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# **Functions and Functionalities of Ratings in Microfinance**

*A comparison with the major credit rating industry with special reference to the case of Peru*

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## List of Abbreviations

ADA	Appui au développement autonome
ADB	Asian Development Bank
ADC	Andean Development Corporation
AUM	Assets Under Management
BICRA	Banking Industry Country Risk Assessments
BOLD	BlueOrchard Loans for Development
Caval	Calificadora de Valores
CDO	Collateralized Debt Obligation
CEPS	Center for European Policy Studies
CGAP	Consultative Group to Assist the Poor
CMAC	Caja Municipal de Ahorro y Crédito
COOPAC	Cooperativa de Ahorro y Crédito
CPA	Certified Public Accountant
CRAC	Caja Rural de Ahorro y Crédito
CRISIL	Credit Rating Information Services of India
CSR	Corporate Social Responsibility
DFI	Development Finance Institution
EBRD	European Bank for Reconstruction and Development
EDPYME	Entidad de Desarrollo de la Pequeña y Microempresa
EECA	Eastern Europe and Central Asia
FCIC	U.S. Financial Crisis Inquiry Commission
FENACREP	Federación Nacional de Cooperativas de Ahorro y Crédito del Peru
FMO	Financierings Maatschappij voor Ontwikkelingslanden NV
FSD	Fondo de Seguro de Depósito
FSDB	Funding Structure Database
GLP	Gross Loan Portfolio
GPA	Gross Problematic Assets
GRI	Global Reporting Initiative
HNWI	High Net Worth Individuals
IAS	International Accounting Standards
IBCA	International Bank Credit Analysis
IDB	Inter-American Development Bank
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPO	Initial Public Offering

JCR	Japan Credit Rating Agency Ltd.
LAC	Latin America and the Caribbean
MDGs	Millennium Development Goals
MENA	Middle East and Northern Africa
MFI	Microfinance Institution
MIF	Multilateral Investment Fund
MII	Microfinance Investment Intermediary
MIV	Microfinance Investment Vehicle
NBFI	Non-bank Financial Institution
NGO	Non-governmental Organization
NRSRO	Nationally Recognized Statistical Rating Organization
PAR > 30	Portfolio at Risk over 30 days
PAT	Poverty Assessment Tool
PCR	Pacific Credit Rating
PPI	Progress out of Poverty Index
PRODEM	Fundación para Promoción y el Desarrollo de la Microempresa
QAT	Quality Audit Tool
ROA	Return on Assets
ROE	Return on Equity
RoSCA	Rotating Savings and Credit Association
S&P	Standard and Poor's
SBS	Superintendencia de Bancos, Seguros y Administradores de Fondos de Pensiones
SEC	Securities and Exchange Commission
SME	Small and Medium-Sized Enterprise
SP Task Force	Social Performance Task Force
SPA	Social Performance Assessment
SPI	Social Performance Indicators
SPM	Social Performance Management
SRI	Socially Responsible Investments
SSA	Sub Sahara Africa
TA	Technical Assistance
TSI	Total Social Impact
USAID	U.S. Agency for International Development
USD	United States Dollar(s)





## **PART I – Introduction**



# **1 Ratings in Microfinance? – Research Questions, Methodology and Structure of the Study**

In the last three decades microfinance has received increasing attention from international development organizations and governments as an efficient contribution to poverty reduction and local economic development. Particularly the discovery that small-scale financial services for the low-income population can be provided in a self-sustainable or even profitable way spurred the euphoria that market-based solutions for fighting poverty were possible. Since then, the microfinance sector has gone through profound changes. In many countries it developed from a primarily donor-driven community to an integral part of the financial sector. Instead of largely distributing microcredits through rather small non-governmental organizations, an increasing number of for-profit institutions started offering adapted financial products, including savings, microinsurance and transfer services. Nevertheless, microcredits are still dominating the scene. In order to further reduce the dependency from donor money and to leverage the growth of the microfinance sector(s), important microfinance stakeholders started promoting the connection with international capital markets as a meaningful source of funding. Promoting the link of microfinance institutions to commercial investors (mostly but not exclusively from the Northern hemisphere) also includes initiatives at the meso-level with a focus on building an investment-enhancing infrastructure. Alongside microfinance associations, specialized investment services firms and a global information platform, for example, specialized microfinance rating agencies appeared as new actors for enhancing transparency and facilitating efficient and sustainable investment decisions.

External credit ratings provided by the major U.S. credit rating agencies Moody's, Standard & Poor's and Fitch are a well-known phenomenon in financial markets. The credit rating agencies' expertise has long been appreciated by financial market participants as well as regulators who increasingly relied on their credit risk assessments. Many borrowers have enjoyed increasing access to financing at lower costs and were, therefore, willing to pay for the rating agencies' services. Therefore, the appearance and (political and financial) support of specialized microfinance rating agencies since the late 1990s might not be very surprising and could be simply explained as an expression of "mainstreaming" the microfinance sector by adapting the same professional standards. Currently, four specialized rating agencies provide risk assessments of an increasing number of microfinance institutions (MFIs) alongside conventional, mostly local raters which are only active in single countries.

Yet, researchers diverge in their analysis regarding the causal relationship between a specific institutional setting and (financial) development. This also applies to the major U.S. rating agencies. Here, academics are rather discordant about the contribution of these organizations and

derive very different explanations regarding their importance in financial markets. Some even argue that the single most important factor for the rating agencies' powerful position is their integration into regulation. If they had not been used to set, capital adequacy rules, for example, rating agencies would have remained one of many sources of information and not at all of critical importance for funding decisions of investors.

Hence, the present study tackles the question in how far ratings in microfinance contribute to the development of the sector. Can external ratings really induce investments into the sector or into single microfinance institutions? Or are they rather the result of increasing investment flows easing investment decisions? What is the cost-benefit relation of these assessments? In how far do MFIs and their clients, who might ultimately bear the costs of higher product prices, benefit from ratings? Ratings in microfinance receive financial support, not only by individual donors but also through the installation of specialized funds exclusively dedicated to their promotion. Are these subsidies justified?

Furthermore, the study addresses the question whether specialized rating agencies – instead of “mainstream” rating agencies – are necessary for being able to overcome existing frictions in the microfinance investment market. Provided that rating agencies actually make a contribution valued by investors, why do microfinance institutions not turn towards the major rating agencies that are already recognized in the mainstream capital markets? Do we need specialized rating agencies simply because mainstream raters have not (yet) identified microfinance as an attractive business for fulfilling its valuable function? Or does the reason for their existence rather lie in the particularity of microfinance which calls for specialized institutions and methodologies? This is especially interesting since there is a persisting confusion among the various microfinance stakeholders about the different rating products and approaches. Therewith, the study also provides insights into the potential evolution of “the microfinance rating industry” by asking whether, and under which conditions, specialized microfinance raters will gain an equally prominent position in the microfinance sector as their major counterparts in the global capital markets.

The latter question is of particular interest since market participants of the mainstream financial market started worrying about the activities of the major rating agencies, especially since the global financial crisis of 2008. Criticism encompasses the lack of transparency regarding the rating agencies' methodology, their independency, their timeliness as well as a possible abuse of power based on the oligopolistic structure of the rating industry. The ratings' systemic importance becomes particularly critical whenever the fortune of entire states depends on the rating agencies' opinion. The most recent testimonial is the acute debate about sovereign ratings and those of government bonds. It became especially fierce with the rating agencies' role in worsening the European debt crisis which resulted in the call to break the power of the U.S. raters. Furthermore,

major rating failures (for example in the case of Enron) have resulted in questioning the quality of credit ratings. So far, criticisms reached its peak with the outbreak of the financial crisis in 2008. Rating agencies were considered the motor of the development of structured mortgage-backed securities which could not have been traded without the rating agencies' seal of approval. The financial crisis revealed that rating agencies had terribly failed in adequately assessing the credit risk of these securities, which at first had received very high grades.

In order to broach possible downsides of this instrument, the study also discusses critical issues related to the activities of rating agencies in general and in how far these issues also apply to the microfinance context. Why did the rating agencies perform so poorly in analyzing the credit risk of structured mortgage-backed securities? And was this failure a unique case due to a complex interplay of market forces which rating agencies – just as anybody else – had not seen coming? Are credit ratings in general a reliable source of information or do they rather follow their own agenda that lies beyond the interests of market participants they officially seek to serve? To which degree can (or should) market participants as well as regulators rely on the assessments of rating agencies?

Apparently, there is a meaningful discrepancy between the various expectations (or perceptions) of different stakeholders regarding the rating agencies' role in the financial market. Rating agencies state that they are simply providing forward looking opinions about borrowers' creditworthiness. Yet, market participants often treat their evaluations as hard facts which in turn might also explain their high relevance and authoritative position. But which task do rating agencies exactly perform? Can rating agencies actually better predict future debt defaults which would justify market participants' reliance on their appraisals? If not, why do market participants and regulators rely on ratings anyway?

In the context of microfinance, "socially minded" investors do not only face the risk of microfinance institutions failing to pay back their loans (credit risk), but they also want to secure a positive social contribution. The need for MFIs and those supporting them to verify their social orientation became especially pressing in the context of an ongoing commercialization of the microfinance industry and related risks. Examples are the "mission drift" of microfinance institutions (when they turn away from the poor in order to serve more profitable, better-off clients), the exploitation of clients through usurious interest rates or over-indebtedness spurred by excessive growth and increasing competition. In response, specialized microfinance rating agencies also started offering social ratings as a standardized means and as objective "proof" for the microfinance institutions' social commitment. Yet, are ratings – with their rather static, standardizing and classifying character – the appropriate instrument for fostering the dispute and settlement of

social principles with universal validity some microfinance stakeholders are now looking for? What are the specific social goals social ratings (can) assess?

The purpose of the present study is to provide a systematic discussion of the functions of external ratings in general and particularly in the context of microfinance. These functions derive from a detailed discussion of relevant theoretical strands across various disciplines. Furthermore, the present study tackles the question whether the existing rating practices can actually fulfill these functions, where the context-related focus points are and under which conditions this instrument turns out to be rather dysfunctional. The following section explains how the various research questions outlined above are captured within one analytical framework. Chapter 1.2 presents the research design and methodology and Chapter 1.3 is dedicated to outline the structure of the study.

### **1.1 Research Question – Functions and Functionalities of Ratings in Micro-finance: What Does That Mean?**

There are few empirical studies on ratings in microfinance focusing on the performance of the specialized rating agencies and their effects on microfinance institutions. For instance, Gutiérrez-Nieto and Serrano-Cinca (2007: 3) and Beisland and Mersland (2011) assess the factors that explain rating grades in terms of selected financial and social indicators. The former study finds that microfinance rating grades contain valuable information for investors. The latter highlights that ratings offered by the specialized raters are very similar to those provided by the major rating agencies while neglecting important aspects such as operational efficiency and social performance. The authors question the justification of subsidies for microfinance ratings. Hatarska (2005; 2006; 2009) analyzes whether microfinance ratings have a positive impact on the institutions' performance. She finds that ratings, in contrast to audited financial statements and regulation, might have, even though limited positive effects on the discipline of MFI managers to operate their institutions more profitable and with larger outreach. However, possible positive effects are limited to the case of one specialized rating agency. And Hatarska (2009) suggests that donors should only promote particularly useful methodologies. The same applies, if the usefulness of external ratings in terms of fundraising activities of MFIs is considered. Again, Hatarska and Nadolnyak (2008) find that only in case of one rating agency these performance assessments helped MFIs to raise funds. Garmaise and Natividad (2010) find that ratings do not have any impact on the amount of funds available to MFIs but instead reduce the costs of funding.

In contrast to these studies, which are of a rather deductive nature and focused on very specific issues, the present research takes a broader perspective on the phenomenon of ratings in micro-finance and the mechanisms behind their possible contribution to the development of the micro-finance sector. The focus lies on generating rather than testing existing hypotheses and is based on a conceptually wide rather than empirically exhaustive analysis. At the same time, the theoretical analysis provided in the following helps to interpret existing empirical results.

In order to approach these questions, a conceptual distinction of function, functionality and performance of ratings is made. Function is defined as the task an object (e.g. a product or service) has to execute in order to solve a specific problem. Functionality is then defined as the ability to perform a function. Finally, the performance is defined as a) the process in which these functions are fulfilled and b) the effects the object on relevant stakeholders or, to put it differently, the function's actual level of fulfillment.

To illustrate this differentiation the following example shall be considered: The function of a chair is to provide a seating-accommodation. The functionality of the chair is linked to the mode of how the chair is designed to perform this function. For example, a chair without a bearing surface would be of little use, and thus, of low functionality. The performance here is the manner and extent people use the chair. If we think of a chair perfectly aligned to the human physiognomy (high functionality) that people would just not use – and sit e.g. on the table instead – the performance of the chair as seating-accommodation would be low. It is true that an explanation for the low performance might be the limited functionality. A chair without a backrest, for example, could still serve as chair but with limited functionality regarding its comfort. Or people would not use the chair because their cultural context does not promote sitting on chairs. In this case, the functionality regarding the cultural background would be low. However, if we consider western schoolboys (or –girls) sitting on tables instead of chairs, the low performance could be rather explained by their unruliness (and the limited authority of school teachers) than by the low functionality of the chair. While in this example the functionality can vary, the performance is equally low. But not only functionality and performance can diverge. For instance, a chair with a low functionality as seating accommodation can have a high functionality in order to barricade a door. Yet, the chair was never designed to serve as a door-barrier. An accidentally discovered functionality can sometimes lead to a redefinition of the function. Hence, functions and functionality of an object are also linked to the needs and expectations of their users and are subject of an evolutionary process.

Therewith, it becomes clear that functions and functionality of ratings in general and in micro-finance do not only depend on what rating agencies do and how they do it. Especially their relevance is also influenced by the specific context they operate in.

## **1.2 Research Design, Methodology and Case Selection– A Qualitative, Comparative Approach**

In the absence of an existing comprehensive theoretical framework which could explain the different functions rating agencies have in financial markets, the first contribution to academic research as to the subject at hand is the systematic discussion of the existing theoretical and empirical literature on rating agencies in order to be able to identify the different functions exercised. This analysis is backed and amended by an in-depth review of underlying theoretical concepts from different disciplines, namely economics, psychology and (economic) sociology. As stated before, rather than testing existing theories, plural theoretical perspectives or “theory frames” (Rueschemeyer 2009:1) are used to form different hypotheses and to identify possible causal relations. In a first step, the developed framework and theoretical concepts behind it are used to shed light on the discussion about the U.S. major raters, especially covering critical issues raised in recent times. In a second step, the framework is applied to the microfinance context in order to answer the questions outlined above.

To start with, the present study draws on the insights of the Theory of Financial Intermediation. This orthodox theoretical strand of the discipline of economics provides valuable insights into the functions as well as *modi operandi* of rating agencies as information intermediaries. The concept of asymmetric information and its possible negative consequences (adverse selection and moral hazard) is the most prominent one to explain the existence of any intermediary in financial markets.

Recent studies within the Theory of Financial Intermediation, instead of focusing on single market failures, follow a functional approach while highlighting the importance of risk management. The integration of these studies is interesting for two reasons. Firstly, because rating agencies are in the business of assessing the risk of credit defaults. Secondly, because the functional perspective can be interpreted as a partial renunciation of the rationalist approach turning towards a rather skeptical, empirical formula (Markie 2004) taking into account institutional changes which can be observed empirically. Doing so, this research strand draws closer to a “historical institutionalism” and away from the “rational choice institutionalism” (Thelen 1999:369-370) – or New Institutional Economics as this approach would be called in the discipline of economics.

Additionally, different theoretical perspectives complement but sometimes also question the theoretical basis derived from the orthodox economic strand. Thereby, the focus lies in identifying various programmatic academic works applicable to the subject at hand. This means that the author of the present study abstains from delivering a complete review of each academic research strand. Instead, the study refers to scholars who can be considered the originators of spe-

cific academic debates. Results of subsequent theoretical and empirical research are partially introduced whenever they are considered useful. For example, the economic debate about financial institutions is amended by theoretical considerations proposed by Schumpeter ([1934] 2008) as well as by Monetary Keynesianism as represented by Riese (2001) without explicitly tracing the successive theoretical amplifications.

The same applies for theoretical amendments outside the discipline of economics. In addition to the rationalist views, the theoretical part of the present study also covers rather constructivist considerations which recognize that “*reality is formed as a consequence of [the] stabilization [of a] controversy*” (Latour and Woolgar 1986:180). This aspect is particularly interesting when considering the definition of and exposure to risk which influences not only the rating agencies’ logic of action but also those of the users of credit ratings. Therefore, the discussion about different meanings of risk and how it can possibly be assessed receives special attention. The distinction of risk and uncertainty as introduced by Knight (1921) and Keynes ([1921], 2008) is of particular importance here. Psychological factors are also be considered, in order to further elaborate on how individuals deal with risk.

In order to gain a complementary dimension to explain the organizational setting of risk assessment and management strategies within the society – or a specific part of it such as the global capital markets–, the present study draws on works realized in the research area of economic sociology. Here, Granovetter’s (1985) approach of embeddedness and Meyer’s (2000) “neo-organizational theory” have been identified as particularly promising to deliver answers to the research questions at hand. Haas’ (1992) insights into “*epistemic communities*” have been used in order to identify the principles of expert systems which appear to be of special importance when dealing with uncertainty in the world’s “risk society” (Beck 1986).

Regarding the empirical analysis of the relevance of ratings in the microfinance context and the performance of the various rating agencies active in the field, the research was conducted with the necessary openness to follow a rather inductive way of investigation. Yet, it is deductive insofar as it applies results derived from the analyses of the major rating industry to the field of microfinance. This does not mean that certain conclusions regarding ratings in the mainstream capital markets cannot be reversed in the context of microfinance. However, the research carried out on credit ratings of the major credit rating agencies is so substantial and extensive that it is worthwhile taking it as a frame of reference and as a starting point to structure the analysis of ratings in microfinance. Furthermore, treating the phenomenon of ratings in microfinance as a variation of the major rating industry eases the way towards a generalization of results even though qualitative in-depth analysis is only conducted in one specific case (Mayring 2007:6).

The empirical assessment of the activities and performances of the major credit rating agencies is largely based on existing academic research. Additional empirical insights were gained through the thorough analysis of various policy reports such as the “Report on the Activities of Rating Agencies” (IOSCO 2003) provided by the International Organization of Security Commissions and by the U.S. Security and Exchange Commission’s (SEC) (2003) report on the “Role and Function of Credit Rating Agencies in the Operation of the Securities Markets”. To assess the major rating agencies’ role during the financial crisis 2008, the “Financial Crisis Inquiry Report” of the Financial Crisis Inquiry Commission (FCIC 2011) was consulted.

The empirical analysis of ratings in the context of microfinance in general is largely based on publicly available primary and secondary sources such as rating reports, grey literature,<sup>1</sup> policy reports, web-sites, newspaper articles and blog entries. Thanks to the global character of “the microfinance industry”, especially if investors, networks and other supporting organizations are considered, online data sources are particularly rich in material, including the most important media covering current news (e.g. MicroCapital, Microfinance Focus, Microfinance Insights). Existing empirical research on ratings in microfinance as well as in related research areas (for example investments in microfinance or the microfinance industry structure) are also considered. In line with the practice of “theory triangulation” applied in the first part of the study, the empirical sections on microfinance rely on “data triangulation” as proposed by Denzin (1970: 301-305). The outcome can be defined an “*emergent construction*” (Denzin and Lincoln 2000: 4), where different theories are applied to contribute to the interpretation of the research puzzle. The theoretical analysis and the results derived from the assessment of the major credit ratings provide the means for a control of plausibility during the different steps of the research.

As far as the analysis of rating methodologies is concerned, this study relies on the public information available and, more importantly, on the rating reports issued by different rating agencies.<sup>2</sup> Detailed information on the methodologies applied is not available in most of the cases. Rating agencies specialized in microfinance mostly limit themselves to disclosing their major rating categories without specifying key assumptions behind their evaluations or reference values for their quantitative indicators. Still, by carefully studying the rating reports major differences can be identified. Furthermore, the style and content of the rating reports as such can be analyzed which might also influence the benefits for different users.

In order to further sustain the analysis, in-depth qualitative research has been conducted in Peru. This country has been chosen as a case study as it is recognized for having one of the most ma-

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<sup>1</sup> Microfinance as a relatively new research field sometimes suffers from a lack of data availability to conduct sound academic research. However, various practitioners’ organizations became engaged in research activities. Generally the author took great care to pick the most reliable sources for specific issues. Whenever the data or the results should be taken with caution, it will be indicated accordingly.

<sup>2</sup> For an overview of the rating reports analyzed see Annex 1.

ture microfinance sectors worldwide, and ratings are a widespread phenomenon among Peruvian MFIs.<sup>3</sup> Moreover, a lot of microfinance investments are flowing into this country which – a priori – increases the significance of ratings in this context. Furthermore, the local capital market is relatively developed with local “mainstream” rating agencies operating also in the field of microfinance. Since the implementation of banking laws and regulation as suggested by the Basel Accord is in an advanced stage, the aspect of rating-based regulation enters and broadens the discussion on different functions and functionalities of ratings in microfinance. Last but not least, a relatively high number of social ratings conducted in Peru deliver the basis for insights into this even younger phenomenon.

Therefore, not all rating agencies active in microfinance world-wide are considered. The focus lies on the four globally active specialized rating agencies (MicroRate, M-CRIL, MicroFinanza Rating and Planet Rating) and on three out of four local accredited rating agencies in Peru which do also rate microfinance institutions but without a specific focus on this sector: Equilibrium, Class & Asociados and Apoyo & Asociados.<sup>4</sup> Furthermore, the approach of Fitch and Standard and Poor’s are included because these rating agencies, in contrast to Moody’s, document their rating approach for MFIs more in detail. Finally, the interviews held with five of these rating agencies (two specialized and three accredited rating agencies) shed further light on the subject. Two of the Peruvian raters have a strategic partnership with one of the major raters. Cooperation includes an active exchange in terms of methodological issues. Since this is also true for many of the other local raters active in microfinance, some general conclusions about the different groups of raters might be valid even if they are applied to different contexts.

The case study largely draws on qualitative methods. Own qualitative data has been collected in the form of 45 guided interviews conducted in 36 different organizations<sup>5</sup>, among them representatives of the regulatory bodies for the banking sector and the stock exchange, five rating agencies (two specialized and three local mainstream raters), three foreign investment management firms with offices in Lima, one commercial bank (Banco de Crédito), two governmental banks (COFIDE, Banco de la Nación) and a total of 19 MFIs with different legal forms (one bank, two finance companies, four CMACs, two CRACs, three EDPYMEs, two cooperatives and five NGOs)<sup>6</sup>. Regarding the selection of MFIs interviewed, it was taken into account that MFIs should have different institutional (and legal) forms as well as different orientations as far as their stated

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<sup>3</sup> The Peruvian microfinance sector is presented in Chapter 6.

<sup>4</sup> The fourth rating agency (PCR) can be neglected as – according to a SBS database on financial institution ratings – this rating agency is almost not active in microfinance. The only MFI rated in recent years by this company is the microfinance bank MiBanco.

<sup>5</sup> For a detailed overview of the persons and respective organization interviewed refer to Annex 2.

<sup>6</sup> The different types of microfinance institutions and their main characteristics are presented in Chapter 6.1.

mission is concerned. In addition, the MFIs interviewed are located in different regions and markets. The regions around Trujillo and Arequipa, where some of the MFIs are located, are considered to be well developed microfinance markets – one in the south the other in the north of the country, whereas Cuzco (South), Chiclayo (North) and Huancayo (Center) are rather moderately developed microfinance markets (Ströh 2010:36-37, 408-414). Some of the MFIs interviewed in Lima had their headquarters in the capital while also working in rather remote areas with little developed microfinance markets.

The interview material has been analyzed following the approach of Mayring (2001) in terms of computer-based qualitative content analysis. The categorization (or coding) process has been realized in a deductive manner following the interview guidelines<sup>7</sup> and also inductively as a result of the content analysis. Results of these interviews are analyzed in combination with other, mainly qualitative and some quantitative data (triangulation).

As far as the microfinance sector is concerned, original quantitative data is largely taken from the MIX Market database. MIX Market data has to be interpreted with some caution as it is largely self-reported. At the time the research was realized there were 1.928 MFIs reporting to the MIX world-wide.<sup>8</sup> For Peru there are 65 MFIs listed in the database including all the important MFIs in terms of outreach and sustainability. Most of these MFIs also provide rating reports and financial statements which increases the validity of the reported data. Furthermore, the results of descriptive statistics derived from this data have been cross-checked with the statistics of Ströh (2010) whose comprehensive analysis of the Peruvian microfinance sector is additionally based on the data provided by the national banking regulation authority. As far as single MFIs are concerned, additional data has been taken from audited financial statements of the respective institution. Another limitation when using MIX Market data is the lack of representativeness regarding the microfinance sector as a whole. Only a small fraction of all microfinance service providers active world-wide uploads its profiles on MIX Market. Yet, it can be assumed that MFIs interested in attracting international funding are more likely to share their data in order to gain visibility. Hence, as far as the topic of the present study is concerned, the MIX Market data is considered to be representative for these MFIs. In the case of funding data, the MIX Market interactive Funding Structure Database (FSDB) has been consulted.<sup>9</sup> The use of this data is limited as it provides in-

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<sup>7</sup> The different interview guidelines are disclosed in Annex 3.

<sup>8</sup> If not indicated otherwise, the data was obtained from <http://www.mixmarket.org/> (accessed April 14, 2010). In general, data as of December 2008 was used since for these years the largest number of MFIs was covered, whereas for 2009 a significantly minor number of MFIs had shared updated data.

<sup>9</sup> For the interactive Funding Structure Database see <http://www.mixmarket.org/mfi/funding-structure> (accessed March 24, 2011). The MIX Market interactive FSDB offers the following filtering options in order to receive the main characteristics (median amount, average rate and term) by lender subtype: commercial bank, cooperative society, dev. program, foundation, fund, government agency/program, individuals, MFI,

formation only in an aggregated manner and for a limited number of MFIs. Other than in the case of data for individual MFIs, the underlying raw data cannot be downloaded. Instead, data is accessible through the application of pre-established filtering options. Still, for single questions the MIX Market FSDB is the only data source publicly available even though the results have to be interpreted with some caution.

Finally, single arguments are backed by the outcomes of a survey conducted among MIVs in the beginning of 2009.<sup>10</sup> 73 MIVs (out of approximately 100) were invited to participate in the survey with 23 collected responses so that the response rate was nearly 1/3. The respondents were classified according to their commercial orientation. In order to do, so the author followed the approach suggested by MicroCapital (n.d.) which follows the classification criteria proposed by MIX Market. Those MIVs which are not yet classified by MicroCapital as either “commercial”, “commercially-oriented” or “non-commercial” were ranged according to their mission statement, legal status and past performance.

It was asked on which data sources MIVs assessed the performance of their investees, how important financial ratings were to them and if financial ratings influenced the decision-making process regarding the costs of funds for MFIs considerably.<sup>11</sup> As far as social ratings are concerned, it was additionally asked whether there has been an increasing interest among investors to measure the social impact of MFIs in the last four years, whether the increasing criticism towards microfinance (e.g. the Compartamos debate) has been a severe danger for the image of microfinance as a socially responsible investment and how important social ratings will be in the decision-making of microfinance investors in the future.

### **1.3 Structure of the Study – From Major Credit Ratings to Ratings in Micro-finance**

The present study is organized in four parts. Chapter 2 of the present PART I is an introduction to the phenomenon of ratings as provided by the major credit rating agencies as well as origins and evolution or ratings within the microfinance sector. Chapter 2.1 is dedicated to the presentation of the spreading of ratings realized by the major U.S. rating agencies and how the rating practice then became an international standard. The context matters when it comes to the assessment of the relevance and expectations of the different stakeholders regarding external risk assessments.

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multi- and bilateral development agency, NGO, peer-to-peer lender, private corporation, public bank, regulator, unknown.

<sup>10</sup> The survey was conducted in cooperation with Kathleen Welvers in the context of her diploma thesis about “Private Sector Investments in Microfinance – An Assessment of the Recent Boom”.

<sup>11</sup> See Annex 4 for the survey questionnaire.

Therefore, Chapter 2.2 focuses on the development of the world-wide microfinance sector as well as on related concerns, particularly when it comes to its commercialization. The microfinance investment landscape and the main characteristics of microfinance investors receive special attention since they are the primary target group of rating agencies. Even though the major aim of that chapter is to provide an introduction to the topic in general, some issues are taken up or referred to during the empirical analysis.

Part II deals with the major credit rating industry, both from a theoretical and empirical perspective. Chapter 3 provides a general overview on the characteristics of credit ratings and related products offered by the major credit rating agencies. In the following, the different theoretical approaches identified as relevant for the identification of the functions as well as the analysis of the functionality of ratings are presented. Thereby, the explanations offered in Chapter 3.2 to 3.4 go (somewhat) beyond the necessary level for the following derivation of the functions of ratings but provide the necessary foundation for the argumentation in subsequent chapters. As stated before, the (sub-) disciplines covered in the theoretical part are majorly (micro-) economics, psychology and (economic) sociology. In Chapter 3.5, the different functions of credit ratings are presented the way they were explicitly or implicitly mentioned in the existing academic literature. Furthermore, the more general theoretical considerations from the previous sections complement the identification and characterization of the different functions. Chapter 3.6 is dedicated to the presentation of the micro-economic foundation of one of the major drivers for the reliability of major credit ratings, namely reputation.

In Chapter 4, critical aspects regarding the *modi operandi* and the possible effects (the performance) of the major credit rating agencies' activities are analyzed in order to assess the functionality of credit ratings in relation to specific expected or desired outcomes. Especially the increasing criticism during and after the financial crisis 2008 is picked out as a central theme. The focus lies on the identification of the reasons for rating agencies to act (or to fail) in a certain manner which then might be a) generalizable, b) avoidable and c) relevant for specific stakeholders using microfinance ratings. This chapter is organized as follows: In Chapter 4.1 additional factors other than the reputation mechanism for the demand of credit ratings and also for the rating agency industry structure are presented. Chapter 4.2 then covers critical issues related to the behavior of credit rating agencies such as the lack of transparency, the conflict of interests due to their remuneration model, poor rating quality and their anticompetitive behavior. Chapter 4.3 is dedicated to the relation of credit ratings and (undesirable) market dynamics also covering the issue of investors' and regulators' possible over-reliance on ratings. Furthermore, the critical issue of the rating agencies' influence on sovereign borrowers are brought up. Chapter 4.4 provides conclusions regarding the functionality of major credit ratings.

Part III is dedicated to the eponymous topic of the present research: The functions and functionality of ratings in microfinance. Before thoroughly entering into the analysis, Chapter 5 is a short introduction to the Peruvian context, covering the state of this specific microfinance market as well as the respective rating environment. It eases the orientation for the reader of the present research when following the proposed interpretation of the qualitative data in the subsequent chapters. In Chapter 6, microfinance rating products and methodologies of different rating agencies are presented. In addition, the characteristics of social ratings and their embeddedness into the larger Social Performance Management (SPM) movement are covered. The basic patterns of Corporate Social Responsibility (CSR) ratings are also presented to the extent that is deemed helpful for the analysis of social ratings in microfinance. Chapter 7 analyzes in how far ratings in microfinance cover the different functions identified in Chapter 3 or whether additional and/or modified functions would better describe the phenomenon. The chapter is divided into two parts. The first part analyses the relevance of rating agencies' functions within the specific microfinance context. The second part deals with the functionality of different raters regarding their products offered, rating methodologies and business-models and (partially) performance. The empirical analysis also covers critical issues regarding the functionality and their meaning for the future development of the microfinance rating industry. Chapter 8 in Part IV summarizes the analysis, identifies further fields of research and discusses future prospects for the microfinance rating industry.

## **2 Contextualizing Ratings in Mainstream Financial Markets and in Microfinance**

The aim of this chapter is to present and contextualize the appearance and spreading of ratings in the mainstream financial markets as well as in the microfinance sector. In a first step, the origins and the evolution of ratings offered by the major credit rating agencies Standard & Poor's, Moody's and Fitch within and outside the U.S. capital market are summarized. In a next step, the major tendencies in the microfinance market are presented as they constitute the context which frames the empirical analysis of the microfinance rating phenomenon. Context related factors are taken up during the discussion about the relevance of ratings in microfinance as compared to their importance in the mainstream capital markets. Therewith, this chapter does not only provide a general introduction to the topic but also builds the basis for a more in-depth analysis at a later stage. The last section presents the evolution of ratings in the context of microfinance, taking into account the distribution of different rating products among the various world regions.

### **2.1 The Evolution of Credit Ratings and Their Spreading in the U.S. and Beyond**

External credit risk ratings have gained considerable importance in the last decades. In order to contextualize the relevance of rating agencies and their principle product, the following sections aim at tracing the evolution and spreading of external credit ratings provided by the major credit rating agencies.

The sub-chapter shows that in their early stages, credit ratings experienced expansion after moments of crisis in order to re-establish trust and possibly prevent credit crunches. Later on the demand was further pushed by rating-based regulation. The relevance of credit ratings is linked to the structure of capital markets and, more precisely, to the phenomena of disintermediation and globalization. In the international context, credit ratings gained importance not only because (large) companies sought access to the U.S. capital market but also because of an active promotion of their transparency standards by U.S. actors.

#### **2.1.1 The Growing Importance of Credit Ratings in the U.S.**

The first rating agencies established in the U.S. market were the mercantile credit agencies, which date back to the mid 19<sup>th</sup> century. They assessed whether merchants were able to pay back their obligations, evolving in New York in the context of the financial crisis of 1837. Luis Tap-

pan established the Mercantile Agency which was subsequently acquired by Robert Dun who published the first rating guide in 1859. Ten years earlier, John Bradstreet had established another agency and published his first rating book in 1857 (Cantor and Packer 1995a: 1-2; Fight 2001: 6-8; Sinclair 2005: 22-24). As separated entities they rated trading firms until 1933 when they finally merged to form Dun and Bradstreet which became the owner of Moody's Investor Service in 1962 (Adams, Mathieson *et al.* 1999: 102). However, the expansion of the ratings business to debt security ratings happened well before in the early 20<sup>th</sup> century – also motivated by market turbulences. Even though Henry V. Poor produced his first “Manual of the Railroads of the United States” as early as 1868 and was followed by John Moody's “Manual of Industrial Statistics” in 1900, the transition from issuing compendiums of information to the practice of making actual judgments about the creditworthiness of debtors occurred in the fringe of the financial crisis of 1907. In 1909 Moody started to rate U.S. railroad bonds, a year later he extended his activities to utility and industrial bonds. Poor followed Moody in 1916, and the Standard Statistics Company entered the business in 1922. Finally, the Fitch Publishing Company started its rating activities in 1924.

In their early days, credit ratings often failed to predict companies' defaults. Yet, their spreading as a signal of trustworthiness was unrelenting (Carruthers and Cohen 2006). This is also true for the interwar period and the rating agencies' assessment of foreign sovereign debt. Between 1931 and 1939 more than half of the sovereign borrowers who had placed their debt at the U.S. capital market during 1920 and 1929 defaulted, and rating agencies had performed poorly in predicting this. However, despite their relatively poor performance U.S. regulators decided for the first time to involve ratings in regulation “*as a direct response to the debt crisis*” (Flandreau, Gaillard *et al.* 2010: 1) and made it obligatory to use ratings for booking the value of U.S. national banks' bond portfolios.

Still, the rating activity mainly stayed a U.S. phenomenon between the 1920s and 1980s. In this period, several buy outs, mergers as well as new entrances occurred. In 1941, Standard Statistics and Poor's Publishing Company merged and formed Standard and Poor's (S&P). The most significant new entry in the United States since that time has been the one of Duff and Phelps, which started its rating activities in 1982. In 1991 Duff and Phelps absorbed McCarthy, Crisanti and Maffei, founded in 1975 (Cantor and Packer 1995a: 2). Furthermore, competition within the U.S. also arose from the emergence of specialized rating agencies like Thomson Bank Watch, founded in the early 1960s and primarily targeting U.S. banks (Fight 2001: 60).

As the U.S. economy evolved, increasingly complex financial instruments were developed. The rating agencies answered in the 1970s by expanding the depth and frequency of their coverage. Beyond rating long-term bonds issued by U.S. corporations, they also started rating a variety of

other debt instruments such as municipal bonds, asset-backed securities, preferred stocks and bank certificates of deposits. In the 1970s, the major rating agencies started charging not only investors but also issuers for their services. Initially, they had provided public ratings free of charge, financing their operations through the sale of publications and related materials. But as publications were easily copied once they were published, the sales did not generate sufficient returns to justify intensive coverage. Another reason was that rating agencies had been increasingly expected to provide a more complex and faster service (Chen 2004: 39). With the newly created revenues, rating agencies expanded their services and products and started “*competing with private sector analysts at other financial institutions*” (Cantor and Packer 1995a: 4).

A major event which served as a catalyst in the transition to charging issuers was the bankruptcy of Penn Central Railway<sup>12</sup> during the recession in 1970. In the 1960s, the commercial paper market had grown rapidly and investors had been very confident with well known firms. When Penn Central defaulted, however, investors began questioning the financial conditions of many companies refusing to roll over their commercial papers. The thereby provoked liquidity crisis coerced many other companies into bankruptcy. Since then, issuers actively sought credit ratings and it became an established market practice to obtain at least one credit rating when new issuers entered the market (Cantor and Packer 1995a: 4; Fight 2001: 6-7).

Another consequence of the Penn Central bankruptcy was the implementation of a set of reforms in the U.S. securities market by the SEC. Among other things, the concept of Nationally Recognized Statistical Rating Organizations (NRSROs) was introduced (SEC 2005: 5). This began by conferring the NRSRO status on a few selected rating agencies in 1975 – primarily those with a national presence at that time: Moody’s, S&P and Fitch – whose credit ratings could then be used to determine net capital requirements for broker-dealers (including major investment banks and securities firms). Subsequently, the term was taken up by other regulatory bodies and has since evolved into a quasi-official regulatory framework. Although banks were already allowed to invest in “investment grade” bonds only since 1936 (White 2010: 213), other regulatory bodies followed in the following decades (insurance regulators, pension regulators and finally the SEC). Since the 1990s, reliance on ratings has encompassed virtually all financial regulators including public authorities supervising banks, thrifts, insurance companies, securities firms, capital markets, mutual funds and private pensions (Cantor and Packer 1995a: 5-6). In the early stage, only the difference between investment grade rated securities (those rated BBB and above) and those assigned a speculative grade (BB and below) was of importance. Regulators ordered that for speculative grade securities extra capital was to be held or they prohibited such investments altogether. The distinction of investment grade and speculative grade was (and is) still of signifi-

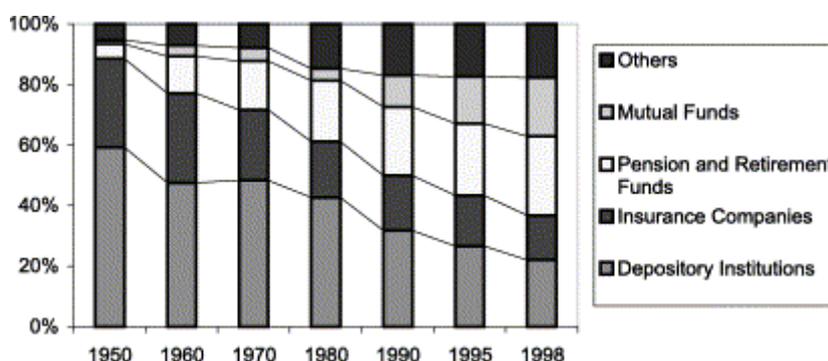
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<sup>12</sup> Penn Central Company was a Philadelphia based railroad company and went bankrupt on June, 21 1970. It was then the sixth biggest U.S. company and caused the biggest bankruptcy until then.

cance. However, over time, regulators tied capital requirements, disclosure requirements and investment prohibitions to other letter grades as well.

The structure of U.S. capital market further influenced the demand for credit ratings. The major changes of the structure of U.S. capital market since World War II have been the growth of financial intermediaries such as insurance companies, investment companies and pension funds and their increasing ownership of corporate stock. From 1949 to 1972, institutional holdings of equities (excluding personal trust) on the New York Stock Exchange grew from 9.7 billion USD to 258.3 billion USD. And combined institutional holdings rose from 34.2% of the outstanding stock to 43.4% between 1969 and 1978 (Whitley 1986: 181). The major new financial institutions which emerged in the post-war period were company and state owned pension funds as well as investment companies like mutual funds. These manage a substantial quantity of personal savings and investments on a fiduciary basis.

**Figure 2.1: Distribution of U.S. financial assets by main types of financial intermediaries, 1950-1998**

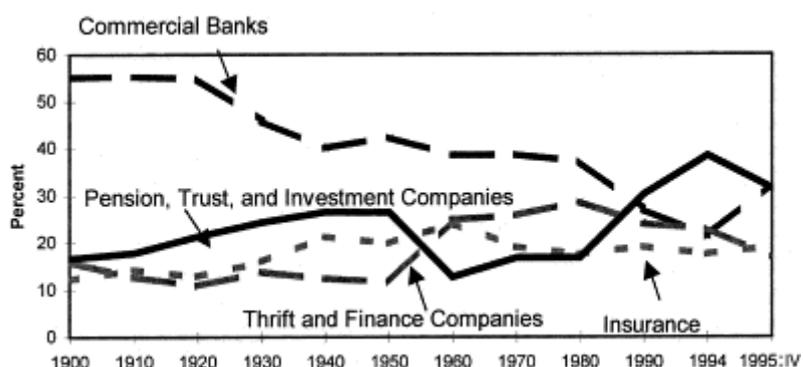


Source: Allen and Santomero (2001: 275) taken from Barth, Nolle et al. (1997) and updated tables from Barth

With the respective “upgrading” of finance through capital markets, the relative significance of traditional banks that take deposits and make loans (depository institutions) decreased. It decreased to such an extent that Chernow (1997) even declared “The Death of the Banker”, stating that “relationship banking” was replaced by “transactional banking”. Figure 2.1 exemplifies the proportionate decline of depository institutions compared to other financial intermediaries.

This shift from traditional bank lending towards market-based financial intermediation remains pronounced when taking a longer historical perspective. Figure 2.2 shows the decline of the share of total financial intermediary assets held by commercial banks from over 50% to under 20% between 1900 and 1995.

**Figure 2.2: Relative shares of total financial intermediary assets, 1900-1995**



Source: Allen and Santomero (2001: 275) taken from Federal Reserve Bulletin

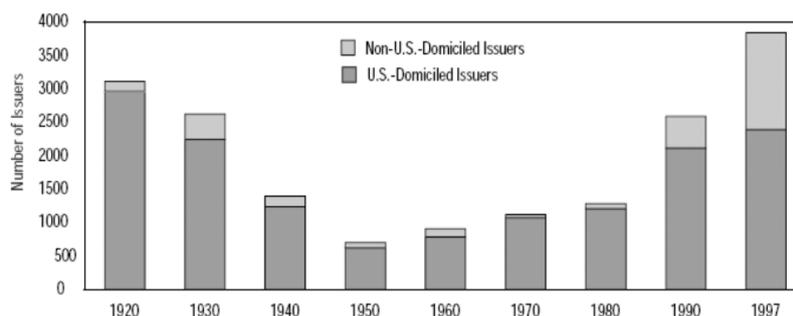
However, financial assets in the banking sector have not declined markedly in relation to total financial assets as a percentage of GDP. Allen and Santomero (2001: 290) point to the fact that banks achieved moving away from simple balance sheet intermediation towards fee-producing activities. In fact, the dominant group of financial institutions engaged in stock markets was the one of bank trust departments which in 1978 managed almost two thirds of the total institutional stock ownership (Farrar and Girton 1981: 372). Other actors which became highly engaged in capital markets were large U.S. companies. The internationalization and diversification of U.S. companies in the postwar period led to the growth in organizational management of capital assets and to the separation of corporate treasurers departments. Dealing with cash management, banking relationships, credit management, dividends, currency movements, insurance and pensions, corporate treasurers put an emphasis on the optimal use of corporate funds. They became increasingly sophisticated users of capital markets and they began *“usurping some of the traditional roles of investment bankers”* (Whitley 1986: 181). Their activities also included lending to short term capital markets. The latter points to another characteristic of market-based capital markets: *“A stock market-centred capital market is said to encourage short-term expectations by investors and responsive short-term strategies by managers”* (Black and Gilson 1998: 244), while bank-based capital markets are supposed to foster patient capital markets and long-term planning. The relative short-termism also includes bond markets. For instance, the average duration of corporate bonds listed at the FINRA/Bloomberg Investment Grade Corporate Bond Index is approximately four and a half years, the one for high yield (below investment grade) corporate bonds is approximately three and a half years.<sup>13</sup> Yet, Pu (2009) as well as Goldstein, Shwalb Hotchkiss et al. (2007) show that bonds are frequently traded in over-the-counter transactions. Asquith, Au et al. (2010: 3) state that between 2004 and 2007 the outstanding value of corporate debt in the world’s corporate bond market averaged slightly over 6 trillion USD with an average

<sup>13</sup> On July 19, 2011 the average adjusted duration was 4.58 and 3.75 years respectively, see <http://www.bloomberg.com/markets/rates-bonds/corporate-bonds/> (accessed July 19, 2011).

trading activity of 17.3 billion USD per day. Analyzing the trading activities of a large U.S. proprietary lending institution in the same period, they find that the median duration of single bond loans held by the institution is eleven calendar days (the mean value is 32 calendar days) with a median amount of 350,000 USD (at par value of 1,000 USD) (Asquith, Au *et al.* 2010: 13-14).

The link between the structure of the financial system and the role of ratings is further developed in Chapter 3. For the time being, the growth of the rating business within the U.S. is simply considered to be primarily driven by the market-based structure of the financial system and the gradual development of more sophisticated financial products. Furthermore, at least in the early stages, ratings have gained considerable appreciation after times of distress and the interconnected diminishing of investors' trust. The development of the rating industry between its inception until the 1970s might have been primarily spontaneous and driven by demand of investors. Nevertheless, ratings also gained importance because of the increasing incorporation of this instrument into regulation. Furthermore, the end of the Bretton Woods System of capital controls and the liberalization of financial regulation in the 1970s and 1980s enhanced international capital flows. Thus a market for lower rated (junk) bonds developed, further raising the demand for credit ratings (Sinclair 2005: 26). Sylla (2002) argues there are two important periods for the expansion of credit ratings. The first started with World War I, when the U.S. replaced England as the world's financial center. Some six decades later, history repeated itself, but "*the whole world was America*" now (Sylla 2002: 34).

**Figure 2.3: Moody's-rated corporate bond issuers, 1920-1997**



Source: Carty (1997: 4)<sup>14</sup>

To illustrate the growth and composition of the major rating agencies' activities, the example of Moody's<sup>15</sup> shall be considered. Before the 1980s, non-U.S. issuers rated by Moody's were predominantly tapping the U.S. bond market. Afterwards, Moody's also rated an increasing number

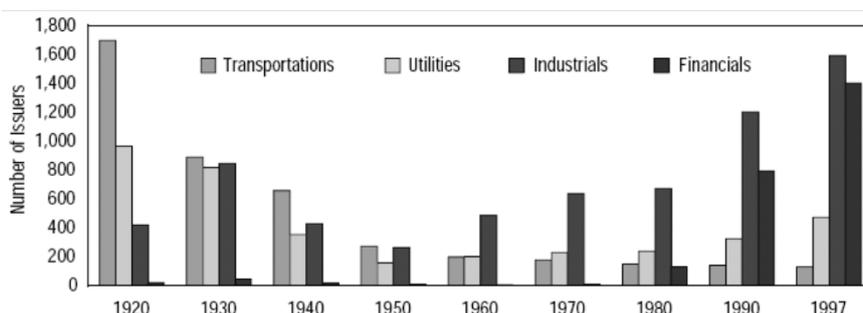
<sup>14</sup> The contraction of the rating activities from the late 1920s to the 1950s is explained by the retrenchment following the Great Depression and World War II.

<sup>15</sup> A description of the market shares of different rating agencies will be provided further below.

of issuers placing debt in non-U.S. markets. Accordingly, not only the absolute number of rated issuers increased but also the share of non-U.S.-domiciled issuers in relation to U.S.-domiciled issuers (Carty 1997: 4), as shown in Figure 2.3.

But not only had the numbers changed. Also the composition of issuers experienced a shift (see Figure 2.4). In 1997, industrials represented 44% of the total number of rated firms in comparison to 14% in 1920 (when transportations constituted the major part). However, the most pronounced expansion can be observed from financial companies which counted for 35% of all rated issuers in 1997 (Carty 1997: 5). The latter can also be explained by expansion of complex financial products developed and held by financial companies.

**Figure 2.4: Moody's industrial composition of issuers, 1920-1997**



Source: Carty (1997: 5)

The growth of the rating agencies' activities is further reflected in the numbers of analysts employed. Partnoy (1999: 649-650) states that in 1980 there were only 30 professionals working at S&P, six years later there were 40. In 1995, S&P already employed 800 analysts and a total staff of 1.200. Moody's employees expanded at similar rates (560 analysts and 1.700 total staff by 1995) as did the number of rated issues.

### 2.1.2 The Internationalization of Credit Ratings

In general, two driving forces need to be distinguished as far as the global expansion of rating activities is concerned. One is the international spread of rating agencies for corporate ratings as well as ratings for financial institutions and their issues (bonds, derivatives etc.). This applies to U.S. based and domestic rating agencies. The other driving force is the increasing activity of U.S. rating agencies from within the U.S., including the introduction of sovereign ratings.

The development of bond markets in Europe, especially with the creation of the Euro zone and the establishment of a single market for sovereign, corporate and municipal debt, shifted the

attention from currency risk to credit risk between European issuers. Thus, the influence of formal credit assessments by independent credit rating agencies grew here, too (Sinclair 2005: 133). Furthermore, the increasing importance of private pension schemes in many European countries as a response to demographic changes (EC Social Protection Committee 2005) and hence the increasing relevance of capital markets also raised the demand for external credit ratings. Finally, the significance of external ratings increased considerably with the establishment of rating-based regulation as proposed by the Basel Committee on Banking and Supervision and its Capital Adequacy Directive.

However, the expansion of external credit ratings – especially those provided by U.S.-dominated rating agencies – did not take place in the same manner in all European countries. Especially in Germany, hostility towards U.S. rating agencies was pronounced (Sinclair 2001b: 490). This was mainly due to the fact that German stakeholders perceived the activities of these agencies as a “colonial attitude”. They criticized that particular characteristics in European accounting, disclosure and management practices were not taken into account, especially with regard to German medium-size enterprises (Deutscher Mittelstand). However, the German initiative to create a pan-European body for credit ratings failed. Around 1999 three local agencies were established and Oliver Everling<sup>16</sup> – called “*Mr. Rating Agency in Germany*” by Sinclair – did not become tired of promoting the development of the German rating business (Sinclair 2005: 133-134). Nevertheless, the local credit rating business did not find its expected market. One of the German rating agencies – the Euroratings AG – had to quit operations only two years after inception in 2002. One of the issues was that the German banks rather relied on internal ratings as they were also contemplated in the Basel rules.<sup>17</sup> Furthermore, the primary market for bonds of medium-sized enterprises did not develop as expected (Werhahn 2002). As far as bigger companies were concerned, the resistance against U.S. rating agencies decreased in the 1990s. This was due to the fact that German corporations were increasingly using U.S. accounting standards seeking a listing on the New York Stock Exchange (e.g. Daimler-Benz) (Sinclair 2001b: 490). But also medium-size enterprises finally could not resist the U.S. standards and the reputation of the leading rating agencies. In 2008, the German rating agency Creditreform Rating AG – proud of being the first German rating agency with a certification of the German bank regulation (Creditreform Rating AG 2009) – signed a cooperation agreement with Standard & Poor’s. The aim was to open the capital markets for German medium-size enterprises and to support the acceptance of these companies’ ratings (Creditreform Rating AG 2008).

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<sup>16</sup> Dr. Oliver Everling is the CEO of Everling Advisory Services, which provides publications and consultancy services on rating related issues since 1998.

<sup>17</sup> However, on a European level it was expected, that at least 30% of European banks would implement the standardized approach to credit risk (38% considering 38 countries worldwide) where the determination of banks’ regulatory capital for credit risk relies on external ratings. This is especially true for small and medium-size financial institutions (Van Roy 2005: 5).

Another country that introduced rating-based regulation relatively early was Japan. Here, in contrast to Europe, that has little substantial competition for Moody's, S&P and Fitch, a couple of local rating agencies developed (Sinclair 2005: 128). The most important is the Japan Credit Rating Agency Ltd (JCR) which was established in 1985 by a group of prominent Japanese investors. The foundation was driven by the desire to have an alternative to the U.S. agencies, an alternative that was better adapted to local conditions (Fight 2001: 84-85). Nowadays, the Japan Credit Rating Agency even enjoys U.S. NRSRO status. Yet, the local rating agencies did not develop as a market response but as a politically encouraged infrastructure to deregulate the Japanese primary financial market (Sinclair 2005: 129-130). Accordingly *"JCR sees its raison d'être not only as providing an information service for investors, but also as an institution which feels obligated to maintain and develop the Japanese pension markets"* (Fight 2001: 84).

The motivation for the development of rating agencies in developing countries was similar to Japan's. Until the 1990s, most developing countries did not have liquid capital markets. However, *"rating agencies are being established in the developing world as disintermediated, market-based capital allocation spreads from the world's economic and financial centers"* (Sinclair 2005: 122). Especially the Asian financial crisis spurred the rating activities in the southern parts of the world because the value of financial transparency was emphasized. Developing countries seek to attract foreign capital and U.S. rating agencies tend to only rate companies that borrow in dollars or in the Euromarkets – since these promise the highest profits. Thus, the establishment of domestic rating agencies is a priority for investment-scarce countries. They received significant support from donor organizations to do so. In 1989 for example, a feasibility study financed by the International Finance Corporation (IFC) and the World Bank led to the rule that debt issuers in Mexico must obtain a credit rating. Major assistance in founding developing countries rating agencies is provided by the IFC. IFC assistance includes ventures throughout Asia and Europe: Pakistan in 1994, the Middle East in 1995, Turkey in 1996, China in 1997, the Czech Republic and Hungary in 1998 and 1999, Sri Lanka in 1999 and the Philippines in 1999 (Sinclair 2005: 124). In Poland, the Central European Rating Agency was established by the Union of Polish Banks and the U.S. Agency for International Development (USAID) in 1996 (Fight 2001: 94). And the Asian Development Bank (ADB) holds stakes at Credit Rating Information Services of India (CRISIL) – the major Indian rating agency (Sinclair 2005: 124).

There are basically two types of rating agencies in many developing countries. The respective market leaders are integrated with the U.S. agencies, either through technical support arrangements or with the latter being shareholders. This is the case with the Mexican Calificadora de Valores (Caval) which was acquired by S&P in 1993. Also CRISIL has large participation by S&P (Sinclair 2005: 123). The second group is not dependent on the major U.S. agencies. Even though there are some similarities between the major agencies and the agencies from developing coun-

tries – especially those with close relationships to Moody's, S&P and Fitch – they considerably differ in terms of origin. Because domestic rating agencies are rather the result of a political agenda Sinclair (2005: 126) calls them *“‘creatures’ of a transition from ‘repressed’ financial systems to market-based systems.[...] But in most developing countries, disintermediation has not progressed enough to make thorough financial examination by the major agencies a serious constraint. Secrecy is the norm, and comparisons are thought unseemly. Hence, these local rating agencies remain primordial.”*

Apart from the evolution of domestic agencies and the expansion of U.S. based agencies throughout the world, the introduction of sovereign ratings further triggered the weight of the major agencies – especially for developing countries seeking foreign capital. Although Moody's started rating bonds issued by foreign governments as early as 1919 (in 1929 fifty central governments were already rated), the Great Depression and the World War II brought the international bond markets to a standstill. And even though these markets revived in the 1970s, the demand for sovereign ratings did not materialize until the late 1980s and 1990s. Partnoy reports that as of 1981, S&P rated only thirteen countries (all AAA). By 1993, 43 countries were rated, including many emerging countries which received low ratings. By 1995, half of the 52 countries rated by S&P and Moody's were in the emerging country category.

The final take-off was largely due to weaker issuers – including those of developing countries – eager to place their debt in the U.S. capital market. Consequently, the growing demand for rating services coincided with a trend towards lower sovereign credit ratings. Before 1985, most initial ratings were graded AAA. In the 1990s, the median rating grade was BBB- (the lowest possible investment grade) (Cantor and Packer 1995b: 1).

Since then, the U.S. government has also promoted sovereign ratings for emerging and developing countries as an initial move towards the integration of these countries into capital markets and away from donor dependency. In April 2002 for example, the U.S. Secretary of State Colin Powell and the Treasury Secretary Paul O'Neill hosted a meeting in Washington with African finance ministers and central bankers. It was agreed that the U.S. administration would finance new ratings of the participating countries which were to be realized by Fitch ratings. At that point only four out of forty-eight sub-Saharan African states had sovereign ratings. Later, O'Neill stated he believed that all nations needed to move in a direction where they had “investment grade” debt (Sinclair 2005: 126).

Issuing sovereign ratings is a privilege primarily reserved to “the big three”.<sup>18</sup> And also when it comes to the rating activities in general, Moody’s, S&P and – even though to a lesser extent – Fitch clearly dominate the global rating market. In 2000, there were an estimated number of 130 rating agencies worldwide (Basel Committee on Banking Supervision (BIS) 2000: 12). However, regarding the market shares, the role of agencies other than Moody’s, S&P and Fitch on a global scale is limited. In 2004, the combined global market share of Moody’s and S&P was estimated over 80% and Fitch’s share was approximately 14% (e.g. Hill 2004: 60). However, these numbers even understate the position of S&P and Moody’s. Issuers typically attempt to obtain both Moody’s and S&P ratings and only occasionally use Fitch as a third rating (for example when Moody’s and S&P disagree) – a phenomenon often labeled the two-rating norm (Hill 2004: 61). The fact that Fitch could gain some market share from the “U.S. duopoly” (Fight 2001: 45) is thanks to further consolidation in the industry. The French-British International Bank Credit Analysis (IBCA), unable to obtain U.S. NRSRO status, acquired Fitch rating agency in 1997, Duff & Phelps in early 2000 and as well as Thomson Bank Watch in late 2000.

Regarding the practice of assignment of NRSRO status, some changes can be observed in recent times. Until 2003, the only recognized NRSROs were “the big three”. In 2007 and 2008, a couple of smaller rating agencies also reached recognition. This happened majorly due to an updated regulation according to the “Credit Rating Agency Reform Act of 2006”. This act stated that: *“the two largest credit rating agencies serve the vast majority of the market, and additional competition is in the public interest”* (US Congress 2006). Currently there are ten rating agencies holding a NRSRO status (SEC 2010). Until now, this did not seem to have a significant impact on competition among rating agencies. In the meantime, the big rating agencies continue to expand into new markets and sectors. In 1999 for example, Partnoy reported that Moody’s rated 20.000 public and private issuers in the U.S. and about 1.200 non-U.S. issuers (both corporations and sovereign states). By the end of 2009, Moody’s had rating relationships with approximately 12.000 corporate issuers and further 25.000 public finance issuers. Additionally, the company had rated and monitored approximately 106.000 structured finance obligations at that point (Moody’s 2010: 8).

## **2.2 The Appearance of Ratings in Microfinance – Expression of a Maturing Sector?**

In the last three decades, microfinance – the provision of small-scale financial services to low income populations excluded from the traditional banking sector – has received increasing atten-

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<sup>18</sup> An example for another company issuing something similar to sovereign ratings is the Paris-based export credit insurance company Coface which started to assign country risk ratings in 2008 (Coface 2010).

tion as a promising tool for poverty alleviation. In 2005, the United Nations declared the International Year of Microcredit. In 2006, one of the pioneering microfinance institutions, the Grameen Bank in Bangladesh, together with its founder Muhammad Yunus, received the Nobel Peace Prize in recognition of “*their efforts to create economic and social development from below*” (Nobel Foundation 2011). And in 2010, the leaders of the G20 officially launched the Global Partnership for Financial Inclusion to set in practice its Financial Inclusion Action Plan signed during the summit in South Korea (Global Partnership for Financial Inclusion 2011). Therewith, microfinance as an integral part of the financial sector received further recognition.

In its early years, microfinance institutions (mostly run or financed by state-run development banks) heavily relied on subsidies while primarily financing agricultural activities through “cheap loans”. However, these initiatives largely failed to reach the poor and induce development (e.g. Von Pischke 1991). Accordingly, in the 1980s and 1990s, policymakers, practitioners and also academics took a big step stating that microfinance institutions should from thereon be financially sustainable in order to increase access to finance to a larger part of the population (Vogel and Adams 1997). Following the commercial approach (Nitsch 2000) enthusiasm among donors and microfinance practitioners grew. It was stated that through this “*microfinance revolution*” (Robinson 2001) “*profit-making poverty reduction*” (Cull, Demirgüç-Kunt *et al.* 2009: 170) was possible. Yet, not all microfinance actors were convinced of this “win-win proposition” (Morduch 2000), particularly when the hardly discernible threshold from profit generation (for securing financial sustainability) to profit maximization is passed. Besides, the sector keeps struggling with a lack of evidence for the positive impact of microfinance on the poor’s well-being and empowerment (Armendáriz de Aghion and Morduch 2005; Duvendack, Palmer-Jones *et al.* 2011).

In order to contextualize the appearance of ratings in microfinance, the next section provides an overview of the current state of the microfinance industry while focusing on a) the distribution and characteristics of microfinance institutions (MFIs) and b) the international microfinance investment market. Critical issues are also raised, particularly in the context of its ongoing trend of commercialization. The presentation of the microfinance (investment) landscape is important because rating agencies are assumed to be an important interface between MFIs and their potential investors. The discussion of their relevance as well as in how far different rating agencies respond to the specific concerns of microfinance investors (and other stakeholders) in Chapter 7 also builds on the specific microfinance context outlined here.

In Chapter 2.2.2 the phenomenon of ratings in microfinance is introduced since it is the core subject of the present research. The focus here lies on providing an overview of the origins and evolution of the microfinance rating industry since its inception in the late 1990s.

The sub-chapter shows that the microfinance institutional landscape is fragmented with a few large and highly profitable organizations and many, rather small non-profit non-governmental organizations (NGOs) operating. Most microfinance investments are channeled through specialized intermediaries while in recent years commercially-oriented investments grew more than purely socially motivated investments. Yet, critical developments in the context of ongoing commercialization potentially endangered the reputation of microfinance as a social asset class.

In the beginning, microfinance ratings were primarily a donor-driven phenomenon. The diffusion of ratings in microfinance increased considerably between 1997 and 2007, depending less and less on external financial support. Yet, between 2008 and 2009 the growth rate of ratings showed a negative trend and the dependence on subsidies increased again, especially when regarding ratings provided by specialized microfinance rating agencies. This is also true for social ratings, even though their overall diffusion is still increasing, particularly in single world regions. Still, their supporters believe in the potential of a self-sustainable rating industry.

### **2.2.1 The Microfinance (Investment) Market – An Overview**

A few, highly profitable MFIs are very well known. In April 2007, the Mexican Banco Compartamos was the first microfinance institution to launch an international initial public offering (IPO) of its stocks which was oversubscribed by 13 times (ACCION 2007). Existing investors received about 450 million USD for 30% of their shares while most of it went to institutions serving the public good such as the IFC, ACCION and Compartamos, a non-profit non-governmental institution (NGOs) (Rosenberg 2007: 3). What appeared to be a signal that microfinance had finally reached the global capital markets was celebrated by some and fiercely criticized by others.

Those who supported Compartamos' IPO did so hoping that microfinance would further on attract more and more private investments which would help to reach ever more of the 80% of the population still lacking access to formal financial services in most developing countries (e.g. Demirgüç-Kunt, Beck *et al.* 2008: 35). They claimed that the high profitability allowed Compartamos to reach thousands of clients who otherwise remained excluded from financial services. Indeed, between 2007 and 2009, the numbers of borrowers reached by the bank grew by almost 80% summing up to 1.5 million clients. This was achieved by charging an annual interest rate of about 100%, while in 2005 almost one quarter of Compartamos' interest revenue counted as profits to be transferred to its shareholders (Rosenberg 2007: 7). The most prominent among the critics was the "father of microfinance" himself, Muhammad Yunus, who testified: "*We created microcredit to fight the loan sharks; we didn't create microcredit to encourage new loan sharks*" (cited in MacFarquhar 2010). Also those who are generally in favor of the commer-

cial approach find that charging such high interest rates would constitute a political and ethical problem for any financial institution (e.g. Schmidt 2008: 25).

The “*battle for the soul of microfinance*” (Harford 2008) has started. However, advocates of the commercial approach – among them leading economists of The World Bank – claim that “*the clash between the profit-driven Compartamos and the 'social business' model of Grameen Bank offers a false choice*” (e.g. Cull, Demirgüç-Kunt *et al.* 2009: 169) and that the wide-spread “moralistic” criticism of the commercial approach followed by ProCredit and ACCION/IFC is ill-placed, not only from an economic but also from an ethical perspective. The radical form of criticism condemns profit generation through development aid *à priori* and departs from the “ethics of conviction” as followed by Yunus. The supporters of the commercial approach rather build on the “ethics of responsibility”, as highlighted by Schmidt (2008: 21).

They state that commercial investment is necessary to fund the expansion of microfinance. Accordingly, microfinance investments have been heavily promoted by donor organizations and development banks. In 2006 for example, the German development bank KfW launched its first dedicated publication with the promising title “Microfinance Investment Funds: Leveraging Private Capital for Economic Growth and Poverty Reduction” (Matthäus-Maier and v. Pischke 2006).

In order to understand the relevance of access to refinancing, it is important to mention that microcredit is still the dominating product within the microfinance sector, despite the fact that savings mobilization has been emphasized since the 1980s as the “*forgotten half*” of finance for the poor (Vogel 1984). Many MFIs are either not allowed to capture deposits or they balk at the related costs (e.g. Fiebing, Hanning *et al.* 1999) and it remains unclear if the provision of small-scale savings can be considered a “business case” (e.g. Westley and Martin Palomas 2010). Accordingly, many MFIs depend on external funds to refinance their lending activities. For instance, by the end of 2008, out of 1.257 MFIs listed at the MIX Market, 40% were credit-only institutions (including Compartamos). And the deposit-to-loan ratio of those MFIs capturing deposits was 54% (median value) which indicates that even these MFIs still depend to a considerable part on external funding.

Yet, even though commercialization is proceeding, the vast majority of microfinance institutions is far from being as profitable (and as exploitative) as Compartamos. The MFI landscape is very fragmented. The total number of microfinance institutions existing worldwide is unknown; an estimated number of 10.000 institutions is often mentioned while only a minor part is estimated to have achieved full financial self-sustainability (Allen 2008)<sup>19</sup>. During the Microcredit Summit

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<sup>19</sup> The example of the Philippines illustrates how little reliable global figures on the number of MFIs are. For instance, in 2008, 65 Philippine MFIs were listed in the MIX Market database. Llanto, Geron *et al.* (2009: 7), however, count 1.400 MFIs in this country alone. It can be assumed, that especially smaller non-formal

Campaign in 2007, 3.316 internationally visible microfinance institutions were reported world-wide (Daley-Harris 2007). And Gonzalez and Rosenberg (2006) drove their results about “The State of Microfinance – Outreach, Profitability, and Poverty” on a dataset which was consolidated out of three different sources and encompass 2.600 MFIs. Cull, Demirgüç-Kunt et al. (2009) provided their “portrait of the microfinance industry” based on the data of 346 MFIs while cross-checking with the results of Gonzalez and Rosenberg.<sup>20</sup>

**Table 2.1: Distribution of microfinance institutions, assets and borrowers by institutional type by 2004**

	% of institutions	% of assets	% of borrowers
Banks	10	55	25
NGOs	45	21	51
Non-bank financial institutions (NBFIs)	30	19	17
Credit unions	10	4	6
Rural banks	6	1	1
Total	100 345 institutions	100 25.3 billion USD	100 18 million

Source: Cull, Demirgüç-Kunt et al. (2009: 174); based on the MicroBanking Bulletin sample, 2002-2004. The sample included 346 institutions. Data on assets were available for 276 institutions.

Considering the total number of borrowers served, Asia dominated the microfinance market. Measured on a per capita basis, South Asia provided twice as many microcredits as any other region (Gonzalez and Rosenberg 2006). Besides, on a world-wide scale, this outreach indicator varied considerable along the institutional type. As shown in Table 2.1, 25% of all borrowers were served by banks while the vast majority (51%) was (still) served by NGOs. This is a sharp contrast to the distribution by institutional types since only 10% of MFIs were listed as banks, whereas 45% were NGOs. It highlights the relative importance of (rather small) NGOs for the provision of microfinance services world-wide in comparison to such big players as Compartamos.

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MFIs and savings and credit cooperatives are underrepresented. In Peru for, example, only ten out of an estimated number of 160 cooperatives (see Chapter 5.1) were listed in MIX Market.

<sup>20</sup> Considering the rapid development of the microfinance industry in the last years, the data presented in their study seems to be a little outdated. They rely on the MicroBanking Bulletin (MBB) which is available already for up to 2008 and covers 1.084 MFIs (instead of 346). The MBB is considered the database with the best information quality, as it does not only rely on self-reported data like the MIX Market database but adjusts this data with financial statements’ information. However, the MBB data which is publicly available does not allow for an in-depth analysis as Cull et al. realized. The authors had access to a more detailed version of the data through a special research agreement. To assure consistency, the author of the present study will rather rely on the analysis provided by Cull et al. and, to a lesser degree, by Gonzalez and Rosenberg and provide updated data on single indicators if possible and deemed necessary.

For small MFIs to reach scale, “upgrading” – as one possible strategy to build professional and financially sustainable MFIs (Krahn and Schmidt 1984) – has increasingly been emphasized by donors and technical assistance providers. Until the end of 2007, since the first transformation of an MFI in 1992 – PRODEM in Bolivia became BancoSol – there have been in total 88 MFI transformations into formal financial institutions in 35 countries worldwide (Lauer 2008) – with increasing tendency. The transformation process of MFIs into regulated financial institutions is likely to continue in the future as well as the formation of new regulated MFIs, which will decrease the relative importance of NGOs. Until 2008, however, the institutional distribution differed only slightly compared to the figures of 2002-2004, with 36% of MFIs still listed as NGOs (out of 1.084 MFIs). Furthermore, most MFIs (52%) are rather small with total assets of 2.2 million USD (median values). 22.5% are medium-size MFIs with assets of 9.5 million USD and only 25.5% are considered large MFIs with assets of 47.4 million USD (MIX 2009).<sup>21</sup>

Concentration remains pronounced when decoupling outreach from institutional type. For instance, Gonzalez and Rosenberg (2006) find that 9% of MFIs account for 75% of borrowers reached. And within single countries, one third of the entire market – considering the median market share – is served by the largest MFI respectively. This increases to a median market share of 81%, considering the five largest MFIs, and 95% when the ten largest MFIs are included. Gonzalez and Rosenberg therefore conclude that donors (with a financial inclusion agenda) should support only those few, small MFIs whose managers show the potential to produce massive growth.

The latter statement is also linked to another issue of major concern within the microfinance industry, namely financial sustainability. Outstanding success stories of a few highly profitable MFIs might suggest that microfinance is a profitable business in general – and as such interesting for commercial investors. According to Cull, Demirgüç-Kunt et al. (2009: 177-178) 57% of the 315 MFIs in their dataset were profitable in general. Profitability, however, does not necessarily mean that MFIs have a for-profit status, meaning that they distribute their profits among their shareholders.<sup>22</sup> Hence, an NGO having a non-profit status can still be profitable or, more precisely, financially self-sufficient.<sup>23</sup> Considering the number of borrowers reached, Cull, Demirgüç-Kunt et

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<sup>21</sup> The MIX MicroBanking Bulletin classification of MFIs is: Small: Gross Loan Portfolio (GLP) in USD < 4,000,000 in LAC; < 2,000,000 in other regions; Medium: GLP in USD ≥ 4,000,000 and ≤ 15,000,000 in LAC, ≥ 2,000,000 and ≤ 8,000,000 in other regions; Large: GLP in USD > 15,000,000 in LAC, >8,000,000 in other regions. Particularly the share of small MFIs is likely to increase considerably when MFIs not reporting to MIX Market are included.

<sup>22</sup> Some profitable MFIs prefer to preserve their non-profit status since this often lowers the weight of regulation and taxes.

<sup>23</sup> Cull et al. follow the definition of financial self-sufficiency as provided by the MBB which is calculated as follows: adjusted financial revenue divided by the sum of adjusted financial expenses, adjusted net loan loss provision expenses, and adjusted operating expenses.

al. further specify that 87% of all borrowers are served by profitable MFIs. Considering NGO microcredits Gonzalez and Rosenberg (2006) find that 64% of borrowers reached by profitable institutions. The total share of profitable NGOs (in numbers) according to Cull, Demirgüç-Kunt et al. is 54% while 76% of banks are considered profitable.

Yet, being profitable does not necessarily mean to be financially self-sufficient. Financial self-sufficiency measures in how far MFIs do not depend on subsidies, including soft loans and grants. Considering the importance of subsidies, the differences between NGOs and banks is more pronounced. Cull, Demirgüç-Kunt et al. (2009: 186) find that for 134 NGOs, 39% of the funding came from donations while another 16% were provided as noncommercial (soft) loans. For the 24 banks in the sample, the two categories contributed only 3% of total funding while commercial borrowing and deposits combined summed up to 84%.<sup>24</sup> However, they also indicate – based on the hope of believers in the commercial approach – that NGOs might, in reality, depend much less on subsidies. They assume that, if pushed, they would become more efficient and capable to attract commercial funding (probably at the expense of donations though).

From an investor's perspective, Meehan (2004: 7) distinguishes between four different tiers of MFIs.<sup>25</sup> Only 2% - at most – could be considered tier I MFIs with strong financial and operational track records ("Top 50 or 100"<sup>26</sup>). 8% of all MFIs are considered tier II compounded mostly by successful NGOs (nearly) reaching profitability. Meehan attests most of these MFIs good chances to grow. 20% of MFIs (tier III) are approaching profitability according to Meehan while 70% of all MFIs are unprofitable, with only some of them having a chance to rise. Hence, Meehan's estimates about investable MFIs appear to be slightly more pessimistic than the analyses of Cull, Demirgüç-Kunt et al. and Gonzalez and Rosenberg about profitable MFIs suggest, probably also because of the size of MFIs which defines their absorption capacity of commercial investments. However, Cull, Demirgüç-Kunt et al. (2009: 184-186) also count for the degree of profitability possibly interesting for commercial investors. They state that Compartamos' level of return on equity (ROE) of above 50% in 2004 is exceptional, even compared to a ROE of 16% of the Citigroup for example. Yet, the median ROE for microfinance banks in their sample is 10%, for NGOs it is only 3%. Conditioned on profitability, the ROE rises to 11.4% and 15.1% respectively, which they consider "impressive" but well below those levels reached by Compartamos. They conclude that the top end of microfinance institutions might be even interesting for profit-

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<sup>24</sup> To calculate the implicit subsidies when soft loans are considered is not an easy task. For a more detailed descriptions how these adjustments are done with the MBB database see Cull et al. (2009: 186-187). The MBB calculations appear to be rather lax. When stricter criteria are applied, more than 50% of NGOs appear to be non-profitable even though they still do not seem to lean too heavily on subsidies.

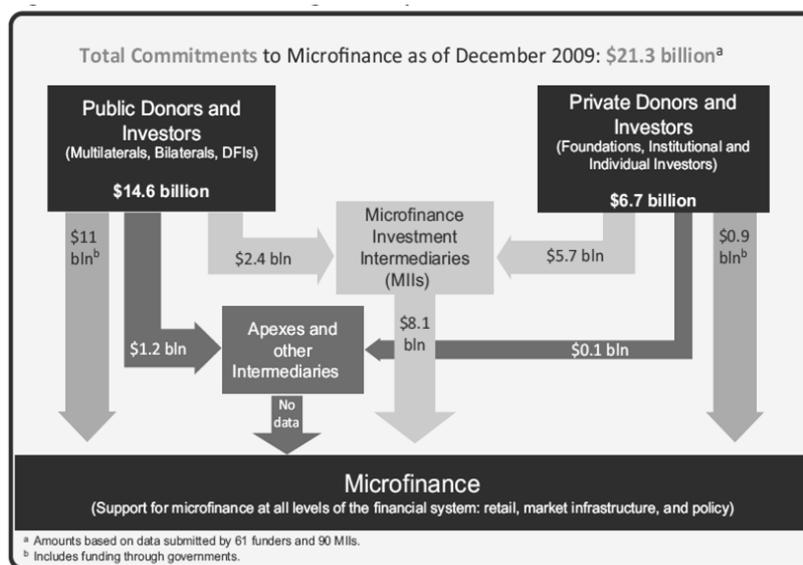
<sup>25</sup> The term "tier" refers to a classification according to the portfolio size and profitability of an MFI. However, the term is far from being standardized and has, thus, to be interpreted with caution.

<sup>26</sup> Note that, unless Meehan does not clearly disclose her data sources she refers to 100 MFIs max. as 2%, thus counting a total of 2,000 existing MFIs.

maximizing investors, while most MFIs will, if anything, have to rely on social investors. Still, in 2008, Dieckman (2008: 1) from Deutsche Bank Research was confident that MFIs will benefit from increasing funding from international private and institutional investor since the importance of Socially Responsible Investments (SRI) in general is increasing. He estimates that funds provided by this investor group will have risen from 2 billion USD in 2006 to 20 billion USD in 2015.

Indeed, size and composition of international microfinance investments have changed considerably since 2004. Primary investors are public multilateral and bilateral Development Finance Institutions (DFIs) such as KfW, the European Bank for Reconstruction and Development (EBRD) and the IFC, private retail investors, high net worth individuals (HNWIs)<sup>27</sup> as well as institutional investors like pension funds. Half of the foreign investments in microfinance are estimated to be provided by DFIs which have increased their outstanding investment in microfinance by 350% between 2006 and 2010 to reach 7.5 million USD. The bulk of the DFI funding (71%) was done by only five DFIs (AECID, EBRD, IFC, KfW and OPIC) (Reille, Forster *et al.* 2011: 2). If bilateral and multilateral government funding is included, El-Zoghbi, Gähweiler *et al.* (2011) estimate that public funding reached 14.6 billion USD by the end of 2009. Figure 2.5 provides an overview of the cross-border microfinance funding landscape.

**Figure 2.5: Cross-border funding landscape for microfinance by 2009**



Source: El-Zoghbi, Gähwiler *et al.* (2011: 2)

<sup>27</sup> According to Eurosif (2008) HNWIs are individuals with more than 1 million USD in financial assets.

Furthermore, it is public donors and investors who provide the largest part of direct financing to the microfinance sector. Private donors and investors largely go through Microfinance Investment Intermediaries (MIIs) instead. Reille, Forster et al. (2011: 2) estimate that half of foreign investment, including a minor part of DFI funding, is channeled through intermediaries and a survey conducted by the Worldbank consortium Consulative Group to Assist the Poor (CGAP 2010a: 9) revealed that the major part (76%) is managed by so-called Microfinance Investment Vehicles (MIVs).<sup>28</sup>

**Figure 2.6: Classification of investors and investment intermediaries for international microfinance investments**

Primary Investors	Microfinance Investment Intermediaries (MIIs)		
	Category	Type	Examples
DFIs (public)  Retail Investors (private)  HNWI (private)  Institutional Investors (private)	Microfinance Investment Vehicles (MIVs)	Socially Focused Funds	Oikocredit, Incofin, Alterfin
		Public Placement Funds	responsAbility Global Microfinance Fund, Dexia Microcredit Fund
		Private Placement Funds	BBVA Codespa Microfinanzas FII
		Structured Finance Vehicles (CDOs)	BlueOrchard Microfinane Securities-1, European Fund for South East Europe
	Holding Companies		ProCredit Holding AG, MicroCred
	Other	Closed Microfinance Investment Funds	ACCION Gateway Fund LLC, Omydiar-Tufts Microfinance Fund
		Non-specialized MIIs	DID Partnership Fund, Triodos-DOEN Foundation, Worldvision
		Peer-to-peer Microlenders	Kiva, MYC4

Source: Own elaboration based on CGAP (2009b), CGAP (2010a) and Kirchstein and Welvers (2010: 5)

Note: This figure only presents possible investment channels in general terms. This does not mean that all MIIs are open to all kinds of primary investors.

<sup>28</sup> The definition of MIV followed here is the one provided by CGAP (2007: 6): “An MIV is an investment entity that has microfinance as a core investment objective and mandate. It is either self-managed or managed by an investment management firm or trustees. It receives money from investors through the issuance of shares, bonds, or other financial instruments. It provides debt, equity or guarantees to MFIs and non-specialized financial intermediaries.”

The CGAP (2010a) together with Symbiotics<sup>29</sup> identify four MIV peer groups. Figure 2.6 gives an overview of primary investors, possible investment channels and MIV peer groups. Among the MIVs, socially focused funds provide debt and equity financing as well as guarantees while generally investing in smaller MFIs. They are often managed by non-for-profit organizations and cooperatives and tend to offer below market returns. Public placement funds are registered mutual funds. They are supervised by their local financial authority and open to retail investors for amounts below 20.000 EUR. Private placement funds raise money from qualified investors through private placements with or without financial authority supervision. Structured finance vehicles offer a range of asset-backed securities with different risk/return profiles and are generally classified as collateralized debt obligations (CDOs) with a static pool of fixed income investments (pool of loans to MFIs). Particularly microfinance CDOs are supposed to meet the expectations of commercial, institutional investors in terms of risk/return and investment size while including a larger number of possibly also smaller MFIs (e.g. Byström 2008; Hüttenrauch and Schneider 2008).

Besides MIVs, other MIIs are microfinance holding companies, closed microfinance funds, non specialized MIIS and peer-to-peer lenders. Microfinance holdings provide (majorly) equity finance to MFIs primarily financing greenfield MFIs, holding a majority stake in their investees. Holding companies are generally accessible by private invitation only (CGAP 2009b: 17, 2010a: 6). The most prominent example is ProCredit. In 2009, ProCredit has had 22 microfinance banks worldwide with total assets of nearly 500 million USD (ProCredit Holding AG 2009).<sup>30</sup> The best known peer-to-peer lending platform is Kiva (founded in 2005).<sup>31</sup> Between 2007 and 2009, the cumulative volume of loans made through Kiva grew from 6 million USD to 60 million USD (Flannery 2009: 30). Another two years later (in March 2011), the cumulative volume was stated to be over 200 million USD (Kiva 2011a). Yet, Reille, Forster et al. (2011: 4) estimate that the share of peer-to-peer lenders represents less the 0.5%. Consolidated aggregated data for peer-to-peer lenders as well as the non-specialized MIIS (providing loans to MFIs as one out of many other activities) is not available.

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<sup>29</sup> Symbiotics is a private company based in Geneva. It offers research and advisory services, brokerage and structuring services, and asset management services for microfinance investors.

