on the Research

This research represents a collaboration between researchers from PlaNet Finance China and Planet Rating. Data was gathered from regulatory bodies and financial institutions, and through interviews and forums conducted with regulators, academics, and practitioners. This was further supplemented by data from the public domain.

The international section benefited from the wide range of existing research on microfinance ratings in an international perspective. We would therefore especially like to thank the authors referenced in the report.

The term "financial inclusion" is used broadly in this report to denote all the services and products that were until the past three to four years unavailable to micro-, small-, and medium-sized enterprises and individuals. Use of the term "microfinance" can be loosely defined as loans that are a multiple of 2.5 x (GNI/population), which would currently render a figure of approximately RMB 100,000 in the Chinese context.

The opinions and representations made do not necessarily reflect the views of Credit Suisse.

Foreword |

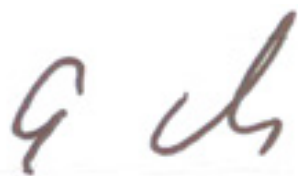
The purpose of this report is to put a spotlight on the potential role that ratings could play in China's drive toward financial inclusion. At this important juncture, Chinese regulators are coping with the supervision of a complex and fast-growing segment of players in financial inclusion. Investors are trying to understand opportunities for investment; microfinance institutions (MFIs) themselves are attempting to benchmark and professionalize themselves, thereby improving their chances of accessing new sources of funding. We believe that third-party service providers such as rating companies could become important catalysts for clarity in a Chinese market segment that is significantly lacking in transparency and benchmarks.

This study covers two main areas:

- For Chinese stakeholders, an overview of the state of the microfinance rating market internationally, principally highlighting the development of the specialized microfinance rating sector, key products and players, and key lessons for China.
- An overview of the existing rating ecosystem. We analyze the potential benefits of ratings for China and identify the factors encouraging or discouraging the further development of such an ecosystem. As Chinese banks have a longer history and more developed framework for regulation, our main focus is on the application of ratings to non-banking lending entities known as micro-credit companies, and other non-deposit-taking lenders.

By providing insight into whether and how regulators, investors, donors, and microfinance institutions could best utilize ratings in China, PlaNet Finance China aims to support efforts by public policy makers and industry leaders on the nature, scope, limitations, and applications of ratings to financial inclusion.

To produce this report, we are grateful for the support from the Credit Suisse Foundation. This report is part of the Microfinance Robustness Program, which focuses on improving risk management in micro-and small-enterprise lending in China.



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1

Our Key Findings
&
Recommendations

1. Our Key Findings and Recommendations

Key Findings on the Role of Ratings in Microfinance Internationally

- Four specialized microfinance rating agencies (SMRAs) have become the leading independent third-party raters in the microfinance rating market globally. Mainstream credit rating agencies have participated to a lesser extent, mainly serving larger, mature deposit-taking microfinance institutions (MFIs) seeking access to global capital markets, or MFIs in countries where credit ratings are mandated by regulators.
- Microfinance Institutional Ratings (MIRs) developed by SMRAs account for the overwhelming majority of ratings contracted by MFIs. In terms of their application, MIRs serve a broad gamut of MFIs, broad enough to include early-stage MFIs that are primarily interested in getting a third-party assessment of their overall capacity. This contrasts with the primary use of ratings by top-tier and mature MFIs that are mainly looking to MIR and credit ratings to access funding.
- In the ratings approach, MIRs differ from credit ratings in nuance: MIR raters are specialists in microfinance and put added focus on benchmarking microfinance best practices. Another key difference is depth. Raters conducting MIRs spend more time on-site with the MFI to verify figures and understand the nitty-gritty of operations, regardless of the size or maturity of the institution.
- Social ratings have also been developed, addressing concerns that traditional rating approaches did not measure sufficiently the social performance of MFIs, and overlooked associated risks. MIRs have also integrated social performance as one aspect of the assessment.
- MFIs themselves have been the main driver of demand, often citing the capacity-building aspect of the MIR as a major benefit. Investors have also used ratings to complement their own due diligence processes.
- SMRAs have become intermediaries channeling knowledge of best practices and

international standards to regulatory authorities. Most countries do not make ratings mandatory; but third-party rating agencies have helped bank regulators to build their understanding of how to regulate microfinance, and how to provide additional transparency and information for regulatory supervision.

- Pricing of rating products, particularly those offered by SMRAs, can be expensive for small MFIs that do not have a lot of money to invest, and this has constrained the growth of this rating model. SMRAs benefited from several major sector-strengthening programs in the early stage, programs that provided co-financing to third-party rating agencies. With the end of the sector level co-financing, SMRAs have continued to be sustainable and have carved out a value proposition for MFIs globally, though this does remain a niche market.
- Third-party ratings have made important contributions to the sustainable development of microfinance. The strengthening of MFI capacity, the dissemination of public information, and a culture of transparency have benefited MFIs, regulators, investors, and the overall public, especially in Latin America, where ratings in microfinance are most prevalent.

Key Findings on the Current Usage of Ratings in Financial Inclusion in China

- Micro and small and medium-size enterprise (SME) lending is growing at an unprecedented pace in China. In particular, the growth of non-banking financial institutions has been a driver, with over 8,000 new non-deposit-taking lenders established since 2007. There is a very low level of transparency and information quality on financial inclusion in China, posing challenges for regulators, investors, and the financial inclusion community.
- Many non-deposit-taking lenders are at an early stage of sustainability as most have been set up by shareholders without a background in finance or banking. Investors and

fundere are also tentative about investing in the sector due to the low level of transparency and capacity of these new institutions.

- Knowledge of how to regulate micro and SME lending is still being accumulated, particularly for non-banking financial institutions. Provincial Offices of Financial Affairs (governmental bodies that regulate micro-credit companies), have launched pilot ratings. The current efforts of regulators to promote rating pilots will help regulators refine their approach to regulation of non-banking financial institutions, and has also exposed rating agencies to non-banking lending institutions.
- The majority of pilots are conducted by mainstream rating agencies. Thus, China has yet to develop an ecosystem of "niche" raters focused purely on micro and SME lending. Mainstream raters are providing useful input to regulators on designing metrics. It will be interesting to see whether mainstream firms will deeply invest in specialization in rating for micro and SME lending institutions.
- For the majority of pilots, the current rating product used for MFIs focuses on self-reported financial and operational indicators and comes with a short on-site investigation period (generally ranging from half a day to two days). Such an approach allows for the coverage of a large number of MCCs, but the short on-site period does not allow for deep benchmarking of the different facets of micro and SME lending operations.
- The current criteria used by rating companies in China are developed by the rating companies to apply to MFIs in China. There is a lack of benchmarking, or even knowledge of benchmarking against global best practices in micro and SME lending. Current rating pilots also charge MCCs a very low fee by international standards. If the current cost structure is used after the pilot stage, it could create limitations on investment available to create diversified and targeted rating products for MCCs.
- The Provincial Financial Affairs Offices (POFAs) do not have an apex institution to coordinate regulation between provinces, so there is considerable variation in the pilots. Differences between different provincial approaches, scope, and aims of these ratings are not well understood, nor are they made transparent between the POFAs of different provinces, or to MFIs, or to the industry at large.
- SMRAs have yet to enter China in a significant way. Currently, stakeholders hold a misconception that ratings conducted by SMRAs are only applicable to poverty-alleviation or socially-oriented MFIs, and cannot be applied to "commercial Chinese microfinance" or SME lending, which is a key business for MCCs.
- Most Chinese microcredit companies would be motivated to pay for a rating for its practical benefits of access funding and policy preferences. A number of MCCs that would be considered to be in the top-tier according to international standards could be made eligible for much higher levels of leverage and geographical reach. However, the hope that some stakeholders have about linking rating results to policy benefits has yet to be fulfilled by the current pilots.
- In the meantime, microcredit companies may not be motivated to engage rating agencies beyond the current mandatory pilot ratings. It appears that the cost of ratings is not a major issue to MCCs, which have an average paid in capital that could absorb such a cost. The main deciding factor for MCCs will be whether rating products gain the credibility of investors, regulators, and the MCCs themselves, ultimately benefiting MCCs.

Our Recommendations for Developing a Third-party Rating Ecosystem for Financial Inclusion in China

1. Regulators are highly influential and rating indicators developed will provide guidance on how they would like MCCs to develop. In designing rating indicators, it will be key for regulators to focus on promoting those MFIs that are sustainable and adhere to the direction that regulators would like the industry to go in.
2. Better coordination and experience-sharing on rating pilots between provincial financial affairs offices is needed. Regulators should come to a consensus on best practices in conducting regulator rating pilots, in particular with regard to selection of third-party rating agencies, designing and weighting of rating indicators, and approaches to implementation of ratings. The participation of the China Banking Regulatory Commission, the People's Bank of China, and policy lending institutions such as China Development Bank, should also be encouraged.
3. At the same time that provincial regulators should come to consensus on the best approaches to non bank financial institutions for regulatory ratings, there should be left sufficient room for nuance, for example, in regional diversity. Regulators should also recognize that rating of micro-lenders and SME lenders have nuanced differences.
4. There remains some confusion in the Chinese market about the ultimate purpose of the current rating pilots. There is also confusion amongst stakeholders regarding the different rating products offered by different players. Better education of the market is needed in the key rating providers. The market should also internalize the key concept that different rating products and approaches should be linked to different outcomes and different types of users of rating products.
5. Linking ratings directly to funding access or to preferential regulatory policies (such as leverage requirements, geographic expansion, and credit bureau access) will drive stronger demand among MCCs for ratings.
6. Depending on the specific policy preference being considered (leverage, geographic expansion, credit bureau access), regulators should carefully deliberate on which rating products and approaches would be the most suitable. Third-party ratings will need to develop products with the credibility to meet the standards of regulators and MCCs. Mainstream raters should continue to accumulate their knowledge of micro-enterprise and SME operational excellence in both a national and global context, in order to gain strong credibility among regulators, investors, and the MFIs themselves. MCCs do not have good benchmarks for operational performance, especially by international standards. Therefore, there is a nascent demand for MCCs to purchase ratings similar to MIRs that take a deep on-site approach to rating. SMRAs, in particular, should be encouraged to share their knowledge with regulators, and when appropriate, local raters, to develop knowledge of MIRs adapted to a Chinese context. SMRAs need to decide how strongly to promote the social aspect of ratings versus financial and operational performance, given the commercial nature of most stakeholders in China at this current stage. Similar to the international experience, donors and other sector level players can play an important role in promoting the development of a third-party rating ecosystem by educating stakeholders, providing platforms for exchange, disseminating knowledge, and through other potential activities drawing upon the global experience of the Rating Initiative and Rating Fund.
- 7.
- 8.

2

Microfinance Ratings
in
an International Context

2. Microfinance Ratings in an International Context

2.1 Development of the International Microfinance Rating Industry

The development of ratings in microfinance can be traced back to the late 1990s. At the time, microfinance was experiencing rapid growth in Latin America (and several other regions globally). By 1997, microfinance institutions worldwide served approximately 7.6 million borrowers; the number increased to about 137 million borrowers by 2011.¹ Along with the steady increase in clients, many microfinance institutions (MFIs) began seeking domestic and international funding to fuel growth.

At the same time, a growing number of mature MFIs were emerging, signalling the potential of microfinance as an asset class worthy of a closer look by mainstream investors. In several countries, regulators also began to analyze how to better supervise this new sub-set of financial services. However, fast growth was outpacing the availability of reliable and transparent information on these new financial institutions. In the absence of globally recognized standards for this asset class, investors were limited in their ability to assess investment viability. In this vacuum, providers of third-party ratings came to be seen as offering an important means for attaining transparency and setting benchmarks. Third-party ratings were further identified as an important source of information not just for investors, but also for regulators, donors, and the MFIs themselves.

Even in the face of this potential demand, many mainstream credit rating agencies initially declared only a lukewarm interest in this new class of widely scattered, initially small-scale microfinance institutions. This is because from a credit rating perspective, many MFIs would have difficulty securing a high credit rating due to their relatively small asset size and their low level of collateralization. These rating agencies were usually engaged by large financial institutions worldwide for public issuances

of different financial instruments; however, some of the major credit rating agencies did eventually develop relevant approaches, something which will be noted later by this study.

The earliest pilot ratings of microfinance institutions were carried out by newly emerging specialized microfinance rating agencies (SMRAs), with the first efforts mainly made in the Latin American markets. These pilots culminated in the establishment between 1997 and 2000 of what are now recognized as the four main SMRAs: MicroRate (established 1997); Micro-Credit Ratings International, Ltd. (better known as M-CRIL, established in 1998); Planet Rating (1999); and MicroFinanza Rating (2000).

SMRAs differed from mainstream credit rating agencies. Mainstream credit rating agencies tend to cover only the largest and most mature MFIs that are approaching a more standard financial institution profile. In contrast, SMRAs are purely focused on rating microfinance institutions and have gradually developed specific rating methodologies and benchmarks for this sector. Their specialization also allowed them to cover a much wider range of MFIs from early-stage institutions to mature institutions.

During the 2000s, the four leading SMRAs in aggregate conducted more than 1,344 ratings worldwide. Broken down by phase, from late 2001 to 2005, 384 ratings were conducted by the SMRAs. From 2005 to 2010, 960 ratings were carried out.

Aside from the emergence of SMRAs themselves, other stakeholders—namely, development donors and international financial institutions—also recognized the potential benefits of ratings for microfinance. They actively supported the rating industry's development from the late 1990s through the 2000s. These donors supported some of the earliest pilot ratings, and these efforts further coalesced in the establishment of several important industry-level donor initiatives that were critical in shaping the microfinance ratings profession we see today.

1. Sample, Bob. "Moving 100 Million Families Out of Severe Poverty: How Can We Do It?" 2011 Global Microcredit Summit. December 28, 2011.

Illustration 1

Overview of Donor-Supported Microfinance Rating Programs

Program	Program Period	Objectives	No. of Ratings	Funders
Rating Fund	2002-2007	Co-financing MFIs, development of rating market	470	<ul style="list-style-type: none"> • IDB • CGAP • EU
Rating Fund II	2009-2012	Co-financing smaller MFIs, initiatives to strengthen rating market	82	<ul style="list-style-type: none"> • IDB
Rating Initiative	2008-2013	Social ratings, smaller MFIs, initiatives to strengthen rating market	125	<ul style="list-style-type: none"> • ADA • Gov. of Luxembourg • OeEB • ICCO • Principality of Monaco • Blue Orchard

Source: *The Rating Guide 2012*

The first major donor-supported initiative was the Microfinance Rating and Assessment Fund (The Rating Fund²). This was a principally Latin America-focused donor program launched in 2002 and spearheaded by the Inter-American Development Bank (IDB)³ and the Consultative Group to Assist the Poor (CGAP)⁴. During the program period from 2002-2007, over 470 ratings were co-financed. The program was renewed with additional donor funding and, from 2009-2012, the Rating Fund II co-financed 82 ratings of small MFIs, and undertook other microfinance rating industry-strengthening measures. The participation of the European Union (EU) in the Rating Fund II in 2005 made it a more global initiative, enabling ratings outside of Latin America.

From 2008 to 2013, another sector initiative, the Rating Initiative⁵, was launched by the Luxembourg-based microfinance agency Appui au Développement Autonome (ADA), in collaboration with a number of other donors. The goal of this global initiative was to continue the work of the Rating Fund, but it shifted the focus to segments of the global market where demand for microfinance

ratings was weak; examples were support for institutional ratings in African countries, ratings of small MFIs, and social ratings worldwide. The Rating Initiative co-financed over 300 ratings globally.

Looking back, we can see that it was during the periods of the Rating Fund and the Rating Initiative activities that the four leading SMRAs enjoyed their initial growth phase. While regional in their roots, the Rating Fund and Rating Fund II had a global impact on the microfinance rating industry by providing co-financing for specialized ratings carried out on MFIs.

Globally, the proportion of microfinance ratings that were subsidized during 2009 and 2010 hovered around the 50 percent mark, showing the influence of the Rating Initiative and its predecessor, the Rating Fund. Significantly, the Rating Initiative stopped co-funding institutional ratings as of April 2011, and since that time has placed more emphasis on mobilizing investor and donor interest in microfinance ratings, and releasing relevant case studies, guides, and research.

2. <http://www.gdrc.org/icm/rating/rate-7.html>

3. IDB is an international organization that is owned by 48 sovereign states and is the largest source of development funding in the region. It supports Latin American and Caribbean economic and social development by making loans to government and government agencies.

4. CGAP is a global partnership of 34 organizations that seeks to advance financial inclusion through practical research and active engagement with key stakeholders.

