VIS

Credit Rating Company Limited.

SOCIO-ECONOMIC PERFORMANCE RATING

Table of Contents

INTRODUCTION

The concept of micro-financing is a growing phenomenon which aims at poverty alleviation and empowering individuals through the generation of sustainable livelihoods. Microfinance is available through Microfinance Institutions (MFIs), which range from small nonprofit organizations to larger banks, called Microfinance Banks (MFBs). For the purpose of this methodology, both MFBs and MFIs will collectively be referred to as MFBIs. Rapidly expanding MFBIs over the last decade, are playing an important role in the extension of financial services to the under and un-served particularly in the rural and low economic parity parts of the country. Beneficiaries of micro-finance generally comprise small traders, agriculturists, entrepreneurs and self-employed skilled workers who are otherwise marginalized by the formal financial system due to their very low value unit borrowing demand making them largely unable to access commercial banks. Growing demand opportunities, an enabling regulatory environment, innovation in products & technology and an increasing interest of both domestic and foreign investors have been the main drivers for the healthy development of the micro-finance sector.

The concept of micro-finance is not confined to the extension of micro loans but encompasses the full range of financial and structural support services extended to the poor. The MFBIs are being assessed on their financial performance for a considerable period of time through their credit rating process which largely captures the MFBIs relative positioning for access to credit, however it is unable to capture their social performances, a prime objective of their existence. VIS has introduced an innovative rating product to evaluate these institutions against common benchmarks in the area of socio-economic outcomes, as well as the readiness and effectiveness of their organizational structures in achieving the intended objectives. Given that MFBIs seek funding from sources other than credit/deposit markets, and because the funds obtained may have social considerations attached, it may be helpful to provide a rating of MFBIs operating in the country, to channel special-purpose funds, other than credit. It is therefore essential to distinguish institutions based on the influence they exert within the community and their contribution to the social and economic development of the beneficiaries and their regions.

Social performance indicators serve as essential tools for a range of stakeholders. For owners and investors, they facilitate the assessment of an institution's social achievements relative to predefined targets. Donors utilize these indicators to evaluate the extent of social outcomes delivered by a microfinance bank or institution (MFBI). Additionally, regulators rely on such measures to make informed adjustments to the regulatory framework, with the aim of enhancing the social contributions and effectiveness of MFBIs.

AN OVERVIEW OF RATINGS FRAMEWORK

The underlying methodology seeks to capture the relative social performances of MFBIs against internationally accepted social performance benchmarks and their ranking on a social rating scale. The Socio-Economic Rating is intended to work alongside credit ratings to present a comprehensive view of the financial performance and social outcomes of MFBIs within an economy, while also implicitly identifying any imbalances between these two aspects.

This methodology assesses the social, economic, community, and gender outcomes generated by individual MFBIs. The rating assigned under this methodology are titled as Socio-Economic Performance Rating (SIP) that measures the social performance of an MFBI and the likelihood that an MFBI meets social goals in line with acceptable social values. SIP is a 5-point scale, qualified by a plus where warranted. The rating aligns institutions along a scale of "very strong" to "weak" and provides an opinion on the relative maturity of the organizational structure and its demonstrated capacity to achieve socio-economic objectives. For the convenience of MFBIs, SIP methodology is designed as a predominantly objective exercise giving the flexibility to clients of submitting information in tranches and online; its evaluation will be largely conducted offsite. To complete the SIP exercise, a number of references such as Human Development Index of UNDP for Pakistan and other published data for district level geographic economic parity assessment and geographical dispersal are to be used.

VIS recognizes that certain qualitative factors are critical in assessing the stability and predictability of an MFBI's social performance over time. Accordingly, its assessment methodology incorporates both qualitative and quantitative analysis. VIS has outlined six broad parameters, which are further segmented into sub-parameters and specific factors to facilitate a detailed evaluation of the processes and practices employed by MFBIs. In developing its framework, VIS acknowledges the use of internationally recognized resources, including the Universal Standards for Social Performance Management (SPM).