<sup>30</sup> The average asset size of six other holding companies (Advans, Access Holding, Global Microfinance Group SA, MicroCred, OXUS Holding, Opportunity Transformation Investments Inc.) which participated at the CGAP MIV Survey 2009 was 2 million USD (CGAP 2009: 18).

<sup>31</sup> The basic mechanism of peer-to-peer lending platforms is: The peer-to-peer platform partners with MFIs which upload profiles of micro-entrepreneurs with financing needs. Individuals from developed countries then choose a project to be financed and lend the money to the respective MFI. The money then goes into an MFI's portfolio for on-lending, even though not necessarily to the client referred to at the peer-to-peer platform (e.g. Kiva 2011).

The estimated number of MIFs in general increased considerably from 24 in 2000 to over 100 in 2009. Since MIVs are an important channel for accessing private (international) capital, it is worthwhile to take a closer look at the MIV landscape and its recent development. In 2011, Symbiotics (2011b) identified 102 MIVs with an estimated asset under management (AUM) of 6.8 billion USD, with debt funding accounting for 82% of AUM. Particularly in 2006 and 2007 the growth rates of MIV assets were impressive with 68% and 86% respectively (CGAP 2009a; Symbiotics 2011b)<sup>32</sup>. Yet, the growth rates slowed down in the following years, reaching only 10% in 2010.<sup>33</sup> It is expected, nevertheless, that growth rates will increase again from 2011 onwards, even though at lower rates than the annualized growth rates of about 50% between 2007 and 2009. MicroRate (2011i)<sup>34</sup> identifies three reasons for this development. Firstly, the microfinance sector was hit by the global financial crisis of 2008 with a one-year lag and either decreased the demand of MFIs for external funding or restricted their access to it because performance indicators worsened. Secondly, and partly in response to this, MIVs started setting stricter standards when extending funding. Thirdly, in several major target countries for MIV investments, local sources of funding which offer very competitive local currency rates have increased (particularly in Colombia, Peru and Bolivia), hence, displacing foreign lenders. Furthermore, the concentration of MIV assets within regions and even within single MFIs is pronounced, which also led to a competition among MIVs. For instance, by the end of 2010 most of the MIV funding went to Eastern Europe and Central Asia (40%), followed by Latin America with 35%. And single MIVs tend to concentrate their lending activities within single regions, countries and even MFIs. The top five country exposure (as % of total microfinance portfolio) was 61% and the top five investment exposure into single MFIs was 36%. Regarding the concentration into few, high performing MFIs, MicroRate (2011i: 6-7) expects this trend to continue in the future. At least between 2009 and 2010, the total assets of MIVs increased, but the number of individual investments decreased.

The concentration of AUM among MIVs is also high. The top five MIVs account for 51% of total assets, the top twenty for 81%. Furthermore, several important and fast growing MIVs are managed by the same asset management firms. Reille, Forster et al. (2011: 5-6) state that almost half of MIV assets are managed by the top five asset managers. They identified 20 asset management firms. Yet, they assume that the number of investment managers will decrease in the future since the development of parallel international networks in order to source and monitor investments is expensive and inefficient for both investors and MFIs. A first indication for the consolidation of

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<sup>32</sup> These numbers are based on responses from 80 MIVs in the case of the CGAP survey and 70 MIVs in the case of the Symbiotics survey. It is estimated that the participating MIVs represent around 90% of the MIV market in both cases.

<sup>33</sup> If not indicated otherwise the following information on the MIV investment landscape are based on the survey conducted by Symbiotics (2011b).

<sup>34</sup> The MicroRate survey is based on 80 MIV responses including some qualitative interviews.

asset management firms is the acquisition of PlaNIS – the asset management arm of PlaNet Finance – by responsAbility in January 2011.

As far as primary investors are concerned, the largest share of MIV assets comes from private institutional investors (45%), followed by retail investors and high net-worth individuals (35%). Especially institutional investors had increased their share from 2005 onwards attracted by risk-adjusted returns, the social value and a perceived low correlation with other asset classes (e.g. Reille, Forster *et al.* 2011: 3). The argument that “commercial investors’ financial returns cannot be sacrificed for social returns” (Meehan 2004: 17) leads the list of ten reasons why commercial investors first hesitated to invest in microfinance. Since annual returns decreased from 6.3% in 2007 to 2.4% in 2010, it still has to be shown whether the interest of institutional investors will remain the same in the years to come. Some MIVs already mentioned that particularly institutional investors are becoming more conservative (MicroRate 2011i: 11).

The skepticisms is also fuelled by the negative press, microfinance has received lately (MicroRate 2011i: 11). Microfinance is considered to be an investment with a double-bottom-line, expected to generate social returns, as well. The expectation also includes large, institutional investors such as European pension funds (World Microfinance Forum Geneva 2009: 6). Out of the 23 MIVs surveyed during the research for the present study only two stated that the social impact of MFIs was of little importance for institutional investors, and one MIV assumes the same for high net worth individuals (HNWIs). As shown in Figure 2.7, all other MIVs state that the social impact is important for institutional investors, high net worth individuals and retail investors.

**Figure 2.7: Importance of social impact for different investor types**



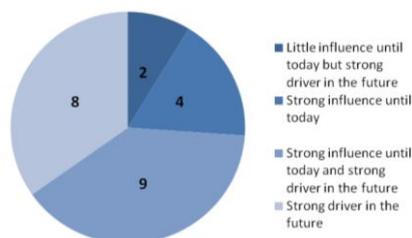
Source: Own elaboration

Furthermore, especially commercial and commercially-oriented investors believe that the general rise of SRIs will be a strong driver in the future, while the non-commercial MIVs share at least the opinion that it has had a strong influence until today (see Figure 2.8).<sup>35</sup> In contrast, the generally good publicity (for example due to the Nobel Peace Prize granted to Muhammad Yunus) is con-

<sup>35</sup> All eight respondents who stated that the rise of SRI would be a strong driver in the future were commercial or commercially-oriented MIVs.

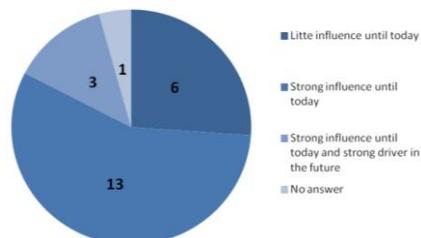
sidered to have had a strong influence until today but will be of less importance in the future (see Figure 2.9).

**Figure 2.8: Influence of SRI rise on micro-finance investments**



Source: Own elaboration

**Figure 2.9: Influence of good publicity on micro-finance investments**



Source: Own elaboration

Yet, the good reputation of microfinance is in danger, especially since the media pays more attention on critical developments related with its ongoing commercialization and related high leveraged growth (e.g. Buse 2008; Malkin 2008; The Economist 2006; The New York Times 2010). In Morocco, Bosnia and Herzegovina, Pakistan and Nicaragua, rapid expansion led to a deterioration of credit standards and, in consequence, massive loan defaults (Chen, Rasmusen *et al.* 2010). Many MFIs concentrated in the same regions competed for the same clients while many of the clients took loans from several MFIs, thus reaching levels going beyond their repayment capacity. In India, around the second (over-)hyped IPO in the world-wide microfinance sector – the leading MFI SKS went public in mid-2010, reaching even higher valuations than Compartamos in 2007 (Reille 2010) – the microfinance euphoria was interrupted by a series of suicides in Andhra Pradesh. These were linked to irresponsibly harsh collection practices of over-indebted clients (e.g. Srivastava, Bharadwaj-Chand *et al.* 2010; The Times of India 2010a, 2010b, 2010c). As if that were not enough, the incidence in India motivated Bangladesh’ Prime Minister Sheikh Hasina to accuse “the father of microfinance” Muhammad Yunus of “*sucking blood from the poor*” (cited in BBC News 2011). Shortly after, she initiated a political campaign to remove Yunus from the chair of the Grameen Bank while further discrediting the concept of microfinance – at least in public opinion. This problem is also reflected in an ongoing discussion (especially in recent times) about a “mission drift” in microfinance, resulting in a possible trade-off between social and financial returns (e.g. Armendáriz de Aghion and Szafarz 2009; Copestake 2007; Cull, Demirguc-Kunt *et al.* 2009; Mersland and Strøm 2010). These developments even lifted reputation risk to position two (right after credit risk) within the 2011 version of the “Microfinance Banana Skins” survey (CSFI 2011).<sup>36</sup>

<sup>36</sup> Since 2008, every year the Microfinance Banana Skins survey, commissioned by CGAP, gathers a large number of microfinance stakeholders in order to identify key risks in the industry. In its first issue, 305 participants from 74 countries answered to the survey. In 2009, 405 participants from 82 countries were

Moreover, the general impact of microfinance on poverty alleviation has been questioned. As more sophisticated methodologies (such as randomized control trials) are applied, recognized researchers' interest in the subject increases (the Financial Access Initiative of NYU, Harvard and Yale illustrates this; see also Bauchet and Dalal (2009) and Rodrik (2008)). In addition (or partly because of this), the assessment of the impact of microfinance and its heterogeneous results increasingly catches the media's attention. Recent studies question specific assumptions of causal impact chains such as the increase in income for female microfinance clients and their progress in decision making as a precondition for their economic, social and political empowerment (e.g. Banarjee, Duflo *et al.* 2009; Karlan and Zinman 2009). The media attention on the reported lack of positive, or even negative social impacts has even motivated some of the most important networks for microfinance (ACCION, FINCA, Grameen Foundation, Opportunity International, Unitus and Women's World Banking) to heavily protest against these studies (ACCION *et al.* 2010):

*"As microfinance practitioners, we have witnessed the positive impact of microfinance first-hand [...] The media's interpretations of several recent studies on the impact of microfinance, however, have questioned whether microfinance has made a quantitative improvement in the lives of the borrowers, or has had any effect on poverty alleviation on a systemic basis [...] Such studies face two fundamental challenges: their ability to capture and analyze all the benefits of microfinance, and the duration of the study itself."*

This debate will probably continue to be fierce, especially since consent on how to adequately measure impact has still to be found. Furthermore, for many MFIs conducting such studies is simply not feasible because they *"cost the earth"* (Hulme 2000: 89)<sup>37</sup> and its time-scales are so long that they are of little operational relevance. Therefore, microfinance practitioners rather focus on finding more practical social performance metrics. There are various social performance initiatives that bring together practitioners, donors, investors (multilateral, bilateral and private), national and regional networks, technical assistance providers, rating agencies, academics and researchers. The most prominent example is the Social Performance Task Force, an open network with more than 850 members with the objective of enhancing knowledge exchange and creating a common social performance framework (Social Performance Task Force n.d.-c). The focus in the work of these initiatives is on addressing the process of how a positive impact is more likely to be created. They focus on the operations of an MFI and the systems implied to track and manage its social performance as *"microfinance works best when it measures – and discloses – its perfor-*

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covered. In 2011, 533 responses from 86 countries were collected (in 2010 only a brief update on critical issues was released without indicating the survey participants).

<sup>37</sup> Hulme estimates the costs of these types of studies between 500,000 USD and 5 million USD, depending on the number of MFIs included in the study.

*mance; accurate, standardized performance information is imperative, both financial information and social information” (Social Performance Task Force n.d.-b).*

Directed towards investors, CERISE – a network of four French microfinance support networks with partners in Africa, Asia and Latin America and one of the leading organizations of providing social auditing tools for MFIs (CERISE 2011) – states:

*“Social utility is the main argument for microfinance investment. Investors who cannot clearly demonstrate the social impact of their activities risk overstating microfinance’s benefits and seeing their own reputation discredited when 'problematic' aspects are publicized. But, for investors to make decisions based on social value added, they must be able to measure it” (CERISE n.d.-b).*

Indeed, several specialized microfinance investors started assessing the social contribution of their MFIs. Some of them also started issuing social performance reports. In 2007, 45 MIVs participated in a survey conducted by the Social Performance Task Force, and almost half of them indicated that they reported annually on social results (De Bruyen 2008: 25). In 2007, this practice was further encouraged by CGAP that published its MIV disclosure guidelines for the first time. These guidelines also contained basic outreach indicators, for example the number of microfinance borrowers reached, the average MFI recipient outstanding loan size and the number of microfinance savers (CGAP 2007). The 2010 version already covered broader Environmental, Social and Governance (ESG) Indicators, taking into account specifications of the microfinance industry while building on wider socially responsible investment initiatives, such as the UN Principles of Responsible Investment (CGAP 2010d: 29-31). In the same year, the organization further incentivized MIVs to report on their commitment towards social goals by granting an MIV ESG Award. In 2010, CGAP stated that one third of 90 MIVs applied for this award which was ultimately given to three of them: Oikocredit, Triodos and Incofin (CGAP 2010b). In 2011, Symbiotics (2011b) indicates that already 88% of MIVs report on social performance metrics in one form or another.

As stated before, these developments are also important to contextualize the relevance of ratings in microfinance as well as the specific informational needs of different types of investors rating agencies have to respond to. The next section describes the origins and evolution of ratings in microfinance and highlights the most important tendencies in terms of the distribution among different world regions and types of ratings.

## 2.2.2 The Origins and Evolution of Ratings in Microfinance

First attempts to rate microfinance institutions were made by ACCION International<sup>38</sup> in the early 1990s. The Moody's CAMEL approach (see Chapter 3.1 further below) was adapted to analyze the financial performance of their affiliated MFIs. However, these diagnostics served as an internal evaluation mechanism for ACCION and were not disseminated within the wider public. The first rating agency for external assessments specialized on microfinance, MicroRate, was founded in 1997 (MicroRate 2011a) as a result of a pilot study realized in 1996 within the project "Standards of Performance for Microfinance Institutions" of the Inter-American Development Bank (IDB). Eighteen of the early ratings were funded by the IDB (Farrington 2005). The foundations of further specialized rating agencies followed shortly after with M-CRIL in 1998 (M-CRIL 2009c), Planet Rating in 1999 (Planet Rating 2010) and MicroFinanza Rating in 2001 (MicroFinanza Rating 2009).

Qualitative evidence suggests that in the early stage external ratings were primarily used and financed by donors to evaluate MFIs, especially in the early stages of the design of specific programs (Buyske 2007: 14). But also today, technical assistance providers use ratings as a basis for comparing their own analyses. Accordingly, there are various organizations, apart from investors and MFIs, which would use and co-fund these assessments, as well (The Rating Initiative 2010: 21,28). In order to encourage MFIs to receive a rating independently, the IDB along with CGAP launched a subsidy fund for external ratings in May 2002 (the Microfinance Rating and Assessment Fund – Rating Fund I). The European Union subsequently joined the Rating Fund I in January 2005 within the EU/ACP Microfinance Framework Programme in order to "*improve the quality, reliability and availability of information on the risk and performance of microfinance institutions*" (European Commission 2010). There is no information available about the relation of subsidized and non-subsidized ratings in the early stages of specialized rating agencies. Nevertheless, the former general manager of MicroRate in Latin America, Todd Farrington, refers to the Rating Fund I as a "*significant [factor of] influence over the direction of the emerging 'industry' of specialized microfinance raters*" (Farrington 2005). Between 2001 and 2008 the Rating Fund I co-financed a total of 525 ratings until it was finally closed as planned.<sup>39</sup>

By the end of 2007, the Rating Fund I had committed a total budget of 1.4 million USD of which 80% were assigned to the co-financing of MFI ratings. The EU/ACP Microfinance Programme disbursed another 1.4 million USD (Tsilikounas 2008: 36). Besides the co-funding of single rating reports, the Rating Fund I also financed a series of awareness raising events on microfinance ratings in order to stimulate the demand for ratings in the microfinance sector.

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<sup>38</sup> ACCION International is a U.S. based microfinance Apex institution founded in 1962 providing capital, technical assistance and/or management services to their 62 partner institutions in 31 countries; see <http://www.accion.org/page.aspx?pid=254> (accessed on May 23, 2010).

<sup>39</sup> The Rating Fund I stopped new approvals by the end of 2007.

By the time the first rating fund was suspended, several public and private stakeholders expressed their interest to further support the microfinance rating industry. Accordingly, in 2009 the Inter-American Development Bank (IDB) launched the Rating Fund II with a total budget of 1.2 million USD to strengthen the rating market in Latin America and the Caribbean (LAC). The fund is financed by the Multilateral Investment Fund (MIF) and the Andean Development Corporation (ADC) (IDB 2009; The Rating Fund II n.d.-a). By the end of March 2011, the Rating Fund II approved 58 ratings, financing a total amount of almost 350,000 USD (The Rating Fund n.d.-e).

In Europe, rating activities are supported by The Rating Initiative, launched and administered by ADA<sup>40</sup> with the financial support of the Government of Luxembourg, the Microfinance Initiative Liechtenstein, the Swiss Development Cooperation, Oxfam Novib, the Österreichische Entwicklungsbank, the Principality of Monaco and BlueOrchard (The Rating Initiative n.d.-a). The Rating Initiative aims at co-funding a minimum of 280 first or second ratings out of which 50% should be placed in Africa. As for financial ratings, MFIs from Latin America are not eligible for co-financing because of the existence of the Rating Fund II. The Rating Initiative plans to encourage at least 700 new MFIs to enter into the rating market and therefore also finances awareness raising events. For the period 2008 to 2012, the total budget available for the envisaged activities is almost 4.8 million USD<sup>41</sup> (ADA 2010).

Besides the fostering of transparency, both initiatives aim at building a sustainable microfinance rating market (The Rating Fund II n.d.-a; The Rating Initiative n.d.-a). Thus, the principle of co-financing in contrast to fully subsidizing ratings is considered essential. Furthermore, the subsidized share of the total rating costs declines with each round so that MFIs have to cover a major part each time until finally paying for their ratings themselves.

In case of the Rating Fund II, an MFI can apply three times at most. In the first round a rating is co-funded by 80% up to a maximal amount of 8,000 USD. The co-funding quota is 60% and 40% in the second and third round respectively (The Rating Fund II n.d.-c). The Rating Initiative would only co-finance two rounds with quotas of 70% (up to 10,000 USD in Africa and 8,000 USD in Asia, Eastern Europe and Middle East) and 50% (The Rating Initiative n.d.-b). In Latin America, the cost of a rating is thus 10,000 USD while the costs in the other regions, especially in Africa, are higher. Furthermore, both initiatives apply specific eligibility to MFIs criteria taking into account the years in operation, the total assets of volume of credit portfolio, the average outstanding loan size and the minimum commitment (in % of total portfolio) in microfinance (The Rating Fund II n.d.-d; The

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<sup>40</sup> ADA (Appui au développement autonome) is a development NGO based in Luxembourg. It was founded in 1994 and is specialized on the development of microfinance.

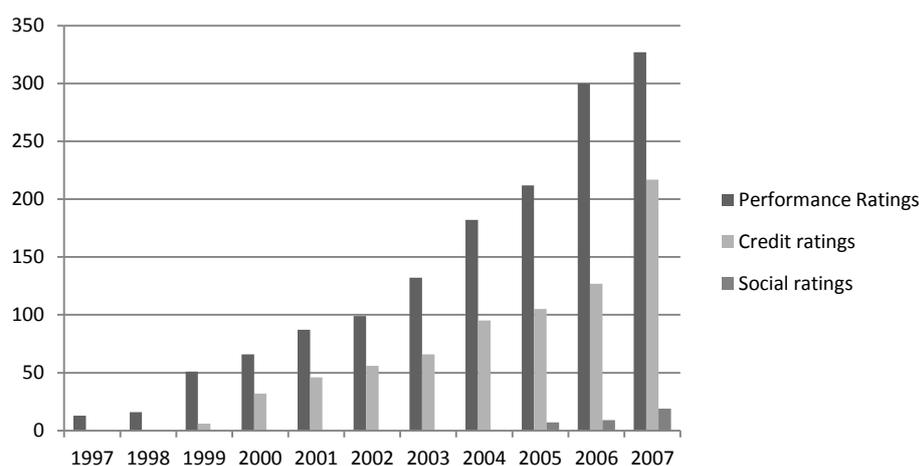
<sup>41</sup> The available budget is 3.4 million Euro converted into USD with an exchange rate of 1.40974 as of December, 31 2008.

Rating Initiative n.d.-c). The eligibility criteria are to a certain extent adapted to the regional context the MFIs operate in.

Both programs also apply minimum eligibility criteria on the rating agencies (years of operation, minimum number of ratings issued in a specific time frame, team of full-time financial analysts etc.) and their methodologies. This holds true especially for those rating agencies which are not authorized by any local banking supervision authority, in order to guarantee the professional standards of the ratings (The Rating Fund II n.d.-e; The Rating Initiative n.d.-g). The four specialized rating agencies mentioned above all fulfill these criteria.

In the microfinance rating market, several rating products for MFIs can be distinguished which are all financed either by The Rating Fund, The Rating Initiative or both. Ratings offered by the specialized rating agencies focus on the institutional strength, the lending activities and financial performance of an MFI and are either called “global risk assessments” (The Rating Fund II n.d.-b) or “performance ratings” (The Rating Initiative n.d.-i). In addition, the specialized rating agencies have offered so-called social ratings since 2005. Social ratings are supposed to measure both the “social risk” (defined as the risk of not achieving an envisaged social purpose) and the social performance (The Rating Initiative 2010: 5).<sup>42</sup>

**Figure 2.10: Growth and distribution of microfinance ratings, 1997-2007**



Source: Own elaboration adapted from ADA (2008: 8)

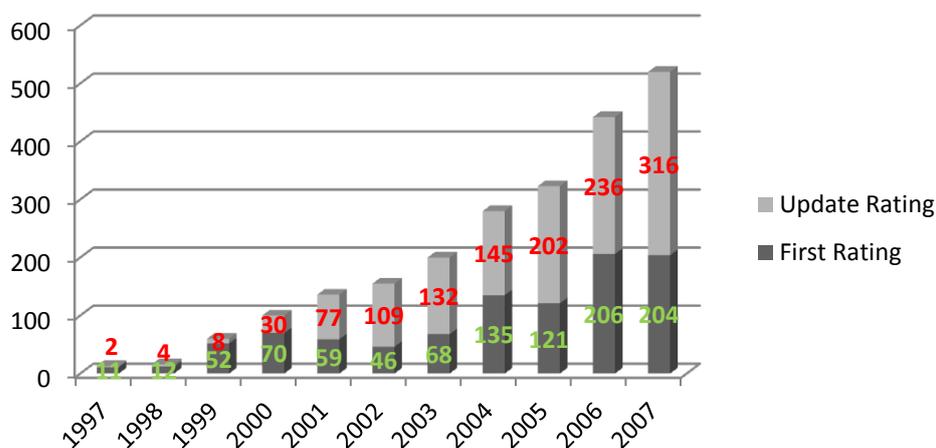
“Credit ratings” are offered by conventional (either international or local) or “mainstream rating agencies” (The Rating Initiative n.d.-h). These are supposed to have a narrower focus than performance ratings while predicting the likelihood that an MFI will (not) be able to meet its debt

<sup>42</sup> An analysis of different rating products will be provided in Chapter 6.

obligations (The Rating Initiative 2010: 4).<sup>43</sup> The most comprehensive overview of the development of the microfinance rating market is provided in the “The Microfinance Rating Outlook Report 2008” (ADA 2008) based on a survey among 17 rating agencies, covering the years 1997 to 2007.<sup>44</sup> In this period, a total of 984 MFIs underwent a rating process (ADA 2008: 8) summing up to a total of 2.280 ratings (all rating products included). Figure 2.10 shows the distribution of ratings in microfinance according to product type and year.

Between 2000 and 2007, the average growth rate of all microfinance rating products was 34% (based on data from ADA 2008: 8). In the later stages, the share of credit ratings grew stronger than the share of performance ratings (ADA 2008: 8). Yet, the absolute share of performance ratings was bigger at any time. This is also true for the market share of the four specialized rating agencies: the average market share of these rating agencies was 58% between 1997 and 2007 (based on data from ADA 2008: 10). The major rating agency with the biggest market share was Fitch, reaching almost 10%. 12% were reached by Class and Asociados, an accredited rating agency active in Peru. All other major or local, conventional raters reached market shares between 0.1% and 6.6%.

**Figure 2.11: Distribution of first and update ratings in microfinance, 1997-2007**



Source: ADA (2008: 15)

Considering all financial ratings (including performance and credit ratings and excluding social ratings), the proportion of update ratings increased considerably, reaching 54% of all ratings in

<sup>43</sup> The analysis of the differences and especially the implications for the functions of ratings in the microfinance sector will be done in depth in Part III of the present study with special reference to the case of Peru.

<sup>44</sup> In 2010, another survey was conducted by The Rating Initiative (2010). However, only 9 rating agencies participated in the survey while the data is presented in an aggregated manner. Furthermore, it only covers the years 2008 and 2009. Hence, it cannot be used for a continuous trend analysis. Still, some results which are particularly interesting for the development in the last two years will be used in Part III.

2007. Figure 2.11 provides an overview of the proportion of first and update ratings. Of the MFIs which had received a performance rating anytime between 1997 and 2007, 42% had at least one update rating in the following years. As far as credit ratings are concerned this percentage reaches 90%. The average frequency for performance rating updates is 1.9 years, in the case of credit ratings it is 0.8 years (ADA 2008: 15).

The higher percentage of credit rating updates can be partly explained by regulatory reasons. ADA (2008: 17) identifies four countries where ratings are to some extent mandatory for MFIs: Bolivia, Peru, Ecuador and Pakistan. However, the average share of mandatory ratings in relation to all ratings between 1999 and 2007 is only 21% with a declining trend (14% in 2007) (based on data from ADA 2008: 17).

The proportion of co-funded ratings by The Rating Fund in relation to self-financed ratings is also declining.<sup>45</sup> In 2002, the percentage of co-funded ratings was 29%, in 2007 it was 22%. However, the dependence on co-funding varies considerably between regions and rating products. In the region of Eastern Europe and Central Asia (EECA), for example, the co-funding share reached 50% on average (2002-2007) while in Asia the share was only 10%. At the same time, credit ratings were co-funded only by 3% (2002) and 6% (2007)<sup>46</sup> while performance ratings depended much more on co-financing with shares of 30% (2002) and 45% (2007). Globally, of the 984 MFIs in the sample, 356 MFIs (36%) benefited at least once from The Rating Fund (ADA 2008: 18).

There is a strong regional concentration of financial performance ratings. In 2007, 43% of all ratings were conducted in Latin America and the Caribbean (LAC), 34% in Asia, 10% in each Eastern Europe and Central Asia and Sub Sahara Africa (SSA) and only 2% in Middle East and Northern Africa (MENA) (based on data from ADA 2008: 8).

This concentration is also pronounced within the different regions. For instance, in LAC, Peru is clearly the market leader with 35% of the 223 ratings realized in the region in 2007 (ADA 2008: 27). It is followed by Bolivia and Ecuador. In these countries, due to regulatory reasons, the demand for credit ratings is particularly high (82% of all ratings realized). In the remaining LAC countries – Nicaragua, Colombia and Mexico are leading the list – MFIs, often not regulated, rather receive performance ratings (87% of all ratings realized). The large proportion of first ratings in 2007 (38% compared to 11% in Peru, Ecuador and Bolivia) indicate that the rating market is still developing in these countries. In 2007, 285 MFIs received a rating at least once.

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<sup>45</sup> In reality, the study only assesses whether a rating is co-funded by The Rating Fund or not. It does not disclose if the apparently non-co-funded ratings are actually self-financed or subsidized by any other party. Thus, the presented figures have to be interpreted with some caution.

<sup>46</sup> The low share of non-co-funded credit ratings can be largely explained by the fact that many of these ratings are mandatory and not eligible for co-financing.

In Asia there were 439 MFIs which were rated at least once between 1997 and 2007. The rating market is dominated by India with 54% of all ratings realized in this country in 2007. Indonesia follows with another 33% (ADA 2008: 28-31). Between 2006 and 2007, driven by India, there was also a large shift from performance ratings to credit ratings (the proportion of the former declined from 98% to 61%). ADA (2008: 29) makes the Small Industries Development Bank of India (SIDBI), an Indian apex bank, responsible for the strong demand in this country since it requires ratings from all of its partner MFIs. In contrast, in Bangladesh which also has a large MFI market, the major apex organization does not require ratings and the diffusion of ratings actually dropped from nine assessments in 2004 to one in 2007. In Indonesia the diffusion of ratings increased significantly after the foundation of the rating agency PRIME, funded by the Bill and Melinda Gates Foundation, in 2005. Between 2005 and 2007 it increased its Asian market share from 7% to 32%.

In Sub Sahara Africa ADA (2008: 32-34) only counts performance ratings offered by specialized rating agencies. In general, the market is much smaller than in the other regions with only 54 ratings realized in 2007 and 132 rated institutions until that point. Furthermore, the region's strong rating markets seem to depend largely on the availability of co-financing. For instance, in the leading country Uganda, 14 MFIs were rated in 2007, using the funds of a governmental development program. The same is true in Mali where nine MFIs were rated in 2006 due to funding from a USAID/Worldbank initiative while in 2007 only one rating was realized.

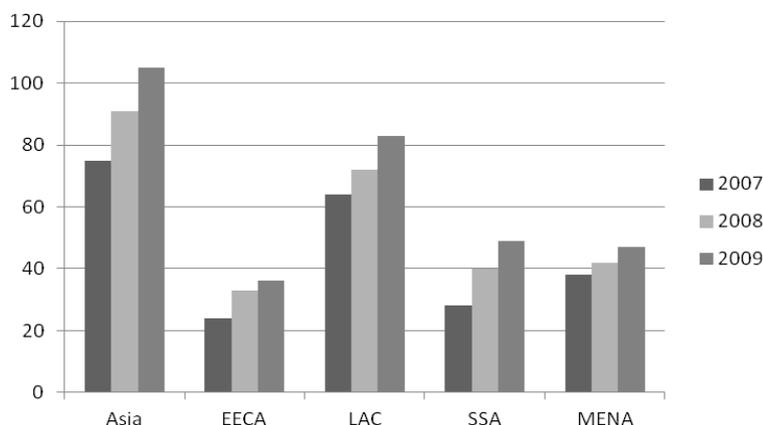
A very fragmented demand can also be observed in Eastern Europe and Central Asia with 53 ratings realized in 2007. 99 MFIs in the region received a rating at least once. Yet, Russia is the only country with ratings in the double digit area. The relatively high demand in Tajikistan and Azerbaijan seem to be linked to special co-financing initiatives, as well (ADA 2008: 36).

In the MENA region there are 29 MFIs which received a rating at least once, majorly in Morocco, Egypt and Jordan. In the latter two countries MFIs started receiving ratings in 2007. Moroccan MFIs have already received ratings since 2001. However, the number of ratings dropped from seven rated MFIs to three in 2007 (ADA 2008).

Looking at the number of ratings compared to the number of MFIs listed in MIX Market in the different world regions, the picture looks slightly different. Suddenly, Asia (instead of Latin America) is the region where ratings are most common. In 2009, the numbers of rated MFIs even exceeded the numbers of MFIs listed in MIX Market. In Latin America rating seems also to be an increasingly common practice since the proportion increased from 64% to 83%. The region of

Eastern Europe and Central Asia is the bottom of the league with a share of 36%. Figure 2.12 provides an overview of the relative diffusion of ratings in different world regions.<sup>47</sup>

**Figure 2.12: Relative diffusion of ratings in different world regions (in %), 2007-2009**



Source: Own elaboration; based on data from ADA (2008: 22) and The Rating Initiative (2010: 27) and MIX Market as of June 30, 2011.

Even though the number of MFIs which received a first rating kept increasing between 2007 and 2009, The Rating Initiative (2010: 27) questions the long-term sustainability of microfinance (performance) ratings.<sup>48</sup> MFIs increasingly started relying on subsidies for their ratings again and were less likely to have an update rating. Figure 2.13 shows the negative growth of non-subsidized ratings and rating renewals between 2008 and 2009. The number of non-subsidized ratings decreased significantly in all world regions. This was especially pronounced in SSA where the number of subsidized ratings increased by 42% in the same period. Also some MFIs in Latin America

<sup>47</sup> Note that the number of rated MFIs for 2008 and 2009 are based on the numbers of ADA (2008: 22). The numbers of first ratings mentioned by The Rating Initiative (2010: 27) were added to the ADA figures. The number of first ratings might be slightly underestimated since a smaller number of rating agencies participated at the second survey. Yet, most MFIs received their first rating by one of the specialized rating agencies (ADA 2008) which participated at both surveys. On the other hand, the numbers of rated MFIs might be overestimated, since they are based on a survey among rating agencies. Rating agencies might indicate that a rating is a first rating even though the respective MFI had previously received a rating by another rating agency. The second survey cited here does not disclose whether they controlled for double counting of MFIs. The number of MFIs listed in MIX Market might also include MFIs which were founded after 2009. In any case the MFIs listed in MIX Market are not necessarily the same which received ratings. However, it is assumed that in general MFIs which seek international visibility to attract funds are likely to do both, that is to receive a rating and upload their profile on MIX Market. Therefore, this table is assumed to be valid for providing a general idea of the relative diffusion of ratings in the different regions.

<sup>48</sup> This second Microfinance Rating Market Review is based on a quantitative survey among nine rating agencies. Hence, eight rating agencies chose not to participate again, among them “mainstream” raters which had a significant market share in the previous version such as Fitch, Equilibrium, PRIME and Crisil. Thus, the data presented here is meaningful as far as the activities of specialized rating agencies are concerned.

started relying on subsidies again. The number of co-funded ratings in this region increased from three in 2008 to 23 in 2009.

**Table 2.2: Growth of non-subsidized ratings and rating renewals between 2008 and 2009**

Region	Non-subsidized ratings	Rating renewals
Asia	-37%	-4%
LAC	-13%	-8%
EECA	-63%	-20%
MENA	-67%	-83%
SSA	-88%	-45%

Source: Own elaboration, based on The Rating Initiative (2010: 27)

Furthermore, the number of rating renewals dropped in all regions. It is too early to conclude that this development represents a general trend, especially since 2008 was the year of financial turmoil which also hit some MFIs. MFIs which did not expect additional funding in that year might have postponed a rating update. Other MFIs might have relied (again) on co-funding because they were temporarily not able or willing to cover the costs for a rating but will do so in the future. Still, there are reasons to question the long-term self-sustainability of the specialized microfinance rating industry which are further discussed in Chapter 7.

As far as social ratings are concerned, subsidies appear to be even more important in all regions. The specialized rating agencies have offered this product since 2005. Until 2007, 19 social ratings were conducted in total. This number increased sharply in the two following years. The Rating Initiative (2010: 24) counted 51 social ratings in 2008 and 76 in 2009. Across all regions the number of co-funded social ratings more than tripled between 2008 and 2009, yet, the number of self-financed social ratings decreased by almost 75% (based on data from The Rating Initiative 2010). The dominant regions for this product are Asia and Latin America. The strong growth of subsidized ratings between 2008 and 2009 (from two to ten and from seven to 34 respectively) was followed by a pronounced decline of non-subsidized ratings (from eleven to one and from 19 to seven) with most of the ratings realized being first ratings. Until May 2011, The Rating Initiative had co-financed 137 social ratings, 52% of which were conducted in Latin America and the Carribean.<sup>49</sup>

<sup>49</sup> See [http://www.ratinginitiative.org/index.php?id=5&dbreports\[sortColumn\]=5&dbreports\[sortOrder\]=A](http://www.ratinginitiative.org/index.php?id=5&dbreports[sortColumn]=5&dbreports[sortOrder]=A) (accessed May 30, 2011).

Further rather new products in the microfinance rating industry are ratings for CDOs as well as for MIVs. In 2006, MicroRate was the first rating agency to rate a loan securitization of 30 MFIs in 15 countries. The first publicly rated CDO (over 108 million USD with 21 MFIs in 13 countries) was issued by BlueOrchard and rated by S&P in May 2007 (Buyske 2007: 16). In 2006, the microfinance investment fund Gray Ghost along with the Gates Foundation and the Omidyar Network invested in MicroRate in order to further develop ratings of microfinance investment funds (MicroCapital 2011). Even though no information on the number of MIV ratings is publicly available, MicroRate considers itself the market leader in this niche (MicroRate 2011h).

In sum, the appearance of ratings in microfinance was largely driven by donors, and – in a few selected countries – also spurred by regulators. In some countries the financial support either by individual donors or by one of the three funds established for this purpose also remained pronounced in the following years. In other countries or regions (particularly India and some Latin American countries with relatively high developed microfinance markets), MFIs depended less and less on subsidies. This, as well as the higher proportion of update ratings indicates an increasing acceptance of these assessments, possibly pointing towards their usefulness for MFIs. Nevertheless, the increasing share of credit ratings offered by (mostly local) “mainstream” rating agencies and the growing share of subsidized ratings and decrease of rating renewals in recent years challenges the view that a sustainable global microfinance rating industry could be established.

The next part is dedicated to the discussion of the different functions the major rating agencies exercise in the global capital markets. The transfer of this analysis to the microfinance context in Part III helps explain the trends outlined above and provides insights into the future prospects of the microfinance rating industry.



**PART II - Functions and Functionalities of  
the Major Credit Rating Agencies from a Theoretical and  
Empirical Perspective**



### **3 Ratings in the Light of the Theory of Financial Intermediation and Beyond – Different Functions of Credit Ratings**

The previous chapter highlighted the growing importance of credit ratings in U.S. financial markets and beyond. The aim of the present chapter is to develop on the diverse reasons for this development while identifying different functions, external credit risk assessments fulfill. Therefore, in Chapter 3.1 the general characteristics of credit ratings are introduced in order to enable the reader to better understand the rather abstract theoretical considerations.

In Chapter 3.2 the Theory of Financial Intermediation is traced to the point that is deemed relevant for the functions of external credit ratings. The arguments are largely based on the existence of asymmetric information and transaction costs. Since the production of information is considered essential, rating agencies are modeled as intermediaries, albeit, suffering the same conflicts of interest as other market participants. The sub-chapter shows that wealth and liability and/or size of the intermediary are important to control conflicts of interest. Newer studies shift the focus towards a rather functional perspective, highlighting risk management as the most important function of financial intermediaries. The sub-chapter argues that credit rating agencies create trust in the future and should be considered active market participants rather than passive agents. Since rating agencies are in the business of assessing credit risk of traded bonds, Chapter 3.3 is dedicated to the discussion of different risk concepts. The difference between risk and uncertainty is considered central for distinguishing numerical probabilities of default and rather vague judgments about the likelihood of such an event. The sub-chapter argues that in modern societies (including globalized capital markets) it is increasingly difficult to predict the future. However, specific behavioral patterns and desires might make people neglect the vagueness of any risk assessment and refer to credit ratings as concrete measures of probability as if uncertainty could thus be eliminated and the future made insurable. From a sociological perspective – as argued in Chapter 3.4 – risk management is institutionalized in a process of standardization within selective expert systems or organizations, sharing common causal beliefs. The ongoing scientization makes deviations from established rules increasingly difficult. This possibly turns rating agencies into authorities over markets without necessarily representing the individual interests of market participants.

Chapter 3.5 then turns to the discussion of the different functions of credit rating agencies found in the literature while the theoretical considerations of the previous sections complement the analysis. Furthermore, the in-depth theoretical analysis is the basis for assessing the functionality of ratings regarding the different functions and sub-functions identified. The most important mechanism for guaranteeing the quality of credit ratings, for safeguarding their reliability and thus functionality of specific functions, is reputation, which is described in Chapter 3.6.

### 3.1 Credit Ratings – General Characteristics of External Credit Risk Assessments

In short, using the definition provided by Standard & Poor's (2010b):

*“Credit ratings are forward-looking opinions about credit risk. Credit ratings express the agency’s opinion about the ability and willingness of an issuer, such as a corporation or state or city government, to meet its financial obligations in full and on time [...] [credit ratings are] relative opinions about the creditworthiness of an issuer or credit quality of an individual debt issue, from strongest to weakest, within a universe of credit risk. The likelihood of default is the single most important factor in our assessment of creditworthiness.”*

As credit ratings solely focus on credit risk they should not – according to the rating agencies – be interpreted as recommendations for buying and selling. They typically reflect long-term developments and do not respond to short-term fluctuations. Changes in credit ratings generally occur because of overall shifts in the economy or business environment as well as circumstances affecting a specific industry (e.g. new competition of technology) *“beyond what might have been expected and factored into the [original] ratings”* (Standard & Poor's 2010a).

Ficht (2001) provides a good general overview of the characteristics, methodologies and processes of credit rating agencies. A credit rating is not an audit or any other type of control of a company's financial statements. Credit rating analysts do use (audited) financial statements to build their opinion but they are not necessarily auditors or certified public accountants (CPAs). To become a rating analyst no formal training or specific professional education and qualification is required (Ficht 2001: 4). Unlike CPAs,<sup>50</sup> rating analysts do not sign their ratings and are not subject to any type of legal responsibility as far as their opinion is concerned.

When defining credit ratings, the process and methods which lead to the final judgment and the actual outcome should be distinguished. The latter, apart from the report, is a grade on a prior defined ordinal evaluation scale. The ratings are expressed in letter grades, the ones for bond ratings are the most commonly recognized.<sup>51</sup> In the case of S&P, long-term credit ratings reach from AAA to D with the first being the highest category while D is the lowest (D indicates that a debt obligation is already in default). The letter grades from AAA to CCC can be modified by add-

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<sup>50</sup> Even though the term „Certified public accountant“ (CPA) is linked to a specific U.S. examination procedure, most (industrialized) countries have similar professions. These accountants have to pass licensing procedures guaranteeing their capabilities and fulfillment of certain duties (e.g. independence, impartiality, discretion and diligence).

<sup>51</sup> The general overview shall be sufficient in this section. A more detailed overview of rating definitions and scales will be provided for the case of specialized microfinance rating agencies in Chapter 6.1.1.

ing a plus (+) or minus (-) sign to show the relative standing within the major rating categories (Standard & Poor's 2010b). Moody's grades slightly differ even though for the most categories an equivalent for the S&P grades can be easily established (Sinclair 2005: 35-39).<sup>52</sup>

Rating agencies provide ratings for different types of issuers such as corporations, financial institutions, funds, insurances, governments and structured finance products. For each category different methodologies are applied. Without going too much into detail, the general process can be described as follows: After the request for a rating, the analysis starts with the data collection on the issuer's business environment. For banks, for example, this means analyzing the national banking market, the degree of banking concentration, the role and function of the country's banking supervision, public reporting requirements, the degree of state control of the banking system etc. Furthermore, basic data from the financial statements of the issuer is compared to those of other players in its specific peer group. The peer group is established out of comparable entities within the country or, if necessary, of entities from different countries (Fight 2001: 102-103). In the following, the agencies typically has a list with further questions organized in sections. For example, Moody's uses the acronym CAMEL (capital, assets, management, earnings and liquidity) to organize its analyses of banks.<sup>53</sup> However, even though the issuers might answer to a standardized checklist, it is also possible for them to present the required information in their own fashion (e.g. through reports or presentations) or even by answering face-to-face. In case the requested data contains confidential information, the rating analyst might be required to sign a confidentiality agreement.

Afterwards, a meeting is usually set up to discuss the provided data to seek further clarification. Besides quantitative data, qualitative data is also collected, especially about the issuer's policy choices and strategic plans. In order to assess the management capacities of an entity, this information is usually taken very seriously by rating officials (Sinclair 2005: 33). The duration and number of meetings depend on the entity's complexity and are usually held with the company's chief financial officer (Fight 2001: 104).

Subsequently, the data is analyzed from a team usually composed of two analysts: a senior (typically from the head office) and a junior analyst, the latter being in charge of the grunt work (e.g. data collection and organized documentation). Different analytical areas are possible. In the case of a bank, the areas include lending, investments (holding, dealing and trading), fund management, off-balance sheet transactions (e.g. derivatives), interest rate and currency risks. As far as banks in non-G8 countries are concerned, the analysis rather focuses on the loan portfolio com-

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<sup>52</sup> For example an AAA in case of S&P is an Aaa in case of Moody's. AA+ would be Aa1, AA- would be Aa3 and so forth.

<sup>53</sup> For sovereign and corporate ratings other indicators might be more important. In this study, the focus lies on financial institutions. More detailed information on the rating criteria for microfinance institutions in the case of Fitch and Standard & Poor's can be found in Chapter 6.1.2.

position as well as the bank's funding and liquidity conditions in terms of volatility. The capital adequacy is determined both in terms of what the rating agency considers adequate and according to those imposed by regulatory authorities. Additionally, the analysis includes the bank's relationship to and likely support from its owners as well as bailouts by regulatory or fiscal authorities. Corporate analysis rather focuses on market positioning, cash flow, sustainable earnings, steady profitability and adequate cushions to secure debt servicing (Fight 2001: 105).

After the basic analysis, analysts draft a rating report which may vary in length. Rating reports of up to 30 pages including spreadsheets and annexes are a usual product. Some agencies send these draft reports to the issuer, so that accuracy can be checked and confidential items removed. After that, the draft report is transmitted to the agency's rating committee members. During the rating committee meeting, the analysts in charge present the data and may also include relevant confidential data omitted from the report as well as updated data (e.g. last-minute press cuttings). The composition of the rating committees varies from one agency to another. Besides the two analysts in charge of the report one or two senior analysts covering peer group entities might participate. To secure impartiality, it may also include members covering a peer group of other countries. It may be governed by a quorum. After the presentation and discussion of the report, a proposed rating grade is held to a vote. Again, the quorum and the required majorities vary from agency to agency (Fight 2001: 106-107).

Once the rating grade is defined and the final report is ready, an issuer has to decide whether to disseminate the rating or not. In case the issuer wants the report to go public, the rating is released through various publications and communication media such as the internet (rating reports can also be found on the agency's websites) and press releases. Regular subscribers then have access to the full report.

As creditworthiness is a dynamic condition which might change over time, rating agencies as well as the users of credit ratings have an interest in maintaining the credit ratings updated. In order to account for the issuer's capacity to adapt to a changing environment, rating agencies beside the rating grade also give an opinion on the possible future evolution of the rating grades. Therefore, a rating outlook assesses the potential direction of long-term credit ratings over the intermediate term (usually over six months to two years). In the case of S&P, rating outlooks can assume the following values: positive (a rating may be raised), negative (a rating may be lowered), stable (a rating is not likely to change), developing (a rating might be raised or lowered) and N.M. (the outlook is not meaningful) (Standard & Poor's 2010b).

What is even more important, however, is the establishment of a surveillance procedure for an ongoing monitoring of issuers. Without having to enter into a full rating process each time the economic conditions of issuers or their environment change, rating agencies have introduced the

mechanism of listing possible future rating changes. Moody's introduced a "Watchlist" as a formal "rating action" in 1991 (Moody's 1998). S&P uses "CreditWatch" for the same purpose. According to S&P, "CreditWatch" highlights the agency's opinion as far as the potential direction of a short-term or long-term rating is concerned. The focus lies on identifiable events and short-term trends that cause the rating to be placed under special surveillance. The following circumstances can cause such a listing:

- When an event or a deviation from the expected trend has occurred or is expected and when additional information would be necessary to re-evaluate the current rating. Such events and short-term trends include mergers, recapitalizations, voter referendums (in case of sovereign ratings), regulatory actions, etc.;
- When material changes in the performance of an issue have occurred while the magnitude of the rating impact has not been fully determined and the rating is likely to change in the short-term;
- A change in the rating criteria has been adopted that makes it necessary to review an entire sector or multiple transactions while a rating is likely to change in the short-term.

Again, different values are possible while "positive" means that the issue is likely to be upgraded, "negative" means that a rating may be lowered (downgraded) and "developing" refers to a situation where a rating might either be lowered or raised (Standard & Poors 2010b). In the past, credit rating agencies have been criticized for their backward and historical focus of their credit analysis. The mechanism of "watch-listing" by incorporating (new) relevant information increases the rating agencies' proactive behavior.

In order to give a proof of the predictive power of the credit risk assessments, rating agencies regularly publish so-called "default and transition studies" and calculate "accuracy ratios". Moody's study on "Corporate Default and Recovery Rates 1920-2009" (Moody's 2009), for example, documents for a period of almost ninety years how many corporations defaulted each year associated with a specific rating grade – expressed in percentages. This type of studies, both from rating agencies as well as from independent researchers (for an overview of these studies issued before 2000 see BIS (2000: 126-132)) allows market participants to monitor rating agencies while observing the correlation of rating assessments with actual defaults. Transition studies document the shifts of ratings between rating categories and tend to measure the accuracy of ratings for issues that do not default while a high rating quality would imply that there are few drastic shifts.

Furthermore, default studies also provide insights into relative default frequencies. With the development of econometric credit risk models, rating agencies also started incorporating their own default data into rating models assessing "real" default probabilities. For example, Fitch developed a "hybrid probability of default and rating model" based on structural models – going back

to option pricing theories developed by Black, Scholes and Merton<sup>54</sup> – which adjust information on equity prices with a firm’s financial information and market information while promising a “forward-looking structural default probability” (Liu, Kocagil *et al.* 2007).

### **3.2 The Theory of Financial Intermediation – From an Institutional to a Functional Perspective**

From a historical perspective, financial intermediaries have a long tradition. Long before the development of a modern monetized economy the ancient Greek had several banks (Stadermann 1998<sup>2</sup>: 158). And the foundation of the oldest surviving bank of the world – The Monte dei Paschi of Siena, Italy – dates back as far as 1472. However, in academia the importance of the financial system for (macro-)economic development was not fully recognized until the appearance of the Theory of Finance with McKinnon and Shaw as its most prominent representatives (McKinnon 1973; Shaw 1973). Since then, a lot of empirical research has been done to indicate the relevance of a well functioning financial system for (economic) development (e.g. Beck, Levine *et al.* 2000). However, still it does not seem completely clear what structure and characteristics an efficient financial system should have. Levine (2002) does not find any evidence that an “intermediary-based” or “bank-based” financial system – as can be found in Germany, for example – is better or worse than a “market-based” system like in the U.S. Also Demirgüç-Kunt and Maksimovic (2002) do not find evidence that funding businesses and hence economic growth critically depend on the “financial architecture” of a country. And Tadesse (2002) comes to the same conclusion, adding that the structure of the financial system also depends on country-specific factors, including the contractual, legal and institutional environment. He argues that in financially underdeveloped countries with weak legal and institutional structures the bank-based financial system appears more likely to prevail and to be more efficient. Similarly, effective bank-based systems are more likely to be found in countries that are dominated by small firms – as is the case in Germany – as they have a greater need for flexible financing (Tadesse 2002: 431). This is interesting in so far as rating agencies are conceptually linked to the market-based model and are designed to address specific frictions, namely those resulting from asymmetric information in otherwise efficient markets.

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<sup>54</sup> The Black-Scholes model is a mathematical description of financial markets and derivate investment instruments widely used in pricing options. Based on a set of explicit assumptions the model shows that any option is implicitly priced when the stock is traded. Merton was the first to publish a paper on the mathematical understanding of the option pricing, followed by Black and Scholes; see (Black and Scholes 1973) and (Merton 1973).

### 3.2.1 New Institutional Economics and Financial Intermediation – About Transaction Costs and Asymmetric Information

Market-based financial systems do not seem to be per se more efficient than bank-based financial systems. Interestingly enough, the Arrow-Debreu model – as it is central in the neoclassical General Equilibrium Theory – as well as the Modigliani–Miller theorem – which states that in the absence of taxes, bankruptcy costs and asymmetric information, thus, in an efficient market, the value of a firm is unaffected by how that firm is financed – leave no place for financial intermediation adding any value towards an efficient resource allocation: “...*the banking sector is at most a passive force in the determination of prices and real activity*” (Fama 1980: 45). Thus, the only reason for financial intermediaries to exist is the insistent predominance of market imperfections. Accordingly, the Theory of Financial Intermediation<sup>55</sup> was first and foremost shaped by approaches dealing with transaction costs and asymmetric information and problems raised in the agency theory like adverse selection and moral hazard (Jensen and Meckling 1976).

In his pioneering work “The nature of the firm”, Ronald Coase (1937) introduced the concept of transaction costs while using markets as the principal explanation for the existence of any business company. Therewith, he placed the starting block for the now widely recognized New Institutional Economics (Williamson 1985: 16) as modification and extension of neoclassical theory. One of the first scholars applying transaction costs to the puzzle of financial intermediation was Tobin (1964) and later Towey (1974). The latter defines banks as “*issuers of intermediary claims*” (Towey 1974: 71) while “creating” money in the course of transferring lenders’ assets to borrowers. The focus here lays on exchange or monetary transaction costs.

Benston and Smith (1976) deepen the transaction cost approach regarding financial intermediaries and refer to their essential feature as “*the reduction of the transaction costs of effecting inter- and intra-temporal consumption decisions*” (Benston and Smith 1976: 216). They distinguish different forms or levels of financial intermediaries with a market maker (like the New York Stock Exchange) as the most basic one. The market maker is in charge of lowering relevant information costs to more complex forms where financial commodities are produced and the dealer of the commodity takes a risk position of his own. To give an example, they present mutual funds as intermediaries able to exploit the returns to scale implicit to the structure of the transaction costs of a stock exchange. They purchase large blocks of securities, package them according to individual needs and sell the packages at prices covering all transaction costs. In general, they state that the production of financial commodities employs considerable higher inputs in terms of documentation, information and monitoring compared to other producers, and that financial intermediaries can realize economies of scale while designing financial services. The relatively large

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<sup>55</sup> The Theory of Financial Intermediation explored here is foremost related to orthodox economics with its focus on efficiency gains. An amended view on financial intermediation will be provided further below.

information requirements are of special importance here, and it raises the question whether rating agencies should be majorly interpreted as information intermediaries enhancing the efficiency of financial markets. Not only can financial intermediaries realize economies of scale through specialization in how to process information but they also have access to this information at much lower costs because a *“financial institution is expected to exhibit, and therefore can more easily acquire a reputation for exhibiting discretion with that type of information”* (Benston and Smith 1976: 223). Finally, financial institutions can reduce the costs associated with search, again with the market maker as the most basic form that brings together lenders and borrowers. Thus, the focus of Benston and Smith lies on search, monitoring and auditing costs. The role of financial intermediaries is primarily to transform (rather than issue) financial claims into other types of claims (qualitative asset transformation). What all transaction cost based approaches have in common is that transaction costs, which for financial intermediaries are the very reason to be, are exogenous. This is in contrast to another concept which many scholars consider even more important when it comes to explaining the principles of financial intermediation: asymmetric information.

The theory of asymmetric information deals with market imperfections created when one party is better informed than the other. Akerlof (1970) – with the example of the market for used cars – was the first in describing the problem of quality uncertainty and the related problem of “the bad driving out the good”. Regarding the financial market, Stiglitz and Weiss (1981) – now also cited in every introductory text book on microfinance – further explain, how credit rationing occurs due to asymmetric distribution of information between lenders (principals) and borrowers (agents), leading to an excess demand for credits and thus inhibiting the equilibrium in credit markets. In general two types of information asymmetries have to be distinguished. Ex-ante, information asymmetries can lead to adverse selection – a situation where “bad” products or costumers are more likely to be selected. Ex-post, information asymmetries can provoke moral hazard, which Krugman describes as *“any situation in which one person makes the decision about how much risk to take, while someone else bears the cost if things go badly wrong”* (Krugman 2008: 65). The “decision” on how much risk to bear can only be taken by a party, if he or she has more information than the other party. This is why Leland and Pyle (1977) state that borrowers cannot be expected to *“be entirely straightforward about their characteristics, nor entrepreneurs about their projects, since there may be substantial rewards for exaggerating positive qualities”* (Leland and Pyle 1977: 371). Therefore, moral hazard prevents the direct information transfer, and financial intermediaries should be viewed as *“the natural response to asymmetric information”* (Leland and Pyle 1977: 372). Again, rating agencies are supposed to lower asymmetric information and with the introduction of watch-listing they might even contribute to solve problems of moral hazard, once a financial contract is signed.

Leland and Pyle further argue that for certain classes of assets, information which is not publicly available, can be obtained spending resources. Opposed to Benson and Smith, they do not consider these information costs (“sorting costs”) as normal transaction costs necessary for exchange (Leland and Pyle 1977: 383 footnote 16). As this type of information can be useful to lenders, organizations that gather and sell this information are likely to appear if and only if some economics of scale can be generated.

However, two important problems arise when selling information. First, as information always has a certain public good aspect, the information-seller might not be able to appropriate all returns. Purchasers of this information could share or even resell the information without lowering the usefulness of the information to themselves (this is the argument Cantor and Packer raise when explaining why rating agencies started to charge issuers rather than only investors for their rating service; see Chapter 2.1.1), while the original information-seller only appropriates a fraction of what all market participants would be willing to pay. Second, a precondition to be able to sell information is the credibility of the information. As information purchasers may not be able to distinguish between information of high or low quality, the very same problem Akerlof describes for used cars arises: the price of the information reflects the average quality crowding out organizations with high quality information (as they can only charge the average price). This is especially true if there are no entry barriers for organizations to sell information, and that might be an argument for the long lasting restrictions of NRSROs status assignment to smaller or foreign rating agencies.<sup>56</sup> For Leland and Pyle the solution for both problems lies in the transformation from an information gathering firm into a financial intermediary, buying and holding assets on the basis of specialized information. The financial intermediary can then fully profit from the gathered information as it is embodied in a purely private good in the form of an asset portfolio: *“While information alone can be resold without diminishing its returns to the reseller, claims to the intermediary’s assets cannot be”* (Leland and Pyle 1977: 383). The increased value of the portfolio then reflects the return for the intermediary’s information gathering. However, an intermediary would also need to cover the costs for its portfolio (including eventual losses) and is thus fully accountable (and liable) for its investment decisions based on the gathered information. The lacking liability of rating agencies as they do not suffer any losses in cases of “misratings” might thus be a problem, which has already been raised by market participants (see Chapter 4 further below).

Diamond (1984) adds to the Leland-Pyle signalling and sorting argument a monitoring component. Financial intermediaries are modelled as “delegated monitors” on behalf of ultimate savers in a multiple-agent, single-principal relationship. The principal here is the saver who delegates the monitoring to the first agent (the intermediary) who then monitors the ultimate agent (the

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<sup>56</sup> Other, political arguments have also to be taken into consideration and will be discussed later on.

borrower). Doing so, Diamond also introduces a new perspective on transaction costs. Besides the sorting, monitoring and enforcement costs also apparent in a single-agent, single-principal relationship, in Diamond's model delegation costs occur. The latter – which also could be described as sorting, monitoring and enforcement costs for monitors – delivers the arguments why diversification within an intermediary rather than diversifying between many intermediaries might be appropriate and thus why big banks could easily develop. This is an aspect also raised by Fridson (1999) which helps to explain another important function of credit rating agencies and are further discussed below.

Ramakrishnan and Thakor (1984) unroll the same issue from the other side. They try to explain how financial intermediaries help to solve the problem of ex-ante asymmetric information. Instead of modelling the financial intermediary as “asset transformer” for savers, they seek to explain it as a (sole) diversified information broker. They explicitly refer to institutions like credit bureaus, financial newspapers, econometric modellers, consultants, investment bankers, accounting firms and – most important for the purpose of the present study – rating agencies. Therefore, they model financial intermediaries as “coalitions of agents” in order to avoid an inefficient duplication in information production. The model is based on Stiglitz' (1975) Theory of Screening where economic agents seeking funds could distinguish themselves from “Akerlofs' average” by having themselves screened through an external certification process and thus profit from quality labeling.

Ramakrishnan and Thakor assume that no non-dissipative (costless) signalling – for example through past dividends as a signal for future earnings or simply the capital structure of a firm – exists as had been modelled (and questioned) by Bhattacharya (1980). Thus, the need to overcome information asymmetries regarding firms' value (and performance) should lead to the emergence of a market for information (Ramakrishnan and Thakor 1984: 417-423). They further argue that it is expensive to produce information so that private information producers have an incentive to produce low quality information. Therefore, an indicator to measure the quality of the information ex-post is needed, which then serves the information producer to build up reputation. If contracts between a firm and the information producer are publicly known (no side payments) all other market participants can foresee the actions of the information provider necessary for his own utility maximisation. If contracts are designed incentive compatible, the credibility of the information provider is secured. The market of information producers shall be deemed to be perfectly competitive meaning that firms search to minimize their costs while designing an incentive compatible contract. From the point of view of the information producers, competition leads to a search for organizational forms with the lowest information production costs possible. The payoffs for information producers are uncertain depending on the performance of their work. Furthermore, information producers are a priori all equal and risk averse.

Thus, information producers would benefit from collaboration as the risk of uncertain payoffs is reduced by diversification. When individual information producers merge towards an intermediary they collectively elaborate a production strategy which also contains the number of firms about which information should be gathered. The efforts to gather information as well as the payoffs are then equally shared. In order to assure that efforts and not only payoffs are internally shared (free rider problem), an internal monitoring mechanism must exist. The internal review committee of many intermediaries, which is also existent in rating agencies, performs this role. This way, internal moral hazard is eliminated and the contracting firm must only care for incentive compatibility with the information producer directly dealing with (or the intermediary as a whole).

This can be done by setting up "Internal Monitoring Joint Contracts" (IMJC). These contracts do not distinguish between a good performance and a bad performance giving incentives through choosing big "incentive spreads" (paying very little in case of bad performance and very much in case of good performance). In contrast, contracts always have the same (high) payoff even though information gathering for one firm was good while for the other one it was bad – based on the reputation (for last performance) of the merged information provider. While lowering incentive spreads the total incentive costs decrease. Thus, the formation of an intermediary offers diversification benefits to its members, and firms will always prefer to transact with merged information producers rather than with independent ones. As the attractiveness of an information producer is furthermore defined by its reputation, the reputation index determines how many new contracts the intermediary receives at a given point of time. The default and transition studies and with it the accuracy ratios presented before constitute such a reputation index. The higher the number of past contracts, the higher is the demand for the intermediary's service and the higher are the present payoffs.

Regarding the size of these kinds of intermediaries, Ramakrishnan and Thakor (1984: 423) even conclude that information production can be undertaken most efficiently by a natural monopoly independent from the existence of economies of scale in information production. That might be an indication why, in spite of regulatory changes, the market position of the big rating agencies is not really challenged until now. That these monopolies do not arise in reality, according Millon and Thakor (1985), is due to the fact that internal monitoring has its costs and that the free-rider problem, given a certain size of the intermediary, offsets the information-sharing gains increasing with size.

The rather single-edge approaches à la Benston and Smith (transaction costs) and Leland and Pyle (asymmetric information) were contrasted by Campbell and Kracaw's (1980) eclectic view on financial intermediation stating that none of the single different factors for the existence of financial intermediaries (economies of scale, lowering asymmetric information, protect confidenti-

ality) can stand alone as satisfactory explanations and should be rather viewed as complementary (Campbell and Kracaw 1980: 864). However, they do not render more precisely in which additional services would consist. And as for the explanation of the existence of rating agencies they lag behind in so far as intermediaries have to be investors themselves. Only by investing a fraction of their own funds, investment brokers as the principal form of intermediaries can establish the reliability of their information (similar to the argument made by Leland and Pyle even though the focus is on reliability rather than appropriation of information gains.). This would be the only form to secure incentive compatibility avoiding moral hazard as an incentive to cheat in the form of accepting high payments but producing no or low-quality information. Campbell and Kracaw also provide an argument for the concentration of investors within a few intermediaries as the reliability increases with the wealth of the intermediary allowing to invest own funds. Wealth rather than reputation represents the entry barrier for smaller information producers in their approach. However, smaller information producers might be able to produce the same high-quality information at lower costs which leads Campbell and Kracaw to the conclusion that the simple information-producer-intermediary does not contribute to market efficiency. Thus, information-production cannot be the only reason for their existence. Additional explanations for the *raison d'être* can be found taking a sociological perspective, which are presented in Chapter 3.4 further below. But also some of the latest developments in the Theory of Financial Intermediation deliver further explanations highlighting the importance of risk management in the process of financial intermediation.

### **3.2.2 Financial Intermediation from a Functional Perspective – The (single most) Importance of Risk Management**

Part of the problem to give a complete answer to the question why financial intermediaries exist, how they operate, and what their actual contribution to economic development is, is partly rooted in the epistemology of modern theory building. Formalising models of financial intermediation always requires building on a set of rather strict assumptions as well as treating a specific problem on a level of abstraction which allows gaining a general understanding of varying institutional forms. The contribution – even though a valuable one – of these approaches is to explain rather isolated reasons and mechanisms behind financial intermediation. What all the before mentioned approaches have in common, however, is that they implicitly (and sometimes explicitly) focus on a specific organizational form. Thus, they follow an institutional perspective of financial intermediation with the intermediary being a rather static entity (THE bank, THE investment broker, THE rating agency etc.).

Merton and Bodie (1998)<sup>57</sup> were the first to develop a conceptual framework on how to analyse the financial system based on a “functional perspective” rather than an “institutional perspective”. Their primary motivation to perform this shift is to explain the mechanisms of financial innovation and how the introduction of more and more market-based financial products compete with and at the same time complement financial intermediaries while advocating for the development of these sophisticated instruments fostering an *“innovative spiral towards complete markets”* (Merton and Bodie 1998: 14). Since the Financial Crisis 2008 – at the latest – the indisputable contribution of securitisation, derivatives, options, swaps etc. towards greater market efficiency can be questioned. However, functions rather than institutions as conceptual anchor allow analysing the financial system across borders independent from its political, cultural and historical background or a given point of time. Merton and Bodie argue that with the growing complexity and “globality” of financial markets, functions previously reserved to capital markets are also increasingly performed by financial intermediaries such as banks and insurance companies: *“Even when the names of institutions are the same, the functions they perform often differ dramatically”* (Merton and Bodie 1998: 1). They place their approach explicitly between two opposed theoretical perspectives: The neoclassical, “institution-free” perspective addresses the dynamics of prices and quantities without having anything to say about how institutions (and thus markets) develop and how they change over time. North (1994: 359) therefore disregards the neoclassical theory as *“an inappropriate tool to analyze and prescribe policies that will induce development”*. The institutional perspective assumes that institutions matter, and public policy should help institutions currently in place to survive and flourish (Merton and Bodie 1998: 6). The analytical approach focusing on functions then helps to explain different institutional settings without claiming that specific functions have to be exercised by specific institutional arrangements.

Four levels of analysis can be distinguished: the level of the financial system, the level of an institution, the level of an activity and the level of a product. To exemplify their argument, Merton and Bodie (1998: 11) take the savings & loans associations or “thrifts” in the U.S. during the 1970s and 1980s. These institutions had two core economic functions. One was the provision of long-term financing at fixed interest rates to home-owners. The other one was to provide “riskless”, liquid short-term savings for a large number of savers. Merton and Bodie stress that these are two economic functions which do not necessarily need to be performed by the same intermediary. In the 1970s and 1980s thrifts faced difficulties which led the U.S. government to take action in order to preserve these institutions and make them healthy again. The focus lay on policies which could improve the thrifts’ competitive position. This institutional perspective, however, ignored that the principal economic functions of the thrifts were already taken over by other institutional mechanisms: The creation of securitized mortgage instruments (in the begin-

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<sup>57</sup> This paper is based on (Merton and Bodie 1995).

ning designed to help the thrifts) and the following creation of an national mortgage market allowed mutual funds and pension funds to become major funding alternatives.

On the product level, Merton and Bodie (1998: 12-13) take the example of municipal bond issuance. In the U.S., specialized insurance companies sell insurance contracts to guarantee principal and interest payments in case of a default, which allows issuers to receive a higher rating for their issuance. A manager with an institutional perspective of such an insurance company would identify other insurance companies as competitors. However, from a functional point of view there might be other alternatives such as an option exchange (physical or virtual marketplace at which options are traded). The creation of a market for options on municipal bonds would allow a market investor to buy uninsured municipal bonds and put an option on that bond (in this case the right to sell at a fixed price: a put). This mechanism would deliver the same protection against a default but with another institutional setting as an option exchange is not an insurance company. Whenever options are the better mechanism to insure against losses, a manager with an institutional orientation would miss to identify his prime competitor. The same is true for regulatory bodies. If regulation is organized exclusively along institutional lines (as is the case in the U.S.) the regulator would miss to exercise control over certain mechanisms and institutions even though these institutions serve as perfect substitutes.<sup>58</sup>

Another advantage of a functional perspective is the recognition that single activities can exercise multiple functions. Merton and Bodie (1998: 12) refer to lending in its “purest” form – which is free of default risk – as the activity to perform the intertemporal transfer of resources. However, as loans are rarely free from default risk, lending also contains a second function, namely risk management. The latter is linked to the specific characteristics of the loan. By purchasing loan guarantees, the lender (supposedly) converts the risky loan into a default-free loan (risk management) which allows the lender to better perform the intertemporal transfer function. Certainly, this does not mean that the single functions can or should overcredulously be separated. Nor does this perspective critically elaborate on the meaning of default risk and how this can be assessed and managed.

Still, the lending example also points to the fact that in order to enable market participants as well as governmental bodies to develop a functional perspective, basic functions which cover all activities and products of every actor and/or institution involved in financial intermediation have to be identified. The single primary function of any financial system is *“the allocation and deployment of economic resources, both across borders and across times, in an uncertain environ-*

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<sup>58</sup> However, even though the functional perspective can help to explain latest developments in financial markets and linked to that the predominant role of rating agencies, it cannot be assumed that from a political or social welfare perspective that these developments are necessarily advantageous, as Merton and Bodie tend to presume.

ment” (Merton and Bodie 1998: 7). Furthermore, six core (sub-) functions can be distinguished (Merton and Bodie 1998: 2,7-11):

- **Clearing and Settling:** To provide way of clearing and settling payments to facilitate trade;
- **Pooling:** To provide a mechanism for the pooling of resources and for the subdividing of shares in various enterprises;
- **Transferring Resources:** To provide way to transfer economic resources through time, across borders and among industries;
- **Risk Management:** To provide ways of managing risk;
- **Information:** To provide price information to help coordinate decentralized decision-making in various sectors of the economy;
- **Incentives:** To provide ways of dealing with the incentive problems created when one party to a transaction has information that the other party does not or when one party acts as agent for another.

Theories developed previously to Merton and Bodie’s approach – following the tradition of the New Institutional Economics (Merton and Bodie see themselves in this tradition) – also discuss single functions or combinations of the same exercised by financial intermediaries. However, only in the following did academics reflect the whole set of possible functions. Levine (1997) – as a scholar from the research line of Financial Development<sup>59</sup> – also assumes the functional view by differentiating five different functions very similar to Merton and Bodie with the only difference that he does not identify the “Information Function” as a standalone function of financial intermediation. The market frictions to be addressed are still defined to be information costs (due to asymmetric information) and transaction costs. Yet, no answers have been given in this new, functional view to the question which functions tend to be the most important ones.

This is the parting point for Allen and Santomero (1997) who argue that the emphasis of the role of financial intermediation to reduce transaction costs and asymmetric information is too strong. Even though these factors may once have been central, they are increasingly less relevant. They point to the fact, that trading costs for individuals in the U.S. fell dramatically in the 1970s through the introduction of competition for brokerage fees at the New York Stock Exchange. However the share of ownership of mutual funds did not decrease (remember that according to Benston and Smith (1976) transaction costs were the principal reasons for mutual funds to exist).

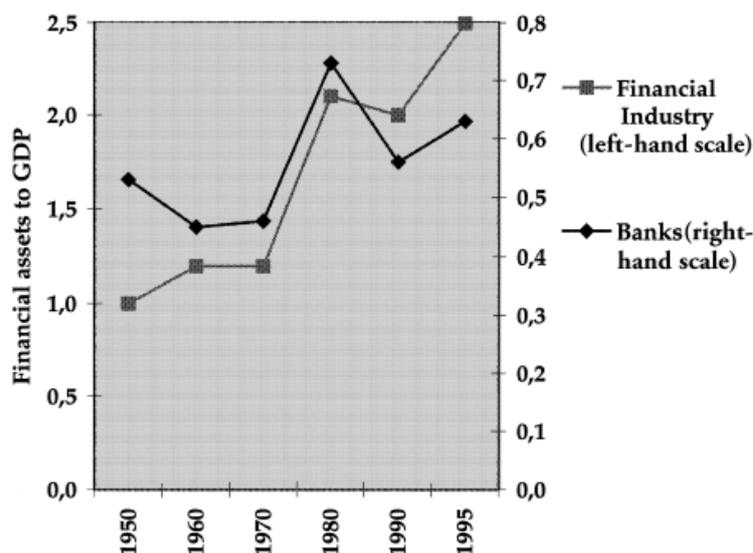
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<sup>59</sup> Researchers from this research line focus on the effects of the financial system on real economic development rather than trying to explain how financial intermediaries emerge.

Likewise, the technological revolution which substantially reduced the cost for information and information asymmetries did not lead towards direct participation of households in capital markets. On the contrary, they argue that financial markets for equity and debt are becoming increasingly dominated by intermediaries (Allen and Santomero 1997: 1474), especially since intermediaries not only hold but also create the bulk of an increasing number of innovative financial products (Merton 1995). Thus, the “distribution function” (combining “Clearing & Settling”, “Pooling” and “Transferring Resources”) caused by transaction costs and the “originating and servicing function” (combining the “Information” and “Incentives” function) due to asymmetric information cannot be the principal reasons for financial intermediaries to exist. Following the functional perspective, they assume risk distribution (or risk management) to be the pivotal function in modern financial systems.

This line of argument was then taken up by Scholtens and Wensveen (2000; 2003) who also explicitly reject the view that a process of disintermediation is defining the development of modern financial markets. Even though the participation of mutual and pension funds such as insurance companies relative to depository institutions increased (see Chapter 2.1.1), the relative share of financial assets to GDP held by banks did not, as shown in Figure 3.1.

**Figure 3.1: Relative size of the U.S. financial sector and the banking industry, 1950-1995**



Source: Scholtens and Wensveen (2000: 1246) based on Barth, Nolle et al. (1997)

The relative size of depository institutions in the U.S. in the mid 1990s was almost two times larger than in the 1950s. Scholtens and Wensveen (2000: 1247), thus, conclude that financial intermediaries are of increasing importance to the modern economy. This view also holds on international level as discussed by Schmidt, Hackerthal et al. (1999) for the case of Europe. The authors

assess whether banks have been losing importance relative to markets in France, Germany and the UK. They find that there is no decline in the importance of banks in Germany or the UK, while in France there are signs of a decline in banks and a move towards markets. However, they find an extension of the length of the intermediation chain, while banks concentrate more on lending activities leaving the task of savings mobilization to non-bank financial intermediaries. Scholtens and Wensveen agree with Allen and Santomero that risk management is the central issue. Especially since the emergence of modern portfolio theory, risk analysis plays a key role in the research on securities and derivatives and is fully incorporated on the micro level in pricing models. However, they question that risk management has only gained importance since the 1960s and 1970s as suggested by Allen and Santomero (1997: 1482-1483). They argue that the “risk/reward relation” has not yet been analyzed on the industry level or the macro level. They take the examples of merchant bankers in the Italian Renaissance (managing the financial risks of kings, popes and merchants), insurers taking over risks of merchants sending their goods overseas and investment bankers of the eighteenth century’s Dutch Republic actively assuming underwriting risks to argue that *“dealing with risk is – and always has been – the bread and butter of financial intermediaries”* (Scholtens and van Wensveen 2000: 1248). For them, even the “seemingly dull” business of savings and loans associations in the U.S. in the 1950s and 1960s is risk management as they manage interest rate risk, credit risk and liquidity risk.

As a response, Allen and Santomero (2001) precise their argument stating that in financial markets, where a significant competition for depository institutions is absent (as is the case in Japan, France and Germany), intermediaries are able to eliminate risk by inter-temporal smoothing. This term refers to *“build up reserves of short term liquid assets when returns are high and run them down when they are low”* (Allen and Santomero 2001: 290). Whereas in countries with more developed and accessible capital markets (like the U.S. and UK), intermediaries cannot engage in such inter-temporal smoothing as investors would withdraw their funds completely and invest them in markets instead. Therefore, intermediaries must deal with risk through cross-sectional risk sharing, and as a result, risk management results in *“investing in derivatives and other similar kinds of strategy, rather than carrying reserves over from one period to another”* (Allen and Santomero 2001: 290). Thus, the shift that occurred in the 1970s rather refers to the question of how financial intermediaries dealt with risk before and after financial globalization and the move towards markets rather than the question whether risk management (opposed to transaction costs and asymmetric information) gained importance or not.

To further dissociate the informational asymmetries approach from the risk management approach, Scholtens and Wensveen (2003) point to the fact that one may wonder whether asymmetric information does not include risk, since a lack of transparency in bargaining situations involves a risk for the less informed party. While this is true, they argue that risk involves much

more than uncertainty because of a lack of complete information: *“Risk predominantly refers to a chance of unpredictable emergencies for both contracting parties. In other words, not asymmetric distribution of information but no (secure) information at all, even with perfect ad hoc information on both sides, on future events is at the heart of the financial business”* (Scholtens and Wensveen 2003: 36).

In consequence, Allen and Santomero (1997) as well as Scholtens and Wensveen (2003) do not see financial intermediaries as more or less passive agents providing solutions for savers as long as market imperfections persist. Instead, they define these intermediaries as active market participants highly involved in creating added value through the development of an increasing number of financial instruments and combinations of the same tackling each time new market segments. If all possible combinations would have been created, the “Arrow-Debreu world” would have been reached. But as *“zillions of missing markets”* (Scholtens and Wensveen 2003: 35) exist – and others will possibly still emerge in the future – it is still a very long way towards this world. This way might be even longer, as intermediaries fearing their own extinction have a vivid interest in creating new financial innovations in order to stay alive. By creating new instruments, so goes the argument of Scholtens and Wensveen (2003: 37-39), financial intermediaries “de-homogenize” the markets and by carving niches for specific product-market combinations and specific geographical areas, they differentiate the market and even create market imperfections in so far as new products and databases for marketing purposes contain unique, captive information. The newly created market imperfections are justified as financial intermediaries create value for their costumers and so are the transaction costs paid by those costumers to the intermediaries. The value that the intermediary creates results from its core function namely risk transformation (either on or off balance sheet) between the risk preferences of the savers/ultimate investors and entrepreneurial borrowers. Intermediation becomes necessary, whenever demand and supply of capital cannot be met because of divergent risk preferences of market participants. Stagnant information flows, unreliable information or idiosyncratic shocks can temporarily lead to adverse selection or credit rationing and disturb the intermediation process. However, according to Scholtens and Wensveen, this has little to do with the normal intermediation process.

Interestingly, – even though perhaps not intended by the authors cited above – the view on financial intermediation as an innovative, value-creating and finally growth enhancing process has much in common with much older approaches towards the analysis of the banking business. Keynes’ view that the wealth owner rather than the consumer is the ultimate sovereign in the economy is already reflected to a certain degree in the amended Theory of Financial Intermedia-

tion à la Scholtens and Wensveen. Especially the notion that risk<sup>60</sup>, or better risk preferences, determines the activities of financial intermediaries and with this the price they can charge – the interest rate as a risk premium –, point to what Keynes had in mind when explaining the liquidity preferences of wealth owners within limited hoarding opportunities in money, the level of interest rates serving as an incentive not to hoard (Keynes 1937: 210-211). This approach was further deepened by the Berlin School of Monetary Keynesianism – headed by Hajo Riese – which emphasizes a partial shift of wealth owners' sovereignty towards financial institutions, including the central bank. The latter can create money *ex-nihilo* and lend this to financial institutions, which again provide entrepreneurs with the means to purchase goods from the wealth owners. Thus, the economy does not depend on the savings of wealth owners but on their willingness to hold financial instead of real assets (Nitsch 1999: 186-189; Riese 1986). The creation of credit as well as of money “from nothing” and the partial autonomy of the financial sector disconnects to some degree the monetary sphere from the real economy, where money only serves as means of exchange. With that, Keynes intended to formulate a “monetary theory of production” within a Saysian rather than Walrasian equilibrium (Riese 1986: 3).

The point of departure for a monetary theory of development is Schumpeter's “The Theory of Economic Development” (Riese 1986; Schumpeter [1934] 2008: 3) in which he stresses the importance of “the banker” for economic development in the sense of growth. Here too, new purchasing power is created through credit “*ex-nihilo*”. This loan is neither backed with money in the strict sense nor by real assets (products) already in existence (Schumpeter [1934] 2008:106). What is central in Schumpeter's approach, however, is the existence of (a few) innovative entrepreneurs who actually set in value the money at hand through “*new combinations of means of production*” (Schumpeter [1934] 2008:74) or even through “creative destruction”. The banker is not so much a middleman (intermediary) of the commodity “purchasing power”, but rather its producer. He creates present purchasing power based on the promise of and trust in (uncertain) future benefits. Schumpeter also assumes, that the number of possible innovations is practically unlimited: “*Every improvement leads further away from the appearance of absolute perfection*” (Schumpeter [1934] 2008:197). This is the very reason for a vivid financial market to emerge, in which financial institutions can (in theory) increase their leverage in an unlimited way. Through this initiated development, bank-credit penetrates into the transactions of what Schumpeter calls the “circular flow” (Schumpeter [1934] 2008:124) to describe the classical Walrasian equilibrium market for regular business or consumption loans emphasizing the sharp contrast to productive loans provided to entrepreneurs. According to Schumpeter, a common mistake is to equalize interest with entrepreneurial profits. There is no such thing as permanent net returns for one innovative good. Generally, once established, a business enters into the circular flow, headed by

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<sup>60</sup> Knight would rather use the term uncertainty than risk. The clarification of the appropriate terminology will be provided in the next section. At this point, the author sticks to the ample definition of risk.

what now must be called a business-manager (“Wirt”).<sup>61</sup> Regular business loans are (or should be?) indeed backed by real assets and financed through savings within the circular flow.

Despite many similarities between Schumpeter’s theory on interest, capital and profits and the amended Theory of Financial Intermediation proposed by Allen and Santomero as well as Scholtens and Wensveen, the latter do not specifically highlight the importance of innovations in the real economy. Here, the innovative forces at the level of the financial system are what counts, in order “to tackle new markets, new products, new agents” (Scholtens and Wensveen 2003: 35). It is not clear whether these “new” markets are actually new in the sense of innovative, or simply unknown. The customer orientation of financial intermediaries is primarily highlighted towards savers and investors, not towards borrowers (and possible entrepreneurs) and by doing so, they seem to fall back into the orthodox logic.

The following Table 3.1 summarizes the different views on the financial sector and financial institutions as presented here:

**Table 3.1: Orthodox contemporary and amended Theory of Financial Intermediation**

	<b>Orthodox Contemporary Theory</b>	<b>Amended Theory according to Scholtens &amp; Wensveen</b>	<b>Amended Theory integrating Keynes and Schumpeter</b>
<b>View on the financial system</b>	Static: perfect market differentiation	Dynamic: financial market development	Dynamic: creation of credit and money ex-nihilo
<b>Main objective of financial system</b>	Efficient allocation of savings	Qualitative asset transformation; risk transformation	Productive allocation of wealth
<b>Role of financial institutions for development</b>	Reduction of market imperfections: transaction costs and asymmetric information	Value creation – oriented mainly towards savers and real investors	Value creation – oriented mainly towards entrepreneurs
<b>Role of financial intermediaries in equilibrium</b>	Financial intermediaries as agents (monitoring loans on behalf of depositors)	Financial intermediaries as risk-taking providers of financial services	Financial intermediaries between wealth owners, the central bank, and borrowers/entrepreneurs
<b>Problems to be solved</b>	Adverse selection, moral hazard, credit rationing	Risk/reward optimization (risk management)	Uncertainty – trust in future profits
<b>Reasons for institutional changes</b>	Disintermediation	Dynamics of intermediation (new markets, new products, new agents)	Dynamics of intermediation (entrepreneurial innovation, “creative destruction”)
<b>Customer orientation mainly towards</b>	Savers/Investors	Savers/Investors	Wealth owners and entrepreneurs

Source: Own elaboration adapted from Scholtens and Wensveen (2003:38)

<sup>61</sup> A “Wirt”, or business-manager (sometimes) also being the business-owner, can be defined as a usual businessman or –woman doing things the “normal” way without notable innovations. Schumpeter does count for exceptions, where within a single (big) enterprise the business-managers are constantly replaced by entrepreneurs enhancing innovation.