5. ratinginitiative.org

Illustration 2

Development of Ratings Carried Out by SMRAs from 2001-2013

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Number of MF Ratings conducted by 4 SMRAs (Microrate, Microfinanza Rating, MCRIL, PlaNet Rating)	45	55	76	89	119	150	154	168	226	262			
Rating Fund I & 2	31%	27%	37%	40%	32%	37%	20%	0.6%	14%	9%			
Number of MF Ratings conducted by 3 SMRAs								168	172	232	208	176	176

Source: *The Rating Guide 2012, PlaNet Rating*

*Worldwide rating data for following SMRAs: Microfinanza Rating, Microrate, PlaNet Rating. M-Cril was contacted by researchers but did not offer comparable rating numbers.

Aside from co-financing ratings of microfinance institutions, these rating initiatives also promoted sector level activities such as knowledge dissemination, exchange among stakeholders at conferences and forums, and the formation of working groups to promote development of rating best practices. Some important landmarks are the creation of a common product name for microfinance ratings (the fruit of 2011-2012 SMRA collaboration) and the compilation of a comparability table for their respective rating products. Another landmark is the completion of 416 social ratings between 2008 and 2013, an achievement which attests to the efforts of the Rating Initiative to develop the market for social ratings to complement the existing microfinance institutional ratings that focused primarily on financial sustainability.⁶

The development of specialized microfinance ratings became the key thrust of the microfinance rating industry worldwide throughout the 2000s and the four leading SMRAs were the main beneficiaries of co-financing for ratings. However, it is also notable that traditional credit rating agencies were encouraged to collaborate and participate in the development of microfinance ratings. For example, in 2008, Standard & Poor (S&P) was engaged in a small-scale pilot program to rate 14 different

microfinance institutions and to evaluate how microfinance operations could be made to fit into S&P's existing financial institutions rating criteria.

Mainstream rating agencies also serve some MFIs because in certain markets, regulators mandate microfinance institutions to periodically receive a third-party credit rating or regulatory rating: These are mostly performed by global or local mainstream credit rating agencies. (Given their specialization in microfinance, SMRAs often do not meet the regulatory requirement for rating licensing in most countries, as this usually requires rating of diverse industries).⁷ For the most part, mainstream credit rating agencies worked with larger MFIs approaching the mainstream capital markets – something which required a standardized and globally-recognized credit rating for a specific financial instrument, as opposed to the more specialized microfinance institutional rating (MIR) from a SMRA.

In reviewing the development of microfinance ratings over the last 15 to 20 years, what stands out is the creation of a specialized microfinance industry for rating MFIs using products and methodologies specifically adapted to the needs of the sector. As previously noted, the initiative to launch specialized

6. Rating Initiative. Rating Guide-Volume 2: The Social Rating Guide. Luxembourg: Rating Initiative, 2013.

7. There are exceptions. Microrate is licensed in Peru and Microfinanza Ratings is licensed in Ecuador and in Bolivia

MFI ratings came from key sector-level donor initiatives that saw the building of a market for third-party rating providers as a way to introduce transparency and improve the sustainability of the rapidly developing microfinance sector of the late 1990s and early 2000s. These SMRAs, while a niche market, have become a sustainable market globally, even though these funding initiatives have ended. This contrasts with the more laissez-faire approach where a rating market develops solely based upon supply and demand of individual investors and investors.

The enduring impacts of microfinance ratings -including the role of SMRAs - continues to be felt most strongly in Latin America, one of the earliest microfinance markets to develop, and also the focal point for the earliest experimentations and adoption of microfinance ratings. In this region, the initial rationale for creating a specialized rating market was to provide information for investors; however, ultimately the key results appear to have been the building of MFI capacity, the dissemination of public information, and a new culture of transparency benefiting both MFIs and regulators.

Illustration 3

Breakdown of Ratings conducted in 2013, by Region and Type

Regional Distribution	MicroRate (Social, MIR and Credit Ratings)	Planet Rating (Girafe MIR)	PlaNet Rating (Social Ratings)	Microfinanza Rating (Social, MIR and Credit Ratings)	Total
Latin America and the Caribbean	16	14	13	53	96
Asia	0	3	6	6	15
Sub-Saharan Africa	4	12	11	17	44
Eastern Europe and Central Asia	0	4	2	6	12
Middle East and North Africa	0	1	4	4	9
European Union	0	0	0	0	0
Total	20	34	36	86	176

Source: Worldwide rating data from Microfinanza Rating, Microrate, and PlaNet Rating. M-Cril was contacted by researchers but did not offer comparable rating numbers breakdown.

Illustration 3.1

Historical data on Ratings from 2009-2013

Region	2009	2010	2011	2012	2013
Latin America and the Caribbean	91	112	103	81	96
Asia	18	18	29	16	15
Sub-Saharan Africa	37	57	40	43	44
Eastern Europe and Central Asia	20	20	18	15	12
Middle East and North Africa	6	16	10	7	9
European Union	0	9	8	14	0

Source: Worldwide rating data from Microfinanza Rating, Microrate, and PlaNet Rating.

A number of countries in Latin America such as Peru, Bolivia, and Ecuador have regulators that now mandate ratings of MFIs, spurring increased involvement of mainstream global and local credit rating agencies. In 2012, Peru, Bolivia, and Pakistan were rated top three countries by Economist Intelligence Unit Microscope in terms of overall microfinance business environment, with Ecuador in 11th place as the country went through a transitional period while new regulations for financial institutions were implemented.⁸ Thus, it is intriguing to see the link between the high rankings of these microfinance business environments and the regulatory rating requirement. Nevertheless it is important to note that not only is the number of countries where ratings are mandated by regulators small, but also the outlook for this changing in the short term is uncertain because the majority of global MFIs are non-deposit taking institutions, where best practice leans toward "light touch" regulation.

The conclusion of the most recent large-scale donor program (the Rating Initiative) seems to signal the end of large-scale co-financing of MIRs for the

time being. Though the impact on the volume of business of SMRAs is too early to assess, based on discussion with industry participants, the 20% decrease in the post-donor phase is not as worrisome when taking into account that most ratings in the industry's initial phase were donor-supported.

In pace with the development of SMRAs over the last 15 to 20 years, the mainstream credit rating agencies have deepened their knowledge of microfinance, with some, such as Fitch Ratings, having developed specific rating criteria. On balance, it is still the case that the global credit ratings agencies take a generalist approach to financial institutions (particularly larger deposit-taking MFIs), whereas the SMRAs are focused on their microfinance specialization and in-depth on-site analysis. Furthermore, the majority of ratings of MFIs are still carried out by the SMRAs, reflecting that major demand for MIRs globally is from MFIs which have yet to reach the level of formality or scale that would warrant seeking a mainstream rating.

Key Conclusions

- Third-party ratings have made important contributions to the sustainable development of microfinance. The strengthening of MFI capacity, the dissemination of public information, and a culture of transparency have benefited MFIs, regulators, investors, and the overall public, particularly in Latin America, where ratings in microfinance are most prevalent.
- Mainstream rating agencies have not been major participants in ratings of microfinance institutions. Rather it was niche players, primarily specialized microfinance rating agencies (SMRAs), that emerged to fill the MFIs' demand for ratings, not only among mature institutions, but also among early-stage MFIs looking for an evaluation of their performance.
- Investors were expected to drive demand in the microfinance institutional rating (MIR) market when these products first emerged, but MFIs surprised the sector by becoming the main drivers of such demand; they often cited the capacity-building aspect of the MIR as a major benefit. Several countries such as Bolivia, Peru, and Ecuador have mandated ratings of MFIs. While the majority of countries do not mandate ratings, regulators have benefited from the information and transparency that ratings have provided.
- The initial impetus for development of ratings for microfinance came from several major sector-strengthening programs, which provided co-financing to third-party rating agencies. With the close of this sector-level co-financing, SMRAs have proven to be sustainable and have carved out a value proposition for MFIs globally. SMRAs will remain niche players, growing in proportion to the size of the microfinance market globally.

8. Economist Intelligence Unit. Global Microscope on the microfinance business environment 2012. Economist Intelligence Unit Limited. 2012.

2.2 Microfinance Rating Providers

2.2.1. Global Mainstream Credit Rating Agencies

Standard & Poor's (S&P), Moody's and Fitch Ratings (collectively known as "the Big Three") all have the ability to rate financial instruments, such as bonds issued by microfinance institutions (MFIs), and rate the MFIs as financial institutions (rating of financial institution involves the rating agency's opinion of creditworthiness of institution; rating of financial instruments issued is the opinion of the rating agency on the probability of the issuer fulfilling its obligation). However, the global mainstream credit rating agencies are mainly focused on applying a general rating methodology to financial institutions, rather than developing a separate methodology that goes deep into the specificities of microfinance operations, or in benchmarking microfinance performance.

S&P was the first of the three global credit rating agencies to develop an MFI rating methodology. It undertook seven pilot ratings in Latin America through funding from the Rating Fund II. However, the main conclusion of those pilots was to re-affirm S&P's confidence in its basic approach to financial institution rating, regardless of type. Fitch Ratings also had a department in charge of microfinance institution ratings (MIRs) that conducted ratings of MFIs in Europe and Latin America, and published several papers on rating methodology for MFIs.

These pilots in microfinance ratings are notable, but today global mainstream credit ratings companies are not the main partner of the majority of existing microfinance institutions, and MFIs have not been major users of the global credit ratings market. Credit ratings by the Big Three tend to come into play only for the most mature first-tier microfinance institutions that want to issue bonds or go to an initial public offering in the capital and debt markets.

Credit ratings conducted by rating agencies are used by supervisory authorities in Bolivia, Ecuador,

Pakistan, and Peru as part of national regulatory requirements governing financial institutions. This requirement may also apply to regulated microfinance entities, and will generally focus on in-country peer comparison. In most cases, locally certified mainstream credit rating agencies or local offices of SMRAs are used. The focus of this assessment work is quite different from the work around issuance of financial instruments.

Globally, it appears that having the capacity and the specialized staff to rate MFIs did not translate into strategic decisions by global rating firms to invest in the microfinance market. Even though the global mainstream credit rating agencies were registered with the Rating Fund, giving them access to co-financing of ratings for early stage MFIs, they, relative to the SMRAs, did not end up participating actively.

2.2.2. Specialized Microfinance Rating Agencies

Specialized Microfinance Rating Agencies (SMRAs) are niche raters that have performed the majority of ratings for microfinance institutions worldwide. Three SMRAs operate globally, while M-CRIL operates primarily in Asia. As previously noted, the SMRAs developed in the late 1990s and early 2000s in response to demand from donors and investors for assessment tools to bring more transparency to the MFI market. The SMRAs have produced various products over the years; however, the two core products are the MIR, which assesses sustainability and credit worthiness of the MFIs, and the Social Rating, which assesses a financial institution's ability to achieve its social goals.

Global rating agencies are generalists. SMRAs are specialists, and purely focus on the microfinance segment, spanning the spectrum of MFIs from early-stage to mature. This is reflected in their small size (SMRAs employ 10 to 20 staff), and also in the nuance of their approach to rating of

microfinance institutions, as well as the extent to which they are "tuned into" the trends and practices in financial inclusion sector.

A concern common to all the SMRAs is the outlook for growth, due to both their relatively low profitability, and to the conclusion of co-financing programs by international donors in 2011. The SMRAs have therefore all been exploring various ways to diversify their business, now offering new services and products such as rating subscription services for investors and donors, social ratings, and Smart Campaign Certification. Obtaining local certification to conduct MFI credit ratings has also been accomplished by several SMRAs in Latin America, securing a steadier stream of business.

SMRAs do not have an umbrella supervisory organization, and are thus self-regulating. In 2012 there was a concerted effort made by Multilateral Investment Fund (MIF), member of the Inter-American Development Bank (IDB) Group, and the four SMRAs to set out a comparability table between the different SMRAs' rating scales. Together, the four SMRAs produced the Rating Guide, which outlined in some detail what is common to their methodologies for analyst training, their methods for optimizing objectivity, and mutually agreed industry guidelines and principles for conducting ratings. All four SMRAs have signed the

Microfinance Rating Code of Conduct (see annex 3 for text of this document).

2.2.3. Locally Certified Mainstream Ratings Agencies

Locally certified ratings agencies can play an important role in microfinance markets where the regulators require ratings, or where international SMRAs are not licensed. In Latin America, a number of locally certified rating agencies were registered to participate in the Rating Fund II. Some of these local players have a well-diversified client base, but MFI ratings have nevertheless become an important stream of business.

Some of these local players share with SMRAs a view that microfinance is a material part of their business model, though they have different strong suits and advantages: whereas the advantage of SMRAs is in their expertise in microfinance globally, the advantage of locally certified agencies is in their knowledge of local markets, the industry diversification of their client base (relative to SMRAs), and their potentially greater ease in securing local licensing. In certain countries, local rating agencies partner with the global mainstream rating agencies in joint venture structures.

Key Conclusions

- Four specialized microfinance rating agencies (SMRAs) have become the leading independent third-party raters in the global microfinance rating market. They have a strong specialization in and knowledge of microfinance, and serve a broad gamut of MFIs ranging from mature institutions to early-stage ones.
- Global mainstream credit rating agencies have also participated in the microfinance sector, but to a much lesser extent than SMRAs. Credit rating agencies are generally only engaged by larger, mature deposit-taking MFIs in order to access global capital markets, or by MFIs in countries where credit ratings are mandated by regulators.
- Local mainstream rating agencies also play a role in serving microfinance institutions. Whereas SMRAs have strong specialization and knowledge of microfinance best practice, local raters have the advantage of local market knowledge. As they do not focus purely on microfinance, in many countries they may also be able to secure local rating licenses.

2.3. Microfinance Rating Products

2.3.1. Credit Ratings Issued by Mainstream Credit Rating Agencies

Mainstream Credit Rating

Credit ratings are the product of conventional rating agencies. They are conducted under a standard methodology, applied to any kind of financial institution, be it a commercial bank or a microfinance institution (MFI), to predict the likelihood that an MFI will not be able to meet its debt obligations. Their primary objective is to formulate an opinion on the MFI's risk of default during a given period of time, and thus tend to be used by potential investors to focus on credit risk. They are also used by supervisory authorities.

Source: *Rating Market Review 2011*

Mainstream credit ratings provide an opinion of the creditworthiness of the rated institution (as defined in the box above), and can also provide an opinion of creditworthiness for specific financial instruments issued by an institution. The credit rating of a financial instrument provides an opinion on how likely it is that the obligation of the financial instrument will be fulfilled. This opinion is provided through an analysis of the institution's data, and an analysis of the statistical probability of default on the financial instrument, with reference to historical rates of default. In the credit rating of the financial instrument, the financial

instruments are treated as investment instruments that are no different from any other instrument being sold to investors.

The benefit of credit ratings of MFIs' financial instrument is that they can be used to compare the creditworthiness of a MFI's financial instruments with those of other asset classes, and ratings are available across different types of financial instruments. Mainstream credit ratings also tend to have a standardized methodology that is applied to any financial institution, whether it is a large banking group, a stand-alone bank, or a non-bank entity.

Global rating agencies have the ability to use a global credit rating scale designed for global comparisons of issuers from different countries, while the national credit rating scale is tailored to meet the specific needs of local and foreign participants in each country's financial markets.⁹ In terms of national-scale credit ratings, locally certified rating agencies are natural choice service providers. However in some cases, global mainstream credit agencies may get involved where they have an informed view on the development of national credit rating scales.

In 2008, the Rating Fund collaborated with S&P to assess how microfinance institutions could fit into the standard financial institutions rating criteria which S&P had developed.¹⁰ While characteristics of microfinance institutions were now more integrated into their modeling, the rating company ultimately concluded that the key credit factors for microfinance included all standard indicators of creditworthiness for financial institutions.

9. Standard & Poor's. "A Pilot Project To Establish A Methodology and Criteria For Rating Microfinance Institutions." P.2. September 25, 2009.

10. For more information on this effort, please see section 2.1

Illustration 3.2

Indicators of Creditworthiness for Financial Institutions



Source: Standard & Poor's. "A Pilot Project To Establish A Methodology and Criteria For Rating Microfinance Institutions"

This reflects the consensus that "the mainstream rating agencies' experience with MFI ratings has led them to conclude that a separate methodology is not required"¹¹. However, such indicators do not measure how effective or efficient these institutions are at extending loans to micro-entrepreneurs. In the opinion of the SMRAs, it is a matter of debate whether the mainstream rating agencies have a deep enough understanding of certain risks that are particular to MFIs.

2.3.2. Microfinance Institutional Ratings

MIRs provided by specialized microfinance rating agencies (SMRAs) are the most common rating product used in microfinance. MIR includes the word "microfinance" to clearly indicate that it is applicable to the full gamut of institutions conducting microfinance, whether they are banks or non-bank lending institutions. Both microfinance institutional and credit ratings provide information on the creditworthiness of an MFI, and analyze many similar dimensions of risk. What cause them to differ are the needs of the clients (e.g. early-stage MFI versus top-tier deposit-taking institution) and the niche/specialist versus generalist profiles.