RATING METHODOLOGY

The Socio-Economic Performance Rating developed by VIS Credit Rating Company is a comprehensive framework designed to evaluate the extent to which Microfinance Banks and Institutions achieve their social mission, while maintaining financial sustainability and responsible governance. Key Socio-Economic Performance rating elements include:

- Socio-economic context
- Compatible Governance Structure
- Analysis of data trends in lending portfolio
- Customer protection
- Fair treatment of employees and compensation
- Balancing the social management program with sustained financial viability

A. SOCIO-ECONOMIC CONTEXT

The social performance of any MFBI is largely based on its ability to achieve the national socio-economic objectives of poverty alleviation, enhancement of financial inclusion and reaching the under/unserved. The extent of social versus profit orientation varies across institutions. As a consequence, the first step in SIP is the understanding of the vision statement of the MFBI being rated. The vision statement is assessed for its level of consistency with the national objectives of poverty alleviation through economic uplift of weak regions/areas along with a focus on financial inclusion and gender balance. The completeness and objectivity of contents covering these goals is evaluated by VIS.

The mission statement is assessed for its focus on under/unserved individuals, fair play and quality of service and identification of a target market. These objectives should be defined in clear terms and constitute the terms of reference fo r the board of directors (BoD) in their actions. The mission should also be achievable in nature and be in keeping with the needs of the society in which the MFBI is functioning. Once the mission has been examined, the adherence to it has to be judged, along with the capacity of the MFBI to implement it in letter and spirit. Numerical targets in mission statements for achieving certain performance indicators are important in assessment.

Environmental and social responsibility is becoming increasingly important for MFBIs. MFBIs that adopt environmentally sustainable practices like reducing paper usage, minimizing waste, and lowering energy consumption can positively impact their operating costs. From a social perspective, MFBIs with a strong vision aligned with national goals of financial inclusion and women empowerment are viewed favorably. Robust corporate governance, ethical practices, responsible lending procedures, experienced management, and oversight by a competent board enhances the assessment of an MFBI.

B. COMPATIBLE GOVERNANCE STRUCTURE

VIS reviews the process by which the BoD guides an MFBI toward fulfilling its social mission, and how an MFBI reinforces board members' knowledge and commitment to social performance.

B. (i) Leadership

The composition of the board in terms of extent of related field's experience and expertise are important rating drivers. The frequency of board and board committee meetings and discussion on social performance indicators is reviewed. Among the various performance areas assessed by the board, geo economic dispersion, gender balances, disbursement volumes and fair pricing in lending products/services against targets are of particular importance from a rating perspective.

B. (ii) Exposure of board members

Participation of board members in social management awareness programs and forums is also taken into consideration. Review of the aforementioned social indicators at the management committee level is also assessed in terms of extent of coverage, depth of discussion and frequency.

B. (iii) Internal control framework:

The extent and level of coverage of internal control framework for monitoring of socio-economic performances are important to determine. The methodology also focuses on the handling of conflict of interest at various delivery points through documented policies and declarations and their cross check in the internal control framework.

C. ANALYSIS OF SOCIAL TRENDS IN PORTFOLIO

A significant analytical tool in assessment of social rating for MFBIs is the review of the social trends in their lending portfolio. It is endeavored here to capture the data by the basic geographic unit i.e. district level within the country.

The review of these trends focuses on the operational areas of MFBIs that reveal the social outcomes of their lending activities.

C. (i) Geo economic dispersal

The assessment starts with the geo economic dispersal of the lending portfolio to assess the coverage awarded to weak economic areas. The amount and number of disbursements in low economic parity districts is compared with total disbursements to determine the social outcome of lending. The trend in year over year and cumulative disbursements by economic parity is also noted.

C. (ii) Gender balancing

Gender balancing is the next social indicator to be assessed to determine the extent of women clientele in financial inclusion, particularly in weak economic areas. The amount and number of disbursements to women in the low economic parity districts in relation to total disbursements in all districts is a social rating determinant.

C. (iii) Geographic coverage

Geographic coverage of MFBIs lending outreach is also an important rating rationale; the assimilation of this data with the economic parity level of the area provides an important tool for social rating. VIS looks at the overall distribution of the branch network in terms of the trend in total branches outstanding and those in low economic parity districts. The branch expansion strategy is also studied with respect to the number of branches opened in low economic parity districts versus high economic parity districts. With respect to MFBIs holding national license, VIS also analyzes the provincial concentration of loans disbursed.