But what then is innovative in financial innovation then? Considering the massive trade of financial assets between financial intermediaries, the creation of innovative financial products might be explained through the same principle as the creation of credit between “the banker and his entrepreneur”. Between banks the same mechanism can be put in motion, namely the creation of credit ex-nihilo with a (theoretically) unlimited leverage, as long as the central bank can be counted on as a lender of last resort and implicitly the state as ultimate risk-taker (Nitsch 2010:15-17). In this setting, financial intermediaries function as investors and as entrepreneurs so that the financial system seems to become largely self-referential. Whether this is actually the case and what this means for the role of rating agencies within the financial market is subject to analysis in Chapter 4.

Concerning the activities of financial intermediaries within the equilibrium (the “circular flow”) Allen and Santomero offer an additional argument for the existence of financial intermediaries, namely the reduction of participation costs. By asking “Who is the market?” they divide market participants into two groups, “loosely defined as the involved and uninvolved” (Allen and Santomero 1997:1480). One group is the “typical”, fully informed market participant in economic theory, at all times active in the dynamic management of her or his asset portfolio. The other group is the one of the uninformed, making decisions with limited information on both the nature of financial claims as well as the most recent information on fair market value. They then argue that it is the second group that financial intermediaries offer participation services – by offering information to the uninformed investor, by investing on their behalf, or by offering fixed income claims against the intermediaries’ balance sheets. The intermediary thus adds value by reducing the perceived participation costs of the uninformed investor. Based on numerous empirical studies, they find that most individuals hold a little diversified portfolio which at the same time cannot be explained by investors holding mutual funds (as until the 1980s only 5% of households’ equity was held in mutual funds). The plausible explanation for Allen and Santomero is that the limited market participation is due to the existence of fixed costs of learning about a particular stock or other financial instrument. Additionally, there are extensive marginal costs of monitoring markets on a day to day basis in order to adequately adjust the portfolio. As the traditional explanation for individuals using intermediaries – the desire to diversify and high trading costs – does not hold anymore, the increasing importance of mutual funds can be explained in terms of participation costs.

Allen and Santomero further argue that the value of people’s time, particularly that of many professionals, has increased to a significant extent in the last 15 years. As mutual funds have low participation costs they are an efficient method for individual investments. Also the use of innovative financial instruments for risk management can be partly explained with participation costs.

If these costs wouldn't exist, households should constantly review their portfolio as new information becomes available. This is unrealistic, when participation costs exist, but it does explain why financial intermediaries are creating products with a relative stable distribution of returns. Financial innovation allows (uninformed) investors to monitor their portfolio on a relatively infrequent basis. A feature of securities investors hold which might be noteworthy is that many of them are debt or debt-like. Debt has relatively low participation costs. Except the risk of default, there is no need to monitor these assets through time, and thus, costs of learning about the market are low. The value of such securities increases to the extent the probability of default can be lowered. Allen and Santomero conclude that a theory of intermediation based on participation costs is consistent with the fact that intermediaries trade and manage risk to such a large extent (Allen and Santomero 1997:1482). Even though Scholtens and Wensveen (2000:1248-1249) disagree (again) that participation costs could explain any changes in the financial markets<sup>62</sup> they do agree that participation costs could be relevant to explain new roles of financial intermediaries. The latter might also include rating agencies and their role to produce reliable information on the risk of default for debt contracts.

In sum, the functional perspective within the Theory of Financial Intermediation offers valuable categories for the departure of the analysis of different functions credit ratings may exercise in financial markets. However, for a critical appraisal of possible functions of credit ratings and, more specifically, of those done by the major credit rating agencies, a broader understanding of some assumptions and definitions lying behind economic theorizing are necessary. The next section tackles one of these issues by providing a deeper understanding of what is risk and how it can possibly be managed.

### **3.3 Dealing with Credit Risk – Linking and Confusing Uncertainty with Default Probability**

Even though risk management has been defined as one of the core functions of financial intermediaries by Merton (1995), a definition of risk is lacking. Nor does the leading textbook “Principles of Corporate Finance” (Brealey and Myers 2003) for university students, for example, clarify the meaning of risk. Instead, Brealey and Myers (2003: 755, 153-154) take risk as “God-given” and turn directly to different management strategies to deal with god's will. They state that “risk ranking” is an intuitive exercise and that investments face different degrees of risk while their intuition leads to the conclusion that treasury bills *“are about as safe an investment you can*

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<sup>62</sup> They argue that direct participation of (high worth and time scarce) individuals indeed increased as did the number of mutual funds. Additionally, they argue that the desire for products with a relatively stable distribution of returns was the principle motive ever since for savers to put their money into banks.

*make. There is no risk of default (...)*"(Brealey and Myers 2003: 154). The events of the 2008 financial crisis question (again) the validity of such statements. Even though it was not the government of the United States which defaulted on its obligations, there were a series of securities considered to have a very low default probability whereas the risk assessment of these securities turned out to be painfully mistaken. As rating agencies are (ostensibly) in the business of risk assessment and prediction of default probabilities, this sub-chapter draws closer on the definition of risk and how this refers to (default) probability.

The point of the departure here is the Bayesian view of probability as it seems to be predominant in economic theory. This approach is contrasted with differentiation of risk and uncertainty provided by Knight and Keynes. The aim is to shed light on the question what kind of probabilities (if any) are given by rating agencies and how market participants (should) deal with them. However, a detailed discussion of the theory of probability and its mathematical implications lies beyond the scope and purpose of this study. Instead, the focus lies on the identification of different types of probabilities and their theoretical relations to risk. In a second step, some insights from psychologist and behavioral economists about how individuals form their beliefs in order to deal with risk is provided, questioning explicitly the rationality of market participants and thus the premise of efficient markets. In contrast to the economic theory of financial markets, behavioral economists claim that inefficient markets do not evolve due to asymmetric information but rather due to the psychological patterns of human beings. This, however, raises the question whether credit ratings might not address the particular formation of beliefs of (sometimes) irrational market participants rather than reduce information asymmetries in order to form the basis for rational choices. The last sub-chapter summarizes the different approaches to define risk and how the behavioral component might influence the definition. In general terms, the sub-chapter argues that rating agencies help anticipate an uncertain future. However, there are two different schools of thought in how far risk can be expressed as a numerical default probability. The sub-chapter shows that while one might be more appropriate the other will be the preferred option. The first draws a clear distinction between risk and uncertainty, highlighting the limitations when approaching risk quantitatively. This especially applies to situations where the likelihood of any event is increasingly influenced by human interaction and less defined by a kind of natural law. The second puts insurable insecurity and sheer luck (or fate) into the same category, to be dealt with under the heading of "risk management".

### 3.3.1 Different Approaches to Define Credit Risk

Since rating agencies are in the business of assessing risk, the question arises in how far their evaluation can predict the likelihood of a default in statistically relevant terms (probability). Fight (2001: 244-246) clearly rejects this view:

*“In other words, the entire argument behind ratings can be summarized as a subjective exercise based on pseudoscientific methods, inconsistent criteria, and ethnocentric viewpoints practiced by analysts who have no recognized qualifications and whose sole criterion for their credibility is the blind faith of the entities consuming their wares [...] There is a serious need to understand the methodologies used by rating agencies to pronounce their judgments on swathes of industry, commerce, finance, and government [...] For under examination, these methodologies hardly seem rigorous as in the method of rigorous scientific inquiry. They exhibit the characteristics of pseudoscience hijacked by marketing gurus.”*

On the other hand, evidence can be found that market participants indeed believe that credit ratings are adequate measures for default probabilities, as exemplified by a study on credit ratings by the European Central Bank (Gonzalez, F. Haas *et al.* 2004: 16):

*“Ratings are a cardinal measure of credit risk, if used over an unspecific long horizon. Indeed, over the long-term, ratings are found by academic studies to be an accurate and unbiased estimator of default probabilities. Thus, while ratings are ordinal in their design, associations can be drawn with cardinal probabilities of default in the long-term.”*

The latter statement refers to the translation of letter grades into numerical default probabilities in the default studies introduced in Chapter 3.1. But who is right? Three main questions arise when approaching this subject: First, how do rating agencies exactly form their opinions? Or, can their judgments somehow approach “the reality”? Second, can these judgments be translated into any numerical value even ex-post? Third, how do market participants deal with these ratings and why do they rely that much on rating agencies’ statements?

At the heart of these issues lie however questions much more profound: What is credit risk? The definition of risk provided by Scholtens and Wensveen (2003: 36, footnote 6) is, if anything, confusing, when trying to explain any kind of risk assessment:

*“Risk predominantly refers to a chance of unpredictable emergencies for both contracting parties. In other words, not asymmetric distribution of information but no (secure) information at all, even with perfect ad hoc information on both sides, on future events is at the heart of the financial business.”*

In general, one could also refer to “uncertainty” when describing the fact that we have “no information at all”. Without any information at all the future in fact has to be considered unpredictable and no distinction has to be made between uncertainty and risk. Then, risk management is de-linked from risk assessment and achieved rather through (perfect) diversification, just as the modern portfolio theory seems to suggest. According to modern portfolio theory, two major risk categories can be distinguished: 1) systematic (or systemic) and 2) unsystematic, idiosyncratic or specific risks. Systematic risk refers to the risk that cannot be avoided through perfect diversification (Hockmann and Thießen 2007: 648). Systematic risks refer to overall market risks and “*refers to the risk or probability of breakdowns in an entire system, as opposed to breakdowns in individual parts or components, and is evidenced by co-movements (correlation) among most or all the parts*” Kaufman and Scott (2003: 371). In contrast, specific risks are inherent in each investment one makes. Specific risks can be eradicated through appropriate diversification.

However, in order to diversify, financial intermediaries do not distribute their money randomly but get indeed engaged in risk assessment (or measurement) in order to make sound, informed or even “perfect” decisions of diversification. They do so by assigning “chances” (Scholtens and Wensveen 2003: 36) or “probabilities” (Kaufman and Scott 2003: 371) to future events while making them predictable. In this sense, financial intermediaries in general and rating agencies in particular are in the business of transforming uncertainty into manageable risk.

Maintaining the principle that risk has to do with anticipation, risk in economic theorizing – in contrast to general uncertainty – is generally treated as probabilities finding its expression in clearly defined numerical values. According to Runde (1995), economists fall into two groups in the discussion about uncertainties and beliefs about probabilities. The second group follows a frequentistic approach, which will be discussed further below. The most prevalent view in economic theory, however, is the Bayesian (and the decision theory), where even in the absence of “objective” probabilities consistent rational choices can be made on the base of “prior probabilities”, which are then updated in the light of new relevant data. The “posterior probability” (or conditional probability) of an event can be interpreted as a measure of a state of knowledge or – as Runde (1995: 336) puts it – as “*the strength of the agent’s personal belief in that event*”. This theory does not make claims about observer-independent probabilities in the sense that it presupposes the existence of homogenous repeated events and therefore avoids entering into the discussion about the connection between agent’s beliefs and reality as mind-independent probabilities (Runde 1995: 337). In this sense, the distinction between uncertainty and risk becomes redundant. A probability is assigned to a hypothesis and – in the objectivists’ view – can well be entered into a numerical calculus by a logical interpretation. Bayesianism claims that all type of uncertainties must be described as probabilities while the numerical representation would be a “*calculus of plausibility of statements*” or even simpler “*quantified values and beliefs*” (Runde

1995: 339). A presupposition in order to make Bayes' theorem work, however, is the requirement of rationality and consistency of agents' decision-making. In order to take rational choices, it is assumed that agents must evaluate options *"in terms of the mathematical expectations of the value of their consequences and they must always be prepared to act on their beliefs"* (Runde 1995: 338). Runde (1995: 339) then rightly questions the assumption that agents always have real-valued degrees of beliefs. Ellsberg (1961) – based on an empirical study about the absence of widespread betting in a situation of "vague" probabilities – points to the fact that most people do not or do not act "as if" they assign numerical probabilities to the outcome of all events.

Proponents of the Bayesian interpretation answer in two ways (Runde 1995: 339): First, some admit that there might be plausible psychological reasons for this behavior which ultimately constitutes a failure of rationality. This, however, would have serious consequences for the normative justification of the theory. Second, those reluctant to give up the rationality assumption state that the reluctance to bet is a rational response to the possibility of asymmetric information. People might suspect that those "vague" probabilities rather represent an informational advantage of the person offering the bet than the "vagueness" of beliefs (and thus probabilities) as such.

When looking at the definition of credit ratings by rating agencies as "opinions", it becomes clear that rating analysts themselves do not assign an ex-ante numerical default probability to the hypothesis that an issuer might default in the future given the quantitative as well as qualitative data analyzed. The ordinal design of letter grades for credit ratings simply implies that an issuer rated AAA is less likely to default than an issuer with a AA rating without any reference on how much more likely it is that the second issuer defaults compared to the first. This is at least the case for credit ratings where analysts do not rely on econometric models to assess default probabilities. However, the ex-post assignment of numerical default probabilities associated with a specific letter grade based on default studies does fit into the Bayesian view that agents revise their beliefs with the appearance of new evidence even though the quantification based on the statistical verification rather forms than updates these beliefs.

Yet, some economists insist that there should be a distinction between risk and uncertainty, especially in more heterodox strands of the discipline. Since the 1980s, this view has begun to emerge also in mainstream economics (Runde 1995: 330). This distinction goes back to a chance-based interpretation of probabilities. Frank Knight (1921) and John Maynard Keynes (Keynes [1921], 2008) can be seen as the most prominent (an originating) representatives of this view offering also philosophically sophisticated statements about the matter. Even though Knight supports a frequency view while Keynes follows a "logical" perspective the two approaches have important similarities worthwhile to be discussed together.

A chance (as opposed to a choice in the Bayesian view) is *“a numerical proportion of a class of equi-probable A’s that are also B’s. The central metaphysical proportion pre-supposition of the chance-based approach to probability, then, is the existence of such classes”* (Runde 1995: 331). The principle distinction of Knight as well as Keynes, most people seem to have in mind, is between a situation in which agents rely on “known chances” (Knight 1921: 21) and situations where they do not. The first is a situation of risk where agents assign probabilities based on “known chances” while chances are defined as numerical proportions of otherwise homogenous A’s that are also B’s. Situations of uncertainty prevail when agents cannot assign probabilities to events because it is not possible to calculate chances. Knight further distinguishes between a priori probabilities, statistical probabilities and estimates with the following meanings (Knight 1921: 224-225):

*“1. A priori probability: Absolutely homogenous classification of instances completely identical except for really indeterminate factors. This judgment of probability is on the same logical plane as the propositions of mathematics (which also may be viewed, and are viewed by the writer, as “ultimately” inductions from experience).*

*2. Statistical probability: Empirical evaluation of the frequency of associations between predicates not analyzable into varying combinations of equally probable alternatives. It must be emphasized that any high degree in confidence that the propositions found in the past will hold in the future is still based on an a priori judgment of indeterminateness. Two complications are to be kept separate: first, the impossibility of eliminating all factors not really indeterminate; and second, the impossibility of enumerating the equally probable alternatives involved and determining their mode of combination so as to evaluate the probability by a priori calculation. The main distinguishing characteristic of this type is that it rests on an empirical classification of instances.*

*3. Estimates. The distinction here is that there is no valid basis of any kind for classifying instances. This form of probability is involved in the greatest logical difficulties of all, and no very satisfactory discussion of it can be given, but its distinction from the other types must be emphasized and some of its complicated relations indicated.”*

The classical example for the first type of probability is throwing an un-weighted dice. The best example for the second type of probability is doing the same with a weighted dice. In order to calculate a probability on which side the dice will fall we would have to exercise homogenous trials (or they must at least be treated “as if” they were) meaning that we would need to throw the dice from the same height, in the same angle, into the same direction etc.

It soon becomes clear that, from this perspective, it must be a misconception that ratings in the long run express numerical default probabilities. This would mean that rating exercises (the trials) must have stayed the same over the last 100 years. This assumption (and actually nobody claims

they did) cannot be held, not only because of the judgmental dimension of credit ratings based on qualitative, non-homogenous information but also because of the fact that the methodologies change over time. The value of credit ratings and the knowledge of rating agencies lie exactly in the capability of changing their assessments of likely future defaults as new evidence appears.

The incorporation of new evidence into any anticipation exercise certainly increases the “weights of arguments” – speaking in Keynes’ terms (Keynes [1921], 2008: 71). However, to measure the evidential weight presents similar difficulties as with the measurement of probabilities: “*when we give the preference to one set of arguments above another, we do nothing but decide from our feeling concerning the superiority of their influence*” (Hume, cited in Keynes [1921], 2008: 70). Credit ratings can thus be best described as estimates about future defaults, however vague or liable to error these estimates (or judgments) may be. Even though people are very much concerned about future outcomes, the knowledge about the future must be described as uncertain. This is especially true in situations where risk is based on human interaction:

*“The game of roulette is not subject, in this sense, to uncertainty; nor is the prospect of a Victory board being drawn. Or, again, the expectation of life is only slightly uncertain. Even the weather is only moderately uncertain. The sense in which I am using the term is that in which the prospect of a European war is uncertain, or the price of copper and the rate of interest in twenty years hence, of the obsolescence of a new invention, of the position of private wealth-owners in the social system in 1970”* (Keynes 1937: 213-214).

Thus, what is really uncertain is what Beck and Giddens (Beck 2006: 335; Giddens 1999: 4) call manufactured uncertainty based on human actions which is not reducible to mathematical probabilities multiplied with the intensity and scope of potential harm (the impact) – which has been one of the central statements in Taleb’s (2008) bestseller “The Black Swan”<sup>63</sup>. Taleb (2008: 61) states, that the sources of Black Swans<sup>64</sup> “*have multiplied beyond measurability*” out of the consequence of human action, which makes us live in “extremistan” rather than “mediocristan”. In “extremistan” randomness is based on Black Swans. This does not allow thinking that randomness is based on ordinary fluctuations, which is usually assumed when calculating statistical prob-

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<sup>63</sup> The central thesis of this book is that surprising events have a major impact while after the fact, these events are rationalized by hindsight. Taleb stresses that those events are not computable using scientific methods based on probability assumptions, given that the probability of these events is a priori low. Due to his style, academics (especially mainstream economists) have some problems to recognize Taleb’s theory. Taleb considers himself as a philosopher; however, he long worked as a quantitative analyst (a “quant”). Since 2008 Taleb works as Distinguished Professor of Risk Engineering at the New York University, Polytechnic Institute. For a discussion of Taleb’s central thesis see Runde (2009).

<sup>64</sup> A Black Swan is an event with low a priori probability but high impact once it happens.

abilities<sup>65</sup>. Thus, situations of choice are those, where the probability of an event to occur is not (only) based on some fundamental law of nature but also (and increasingly) on human decision-making. Referring to the previously introduced risk classification of modern portfolio theory, one could say that systemic risks prevail in “extremistan”.

### 3.3.2 Uncertainty and Irrationality – Credit Ratings from a Behavioral Perspective

Nevertheless, the necessity for action and decision and in order to “*save our faces as rational, economic men*” (Keynes 1937: 214) makes people forget this fact and behave “as if” everybody did a Benthamite calculation of utilities, each multiplied by its probability. Keynes (1937: 214) identifies the following three ways to do so:

- “1. *We assume that the present is a much more serviceable guide to the future than a candid examination of the past experience would show it to have been hitherto. In other words we largely ignore the prospect of future changes about the actual character of which we know nothing.*
2. *We assume that the existing state of opinion as expressed in prices and the character of existing output is based on a correct summing up of future prospects, so that we can accept it as such unless and until something new and relevant comes into the picture.*
3. *Knowing that our own individual judgment is worthless, we endeavor to fall back on the judgment of the rest of the world which is perhaps better informed. That is, we endeavor to conform with the behavior of the majority or the average. The psychology of a society of individuals each of whom is endeavoring to copy the others leads to what we may strictly term a conventional judgment.”*

The last point refers to what is known as “Keynes’ beauty contest”. In his “General Theory” he compares the behavior of investors in financial markets with the on-goings of newspaper beauty contests where competitors are rewarded for picking the face which on average was considered the most beautiful. That means, that participants do not need to pick the face they consider most beautiful but the one they think the majority would find the prettiest. However, as all competitors are looking at the problem from the same point of view “*we have reached the third degree where we devote our intelligence to anticipating what average opinion expects the average opinion to be*” (Keynes [1936] 1997: 156).

For a rational actor it might be appropriate to base his or her investment decisions on ratings even though he or she does not believe that ratings reflect a numerical probability. He or she

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<sup>65</sup> The Gaussian Bell Curve is the most basic empirical distribution function based on the assumption of ordinary fluctuations.

does not even have to share the same opinion regarding the ordinal classification or might disagree with the informational content. As long as investors expect that other investors base their decisions on these credit ratings it would be totally rational to do so as well. This is even more true if credit ratings themselves are not so much based on “fundamentals” as rating agencies always claim (whatever these fundamentals are supposed to be), but rather reflect the conventional judgment itself. Interestingly enough, even though people (here investors and rating analysts alike) ignore factors that they can know nothing about, accepting that current valuations are a correct reflection of future prospects while focusing only in changing news to “correct” their expectations, this conventional method of calculation can lead to a relative continuity and stability, *“so long as we can rely on the maintenance of the convention”* (Keynes [1936] 1997: 152). Applied to the present research, credit ratings can then become a self-fulfilling prophecy. However, the conventional judgment, as it is *“based on so flimsy a foundation”* (Keynes 1937: 214) is subject to sudden and violent changes: *“The practice of calmness and immobility, of certainty and security, suddenly breaks down”* (Keynes 1937: 215). Anyway, after a short period of disillusion a new conventional judgment may be imposed. Keynes accuses the economic theorists of trying to deal with the present by abstracting from the fact that we know little about the future and that theories about how we behave in the market place should not submit themselves to marketplace idols (Keynes 1937: 215).

Newer studies from the field of behavior finance shed additional light into the subject. Shefrin (2000) provides a good overview of the principle themes to understand the psychology of investing. First of all, behavioral economists are concerned with the processes of how people find things out for themselves based on their personal experiences. Shefrin (2000: 13) states that people tend to develop rules of thumb. The big advantage of a behavioral perspective is then the identification of the principles underlying these rules of thumb which in fact have come to be called heuristics themselves.

The first “rule” is called “availability heuristics” which refers to the fact that people tend to rely on information easily available and they develop general principles as they find things out for themselves (Tversky and Kahnemann 1982). Shefrin (2000: 14-18) then refers to “representativeness” as one of the most important principles affecting financial decisions. Representativeness refers to the judgement based on stereotypes. Shefrin (2000: 165) further argues, that people rely on representativeness to assess likelihood. With the example of school grades – similarities to rating grades cannot be denied – he shows how people make (false) projections regarding the likely grade of the university degree of students based on their final high-school grade. People tend to be overconfident regarding their own guess setting their high guesses too low and their low guesses too high. Furthermore people tend to “anchor” their guesses based on their initial belief. These initial beliefs were formed by initial (easy available) information. One case of an

initial belief could be about the probability of default of a company based on the initial rating grade. People then tend to stick to their initial beliefs even though some new information would recommend to re-adjust the belief about e.g. a default probability or positive future earnings. Two different biases are held responsible for such an attitude. First, “belief perseverance” describes generally how people “*tend to hold on to their beliefs even when it appears that they should not. Belief perseverance is the tendency to cling to one’s initial belief even after receiving new information that contradicts or disconfirms the basis of that belief*” (Anderson 2007: 109).<sup>66</sup> Second, “confirmation bias” means that humans sometimes process information in an “illogical”, biased manner as it is seen to be more efficient in a world with increasing information flows (Casad 2007). Furthermore, motivation might influence reasoning (motivated reasoning), while motivation refers to any wish, desire, of preference towards the outcome of the reasoning. Two major motivation can be distinguished: a) to arrive to an accurate conclusion and b) to arrive a particular, directional conclusion (Smoak 2007).

Finally, the last heuristic principle is called “aversion to ambiguity” which means simply that people prefer the familiar to the unfamiliar and is labelled by Shefrin (2000:21) as “fear of the unknown”. The latter also suggests, that some of these heuristics describe both, a cognitive process – which shows similarities of what Keynes called conventional judgement – as well as an emotion. For the “availability heuristics” Shefrin (2000: 21-22) exemplifies the emotional sphere with a statement of the long-active money manager Russell Fuller who said that people like him (meaning people who are in the investment business since before the 1970s) were terrified by the stock market crash in 1973-1974. Even though it was a very low probability event he stated that many people in the business spent worrying the next 20 years about such an event happening again.

The second theme in behavioral economics is the one of “frame dependence”. A “frame” is the form in which a (decision) problem is described. Economists usually assume that objectively useful information is the only type of persuasive content that matters for market participants and define e.g. advertising as the information provision about the availability and quality of a commodity (Mullainathan, Schwartzstein *et al.* 2008). Thus, decisions of market participants are frame independent – an assumption which also lies in the heart of the Modigliani-Miller theorem – or frames are supposed to be transparent: “*This means that practitioners can see through all the different ways cash flows might be described*” (Shefrin 2000: 23). Behavioral economist argue instead that many frames are rather opaque, and when a person does not clearly see through such an opaque frame, decisions typically depend on the particular frame he or she uses: “*Conse-*

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<sup>66</sup> Note that the definition leaves open, what the initial belief should have looked like. Heuristic biases implicitly assume that the initial belief contains a mistake. However, that the initial belief was indeed erroneous can only be proven ex-post. The same is true for an update of the initial belief. In complex situations of human decision-making it might not be that simple to identify ex-ante the bias in the processing of information.

quently, a difference in form is also a difference in substance. Behavior reflects frame dependence” (Shefrin 2000: 23). A categorical comparison of “risk” by means of benchmarks like credit ratings can be such a frame and thus caters a certain form of behavior. If ex-post, these ratings gain in addition a “statistical costume” through the before mentioned accuracy ratios, they might indeed change in substance in the cognition of many market participants.

Frame dependence becomes especially important considering decisions in the face of risk and uncertainty as has been first shown by Kahneman and Tversky (1979). “Loss” and with that the risk to lose plays an important role. They showed that people tend to opt for a chance between losing more or less money than to accept a guaranteed loss even though the expected loss is the same in both cases. People hate to lose – Kahnemann and Tversky call it loss-aversion – and weight a loss about two and a half times the impact of a gain of the same magnitude. People gamble in their example because an uncertain choice (the chance) brings people hope that they won’t have to lose. However, people do differ in their tolerance of risk especially when they face a prospect of loss. Some people are risk-averse when facing gains but risk-seeking when facing losses (2000: 29-31). Again, both have a cognitive component – of how people organize their information – and an emotional component of how people feel registering their information. One of the most important feelings regarding loss is regret. However, regret is more than the pain of the loss itself. It is rather the feeling of being responsible for the loss. People who “suffer” a lot of regret when things go wrong tend to minimize possible future regret and do not necessarily seek an optimization of risk and returns. The regret-aversion (rather than risk-aversion) might thus also be a reason why people tend to “agree” (or do not question) the risk assessments of rating agencies. If people cannot eliminate uncertainty about the future anyway it might simply be comforting to rely on supposed experts’ judgments and accuse the “common beliefs”, if things go terribly wrong. Credit ratings could serve as a “chill-pill” and a scapegoat in order not to be paralyzed by the Platonic “I know that I know nothing”.

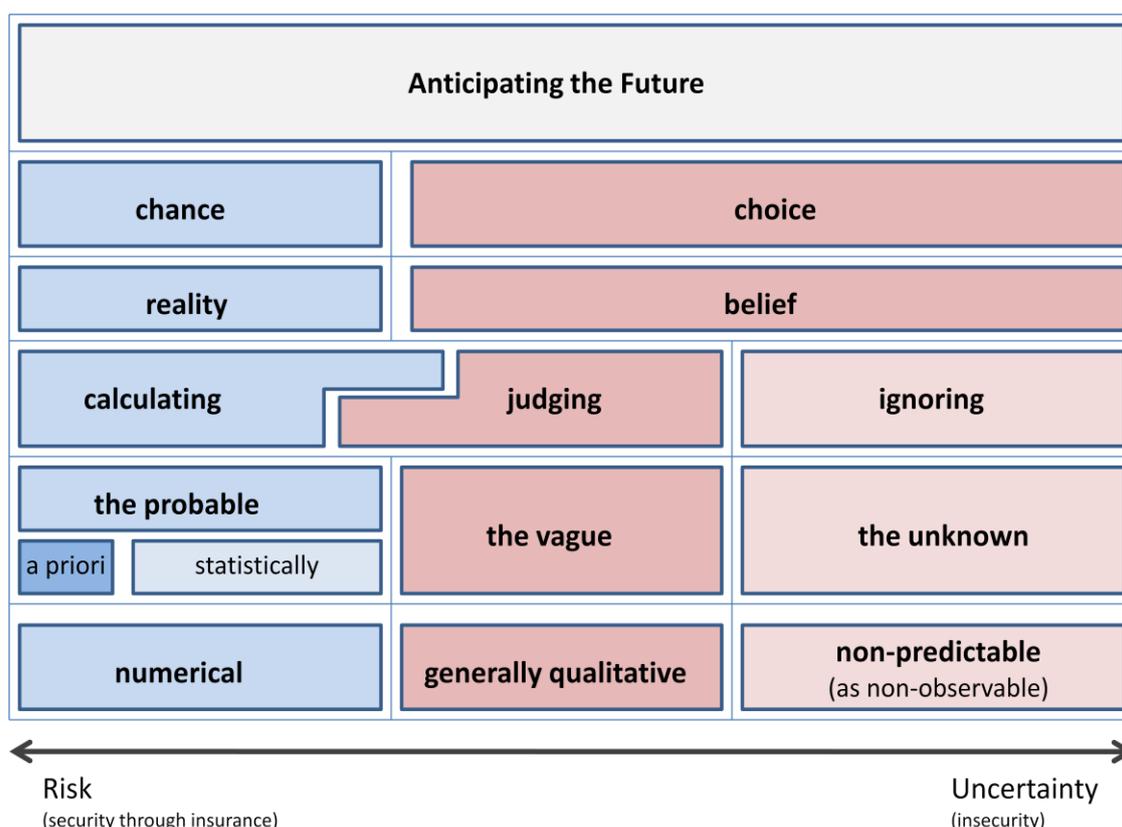
### **3.3.3 Summing-up – Anticipating the Future as a Matter of Judgment**

To finally answer the questions raised at the beginning of Chapter 3.3.1: Do the opinions (or judgments) of rating agencies somehow reflect the reality? Do these judgments have a numerical equivalent? And how do market participants deal with these ratings?; the different concepts and definitions of the previous sections are summarized. However, the definite answer is (unfortunately or not) a matter of choice what to believe – just as the definition of risk itself.

To start with, it should be kept hold of the fact, that rating agencies are – generally spoken – in the business of anticipating the unknown future. Up to this point, no distinction has to be made between risk and uncertainty. The extent, to which people want to control the future, might have

to do with the development of modern societies and their renunciation of the divine or the “superior force” (the force majeure). However, trying to capture the consequences of our actions (and non-actions), lies in the very nature of human beings. “To see things coming” and to react to situations before these events materialize is what distinguishes animals from conscious human life. It is also true, however, that our knowledge about the future – as Keynes has described it – has to be described as largely uncertain. The following Figure 3.2 summarizes the discussion of the previous sections:

**Figure 3.2: Mechanisms of anticipating the future and their possible relation to risk and uncertainty**



Source: Own elaboration

Note: One may think of adding other lines to the table, for example with the category of “how to deal with a situation” or any other category beyond those already presented as: “situation with regard of decision” (chance of choice), “what it represents” (reality or belief), “ways of assessment” (calculating, judging, ignoring), “the outcome” (the probable, the vague, the unknown) and “the form how it is represented” (numerical, generally qualitative, non-predictable).

First of all, a clear line between chance and choice should be drawn. Following Knight and Keynes only the former relates to the reality and can actually be calculated transforming itself into a numerical probability with a (more or less) high degree of certainty. Only in these cases, Knight

would speak about (measurable) risk, while any other situation would need to be described as (“true”) uncertainty (Knight 1921: 19-20). (Almost) absolute certainty can only be reached in those rare cases where the probability can even be calculated a priori. Whenever a probability is assessed statistically it already contains a component of judgment<sup>67</sup> as we have to make assumptions about the equi-probability of events leading to an empirical distribution function. From a Bayesian perspective of choice, probabilities can even be calculated on the base of beliefs whenever estimations are translated into numerical values, independently from its relation to reality. This happened in the moment credit ratings found its statistical representation in default studies which might, however, be misleading. Nevertheless, the likelihood of a specific event to occur in comparison to another might still be assessed in an ordinal manner based on the “weight of arguments” provided. The statement that human beings do not and cannot know anything about the future seems clearly overdrawn. Still, “the unknown” – one could also refer to it as “the never experienced” – exists and it is necessarily ignored. “We cannot know what we do not know” is the principle described by Luhmann’s “law” of observations of first order (Kneer and Nassehi 2000: 174).

Yet, the potential error of anticipation when not differentiating between risk and the suggestion of insurability on the one hand and (true) uncertainty on the other hand might have severe consequences. The ignorance of the unknown, thus, the consequences of actions of more or less rational individuals, leads to a situation where people must think “inside the box”. This is not only true when forming one’s own beliefs based on personal experience but also whenever the belief is based on somebody else’s observation. This leads to the frame dependence as highlighted by behavioral economists. Knight (1921: 13) referred to this phenomenon as follows:

*“If our social science is to yield fruits in an improved quality of human life, it must for the most part be ‘sold’ to the masses first. The necessity of making its literature not merely accurate and convincing, but as nearly ‘fool-proof’ as possible, is therefore manifest.”*

Based on biases and emotions when forming one’s beliefs might also lead to a situation where everything is perceived as risky (as opposed to uncertain), and thus, measurable in numerical terms and controllable as such<sup>68</sup>. Along the line between risk and uncertainty there might be situations which are clearly quantifiable and controllable while others are still manageable - either by accepting, avoiding or transferring them. Still others might require a considerable degree of flexibility ex-post which might even lie beyond the individual capacity, especially when it comes to situations where a specific event is influenced by the beliefs and (inter-)actions of different

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<sup>67</sup> Knight would say “estimation”.

<sup>68</sup> In fact, Knight might have even opened the door for this kind of reasoning even though his motivation was to question existing beliefs about the economic system, namely the existence of a general equilibrium, based on the missing differentiation between risk and uncertainty.

parties and the limited capability of anticipating these beliefs. The next section further explains, considering the perspective of (economic) sociology, how and under which premises these beliefs are formed.

### **3.4 Rating Agencies from a Sociological Perspective – The Meaning of Global Scientization within a “Risk Society”**

The methodological individualism in orthodox economics and the notion of rational choices economic individuals make is based on the assumption that they will always act in their own interest. When talking about “interests”, however, another problem appears. This concept in economic theory has stood for fundamental forces and motivation behind human action which are based on the urge for self-preservation and self-aggrandizement. In the 17<sup>th</sup> and 18<sup>th</sup> century interests “*were called upon to counteract the passions*” (Hirschman 1977: 489) from some economic thinkers while “interests” took the form of commerce and was supposed to calm the passions of kings and lords to transform a war-driven society into a peaceful and flourishing one. Since then, emotions had to be oppressed to make rational decisions which became also true for its analysis. At times, individual interest had a very inclusive meaning including honor, self-respect, glory, after-life etc. Then, it referred only to the drive for economic advantage (Hirschman 1992: 35). This means that “pursuing one’s interests” can become a tautology, and for analytical purposes it might be useful to stick to the narrow definition of traditional (economic) self-interest in the sense of (monetary) utility maximization. In this sense, by avoiding regret at the costs of losses is irrational in the sense that actors do not pursue profit maximization as their supposed-to-be prevalent interest but are guided by emotions. At the same time, theories based on this narrow definition of interest lose a lot of explanatory power as “*the only certain and predictable feature of human affairs is their unpredictability and futility of trying to reduce human action to a single motive – such as interest*” (Hirschman 1992: 53). The following two sections argue that individuals might not act in their own interest but respond to norms and values developed over time which might in turn influence the formation of interests. The way organizations work, which (in turn) can develop interests of their own, depends on their embeddedness in society and markets. Rating agencies as “uncertainty transformers” might simply respond to societal needs in the context of increasing risk based on human interaction. They possibly gain in importance as they increasingly draw a scientized picture, aspiring to control the future. They do so by forming an expert system people might find difficult to elude.

### 3.4.1 Abolishing Self-Interest and its Consequences – Systemic Organization of Risk Management

The abolishment of the separation of self-interest and other forces for behavior are on the agenda of economic sociologists. The traditional sociological perspective implies that human action is always based on culture which is *“immersed in a history, a tradition, a particular world and a particular form of common sense”* (Dupuy 1989: 51). Therewith, Dupuy (1989: 57-58) explicitly includes the type conventional judgment as presented by Keynes and described in Chapter 3.3.1. The *“signifying convention”* then manifests itself in a symbol as the mark and effect of collective will. However, the major contribution of this structural discourse is the insight that symbols at some point might not be any longer the effect of a convention but rather its source: *“Now it is the symbol that creates mankind in society, and not the reverse”* (Dupuy 1989: 60).

A little more concrete, Swedberg (2009: 239-243) states that *“structuralists”* refer to culture as the setting of values and that values often manifest themselves as norms. Culture becomes then *“constitutive”* as it influences the development of individual interests and their normative foundation. Whereas it is *“regulative”* whenever it limits the activities of individuals to act upon their own interest (DiMaggio 1994: 27-28). Still, there is no consensus on how to treat norms, and followers of the rational-choice approach within sociology criticize that sociologists treat norms as given instead of explaining how they evolve (Coleman 1990: 241-244). One outstanding exception and probably the most discussed work on how values define human economic action is Weber’s (1904-05) *“The Protestant Ethic and the Spirit of Capitalism”*. In a following work Weber applied his thesis to protestant sects stating that members of these sects can instill certain characteristics to other members and supervise them so that they follow a given set of standards or even a general economic way of life (Swedberg 2009: 251-252). Even though modern society should not be modeled as a homogenous global sect, it might still be true that values and the influence of their specific historical development evolve into norms and into stable dispositions or habits which organize the activities of economic agents in contrast to the concept of the homo oeconomicus who does not have a past and acts as if everything is new time and again. Bourdieu, for example, sees in the homo oeconomicus an *“anthropological monster”* (Bourdieu 2005: 209). Economic actors are not rational even though they can act responsibly according to a habitus which relates economic actions with past experiences (Swedberg 2009: 80). Swedberg therefore suggests linking both concepts assuming the existence of material as well as ideal interests while the latter refer to the cultural values which function as a position of points and influence the general dynamics and direction in which material interests can evolve. And the perceptions of these interests are structured by different cognitive mechanisms (Swedberg 2009: 239-243). Thus, there might be a complex interplay between economic, cultural and social forces (Bibow, Lewis *et al.* 2005: 520-521) also defining the functions of rating agencies.

In his programmatic work “Economic Action and Social Structures” Granovetter (1985) stresses the importance of a neither under- nor oversocialized view on the appearance of economic organizations. The former – as exemplified by the new institutional economics à la Williamson – would result in an optimistic functionalism in which organizations as a hierarchical order create trust and thus enhance efficiency.<sup>69</sup> However, Granovetter highlights that the more complete the trust, the bigger the potential gains from opportunistic behavior. For example, fraud is most efficiently pursued by teams which require a high level of internal trust (Granovetter 1985: 491-492). Accordingly, Granovetter (1985: 489) does not assume that organizations actually produce trust, but that they are rather a functional substitute for it. Even though he recognizes close personal relations as the major force of building up trust, he does not assume that this would necessarily lead to a complete integration of economic activities under one organizational roof, not even if the factor specificities require a high degree of integration. Instead, he highlights the importance of social relations (namely networks) forming specific organizational structures into which economic action has to be considered embedded. He argues that the anonymous market of neoclassical models is virtually nonexistent in real economic life and that some organizations might enhance efficiency while others do not – an argument also stressed by institutional economists like North (1990: 69).

Granovetter takes the extensive use of subcontracting in many industries as an example of “quasi-integration” into “quasi-firms” where long-term personal relations determine the functioning of industries rather than open, market-based bidding processes (Granovetter 1985: 497-498). Thus, whether and how an industry is organized has to be considered as a social construction depending on the shapes of interpersonal networks of leading actors. At the same time, groups (or networks) of actors and the inherent relation of trust is mostly based on a similar personal, ethnic or communal background (Granovetter 1992a). Depending on whether relations are direct or rather loose, Granovetter (1992b: 34-37) further distinguishes between a rational embeddedness in the former and a structural embeddedness in the latter case. And he opens the possibility of a lock-in situation where organizations take a life of their own and thus limit the form future organizations could take despite the fact that the originating personal networks might not be any longer in place (Granovetter 1992a: 9). What he does not claim, however, is that every case is unique and anything is possible. In all his empirical examples there are only a few major possibilities of structures. Nor does he try to answer large-scale questions about the nature of modern society and sources of economic change in general, which would, however, be interesting to know in order to explain the central role of rating agencies as “uncertainty transformers”.

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<sup>69</sup> Empirical evidence that the “nature of the firm” is based on transaction costs, like the classical theory suggests, does not provide a clear picture as shown in the systematic assessment of 63 empirical studies by David and Han (2004).

This is the departing point for Meyer (2000) who develops further on the essence of the modern, globalized society within his neo-organizational theory (of sociological institutional theory) while explaining the cultural and cognitive nature of modern organizations. Unlike ideal bureaucracies – as “modeled” by Weber ([1921/22] 1972: 125-127,552-565,825) and which also encompass enterprises – modern organizations do not depend any longer on the legitimate authority and capacity of the state, or any other external principal. Even though organizations might be accountable to external stake- or shareholders with partial sovereignty, Meyer et al. (2006: 40) highlight that the organization itself appears foremost as an “*accountable, responsible and authoritative decision-maker*”. The notion of authority or power seems central in this approach while the source of the global culture lies in western societies and their epistemological base with its expanded rationalized and scientized environment. According to Meyer et al. (2006: 26) scientized pictures of a universal and lawful nature prevail in which humans live and act, providing common global frames and rules governing action which then spread around the world. Humans are supposed to be informed about the rules of nature and can find rational bases for cooperative and collective action. The rational bases are understood as universalistic. They are objectively true everywhere, even in unfamiliar and distant contexts. They argue that an issue is scientized when it is categorized, ordered, codified, and universally lawful (Meyer, Drori et al. 2006: 37). And modern schooled persons are seen “*as having a natural capacity to act rationally and cooperatively in organized collective action*” (Meyer, Drori et al. 2006: 36).

With this global conception of abstract rationality, the instructions of social scientific professionals – also referred to as experts – gain a widespread and increasing authority (Meyer, Drori et al. 2006: 37). At the same time, globalization is supposed to promote formalized associations and organizations in an “argentic” form. Actorhood shifts from the professional community to organizations as formal and rationalized arrangements. These “rationalized actors” often form global networks calling for global standards. However, the “little gods” (Meyer 2000: 239) do not necessarily emerge out of an increasing socio-technical complexity, but are deeply interdependent and constructed in their social and cultural environment.

Beck (1986) in his programmatic work about “The Risk Society” distinguishes between risk and catastrophe. Assuming that risk is generally negative he defines risk as the anticipation of a catastrophe (Beck 2006: 332). Giddens (1999: 3) gives a similar definition explaining that risk has to be separated from hazard or danger. According to him, “*risk is the aspiration to control or the idea of controlling the future*”. Risk in the negative sense is the chance of avoiding an unwanted out-

come.<sup>70</sup> However, Giddens – unlike most sociologists dealing with the matter – also suggests that risk can also have a positive connotation. Accordingly – Giddens states– a risk society is one in which there is an expansion of choice. This is particularly true in modern financial markets in which risk becomes an engineering principle (Giddens 1999: 8). Following Beck, modern society has become a risk society in the sense that it continuously debates, prevents and manages risks that itself has produced, claiming as well, that in order to be perceived as “risks” they have to be visualized (and communicated) somehow. The German sociologist Niklas Luhmann would say that the societal dynamics regarding risks and dangers are not based so much on the damages but on the communication of risks, as those damages can only be realized by the society through communication. Thus, decisions appear as risks, only if they are observed per – what Luhmann calls – observation of second order (Kneer and Nassehi 2000: 174). It doesn’t matter so much whether we live objectively in a safer world. The visualization of risks as the anticipation of destruction makes it – in a moral sense – compulsory to act. With this, however, also comes an irony as risk management becomes a promise of security. With that, risk management and prevention become an explosive question of social accountability and responsibility as “*the decision-governed social roots of risk*” make it impossible to externalize the question of accountability: “*Risk makes its appearance on the world stage when God leaves it*” (Beck 2006: 333).

What follows the “Risk Society” – according to Power (1997)– is the “Audit Society”. Power (2000: 111) takes into account the increasing demand for accountability and transparency and with it “*the rise of quality assurance models of organizational control*”. Meyer et al. (2006: 30) then stress that modern organizations arise in response to and to control uncertainties which can be understood and managed. The idea of audit as a first step for measuring the performance and reflecting specific objectives to be fed back for management activities is an important component of this process (Power 2000: 113-114). However, the “performance measurement explosion” has been introduced uncritically, according to Power, as an ideological driven system of control without considering possible dysfunctional effects. Many auditing processes are characterized by the imperative of making organizations auditable rather than neutral acts of verification, possibly enhancing a “*creative compliance*” (Power 2000: 115) and creating new interests at the expense of others. Problems further arise whenever the authoritative forces of an expert-based system do indeed require certain obedience, be it because of some sort of legal enforcement or because of a lack of alternatives. Beck (2006) refers to the “tragic individualization” as a new variant of individualism within a “risk society”, where individuals must cope with (increasing) uncertainty in a global world by themselves. This individualization evolves due to a failure of the expert system to manage risks as they are not – despite the myth of rationality – in a position to rationally define how to avoid risk. Individuals are, thus, forced to mistrust the promise of rationality of expert-

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<sup>70</sup> Note that risk in both sociological definitions is neither the unpredictable event itself nor the simple chance of this event to occur. Risk refers to the chance of avoiding an unpredictable event.

based institutions (or organizations) and to rely on themselves again. However, individuals grow away from these expert-based systems without having an alternative. *“People are disembedded without embedding”* and at the same time *“unable to escape the power of definition of expert systems, whose judgments he cannot, yet must trust”* (Beck 2006: 336).

### **3.4.2 Epistemic Communities – The Principles of Expert-Systems**

Chapter 2.1.2 presented the extent and mechanisms behind the global expansion of external rating agencies. Even though this might be partly explained by the growing complexity of global financial markets which requires more complete and homogenous information, the question comes up whether rating agencies actually gained an independent existence as “rationalized actors” with an authoritative character and what would be the implications regarding their functions and functionalities. Furthermore, it will be interesting to see which are the similarities and differences concerning the functions and functionalities of ratings in the global financial market and the microfinance industry, since one can assume differences in culture, and with it social values and norms. However, before turning now to the different functions of rating agencies, the following passages develop a bit further on the characteristics of scientized expert-systems and organizations in a global environment.

Haas (1992)<sup>71</sup> provides a useful analytical approach to distinguish between different types of organizations. While he agrees on the general conclusion that scientific rationality prevails over alternative paradigms of knowledge and that scientific staff became more and more important in almost any type of (governmental) organization, he makes a valuable distinction between disciplines and professions, interest groups and social movements, legislators and bureaucratic agencies and what he calls “epistemic communities” (Haas 1992: 18). According to Haas, epistemic communities are influential groups in international (political) decision making and can be defined as knowledge-based networks of professionals with recognized expertise and competence in a particular domain and an authoritative claim to their knowledge and its relevance. Unlike members of the broader scientific community or disciplines, those of epistemic communities have a normative commitment (“principled belief”) arising from the approach to the issue at hand, ra-

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<sup>71</sup> Haas’ research focus lies on the coordination of international policies. Therefore, in his analysis, he most often refers to national governmental bodies, international organizations and their relevant expert organizations. However, his approach is open and general enough that the applicability to other settings where decisions have to be made seems fruitful. The approach of Haas as well as Meyer and Granovetter to explain the existence and logics of action of rating agencies have already been considered as promising by Sinclair (2005). His arguments will be introduced in later stages of the present study.

ther than from a professional code.<sup>72</sup> What both groups have in common, however, is their belief in causality in general which is not necessarily shared within social movements or interest groups (including political or economic lobbies). Epistemic communities differ from bureaucratic bodies<sup>73</sup>, as they do not operate in order to preserve their missions and budgets but to apply their causal knowledge to a situation subject to their normative objectives. They have a common knowledge base and follow a joint interest.

Regarding rating agencies and their own declaration about their knowledge base, this leads to the question what has to be regarded as so-called “fundamental” when predicting future events. Fight (2001: 246) does deny rating agencies any scientific standard. However, one should avoid falling back to the assumption, that only what is quantifiable can be scientific. The price would be the loss of one’s sense of reality either by ignoring “the unknown” or misleadingly framing “the vague” as something numerically “probable”. In general, however, one might not be able to fully control one’s own beliefs regarding what has to be considered as fundamental. For example, Whitley (1986) shows how the transformation of the sub-discipline of “business finance” into “financial economics” and the increasing influence of the academic sphere on real-life activities (scientization) had an impact on the changing structure of the U.S. capital market. He observes that finance was each time more tied to the neo-classical micro-economic theory with its mathematical models which also transcended into usual business schools. He refers to orthodox, neo-classical economics as “partitioned bureaucracies” which are highly rule-governed scientific fields with a considerable degree of uncertainty regarding the technical approach in dealing with empirical phenomena, while at the same time exposing a great degree of control over analytical work and objects. The results of empirical research – mostly quantitative econometrics – are considered uncertain and open for discussion. However, the outcomes of analytical research are much more restricted: *“Problems, concepts and techniques are relatively uniform, stable and standardized [...] so that results are fairly predictable and unambiguous”* (Whitley 1986: 174).<sup>74</sup> De Scheemaekere (2006), in his article on “the epistemology of modern finance”, further exemplifies the expansion of “modern finance” as mathematical finance. And Cohen (2010) complains how the epistemology of neo-classical economics with its *“well-known penchant for formal modeling and higher mathematics”* (Cohen 2010: 887) even takes possession of the field of International Political Economy through the editorial control of academic journals.

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<sup>72</sup> The difference of principled beliefs in the discipline of economics can be exemplified through the distinction between several subgroups like neoclassical economist, Keynesians, etc.

<sup>73</sup> Please note that Haas does not assume a „state-less“ global society like Meyer where classical bureaucratic bodies are subject to extinction.

<sup>74</sup> In fact, the “Principles of Corporate Finance” introduced earlier can be considered a vivid testimonial of this development when it comes to risk assessment and management.

Rating agencies – as far as institutions are concerned – do not rely so much on quantitative modeling. However, what they or the individual rating analysts consider as “fundamental”, including qualitative aspects, most probably refers to some kind of methodological standard based on their experience, be it through their daily work or a similar educational background. They decide on which information to rely on, what they have to calculate, to estimate or to ignore and finally express themselves in a judgment of the likelihood of future events.

The expansion of standards as fundamental norms and values encompasses many fields. Moon and Wotipka (2006) show how the Master of Business Administration (MBA) and business schools expanded over the last century. Mendel (2006) demonstrates the global diffusion of ISO 9000 Quality Management Certificates as an international recognized management standard. And Jang (2006) identifies transparent accounting as a world societal rule. While disputes regarding these standards and procedures can be expected among interest groups or social movements, epistemic communities seem to build on a consensus on how a certain objective can be achieved (e.g. regarding the financials, be it on the level of an individual firm (sustainability) or the financial system (stability)). Standards are then likely to be considered as fundamental to lead to a desired outcome. Furthermore, epistemic communities follow a joint interest (e.g. world-wide transparency), something they have in common with interest groups and social movements.

In sum, epistemic communities can be identified through their shared normative and principled beliefs in order to enhance their shared causal beliefs and their shared notion of validity as well as a set of common practices and views on social welfare associated with a set of problems to which their operations are directed (Haas 1992: 3, 20). Even though epistemic communities in general do not have to consist of scientists of any specific discipline or profession, they do have to be formed by individuals with a sufficient claim to a body of knowledge that is valued by society. They do not need to employ specific methodologies either (like those of natural science), but they have to agree on the nature of social, economic or other processes and find analytical methods and techniques which seem appropriate for the objectives they pursue (Haas 1992: 16).

Rating agencies seem to have much in common with these epistemic communities. In order to reach a common judgment, they have to share beliefs on what has to be considered as fundamental, while their beliefs are certainly causal as, through their analysis, they claim to assess the causal relation between the data they assess and a possible default. Their knowledge base is likely to be the same too, for instance because of a similar educational background. And their (most obvious) shared interest – besides the generation of profits – is to increase transparency; again, sharing the belief that increased transparency leads to greater efficiency. Rating agencies should not be disqualified simply because they do not base their opinions on rigorous scientific inquiry. In fact – as will be argued later – too much “science”, or better the inappropriate application and

belief in specific (quantitative) methods, in real-life activities might even be harmful – not only in the field of finance.

### **3.5 The Different Functions of Credit Ratings**

The previous sections served as a theoretical basis to approach the reason-to-be for external rating agencies, which are now concretized in different functions these rating agencies exercise. Therefore, the literature on rating agencies is being reviewed explicitly to identify those functions, even though the respective authors themselves do not explicitly have that aim. Most of the literature rather implicitly assumes a given function when writing about ratings. Others focus on one specific function, resting sometimes, however, upon rather narrow theoretical concepts. In these cases, the theoretical considerations of the previous sections serve as a supplement. The aim is to deliver a coherent picture of different functions rating agencies can exercise with regard of the stakeholders involved. The sub-chapter constructs a conceptual encompassing framework which helps analyze critical aspects of the current rating practice in mainstream capital markets (see Chapter 4). It is later applied to the context of microfinance to discuss the relevance of different functions in this context as well as the functionality of different types of raters (see Chapter 7). The aim here is not, however, to identify THE single most important function, not theoretically, nor empirically nor as a normative recommendation.

The four core functions of credit ratings identified in the literature and amended by theoretical concepts outlined in the previous sections can be subsumed as follows: A) the Information Function which describes how rating agencies collect information and release private information, generating economies of scale and potentially raising market efficiency. With the increasing complexity of global capital markets they furthermore give a means of orientation by standardizing information and knowledge and creating benchmarks. B) The Certification Function is split into a Labeling function which allows issuers to benefit from a rating agency's reputation in form of a quality label. The Risk Classification function aims at reducing or even transforming uncertainty, at the same time responding to psychological and societal needs. The role of ratings in regulation is also mainly treated here. C) The Control Function aims at giving issuers and asset managers incentives to act in the interest of investors (mainly) through constant monitoring. D) The Coordination Function describes how ratings can serve as a focal point for investors in order to establish and maintain a stable equilibrium of financial markets.

The different functions and sub-functions differ from those identified by Merton and Bodie (1995) for financial intermediaries in general. The functions of Clearing and Settling, Pooling and Transferring Resources are generally not carried out by rating agencies. The other functions (information, incentive and risk management function) have a more central position. Yet, the incen-

tive and risk management function has been subordinated to one of the other core functions identified as more meaningful to describe the rating agencies' role in financial markets. Chapter 3.5.1 to 3.5.4 elaborates further on each function as well as on the different sub-functions. Chapter 3.5.5 summarizes the findings.

### **3.5.1 Economies of Scale in Environments of Increasing Complexity - The Information Function**

As discussed in Chapter 3.2.1 and formally modeled by Ramakrishnan and Thakor (1984), credit rating agencies can be defined as financial intermediaries in the form of diversified information brokers solving problems of asymmetric information. However Ramakrishnan and Thakor do not distinguish various organizational forms and services and make no difference between credit rating agencies and credit bureaus, financial newspapers, econometric modellers, consultants, investment bankers, or accounting firms. That the specific role of rating agencies is not clearly defined vis à vis other information providers is dissatisfactory insofar, as rating agencies are getting so much attention from financial market participants, regulators and researchers alike. Nor does this approach explain why rating agencies gained so much weight – especially in the last 30 years – even though information asymmetries have declined. White (2009) also defines rating as means to reduce information asymmetries while, at the same time, he explains that the only reason for their overwhelming importance is their integration into regulatory laws and rules. While it is true that the regulatory value of ratings might be an important factor (difficult to separate from any other), the theoretical considerations about the financial intermediation documented in the previous sections shed additional light on the services offered by credit rating agencies.

According to the neoclassical view – focusing on market efficiency – the rating agencies' core business to gather and sell information suggest in the first place that their principal reason to be is the avoidance of a duplication of efforts by investors while gathering information about possible investees to reduce information asymmetries. Issuers with a high credit rating from a reputable agency are supposed to be able to attract many investors and sell their debt securities at relatively low costs. They can do so paying lower interest rates than issuers with low credit ratings. Even though each investor could generate the information itself, on the financial market level this would mean a duplication of efforts as the same information would be produced many times over. On the contrary, rating agencies generate information only once and can thus exploit vast economies of scale.

The informational value of credit ratings can be explained partly by the integration of private information into their reports (and final judgments) without disclosing the information itself.

Campbell (1979) shows that private debt financing rather than equity financing might be beneficial to managers and current shareholders as this could preserve claims for monopoly profits. Managers are assumed to produce valuable insider information while Campbell distinguishes between technological information (e.g. about the mode of operation and technical details of a specific product) and strategic information (e.g. marketing strategies, price setting, organizational techniques, research and development procedures). While the value of technological information is often protected through patent rights and, furthermore, cannot that easily be discovered by launching a product, the value of strategic information diminishes immediately once becoming public. Private debt financing would thus maintain confidentiality about strategic insider information while sending a signal to the public about the real value of a firm. Accordingly, Jorion, Lui et al. (2005) show that the informational value of credit ratings increased with the exemption of rating agencies from the Regulation of Fair Disclosure (introduced in the U.S. in October 2000), which prohibits U.S. public companies to make selective, non-public disclosures to favored investment professionals. Jorion, Lui et al. further argue that this rule provided rating agencies with a strategic advantage compared to other parties.

In sum, the Information Function of rating agencies in this view is that they generate information through the incorporation of private information which allows market participants to set and inform themselves about prices (interest rates in the case of debt securities). They provide this information making use of economies of scale. The necessity of reducing information costs, even though the absolute costs of information production declined, might be linked to the very structure of capital markets with more and more relatively uninvolved investors participating in capital markets including an ever bigger number of financial intermediaries (be it because of globalization or disintermediation or both) which would lead to an increase of duplication of efforts and the related costs. Another feature which increases the informational value of credit ratings is the short-term nature of capital markets where debt securities are actively traded in secondary markets, which requires market participants to regularly revise their portfolio, and thus, search information on new issuers.

Several researchers tried to assess empirically to what extent credit ratings bring new information to (secondary) capital markets.<sup>75</sup> Extensive literature exists on the relationship between bond prices, bond spreads and equity prices on the one hand and changes in credit ratings on the other (Cantor (2004) provides a good overview). However, empirical evidence about the extent to which credit ratings bring new information to the market (i.e. their informational value) is mixed and can be summarized as follows: First, in the month before a rating change, both bond and

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<sup>75</sup> The following discussion on the potential informational value of credit ratings is strongly related to the assessment of their functionality which will be further discussed in Chapter 4. Yet, the review of this empirical academic discussion on this specific issue has been forestalled because it constitutes the necessity to identify other, possibly equally or even more important functions.

equity prices decline or rise in anticipation. This could either signify that investors pay much attention to pre-announcements of rating changes and especially on watch-lists or that they are simply concerned about the same factors that determine ratings. Second, price changes prior to a rating event are generally larger than the rating event itself would suggest. This means, that market participants tend to overreact to rating changes. These effects are bigger for negative rating events (announcement of downgrades) than for positive ones (announcements of upgrades). Third, even though price reactions are statistically significant they are often not economically significant and smaller than the magnitude of the rating change itself suggests (Cantor 2004: 2570). A recent study by May (2010) confirms most of these findings based on the analysis of 1093 rating events between September 2002 and March 2009. By eliminating the contamination effect of non-rating firm specific news through using daily prices of over-the-counter deals rather than monthly prices (from the infrequently traded securities listed at the New York Stock Exchange) to track movements<sup>76</sup> he finds that the corporate bond market receives some new information both from downgrades and upgrades. He also finds that upgrades which move a firm from the speculative grade category into the investment grade category make prices respond much more positively than other upgrades, while effects of downgrades are in general three times larger than effects of upgrades.

Yet, the quantification of the informational effect is difficult as price changes can be foremost influenced by changes in the regulatory status of bonds, such as a change from the “investment grade” status to the “speculative grade” status. The bigger reaction on downgrades than on upgrades might be an indication for this. This is even more pronounced when looking at stock prices, as the legal status – and the legal value of ratings – might have a strong impact on the value of equity (e.g. through lower reporting costs or increasing financial flexibility) (Dittrich 2007: 12).

Newer studies therefore focus on credit defaults swaps (CDS) in order to single out the informational value of credit ratings. As the prices for these instruments are solely determined by the information available on the probability of defaults – CDS prices are the market prices for what credit ratings intent to measure – prices for CDS, so goes the argument, would only react to rating changes if they indeed contain new information (Cantor 2004: 2570). Hull, Predescu et al. (2004) only focus on negative rating events (due to data constraints). They do however include all three possible events: an actual downgrade, a negative outlook assignment and negative reviews (watch-list assignments). They find a significant anticipation effect of CDS prices regarding rating reviews but no significant effect for rating changes or outlook changes. Norden and Weber (2004) examine both CDS and equity prices while building on a richer dataset (more European issuers as well as a greater number of rating events) and also find that both markets anticipate rating changes well in advance (60 to 90 days). Thus, CDS spreads have a predictive power for rating

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<sup>76</sup> They argue that it is infeasible to exclude contamination of non-rating news in a monthly window.

downgrades rather than the other way around. Furthermore, they find that reviews for downgrades by Standard & Poor's and Moody's are associated with significant abnormal pre-announcement performance in both markets whereas actual downgrades are not. Reviews or downgrades by Fitch have in neither case a significant impact. While the overall findings suggest that ratings have little informational value, the difference between reactions regarding the different rating agencies suggest, that rating events of Standard & Poor's and Moody's are perceived as more important than the ones of Fitch. However, the authors point to some important limitations of their study. First, they state that the study only observes credit ratings by firms which are liquid reference entities in the derivate markets which again are subject to constant market monitoring anyway. They do not take a sample of all rated firms of these rating agencies. Furthermore, they do not take into account the reason for the rating change nor the timing of the original firm news that induced the rating change. Finally, they point to the fact, that credit ratings are less volatile than market prices and can thus be still useful for long-term investors in case of a positive relationship between less volatility and predictive power. This would be especially true, if financial market volatility is considered to be due to behavioral (irrational) patterns of market participants rather than constant and timely risk/return assessments. Still, the real value of the positive relationship between less volatility and predictive power would then need to be based on "fundamentals" rather than the (more or less stable) conventional judgment. Otherwise, all empirical assessments on the informational value of external credit ratings become obsolete.

In contrast to the suggestion of the classical Theory of Financial Intermediation which focuses on asymmetric information in a principal-agent relationship where a borrower could deprive lenders of important information, the globalized and disintermediated financial markets are rather overwhelmed with data about prices, business activities, political risk etc. Within a "risk society" the main challenge is to reduce complexity rather than produce ever more (complex) information. This leads Sinclair (2001b: 490) to the conclusion that what rating agencies offer, is to supplement (through releasing private information) and organize readily available information. They do so by offering two types of knowledge: scientific or expert knowledge and locally held knowledge. The latter refers to particular circumstances of time and place. The outcome of the rating process (here the rating grade) is a condensation of this knowledge. Since rating agencies also assess qualitative areas such as the governance structure and management procedures, the standardization process also includes a learning component for the identification of "optimal" organizational structures and "best practices". The rating then becomes a benchmark around which market actors organize their activities. Even though market actors can depart from this benchmark, these benchmarks still set the standard for those and other actors. This is why the major rating agencies can indeed be identified as authoritative, epistemic communities, providing scientized pictures of the world even though they might miss a "*rigorous scientific inquiry*" (Ficht 2001:

244). As long as their general expertise and their independency must not be questioned, the knowledge they produce will be framed as objectively true.

Accordingly, credit rating agencies have a standardization function (Dittrich 2007: 13), which is, however, so much interconnected with the Information Function (standardization AS information) and Certification Function (certification THROUGH standardization), that it is not incorporated as a standalone function in the present analysis.

If ratings were just the outcome of an analysis of credit risk, they would not differ so much from any other financial intermediary who needs to assess the creditworthiness of its borrowers. In fact rating agencies themselves refer to their methodologies as:

*“...the same type of credit analysis that you would do if you were a bank... there’s really no magic in it. I mean, although we can create the magic, there’s no sort of basic black box that you put all this in and it sort of pops out... It actually is very fundamental financial analysis, and very fundamental industry analysis, and very fundamental business-risk analysis...”<sup>77</sup>*

The (supposed) focus on fundamentals which defines credit risk while looking “through-the-cycle” rather than mutual observations of market participants, which defines market prices (like bond spreads), is where rating agencies make a difference and, related to the argument, that ratings might not contribute to information gathering in CDS markets but might still be useful to long-term investors. In this sense, rating agencies do not even need to reflect credit risk more accurately than capital markets. Their standardized approach could rather be seen as “*time-honored heuristics that help analysts cope with the complexity and not as avenues to the real credit risk*” (Kerwer 2001: 12). In this view, the major function of credit ratings would be to provide orientation (Orientation Function), which in the present study is considered an important sub-function of the Information Function.

### **3.5.2 Signaling Integrity and Classifying Levels of Risk – The Certification Function**

The Information Function based on the actual content of information (informational value in its broadest sense, where “everything” has to be considered information) does not necessarily equip rating agencies to deliver an information service clearly different from other information providers. In fact, the question whether rating agencies provide any new information to the market compares their service with any other possible source of information which could be rapidly integrated into market prices. In this sense, rating agencies are not much different than, for example,

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<sup>77</sup> Stated by Brian Neysmith, President of the Canadian Bond Rating Services, in June 1992, cited in Sinclair (2001: 499).

(financial) newspapers or news services. This is why White (2010) states that without regulators' reliance on credit ratings, these evaluations would be just one of many other sources of information available to the market, and that the importance and amplitude of credit rating agencies would possibly decline if the integration of credit ratings into regulatory rules would be abolished.

However, ratings might have still other functions important to market participants not directly linked with the basis of information. If an issuer seeks a rating, this can be interpreted by market participants as a sign of integrity, independent from the actual outcome. It certifies the commitment towards transparency by getting oneself screened while "opening the books". If the rating agency furthermore enjoys a good reputation the issuer can "buy a share" of this reputation. Thus, part of the Information Function or rating agencies is to provide a "reputational bond" (Dittrich 2007: 11). Meyer et al. (2006: 32) state that openness is a core world virtue, including openness for inspection. And Armijo (2001) identifies the "transparency advocates" – opposed to laissez-faire liberalizers, financial stabilizers and antiglobalizers – as the dominant group influencing the political geography of the world-wide financial architecture.<sup>78</sup> In this sense, a credit rating from a recognized, international rating agency is a quality label simply because it certifies that an issuer (wants to) belong to the modern, world-wide financial market recognizing its virtues.

Furthermore, by assigning a specific rating grade along an ordinal scale (rather than the pure informative report) rating agencies provide the means to make a distinction between one issuer and another, which is of crucial importance for (more sophisticated) issuers. Rating agencies thus also certify the quality of bonds (and issuers). This Certification Function also applies to regulators when applying rating-based regulation, while ratings gain a license value. The quantity and quality of information – directly linked to the informational value – used for the evaluation might be crucial for the rating agency to adhere their reputation of reliable information providers. However, what is equally important are the methodologies and courses of action of how the information is processed.

The comparison of "credit risk" is possible because the rating output (the rating grade) is organized on an ordinal scale which in fact only provides a measure of relative credit risk. Standard & Poor's (2010a) puts it as follows: *"For example, a corporate bond that is rated 'AA' is viewed by Standard & Poor's as having a higher credit quality than a corporate bond with a 'BBB' rating. But the 'AA' rating isn't a guarantee that it will not default, only that, in our opinion, it is less likely to default than the 'BBB' bond."*

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<sup>78</sup> Even though Armijo identifies four different groups with different goals, concerning single issues, overlapping is possible. For example, among the financial stabilizers are many transparency advocates led to a couple of reform recommendations including the formation of a global credit rating agency; see Armijo (2001: 387).

However, this rather modest interpretation of what a rating reflects stays in contrast of how market participants refer to ratings. Sinclair (2005: 52) finds evidence on how traders refer to “AA companies” or other rating categories as if it were in fact an agreed and uncontroversial way of distinguishing between companies or other issuing entities. It appears that ratings are the unchallenged common sense of the market. In this sense, the importance of rating agencies lies not so much in their provision of any individual rating (and again the specific provision of information) but much more in the fact that they are part of the internal organization of the market. Rating agencies can be classified as “*embedded knowledge networks*” (Sinclair 2005: 15).

The functional perspective of financial intermediation developed in the previous section highlights the importance of risk management rather than market imperfections to define the role of financial intermediaries. As rating agencies are (or pretend or are just supposed to be) in the business of assessing credit risk they can be also characterized as active market participants rather than passive agents who assist in the risk transformation according to different risk preferences of savers by establishing different risk categories. Thanks to their long-term existence and statistical performance validation they even provide the means for translating their grades (with good cause or not) into numerical values – a dimension particularly valued in times of increasing “quantification” of the economic science. And whenever rating agencies are framed as risk analysts their value-contribution lies in reducing complexity through standardization while (ostensibly) transforming uncertainty into measurable and manageable risk. Furthermore, by (again ostensibly) always applying the same methodologies when processing information, rating agencies make these risks comparable across industries and regions.

Their role as “risk transformers” is further perpetuated by their active engagement not only in the assessment but in the creation of structured securities by commenting financial innovators of how such a security should be structured in order to achieve a specific rating (Grais and Katsiris 2007).

Taking this thought a little further, by recognizing the role of financial intermediaries as “value creators” who “de-homogenize” the markets and, thus, temporarily create market imperfections in their innovative process and/or be tackling new markets, the role of rating agencies becomes even more important. The establishment of credit ratings as a common mental framework or “rule of thumb”, and therefore, integral part of the financial market in the last century, could be interpreted as a response to newly created information asymmetries. The absence of a rating alone can be interpreted as a peculiarity of imperfect information which then can only be overcome by the newly assignment of a credit rating which then again re-establishes homogeneity. In this sense, rating agencies might indeed create markets and have an origination function. They frame the unknown as something familiar.

### 3.5.3 Aligning Interests of Issuers and Asset Managers – The Control Function

Ratings are supposed to deliver orientation to uninvolved investors as well as regulators while certifying the quality of bonds (and its issuers). However, in reality many institutional, thus, rather involved investors such as pension funds, mutual funds, money managers etc. also rely to a certain degree on ratings in their investment decisions (Baker and Mansi 2002). In fact, it was shown earlier that disintermediation does not only mean that more and more individuals become engaged directly in capital markets, but that other intermediaries than banks take up the business, or that banks themselves become more active in capital markets and provide more and more cross-sectional smoothening rather than inter-temporal smoothening services. The institutional investor still operates as an asset manager for the primary investor. However, in the literature, the distinction between the uninvolved (and inexperienced) primary investor and the (supposedly) involved asset manager is often missing. In fact, Ellis (1998) as well as Baker and Mansi (2002) who – on the basis of a survey – address the question of different perceptions about rating agencies and their services from issuers and investors, solely interview institutional investors to capture the view of investors. Besides the (possibly) limited information value there might be additional arguments why this missing distinction creates some shortcomings.

Fridson (1999: 3) argues that, even if ratings made nonpublic disclosures (which could be reflected in bond prices), investors may also interpret disparities between the ratings and the public information as evidence that rating agencies had misrated an issue, and thus, reject the incorporation of the rating into their investment decision and hence market prices. Fridson (1999: 4) further argues that the rating agencies role to concentrate a vast amount of data by classifying thousands of issues into a small number of risk categories (standardization) might not be an argument strong enough to explain the importance of rating agencies. Financial analysts in brokerage firms (sell-side) as well as pension funds and mutual fund companies (buy-side), through their own analysis and comparisons, produce distinctions of credit quality that are much finer than letter grades and modifiers ( as + and -). Equity investors determine risk premiums for a vast number of stocks without the help of an external rating agency-produced classification system.

Therefore, the efficiency-of-information-management argument alone to explain the existence of rating agencies does not stand up under scrutiny. Instead, Fridson offers an alternative explanation stating that rating agencies might help to mitigate conflicts of interests between owners, guarantors and managers of assets. Even though the founders of the first rating agencies might not have targeted imperfectly aligned incentives among the various participants in the investment process, it might still be possible that the success of their rating operations resulted from the use of ratings as an instrument to control financial agents and “discipline” seekers of financial

guarantees. He distinguishes three categories of stakeholders on the investment side: asset-owners, asset-guarantors and asset-managers. The following Table 3.2 summarizes the examples provided by Fridson:

**Table 3.2: Market participants of capital markets on the investment side**

Asset-Owner	Asset-Guarantor	Asset-Manager
<ul style="list-style-type: none"> <li>• Individual investors</li> <li>• Trust beneficiaries</li> <li>• Beneficiaries of public and private pension plans</li> <li>• Policy-owners of mutual insurance companies</li> <li>• Mutual bond fund shareholders</li> <li>• Shareholders of commercial banks, thrifts, credit unions and other financial institutions</li> </ul>	<ul style="list-style-type: none"> <li>• Underwriters and reinsurers of bond insurance</li> <li>• State-sponsored providers of deposit insurance</li> <li>• State-sponsored insurance guaranty funds</li> </ul>	<ul style="list-style-type: none"> <li>• Portfolio managers employed by public-sector institutions that manage their investments in-house</li> <li>• Investment advisory firms</li> <li>• Stockbrokers with discretionary authority over costumers' accounts</li> </ul>

Source: Own elaboration based on Fridson (1999: 4-5)

Regardless of the principal objective of the asset-owner (be it wealth-maximization, capital preservation or simply compulsive gambling) conflicts of interest may arise because of asset-managers and asset-guarantors pursue objectives that may lay outside the asset-owners' interest: *"Maximizing asset-owners' utility is a duty, but not the direct interest of an asset-manager"* (Fridson 1999: 6). For example, a money management firm that serves pension plan clients also has the duty to maximize the wealth of its own equity holders besides that an employed money manager also wants to maximize his or her own income. In order to align the incentives, compensation plans usually seek to reward single money managers for increasing the asset-owners utility (however utility is defined). Imperfections in the compensation plan may then create opportunities for asset-managers to maximize their own utility without enhancing or even reducing asset-owner's utility. Fridson (1999: 6) identifies one such imperfection in the practice of firing managers who underperform market benchmarks over extended periods. He argues that firms facing imminent termination of asset management contracts have an incentive to take higher risks. If the strategy pays off the manager will be rewarded with the retention of the client and related income streams. If the strategy fails, the outcome will be almost the same as if the manager would have not changed his strategy. Hence, the manager is in a win/no-lose situation. The asset-owner, however, might be far worse off than if the manager would have maintained a constant risk profile in the portfolio.

There are other mechanisms which might set off the asset-manager's incentive to act in the asset-owner's interest. For example, corporate bond market dealers (often acting as principals with

certain risk exposure of their own capital) might rebate to the asset-manager's personal assets while convincing the asset-manager to sell overpriced bonds to the asset-owners which then might offset the sacrifice in income the asset-managers does with that deal for himself. Finally, asset-managers might simply get engaged in lower-level (and intangible) corruption like lavish entertainment even if they would reject outright (and legally traceable) cash bribes.

Ratings by external and independent rating agencies might then be a mechanism to constrain the actions of (investment) agents. By prohibiting asset-managers to invest in securities beyond a specified grade, asset-owners as well as asset-guarantors could significantly limit their risk even though they lack the expertise to quantify that risk themselves:

*"Monitoring the rating mix is likewise cheaper than tracking the asset-manager's social calendars to try to determine whether they may have been swayed by expensive meals of hard-to-obtain tickets to premier sporting events"* (Fridson 1999: 8).

The appraisal made by Cantor and Packer (1995a) – as presented in Chapter 2.1.1 – that ratings were established in the first place as guides for uninvolved investors but were than more and more appreciated by regulators and financial institutions alike fits well into this argument. Whenever self-interested asset-managers have an incentive to take greater risk as they can shift part of the losses from risk-taking investment decisions to the asset-guarantor, the rating serves as a mechanism to control moral hazard. But also regulators of capital markets and mutual funds who do not function as asset-guarantors might have an interest to limit risk-taking by asset-managers in order to head off financial inquietudes. Regulators for capital markets seek to maintain financial stability as they are accountable to legislators who are in turn accountable to voters who might be negatively affected by financial instability even though they are not necessary asset-owners. The use of ratings could then serve as a simplified mechanism to fulfill the regulator's task by imposing objective standards ("black-and-white rules") instead of spending enormous resources for administrative law cases about the fairness of regulatory actions (Fridson 1999: 12).

The "disciplining" function does not, however, stop at the level of asset-owners, -guarantors and -managers. Boot, Milbourn et al. (2006) further develop on how credit rating agencies may influence issuers' behavior while highlighting the role of watch-listing in order to monitor issuers beyond the assignment of an initial rating grade and with that provide incentives so that the issuers takes efforts in the investors' interest. Boot, Milbourn et al. (2006: 91) argue, that – which has been often ignored – firms and rating agencies do have regular interactions and that the establishment of watch-lists can be interpreted as an implicit contract between these two stakeholders. Whenever a firm is put "on watch" it will generally be asked to provide information on how it is going to deal with the change. The firm will then implicitly commit to undertake specific (recovery) actions to mitigate the possible negative consequences of the change. Concrete targets

and deadlines are often set while during the period the credit rating continues to be “on watch”. If the firm complies with the implicit contract and furthermore manages to take effective actions the rating may be reconfirmed. Otherwise, a downgrade will be the consequence. The implicit contract comes from the investors who base their investment and pricing decisions on credit ratings. This becomes particularly obvious when investors incorporate credit ratings explicitly into their covenants (rating triggers).<sup>79</sup> Hirsch and Bannier (2009) realized empirical research on that topic – while analyzing rating data from Moody’s between 1982 and 2004 – and found that especially for low-quality issuers the watch-list procedures developed into an effective monitoring device. Thus, credit rating agencies exercise control over firms’ behavior. This is why Sinclair (2005: 177) concludes that what rating agencies say is not so much persuasive but rather perceived to be authoritative: “...rating agencies have constructed for themselves the eminence of an epistemic authority”.

Even without the watch-list-argument, rating agencies exercise control over market participants. Kerwer (2002: 7) refers to ratings as “standards, in the sense of expertise-based voluntary rules”. Opposed to technical standards these standards do not specify the desired properties of a technical object, nor are they just specifications of a minimum and maximum level of risk defined in regulation (as e.g. emission standards define a minimum level of protection). Instead, ratings “are rules aimed at promoting certain organizational procedures or structures” (Kerwer 2001: 8). Once established as a recognized mental framework and, furthermore, promoted by rating-based regulation (note that for the U.S. capital market it is obligatory for a firm to be rated) firms will always behave “rating-conform” beginning with the preparation for the very first rating process. Watch-lists are mechanisms to warn the market about possible downgrades. The influence on firms’ behavior, however, might also include actions to receive a possible upgrade in the next round, not only to avoid a downgrade. This might be especially true at the threshold to the investment grade category. Following the concepts of the amended theory of financial intermediation and their focus on different functions, rating agencies, thus, also exercise a Control Function.

### **3.5.4 Influencing Investors’ Beliefs and Behavior – The Coordination Function**

Ratings might also influence the behavior of asset-owners (or simply investors). Within the orthodox contemporary Theory of Financial Intermediation the focus lies on information asymmetries where investors cannot observe the firms’ project choices nor their recovery efforts (Stiglitz and Weiss 1981). This may induce moral hazard. Boot, Milbourn et al. (2006: 83) show with their

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<sup>79</sup> A rating trigger is a provision in a loan agreement that initiates a specific action in the event of a change in a firm’s credit rating. For example, a downgrade in a firm’s credit rating may set off accelerated debt repayment.

model how a firm may be influenced in their project choice depending on the market's beliefs. For instance, if the market believes that a firm will choose a high-risk project and accordingly increases the funding costs, this belief can be self-fulfilling: As the firm is confronted with the high funding costs, it will optimally engage in the high-risk project. Alternatively, the firm might be engaged in the low-risk project if this is what the market anticipates. While Stiglitz and Weiss focus on a single creditor relationship, Boot, Milbourn et al. amplify this model towards an aggregated perspective and show how such mechanisms can lead to a situation where multiple equilibria exist while one of the equilibria might be dissipative.

In case a considerable proportion of investors (e.g. big pension funds) follow the credit rating in their investment decision, it would be rational for other investors to follow as well. Accordingly, credit ratings can serve as "focal points" to align investors' beliefs while solving the multiple equilibria problem. Credit ratings thus also have a "Coordination [of Beliefs] Function" (Boot, Milbourn *et al.* 2006: 85). The focal-point-argument essentially assigns credit ratings the role of an insurance policy against uncoordinated jumps to the bad equilibrium. The value of a credit rating thus depends on how divergent and uncoordinated the beliefs of investors in the market are (Boot, Milbourn *et al.* 2006: 99).

But, even if the stylized view with its laboratory-like terms and conditions is abandoned and rating agencies can have more than one single function, it seems reasonable to assume that rating agencies, as an "authority in markets" even though not an "authority over markets" (Sinclair 2001a: 442), might influence investors' behavior. This might even be the case when ratings do not have any influence on the particular beliefs of skilled investors. Even though analysts have (at least theoretically) some ways to avoid to incorporate ratings, they do not agree with (Fridson 1999: 9-10)<sup>80</sup>, even the most skilled analysts will still have to acknowledge the rule of thumb rating agencies provide as a social fact and as such as a part of the environment they operate in. They have to take ratings into account at least to the degree that these judgments can influence the behavior of others, which in turn can change the market the bonds are priced in (Sinclair 2005: 178). Thus, rating agencies help to perpetuate the conventional judgment "creating" a stable, decision-enhancing environment. Besides, since market participants know about their authoritative position they deliver an ideal scapegoat if things go wrong.