Microfinance Institutional Ratings

Microfinance institutional ratings (MIRs) perform analysis of institutional risks, including credit risk, and of the financial performance of MFIs. Microfinance ratings do not only measure the MFI's creditworthiness, but also its trustworthiness and performance in microfinance. They indicate how well an MFI is performing compared to its peers, i.e. whether the MFI reaches micro-entrepreneurs efficiently and with well-designed loans. Performance ratings are used by investors, donors, technical assistance partners and the MFI's management and administrators.

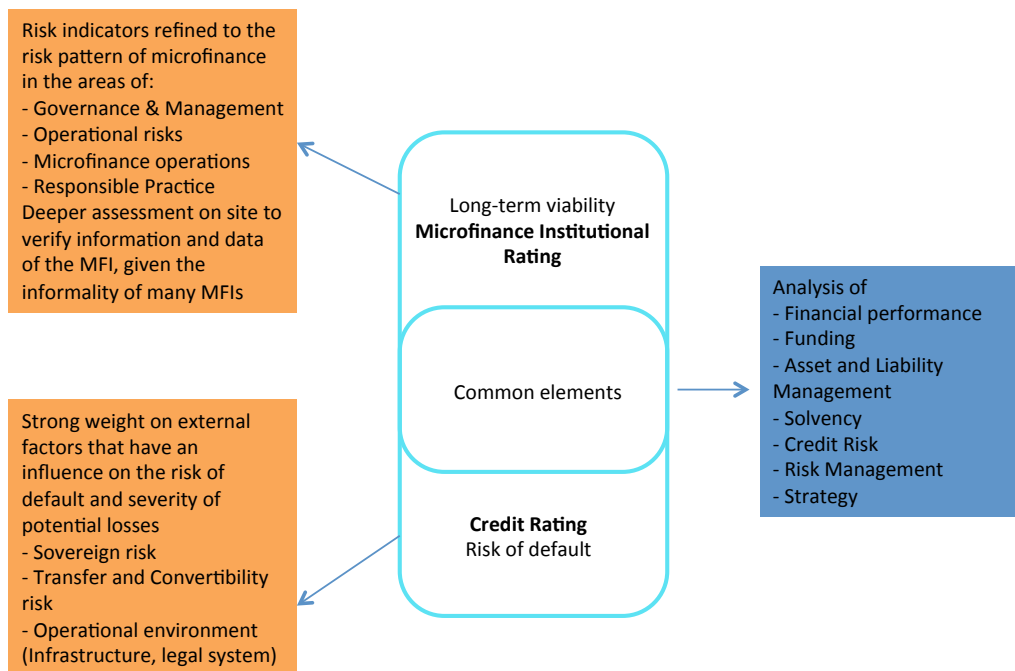
Source :Rating Market Review 2011

Mainstream credit ratings focus on sustainability and quantitative performance. MIRs, on the other hand, not only measure an MFI's creditworthiness, but also assess microfinance performance, going deeper in benchmarking of governance, information and internal control systems, risk management, credit methodologies, and client protection -- all measured against microfinance best practice. Another difference is the relatively longer on-site rating missions of three to seven days regardless

11. Buyske, Gail. "Microfinance Ratings Market Assessment." May 2013.

Illustration 4

MIRs vs. Credit Rating



Source: Rating Guide 2012

of the asset size of an MFI. SMRAs typically offer a relatively flat fee range due to the burden of the longer site visits, which results in fees that can be too high for some smaller MFIs in the absence of co-financing.

Many MFIs (particularly the more early-stage ones) have benefited from the depth and specialization of the ratings provided by MIRs, as well as the ability to compare with peers in a competitive market still lacking transparency.

Significantly, social performance elements have been introduced into the structure of the MIR. This methodological change was developed cooperatively by the SMRAs, and was formally adopted by all of them in October 2012 following a pilot-testing period. This change consisted primarily of three additions to the original MIR methodology:

a client protection evaluation, an evaluation of whether an MFI's decisions and strategies are consistent with its stated goals; and finally an assessment of the MFI's "responsible financial performance," which takes into account elements such as profit margins and management compensation.

A number of sub-products of MIRs have also been brought on to try to cater to specific client needs and the general need to diversify product offerings. Examples are mini-ratings, investment advisory reports, and pre-ratings, which target more early-stage MFIs that do not yet want to conduct a full rating. It should also be noted that while not comparable, mainstream credit rating agencies also offer products with some comparability to microfinance institutional ratings.¹²

12. Buyske, Gail. "Microfinance Ratings Market Assessment." May 2013.

Box 1: A Closer Look at the Microfinance Institutional Rating Methodology

What is specific to the Microfinance Institutional Rating (or MIR)?

Governance: Understanding the tensions in the boardroom and the capacity of management teams, board members or shareholders to manage a double bottom-line, microfinance rating agencies have developed an evaluation of governance that incorporates ideas of responsible finance and the balancing of these boardroom tensions.

Credit 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 frequently backed by collateral. Rating agencies check the loan portfolio quality by reviewing credit methodologies, as well as the quality of implementation, and thus need to visit field offices, interview loan officers, and interact with clients, benchmarking operations for trust group loans and individual loans versus microfinance best practice.

Responsible Finance: If a client's situation should badly deteriorate while using the service of an MFI, or if clients come to distrust an MFI to serve them in the long run, the value of microfinance assets can quickly drop due to the short tenor of loans (4-6 months in many cases): MFI loans are mostly non-collateralized and where they are collateralized, legal collection processes are usually slow or inefficient due to challenging local legal environments.

Regulatory Environment: The existence of a sound market infrastructure and an enabling regulatory framework enhances the capacity of MFIs to develop adequate financial services and to prevent the emergence of certain risks such as market saturation or multiple lending. In MIRs, the following elements are therefore taken into account: whether sound regulation and supervision exist in the environment; whether there is transparency on local risk levels and in the performance of all actors; the status and enforcement of customer protection norms; existence and operational effectiveness of credit bureaus; etc.

Illustration 5

The MIR Rating Process



Source: *The Rating Guide 2012*

The opinion expressed in a rating is the result of thorough desk research 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 candidate MFI the complete list of documents and information

questions on loan and savings portfolio reporting standards, accounting norms, etc. The rating analysts' team normally leaves for the rating field visit having already studied the main policy manuals and strategic planning documents, analyzed accounting and portfolio data, and input them into the analysis software for elaboration.

- **Field visit:** Typically, interviews with board members and all the top and middle managers are conducted. Visits to the operational branches are made systematically, this being a crucial activity for direct observation of the operational model, and to cross-check the information included in the manuals with the information provided by the managers. The rating analysts also interview external stakeholders such as regulators, external auditors, microfinance associations, local and international investors as well as the main competitors of the rated institution. Another objective of the site visit is to cross-check and validate the information provided by the 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. The team conducts a debriefing on findings at the end of the site visit.
- **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 deep analysis and screening of the draft report presented by the first-phase analysts, as well as the post-briefing comments from the rated institution. Final rating reports are officially and publicly issued only by the Rating Committee.¹³

2.3.3. Social Ratings

Social Ratings

A social rating is an "independent assessment of an organization's social performance using a standardized rating scale". Achievement of social impact is the ultimate goal of social performance, and the extent to which social impact is achieved is assessed through social risk (the risk of not achieving a given social purpose) and social performance.

Source : *Rating Market Review 2011*

The ratings industry has generally focused on financial performance, sustainability, and default risk. In contrast, social ratings assess the social performance management of the MFI. They

measure social outcomes such as "outreach to the poor, appropriateness of services for the needs of the poor and the excluded, social responsibility to the community, social responsibility to the environment, and social change (women's empowerment, education, etc.)."¹⁴

The emergence of social ratings took place as part of the dynamic evolution of the microfinance market, and reflected growing concerns in financial inclusion circles about whether MFIs were truly fulfilling their purported social benefits for society. For many stakeholders, the social objectives associated with financial inclusion were a key element in the work of MFIs. However, fulfillment of these objectives was not yet measured or fully reflected by MIRs at the time. When microfinance crises emerged in the late 2000s, they drove concerns about reputation risk and the consequences arising from the failure to meet social objectives.

13. Rating Guide p.15-16

14. Rating Initiative. Rating Guide-Volume 2: The Social Rating Guide. Luxembourg: Rating Initiative, 2013.

Illustration 6
Common Elements in Social Ratings



Source: Rating Guide-Volume 2: The Social Rating Guide

One of the key reasons for the set-up of the Rating Initiative was to support the development of the social rating industry, with the SMRAs being in the driving seat for social rating development. Between 2008 and 2010, the Rating Initiative co-financed 208 social ratings. Of these, 105 were executed in Latin America, 38 in Sub-Saharan Africa, 30 in Asia, with the remainder in Eastern Europe, Central Asia, the Middle East, and North Africa¹⁵. Given the positive response to this first attempt to introduce social ratings, and taking into account the globally emerging interest in corporate social responsibility, there appears to be potential for further development of this rating typology.

An important development has been the creation of a Client Protection Certification Program by the Smart Campaign (a microfinance sector initiative to ensure that MFIs adopt best practices in terms of client protection). Certification enables MFIs to go one step further than endorsing the seven Client Protection Principles¹⁶ and to obtain certification demonstrating that they are successfully implementing those principles. The program was launched in early 2013 and the SMRAs are the four institutions that are licensed to conduct such certifications.¹⁷

2.3.4. The cost of ratings and the role of subsidies

The role of subsidies in supporting the ratings of microfinance institutions is one of the unique

characteristics of this industry's development. A subsidized rating is a rating whose costs are fully or partially funded by a donor or partner. The main sources for these subsidies have been development finance institutions, socially-motivated funders, and donors via the large program frameworks of the Rating Fund and Rating Initiative. As of this writing, the role of subsidies in the funding of MIRs and credit ratings has declined substantially.

Despite the now reduced role of subsidies, pricing of MIRs has remained in the range of USD 10,000-USD 17,000 (up to USD 20,000 for some of the largest institutions). The Rating Fund and Rating Initiative, both of which capped co-financing levels, influenced the pricing ranges and market norms around pricing, and these norms still prevail in the face of the rising costs associated with qualified analysts and long field missions. SMRAs therefore consider MIRs to be a low-margin product, exacerbated by fierce competition among the four SMRAs in this niche market. There appears to be little wriggle room for pricing, but SMRAs are committed to maintaining their positioning as higher quality providers-and the likelihood is therefore that pricing will continue its trend upward.

Rating Funds I and II made funding conditional on publication of all co-financed ratings and these were made available on the funders' websites. This had the effect of reducing the capacity of rating agencies to charge investors to get access to the reports; a secondary effect was that the market at

15. Buyske, Gail. "Microfinance Ratings Market Assessment." May 2013.

16. The seven principles are appropriate design and delivery channels, prevention of client over-indebtedness, transparency, responsible pricing, fair and respectful treatment of clients, privacy of client data, and mechanisms for complaint resolution.

17. www.smartcampaign.org

large went away with the impression that ratings are donor-driven. An approach that was piloted during the last phase of the Rating Initiative was to compromise by making it mandatory to publish the co-financed rating grade on the website, but leaving the rating reports that underlay that grade as a private good that investors would have to purchase¹⁸.

2.3.5. Conflict of interest issues

Rating agencies need to be independent third parties in order to be as objective as possible, and thus credible to all actors. They derive their independence from governance structures that reduce potential conflicts of interests to minimal levels: for instance, controlling shareholders and managers of rating agencies cannot have vested interests in the entities they rate, and procedures to manage conflicts of interests should be in place if and when they arise.

To build and maintain their credibility, rating agencies must ensure and promote the integrity and quality of ratings they perform. To bolster this, the SMRAs created a code of conduct to govern their activities. However, while the code of conduct and the culture of rating itself plays an important role in reducing conflict of interest, the SMRA ratings industry still faces the same fundamental conundrum as all rating agencies:

the institution being rated pays the rater for the rating, something known in the industry as the "issuer pays" syndrome. This reliance on payment from the rated institution itself has the potential to compromise the SMRAs' neutrality.

Taking a broader look at the global rating industry, high demand for funding has led to some rating agencies being accused of delivering less-than-conservative opinions, and less than rigorous following of guidelines, criticisms typically followed by corrections. Thorough reviews of rating methodologies and weightings are now underway by governing organizations such as the European Securities and Markets Authority to ensure fairness and transparency in the process, and to reduce the over-reliance of financial firms on credit ratings.

There is also more intense scrutiny of ratings agencies and their processes in the United States in the wake of what has been seen as a systemic failure to predict the failures of Enron, Lehman Brothers, and others. In the United States, the Dodd-Frank Reform Act now mandates annual testing of rating methodologies, complementing the work of the Office of Credit Ratings. This office assists the SEC in protecting investors, encouraging capital creation, and maintaining efficient markets through the oversight of credit rating agencies registered with the SEC as nationally recognized statistical rating organizations.

Key Conclusions

- Credit ratings take a generalist approach, and mainstream rating agencies have formed a general consensus that there is not a need for specific indicators or methodology for microfinance. Rather they have general indicators for institutions involved in finance, irrespective of their size, scale of operations, or the type of product they offer. Also credit ratings for specific financial instruments are offered. Credit ratings of financial instruments are valuable to investors as they allow for comparison across asset classes.
- In contrast, the Microfinance Institutional Rating (MIR) is the most widely used product for MFIs, accounting for the overwhelming majority of ratings in microfinance globally. It shares many similarities with mainstream credit rating products in emphasizing sustainability and default risk.

18. Buyske, Gail. "Microfinance Ratings Market Assessment." May 2013.

- MIRs differ from credit ratings of financial institutions in nuance: namely, MIRs put added focus on benchmarking microfinance best practices. Another key difference is depth. Raters conducting MIRs spend more time on-site with the MFI to verify figures and understand the nitty-gritty of operations, regardless of the size or maturity of the institution.
- Social ratings have also been developed to address concerns that traditional rating approaches did not measure the social performance of MFIs sufficiently, and to pay attention to the risks of overlooking social performance such as reputation risk, a key factor that led to the crisis in Indian microfinance. MIRs have also integrated social performance into their methodology as one aspect of assessment.
- Pricing of MIRs and social ratings tends to be high, ranging from USD 10,000 – 17,000. While MFIs have found the product useful for their operations but the price high (particularly for smaller MFIs), SMRAs view the MIR and social rating as low margin products because of the need to hire and bring on specialized rating analysts, and to spend significant amounts of time on-site at the MFI. Co-financing thus played a role in increasing the number of ratings done by SMRAs.
- The issuer-payer model is a continuing topic of debate, and the stakeholders in the rating industry are searching for ways to ensure the neutrality of ratings. The rating industry's credibility is built upon its ability to maintain its impartiality and objectivity.

2.4 Use of ratings

2.4.1. MFIs

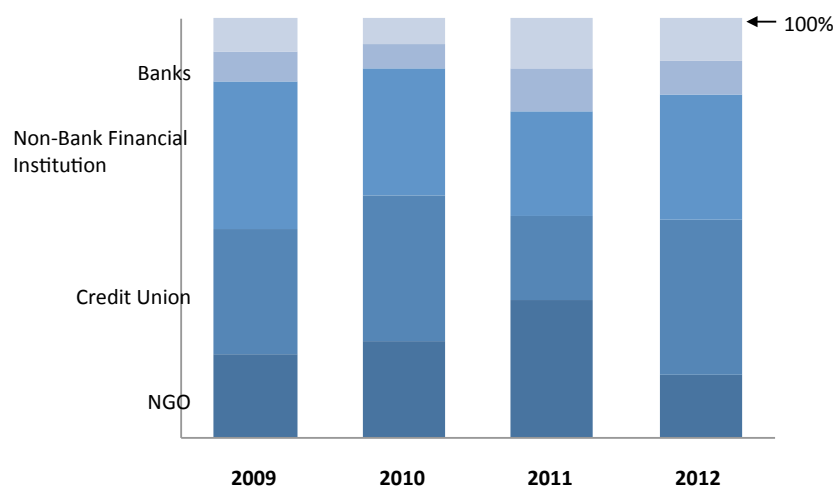
Regulated microfinance institutions (MFIs) in some countries may have mandatory credit ratings done; however, where there is no such regulatory requirement, it is interesting to examine the natural level of demand by MFIs for ratings, as well as

their key motivations for getting a rating. Through interviews with various stakeholders, we have examined the main reasons why MFIs engage rating organizations. As noted earlier in this paper, during the early development phase of microfinance institutional rating, a deemed key driver was the need to access new funds. However, interviews have revealed that in hindsight, the real value-add of an external assessment was the

Illustration 7

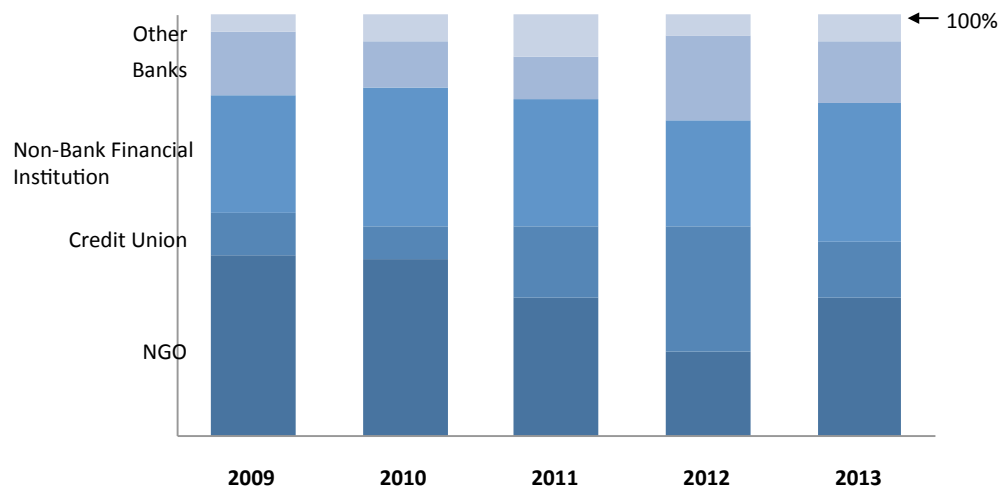
Use of ratings by MFI charter type and by Year

Microfinanza Rating's Microfinance ratings, per year and by MFI charter type



Source: Rating Results - Asia

PlaNNet Rating's Microfinance ratings, per year and by MFI charter type



Source: PlaNNet Rating

improvement of operations, and the other changes implemented as a result of the ratings.

