



RATING RESEARCH

Publication Date: January 14th, 2008

Primary Credit Analysts: Emmanuelle Javoy - ejavoy@planetrating.com
Minh-Huy Lai - mlai@planetrating.com
Philippe Serres - pserres@planetrating.com

Note: This is the second of two parts on the new GIRAFE rating methodology. Please read the Press Release, titled “New Enhanced GIRAFE Microfinance Rating Methodology” for the rationale of this research project.

New Enhanced GIRAFE Microfinance Rating Methodology

I. Scope

Planet Rating established a Working Group in late 2006 under the leadership of its Technical Director Emmanuelle Javoy to conduct the review of our GIRAFE rating methodology. It quickly became evident that Planet Rating will not only make small incremental changes, but we will have to undertake bold changes in order to anticipate and meet future microfinance rating risks and challenges.

II. Key Revamped Areas

Based on internal and external consultations, rating experience and research work, Planet Rating concentrated its core revamp efforts on three key areas: governance; capital structure and market/financial risks; and profitability structure.

- a. Governance: Planet Rating has always put a lot of emphasis on ownership and governance issues - traditionally much more than mainstream rating agencies for their credit ratings. We have been asking whether the MFI has appropriate, timely and effective governance and decision-making structures to anticipate risks, adopt relevant strategies, monitor their implementation and adequately protect its assets. We further asked whether these MFIs are adequately prepared for and effectively addressing current or future regulatory risks and challenges. To send a clear message that good governance matters, Planet Rating has decided to increase the relative weighting of this domain to 24% from 20% pulling this domain to the “top” of the six rating domains from a third place previously. Please see Section IV below for more details!
- b. Capital structure & Market/financial risks: Under the now old GIRAFE methodology, the “F” domain covering capital structure and market risk issues represented only 7% of the overall grade. This reflected the fact that in the late 1990s, the vast majority of MFIs are either NGOs or simple cooperatives. Most of them had very simple and low risk capital structure in addition of not being exposed to material market risks. This is no longer the case for the past few years for many MFIs that borrow in hard currency. Consequently, Planet Rating decided to double the weighting of the “F” domain to 14% to formally recognize this evolution and to formalize our existing practices during rating missions. Indeed, we have been asking whether the rated MFI knows and has strategies to optimize its capital structure and diversify its funding sources. And we further asked, given differences in local contexts and funding options, whether the rated MFI has effective strategies to identify and mitigate market and financial risks that go beyond the mere compliance with prudential norms, especially for deposit-taking MFIs. We seek to put a value to a MFI’s success in creating an optimal capital structure and in obtaining lowest possible weighted average cost of capital; and thus secure or maintain a competitive advantage over its competitors.

- c. **Profitability structure:** Until now and when analyzing an MFI profitability, Planet Rating has concentrated on examining ROA and operating expense ratio in addition to analyzing portfolio yields and yield gaps, productivity ratio and other expense ratios (e.g. loan loss provisioning and financing expense ratios). In past Rating Committees, we often encounter cases of highly profitable MFIs hiding more complex pictures and notably elements that would undermine their competitiveness and thus profitability in the long run. We decided that our secondary attention (until now) to revenue quality and asset optimization needed to be elevated into full rating factors, and that all efficiency indicators needed to be benchmarked to the MFI peers in addition to global rating scales. All this will allow us to better take into account the differences in revenues, cost and efficiency characteristics of MFIs operating in different contexts when conducting a rating.

III. Rating Factor Changes

To adequately address the challenges ahead, Planet Rating approved the following changes:

Old GIRAFE

| Rating Domains | 19 Rating Factors |
|----------------------------|--|
| Governance | Decision-making, Planning, Management, HR Management |
| Information | MIS Systems, Portfolio Data, Financial & Accounting Data |
| Risk Management | Procedures & Internal Controls, Internal Audit |
| Activities | Portfolio Management, PAR, Write-Off, Risk Coverage |
| Funding & Liquidity | Funding Strategy (including ALM), Liquidity Management |
| Efficiency & Profitability | ROA, Productivity, Operational Expense Ratio, Financial Self-Sufficiency Ratio |