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<sup>80</sup> Fridson refers to the possibility that asset-managers could for example hold a below-minimum-rating issue in between portfolio statement dates. An underwriter could decline to seek a rating from an agency that he or she expects to assign a rating that falls below the guidelines of many investors (rating shopping), etc.

### 3.5.5 Summarizing the Different Functions of Credit Ratings

As previously introduced the four core functions of credit ratings have been identified as: the Information Function, the Certification Function, the Control Function and the Coordination Function. Some of the core functions have several sub-functions. Figure 3.3 summarizes the different functions and how they correspond to the needs and expectations of different stakeholders in the financial market.

The production of new information for a broader public within the financial market as one sub-function identified as part of the **Information Function** is of special importance for primary investors as well as their asset managers. This is achieved through the release of private information. For regulators this type of information is also valuable, especially (even though not exclusively) in cases ratings are incorporated into the prudential regulation of financial institutions. As rating agencies are specialized in the collection and dissemination of information, they can realize economies of scale during the collection of information while investors do not need to make the same effort themselves. This is especially valuable for otherwise uninvolved investors facing significant participation costs when searching for investment opportunities in an environment of increasing complexity and uncertainty. The larger the investor and, more importantly, single investments or the longer the duration of an investment, the cost advantages decrease. For large investors, rating agencies, with their highly standardized provision of information, might not provide information in a sufficiently differentiated and timely manner. They do not rely on the rating agencies' information to the same degree as smaller, possibly rather uninvolved investors. However, the highly standardized approach might still serve to provide a first orientation before the decision is made to enter into more detailed information collection efforts or an in-depth due diligence process. For the sorting out of potential investments, it becomes crucial that a large number of ratings are comparable with each other, be it because they are provided by one big rating agency, or because different rating agencies take the effort to make their ratings comparable to those of other rating agencies. The availability of a benchmark might furthermore be valued by those issuers who proactively search for new investors as they could benchmark themselves against their competitors and adjust their re-financing strategy accordingly.

**Figure 3.3: The different functions of credit rating agencies**

Function \ Stakeholder	Issuer	Asset-Owner (Investor) & Asset-Guarantor	Asset-Manager	Regulator
<b>Information Function</b>		<b>Information Release Function</b> - release new and private information <b>Information Collection Function</b> - generate economies of scale; avoid duplication of efforts <b>Orientation Function</b> - induce learning process (create knowledge) through standardization, provide benchmarks		
<b>Certification Function</b>		<b>Labeling Function</b> - provide quality label through standardization and reputation <b>Risk Classification Function</b> - reduce/transform uncertainty - organize private risk management through horizontal monitoring - facilitate financial innovation		<b>Regulation Function</b> - Legal: avoid administrative law suits - Risk Classification Function (systemic risk management)
<b>Control Function</b>	<b>Monitoring and Disciplining Function</b> - induce discipline among issuers and asset-managers ex-ante - avoid moral hazard ex-post			- Justification for compulsory interventions
<b>Coordination Function</b>		<b>Coordinate investors' beliefs and investment decisions</b> - enhance market stability - ex-post rationalization (avoid regret, serve as scapegoat)		

Source: Own elaboration inspired by Dittrich (2007: 14)

Independently from the actual outcome of the rating process (the rating grade), credit ratings, especially those of internationally recognized rating agencies, serve as a quality label. Issuers signal their belonging to the international, financial community and, thus, accept its rules. The larger the reputation of the respective rating agencies, the larger is the labeling effect of the credit rating. Considering the risk classification of bonds along an ordinal scale and especially their translation into statistical probabilities (cardinal risk measures), rating agencies (seem to) transform uncertainty into manageable risk. Both, the labeling and the risk classification are part of the **Certification Function** of credit ratings, while the latter also helps investors as well as asset managers to organize their risk management and diversify their portfolio accordingly. Considering the role of credit ratings in the process of financial engineering, risk classification also helps to tackle or create new markets to be served. In rating-based regulation, the classification of bonds into “investment grade”, “speculative grade” and “junk” is crucial, because regulators avoid administrative law suits when this is done through an external, independent and objective player from the private sector.

Credit ratings from external rating agencies also have a **Control Function**. Thanks to the authority of rating agencies arising from their structural embeddedness into the financial system and their recognized expertise they influence the behavior of issuers and asset managers. Ex-post, they help to avoid moral hazard, especially through the mechanism of watch-listing backslide issuers. They align the interests of issuers and asset managers with those of the original investor and/or financial regulator and thus, provide incentives for acting in the latter's interest. This disciplining function even holds for new issuers, as market entrance is only possible with a favorable rating. For regulators, ratings might also provide the means for justifying compulsory interventions, particularly when state interventions into financial markets are largely considered unacceptable.

As investors and asset managers know about the importance of the rating agencies' opinions in the financial market, they can anchor their beliefs on these risk assessments. This is especially useful in cases with multiple equilibria as they can – given that their judgment is appropriate, independent and objective – enhance financial stability. However, this is also true in cases investors would judge differently. Given the central role of the big rating agencies, they cannot ignore their assessments as it still might influence beliefs and, thus, the investment decisions of other investors (the conventional judgment). This also opens the possibility to blame rating agencies if things go wrong. Rating agencies are an ideal scapegoat. Accordingly, credit ratings have a **Coordination Function** while creating a relatively stable investment climate facilitating calm decision making.

In order to fulfill these functions in a desired manner, however, certain preconditions have to apply. From an empirical perspective, critical aspects regarding the functionality of these rating are analyzed in Chapter 4, while the theoretical considerations developed in this chapter help to further consolidate the analysis. Still, one principle appears to be central to safeguard the quality, and hence, reliability, of credit ratings: reputation. This last sub-chapter therefore presents the reputation mechanism from a theoretical perspective as the driving force behind rating quality.

### **3.6 Safeguarding Reliability – Reputation as the Driving Force for Information Quality**

As the production of information is expensive, firms becoming engaged in this business considerably depend on their good reputation in order to be able to compete with other information providers. Shapiro (1983) was one of the first scholars to model the returns of reputation, while stating that reputation is typically relevant in multi-period relationships with asymmetric information when consumers cannot observe the quality of a product ex-ante, but have to “experience” its quality in the course of time. Nelson (1970) therefore calls this type of goods “experience goods” in contrast to “search goods”. Ratings are certainly such type of “experience good”. Investors

such as regulators cannot observe the quality of a rating ex-ante but have to rely on ex-post information in order to assess the rating agencies performance to properly categorize credit risk. A “reputation index” (Ramakrishan and Thakor 1984: 420) is needed in order to prove the rating agencies’ performance. The “default and transition studies” mentioned in Chapter 3.1 are such reputation indices.

However, in any period rating agencies could try to earn extra profits either by lowering the costs of information production (e.g. through cancelling subscription to certain data sources or through reducing the depth of analysis in order to save labor costs) or by earning extra profits through the issuance of favorable ratings.<sup>81</sup> In both of these “milking” strategies (Dittrich 2007: 21) the information quality would be reduced. However, once identified, these actions would cause a decrease in reputation and lower the gains of the agencies in the following periods. Thus, only if the “milking” strategy in one period offsets the sum of future gains in the following periods, the rating agency would risk its reputation capital. Otherwise it would always produce high quality ratings.

Even though the exact quality of a rating can only be observed ex-post, market participants have the possibility to at least assess a minimum quality based on the input factors employed by the rating agencies (Dittrich 2007: 23). Two input factors are identified as important, namely the data sources and the level of preparedness of rating analysts. At least the issuers who have a regular contact with the rating analysts can observe the degree of “expertise” of the rating agencies’ employees. And also the methodology applied can at least be observed to a certain extent based on the process and query of data. Accordingly, attempts to influence the rating quality ex-ante and secure high rating standards are focused on input factors as can be observed in the “Code of Conduct Fundamentals for Credit Rating Agencies” issued by the International Organization of Securities Commissions (IOSCO 2004). Investors are able to observe minimum quality ex-post but right after the issuance through (roughly) comparing the ratings with market prices. If discrepancies are too big, investors might believe that a rating agency mis-rated the issuer rather than the market failing completely to display the riskiness of the security was the explanation provided by Fridson (1999) . However, for this type of reasoning one has to build on the assumption that market prices do indeed reflect the riskiness of a security. It was argued that behavioral economists seriously challenge this view. Then, if (and only if) risk assessments by credit rating agencies are really based on fundamentals, market participants should actually value the judgments of rating agencies more than their observation of market prices fluctuations. But then again, market participants need to appear more rational than they (probably) are. Skipping the rationality assumption thus might offset large part of the reputation mechanism presented here. Market partici-

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<sup>81</sup> A favorable rating is one with a higher grade than the issuer would actually “deserve” while the issuer would be willing to pay extra for this favor. One could also simply call it a bribe.

pants might simply relegate undesirable ratings as mis-ratings. Alternatively, they could over-rely on ratings for other reasons than its quality – a subject which is further discussed in Chapter 4.

Turning again to the classical economic reasoning, Shapiro (1983) shows in a multi-period model how inter-temporal reputation returns emerge. A rating agency needs first to invest several periods to gain reputation while offering high quality ratings at prices below costs and only can raise prices above costs in later stages. Accordingly, a rating agency would suffer several periods of losses after cheating (provided that the cheating is detected). In the long run, gains from a continuous high quality production offset the gains from a one-time cheat followed by several periods of losses.

The fact that rating agencies must undertake an initial investment also implies another interesting dimension of the rating business: the competitive industry structure. Besides the price discounts covered in the model, rating agencies also need to invest in marketing strategies including the publication of default and transition studies. Even though these studies are technically simple, rating agencies still need to realize substantial efforts, and newcomers might need to do these studies themselves (just as the big rating agencies), while the proportional costs are much higher for small newcomers than for the big established rating agencies. Furthermore – and possibly more important – newcomers need to count with a certain level of activity (in terms of numbers of ratings issued) in order to provide meaningful studies. All these factors constitute considerable entry investments for newcomers. Given the high profitability and market power of the major rating agencies, the obvious question arises whether the reputation mechanism also can constitute a barrier to entry, impeding new entrants to successfully compete with the incumbents. This aspect is further discussed in Chapter 4.1.

Dittrich (2007: 28-32) answers this question affirmatively. He raises the important point that the point of departure for the major rating agencies in the 19<sup>th</sup> century is not the same as for nowadays new-entrants. He highlights the declining value of minimum quality ratings as a crucial variable to shed light into this topic. While still focusing on the informational value of credit ratings, it is argued that the value of minimum quality is zero as the freely available market data provides the same information as cheaply produced ratings. No issuer would thus buy a minimum quality rating in times of the internet, mandatory business reports and other transparency standards, where the easy accessible data pool is large enough to allow investors to inform themselves without incurring major costs. Even though in the present study the assumption that external credit ratings exist mainly because of their informational value is skipped, it still seems plausible that (uninvolved) investors mainly seeking “orientation through standardization” would reject too rudimental ratings and rely on their own (maybe equally rudimentary) analysis without consequences on the issuer’s funding costs.

The situation in times when the first rating agencies appeared was quite different. Freely available information especially through information technology was very limited. Furthermore, strict disclosure laws were only gradually introduced since the 1930s (Sylla 2002: 25). Therefore, ratings with minimum quality information (even of newcomers) did originally carry valuable information, while the fact that in those times investors would pay for the ratings further backs this argument. The incumbent agencies hence received at least a price for their minimum quality ratings which covered their costs.

At the same time, producing even low quality ratings always implies real costs for the rating agencies. Accordingly, rating agencies nowadays would always produce ratings of a quality (at least slightly) higher than the minimum quality (Dittrich 2007: 28-32). At the same time, issuers would also assume that the actual rating quality is (at least slightly) higher than the observable minimum quality. However, as newcomers do not count with reputation capital, issuers would be willing to pay for (and thus only offer the price for) the minimum quality. They cannot offer credit ratings at any quality level in a cost-covering way (as the incumbents still could). Thus, the build-up of reputation has become more expensive over time which endowed the incumbent agencies with an “early-mover-advantage”. Even though these arguments have to be contemplated with care, as rating-based regulation can still be one of the driving factors behind the competitive environment, this stylized view still provides some additional insights. Furthermore, it seems to be supported up to some degree by actual market developments, as the number of successful newcomers has been small, and policies aiming at raising the competition (such as the gradual recognition of more rating agencies as NRSROs) did at least until now not lead to a lowering of the major rating agencies’ market power. The fact that many newcomer rating agencies outside the U.S. become to some extent officially engaged with the major agencies – sometimes even after years of existence, as in the case of the German Creditreform Rating AG (see Chapter 2.1.2)–strengthens this market-driven, reputation-based argument.

Another aspect, why the big rating agencies might have a competitive advantage compared to new-entrants, is the cost structure of the rating’s production (Dittrich 2007: 32-34). Starting with the quite general argument that the relative production costs of services (e.g. the production of knowledge) in comparison to physical goods increased over time, linked to productivity gains in the production of the latter, the relative price increase for ratings is especially nuanced as the provision of high quality ratings is much more complex than in times of inception of the industry. This is due to several factors, such as the internationalization, fast changing technology, increasingly complex legal positions and financial regulations. Furthermore, the complexity of corporations as well as financial transactions (and products) has risen. Besides, the cost increase might be over proportional the higher the quality of ratings while the production of low quality ratings might be less affected.

Incumbents, however, did their investment in reputation at lower cost levels in knowledge production. While facing a lower initial loss than new entrants, the “old” reputation premium still permits these agencies to break even at presently higher costs while newcomers face a situation where a relatively higher investment in reputation is needed. This means that the value of existing reputation increases over time. Still, in practice this does not necessarily mean that newcomers face a barrier to entry as prices for (high quality) ratings also rose over time. In order to avoid a “milking” strategy, incumbents would not lower the prices aiming at impeding newcomers to enter the market. Strausz (2005: 46) argues that an honest rating – Strausz actually refers to any certification product based on reputation – would always require a high price (possibly even higher than a monopolistic price). The additional profits might, however, be used to enter into a non-price competition strategy.

So far, only the existing rating business has been considered. Another interesting question arises from the insights above – as will be shown, also considering the rating industry directed to micro-finance: Can established rating agencies also transfer their reputation into new market segments they were prior not engaged in? Alternatively, one could ask whether a newcomer could transfer some of its reputation gained in a specific niche market to market segments he would need to compete with the incumbents.

Reputation always consists of two different elements. One is linked to the brand name. Once this kind of reputation is established, market participants associate a certain product quality as well as an overall image with it. Another important element of reputation is linked to the specific rating service offered. In case the production technology or capacity of rating agencies in already established rating markets can easily be transferred to new market segments, incumbents are likely to have a competitive advantage over newcomers. Thus, if rating services are very similar and share important key factors, for example regarding the rating methodology, it is reasonable to assume that market participants would trust the established rating agencies of being capable to provide equally high quality ratings. Dittrich (2007: 45) further argues that the successful transfer of reputation is even more likely if the new market segment is not very large in comparison to the core market. If the new market is large also incumbents would make to have considerable new investments into reputation. However, the larger the rating agency is, the bigger is also the scope for a potential reputation transfer. Dittrich (2007: 84-85) furthermore concludes, that there might even be room for economies of scale in the reputation building. He refers to models where information about past quality explicitly spreads to non-customers and diffuses gradually and dynamically in complete markets as the one proposed by Rob and Fishman (2005). The longer a rating agency is in the market the bigger the potential customer base grows. This again justifies bigger investments into high quality ratings in order to protect the reputation, while the fact of being long established and big becomes a quality signal by itself. A high price in this setting

would serve furthermore as a quality assuring signal and new issuers would pay that price based on the experience others have had with the rating agency. The fact that the big rating agencies were very successful in entering into new market segments (e.g. emerging countries) points to fact that they could successfully transfer their reputation. Again, the (partial) take-over of newcomers by the major rating agencies even though some market participants might have had some reservations in the beginning, further exemplifies this transfer of reputation.

Being big also has an advantage looking at factors which could put the reputation in danger. Two ways beyond the control of rating agencies can negatively influence the agencies' reputation. First, high quality ratings can erroneously be perceived of low quality. Second, single unexpected events can cause not anticipated defaults which could be over-emphasized by market participants. In general – as it was discussed in Chapter 3.2.1 – Ramakrishan and Thakor (1984) show that small information producers want to merge in order to diversify these risks. The risk of a loss of reputation for small rating agencies because of a single event or misperception would be much bigger than for big rating agencies, especially when it is expressed in a statistical manner like in transition and default studies. This would also apply in case of sporadic low quality ratings of single analysts, for example in the case where an effective internal monitoring mechanism is absent. Furthermore, effective internal monitoring structures are easier to be set up in bigger rating agencies than in smaller agencies as bigger agencies have, for example, larger personal capacities to split rating teams and committees.

Before turning to the characteristics and modes of operation of different kind of rating agencies in the field of microfinance, the next chapter discusses critical issues regarding the major U.S. raters. Some of these issues challenge the reputation capital view outlined above.

## **4 Ratings above Suspicion? - Empirical Analysis Regarding Critical Aspects of the Performance of the Major Rating Agencies and the Functionality of their Assessments**

The activities and performances of rating agencies have received a lot of attention in times of financial globalization. Discussions were further triggered by the events of the financial crisis of 2008 and the major credit rating agencies' failure to accurately assess the credit quality of structured financial products. However, criticism goes beyond the quality of credit ratings and is much older, too.

The oligopolistic structure of the rating market and related inefficiencies as well as irresponsible, if not hostile, behavior of the rating agencies has been subject to heavy debates. Among other things, rating agencies have been accused of being non-transparent while suffering from strong conflicts of interest possibly leading to low-quality ratings. These in turn might cause heavy losses for investors and multiply destabilizing forces in financial markets in times of distress. On the other side, (orthodox) economists modeling the role of reputation exhibit some convincing reasons for believing that rating agencies are immune to most of the charges and that they, indeed, serve as dedicated agents, delivering reliable information to financial markets.

The purpose of the present chapter is to provide an overview on the different concerns related to rating agencies possibly hampering their functionality. Firstly, driving forces regarding the structure of the rating market other than the reputation mechanism is presented, namely network and lock-in effects as well as rating-based regulation. Secondly, the criticism as to the behavior of rating agencies is summarized. Finally, the market dynamics associated with credit ratings and related concerns are presented. Chapter 4.4 summarizes the findings. In general, the chapter argues that rating agencies face serious conflicts of interests which became manifest in a daunting way during the financial crisis in 2008. Due to a lack of transparency, market participants could not spot the deterioration of rating quality while the major rating agencies, through anti-competitive practices, further perpetuated their position of power. Market participants, fueled by rating-based regulation, tend to over-rely on credit ratings, causing serious systemic effects in times of financial distress. The major raters' dominance has been repeatedly criticized, especially when the destiny of sovereign states depends on the rating agencies' grace.

### **4.1 Additional Factors Influencing the Demand for Credit Ratings – Network-effects, Lock-in and Rating-based Regulation**

Taking the standardization argument developed in Chapter 3.4.1 and 3.5.1 seriously, rating agencies make very different kinds of companies comparable while applying similar methodologies.

Even though the analysis might vary, rating agencies always deliver exactly the same output. Rating agencies assign the same rating scales for different rating products and industries. Thus, they establish a similarity in their products that issuers and investors alike can easily recognize. The value of a single rating expressed on a specific scale increases in the context of other ratings on the same scale. Therefore, rating agencies actively seek to minimize differences in default rates within specific rating scales but different segments of the rating market, like ratings of financial institutions and industrials or U.S. and foreign firms (Ammer and Packer 2000: 11-12). The survey of Baker and Mansi (2002: 1386-1387) shows that rating consistency is indeed considered the most important factor for a high ranking of a particular rating agency. This creates network-effects or “demand side economies of scale” (Dittrich 2007: 73-74), where an investor always profits from an increase in the number of ratings of one agency since the information value of every possible comparison is zero or larger. Besides the quality of ratings, these network-effects can also contribute to a concentration within the rating industry while establishing a competitive advantage of bigger agencies. Furthermore, this is why the three major rating agencies use very similar rating symbols and scales. This standardization of rating symbols among rating agencies allows investors to compare ratings of different rating agencies. However, a similarity of default rates for single rating categories among different agencies would be a prerequisite to establish ex-post comparability. Hence, default and transition studies do not only serve as a reputation index but also as a means to create comparability in a broader standardization process. This then serves for the establishment of the before mentioned rules of thumb.

In any case, the explanations about transferring reputation provided in Chapter 3.6 did not distinguish between new issuers and current issuers. The transfer of reputation into new market segments implied that new issuers would have to decide for one or another rating agency. Yet, it is also possible for current issuers to change their rating agency. In practice this does not seem to be that easy, though, since issuers could be suspected of “shopping” for favorable ratings (Dittrich 2007: 80-83). If issuers change their rating agency for no obvious, observable reason, investors would suspect that this occurs in order to receive a higher rating. This might especially be true if an issuer changes from an established, highly recognized rating agency to a new, less reputable one. As such an action would shed no good light on the issuer (or on the newcomer rating agency), issuers would abstain from it: They are locked-in. However, the lock-in effect does not work the other way around. It should not be a problem to switch from an unknown rating agency to a high quality established rating agency. Thus, established rating agencies tend to have an increasing market share. Furthermore, it explains why the major agencies do not enter into a price competition with newcomers. The (high) price of a supposedly high quality rating is lower than the costs of changing the rating agency. Besides the costs for lowering investors’ suspicions, changing costs also compass the costs of getting used to the specific procedures of a rating agency (new formats, additional data, etc.).

Finally, additionally to the information value (be it through standardization) rating agencies have a licensing value through the incorporation into many national regulation schemes of the financial sector. For Partnoy (1999) – just as for White (2009) – the license value is even the main driver for the demand for credit risk ratings. He criticizes the widely recognized “reputational capital view”, arguing that inaccuracies in credit spread estimations show that credit ratings do not accurately capture credit risk (Partnoy 1999: 658). Instead, he offers a “*regulatory license view*” (Partnoy 1999: 681) in which credit ratings are valuable, not because of their informational content and their accuracy and credibility, but because they reduce costs associated with regulation. He further claims that even though in theory rating agencies have good reasons to avoid conflicts of interest and secure the quality of their ratings to preserve their reputation, after a small number of rating agencies have been “enshrined” by regulators who incorporate credit ratings into substantive regulation, market participants become less vigilant about the rating agencies’ practices. For Partnoy (1999: 682), periodic regulatory expansion (see Chapter 2.1.1) is the explaining factor for the growth of the major rating agencies. Furthermore, by limiting the numbers of eligible raters for regulation or imposing costs for new entrants, barriers to entry are created. This allows a few rating agencies to gain market power by selling regulatory licenses under oligopolistic (or even monopolistic) conditions and thus, generating abnormal profits. The problem Partnoy identifies is that regulators, consciously or not, assist rating agencies in creating market power while enhancing moral hazard for raters. According to the Partnoy, any form of subsidization of rating agencies can exacerbate market failures. As rating agencies are sheltered from competition, they have no incentive for maintaining high quality ratings. Thus, “*the regulatory license view suggests that certain activities should not be privatized if markets are to function properly. Included among these activities is the rating of credit*” (Partnoy 1999: 686).

Empirically, the proportion of the two different value drivers has not been proven. There are indications in favor of and against both scenarios. For example, the drastic reaction of bond markets, whenever rating changes affect the regulatory status, would favor the regulatory license view. In contrast, Jewell and Livingston (1999) show how market participants value ratings of the three major rating agencies differently. And Hill (2004: 67) argues that if Partnoy was right, all market participants would buy the cheaper Fitch ratings instead of obtaining ratings from S&P and Moody’s. However, Hill (2004: 68-69) recognizes the problematic case where credit information is self-induced because a rating downgrade becomes information itself under rating-based regulation. Even though the view that rating agencies are not delivering any valuable information to market participants seems clearly too drastic, it might well be true that rating-based regulation as well as specific practices of rating agencies invoke some problems which might even require (state) intervention. The following sub-chapters turn now to some of these issues discussed in the literature.

## **4.2 The Behavior of Credit Rating Agencies**

Regarding the activities and behavior of the three major U.S. rating agencies, Frost (2006) provides a comprehensive overview on the criticism these rating agencies are confronted with. Many of the issues covered in Frost's study had also been raised by the Technical Committee of the International Organization of Securities Commissions (IOSCO) which in 2003 formed a Task Force with members of financial regulators from 13 countries to discuss the activities of credit rating agencies (IOSCO 2003). In the same year, the U.S. Securities and Exchange Commission (SEC) published a report on the "Role and Function of Credit Rating Agencies in the Operation of the Securities Markets" (SEC 2003) based on public hearings on the rating agencies performance. This report also covers many issues of lasting criticism. The criticism toward the major rating agencies peaked – for the time being – during and after the financial crisis of 2008. The "Financial Crisis Inquiry Report" of the Financial Crisis Inquiry Commission (FCIC 2011) can be considered the richest source of information on the rating agencies' role in the financial market and its collapse with the fall of Lehman Brothers. The following sub-chapters provide an overview on critical issues mentioned.

### **4.2.1 The Lack of Transparency**

One of the mentioned problems refers to the disclosure practices of rating agencies in terms of their rating procedures, analytical methods and rating criteria. Users of credit ratings wish to fully understand the reasoning behind rating decisions and types of information that rating analysts rely upon. Specifically, users want to have more information on analysts' key assumptions and expectations regarding the issuers' financial performance and industry trends. Finally, they would appreciate to have a list of the key documents reviewed during the rating process (SEC 2003: 33-34). Frost (2006: 11) summarizes the advantages of increased transparency as follows: Credit rating agencies would gain a stronger reputation and credibility through a higher quality rating product that the market would value. Furthermore, rating agencies would have a better chance to preempt increased regulatory requirements or oversights. Market participants also claim that increasing transparency would reduce uncertainty and accompanying market volatility that frequently surrounds rating changes (SEC 2003: 33).

Up to this point, disclosure adequacy has not been defined precisely. IOSCO (2004: 3) vaguely propose that rating agencies should publish sufficient information about their procedures and methodologies so that a user can understand how a rating was conducted. This information should include the meaning of each rating category, the definition of default as well as the time horizon a rating agency uses when making a rating decision. The major rating agencies do actually publish methodological guidelines and rating criteria which are publically available on the agen-

cies' websites. Furthermore, these rating agencies publish a vast number of press releases each year. However, specific evidence for the degree of disclosure of rating agencies which also could be compared to each other is not available (Frost 2006: 12). Regarding the adequate disclosure requirements, Frost (2006: 11) furthermore argues that it would be difficult to objectively test when the appropriate point of adequacy is reached. The Credit Rating Agency Reform Act of 2006 (see Chapter 2.1.1) and the rules adopted in 2007 address this issue by requiring NRSROs to make their registration materials, including their rating procedures, public. However, Hunt (2009: 23) criticizes that SEC decided not to require the disclosure of rating methodologies but rather a description of methodologies and procedures. As a result, rating agencies certifications contain a lot of information about the committee processes but little information on how they substantively decide on ratings. He therefore concludes that SEC is *"paying lip service to transparency in all its forms while adopting rules that appear to be of limited effect"* (Hunt 2009: 24).

It is questionable whether full transparency is likely to be achieved. For rating agencies increased transparency might incur costs as it implies releasing proprietary information to competitors as well as to users, who could then no more require the rating agencies' services. However, if efficiency gains in highly disintermediated capital markets by avoiding a duplication of efforts are where rating agencies primarily produce an added value, this argument is less convincing. Even if rating agencies were fully transparent in terms of information used and how they derive their judgment, it would still require considerable efforts to collect the relevant information. Furthermore, at least small uninvolved investors do not have the (human and data) resources for doing the same type of analysis. Yet, the rating process is a complex analytical (and political) exercise<sup>82</sup> with the reasons derived from various data sources (quantitative and qualitative) being repeatedly balanced against each other. Even though the rating grade and reports are presented in a highly standardized way, the process itself is not (always) standardized to a degree which would allow full transparency. Furthermore, private, confidential information of issuers is integrated, too, thus, rating agencies cannot simply publish all of the documents they base their judgments on. Still, a considerably higher degree of transparency is possible. It seems that rating agencies rather aim at protecting their superior knowledge (rather than underlying information) vis-à-vis relatively involved investment intermediaries (asset managers). The belief that rating agencies are better predictors of the future and hence create trust within uncertain environments is nourished by opacity and secrecy. This is how oracles have worked ever since. The question, therefore, is rather whether market participants want (or should?) recognize rating agencies as epistemic communities and strongly rely on their opinions, given that they are neither subject to liability nor accountability.

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<sup>82</sup> This will be further discussed in Chapter 7.2.2.

The call for an increased disclosure does not only encompass the methodological transparency, however. Rating agencies have also been criticized for being selective in their disclosure to subscribers. Even though rating agencies ensure that the ratings are disclosed to subscribers and the public at the same time, there may be additional, more extensive information which is only provided to subscribers. Furthermore, many subscribers have direct access to rating agency analysts and hence can further discuss rating reports (SEC 2003: 35). A preferential treatment of subscribers compared to the general public ensures rating agencies an extra income besides the fees paid by issuers. Yet, concerns have been raised whether these privileges could create unfair information asymmetries in the market place. For instance, the regular contact with rating analysts could lead to a situation where subscribers are informed about a forthcoming rating change prior to the public. Moreover, there is a risk that private information is also released. However, the call for general accessibility of ratings and supportive documents might also imply that rating agencies need to fully rely on issuers' fees. This, however, has been fiercely criticized as is shown in the following section.

#### **4.2.2 Conflicts of Interest**

Another, even more important aspect that has been confronted with ongoing criticism is the existence of conflicts of interest. Within the rating agencies' business model there are many potential sources for conflicts of interest. Regarding the SEC (2003: 40-43), the two most obvious potential reasons are a) issuers paying for the rating services and b) the development of ancillary businesses.

Rating agencies' dependence on revenues from the companies they rate could induce them to issue favorable ratings. This potential conflict of interest could be especially pronounced in cases where rating agencies charge their fees based on the size of the issuance. In that case, large issuers could receive inordinate influence within the rating agencies. The large rating agencies agree that the issuer-fee model creates conflicts of interest. However, they also believe that rating agencies have historically proven that they can effectively manage this problem. Rating agencies point to the fact that fees received from an individual issuer are too small to make a milking strategy worthwhile. Furthermore, they state that the costs through the loss of reputation would be higher than any gains of an individual attempt to issue a favorable rating (ibid).

Prior to the financial crisis of 2008, empirical evidence – however few – did not suggest a manifestation of conflicts of interest. For instance, Covitz and Harrison (2003: 23) conclude that rating agencies appear to be relatively responsive to reputation concerns and thus protect the interests of investors. Butler and Rodgers (2003: 19), too, find no evidence that “*rating shopping biases have a strong and consistent effect on the rating process*”. However, there might be seri-

ous limitations to empirically testing conflicts of interest (Frost 2006: 17). The conflict of interest issue based on the issuers-pay-model has been again seriously discussed after the financial crisis of 2008.

The market for structured products is different from the one of corporate debt. While in the latter there are thousands of (relatively small) issuers, the structured finance market is dominated by a relatively small number of (big) investment banks. Profit margins for these issues are large and investment banks could threaten rating agencies to move all its securitization business to another agency in much more powerful way than any individual corporate issuer could (FCIC 2011: 149; White 2010: 221). For example, the U.S. Financial Crisis Inquiry Commission (FCIC) found out that among U.S. bank holding companies 97% of over-the-counter derivatives have been installed and traded by just five large institutions (FCIC 2011: 50). At the same time, the share of revenues from structured finance ratings at the large rating agencies have grown constantly. At Moody's<sup>83</sup>, almost half of its revenues was made up by rating structured finance products in 2005, 2006 and 2007, and from 2000 to 2007 revenues from such ratings more than quadrupled (FCIC 2011: 118). To which extent major rating agencies cashed in on this development can be exemplified by the following: The reported revenues of Moody's from rating structured products grew from 199 million USD in 2000 to 887 million USD in 2006 which made up for 33% and 44% of total revenues respectively (FCIC 2011: 149).

Accordingly, rating agencies were considerably under pressure to hold their market share as investment banks frequently threatened to withdraw their business. This is testified by Richard Michalek, a former Moody's vice president and senior credit officer: *"The threat of losing business to a competitor, even if not realized, absolutely tilted the balance away from an independent arbiter of risk towards a captive facilitator of risk transfer"* (cited in FCIC 2011: 210). The changing business culture away from *"resembling a university academic department to one which values revenues at all costs"* – as stated by a former managing director at Moody's (cited in FCIC 2011: 207) – was further enhanced by the entrance of external investors when Moody's went public in 2000. These investors were most of all interested in revenues based on the pricing power Moody's exercised (FCIC 2011: 206-207). In the following, the increase of market share became part of employment evaluations and managing directors were granted cash bonuses in order to integrate market coverage, revenues and market outreach into the performance goals (FCIC 2011: 208-209). The problem was addressed in an internal memorandum in 2007 which was supposed to encourage rating analysts not to lower credit standards for solving the market share problem. However, this plea appeared insufficient – as Moody's Chief Credit Officer Andrew Kimball noted. In this case, the control mechanism of the rating committee was reversed. Even

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<sup>83</sup> Moody's served as a case study in the FCIC report. However, it seems reasonable to assume that similar developments can also be found at S&P and Fitch.

though single rating analysts might have wanted to keep standards high, *“entire committees, entire departments, are susceptible to market share objectives”* (cited in FCIC 2011: 210). The conflict of interest problem sharpened because investment banks, thus, asset managers acting on behalf of the ultimate investor, while facing little liability, successfully used the rating agencies for extra profits. And the reputation mechanism in order to guarantee high quality ratings also failed because high standards might not even have been the priority for those actually using these ratings: *“Issuers want high ratings; investors don’t want rating downgrades; and bankers game the rating agencies for a few extra basis points on execution”* (Kimball cited in FCIC 2011: 211).

The conflict of interest also increased through the development of ancillary businesses which has taken place in recent years. These businesses include assessment services where an issuer presents hypothetical scenarios to a rating agency to determine how their ratings would be affected by a proposed action. Furthermore, rating agencies also offer risk management and consulting services. The potential conflict of interest arises since rating agencies’ decision-making might be affected by the fact that an issuer requires additional services or not. Especially in cases where a real rating follows a hypothetical rating, rating agencies are under pressure to match the actual rating with the “promised” rating in the consultation phase, even if the analysis does not support such an action. In the context of the financial crisis of 2008 it has to be noted that rating agencies were heavily involved, not only in rating structured financial products but also in advising investment bankers how specific products should be designed in order to receive a certain rating. The FCIC concludes that rating agencies were *“key enablers of the financial meltdown”* and that the *“mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval”* (FCIC 2011: xxv, 44, 139-140). Amadou (2009: 16) even refers to high quality ratings as the *“Gold Standard of the SP [structured products] boom”*. As investment banks and other designers of structured financial products realized that they needed to secure favorable credit ratings, they *“paid handsome fees to the rating agencies to obtain the desired ratings”* (FCIC 2011: 44). This was certainly triggered by rating-based regulation. The capital requirements for securities rated other than investment grade were ten times higher than those rated between AAA and BBB (FCIC 2011: 100). Thus, incentives were high for entering into regulatory arbitrage. However, this is by far not the only reason as will be shown further below.

### 4.2.3 Declining Rating Quality and Timeliness

One situation in which rating agencies are accused of behaving opportunistically occurs when they “mis-rate” an issuer, that is when a default occurs which had not been foreseen. The most famous case of such a misrating prior to the recent financial crisis is the one of Enron in 2001.<sup>84</sup>

Until end of November 2001, the major rating agencies rated Enron<sup>85</sup> investment grade. Only four days before the company declared bankruptcy on December 4, 2001 the rating agencies downgraded Enron to the “junk” category (Hill 2003: 1145). However, the criticism soon turned out to address the lack of competence rather than the lack of independency. One rating agency representative put it as follows: “*We may be incompetent but we are not dishonest*” (cited in Hill 2004: 75; N.N. 2003). Besides, apart from questioning the thoroughness of the analyses as well as the training and qualifications of analysts for adequately assessing a company’s credit risk, rating agencies were affronted because of the timeliness of their ratings. The latter refers first of all to delayed downgrades.

Rating agencies were charged of exercising a “*dismal laxity*” (Hill 2004: 80), not only in the case of Enron but also in other cases of rating failures like WorldCom, Global Crossing, Executive Life, Orange County and Washington Power.<sup>86</sup> However, Hill (2004: 79-80) argues that all these cases were extraordinary. Enron (and others) were cases of serious fraud. Moody’s and S&P recognized that they could have asked more detailed and probing questions and they implemented a couple of measures in response to that wave of corporate scandals (Frost 2006: 28). However, even though it became apparent ex-post that rating agencies performed poorly, it seems hard to reconstruct what rating agencies have to know at what moment. In general, rating agencies claim to rank debt issues by quality while conducting in-depth research on companies. They do not, however, go beyond what company officials tell them. Going beyond company statements and documents would be another speciality; the focus would need to lie on fewer companies though (Hill 2004: 80).

In the context of the recent financial crisis, however, criticism was harsh again when it became apparent that rating agencies had failed to correctly assess credit risk of structured financial products. In general, securities backed by subprime mortgages were rated widely optimistic (FCIC 2011: 8), especially those issued between 2005 and 2007. At one moment, 80% of collateralized

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<sup>84</sup> In fact, the Enron debacle was the reason for the accelerated efforts to reform the regulatory regime for rating agencies in the U.S. and the SEC hearings in 2003 mentioned above; see Hill (2004).

<sup>85</sup> Enron was a large U.S. energy company which realized a major accounting fraud and has since become a popular symbol for corporate fraud and corruption.

<sup>86</sup> For more information on each of these cases, refer to Hill (2004).

debt obligation (CDO) tranches were rated AAA despite the fact that they compromised lower-rated tranches of mortgage-backed securities (FCIC 2011: 127).

Consensus prevails upon the fact that rating agencies' methodologies were not appropriate to correctly assess credit risk for these structured products. FCIC identifies two key mistakes committed by the rating agencies. Firstly, rating agencies, while using quantitative financial models, applied unrealistic correlation assumptions between and across categories of mortgages and believed the securitizers could create safer financial products through diversification. However, these securities did not appear different enough for investments to be actually diversified. Furthermore, these models put little weight on sharp price changes in the housing market. Rating agencies rather relied on a limited historical data base, again leading to erroneous assumptions about future changes. Secondly, rating agencies based their CDO ratings on ratings they themselves had assigned to the underlying collateral (FCIC 2011: 120, 149), meaning that they integrated credit ratings as hard facts into computer models even though the original rating was not an adequate absolute, quantifiable predictor of future defaults. In this sense, rating agencies relied too much on (pseudo) science instead of on actual judgments, as will be argued further below.

Rating agencies publically stated they were able to correctly assess credit risk of novel, complex products as they were only variations of long existing technologies (Hunt 2009: 48). These statements were always adorned, though, with the standard disclaimer, that ratings are solely statements of opinion and not statements of facts or recommendations to buy and sell any securities (FCIC 2011: 120). While it is true that most (if not every) anticipations of future events have to be described as vague (see Chapter 3.3), it sounds like a poor excuse vis-à-vis the magnitude of rating agencies' mis-judgements. Three possible reasons contributed to the decline in rating quality. The first has to do with the problem of conflicts of interest described in the previous section. Indeed, there are indications that rating agencies deliberately ignored evidence (data) that would result in lower ratings (FCIC 2011: 167-168). Secondly, rating agencies might have actually believed that their models correctly assessed credit risk while putting little weight on the qualitative parts in their rating process.<sup>87</sup> Thirdly, they simply did not have the means to deal with the increasing volume and complexity of the structured products. In fact, while the volume of CDOs to be rated by Moody's increased sevenfold between 2002 and 2006, the staff increased only by 24% (FCIC 2011: 206). Furthermore, in the search for profits, Moody's management was reluctant to pay up for experienced staff: *"The problem of recruiting and retaining good staff was insoluble. Investment banks often hired away our best people. As far as I can remember, we were never*

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<sup>87</sup> This might also be the case for investors who consciously relied on the rating agencies' risk assessments. In order to avoid duplications, this issue will be discussed further below.

*allowed funds to make counter offers*”, confessed Gary Witt (a former team managing director at Moody’s) (cited in FCIC 2011: 149). The result was a high staff turn-over. In 2005, nearly 25% of the staff left Moody’s to work for investment or commercial banks (FCIC 2011: 150). Furthermore, investment bankers put pressure on the rating agencies to submit a rating within a very tight time frame. Before the peak of the housing boom, it took a rating agency between six weeks and two months to rate a CDO. In 2006, Moody’s gave AAA ratings to an average of more than 30 mortgage securities each and every day, while there were cases in which rating agencies were only allowed three to four days for the review and final judgment of CDO deals (FCIC 2011: 211).

Another feature linked to credit quality is the timeliness of credit ratings and revisions (Hill 2004: 79; White 2010: 218). However, in defense of the rating agencies, Hill (2004: 71) points to the fact that ongoing monitoring is expensive for the rating agencies and thus, downgrades and upgrades will always be less accurate than the initial rating. In the case of corporate ratings, this is also due to the incentives of companies to provide accurate and timely information. In the initial rating process rating agencies and companies alike want to provide the “whole picture”. Once this is done, the company has little incentive to voluntarily provide negative information which could cause a downgrade. For a rating agency, it is not feasible to investigate a company on an ongoing basis as thoroughly as in the initial rating process. This is especially true, if, as in the case of Enron, the events are basically unpredictable and something like fraud can almost lead to an immediate default. Still, it is widely recognized that rating agencies did a poor job on Enron and the other companies mentioned before (Hill 2004: 71).

When regarding the timeliness of credit ratings, in general, another factor has to be taken into account. Credit ratings serve different functions. Taking the Information Function, ratings should be as timely as possible. However, there are conflicting objectives of ratings’ timeliness and stability which rating agencies have to balance. Rating agencies claim to follow a “through-the-cycle” approach which *“attempts to filter out noise of every fluctuation in market sentiment”* rather than a “point-in-time” assessment (Gonzales, F. Haas *et al.* 2004: 16,22; Löffler 2004, 2005). This practice is due to the rating agencies’ links to institutional investors which incorporate ratings into their investment contracts and due to regulatory rules (White 2010: 218). Beaver *et al.* (2006) conducted empirical research on the differences between non-certified and certified rating agencies. They find that while non-certified agencies tend to provide timely information to investors, for certified agencies the contracting role seems to be more important (Beaver, Shakespeare *et al.* 2006: 303-332). Prudentially regulated investors (regulated for safety such as banks, insurance companies, etc.) are interested in rating stability in order to reduce the need for frequent and expensive portfolio adjustments (White 2010: 218). Hence, the Certification Function, especially when considering rating-based regulation, rather calls for stability rather than timeli-

ness. Furthermore, for rating agencies a “through-the-cycle” strategy is certainly more profitable as they can employ less staff (White 2010: 219).

No consensus has been reached on adequate time patterns. Yet, scholars trusting in reputation capital view state that timeliness is part of the rating quality and is, therefore, incorporated by rating agencies in their efforts to perpetuate their reputation (Dittrich 2007: 129). Accordingly, rating quality in terms of methodology (including major failures) and timeliness is often discussed simultaneously.

This is also true in the context of the financial crisis, however, seriously challenging the reputation capital view. For example, the rating agencies still had “investment grade” ratings on Lehman Brothers’ commercial paper on the very same morning the bank declared bankruptcy in September 2008 (White 2010: 218). Once the financial turmoil took off, rating agencies massively downgraded structured finance products while applying very sharp cuts (FCIC 2011: 148, 222,242).<sup>88</sup> Given that these downgrades had serious consequences for some market participants, they wondered why rating agencies re-adjusted their judgments so lately:

*“I’d like to know why” – Steve Eisman (the founder of an investment fund within FrontPoint Partners) asked – “I mean, the news has been out for subprime now for many, many months. The delinquencies have been a disaster now for many, many months. [Your] ratings have been called into question now for many, many months. I’d like to understand why you’re making this move today when you – and why didn’t you do this many, many months ago... I mean, it can’t be that all of a sudden, the performance has reached a level where you’ve woken up” (cited in FCIC 2011: 242).*

A tentative answer to this question is provided further below. It is discussed how credit ratings influence and are influenced by market dynamics.

#### **4.2.4 Anticompetitive Behavior**

Before turning to the market dynamics related to credit ratings, the following section briefly discusses one last concern in terms of rating agencies’ behavior. Some critics allege that the major rating agencies use certain competitive practices in order to maintain their dominant market position (Frost 2006: 19). One of the activities mentioned are unsolicited ratings. S&P calls them “public information (pi) ratings”, Moody’s offers “investor-initiated ratings” and Fitch found the

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<sup>88</sup> Downgrades of four notches per security were not rare while prior to the crisis downgrades of one or two notches were the routine. A notch describes the difference between two rating grades. For example a downgrade of a single notch would correspond to a movement from AAA to AA.

label “shadow rating” (Dittrich 2007: 111). Rating agencies argue that unsolicited ratings are legitimate as a) the actual costumers of rating agencies are investors, not issuers. Rating agencies thus had an obligation to conduct ratings based on publicly available information, regardless of whether the rating has been solicited by the issuer; b) there should be no basic differences in the quality of rating information. If there are, it is because the issuer did not make sufficient information available to the public. Hence, unsolicited ratings were fair and objective. If this were not the case, the ratings would be of low quality, putting in danger the reputational capital (Fight 2001: 213).

Even though it is not an easy task to find out about the (hidden) reason of certain actions, there are some arguments which contradict the agencies’ description. Fight (2001: 213-214) points to the fact that the “investor service” argument is hard to maintain as long as issuers are paying for the rating service and remains unclear which selection criteria are used to target companies for unsolicited ratings. Moreover, the argument is weakened by the fact that there also exist not-for-publication solicited ratings. This suggests that as long as issuers pay for their ratings, rating agencies are willing to – at least temporarily – interrupt their investors’ service policy. Unsolicited ratings should thus rather be interpreted as a means to force issuers into solicited ratings. While unsolicited ratings tend to be lower than solicited ratings – given that they are based on a limited informational basis – issuers have an incentive to pay for a more accurate and, most of the time, higher rating. The statement on the similarity of rating quality of un- and solicited ratings would, thus, contradict the argument that solicited ratings are to some degree based on private information.

Empirical evidence also suggests that in some cases there might be a systematic abuse of unsolicited ratings. Poon (2003) finds that unsolicited ratings of S&P tend to generally have lower grades. His explanation, however, is a negative selection bias. Companies which received lower unsolicited ratings have weaker financial profiles than companies which willingly go for a rating. He only finds systematic differences for the case of Japanese corporate bonds. Frost (2006: 21), on the other hand, argues that the results for the Japanese case might be driven by instability of the rating industry during the sample period as S&P more than doubled its rating actions between 1998 and 2000. Butler and Rodgers (2003) suggest that unsolicited ratings differ from solicited ratings in terms of content. They find that rating agencies for solicited ratings do not rely that much on “hard” information but are also active in soft information production. The evidence presented by Poon and Firth (2005) is based on a somewhat richer dataset than the study of Poon in 2003. It suggests a strong systematic difference between solicited and unsolicited ratings in the case of Fitch. Furthermore, there is evidence that issuers feel threatened by unsolicited

ratings. The “Cantwell-Survey”<sup>89</sup> of 1998 states that about 90% of issuers who first received an unsolicited rating went for a paid rating afterwards (Fight 2001: 155). The survey also reveals that Fitch as the smallest agency among “the big three” issued far more unsolicited ratings than its two most important competitors. Apparently, unsolicited ratings are a convenient way for newcomers to build up their reputation in times issuers are not yet willing to pay for the ratings.

However, there are two practices which are related to the abuse of market power foremost related to the biggest rating agencies S&P and Moody’s: notching and tying (Dittrich 2007: 113-114; Frost 2006: 21-22). “Notching” refers to the practice of lowering ratings (or to refuse to rate, at all) of structured securities unless the underlying securities are also rated by the same agency. Moody’s, however, justifies differences in ratings because of the adjustment for uncertainty and perceived differences in evaluation practices. An independent study on this issue of reasonable ranges is inconclusive though (Carron, Dhrymes *et al.* 2003: 46-50). “Tying” means that a rating agency conditions the issuance of a credit rating to the purchase of another product (e.g. another rating or some ancillary service).

Another possible abuse of power has a broader, political dimension and currently criticism has become louder due to the impact on some, highly indebted European countries. The issuance of sovereign ratings is in most cases unsolicited and rating agencies were even accused of being part of some U.S. conspiracy against European economies (Balzli 2010: 74). However, the discussion on sovereign ratings has two dimensions. Only one is the “unfair” behavior of rating agencies. The other one includes market dynamics linked to the importance of credit rating agencies in financial markets. In order to avoid duplications, both topics are dealt with in the next sub-chapters.

### **4.3 Credit Ratings and Market Dynamics**

In order to complete the review of critical issues linked to credit ratings, the following two sub-chapters focus on the structure of the rating industry and on how ratings are used by market participants and the respective allocation effects. The first section develops on the impact of credit ratings on market (in-)stability. The second section turns to allocation effects due to the quasi-monopolistic structure of the rating industry. Furthermore, the discussion on the perceived (and feared) power of credit rating agencies to control capital flows are also covered.

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<sup>89</sup> Cantwell & Company is a consultancy specialised on advisory services for issuers seeking a credit rating.

### 4.3.1 Financial Market Instability and Over-reliance of Investors

Financial regulators have a vivid interest in securing financial stability. The “through-the-cycle” approach of rating agencies could enhance financial stability (Gonzalez, F. Haas *et al.* 2004: 22). Yet, there tend to be extreme situations in which rating agencies overreact to market developments due to an increased pressure for corrections. Since investors’ decisions are influenced by credit ratings they can have a pro-cyclical effect. Mora (2006: 2041) questions that rating agencies are actually pro-cyclical. For the case of the Asian Financial Crisis she concludes that “*ratings are, if anything, sticky rather than pro-cyclical*” and “*it is questionable that ratings exacerbate the boom-bust cycle if they are simply reacting to news, whether macroeconomic or market*”. Their stickiness supports the “through-the-cycle” view which, based on “fundamentals”, would ignore any type of noise in financial markets. Credit ratings of different rating agencies are supposed to be quite similar given that they are based on some sort of fundamental analysis and issued on basis of similar methodologies. Nevertheless, there are situations in which sudden rating actions appear to be too similar.

During the Asian Financial Crisis it became apparent for the first time that rating agencies were subject to a “conformity bias”.<sup>90</sup> They tried to avoid diverging too much from their rivals’ opinions out of fear of a relative loss of reputation for getting things wrong while the other rating agencies do not. Vaaler and McNamara (2004) assess this case empirically. They find out that rating agencies are prone to distorted decision making in cases where the stability of their own industry environment changes and thus, their position in the industry. In times of crisis, rating agency experts tend to be overly pessimistic, especially incumbent as well as regionally focused agencies. They conclude that rating experts might mislead clients in unstable environments and, hence, in times when their indifference and objectivity is most needed. Ferri, Lui and Stiglitz (1999) criticize the initial stickiness of credit rating agencies, too, stating that once they react, credit ratings foster pro-cyclicality. This “isomorphism” which increases the organizational legitimacy (Deephouse 1996; Dittrich 2007: 106) fits well into the logic of the credit rating industry as conformity helps to maintain reputation. As long as they do not diverge too much from the conventional judgment – speaking the in the words of Keynes (see Chapter 3.3) –, their reputation is not in danger. In situations of multiple equilibria, rating agencies coordinate investors’ beliefs towards the “god”, meaning (relatively) stable equilibrium (see Chapter 3.5.4). In times of distress, the initial immobility of rating agencies tends to prolong the retention within this equilibrium. Yet, in the end,

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<sup>90</sup> Conformity bias refers to the tendency of individuals to behave similarly to the others in their group, even if doing so is against their own judgment. It is also known as “Asch Paradigm” named after the psychologist Solomon Asch who conducted a couple of experiments to find out how social pressure influences the individual human opinion. One could say that these experiments empirically assess the mechanisms behind what Keynes intuitively described as conventional judgment as the result of collective reasoning or reasoning in public; see Bond and Smith (1996).

market dynamics are probably as fundamental to financial markets and as related risks based on past performance of individual issuers. And rating agencies as private stakeholders and rationalized actors (see Chapter 3.4), which follow their own logics of action cannot ignore these dynamics eternally and will, accordingly, react with massive downgrades all at once at a certain point.

The conformity bias is related to the behavior of rating agencies and to the question of rating quality. What makes this issue critical for market (in-)stability, however, is the attitude of market participants towards these ratings. Irrelevant of whether rating agencies update their judgments based on fundamentals or some sort of conforming pressure, credit ratings ultimately have pro-cyclical effects, possibly enhancing a downward spiral, because investors simply rely too much on them.

The “over-reliance” of investors becomes most apparent whenever investors introduce so-called “rating triggers” into their debt contracts. Rating triggers permit investors to take certain actions automatically whenever a rating passes a pre-defined threshold. One action could be the automatic increase of interest rates or an immediate repayment requirement (Gonzalez, F. Haas *et al.* 2004: 12-15). From an investor’s point of view, rating triggers considerably lower monitoring costs. From an issuer’s point of view, rating triggers can be beneficial as issuers can demand a lower initial spread on debt contracts. Even though over 60% of investors conduct their own internal analysis and do not solely rely on credit ratings when deciding to enter into a credit relationship (Baker and Mansi 2002: 1381), the incorporation of rating triggers is widespread. In 2001, 87.5% of 771 U.S. corporate issuers rated investment grade reported that they found rating triggers in their debt contracts (Gonzalez, F. Haas *et al.* 2004: 13). The structural problem with rating triggers is that in some cases they can induce liquidity crises or even bankruptcies. Especially “acceleration clauses” or even the termination of a loan contract can have severe if not critical effects since not only the costs of capital increase but they also cause an immediate need for new capital which might not be easy to find in a situation of distress. While “hitting issuers when they are down”, a rating downgrade can thus have a self-fulfilling effect and cause a “credit cliff” – a situation in which dire consequences like a compounding credit deterioration lead to a default (Gonzalez, F. Haas *et al.* 2004: 14).

Prior to the financial crisis of 2008, there was no clear picture of the size of the contingent liability of triggers. In 2002, a survey among 1000 U.S. issuers revealed that half of them were exposed to rating-based contingent liability but only 3% mentioned this type of liability to be critical (Gonzalez, F. Haas *et al.* 2004: 15). Regarding pro-cyclicality, in general, Amato and Furfine (Amato and Furfine 2004: 2674) do find empirical evidence for pro-cyclicality of U.S. firm ratings while Kräussl (2005) finds that sovereign credit ratings had a substantial influence on emerging markets’ lending during the financial turmoils of the 1990s, especially if downgrades are considered. In the context of the latest financial crisis, FCIC (2011: 119, 243-244, 273) reports that rating triggers

played an important role. They enhanced the downward spiral and helped crippling AIG<sup>91</sup> which would later lead to one of the biggest government bailouts in American history.

The degree of reliance has also to do with rating-based regulation since investors might be forced to sell in the short-term (Dittrich 2007: 107-108). This induces price-overreactions (expressed by falling prices) and investors have to bear losses since they have to sell at a point where everybody else is selling, too. Especially “safeguarded” investors (who have to comply with rating-based regulation) are stuck with their losses. This structural inefficiency clearly raises the costs of rating-based regulation.

However, similar effects are possible even if investors are not (more or less) officially forced to sell, whether it is because of rating-based regulation or private rules (e.g. in order to control asset managers, see Chapter 3.5.3). “Herd behavior” is one of the key concepts in behavioral finance and describes the tendency of individuals to imitate the actions of a larger group while individually most of them would not necessarily make the same choice (Banarjee 1992). Thus, investors as a group are also subject to a conformity bias, whether it is only to avoid regret or to have somebody to blame because their individual judgments might prove wrong, or because they are aware of the negative consequences for their investments if the conventional judgement perpetuated by rating agencies changes abruptly. For instance, during the financial crisis of 2008, investors started panicking once rating agencies massively downgraded mortgage-backed securities and CDOs and markets for these securities shut down (FCIC 2011: 226).

Another reason why investors and regulators alike stick to their orientation on credit ratings might be that they did not have to mistrust rating agencies a priori. Hill (2009) argues that rating agencies successfully rated mortgage backed securities for a long time. Hence, market participants had good reason to believe that ratings were generally accurate, even though they knew that these ratings were not based on “rocket science”. At the same time, rating agencies had no incentives to wait and learn how to rate new financial products since they were forced to exploit the “first-mover advantage”. Otherwise they might have been “frozen out of the market” (Hunt 2009: 52). Furthermore, “dry runs” might be very difficult and expensive. Investors, on the other hand, might not be too strict as long as rating agencies are willing and able to learn and issue high-quality ratings in the longer run. This is especially true when considering that the market for CDOs and alike would not have developed without the help of the rating agencies. As it was convenient to believe in the correct assessment of credit risk provided by rating agencies (motivated reasoning, see Chapter 3.3.2), and even past rating failures, like the one of Enron, did not lead to a major mistrust in those evaluations. The case of Enron (and others) implied a major fraud and high complexity which was used by market participants as an excuse for not “overthrowing” their

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<sup>91</sup> The New York based American International Group (AIG) is one of the largest insurance companies worldwide.

initial belief (belief perseverance). This does not have to be necessarily considered a mistake (a bias) as otherwise – at least with the current structure and “rules” of capital markets – market participants would be paralyzed, given the ongoing informational flow (Hill 2009). Furthermore, as the mortgage-related securities were indeed much more complex than traditional debt securities, rating errors were less likely to be spotted by critics in the short-run (White 2010: 221).

At the same time, rating agencies (or rather their lead analysts) might also have believed for some time that their ratings, especially those for which model based methodologies were applied, reflected fundamental laws of finance and risk correctly. Even though the FCIC (2011: xxii-xxiii) denounces the “*erosion of standards of responsibility and ethics*” within the financial market in general, it also takes into account that to “*pin the crisis on moral flaws like greed and hubris would be simplistic*”. It might be true that rating agencies were extremely sluggish in updating their methodologies (FCIC 2011: 120-121) what also might be considered extremely negligent or even criminal. However, it also appears to be the case that it took rating agencies a while to even recognize what was wrong about their models – as the following statement of Jerome Fons, former managing director at Moody’s, exemplifies (cited in FCIC 2011: 121):

*“I sat on this high-level Structured Credit committee, which you’d think would be dealing with such issues [of declining mortgage-underwriting standards], and never once was it raised to this group or put on our agenda that the decline in quality that was going into pools, the impact possibly on ratings, other things... We talked about everything but, you know, the elephant sitting on the table.”*

The rating methodologies for CDOs and alike were (ostensibly) much more based on “rocket science” than the traditional corporate ratings, which apparently makes it particularly hard to question their results. Rating agencies followed a general development of depending increasingly on statistics and while ever more complex products were created these models promised an unrealistic degree of certainty about the underlying risk. What aggravated the matter further is that leading academics, who were most likely to uncover this pseudo-scientization in the practical sphere, might have suffered from their own conflicts of interest. Epstein and Carrick-Hagenbarth (2010) reveal that the great majority of nineteen prestigious academic financial economists in the U.S., all considered objective experts in the media who also gave recommendations for public policy reforms, had business relations (as consultants, board members of owners) with private financial institutions without making these relations public. One of these academic economists even formed part of the board of directors at a credit rating agency (Epstein and Carrick-Hagenbarth 2010: 6).

One major mistake of or within these models, as mentioned before, was the reliance on insufficient historical data. Another source of mistakes might have been the ignorance of the difference

between risk and uncertainty while putting out of sight the existence and growing probability of “Black Swans” to occur. The latter is linked to the fact that uncertainty is increasingly produced out of interrelated human action and behavior. This, however, was (necessarily?) insufficiently reflected in most of the models and their assumptions about specific empirical distribution functions.

Another mistake might also include a fundamental (mis-)perception of how financial markets function as a whole. In Chapter 3.2.2 the Schumpeterian difference between finance within the circular flow and the financing of economic development was introduced. It was argued that financial innovations cannot be put on the same level as real (economic) innovations carried out by the entrepreneur. The (dominant) Walrasian view on the financial system implicitly equalizes all types of innovations while obscuring the fact that the apparently pure bill-jobbing between financial institutions can ultimately transcend into the real sphere. Wall Street believed to have “created the investor” (cited in FCIC 2011: 127) by building new securities and rating agencies willingly helped to construct and promote these creations. As it turns out, Schumpeter can also be applied in reverse. The financing of innovative entrepreneurs ex-nihilo and the promotion of “creative destruction” can lead to real economic development. Financial innovation, however, when “divorced from reality” (FCIC 2011: 28) should be rather considered “destructive creations”, leaving the (world’s risk) society to bear with the pile of broken glass.

An important question is, whether market participants with respect to rating agencies will behave differently next time. If the reputation capital view was right (and the rating-based regulation did not exist), after the financial crisis, market participants would seriously question the viability of ratings. The reputation capital view suggests that a transfer of good reputation from one segment to another was relatively easy for highly recognized rating agencies. At the same time, negative spillovers will prevent rating agencies from delivering bad quality ratings. Yet, as Hunt (2009: 46) observes, official reports on the crisis did not mention the rating agencies’ performance on corporate ratings but drew a fundamental distinction between the agencies’ traditional and structured-finance ratings, criticizing only the latter. Hence, regulators as well as investors rather segregate products and product types when assessing the quality of rating agencies.

Moreover, as standards are “expertise-based voluntary rules” (Kerwer 2001: 8), the main responsibility while using a standard lies with the user. Hence, when disappointment about the performance of rating agencies arises, users are less likely to complain to the standard setter but rather search for their own mistakes in judgment (Kerwer 2001: 9). Accounting and auditing standards are set by independent professional associations with auditing firms checking the compliance or market participants with these standards. Rating agencies, on the other hand, define standards they also “audit”. This leads to an “accountability gap” (Kerwer 2001: 20): a situation in which there is a breach between the power to make rules and the possibility for “rule-takers” to com-

plain. The accountability gap is even bigger in cases of third-party enforcement as established with rating-based regulation. This does not mean that the big rating agencies are all in all immune to criticism. It is, however, striking how little their reputation suffered after a series of misratings in the past, in the sense that market participants would actually change the supplier. An additional interpretation – as has been argued in Chapter 3 – would be that market participants have no interest in losing their scapegoat and, in the case of asset managers, endanger their own reputation.

### **4.3.2 Monopolistic Power and its Possible Abuse**

The credit rating industry can be described as oligopolistic, if not even – considering the “two-rating-norm” – as monopolistic. The high concentration and distinct entry barriers give rise to concerns about inefficiencies. The biggest rating agencies hold market power to the extent that they can set prices above costs while the overall welfare is reduced. To approach this problem, “static” and “dynamic” inefficiencies, possibly having arisen with the credit rating industry structure, can be distinguished (Dittrich 2007: 99-104).

According to orthodox micro-economics, static inefficiencies occur when monopolies set their prices so high that quantities are reduced. The high profitability of the biggest rating agencies could be an indicator for this type of inefficiencies. However, Chapter 3.2.1 argued that information production might be most efficiently organized even in (natural) monopolies, provided that structures are in place (here: balanced rating committee and credible reputation index) to guarantee high quality information production. Representatives of the reputation capital view argue that ratings of incumbent rating agencies are highly valued by market participants and that there are no indications that issuers would seek less ratings because of the high prices – mainly because there is no alternative to receiving a rating when placing bonds in the U.S. capital market. Thus, there are no reductions in overall welfare even though surpluses are indeed transferred from issuers to rating agencies. Furthermore, Dittrich (2007: 100-101) argues that static inefficiencies could also materialize because of the costs of capital for issuers. Rating fees form part of the total capital costs for firms and they might rise to the extent, that a bond issuance is not profitable any longer. However, given the relatively low fees for ratings of about three hundreds of a percent of the total value of a specific issue, Dittrich finds these costs too low to considerably influence allocation decisions. Even though static inefficiencies do not seem much of a concern in the globalized capital markets, Dittrich raises an interesting point. The absence of this type of inefficiency is closely linked to the fee structure of major rating agencies. However, the latter might induce another type of inefficiency.

“Dynamic inefficiency” refers to technological progress which might be hampered due to limited competition. Monopolies in general have few incentives for innovating. Yet, rating agencies have been innovative while responding to the needs of financial markets. Dittrich (2007: 102) argues that, per se, rating agencies cannot be innovative but only along financial markets. Considering the role of rating agencies within the market for structured mortgage-backed securities and their reluctance to update their methodologies on time, the question arises who is considered “the financial market” rating agencies respond to. As has been argued above, rating agencies were increasingly manipulated by (a few) asset managers while “the financial market”, willingly or not, collectively ignored the growing conflicts of interest arising among rating agencies. The reputation mechanism was largely offset also because of the structure of the financial market. One could even argue that the rating agency industry was not monopolistic enough to be confronted with the largely oligopolistic investment (agent) market and to safeguard the interests of the ultimate investors including small savers and taxpayers. Indeed, in a recent study, Becker and Milbourn (2010) state that increasing competition would lead to lower credit standards and higher rating grades, questioning the recently adopted policy in the U.S. to foster competition among rating agencies.

However, the rating agency might be too monopolistic when looking for alternatives. Speaking with the words of Hirschman (1970), monopolies repress “voice” as well as “exit” (here of bond issuers). The effectiveness of the voice mechanism is strengthened by the possibility of exit (Hirschman 1970: 83). To a certain degree, rating agencies can be interpreted as “loyalty-promoting institutions” in which loyal behavior is based on the internalized belief of the existence of some sort of exit penalties (Hirschman 1970: 92,98). Credit ratings are preconditions of bond issuers’ access to capital markets. Hence firms feel that leaving the rating based system or at least a particular rating agency carries a high price with it, even though no specific sanction is imposed (issuers are locked-in). Yet, Hirschman (1970: 121) states that organizations which consider exit as treason and voice as mutiny are likely to be less viable in the long run. When deterioration has reached very advanced stages, exit and voice would be undertaken with such strength that their effect will be rather destructive than reformist. Still, as sanctions are imposed systematically by the financial market – and not by single organizations (like authoritarian regimes) Hirschman refers to. Rating agencies are generally recognized as epistemic communities and it is questionable whether massive exit will ever be an option as long as the current structure of capital markets persists.

This is especially true as a breakdown of one of the major rating agency might cause disruptions in capital markets, up to serious liquidity and debt crises. Competitors – especially the smaller ones – might not be easily ready to take up the business and credit ratings are a vital part of bond markets. Accordingly, Sinclair (2001b: 495) argues that due to the rating agencies’ “*long accumu-*

*lation of eminence*”, they have gained a position of authority in the global financial market and *“once established, it is, by its very nature, hard to budge as market participants are likely to discount the ‘mistakes’ or epistemic failures of the agencies, given their position and stock of eminence”*. Especially in the absence of a coherent alternative in the production of judgmental credit risk analysis within disintermediated financial markets, a collapse of the big rating agencies is unlikely to happen. Hence, the major rating agencies can be considered as “too big to fail”, simply because of the degree of their embeddedness in the economic process.

This is why market participants indeed perceive rating agencies as powerful bodies, or as The New York Times columnist Thomas L. Friedman put it (cited in N.N. 1996):

*“There are two superpowers in the world today in my opinion. There’s the United States and there’s Moody’s Bond Rating Service. The United States can destroy you by dropping bombs, and Moody’s can destroy you by downgrading your bonds. And believe me, it’s not clear sometimes who’s more powerful.”*

“The Power to rate” (Gras 2003) becomes especially worrisome because there is no regulatory control over rating agencies and they are not held responsible for their actions. Criticism is most notably pronounced when considering sovereign ratings and the establishment of “sovereign ceilings”<sup>92</sup> which serve as a cap for every issuer based in a certain country. Sovereign ratings alone influence the ability and costs of sovereign states to borrow. In times of financial distress, continuous downgrades – as has been argued before – can aggravate instability and have, furthermore, severe influence on (conflictive) budget debates. For example, from October 2009 to April 2010 Greece was downgraded three to four times by the major rating agencies (depending of the rating agency) (e.g. Balzli 2010: 74) and ultimately received “junk” status. The latter led to severe criticism by, for example, the European Commissioner for Economic Affairs, Olli Rehn, who called the cutting of Greece’s rating as “surprising” and “unfortunate” since the European Union along with the International Monetary Fund (IMF) were already taking actions to reduce Greece’s debt (cited in Blau and Tandy 2010). Moreover, uncertainty exists as to possible rating actions to an extent that Europeans perceive rating judgments as weird (“unheimlich”). And Spain saw itself “punished” by S&P and Fitch for implementing an austerity program while the excessive debt at the time would also have led to the same downgrade (e.g. Balzli 2010: 72). Hence, rating agencies are blamed to have considerable influence on economic and social policy of sovereign states, which could hamper development. This possible influence is further enhanced by sovereign ceil-

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<sup>92</sup> Sovereign ceilings imply that private borrowers cannot lend to better terms than their respective governments. The credit-worthiness of a government is considered influential for the individual credit-worthiness because a) governments tend to be (implicitly or explicitly) the lender/guarantor of last resort and thus function as a social insurance against credit defaults; and b) sovereign credit crises generally lead to an overall economic downturn which might negatively influence the performance of private borrowers (including private credit crises).

ings which link the ability of private firms to access capital markets to the rating agencies' assessment of the performance of the respective governments. A particularly severe case was the (apparently accidental) downgrade of France by Standard & Poor's in November 2011. The lower creditworthiness of this country has significant negative consequences on the potential leverage of the European Financial Stability Facility which was installed to overcome the European Debt Crisis (e.g. Ulrich, Gammelmin *et al.* 2011). Hence, rating agencies significantly influence the development within entire world regions.

In the case of developing and emerging countries, rating agencies are accused of lacking sufficient experience, of relying on insufficient data and employing unqualified staff, thus, not being able to adequately assess sovereign credit risk (e.g. Gras 2003: 25). Indeed, directly addressing the dynamic inefficiencies mentioned above, Ferri and Liu (2005) also find a relative under-investment of major rating agencies when rating corporations in emerging countries.<sup>93</sup> Hence, rating agencies are less reliable just in the cases that – from a developmental perspective – are more important.

However, until recently, it remained an open question whether rating agencies are prone to knowingly and willingly abusing of their power, or if private power deciding over public interests as such should be content of the debate. Orthodox economists appear confident that the reputation mechanism will not fail and that any discussion on (an abusive) power is irrelevant: *"Power is not a bad thing if it cannot be abused"* (Dittrich 2007: 118). In the case of Greece, some financial experts, such as Alcidi Cinzia from the Center for European Policy Studies (CEPS) share this view. She states that *"the agency [Moody's] has just put down on paper what the market has been thinking for some time"* (cited in Blau and Tandy 2010). Hence, rating agencies were rather used as a scapegoat. Others, however, suspect rating agencies are the "spearheads" of Wall Street, enforcing U.S. (neoliberal) interests (e.g. Blau and Tandy 2010: 74). Fight (2001: 246) argues that when rating agencies enter into new markets, their credibility is most often not questioned, either because of blind faith or ideological enthusiasm of the stakeholders involved in these new segments. Certainly, even though rating agencies might not knowingly abuse their power, their assessment is still highly influenced by a specific world-view some market participants might consciously follow while others just (have to) accept their rules.

For the time being, it should be kept hold of the fact that rating agencies' credit risk assessments might be of limited functionality in key areas and situations. The following sub-chapter briefly summarizes the different arguments outlined.

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<sup>93</sup> Ferri and Liu refer to „relative under-investment“ whenever more intense efforts of the rating agencies (Moody's in this case) raise the level of a rating in emerging but not in developed countries. „Absolute under-investment“ – not found in their assessment – would mean, that rating agencies spend less effort in absolute terms (here numbers of analysts employed and average time spent on a single rating process) when rating firms in emerging countries.

#### **4.4 Interim Results – Assessing the Functionality of Credit Ratings and its Limits**

In Chapter 3.5 the different functions of credit rating agencies have been presented (Information Function, Certification Function, Control Function, Coordination Function) while the reputation mechanism has been identified as crucial for guaranteeing their reliability. Especially when regarding the issue of conflicts of interest, the possible loss of reputation capital would prevent rating agencies from entering into a “milking strategy” meaning that favorable ratings are issued in order to gain extra short-term profits. Furthermore, as high quality information production is expensive, it is most efficiently done by a few (if not one), big information producers who could a) generate economies of scale while b) counter-balancing conflictive interests within the organization. By producing high quality information (Information Function), investors can avoid duplications of efforts in the production and collection of information and instead rely on the information provided by rating agencies.

However, it has been repeatedly discussed in the past (especially in the context of the financial crisis of 2008), to which degree investors should rely on credit ratings. Consensus appears to prevail on the following: whenever credit ratings are integrated into debt contracts in the sense that downgrades automatically impair credit conditions (rating triggers), there is a situation of over-reliance of investors. This is where the Certification Function dominates the Information Function, a situation where the standardized judgment provided by rating agencies is taken as a rule of thumb rather than a means for orientation or simply a second opinion.

But the functionality of the Certification Function as risk classification might be limited. The interpretation of quantitative as well as qualitative information has been identified as critical for the importance (and profitability) of rating agencies. While this opens the possibility for orientation among investors and their agents in highly disintermediated, globalized financial markets, credit ratings are not (at least officially) meant to replace investors’ in-depth analysis or to be taken as an absolute credit risk measure investors could base their investment decisions on. That investors seem to over-rely on ratings anyway appears to have several reasons. Firstly, rating-based regulation makes it expensive for investors to ignore ratings. Secondly, investors have become increasingly uninvolved due to a growing complexity of highly liquid global capital markets which made it difficult and expensive to disagree. Rating agencies reduce complexity and with it uncertainty. Their lack of transparency, as far as the rating methodologies and rationales are concerned, made it easy to believe that rating agencies in fact used some kind of black box that knew things better. This might be especially convenient for asset managers if things go wrong, since they would have somebody to blame. But also epistemic failures and the belief that ratings were indeed adequate

measures of absolute default probabilities might have spurred their importance in investment decisions.

Credit ratings as absolute risk measure were even used by rating agencies themselves when rating structured mortgage-backed securities (or CDOs in general), applying increasingly mathematical models. In the meantime, more or less “unmoral” investment bankers exploited the rating agencies’ epistemic authority for disguising highly risky financial products as low-risk investment opportunities. (Most) market actors (investors and regulators alike) appeared to collectively ignore the fact, that a) these models might not be that viable altogether and b) rating agencies – unlike in the case of corporate ratings – stood under the influence of a few asset managers which seriously hampered their independency and objectivity. The issuers-pay model in general and especially under conditions of a growing share of revenues from a few issuers has been identified as a key factor in limiting the reliability, and thus, functionality of credit ratings as objective risk assessments – even in the vaguest sense of risk. The entrance of commercial shareholders and their influence on the governance structures and business objectives of rating agencies appeared to further counter-balance the rating agencies’ conflicting aims: delivering high quality ratings versus gaining market share and increasing revenues.

Moreover, epistemic failures by the rating agencies, but also by market actors largely offset the reputation mechanism. This is especially true in the context of the financial crisis since the complexity of structure finance products made it increasingly difficult to spot rating failures. However, also for rather simple corporate ratings, it has to be taken into account that whatever is considered “fundamental” in the analysis of risk is based on a specific world-view (shared causal beliefs) and – important for rating agencies as epistemic communities – a specific knowledge base and shared interest of its members. Especially when it comes to external, highly interrelated factors, risk assessments become increasingly vague and judgemental and should, thus, not be treated as hard facts. This is particularly the case when a lack of transparency does not allow tracing these evaluations.

Their limited functionality as risk classifiers can have serious implications for the Coordination Function that rating agencies exercise. Based on the large recognition as experts, rating agencies have gained an increasing epistemic authority which influences the beliefs of investors. They serve as a focal point in situations of multiple equilibria and can prolong the persistence in the formerly “good” equilibrium in situations in which the conventional judgment begins to crumble. When the tensions increase though, rating agencies as private firms and market participants react all of a sudden and with such a force that they induce panicky reactions in investors. Rating-based regulation further (or foremost?) boosts such actions and formerly considered to have stabilizing effects turn out to be largely destabilizing.

Still, in good times and when their analysis is considered reasonable<sup>94</sup> and, most importantly, objective and independent, rating agencies can indeed have favorable effects. They provide a transparency label and first means for orientation. Besides, they can influence the behavior of issuers and asset managers since their authoritative position gives incentives to act in the investors' interest. On the level of single principle, multiple agent relationships, the functionality of rating agencies in terms of their Control Function on single corporate bond issuers has, so far, never been questioned. However, it must be secured that rating agencies are not actually controlled by asset managers (as has happened with structured mortgage-backed securities) without the original investor taking notice. Furthermore, effective mechanisms for complaint (to exercise voice) should be in place, especially since exit is not an option and rating agencies might enforce undesirable business practices. Both issues are further discussed in Chapter 7 for the context of microfinance.

On the other hand, the Control Function (as well as the Certification Function) has been fiercely criticized in the context of sovereign ratings. Generally speaking, the rating agencies' judgments are much more controversial when the underlying world-views are less homogenous regarding the performance of governments and their respective public policies than they are regarding the corporate level. Whether rating agencies are positive about their own assessments or whether they are agents of a larger Wall Street conspiracy is thereby only secondary. Ratings have considerable influence on international capital flows, particularly because of their prominent position in regulation. Their destabilizing effects in negative events are dysfunctional from a developmental perspective. Their developmental effects includes their encouragement of an overly enthusiastic expansion of capital flows, perpetuating the conventional judgment, without taking into account whether those absorbing the extra cash actually set the additional capital in value.

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<sup>94</sup> Even if they only reflect what is considered as fundamental at a given point in time by the majority of market actors.



**PART III –  
Functions and Functionalities of Ratings  
in Microfinance  
- with Special Reference to the Case of Peru**



## **5 The Peruvian Microfinance Market - Contextualizing Ratings in this Specific Environment**

This chapter is dedicated to the presentation of the Peruvian microfinance sector in order to provide orientation to the reader when following the proposed interpretation of qualitative data. Therefore, the general characteristics of the various types of microfinance institutions are introduced as well as their relative importance within the microfinance sector. Furthermore, insights into international investment flows into the country as well as the refinancing strategies of Peruvian MFIs are provided. In the last section, the current state of the spreading of MFI ratings and the role of regulation in this context are presented.

Some of the hypotheses which are developed in Chapter 7 aim at describing phenomena valid beyond a specific context. However, some arguments are based on an in-depth qualitative research in Peru which was then backed by data reaching beyond this country.

The chapter shows that Peru has a mature microfinance sector with rather large deposit taking MFIs dominating the market. Furthermore, due to its favorable macroeconomic conditions and sound (microfinance) regulation, Peru is one of the main targets for international microfinance investments. Large Peruvian MFIs, however, rely more and more on local funding. Ratings are a common phenomenon among Peruvian MFIs. The majority of large MFIs, also due to rating-based regulation, receive conventional credit ratings (sometimes) in addition to performance ratings from specialized raters. NGO MFIs, however, only get ratings from specialized raters.

### **5.1 The Microfinance Sector in Peru**

In its “Microscope 2008” issue dedicated solely to the region Latin America and the Caribbean, the Economists Intelligence Unit (EIU) characterized Peru as the country with the most microfinance-friendly environment in Latin America (EIU 2008).<sup>95</sup> In the two following years, Peru was ranked first even on a global scale (EIU 2009, 2010a). And in the 2010 issue, it was highlighted that Peru was the only country which ranks in the top five for all of the three categories measured: the regulatory framework, the investment climate and the institutional development (EIU 2010a: 6).

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<sup>95</sup> The Microscope studies of the EIU provide an index about the microfinance business environment covering three main areas with the following weights: The regulatory framework is weighted with 40% of the overall score, the institutional development of the microfinance industry with another 40% and the investment climate with 20%. Since 2009 the Microscope is applied on a global scale. It is supported by several international development institutions such as IFC, IDB and CAF.

As far as the regulatory environment is concerned, EIU (2010b) point to the positive fact that in Peru there are no interest rate restrictions and MFIs face no (or at least very limited) direct competition from subsidized public retail finance institutions. Microfinance institutions are regulated according to the General Law of the Financial and Insurance Systems N<sup>o</sup> 26702 from 1996 with the Superintendencia de Bancos, Seguros y Administradores de Fondos de Pensiones (SBS) as its principal regulator. The law applies to commercial banks as well as to a series of specialized MFIs. Minimum-capital requirements for MFIs (except finance companies) are considered to be rather low (250,000 USD compared to 1 million USD in Bolivia)<sup>96</sup> and documentation requirements and capital adequacy ratios seem reasonable. For example, loan-loss provisioning is based on loan status rather than institutional type (Ebentreich 2005; EIU 2010b). Furthermore, stringent requirements for internal controls and extensive on-site inspection procedures are applied, which leads Ströh (2010: 184) to attest the microfinance department of SBS a very proactive supervision. To further support the development of the microfinance sector, in June 2008, SBS adopted the Legislative Decree 1028. This reform aims at facilitating the access of regulated MFIs to local capital markets and enabling non-bank MFIs to engage in a series of financial operations previously restricted to banks (e.g. issuing stocks and bonds as well as becoming involved in mortgage lending) (EIU 2008: 48).

There are seven different types of MFIs, five of them falling under the umbrella of the before mentioned adapted regulatory framework (COPEME 2009; EIU 2010b; Ströh 2010: 175-188):

- Microfinance **NGOs** are not regulated by the SBS or any other entity.<sup>97</sup> They are credit-only institutions with a clear focus on group lending methodologies. Furthermore, most microfinance NGOs are members of the network PROMUC (Promoción de la Mujer y la Comunidad) promoting a village banking approach which links the provision of microloans to the promotion of savings and capacity building primarily (sometimes exclusively) dedicated to women. These institutions usually serve the lowest segment of the microfinance clientele.
- **EDPYMEs** (Entidades de Desarrollo de la Pequeña y Microempresa) are regulated credit-only institutions which emerged from the transformation of some microfinance NGOs. The transformation was encouraged by an exception from paying value-added tax (VAT) on interest earned on their loans and the possible access to governmental second-tier funds.

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<sup>96</sup> According to the updated Law for Financial Institutions issued in 2011 (SBS 2011: Article 16) the minimum capital requirement for CMACs, EDPYMEs, COOPACs and CRACs was 678.000 Nuevos Soles (~250.000 USD as of January 2011) which equates to 4.5% of the minimum capital required by commercial banks.

<sup>97</sup> Nevertheless, these institutions do face pressure for self-regulation which is exercised by their federation COPEME.