Reviews with MFIs of their experiences with ratings have revealed there have been multiple improvements directly implemented as a result of ratings. Most often cited improvements are the creation of risk management departments, creation of internal audit departments, strengthening of governance, and beneficial changes to credit operations. These are significant improvements and capacity building catalyzed by the input from microfinance ratings. This is not to negate the use of ratings for MFIs to access funding sources; however, capacity building has been cited as the key benefit.

2.4.2. Investors

Globally, microfinance institutions have benefited from a wide range of funding sources. Local funding sources include client deposits, wholesale bank funding, and private investor funding. At the same time, MFIs can benefit from a broad range of international funding sources such as public funders (development finance institutions, donors) and private funders (some specifically specialized in microfinance) for whom microfinance presents an opportunity to diversify their investment portfolios.

These investors can benefit from the information provided by rating agencies. This is especially true of investors who are located far away from the target investee, and who can benefit from the in-country expertise of the rating agencies. However, as we have seen worldwide from the last 10 years' experience, such demand in fact is not as strong as might be anticipated. According to our research findings, there are several reasons why there is relatively limited demand for ratings from investors.

First, according to several sources in rating agencies, too much funding from investment funds known as microfinance investment vehicles has been chasing too few MFIs ever since the high-profile award to Professor Yunus of the Nobel Peace prize in 2006. In certain African countries, over-liquidity is particularly evident, and because funding has been earmarked for these countries, multiple investors ended up chasing the few MFIs deemed to be investable. Thus, there has been little incentive for getting rated when even non-rated institutions can get funding.

Second, microfinance investments rarely constitute tradable securities. Third, the investor-investee relationships tend to be rather long-term, and funders invest in developing in-house due diligence and monitoring capacities. Microfinance

investors often have the inside track on information compared to the external rating agencies because of regular investee reporting, and sometimes they additionally employ in-house analysts.

In interview, investors nevertheless recognize that ratings can provide significant indicators and are an important complementary source of objective information. Investors are also becoming increasingly interested in social ratings as most of them do not have internalized social performance assessment skills, nor do they have the time to cover this content during regular due diligence missions.

2.4.3. Regulators

Because regulators are responsible for monitoring the performance of financial institutions and for enforcing related legislation and regulatory policy, they often have their own internal "rating" systems. While these vary widely in scope and purpose from country to country, there are some characteristics of regulatory "ratings" that distinguish them from other typologies of ratings such as those utilized for the purpose of financial instrument issuance, and those which serve as a diagnostic/capacity building tool for MFIs.

- Regulators often develop their rating systems in-house (based upon variations of commonly available rating frameworks such as CAMEL).
- The information needed to produce a regulatory rating can usually be gathered from reporting submitted by the financial institutions

themselves, and may tend to focus more on compliance or key financial indicators that help regulators forecast financial solvency.

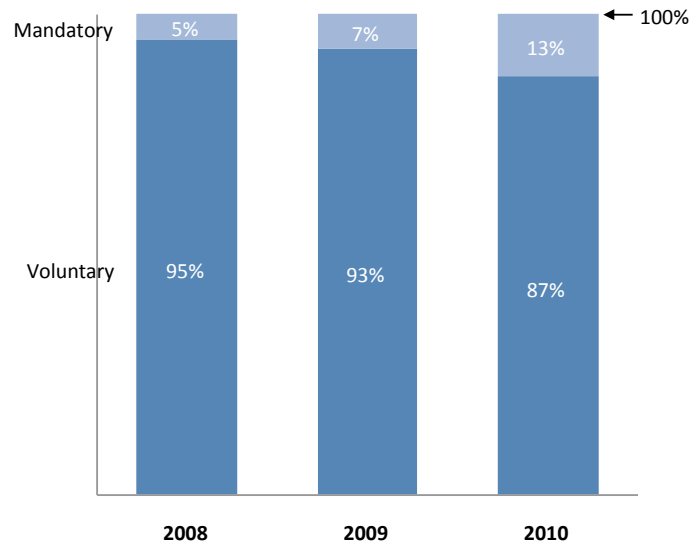
- Used in this way, regulatory ratings are a filtering tool to classify financial institutions into different buckets that are then subject to different levels of regulatory scrutiny or, in some cases, singled out for preferential policy treatment.

In developing off-site supervisory "indicators" for microfinance institutions, specialized microfinance rating agencies (SMRAs) can be particularly helpful in setting standards and weighting of different indicators. This is particularly true in new markets and markets where regulators have a background in banking but little experience in regulating microfinance. In countries/regions where regulators need to boost their capacity to evaluate the institutions they oversee, it is often the rating agencies that provide such capacity-building programs. Recently this has been a growing trend in Ivory Coast, DRC, Sudan and in Sub-Saharan Africa.

In other cases, regulators outsource the task of conducting regulatory ratings to third-party rating agencies. Peru, for example, has an extensive supervisory system, which includes mandated credit ratings and inspection of internal control for all microfinance institutions by third-party rating agencies. To date, there are four countries in the world where the regulator mandates regular third-party credit ratings as part of the reporting from MFIs. Other countries, such as India, run regulatory regimens through which they require third-party ratings on MFIs if they apply to accept fixed-term deposits from borrowers and the general public.

Illustration 8

Percentage Breakdown of MFIs in terms of Mandatory Ratings vs. Voluntary Institutional Ratings 2008-2010



Source: Rating Market Review 2011

The vast majority of national regulators do not require third-party ratings for microfinance institutions. This may be because most MFIs worldwide are non-deposit-taking financial institutions subject to a more laissez-fair approach from regulators. Regulators typically divide between MFIs requiring on-site examinations (generally deposit-taking institutions) and those requiring only self-reporting without on-site visits.

From the SMRAs' point of view, what is telling is that the 2008-2010 microfinance crisis that started in India and went on to impact many other countries (not to mention the entire global MF investment environment) showed that the risk factors that led to failures of the MFIs were caused by risks that would not be uncovered by regulatory monitoring practices or other types of assessments that do not include in-depth site visits to the operations field. The same would be true of Nigeria, where MFI operations had at one time deteriorated to the point where the regulator had to close down 200 MFIs.

The above cases illustrate the role that microfinance institution ratings could have - not only in

institution building, but also in helping regulators who are still in the process of setting up appropriate regulation and supervisory processes. It also raises questions about what is the right level and substance of regulation that is needed, especially for the non-banking sector, where the default position amongst many countries is to take a light touch approach.

Regulators have to make a remarkable amount of decisions regarding their approach to controls and the means of getting the controls set up. Institutional typologies, local economic conditions and financial sector development goals all need to be taken into consideration in shaping a regulatory framework. These should also be borne in mind when considering options such as involving third-party rating mechanisms in regulation, and the option of regulators conducting their own assessments. Our research confirms that while third-party rating agencies can help contribute to good regulation, there does not appear to be any direct correlation between the existence of third-party ratings and an absence of crisis in microfinance.

Key Conclusions

- The capacity-building results from conducting a third-party rating are cited as a major benefit for MFIs: strengthening of internal control, governance, and risk management have often followed third-party ratings.
- Many investors have also developed their own capacity for conducting due diligence on MFIs. Investors often use ratings as a complement to their own due diligence, finding useful the benchmarking and information provided from ratings, particularly social ratings, where in-house capabilities are hard to develop.
- SMRAs have also become intermediaries channeling knowledge of best practices and international standards to regulatory authorities and, sometimes, generating new benchmarks. This was especially useful for nascent markets when bank regulators were still building their understanding of how to regulate microfinance institutions and the self-reporting of MFIs lacked timeliness, accuracy, and transparency.

3

Analysis of the Relevance of Ratings to Financial Inclusion in China

3. Analysis of the Relevance of Ratings to Financial Inclusion in China

3.1 Relevance of third-party ratings to financial institutions broadening financial inclusion

3.1.1. Banks

In China, the provision of loans to micro-enterprises and small/medium-sized enterprises (SMEs) is executed by organizations that can be separated into two broad categories: deposit-taking institutions (predominantly nationwide and regional banks) and non-deposit-taking lending institutions. An increasing number of established banks in China are getting involved in pushing financial inclusion, focusing on SME lending, urban micro-lending, and, to a much lesser extent, rural micro-lending. A number of regional banks (113 city commercial banks and 119 rural commercial banks) have also set up micro- or small-enterprise lending departments, and, as such, are becoming an important contributor in the financial inclusion space. Most significantly, the China Postal Savings Bank, which has the most extensive nationwide network, has rolled out a micro-lending program. The "downscaling" trend has picked up momentum over recent years during which at least 30 to 40 banks have downscaled their lending operations to varying degrees.

While they have begun to include micro and SME lending assets in their portfolios, it is unlikely that these banks will pursue a rating specifically for their micro and small lending business, or see a particular need to retain a specialized

microfinance rating agency. This is because these banks only seek third-party ratings when they plan to issue bonds or engage in other types of debt and capital fundraising (such as an initial public offering). In these cases, credit ratings are carried out on the entire business of the bank.

The only potential exception would be the Village and Township Bank (VTB), the smallest and newest of all licensed bank models in China. This type of financial institution was approved by the China Banking and Regulatory Commission (CBRC) in 2006 with a mandate to focus on support of agriculture, and smaller loans at the county level (the regulators in China often do not distinguish between micro- and small-enterprise lending).

As of the end of 2013, there were approximately 987 VTBs established and 84 VTBs preparing to open. Their registered capital requirements are deliberately set much lower than existing nationwide and regional banks, and they are limited to operating in a single county, municipality, or township; in contrast, existing regional banks often cover an entire province or multiple prefectures within a province.

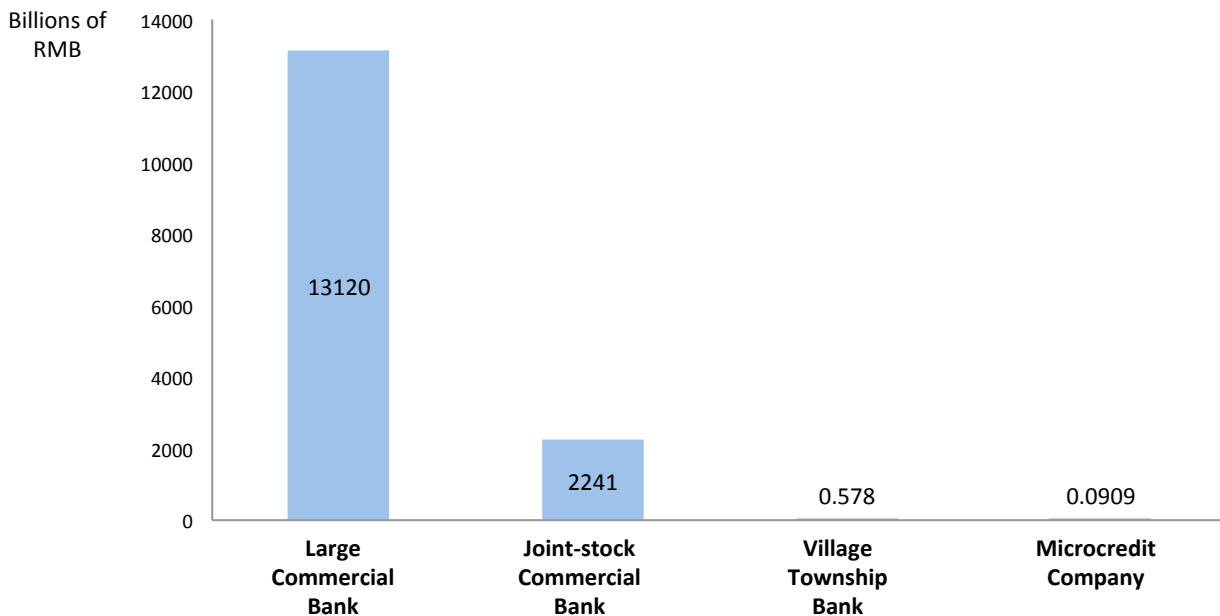
As their capital bases are much smaller, and given that they are subject to single-loan limits¹⁹, many VTBs tend to have large SME lending portfolios as well as significant involvement in rural lending and micro-enterprise lending. A recent Asian Development Bank study, *People's Republic of China: Credit and Social Rating System Development for Microcredit Companies*²⁰ suggested that the average loan size of VTBs is around RMB 300,000, a reality which suggests an even smaller loan size than non-bank financial institutions, an issue to be discussed in section 3.1.2 of this paper.

19. Single loan rules state that VTB loans to individuals cannot exceed 10% of total registered capital amount, while 15% of registered capital is the maximum amount for a single loan to enterprises.

20. Asian Development Bank. *People's Republic of China: Credit and Social Rating System Development for Microcredit Companies*. December 2012.

Illustration 9

Comparison of Average Asset Size of Banks and Microcredit Companies



Source: ADB, PBOC, CBRC

If this trend of specialization in micro and SME lending continues, some VTBs could see value in obtaining specialized rating—not necessarily for funding purposes, but rather to benchmark themselves against global micro and SME lending best practices. This is especially important given that staff of VTBs still mainly come from a traditional banking background, and may lack specialization in micro- and small enterprise lending.

However there have, to date, been very few cases of microfinance institutional ratings being conducted on a deposit-taking institution in China, and there is little marketing of micro or SME lending rating products (as assessment tools) among mainstream rating agencies and SMRAs to VTBs as potential clients.

3.1.2. Microcredit companies

In a very short period of time, microcredit companies (MCCs) have become significant actors in the financial inclusion story of China. Back in 2006,

the People's Bank of China issued guidelines for private investors (individuals and companies) to create MCCs, a new type of non-deposit-taking limited liability company designed to provide financing to micro-businesses and SMEs in China. By the end of 2013, 7,839 MCCs representing approximately RMB 713 billion in outstanding loans had been established nationwide.

Loans to MCC clients finance the working capital needs of these clients. The majority of MCCs are engaged in SME lending, although some MCCs are beginning to do micro-enterprise lending. Like VTBs, MCCs are limited by the size of their capital base and geographic coverage (strictly speaking, they are only able to operate in a single county or district of a city). However, due to the large number of institutions already set up, if assessed as an institution type, they are spread out across China. For MCCs, the potential benefits from developing an ecosystem of third-party rating service providers can best be viewed from three perspectives.

First, from a capacity-building perspective: The majority of MCCs are quite profitable, but they

tend toward high concentrations of risk in terms of loan size and industry sector; governance is also not well understood (and sometimes, not even accepted). Organizational structures are rudimentary and do not align with financial institution best practice. Related-party lending, lack of process standardization, and weak internal controls are all still quite prevalent in the majority of microcredit companies.

This high level of informality among MCCs echoes the early international MFI experience where the management and board of directors did not spend time to make improvements in risk (creation of a risk department or internal audit department, strengthening governance, etc). This might be due to lack of expertise in microfinance as management and board tend to come from non-lending backgrounds, or from traditional banking roles without microfinance exposure. Based on these characteristics, third-party service providers, with the ability to conduct independent assessments on the quality of micro- and SME-lending operations, could be quite useful for the majority of these young institutions.

Second, from a regulatory perspective: ratings and rating grades could conceivably be linked to differentiation within this large class of lending institutions and to the offer of preferential policy to best-of-class MCCs. Such preferential policy could lie in the areas of tax breaks, improved leverage ratios, and/or the promise of geographic expansion beyond the current boundaries. Geographic expansion and the leverage cap²¹ have been a focal point of lobbying amongst MCCs. These restrictions are perceived by MCCs as a major barrier to maximizing profit and achieving scale. This issue is particularly urgent for the top-tier MCCs, which in an international setting would qualify for much higher leverage and geographic expansion.