New GIRAFE

| Rating Domains | 17 Rating Factors |
|----------------------------|--|
| Governance | Decision-making, Planning, Management, HR Management |
| Information | Information System Design & Data Quality (revamped) |
| Risk Management | Procedures & Internal Controls, Internal Audit |
| Activities | Financial Services Management (revamped), Credit Risk (revamped), Risk Coverage |
| Funding | Market Risks/ALM Management (revamped), Liquidity Risk (new), Funding Strategy & Capital Adequacy (revamped), |
| Efficiency & Profitability | ROA, Revenue Quality (new), Operational Efficiency (revamped), Asset Optimization (new) |

Note:

Some old factors such as “Financial Self-Sufficiency” have simply been eliminated, but most old factors (not figured separately as a full rating factor in the new GIRAFE) have been folded into newly revamped rating factors.

IV. Rating Scale Changes

To stress the importance of the raised issues featured in Section II, Planet Rating approved the following changes to the rating scales:

| Rating Domains | Old weightings | New weightings |
|----------------------------|----------------|----------------|
| Governance | 20% | 24% |
| Information | 12% | 10% |
| Risk Management | 12% | 10% |
| Activities | 25% | 20% |
| Funding & Liquidity | 7% | 14% |
| Efficiency & Profitability | 24% | 22% |

Under the new weightings, “Governance” and “Funding” areas are “winners” which underscore Planet Rating’s strong belief that **no MFI can do well over the long term without excelling in governance and funding areas** in the context of growing commercialization of the microfinance sector.

| Rating Factors | Overweight* | Underweight* | No change* |
|--------------------------------|-------------|--------------|------------|
| Decision-making | X | | |
| Planning | | | X |
| Management | X | | |
| HR Management | | | X |
| Information | | X | |
| Procedures & Internal Controls | | X | |
| Internal Audit | | X | |
| Market Position | X | | |
| Financial Services Management | | X | |
| Credit Risk | X | | |
| Risk Coverage | | | X |
| Market Risks/ALM Management | X | | |
| Liquidity Risk | | | X |

| | | |
|-------------------------------------|---|---|
| Funding Strategy & Capital Adequacy | X | |
| ROA | | X |
| Revenue Quality | X | |
| Operational Efficiency | | X |
| Asset Optimization | X | |

Note:

*** Compared to the old GIRAFE weightings; actual weightings are not disclosed**

“Underweight” means less relative weight given to this factor in the new GIRAFE, but it does not imply its reduced importance as the various “caps” to relevant rating factors have been introduced in order to compensate this.

V. New & Revamped Rating Factors

The Working Group adopted three (3) brand new ratings factors namely liquidity risk, revenue quality and asset optimization.

- Liquidity risk (replacing liquidity management): We have always been looking at various liquidity-related issues (e.g. the structure and diversification of a MFI’s funding base, refinancing risk, contingency plan to handle liquidity crisis). This new broadened factor now includes additional analysis elements of capital cushion levels, respect to local prudential norms or Basel II rules (i.e. capital adequacy ratio, analysis of Tier I and II capital) if applicable. Specific guidelines and three liquidity ratios have also been added to the analysis framework.
- Revenue quality: This new factor consolidates our analysis of product pricing and its attractiveness and sustainability in addition to existing analysis of comparative APR levels, market shares, key competitive advantages, product range and diversification, revenue mix, fee-based income, product development capability, branding and market leadership/power, profitability levels...etc.
- Asset optimization: This new factor groups our productive asset use analysis (e.g. portfolio to asset ratio, productive use of assets; the existence, regularity, effectiveness and quality of cash flow projections and management, investment plan for excess cash, quality of finance department staff, respect for to local prudential norms...etc). We look for the optimal use of available resources for a given legal status.

The Working Group significantly revamped six ratings factors namely Information System Design & Data Quality; Financial Services Management (credit and non-credit); Credit Risk; Market/ALM Risks; Capitalization and Funding Strategy; and Operational Efficiency. All these rating factors have been broadened in their scope in order to incorporate additional analytical elements. For the relevant factors, Planet Rating formally adopts caps, upgrades and downgrades which were previously used on only a case-by-case basis. Specific details are not disclosed herein.