- **Finance companies** (financieras) currently existing and dedicated to the provision of micro-finance services are relatively young (and rare) and emerged either by the further upgrading of EDPYMES or as a downscaling strategy of commercial banks. These institutions are allowed to capture deposits but are not (unlike banks) allowed to offer checking accounts.
- Microfinance **banks** are regulated like commercial banks and are full-fledged financial institutions but with a significant share of their portfolio employed in micro-lending. The only microfinance bank in Peru (MiBanco) started operations in 1998 by upgrading the NGO Acción Comunitaria del Perú which had supported small and medium-sized enterprises (SMEs) since the 1950s.
- **CMACs** (Cajas Municipales de Ahorro y Crédito) are local government-owned, full-fledged savings banks which are regulated according to the before mentioned law 26702 and the Supreme Decree N° 157-90-EF of 1990. Among the CMACs are many of the biggest and oldest MFIs in Peru which emerged in the 1980s out of local pawn shops based on the model of the German savings banks.
- **CRACs** (Cajas Rurales de Ahorro y Crédito) are privately owned rural savings and credit banks and also have some tradition in Peru. However, many of them suffered from their strong focus on high-risk lending in agriculture which resulted in the closure of many institutions between 1997 and 1998. The remaining CRACs diversified their portfolio considerably after a governmental intervention for re-structuring non-performing farming and live-stock loans in 2001. These institutions are allowed to capture deposits.
- Finally **cooperatives** (COOPACs, cooperativas de ahorro y crédito) offer both, loans and deposits, to its members. COOPACs have existed since the 1950s but have only been registered by SBS from 1992 onwards. However, the supervision has been delegated to its federation FENACREP (Federación Nacional de Cooperativas de Ahorro y Crédito del Peru). The 161 existing cooperatives with nearly 750.000 members are very diverse and differ in size and how they operate. Yet, there are only few cooperatives with significant microfinance activities. COOPACs are allowed to take deposits from their members.

According to the microfinance network COPEME (2009), in June 2009 there were 39 regulated financial institutions dedicated to microfinance: One bank (MiBanco), two finance companies (Edyficar and CredScotia), 13 Cajas Municipales de Ahorro y Crédito (CMACs), ten Cajas Rurales (CRACs) and 13 Entidades de Desarrollo de la Pequeña y Microempresa (EDPYMEs). Furthermore there are 161 cooperatives, out of which eight, according to COPEME, have a significant microfinance portfolio,<sup>98</sup> and 16 NGOs offering microfinance services. Since two EDPYMEs transformed

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<sup>98</sup> Ströh (2010: 185), however, states that 17 cooperatives have a microfinance focus.

into finance companies (financieras) in the course of 2009 (Crear and Confianza), at present there are four finance companies and eleven EDPYMEs. It is noteworthy, that several traditional commercial banks, which started to enter the microfinance market in the mid 1990s, have a significant market share considering the portfolio of microenterprise loans and small-scale savings (Ströh 2010: 181, 187), which even exceeds the compound share of the most important sub-group (CMACs) mentioned above. For the purpose of this study, however, only “grass-roots providers” with an explicit microfinance focus potentially in need of external funding for their microfinance operations, which have been identified as MFIs by the microfinance network COPEME and which have one of the previously mentioned legal forms are considered when describing the microfinance sector.

The size of the institutions differs considerably. In 2008, 60 MFIs reported to MIX Market, and the microfinance bank MiBanco can be clearly identified as the individual market leader on a national scale with 20% of total assets in the sector. The group of CMACs held 45% of total assets, yet, with significant differences between the CMACs. Four CMACs (Piura, Trujillo, Arequipa and Sullana) held 64% of the total assets of the group. Therefore, different stakeholders stated that MiBanco was indeed the national market leader but CMACs often hold the first position within their respective regions (Interviews 17, 18, 20 and 33).

**Table 5.1: Market shares of different Peruvian MFIs in terms of assets, number of borrowers and deposits, 2008**

Type of MFI	MFI	% of Total Assets		% of Active Borrowers		% of Deposits	
Commercial banks	MiBanco	19.9%	19.9%	14.4%	14.4%	21.7%	21.7%
Financieras	Crediscotia	9.2%	17.5%	19.2%	34.9%	12.2%	12.4%
	Financiera Edyficar	4.7%		6.8%		0.2%	
	Rest Financieras	3.6%		8.8%		0.0%	
CMACs	CMAC Arequipa	7.9%	44.9%	5.7%	29.5%	8.6%	54.3%
	CMAC Piura	8.1%		4.7%		10.6%	
	CMAC Sullana	4.8%		2.8%		5.9%	
	CMAC Trujillo	8.0%		4.7%		9.8%	
	Rest CMACs	16.1%		11.6%		19.4%	
CRACs	CRACs	6.9%	6.9%	6.0%	6.0%	7.5%	7.5%
EDPYMEs	EDPYMEs	5.3%	5.3%	9.9%	9.9%	0.0%	0.0%
COOPACs	COOPACs	3.6%	3.6%	3.3%	3.3%	4.0%	4.0%
NGOs	NGOs	2.0%	2.0%	6.6%	6.6%	0.0%	0.0%

Source: Own elaboration with data from MIX Market as of December 2008

Note: One may think of excluding Crediscotia from the list, since it is not a grassroots MFI. This would lower the significance of financieras as an important sub-group considerably.

In 2008, CMACs were allowed to operate on a national scale for the first time, some of them hoping to gain market share at a national scale in the near future (Interviews 18 and 26). Another

important player in the microfinance industry is Crediscotia which was created when Scotiabank bought Banco del Trabajo in July 2008 within its downscaling strategy to attend the microfinance segment. Furthermore, in 2009 one of the leading Peruvian commercial banks, Banco del Crédito, bought EDPYME Edyficar – the leading institution within this sub-group – and converted it into Financiera Edyficar. Table 5.1 provides an overview on the market shares by institutional type in terms of assets, number of active borrowers and deposits for the most important MFIs.

As far as the efficiency and profitability of Peruvian MFIs is concerned, Ströh (2010: 265-271) shows that the most profitable (in terms of Return on Assets, ROA) are the finance companies, followed by MiBanco and the group of CMACs. Both had stable returns on assets between 4% and 6% (2001-2008). CRACs also increased their profitability between 2001 and 2008, however, at a much lower level reaching about 2.5% by 2008. The profitability of EDPYMEs as a group was very unstable over the same period; yet, negative returns between 1% and 10% were largely driven by single institutions which reached up to 10% while the most profitable EDPYMEs reached the same return in positive terms. In 2008, the EDPYMEs reached levels of profitability around 5% which is slightly higher than those of CMACs. NGOs as a group reach an ROA of around 0%, however, the results for single NGOs vary considerably in both directions. The same applies for COOPACs. As far as operational and administrative efficiency is concerned, the best performing MFIs in 2008 are the CMACs and COOPACs, followed by MiBanco and the CRACs, the EDPYMEs, the finance companies and finally the NGOs. The NGOs final position here is not surprising since they generally provide smaller microloans (with the lowest average loan size) while working also in very marginalized areas which increases the operational costs (Ströh 2010: 240-241, 257). Decreasing efficiency while working with poorer clients is assumed to be a typical trade-off in microfinance (e.g. Cull, Demirguc-Kunt *et al.* 2009). Finally, credit risk (measured in portfolio at risk, PAR) has decreased significantly for NGOs, EDPYMEs, CRACs and COOPACs since 2001, while for CMACs and MiBanco credit risk has remained at low levels all the time. According to MIX Market data, all types of MFIs had portfolios at risk over 30 days (PAR>30) around 3%-5%. However, in 2009 the situation slightly worsened with an average PAR>30 moving from 4.3% of 6.1% (based on MIX Market data).

One of the reasons for credit risk being relatively low is the good information infrastructure in Peru, with private credit bureaus covering all types of MFIs, including non-regulated NGOs. Credit bureaus provide both positive and negative information on prospective clients (EIU 2010b; Ströh 2010: 184-185). Furthermore, the very high regulatory capacity and flexibility has allowed counter-cyclical loan loss provisions since the global financial crisis 2008 (EIU 2010b, Interview 2).

The good regulatory framework also influences Peru's good investment climate. However, in this category there are also broader indicators assessed which are not necessarily related to microfinance. The categories are: political stability, capital market stability, judicial system, accounting

standards for microfinance, governance standards for microfinance and MFI transparency (EIU 2010b). Especially the MFI specific categories rank high. The International Accounting Standards (IAS) were adopted in Peru in the 1990s. Listed firms are obliged to follow the International Financial Reporting Standards (IFRS) which also applies for regulated MFIs. NGOs also follow these standards. Accordingly, the level of transparency is high and further enhanced by the obligation (for regulated MFIs) to publish their balance sheet summary in the official state newspaper (El Peruano) each year. Only very small institutions are allowed to submit unaudited financial statements<sup>99</sup> which in fact has not been the case for any of the Peruvian MFIs yet. Disclosure requirements are most stringent for publicly quoted MFIs which have to submit audited financial statements every year and unaudited accounts quarterly to the regulatory body for the stock exchange CONASEV. Finally, transparency is also enhanced through the promulgation of credit risk ratings.

As far as governance standards are concerned, progress has been made, such as the improvement of shareholder rights and the development of guidelines for the selection of board members. In the Investor Protection Index of the World Bank's "Doing Business 2010", Peru reached a score of 6.7 out of 10, while regional average was 5.1 and the OECD countries as a group reached 6.0 (World Bank 2011).

In general, the good evaluation of the investment climate was further supported by the raise of Peru's sovereign rating of two major rating agencies to the investment grade category in 2008. This was due to the country's decline in fiscal and external vulnerabilities (e.g. Lesova 2008b). Especially the first upgrade by Fitch in April 2008 created enthusiasm among financiers since the stock market was expected to boost, private investment to increase and Peru's financial channels were supposed to improve (e.g. Lesova 2008a).

## **5.2 International Investments into Peruvian MFIs and their Refinancing Strategies**

A look at some of the largest MIVs confirms the important role Peru plays for investors: Since its inception in 2004, the ResponsAbility Global Microfinance Fund has invested the largest portion of its capital in Peru. For Oikocredit, Peru is the third most important country in terms of outstanding portfolio worldwide. As for the portfolios of BOMS 1, BOLD 1 and the Dexia Microcredit

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<sup>99</sup> This applies for institutions with assets below 91 tax units. On March 24, 2011, the value of 1 tax unit was 3.600 Nuevos Soles. Thus, institutions with assets above 327,600 Nuevos Soles (= 118,566 USD at the same day) need to provide audited financial statements.

Fund, all managed by Blue Orchard, Peru is among the top ten countries (Blue Orchard 2010a, 2010b; Credit Suisse 2010; Oikocredit 2010).<sup>100</sup>

In the MIX Market interactive FSDB, 364 MFIs were listed in 2008 and the total amount of MIV funds lent to these MFIs was 3.2 billion USD. This sum represents 48.5% of the estimated 6.6 billion USD asset under management of all MIVs in that year (CGAP 2009b: 5). Out of the 364 MFIs, 29 (8%) were located in Peru while 7% of the total amount lent flew into this country. Of the 38 countries represented in this sample, Peru was only outperformed by two countries (Serbia and Bosnia and Herzegovina) in terms of total amount lent. If only Latin America and the Caribbean is considered, Peru received 22% of the total amount lent. Table 5.2 provides an overview on the regional concentration of MIV lending activities and the position of Peru. Furthermore, median amounts lent as well as weighted average interest rates and terms are disclosed.

**Table 5.2: Regional concentration of MIVs lending activities and the position of Peru, 2008<sup>101</sup>**

	Number of MFIs	Total Amount (in USD)	Total Amount (in %)	Amount USD, median	Rate, weighted average	Term, weighted average (months)
Africa	52	108,379,560	3%	605,820	9.88%	54
East Asia and the Pacific	21	184,536,267	6%	552,864	9.37%	40
Eastern Europe and Central Asia	98	1,838,273,750	58%	1,000,003	8.39%	53
Latin America and The Caribbean	145	955,574,061	30%	777,034	9.23%	49
Middle East and North Africa	14	29,073,806	1%	706,751	7.97%	72
South Asia	34	40,837,202	1%	589,838	10.79%	55
<b>Total</b>	<b>364</b>	<b>3,156,674,646</b>	<b>100%</b>			
<b>Peru</b>	<b>29</b>	<b>216,643,158</b>	<b>7%</b>	<b>790,319</b>	<b>9.71%</b>	<b>46</b>

Source: Own elaboration with data from MIX Market interactive FSDB as of December 2008

The weighted average interest rate to be paid in Peru was 9.71% which is slightly above the regional weighted average. However, the weighted average term of 46 months was slightly below the regional weighted average of 49 months.

Within the country, about 40% of all external funding (without deposits) came from MIVs. 18% came from (local) commercial banks, 10% from multi- and bilateral development agencies and 8%

<sup>100</sup> According to CGAP (2010), Oikocredit ranks first, the Dexia Microcredit Fund ranks second and the responsibility Global Microfinance Fund ranks third among the top 10 MIVs.

<sup>101</sup> As of December 2010, according to the more representative study of Symbiotics (2011b: 13) the regional concentration of MIV funds differ slightly. In particular, the amount lent to MFIs from Eastern Europe and Central Asia was considerably lower reaching 40%. Funds flowing to Latin America and the Caribbean on the other hand were slightly higher reaching 35%.

from NGOs. 18% came from unknown sources and the remaining 6% came from peer-to-peer lenders, cooperative societies, NGOs or other MFIs.

However, a specific feature in the Peruvian microfinance market compared to many other countries is that deposits account for an important funding source for major MFIs. While the world's average of the ratio of deposits to outstanding loans is 46% (Chen, Rasmusen *et al.* 2010: 3) in Peru it is 67%. Especially the CMACs keep this percentage high. The biggest CMAC (Piura) has a ratio of deposits to outstanding loans of 90%. But also MiBanco as the largest MFI has a ratio of 74% (based on MIX Market data). This also has consequences when it comes to the willingness to absorb international investments and the conditions to be applied.

Taking MiBanco, for instance, the most important lenders are bilateral public entities (IFC, Instituto de Crédito Oficial de España, Financierings Maatschappij voor Ontwikkelingslanden NV (FMO)) with 79% of outstanding borrowings by the end of 2008 (Ernst & Young 2009). The duration of these loans are up to 10 years (IFC and Instituto Nacional de Crédito de España). This level of maturity was only offered by one of the private international MIVs (Triodos Fair Share Fund). MiBanco furthermore received loans from international commercial banks with durations between one and two years. While the costs of these funds were not disclosed, the interest rates applied for national funds (of development banks as well as commercial banks) varied between 6.15% and 9.65%. In order to diversify the sources of funding, an increasingly used instrument is also the issuance of corporate bonds. MiBanco issued its first bonds in 2005 with a total value of 30 Mio. Nuevos Soles (~ 9.5 million USD<sup>102</sup>), followed by three more issuances of the same amount until 2009. The interest rate of these bond issuances varied from 5.94% to 7.38%, thus the interest rate was up to 2% lower than for national debt.

Funding through bonds can be much cheaper especially with medium-term maturities (here between two and four years) as exemplified by Financiera Edyficar. The average interest rates of bonds placed at the local stock market was 7% (for two years) while the interest rate for important borrowings from international MIVs varied mostly between 8% and 10%, with the highest interest rate (due in 2015) of 12.85% (PriceWaterhouseCoopers 2009b).

Crediscotia received its first allowance for bond issuance in 2008, placing those in 2009. CMAC Arequipa got the allowance to place deposit certificates with a maturity of one year in 2009 and is (or was at the moment of the interview) waiting for a good moment for the issuance (Interview 18). Other MFIs plan to issue deposit certificates in the long run, as well (Interviews 10, 17, 26, 31 and 32). According to representatives from CONASEV – the regulatory body for the stock exchange – the local capital market is welcoming new investment opportunities, and they expect more and more MFIs to follow these examples (Interview 13). Refinancing through the local capi-

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<sup>102</sup> Exchange rate as of December 31, 2005: 1 Nuevo Sol = 0.2925259617 USD

tal market is also envisaged by (at least) one of the lately transformed financieras. Two major advantages are considered to be linked to refinancing through local capital markets. First of all, international debt often contains an exchange risk which can be mitigated with a stronger reliance on local markets. Secondly, local capital is cheaper than international debt and often cheaper than deposit taking (Interview 17).<sup>103</sup> Nevertheless, another financiera mentioned that lowering the funding costs was a motivation to start offering savings, which is (on average) expected to be cheaper than relying on international funds (Interview 31). It was mentioned during the interviews that lowering the costs for funding has become crucial especially since MFIs' interest rates for credits have to sink for MFIs in order to stay competitive in a context of increasing competition. Especially the commercial banks can offer microloans at much lower interest rates, partly due to their lower refinancing costs (Interview 20, 26 and 31) when serving better-off clients (with higher average loan balances) in urban areas. Many of those clients started to take microloans from traditional MFIs and constitute an important client base MFIs do not want to lose to commercial banks once these clients ask for higher loans (Interview 18).<sup>104</sup>

Taking the CMAC Arequipa as an example, the interest rates for deposits varied between 1.20% and 12.00% p.a. (Jara Alva y Urquiza 2009: 22). While interest rates for demand deposits (ahorros) are usually very low (despite having higher transaction costs), the interest rates for fixed deposits (depósitos a plazo) are high. The majority of deposits (~85% by the end of 2008) are fixed deposits. Long-term fixed deposits of over one year even reach a share of 13%, for which usually the highest interest rates have to be paid. Therefore, it was stated that for CMAC Arequipa, the right funding mix was crucial for the future development (Interview 18). Still, it was stressed that the deposit ratio should not decrease. Instead, measures would have to be taken to bring down the interest rates for fixed deposits. The reason mentioned by one of the MFIs for relatively high interest rates compared to commercial banks was the relatively higher risk as perceived by depositors of holding their deposits with an MFI. Furthermore, it was stressed that higher interest rates have to be paid also due to the limited product range the CMAC Arequipa is still offering in order to hold clients with more sophisticated needs for financial services. Therefore, the CMACs would have to broaden their product range and also offer factoring and leasing, for example.

Besides the lowering of funding costs, to offer a wider product range as a precondition to satisfy clients' needs and stay competitive was also the reason for the newly transformed financieras to offer savings products to their clients (Interview 17 and 31). Financiera Confianza even plans to

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<sup>103</sup> As mentioned in Chapter 2.2.1, low-priced local funding was also identified by MIVs as one of the reasons why growth rates of their allocation within single countries (including Peru) declined (MicroRate 2011b: 7).

<sup>104</sup> See Ströh (2010: 257) for an overview of average loan sizes for microenterprise loans offered by different types of institutions and possible overlaps regarding specific client segments.

further transform into a bank (Interview 31). However, it was mentioned that strong alliances, mergers and/or the entrance of strong shareholders (as happened with EDPYME Edyficar) would be necessary for the next steps. At least, one other EDPYME interviewed stated that it had plans to transform into a finance company in the medium-term and it seems likely that others will follow the examples in the long-run (Interview 27).

Most NGOs, on the other hand, had no plans to transform into a regulated MFI. Only one of the NGOs interviewed mentioned that it planned to transform into EDPYME and further into a finance company in the long-run (Interview 19). Still, a precondition would be to find shareholders with clear social objectives. NGOs' fear of mission drift when converting into a for-profit entity seemed high (Interviews 12, 19, 24 and 30). Those rejecting a transformation stated that even if self-sustainability was very important for them, to become a leading microfinance institution that reaches a large part of the Peruvian population (and have strong growth plans in terms of numbers of clients) was not part of their vision (Interviews 12, 24 and 30). This was a goal envisaged by most of the finance companies, CMACs, CRACs and EDPYMEs interviewed. Regarding their funding sources, NGOs very much depended on international funds. For example, the Cusco-based NGO Asociación Arariwa refinanced itself with a percentage of 91% through international MIVs with an average interest rate of 8.6% (Alfonso Munoz & Asociados 2009: 17). In comparison, only 6% of the liabilities of CMAC Arequipa were compound of international debt (Jara Alva y Urquiza 2009: 3, 24) with an average interest rate of 6.5%. Still, in absolute terms, the sum of international debt was almost four times higher than for Asociación Arariwa (15.5 Mio Nuevos Soles versus 60 Mio Nuevos Soles; ~ 5.4 million versus USD ~ 21 million USD). In 2008, Asociación Arariwa with 9.1% of total assets of all NGOs held the fifth place within this sub-group (based on MIX Market data).

Another funding source which will gain further importance in the future is debt financing through local banks. While the development bank COFIDE has been an important refinancing source for regulated MFIs ever since (Interview 9), in 2006, a revolving fund of 200 Mio. Nuevos Soles was set up by the state-owned bank Banco de la Nación to support micro entrepreneurs through MFIs. Currently, Banco de la Nación works with 22 regulated MFIs, and discussions on raising the funding resources have already begun (Interview 34). At the same time, the Banco de Crédito has established credit lines with several MFIs even though guarantees of 100% are still necessary in order to qualify. Thus, Banco de Crédito transfers the credit risk to a third party (usually international investors). However, the microfinance sector is gaining importance and recognition as a sustainable and profitable business. And since traditional business segments of commercial banks turn out to be less and less profitable, Banco de Crédito already started internal discussions on loosening these strict guarantee policies (Interview 36).

Hence, the number, composition and origin of investment relationships with different investors can be expected to change in the future. By the end of 2008, the number of different funding relations of Peruvian MFIs varied largely, depending on the type of organization. Yet, it can be considered limited for most MFIs. When looking at the audited financial statements of interviewed MFIs at the MIX Market,<sup>105</sup> as of December 2008 the average number of funders (corporate bonds, deposit certificates and deposits excluded) for MFIs was twelve and the average number of international funders was 8.5. As far as MIV financing is concerned, the number of funders ranged between zero and five in the case of deposit taking MFIs and between seven and more than 18 for regulated credit-only entities (two finance companies and two EDPYMES). Microfinance NGOs lay between the two groups, depending on its size. The maximum number of funding relations of one financiera was 26. In December 2008, EDPYME Crear Arequipa (now Financiera Crear) had investment relationships with six national investors (commercial banks and governmental development entities/funds) and 14 different international investors (19 if 2007 is considered, as well). The number of funding relations of the other financiera keeping the average number high was 23. The average outstanding debt balance from international investors was 13,866,000 Nuevos Soles (~4.5 million USD) with a maximum amount of 15,860,000 Nuevos Soles (~5 million USD)<sup>106</sup>. The interest rate for international debt mostly varied between 9% and 11%.

### 5.3 The Diffusion of Microfinance Ratings in Peru

Nowadays, ratings of MFIs are a wide-spread phenomenon in Peru, which is one of the reasons why EIU (2010b) assigned a high score to Peru's MFI transparency standards. This can be partly explained by the regulatory framework which includes credit ratings and also applies for regulated MFIs.

According to the Peruvian Law N° 26702, all deposit-taking financial institutions are required to have a credit rating of two accredited rating agencies every six months (SBS 2008: Article 136). However, until mid 2010, this rule did not apply for regulated MFIs, even though they were allowed to capture deposits (Díaz Ortega 2006, Interview 2). Still, many MFIs saw themselves implicitly obliged to receive a credit rating.

First of all, all financial institutions which capture deposits are members of the Deposit Insurance Fund (Fondo de Seguro de Depósito, FSD). The amount of premiums to be paid by members is

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<sup>105</sup> The information on funders were taken from the audited financial statements as of December 2007/2008 or, when the latter was not available, as of December 2006/2007: Alfonso Muñoz & Asociados (2009), Asociación Martínez Rodríguez y Asociados (2008), BDO (2009), Cabanillas & Asociados (2009), Deloitte (2009), Ernst & Young (2009), Jiménez & Asociados (2009), Jara Alva y Urquiza (2009), Noles Monteblanco & Asociados (2009), Portal Vega y Asociados (2009), PriceWaterhouseCoopers (2009), Salas y Salas Asociados (2009), Venero Ferreyros (2009), Very & Asociados (2009).

<sup>106</sup> Exchange rate as of December 31, 2008: 1 Nuevo Sol = 0.31526 USD.

determined on the basis of the received credit rating grade. In 2008, the minimum base was 0.65%, based on the three-months average of the obligations covered by the fund.<sup>107</sup> The premium payments have to be made quarterly and the percentage to be paid increases by 0.20% with each rating category (SBS 2008: Article 148).

Secondly, for MFIs a modular regulation of their operations was applied. Article 221 of the Law N° 26702 establishes 43 operations<sup>108</sup> for financial institutions. Article 285 limits the number of operations to 13 operations for CRACs, and Article 288 limits this number to nine for EDPYMES. For CMACs, the number of operations allowed was additionally established within a special law and was limited to 15 operations (El Peruano 1990; SBS 2008: Article 286). In each of the three existing modules, the number of permitted operations is raised while the minimum capital required successively increases. Furthermore, for each of the modules, MFIs are required to have a credit rating with the a minimum grade of B in the last 12 months (SBS 2008: Article 290). Among these operations are: to issue debit and credit cards and realize factoring operations (modul 1); to capture sight deposits, to grant mortgage loans and to issue bonds (modul 2); to handle overdrafts (modul 3).

Hence, having a credit rating was of importance especially for more sophisticated institutions with a diversified client base that has diverse financing needs, such as some of the CMACs. For the latter, a rating was also important since CMACs were long restricted to only operating in their region of origin. A good rating was a precondition for receiving a special allowance from SBS to open branches in Lima, which in turn was very important for some CMACs in terms of their deposit-taking (Interview 2). Accordingly, some of the bigger CMACs started receiving ratings from accredited rating agencies at a relatively early stage. For instance, SBS has received rating information from CMAC Arequipa, CMAC Piura, CMAC Cusco and CMAC Trujillo since 2001.<sup>109</sup>

The modularization of operations for regulated MFIs was later abolished and the permitted number of operations for EDPYMES (now 26), CRACs (now 27) and CMACs (now 35) increased (SBS 2011: Articles 285,286,288), independently of credit ratings. However, since June 2010, all deposit-taking institutions, without exception, have been required to get two external ratings of different accredited rating agency every six months (Interview 2). This will further increase the demand for this type of ratings.

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<sup>107</sup> The average amount covered in the period between December 2008 and February 2009 was 87,580 Nuevos Soles (=28,249 USD as of December 31, 2008) (FSD 2011).

<sup>108</sup> Any other type not mentioned in the law requires a prior approval from SBS.

<sup>109</sup> This data was taken from a list of all ratings from financial institutions since 1998 which was provided by SBS.

Analyzing the data provided by MIX Market, by 2008, 25 of the 61 listed Peruvian MFIs<sup>110</sup> had received a rating from a local accredited rating agency.<sup>111</sup> 23 institutions had received a rating from a specialized rating agency out of which eleven MFIs had received ratings from both agency types. Hence, at least 60% of the listed Peruvian MFIs had received a rating, at least, once by either an accredited or specialized rating agency. Among the 20 large MFIs with a number of active borrowers over 30.000<sup>112</sup> there was only one MFI which had never listed a rating.<sup>113</sup> Among the medium-sized MFIs six out of 19 had not listed a rating while most of the MFIs which had never listed a rating report (16 out of 22) were among the small MFIs with less than 10.000 borrowers. Among the latter group, ten were NGOs, five COOPACs and one EDPYME. Only one NGO had ever uploaded a credit rating from an accredited rating agency. And only one (deposit taking and regulated) CMAC and one CRAC had not listed a rating report from an accredited rating agency. This might be a first indicator for the fact, that ratings from different rating agencies serve different purposes. Why should MFIs which regularly receive credit ratings from accredited rating agencies also pay for another rating provided by a specialized rating agency? And why did only one NGOs go for a credit rating of an accredited rating agency while eight NGOs chose to be rated by a specialized rating agency?

Taking a look at the diffusion rate of social performance ratings, Peru can be considered advanced, too. Until May 2011, The Rating Initiative has co-funded 20 (out of 137) social rating exercises in this country, ten out of 19 MFIs interviewed in 2009 already had received a social rating at least once and ten Peruvian MFIs had uploaded their social rating in the MIX Market, seven of them NGOs, two EDPYMEs and finally the microfinance bank MiBanco.

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<sup>110</sup> Since COPEME (2009) counts 63 MFIs with important microfinance activities these figures can be considered largely representative for the Peruvian microfinance sector. Only cooperatives are underrepresented.

<sup>111</sup> In MIX Market, additionally to the reported financial and outreach data, MFIs have the possibility to upload files with their profile such as audited financial statements and rating reports. The degree to which MFIs make use of this possibility is very diverse. For the 61 Peruvian MFIs which reported to MIX Market in 2008, the author analyzed how many of them provided audited financial statements and rating reports for 2008. Furthermore, it was assessed whether MFIs provided a rating report by either a locally accredited rating agency or specialized MF rating agency at any time until the end of 2009. The same was done for social performance reports and -ratings. It is still possible, however, that MFIs received ratings but decided not to publish any of them in the MIX Market. However, for a first rapprochement of the establishment of ratings in this market, this data seems appropriate. The MIX Market diamond score then ranks these MFIs according to their level of transparency. For any MFI it is possible to receive a maximum of five diamonds. Three diamonds are granted if an MFI uploads its financial data, four diamonds are reached if the data is backed by uploaded (audited) financial statements, five diamonds are reserved to rated institutions which also uploaded the respective rating report.

<sup>112</sup> Here the MIX Market outreach classification is used with small MFIs reaching less than 10.000 borrowers, medium MFIs reaching between 10.000 and 30.000 and large MFIs reaching more than 30.000 borrowers (MIX 2009). Applying this classification to the year 2008, there were 22 small MFIs, 19 medium MFIs and 20 large MFIs.

<sup>113</sup> For another MFI (CMCP Lima) a technical problem on the MIX Market web site did not allow, even after several trials, to access the MFI's profile.

Before interpreting the data for the Peruvian context, the next chapter turns to the different rating agencies active in the microfinance context. The characteristics or different types of rating agencies and their services determine the functionality in respect to different functions and different stakeholder settings.

## **6 Microfinance Ratings – Characteristics, Products and Methodologies of Different Rating Agencies**

The aim of the present chapter is to provide background information on the specialized rating agencies and the services they offer. Furthermore, in Chapter 6.1.1 the general characteristics of their rating methodologies and reports concerning (financial) performance ratings are presented and compared. In Chapter 6.1.2, the major differences regarding rating methodologies and rationales of specialized raters compared those of conventional rating agencies in Peru and those provided by the major U.S. rating agencies are analyzed. As far as local rating agencies are concerned, the discussion is limited to those active in Peru. Nevertheless, as has been argued in the introductory part of this study, the results might be generalizable to a certain extent since many local raters have more or less close relations to one of the major U.S. raters. As far as the specialized rating agencies are concerned, the explanations do not specifically refer to the case of Peru and also include raters not at all active in this country but sharing important characteristics with those who are.

Since microfinance institutions are supposed to serve a double, if not triple-bottom-line, specialized rating agencies started offering social ratings, too. Chapter 6.2.1 provides an overview of the logics and assessment categories of the social performance management movement as introduced in Chapter 2.2.1. This is considered important since microfinance raters build on these approaches when developing their social rating methodologies. In Chapter 6.2.3 the general characteristics of social rating methodologies are outlined. The starting point is the discussion of the basic models of corporate social responsibility ratings which further helps to understand the inherent logic of social ratings.

This chapter builds the basis for the analysis of the functionality of different types of raters regarding the different functions presented in Chapter 3. And it delivers important links for a more detailed discussion of selected aspects in the subsequent chapter.

### **6.1 Performance versus Credit Ratings – What is the Difference?**

As initially stated in Chapter 2.2.2, performance ratings are those ratings assigned by specialized microfinance rating agencies while credit ratings are granted by the conventional (“mainstream”) rating agencies. However, in the (gray) literature (mainly practitioners’ surveys and policy reports) the differentiation of performance and credit ratings remains rather vague. Confusion about the various types of rating products was identified by rating agencies and MFIs alike as one of the major obstacles for the further consolidation of the microfinance rating market (The Rating Initiative 2010: 23).

The Rating Initiative (2010: 4) defines performance ratings as follows:

*“Performance rating: These products correspond to the product that is commonly called a ‘performance rating’. Such ratings include the analysis of institutional risk, including credit risk, and the financial performance of MFIs. Microfinance ratings do not only measure the MFIs creditworthiness, but also its trustworthiness and excellence 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 high quality loans. Performance ratings can be used by investors, especially donors, technical assistance partners and the MFIs management and administrators.”*

In contrast, the definition of credit ratings is:

*“Credit ratings are the product of conventional rating agencies and have a narrower focus than performance ratings. Credit ratings predict the likelihood that an MFI will not be able to meet its obligations. Credit ratings do not focus on how effective or efficient an MFI is at extending loans to micro-entrepreneurs. They are conducted under a standard methodology, applied to any kind of financial institution, be it a commercial bank or an MFI. Their purpose is to formulate an opinion on the MFI’s risk of default during a given period of time. They focus on credit risk and are used by investors and supervisory authorities as part of the compulsory requirements to comply with national regulation.”*

Reille, Sanaikone et al. (2002: 11) compared different microfinance assessment methodologies in their very early stages and define the fundamental difference between MFI evaluations and “*real risk assessments*” according to the question one is trying to answer: “*is this a good organization?*” in the case of MFI assessments, or “*how likely am I to be repaid in full and on time?*” in the case of public credit-risk services” – a difference which is labeled by MicroFinanza Rating with the terms “*fiduciary risk: focus on governance and management: trustworthiness*” and “*credit risk: focus on ability to pay back obligations*” (MicroFinanza Rating 2011e). Yet, are “trustworthiness” and the organizational quality not also essential components of “creditworthiness” and thus the ability to pay back obligations?

These definitions suggest that performance ratings provided by specialized rating agencies are assessing the quality of MFIs in a more complete or comprehensive manner while credit ratings “only” focus on the likelihood of an MFI defaulting on its loan obligations. However, Reille, Sanaikone et al. (2002) do not include credit ratings into their analysis, neither do Mitra, Ranjan et al. (2008) who, based on rating reports from 2005, make first attempts to compare different rating “models”.

Implicitly stated in the definition of credit ratings from The Rating Initiative, one of the differentiating factors for these products compared to performance ratings is the difference of bench-

marks. While performance ratings are supposed to compare MFIs with each other, in the case of credit ratings they are (also) compared to commercial banks. Another difference becomes clear when taking the definition of credit ratings by MicroRate (2011d):

*“MicroRate also executes Credit Ratings for MFIs. Credit Ratings measure an MFI’s creditworthiness, considering country-level risk, the possibility of external support or interference, and overall financial strength.” While “Performance Rating Reports provide a comprehensive evaluation of microfinance institutions (MFIs), measuring the MFI’s level of excellence in microfinance.”*

Thus, what appears to determine the creditworthiness of an MFI actually goes beyond its “level of excellence in microfinance” but rather has to do with the context it operates in. For MicroFinanza Rating, on the other hand, the single most important differentiating factor between their microfinance ratings and credit ratings is the official recognition of the banking supervision to whose requirements its rating methodology and grades have been adapted (MicroFinanza Rating 2011e).<sup>114</sup>

The main purpose of the next sections is to shed light on the somewhat diffuse differentiation and to comprehend the difference between performance ratings and credit ratings. Furthermore, the differences between specialized raters regarding their characteristics and services offered are presented as far as they are considered important for the analysis of their functionality in Chapter 7.

As far as the rating reports and underlying methodologies are concerned, specialized microfinance raters largely share the analytical focus in terms of major rating categories. Yet, rating reports differ considerably in style and output. Furthermore, two of the specialized raters work with pre-defined weights for each rating category to be factored into the final grade while the other two apply a case-by-case approach. The latter is also applied by the conventional “mainstream” credit rating agencies, both by local Peruvian ones and the two international raters assessed here. Conventional rating agencies depart from their bank rating methodology, yet, adapting their rating rationales and assumptions to the context of microfinance. These rationales and assumptions are not traceable in detail, nor are the differences with the specialized raters. Still, the major difference between specialized and conventional raters is that they do not explicitly disclose key risk (or success) factors of MFIs considered important by specialized raters. The negligence of these factors possibly points towards the relatively little importance given to these dimensions. Furthermore, (Peruvian) conventional raters put a stronger focus on quantitative solvency factors, in particular regarding a strong capital base and liquidity. Besides, the availability of external financial support in times of financial distress is considered important. As for the

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<sup>114</sup> The role of MicroFinanza Rating regarding rating-based regulation will be explained further below.

international MFI ratings of the major global rater Standard & Poor's, the country risk and the strength of the financial system are explicitly factored, too.

### 6.1.1 Characteristics of the Four Specialized Rating Agencies, their Products and Rating Methodologies

The first and most obvious difference between the ratings of the four specialized rating agencies is the rating scale, which varies from 9 to 30 characters while two rating agencies use Arabic letter grades and the other two rely on Greek letters.<sup>115</sup> Furthermore, the length of the reports and hence the detailedness of the information differs just like the order in which the information is presented. Table 6.1 provides an overview of the major rating categories along which the information is organized.

**Table 6.1: Major rating categories as stated by the four specialized rating agencies**

Major rating categories of the four specialized rating agencies	
Planet Rating	<ul style="list-style-type: none"> <li>• Governance</li> <li>• Information</li> <li>• Risk Management</li> <li>• Activities</li> <li>• Funding &amp; Liquidity</li> <li>• Efficiency and Profitability</li> </ul>
MicroRate	<ul style="list-style-type: none"> <li>• Financial Situation</li> <li>• Microfinance Operations and Portfolio Quality</li> <li>• Organization and Management</li> <li>• Governance &amp; Strategic Planning</li> <li>• Social Perspective</li> </ul>
M-CRIL	<ul style="list-style-type: none"> <li>• Governance and strategic positioning</li> <li>• Organization and Management</li> <li>• Financial Performance</li> </ul>
MicroFinanza Rating	<ul style="list-style-type: none"> <li>• External Environment</li> <li>• Governance and operational structure</li> <li>• Lending and savings operations</li> <li>• Asset structure and quality</li> <li>• Financial structure and Assets and Liability Management (ALM)</li> <li>• Financial and Operational Results</li> <li>• Strategic Objectives and Financial Needs</li> </ul>

Source: Own elaboration based on M-CRIL (April 2009; December 2008a), MicroRate (2011c; December 2008; September 2008), Planet Rating (April 2008; July 2010; March 2010; n.d.-a) and MicroFinanza Rating (2010c; May 2009; September 2009b).

<sup>115</sup> For an overview on the rating scales of the four specialized rating agencies as well as the respective definitions, see Annex 5.

However, when studying the rating reports and the scarce information provided by the rating agencies on the sub-categories analyzed, the four specialized rating agencies' general focus is on the same areas:<sup>116</sup>

- A) All four start their analysis with providing basic information about the **context** an MFI operates in. This covers information on the macroeconomic environment, the microfinance sector as well as the regulatory environment MFIs in a specific country operate in. Still, it is not clear in how far this information is factored into the final judgment. As shown in Table 6.1 the only specialized rating agency explicitly mentioning the context as a rating category is MicroFinanza Rating. The others provide this section for informative purposes only. Usually, this section also covers or is followed by a section covering some general background information on the rated MFI.
- B) All specialized rating agencies have a section in which **governance and planning** issues are assessed. As far as the governance structure is concerned, the rating agencies focus on the existence and composition of relevant governance bodies (especially the board) and on whether a regular and independent decision making is guaranteed. The level of preparedness of board members is analyzed as well as in how far the board is provided with updated information on the institution's on-goings. Furthermore, potential conflicts of interest are addressed between the major governance organs and the MFI's management and in how far measures are taken to avoid related problems. It is also analyzed in how far an MFI has a realistic strategy for its future development and how the necessary means to reach its goals are going to be secured.
- C) In the **management** section it is analyzed in how far an MFI has important management positions in relation to its current state of development. Furthermore, rating agencies assess whether the management team has relevant experience and knowledge to exercise its duties. Special attention is given to the management of human resources. Since especially the skills of credit officers dealing with microfinance clients is a key bottleneck in microfinance, the successful retention of (motivated) staff is assessed as well as in how far MFIs secure professional trainings for their employees.
- D) Specialized raters also assess whether adequate **risk management** procedures are in place. First of all, relative risks have to be identified by the MFI. Moreover, they focus on whether MFIs count with clear policies and relevant control systems to avoid these risks. Responsibilities have to be clearly defined. In addition, special attention is given to the issue on how cash is handled by employees and on how fraudulent activities (e.g. the disbursement of

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<sup>116</sup> For an overview of the categories and sub-categories covered and disclosed by the four specialized rating agencies, see Annex 6.

credits to non-existent clients) are prevented. The existence and quality of an internal audit department and the consistency of relevant information is also addressed.

- E) Crucial for the successful (risk) management of an MFI is the **management information system** which is explicitly evaluated by all rating agencies. This covers both the systems for loan-tracking as well as accounting and also (most importantly from a technological point of view) how reliable and timely information is secured as a precondition for sound decision making.
- F) For any financial institution, the major risk is credit risk arising from its principle **activity**, namely lending. Therefore rating agencies assess the policies and procedures of MFIs different loan products, especially the way clients' repayment capacity and willingness (creditworthiness) is evaluated, how decisions on loan-approval are taken and how MFIs deal with delayed payments (delinquency management). The competitive situation of an MFI, which might increase the possibility of over-lending, is also considered. Finally, the portfolio quality is assessed, usually with the two basic indicators portfolio at risk over 30 days (PAR > 30)<sup>117</sup> and the write-off ratio, and it is assessed in how far credit risk is covered by loan provisioning.
- G) In a section about **funding and liquidity**, rating agencies evaluate the different funding sources (and their terms) of MFIs and whether their liabilities are adequately backed by their capital (capital adequacy). It is also assessed in how far MFIs are exposed to market (exchange and interest) and liquidity risks and how the MFI manages them.
- H) Finally, the **financial sustainability** of MFIs is assessed, focusing primarily on profitability (most importantly in terms of return on assets) and operational efficiency (most importantly in terms of the operating expense ratio). Some rating agencies include the productivity of MFIs' employees in terms by dividing the number of active borrowers by the number of staff.

Even though the four specialized rating agencies seem to agree on the relevant categories to be assessed when evaluating the performance and creditworthiness of an MFI, there is very little information on how the single areas are factored into the final judgment. From a methodological perspective, two main approaches can be distinguished. One possibility is to evaluate an MFI on a case-by-case basis. Here the rating agency decides every time anew how single categories or even indicators should be weighted. The alternative is to pre-define the relative importance of different factors. Furthermore, it has to be decided whether or not to work with pre-defined

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<sup>117</sup> M-CRIL is an exception disclosing PAR > 60.

benchmarks for single (quantitative variables), meaning that it is not judged every time again whether, for example, a return on assets (ROA) of 1.6% is good, bad or moderate.

An example for an organization which evaluates MFIs and works with both, pre-defined weights and benchmarks, is ACCION.<sup>118</sup> In its CAMEL<sup>119</sup> approach, a set of 20 indicators is scored between 0 and 5 while seven of those indicators are quantitative and weighted 46% and the remaining 13 indicators are qualitative and factored to 54% into the final score (Curran 2005)<sup>120</sup>. Table 6.2 shows how the single factors are weighted and Table 6.3 illustrates the pre-defined benchmark levels for some of the quantitative indicators applied by ACCION.<sup>121</sup>

**Table 6.2: Indicators and respective weights of ACCION's CAMEL rating approach (as of 2005)**

Quantitative Indicators		Qualitative Indicators	
Indicator	Weight	Indicator	Weight
<b>Capital Adequacy (16%)</b>			
Capital Adequacy Ratio	5%	Ability to Raise Equity	5%
Adequacy of Reserves	6%		
<b>Asset Quality (21%)</b>			
Portfolio at Risk	8%	Portfolio Classification System	3%
Loan Loss Rate	7%	Productivity of Long-term Assets	3%
<b>Management (23%)</b>			
		Governance	4%
		Management	4%
		Processes, Controls, Audit	4%
		Human Resources	4%
		Information Systems	4%
		Strategic Planning & Budgeting	3%
<b>Earnings (24%)</b>			
ROE	5%	Interest Rate Policy	4%
Operating Efficiency	8%		
ROA	7%		
<b>Liquidity (16%)</b>			
		Liability Structure	8%
		Cash Flow Projections	4%
		Productivity of Liquid Assets	5%
<b>Total</b>	<b>46%</b>	<b>Total</b>	<b>54%</b>

Source: Curran (2005)

In the case of M-CRIL and MicroRate, the self-provided information about the relation between quantitative and qualitative factors is rather approximative, varying between 60/40 and 50/50. Planet Rating and MicroFinanza Rating are much more precise in this regard, not only because

<sup>118</sup> Chapter 2.2.2 stated that ACCIÓN was the first organization in developing a microfinance rating methodology (based on Moody's CAMEL categories) designed for internal purposes. It is considered here since it is the only source illustrating this approach with a relatively high degree of transparency.

<sup>119</sup> For a description of Moody's CAMEL categories see Chapter 3.1.

<sup>120</sup> Note that the exact weights might have changed as the source of information is from 2005. However, this does not change anything in terms of the general argument stressed here.

<sup>121</sup> For an overview of how the different ratios are calculated see Standard & Poor's (2007: 29).

they use a similar approach to ACCION but also because they are more transparent about the weights assigned to each category than the other two specialized rating agencies.

**Table 6.3: Benchmark levels for selected quantitative indicators of ACCION's CAMEL rating approach (as of 2007)**

Score	Capital Adequacy	PAR	Loan Loss Rate	ROA	Operating Efficiency
5	≥16.7%	<3.0%	<2.0%	>3%	≤20%
4	14.3%-16.6%	3.1% - 6.0%	2.1% -3.5%	2.0% - 3.0%	20.01% - 25%
3	12.5% - 14.2%	6.1% - 9.0%	3.6% - 5.0%	1.0% - 1.9%	25.01% - 30%
2	11.1% - 12.4%	9.1% - 12.0%	5.1% - 7.0%	0 – 0.9%	30.01% - 40%
1	10.0% - 11.0%	12.1% - 15.0%	7.1% - 10.0%	<0 to (2.0%)	40.01% - 50%
0	<9.9%	> 15%	>10.0%	<(2.9%)	>50%

Source: Standard & Poor's (2007: 30-33)

**Planet Rating** was created in 1997 as a department of the French and internationally active NGO PlaNet Finance which is specialized in the development of microfinance. Since 2005, it has worked as an independent organization even though PlaNet Finance still is the major shareholder, holding 61% of the company. The remaining 39% are held by the French government-owned savings bank Caisse des Dépôts et Consignations (13%), the credit insurer Coface (13%) and the holding company Viel et Compagnie Finance (13%)(Planet Rating 2009: 5). Planet Rating is headquartered in Paris and has five further offices around the world (Beirut, Lima, Dakar, Nairobi, Manila). By the end of 2008, it had conducted more than 400 rating missions of 290 MFIs worldwide working with 17 full-time rating analysts (Planet Rating 2009). Currently, the organization states to have conducted over 600 rating missions (Planet Rating n.d.-e). Planet Rating offers financial as well as social ratings. Furthermore, it offers “interactive assessments” (formerly called mini ratings) as a sub-product of its rating services. Here the rating exercise is combined with training units and joint evaluations of the MFI’s performance. Another business line is the provision of three-day trainings directed at microfinance bankers, Apex institutions, regulators and practitioners (Planet Rating 2010). Even though the major sources of revenues are the fees paid by MFIs (issuers-pay model), the rating agency has a subscription service for microfinance investors which guarantees access to the most recent rating reports. According to the organization, “*the most prominent investors and funders*” (like CGAP, EFSE, Citigroup, Morgan Stanley, Incofin, Oikocredit, Blue Orchard, Triple Jump) have subscribed to this service (Planet Rating 2010).

Currently, the organization is working on the development of country reports as a first step towards specific microfinance country ratings to be able to answer to which degree the environ-

ment potentially endangers an MFI's performance.<sup>122</sup> The country reports do not contain a rating grade<sup>123</sup> yet and cover the following areas: Regulatory environment, financial access, micro-finance industry environment (including the competitive environment, market saturation and client indebtedness, funding and probability of outside interference) and the operating environment (including the political, macroeconomic and socio-economic context) (e.g. Planet Rating August 2010). Currently, there are six country reports available on the rating agency's web site.<sup>124</sup>

Finally, customized services, mainly to donor organizations or regulators, are offered. For example, in Mexico Planet Rating worked on the development of an adapted evaluation method for credit unions in the context of a new regulatory framework; and for Uganda the EU mandated Planet Rating to develop an assessment tool for non-regulated MFIs (Planet Rating n.d.-f).

As for the evaluation of the (financial) performance of MFIs, its GIRAFE methodology is called after the initials of the single rating categories with the following fixed proportion: Governance to 24%, Information and systems to 10%, Risk Management to 10%, Activities to 20%, Funding and liquidity to 14%, Efficiency and profitability to 22% (Planet Rating 2009: 11). All in all, qualitative variables (57%) are considered slightly more important than quantitative factors (43%) (The Rating Initiative n.d.-f). For each rating category, specific sub-categories (or indicators) are defined and disclosed which are also assessed with fixed weights. However, the actual weightings for the 18 indicators are not disclosed in detail.

The methodology received its last major update in 2008 (Keller 2008) when single weights were adjusted. The relative importance of governance and funding related issues was enhanced while the importance of the other categories decreased. Changes in the area of microfinance activities (lending procedures, credit risk management and portfolio quality) are most pronounced. Furthermore, Planet Rating introduced formal caps in order to compensate for the otherwise rather rigid method. This means in general that a total area grade (as well as the final grade) cannot pass a pre-defined maximum when single indicators reach very low values. This also applies for the environment factors in the GIRAFE ratings without bearing a specific percentage. Prior to this adaption, these decisions were taken on a case-by-case basis. However, specific details on existing caps are not further disclosed (Planet Rating 2008). Finally, the rating scale was lengthened from 11 to 14 letter grades reaching now from A++ to E.

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<sup>122</sup> Background information on the country reports as well as on the current consideration of environmental factors in MF performance ratings were provided during a telephone interview with Planet Rating's Operations Manager, Otto Wormgoor on April 12, 2011.

<sup>123</sup> However, they already carry the name "Country Rating".

<sup>124</sup> See <http://www.planetrating.com/EN/country-reports.html> (accessed November 9, 2011).

The rating reports of Planet Rating are relatively comprehensive and easy to review.<sup>125</sup> They start with a presentation of the respective microfinance sector and the general political and economic environment. The strength and weaknesses of the latter are highlighted separately and a Coface Country Ratings<sup>126</sup> is given for informative purposes. Afterwards, the institution is presented covering aspects like the legal form and how the MFI is supervised (or not), the ownership structure, the funding composition including the receipt of donations, the organizational structure and the management team (in most general terms), the MFI's market penetration and products and finally its affiliation to microfinance networks and federations. Then, the report goes through the GIRAFE categories while the sections are sub-divided by the single indicators offering further orientation. The assignment of letter grades reaching from a to e for each GIRAFE category further facilitates the understanding of the final rating grade. Following the written explanation, the MFI is benchmarked with its major competitors and/or best performance MFIs in the country as well as regional averages using the most important quantitative indicators: number of active borrowers, size of loan portfolio (in USD), the average outstanding loan per clients, ROA, portfolio yield, operating expense ratio, PAR > 30 and write-off ratio. The data is either taken from MIX Market (especially in the case of regional benchmarks) or data compilations gathered by the rating agency during their rating exercises of other MFIs. The performance indicators considered relevant by the rating agency over the last years<sup>127</sup> are disclosed in a separated table just like the income statement and balance sheet of the institution. Finally, Planet Rating provides an overview of the formula used to calculate relevant indicators as well as its rating scale and definitions.

**MicroRate** bases its analysis on the development of financial data and performance indicators of the last (approximately four) years, as well, in most cases using the same indicators as Planet Rating. However, MicroRate does not display the income statements and balance sheets of MFIs but only provides information on a few key figures. All in all, the rating reports of MicroRate are shorter and less detailed than those of Planet Rating. MicroRate is the only specialized rating agency which does not provide a general overview of the MFI and its activities but only mentions specific aspects when considered relevant for the evaluation. According to a survey conducted by The Rating Initiative, this rating agency values quantitative factors as much as qualitative factors (50% each). However, in one of the interviews realized in Peru the managing director of MicroRate Latin America stated that the analysis of financial performance data is considered more important since qualitative factors like good governance and management structures are,

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<sup>125</sup> For an overview of the rating reports analyzed refer to Annex 1. In the following, if not stated otherwise, all methodological descriptions for all rating agencies considered here are based on these reports.

<sup>126</sup> Coface is an important provider for intercompany trade credit insurances. One of its services are country risk assessments; see [http://www.coface.com/CofacePortal/COM\\_en\\_EN/pages/home/risks\\_home](http://www.coface.com/CofacePortal/COM_en_EN/pages/home/risks_home) (accessed November 9, 2011).

<sup>127</sup> The number of years covered varies depending on the data availability. In the reports reviewed here the tables cover between four and five years.

to a certain extent, already expressed in the past financial performance (Interview 5). In general, MicroRate decides on a case-by-case basis. Thus, there do not exist fixed weights nor are the major rating categories (financial situation, microfinance operations and portfolio quality, organization and management, governance & strategic planning, social perspective) along which the report is organized and marked by single rating grades. MicroRate does not further sub-divide its reports along single rating indicators, which might make the orientation more difficult but is due to the compactness of the reports. Still, most indicators explicitly mentioned by the other specialized rating agencies are covered, again, being much less detailed regarding the underlying information. In the reports reviewed for the purpose of the present study<sup>128</sup> no explicit information was found about the risk management procedures and internal controls of the MFIs. As far as benchmarks are concerned, the MFIs are only implicitly compared through an index to regional and global peer groups compiled from a list of MFIs that MicroRate regularly collects data from (MicroRate 50).<sup>129</sup>

MicroRate is the only specialized rating agency which explicitly factors social performance indicators into its (financial) performance assessments. In this category the outreach and depth of operations are evaluated. Furthermore, it is assessed whether the MFI has a clearly stated social mission which is shared by all relevant governance bodies and the management team and in how far monitoring systems allow controlling whether social goals are reached. Finally, it is analyzed in how far the staff of an MFI is treated fairly and motivated by appropriate incentive schemes.<sup>130</sup> However, it is not disclosed in how far this category is considered in the final rating grade which is expressed in Greek letters encompassing nine grades from  $\alpha++$  to  $\gamma$ .

In addition, MicroRate also offers explicit social ratings and “Institutional Evaluations” as an equivalent to Planet Rating’s “Interactive Assessments” directed to smaller and younger MFIs. These assessments are flanked by a capacity or institution-building program in which struggling MFIs are assisted over a period of two to three years “to bring them to a level of performance which enables them to attract outside investments” (MicroRate 2011d). Furthermore, MicroRate is the only specialized rating agency which actively offers credit ratings which “strictly evaluate the risk of default”<sup>131</sup> focusing on the financial strength and solvency of an MFI. It started to do so in 2006 (MicroRate 2011a). Until now the demand for this rating product, however, has remained

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<sup>128</sup> At the time this analysis was done, there were only two rating reports publicly available on the website of MicroRate. Even though this is not a number large enough to make representative claims about the content, these reports are those provided by the organization as sample reports and as such marked as somewhat representative by the organization itself.

<sup>129</sup> This information was provided during an email correspondence with MicroRate’s headquarter on March 30, 2011.

<sup>130</sup> In the next section, it will be analyzed more thoroughly how single rating agencies evaluate the social performance of MFIs.

<sup>131</sup> This information was provided by Kathrine Devine from MicroRate’s headquarter on March 31, 2011 (through an e-mail conversation).

low and the rating agency has not realized many of them. The same is true for its MIV fund ratings which MircoRate began offering towards the end of 2009. Up to this point, all MIV ratings have remained confidential.<sup>132</sup> The goal is to provide MIV performance data on the internet-based platform LUMINIS which was announced along with LuxFLAG<sup>133</sup> in May 2010 and “allows investors to compare MIVs, analyze performance and trends, and ultimately make informed investment decisions” (MicroRate 2010a). MicroRate is expecting to launch the platform in the course of 2011. Finally, MicroRate also offers tailor-made due diligence services for investors (MicroRate 2011h).

Additionally to its evaluation services, MicroRate publishes a series of sector reports called MFInsights (MicroRate 2011g). Since 2006, the organization has conducted its own annual MIV survey (e.g. MicroRate 2010b). In 2007, it published a study on the role of international development finance institutions and their potential crowding-out of private investors (MicroRate 2007). Finally, the series also covers two studies on the impact of the global financial crisis of 2008 on MFIs in Latin America and the Caribbean conducted in 2009 (MicroRate 2009a, 2009b).

MicroRate was officially founded in 1997 as the first specialized rating agency for MFIs and operates from three offices (Washington as Headquarter, Lima, Casablanca) with 18 employees (12 rating analysts) (MicroRate 2011a; The Rating Initiative n.d.-e). Its founder, Damian von Stauffenberg, is considered (and praised as) a recognized expert of the microfinance industry who had worked at the World Bank and IFC for 25 years and has gained further experience as chairman of several microfinance investment companies (MicroRate 2011b). Since its inception, MicroRate has conducted more than 500 ratings of more than 200 MFIs<sup>134</sup> with its biggest share in Latin America (ADA 2008: 20). It covers all regions except Asia which is left to M-CRIL. In 2007, MicroRate formed a strategic alliance with M-CRIL and launched MicroRating International as the first step towards a merger of the two rating agencies and with it the consolidation of the microfinance rating industry (MicroCapital 2007).

Accordingly, **M-CRIL** is active in all regions except Latin America and the Caribbean, operating from its only branch in Gurgaon (India) and with a very strong focus on Asia.<sup>135</sup> In 2009, it had 12 rating analysts and since its inception in 1998 it has realized almost 600 rating missions (The Rating Initiative n.d.-d). M-CRIL's foundation goes back to an initiative of EDA Rural System Pvt Ltd (EDA), an international development sector consultancy with a strong focus on the development

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<sup>132</sup> See supra note 131.

<sup>133</sup> LuxFLAG is a non-profit association which aims to promote the raising of capital for microfinance by awarding a label to eligible Microfinance Investment Vehicles (MIVs) in order to reassure investors that the MIVs actually invest in the microfinance/environment sector (LuxFLAG 2011).

<sup>134</sup> MicroRate does not publish annual reports with more detailed information on its activities.

<sup>135</sup> In 2008, 98% of M-CRILs rating assignments were realized in Asia (ADA 2008: 20).

of microfinance in Asian countries (EDA 2011). The rating agency is still owned by EDA, and one of its founders (Sanjay Sinha) is now the managing director of M-CRIL (M-CRIL 2008a: 10).

As far as the rating methodology for (financial performance) ratings is considered, M-CRIL only provides broad information on its three major rating categories (governance and strategy, management systems, financial performance) without any further explanation on its importance or specific weights (M-CRIL 2008a: 13).<sup>136</sup> However, the assignment of single grades for each major category permits to a limited degree the reconstruction of the overall rating grade on a scale of 10 Greek letters between  $\alpha+++$  to  $\gamma$ . The report itself is relatively comprehensive, similar to those of Planet Rating, if the length is considered. M-CRIL also provides an overview of the country as well as the MFI in general terms, including its products. The evaluation part follows a clear structure with 18 sub-categories along which the report is organized and whose clear denomination in sub-headings allows orientation. The only information that cannot be found in the reviewed reports but covered by all the other rating agencies is the one about MFIs' exposure to market risks related to their funding structure. M-CRIL explicitly benchmarks the MFIs according to four relevant performance indicators (operating expense ratio, borrowers per staff, PAR > 60, ROA) against other MFIs rated by the rating agency. However, it does not provide information on the composition of the peer group and indicates only in general terms the position of the MFI on a scale from weak to excellent. Still, the designation of concrete values along this scale as well as average values, including all MFIs, also the upper-end ones, gives further insights into the relative classification of a specific MFI. According to a survey of The Rating Initiative (The Rating Initiative n.d.-d), M-CRIL weights the quantitative part (60%) higher than the qualitative part (40%).

Since 2008, besides the ratings of MFIs, M-CRIL has also offered rating services to (or about) Indian chit fund companies<sup>137</sup> and self-help promotion agencies which support forming Self Help Groups under the governmental SHG Linkage Program (Harper 2002; M-CRIL 2008a: 9). This way M-CRIL is seeking to move beyond the offering of rating products "*into the wider process of analytical support for the financial inclusion agenda*" (M-CRIL 2008a: 8). Directed towards MFIs, M-CRIL furthermore offers "Loan Portfolio Audits" which are in-depth analyses of MFIs' portfolio quality as well as lending procedures (M-CRIL 2009b). In the context of its "Research & Advisory Services" (M-CRIL 2008a: 8), the rating agency offers a variety of services ranging from consultancies to individual MFIs or microfinance programs, policy reports for donor organizations and financial regulators as well as general sector studies (majorly focusing on India) (M-CRIL 2008a: 6,

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<sup>136</sup> A statement from the managing director of M-CRIL in 2006 implicitly indicates, however, that M-CRIL follows a similar approach to MicroRate: "*The ratings of M-CRIL and MicroRate have a high degree of comparability on account of an exchange of information between these two agencies about methodologies and rating scales*" (Sinha 2006).

<sup>137</sup> A chit fund company organizes, conducts or supervises Indian chit funds which in turn can be described as formal RoSCAs (Rotating Savings and Credit Associations) and were officially recognized with the Chit Fund Act of 1982.

2009d). Furthermore, its managing director is an active author of newspaper and magazine articles (microfinance advocacy), many of them (prominently) published in *The Economic Times of India* (e.g. Sinha 2007a; Sinha 2007b, 2008b). Even though M-CRIL has not (yet) started actively advertising it on its website as an official business-line, it has also started rating MIVs including their social performance (e.g. M-CRIL December 2009).

**MicroFinanza Rating** is the youngest among the four specialized rating agencies and was founded in 2001 as a department of the Italian microfinance consultancy firm *Microfinanza Srl*. In 2006, *MicroFinanza Rating* was spun-off of its mother organization and became an independent company, however, with *Microfinanza* still holding 90% of its shares. In mid 2010 the company was bought by 100% by two founding partners of *Microfinanza* who both sold their shares of the latter, therewith re-inforcing the organizational independency of the rating agency (*MicroFinanza Rating* 2011a, 2011c). One of the owners, Aldo Moauro, functions as the Executive Director of *MicroFinanza Rating*.

*MicroFinanza Rating* is headquartered in Milan and has 7 regional branches in Quito, Managua, Mexico City, Bishkek, Manila and Nairobi, working with 21 rating analysts<sup>138</sup>. Since its inception, it has exercised more than 600 assignments in 63 countries (*MicroFinanza Rating* 2011b), however, with a regional focus (until 2008) on Eastern Europe and Central Asia as well as Latin America and the Caribbean (ADA 2008: 20).

The performance ratings of *MicroFinanza Rating* can be distinguished from those of the other rating agencies in several aspects. First of all, they reach the major level of detailedness with the final reports being the longest of all specialized rating agencies, explicitly covering and disclosing all sub-categories identified. Furthermore, they reach the highest level of disclosure in terms of sub-categories analyzed, which can be easily found thanks to a standardized table of content at the beginning of the report following the rating summary. Another differentiating characteristic is the clearly arranged table of risk factors identified per major rating category. The weight *MicroFinanza Ratings* assigns to each of its seven major rating categories is not disclosed in the methodological descriptions publically available on the website (*MicroFinanza Rating* 2010c). Yet, on demand the rating agency discloses the absolute weights of the seven major categories as follows: External context and positioning of the MFI (14%), governance, management, structure and operational risk (20%), products and financial processes (10%), asset quality and structure (12%), financial structure and assets and liability management (15%), financial and operational results (17%), business planning and funding strategy (12%)(*MicroFinanza Rating* 2010b).<sup>139</sup>

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<sup>138</sup> The number of rating analysts was retrieved by summing up the number of analysts of the regional offices as stated on the company's website; see [www.microfinanzarating.com](http://www.microfinanzarating.com) (accessed April 20, 2011).

<sup>139</sup> The more recent version of the methodology and information on other services offered were provided by *MicroFinanza Rating's* managing director Aldo Moauro after a telephone interview held on May 24, 2011.

The identification of risk factors is accompanied by the corresponding observation providing further explanation why a specific risk factor is considered problematic. Furthermore, the rating agency discloses in how far a specific risk factor is considered relevant by ranging it on a scale of five values from “low” to “high”. Figure 6.1 is an illustration on how the rating agency lists the key risk factors of an MFI. The final rating grade is the result of a compilation of the different grades scored by the MFI for each area of the risk analysis and is computed automatically on a quantitative basis, regardless of the rating analysts’ subjective experiences. Yet, the outcome of the “quantitative model” only serves as a point of reference for the discussions within the rating committee to a degree that even the fixed weights assigned to each rating area are not in all cases rigidly applied.<sup>140</sup>

**Figure 6.1: Details of an MFI's risk as disclosed in MicroFinanza Rating reports (example)**

**8. Details of the risk factors**

According to our analysis, the main risk factors of YEHU are the following:

AREA	Risk factors	Relevance <sup>a</sup>	Main measures implemented and/or to implement in the short term	Observations
<i>External environment</i>	<i>Lack of Credit Bureau</i>	Low	-	Besides the absence of a credit bureau, the information exchange on bad clients among MFIs is quite limited.
<i>Governance, management and operations</i>	<i>CEO sitting in the BoT and with voting rights</i>	Medium	The BoT is aware of the problem and is foreseeing to solve it in the near future.	It may create conflict of interest exacerbated by the unbalanced relationship between the CEO and the other BoT members
	<i>BoT not fully capable to play its supervisory and guidance role</i>	Medium-high	Yehu has planned to mitigate such a risk also through the support of International Partners.	Weak competences in microfinance and finance. Low commitment of some of the members.
	<i>Key person risk at management level</i>	Medium-high	Other key positions have been hired (COO) or are planned to be hired in the next future (CFO, Internal Auditor).	Reporting lines and decision making processes centralized in the CEO who in his turn is overloaded playing multiple control functions and at the same time being implied in other functions
	<i>Top management team characterized by high turn over and overall low technical skills</i>	Medium-high	A new COO has been recently hired while the CFO hiring process should be launched in the near future.	Key positions have been characterized by a high turnover and an overall low level of skills which has affected the continuity of the operations
				Yehu is undergoing a hiring process for the research of an

Source: MicroFinanza Rating (September 2009b: 27)

The indication of relevance in the view of MicroFinanza Rating allows (to a certain extent) to reconstruct the final judgment. Relevance is defined as “the damage/loss brought about by negative events associated to each risk factor and to the probability that a damage/loss occurs” (MicroFinanza Rating 2010c: 1). Furthermore, MicroFinanza also indicates in how far an MFI is aware of the risks and takes measures to address critical issues. Finally, MicroFinanza Rating is the only specialized rating agency which explicitly factors the external environment (here: macroeconomic context, the microfinance sector, regulation and supervision and market positioning)

<sup>140</sup> The more detailed information on the methodology of MicroFinanza Rating is based on a telephone interview held with its managing director Aldo Moauro (ibid).

into its opinions, yet, with a strong focus on factors with immediate relevance for MFI's operations.<sup>141</sup> In total, MicroFinanza Rating states to factor quantitative indicators to 50% and qualitative indicators to 50% (MicroFinanza Rating December 2010c). The rating scale from AAA+ to D- with 30 characters in ten groups provides the finest differentiation of all specialized rating agencies.

Since 2007, MicroFinanza Rating has been the only specialized rating agency which is authorized by a regulatory body (the superintendency of banks and insurance in Ecuador) to issue mandatory credit ratings for regulated MFIs (MicroFinanza Rating 2011c, 2011d, December 2010a).<sup>142</sup> However, the only noticeable differences are the style of the rating summary (mainly the integration of a standard disclaimer about the meaning of the rating grade according to the regulatory body), a slight adaption of the rating scale and the inclusion of an analysis of compliance with specific regulatory norms, using different indicators of solvency and liquidity evaluations.<sup>143</sup>

Besides, MicroFinanza Rating offers two different "pre-rating products". "Mini assessments" can be considered the counterpart to Planet Rating's "Interactive Assessments" and MicroRate's "Institutional Evaluations". Its "Institutional diagnostics" are primarily directed at MFIs with access to technical assistance (TA). The TA providers can gain orientation of the specific needs of an MFI as the institutional diagnostics include short-term and medium-term recommendations for specific risk factors in every rating category (MicroFinanza Rating 2011g, 2011h, December 2009, November 2009). Furthermore, MicroFinanza Rating also offers evaluations of single areas (governance, internal control, loan portfolio).

**Table 6.4: Key differentiating factors of the four specialized rating agencies**

Planet Rating	MicroRate	M-CRIL	MicroFinanza Rating
<b>Rating Scale</b>			
A++ to E (14 grades)	α++ to γ (9 grades)	α+++ to γ (10 grades)	AAA+ to D- (30 grades)
<b>Methodology</b>			
<ul style="list-style-type: none"> <li>• Pre-defined weights (and values) for single rating factors</li> <li>• Single grades for major rating categories</li> </ul>	<ul style="list-style-type: none"> <li>• Factoring social performance</li> <li>• Case-by-case approach</li> </ul>	<ul style="list-style-type: none"> <li>• Single grades for major rating categories</li> </ul>	<ul style="list-style-type: none"> <li>• Pre-defined weights for single rating factors</li> <li>• Factoring of context</li> </ul>

<sup>141</sup> Ibid.

<sup>142</sup> This has been the case until recently at least. In mid 2011, MicroRate was authorized by the Peruvian financial regulation to rate MFIs (see Chapter 7.1.2). In Ecuador, all MFIs capturing deposits (including credit and savings cooperatives since late 2009) are prudentially supervised and have to undergo external ratings (EIU 2010b).

<sup>143</sup> This is based on the comparison of two rating reports, one being a standard performance rating report and one credit risk rating of two different Ecuadorian MFIs (MicroFinanza Rating 2010, September 2009). The differences identified were confirmed by Aldo Moauro during the telephone interview mentioned above (see supra note 139).

Relative Weight Quantitative/Qualitative Factors			
(~)43/57	~50/50	~60/40	~50/50
Benchmark			
<ul style="list-style-type: none"> <li>National and regional benchmark (own and MIX Market data)</li> </ul>	<ul style="list-style-type: none"> <li>Global and regional (MicroRate 50); not explicitly disclosed, based on own data</li> </ul>	<ul style="list-style-type: none"> <li>Based on own data; peers not further disclosed</li> </ul>	<ul style="list-style-type: none"> <li>Relevant peer groups from MBB (MIX Market)</li> </ul>
Report Style			
<ul style="list-style-type: none"> <li>Comprehensive / neutral overview of MFIs general characteristics</li> </ul>	<ul style="list-style-type: none"> <li>Very compact; single rating factors not explicitly disclosed</li> <li>No introduction into MFI's general characteristics</li> </ul>	<ul style="list-style-type: none"> <li>Comprehensive</li> </ul>	<ul style="list-style-type: none"> <li>Very comprehensive and detailed</li> <li>Detailed list of single risk factors and disclosure of their relevance</li> </ul>
Regional Coverage (compared to peers)			
<ul style="list-style-type: none"> <li>All regions, relatively strong in SSA and MENA</li> </ul>	<ul style="list-style-type: none"> <li>Not active in Asia</li> </ul>	<ul style="list-style-type: none"> <li>Asia (especially India)</li> </ul>	<ul style="list-style-type: none"> <li>All regions, relatively strong in EECA</li> </ul>
(Additional) Products Offered / Activities			
<ul style="list-style-type: none"> <li>Country Reports</li> </ul>	<ul style="list-style-type: none"> <li>Annual MIV survey and MF sector reports for LAC</li> <li>Capacity-building program for small MFIs</li> <li>(Credit ratings and MIV ratings; web-based investor platform LUMINIS, tailor-made due diligence)</li> </ul>	<ul style="list-style-type: none"> <li>Ratings for Indian chit funds and SHGAs</li> <li>Pronounced MF advocacy activities</li> <li>Various research and consultancy activities</li> <li>(MIV ratings)</li> </ul>	<ul style="list-style-type: none"> <li>Allowance to offer mandatory credit ratings in Ecuador</li> <li>Institutional diagnostics with TA recommendations</li> <li>(Quarterly country bulletin for six countries; investor advisory reports; monitoring)</li> </ul>

Source: Own elaboration

Note: For indications of the regional coverage compared to their peers see ADA (2008: 26, 30, 33, 36 and 38).

Similar to Planet Rating, MicroFinanza Rating also offers trainings and country screenings which provide general information about the microfinance environment and one-paged MFI profiles of institutions rated by MicroFinanza Rating. It also has a subscription service which furthermore contains the provision of (recently created) country bulletins for each of the six countries which are updated on a quarterly basis. The country bulletins contain information on the political and macroeconomic environment as well as on the microfinance sector and related changes in regulation. Finally MicroFinanza Rating offers "investment advisory reports" in which the due diligence is optionally conducted in cooperation with an investor's representative. Besides, the rating agency offers to monitor MFIs on behalf of the investor, including (monthly, quarterly or bi-annual) reports with an updated performance and risk analysis (MicroFinanza Rating 2011f, 2011i, 2011k). However, until now the demand for these services has been rather limited.<sup>144</sup> Table 6.4 summarizes the main distinguishing factors of the different specialized rating agencies.

<sup>144</sup> Aldo Mouaro (see supra note 139) mentioned that you could "count MIVs on one hand" which required this service so far.



### **6.1.2 Credit Ratings – Main Characteristics of Conventional Rating Agencies’ Methodologies and their Differences to Specialized Approaches**

As has been shown in Chapter 5.3, in Peru credit ratings have gained increasing importance for MFIs because of rating-based regulation which now applies for any deposit-taking financial institution, including the most important MFIs in Peru (in terms of outreach). However, more advanced MFIs in terms of regional outreach and product portfolio had to have a credit rating long before June 2010. These credit ratings were provided by four officially recognized “mainstream” rating agencies.

The appearance of the four accredited rating agencies – Pacific Credit Rating (PCR)<sup>145</sup>, Class & Asociados, Equilibrium and Apoyo & Asociados – in Peru dates back to the early 1990s. With the introduction of the first law to regulate the stock exchange, all four rating agencies were registered between 1993 and 1994. At the beginning it was obligatory that the respective rating methodologies were elaborated by an internationally recognized rating agency. This rule was abolished in 1996, still (until 2011) no further rating agencies have been registered since then (Interview 13). PCR started as a subsidiary of Duff and Phelps, Equilibrium was related to Thomson Bankwatch and Apoyo & Asociados to IBCA. As all these rating agencies were later merged into Fitch Ratings (see Chapter 2.1.1), PCR and Equilibrium became independent and only Apoyo & Asociados remained with Fitch which today owns 20% of its shares. Since 2007, Equilibrium has had a strategic partnership with Moody’s even though the latter is not (yet) a shareholder. Class & Asociados which started as an affiliate of the Chilean rating agency Feller Rate (which itself is related to S&P) became (and remained) independent in 1996-97 (Interviews 4, 13, 28 and 35).

In other Latin American countries, most of the existing rating agencies are affiliates of one of “the big three”, too. For instance, of the 28 rating agencies listed by The Rating Fund (n.d.-d) as (more or less) active in microfinance 11 are affiliates of Fitch, four are related to Moody’s, six are with PCR and only four can be considered as 100% local. The influence of the large rating agencies is also apparent considering those rating agencies which participated in the 2008 survey of ADA (ADA 2008: 20). Here only one rating agency can be considered 100% local (PRIME in Uzbekistan), one rating agency is an affiliate of the major Japanese credit rating agency (JCR-VIS in Pakistan) while seven rating agencies are affiliated with the U.S.-based global players.

These partnerships also imply cooperation during the development of rating methodologies. For example, Apoyo & Asociados closely cooperates with Fitch in Bolivia to further develop their rating methodology for MFIs (Interview 35). In general, all of the Peruvian rating agencies interviewed stated that they applied the same rating methodology to MFIs as they did to any other

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<sup>145</sup> Note that PCR will not be considered when assessing its microfinance rating methodology due to its limited activities in this field (see Chapter 1.2).

financial institution. All of them follow a case-by-case approach and express their judgment on a rating scale predetermined by the banking regulation SBS from A to E which can be increased or lowered by adding “+” or “-” (Apoyo y Asociados 2011b; Class y Asociados 2011b; Equilibrium 2011b).<sup>146</sup>

**Apoyo & Asociados** has established ten major rating categories which in general also cover the areas assessed by the specialized rating agencies (Apoyo y Asociados 2011a). However, when analyzing the methodology<sup>147</sup> along with the rating reports (Apoyo y Asociados Marzo 2010; Septiembre 2010) differences in terms of the priorities can be identified.

After providing some general information of the MFI, especially on major changes in the respective rating period,<sup>148</sup> the analysis of the MFIs’ performance (desempeño) includes the growth of earnings and the quality of an MFI’s revenues (e.g. major source of income and interest margins), its operational efficiency as well as its level of profitability compared to its major competitors and MFIs of the same type (CMAC, EDPYMES etc.). MFIs are benchmarked with other MFIs in Peru (national benchmark), and commercial banks without significant microfinance activities are not considered direct competitors. Hence, in this case it seems to be a misconception that, as far as performance indicators are concerned, MFIs are directly compared to banks. As for the definition and calculation of financial ratios, Apoyo & Asociados (just like the other Peruvian rating agencies) follows the approach of the banking supervision from which they also obtain the data for the benchmarking exercise. In comparison to the specialized rating agencies, very little information is provided about the organizational and governance structure of the MFI and the composition of its management team. However, in the interview with Apoyo & Asociados it was stated that in the case of rating MFIs they did evaluate the governance and management area more in detail than when rating commercial banks. This is due to the fact that they recognize that it is a critical area for many MFIs (Interview 35).

A lot of attention is given to the exposure and management of risks including operational risks, credit risk and market risks. In terms of operational risks, Apoyo & Asociados focus on the internal procedures in place (including manuals) to identify those risks. The management information system is part of the analysis, however, occupying less space in the reports in comparison to the specialized rating agencies. No explicit information is provided as to the internal controls in place (including internal audit). The main focus in the assessment of credit risk lies in an MFI’s portfolio diversification and how it takes advantage of specific market niches. In contrast to the specialized

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<sup>146</sup> In the case of bond ratings every rating agency uses its own rating scale. In the case of Equilibrium and Apoyo & Asociados it is the one of Moody’s and Fitch respectively.

<sup>147</sup> The description of the methodology for all Peruvian raters only contains a general description of rating factors without a specification of key assumptions and rationales.

<sup>148</sup> Note that credit ratings for regulated MFIs follow a more regular schedule with rating reports having to be updated every six months.

raters, no information is provided on an MFI's lending technology and procedures and the risks following from those. Nevertheless, another particularity when assessing the portfolio quality of MFIs was mentioned in the interview, which is not done when rating commercial banks: Clients' visits were made in order to assess who the clients were, what they were doing and whether or not these clients had access to other MFIs (Interview 35) – a standard procedure for the specialized raters.

The analysis of the funding structure and especially an MFI's capital adequacy receives special attention as it is considered an important indicator (if not the most important indicator) for an institution's solvency. Additionally, it is analyzed whether an MFI has any type of external support by financially strong shareholders (soporte y propiedad) who feel committed to providing additional capital if needed (especially in times of distress). The latter is considered an important factor by all Peruvian rating agencies and the major reason why most of the MFIs receive lower rating grades than commercial banks (Interviews 4, 28 and 35) even though their financial performance data are not compared directly. At the same time, this is the only factor which is not covered within the performance ratings offered by the specialized rating agencies and one of the factors which is supposed to be assessed within the credit ratings of MicroRate (*"the possibility of external support or interference"* (MicroRate 2011d)). MicroFinanza Rating on the other hand, explicitly considers the support factor in their regular performance ratings, as well, yet focusing also on the availability of operational support from microfinance networks and (obviously) only compared to other MFIs (MicroFinanza Rating December 2010c).

As far as the weighting of qualitative and quantitative factors is concerned, Apoyo & Asociados does not assign fixed weights but, as stated before, follows (as does Fitch) a case-by-case approach (Interview 35). The rating agency stated that qualitative and quantitative factors could not easily be separated and that assigned fixed rates signified a loss in flexibility when building an adequate opinion. This view was also put forward in the case of Equilibrium, yet, in the latter case it was said that quantitative factors were more important, with an estimated relation of 75:25 (Interview 28).

Accordingly, the focus of **Equilibrium's** reports (Equilibrium Diciembre 2010, Marzo 2011, Septiembre 2010) seems to be even more narrow, primarily concentrating on the quantitative analysis of the financial performance of an MFI (profitability and efficiency), its funding structure (including liquidity risk) and capital adequacy. Credit risk is assessed by the analysis of the portfolio quality, the portfolio diversification and to which extent microfinance loans are backed with some type of guarantees (the latter was also mentioned as an important distinguishing factor during the interview; Interview 28). Here, this rating agency most obviously diverges from the conventional microfinance knowledge by assuming that microloans are inherently more risky. Yet, Equilibrium also puts a special focus on MFI clients' creditworthiness by exercising clients'

visits (Interview 28). However, in the report there is no information on lending policies and its evaluation. In contrast, the rating agency repeatedly refers to the compliance of an MFI with guidelines and resolutions issued by SBS, including how an MFI encounters the problem of over-indebtedness and whether or not it has implemented specific recommended risk management methodologies. In contrast to specialized rating agencies, there is no indication as to in how far the risk management of an MFI is compared to the best practices in the sector. The relatively low importance which is given to qualitative factors is also expressed by the fact that Equilibrium in a (very brief) description of its rating methodology mentions qualitative indicators as a rating category as such. This includes management issues and an institution's perspective to remain in the market, however, without any further specifications (Equilibrium 2011a). As for the length of the report, those of Equilibrium are slightly more compact and less detailed than those of Apoyo & Asociados.

The same is true for the reports issued by **Class & Asociados**. The fact that the reports are relatively long is majorly due to an extensive description of the Peruvian financial and microfinance market<sup>149</sup> – both aspects neither covered by Apoyo & Asociados nor by Equilibrium – and the MFI's position in it. As far as the analytical part is concerned, the level of detailedness varies considerably in the reports reviewed. In the rating report of CMAC Huancayo in September 2010 (Class y Asociados Septiembre 2010) the information provided on the management structure and decision-making process is quite detailed, in the rating of CRAC Nuestra Gente from March 2010 (Class y Asociados Marzo 2010), on the other hand, the rating agency merely indicates the names of the management team. Besides, the rating agency seems to put a strong focus on the analysis of quantitative indicators principally similar to Equilibrium (Class y Asociados 2011a).

In sum, up to this point Peruvian raters have appeared to put a relatively strong focus on quantitative factors. Apoyo & Asociados is the rating agency with the relatively strongest focus on qualitative dimensions and openness to adapt rating rationales when it comes to rating MFIs. One major difference of Peruvian conventional raters and specialized raters is the weight given to funding and liquidity, the capital base and the availability of outside support. Another, possibly even more important, difference is that Peruvian raters do not explicitly assess and disclose in their reports the important observations regarding the lending methodologies and activities of MFIs. This might also hamper their reliability and hence functionality in general or at least for some stakeholders. The same applies to rating methodologies of Fitch and Standard & Poor's. The following discussion of differentiating factors shed further light on this subject. This discussion also includes the more detailed methodological guidelines issued by these rating agencies.

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<sup>149</sup> In the case of the 2010 rating of CRAC Nuestra Gente, three out of six and a half pages (excluding the first pages with the summary and the rating rationale) are dedicated to the external context (Class y Asociados Marzo 2010).