As the overall quality of information from MCCs' reporting still presents a pretty opaque picture to regulators, third-party assessment could be quite useful in providing additional evidence of good performance to the regulators so that they

could more easily judge whether the higher-tier MCCs should have a chance to enjoy preferential treatment. Interviews with various MCCs suggest that if rules linked to "ratings for preferential policy" become further formalized and set out in regulations or guidelines, they could provide a much more powerful impetus for MCCs to engage rating firms than the need for funding or capacity building.

Third, attainment of good rating grades could become a means for accessing funding: MCC borrowing from Chinese commercial banks is limited. This is reflected in the fact that total lending by MCCs is estimated at only 1.13 times the paid-in-capital.²² Banks and their regulatory authorities view MCC companies and their operations as part of informal financing; however, circumstances such as local-level bank branch cooperation with MCCs on lending has forced both the regulator (China Banking Regulatory Commission or CBRC) and the banks themselves to find ways to start assessing these relatively young institutions. At the same time, some banks also consider the current supervisory framework for MCCs to be deficient, leading to gaps in compliance and less reliable or incomplete quality of information in the reporting from MCCs.²³

Due to the above uncertainties, the CBRC has not been encouraging retail banking institutions to provide debt funding to MCCs. But a bank that is, these days, a hybrid of state policy bank and wholesale lender is the China State Development Bank (CDB) which is directly subject to the authority of the State Council. CDB has, from the first days of the MCCs, driven an aggressive campaign to be a lender to the better MCC companies; it has therefore become the main exception to the stonewalling of banks and the CBRC for debt funding. This policy-driven bank had, by May 2014, already provided wholesale funding to more than 700 MCCs.

Given their track record as a lender to MCCs, it is interesting to consider whether other MCCs could attract the attention of the CDB by having themselves reputedly rated. There are a few factors

21. The MCC segment is still bound by the original guidelines which allow a maximum debt to registered capital ratio of only 0.5:1, which is widely seen as excessively restrictive and not conducive to long-term sustainability.

22. Asian Development Bank. *People's Republic of China: Credit and Social Rating System Development for Microcredit Companies*, December 2012.

23. It is worthwhile to note that unlike microfinance internationally, international microfinance investors are not a significant player in the MCC equity or debt market due to capital controls, language barriers, and lack of information transparency. Furthermore, the inability to issue debt onshore for foreign funds is also a major barrier, thus limiting them to equity deals (which they perceive as more risky way to dive into a new sector). They are so far limited to investing in the small handful of MCCs that have offshore holding companies.

that could make this challenging: first, CDB's standard process is to receive recommendations from the Provincial Offices of Financial Affairs (POFAs), which have assumed responsibility for regulation of local MCCs since May 2008. Due diligence and lending decisions on individual MCCs are made by provincial CBD branches. Whether an external rating could be used to augment this process will ultimately depend upon whether CDB would consider such a rating useful in improving its own internal selection and due diligence process.

Alternative debt funding sources are also gradually opening up to MCCs. As noted in the joint study on the possibility of MCCs' accessing funding through the bond market,²⁴ it is conceivable that more MCCs will start using the bond and capital markets to raise funds. This means that they obtain good grades in credit ratings, something already well embedded in the process and required by the regulators. However, similar to the international experience, this route will be restricted to the "cream of the crop" for the foreseeable future.

Another funding avenue available to a broader group of MCCs (but at higher cost of funds) can be the different asset-back securitization structures realized through "exchanges" (the earliest of which was established in Chongqing).²⁵ A number of MCCs have been able to get funding through other platforms, such as through link-ups with Person-to-Person (P2P) lending structures. Such alternative funding sources could be interesting facilities for bridging the funder to the fund-seeker. So far, in the case of these funding sources, ratings do not appear to have been used as a tool by MCCs to bargain for better funding costs. Therefore, if they are to come into the picture, it will likely be the funders who will need to show the MCCs that they favor the use of ratings as credible tools in their due diligence and assessment process, as otherwise there will be no incentive for the MCCs to invest in ratings as a way to access funding.

In the short term, the most compelling case for third-party rating is its potential use as a tool in advocating for more favorable regulatory policy treatment of high-performing MCCs. In this regard, in-depth credit ratings and/or specialized microfinance institutional ratings could be attractive products given their ability to provide either detailed feedback on micro- and small-enterprise lending operations or even more granular detail on which to base regulatory decision-making. Funding and capacity building are also areas where third-party ratings can clearly play a role in bridging gaps, but this would require as preconditions that funders and MCCs are educated about the benefits of ratings, and they view the ratings products available in China as legitimate and credible.

3.1.3. Other non-bank financial institutions

Poverty alleviation microfinance institutions (MFIs) are non-deposit taking lenders that have usually been started by international aid organizations working with grassroots governments in the late 1980s and early 1990s. They are mission-driven organizations; the 42 MFIs that report to the China Association of Microfinance (CAM) have fewer than 2,000 clients each, and of the remaining 70-odd that do not report to CAM, the China Foundation for Poverty Alleviation Microfinance company, with over 150,000 clients, is by far the largest.

The majority of these mission-driven organizations operate in an incomplete legal framework and function thanks to special approvals for on-lending in poverty areas, and it is unclear whether the central government is going to actively support their continuation in their current form. Since 2008, poverty alleviation MFIs have technically been able to convert into MCCs. However, for most NGOs and government-run associations doing NGO-style work, there is a low probability of conversion due to their complex legacy structure and small capital base. There has been exception: In 2008, the first such conversion resulted in the creation of Ningxia Huimin MCC Ltd.

24. *Study on Microcredit Companies Accessing the Short- and Medium-Term Bond Market in China*. This was a joint research publication by PlaNet Finance and the Research Institute of Finance and Banking under the People's Bank of China published March 2013. This research was also supported by the Credit Suisse Microfinance Capacity Building Initiative.

25. On July 19, 2011, Chongqing Hanhua Micro-credit Limited and two other micro-credit companies' nearly \$100 million certificate of credit assets started on-line trading in Chongqing Financial Assets Exchange.

Ratings would be welcomed by many of the mission-driven MFIs that are planning or already in the process of transitioning to MCC status— in fact they would even be welcomed by those who have already transitioned. Compared to the more commercially-driven MCCs, this segment would welcome ratings not only to evaluate their financial sustainability, but more particularly to assess their social impact. Interestingly, several leading players in this space have already received ratings from the international specialized microfinance rating agencies (SMRAs) and appear to be the first movers in this regard, welcoming the potential inputs. CFPA Microfinance received ratings in both its institutional and its social aspects, and the MCCs associated with Fuping School received an institutional rating. In each case, co-financing was secured from different initiatives.

Recently a distinct type of players from the other end of the spectrum that has entered into the financial inclusion landscape is the P2P lender, a new type of non-bank organization which frequently works through an online platform. P2P platform managers intermediate between individual investors and borrowers.²⁶ They tend to be registered as non-financial companies. Though they are not subject to geographic restrictions, leverage ratios, or interest rate caps, they are liable to incur high regulatory risk as long as the legal status of their operations remains uncertain.

While often reported in the media, very little high quality information is known about P2P platform managers because the majority of these do not publish detailed information on their business models or results. Many of them have come under close government scrutiny in the past two years and have experienced significant defaults. According to press reports, Credit Ease is the largest of the P2P platform managers, which, in aggregate,

is estimated to approach almost RMB 68 billion in assets. It has developed consumer and business loan products, with which it reaches 70,000 clients, a process funded through wealth management products on the liability side.²⁷ It is difficult to find reliable statistics, although one report cited over 600 P2P platforms started by February 2014, with an average paid-in capital of RMB 13.6 million.²⁸

As P2Ps are similar to MCCs in being nascent financial institutions, third-party assessment of their operations could theoretically lend their vehicles legitimacy and transparency, and published ratings would help improve confidence amongst regulators, investors, and the broader public in the sustainability of P2P as a platform. This could be especially important given that this particular segment of the financial inclusion space has been beset with rumors, scandals and government suspicion. Militating against that, P2P platforms have an interest in keeping their business models and operating results confidential until customized legislation is in place. P2Ps are therefore not expected to pursue ratings that would be published openly - at least not for the time being.

China is in the midst of drafting its first online transaction law, which will eventually cover the gamut of online transactions ranging from retail ordering to P2P lending and Bitcoin. It is planned that the first draft of this new legislation will emerge for review around 2018, signifying that for now these transactions and the organizations behind them are in a legal limbo. Therefore, depending on who you ask, P2P lenders represent either a positive type of financial innovation for inclusion, or a grey-market lender that may be conducting illegal forms of fund-raising. Currently, for basic transactions, P2P models rely on the Private Lending Law which governs transactions between individuals.

26. For most recent developments and ruling of China's Supreme Court on P2P online lending platforms, see <http://english.caixin.com/2014-05-30/100684772.html>

27. CGAP and The Working Group on Inclusive Finance in China. "Financial Inclusion in the People's Republic of China." China Papers on Inclusiveness No. 7 (2012):

26. Web. <<http://www.cgap.org/sites/default/files/CGAP-WMFG-Financial-Inclusion-in-China-Aug-2012.pdf>>.

28. "2月底全国P2P网贷平台626家平均注册资本1360万元." - 财经快讯.N.p., n.d. Web. 25 June 2014. <<http://www.yudai360.com/zixun/show-197.html>>. (Title translation: "At end-February, the 626 P2P platforms throughout China had an average registered capital of RMB13.6 million")

Key Conclusions

- The current rates of growth in micro- and small-enterprise lending, as well as non-bank financial institutions are unprecedented in China. In particular, the 8,000-plus new non-deposit taking lenders are a new phenomenon in the financial sector, for which ratings will be especially beneficial.
- There is a very low level of transparency and little quality information on financial inclusion in China, especially regarding the large number of early stage MFIs that have sprouted up in recent years. This opacity poses challenges for regulators, investors, and all parts of the financial inclusion community concerned about the sustainability of financial inclusion in China. Many MCCs and other non-deposit-taking lenders are at an early stage of sustainability as most have been set up by shareholders without a background in finance or banking. Ratings could be an important assessment tool to help them improve their capacity, and move towards more sustainable business models.
- Knowledge of how to regulate microfinance is still being accumulated by regulators of non-banking institutions. Third-party ratings can help regulators in differentiating between good and poor performers and setting standards, both of which have the goal of achieving more nuanced supervision, policy setting, and credit bureau access.
- Debt funding from banks is difficult for MCCs to access. Other funding sources for non-banking financial institutions are becoming more prevalent. Ratings - if they can become credible in the eyes of funders - could be a tool for funders to help discern risk levels of various players.
- Banks are subject to the internal ratings of the China Banking Regulatory Commission (CBRC). For debt issuances, the CBRC will pursue ratings covering all assets of the banking institutions that are still typically dominated by corporate lending. However, for smaller banks, such as Village-Township Banks for which the SME portfolio is the core part of the business, they may benefit from ratings that can benchmark their performance against MSME best practice.

3.2. Current Rating Initiatives

3.2.1. Current rating pilots are focused on MCCs and driven by regulators

The microfinance sector is constantly developing, with a number of new players involved in financial inclusion. The local funders of these new non-banking institutions do not appear to be set to drive demand for third-party ratings to get additional funding-this is due to the tight regulatory restrictions on bank debt funding applied to microcredit companies (MCCs). Compounding this, there are few international debt-funders in China.

In this vacuum, it is in fact the regulators who are providing the impetus to develop third-party rating initiatives. In light of the fact that the number

of MCCs has recently exceeded 8,000, getting the MCCs rated is no small task for any regulatory body. This is especially so given the relatively small asset size of each institution (the average paid-in capital of a MCC is around RMB 90 million), and the fact that such asset size does not necessarily equate to more simplicity in regulation.

They urgently need to be able to differentiate between institutions that need close monitoring and those that are performing well and require less hands-on attention. The central regulatory authorities and the Provincial Offices of Financial Affairs (POFAs, the regional organizations that regulatory powers over MCCs have devolved to since May 2008) are both new to the regulation and monitoring of non-banking financial organizations.

19. Single loan rules state that VTB loans to individuals cannot exceed 10% of total registered capital amount, while 15% of registered capital is the maximum amount for a single loan to enterprises.

20. Asian Development Bank. People's Republic of China: Credit and Social Rating System Development for Microcredit Companies. December 2012.

Rating has become a buzzword among MCCs and POFAs for at least the past two years, as ever greater numbers of microcredit companies have been registered. However, the situation on the ground illustrates that there is, that there is, as yet no single regulator playbook for the classification and assessment of risk in MCCs. It is becoming increasingly understood that frameworks designed for banking institutions cannot be applied in a universal fashion. Therefore, the POFAs have been learning about the methodologies, approaches, and goals of rating. The pursuit of appropriate models has also prompted discussion and debate at the industry level and led to regulator-led rating pilots at the provincial level.

For several reasons, it makes sense for the POFAs to be the leading promoters of third-party rating practices. First, rating pilots for MCCs will ultimately benefit the regulators, who will eventually have a better monitoring framework for MCCs under their supervision (which currently can number as many as 600 in a single province). Given the "gap" between traditional knowledge of banking and the current level of knowledge about micro-enterprise and SME lending processes, rating firms and regulators could usefully engage in an iterative process of interaction, ultimately improving supervisory indicators in order to fine-tune off-site risk-discovery and prevention, and develop appropriate benchmarking for MCCs.

Second, the People's Bank of China currently operates the national credit bureau system. Given the increasing number of non-bank financial institutions, information asymmetry around borrowing has become a larger concern to lenders. Now the sizable cohort of MCCs has inspired a determined effort to qualify these organizations for formal entry into the credit bureau system. Ratings are seen as a possible filtering or classification tool for some POFAs and microcredit associations to more easily advocate for high-performing MCCs to enter into the credit bureau.

Third, it is a hope of the microcredit companies and those who advocate on their behalf that the excellent performers in this class be enabled to

stand out through a rating process, that they be rewarded with a loosening of the MCC policy restrictions, as has occasionally been hinted at by policy makers.

Regardless of whether the underlying motivation is entry into the credit bureau or access to preferential policy treatment, it is crucial that the dearth of reliable data on MCC operating performance be addressed through ratings. Although most provincial MCCs are required to report their operating and financial results (usually through regulator-mandated IT systems) on a monthly basis, the accuracy of these reports remains in question. Furthermore, some MCCs also have significant off-balance sheet items that further detract from the veracity of their operating performance results. Problematic data pose a particular challenge at this juncture in the development of MCCs: the sector is simultaneously lobbying for loosening of restrictions and struggling with compliance issues.

The introduction of third-party ratings products could help to analyze MCC operating performance in much more detail than what the regulatory self-reporting can provide. This would be particularly important when assessing credit bureau entry or policy leverage, areas where the depth of a rating could provide more information than a regulatory "scorecard".

3.2.2. Provincial financial affairs offices have launched pilot rating programs

The current period is one marked by rating pilots run by different POFAs. A small number of POFAs are "rating" MCCs themselves through physical visits to each MCC. This creates some concerns given that POFA staff are not trained in financial regulation and, in many cases, are only assigned to their POFA duties part time (often holding a full-time position in another government bureau). But the most common approach to pilots is cooperation between the POFAs and local third-party rating agencies. Under this model, POFAs fix a

general framework or scope for a regulatory rating pilot and then work with third-party Chinese mainstream rating agencies to carry out the work in their respective provinces. This model has

several benefits since, in addition to the actual ratings of MCCs, the regulators can rely on third-party rating agencies to create specific criteria and indicators for assessing MCC performance.

Box 2: China Microfinance Institution Association and Supervisory Criteria

For the past few years, the China Microfinance Institution Association (CMIA) has been leading a coalition of organizations in working on MCC rating and regulation in different provinces. Two of the domestic credit rating agencies – Shanghai Far East Credit Rating Co., Ltd. and Golden Credit Rating International Co., Ltd. – worked with CMIA on their "Five-Star Microcredit Company CC Trial Rating System"²⁹ which was published in the spring of 2012.

In 2013, the CMIA went on to summarize and combine supervisory monitoring indicators for MCCs used by Yunnan, Shanghai, Liaoning, and Shandong POFAs, and tried to improve this model further with both inputs from academics and elements drawn from the international Smart Campaign. The CMIA has invested heavily in round-tableing to gather a consensus on the evaluation methodology. Many of the leaders of the CMIA were originally involved in promoting the People's Bank of China initiative aimed at launching the new legal vehicle of the microcredit companies. That said, it is now also an association with a membership of almost 200 MCCs that are primarily profit-driven.

Their first draft was, in the view of peers, too heavily weighted for social responsibilities, a problem that was adjusted for in the second version. This reflects the current state of the financial inclusion sector in China where there is often a distinction made between "commercial" micro and small lending and "socially oriented" micro and small lending. In China, the majority of MCCs does not believe institutions involved in commercial activities should have any social objectives.