C. (iv) Pricing

Lastly, for an MFBI to achieve its social mission, it is important to ensure that pricing of products is affordable to the client while allowing for MFBI to be financially sustainable. Accordingly, fair pricing in lending products/services offered is evaluated through analysis of concentration in pricing and type of loans by amount and number of loans disbursed. Pricing data of the loans is gathered along with asset class distribution of loans to understand the competitiveness of lending and the focus areas of lending. Loans for productive purposes are more important to enhance the revenue stream of clientele in under-served areas.

D. CUSTOMER PROTECTION

The client base of MFBIs largely comprises of individual with some group lending. The clientele is generally from low income group with little or no prior experience of documented borrowing. Given the afore and their weak educational background, their fair treatment and protection from undesirable borrowings is an important social rating ingredient. Three rating attributes are important here.

D. (i) Structured avoidance of miss/over selling, documentation understanding and ease; and awareness programs to select suitable loan products. Debt burden recognition and matching with client resources.

VIS examines an MFBI's written policies as they relate to customer protection issues. Existence of a code of ethics/policies defining the ethical and professional standards for employees is considered important. Key guidelines include fair and respectful treatment of the client, avoidance of over-selling and prevention of over indebtedness. Pricing transparency which refers to how well customers understand the all-in cost of loans or other product offerings, can be evaluated through brochures, loan documentation and awareness programs conducted by the MFBI. Moreover, loan evaluation documents are examined for the quality of their guidelines and the quality of income/ debt evaluation of borrower. The loan approval process is examined in detail to ensure that the process is objective and tailored to the needs of the client. Availability of loan documentation in native language adds to social rating.

D. (ii) Customer retention ratios and feedback surveys. Privacy of customer's loan and deposit data.

An evaluation of customer retention entails how an MFBI handles customers that are leaving or opting out of certain products, including its use of exit interviews, surveys or other methods that can help identify customer dissatisfaction. The contents and scope of customer data privacy policy and implementation status is reviewed.

D. (iii) Extent of community support programs. Customer complaint handling mechanism and its awareness.

VIS looks to see how effectively an MFBI's management monitors customer complaints and complaint resolutions. It is assessed whether customers are appropriately informed and encouraged to give feedback and make complaints. Apart from this, a review of whether an MFBI is involved with its target community in ways other than those directly related to its core business such as community involvement, is also conducted.

E. FAIR TREATMENT AND COMPENSATION

The role of human resource of an MFBI is an essential ingredient in its social performance level determination. A motivated and competitively compensated human resource, well aware of the social performance objective is important. Human resource strength assessment is drawn from the following two rating attributes:

E. (i) Well-developed HR function with fair and disclosed policies.

The social mission of an MFBI encompasses not only its customers but also the employees that work for it. Accordingly, the depth of human resource (HR) function in terms of Board level policy formation and review and Management level oversight in implementation of policies is important. The coverage of HR policies in terms of gender balance, promotion of merit and institution of work ethics is evaluated. The recruitment mechanism should entail a well-defined policy, a documented and transparent recruitment process with focus on merit and no gender bias is among the rating drivers. Employee satisfaction surveys at regular intervals add to the efficacy of the HR function and social rating.

E. (ii) Competitive compensation, grievance handling and job satisfaction.

The extent of women and ethnic minorities' representation is compared with the general population, and the extent to which equal opportunities are available to them is taken into rating consideration. Other areas measured by VIS include the extent of training opportunities provided, employee turnover ratios and mechanism for performance incentives. The structure and access to employee grievance redressal system is analyzed to determine its effectiveness. In employee performance evaluation use of social performance achievements/benchmarks is also a rating factor.

F. BALANCING FINANCIAL AND SOCIAL PERFORMANCE

It is considered imperative that an MFBI's targeted growth rates are sustainable. Sustainable growth allows an MFBI to maintain good customer service, respect clients' rights, and ensure manageable workloads for employees. Accordingly, VIS examines if an MFBI has firstly set sustainable growth targets and secondly, if it monitors financial indicators such as number of loans outstanding, infection ratio, productivity and outstanding portfolio on a periodic basis. Presence of social performance targets in annual plans is also important along with the monitoring of spreads in social lending products. The visible adoption of "double bottom line" approach is considered an important ingredient in managing financial risk along with social achievements.

The understanding of the business & market conditions and the external environment are extremely important because they have a significant impact on the MFBI's social and credit profile. The identification of the risks and challenges faced by the local MFBIs and their risk management measures to combat the challenges are an important step in deriving the final rating.