The major international credit rating agency with the most pronounced microfinance activities is **Fitch**, mainly through its international branches and with a focus on internationally active “top-tier” MFIs. For instance, among Fitch’s most prominent clients are 14 ProCredit Banks as well as the ProCredit Holding in Germany, Bank Rakyat in Indonesia, Khan Bank and XacBank in Mongolia, Banco Sol in Bolivia and Banco Compartamos in Mexico (FitchRatings 2010: 8-9). Furthermore, Fitch is particularly active in Latin America and especially in Bolivia which is majorly driven by regulatory requirements. For 2007, it is estimated that this rating agency had a market share of around 10% of the overall microfinance rating industry (ADA 2008: 10).

*“Fitch does not believe that a separate rating methodology or rating scale is needed for MFIs”* (FitchRatings 2008: 1) and bases the analysis on its Bank Rating Methodology<sup>150</sup>, too, while in a document published in 2008, the microfinance specific factors of the risk assessment are specified. Since the rating approach of Apoyo & Asociados is largely based on the approach of Fitch’s approach, the key rating areas are similar. As far as the methodological description and the explanations in the reports are concerned quantitative factors dominate, yet also central risk management capacities are explicitly assessed and disclosed (FitchRatings 2003: 5-9, June 2010). The information is organized as follows:

- Profile (including strategy and planning);
- Financial Performance (including income, financing costs and provisioning);
- Risk Management (including credit risk and portfolio quality, market risk and operational risk);
- Funding, Liquidity and Capital.

A particular feature of the ratings provided by this company is the distinctive focus on the support factor which appears to be more pronounced than in the case of Apoyo & Asociados and even finds its expression in a separated Support Rating (FitchRatings 2008, 2010). The Support Rating is divided into two categories: the institutional support and the sovereign support. The particular assumptions regarding MFIs embedded in larger networks and the support they can expect are further disclosed in a separated publication issued in 2010 (FitchRatings 2010). Furthermore, Fitch adapted its microfinance methodology considering the weighting – which is not fixed in any case – of single indicators based on the experience gained during the years. Generally, issues considered of special importance in the context of microfinance are similar to those emphasized by the specialized raters, such as governance and management structures, the credit

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<sup>150</sup> The Bank Rating Methodology Fitch refers to in the cited document was not publically available at the time the present study was developed. Therefore, the author will refer to a previous version issued in 2003 (FitchRatings 2003). Although on the company’s website it is stated that the methodology was updated in 2006, the 2003 version in combination with the rating reports analyzed should still be considered useful for a general overview.

risk linked to the credit technology and the human resources policy. These dimensions receive special attention when explaining the rating rationales. Yet, they are not explicitly highlighted as single rating categories which might (though not necessarily) reflect the relatively lower importance which is given to these dimensions compared to “classical factors”. Furthermore, MFIs are explicitly benchmarked against their major competitors with the reports being relatively detailed compared to those of Standard & Poor’s.

**Standard & Poor’s** set up its “The Microfinance Rating Methodology Working Group”, composed by nine S&P senior level rating analysts in charge of different sectors (one from Mexico in charge of financial institutions) and one independent consultant. Furthermore, seven designated microfinance experts took also part in the working group (Standard & Poor's 2007: 10, 27). The goal was to develop an MFI rating methodology based on the existing S&P rating criteria as a starting point to meet analytical requirements of commercial investors in microfinance while considering the special characteristics of MFIs (Standard & Poor's 2007: 11). The key criteria for MFI ratings were defined and a general “MFI Rating Analysis Methodology Profile” was set up. This profile contains an extensive list of rating indicators ordered by major categories (Standard & Poor's 2007: 65-78). The IDB Multilateral Investment Fund agreed to fund ten rating missions in 2008 and 2009 in order “*to develop globally accepted ratings for microfinance institutions*” (IDB 2008).

After these rating missions, S&P published two further documents explaining which rating criteria are considered important when rating MFIs and the key rationales and assumptions behind those. One was published as a standard document within its web-portal “RatingsDirect”, which is its main distribution channel for rating information and related research (Standard & Poor's 2009d, 2009e). S&P, too, follows a case-by-case approach which is principally based on its methodologies for bank ratings (Standard & Poor's 2004, 2011) and organized around the following categories (Standard & Poor's 2009d, 2009e: 29-37):

- Systemwide factors (economic and industry risk);
- Corporate structure (including group ownership and systemic importance);
- Business profile (market position, diversification, management and strategy);
- Financial risk profile (credit risk, funding/liquidity risk, earnings, capitalization and financial flexibility).

In comparison to bank ratings, there are five major areas which receive a greater emphasis and weight: the regulatory risk as a subcategory of industry risk, the management and strategy, risk management in general, credit and operational risk, and funding and liquidity. The compliance with the social mission is to some degree factored into the last category as it is assumed that it would influence the re-financing possibilities through majorly socially motivated investors and

donors – an approach also chosen by Fitch. Other points S&P puts special emphasis on resemble those issues also emphasized by the specialized rating agencies and Fitch, for instance, the retention of motivated and trained staff, the MIS and internal controls, an MFIs' board composition etc. In fact, S&P deviates (at least in theory) from its established bank rating methodology in those areas which are considered microfinance specific and are well documented in CGAPs "Appraisal Guide for Microfinance Institutions" (Isern, Abrams *et al.* 2008). However, these dimensions are, again, not explicitly disclosed or discussed in the reviewed reports nor is their importance reflected in the creation of respective rating categories.

Besides, even though the influence of microfinance practitioners is evident when looking at the methodological guidelines for MFIs, (at least) two major differences exist to microfinance performance ratings à la MicroRate et al. Firstly, S&P, analogue to the Peruvian "mainstream" raters (and Fitch), also considers the support factor and ownership structure as particularly important. Secondly, the economic and industry risk is factored explicitly and probably to a considerable extent.

S&P's "Banking Industry Country Risk Assessments (BICRA)" methodology (Standard & Poor's 2009a) evaluates the strength and weaknesses of a country's banking system relative to other countries and classifies it into one of ten groups (with 1 being the lowest and 10 the highest risk). It is a combination of multiple factors related to the structure and performance of a country's economy, including the legal and regulatory environment of the financial system as well as the structure and credit culture in the country's banking system. The effectiveness of bank regulation and the central bank's capacity (track record) in managing turmoil in the financial sector are evaluated. A key component of BICRA is the estimation of the potential proportion of credit to the private sector, which could become problematic in economic downturns (gross problematic assets, GPA). Here, a country is placed into one of six ranges from 5%-15% to 50%-75%. Problematic assets include overdue loans, restructured assets, foreclosed real estate and nonperforming assets sold to special-purpose vehicles. Projections are drawn on historical data on a banking system's problematic assets during past downturns, taking into consideration subsequent structural adjustments. Taking Peru as an example, in 2009 the country was placed in group 6 in the overall BICRA score with a GPA range of 15%-30% (the third range) and with a foreign currency sovereign rating of BBB-.

BICRA is used to evaluate an MFI's exposure to macroeconomic risk (Standard & Poor's 2009d). S&P assumes that top tier MFIs (being S&P's target MFIs) generally operate in countries with greater economic integration and that the exposure to a changing macroeconomic environment closely resembles that to a local or regional bank. Thus, the GPA measure is considered representative for these MFIs. Whereas S&P acknowledges that for lower tier MFIs the case might be

different, the rating agency does not make any propositions how the BICRA methodology could be adapted. In terms of regulation, S&P also focuses on issues which go beyond the capacity of creating successful regulatory frameworks. By acknowledging the political role of microfinance with regard to poverty reduction, S&P also assesses in how far the relevant government philosophy is interventionist, for example, by imposing interest rate caps or extending guarantees or subsidies to organizations which compete with MFIs and/or by lending directly to the poor. These interventions might hamper the development of financially self-sustainable MFIs. The advantages and disadvantages of factoring external conditions to the extent S&P does is discussed in Chapter 7.

Examining the rating reports issued by S&P (Standard & Poor's 2008, 2009b, 2009c), it is striking that even though the (macroeconomic) environment is factored into the final grade, the information on the country, especially the information of special importance to MFIs, is not included.<sup>151</sup> With regard to the major categories along which the information is organized (Profile, Support & Ownership, Strategy, Risk Management, Funding & Liquidity, Accounting, Profitability and Capital) the S&P reports are much closer to the (other) Peruvian "mainstream raters" than to those of the specialized rating agencies. Again, the information presented is very compact and in contrast to the methodological guidelines, no specific issues on microfinance are explicitly raised. For example, no information can be found on the governance structure and composition neither on the board nor on human resources management and staff of an MFI. An explicit benchmark exercise is also missing, even though according to the methodological guidelines, it is considered important "*to consult appropriate peer group information to assess the significance of a particular MFI's earnings performance*" (Standard & Poor's 2009d: 9).

Finally, where Standard & Poor's clearly makes a difference compared to specialized raters in terms of services offered is the provision of ratings for microfinance securitizations. In May 2007, S&P was the first rating agency to rate a multiple-MFI securitization: the BlueOrchard Loans for Development S.A. series 2007-1 (BOLD1). "Multiple-MFI transactions" are those where the underlying pool of assets (a pool of microloans) is based on loans from various MFIs whereas "single-MFI transactions" refer to CDOs. Here the loans of a single MFI (or a network of related MFIs) issued to its borrowers are considered (Standard & Poor's 2009e: 41-47). In the first case, a static pool of loans to multiple and geographically diverse MFIs is considered which can then be structured into senior or subordinate tranches. In the second case, though, the transaction is backed by a specific pool of loans of a single MFI (e.g. the consumer, small enterprise and mortgage

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<sup>151</sup> That the country information is indeed factored into the final grade can be derived out of the fact that S&P sometimes additionally provides the national rating issued by its local partner rating agency. In the case of the Mexican MFI FinComún the local Caval rating grade is BBB+, while the international S&P rating is BB-, that is five notches lower (Standard & Poor's 2009a).

loans). As microloans have relative short terms (typically up to one year), the single MFI pools tend to have a revolving structure in order to match the term of the structured finance transaction.

The methodology for rating this type of products is based on Standard & Poor's (2009g) "Principle-Based Rating Methodology for Global Structured Finance Securities". S&P has developed a special CDO Evaluator model which computes the expected default distribution for the portfolio assets. The default probability of the respective sovereign country (or countries) is also included. Furthermore, the geographical diversification (based on 20 regions) is also integrated into the model while a bigger concentration of MFIs within a specific region would lead to a higher default probability. Through a Monte Carlo simulation the computer model determines the gross default rate. The Monte Carlo simulation randomly defaults the various MFIs and sovereigns based on their associated default rates, correlations and geographic locations. The assessment closes with an evaluation of the management capacity and performance of the MIV, evaluating its performance history, underwriting capabilities, systems and operations.

As for the data entry for the computing exercise, S&P works with a set of key assumptions. Firstly, S&P generally assumes that there is no correlation between the performance levels of individual MFIs. Secondly, in order to assess potential recoveries, the rating agency works with its emerging market recovery matrix which includes recovery rate assumptions for corporations and financial institutions. Thirdly, the credit quality of underlying MFIs is a key component for the CDO Evaluator assessment. In case an MFI is publicly rated by S&P (as seldom as this might be the case), they use this rating as an estimator of an MFI's default probability. Otherwise, S&P would perform a credit estimation without any formal interaction with the MFI and based solely on the quantitative and qualitative data provided by the MIV. If no information is available, S&P assumes a rating of CCC-.

In the case of single-MFI transactions the same models are applied with the difference that more emphasis is put on the assessment of the originating MFI as well as on the MIV. As for the analysis of the loan pool, the specific characteristics of single loans are analyzed such as the interest-rate type (fixed or floating), the borrower type (e.g. individual borrower, small business, etc.), the purpose of the loan (e.g. productive or consumption), the loan amount and term and finally the regional diversification of the loan portfolio. In both cases (single- and multiple-MFI transactions), the specific transaction structures (e.g. the existence of hedging agreements for addressing potential currency and interest-rate mismatches) as well as legal issues (e.g. the tax status of a structure) are also taken into consideration.

## **6.2 Social Ratings – Underlying Concepts and Practical Approaches to Implementation**

The need for MFIs and their investors to “prove” their social commitment and contribution has increased recently. The reasons were negative events experienced lately in some microfinance markets and an ongoing discussion about a “mission drift” of MFIs in the context of their commercialization. The un-conditional positive impact is not considered self-evident anymore and MFIs face an increasing reputation risk. In order to balance social and financial returns some microfinance stakeholders became engaged in designing so-called social performance management approaches with a larger operational relevance than expensive nonrecurring impact assessments (see Chapter 2.2.1).

The specialized rating agencies developed their social rating methodologies mainly based on the principles of social performance management as defined by the SP Task force and, above all, on the most important social performance initiatives such as the Imp-Act Consortium, the CERISE group, the Client Protection Principles work of the Center for Financial Inclusion and CGAP, and the Social Performance Working Group of the SEEP Network (Social Performance Task Force n.d.-c). The following section shortly presents and classifies the most important instruments. In the following, the social rating methodologies and report contents are presented.

### **6.2.1 The Objectives of Social Performance Management and Global Social Performance Reporting**

According to the SP Task Force, the social performance of an MFI is defined as follows (Hashemi 2007):

*“Social Performance is the effective translation of an institution’s social goals into practice in line with accepted social values; these include sustainably serving increasing numbers of poor and excluded people, improving the quality and appropriateness of financial services, improving the economic and social conditions of clients, and ensuring social responsibility to clients, employees and the community they serve.”*

Social performance management (SPM) then refers to the systems in place to track, understand and improve the social performance. The necessary first step for initiating a social performance management process is to audit the social performance. The first comprehensive social auditing tool available (the Social Performance Indicators, SPI) was developed in 2001 and has been continuously updated. Other initiatives followed such as the one by Gary Woller (2006) which was funded by USAID, the SOCIAL framework developed by ACCION (ACCION 2011) or the Quality Audit Tool (QAT) provided by the Microfinance Center (Microfinance Center n.d.).

The specific focus or categories along which the assessment and reports are organized slightly differ from one tool to another. For example, CERISE divides its analysis into four dimensions: 1) outreach to poor and excluded, 2) adaption of services and products to clients needs, 3) improvement of social and political capital of clients and 4) social responsibility of the institution. The SPI self-assessment tool consists of a questionnaire of 75 questions divided into two parts. The first part (MFI Context and Social Strategy) is a qualitative assessment of an MFI's history and social mission and social strategy. The second part consists of a standardized and quantifiable questionnaire in which the answers are assigned a score that is later represented in diamond and radar graphs in order to visualize the strengths and weaknesses of a specific MFI (CERISE n.d.-a).

Woller (2006) organizes his analysis around the six dimensions of outreach (breadth, depth, length, scope, cost and worth of outreach to clients and the community) originally proposed by Schreiner (2002). His Social Performance Assessment (SPA) tool already proposes a rating score from AAA to D to evaluate an MFI's social performance in a highly standardized manner. ACCION referred to other "mainstream tools" when developing its scorecards which assess an MFI's social performance along the following dimensions: Social Mission, Outreach, Clients, Information Transparency, Association with the Community and Labor Climate (ACCION 2011).

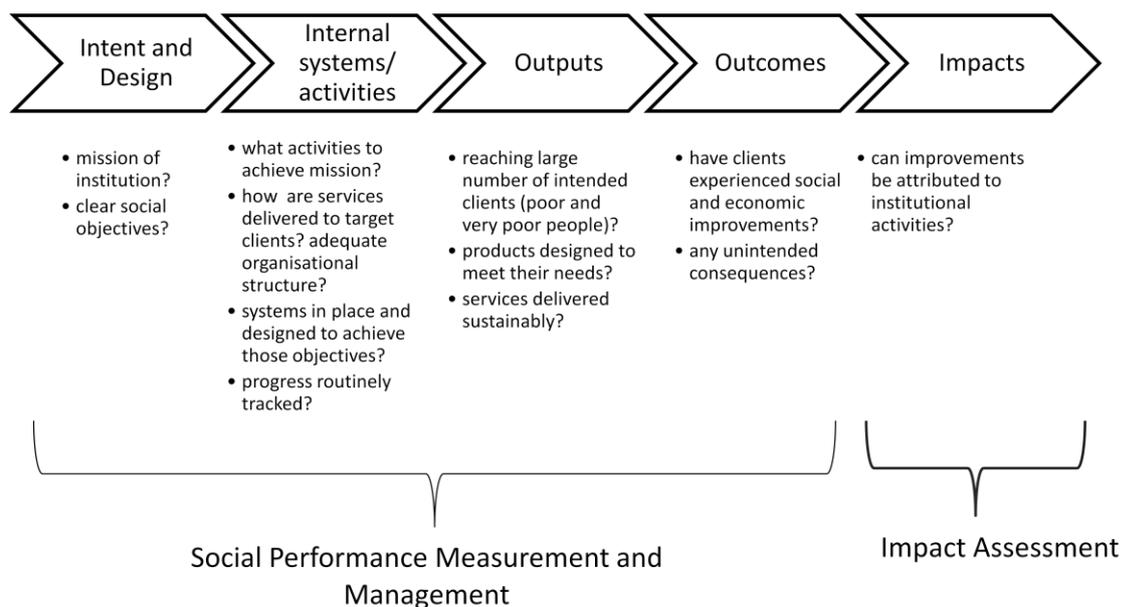
What all these tools have in common, however, is their strong focus on the processes which could possibly lead to a positive impact. The impact itself is secondary; that is answering the question whether the effects can be clearly attributed to the MFI's activities. This focus goes back to the ImpAct research program which started in 1999 and is hosted at the Institute of Development Studies at the University of Sussex in Brighton (UK). Based on the insights of 30 research partners in 22 countries, with the group being composed of microfinance practitioners, national and international networks, support organizations and academics from three UK universities, the initiative published its "Social Performance Management Guidelines" in 2005 (ImpAct 2011). Nowadays, the ImpAct Consortium is formed by nine organizations – among the MFI CARD (Philippines), the Grameen Foundation, EDA Rural Systems (the founding organization of M-CRIL in India), Pro Mujer International and the Microfinance Center (Poland) – and has a strong focus on capacity building for social performance management in MFIs, for example, through the provision of comprehensive and free-of-charge training materials.

Social performance measurement (or audit), as it forms part of SPM, has an equally strong focus on evaluating the different stages of the management process. It assesses whether an MFI has a clearly defined social mission which is furthermore translated into concrete and measurable social objectives (Intent and Design). It also assesses whether an MFI has appropriate (information) systems in place to control the achievement of its objectives (Internal systems/activities) and whether (in consequence) the intended target group is actually reached with products and ser-

vices that satisfy their needs (Output). Figure 6.2 provides an overview of the different assessment categories along the social performance management process.

In order to assess whether the intended target group is reached and whether microfinance clients enjoy any improvements in their well-being (Outcomes), there are several tools for evaluating clients' conditions and poverty statuses ("client data tools", see SP Task Force (n.d.: 11)). The most prominent is the Progress out of Poverty Index (PPI) which was developed in 2005, commissioned by the Grameen Foundation in cooperation with CGAP and the Ford Foundation. Mark Schreiner develops simple poverty scorecards specific to particular country characteristics which estimate the likelihood of clients falling below the national poverty line. Based on national income and expenditure surveys, 400 - 1.000 possible indicators are ranked according to how adequately they predict poverty levels. In the end, the ten most predictive indicators are chosen to form a simple scorecard for which the information could easily be collected from microfinance clients (Grameen Foundation 2008: 13-14, 2010a; Schreiner 2007). Using this scorecard, MFIs can identify whether they serve their intended target group (the poor) and, applying it repeatedly, track the changes in clients' poverty statuses. Currently, there are poverty scorecards available for 39 countries world-wide with more to follow (Grameen Foundation 2010b).

**Figure 6.2: Assessment categories for social performance measurement and impact assessments**



Source: adapted from ImpAct (2005: 14) and Hashemi (2007: 4).

USAID together with the IRIS Center of the University of Maryland developed a similar tool with 15 indicators. The Poverty Assessment Tool (PAT) is available for 33 countries and has to be applied by any USAID implementing partner who works in a country for which a certified PAT is available and which receives funding for supporting microenterprise development. These organizations must track the share of their clients who are very poor and submit the results to USAID on an annual basis (IRIS 2005; IRIS/USAID 2011a, 2011b).

Another initiative that goes into the same direction comes from FINCA International. The organization developed its FINCA Client Assessment Tool (FCAT) which has been applied on an annual basis on its 21 affiliated MFIs since 2003 and assesses the following five dimensions: Expenditures and Assets (e.g. home ownership, food expenditure and other household or social expenditure, expenditure on education, ownership of health insurance), Business Activities (e.g. main business sector and the duration of their businesses), Access to Financial Services (e.g. loan use, credit constraints previously experienced, other sources of borrowing, other financial accounts), Satisfaction with FINCA (e.g. satisfaction with interest rate and loan structuring, ease of application and disbursement, the extent to which FINCA helped clients achieve their goals and details about client retention) and Household Demographics (e.g. details about households and heads of households as to their education levels, school attendance, literacy rates, occupation statuses, sources of drinking water, sanitation facilities and experiences with illness) (FINCA 2009, 2010). In many cases the indicators of the PPI and the USAIS PAT are similar to those of the FCAT (excluding the client satisfaction part), however, reduced in number and with changing priorities depending on the specific context and predictive power.

Recently, the diffusion of social performance data available to a larger public has been further enhanced. In 2009, MIX Market started collecting Social Performance Standard Reports to encourage MFIs without any formal affiliation to any of the before mentioned networks to report on their social performances. The MIX Market was founded by CGAP in 2002 as an independent organization in order to *“improve transparency among microfinance institutions, provide a means of standardization, and help move the industry towards mainstream financial markets”* (MIX 2010a). Today it is the only available source of information that covers a significant number of MFIs on a global scale. The board of directors is composed of representatives from development agencies (CGAP, IFC), philanthropists (Omidyar Network) and researchers (Harvard University) as well as commercial investors (Citi Microfinance Group, Deutsche Bank) and one of the major credit rating agencies (Standard & Poor’s). The company collects financial data of MFIs as well as performance indicators according to industry standards and publishes them on an internet platform.

The number of MFIs sharing their financial data on MIX Market is constantly increasing. By the end of 2003, around 150 MFIs world-wide were listed on MIX Market. Two years later, the plat-

form covered over 600 MFIs. By mid-2008, this number had doubled again (MIX 2008: 15). By mid-2010, the platform counted 1.800 MFIs. By June 2010, 350 of these MFIs published their social performance reports which first contained 22 core indicators selected by the SP Task Force (MIX 2010b). After a pilot phase of two years, the number of indicators was reduced to eleven (MIX 2011). Furthermore, MFIs have been encouraged to share their social performance data through the Social Performance Reporting Awards, granted by CGAP, since 2009 (CGAP 2009c). These awards feature three levels of recognition. MFIs that complete the Social Performance Standard Report receive certificates. MFIs that complete the report and also provide data on poverty measurement are given a Silver Award. MFIs which additionally have a social rating are granted a Gold Award.

Another global initiative for the strengthening of MFIs' social commitment is directly linked to the latest developments within the microfinance industry. Here, the assignment of externally validated certificates rather than the sole diffusion of standardized, majorly quantitative information is planned. The Smart Campaign was launched in 2009 by the Center for Financial Inclusion of ACCION International and CGAP (Inside Microfinance 2009; Lee 2009) and its principle objective is to make MFIs implement the following six "Client Protection Principles" (ACCION/CGAP 2010a, 2010b):

***1) Avoidance of Over-Indebtedness.*** *Providers will take reasonable steps to ensure that credit will be extended only if borrowers have demonstrated an adequate ability to repay and loans will not put the borrowers at significant risk of over-indebtedness. Similarly, providers will take adequate care that only appropriate non-credit financial products (such as insurance) are extended to clients.*

***2) Transparent and Responsible Pricing.*** *The pricing, terms and conditions of financial products (including interest charges, insurance premiums, all fees, etc.) will be transparent and will be adequately disclosed in a form understandable to clients. Responsible pricing means that pricing, terms, and conditions are set in a way that is both affordable to clients and sustainable for financial institutions.*

***3) Appropriate Collection Practices.*** *Debt collection practices of providers will be neither abusive nor coercive.*

***4) Ethical Staff Behavior.*** *Staff of financial service providers will comply with high ethical standards in their interactions with microfinance clients, and such providers will ensure that adequate safeguards are in place to detect and correct corruption or mistreatment of clients.*

**5) Mechanisms for Redress of Grievances.** Providers will have in place timely and responsive mechanisms for complaints and problem resolution for their clients.

**6) Privacy of Client Data.** The privacy of individual client data will be respected in accordance with the laws and regulations of individual jurisdictions, and such data cannot be used for other purposes without the express permission of the client (while recognizing that providers of financial services can play an important role in helping clients achieve the benefits of establishing credit histories)."

So far the Smart Campaign has been endorsed by 1.600 MFIs, networks and associations, supporting organizations, investors, donors and individual industry professionals. On its website several tools are provided in order to facilitate MFIs' implementation of these principles, starting with a questionnaire of 43 questions for an MFI's self-assessment (ACCION/CGAP 2010c). In February 2011, the Smart Campaign announced the plan to launch a certification program for external verification of an MFI's compliance with the client protection principles. The certification is expected to be in place by the end of 2011, after a period of field-testing (ACCION/CGAP 2011).

### **6.2.2 Rating the Social Performance of Microfinance Institutions – Similarities and Differences of Methodologies and Report Styles**

The four global specialized rating agencies explicitly build on the experiences and agreements of the several social performance management movements when developing their social rating methodologies. In 2006, a sub-committee for social rating and reporting of the SP Task Force – comprised by a representative of each of the four specialized rating agencies and one member of ACCION International, the ImpAct Consortium, CERISE, Chemonics (Gary Woller), Integra and SIDI respectively – issued a report with the basic agreements on a common framework (Sinha 2006a). In the following, M-CRIL – which as the first rating agency had started experimenting on social ratings in 2005 – and MicroFinanza Rating conducted a pilot study with nine MFIs from different world regions in 2007-2008 in order to refine the methodology for social ratings. The final report provides a detailed overview of the general methodological guidelines and some key assumptions and rationales (MicroFinanza Rating / M-CRIL 2009). The "Social Performance Map" (Woller 2008) of The SEEP Network Social Performance Working Group<sup>152</sup> further summarizes the approaches of the four specialized rating agencies.

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<sup>152</sup> The SEEP Network is an international member organization conformed by 120 international non-profit organizations with microfinance and/or enterprise development programs; see [www.weepnetwork.org](http://www.weepnetwork.org) (accessed April 30, 2011).

The SEEP Network defines social ratings as “*an independent assessment of an organization’s social performance using a standardized rating scale*” while assessing both social risk and social performance. Social risk is defined as “*the risk of not achieving a social mission*” and social performance refers to the “*likelihood of contributing social value*” (Woller 2008: 115). Hence, from an investor’s perspective, social ratings could not only help avoiding a negative event but also help increasing positive results. The SEEP Network draws on a common understanding of social performance (as defined by the SP Task Force), social performance management and social responsibility. The latter refers to standards and dimensions commonly associated with CSR. The most common framework here is the one offered by the Global Reporting Initiative (GRI)<sup>153</sup> which developed an extensive list of indicators, some of them explicitly for the financial sector. The four dimensions important in terms of policies and mechanisms are: responsibility to clients, responsibility to staff, responsibility to community and responsibility to environment. Thus, CSR stand for a triple-bottom line seeking to balance financial, social and environmental issues (Woller 2008: 12-14, 139). In the following the principles and possible dimensions of CSR ratings in general are shortly presented in order to further understand the logics of social ratings.

One of the first comprehensive social impact rating approaches trying to measure management practices and corporate performance – instead of only applying an avoidance screening<sup>154</sup> – was introduced by the Summit Social Impact Fund in 2000 (Dillenburg, Greene *et al.* 2003). Its Total Social Impact (TSI) rating assigns a quantitative score to the different social responsibility dimensions (here towards customers, employees, owners/investors, suppliers, competitors, communities, the environment and a company’s compliance with fundamental duties<sup>155</sup>). The scores are then summed up according to specific weights and indexed back to a rating on a scale between one and 20. The Fund holds all 500 companies in the S&P 500 but re-weighted according to the TSI rating. Until its closure in 2005, the fund consistently outperformed the S&P 500 (in financial terms) which made Wisebrod (2007: 31) hope that social impact ratings would “*make responsible investments [especially] appealing*”. In microfinance, this idea was promoted by Dorfleitner, Leidl *et al.* (2010: 4), for instance, who “*assume that there is a metric for social returns which allows us to rank alternative investments in terms of social returns*”.

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<sup>153</sup> GRI is a network-based organization, founded in 1997. Its reporting framework is developed through a consensus-seeking, multi-stakeholder process. In 2010 it signed a memorandum of understanding with the OECD while having nearly 1.850 companies reporting to the initiative. For the history, the reporting framework and report lists see [www.globalreporting.org](http://www.globalreporting.org) (accessed April 30, 2011).

<sup>154</sup> Avoidance screening, sometimes also referred to as sin stock screens, aims at disqualifying harmful industries such as gambling, alcohol or weapons (Dillenburg, Greene *et al.* 2003: 169).

<sup>155</sup> With fundamental duties Dillenburg, Green *et al.* (2003: 173) mean the compliance with two business ideals: trust and transparency. This is achieved, for example, when companies adhere to international standards and communicate accurately and timely towards different stakeholder groups.

In general, Schäfer (2005) distinguishes two major rating approaches: Normatively oriented approaches can be primarily found among consumer-oriented models and are dominated by ethical motivations and principles (yet, they are not further discussed by Schäfer). Descriptively or economically-oriented models, on the other hand, are more likely to consider real economic preconditions. Although in practice both approaches cannot always be completely separated, the economically-oriented approach can be further differentiated into:

- a) Risk assessment approaches which focus on how a company deals with social and environmental risks it faces. Here, the notion prevails that the reduction of related risks will result in an increasing financial success of the company. Linked to the concept of systemic risks of a company's sustainable development is first and foremost a prevention of non-sustainability. In the context of microfinance, the client protection principles of the SMART Campaign with its strong focus on the prevention of over-indebtedness fall into this category.
- b) Enterprise value increase approaches (also referred to as efficiency, intangible value of eco-efficiency models) focus on corporate management and its overall orientation towards sustainability. Management strategies are supposed to respond to economic, environmental and social micro and macro trends, generating a competitive advantage and thus increasing shareholder value. Stakeholders are supposed to benefit from rising enterprise values, responsible production technologies and "good" products. It is in this sense that Schäfer and Oehri (2008) and Dieckmann (2008) – as many others before them – label microfinance as an ideal SRI while Byström even refers to microfinance CDOs as "*a modern Robin Hood*" (Byström 2008).
- c) Industry-of-future-approaches focus on outstandingly innovative and pioneering companies. Usually these models do not integrate all relevant stakeholders. For example, eco-innovator models limit their analyses exclusively on environmental aspects.
- d) Management models seek to signalize management best practices with process elements, such as strategy and planning, operational implementation, with evaluation and reporting playing a key role. "*What gets measured gets managed!*" is the straightforward message of this approach (Dillenburg, Greene *et al.* 2003: 170). In the context of microfinance, this slogan even converts to "*We value what we measure*" (Planet Rating 2007) and is one of the key aspects in social ratings provided by specialized microfinance raters.

In microfinance, the SP Task Force recently proposed the differentiation between the assessments considering dimensions of responsible finance (by making sure that no harm is done and MFIs act ethically) and dimensions of social performance which additionally focus on whether an MFI clearly commits to a positive change for clients (Social Performance Task Force n.d.-a: 13). Social ratings aim at assessing the social performance, analyzing the different steps from Intent &

Design to Outputs (see Figure 6.2). Thus, considering the different CSR rating approaches outlined above social ratings can be related to model a, b and d. The dimensions of the analysis generally covered by all four rating agencies are (Sinha 2006a):<sup>156</sup>

The **context**: In order to analyze an MFI in its respective context in this area, the socio-economic environment is described (mostly from secondary data) including information about national poverty lines and the percentage of population living below this lines, information about income inequality, the human development index, the state of financial exclusion, etc. With the exception of MicroRate,<sup>157</sup> the rating agencies also describe the microfinance sector and its regulatory environment. MicroFinanza Rating, furthermore, has a section on the MFI's profile as well as its financial performance (for informative purposes only).

The section on the MFI's **processes** covers the analysis of the social performance management including the clarity, communication and governance of the social mission. Of particular importance here is the definition of specific (and quantifiable) social objectives. The organizational systems (MIS, human resources and incentives) have to be aligned with these objectives. Furthermore, it is assessed whether an MFI monitors and reports on these objectives (for example, by conducting market research, scoring the clients' poverty status, tracking drop-outs or setting up impact studies). The use of such information for strategic decision-making is also assessed.

The three dimensions of social responsibility (clients, staff, community and environment) are covered with different emphases and within different dimensions by the four raters. Aspects of client protection and especially the compliance with the client protection principles of the Smart Campaign (see previous section) are considered particularly important. This is also reflected in the methodological updates that are traceable in the rating reports of M-CRIL, MicroFinanza Rating and Planet Rating (MicroFinanza Rating / M-CRIL 2009; Planet Rating 2011a).<sup>158</sup> For example, before the end of 2009, Planet Rating weighted the entire social responsibility dimension with 30% of the total grade. Client protection and ethical finance now make up for 30% of the total

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<sup>156</sup> See Annex 7 for an overview of the social rating categories and sub-categories covered and disclosed by the different rating agencies.

<sup>157</sup> Individual information about the social rating reports of single rating agencies is based on the analysis of sample reports available free-of-charge on the rating agencies' websites. In the case of Planet Rating, the analysis is based on two newer reports, not yet available free-of-charge which were provided as sample reports upon request. Additional reports were found on the websites of the Rating Initiative. Analogue to the financial rating reports, only a limited number of rating reports were reviewed. But since these reports are provided by the rating agencies as sample reports, for this study they are considered as representative. The following social rating reports were reviewed: MicroRate (July 2008), MicroFinanza Rating (December 2010; July 2009), Planet Rating (January 2010; September 2009) and M-CRIL (2007; 2008).

<sup>158</sup> Planet Rating last updated its social performance rating methodology at the end of 2009. Note that Planet Rating never officially published any document about the new methodology of social ratings in which changes in weights are disclosed. The cited document about the "New Enhanced Social Performance Rating Methodology" was provided upon request.

grade while the human resources policy alone makes up for another 20%. MicroRate covers the client protection part as a subcategory of its major category “social commitment” while the institutional social responsibility is analyzed within the major category “social results”. Planet Rating also covers the environmental sustainability as an output dimension. The same applies to questions of gender equity and women empowerment – categories covered by M-CRIL as part of the subcategory “gender approach” (at staff and client level) in the major category “other social responsibility”. MicroFinanza Rating puts a special focus on the subcategory “contribution to change in clients’ lives” as part of the social responsibility to clients. In this category it assesses whether an MFI is engaged in broader development programs and what the related non-financial services are.

The dimension “social responsibility to community” may include policies for a) the type of activities for which credits are provided which are especially beneficial for the community (for example for start-ups or job-creating SMEs), b) direct support to the community (through investments or donations) or c) general positive actions which improve the local culture. The responsibility for the environment is measured by assessing whether organizational practices are in line with the environmental conservation (energy, paper, etc.) and the environmental policies applied to the core business lines (mainly loan provision). The responsibility for the staff covers the compensation policy and labor conditions as well as guaranteeing of equal rights.

Considering the social **results** of MFIs the four raters mainly focus on different output dimensions. So far outcomes (and impact) have rarely been covered since few MFIs have conducted impact assessments or tracked their clients’ poverty status over time. In this category different dimensions of outreach are covered. All raters analyze in how far an MFI contributes to financial inclusion (breadth and depth of outreach). Planet Rating, MicroRate and MicroFinanza Rating also explicitly consider the scope (variety and adaption of services, eventually including non-financial services) and costs of outreach. MicroRate furthermore assesses whether the services can be provided on a sustainable basis – an approach also chosen by many CSR raters. Planet Rating does so implicitly by only offering a social rating to an MFI which also counts with a financial performance rating (Woller 2008: 122). MicroFinanza Rating provides information on the financial performance of MFIs, but without factoring it into the social performance grade. M-CRIL considers these dimensions rather implicitly by putting a focus on clients’ awareness, feedback, satisfaction and exit.<sup>159</sup> Since its last methodological update, Planet Rating introduced a separate rating category to assess social change, yet staying at the process and output level. Here an MFI’s possible contribution to the fulfillment of the Millennium Development Goals (MDGs) is analyzed by assessing the following sub-categories: health, education and basic services (e.g. through aware-

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<sup>159</sup> Some of these indicators can only be analyzed by asking MFI clients directly. Therefore, M-CRIL includes clients’ surveys into its social rating assessment. The differences in the four raters’ methodologies will be described further below.

ness raising and/or non-financial services); gender equity and women empowerment; democracy and human rights; job creation; environmental sustainability; end poverty (through poverty tracking). No fixed weight is assigned to this category, in case of a positive result, however, the final grade can be notched up (Planet Rating 2011a).

Analogue to financial performance ratings, the four specialized rating agencies use different rating scales and definitions to express their opinions.<sup>160</sup> Furthermore, the raters assign different weights to single indicators, however, without further disclosing them. M-CRIL and MicroFinanza Rating state that they assign more or less equal weights to process and results (MicroFinanza Rating / M-CRIL 2009: 46). MicroRate expresses its final judgment in the assignment of one to five stars<sup>161</sup> which is the sum of a separated assessment of its only two major categories “social results” and “social commitment”. The two categories are also covered in their financial performance ratings. The social commitment section, in addition, has a strong focus on the (non-) likelihood of mission drift, which is also expressed in the wording of the rating definition.

As in the case of financial performance ratings, MicroRate’s reports are the most compact and less detailed. Furthermore, it is the only rating agency which does not offer so-called “enhanced social ratings” that also cover clients’ surveys (conducted by the rating agency or an external party). These ratings assess clients’ poverty status (for example, by using of the PPI) as well as their level of satisfaction and awareness without having to rely on sometimes imprecise or even misleading proxy indicators (MicroFinanza Rating / M-CRIL 2009: 36-42).<sup>162</sup> M-CRIL and MicroFinanza Rating have offered “enhanced social ratings” since 2007. Planet Rating followed in 2009. Still, Planet Rating and MicroFinanza Rating also maintained offering “simple” social ratings.

Considering the report style, MicroFinanza Rating’s reports are (again) the most detailed. The main results of the social rating are listed separately along different areas, expressing whether it is a positive or a negative factor. Some information is listed for informative purposes only. However, there is no indication of relevance (expressed on a score). This makes it more difficult to reconstruct the final grade than in the case of financial performance ratings. M-CRIL and Planet Rating assign separated rating grades to every major category while (again) only in the case of Planet Rating the actual weights are publicly known. As for the level of detailedness of the rating reports, both rating agencies are similar.

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<sup>160</sup> See Annex 8 for social rating scales and definitions.

<sup>161</sup> In the rating report cited the scale only encompasses four stars. However, the author was informed by Kathrine Devine (see supra note 131) that the range now encompasses five stars.

<sup>162</sup> For example, proxy indicators to assess an MFI’s depth of outreach (in terms of poor clients reached) include average loan balance per borrower, percentage of women borrowers, proportion of rural clients, etc. Yet, a comparison of the results when using survey data and proxy indicators showed that the latter tend to be inadequate.

## 7 Functions and Functionalities of Ratings in Microfinance – Assessing the Role of Rating Agencies in Peru and Beyond

In the global capital markets, rating agencies play a pivotal role for bond issuers, investors and those acting on their behalf as well as regulators. Spurred by rating-based regulation, ratings opened the doors especially for the U.S. capital market and the major credit rating agencies became the unchallenged market leaders on a global scale. Their assessments are considered critical for the access to and the costs of funding. Chapter 3.5 discussed the different functions rating agencies exercise: the Information Function, the Certification Function, the Control Function and the Coordination Function.<sup>163</sup>

Specialized microfinance rating agencies, which currently provide the major part of MFI ratings, implicitly or explicitly evoke some of the substantial arguments for the rating agencies' importance when promoting their services. For instance, Sinjay Sinha, managing director at M-CRIL, highlights the existence of asymmetric information – or better, asymmetric knowledge – as one important market friction rating agencies can help to overcome:

*“The microfinance funding situation can [...] be characterized as one of information asymmetry. Commercial banks and international investors have funds but not the specific expertise to assess and analyze microfinance operations”* (Sinha 2008a: 50).

Other raters implicitly build on the Certification Function and/or the Control Function when summoning their beneficial allocation effects. They explicitly respond to rather recent events such as the repayment crises in some microfinance markets (see Chapter 2.2.1), which have been tentatively related to the concentration of funds into too few MFIs (e.g. Wiesner and Quien 2010:18):

*“Ratings help MFIs to resist the pressures of too much funding”* (Damian von Stauffenberg in ADA 2011) and *“ratings should play a much stronger role to limiting the impact of new crises in microfinance”* and there should be a *“more systematic use of the ratings for investment decisions, stronger pressure on MFIs towards undertaking a rating and having it updated every year”* (Aldo Mouaro in ADA 2011).

Yet, there is a persisting confusion and uncertainty about what the specialized microfinance rating agencies (should) do:

*“There is confusion about what it is that microfinance raters measure – financial risk? Performance compared to peers? Social performance? Take social performance for instance. Microfinance has a social-, as well as a financial dimension. Shouldn't microfinance ratings then reflect*

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<sup>163</sup> Refer to Figure 3.3 in Chapter 3.5 for an overview of the different functions and sub-functions.

*both? Most people agree that they should, but as of now very few people agree how that ought to be done” (Damian von Stauffenberg in ADA 2011).*

Also, microfinance raters complain about the lack of recognition of their services from some (“mainstream”) investors. This made The Rating Initiative presume that the rating agencies’ claim that their assessments help MFIs to attract more funds was rather a “sales pitch” than a well-founded rationale (The Rating Initiative 2010:31). In April 2011, The Rating Initiative even suspended the co-financing of performance and credit ratings until a new rating product is available.<sup>164</sup>

The present chapter aims at contributing to this debate insofar as it systematically discusses the different functions of microfinance raters and their functionality vis-à-vis the various expectations of microfinance stakeholders, especially MFIs and their (possible) investors. This discussion is divided into two parts. Chapter 7.1 focuses on the discussion on the relevance of single rating agencies’ functions related to the specific microfinance context. Taking a functional perspective, the context and its historical (and possible future) evolution matter when it comes to the evaluation various dimensions in a specific institutional setting (see Chapter 3.2.2). Chapter 7.2 addresses the functionality of ratings in microfinance, analyzing the performance of different rating agencies in terms of offered products, their business model and behavior. The analysis includes some of the critical issues raised in Chapter 4 (lack of transparency, conflicts of interest, lack of timeliness), which might foster or hamper their reliability. In order to structure the analysis, three of the functions (the Information Function, the Certification Function and the Control Function) and their sub-functions identified in Chapter 3.5 are analyzed separately. The fourth function – the Coordination Function – is not discussed as a stand-alone function. It is closely linked to the Certification Function and the status of the major raters in the global mainstream market which has not (yet) appeared to be of particular relevance in the microfinance context (q.e.d). Moreover, assertions about the possible performance of specialized rating agencies compared to the major U.S. raters in promoting market stability would, at the current stage, be of rather speculative nature. Some initial thoughts, however, are introduced in the analysis of the other functions which showed to be more important in the context of microfinance.

It is important to remember that the different functions are interrelated and not always easy to be held apart. The same applies when trying to separate functions and functionality of rating agencies, their linkages to the specific context and the effects they might have. The analysis of the performance of rating agencies in the sense of what they do (functionality) but also what

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<sup>164</sup> The corresponding announcement was retrieved from the organization’s website (<http://www.ratinginitiative.org/>) on June 1, 2011. The new financial rating product was to be developed by The Rating Initiative in cooperation with the Ford Foundation and the four specialized rating agencies. Yet, the specific characteristics of the new product are unknown so far.

their empirical effects are (as an indication of their functionality) led to the identification and questioning of the relevant functions. This can be backed by rather general, theoretical considerations. The same applies to the case of rating agencies in the microfinance sector. Both, the context they operate in as well as their performance leads to a slight re-interpretation of specific functions and their respective relevance. Thus, the separation of different functions as well as the division of the discussion concerning the context and the raters' performance provides a valuable systematization. It is, however, especially of an analytical nature. For advancing towards conclusions, the different arguments of the analytical discussion by functions and functionalities need to be consolidated all together. In order to avoid duplications, this consolidation is done in the concluding part of the present research.

The following discussion does not aim at normatively asserting or questioning the relevance of rating agencies active in microfinance, including the re-defined functions more specifically linked to the microfinance context. The focus is on the comparison with the major global raters at the current stage which helps assess whether or not ratings in microfinance might pay off in this very moment. Some remarks concerning the question whether rating agencies should play a more or less significant role in microfinance and the related possible effects are provided in the concluding Chapter 8, too.

To answer the question of the relevance of microfinance ratings it is also important to look at the cost-benefit relations. A self-sustainable microfinance rating industry will first and foremost evolve if the benefits outweigh the costs. If this is not the case, particularly specialized microfinance raters will either not survive, operating at the expense of those paying for their services, which are mainly MFIs and, ultimately, their clients, or will have to be subsidized by a third party. Therefore, reading the discussion of functions and functionalities of ratings in microfinance one should keep the relative costs of ratings for different types of MFIs, which are presented in the following, in the back of one's mind.

The relative costs for a rating varies strongly depending on the size of single MFIs. For instance, in the case of the smallest MFI interviewed (MIDE in Cusco) the costs of a rating of 10,000 USD – apart from transaction costs incurring during the rating process – reached 13.1% of all financial expenses in the year 2008. In the case of the largest MFI (MiBanco) the share was only 0.02% (based on MIX Market data). On a world-wide scale the difference is even more pronounced. Table 7.1 provides an overview of the rating costs compared to MFIs' financial expenses for different size categories of MFIs in terms of gross loan portfolio. In the case of small MFIs, the median value of rating costs in relation to total financial expenses – assuming that these MFIs did re-

ceive a rating in 2008<sup>165</sup> – reached 18.3%, varying strongly for single MFIs (as the mean value of 256.9% indicates). In the case of medium-scale MFIs, the relative costs reached 3% and for large MFIs the percentage was only 0.4.

**Table 7.1: Rating costs as percentage of financial expenses, 2008**

Scale **	Nr. of MFIs	Total Assets (Amount USD, Median)	Financial Expenses (Amount USD, Median)	Rating Costs * / Financial Expenses	
				Median	Mean
Small	400	1,284,622.50	55,497.74	18.3%	256.9%
Medium	307	6,227,667.00	343,043.71	3.0%	22.2%
Large	355	44,260,602.00	2,614,868.13	0.4%	2.6%
<b>All</b>	<b>1062</b>	<b>5,833,321.00</b>	<b>313,901.95</b>	<b>3.2%</b>	<b>95.9%</b>

\* The price of a rating was assumed to be 12,000 USD for the African region and 10,000 USD for the rest of the world.

\*\* Definitions of scale according to the MIX MicroBanking Bulletin: Small: Gross Loan Portfolio (GLP) in USD < 4,000,000 in LAC; < 2,000,000 in other regions; Medium: GLP in USD ≥ 4,000,000 and ≤ 15,000,000 in LAC, ≥ 2,000,000 and ≤ 8,000,000 in other regions; Large: GLP in USD > 15,000,000 in LAC, > 8,000,000 in other regions.

Source: Own elaboration, data on MFIs assets and financial expenses taken from MIX Market

Hence, for small MFIs – if it is not for other, possibly less tangible effects – it would be crucial to attract more funding so that relative rating costs decrease. Or the costs of funds for these MFIs have to decrease considerably. Otherwise, rating exercises for these MFIs might further (need to) largely depend on subsidies. In turn, larger MFIs can already benefit from relatively small interest rate reductions. This effect increases when MFIs rely on a relatively larger number of funders. It is especially important for those MFIs that are under pressure for decreasing their interest rates charged on microloans because of a growing competition – as is the case for a couple of Peruvian MFIs (see Chapter 5.2).

## 7.1 The Relevant Functions of Rating Agencies in the Context of Microfinance

This sub-chapter locates rating agencies into the microfinance context in order to analyze their relevance for different microfinance stakeholders. The main microfinance stakeholders as a possible target group for ratings encompass MFIs, their clients, (individual and institutional) investors, microfinance investment intermediaries (mainly MIVs), donors, technical assistance providers and regulators. Special emphasis is given to different types of MFIs, different principal inves-

<sup>165</sup> Many of the MFIs considered here might indeed not have received a rating in 2008. Yet, for a general idea of the costs of ratings in relation to total financial expenses (including fees and interests paid on borrowings, subordinated debt and, if applicable, deposits) the method of calculation applied is considered valid.

tors (individual and institutional investors), investment intermediaries (asset managers) and regulators, since a) these are the stakeholders identified as particularly relevant in the context of mainstream capital markets, b) they are referred to by rating agencies (including specialized microfinance raters) as their primary target group and c) they are identified as relevant in the Peruvian context. Even if the major focus lies on the analysis of microfinance ratings in Peru, whenever possible, the discussion also takes a broader perspective.

### **7.1.1 The Information Function in a Highly Intermediary-Driven and Long-Term Investment Market**

The first sub-function identified in the context of mainstream capital markets is the Information Release Function. Rating agencies can release information including confidential mainly qualitative and strategic information without explicitly disclosing it. Furthermore, they have an Information Collection Function that avoids duplication of efforts by investors, hence creating economies of scale. The relevance of both sub-functions is particularly high in disintermediated, global and short-term capital markets where investors repeatedly need to screen new investment opportunities, yet, facing high participation costs when learning about individual bond issuers or markets (see Chapter 3.2.2). Thus, the relevance of rating agencies as information intermediaries is also linked to the structure and dynamics of disintermediated capital markets and the availability of ready-at-hand information. The same applies to the Orientation Function. Rating agencies define the relevant information and collect it accordingly. They standardize the information considered to be relevant. Their rating grades are a summary of the information collected and are particularly relevant in disintermediated capital markets with a high number of investment opportunities. In this context, ratings efficiently help in sorting out eligible investment targets that match investors' (risk) preferences.

In microfinance, as will be argued in the following, the Information Release and Collection Function of ratings appear to be particularly important when considering the limited availability of information. Yet, they are less relevant from an aggregated perspective because the microfinance investment landscape is currently highly intermediary-driven. They are less likely to generate larger economies of scale. MFIs rely on a rather limited number of investors with whom they have rather long-term and individual debt contracts which are not actively traded in secondary markets. Besides, the availability of alternative information increases. As far as the Orientation Function is concerned, rating agencies contribute to the standardization process. This is particularly relevant at an early stage of the standardization process. During the last decade, they have contributed to the standardization of financial performance indicators for MFIs. At the present moment, this holds particularly true when regarding the identification of relevant social metrics.

As far as financial performance indicators are concerned, rating agencies face increasing competition from alternative information providers, above all from the readily available information platform MIX Market. In the following, the arguments are further discussed and sustained:

*The importance of rating agencies in releasing and collecting new information*

The relevance of major rating agencies' releasing and collecting of new information to capital markets (**Information Release and Collection Function**) has been repeatedly disputed. Some empirical studies argue that market prices for bonds might already reflect the information provided by rating agencies (see Chapter 3.5.1). In the context of microfinance, in contrast, the implicit and explicit availability of quantitative and (especially) qualitative information on individual MFIs is often much less available. MFIs issuing securities that are actively traded in secondary capital markets are rare. Hence, there are no market prices for MFI bonds which could implicitly reflect the important information based on the behavior of better informed investors.<sup>166</sup> The media coverage of microfinance institutions is also much less pronounced than that of rather large, corporate bond issuers, let alone governments. In addition, MFIs rarely publish comprehensive information on their company (e.g. on their websites or in annual reports). This is especially true when it comes to information readily available to investors who are based outside the target country or region. The microfinance sector is characterized by a lack of rather than excess of information which possibly prevails in the mainstream capital markets (see Chapter 3.5.1). Hence, the relevance of rating reports as time-honoring heuristics that collect new information is high and might even be higher than in the mainstream capital markets.

Accordingly, Microfinance Investment Vehicles (MIVs) which are a major channel for investments into microfinance (see Chapter 1.2.1) consider ratings as an importance source of information for their investment decisions. In a conducted survey of 23 MIVs, only four indicated not to use ratings during their research. The majority uses rating reports as an additional source of information along their own risk assessments, whatever the relevance they attach to them (see Figures 7.1 and 7.2).

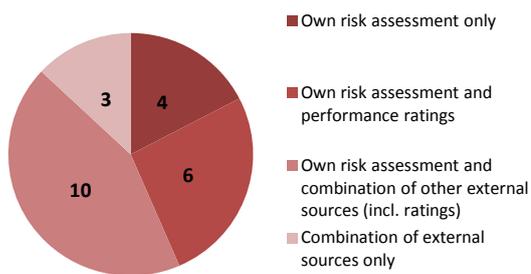
In a survey conducted by CGAP among 17 investors in 2005, almost half of the respondents indicated they save between 10-15% of their due diligence time by using the reports. Four investors even indicated to save up to 50% of the time (CGAP 2005).<sup>167</sup>

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<sup>166</sup> An overview of the few examples known so far will be provided further below.

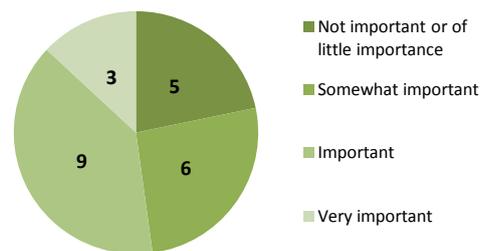
<sup>167</sup> The document discloses the twelve questions asked during the survey. However, the answers are presented only as a half-page summary indicating responses as percentages while answers on more qualitative questions are not disclosed. Considering the low number of respondents and the fact that survey participants are not mentioned, this survey cannot be considered as representative. Yet, it still might give a first impression on how ratings are used.

**Figure 7.1: Sources of information used by MIVs**



Source: Own elaboration

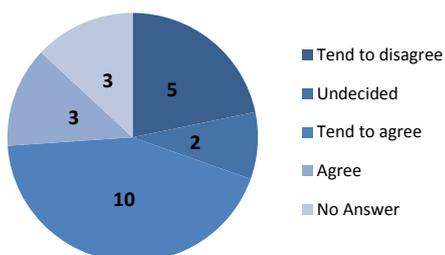
**Figure 7.2: Importance of ratings for investment decision**



Source: Own elaboration

The saving of time also appears to influence the costs of funds for MFIs. This effect further indicates the relevance of ratings in this regard. The majority of MIVs surveyed during the present study (tended to) agree that ratings influenced the decision making as to the costs of funding for MFIs considerably (see Figure 7.3). Nine out of the thirteen MIVs which (tended to) agree had a commercial orientation, indicating that (rather large and profitable) MFIs targeted by this investor group can particularly benefit from cost reductions.

**Figure 7.3: Influence of ratings in terms of costs of funding**



Source: Own elaboration

Garmaise and Natividad (2010) try to assess the question of funding costs empirically. They base their analysis on 338 ratings realized by MicroRate between 1997 and 2008 covering 138 MFIs, mostly located in Latin America.<sup>168</sup> They found out that ratings had a significant effect on the costs of funding. The effect was larger in the cases where the funds came from commercial investors.<sup>169</sup> Also, the effect was more pronounced in the cases the loan term agreed between inves-

<sup>168</sup> Note that Latin America is the region where a big part of all ratings are realized (see Chapter 2.2.2), and MicroRate is the rating agency which is particularly strong in this region.

<sup>169</sup> To define commercial sources the authors take the examples of global and local banks as well as commercial funds. Yet, they do not further explain how they undertook the classification of the latter.

tors and MFIs was below a year. In addition, Garmaise and Natividad found that the rating grade had no influence on the funding costs. This indicates that investors appreciate the rating report and thus the written information rather than the summary or interpretation of the latter (the rating grade).<sup>170</sup> However, the overall rather positive appraisal is contrasted by the perception of Peruvian MFIs. Here, the majority of MFIs did not have the impression that ratings had an influence on the costs of funds.<sup>171</sup> Likewise, investors interviewed in Peru stated the rating had no effect on the interest rate charged and that it was based solely on the internal risk analysis (Interviews 3, 6, 7, 34 and 36).

As far as social ratings are concerned, a large majority of the 23 MIVs surveyed during the research of the present study stated that social ratings will play an important role in making funding decisions in the future. Many of them already use social ratings when assessing the social performance of MFIs (see Figure 7.4 and 7.5). Accordingly, many Peruvian MFIs interviewed stated that investors' interest in social ratings had increased.<sup>172</sup> This can sometimes also translate into interest rate reductions by socially-oriented investors (Interview 3).

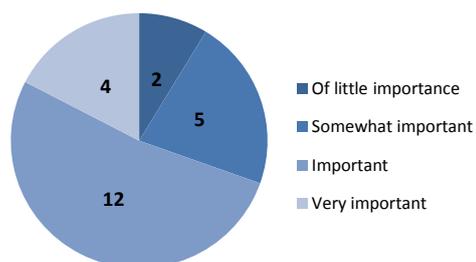
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<sup>170</sup> Nevertheless, the study of Garmaise and Natividad has to be interpreted with some caution since most of the ratings covered in the study were probably realized in a few years. Hence, they fall together with an increasing funding flow into the microfinance sector and especially into the Latin American region. The latter increased the competition of funders tackling a relatively small number of well performing MFIs (see Chapter 2.2.1). This might be a more important factor to explain decreasing costs of funds for MFIs and which is not accounted for in the study.

<sup>171</sup> Only one large MFI stated that the rating had, through negotiations, a positive impact on the costs of funding, particularly at a time where ratings were not yet a common phenomenon among MFIs (Interview 33). Three stated that they did not feel that the rating has had any influence (Interview 10, 12 and 32) and two MFIs were not sure even though they tended to disagree (Interview 17 and 19). The answers of two MFIs were confusing in this regard. They stated that the rating had an impact on the interest rate but linked this directly to the level of risk involved. Hence, they rather acknowledged the correlation between rating grade and risk than the impact of the rating as such.

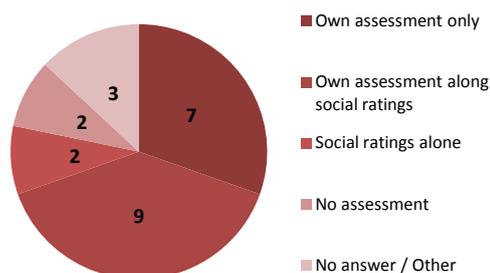
<sup>172</sup> At the moment the interviews were held, ten of the 19 MFIs interviewed in Peru had already received a social performance rating, while two other MFIs expressed their interest in having one in the future (Interviews 16 and 24). In the case of the largest MFI MiBanco, which also applies the PPI, this was majorly due to a request of one of its shareholders (Interview 33). Other MFIs also stated that the interest of social investors to receive social rating reports had increased (Interview 12, 14, 17, 19 and 31). Another MFI, even though not rated, stated that its principal shareholder wants the MFI to assess its social performance more systematically in the future (Interview 10). Only one MFI was convinced that, even though social performance has been an often talked about issue, what actually mattered to international investors was the financial performance. Hence, the MFI decided not to get further social ratings (Interview 27).

**Figure 7.4: Future importance of social ratings in investment decisions**



Source: Own elaboration

**Figure 7.5: Use of ratings in social performance assessments**



Source: Own elaboration

*The limited relevance of ratings due to the microfinance investment landscape's specificities*

Taking a broader perspective, ratings appear less relevant in terms of the collection of information. This also includes incentives for MFIs to receive regular updates. Whether ratings pay off on a larger scale also depends on the number of investors funding single MFIs and on the duration of investments since they would need to produce the same information over and over again. In disintermediated global capital markets with a large number of (individual and institutional) investors and investment organizations (e.g. asset managers of mutual funds) which trade bonds of individual issuers frequently (see Chapter 2.1.1), efficiency gains by using ratings as a source of information can be assumed to be relatively high. The microfinance investment landscape, however, is highly intermediary-driven with a few large, specialized MIVs and asset management firms channeling the bulk of funds into MFIs (see Chapter 2.2.1). And even in Peru, which is considered especially attractive for microfinance investors, single MFIs hold investment relationships with a rather limited number of investors (with an average number of 8.5; see Chapter 5.2). The number of investors is higher for rather large, credit-only institutions and rather low, when small or deposit-taking institutions are concerned. More importantly, though, funding relations are of a rather long-term nature. MFIs would benefit more from ratings, and hence, would have also a greater incentive to receive regular updates if they became engaged in arm's-length transactions. The advantage for issuers of bonds lies in the mobilization of larger sums through the division into parts while the term, size and risk transformation is also improved through liquid secondary markets. Investors interested in (or forced to hold) long-term funding relationships will collect background information on their own, depending less on ratings, especially in the case of repeated interactions.

In the case of Peru, long-term funding relationships seem to be envisaged by all interviewed investors. The development bank COFIDE, for instance, concedes indefinite credit lines for regulat-

ed MFIs while the duration of single loans depends on the designated use (for example, onlending to SMEs, mortgages, agricultural activities) (Interview 9). The other two local banks only granted short-term loans (below one year), yet expressing interest in establishing long-term funding relationships constantly renewing the loans (Interviews 34 and 36). In the case of MIVs interviewed, the average term ranged between 2.5 and five years (Interview 3, 6 and 7) depending on the commercial orientation of a specific fund. CGAP (2010a: 31) estimates that the global average maturity for MIV financing is 31 months. Analyzing the 2008 MIX Market Funding Structure Database (FSDB) containing data for 774 MFIs around the world, it stands out that the weighted average term of foreign and local funding sources combined exceeded 56 month. Even in the case of (local) commercial banks the average term exceeded three years.<sup>173</sup>

Furthermore, at a current stage, investments into MFIs are illiquid and, unlike bonds, not actively traded in (local or international) secondary markets. Microfinance investors and their agents provide “patient” capital following the principles of relationship banking rather than frequently shifting their money from one borrower to another, thus, becoming relatively uninvolved. Uninvolved investors can be rather found among the (institutional and retail) investors who put their money in MIVs rather than among the these institutions themselves. Consequently, specialized rating agencies started offering MIV ratings and related services just like the internet-based platform LUMINIS MicroRate is creating (see Chapter 6.1.1). Whether the relevance of ratings at the MFI level increases in the future also depends on the development of the microfinance investor landscape. Will the number of MIVs and those managing them further increase? Or will they rather consolidate, as Reille, Forster et al. (2011: 5-6) assume? Will institutional and individual investors start investing directly into MFIs on a larger scale? In Peru, some large mature MFIs have started tackling local capital markets (see Chapter 5.2) which might raise the relevance of ratings in this country. Yet, the majority of MFIs is rather small and most probably unable to handle and absorb this type of capital. This and the state of development of local capital markets in many developing countries make it unlikely that rating agencies will have an equally prominent position in the microfinance market as the major raters in global capital markets any time soon. This is also one of the reasons why the Coordination Function as a mechanism for influencing investors’ beliefs and investment decisions is not very relevant yet. This function is relevant in highly liquid, yet largely nontransparent and thus volatile secondary markets where single investors’ beliefs are uncoordinated and abrupt, and disequilibrating jumps are more likely to occur.

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<sup>173</sup> The shortest average terms can be found in the case of debt provided by individuals with eight months in Latin America and the Caribbean and nine months in East Asia and the Pacific. However, there were only nine MFIs engaged in this type of funding relations in each of the region. The second shortest average term is offered by peer-to-peer lenders with twelve and 15 months respectively for the regions mentioned before. Yet, even though for the Latin American region there were 19 MFIs listed for having relations with peer-to-peer lending platforms, the amount channeled through this platforms was negligible and did not reach 0.1% of the total amount. DFIs, however, tend to have much longer maturities with an average term of 70 months. Especially institutions from North America had a long average duration of 90 months.

Furthermore, especially the specialized microfinance rating agencies compete with investment advisory firms who become engaged in the same type of activities. The availability of alternative sources of information increases. One example is Symbiotics, founded in 2004. It offers asset management, brokerage and structuring services along their research and advisory activities covering an increasing number of MFIs world-wide. Symbiotics created the internet platform SymInvest whose information services cover and even go beyond the ones provided by single specialized raters.<sup>174</sup> It has yet to be shown in how far specialized rating agencies will complement or rather compete with other rather large information producers<sup>175</sup> and expand their relevance. At first glance, the development within the microfinance sector compared to the mainstream capital markets seems to be reversed. While in the mainstream market, rating agencies at some point started usurping functions of established investment intermediaries (see Chapter 2.1.1), in microfinance investment intermediaries have started offering services previously covered exclusively by rating agencies. And (at least) two rating agencies (MicroFinanza Rating and MicroRate) with the offering of tailor-made due diligence services (see Chapter 6.1.1) become engaged in activities which were previously reserved to investment intermediaries and consulting firms.<sup>176</sup>

#### *Specialized rating agencies' role as standard setters*

Apart from releasing and collecting new information, rating agencies also have the function to provide orientation (**Orientation Function**). They standardize information and knowledge and therewith homogenize capital markets which can help investors to find and sort out possible investees more efficiently.

As first-movers specialized rating agencies certainly do play a role as standard setters. This finds its most obvious expression in their contribution of setting standards in collaboration with CGAP as the most important (and powerful) research and policy center within the microfinance sector.

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<sup>174</sup> SymInvest contains:

- a) country profiles (and ratings) analyzing the social, political and economic conditions, the local financial market, aspects of investment regulation and funding conditions within a specific microfinance market as well as information on the industry environment and the microfinance market (both supply and demand side);
- b) profiles of currently over 125 MFIs including supporting documents, a credit risk and social rating and a monthly reporting service on 50 key financial indicators;
- c) profiles on all MIVs worldwide with key indicators and structural information;
- d) a world-wide microfinance directory covering 3.000 microfinance practitioners (MFIs, NGOs, DFIs, MIVs, etc.), an event database listing the key microfinance events and conferences, a library with research articles, and a news services (NewsWatch) for microfinance related press articles;

See <http://www.syminvest.com/> (accessed June 30, 2011).

<sup>175</sup> The company currently has 49 employees and four regional offices, see Symbiotics (2011a).

<sup>176</sup> This also includes local organizations. In Peru, for instance, the microfinance network COPEME also offers tailor-made reports for investors (Interview 11a).

Roy (2010: 77-79) even goes as far as to label the modern World Bank (and hence also CGAP) a “knowledge bank” rather than a development bank. In times where the market mechanism is considered the key to successful development (as is particularly the case in microfinance), the provision of knowledge lies at the heart of any development strategy. In this sense, the role of rating agencies should not be underestimated. For instance, in 2003 MicroRate published a first technical guide regarding financial performance indicators for MFIs (MicroRate 2003). It gathered not only two other specialized raters (M-CRIL and Planet Rating) but also representatives of IDB, CGAP and USAID as important donor organizations in order to “highlight(s) 14 of the most commonly used indicators” gathered through roundtable discussions with other entities, believing that the guide “will make an important contribution to the field of microfinance” (MicroRate 2003:iii).

And also Sinha (2006b: 5, 9) – not entirely altruistically though<sup>177</sup> – highlights the role of specialized raters when benchmarking the performance of single MFIs against “best practices”. This is also based on the experience and data collected of specialized rating agencies. The standardization process and fixing of best practices does not stop at the level of quantitative indicators, still, the latter involves a setting of indicators commonly agreed on – such as using PAR > 30 as one of the key standard indicators to assess an MFI’s portfolio quality and performance –, how these indicators should be calculated and its “best practice” reference values. Later on, rating agencies’ representatives also contributed to the elaboration of CGAP’s “Microfinance Consensus Guidelines. Definitions of Selected Financial Terms, Ratios, and Adjustments for Microfinance” (CGAP 2003) and its “Appraisal Guide for Microfinance Institutions” (Isern, Abrams *et al.* 2008). In the former case the director of MicroRate, Damian von Stauffenberg, is mentioned as its initiator. These guidelines are intended to be used by many types of stakeholders (including development organizations, technical assistance providers and investors). So-defined standard indicators can then also be found in the MIX Market database which in turn is used by microfinance practitioners and investors to benchmark the performance of their future investees.<sup>178</sup> In the case of MIX Market, which sets standards for the relevant areas to be analyzed in a due diligence process of MFIs, Francis Sinha from M-CRIL and von Stauffenberg also participated along 22 other actors from the microfinance field including three microfinance investors (Oikocredit, Citigroup and Triodos Bank).

Besides, the rating agencies’ assistance in institutionalizing a sector-wide learning process is reflected by their training activities (see Chapter 6.1.1). They are not only provided to microfinance investors and asset managers but also during the annual Boulder microfinance training program.

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<sup>177</sup> The author is the managing director of M-CRIL.

<sup>178</sup> For instance, according to MIX more than half of the participants of a user satisfaction survey (the numbers of participants was not disclosed) used MIX data for operational and financial decisions (MIX 2010: 13).

Representatives of three rating agencies (MicroFinanza Rating, Planet Rating and M-CRIL) are listed as faculty members of the Boulder Institute of Microfinance. In the training program for 2011, two rating agencies' representatives are actively involved in offering courses on "Analysis of Changing Risks in Microfinance" and "Integrating Social Performance Into Microfinance Management and Performance" (Boulder Institute of Microfinance 2011).<sup>179</sup>

Donors and regulators also build on the experience of rating agencies when designing adequate assessment processes of entire groups of MFIs. The example of Planet Rating's role in the design of an evaluation method of credit cooperatives in Mexico in the context of a new regulatory framework illustrates this (see Chapter 6.1.1). Hence, rating agencies can be considered an integral part of the epistemic community of international microfinance experts. They are part of the knowledge network embedded in the microfinance industry (see Chapter 3.4.2).

As far as social performance indicators are concerned the potential role of rating agencies to find standardized reliable social metrics is even more pronounced. So far, social metrics assessed by investors appear to rarely go beyond the collection of ready-at-hand indicators, which, however, might lack the explanatory power regarding the social contribution, the commitment and the responsibility of MFIs.<sup>180</sup> The need for standardized and reliable social metrics increased particularly after the more recent events and debates in the microfinance sector about the ongoing commercialization, the incidences of inadequate lending and collection practices and the lack of proof for a positive impact (see Chapter 2.2.1). For instance, Harris and Summerlin (2011: 9)<sup>181</sup> state that most investors and donors would prefer social ratings focusing on a few (outcome) indicators "*integral to success*". Even though the identification of relevant categories and the development of social performance management tools as brought forward by the ImpAct consortium and the Social Performance Task Force (see Chapter 6.2.1) is in an advanced stage, they are not designed to and used for enhancing external accountability. Instead, social performance

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<sup>179</sup> The Boulder Institute of Microfinance is (one of) the leading training programs for microfinance practitioners offering a three weeks course each year. In 2011, the 17<sup>th</sup> Boulder training program was realized; see [http://www.bouldermicrofinance.org/\\_eng/index.php](http://www.bouldermicrofinance.org/_eng/index.php); for an over view of the Boulder faculty members see [http://www.bouldermicrofinance.org/\\_inst/faculty.php?lang=EN](http://www.bouldermicrofinance.org/_inst/faculty.php?lang=EN) (both accessed July 10, 2011).

<sup>180</sup> Many of the 23 MIVs surveyed indicated they collect information on the number of clients, percentage of women borrowers, percentage of rural clients and average loan size. Only two socially-oriented MIVs, which solely rely on own assessments, mentioned they assess a broader set of indicators, one of them also having a focus on the environmental sustainability of lending operations. One commercial MIV focused on the labor market instead, represented by the indicators "number of businesses supported" and "number of jobs created".

<sup>181</sup> The authors conducted a survey on behalf of The Rating Initiative among 66 MFIs from different regions, rated by different raters, and among 22 donors and investors. Note that the authors do not disclose the exact distributions of different answers but generally refer to "most" or "some" investors/donors of MFIs when discussing the results of their research, especially in the more qualitative part of their survey. Furthermore, the survey only covers a very small fraction of possible stakeholders and cannot be regarded as representative. Thus, the results have to be interpreted with some caution. Yet, they are considered a valid first indication of stakeholders' sentiment until more comprehensive research is available.

management tools are meant to be adapted by MFIs to their specific context and social mission(s). Therewith, individually generated social performance audits as a result of a social performance management exercise might lack the reduction of complexity which makes a large number of MFIs comparable among each other. Apart from lifting SPM approaches towards external accountability (which will be discussed further below), ratings aim at reducing complexity and establish comparability. This standardization can also be fed back into social performance management tools as the following statement of the Microfinance Center reveals:

*“[The Quality Audit Tool] has been designed to be aligned to the social rating methodologies of M-CRIL and Microfinanza. In practice this means that information gathered through the QAT can be used directly to inform an external social rating process”* (Microfinance Center n.d.).

Yet, the performance of (specialized) rating agencies in providing orientation through rating grades as a summary of their standardized evaluation approach also bears some risks and its validity for different stakeholders has its limits (see Chapter 7.2.1 further below).

#### *The limited relevance of ratings for the identification of new MFIs*

Once accepted standard indicators are set, the same arguments outlined above apply regarding the limited degree of disintermediation. For specialized microfinance investors, the Orientation Function for identifying new, potential investees through rating grades might be important for rather small and relatively inexperienced MIVs that operate from the Northern hemisphere without a local infrastructure and that lack an overview of different microfinance markets. It is probably this investor type MicroFinanza Rating tries to serve with the newly created country reports that also cover a short presentation of all rated MFIs in the country (see Chapter 6.1.1).

For the (rather large) microfinance asset management firms and MIVs interviewed in Peru<sup>182</sup>, ratings were not regarded as useful for identifying new investees. They found new partner MFIs because they were directly contacted by them, through personal contacts or they encounter them on conferences (Interview 3 and 6). Hence, the little anonymity of the investors in microfinance plays a role, too. Well informed MFIs will rather contact them than the other way around. Only one MFI stated that it was approached once by an investor because they had read the rating report (Interview 19). For Peruvian banks the local microfinance market is easy to oversee since financial data is easy accessible through the banking supervision SBS (for regulated MFIs) and because sector reports that also cover NGOs and large cooperatives are available (e.g. COPEME 2009). To what extent the local market knowledge on microfinance is easily available in other

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<sup>182</sup> Two of the asset management firms (Blue Orchard Finance and Oikocredit) were among the top five companies in terms of size (Reille, Forster *et al.* 2011: 5). The third asset management firm (Tripple Jump) is much smaller, however, managing one of the biggest microfinance funds (the ASN-Novib Fund) (Tripple Jump 2010).

countries cannot be answered in the present study. Yet, what matters when assessing the need for orientation for investors or those acting on their behalf is the number of MFIs as potential recipients of funds. Sorting out the most suitable investment opportunity becomes more challenging (and expensive) once the number of MFIs eligible for (commercial) funding increases. International MIVs, however, appear to follow a rather conservative investment strategy. This is exemplified by the high concentration of funds flowing into single markets and MFIs and the relative conservative estimations regarding the number of MFIs attractive for (commercial) investments (see Chapter 2.2.1). Hence, the future relevance of (particularly specialized) rating agencies in microfinance regarding their Orientation Function also depends on the (future) MFI landscape. Here, the eligibility for investments as well as the demand for investments of MFIs does not only depend on the risk profile of individual MFIs. It also, depends on their absorption capacity (their size) decisive for other transaction costs, on the criteria lying beyond the institutional level (e.g. political and macroeconomic conditions, quality of (microfinance) regulation, exchange stability) and on the availability of mechanisms to hedge related risks, for example.

As far as the availability of alternative sources for a first means of orientation on a global scale is concerned, microfinance raters (again) face increasing competition from other benchmark providers, above all from MIX Market, which covers financial and social performance data. For instance, for some MIVs interviewed in Peru rating grades were regarded useful to give a first impression (*"I would be lying if I told you that the grade was not the first thing people looked at, it gives you a tendency"*<sup>183</sup>; Interview 7). However, to receive a first insight on an MFI's performance compared to its respective peers, some MIVs consulted MIX Market directly rather than comparing different rating grades (Interview 3 and 6).<sup>184</sup> These initiatives (rating agencies and the MIX) are and are meant to be complementary in many aspects.<sup>185</sup> However, as far as single functions are concerned, a significant overlapping in terms of single activities partly create a competitive situation. And at least for quantitative data, scope and quality have increased during the years of operation (see Chapter 6.2.1) and are likely to continue increasing in the future. For instance, in 2009 MIX also started collecting interim financial data on a quarterly basis alongside annual data for 240 selected MFIs. Furthermore, increasing efforts were made to cross-check and verify the self-reported data provided by MFIs. By MIX's own accounts 69% of the data provided came from audited financial statements and was reclassified to comply with IFRS. Based on the collected data, MIX also published a series of benchmark studies including an annual review of the 100 best performing MFIs world-wide (Global 100) and for the LAC region (LAC 100) (MIX

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<sup>183</sup> *"Sería mentirte decir que la gente no ve la nota primero, te dicen la tendencia."*

<sup>184</sup> However, this might also have to do with the performance of specialized raters which will be discussed further below.

<sup>185</sup> The IDB project "Risk Assessment of Microfinance Institutions" did not only set up the Rating Fund (see Chapter 2.2.2) but also co-funded the MIX. The program contemplates that the MIX Market should help disseminating rating reports (Díaz Ortega 2006: 7).

2010a:7,10,11,14). Furthermore, MIX country reports give an overview of the microfinance market in specific countries and provide information on the business environment in terms of macro-economic and regulatory conditions (e.g. MIX 2010c; MIX / CGAP 2011). Hence, MIX Market also started providing a useful means of orientation for rather uninformed investors and will probably increasingly do so in the future which might further decrease the relevance of the orientation function of (specialized) rating agencies.

### **7.1.2 The Certification Function in Different Markets and the Importance of Regulatory Recognition**

The first sub-function identified in Chapter 3.5.2 within the Certification Function was conceived as Labeling Function. Its functionality was considered to be largely based on the reputation of the rating agency which passes part of its reputation on to the issuer. Being rated, regardless of the rating grade, already provides a signal of integrity and transparency which can create trust among investors. Once recognized as a quality label, ratings become information in itself and are increasingly established as a rule of thumb. As such, having a rating becomes critical for the access to funding. As far as the rating grade is considered, ratings also classify bonds into several risk categories (Risk Classification Function). This might be critical for the access to funds with higher rated bonds being more likely to attract (cheaper) funding than lower rated bonds. The latter is further enhanced once ratings are integrated into regulatory frameworks (Regulation Function).

As will be shown in the following, in microfinance ratings also increasingly become a common practice, especially among MFIs in more mature markets such as Peru. They are perceived as a quality label, however, without (yet) being critical for the access to funds for most MFIs. To a certain extent the demand for ratings is actively created by rating agencies and those supporting them rather than based on a concrete necessity among microfinance investors. Specialized raters encourage investors to rely more strongly on ratings and therewith tend to be more persuasive than their major counterparts. Yet, partly due to the structure of the microfinance investment landscape, investors and local banks do not have to and do not want to rely on ratings to the same degree as investors active in the mainstream (secondary) capital markets. Besides, until recently, no major breaches of trust regarding microfinance as a relatively secure investment opportunity occurred, thus, ratings do not need to re-establish trust. However, due to the recent negative events in some microfinance markets this might change in the future. Furthermore, particularly specialized microfinance raters face a lack of reputation among stakeholders departing from mainstream capital markets. For commercial banks in Peru, regulatory recognition more than specific sector knowledge appears to be important. Since ratings have a “license value”, specialized raters, too, seek official approval.

*The importance of ratings as a sign of integrity and transparency in more mature microfinance markets*

The **Labeling Function** seems to be one of the more important functions in the microfinance context. At some point, some specialized microfinance investors also required a rating when deciding about the eligibility for funding of MFIs. Yet, the Labeling Function mostly appears to be an implicit rule in more developed markets and is partly based on the belief that rating agencies simply (have to) form an integral part of a mature microfinance market.

According to the CGAP (2005) survey, six<sup>186</sup> out of 17 investors formally required a rating report. Interestingly enough, one (commercial) MIV manager interviewed in Peru mentioned that he desisted from this practice later on, however, recognizing ratings are a quality label which “*makes me feel more comfortable*”<sup>187</sup> (Interview 7). Yet, already 70% of the MFIs financed by these investors (the figures for single investors ranged from 10% to 100%) were rated. In case the regulatory status of an MFI is not already an important eligibility criterion, the transparency label appears to be more important whenever an MFI is not regulated and as such is not subject to any third-party accountability (Interview 3).

In 2007, Latin America was identified as the region where ratings were most common. And within the region, Peru (followed by Bolivia and Ecuador) was the country with the most important microfinance rating market (ADA 2008:27). As has been shown in Chapter 1.2.2, many ratings of MFIs have been realized by the local accredited rating agencies for regulatory purposes. However, also many (if not most) of the non-regulated NGOs in Peru also have a rating despite the fact that they have relations with a relatively small number of rather socially oriented investors. None of the (local and international) investors interviewed in Peru stated they require a rating. Nevertheless, the managing director of one NGO MFI was convinced that:

*“...it is never something obligatory [...] but I think in terms of image it is already something, let’s say it is very subtle, right? Nobody will tell you that you have to have a rating because otherwise you will have no [funding], but it is a prerequisite, right? So you know if you are doing things well you have no problem to do it, right?”*<sup>188</sup> (Interview 12).<sup>189</sup>

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<sup>186</sup> See supra note 167 for more details on this survey. Here, the survey states that 35% of investors required a rating report.

<sup>187</sup> “*Es un sello de calidad que me permite sentirme más cómodo.*”

<sup>188</sup> “*O sea, mira nunca nada es obligatorio o activo no? Pero creo que entre las cosas de imagen si ya es algo, o sea es muy sutil, no cierto? Nadie te va a decir: sabes que te tienes que calificar porque si no, no hay, pero esta dentro de los requisitos por ejemplo no? Entonces si tu sabes que haces bien las cosas tampoco tienes problema de hacerlo no?*”

Other MFIs expressed themselves similarly (Interviews 14 and 19). And if MFIs did not have a rating when the relationship with the respective investor was first established, they were actively encouraged by some (socially-oriented) investors to receive one (Interviews 12 and 19). On the one hand, this is an indicator that investors think it is important that MFIs receive ratings beyond the reduction of asymmetric information prior to the establishment of the relationship. On the other hand, the belief that a rating was a precondition is also actively nourished by the (specialized) rating agencies. For instance, one representative of a Peruvian cooperative – after having spoken to a Lima-based rating agency<sup>190</sup> – was convinced that international investors would ask for a rating (apparently without further reflections repeating the raters’ advertisement slogan). The MFI had never even had any relations with international investors and had actually rejected the only one by whom it was ever approached because it had no need for external financing:

*“[The rating] makes you a value-scan, an ultrasonic scan, I don’t know what [...] and it is good, I think we should have one [...] I think through this we could perhaps have access to international funds because it is a prerequisite and we did not have it”<sup>191</sup> (Interview 25).*

All investors did their own due diligence and ratings only helped them *“informally”*<sup>192</sup> (Interview 16). Still, rating reports for MFIs were ranked as implicitly obligatory by some Peruvian micro-finance experts (*“who is not rated is dead”*<sup>193</sup>, Interview 1) even to have access to funds of the local public funders. In Peru, *“the diffusion of ratings was something very enhanced by the banking law. I mean, it was not a spontaneous development [...] for classical reasons like in Europe or the United States linked to capital markets”*<sup>194</sup>. Nevertheless, ratings were accepted as a very *“common concept”* and *“an expression of a maturing market”* just *“like credit bureaus”*<sup>195</sup> (Interview 1). The previous institutionalization of ratings in single markets is likely to be a breeding ground for specialized microfinance ratings, too. In other world regions, like in Africa, where ratings are less common practice, MFIs are more skeptical regarding the added value of ratings compared to, for example, good financial audits (The Rating Initiative 2010: 36). So far, ratings have not been regarded as critical for the access of funds. Yet, particularly larger MFIs in Latin

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<sup>189</sup> By the end of 2008, this NGO had relations to four specialized (non-commercial) MIVs including one of those interviewed in Peru.