The original hope of the CMIA was that all provinces would quickly coalesce around one workable evolving standard which could be used by regulators to help differentiate between MCCs, determine eligibility for potential policy preference; however, the reality is that different provinces are still prioritizing different elements. For instance, the CMIA takes social performance as a factor whereas POFAs in various provinces may stress financial performance and profits. China suffers from very uneven economic development and many provinces are trying to work out how to make a supervisory appraisal fair to all MCCs working in these areas of different development levels some of which, at times, even fall within a single province.

The first draft discussion paper set out by the CMIA (in March 2013) was composed of six main sections with 42 sub-categories; the main organizations offering feedback were the provincial financial affairs offices in charge of overseeing MCCs. Some analysts believe that one system will eventually evolve, but will take time and may require the guidance of rating professionals: "Ultimately the best thing would be to get all the rating agencies working on this to come around a table and thrash out which core indicators ultimately can be used nationally, with optional indicators available for provinces that want to emphasize certain indicators such as social performance. It may take five years of consensus-building, but ultimately the alignment of methodologies should be tackled by a nationwide network of rating professionals, even if the CMIA and the POFAs themselves have diligently kicked this off."³⁰

29. In Chinese this is called 《小额贷款公司五星分类评价体系》. See blue column on page XX for basic list of rated aspects.

30. Interview with Tammy Lam, Risk Management consultant August 18th 2013.

Subsequent to the CMIA's initial efforts, as mentioned, a number of provincial offices have taken the initiative to draft their own rating systems and start actually performing ratings of MCCs based on these initial efforts; others appoint external local rating agencies, most of which have not been approved by the SCRC. The provinces with the greatest numbers of MCCs are the ones working fastest on rating infrastructure as they are the ones with the most urgent need for differentiation. Some areas (e.g. Tianjin) require that a rating report and an audit report be submitted to the local POFA once a year.

Regardless of how well the indicators emerge from various round-tableing and sector level initiatives, a major bottleneck will be the MCCs themselves. In the absence of high quality data provided by MCCs, most stakeholders will have very little faith in the credibility of off-site indicators. The suspicion will remain that self-reported data is unreliable and easily altered for the purpose of raising rating grades. This will put pressure on rating agencies to develop methodologies that can examine the accuracy and completeness of information provided by MCCs.

When third-party rating agencies are involved, a formal bidding tender is sometimes issued with specific criteria for the third-party rating agencies participating in the MCC pilots. In some provinces, either MCCs are able to select third-party rating agencies themselves, or regulators will provide verbal recommendations on qualified third-party rating agencies. With the exception of Heilongjiang Province, the current rating pilots are being conducted predominantly by the larger domestic credit rating agencies.

Generally, the third-party rating pilots involve a large amount of off-site collection of data of MCCs by the rating agency. This is followed by a fairly brief on-site assessment component (generally half a day to two days for the larger MCCs) and, finally, the issuing of the rating report. As the POFA has spearheaded the rating pilots in most provinces, some POFAs are also sharing the results either with other regulatory agencies in the provinces such as the People's Bank of China, or with other players such as the China Development Bank. In other cases, the pilot data are treated as confidential.

It is too early to tell if the POFAs will be inclined to make the ratings a permanently rolling procedure. As of this writing, some POFAs have only just started their rating pilots. These pilots have

demonstrably allowed the regulators to gain additional information on the MCCs, data which would have been much more time consuming to obtain through current standard reporting.

Interestingly, the feedback from MCCs regarding the rating pilots conducted to date has been mixed. A key concern revolves around the practical benefits of the ratings. While MCCs are required to carry out (and pay for) the ratings at the behest of the regulators, ratings have yet to be linked to any regulatory preference. Nor are ratings perceived as a credible stamp of approval which MCCs can currently use to approach banks or other funders to access new credit or to receive credit on better terms.

The pilots have also given rise to differences in opinions between the rating agencies and the MCCs on assigned rating grades. Seen from the MCC's perspective, third-party rating agencies are spending a very short period of time on-site to assess performance. The rating agencies' perceived lack of specialization or experience in assessing the risks related to SME or micro-enterprise lending is viewed as weaknesses in both the rating indicators and the quality of the on-site assessment. Given that most of these rating agencies are more used to rating much larger banks and financial institutions, there are indeed questions with regard

to the capacity of their rating methodologies to be more tuned in to the realities of micro- and SME-lenders.

From the rating agencies' perspective, a major issue is the cost-benefit of providing deeper analysis relative to the low pricing currently set for these rating pilots (generally ranging from RMB

10,000 – 20,000). At the current level, significant time spent on-site for an assessment is ruled out. Some of these third-party rating agencies view their primary role as helping the regulators to set up rating criteria for their future regulatory supervision, rather than performing deep on-site ratings of MCCs themselves.

A Comparison of POFA Rating Pilots

Component	Province 1	Province 2	Province 3
Coordinators	POFA	Provincial-level branch of People's Bank of China (PBOC) / POFA	POFA/ Provincial MCC Association
Participating Rating Agencies	Four national domestic credit rating agencies	Three national domestic credit rating agencies	Local and national main-stream rating agencies
Selection of Rating Agency	Through bidding	Rating agencies submit application, experts organized by local PBOC do evaluation and selection	Through recommendation by different POFAs
How MCCs were Drawn into the Rating Pilots	Requirement of regulators	MCCs can volunteer to participate; some MCCs also recommended for participation by POFA	Selection of MCCs by specified period of operating or performance, along with other indicators
Who Developed the Rating Scope	No information	A working group led by the local PBOC and POFA did methodology research	General scope set by the coordinators, with reference to work of other provinces
Fee Structure	1000-5000RMB, based on MCC capital size. MCCs and rating agencies sign an agreement on rating fee and rating dates; MCCs pay to rating agencies directly	No information	5,000 – 20,000 RMB
Rating Approach	Mainly offsite, with a 0.5-1 day on-site component	Mainly offsite, with a 0.5-1 day on-site component	Mainly offsite, with a 0.5-1 day on-site component
Recommended Frequency of rating	Annually	Annually, but there are scheduled and non-scheduled follow-up ratings	Pilot phase only
Sharing of results with other regulatory bodies	Results shared with local branches of CDB, PBOC, and other bodies	No information	No information

Finally, as there is no central-level body coordinating the work of the different POFAs with MCCs, the pilots are inevitably heterogeneous in nature. On one hand, this has allowed for a wider experimentation with different approaches. On the other, it has also led to a number of variations in both the way that rating pilots are undertaken, and in the resulting ratings criteria used to assess MCCs. Currently, there is a lack of dialogue between different POFAs, as well as between the regulators and other key stakeholders (third-party rating agencies and MCCs), impeding any arrival at a consensus about "best practices" for regulatory ratings.

3.3 Adaptation of Rating Agencies to China's Increasingly Inclusive Financial Services

3.3.1 Domestic Credit Rating Agencies

In China, rating licenses are issued by different regulatory bodies, including the People's Bank of China, the China Securities Regulatory Commission, the National Development and Reform Commission, and the China Insurance Regulatory Commission. These rating licenses are mainly

related to rating the creditworthiness of different financial instruments. Three mainstream nationwide rating agencies, China Chengxin International Credit Rating Co., Ltd., China Lianhe Credit Rating Co. Ltd., and Dagong Global Credit Rating Co., Ltd. dominate the domestic market with a more than 90% share. S&P is in a partnership with Shanghai Brilliance Credit Rating & Investors Service Co., Ltd.

The Big Three, namely Fitch Ratings, Moody's and Standard & Poor's, all hold all the necessary qualifications for credit rating recognized by Chinese government. Anecdotally, there are an additional 70-100 credit agencies operating in the small niche markets, some of them being affiliates of the approved entities that are accredited by different regulatory agencies.

For the Big Three rating agencies and their Chinese partners, the bread and butter business is credit ratings delivered to the Chinese inter-bank market. As their main cash flow comes from other industry sectors and larger clients (similar to their international counterparts) for credit ratings related to debt and capital market issuances, these mainstream rating agencies have little interest in (MCCs') ratings, as few of these currently approach a scale or degree of formality to warrant using these agencies. To date, their efforts in the MCC market have been at the request of local regulators.

The three mainstream Chinese nationwide rating agencies	
Agency	Description
China Chengxin International Credit Rating Co	Has a subsidiary, China Chengxin International Credit Rating Co., Ltd. that is a joint venture with Moody's
China Lianhe Credit Rating Co. Ltd.	Joint venture with Fitch
Dagong Global Credit Rating Co., Ltd	Not affiliated with The Big Three rating agencies, and trying to add itself to the ranks of the "Big Three" in alliance with rating agencies based in England and Russia.

Rating agencies generally either win calls for bids organized by Provincial Offices of Financial Affairs (POFAs), or get work due to a regulator's or a provincial Chinese MCC association's recommendation to help set regulatory rating indicators for MCCs and/or to carry out ratings of these MCCs. It is important here to note that in China there is a diversity of regulators working different fields and there are also different levels of regulators. The rating agencies participating in the financial inclusion space are not limited to the largest nationwide mainstream rating agencies (and their local offices), but also include local rating agencies.

So far, there is little public information available regarding which rating companies are most active in this space. However, from our interviews, we found that China Lianhe Credit Rating Co. Ltd. and China Chengxin International Credit Rating Co., Ltd. are cited as the two most active players cooperating with regulators.

From interviews conducted with MCCs, provincial MCC associations, and regulators, rating fees during the pilot ratings (shouldered by the MCCs) could vary from as low as RMB 3,000 to around RMB 30,000, with an important factor on the cost being the asset size of the MCC being rated. For example, for MCCs in a particular province with a paid-in capital above RMB 500 million RMB, the stated rating fee was RMB 5,000, for those with paid-in capital between RMB 200-500 million, the rating fee was 4,000 RMB, and for those below RMB 200 million, the rating fee was RMB 3,000.

Relative to the price of core business of mainstream rating companies, the prices charged for ratings during the pilots is low. Several possible factors have been given for this. One explanation is that while the single rating may not be particularly attractive, if the business were to reach economies of scale (and be required periodically by the regulators) the business could become a significant enough stream of income to justify the initial investment. Other factors cited include the motivation for rating agencies to maintain strong connection with governments. Perhaps the most plausible explanation revolves around scoping:

the rating companies are not conducting in-depth credit ratings but are rather responding to much more narrowed scopes proposed by regulators to do on-site surveys of MCCs based upon a set of operational and financial indicators.

Lianhe Credit Rating Co. Ltd., which was interviewed for this paper about whether MCCs represent a new market for rating agencies, holds the view that for a number of MCCs, some of the lending business is deliberately non-declared, making it less than feasible to get any realistic picture of their operations, and rendering the value of rating difficult to ascertain. Furthermore, they noted that based on current cost structure of analysis, it will not be plausible for mainstream ratings agencies to conduct in-depth fieldwork on MCCs - without this element, it is impossible to make an accurate evaluation as it will be missing due diligence and standard cross-checking with the MCC's clients and peers.

Lianhe Credit Rating Co. Ltd. is recommending that the market rethink what information can be treated as reliable and then proceed to build rating systems on such data. Lianhe Credit Rating Co. Ltd. is helping the POFAs of several provinces construct a new analytical system based on the data, which has been reported to them by the MCCs they oversee, to provide some basis for a more realistic appraisal. At the same time, they are urging regulators to look for more sources of useable data to anchor supervisors' views of these organizations in something closer to reality. In other words, Lianhe's work is more focused on helping supervisory offices come up with a workable group of indicators – as opposed to necessarily performing credit ratings or institutional ratings that measure default. Even so, some of the rating agencies are taking advantage of the rating pilots as a way to familiarize themselves with the non-bank financial sector, and to date it seems they perceive their main "clients" to be the regulators who are setting a more narrow scope for the ratings.

Also interesting is their related business lines. While some rating agencies are part of financial

holding groups with majority ownership in micro-credit companies, others have consulting arms, or IT businesses that are also providing services to MCCs themselves. It has yet to be seen whether MCCs or rating agencies themselves will attempt to draw boundaries around potential conflicts of interest or confidentiality between the various arms of the financial groups in the future.

There also appears to be an emerging mismatch in expectations between those of the rating agencies and those of their clients. Whereas the rating agencies cite the price sensitivity of MCCs and the low level of formality and reliability of data as key problems, MCCs cite weaknesses in mainstream rating products such as lack of depth in analysis, something that weakens feedback and the ability to pinpoint risk. MCCs have also referenced cases where ratings have led to very odd results, in which clearly weaker or less specialized players receive higher rating grades than those considered stronger. An example of distorted perception is rating methodologies where asset size is considered a major positive affecting the rating result in some provinces, a weighting which some MCCs find concerning, given that scale does not necessarily equate to either excellent or strong risk management.

On top of this, MCCs generally hope that rating would lead to investments from MCC investors or more access to funding from banks; so far, this has not been the case. Implied in some of the ongoing regulatory rating experiments is a potential for policy preference (e.g. changes to leverage, geographical expansion). However, it does not appear that such policy preferences have become an outcome of these pilots, which has led to some dissatisfaction amongst MCCs. MCCs would see value in ratings pinpointing weaknesses and leading to capacity building, but as mentioned above, the generalist nature of the mainstream rating approach taken by regulators in the pilots is not delivering on this aspect of their needs.

Stepping back to look at the overall mainstream rating market in China, the fierce competition merits attention, a phenomenon some people

have referred to as one of "price determining rating grades" and "grades at the right price". According to some of the internal auditors mentioned, certain rating agencies are prone to coalescing around rating grades that allow them to maintain their relationships with clients. Indeed, it is very rare to find weak grades of bonds rated in the Chinese market according to one interview, leading to some suspicion as to whether this is a reflection of the excellent performance of Chinese companies, or of a lack of serious risk differentiation. This concern has been raised in the specific context of MCCs, as a number of these companies have been rated AAA, a fact which is surprising, especially from an international perspective as even the largest and most high-performing MCCs are often rated in the C and B range. Even from a national benchmark, the existence of AAA-grade MCCs in such a nascent market is questionable and begs for more clarification regarding the ranking system.

3.3.2 Specialized Microfinance Rating Agencies

All of the main SMRAs -- MicroRate, Micro-Credit Ratings International (M-CRIL), Planet Rating and MicroFinanza Rating have participated in various forums and exchanges in China, with some having even tested the water for MIRs as well as social ratings in China. But practical pilots of ratings have been limited in number.³¹ Clearly, the early-stage capacity of most Chinese MCCs combined with the lack of long-term experience in rating and benchmarking of microfinance institutions would seem to be an opportunity and future niche for the Specialized Microfinance Rating Agencies (SMRAs) in China. However, at the current stage, the microfinance institutional ratings (MIRs) and social ratings in which SMRAs specialize are not well understood in China.

For example, since the late 1990s, Planet Rating has conducted over 800 ratings worldwide but has only undertaken 10 missions in China. Of these 10 missions, five were MIRs, four were social ratings,

³¹ Microcrate, a major player in Latin America and other regions, is the one SMRA which has yet to conduct a rating in China, although it has been an active participant in forums in China related to this subject.

and there was a single client protection certification. 10 missions were carried out with five Chinese clients: two NGO microfinance organizations, one city commercial bank, one private microcredit company belonging to a holding group, and one

fully foreign-owned microcredit company. There seems to be no necessary chronological coherence of the ratings; they seem randomly scattered between 2005 and 2014. Co-financing for the four social ratings was secured through the Rating Initiative.

Box 3: Asian Development Bank Pilot Rating Initiative in Heilongjiang

Starting in 2013 and scheduled for completion in 2015, the Asian Development Bank (ADB) has been promoting financial and social performance ratings for Microcredit Companies (MCCs) in collaboration with the Heilongjiang Financial Affairs Office.

According to the ADB terms of reference for the project, the key activities of the program include:

- Supporting three rating firms to develop their social and financial ratings for microcredit companies. (Two SMRAs and one local mainstream rater were selected.)
- Each rating company will conduct five pilot ratings and share the results with the provincial regulators.
- Provide capacity building to the provincial regulator with regard to data reporting formats for their regulatory rating systems, and developing criteria for approval of rating firms to work with MCCs.

One of the key points of the rating exercise is to promote transparency in the MCC sector, particularly for the benefit of regulators and investors. Given the low level of financing of MCCs relative to the leverage requirement, ADB believes that the demonstration of ratings to different funders and investors could help encourage the market and potentially serve as a case study for the wider adoption of ratings among regulators, investors, and funders in China.

Two of the three rating firms selected were international SMRAs: this is therefore the first pilot rating exercise in China to promote such close interaction between regulators and SMRAs. The fact that the ratings are co-financed by ADB provides an entry point for several SMRAs to test their methodologies in the Chinese context. The two selected SMRAs are Microfinanza and M-CRIL.