As such, although the key focus of assessment is the extent of achievement of social objectives pursued by an MFBI, long-term program viability remains a key concern. VIS's approach therefore does not place excessive focus on recovery ratios or profitability, rather the assessment criteria are focused on business viability indicators in relation to sustainable operations, and as such these factors are evaluated within the context of enabling operations in the long-term.

The major evaluation factors are as follows:

- Portfolio Recovery Ratio which is defined as Portfolio at risk (greater than 30 days) to Gross disbursements.
- Expense Ratios (ER) which is defined as a ratio of Operating Expenses to Operating Income.
- Operating Self Sufficiency (OSS) which is Operating Income divided by the sum of Finance Expense, Operating Expense & Loan Loss Provision.
- Scale and Reliability of Access to External Funds is measured through funding lines available, diversity of fund sources & donations or subsidies as % of total assets.
- Capitalization is also measured to assess the ability of the MFBI to absorb losses in case of business losses or provisioning of bad dets. The minimum capital requirement is also checked against the capital available net of losses or as required for regulatory compliance.

RATING SCALE & VALIDITY

The Socio-Economic Performance (SIP) scale is designed to evaluate the ability of microfinance banks and institutions (MFBIs) to achieve their intended social objectives. It ranges from SIP1, reflecting a very strong ability supported by deeply institutionalized practices ensuring consistent and sustained excellence, to SIP5, indicating weak ability with underdeveloped infrastructure and significant gaps relative to standard practices. Intermediate ratings, such as SIP2 and SIP3, capture varying degrees of strength, with SIP2 denoting strong but slightly less robust performance than SIP1, and SIP3 representing largely adequate performance. Lower ratings, SIP4 and SIP5, highlight institutions that face considerable challenges in delivering social outcomes. Plus ("+") and double-plus ("++") modifiers provide additional granularity within each category, recognizing relative differences in performance strength. The details of SIP Scale and definitions of each scale are provided on the following page. The scale assigned to an MFBI will be valid till such time as withdrawn and is reviewed generally on an annual basis. VIS may at any time deem necessary to change the rating assigned to the institution depending on changes to corporate practices affecting the social performance profile of the institution.

RATING SCALE & DEFINITIONS:

Rating scale and Definitions may be accessed at (https://docs.vis.com.pk/docs/VISRatingScales.pdf)

Jahangir Kothari Parade (Lady LLoyd Pier) Inspired by Her Excellency, The Honorable Lady Lloyd, this promenade pier and pavillion was constructed at a cost of 3 Lakhs and donated to the public of Karachi by Jahangir Kothari to whose genrosity and public spirit the gift is due. Foundation stone laid on January 5, 1920. Opened by Her Excellency, The Honorable Lady Lloyd on March 21, 1921.

Dome: A roof or vault, usually hemispherical in form. Until the 19th century, domes were constructed of masonry, of wood, or of combinations of the two, frequently reinforced with iron chains around the base to counteract the outward thrust of the structure.

Origins: The dome seems to have developed as roofing for circular mud-brick huts in ancient Mesopotamia about 6000 years ago. In the 14th century B.C. the Mycenaean Greeks built tombs roofed with steep corbeled domes in the shape of pointed beehives (tholos tombs). Otherwise, the dome was not important in ancient Greek architecture. The Romans developed the masonry dome in its purest form, culminating in a temple built by the emperor Hadrian. Set on a massive circular drum the coffered dome forms a perfect hemisphere on the interior, with a large oculus (eye) in its center to admit light.

VIS Credit Rating Company Limited is committed to the protection of investors and offers a blend of local expertise and international experience to serve the domestic financial markets. With its international reach, VIS is positioned to aim for an international mark. In this regard, the global experience of our international affiliates and partners have been invaluable towards adding depth to our ongoing research endeavors, enriching us in ways, that enable us to deliver our responsibilities to the satisfaction of all investors. The edifice of the Jahangir Kothari Parade has stood proudly through the years and is a symbol of our heritage. Its ‘Dome’ as the most stable of building structures, exemplifies architectural perfection. Committed to excellence, VIS continues its endeavour to remain an emblem of trust.

INTERNATIONAL

Affiliates

Islamic International Rating Agency – **Bahrain –** iira.com
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Collaborations

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