<sup>190</sup> The interviewee could not remember the exact name of the rating agency but stated that it had the term “rating” in its name pointing towards the specialized rating agency Planet Rating (or maybe Micro-Rate).

<sup>191</sup> *“ [La clasificación] te va a tomar una valografía, una ecografía, que sé yo [...] es bueno. Yo creo que debemos apuntar a eso. Porque nosotros a través de eso creo que tal vez podamos acceder a créditos internacionales porque era una exigencia y no teníamos.”*

<sup>192</sup> *“de manera informal.”*

<sup>193</sup> *“Quien no está clasificado está muerto.”*

<sup>194</sup> *“La difusión de las clasificadoras fue muy apoyada por la ley de bancos ósea no fue un desarrollo espontáneo [...] por las razones clásicas de Europa o Estados Unidos ligadas al mercado de capitales.”*

<sup>195</sup> *„concepto común“ and „expresión de la maduración del mercado“, “como bureaus de crédito.”*

America without a rating have already been perceived as “weird animals” (Interview 6). “If you have nothing to hide, get rated!” is the device and follows the same principle why MFIs share their data in the MIX Market database in order to demonstrate their integrity and belonging to the international microfinance community. In that context, transparency advocates work closely together, which is, for example, reflected by the fact that the rated MFIs are “rewarded” five diamonds in MIX Market in case they upload a rating report.<sup>196</sup> The demand for ratings is actively created by (specialized) raters and the donors supporting them and increasingly established as a rule of thumb, despite the fact that the envisaged result in terms of increased access to funds might have yet failed to appear. However, once established as a rule of thumb, ratings might become increasingly critical. Some MFIs in Peru which do not believe in the added value of MFI ratings either already fear exit penalties and go for ratings simply because everybody else does so, too (Interview 21).

The reputation of single rating agencies did not appear to be a criterion with regard to the Labeling Function, at least as far as the Peruvian case is concerned. Most investors interviewed do not prefer one specialized rating agency over the other. Instead, in Peru the MFI rating market was divided with MicroRate as a first-mover serving the more mature and Planet Rating the smaller MFIs (Interview 15). MIVs (or better the specific investment analyst interviewed) and banks do not compare different rating reports but simply accepted the ones available (Interview 3, 6, 34 and 36). Harris and Summerlin (2011: 1) find the same behavior in the case of social ratings.<sup>197</sup>

#### *The limited importance of ratings for the creation of trust and access to funds*

In the mainstream capital markets, the rating grade is of particular importance. Chapter 4.3.1 showed that investors (or their agents) increasingly relied on rating agencies’ judgments. Sometimes they even neglect their own fiduciary duties of exercising their own thorough risk assessments and, if necessary, of disagreeing and thus ignoring the raters’ opinions. Ratings became much more than one additional source of information, a first means for orientation or simply a second opinion, despite the fact that rating agencies kept insisting that they only measured relative probability of default and should not be understood as a recommendation for buying and selling (see Chapter 3.1). Instead, the **Risk Classification Function** became increasingly important.

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<sup>196</sup> MIX Market assigns MFIs with zero to five diamonds depending on their level of transparency. For an explanation of the MIX Market diamond scores see supra note 111.

<sup>197</sup> Only one expert (and investor, yet being strongly embedded into the Peruvian context) mentioned that he clearly preferred MicroRate over Planet Rating since the former was supposed to have more experience in rating MFIs and was considered more independent (Interview 1). Indeed, MicroRate first entered into the Peruvian microfinance market and rated, if not more, at least more mature and possibly more prestigious MFIs. An MFI further highlighted the importance which was given to Peruvian MFIs by this rating agency since even “*the boss of the bosses*” (“*el jefe máximo*”) (referring to Damian von Stauffenberg) came to participate in the rating process (Interview 17). Hence, this rating agency strongly builds on the reputation of the former Worldbank official.

In microfinance, too, some specialized raters now do not miss publishing a standard disclaimer with their reports saying that the organization does not guarantee the validity of their opinions and that it cannot be held responsible for investments made based on their reports (e.g. Planet Rating April 2008: 11, July 2010: 13). Yet, they (still) openly encourage investors and regulators alike to rely on their assessments being much more persuasive than their major counterparts. (Most of) the specialized rating agencies departed from technical assistant providers with a clear developmental mandate. This can explain the fact that they want to encourage investors to invest into a larger number of MFIs they consider being worthy of attracting investments. The managing director of M-CRIL, for example, is very direct regarding the envisaged goal of their assessments. In earlier reports, this rating agency even indicated the absorption capacity of single MFIs (e.g. M-CRIL June 2005: 1) being convinced that

*“other raters such as MicroRate and Planet Rating do not make lending recommendations but their reports are used this way” (Sinha 2008a: 57).*

Another indication supporting this view is Planet Rating’s categorization of rating grades into *“Investment Grade”*, *“Speculative Investment”* and *“Technical Assistance Required”* (Planet Rating 2009: 12) without being recognized by any regulatory authority which would back this type of classification, as in the case of the major raters.<sup>198</sup> Furthermore, after the recent repayment crisis in single microfinance markets, raters implicitly summon the Certification (and Coordination) Function in order to prevent future crises (see introduction of the present chapter). They state that investors should take ratings more into account and therewith actively try to sell their (supposedly) superior judgments.

The reason that ratings have not yet been regarded as critical by investors might also have to do with the fact that negative events that could shake the confidence of these stakeholders in microfinance have been rare until now. As to the critical issue of (over-)reliance of investors and regulators, it is noteworthy that in their early days ratings and particularly rating grades as risk classification certificates in the U.S. gained importance in times of financial distress. This was to re-establish trust, if not faith, in the functioning of financial markets (see Chapter 2.1.1). In microfinance, only single default cases have been observed so far (Abrams 2009; Rozas 2009). Hence, the optimism of microfinance investors about having found a relatively secure investment opportunity which is not correlated to other asset classes (e.g. Galema, Lensink *et al.* 2011; Krauss and Walter 2008) might not have been sufficiently disrupted yet, in the sense that they (need to) distrust their own ways of assessing risk. They do not need ratings as potential oracles and uncer-

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<sup>198</sup> Yet, it might also be plausible that the rating agency simply mimics the major raters, as already done when adapting the rating scale. Still, until 2002 MicroRate did not assign rating grades but classified MFIs as *“recommended”* or *“observed”* (Díaz Ortega 2006: 22), highlighting the intended persuasive dimension even though they are now more cautious in this regard.

tainty transformers. For the same reason, it is not surprising that some microfinance raters try to capitalize on the latest repayment crisis promising of being an adequate instrument for preventing such situations. It is possible that their relevance as a result of negative events experienced lately or the ones yet to come will increase in the future, just as the increasing demand for social ratings is most probably linked to the lately increasing awareness of microfinance's "reputation risk".

As far as financial performance ratings are concerned, their superiority rather applies, again, to MIVs or individual investors without necessary (local) infrastructure and market knowledge.<sup>199</sup> The large MIVs currently dominating the scene rather trust in their own experience. More than that, they estimate that this is one part of bringing an added-value to investors. For instance, the large asset manager in Peru, who stated to have once insisted that MFIs had a rating report and stopped to do so later on, mentioned that this was due to the service his organization sought to offer to their investors: "[...] *it is an opinion, which is valid, and I have to give mine*"<sup>200</sup> (Interview 7). Therewith, since fund managers of rather long-term investments have a strong interest in cashing in their own expertise, rating agencies are, even if valued as complementary, at least to a certain extent, competing with asset managers they officially seek to serve. The same applies to (local) commercial banks in Peru who serve MFIs within their traditional banking business.

Therefore, it is not surprising that Hatarska and Nadolnyak (2008) as well as Garmaise and Natividad (2010) do not find any or a very limited effect in the case of one specific rating agency of ratings on the amount of debt funds – regardless of the rating grade. Instead, there appears to be a much more potent signal of trust for the attraction of funds, namely the degree of an MFI's capacity to build and maintain financial relations with other investors. "*Investors are a herd of sheep*"<sup>201</sup> (Interview 1) and simply follow the pioneering public investors like IFC or KfW or large, locally well embedded socially-oriented MIVs concerning small MFIs once their absorption capacity increases (Interview 3). Since these "patient" investors, whose investment strategy can furthermore be observed relatively easy, have "skin in the game", they appear to be a more reliable risk certificate than rating agencies who lack any sort of liability. Hence, as far as the concentration of funds is concerned, at a current stage it appears to be critical that these pioneering investors further include a larger number of MFIs so that smaller and less informed investors can follow their example rather than relying on ratings.

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<sup>199</sup> Note that so far only three out of 23 MIVs stated not to conduct own risk assessments (see Figure 7.1).

<sup>200</sup> "*Es una opinión es válida y yo tengo que dar la mía.*"

<sup>201</sup> "*Inversionistas son un rebaño de carneros.*"

### *The significance of rating agencies' specific reputation*

Turning back to relatively uninvolved investors, in Peru ratings have recently gained importance for those mature MFIs with direct access to local capital markets through the issuance of corporate bonds and deposit certificates. This is likely to increase in the future (see Chapter 5.3) and therewith the importance of ratings for these (few) MFIs.<sup>202</sup> Yet, even before, ratings were important for MFIs capturing deposits. Large-scale depositors include private pension funds (Administradores de Fondos de Pensiones) where ratings are required for regulatory reasons. But also private companies (examples mentioned included local electricity companies and universities) are attracted by relatively high interest rates offered by this group of MFIs and want to see the level of risk involved. Unlike small-scale savers they are not protected by regulation since their deposits are not covered by the Deposit Insurance Fund. Only in these cases, MFIs interviewed actively use ratings as a marketing tool, while small-scale savers were declared of not being aware of their existence (Interviews 10, 18, 20 and 22). Interestingly enough, Garmaise and Natividad (2010) find a causal relationship between ratings and the amount of demand deposits of MFIs rated by MicroRate.

Yet, it depends on the stakeholder involved which type of rating agency is recognized as reliable risk-classifier. Even though specialized rating agencies were the first-movers within the microfinance context, once the market becomes more mature and MFIs are integrated into local or international mainstream capital markets, these rating agencies have to run against established conventional rating agencies. These might find it relatively easy to transfer their reputation into the previously neglected microfinance sector.

Specialized raters enjoy a good reputation among dedicated microfinance investors and MIVs because of their specialization and in-depth research of the microfinance technology (Interview 1, 3 and 7). Yet, local Peruvian banks rather trusted in local Peruvian raters, because they were themselves certified and supervised (and thus “enshrined”, see Chapter 4.1) by the banking supervision:

*“They are independent because these rating agencies are approved by the superintendence, I mean, not all reports of any rating agency are accepted”<sup>203</sup> (Interview 34).*

Also, the good track record and reputation in the Peruvian market was highlighted, which further confirms the view that ratings are an “experience good” (see Chapter 3.6):

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<sup>202</sup> In that case, MFIs use their rating comparing it to other financial institutions as a PowerPoint presentation of the Peruvian microfinance bank MiBanco exemplifies (MiBanco 2009).

<sup>203</sup> *“Son independientes porque esas clasificadoras de riesgo son aprobadas por la superintendencia de bancos, o sea, no de cualquier identidad clasificadora se aceptan los informes.”*

*“In reality, the most trustable are Apoyo, Class Rating, here. Planet Rating ..., it is more a question of experience. It is a question of seeing that they cannot modify numbers or contents or comments on a specific client, isn't it?”*<sup>204</sup> (Interview 36).

And some MFI representatives departing from the commercial banking sector, and thus, being more familiar with related institutions, even identified two of the Peruvian raters as specialized in microfinance (referring to Class & Asociados and Equilibrium).<sup>205</sup> They consider MicroRate and Planet Rating to be designed for rating NGOs (Interview 10). They had no doubt that the accredited rating agencies were well prepared to deliver high quality ratings of MFIs (Interview 10, 26 and 31). Quite the contrary: The affiliation with one of the major U.S. credit rating agencies was highlighted as a quality label (*“it is a Moody's!”*<sup>206</sup>) while counting with such a rating was mentioned as a (supposed) requirement of international partners including designated microfinance investors (Interview 31). In Peru, local raters are well embedded – speaking in terms of Granovetter (1985) – into their context. Specialized raters, however, are rather linked to what one MFI representative called – referring to the microfinance (investment) community – *“a somewhat closed world”*<sup>207</sup> (Interview 10).

By insisting that no separate methodology for rating MFIs is necessary (see Chapter 6.1.2) the transfer of reputation from the commercial banking sector to the microfinance context is carried out straightforwardly. The respective rating agency only has to credibly reassure investors that it is aware of and willing to learn about the particularities of MFIs and adapt its judgments accordingly. Provided that there is a “business case” for MFI ratings, who (especially among the mainstream investors) would argue that they are not able and willing to do so properly? Yet, it might be true that a considerable portion of blind faith in the brand of the major raters does play a role. Taking a glance at the spreading of the major raters throughout the world who “conquer” new markets and take over the business of local rating agencies or even the rating agencies altogether (see Chapter 2.1.2), it is possible that specialized raters will face the same destiny. This is possibly also one of the reasons why credit ratings (as opposed to performance ratings) offered by MicroRate did not encounter a big demand (see Chapter 6.1.1).<sup>208</sup>

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<sup>204</sup> *“En realidad las más confiables son Apoyo, Class Rating, acá. Planet Rating...es un tema ya de experiencia, es un tema de ver que no puedan alterar cifras o contenidos o comentarios acerca de un cliente específico, no?”*

<sup>205</sup> Apoyo & Asociados entered relatively late into the microfinance sector and only started in recent years to rate a larger number of MFIs, while it considers Class & Asociados and Equilibrium as first movers in this segment (Interview 35).

<sup>206</sup> *“Es un Moody's!”*

<sup>207</sup> *“un mundo poquito más cerrado.”*

<sup>208</sup> Kathrine Devine (see supra note 131) refers to credit ratings as not one of their highly demanded products and states that the rating agency has not performed many of them.

Accordingly, S&P representatives did not even mention the existence of specialized raters when celebrating their entry into the microfinance market (Esposito, Kuchubka *et al.* 2008). They appear to be quite confident of who will win (this time) the fight between “*Davids and Goliaths in International Microfinance*” – evoked as such by M-CRILs managing director Sinjay Sinha (2006b). The latter already perceives the established raters as a real threat while at the same time questioning their reliability:

*“... as MFIs improve and professionalize, they may increasingly use public credit risk ratings offered by corporate raters [... the] viability of specialized MFI rating agencies could become an issue [...CGAP has devoted] development resources to encourage traditional agencies to rate MFIs. Yet the commercial logic of this luring strategy is doubtful [...] It is difficult to see the corporate agencies treating microfinance rating as anything more than a niche market [...with] minimal resources devoted to understanding microfinance [...] As it is, even some specialist raters undertaking ratings by the dozen find it difficult to brake-even”* (Sinha 2008a:65).

Indeed, those high performing MFIs tackling (global) capital markets directly, for example, through the launching of IPOs (for an overview see Lieberman, Anderson *et al.* 2007) already receive ratings from the major raters. For instance, Bank Rakyat Indonesia was rated by Fitch as well as Moody’s and Banco Compartamos in Mexico was rated by Fitch as well as by S&P.<sup>209</sup> Likewise, ProCredit Banks received ratings from Fitch right from the start (see Chapter 6.1.2). Particularly in India which is the most important microfinance rating market in Asia (see Chapter 2.2.2), in the case of more mature MFIs, commercial investors appear to ask for ratings by conventional raters rather than accepting the ones from M-CRIL (e.g. Unnikrishan 2011: 2).

#### *The relevance of rating agencies’ “license value”*

The integration of ratings into regulation, where, for example, capital adequacy rules were linked to the risk evaluations of rating agencies, was identified as another, possibly very important driver for the demand of these assessments (see Chapter 2.1.1 and Chapter 4.1). They have a **Regulation Function**. In Peru, ratings of local Peruvian raters were even labeled as “*legal ratings*”<sup>210</sup> right away (Interview 17) to mark the major difference to those offered by specialized raters. Hence, also for specialized raters it appears to be critical to become recognized by local supervising bodies in order not to lose their business to their competitors in the case of more mature MFIs. But also in contexts where specialized raters do not compete with local rating agencies because of

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<sup>209</sup> BRAC in Bangladesh received a rating from the locally recognized Credit Rating Agency of Bangladesh, SKS in India got ratings by CRISIL (an S&P affiliate) after having received ratings from M-CRIL, and Equity Bank in Kenya was rated by the African Global Credit Rating Co. after having received prior ratings by Planet Rating and MicroRate. The rating history of the MFIs mentioned here was based on the information available at The MIX Market; from <http://www.mixmarket.org/> (accessed May 26, 2011).

<sup>210</sup> “*clasificaciones legales.*”

already established rating-based regulatory rules, they seek official recognition and the creation of such rules in order to secure their existence.

In Peru, ratings played an increasingly important role for MFIs because of regulatory reasons (see Chapter 5.3). The scope of activities and contribution to the deposit insurance funds depends on ratings as well as their access to funds from prudentially regulated institutional investors. Until recently, the lack of official recognition of specialized microfinance raters by the local regulatory bodies led to a situation where some MFIs received three different ratings in one year in order to meet the different (supposed) expectations and requirements (Interviews 16, 17, 19, 26, 27 and 32). This might have raised the rating costs to a significant level even for medium-scale MFIs.

The good reputation as an independent and internationally recognized rating agency was mentioned as the most important precondition for the Peruvian banking supervision (SBS) for the accreditation of any specialized rating agency. SBS did not disqualify the specialized rating agencies per se as long as they had a good, international reputation counting with “important” MFIs among its clients (Interview 2). However, CONASEV, as the organization in charge of approving and supervising all Peruvian rating agencies, mentioned two major obstacles for recognizing the specialized rating agencies. First of all, by law, rating agencies’ main purpose had to be the rating of debt securities – a service neither offered by MicroRate nor by Planet Rating – while the evaluation of financial institutions has to be carried out complementarily only. Therewith, the organization implicitly recognizes the relevance of ratings linked to a specific structure of financial markets (that is, they are more important in capital-market-based than in bank-based financial markets). Secondly, any rating agency has to count with a minimum capital of 250,000 USD, and CONASEV doubted that this investment would be worthwhile for any new rating agency since the Peruvian capital market was “*small and consolidated*”, and it would be difficult to “*find a market*”<sup>211</sup> (Interview 13).<sup>212</sup> An exclusive registration from SBS, even though possible, was not contemplated upon for a long time.<sup>213</sup> However, in July 2011, after having approached CONASEV years before, MicroRate announced its official recognition by SBS and is now allowed to rate financial institutions only (El Peruano 2011; MicroRate 2011e, Interview 13).

This will be especially welcomed by those (major) MFIs which need a rating for regulatory reasons while at the same time still largely depending on funds provided by international microfinance investors. MFIs which are not looking to gain access to specialized MIV funds (Interview 10, 20 and 26) or those already known and sufficiently attractive to MIVs (Interview 18 and 27) stated

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<sup>211</sup> “*El mercado es pequeño y esta consolidado, entonces que venga una nueva clasificadora es un poco difícil que encuentre un mercado.*”

<sup>212</sup> For the same reason, one of the local Peruvian raters highlighted the legal (rather than informational) value of ratings as particularly important (Interview 4).

<sup>213</sup> This was noted already by Díaz Ortega (2006) and appeared to be still the case at the time the interviews were held in Peru.

they abstain from receiving an additional rating from a specialized rater in the future. MiBanco as the biggest MFI in Peru and internationally possibly one of the most prestigious never received a financial performance rating by any of the specialized raters (Interview 33). It will be interesting to assess in the future in how far these MFIs change their opinion and start or return to receiving ratings from MicroRate, especially since specialized rating agencies are supposed to assign higher grades (see Chapter 7.2.2 further below).<sup>214</sup> It will also be interesting to assess if MicroRate applies any considerable changes to its rating criteria and rationales as well as if and how conventional raters react to this increasing competition.

Yet, specialized raters do not only seek official recognition in the case rating-based regulation already applies to MFIs where the objective is to overcome a major competitive disadvantage compared to accredited conventional rating agencies.<sup>215</sup> Specialized rating agencies are aware that in some regions the “legislative leverage” by making ratings compulsory is crucial in order to expand the demand of MFIs, and thus, should be encouraged (The Rating Initiative 2010: 36). The latter happened in the Philippines in May 2011. Planet Rating, after successful lobbying, received the newly created status of a Microfinance Institution Rating Agencies (MIRA) from the Philippine central bank (Planet Rating 2011b). This is – according to the former regional director of Planet Rating – supposed to help Philippine MFIs to attract funds from a wider range of market participants<sup>216</sup> (including institutional investors). These could better assess the creditworthiness of MFIs and would serve microfinance regulators to more effectively undertake the due diligence of MFIs under their supervision (cited in Chong 2009; Republic of the Philippines. Department of Finance n.d.).<sup>217</sup> More research on the exact role of rating agencies in the Philippines regulation has yet to be done. In any case, this step most probably opens an important business line for Planet Rating since there are many MFIs in this country but only a minority has received a rating so far.<sup>218</sup> Yet, taking a glance at the mainstream capital markets and especially the discussion of over-reliance of regulators and (partly as a consequence) of investors, it can at least be questioned whether this “enshrinement” of rating agencies embraces taking up “*the best of the techniques and expe-*

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<sup>214</sup> Ecuador would be another interesting case to study the motives of different MFIs to receive ratings from different types of rating agencies. Here, MiroFinanza Rating has long been recognized by the respective regulatory body and is, for example, competing with Ecuability as a local conventional rater active in the field of microfinance (ADA 2008: 26).

<sup>215</sup> It is noteworthy that if prudentially regulated investors from the U.S. and Europe were about to invest larger sums directly into MFIs and did not have recognized internal rating procedures, specialized raters would also need to be recognized by U.S. and European regulators.

<sup>216</sup> Until now, Philippine MFIs are said to be refinancing themselves majorly through local bank loans.

<sup>217</sup> EIU (2010a) reports that the examination capacity of the regulatory body regarding MFIs has been limited so far.

<sup>218</sup> In 2009, 38 regulated MFIs and 22 non-regulated MFIs were listed on MIX Market, letting aside the thousands of unregulated savings and credit cooperatives (see supra note 19), while Planet Rating up to now has only publicly rated eight MFIs in this country; see [http://www.planetrating.com/EN/girafe-ratings\\_\\_nom\\_pays\\_\\_ASC.html](http://www.planetrating.com/EN/girafe-ratings__nom_pays__ASC.html) (accessed on October 14, 2011).

*rience of the mainstream world and adapt them to a sector that is defined by its social goals and its specific reach” (Planet Rating n.d.-b).*

### **7.1.3 The Control Function – Ratings as an Advisory Service**

Ratings do not only help investors and regulators to screen investment opportunities. They also give incentives to recipients of investments for behaving according to their principals’ interest. They have a Control Function. They help preventing moral hazard after an investment decision is made and help investors to efficiently monitor their investments (Monitoring Function). But also prior to investments, they might induce discipline among debt recipients (Disciplining Function) in order to receive an investment status.

In microfinance the monitoring function, as will be argued below, is not yet playing a major role. This is mainly due to the structure of the investment landscape and the little relevance of rating-based regulation in this context. Instead, they have a more important role to play in professionalizing MFIs to make them eligible for (commercial) investments. Yet, this depends on the maturity status of MFIs. In the case of small MFIs, one could even argue that rating agencies have a consulting function. In some microfinance markets, they can also be considered as an authority in the sense that MFIs are aware of the possible negative consequences when receiving low rating grades. Yet, it is not clear in how far rating agencies can actually impose a specific behavior of MFIs to react to rating agencies’ “recommendations” in case they are not willing to do so. As far as the control of asset managers is concerned, ratings have been of little relevance so far, which is again linked to the characteristics of microfinance investments.

#### *The low importance of ratings as automatic monitoring device*

As for the **Monitoring Function**, in the mainstream capital markets the reliance on ratings even led to a situation where ratings were directly integrated into debt contracts. Rating triggers (see Chapter 3.5.3) in accelerated repayment clauses, for example, were introduced as a (supposedly) efficient monitoring mechanism. Especially for bond issuers attracting investments from prudentially regulated investors, who are not allowed to hold bonds below a certain threshold (or have to hold expensive capital reserves), the monitoring function became critical. With their increasing relevance as focal points and representatives of the conventional judgment (as part of the Coordination Function) in situations of multiple equilibria, their Monitoring Function became even more influential. Investors could not afford to ignore the major rating agencies’ judgments since the behavior of other investors (most probably influenced by rating movements) has a direct impact on the credit risk involved. Notably, the so-induced over-reliance was one of the most

criticized aspects of the dynamics linked to the rating agencies' status as gray eminences after the financial crisis of 2008 and during the following European debt crisis.

In microfinance, this function has yet been of little relevance. Again, this is linked to the investment landscape and structure as outlined above and to the limited recognition of specialized raters as risk classifiers, including the governmental recognition as a result of rating-based regulation. The rating agencies delivering the bulk of MFI ratings lack the eminent position to significantly frame investors' beliefs. Also, most microfinance investors are rather patient and long-term oriented. Therefore, single investors do not need to fear that their (equally long-term) investment is in danger simply because other investors would withdraw their money after a rating change which would plunge MFIs into liquidity crises. The latter could influence their repayment capacity in the long-run or even the probability of going bankrupt in the short-run. Accordingly, none of the investors and MFIs interviewed in Peru stated that the rating grade was somehow integrated into their debt contracts. And investors monitored MFIs themselves on a constant quarterly or even monthly basis (Interviews 3, 6, 7, 9, 34 and 36).<sup>219</sup>

#### *The effectiveness of ratings as a disciplining tool*

Yet, specialized rating agencies try to help MFIs to develop in a much more direct sense. Besides imposing a specific behavior that MFIs are already aware about but might not be willing to take into action (**Disciplining Function**), they include MFIs into the learning process ("asymmetric knowledge"). Especially small MFIs can benefit from this. Thus, specialized rating agencies also have a "Consulting Function" and serve as an advisory service.<sup>220</sup> This finds its most obvious expression in the offering of pre-rating products by all specialized raters (see Chapter 6.1.1). These are developed in a much more participatory way and disclose more detailed which strength and weaknesses MFIs are facing. Furthermore, (at least) MicroFinanza Rating and MicroRate even directly offer consulting services to small MFIs in order to make them "investable". Their inclusion of MFIs into a learning process also appears to be one of the reasons why donors and social investors actively encourage and financially support rating exercises.<sup>221</sup> Some MIVs were convinced that MFIs used the rating reports as a consulting service (Investor 3 and 7). They men-

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<sup>219</sup> For those investors (or small MIVs), who are not able or willing to monitor MFIs themselves, Microfinanza Rating started offering a direct monitoring service for investors, again, usurping the role of existing asset managers. However, so far there is little demand for this service (see Chapter 6.1.1 and supra note 139).

<sup>220</sup> It can not be ruled out, however, that major rating agencies have this function, too. Yet, it is not explicitly mentioned in the literature and is likely to be more pronounced in the microfinance context at the current stage. The major rating agencies' provision of advisory services when designing structured finance products should not be considered here since it was more a collaboration with large investment banks which probably did not need the rating agencies to build these innovative products but simply needed their seal of approval for regulatory reasons.

<sup>221</sup> The Rating Initiative (2010: 28) finds that besides itself and the Rating Fund II there are at least 34 organizations co-funding ratings.

tioned that they primarily used ratings, and for the same reason encouraged MFIs to receive them, because on this basis they developed a strategy or specific activities to improve their performance on this basis, if necessary also by providing additional funding for technical assistance (Interview 3).

Nevertheless, the expectation of receiving (or being otherwise excluded) from additional funding is the predominant motive for MFIs to receive ratings and probably also to act upon the “recommendations” made – an appraisal is also shared by some specialized raters. According to the representative of Planet Rating in Peru, 60% of MFIs received ratings for funding purposes only and because investors asked for it. Only 15% did it primarily in order to improve their organizational structure and performance (Interview 15).<sup>222</sup> Hence, it is not surprising that specialized raters use the funding argument as a “sales pitch”, believing, however, that their evaluations have an effect on the behavior and performance of MFIs.

Ironically, the advertisement slogan (and the related position of power of rating agencies) might be one of the reasons why very small, immature MFIs, which potentially benefit more from the consulting component, abstain from receiving ratings out of fear that their rating grades would turn out very low (Interview 3). MFIs are aware of possible disadvantages arising from ratings as far as the Control Function is concerned. For instance, one MFI stated that, while generally agreeing with the rating agencies’ appraisal, there were management aspects the MFI could not or did not want to change. Yet, this was not considered critical since the remarks only covered minor issues (and could thus be ignored). If it embraced major risks instead, the evaluations “*suddenly would simply not be useful to us*”<sup>223</sup> (Interview 9). In case MFIs suffer major weaknesses considered especially important by the specialized raters, but their overcoming would signify serious and delicate changes, the control component becomes even more obvious. It can be assumed that changes become particularly critical whenever they affect the people involved, namely regarding the governance and management structure (opposed to mere management tools) of MFIs. For instance, the only MFI expressing almost hostility towards specialized rating agencies and largely neglecting the usefulness of ratings, received a rating report where particularly the governance structure and the prominent position of the executive manager (lacking a profession-

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<sup>222</sup> Another indication that the improvement of performance is not the priority for small MFIs when demanding ratings is the fact that institutional diagnostics, which disclose in a much more detailed way the areas of improvement, are not the most demanded. Only 23 of the 431 financial evaluations listed on The Rating Initiatives website were labeled as this type of assessment; see [http://www.ratinginitiative.org/index.php?id=5&dbreports\[sortColumn\]=5&dbreports\[sortOrder\]=A](http://www.ratinginitiative.org/index.php?id=5&dbreports[sortColumn]=5&dbreports[sortOrder]=A) (accessed May 30, 2011).

<sup>223</sup> “ [...] *claro si fuera significativo, simplemente de repente estas evaluaciones de riesgo no nos convendrían a nosotros, ok?*”

al financial background) were observed. Yet, he felt that he had to receive a rating because everybody else did so, too (Interview 21).<sup>224</sup>

Whether ratings are an adequate and efficient mechanism to induce major changes within MFIs is not clear. One can assume that the disciplining mechanism is more effective in a context where the diffusion rate of ratings is more pronounced, such as in Peru. It is more effective in case MFIs actually believe that the rating grade influences the access to or exclusion from additional or existing funding respectively. For instance, the weak governance and management structures of many African MFIs was highlighted as one major reason why these MFIs were not eligible for MIV financing (MicroRate 2011i: 6). It was also the region where the demand for (update) ratings suffered its most pronounced decrease in recent years (see Chapter 2.2.2), partly because MFIs did not believe that ratings had an influence on the access to funds (The Rating Initiative 2010: 36). For these MFIs, equity investments and the potential control through strong and powerful shareholders, flanked by technical assistance were regarded essential for their development. Here, rating exercises probably can only have a limited, complementary role.

This might be one of the reasons why Hatarska (2009), in quantitative approach, finds that ratings only had a limited (if any) effect on MFIs in terms of increased outreach and profitability.<sup>225</sup> Garmaise and Natividad (2010: 2580), however, do find a relationship between ratings and operational efficiency in terms of clients per credit officer. According to Hatarska (2009: 979), a possible reason why effects on MFIs might be limited are the explicit and implicit guarantees provided by donors who, because of their mission, might recapitalize bad performing MFIs, and hence, protect commercial investments.<sup>226</sup> One could add that à priori the effects of ratings also depend on donors and (social) investors and their goals (including the relative importance of financial versus social objectives). The effects depend on the willingness of donors to stop financing MFIs who do not respond to standards set by the rating agencies which are considered essential to

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<sup>224</sup> The MFI manager further mentioned that he would be seen as a “*strange animal*” (“*un animal medio raro*”) in case he abstained from being rated. Yet, he did not care which rating agencies did the evaluation, nor did he find the observations useful, with a few exceptions. He questioned whether rating analysts could be experts in all related fields they try to analyze while other MFIs regarded the level of preparedness of rating analysts as high. The information about the observations made by the respective rating agency were taken from the rating report which is publicly available but, for the purpose of anonymization of the interview partners, will not be disclosed here.

<sup>225</sup> Yet, another reason for this might be that the outcome indicators are not well chosen. Hatarska chooses ROA equaling profitability with sustainability. Furthermore, she argues that ratings should have an effect on outreach in terms of number of borrowers because this is supposed to be the main objective of MFIs and those supporting them. Yet, these are neither necessarily the indicators which could be easily influenced by MFIs in the short-term nor the decisive ones for an MFI’s repayment capacity investors would then react upon.

<sup>226</sup> Notably, Standard & Poor’s (2007: 30) assumes just the opposite, especially in times of crisis. Yet, in S&P’s methodological outline for MFIs the rating agency, too, acknowledges the role of funders with a social agenda providing long-term debt even in times of scarce liquidity (Standard & Poor’s 2009b: 8).

improve their performance. For instance, Cull, Demirgüç-Kunt et al. (2009) suggest that some MFIs might be pushed towards sustainability, when easy and cheap money was not available anymore. Again, the relevance of ratings as a disciplining device is also linked to the logic of commercial capital markets as well as rating-based regulation and is less efficient in a context defined by different rules.

Finally, rating reports were also presented to the board of directors (Interviews 1, 14, 16 and 17) the upper management has to respond to. Yet, only in one case it was mentioned that ratings were sometimes used to put pressure on an MFI's management (Interview 16). In Peru, this might be also due to the reason that so far most MFIs have not yet suffered downgrades but kept improving. It also depends on the governance structures of MFIs and especially the strength of the board and the interests of their members. However, it is at least theoretically an instrument which could be used directly to exercise control.

#### *Ratings as an advisory service for less mature MFIs*

Even though ratings might be little effective in imposing larger organizational changes, the big majority of MFIs interviewed in Peru appreciated them as an objective external evaluation and means for comparison with their peers and to learn from international best practices. Thus, they used ratings as an advisory (or consulting) service. Five rather small MFIs even took direct measures to follow some of the "recommendations" made by the rating agencies, either by improving their management information systems (Interviews 24 and 30), by re-defining their human resources policy (Interview 12) or by (re-)defining specific indicators to assess the quality or efficiency of lending technology (Interview 14 and 32). Furthermore, some MFIs stick with the same rating agency for consecutive ratings in order to track possible progresses (Interviews 12, 19 and 21). The latter was also mentioned as one factor to receive update ratings in the survey realized by The Rating Initiative (2010: 31) even though it stays behind the argument of investors requiring ratings. As far as the lending technology in general is concerned, ratings might be particularly relevant in countries where the microfinance sector is less developed (for example Mexico and Brazil) and MFIs sometimes did make a distinction between microcredits and consumer credits and suffered a lack of knowledge about adapted credit technologies (Interview 5).

Yet, with a higher degree of professionalism the usefulness of financial ratings as an advisory service diminishes (Interview 19). Rating agencies learn from "best" performing MFIs, then passing the generated knowledge on to less developed MFIs. Accordingly, for larger MFIs in Peru remarks made by raters were of a rather general nature; MFIs in many cases were already aware of (Interviews 10, 14, 16, 17, 27 and 31) yet sometimes forgot to take care of in their day-to-day

business (Interview 16).<sup>227</sup> As far as social ratings are concerned, the relatively high importance of the consulting function might also apply to some larger MFIs whose principal reason to receive a social rating, in contrast to the motivation of receiving financial performance ratings, was to learn about social performance measurement. They expected synergies between their financial and social performance (Interview 17). Harris and Summerlin (2011) confirm this impression. They state that for the majority of MFIs which participated in their survey the principal motive to receive a social rating (most of them relying on subsidies though) was to better understand social performance indicators and how they could be managed and improved. Yet, in Peru, the smaller (probably more flexible) NGO MFIs were again the ones which directly applied changes in measurement policies and indicators (Interview 12, 19 and 30).

#### *The limited relevance of ratings regarding the control of asset managers*

Finally, ratings also serve as a mechanism for investors to control their asset managers (be it external asset management firms or employees). Separating the investment decision from the risk assessment helps preventing that asset managers take unduly risky investment decisions in the expectation of higher returns without being liable for related losses (see Chapter 3.5.3). In micro-finance, the use of ratings by primary investors to monitor or discipline asset managers (or better asset management firms) does not appear to be pronounced either. In many cases ratings were not an obligatory requirement and asset managers and MIVs already followed a rather conservative (instead of speculative) investment strategy (even though more representative research would be necessary to provide a clear answer, including the gratification structure of micro-finance asset managers). Socially-oriented investors who are willing to invest in smaller (and thus supposedly riskier) MFIs have lower return (and sometimes repayment) expectations. For instance, one interviewed investment analyst mentioned that one of their funds, which is designed to finance small and less mature MFIs, does not have any objectives as to envisaged returns but rather sets maximal loss thresholds (Interview 6).

However, as far as the more commercial funds are concerned, a rating could serve as a justification for investment analysts vis-à-vis their superiors to start an in-depth analysis of an MFI (Interview 6). Likewise, rating reports (if available) were handed out to credit committee members as a second opinion so that more serious questions could be asked if an MFI had received a rather low rating (Interview 7). Ratings were used as an internal control mechanism, yet, so far hardly in a systematic way. Instead, in one case, investors found an unusual solution for dealing with the internal conflict of interests of asset managers. While the due diligence was realized by employ-

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<sup>227</sup> In these cases, ratings can be useful as an (internal) control mechanism. For instance, one general manager of an MFI also mentioned that the rating was useful for internally justifying corrective measures vis-à-vis its middle management (Interview 16). It has to be noted, however, that in this specific case the general manager was relatively new in the institution and apparently faced the problem that its middle management sometimes questioned her authority.

ees of the asset management firm, the credit committee was composed by external, independent members assigned by their (rather large) principal investors<sup>228</sup>:

*“The credit committee is a rather strong authority in our case, precisely because it is independent”<sup>229</sup> (Interview 6).*

Again, the relatively low importance of ratings compared to “the mainstream world” in this setting might also be linked to the past performance of MIVs and asset managers who have not suffered major losses because of MFI defaults so far. Until recently, investors did not have concrete reasons to distrust their agents’ judgments. This might change with the increasing number of MFIs facing a higher credit risk or even MFI defaults. For instance, MicroRate (2011i: 11) indicates that some investors already started requiring more detailed reports when supporting new credits after the first “credit crunch” experienced in the microfinance investment market in 2008 and 2009 (see Chapter 2.2.1) – including a higher demand for social metrics. It would be interesting to assess in the future whether the increasing reporting requirements will include rating reports provided by (specialized) rating agencies.

## **7.2 Functionality of Microfinance Raters regarding their Performance and Reliability**

The previous sections discussed the functions (and if directly related also functionality, for example, when referring to the effects of ratings on funding costs) of ratings in microfinance with regard to their relevance in the specific microfinance context. This sub-chapter is dedicated to the analysis of the performance of rating agencies as a major driver of their functionality. Rating agencies exclusively dedicated to rate MFIs will receive special attention since they are currently the ones rating the largest number of MFIs. They are compared to conventional raters as far as their business model and the product features are concerned. As in the previous sections, the expectations of different stakeholders are also taken into account. The sub-chapter provides an answer to the question whether specialized rating approaches and organizations are needed in the microfinance context. This also leads to a re-interpretation of the Information Function. It also addresses the challenges specialized rating agencies are facing at a current stage.

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<sup>228</sup> In this case the major investors into the respective microfinance funds are commercial banks from the Netherlands.

<sup>229</sup> *“Das Kreditkomitee ist eine ziemlich starke Instanz bei uns, weil die eben unabhängig ist.”*

### 7.2.1 The Information Function – Ratings or Audits?

This sub-chapter argues that ratings provided by specialized rating agencies are valued by some stakeholders because of their in-depth research. This allows them to release and collect information investors do not collect themselves, and thus, are more functional than those offered by (local) mainstream raters. Rather than their judgments (and consequently the rating grade), it is their performance as “auditors” which brings an added value. This “Auditing Function” is even more pronounced when it comes to evaluating the social performance of MFIs. On the other hand, considering their Orientation Function, ratings offered by specialized raters are less functional than those of (mainly global) mainstream raters when addressing the potential orientation needs of investors. This is due to their limited degree of standardization. Regarding social ratings, specialized raters additionally face the difficult task of bringing together heterogeneous objectives when producing standardized social metrics. Even though the qualitative and quantitative information in the rating reports can be useful, the rating grades as the culmination of the standardization process can be misleading. This depends on the specific objectives of different investors and donors.

#### *The added-value of in-depth research and the production of validated information*

Starting with the **Information Release and Information Collection Function**, rating reports of specialized raters were valued particularly because they covered “*a lot of qualitative information, which for us is also very important*”<sup>230</sup> (Interview 6). Yet, it is not primarily the quantity of information (and hence, the length of the reports, for example)<sup>231</sup> but its reliability that matters. The importance of producing reliable qualitative information is also reflected by an initiative which was initiated by the supporting network COPEME in charge of the voluntary “supervision” of credit-granting NGOs.<sup>232</sup> In 2000, at a time where ratings for MFIs were not yet a wide-spread phenomenon, the organization started cooperating with Peruvian financial auditors (and financial support of IDB). The latter prepared audited financial statements for member-institutions in most of the cases were previously not available. Besides, the network trained financial auditors to additionally assess the management capacities and lending activities of MFIs (“*we call them audits*”).

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<sup>230</sup> “...es geht viel um qualitative Informationen, was bei uns ja auch sehr wichtig ist”.

<sup>231</sup> If the disclosure of qualitative information matters, one might assume that more detailed reports (as the ones delivered by MicroFinanza Rating, Planet Rating and M-CRIL) are more functional than others (as those provided by MicroRate and, especially, most of the ones of (local and international) mainstream raters). The impression was confirmed by only one MFI mentioning that some investors indeed preferred the reports by Planet Rating over the ones by MicroRate because of their completeness (Interview 17). However, the same MFI also stated that it depended on the preferences of individual analysts. None of the investors interviewed stated to favor any particular report style (mostly not even being aware of the differences).

<sup>232</sup> Even though not officially recognized, COPEME evaluates microfinance NGOs using the criteria of SBS in order to increase transparency and credibility of this sub-sector.

of management, financial statements and portfolio”<sup>233</sup>; Interview 11a). These audits were supposed to evaluate the same areas covered by rating agencies. Therefore, the institution did not actively promote ratings among its members since it felt that they would not provide any added value.<sup>234</sup> Nevertheless, specialized rating agencies were considered better prepared (or experienced) and had a deeper insight into MFIs (Interview 12). The same applies to the social ratings compared to social performance audits offered by CERISE (see Chapter 6.2.1), for example (Interview 30). Accordingly, Harris and Summerlin (2011: 13) find that here, too, the report was considered the most useful part by donors and investors. Furthermore, investors and donors considered the reports based on surveys (enhanced social ratings, see Chapter 6.2.2) as an independent verification (an audit) of what MFIs claimed to do rather than a sole review of social performance policies more useful. Rating agencies have an “Auditing Function”. These extensive audits are apparently something investors cannot or do not want to do during their own due diligence. Particularly with social rating reports, externally validated information about the social performance of MFIs was produced for the first time (Interview 3).

The importance of the profundity of underlying research specialized raters then base their judgments on, was also highlighted regarding the financial performance of MFIs. The departing point for specialized microfinance raters were loan portfolio audits aiming at producing the necessary qualitative and quantitative information as to the portfolio quality of MFIs: Qualitative through the thorough review of lending methodologies and practices, quantitative through the uniform calculation of relevant indicators not already covered in audited financial statements.<sup>235</sup> To adequately assess the lending practices, time-consuming field visits of different MFI branches and particularly selected MFI clients are considered essential. The profundity of the research of specialized raters and particularly the time spent with an MFI was mentioned as the key factor valued by investors. Especially more commercial investors with lower interest margins state they do not have the resources to spend as much time with an MFI as the specialized raters (Interview 1 and 7). The interviewed investors spend one to three days with an MFI when realizing their due diligence (Interview 3, 6, 7 and 9).<sup>236</sup>

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<sup>233</sup> “*Le llamamos auditoria de gestión y estados financieros y de cartera.*”

<sup>234</sup> However, another influencing factor of neglecting the added value might have been that the network itself provides investment advisory services.

<sup>235</sup> Aldo Moauro (see supra note 139) mentioned that the first attempts of the specialized raters could not be considered ratings but were rather a performance evaluation in terms of portfolio quality. One of the accredited rating agencies in Peru was convinced that nowadays this was still the case (Interview 35). And Díaz Ortega (2006:8) attest in his project report of the IDB project “Risk Assessment of Microfinance Institutions” that initially the methodologies of specialized raters did not recognize other risk categories but that it had changed recently.

<sup>236</sup> Only one investor stated that in single cases of large MFIs he would abstain from a visit, if the information previously collected indicated that no further assessment was necessary (Interview 34). However, this case is specific since this government-owned bank had a special agreement for exclusive access to all

Local mainstream raters also highlighted the importance of client visits when assessing an MFI, which was furthermore stressed as one of the major differences between MFI and commercial bank rating exercises (Interview 28 and 35). Yet, this does not translate into a more profound research in terms of time spent on-site. The Peruvian mainstream rating agencies stated they spend two to three days (the latter especially in the first visit while the following visits might be shorter) (Interview 4, 28 and 35), which is similar to the time spent by the interviewed investors. The specialized rating agencies, however, spend four to eight days on-site. This is in any case longer than the time spent by the local raters (MicroFinanza Rating 2010b; Planet Rating 2009, Interview 5).<sup>237</sup>

Whether global mainstream raters (will) find it necessary and commercially viable to dedicate the necessary resources for analyzing an MFI with the same profundity in the future has yet to be shown. In Peru, one of the interviewed raters clearly sets himself apart from the functions of auditors when asked about the importance of clients visits:

*“In reality it has to be mentioned that a credit rating is not an audit. Let’s say, an audit includes controls. In theory they inspect everything. We are not auditors, right? We make an opinion on the basis of necessary information, our experience and our market knowledge”*<sup>238</sup> (Interview 4).

This is to a certain extent in line with the discussion of the role of rating agencies in the mainstream market. The global major raters also set themselves apart and are sometimes not even expected to serve as auditors, even though their reputation suffered – at least temporarily – whenever they based their opinions on insufficient or incorrect information (see Chapter 4.2.3). In the case of microfinance, however, the auditing component appears to be much more relevant, particularly when it comes to loan portfolio audits assessing the heart of an MFI’s business.<sup>239</sup>

#### *The importance of a high degree of standardization*

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evaluation material from the Peruvian banking supervision, including a comprehensive rating report (prepared by the SBS) about the individual MFIs. Only regulated MFIs were eligible for financing, and the Peruvian supervision body carefully assesses every MFI including a yearly onsite-visit of seven to ten days and a monthly collection of performance indicators for ongoing monitoring (Interviews 2 and 34).

<sup>237</sup> Regarding the number of analysts involved, there was no difference between the local and the specialized rating agencies (at least in the two cases interviewed on this question): Both use to send two analysts to each rating mission (Interviews 5 and 28).<sup>237</sup>

<sup>238</sup> *“En realidad también hay que senalar que informe de clasificación de riesgo no es un informe de auditoría, no? O sea, en un informe de auditoría haces, este, controles que en teoría auditan todo, no somos auditores, no? Hacemos una opinión a base de la información que es necesaria. Y con la experiencia y nuestro conocimiento del mercado, no?”*

<sup>239</sup> This will be discussed further below.

Within the mainstream capital markets, other functions than the Information Release and Collection Function became more and more important. This applies to the **Orientation Function** which serves to provide an efficient means for comparison. Here the degree of standardization, not only of the underlying information but of its expression in a single grade is of importance. This includes the comparability of rating grades provided by different raters, which is a dimension considered important by mainstream capital markets participants (see Chapter 4.1). Within the microfinance context, specialized raters lack this comparability. As far as the financial performance is concerned, the limited possibility of comparing different specialized raters finds its most obvious expression in the application of different rating scales (see Chapter 6.1.1). For those rather large MIVs exclusively dedicated to microfinance investments without need for orientation, this is not a major issue of concern. For instance, one of the interviewed MIVs stated that, even though they were aware of the ongoing discussion that specialized raters should homogenize their scales, they questioned whether it was really worth the effort (Interview 3). However, for smaller MIVs lacking the overview of different microfinance markets, standardized rating grades and scales are possibly of higher importance. This applies especially to MIVs which are not a priori focused on a specific region and want to scan all possibly eligible MFIs. Yet, MIVs encounter a relatively segmented rating market with each of the specialized raters being more active in one region than in another (see Chapter 6.1.1). In Peru, in the context of rating-based regulation, the application of a homogenous rating scale is even a precondition (see Chapter 6.1.2) MicroRate will have to respond to after its recent approval by SBS. Yet, to achieve full comparability, raters would not only need to standardize the expression of their judgments but also the one of their underlying methodologies. As long as specialized raters are competing with each other, however, this degree of standardization is difficult to achieve. MicroRate and M-CRIL made a first step towards a consolidation of the microfinance rating industry. Yet, so far, the formation of the rating agency Microrating International (see Chapter 6.1.1) has rather appeared to be an agreement (a cartel) than a real intent to merge – considering their still very different procedures and reports. The former abstains from entering into the Indian market and the latter into the Latin American. Alternatively, specialized raters could try to establish comparability ex-post by “proving” that their grades ultimately reflect the same outcome (the default probability of an issuer). This is the strategy followed by the major U.S. raters, yet, for specialized raters this appears to be even more challenging, as will be discussed further below.

In contrast to the specialized raters, the (global) major raters cover a much larger number of different debt products and sectors. This again might be important for those investors (and asset managers) who are not a priori bound to the microfinance sector but want to compare MFIs with other asset classes. Accordingly, S&P enters the microfinance scene with the promise that their ratings

*“allow investors to compare [an MFIs] credit risk with any other rated MFI or non-microfinance rated investment opportunity. An example of this could be a comparison of [an MFI] with an investment opportunity in the same rating category such as the “B” rated Hunter Fan Company, a ceiling fan designer and marketer in the United States”* (Esposito, Kuchubka et al. 2008: 51).

If mainstream investors decide to enter directly into the microfinance market on a larger scale, specialized microfinance raters face a probably insuperable competitive disadvantage regarding this specific function if they try to run against the major global raters – even if they apply more adequate methodologies. Standard & Poor’s, probably inspired by microfinance practitioners participating in the “Microfinance Rating Methodology Working Group” (see Chapter 6.1.2), even considers to offer a combined rating approach with the application of a specialized MFI-focused rating scale (along the traditional scale) which would facilitate a cross-border comparison of MFIs not falling within the same global rating category (Standard & Poor's 2007: 23). Yet, it is not clear whether the rating agency actually keeps with this promise. Considering the psychological dimension of how individuals respond to frames (see Chapter 3.3.2), it is disputable whether the approach of MicroRate (as well as M-CRIL) is a good selling strategy. To highlight the difference of their approaches, compared to the ones of the major raters, they assign grades in Greek letters (Farrington 2005: 2). Planet Rating, on the other hand, consciously adapted its rating scale to the one of major credit rating agencies including the introduction of a finer differentiation with “+ and –” notches (Planet Rating 2008: 4-5).<sup>240</sup> This approach was also chosen by MicroFinanza Rating right from the start.

*The difficult task of standardizing social performance information for stakeholders with differing objectives and beliefs*

To standardize information and particularly to subsume it in a single grade becomes particularly challenging whether not only different stakeholders are to be served but also very different performance dimensions to be covered. The majority of stakeholders currently active in the microfinance sector agree that microfinance (should) have a double, if not even triple-bottom line. In this regard, the specialized rating agencies definitely have a role to play since the social dimension is not covered by mainstream raters. At least those interviewed in Peru did not show any interest in offering this type of service (Interview 4, 28 and 35). Yet, in the face of possible trade-offs and different assumptions on how a positive impact is more likely to occur, microfinance raters face the challenge of balancing different stakeholders preferences. Possible trade-offs exist between a) the financial versus the social performance, b) the different dimensions of social performance and c) the ecological dimensions in the case of triple-bottom line endeavors.

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<sup>240</sup> In its early reports Planet Rating assigned grades being a combination of letters and numbers reaching from G1 to G5 (e.g. Planet Rating April 2002).

Most investors and donors interviewed by Harris and Summerlin (2011: 10) would welcome an integrated rating product (covering both, the financial and social performance of MFIs). They believe that in many cases weaknesses on the financial side would be more evident when placed into the social context. The possible synergies between financial and social performance have also been highlighted by Copestake (2007) as one major advantage of social performance management approaches. His findings are based on the experience of 17 pioneering MFIs and MFI networks active in consciously managing their social performance. For Beisland and Mersland (2011) the negligence of (client focused) social performance indicators (here measured as average loan size) when rating the financial performance of MFIs is even a reason to believe that specialized rating approaches in microfinance make no sense at all.

However, specialized rating agencies do not know how an integrated rating approach should look like.<sup>241</sup> When asked why MicroRate started offering separated social ratings, despite the fact that their conventional performance ratings already covered the social responsibility dimension (see Chapter 6.1.1), its director for Latin America stated that “*sincerely, it was a bit the pressure of the market. The market asked for it*”<sup>242</sup> (Interview 5). However, it is the methodology of MicroRate which most obviously differs from the one of the other three specialized raters (see Chapter 6.2.2). “*The market does not know what to ask for*”; was the reason provided by the representative from Planet Rating:

*“I mean, the meaning of social performance is not something established. I mean, it is established what you have to evaluate but it is not known what happens if I do not evaluate it. How do I have to evaluate it? Do I have to generate indicators or not? This is why three different methodologies can coexist”* (Interview 15).<sup>243</sup>

Accordingly, Harris and Summerlin (2011: 9-10) find that donors and investors do not understand what it is that rating agencies rate and how the different indicators are weighted, even though they principally believe that social performance ratings can shed light on the social performance of MFIs. Besides, they state that investors found reports were too detailed and contained too many indicators. As stated before, most investors would prefer ratings based on a limited number of key success factors. However, it is just the definition of success which varies depending on specific social priorities. The question arises whether there will ever be “*generally accepted social values to different socioeconomic contexts*” and “*generally accepted values of outreach and pov-*

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<sup>241</sup> Yet, another reason for holding the two products apart, which should not be neglected, is that they can increase their earnings.

<sup>242</sup> “*Pues la verdad es un poco la presión del mercado no? El mercado nos pedía*”.

<sup>243</sup> “*El mercado no sabe que pedir. O sea, no ha establecido que es el desempeño social. O sea ha establecido lo que se tiene que evaluar pero no ha establecido que pasa si yo no evaluo esto. Como tengo que evaluarlo? Tengo que generar indicadores o no tengo que generar indicadores? Entonces, por eso pueden coexistir tres metodologías diferentes.*”

*erty reduction to different MFI targets and missions”* (MicroFinanza Rating / M-CRIL 2009: 44) to be evaluated and summarized in a single grade.

The least controversial dimension is probably the relevance of testing the compliance with the SMART client protection principles (see Chapter 6.2.1). These gained support by a wide range of microfinance stakeholders and are also accounted for in one way or another by the specialized raters. While it is not clear what MFIs should do, it is quite indisputable what they should not do. Therefore, in 2010 the Indian microfinance consultancy M2i Consulting started offering a “Microfinance Code of Conduct Compliance Assessment” (COCA) limiting itself to a “do-no-harm” approach assessing the SMART dimensions (e.g. M2i Consulting September 2010). And Harris and Summerlin (2011: 10) report that many investors and donors would welcome the development of a set of definitions and indicators to measure the compliance with these principles. Whenever broader social dimensions are to be covered, though, the issue becomes more intricate.

Looking at the development of the “big sister” of social performance ratings, it stands out that despite the euphoria about the quantitative potential of CSR ratings with “*pre-defined uniform calculation methodologies*” and “*natural market forces [setting] the pace for adoption*” (Wisebrod 2007: 34, 38) little progress towards uniformity in the assessment of CSR can be observed. Besides, the number of organizations involved in the assessment of CSR is increasing. For instance, in 2006 Schäfer, Beer et al (2006) analyzed 58 institutions operating independent CSR ratings on an international scale out of nearly 2000 firms producing CSR reports globally in 2010 (Scalet and Kelly 2010:69). Even though most of the rating institutions work with “quantitative models” (instead of purely collecting and qualitatively processing the information), many raters have been continuously changing their rating models since they were founded (Schäfer 2005:113). The large number of CSR reporting organizations (using different approaches) alone already indicates they respond to different masters. CSR rating approaches vary widely depending on the stakeholder they are looking to serve (for example, consumers, future generations, employees) (Scalet and Kelly 2010:70). As a result, big companies often have various CSR ratings. Will this also happen in the context of microfinance? In Peru, for instance, the microfinance bank MiBanco received an additional CSR rating by the Spanish organization Management & Excellence (2009) which focuses on assessing the corporate social responsibility of commercial banks in general.

Specialized microfinance raters claim that they do not judge the mission of MFIs but only the compliance to their individually defined missions. Hence, they insinuate that they follow a descriptively or economically-oriented rather than a normatively oriented approach (see Chapter 6.2.2). This is generally in accordance with the principles of social performance management, majorly directed towards MFIs who want to improve their social performance. The strength of the assessment lies in the relative flexibility for MFIs to choose which dimensions should be assessed and how specific indicators are to be identified and measured (Copestake 2007). This pro-

cess depends not only on an MFI's mission and the corresponding mission statement but also on its institutional facilities and, most importantly, its specific context. Yet, purely descriptive models might not be satisfying for investors and donors who seek a quick evaluation in a highly standardized manner. Rating agencies also have to reflect the mission(s) and specific social objectives and concerns of these stakeholders, at least if the rating grade is considered important and it is not traceable in detail how rating agencies derive their judgments. Indeed, rating agencies do not strictly limit themselves to simply the assess the coherence between MFIs' missions and specific social objectives (for example financial inclusion, job creation, empowerment, education, health) or the coherence between the intended target group (for example micro-entrepreneurs, rural clients, farmers, women, displaced persons, indigenous, children) and actual clients reached.

This finds its most obvious expression in the integration of the MFIs' contribution to financial inclusion assessed by all specialized raters (in some way or another) as an important output dimension.<sup>244</sup> While the "financial inclusion agenda" might indeed be the dominant position within the microfinance cosmos, different stakeholders still have varying priorities as to the different dimensions of outreach. Some might put a strong focus on the number of clients reached who were previously excluded from formal financial services (breadth of outreach). Others (additionally or not) put a stronger focus on the poverty level of clients (depth of outreach). Some prefer a rather minimalist approach where MFIs limit themselves to provide financial services – for some of them the offering of a broader range of financial services might be a must (scope of outreach). Others deem it necessary that additional services (for example, business development services and trainings) are offered so that clients can set their microcredits in value. Since the 1990s there has been an ongoing discussion about whether MFIs should become engaged in some sort of "microfinance plus" activities or rather follow a minimalist approach (e.g. Bhatt and Tang 2001; Morduch 2000) while research on the possible trade-offs has remained limited (Lensink, Mersland *et al.* 2011). What is important to recognize is that each strategy is based on specific assumptions on how positive impact is most likely to be created.<sup>245</sup> However, the dispute among different stakeholders on the best way to achieve a positive impact has not been settled. Instead, lately the limitations of microfinance (especially microcredit) including the assumptions on the very high numbers of people in need of these products have been questioned (see for example the collection of essays written by various practitioners and academics in Dichter and Harper's (2008) "*What's wrong with microfinance*"?). Bateman and Chang (2009)<sup>246</sup> are the most fierce critics of the "financial inclusion agenda". They state that the focus on credits (mostly channelled

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<sup>244</sup> The inclusion of Millennium Development Goals of Planet Rating is another example even if the dimensions are not factored to a major extent.

<sup>245</sup> Mayoux (2005) provides a good overview of possible impact chains (here for the economic, social and political empowerment of women), underlying paradigms and assumptions as well as reasons why the automatic positive impact correlations should be questioned.

<sup>246</sup> See also Bateman (2010).

into the services sector) and on very poor clients is sometimes actually more likely to create negative impacts, countervailing broader local or regional development. The latter might be better achieved, for example, by financing job-creating SMEs instead of self-employed micro-entrepreneurs.

So far, (most) specialized raters have largely followed the majority view of SPM advocates. The reason is that these are the most active in “defining” social standards rating agencies use as a starting point with less interested parties having little incentives to answer back. One major focus of the SPM movement is to measure the depth of outreach. For example, in the Social Performance Indicator Template developed by CERISE (see Chapter 6.2.1) much attention is given to the depth of outreach by asking “Does the MFI select operating areas based on criteria of poverty/exclusion?”, “What percentage of clients come from poor/excluded areas?”, “Does the MFI serve clients living in rural areas?”, “What percentage of clients are women?”, “What percentage of clients are from socially marginalized and/or vulnerable groups?”, etc. and the adaption of services to these client groups (CERISE n.d.-a). Here, rating rationales clearly become a normative dimension. This also applies to the assessment of an MFI’s breadth of outreach which becomes an issue if, for example, bancarization is not among the envisaged goals of an MFI. For instance, the only complaint of one NGO MFI interviewed in Peru as to the social rating it received was that its low breadth of outreach was criticized. The MFI did not want to reach an ever larger number of poor women but rather deliver integrated services and programs for their empowerment. While the microfinance part, evaluated as a separate entity, could grow more, the NGO was constrained by a lack of funding for their other activities which they deemed more important:

*“[...] but we had discussions. One was about outreach, I remember, I mean, they told us that they had to evaluate our outreach relative to the poverty level of the whole country [...] how do you include this in your objectives to achieve this, they told us, right? [...] because you put it, so to say, as an objective [...] I believe that, since the work with methodologies and these are international standards [...] I imagine the international perspective is what counts in this sense of poverty, right? [...] and they evaluate this totally independent of your organization”<sup>247</sup> (Interview 12).*

Besides the difficult task to balance different social goals, microfinance raters face the challenge of a) finding adequate indicators and b) measuring them accordingly. Concerning the poverty level of MFI clients in order to assess the depth of outreach, for example, ready-at-hand proxy

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<sup>247</sup> “Pero hubieron discusiones y una fue sobre el alcance, me acuerdo, o sea, porque ellos te tienen que calificar en el alcance en relación a todo el nivel de pobreza del país, nos decían [...] decíamos como esta en tus objetivos llegar, decían, no cierto? [...] porque tu eso me lo pones como entre comillas como meta digamos [...] creo que como son metodologías y son estándares a nivel internacional no? Y jala lo internacional, me imagino, en ese sentido de la pobreza no? Y lo relacionan como el total, independientemente de tu organización.”

indicators such as average loan size or initial loan balance could either overstate, understate or give mixed messages regarding the depth of outreach. This is the most important reason for specialized raters to conduct own, however, expensive<sup>248</sup> surveys (MicroFinanza Rating / M-CRIL 2009: 38).<sup>249</sup> Yet, up to this point they seem to not have found an approach yet to quantify other developmental objectives, such as the effective support of SMEs, envisaged by some investors. Rating agencies have found a way by simply judging the same indicator differently. They would still take, for example, average loans size as an indicator for measuring the depth of outreach but without expecting (and thus judging accordingly) that an MFI focusing on SMEs reaches the same level of depth as an MFI targeting “the poorest of the poor” (MicroFinanza Rating / M-CRIL 2009:45).<sup>250</sup> This rather opaque procedure, however, could not resolve doubts among investors that an increase in average loan size under the current rating methodology could reduce the rating grade of a respective MFI. This in turn would contradict the development goal of these investors to provide more capital to successful (and hence growing) enterprises over time (Harris and Summerlin 2011: 9).

The trend to quantify every possible social objective which could then be managed was identified by one MFI as something rating agencies as well as the international microfinance community aim at (Interview 21). Yet, this could be misleading, too. Quantified social indicators might not reflect the multiple ways a positive change can be achieved. These ways are, however, often not traceable in detail. Above all, this applies to those cases where the mission of an MFI embraces a largely qualitative dimension (the example provided was the improvement of livelihoods of the poor in terms of increased autonomy) which can be interpreted in many ways. An MFI linked the social rating exercise with the much older and controversially discussed trend of assessing the impact of an MFI. It stated that the reliance on pre-defined indicators would rather “relativize” the social mission, especially since these indicators are not (and cannot be) proven to lead to a bigger social impact (Interview 21). Insisting that a quantitative measurement of social indicators is necessary in any case bears the risk that MFIs with more complex and more specific social missions (the example provided was to improve nutrition of children in a certain region) would receive lower rating grades than an MFI with a more basic mission (for example providing financial services to a certain segment of the population). This is the major reason why social ratings were not considered useful to measure the social performance by one interviewed investor (Interview 7).

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<sup>248</sup> Microfinanza Rating and M-CRIL (2009: 48) state that the costs for an enhanced social rating with own surveys lie between 11,000 USD and 20,000 USD with possible discounts if financial and social ratings are realized simultaneously.

<sup>249</sup> For a discussion about the inappropriateness of the average loan size in order to assess the depth of outreach see, for example, Copestake (2007).

<sup>250</sup> Aldo Mouaro from MicroFinanza Rating (supra note 139) confirmed this.

Another “balancing” or weighting problem, especially if an integrated rating product was to be designed, comes up whenever trade-offs between the financial and social performance are expected, also – though not exclusively – regarding the management level. A few investors or donors interviewed by Harris and Summerlin (2011: 9) worried that, with an integrated rating approach, the financial rating would “overshadow” the social performance. Some commercial investors, on the other hand, feared that an MFI’s management could be distracted from focusing on the institution’s financial sustainability. Some investors, for instance, raised their concern that rating agencies assess the existence of staff training on social performance even though there is yet no evidence that this would lead to improved services for clients, creating synergies between the financial and social performance. It is, however, an area MFIs would need to devote resources to, which might be better spent elsewhere. Rating agencies indeed have an impact on how MFIs distribute their resources. This is exemplified by one EDPYME interviewed in Peru which rejected the “proposition” of creating a separated management position for SPM. However, it assigned a controller within the internal audit department who would solely focus on the achievement of social objectives (Interview 19).

But there is more: Specialized raters also include broader categories of corporate social responsibility which even raises concerns among stakeholders generally in favor of SPM. Here, the balancing of different social performance dimensions is the area of concern, applicable also to stand-alone social ratings. Classical CSR criteria could outweigh the interest of clients compared to other CSR activities (Interview 11b). This would become, for example, a problem in those cases trade-offs in the triple-bottom line exist. For example, an increasing number of stakeholders agree (also encouraged by CGAP as the leading actor in microfinance to produce standardized knowledge) that MFIs should consider environmental objectives. There is a vast amount of grey literature on how this could be achieved. Yet, little empirical research has been conducted so far, as to how far “greening microfinance” stays in contrast to poverty reduction objectives (and the financial sustainability of MFIs). For example, Allet (2010) raises the issue that MFIs adopting environmental criteria in their loan screening process might end up excluding poor people because they lack the capacity to integrate environmental practices into their business. Or they oblige micro-entrepreneurs to adopt technologies culturally not acceptable.<sup>251</sup>

It is especially the opacity as to how rating agencies come to their judgment which was implicitly criticized by investors and donors and led to the fact that the rating grades were often not considered useful. Accounting for dimensions such as environmental responsibility, responsibility

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<sup>251</sup> Yet, it has to be mentioned that this would rather be a criticism towards the stakeholders’ focusing on this kind of indicators in a too enthusiastic manner rather than towards rating agencies taking up this trend. Nevertheless, the argument that balancing different social performance categories can be problematic remains untouched.

towards the community and staff, but also by putting too much emphasis on management procedures, might be even more disturbing for stakeholders driven by specific values and ethical concerns, regarding the business model of profit-driven, fast growing MFIs. The Mexican micro-finance bank Banco Compartamos has been repeatedly criticized for charging excessive interest rates that favor shareholders, employees and (possibly) future clients while exploiting current clients (e.g. Ashta and Hudon 2009). The high interest rates are also accounted for in the social rating provided by MicroRate in 2008 (MicroRate April 2008: 2). Nevertheless, the MFI receives four out of five stars attesting the MFI an excellent social commitment, apparently based on their advanced management methods. The Compartamos case somehow caused the uproar about commercialization and mission drift, endangering the good reputation of microfinance. Could this rating practice not countervail the trust of some stakeholders in these assessments, including those investors that care about their own reputation among the wider public? Here, a lack rather than excess of normativeness might be a reason of concern.

Microfinance raters are conscious of the need for a constant adaption of their social rating methodologies along the changing beliefs and values of microfinance stakeholders (MicroFinanza Rating / M-CRIL 2009: 48). Yet, they believe that *“if you don’t start it will never improve”*<sup>252</sup> (Interview 15). But to account for the difficulty of meeting different stakeholders’ expectations, one specialized rater took a step backwards and disintegrated its social performance rating grade. In earlier reports, Planet Rating only assigned one final grade (e.g. Planet Rating October 2008). With its updated social rating methodology, the rating agency does not only disclose grades and weights for single categories (which is not done by other raters) but also started assigning single grades for various indicators within one category (e.g. Planet Rating September 2009 and Chapter 6.2.2), leaving the final judgment to the respective stakeholder.

In sum, it appears that microfinance raters still have some way to go in order to find the specific indicators to be assessed to reflect the preferences of all, or at least the majority of stakeholders active in the field. Whether this can ever be achieved remains an open question. A larger degree of transparency regarding the methodologies, rating rationales and specific weights appears to be crucial, however, in order to encourage a participatory process of adaption. At a current stage, especially as far as an integrated rating approach is concerned, meeting the different stakeholder expectations rather calls for one sorting out “bad”, non-ethical behavior through the definition of “failure factors” (do-no-harm and act ethically). It also calls for an assessment how MFIs secure the prevention of these failures rather than spending many resources on assessing still diffuse factors of “impact” and “success”.

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<sup>252</sup> *“Si no se empieza nunca se va a mejorar”.*

### **7.2.2 The Certification Function – The Behavior of Rating Agencies and the Reliability of their Judgments**

In addition to the Information Function that also serves for giving orientation to investors, ratings also have a Certification Function. The boundaries between the Orientation and Certification (Sub-) Functions are fluid. They are not to be considered as “carved in stone” but understood as a useful differentiation within the proposed analytical framework when it comes to the analysis of critical issues regarding single functions and sub-functions. The difference between the two functions can be characterized as follows: The added value of the Orientation Function is the provision of standardized information where the rating grade can be simply regarded as the culmination of the standardization process. In the case of the Certification Function, the rating grade has a much more prominent position. It is the expression of a forward-looking opinion which is related to the notion of risk and the validity regarding some sort of probability. This probability is based on the (assumed) objective superior knowledge of rating agencies other market participants (especially investors) can then rely on.

Therefore, this sub-chapter is dedicated to the reliability of external risk assessments provided by different types of rating agencies. Two dimensions are important in this regard. Firstly, the sub-chapter discusses the reliability of rating methodologies. Secondly, the sub-chapter picks up the discussion of Chapter 4 concerning the reliability of major rating agencies in terms of their behavior and business model. It analyzes in how far this also applies to specialized rating agencies.

The main arguments put forward in this sub-chapter are that specialized rating agencies differ from conventional credit rating agencies in their methodologies and rating rationales in so far as they put a more explicit focus on key risk factors of MFIs’ (future) performance. They are more reliable, not only because of their experience and embeddedness within the microfinance sector, but also because of their auditing component regarding MFIs’ lending technology. However, the “right” weighting of different factors might be particularly difficult in the young and dynamic microfinance sector. Specialized raters will need to further regularly adapt their rating rationales alongside the complexity of the microfinance industry, also taking “classical” and external factors more into account than at the current stage. Furthermore, they face the challenge that their methodologies remain largely “unproven”, lacking the scientized image of major U.S. raters to reflect statistical probabilities. Finally, their conflicting roles as consultants and evaluators put their independency in question. Just like major raters, specialized raters face a conflict of interest as a result of the issuer-pays model. They might have even bigger problems with internally mitigating this conflict because of their minor size. Yet, they also have more to lose when deliberately providing unreliable information. At this point, no global supervision of specialized raters is in sight, but a rather close microfinance community is possibly keeping a critical eye on them.

### *The difficult task of balancing different risk dimensions*

Ratings are judgments. Assuming that uncertainty (or no information) rather than asymmetric information is dominating the global financial scene, it is not only (or even primarily?) the magnitude and scrutiny of information collection, but the “right” estimation of the factors influencing negative events that defines rating agencies’ reliability. Even though ratings issued by the major U.S. rating agencies are often treated as (some kind of) hard fact, they have a distinct judgmental dimension. As far as the corporate and bank ratings are concerned, Standard & Poor’s (2009f), for instance, refers to their methodology as the way their decision-making process is structured. The process might or might not (with the latter case prevailing) start with a “rating model”: “Ultimately, ratings are subjective opinions that reflect the majority view or the committee members” (FCIC 2011: 121). In the case of microfinance, S&P only mentions the usage of a statistical model for CDO ratings (see Chapter 6.1.2). The same applies to local Peruvian raters when it comes to weighting different factors:

*“[...] you reach a consensus, which is like developing a sixth sense. You discuss it in the committee and you issue a rating. But many times, if you say how much the capital adequacy weighs in the analysis, it is not a number. There are different factors. It is very difficult to define a number”<sup>253</sup> (Interview 35).*

Furthermore, the final rating grade is the result of intense discussions within the rating committee. It also includes a political rather than solely technical, expertise-based dimension – as the following statement exemplifies:

*“In the committee, there is an interesting competition which leads to the best final result. It is like with college professors at least, where, of course, I will not agree that the other raises [their client’s grade]. Because my client will start pressuring me if he feels that he is at the same level [than the competing issuer], and I will start defending myself”<sup>254</sup> (Interview 35).*

As far as the rating process is concerned, the overall importance of a qualitative and subjective judgement also applies to specialized raters, even though (at least) two of them (MicroFinanza

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<sup>253</sup> “[...] de ahí ya tu sacas un consenso, que ya es como desarrollar un 6to sentido. Se discute el comité y se otorga un rating. Pero muchas veces decir, cuanto pesa mi apalancamiento en tu análisis, no es un numero. Son varios factores, es bien difícil decir un numero.”

<sup>254</sup> “En el comité se presenta una competencia bien interesante que lleva a que el resultado final sea el mejor. Actúa como un colegio con profesoras por lo menos, y donde claro, a mi no me conviene que el otro suba [el rating de su cliente] porque mi cliente me empieza a presionar porque se siente al mismo nivel de la otra institución, yo también me empiezo a defender.”

Rating and Planet Rating) apply fixed weights to single rating categories. Notwithstanding, entrenched within the microfinance context, they might (and claim to, Interview 15) be more reliable when assessing the risk of MFIs. This is due to the fact that they are specialized, have a bigger experience in rating MFIs and conduct a more thorough research concerning key risk factors in microfinance. They are strongly embedded into the microfinance sector and can be assumed to closely follow the developments and discussions of the microfinance community on an international scale regarding the key bottlenecks of MFIs. For instance, the explicit focus on governance and management is coherent with the findings of all “Microfinance Banana Skins” surveys commissioned by CGAP.<sup>255</sup> The management quality and especially the poor professionalism of many MFI managers and insufficient management technologies can be found among the top ten risks in microfinance influencing other risks identified (for example, credit risk, ineffective strategies or insufficient product development that leads to unachieved growth) (CSFI 2008, 2009, 2010, 2011). Especially for smaller, less mature MFIs, putting a stronger weight on these factors can be assumed to deliver a more reliable picture on the future performance and probably also the likelihood of MFIs defaulting on their loans.

Local Peruvian raters, on the other hand, who are unspecialized base their analysis on the experience and knowledge gained while rating conventional commercial banks. The result is a different mindset than that of specialized raters. Also due to a pronounced lack of transparency when it comes to rating rationales and key assumptions, methodological differences are not traceable in detail, and comprehensive research on rating differentials among different rating agencies (if possible at all) has yet to be done.<sup>256</sup> It can be said that Peruvian raters put a stronger focus on the liabilities side of an MFI’s balance sheet (funding, liquidity and equity base). This is very much linked to the size of an institution and less on financial performance indicators such as profitability. As a consequence, several MFIs complained about the fact that microfinance organizations per se could never receive as high rating grades as local commercial banks, even though they were more profitable than the latter (Interviews 17, 18, 23 and 33). They also state that there should be different evaluation criteria also taking into account that microfinance had a younger history than commercial banks.<sup>257</sup> According to some local raters, however, MFIs need a higher

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<sup>255</sup> For an explanation of the Microfinance Banana Skins see supra note 36.

<sup>256</sup> Beisland and Mersland (2011) state that, as far as quantitative indicators are concerned, specialized rating agencies, just as major raters, strongly focus on an MFI’s size. Furthermore, they indicate that there are differences among specialized raters. Planet Rating, for example, puts more emphasis on efficiency and the historical development (such as growth) while MicroRate factors capital adequacy (in terms of debt to equity) more than other raters. And M-CRIL puts a stronger focus on credit risk and less on profitability.

<sup>257</sup> Comparing the rating grades of MFIs which received ratings by local Peruvian raters and specialized raters (mainly MicroRate) indicates that rating grades assigned by the latter are indeed higher. The statement is based on data provided by SBS on all ratings assigned by accredited rating agencies to financial institutions between 1994 and 2008. Rating grades assigned by specialized raters active in Peru (MicroRate and Planet Rating) were retrieved from the rating agencies websites. For example, in 2006 CMAC Arequipa got a B- rating from Apoyo & Asociados and a B+ rating from Equilibrium. The rating grade assigned by

profitability to build up necessary reserves and that this performance indicator (which micro-finance raters deem important) should therefore not be a reason to assign higher grades. This is particularly the case since high profitability is endangered as soon as the sector becomes more competitive (Interview 28). As far as quantitative performance indicators are concerned, the MicroRate's former managing director for Latin America, Farrington (2005: 3), too, states that microfinance raters might put an overemphasis on profitability which is mainly driven by high leveraged growth. And the recent experience in some microfinance markets shows that overexpansion is one major driver for portfolio deterioration, in some cases leading to MFI defaults (Abrams 2009: 9; Chen, Rasmusen *et al.* 2010). This is related to the fact that excessive growth might lead to a loosening of lending standards, which becomes especially problematic in a context of increasing competition. By focusing more on the financial strength of an institution, including the availability of outside support, investors are on the safe side even if the lending activities of a specific MFI might be more risky than that of another MFI. It has only to build up large reserves over time and the rating agency should not misjudge the willingness of shareholders, and sometimes, as is the case of financial institutions rated by the major raters, the government, to bail out troubled financial institutions<sup>258</sup>.

Furthermore, (some) local raters (still) considered microfinance operations inherently riskier than those of commercial banks. The reason is that micro-credits are not backed by usual types of guarantee and concentrated in specific sectors, despite the fact that the raters recognized the higher granularity of an MFI's portfolio due to the small size of loans (Interview 28 and 35). Yet, instead of recognizing the consequential importance of thoroughly analyzing and auditing an MFI's lending technology to prevent credit risk, they appear to trust more strongly in quantitative portfolio indicators as a reflection of sound business practices (Interview 28). Yet, quantitative indicators (especially the portfolio at risk indicator) are less reliable in high growth phases.<sup>259</sup> This is the reason why specialized raters stress the importance of loan portfolio audits which come together with a rating exercise of this type of rating agency:

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MicroRate was  $\alpha$ -. CMAC Trujillo also received  $\alpha$ - while it was rated B+ by Equilibrium and Class & Asociados. EDPYME Proempresa received C from Class & Asociados and  $\beta$  from MicroRate. In 2007, CMAC Huancayo received a B- rating from Apoyo & Asociados and  $\alpha$ - from MicroRate. The ratings assigned to EDPYME Confianza increased from C+ to B- between 2006 and 2008 in the case of Equilibrium while MicroRate assigned  $\beta$ + in both years. Until 2008, MiBanco was the only MFI which received a letter rating of the highest category (A) from an accredited rater, which is a common grade among large Peruvian banks. For rating grades assigned by MicroRate see <http://microrate.com/mfi> (accessed May 20, 2010).

<sup>258</sup> In this sense, the biggest rating failure of major raters considering the rating of Lehman Brothers was an overly optimistic emphasis on the "too-big-to-fail" rationale. The same could apply to MFIs that are (or not) protected by important donors.

<sup>259</sup> Portfolio at risk is calculated taking the balance of outstanding loans past due more than x (mostly 30) days divided through the outstanding loan balance. In times of high growth, this risk indicator can underestimate the credit risk of an MFI. This is due to the fact that increases of the loan balance at a given point of time might overshadow late repayments which occur at a later stage.

*“a rating catches poor lending practices as loans are made, not as they are being repaid and fast growth dilutes arrears. Portfolio quality may be deteriorating, but the indicators won’t show it as long as growth continues”* (Damian von Stauffenberg in ADA 2011).

Planet Rating together with The MIX issued a study on “Microfinance and the Role of Policies and Procedures in Saturated Markets and During Periods of Fast Growth” which shares this view. They made a first attempt to prove the importance of analyzing the lending technologies of MFIs in different markets and state that discussions about *“the causes of the recent microfinance crisis have undervalued the importance of lending methodologies, in comparison with other policies and procedures such as information systems, risk management, and governance”* (Gonzalez and Javoy 2011: 10).

The managing director of M-CRIL even accuses the mainstream raters in India of having put too much emphasis on the size of their rated MFIs. As a consequence, he claims, the assignment of rating grades were higher than deserved compared to the performance of other MFIs. Obviously, the local Indian raters disclaimed any responsibility, stating that their judgments had been appropriate and that they had reacted to the increasing risk in the sector (cited in Unnikrishan 2011: 1).

It is intuitively comprehensible that a more thorough analysis and deeper understanding of the microfinance business is essential, and that specialized raters are more reliable (and thus functional) in this regard. One could even argue that the differentiation between the approaches of specialized raters also assessing the “fiduciary duties” of MFIs and conventional raters having a more “narrow” focus on credit risk is misleading: The negligence of these fiduciary duties might be a major driver for MFI defaults and its assessment should, thus, be part of any credit risk evaluation. From a stakeholder perspective, not only accounting for the interests of investors but also the ones of MFIs and their clients, it certainly is.