VI. Global Rating Scales

The Working Group also reflected on the somewhat narrow range of grades for each level of the existing GIRAFE global rating scale (e.g. A+, A and A- before dropping to B+, B, and B-...etc). After lengthy reflection, Planet Rating has decided to add one additional layer into a grade within each range. We inspire on precedence established by the three mainstream rating agencies. Per example, mainstream rating agencies

have up to 7 levels within the A range (e.g. AAA, AA+, AA, AA-, A+, A, A- per example for FitchRatings and Aaa, Aa1, Aa2, Aa3, A1, A2, A3 for Moody's). Effective immediately, a new grade “++” is introduced to each letter grade (e.g. B++ which did not exist previously). We added this new level in order to give ourselves the flexibility of recognizing, a MFI rated B+ in 2007 has been making good progress, but in 2008 did not make enough progress to become an A-range rated MFI to potentially obtain a B++ grade if the MFI meets our stringent criteria. Planet Rating has consequently revamped its internal ranges and quartiles (undisclosed) that would place a rated MFI between various categories of, per example, “B++, B+, B or B-”. From now on, Planet Rating will use the following global scales:

| Rating | Rating summary | |
|----------------------|--|-------------------------------|
| A++ | Current institutional, operational and financial performances are optimal. There is no downside risk in the short-term. Medium and long-term plans are well-designed, execution capacity is excellent and goals are very likely to be achieved. Short and medium term risks are minimal and/or well-managed. Long-term risks are adequately monitored and anticipated. Changes in the economic, political or social environment should only minimally affect the institution's financial condition given its high resilience. | INVESTMENT GRADE |
| A+ A A- | Current institutional, operational and financial performances are excellent when compared to industry standards. Medium and long-term plans are well-designed, execution capacity is very good, and goals are very likely to be achieved. Short and medium term risks are minimal and/or well managed. Long-term risks are adequately monitored and anticipated. Changes in the economic, political or social environment should have a limited impact on the institution's financial condition given its ability to quickly adjust its strategies and/or take corrective actions. | |
| B++ B+ B | Current institutional, operational and financial performances are satisfactory when compared to industry standards. Medium and/or long-term plans are adequately designed, execution capacity is good and goals are likely to be achieved. Short and medium term risks are low and/or well managed. Areas for improvements have been identified and are being addressed. Changes in the economic, political or social environment might have an impact on the institution's financial condition that should however remain moderate. | |
| B- | Current institutional, operational and financial performances are close to industry standards. Short and medium term risks are moderate but are not fully addressed. Most areas for improvements have been identified, but medium and long term plans miss one or several critical elements, execution capacity is uneven and some goals are unlikely to be achieved. The institution is vulnerable to major changes in the economic, political or social environment. | SPECULATIVE INVESTMENT |
| C++ C+ C C- | Current institutional, operational and financial performances are below comparable industry standards. Short and medium term risks are moderate-high but are not fully addressed. Most areas for improvements have been identified, but medium and long-term plans miss one or several critical elements, execution capacity is weak and many goals are unlikely to be achieved. Most management processes and systems are in place but need to be refined or updated. The institution is vulnerable to major changes in the economic, political or social environment | TECHNICAL ASSISTANCE REQUIRED |
| D | High risk: Important weaknesses in operational and financial areas result in high institutional vulnerability and potential risk of default. Performance is very poor in several important evaluation areas. | |
| E | Immediate risk of default: Existing operational and/or financial and/or strategic weaknesses create an outstanding risk of default. Performance is very poor in most evaluation areas. | |



VII. Conclusion

Planet Rating is pleased to publish this major overhaul of the GIRAFE methodology as our contribution to the development of the microfinance rating industry in general and to keep Planet Rating at the leading edge of the rating industry in particular. Anticipating further commercialization of the sector, Planet Rating has revamped and over-weighted the governance and funding areas of GIRAFE in addition to introducing caps, upgrades, downgrades and broaden rating scales to provide further rating scope and flexibility. MFIs and industry stakeholders can count on Planet Rating’s continued technical improvements while keeping overall methodology consistency and integrity. Effective immediately, this new GIRAFE methodology replaces all prior versions of the GIRAFE methodology.