This pilot also is significant in its choice of a local mainstream rating agency to work in the project to develop not only an institutional rating methodology for MCCs, but also a social rating methodology. Given the low level of specialization of mainstream rating agencies in microfinance internationally, it will also be interesting to review and compare the business models and products of participating SMRAs and the mainstream rating agency.

Whether this pilot will indeed lead to greater uptake of the MIR approach to ratings in Heilongjiang remains to be seen. But clearly, the exposure of SMRAs to Chinese MCCs and vice versa will maintain a lasting impact. Language, translation and localization will loom large in the workload as Chinese MCCs are owned by non-English speakers. This is no small concern given the number of documents required to be translated during the desktop research phase of an MIR.

Interviews with the few Chinese MCCs previously rated by SMRAs show that the overall evaluation by the rated MCC has been quite positive, especially in terms of the professionalism, expertise, depth, and transparency of the entire process. Feedback on the quality of mainstream credit rating agencies participating in recent pilot ratings has given rise to a wider range of reviews.

According to the SMRAs interviewed, the approach taken in the MIR is universally applicable without any need to re-invent the wheel for a particular market. It should, however, be mentioned that the pronounced difference when working with China is the large average loan size of Chinese MCCs, which can often range from RMB 1 – 3 million for a single loan, much larger than global averages in the financial inclusion space.

For this paper we interviewed various sector players (but with some concentration on MCCs) to try to understand why there has been a lack of uptake for microfinance ratings. One factor is that MCCs perceive rating in general to be a costly exercise, an opinion held even before they face the USD10,000 to USD20,000 price tag of an MIR performed by an SMRA (with its international travel and the relatively long on-site work).

That said, the paid-in capital of the average MCC is around RMB90 million (US\$14.5 million); a lack of resources does not seem to strongly inhibit participation, especially given that the average asset size of microfinance institutions (MFIs) currently engaged in ratings internationally is, if anything, smaller than averages for these kinds of MFIs in China. Interviews with SMRAs show that this phenomenon is more linked to the overall state of acceptance of ratings in this market, and is compounded by the difficulty that SMRAs have in trying to link investment in ratings with tangible benefits for the rated organization. Chinese regulators currently are not requiring MCCs to use SMRAs. Nor have they granted licenses to non-Chinese rating agencies who have not structured formalized partnerships with local entities.

There is a general lack of awareness of the existence of SMRAs and the specific products they offer (institutional and social ratings); potential ratees also confront language barriers. But efforts are being made to address this: the China Development Bank and the Inter-American Development Bank, for example, held a forum, a follow up to a previous conference held in 2012 in which four SMRAs participated, on May 23, 2014 on the relationship between financial inclusion regulation and ratings, enjoying the renewed participation of the same SMRAs. SMRAs have had interactions with the two Chinese microfinance associations, although no particular collaboration has been proposed to date. PlaNet Finance, together with China Microfinance Institute Association and International Finance Corporation, also held a forum on June 20, 2014 to raise the Chinese Microfinance community's awareness of ratings and attendant knowledge level.

Currently none of the SMRAs have local offices in China because demand has not grown to a point where they can justify investment in on-the-ground staff. In the short term, the minimal marketing targeting Chinese MFIs, combined with the lack of local presence, are the main strategic disadvantages of SMRAs compared with domestic mainstream rating agencies. Unlike Latin America and Africa, there is also the absence of any large scale initiative to help spur the development of the rating eco-system, especially when it comes to co-financing.

Short of market entry - additional exchange between SMRAs and Chinese mainstream raters could also be a way SMRAs can contribute positively to the Chinese market. But currently, there are also few mechanisms to allow Chinese mainstream rating agencies to build up their knowledge of microfinance and SME, through exchange with SMRAs. In discussions with several mainstream raters, there has emerged a stereotype that SMRAs are focused on "socially oriented microfinance", and are unable to rate "commercial Chinese microfinance". This misperception may have emerged either from the lower average loan sizes of MFIs rated by SMRAs globally, or from the integration of social indicators in the MIR itself. This would be an

unfortunate conclusion for the China market to make, given that one of the key benefits of further exchange between SMRAs and mainstream raters is not only in terms of social aspects of rating, but

also to exchange SMRAs experience rating thousands of micro and small lenders worldwide in terms of financial and operational performance.

Key Conclusions

- To date, rating pilots have focused on MCCs and have been spearheaded by the local regulators. Regulation of financial institutions and regulation of non-banking institutions is a new sphere of knowledge for regulators in China.
- Provincial Offices of Financial Affairs (governmental bodies that regulate MCCs and guarantee companies) are mainly commissioning local third-party rating agencies to conduct ratings of MCCs in their provinces. MCCs are mandated to participate in these pilots.
- These rating pilots will help the financial affairs offices better supervise MCCs. Given the previous lack of experience of regulators in dealing with non-banking institutions, the additional data on MCCs provided by these pilots are helpful.
- The financial affairs offices do not have an apex institution to coordinate regulation between provinces. Thus, there is considerable variation in the pilots. Differences between different provincial approaches, scope, and aim of these ratings are not well understood, nor are they made transparent between financial affairs offices of various provinces, to MFIs, or to the industry at large.
- With the exception of the rating pilot in Heilongjiang province, the majority of pilots are conducted by mainstream rating agencies. Thus, there currently has yet to develop an eco-system of "niche" raters focused purely on micro and SME lending in China. These mainstream rating agencies are providing useful input to regulators on designing metrics for measuring financial institutions, but still need to gain experience on refining metrics on the specifics of micro and SME lending
- For the majority of pilots, mainstream raters focus on self-reported financial and operational indicators, with a short on-site investigation period (generally ranging from half a day to two days). They also tend to charge MCCs a very low fee by international standards. The current cost structure limits future investment in more diversified and targeted products for MCCs.
- While the current approach of mainstream rating agencies has allowed raters to cover a large number of MCCs on behalf of regulators, the short on-site investigation raises questions about the accuracy of rating results as the quality of information provided by self-reporting cannot be verified in depth on-site. Furthermore, a short on-site period does not allow for a deep benchmarking on different facets of micro and SME lending operations.
- Current rating scales may be creating a rosy picture of the performance of MCCs as rating scales are national in nature, but often only benchmarked to performance in a single province. The entire micro and SME lending industry in China is nascent, and there is a lack of benchmarking or even knowledge of benchmarking to global best practice in micro and SME lending.
- Chinese microcredit companies would be motivated to pay for a rating if policy preferences might follow from a good rating result. However, actual linkage of rating results to policy benefits has yet to emerge from the current pilots. It is unclear whether and, if so, when regulators will consider forging this connection. Furthermore, current rating products offered do not delve deeply into the micro or SME lending operations, providing little added value for MCCs seeking to improve their capacity building through a third-party rating.

- Microcredit companies may not be especially motivated to engage rating agencies beyond the current phase of mandatory pilot ratings. It appears that the cost of ratings is not a major issue to MCCs, which have an average paid-in capital that could absorb such a cost; the deciding factor for MCCs will be whether or not there are practical benefits resulting from such an exercise.
- Specialized microfinance rating agencies (SMRAs) are not well understood in China. Leading international providers of both financial and social ratings have very little presence in China. Stakeholders are mistakenly under the impression that ratings conducted by SMRAs are only applicable to poverty-alleviation or socially oriented MFIs, and cannot be applied to "commercial Chinese microfinance" or SME lending, which is a key business for MCCs.



4

Appendices

Appendix 1: Key Sector Strengthening Initiatives

The Rating Fund II Provides Key Support for Development of SMRAs (2009 – 2012)

In February 2009, the Multilateral Investment Fund (MIF) of the Inter-American Development Bank and the Development Bank of Latin America (CAF) launched the Rating Fund II. The primary objectives of the Rating Fund II were to strengthen the MFI rating and assessment market in Latin America and the Caribbean and to improve the transparency of MFI financial performance in Latin America and the Caribbean.

The Rating Fund II was based on the following principles:

- **Transparency:** Promote and facilitate the public disclosure of MFI performance information through increased use of ratings and assessments.
- **Availability of Information:** Promote information-sharing to increase the amount of reliable information on MFI performance, for example, through the Rating Fund II and the MIX Market website. (The MIX Market is a website that links MFIs with investors.)
- **Quality of Information:** Ensure that ratings and assessments financed by the Rating Fund II contain enough information to enable investors to make informed decisions about MFI performance.
- **Sharing Costs and Added Value:** Require MFIs to bear an increasing portion of the cost of a rating or assessment so that they recognize the benefits of undertaking a rating exercise and build it into their normal business costs.

The Rating Fund II was managed by a small steering committee composed of representatives of the key donors.³³

The Rating Initiative Promotes Social Ratings and Further Sector Strengthening (2008 – 2013)

The Rating Initiative was launched by ADA in 2008 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 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 the 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.

A total of 334 ratings were co-funded since the launch of the project. Notably, 206 of the ratings performed were social ratings. In that sense, the objective of increasing demand at the MFI level for social ratings was a key focus. The Rating Initiative was also active in promoting the concept of microfinance ratings via regular participation in relevant international conferences, the organization of workshops and

³³ ratingfund2.org

the development/dissemination of promotional tools.

Finally, the Rating Initiative contributed towards generating market information via the regular publication of studies focused on microfinance ratings, including the "Rating Market Review" - which provided a general overview of the microfinance rating market as well as an analysis of its regional maturity. After more than three years of successful activity, the Rating Initiative came to a close, with a focus on ensuring the sustainability of the microfinance rating market.³⁴

Standard & Poor Pilots an Approach for Rating Microfinance Institutions (2008-2009)

To promote the development of a sound global and local capital market infrastructure for microfinance, and, in particular, to help build a healthy secondary market, the Multilateral Investment Fund of the Inter-American Development Bank (IDB) asked Standard & Poor's Ratings Services to participate in a pilot project to rate microfinance institutions (MFIs).

The goal of IDB was to encourage mainstream rating agencies to get involved in developing metrics that would enhance transparency within the microfinance industry, and unlike SMRAs, enable comparisons of microfinance investments opportunities within and across borders and with non-microfinance opportunities.

The pilot began in early 2008 and evaluated how microfinance institutions fit into Standard & Poor's existing financial institutions rating criteria, making adjustments to fit the special characteristics of MFIs and their weighting and to test the validity of these factors through a pilot rating program. The sample included MFIs from seven countries in Latin America, one country in Eastern Europe, and one in Asia.

The mainstream credit ratings on the MFIs ranged from a high of 'BB' to a low of 'CCC', with the outlook being stable. In many instances, the ratings were constrained by the country risk, keeping in mind overall ratings for financial institutions had been hurt by the economic and financial crisis at the time. The pilot resulted in a mainstream rating agency having a more nuanced approach that better reflected the specialized nature of microfinance institutions and their operations.³⁵

34. ratinginitiative.org

35. Standard & Poor's. "A Pilot Project To Establish A Methodology and Criteria For Rating Microfinance Institutions." September 25, 2009.

Appendix 2: The Specialized Microfinance Rating Agencies



Microcredit Ratings International Ltd. (M-Cril) is a private and independent international rating agency started in 1998. M-CRIL came into being in response to the need for an agency that would bring about a standardized assessment of financial performance and highlight the importance of governance and management in running sustainable business models of MFIs. It also responded to the need for MFIs to incorporate systems and processes appropriate to the overall objective of providing financial services to a large number of poor and vulnerable families. M-CRIL plays a key role in the development finance space across its operational area.

M-CRIL since its inception has played a pivotal role in the provision of financial services to the poor. With time M-CRIL has diversified itself to a complete knowledge and data center for the microfinance sector. Its regular interest in financial research and assessments helped to evolve its other current service products like Social Rating, portfolio audit, rating of affordable private schools, sector analysis and assessment, financial research and data management. M-CRIL has also undertaken a number of assignments focused on sector advocacy and is a member of national and international networks.³⁶



MicroFinanza Rating is a private and independent international rating agency specialized in microfinance, founded in the year 2000 and based in Italy. According to the company, its mission is to provide the microfinance and responsible finance industry with independent, high quality ratings and information services, aiming at enhancing transparency, facilitating investments and promoting best practices worldwide. Its product offering includes:

Microfinance Institutional Ratings

- Social Rating
 - Client protection certification
 - Credit Rating
 - Pre-rating services
-



MicroRate is a private company based in Washington, D.C. metropolitan area of the USA with offices in Lima (Peru) and Casablanca (Morocco). MicroRate was the first microfinance rating agency dedicated to evaluating performance and risk in microfinance institutions (MFIs), as well as evaluating microfinance funds, also known as microfinance investment vehicles (MIVs). MicroRate's primary goal is to promote growth in the microfinance industry by facilitating the efficient flow of money from capital markets to MFIs through independent evaluation and increased transparency. Since its inception in 1997, MicroRate has conducted over 750 MFI ratings throughout Latin America, Africa, Europe, and

36. <http://www.m-cril.com/OurHistory.aspx>

Central Asia. The entities evaluated by MicroRate, range from large banks to small NGOs, including many of the world's leading MFIs, as well as some of the largest and smallest microfinance funds. MicroRate was the first microfinance rating agency to be formally approved by CGAP and the Inter-American Development Bank. According to the company, it is the first rating agency to be recognized by a national regulatory authority (Banking Superintendent of Peru) and licensed to carry out credit ratings of regulated MFIs in Peru.



Planet Rating, headquartered in Paris, France, is a specialized microfinance rating agency offering evaluation and rating services to microfinance institutions, using the Smart GIRAFE and Social Performance methodologies.

Planet Rating was created as a department of PlaNet Rating in 1999 and by June 21st 2005, Planet Rating was officially spun off and became an independent, private entity registered as a "Société par Actions Simplifiées" under French laws.

It currently employs around 20 people in five offices worldwide with staff coming from France, Peru, Senegal, Morocco, India and the Philippines. The team comes from various professional backgrounds including banking, investment funds, strategic consulting, public funding agencies, microfinance consulting and mainstream rating agencies. To date, Planet Rating has conducted over 700 missions in more than 85 countries and continues to expand its international presence. Main products and services are:

- Ratings
 - Interactive Assessments
 - Customized Services. Recent examples of customized services:
 - Diagnostics of small Palestinian MFIs on behalf of the Islamic Development Bank, including a detailed analysis of their respect of Islamic credit methodology.
 - Development of a specific evaluation method of saving and credit cooperatives in Mexico, in the context of the application of a new legal framework.
 - Development of an analysis framework for non-regulated institutions in Uganda, on behalf of the EU and with the support of various donors.
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Appendix 3: Code of Conduct for Microfinance Rating Agencies

Preamble: The goal of this Code is to ensure and promote the integrity and quality of ratings of microfinance institutions (MFIs). It describes standards of "best practices" for microfinance rating agencies.

In addition to the best practices outlined below, microfinance rating agencies should promote and embody an internal culture of integrity, honesty and ethical behaviour within their own operations and by their own staff. Such agencies adopt and enforce internal codes of ethical conduct for their staff. They recruit staff and board members with high ethical standards. They communicate honestly and openly with their boards of directors and other stakeholders.

1. INTEGRITY: 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.
 - Rating agencies seek a diversification of income streams beyond relying exclusively on MFIs to pay for ratings.
 - Rating agencies disclose in rating reports the prior ratings, given to rated MFIs by them and other rating agencies.
 - Rating agencies provide information to their subscribers on MFIs which have determined not to receive a rating after having started the rating process.
 - Rating agencies occasionally change the leadership of their rating teams for repeat customers.
 - When rating a repeat customer, rating agencies test and, if appropriate correct prior opinions even if such correction results in a downgrade from prior ratings.
 - Rating agencies maintain control over their rating reports so as to avoid any tampering with the report's conclusions.
 - To avoid prior rating bias, rating agencies highlight to their rating committees not only prior grades given to a rated MFI, but also any significant changes in peer benchmarking since the last rating.
 - Best practice rating agencies ensure that the non-rating services that they offer do not compromise the integrity of their rating services and products.
 - Rating agencies do not provide technical assistance or professional advice to MFIs.
 - Best practice rating agencies minimise the chances that the relationship between their Board members and/or employees and the staff of MFIs and/or investors in MFIs might influence the integrity of the rating.
-

- Rating agencies prohibit their rating agency Board members and staff (and relatives of such Board members and staff) from holding any familial or financial ties with rated MFIs or with investors in rated MFIs.
- They routinely require rating analysts to confirm the absence of familial or financial ties that may give rise to a conflict of interest (or even an appearance of a conflict) with MFIs or investors in MFIs
- Rating agencies review the employment histories of their rating analysts to ensure that rating analysts are not assigned for at least three years to rate prior MFI employers or to rate MFIs invested in by prior employers .
- 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
- Rating agencies avoid all ownership ties to companies providing services (financial or technical) to the microfinance sector.
- The governance structure of best practice rating agencies ensures that business interests of the company do not impair the independence and accuracy of the rating process
- Rating agencies shall have an administrative or supervisory board or an internal committee that is responsible for ensuring a) the independence of the rating process; b) that conflicts of interest are properly identified, managed and disclosed.
- Rating agencies shall have sound administrative and accounting procedures as well as internal control mechanisms. Their financial statements should be audited every year by a reputable external audit company that shall provide a report on internal controls.
- The Board decisions and Rating Committee decisions shall be documented in clear and detailed minutes. These confidential documents shall be made available to the third party in charge of the verification of the compliance with the present Code.
- The senior management of the rating agencies shall be of good repute and sufficiently skilled and experienced, and shall ensure the sound and prudent management of the rating agencies.

2. QUALITY: RATINGS THAT ARE CHARACTERIZED BY QUALITY ARE FAIR, RELIABLE, CONSISTENT, COMPLETE AND EASILY UNDERSTOOD.

- Best practice rating agencies are fair and transparent.
- Rating agencies deliver opinions that are supported by all relevant facts. They offer rated MFIs adequate time to comment on their draft opinions.
- They disclose to MFIs their rating methodology, processes, and fees before beginning the rating process.
- They use labels for their rating products that are consistent with the intended scope of their ratings.

- They seriously consider criticisms offered by their customers.
 - Rating agencies provide MFIs with a transparent and complete explanation of the full cost of ratings prior to the execution of rating contracts. In addition to the rating fee, all other charges and fees also are disclosed in writing to the rated MFI. The rating contract clearly provides the amount of payment, currency of payment, and conditions of payment.
 - 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.
 - Rating agencies are fact driven. Their rating processes include spending time on-site with rated MFIs and travelling beyond MFIs' headquarters. They look to other stakeholders of the rated MFI for information. They crosscheck data and seek verification of information.
 - Best practice rating agencies use straightforward and clear language in their rating reports to express fact-based opinions
 - Rating agencies structure their rating reports so that each offered opinion is supported by facts. They offer context for their ratings. They use easily understood language in their reports. They clearly identify what is being measured in the rating process and the scope of the rating. They document their rating methodologies as well as the actual rating.
 - Best practice rating agencies ensure that their rating missions are conducted by skilled rating analysts.
 - Rating agencies invest in the recruitment, training and retention of their rating analysts. They install only skilled and experienced analysts as the leaders of rating teams.
 - Best practice rating agencies develop internal procedures to ensure that ratings are consistent across rated customers and standardised product-by-product.
 - Rating agencies clearly document the rating methodologies for each of their rating services and products. They continually train staff in the use of such methodologies.
 - Rating agencies employ the use of a committee of senior, experienced staff (often called the Rating Committee) to screen for consistency across rated MFIs and across rating products.
 - Best practice rating agencies develop internal procedures to ensure that ratings are consistent across rated customers and standardised product-by-product.
 - Rating agencies take great care in clarifying the scope of their ratings. The scope of a rating informs what facts and issues are necessary and relevant to review in order to ensure the completeness of a rating. Complete ratings address risk probabilities, and performance of the rated MFI.
 - Rating agencies share with the applicable Rating Committee information about any disagreements with the findings contained in the rating report that may have been raised by the rated MFI, and also inform the Rating Committee about how those disagreements were resolved.
 - The time-bound nature of ratings also impacts their completeness. Rating agencies indicate a validity period for their rating, which is usually of one-year duration, provided that no significant
-

change occurred in the operating environment or institutional or operational setup of the MFI. To ensure the completeness of a recent rating, rating agencies encourage recently rated MFIs to report changes that could impact adversely the recent rating's validity or completeness

IMPLEMENTATION:

EVOLUTION

Best practice rating agencies are learning institutions. Rating agencies are evolving and growing to keep pace with the microfinance sector. This requires that their standardised rating methodologies and processes must also evolve.

SELF CERTIFICATION AND COMPLIANCE ASSESSMENT

Signatories to this Code of Conduct agree to conduct annual self-certifications of their conformance with the above best practices. Such self-certifications shall be cross-checked to verify their accuracy, according to a standardized format (a compliance assessment), by a qualified, independent, third party institution that is agreed upon by signatories to this Code. Each rating agency will publish its annual self certification and compliance assessment of the accuracy of such self-certification. Each rating agency also will authorise said third party to publish the rating agency's self-certification and compliance assessment.

DISCLOSURE OF COMPLIANCE LEVEL

Signatories to this Code of Conduct agree to conduct annual self-certifications of their conformance with the above best practices. Such self-certifications shall be cross-checked to verify their accuracy, according to a standardized format (a compliance assessment), by a qualified, independent, third party institution that is agreed upon by signatories to this Code. Each rating agency will publish its annual self certification and compliance assessment of the accuracy of such self-certification. Each rating agency also will authorise said third party to publish the rating agency's self-certification and compliance assessment.

- **Green light:** full compliance with the best practice.
- **Orange light:** partial compliance with the best practice; the rating agency has however put in place mechanisms and procedures that ensure that the integrity and quality of their ratings is not severely affected.
- **Red light:** very partial compliance or negligence

CONSEQUENCES OF THE NON-COMPLIANCE WITH ONE OR MORE OF THE PRACTICES

- Agencies that are granted a **RED** light on one or more of the items of the Code will be given a period of one month to provide an action plan that will aim to resolve the identified problem within a 6-month timeframe. If the agency fails to comply with these requirements or with the action plan, it cannot be deemed to be a signatory of this Code anymore and should remove all mentions to this Code from its communications documents.
 - Agencies that, within a calendar year, do not provide their self-certification or do not undergo the compliance assessment mentioned in this code, cannot be deemed to be a signatory of this Code anymore and should remove all mentions to this Code from its communications documents.
-

They will not be allowed to apply to become a signatory of the Code during the next calendar year.

Appendix - EXAMPLES OF COMPLIANCE LEVELS

Examples of potential green, orange and red lights levels are given for practices where full compliance is currently not achieved by all rating agencies signatories to the present Code.

- **GREEN:** Rating agencies avoid all ownership ties to companies providing services (financial or technical) to the microfinance sector.
- **ORANGE:** Where that is not possible, rating agencies actively minimise the risk (or appearance) of a conflict of interest by fostering the independence of management of the rating agency from the economic and reputational interests of related companies. This independence is protected by requiring, for example, that any related companies that also provide services to MFIs (i) do not hold a controlling ownership stake in (or majority of directors on the board of) the rating agency, (ii) do not share interlocking directorships with the rating agency, (iii) engage in only arm's length dealings with the rating agency, (iv) do not share staff or management with the rating agency, and (v) avoid cross-marketing or co-branding of products and services with that of the rating agency. Additionally, any ownership interest that could give rise to a conflict (or the appearance of a conflict) of interest will be disclosed in the applicable rating report.

Integrity - Provision of non-rating services

- **GREEN:** Rating agencies do not provide technical assistance or professional advice to MFIs.
- **ORANGE:** Where rating agencies receive direct financial revenues from MFIs for paid training services, rating agencies actively avoid a conflict of interest (or appearance of such a conflict) by ensuring that the training revenue that they receive directly from MFIs is a relatively insignificant proportion of the rating agency's overall annual revenue (less than 5%). Rating agencies also avoid arrangements that link, intentionally or unintentionally, the delivery of non-rating services to rating services and products (and vice versa).

Integrity - Issuer-pays model; Diversification of revenues

- **GREEN:** The rating agency derives less than 80% of their 2011 and 2012 revenues directly from MFIs. This limit will drop to 70% of 2013 revenues and 60% of 2014 revenues.
- **ORANGE:** The rating agency has made credible steps to derive revenues from investors or more generally other parties than MFIs; but revenues from MFIs represent more than the limits specified above.

Integrity - Governance structure; Sound administrative and accounting procedures

- **GREEN:** The rating agency is audited every year by a reputable external audit company.
- **ORANGE:** The rating agency is not required by the law of the country to be audited by external audit companies, but in verifying compliance with this Code, the independent third party has been given access to the officially registered financial statements.

Note of Acknowledgement

The development of this Microfinance Rating Code of Conduct was supported and facilitated by the African Microfinance Transparency forum. Further thanks are extended to Deborah Burund and her team at the University of Michigan whose valuable input helped build this code.

Source: 2011 Code of Conduct for Microfinance Rating Agencies.

Appendix 4

Key parameters for social rating

Source: Rating Guide Volume 2: Social Rating Guide

Country Context

Rating Parameters	Review carried out by rating agencies
<ul style="list-style-type: none"> ▶ Socio-economic environment ▶ Microfinance sector regulation ▶ Microfinance sector actors and offerings 	<p>Documents such as The Human Development Report, World Bank country statistics; Global Findex, regulation for microfinance; country data on FIs.</p>

Social Performance Management

Rating Parameters	Due diligence carried out by rating agencies
<ul style="list-style-type: none"> ▶ Definition and monitoring of social goals ▶ Board, Management and Staff Commitment to social goals ▶ Balanced financial and social goals and performance 	<p>Interviews with Board members, Shareholders, Management Team members and field staff</p> <p>Documents such as Business Plan, Board minutes, Operations manual, MIS reports, any documentation of client surveys/other research, HR manual</p>

Social Responsibility

Rating Parameters	Due diligence carried out by rating agencies
<ul style="list-style-type: none"> ▶ Client protection: compliance with the seven client protection principles; and with country regulation or code of conduct ▶ Responsibility to staff: written HR policies that protect employees, provide a living wage, create a supportive working environment, and ensure non-discrimination policies and practices ▶ Services to Community, Protection of the Environment: analysis of methods the financial inclusion uses to minimize its ecological footprint, manage the environmental risk of the activities financed, and contribute to the social development of the communities where the financial inclusion operates 	<p>Questions related to these topics are added to the discussions conducted for SPM interviews with field staff and with clients. For more in-depth analysis, specific focus groups and a client survey may be performed.</p> <p>Documents such as the Code of Ethics, HR manuals, Reports on Client Grievance, Operations Manuals, Internal audit reports and; Environmental policy. Staff survey, Salary survey/benchmarks</p> <p>Review of documentation and agreements with clients</p>

Depth of Outreach

Parameters	Due diligence carried out by rating agencies
<p>Outreach to underserved, less developed regions, including rural areas</p> <ul style="list-style-type: none"> ▶ Outreach to clients without prior access to formal financial services ▶ Outreach to vulnerable communities (ethnic, religious, vulnerable in local context) ▶ Fair representation of women in the clientele <p>Outreach to poor clients</p> <ul style="list-style-type: none"> ▶ Accessibility of the services to all types of clients and activities (start-ups, informal businesses, formal businesses.) 	<p>Documents: MIS information for portfolio distribution and analysis; reports/surveys on client profile indicators, with rater verification of data quality.</p> <p>Interviews: with staff and management, including branch offices</p> <p>Optional: in the absence of good quality data generated by the financial inclusion, a client profile sample survey is part of the rating</p>

Quality of Services

Parameters	Due diligence carried out by rating agencies
<p>Institutional understanding of the needs and preferences of different types of clients, demonstrated by findings from client retention statistics, client satisfaction surveys and</p> <ul style="list-style-type: none"> ▶ how clients use products and services by client characteristic (e.g. men, women, income level, business type) <p>Range and type of financial products and services (within regulatory limitations); non-financial services and client access to these services</p> <ul style="list-style-type: none"> ▶ Design of products, services and delivery channels in such a way that they provide benefit to clients, in line with the institution's social goals ▶ Adequacy of products services and delivery channels and models to clients' needs: e.g. convenience, procedures, collateral, repayment schedules, amounts, cost to the client ▶ Monitoring client retention and reasons for exit <p>Understanding client satisfaction (e.g. overall experience and value, convenience of</p> <ul style="list-style-type: none"> ▶ accessing services, suggestions for product improvement) by client characteristic ▶ 	<p>Documents: Description of products and services, management information systems, transparent documentation provided to clients; any relevant documentation/research available produced by the financial inclusion, such as client satisfaction surveys, market research, quality monitoring, or internal audit reports. Questions related to these topics are added to interviews with relevant departments (marketing, research, operations, MIS)</p> <p>Optional: to include relevant questions in the sample survey conducted as part of rating focus groups with field staff and clients.</p>

Outcomes

Parameters	Review carried out by rating agencies
<ul style="list-style-type: none">▶ Indicators of client progress associated with financial inclusion services▶ Evidence of change for clients with data and methods that are reasonably robust	<p>Documents and management information systems data that provide relevant information (e.g. distribution of mature clients by loan size, and, saving amounts).</p> <p>Review of documents: If the financial inclusion has conducted studies or robust surveys that document outcome indicators, these documents are reviewed. They may review client use of services and change over time. Client case studies –allowing for client dropout and failures as well as success stories- are also examples included in the review.</p>

Appendix 5

Key parameters for Microfinance Institutional Ratings

(Valid for rating methodologies as of September 2012)

In order presented in each SMRA's rating report

M-CRIL	MICROFINANZA RATING	MICRORATE	PLANET RATING
<p>Governance and Strategy</p> <ul style="list-style-type: none"> Country external environment Board (experience, independence, strategic role, separation with management) Quality of management – key man risk Institutional experience and focus Strategy/orientation of MFI (market competitiveness, target clients) Suitability of products and services Funding strategy and sources (diversification, subsidized/commercial, stable/fluctuating, currency) Compliance with legal and regulatory requirements/ Network participation <p>Organization and Management</p> <ul style="list-style-type: none"> Human Resource Quality & Systems Staff – salary/incentive structure and productivity Client protection principles – policy and practice Quality of Accounting systems and practices MIS (Management information systems) – data flow integrity and report generation capability IT systems – MIS & Accounting Integration Internal Audit and Monitoring -scope, frequency and rigour Tracking system for overdue Client dynamics and awareness <p>Financial Performance</p> <ul style="list-style-type: none"> Capital Adequacy Profitability (RoA, OSS, FSS) Margins – spread (FCR, OER, and Yield analysis) Asset Utilisation Portfolio analysis for concentration risk (area and activity) Repayment track record on external debt Debt Service coverage Ratio and ALM 	<p>External Context</p> <ul style="list-style-type: none"> Country Risk. Political and Macroeconomic context Regulatory Risk. Tax and supervision compliance Industry Risk: Financial System and Microfinance Sector <p>Governance and Strategy</p> <ul style="list-style-type: none"> Institutional Background Ownership, Governance and Decision-making Strategic and Operational Plan Financial Projections Quality of products offered Market Positioning and franchise value <p>Organization and Operations</p> <ul style="list-style-type: none"> Organization and Structure Human Resources (HR) and Staff Policy Risk Management, Internal Control and Internal Audit Information Technology (IT) and Management Information System (MIS) External Audit and Accounting Policies <p>Assets Structure and Quality</p> <ul style="list-style-type: none"> Assets Structure Portfolio Structure, Seasonality and Concentration Risk Portfolio Quality and Credit Risk Credit Policies and Procedures and management of lending activities <p>Financial Structure and Management</p> <ul style="list-style-type: none"> Capital Adequacy and Solvency Risk Liabilities, indebtedness and Concentration Risk Financial Needs and Funding Plan Assets and Liabilities Management (Liquidity Risk and Market Risk) <p>Financial and Operational Results</p> <ul style="list-style-type: none"> Profitability and Sustainability Revenues and Expenses Structure and Margins, Efficiency and Productivity 	<p>Financial Situation</p> <ul style="list-style-type: none"> Profitability Solvency and capital adequacy Financial Liquidity Maturity Risk Interest Rate Risk Foreign Exchange Risk <p>Microfinance Operations</p> <ul style="list-style-type: none"> Portfolio Composition Reliable credit information and Credit Analysis Credit Approval Process Guarantees Credit Terms and Conditions Overindebtedness Savings Products and Services <p>Portfolio Quality</p> <ul style="list-style-type: none"> Portfolio at Risk Write-offs Refinanced Loans Risk Operations Provisions Collections <p>Organization and Management</p> <ul style="list-style-type: none"> Management and Personnel Organization and structure Internal Control Management Information Systems <p>Governance and Strategic Position</p> <ul style="list-style-type: none"> Ownership and Board Strategic Positioning <p>Social Profile</p> <ul style="list-style-type: none"> Mission analysis Social orientation <p>Context</p> <ul style="list-style-type: none"> Financial and microfinance sector 	<p>Microfinance sector Governance</p> <ul style="list-style-type: none"> Decision-making Planning Management team HR Management <p>Information</p> <ul style="list-style-type: none"> Information management and systems <p>Risk management</p> <ul style="list-style-type: none"> Internal controls Internal audit <p>Activities (financial services)</p> <ul style="list-style-type: none"> Financial services management Credit risk level Credit risk coverage <p>Funding and liquidity</p> <ul style="list-style-type: none"> Capital Adequacy and funding strategy Minimum capital requirement Liquidity risk Market risk <p>Efficiency and profitability</p> <ul style="list-style-type: none"> ROA Revenue quality Operating efficiency Asset deployment Profitability outlook

Appendix 6

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We also want to thank the following independent consultants for providing guidance for this report.

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