Nevertheless, specialized raters might have a too narrow focus when it comes to other, important dimensions that influence the repayment capacity of MFIs without, however, discrediting their evaluations altogether. Little is known about the ability of rating agencies to foresee microfinance defaults. In the context of the recent crisis Beisland and Mersland (2011: 3-4) mention one major failure of MicroFinanza Rating which assigned a good rating to an Afghan MFI. That MFI could, therefore (?), double its international borrowings shortly before it collapsed because of severe internal fraud. Here, the apparently bigger weight on qualitative factors assigned by specialized raters could be a disadvantage since they are more difficult to judge<sup>260</sup> and the under-

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<sup>260</sup> For instance, Damian von Stauffenberg (in ADA 2011) from MicroRate points out that especially the governance structure of an MFI is difficult to judge in an objective manner, especially because it can take many forms while a specific form does not guarantee a “good governance” of an MFI.

lying information (for example manuals and especially interviews) is easier to be manipulated or “polished” by MFIs. This increases the necessity for an appropriate, yet expensive auditing component which might even go beyond the capacities of specialized raters. And Damian von Stauffenberg (in ADA 2011) admits that microfinance raters might not be infallible either when it comes to “*extraordinary situations*”. He refers to the collapse of an Nicaraguan MFI which received an “investment grade” from Fitch shortly before its liquidation. Yet, what are these “extraordinary situations”? And in how far are different factors leading to negative events interrelated? Do (specialized) rating agencies adapt their judgments in a timely manner? Are they even ahead of possibly erroneous beliefs persisting in the industry? Taking the recent over-indebtedness crisis as an example, did microfinance raters go against the flow, questioning the conventional judgment that rapid expansion of many MFIs was desirable and possible? Or are these first crises rather to be interpreted as the first Black Swan (see Chapter 3.3.3) which the microfinance industry, including specialized raters, did not see coming?

The appropriate weighting of different factors might be challenging in a young and dynamic industry, where wide-spread practices (leading to an MFI’s growth and profitability) are declared “best practices”, while the knowledge whether these are actually “good” practices remains limited and are again context related.<sup>261</sup> And microfinance raters, just as investors, will need to regularly further adapt their rating rationales and adapt them to the changing conditions “*in order to incorporate important evolutions in the nature of microfinance risk*” (Gonzalez and Javoy 2011: 4). This also includes putting a stronger focus on “classical” factors. For instance, funding and liquidity become more important whenever MFIs decrease their reliance on donors and increase their interactions with (global) commercial investors. But also the risk of political interference might increase at the moment MFIs’ activities are significant enough to slide into the visual field of politicians.

For instance, in a methodological update realized in 2008, Planet Rating doubled the weight of the “Funding & Liquidity” section (from 7% to 14%) and increased the weight of the “Governance” section from 20% to 24%. At the same time, it lowered the weight of the “Activities” part (where the lending methodologies and credit risk is assessed) from 25% to 20% (Planet Rating 2008). Will the latter be reversed now that the rating agency states that this category is the most

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<sup>261</sup> An anecdotal evidence for this dilemma is the possibly delayed downgrade of a Peruvian MFI by MicroRate. For instance, it took MicroRate until 2011 to downgrade one of the larger Peruvian MFIs (Financiera Crear) from its second highest category  $\alpha$  (granted in 2007, 2009 and 2010) to  $\alpha-$  (due to weak incentive policies and an unconsolidated product strategy) despite the fact that the rating agency was well aware of the increasing saturation of the Peruvian microfinance market – according to Kappel, Krauss et al. (2010) Peru is the country that faces the biggest risk of over-indebtedness – and the portfolio quality of the MFIs already worsened considerably from PAR  $>30$  of 3.0% in 2008 to 4.1% in 2009. Instead, in 2009 and 2010 the rating agency praised the MFIs significant portfolio growth and good lending standards as two of the four outstanding factors in favor of the organization’s performance (MicroRate December 2007, March 2009, March 2010, March 2011).

important determinant to predict an MFI's credit risk (and possibly repayment capacity), irrelevant of the specific context (Gonzalez and Javoy 2011: 2)?

For some MIVs, the negligence of country risk is the major concern when it comes to specialized raters' reliability (Interview 6 and 7). Yet, one of the specialized raters stated that microfinance ratings would simply – from a developmental perspective – make no sense if country risk was factored to the same extent as was done by major raters. The reason is that MFIs in low-rated countries would always receive low ratings without a chance to attract international funding.<sup>262</sup> The same applies if the availability of external support is given too much importance. Indeed, methods of assessing the strength of a country's banking sector, as applied by Standard & Poor's, might not be adapted to the microfinance industry, especially when smaller MFIs are concerned which have little connections with the local banking sector (see Chapter 6.1.2). Nevertheless, Planet Rating recognizes the need of investors to explicitly factor the external environment. While previously applying a general cap on the final grade, without further explaining its rationales, the rating agency recently started offering country reports as a first step towards the assignment of country grades (see Chapter 6.1.1). This potentially increases their reliability for international investors in the future.

#### *The meaning of proving the validity of rater's judgments*

Another factor hampering the (perceived) reliability of specialized raters (as well as local Peruvian raters) is the fact that they cannot prove the validity of their assessments. So far none of the specialized rating agencies (or the accredited raters in Peru) has published a default study that indicates the correlation between rating grades and MFI defaults which could serve as a major reputation index. This is due to the limited period of time which did not allow for a meaningful research to be conducted (Interview 35). It is also, as far as the context of microfinance is concerned, due to limited experiences of MFI defaults observed so far.<sup>263</sup> Only recently did Planet Rating, with the study mentioned above, make a first step into this direction. Gonzalez and Javoy (2011: 10) claim to have validated the predictive power of Planet Rating's GIRAFE scores (see Chapter 6.1.1) for MFIs' portfolio quality twelve months in advance. And they suggest that their evaluations should also play a role in investors' recent attempts to model quantitative early-warning indicators of credit risk and over-indebtedness in microfinance markets.<sup>264</sup>

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<sup>262</sup> The statement was given by Aldo Mouaro from MicroFinanza Rating (supra note 139).

<sup>263</sup> See supra note 139 for details of the interview held with Aldo Mouaro from MicroFinanza Rating.

<sup>264</sup> In 2010, the microfinance asset manager responsAbility, Triodos Investment Management and the Council of Microfinance Equity Funds mandated researchers of the Center of Microfinance of the University of Zurich to construct a quantitative Early Warning Index to better predict the likelihood of credit risk at the country level. The credit risk is assumed to be linked to the level of market saturation. However, the authors Kappel, Krauss et al. (2010) highlight the serious limitations of the proposed index since necessary data is not available in many countries.

Yet, some market participants do not even make a distinction between the “proven” ability and willingness to constantly adapt rating methodologies and foundations of rating judgments and the numerical, statistically meaningful quantification of rating grades as an expression of default probabilities. One specialized rating agency stated that the process of standardization of the four microfinance raters was not as developed as is the case with the major raters and that their methodology was not “100% tested”. Their “*quantitative rating model*” only served as a first indication.<sup>265</sup> And some MIVs are convinced that the rating products of specialized rating agencies could not be compared at all with those offered by “mainstream raters” since the latter indicate a quantitative default probability (Interview 7).<sup>266</sup> Accordingly, in a survey conducted by CGAP in 2005, the majority of 17 investors mentioned that they considered the rating grade somewhat important, while it was stressed that rating grades could be more useful if they were standardized and based on default probabilities (CGAP 2005). The belief that, in the long run, rating grades could be indeed translated into cardinal risk measures can also be found among mainstream capital markets participants (see Chapter 3.3). It has also been nourished by the lack of transparency of mainstream raters.<sup>267</sup> In the case of microfinance performance ratings, investors apparently miss the – misleading, if opportune – scientized picture (see Chapter 3.4.1). It means that microfinance raters cannot hide behind a (pseudo-) scientific objectification of their knowledge and the judgmental dimension of their assessments is possibly too obvious. And, apparently, a lack of transparency fosters “under-reliance” in case a rating methodology is considered not to be “proven” and over-reliance once it is.

However, the impossibility of a (even though (un-)realistic) quantification is already a real practical disadvantage when it comes to structured finance products as an instrument referred to as promising to connect MFIs with mainstream investors (e.g. Byström 2008; Dorfleitner and Priberny 2010). Here, mainstream raters indeed base their analysis of default probabilities on statistical models, taking rating grades as an important input factor. Whether they actually turn out to be reliable, however, has still to be assessed.<sup>268</sup>

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<sup>265</sup> See Interview with Aldo Mouaro (supra note 139).

<sup>266</sup> Aldo Moauro (Microfinanza Rating) and Otto Wormgoor (Planet Rating) (see supra note 139 and 122) also identified this to be the major difference.

<sup>267</sup> Note that the explicit rectification of S&P (2009c) on the use (or better avoidance) of rating models was issued only in 2009 as a reaction to the financial crisis 2008.

<sup>268</sup> Rozas (2009) for example, who investigated first cases of MFI failures, shows that microfinance organizations tend to default en-masse and investors had to leave empty-handed. This is linked to the specific incentive structure in MFIs’ lending activities. Once microfinance clients foresee that their MFI is in trouble, possibly hampering the further access to credits, they stop repaying their loans even though their personal repayment capacity is not affected. This can also have a negative impact on the credit risk of structured finance vehicles, and therewith, also on the validity of rating models not capturing this dimension.

As far as the low degree of transparency as to their rating methodologies is concerned,<sup>269</sup> one specialized rater stated that “*it is a habit, not a policy*”.<sup>270</sup> The reasons are apparently the same as with the major raters. They would simply lose their deferred asset on any type of superior knowledge compared to their competitors (including major raters) but possibly also compared to specialized investors. Yet, investors could always receive more information regarding the rating agencies’ judgment if considered necessary and explicitly asked for.<sup>271</sup> One Peruvian rater even provided the (somewhat illogical) argument that he would not publish transition and default studies as a proof of their validity as long as the competitors did not do the same. The reason provided is that other rating agencies could benefit from it (Interview 28).

#### *The limited reliability regarding rating agencies’ behavior and business models*

Another factor hampering the reliability of specialized raters is the hybrid role of consultants and evaluators. This bears the risk that raters are forced to issue higher ratings in another round meeting the expectations of MFIs that stay loyal and comply with rating agencies’ implicit recommendations. This problem is partly addressed by two of the specialized raters (MicroFinanza Rating and Planet Rating) by securing at least their organizational independence through the dissociation of their founding organizations (Microfinanza and PlaNet Finance). Both are technical assistant providers who could otherwise use the ratings in order to cross-sell their advisory services and to deliver proof of their success. Currently, a lack of independency of this type only remains a potential problem in the case of M-CRIL (see Chapter 6.1.1). Yet, (some) of the specialized rating agencies offer advisory services directly which is certainly conflicting with their role as evaluators and was also addressed as a major issue of concern in the case of the major raters in the context of the financial crisis 2008 (see Chapter 4.2.2). Notably, none of the rating agencies publishes activity reports containing information about the proportion of different income sources which would enable potential users to spot potential conflicts of interest caused by their consulting activities. Nor do they publish explicit policies on how they try to avoid this potential problem.

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<sup>269</sup> The lack of transparency with rating methodologies and rationales in the case of specialized but also the local Peruvian raters is generally even more pronounced than with major U.S. raters. None of the specialized rating agencies issues comprehensive documents disclosing more in detail how they form their judgments and on which information it is based on. Nevertheless, it is a little less pronounced in the case of those rating agencies that issue more comprehensive reports. This makes their judgments more traceable (like M-CRIL, Planet Rating and MicroFinanza Rating). This is particularly the case with Planet Rating and MicroFinanza Rating which apply fixed weights, à priori signaling a greater degree of transparency.

<sup>270</sup> See Interview with Aldo Mouaro (supra note 139).

<sup>271</sup> Notably, in the mainstream capital market, the partial disclosure of information to selected investors was again criticized by those emphasizing the public good character of ratings for the price-setting in bond markets, especially since rating agencies could have important insider information (see Chapter 4.2.1).

Finally, specialized (and local Peruvian) raters, just as their major counterparts, rely on issuer-fees to finance their activities. This is potentially the largest source of conflicts of interest (especially if combined with their consulting role). Compared to the major U.S. raters, the risk of specialized raters to take the bait might be less pronounced because of their specialization. They cannot afford to endanger their reputation within the microfinance sector. Mainstream market participants apparently do not accuse the major raters of misjudgments in general because they did “err” in one specific sector. Yet, mainstream market participants and specialized investors might do so in the case of specialized raters. Besides, one can assume that profit maximization has so far not been among the objectives of specialized raters. Yet, the danger might be more severe because of their limited size. This makes it more difficult to internally mitigate potential conflicts of interest.

From a theoretical perspective, the internal monitoring mechanism is central for the production of objective, independent evaluations and avoidance of moral hazard (see Chapter 3.2.1). Especially long-lasting relationships with the same MFI can compromise the independence of rating analysts and rating committee members. Therefore, the European Union, for example, within its regulatory framework for rating agencies issued in 2009, requires that rating agencies make sure that an appropriate rotation mechanism is in place. The aim is to provide a gradual change in analytical teams and the composition of the rating committee (European Union 2009: Article 33). For specialized raters this is difficult to achieve because of their limited size. In the case of MicroRate, for instance, the rating committee is composed by five to six persons (in the case of Latin America) with the founder and chairman Damian von Stauffenberg participating in all of them (Interview 5). Therewith, as stated before, the rating agency strongly builds on the experience and good reputation of the former World Bank official. In the case of Planet Rating the quality of the rating committee is (supposed to be) secured through the participation of (at least) one of the three members of the management team beyond the analysts in charge (Planet Rating n.d.-c). This practice partly compensates for the high turn-over the rating agency possibly faces and assures that one experienced member participates in the evaluation process.<sup>272</sup> The procedure of MicroFinanza Rating is similar: The rating committee consists of two (out of three) directors of the company and the committee president (MicroFinanza Rating 2010c: 2). However, this practice limits the rotation possibilities within the committee considerably. Furthermore, it is

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<sup>272</sup> For instance, five of the twelve employees listed on the company’s website had a relationship with Planet Rating of around one year only. Its managing director was the only person who had stayed with the rating agency for over five years (Planet Rating n.d.-a). The team profiles disclosed on the websites of MicroRate and Microfinanza Rating only cover senior analysts and cannot be considered representative for the total number of employees (MicroFinanza Rating 2011b; MicroRate 2011a). Yet, in the case of Microfinanza Rating six of the ten members of the senior staff have stayed with the rating agency for more than five years, which could be an indicator for a lower turn-over rate than in the case of Planet Rating. Even though, it is also possible that the lower number of senior staff in case of Planet Rating is the result of a stronger growth in recent years.

probably the upper management which is most concerned with the rating agencies' financial self-sustainability, thus, facing the biggest conflicts of interest.

In this regard it is questionable whether the existence of four separated rating agencies for a relatively small market with their analysts (and potential committee members) dispersed around the world is viable. In the future these rating agencies might be forced to enter into a much closer cooperation in order to prevent a possible "unhealthy competition" (see Chapter 4.2.2) , at least if their certification function is to gain importance. Yet another possibility would be their incorporation into another organization – such as one of the major rating agencies. This was already envisaged by a former manager of MicroRate in 2005 (Farrington 2005).

M-CRIL instead chose a new strategy to address conflicts of interest. The rating committee is composed of microfinance experts – academics, bankers and accountants – independent from the management of M-CRIL. M-CRIL states that none of the rating committee members is significantly dependent on earnings from the rating agency. In each rating process a sub-committee of two committee members is built, assuring that the sub-committee has no relationship with the rated MFI (M-CRIL 2009a). Therewith, the rating agency recognizes the pivotal role of the committee as the "heart" of any rating agency's business.

At this point, no supervision of specialized rating agencies is in sight. The eligibility criteria of The Rating Fund as well as of The Rating Initiative is rather a documentation of existing practices (The Rating Fund II n.d.-e; The Rating Initiative n.d.-g). This is coherent when considering the state of development of the "microfinance rating industry" as well as their limited role in regulation. Nevertheless, specialized rating agencies try to "enshrine" themselves by advertising "*to be formally approved by CGAP and the Inter-American Development Bank*" (MicroRate 2011a) when referring to their eligibility for co-financing.<sup>273</sup>

As for the "policies" of The Rating Fund II and The Rating Initiative, the only similarity to the IOSCO code of conduct for recognized NRSROs (see Chapter 3.6) is that rating agencies should disclose any conflicts of interest involving its owners, managers, representatives, staff members, analysts or the rating agencies' activities. Besides, they should accept to apply preventive measures to avoid such conflicts of interest. MicroFinanza Rating, MicroRate and Planet Rating state to address conflicts of interest by making sure that rating analysts are independent from the MFIs they rate and that they are exclusively dedicated to rating activities (The Rating Fund n.d.-a, n.d.-b, n.d.-c).

In contrast, the Peruvian raters are supervised to a certain extent according to the resolution N°74-1998-EF/94.10 issued by CONASEV (1998) and, in the case of ratings for financial institu-

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<sup>273</sup> Similar statements can also be found on the website of Planet Rating (n.d.-b) and Microfinanza Rating (2011a).

tions, additionally by the resolution N°18400-2010 issued by SBS (SBS 2010). The resolutions cover the following topics: independency of rating officials, minimum capital requirements, documentary obligations vis-à-vis CONASEV and SBS and specifications about how ratings have to be diffused (for ratings of financial institutions the rating scale is pre-established). Additionally, CONASEV requires that any rating agency counts with at least five rating officials with a minimum working experience in the financial sector of three years. Rating agencies are visited on a yearly basis in order to review financial statements and the compliance with the above mentioned resolution. Furthermore, CONASEV also controls for other input factors which could influence the quality of ratings. For instance, the interviewed representative mentioned that they would also assess the workload per analyst in terms of number of rating missions within a specific period (Interview 13). In case of non-compliance or considerable divergences from established standards, rating agencies, just as any other participant in the Peruvian securities market, can be sanctioned according to resolution N°55-2001-EF/94.10 issued by CONASEV (2001). For example, one rating agency had to pay a penalty once because it issued a rating based on non-audited financial statements which proved to be wrong (Interview 28).

### **7.2.3 The Control Function – The Importance of a Specific Microfinance Focus**

As far as the Control Function is concerned, the picture of the performance of (specialized) rating agencies which is based on the data sources analyzed in the present research remains rather vague. Regarding the monitoring function, (specialized) rating agencies are not very functional since they do not provide any follow-up on rated MFIs. When assessing the Disciplining Function they appear more functional than (local) mainstream raters because of their explicit focus on aspects which can be influenced by MFIs in the short and medium-term. Yet, there is a risk that rating agencies also provide dysfunctional incentives. In the context of the present research this possible dysfunctionality has become more apparent in the case of social ratings.

#### *The limited value as monitoring device*

As far as the **Monitoring Function** is concerned, the performance of the major U.S. rating agencies to provide an efficient monitoring device was secured through the introduction of watch-lists in order to announce possible rating changes (see Chapter 3.5.3). A precondition for this instrument to work properly is that rating agencies to some extent monitor the evolution of bond issuers and especially external factors which could influence their repayment capacity. Otherwise, ratings can even enhance moral hazard in case a bond issuer receives a high rating in the first place he can then rest on (Hatarska 2009: 978). In the mainstream capital markets the major rating agencies were sometimes criticized for not providing timely ratings (see Chapter 4.2.3). They do not update their opinions in a timely manner. The same applies to specialized rating agencies

active in the field of microfinance. In Peru, regulation secures to some extent the timeliness of ratings.

The Peruvian locally accredited rating agencies are obliged to guarantee the validity during the year. This is achieved through the quarterly revision of financial data complemented by telephone conversations (Interview 28). Since MFIs rated by these raters need the ratings for regulatory reasons, they cannot refuse to send their updated data. In the case of specialized raters, however, MFIs have little incentives to keep rating agencies informed. Hence, so far none of the interviewed rating agencies has offered a regular follow-up of rated MFIs, even if all of them were planning to do so (Interview 5, 15 and Aldo Mouaro<sup>274</sup>). MicroRate asks for updated data every six month. However, even though in good times many MFIs are willing to share their data, it is just in times of distress, as happened in 2008 partly as a result of the global financial crisis 2008, when MFIs refuse to keep the rating agency informed (Interview 5). Instead, in particular severe cases of expected mass defaults – like in Nicaragua due to the No-Pago movement (Chen, Rasmusen *et al.* 2010: 4) – MicroRate reacted by announcing an overall withdrawal of ratings for MFIs in the country (MicroRate 2009c). Hence, at a current stage specialized rating agencies are not very functional in this regard. Besides, if their focus on lending methodologies and other qualitative areas makes the difference, the constant monitoring is probably very expensive and might endanger the rating agencies' sustainability while the added value of simply reviewing quantitative performance data might be limited. Besides, specialized raters do not factor the external conditions enough.

#### *The importance of focusing on microfinance specific factors*

When it comes to the **Disciplining Function** (or consulting role), the focus of specialized rating agencies on qualitative, microfinance specific factors has been particularly valued by MFIs. This is because specialized raters focus on factors which can be directly influenced by MFIs. They focus on “*current weaknesses, easier to manage or influence directly*” so they “*help me manage the short and mid term*” while, as stated before, “*legal ratings, this is how we call them, help me in the future*”<sup>275</sup> (Interview 17).<sup>276</sup> Mainstream raters in Peru focus much more on size and the funding structure. These are both areas that lie beyond the area of influence of MFIs, at least in the short-run. It applies especially to the evaluation (auditing) of lending methodologies combined

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<sup>274</sup> See supra note 139.

<sup>275</sup> “*Entonces si son debilidades actuales es mas fácil que tu puedas manejarlas influir directamente o tomar una acción que te permita modificarlas pero no puedes hacer con el otro tema. Veo que las clasificaciones legales, que nosotros las llamamos así en realidad me ayudan mucho, pero para el futuro. Me ayudan mucho pero para incluirlas en mi estrategia de largo plazo, las de digamos especializadas en el tema de microfinanzas me ayudan mucho digamos a manejar el corto y mediano plazo.*”

<sup>276</sup> Accordingly, one of the local Peruvian raters stated that the services provided by the specialized raters appeared to be more of a consulting service than a rating (Interview 35).

with field visits. Specialized rating agencies were (by some MFIs) expected to make recommendations on how to improve the lending process:

*“They become very well informed when they interview our staff. They also go to the field which is something we always demanded of a rating agency, that they go to the field to supervise, that they see a credit. We work with group loans so they should go to see the collection process. We are not interested in receiving a rating if they do not deliver a good report. They should tell us where we are failing so we can solve it”<sup>277</sup> (Interview 14).*

Furthermore, the transparency regarding rating rationales was considered important. For MFIs, the detailedness of the reports might be less relevant than for external parties due to their participation in the rating process. Instead, the discussion of main observations at the end of a rating process was mentioned as particularly important by MicroRate (Interview 5). Some MFIs prefer the services of one particular rating agency because it provides some sort of follow-up, helping MFIs to address areas for improvement (Interview 3).

Planet Rating additionally highlighted its transparency and coherence – given the fixed weights assigned – as important for MFIs for being able to follow and act upon the remarks:

*“Our methodology focuses on the transparent transmission of results of the work [...] other rating agencies do not do this [...] we worry a lot for having an objective methodology, with the advantage of being able to make it public, I think this is a big advantage. If we do a rating the rated institution knows what we evaluate [...] I think this helps establish best practices and increases the possibility that MFIs use ratings to internally improve”<sup>278</sup> (Interview 15).*

#### *The risk of providing dysfunctional incentives*

A more systematic analysis of the effects of rating exercises on management and lending practices of MFIs is a subject for further research. A clearer picture on this issue would also be necessary in order to answer whether providing additional consulting services by (some) specialized raters is justified even if it could enhance conflicts of interest and hamper their role as objective certification entities. Furthermore, it has also yet to be analyzed in how far rating agencies can also

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<sup>277</sup> *“Se informan muy bien cuando se entrevistan con el personal. Van al campo también. Eso es algo que siempre hemos demandado a una calificador, que vayan al campo a supervisar, vayan a ver un crédito. Nosotros trabajamos con metodologías grupales. Que vayan a ver un desembols o sea no estamos interesados en la calificación propiamente dicha si no que nos hagan un buen informe, que nos digan que cosa estamos fallando para poder solucionarlo.”*

<sup>278</sup> *“Nuestra metodología esta enfocada siempre en transmitir de manera transparente el resultado del trabajo no? [...] cosa que por ejemplo las otras calificadoras no hacen, eh nos preocupamos mucho que al tener una metodología que es objetiva tenemos la ventaja de poder hacerla pública y creo que esa es una gran ventaja. Cuando nosotros hacemos un rating la institución que es calificada sabe que le vamos a evaluar [...] entonces yo creo que eso permite también establecer las mejores prácticas e incrementar digamos la posibilidad de los resultados de mejora interna en la institución.”*

have negative effects on MFIs' behavior. For example, with the focus on qualitative factors combined with a higher degree of transparency, MFIs might be tempted to polish relevant policy documents and interview answers, possibly overburdening the auditing capacities of rating agencies.

Moreover, when it comes to social ratings and the very different dimensions assessed in these evaluations, MFIs could use a social rating in order to polish their image. They could become engaged in activities relatively easy to implement, distracting investors (and the MFI) from other possibly more important deficiencies. For example, one interviewed CMAC did not previously track its social performance in a systematic manner. It was convinced that it did comply with its social mission since it handed parts of its profits over to the municipality (a usual practice among CMACs) which in turn (has to) invest the money into social works (obras sociales) in benefit of the community. However, for improving its social rating (delivered by MicroRate) the MFI opted to improve its environmental performance by creating a program – managed by its marketing department – of planting trees (Interview 32). Is this really what the microfinance community aims at?

Besides, raters might rather encourage a “mission drift” than preventing it, when social indicators are to be assessed and managed. The reason is that they necessarily rely on indicators which are relatively easy to standardize and introduced into an MFI's information system. MFIs could be encouraged to re-define their specific social objectives along their measurability (see the comments made by one of the NGO MFIs on “relativizing” the social mission in Chapter 7.2.1). This potential risk certainly exists regarding any attempt to measure and audit the social outcome directed towards external accountability. Critical empirical research that also covers possible dysfunctionalities of social performance management and measurement in general as well as the setting of specific indicators has yet to be done. Power (2000: 117) states that:

*“The prospects of light, self directed audit processes, which harness productive learning and self-help to regulatory compliance, is an attractive ideal. Defensive auditing is the antithesis of this ideal.”*

The need to assign a rating grade as the result of a judgmental exercise might be boosting a defensive, self-referential type of verification more than would be favorable for the support of an open-minded, productive learning process which is needed and stressed by SPM supporters at the current stage. Therewith, it remains crucial to closely follow on how specialized rating agencies manage this balancing act and respond to concerns raised by different stakeholders.



## **PART IV – Conclusions**



## **8 Similarities and Differences of Rating Agencies' Functions and Functionality in Distinct Markets**

The aim of the present chapter is to summarize the main theoretical concepts and the empirical findings of the study. It briefly introduces the motivation of the research, the case and context of ratings in microfinance and the research method. In the following, the two main parts of the thesis are presented: a) The theoretical framework and a critical appraisal of the performance of the major rating agencies in the mainstream capital markets and b) the application of the framework to the case of microfinance. This framework is in itself designed as a contribution to the current debates about the functions and functionalities of rating agencies in both sectors, and opens relevant fields for future research in the latter case. The functions of ratings in the mainstream capital markets are recapitulated and further discussed, building the frame of reference for approaching the topic within the microfinance context. The main conclusions regarding the relevance of each function in the case of microfinance are presented and compared to those predominant in the mainstream capital markets. Critical aspects related to the activities of the major U.S. rating agencies receive attention, too. It is highlighted in how far these issues also apply to rating agencies active in the microfinance sector. At the same time, the limitations of the present study are discussed and suggestions for further research are brought forward. Finally, some future prospects for the microfinance rating industry are raised.

### **8.1 Motivation and Methodology of the Study**

The study is motivated by the fact that specialized rating agencies in microfinance have been promoted since the late 1990s, also receiving considerable financial support from international donors. Considering that microfinance follows different logics than mainstream capital markets it departs from the question whether the microfinance industry also needs (specialized) ratings. Scientific inquiries about their contribution to the development of the microfinance sector in favor of the world's poor are still rare and only cover very particular issues. There is no systematic research which would explain the mechanisms behind the possible outcomes for the different stakeholders in the microfinance industry. There are no studies tackling the relation of costs and benefits for investors, MFIs and their clients in a comprehensive manner. Furthermore, there is no critical assessment of the possible downsides of this instrument so far. This is problematic when taking into account the recurring criticism regarding the three dominating U.S. rating agencies in the globalized financial market. Some critical issues raised as to the performance and impact of the major raters in the mainstream capital markets apply to ratings in general, thus also to specialized microfinance raters.

The microfinance industry has gone through profound changes in the last decades. It developed from a primarily donor-driven community into a commercial industry. The success of some large and (sometimes highly) profitable microfinance institutions spurred the euphoria that profit-driven poverty alleviation was possible and that an ever larger number of the poor population could be reached with financial services. With increasing professionalism the institution-building requirements became more complex in order to create an environment in which a global microfinance industry could prosper. Beyond the different models of setting up sustainable microfinance institutions, the institution-building process encompasses strategies at the meso-level, such as finding and installing appropriate regulatory schemes for individual countries and fostering supporting institutions like microfinance federations and networks. Recently, and in more competitive microfinance markets, the set-up of credit bureaus for an enhanced transparency as to the creditworthiness of micro-borrowers has also received a lot of attention. On a global scale and at the level of microfinance institutions, transparency has been promoted. For example, the data platform MIX Market has been set up which collects and disseminates performance data of currently close to 2.000 microfinance institutions in 120 countries. The evolution and promotion of specialized rating agencies in microfinance has to be placed into this context, too. It is important to recognize that microcredit is still the dominating financial product offered, despite the fact that microsavings have been identified as possibly even more important for meeting the financial needs of the low-income population. Many MFIs are either not allowed to capture deposits or shy away from the costs which occur by offering a broader range of financial services. Therewith, they also lack an important source for refinancing their lending activities. To avoid donor-dependency, MFIs and those trying to support them encourage the link to local and international commercial capital markets in order to increase the outreach of microcredits.

Especially since the second half of the last decade the flow of international funds into the microfinance sector has increased. This is particularly, though not exclusively, true for those from commercial sources. In the mainstream capital markets external evaluations of borrowers' creditworthiness are a precondition for most lenders to invest into single companies. Investors appreciate ratings as an independent and reliable source of information. Accordingly, ratings in microfinance might matter when it comes to filling informational gaps between investors and MFIs. In the mainstream capital markets the three U.S.-based raters Standard & Poor's, Moody's and Fitch are dominating the scene. Their rating business dates back to the early 20<sup>th</sup> century and has since then grown in scale and geographical outreach covering ever new markets, including microfinance. Therefore, this study does not only address the question of relevance and possible contribution of ratings in the microfinance context per se. It also scrutinizes whether specialized raters have a role to play and whether different rating methodologies than those offered by their major counterparts are needed. Since specialized microfinance raters might face increasing competition from conventional credit rating agencies, this study also delivers answers regarding the

competitive (dis-)advantages of different types of rating agencies and provides insights into the possible future development of “the microfinance rating industry”.

A comprehensive and sufficiently detailed theoretical discussion about external credit risk assessments could not be identified in the international research. Therefore, the study starts with the development of a framework which carves out the different functions rating agencies exercise in the global financial markets. It draws on the existing theoretical and empirical literature on ratings and rating agencies addressing single factors to explain the relevance of these organizations. The distinction between function, functionality and performance is introduced. Function is defined as the task external credit risk assessments have to execute in order to overcome frictions in financial markets. Functionality is defined as the ability to perform a function. The relevance of a specific function and the functionality is related to the context rating agencies operate in as well as to their performance. Performance is defined as the particular way they operate in terms of methodologies and business models. Related to the context, performance also describes the outcomes or rating agencies’ activities which in turn sheds light on their functionality. Functions and functionalities are closely interrelated and cannot easily be held apart. Especially considering the discussion about the major rating agencies, the assessment of their functionality often defines their functions. Nevertheless, this distinction is considered important. Firstly, the performance of rating agencies might encourage or hamper the functionality regarding different stakeholders’ expectations. Secondly, this differentiation makes it possible applying the framework to a different context (here to the one of microfinance). It also provides the means for a comparison of the functions and their relevance as well as the in how far different rating approaches are adapted to varying environments.

In order to gain a deeper insight into the reasons for rating agencies’ evolution, the mechanisms of action and the problems that might occur as to their activities and position in financial markets, the study reviews relevant theoretical concepts which can be linked to these organizations. Many of them also build the basis for the existing theoretical literature on rating agencies. The study follows an interdisciplinary approach and draws on insights from (micro) economics, psychology and sociology.

As far as the empirical part of the present study is concerned, the research builds on a series of qualitative interviews held in Peru with different types of microfinance institutions, regulatory authorities, rating agencies, international investors and local banks. Peru has been chosen as a case study because of its relatively high developed microfinance market and because the outreach of microfinance institutions’ ratings provided by different types of rating agencies is relatively pronounced. A survey among specialized microfinance investment vehicles further augmented the collection of primary data. Besides, the analysis builds on a collection of primary and

secondary data, namely rating reports, existing practitioners' surveys, policy reports, newspaper articles and website contents. Primary quantitative data for sustaining some of the arguments has been retrieved from the MIX Market data platform and by analyzing financial statements of some of the interviewed microfinance institutions.

## **8.2 Summary of the Theoretical Framework - The Functions of Ratings in the Mainstream Capital Markets**

When regarding the discipline of economics, the most important research strand is the one labeled as Theory of Financial Intermediation. It departs from the well-known concept of asymmetric information as the main reason for the existence of any financial intermediary. With regard to rating agencies the most important lesson derived from the discussion of the related literature is that the size of intermediating organizations matters. Large organizations generate the biggest economies of scale when gathering information in order to lower transaction costs. Furthermore, they avoid an inefficient duplication of efforts. More importantly, though, size also matters because information intermediaries face the same conflicts of interest as borrowers. Information producers have the choice of providing information of high or low quality. The production of high quality information is expensive. Yet, investors cannot a priori observe the quality of the information and will only pay an average price. Accordingly, individual information producers have an incentive to merge with others to jointly build up a reputation as high quality information producers which allows them to charge higher prices and to internally share the occurring costs. An internal monitoring mechanism within the large information intermediary will ensure that not only payoffs but also efforts are shared. A precondition is that the charged price is independent from the performance of one individual transaction (information gathering about one particular firm). Thus, no extra payments are necessary to provide incentives for producing information of high quality. From an aggregated perspective, this lowers the costs for high-quality information production which ultimately might result in a natural monopoly.

This partly explains the competitive structure of the rating industry. Yet, it does not provide a satisfactory answer regarding rating agencies' relevance in financial markets in relation to other financial intermediaries also engaged in the production of information. Therefore, this study adopted a functional perspective as proposed by newer studies within the Theory of Financial Intermediation. The main idea of this research strand is that different institutional arrangements are possible to exercise persisting functions. Therewith, this perspective takes into account the historical evolution of different kinds of organizations. A central aspect is a reinterpretation of the term disintermediation to describe the structural changes in financial markets in the last century. According to a general understanding, disintermediation refers to the shift from an inter-

mediary-driven (or bank-based) to a market-based financial system. The notion “market-based” is accompanied by the idea that capital markets are free from intermediaries. Market-based, intermediary-free financial systems are, according to the neoclassical theory, more efficient. Yet, what appears to shape the global and particularly the U.S. financial market is rather a diversification of intermediaries. The increasing importance of capital markets resulted in a large number of large and small intermediaries serving a broad spectrum of investors. Some of them have been more involved and directly participating in financial markets than others. Furthermore, traditional banks did not disappear. They rather became increasingly engaged in capital market transactions of buying and selling stocks and bonds.

Managing risk according to the individual risk preferences of investors and savers, or more precisely, risk transformation has been identified as one (if not the most) important function of financial intermediaries. In a bank-based system there is the tendency to achieve risk management through inter-temporal smoothing, where reserves of liquid assets are built up when returns are high and run down when they are low. In a market-based system risks are shared in a cross-sectional manner where new financial products are created to meet the risk-return expectations of investors. This is supposed to enhance the short-term nature of investment decisions. Intermediaries active in this process of financial innovation are, therefore, much more than passive agents. They should rather be defined as active market participants, creating an added value for investors. This also applies to rating agencies which became heavily engaged in the creation of structured financial products. Furthermore, another particular added value provided by the three major rating agencies is the re-homogenization of financial markets by making the risk of diverse financial products comparable. Hence, the importance of rating agencies goes along with the specific structure and dynamic of the financial markets which are characterized by becoming increasingly global, complex, short-term and volatile.

Going one step further in order to clarify what rating agencies do, the study relies on the main thoughts of Monetary Keynesianism as well as on Schumpeter’s concept of “the banker” and his contribution to development. Here, the notion of intermediation as a matching of lenders hoarding money, and borrowers in the need of it is abandoned. Money is created “from nothing” through credits granted by banks to innovative entrepreneurs. The banker produces new purchasing power based on the promise of future benefits. The trust in the entrepreneur and in the future is essential for this process to occur. Yet, the future is uncertain and full of risks. Risk assessments provided by rating agencies can help establish trust.

Rating agencies provide risk assessments. Yet, a clear definition of “risk” in the literature on ratings is missing. This is unfortunate insofar as it obscures what rating agencies can or cannot provide. In the literature, the collected information and its evaluation is all too often mentioned in

the same breath. Ratings are supposed to assess default probabilities and are often treated as hard facts rather than subjective opinions. Therefore, this study dedicates one section to the definition of risk as well as to the ability of market participants (including rating agencies) to anticipate future events. Furthermore, the study draws on insights from behavioral economics to shed light on psychological patterns of human beings when processing information and their perception of risk.

The study revives the distinction between risk and uncertainty first introduced by Knight (1921) and Keynes ([1921], 2008). Anyone's knowledge about the future must be described as largely uncertain. Only in very rare cases, where a probability can be calculated a priori, certainty about a future event is possible. According to Knight, only these situations should be described as ones of risk. In case probabilities are assessed statistically, declarations about the future already contain a judgmental component. Nevertheless, valid statements about the likelihood of a specific event to occur (such as a default) might still be possible in an ordinal manner based on the arguments provided. Yet, a numerical expression will (or should) not be formed. The sheer but inevitable ignorance of what has been described as "the unknown" contributes to the inaccuracy or vagueness of these estimations. This is especially true in a world, and particularly in financial markets, where events outside the visual field of individuals and based on increasing human interaction – labeled by Taleb (2008) as Black Swans – become more prevalent. Yet, psychological biases and emotions as well as broader societal dynamics might lead to a situation where people (want to) perceive everything as risky (as opposed to uncertain), and thus, measurable in numerical terms and insurable.

In order to bring the theoretical deep-dive to a round figure, especially in terms of the societal dynamics which can be linked to the establishment of specific practices and organizations, the study additionally builds on insights from economic sociology. Theoretical approaches from this discipline break with the methodological individualism that is prevalent in economic theories. They reject the notion that the homo oeconomicus and rational actor pursues individual interests in all moments. They claim that norms, values and convictions evolve within a specific historical development instead and can take a life of their own. In pursuit of controlling the future within a "Risk Society" (Beck 1986), scientific pictures of the world's incidents are created. Organizations evolve which promote standards as pre-defined categories, orders and codes, many of them building on the same ideological background. These organizations do not essentially exist or keep existing because of socio-technical necessity. Instead, they are embedded in a specific socio-cultural and socio-economic structure, some of them enhancing efficiency and social welfare while others might not. Especially expertise-based organizations and networks, here also labeled as "epistemic communities" (Haas 1992), often develop a universal and lawful claim on their knowledge and relevance. They gain an authoritarian position over some parts of society and, as

is the case with rating agencies, over (financial) markets. Market participants are forced to rely on these experts, whether it is because of legal enforcement or a lack of alternatives. Consensus rather than dispute is the device. Concomitant to the standardization comes the need to make things measurable, and thus, controllable. It is followed by the imperative to capture and disclose (often quantified) information from those who are envisaged to be controlled.

In reviewing the theoretical and empirical literature on credit ratings, four major functions have been identified which encompass the function to manage risk: (1) the Information Function, (2) the Certification Function, (3) the Control Function and (4) the Coordination Function. The principal stakeholders that use ratings are bond issuers (or more generally, rated entities), investors and those acting on their behalf (asset managers) as well as financial regulators. The discussion of each function is amended by the theoretical considerations outlined above. Some of the functions have been further divided into sub-functions in order to render more precisely their added value within their specific context.

(1) The function which has received the most attention in the empirical literature on ratings is the **Information Function**. This function is composed of the Information Release Function, the Information Collection Function and the Orientation Function. The Information Release Function refers to the rating agencies' task of gathering and distributing new information not readily available, for example by issuing corporate presentations, annual statements and reports or through the media. Furthermore, rating agencies, through their evaluations, can release proprietary information without explicitly disclosing them. Hence, issuers do not have to fear competitive disadvantages while being transparent. The Information Collection Function helps generate economies of scale and avoid duplications of efforts. Instead of having investors produce the same information over and over again, they can use the information provided by rating agencies to carry out their own risk assessments. Intuitively, these two sub-functions appear to be the most important ones. Nevertheless, in the empirical literature it is discussed quite controversially whether rating agencies actually have an informational advantage and whether they release information unknown to financial markets. Therefore, scholars search for additional explanations for the prominent position of rating agencies. Rating agencies do not only provide information with their written reports. They also assimilate the information using standardized methodologies and by summarizing their evaluations in a grade. It is not clear whether rating changes are of a pro- or rather reactive nature. Yet, rating grades provide a benchmark and a means for orientation in financial markets characterized by increasing complexity and an abundance rather than scarcity of information. The Orientation Function is described by the rating agencies' role of setting standards, filtering out the information considered relevant rather than contributing to an otherwise existing superfluity of confusing information. Therewith, rating agencies also induce and

institutionalize a learning process and rating grades re-homogenize investment opportunities by making them comparable.

(2) Another important function of ratings is the **Certification Function** which can be divided into the Labeling Function, the Risk Classification Function and the Regulation Function. Once rating agencies are recognized as reliable information producers, being rated becomes information itself. Rated entities buy a share of the rating agencies' reputation and gain a quality label of transparency and integrity. The Risk Classification Function aims at reducing uncertainty or even transforming it into measurable and manageable risk. The rating grade and the outlook for its future development rather than the report are of particular importance. The difference to the Orientation Function lies in the claim that ratings are forward-looking rather than a simple, standardized snapshot of past and present performance. The ability of rating agencies to prove the predictive power of their assessments becomes crucial. Transition and default studies issued by the major rating agencies serve this purpose. They establish the correlation between letter grades and debt defaults. Default studies turn rating grades into (an illusion of) a hard fact – at least in the perception of some market participants. This happens despite the fact that the underlying methodologies have changed repeatedly and are mostly not even based on quantitative models but on a mix of quantitative and qualitative information. People who are inclined to anchor their beliefs on past performance are more likely to rely on credit risk ratings. A side effect in times in which numbers and quantitative methods are beyond reproach is that market participants can partially abdicate from their responsibilities of making their own in-depth analyses. Sometimes asset managers even have to do so in order to meet the return expectations of principal investors who would not wait until financial intermediaries really analyze every investment opportunity. Furthermore, if investors and their agents err, they can blame rating agencies instead of assuming responsibility and regretting wrong investment decisions. Financial regulators are also relying increasingly on ratings to safeguard financial stability. In the U.S. regulators in the early 20<sup>th</sup> century started incorporating ratings into their regulation, either by issuing capital adequacy rules for financial institutions and pension funds as a function of ratings or by prohibiting low rated investments altogether. In other parts of the world this practice was adopted along with the set-up of the Basel Accords. Therewith, ratings also fulfill a Regulation Function possibly to protect regulators from (administrative) appeals, especially in times of a general uneasiness regarding governmental influence and interventions. Some scholars even refer to this function as the single most important for explaining the power of rating agencies and the reliance of investors on their assessments.

(3) Thanks to their powerful position and authority, rating agencies can influence the behavior of issuers and asset managers. They exercise a **Control Function** which again can be subdivided into the Disciplining, Monitoring and also a Regulation Function. Issuers seeking high rating grades in

order to have access to (cheap) funds might adapt their business models and activities accordingly. This is achieved by the Disciplining Function. Ex-post, ratings help avoid moral hazard. Watch-listing backslide issuers is the instrument through which this can be best achieved. By announcing possible downgrades rating agencies help investors efficiently monitor their investments (Monitoring Function). This also holds true for asset managers whose risk assessments can be cross-checked with independent ratings by principal investors and regulators. Therewith, an all too ambitious and at the same time risk-taking investment strategy can be avoided. Besides, regulators might find it easier to justify compulsory interventions concerning single institutions in order to secure financial stability.

(4) Finally, ratings have a **Coordination Function**. Rating agencies might further contribute to financial stability because their appraisals cannot be ignored by single market participants. This is because market participants have to expect that others will follow the raters' opinions and questions of access to funds and liquidity are highly influential regarding the default probability of rated entities. With the existence of multiple equilibria, ratings can coordinate investors' decisions towards the good equilibrium even if single investors might disagree with the rating agencies' opinions. They have a Coordination Function since they enforce what Keynes (1937: 214) labeled as the "*conventional judgment*".

In order to develop a little further on what guarantees the reliability of rating agencies as high-quality information producers, the theoretical discussion closes with the presentation of the reputation mechanism. This section also discusses more in detail why newcomers have difficulties in competing with established rating agencies. Established rating agencies with a reputation of providing high-quality ratings might choose to issue low-quality ratings at a certain point in order to gain extra profits. They might do so by spending less effort and thus lower the costs. Or they willingly cheat by providing unjustified high ratings because issuers pay for it. The former might, to a certain extent, be detected by market participants who control the input factors. Ex-post verification shortly after the rating is assigned is more difficult, especially if financial markets are not assumed to follow the rationality premise. However, classical theoretical models suggest that rating agencies have no incentive for endangering their initial investment into reputation for one-time extra profits. The reason is that the losses in the periods following the cheating will offset the gains, provided that market participants are willing and able to punish rating agencies' bad behavior. As far as the industry structure is concerned, the study argues that the costs for the production of high-quality ratings, going beyond the easy accessible information for a rather rudimentary analysis, have increased over time. Yet, newcomers who have no reputational capital cannot charge prices which would cover these costs right from the start. Hence, relatively higher investments into reputation are necessary. This probably also applies when large rating agencies enter into new markets and start competing with existing, but much smaller raters. The bigger

the rating agency, the easier it is for them to successfully transfer their reputation into new segments. Furthermore, with the promise of future gains, large rating agencies have incentives for investing into high-quality ratings and acquiring the necessary knowledge about the particularities of new segments. However, the reputational capital view has been disputed repeatedly, most fiercely after the financial crisis of 2008. On the one hand, issuers might not be able to act upon a deteriorating rating quality because they might be charged of “shopping” for good ratings. They are locked-in. Investors, on the other hand, might not be willing or able to control the quality of ratings provided by recognized rating agencies and act accordingly. A lack of transparency regarding rating methodologies and rationales makes it difficult to spot rating failures. Besides, the major rating agencies are “enshrined” by regulators. This “enshrinement” apparently makes investors less vigilant. Furthermore, disagreeing with the rating agencies can be expensive, not only because of regulatory effects but also because of the reactions of other investors to the rating agencies’ judgments. In microfinance, specialized rating agencies accuse the major rating agencies and local conventional raters of not investing enough into understanding and assessing microfinance institutions. This might be one good reason why specialized approaches are needed, even though this is only one side of the coin.

### **8.3 Ratings in the Context of Microfinance – Empirical Findings, Limitations of the Study and Suggestions for Further Research**

The major part of ratings of microfinance institutions (MFIs) worldwide is conducted by four specialized microfinance rating agencies. The number of so-called performance ratings constantly grew in the past decade and MFIs first depended less and less on subsidies for their rating exercises. However, there is a strong regional concentration of rated MFIs, with Latin America and Asia heading the list. This can be partly explained by the number of MFIs active in these regions. But also in relative terms ratings are a much more common phenomenon there. Furthermore, the diffusion of ratings within this region is also fragmented. In Asia the rating market is largely driven by India while in Latin America Peru, followed by Bolivia and Ecuador, is mainly responsible for the demand of these products. In the mentioned countries, however, the increasing share of so-called credit ratings (as opposed to performance ratings in the understanding of many microfinance stakeholders) is particularly pronounced. Credit ratings are first and foremost defined by their official recognition by the respective regulatory authorities and are to a major part offered by conventional credit rating agencies. Many of these rating agencies are partly owned by or have a strategic partnership with one of the major U.S. raters. Besides, the negative growth of update and non-subsidized performance ratings by the end of the past decade puts the long-term sustainability of a specialized microfinance rating industry into question.

The specialized rating agencies claim that they can help MFIs attract funding and develop. Furthermore, they state they can help to prevent future negative developments in the microfinance sector referring to first repayment crises experienced in single microfinance markets. Due to their development mandate, specialized raters are much more persuasive than their major counterparts. They actively encourage investors, and sometimes even regulators, to strongly rely on their assessments. This could pave the way for a larger number of MFIs to enter local and international commercial capital markets. However, there is a persisting confusion about what specialized raters actually do and in how far they differ from conventional credit rating agencies. Also, they often lack the recognition of important stakeholders departing from the mainstream financial sector who prefer risk assessments by the conventional raters.

The present study approaches the topic of the functions and functionalities of ratings in microfinance and the role of different types of rating agencies, analyzing the case of Peru. Peru is considered an interesting case majorly because MFI ratings, as stated above, are a widespread phenomenon with specialized as well as conventional raters active in this field. Whenever possible the study also takes a broader, international perspective generating hypotheses which also hold true for a larger context. Nevertheless, the degree to which these results can be generalized is limited in several aspects. Some of the shortcomings of this study are presented in the following in conjunction with the main results. Generally speaking, it might be worthwhile to conduct in-depth research in other microfinance markets precisely because one of the arguments repeatedly put forward in the present study is that the functions and functionality of ratings are context-related and the representativeness of any particular case regarding “the microfinance sector” is limited. This might especially apply to the case of Peru which is considered to have a relatively mature and well regulated microfinance sector and has early been identified as an attractive market for international microfinance investments. Furthermore, it is one of the few countries where microfinance regulation also requires ratings.

In the following, the main results regarding the functions of ratings and their relevance within the microfinance context compared to their importance in the mainstream capital markets are presented along the line of the four functions just recapulated. At the same time, important findings as to the performance of different types of raters are shown. Critical aspects derived from the discussion of the industry structure, the behavior of rating agencies and their effects on dynamics within the mainstream capital markets are also taken into account.

(1) As far as the **Information Function** is concerned, ratings in microfinance appear to be particularly relevant in the sense of collecting and releasing information otherwise not available in the market. This especially applies to qualitative information which was mentioned by some interviewed microfinance investment intermediaries to be particularly valuable. Furthermore, it was

the profundity of research, reflected in the time spent on-site, with which specialized rating agencies made a difference, bringing an added value even to equally specialized microfinance investment firms. Their performance as (loan portfolio) auditors appears to be essential. Also, with the Peruvian conventional credit rating agencies largely neglect their potential auditing function. Therefore, specialized rating agencies are certainly more functional in this regard. Furthermore, specialized rating agencies also started offering social ratings. The demand for this product is linked to the very nature of the microfinance sector, with MFIs being expected to serve a double, if not triple- bottom line. Here, Peruvian raters showed they were relentless in offering this service. At the same time, the pressure for MFIs and their investors to prove their positive contribution and social responsibility increased in the last decade due to the ongoing commercialization of many MFIs. This trend was accompanied by an increasing criticism of a possible mission drift of MFIs, their lack of transparency in terms of pricing policy and sometimes irresponsible lending practices that possibly resulted in the over-indebtedness of microfinance clients. Furthermore, sound academic research about the impact of microfinance on poverty alleviation and development remains very limited. Therewith, the microfinance industry faces an increasing reputation risk which social ratings can possibly countervail by producing reliable information on the social performance of MFIs.

Since the microfinance sector is characterized by a lack of (qualitative) information, the rating reports are used by a large number of international Microfinance Investment Vehicles (MIVs) as a time-honoring tool for preparing their own due diligence and risk assessment. First statistical evidence covering a larger number of mainly Latin American MFIs indicates that this also reduces the costs of funds for MFIs even though more research in this field is necessary to get a clearer picture. This research should cover a larger number of MFIs in different world regions and rated by different raters. In Peru, MFIs rather had the impression that refinancing costs declined because of an increasing competition among microfinance investors. Additionally, none of the interviewed investors in Peru stated that the availability of a rating report had any influence on the interest rate charged, with only few exceptions when it comes to social ratings.

In any case, whether ratings pay off at a larger scale also depends on the structure of the microfinance investment market. At the current stage, the international microfinance investment landscape is highly intermediary-driven. It is of a rather long-term nature with a limited number of large MIVs channeling the major part of funding into the microfinance sector. Most MFIs in Peru, but also in other parts of the world rather, maintain a limited number of individual funding relationships (including those with local commercial banks) instead of issuing standardized bonds tradable in liquid secondary markets where potential investors would need to produce the same information over and over again. Hence, the generation of larger economies of scale is still less relevant than in the mainstream capital markets. Whether the importance of ratings in micro-

finance will increase in the future in this regard, thus, also depends on a) in how far the number of investors or asset management firms directly lending to MFIs increases and b) in how far an increasing number of MFIs starts tackling capital markets directly by issuing bonds and other securities. In Peru, at least, a few mature MFIs have already taken first steps in this direction increasing the relevance of ratings in the country.

When looking at the Orientation Function the same arguments apply with the future relevance increasing with the number of MFIs eligible for (commercial) funding. This probably lies outside the rating agencies' field of influence and rather depends on the MFIs' individual profiles, the context they operate in and on the (microfinance) investors' investment strategies. Nevertheless, specialized rating agencies play a role in defining standards adapted to the operations of MFIs which might be even more pronounced than in the mainstream context, considering that the microfinance sector is relatively young and dynamic. Specialized rating agencies complement and sometimes take the lead in the setting of standards in cooperation with CGAP as the most important policy and research center and standard-setter within the international microfinance community. As such, they can be considered an integral part of the microfinance industry even if immediate material benefits for single MFIs and investors are not always tangible. Therewith, they also complement other initiatives, most importantly the microfinance data platform MIX Market, aiming at raising the transparency of MFIs and their connection with mainstream investors. At the moment this especially includes the standard setting of reliable and externally validated social metrics that many microfinance investors and also donors are now looking for. However, at the current stage ratings are not considered useful for identifying and sorting out eligible MFIs, at least in the case of the interviewed investors in Peru. Investors rather found new investee MFIs because they were directly approached by MFIs. International MIVs used the MIX Market database to get a first impression of the relative performance of these MFIs rather than comparing rating grades. Nevertheless, more representative research among MIVs and other local and international commercial investors would be necessary to get a clear answer. The limited functionality of specialized ratings for providing orientation compared to the global U.S. raters also lies in the limited size and limited regional coverage of single rating agencies. Moreover, rating grades by specialized raters are not comparable, which finds its most obvious expression in their different rating scales. Comparability and consistency were identified as important demand-drivers for investors who benefit from an increasing number of ratings. The major rating agencies therefore spend much effort in guaranteeing consistency even among each other. Concerning microfinance they even lure investors with the promise of making MFIs comparable with other investment opportunities. Whether this can easily be achieved is another question. However, frames also matter and investors are either not able (e.g. because of a lack of transparency) or willing (e.g. because of time constraints) to look through these frames, and thus, might simply follow the major raters. Regarding those investors not a priori committed to microfinance, spe-

cialized raters possibly face a major competitive disadvantage. Investors with a microfinance focus, on the other hand, would possibly benefit if specialized raters moved closer together, at least as far as the Orientation Function is concerned.

Regarding the standardization of MFIs' social performance, specialized raters face the additional challenge that different microfinance stakeholders potentially in need of this type of information do not agree on the relevant indicators and relative weights on the different dimensions of the social performance. This becomes even more challenging if a combined rating product is to be designed, which would be preferred by some stakeholders. Balancing the different stakeholders' preferences is difficult because possible trade-offs exist between a) the financial versus the social performance and b) the different dimensions of social performance. Furthermore, the quantifiability and therewith standardized measurability of social objectives is difficult to achieve in some cases. Thus, some MFIs and investors fear that MFIs with more ambitious objectives could be punished with lower rating grades. Furthermore, the choice of quantitative indicators is also linked to the definition of the mission and the specific assumptions of how a positive impact is more likely to be created. Yet, these expectations and assumptions can be assumed to be far from homogenous among microfinance stakeholders. Therefore, measurable indicators would need to be adapted accordingly. The present study provided some evidence in this regard. Again, a more representative and in-depth research on how different stakeholders (including MFIs) identify and measure their relevant social indicators beyond the few standard indicators (e.g. average loan size and percentage of women borrowers) directed towards external accountability and on how the specialized rating agencies respond to this has yet to be done. Meanwhile, at least when an integrated rating approach is envisaged, it might be more useful to reduce the complexity of social rating methodologies and focus on factors that lead to clear failures, the majority if not all microfinance stakeholders would agree with (such as the non-compliance with client protection principles) rather than trying to assess still diffuse success factors.

(2) The consistency but also traceability of rating grades is even more relevant when it comes to the **Certification Function** of ratings. For providing a simple quality label as a sign of integrity and transparency, the performance of single raters in adequately predicting the future performance of MFIs is less relevant. The Labeling Function has been identified as one of the relevant functions in the microfinance context and applies especially to countries where ratings are a common phenomenon, such as Peru. Particularly more mature MFIs are expected to be rated and all interviewed MFIs in this country were convinced that ratings were a precondition to receive external financing. However, this belief is actively nourished by specialized raters and, as for investors asking for rating reports it might also be a self-fulfilling prophecy rather than a real necessity. This is especially the case when considering that the reputation of single raters does not appear to be an influential factor. The more MFIs are rated, the more investors will expect MFIs to have a rat-

ing. None of the interviewed investors in Peru had a formal obligation in this regard. At some point, some MIVs indicated that they require ratings, yet, one of these interviewed MIVs in Peru desisted from this practice later on. First empirical evidence, building on a larger number of MFIs from different countries indicates that ratings have no impact on the access to funds for MFIs. Nevertheless, more research including representative surveys among MIVs and other local and international investors is needed here, too.

A possible explanation for the low importance of ratings with regard to access of funds lies, again, in the structure of the investment market. Large, specialized MIVs and local commercial banks interviewed in Peru claim to and probably do have the necessary market knowledge and expertise to make sound investment decisions. In fact, in the case of large asset management firms this is what they sell to their primary investors. In this regard rating agencies even compete with these organizations, at least as far as their judgment and thus the “right” estimation of an MFI’s creditworthiness is concerned. The fact that rating agencies started usurping single functions of investment firms has already been identified in the context of the U.S. capital market at the early stage of the major rating agencies’ development. For rather uninvolved (commercial) investors specialized raters lack the high reputation of conventional credit rating agencies which leads large MFIs to rather turn to the latter. Certainly, the enshrinement of regulators as well as a dose of blind faith in the brand of major global raters also play a role.

Linked to the behavior of specialized rating agencies, the reliability might be hampered because of a lack of transparency regarding their methodologies and underlying information. This makes it hard for market participants to follow their assessments, and hence, to control their performance. The limited transparency in terms of rating rationales and methodologies is also an issue of major concern for the major U.S. rating agencies. Rating agencies want to protect their (supposedly) superior knowledge vis-à-vis their competitors but probably also against large and more involved investors who otherwise might not need the rating agencies’ services. Moreover, full transparency is difficult to achieve, especially in those cases where a case-by-case approach is applied. Yet, the methodologies of specialized raters remain largely unproven to investors. Unlike the major U.S. raters, the specialized raters did not publish default and transition studies that could serve as a reputation index. Furthermore, the lack of statistical evidence for the link between rating grades and credit risk does not allow for a translation (erroneous as it may be) of rating grades into quantitative default probabilities, and the judgmental dimension might be all too obvious.

The evaluations of specialized raters regarding MFIs’ future performance, however, might be more reliable due to their high degree of specialization and embeddedness into the microfinance context. More importantly, the specialized raters base their analysis on a more profound re-

search when it comes to the central area that lies at the heart of an MFI's business: its lending methodology and processes. Even though the conventional credit rating agencies interviewed in Peru, departing from their methodology of rating commercial banks, also adapted their rating process when rating MFIs in the sense that they check individual client files and visit some of them, this does not (yet?) translate into a larger effort in terms of numbers of days spent on-site. The reputational capital view suggests that established rating agencies have an incentive to invest into gaining the necessary expertise when entering into new market segments. Taking a look at the discussion about the major U.S. raters, it stands out that they were nevertheless accused of under-investing, for example, when rating emerging markets securities. If one accepts the specialized raters' claim that a thorough analysis of MFIs' lending techniques is essential, rather than relying on quantitative portfolio quality indicators, this result also allows a conclusion to be drawn with respect to the discussion about conventional credit rating agencies. The conclusion is that conventional credit rating agencies probably under-invest when entering into new markets. In Peru, one local credit rating agency clearly established the borderline between what auditors do and what the role of a rating agency is supposed to be. In the U.S. context, this argument also served as a powerful excuse for some major rating failures.

As far as the major methodological differences in terms of weights of rating factors are concerned, specialized rating agencies tend to rather focus on factors that respond to the state of knowledge within the microfinance sector in terms of the key risk areas influencing the performance of MFIs. Some of them also tend to put a stronger emphasis on qualitative factors which potentially bears the risk of making their assessment less verifiable. The reason is that these dimensions are more difficult to judge and easier to manipulate by MFIs (the latter strengthening the necessity of the auditing component during the rating process). Regarding quantitative factors, specialized raters focus more on individual performance measures such as profitability and efficiency. Peruvian accredited raters, on the other hand, put a stronger focus on liquidity, the capital adequacy and the availability and willingness of shareholders (or also governments in the case of the U.S. raters) to bail out troubled institutions. Both approaches have advantages and disadvantages which also depend on the specific stakeholders' preferences and expectations when using this product. A major concern as to the reliability of specialized raters compared to global rating agencies, however, is their negligence of external, country-related factors. At least one specialized rating agency already made a first step to stronger factoring country characteristics when rating MFIs.

When regarding their business model, specialized rating agencies rely on payments from rated entities, as well, therefore suffering from the same conflicts of interest as their major counterparts (including Peruvian raters). This has been an issue heavily debated in the "mainstream world". Some empirical studies indicate that in the past the U.S. rating agencies did rather not

take the bait to issue unjustified favorable rating grades but protected their reputational capital. However, before the financial crisis of 2008 and specifically concerning the evaluation of mortgage-backed securities, a few large issuers became increasingly influential and used the rating agencies to bring these financial products to the market. Rating agencies willingly supported this development, also by granting ancillary services that included advice on how to structure financial products in order to be granted high rating grades. The threat by large issuers to remove their business apparently took effect at the expense of rating quality. Besides, epistemic failures regarding quantitative models and the reliability of underlying data also put the rating quality in question. (At least) in the case of one rating agency this was aggravated by the entrance of commercial shareholders when going public.

Whether specialized raters are better equipped to control conflicts of interest remains inconclusive. On the one hand, the risk that specialized raters would issue favorable ratings when rating MFIs might be lower since they have no other business segment to move back to. Also, single MFIs (except perhaps the most prestigious once) do not impose a major threat when changing the rating agency. They cannot afford to endanger their good reputation within the microfinance sector. On the other hand, (some) specialized raters additionally offer advisory services to MFIs which put their independence in question. Perhaps more importantly, though, specialized rating agencies appear to be too small to efficiently mitigate conflicts of interest internally. Three of them put their managing directors, also in charge of securing the commercial viability of the rating agency (even if profit maximization is probably not one of the objectives), into a very central position of every rating committee while rotation possibilities remain limited. Besides, competition alone is no longer expected to provide adequate incentives for preventing moral hazard. Newer studies on the behavior of the major U.S. raters suggest that competition could rather be “unhealthy”. In how far this also applies to microfinance raters has still to be assessed. Yet, it might be limited as long as the rating market is divided with respect to different world regions of types of MFIs.

An external supervision of specialized raters in general is yet not in sight. This is due to the fact that, with a few exceptions, specialized raters are not incorporated into the regulation of MFIs, either because there is none or because they are not recognized by the respective supervisory body. In Peru, until the recognition of MicroRate in 2011, the ratings of specialized raters had no “legal value” (or no Regulation Function). Therefore, at the time the interviews were held, larger MFIs that had been previously rated by a specialized rater and needed a rating for regulatory purposes stated to rather turn to an accredited rating agency in the future. Some MFIs will opt, at least for a while, for having both types of ratings instead. Since the Regulation Function is considered an important demand-factor, specialized raters increasingly seek official recognition, even in countries in which rating-based regulation has so far not been applicable to MFIs.

(3) As of yet, none of the specialized raters has monitored its rated entities on a regular basis. The Peruvian raters at least hold interviews and gather updated financial data from their MFIs (and other companies) on a six-month-basis. None of the specialized rating agencies, however, have watch-lists which would also consider changing external conditions that MFIs would then need to respond to. Again, considering the current funding relations of MFIs and microfinance investors' investment strategy, the Monitoring Function as one sub-function of the **Control Function** is at a current stage of little relevance. Ratings might, however, already have a disciplining effect on MFIs. The Disciplining Function which also aims at influencing the behavior of a rated entity before it enters into a new funding relationship, and thus, possibly makes it eligible for investments, is more relevant for small, less mature MFIs. Rating agencies have a consulting function and include MFIs into the learning process based on the experiences made with "best" performing MFIs and the so-developed standards. In the case of social ratings, this also applies to larger MFIs. Specialized raters perform better in this regard, not only because of their specific and broader microfinance expertise but also because they focus on factors MFIs can immediately influence. Nevertheless, whether and under which conditions they actually have the sufficient authority to enforce their standards and whether this would be beneficial for MFIs and their clients would need to be addressed in further research. Particularly social ratings bear the risk of possibly providing wrong incentives as long as standards are not fixed. Since rating agencies do not appear to influence the access to funds, they lack an important enforcement mechanism and their authority appears to be limited at the current stage. As far as quantitative performance indicators are considered, the effect of ratings on MFIs appears to be still limited. More research with recent data that covers a larger set of MFIs would be worthwhile. Furthermore, it would be interesting to conduct a more in-depth research on the effects of rating exercises on qualitative areas of less mature MFIs which receive rather low grades possibly without even publishing them. Also, the effects of pre-rating products compared to full performance ratings could be assessed.

Finally, rating agencies could not only control the entities they rate. Ratings are also used by primary investors and regulators (or investment-guarantors) for disciplining and monitoring asset managers as intermediaries. The aim is to prevent that the latter become engaged in investments which might bring them higher returns but are also riskier. In the past, this dimension was of little relevance, since MIVs rather followed a conservative investment strategy. Whether primary investors will include rating reports in their possibly stricter documentation requirements after the first microfinance crises experienced in some countries lately has yet to be seen.

(4) Past financial crises and resulting credit crunches have probably contributed to the strong reliance on ratings in the U.S. mainstream capital market, not only by investors but also regulators. Their establishment as authorities in the capital markets enacted their **Coordination Func-**

tion. Yet, while in good times the approach of rating “through-the-cycle” fosters market stability, the major U.S. rating agencies’ reactions to market dynamics have been subject to fierce discussions. In times of financial distress rating downgrades enhance pro-cyclicality. This applies especially to those cases where rating agencies, also due to their own conformity bias, jointly exercise massive downgrades all of a sudden. Investors, on the other hand, cannot or do not want to ignore the rating agencies’ actions. So far, specialized raters do not have the status to influence investors’ beliefs and behavior to this extent. Therewith, their Coordination Function is of little relevance at the present moment – at least in the Peruvian microfinance context.

#### **8.4 The (Questionable) Importance of Ratings in Microfinance and Future Prospects**

In the following, the most urgent initial questions are taken up. The relevance of (specialized) rating agencies in microfinance has been questioned. Hence, this sub-chapter develops further on the question whether microfinance raters should have a more prominent position. Furthermore, it develops further on the question whether subsidies are justified and under which conditions. Finally, some possible scenarios of the future development of the microfinance rating industry are presented.

One might argue that, at the current stage, specialized rating agencies are what the major rating agencies are meant to be in general: One additional source of information, a first means for orientation and a signal of transparency and integrity, yet without being existential in terms of the access to funds for MFIs. Should they have a more prominent position? There are some arguments in favor but possibly more against.

First of all, it seems that it is not only a question of the sheer amount of funds flowing into the microfinance sector but also one of the possible channels. Those who believe in the superior efficiency of capital markets and want to encourage a process of disintermediation would possibly answer the question regarding rating agencies’ prominent position affirmatively. Attracting higher number of individual and institutional, but, rather uninvolved investors who invest directly into MFIs, requires another infrastructure at the meso-level than in the case of a limited number of specialized MIVs and asset management firms with a good local infrastructure which build on the principles of relationship banking (based on repeated interactions with a long-term horizon). It might be more than a coincidence that the first rating agency in microfinance is based in the U.S. and is probably closer to the ideological conviction that a capital-market-based financial (and funding) system is superior to a bank-based one. Still, in microfinance the close relationship between MFIs and their clients is central. This might also hold true for the relationship between

MFIs and their investors, especially as far as small and medium-sized MFIs are concerned, letting aside the question whether MFIs in fact need so much external funding at all (instead of being further encouraged to capture deposits).

Moreover, encouraging investors to rely on ratings also has its downsides. This holds particularly true when regarding those who are supposed to be involved and have their own fiduciary duties, and thus, are rather asset managers. The barrier between an adequate level of reliance and over-reliance appears to be a thin line. The call of specialized rating agencies for investors to take ratings more into account might be reasonable at the current stage: Investors do not assess MFIs' level of risk with the same thoroughness as these rating agencies but rather tend to trust in the explanatory power of quantitative portfolio quality indicators. The specialized rating agencies might rightly suspect the investors to neglect their fiduciary duties when claiming that investors should rely more on them. Yet, as long as the belief in quantitative indicators persists it is difficult to see how the microfinance rating industry will reach self-sustainability with investors directly or indirectly covering the bulk of the costs. Once the analysis and auditing of lending practices is considered essential, investors probably should become engaged in realizing loan portfolio audits themselves rather than fully relying on rating agencies. This is especially the case when rating agencies cannot be held liable for their evaluations. Stating, however, that investors including local commercial banks should rely on ratings because they do not have the necessary knowledge to adequately assess the risk of MFIs is more delicate. To respond to the current situation, to encourage investors to make the first steps into the microfinance sector and to help them gaining the necessary knowledge might be an attractive ideal. In this case, specialized rating agencies can be appreciated as a temporary phenomenon. Yet, providing incentives for not gaining the necessary knowledge is another story, even if this might ultimately mean that microfinance investments turn out to be less attractive from a risk/return perspective. This becomes even more tenuous if regulators are encouraged to rely on ratings. Again, it is one thing to acknowledge rating agencies' complementary role in governing the microfinance industry as long as an effective regulation is not in place in some countries. Yet, depending on ratings by regulators and setting up rules which make investors having to rely on them can cause more harm than good, as is explained in the following.

A regulation-based dependency is not only problematic because rating agencies suffer from conflicts of interest. Equally, if not more important is the fact that affirmations about risk are not characterized by indisputable objectivity. Opinions about the future are necessarily vague and can and possibly should diverge. And not everything should be captured within a rather short-sighted efficiency postulate, liberating investors of making their own judgements. Taking a glance at the dynamics and discussion linked to rating agencies in the mainstream capital markets, a very (or excessively) prominent position of raters in the microfinance sector cannot be deemed

desirable. The major U.S. raters are perceived as authorities over markets. This also implies that issuers will (need to) comply with rules of the rating agencies whose power is not rarely perceived as threatening – especially when the fortune of entire states seems to be at stake. Rating rationales are based on specific world-views. Those who share their views tend to state that rating agencies' reactions simply express what the market has been thinking already. Those, who do not (and those, for whom rating agencies' opinions are largely inconvenient) are less optimistic when it comes to a few private actors deciding over matters of public interests. How likely is it that (specialized) raters in microfinance would behave differently in situations of crises, especially once they start stronger incorporating external factors and the interplay of diverse forces in the microfinance sector becomes more complex? Will they update their judgments in a timelier manner possibly countervailing the conventional judgment? Did they do so prior to the recent repayment crises in some microfinance markets? And what would have happened if investors started to indeed rely on ratings to a large extent? Microfinance raters should certainly not become the masters of the microfinance funding landscape, significantly influencing the development of entire microfinance markets.

After the financial crisis of 2008 regulators in the U.S. and Europe started rethinking their position regarding an adequate regulation of rating agencies. Notably, this also includes an appeal to the users of credit ratings *“not [to] rely blindly on credit ratings but [they] should take utmost care to perform own analysis and conduct appropriate due diligence at all times regarding their reliance on such credit ratings”* (European Union 2009: Article 10). Besides, the U.S. Dodd Frank Act of January 2010 envisages making rating agencies liable in the cases they fail to make a thorough investigation, taking also into account information of independent third parties.<sup>279</sup> Similar discussions can also be found at the European level. Furthermore, after the downgrade (apparently by mistake) of France in November 2011, the European Commission is even thinking of forbidding sovereign ratings in times of crisis altogether (e.g Gammelín 2011: 1). Becoming engaged in a similarly serious supervision of specialized microfinance raters would certainly be overdrawn at the present moment. However, specialized raters and those supporting them should closely follow the ongoing discussion in order to learn not only from “best” but also from bad practices.

In the light of this, are subsidies justified? Again, the issue is multilayered, while the subsidization of microfinance ratings for the sake of the rating industry in general is little conducive. If their contribution towards standardization is considered important and a process which would probably not emerge naturally out of the market in the short run, the answer could be yes. Nevertheless, one could ask whether subsidies due to this purpose are still justified and for which kind of product (e.g. financial vs. social ratings). Could CGAP, among others, not build more strongly on

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<sup>279</sup> For a brief summary of the Dodd Frank Act and the changes regarding the regulation of rating agencies see Hunington, Weiss et al. (2010).

the knowledge of other stakeholders including investors, donors and technical assistant providers or consultants? Yet, if the contribution of rating agencies is considered essential, one might also think at some point of setting-up an appropriate mechanism for users to complain about the rating agencies' evaluations as a feedback loop (facilitate voice). The goal is to avoid a self-referential process of standardization. Rating agencies should be held accountable regarding their standards and encouraged to acknowledge differentiated views. As far as the consulting component is considered, it might be better to leave the decision of subsidization to individual donors and technical assistance providers who identify MFIs to be worth the effort and can set the complementary consulting component in value (by making more concrete recommendations).

Besides, should subsidies be assigned to specialized raters only? Does the microfinance sector need specialized approaches? Subsidies for specialized raters would be justified if the aim is to build-up a counterpart to the major rating agencies, believing that profit maximizing entities would indeed never make the sufficient investments to properly evaluate MFIs and assuming that capital markets will indeed play a major role for the re-financing strategies of MFIs. The investment of newcomers into the necessary reputation capital might overburden the specialized raters and the co-financing of ratings provided of these, and only these rating agencies should possibly even be extended. Nevertheless, the possible downturns of any "enshrinement" should also be taken into account. If an over-enshrinement is to be avoided one might think of letting the subsidizing party assigns the responsible rating agency (e.g. by lot or by turns). This would additionally have the advantage that investors would get to know different methodologies and report forms. They could also form an opinion on which format best serves their needs for the time when subsidies are not required any longer. If only the connection of MFIs with the mainstream capital markets is envisaged there are little reasons to subsidize ratings. MFIs possibly attractive enough for these investors will find out for themselves whether a rating is a necessary evil in order to have access to these funds and will, thus, voluntarily pay for them. That specialized raters, lacking the reputation capital, "create" access in the short run is rather unlikely.

Therewith, the question comes up what will happen when the present form of subsidization by co-financing comes to an end. How will the microfinance rating agency industry develop? As far as the regions beyond Latin America and the Caribbean are concerned one might find out soon since The Rating Initiative, covering only these other world regions, just suspended the subsidization of financial performance ratings.

One possible scenario would be the following: Specialized rating agencies are already established enough in mature microfinance markets to convince MFIs that having a rating is obligatory while investors have no obvious reason for convincing MFIs of the opposite. Peru probably is such a case, not only because of but certainly triggered by rating-based regulation. Here, also small MFIs

might increasingly receive ratings even though their benefits might not justify their costs and rating agencies work at the expense of these MFIs and their clients. The rating trend might subsequently spill over to other (neighboring) countries and become a rule of thumb covering entire world regions, possibly even flanked by newly introduced regulatory schemes that are based on intense lobbying efforts by the rating agencies. It is also possible, however, that investors finally fully recognize the added value of ratings and actually make them a formal requirement. They might be also encouraged to do so by their primary investors who, after experiencing repeated disruptions, might not want to rely on their asset managers' decisions and ask for a second, external opinion. Situations in which MFIs compete with each other for funding rather than MIVs competing for the funding of eligible MFIs would further enhance this trend. It is in this scenario, however, where a possible over-reliance, including automatic rules, could become an issue. If this over-reliance includes regulators who might set-up rating-based rules for regulating and supervising MFIs, microfinance stakeholders might well hold similar discussion in the years to come as those dominating the political arena in Europe and the U.S. these days.

A second scenario would be that MFIs ultimately recognize that ratings do not have a major effect on the amount of funds. Here, only large MFIs might further receive ratings in case they expect interest rate reductions high enough (they would probably not have to be very high) to make them worthwhile. The market for rating smaller MFIs, however, might simply dry out. Once large MFIs, however, want to tackle the "real" mainstream capital markets they will probably turn to the rating agencies recognized in this market. Who knows whether in that moment specialized raters would have already built up the necessary reputation to successfully compete with established rating agencies. If they did not, they might either simply disappear or merge into a larger, incumbent rater. In fact, in order to compete with the major global raters a consolidation of the specialized microfinance rating industry in form of mergers is also likely in this scenario.

Finally, it is also possible that donors will keep on subsidizing rating exercises in the long run. It is in this third scenario that specialized rating agencies and those supporting them might be repeatedly confronted with the legitimate question whether such subsidies are justified or not – including smart academics trying to ascertain the "real" impact of microfinance ratings. After all, specialized raters rather operate as promoters of market-based solutions to close the supposed financing gap. And the commercial approach should probably not stop at the threshold of their most fierce advocates?

Regarding the probability of the mentioned scenarios, the present thesis has pointed to the difficulties related to the prediction of the future. Accordingly, all possible scenarios have, of course, to be considered as vague and characterized by a high degree of uncertainty: We never know whether a Black Swan is already approaching.



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## Annex

### Annex 1– Rating reports reviewed for the analysis of rating methodologies<sup>280</sup>

Financial Ratings				
Rating Agency	Month and Year	MFI	Country	Rating Grade
Planet Rating	April 2008	Small and Micro Enterprise Programme (SMEP)	Kenya	C-
	March 2010	Semisol	Mexico	B
	July 2010	Socialcred	Brasil	C++
MicroRate	September 2008	ABA SME	Egypt	β+
	December 2008	FMM Bucamaranga	Colombia	α
M-CRIL	November 2008	FinAgro	Georgia	n/a
	December 2008	CBIRD MFI Ltd.	Cambodia	B
	April 2009	MAXIMA Mikroheranhvatho Company Ltd.	Cambodia	β+
MicroFinanza Rating	May 2009	PADECOMSM CREDITO	El Salvador	B+
	September 2009	COAC Artesanos	Ecuador	B-
	September 2009	Yehu	Kenya	CCC
	December 2010	COAC Juventud Ecuatoriana Progresista	Ecuador	A-
Apoyo & Asociados	March 2010	CMAC Arequipa	Peru	B+
	September 2010	Financiera Crear	Peru	B-
Equilibrium	September 2010	CRAC Nuestra Gente	Peru	B+
	December 2010	EDPYME Nueva Visión	Peru	C+
	March 2011	CMAC Arequipa	Peru	B+
Class y Asociados	March 2010	CRAC Nuestra Gente	Peru	B+
	September 2010	CMAC Hunacayo	Peru	B
FitchRating	2010	Banco Compartamos	Mexico	AA-(mex)
Standard & Poor's	2008	Partner Mikrokreditna Organizacija Tuzla	Bosnia and Herzegovina	B
	2009	FinComún Servicios Financieros Comunitarios S.A de C.V. Sociedad Financiera Popular	Mexico	BB-
	2009	Fundación Integral Comunitaria A.C	Mexico	BB-

<sup>280</sup> In case of the specialized rating agencies, the rating reports used in order to analyze the report style and rating methodology were chosen because they were the most current reports publically available (and free of charge) either as sample reports provided on the rating agencies' websites and/or on the website of The Rating Initiative.

Social Ratings				
Rating Agency	Month and Year	MFI	Country	Rating Grade
Planet Rating	September 2009	Vision Fund	Cambodia	4-
	January 2010	Al Majmoua	Lebanon	3+
MicroRate	July 2008	Enda Inter-Arabe	Tunisia	4.5 Stars
M-CRIL	2008	SEF	South Africa	$\Sigma \alpha$
	2008	AMK	Cambodia	$\Sigma \alpha$
MicroFinanza Rating	July 2010	SINERGIJApplus	Bosnia and Herze-govina	<sup>s</sup> BB
	December 2010	Patner	Bosnia and Herze-govina	<sup>s</sup> AA-

## Annex 2 - List of interviews held in Peru between February 16 and March 30, 2010.

In order to protect the interest of the interviewees, their names as well as those of their respective institution have been made anonymous. Only the type of institution as well as the position(s) of the person(s) interviewed within the respective institution is generally disclosed.<sup>281</sup> Whenever an interview is cited the respective number of the interview will be disclosed. Only in those cases where it is important to know the identity of an interviewee or its organization to understand a specific statement the anonymization is partly abolished.

Nr.	Type of Institution	Position of Interviewee (s)	Date of Interview	Length of Interview
1	DFI	Here: expert	February 16	00:51:53
2	Banking Supervision	General director of microfinance Chief of microfinance supervision	February 17	01:17:51
3	MIV	Legal advisor Monitoring officer	February 17	01:30:16
4	Accredited Rater	President of the board Managing director	February 18	02:06:39
5	Specialized Rater	General manager LAC	February 18	01:02:33
6	MIV	Investment officer	February 19	00:57:21
7	MIV	Regional director investments	February 19	00:34:26
8	MFI Federation	Managing director	February 22	01:09:28
9	Development Bank	Chief of credit risk management Analyst credit risk Analyst credit risk	February 23	00:38:37
10	CRAC (MFI)	Managing director	February 23	01:02:41
11a <sup>282</sup>	MFI Federation	Managing director	February 24	00:37:20
11b	MFI Federation	Coordinator social performance	February 24	00:51:53
12	NGO (MFI)	Director microfinance program	February 25	00:51:29
13	Stock Exchange Supervision	Director of issuers Director of issuers	February 25	01:08:18
14	EDPYME (MFI)	Managing director	February 26	00:39:46
15	Specialized Rater	Office director LAC	February 26	01:49:50
16	EDPYME (MFI)	Managing director	March 1	01:11:37
17	Financiera (MFI)	Director of deposits and finance	March 2	01:04:38
18	CMAC (MFI)	Director of deposits and finance	March 3	01:18:10
19	NGO (MFI)	Managing director	March 3	00:50:25
20	CMAC (MFI)	Director of credits	March 8	01:24:18
21	NGO (MFI)	Executive director	March 8	01:40:39
22	COOPAC (MFI)	Managing director	March 9	00:48:02
23	CRAC (MFI)	Managing director	March 9	01:10:51
24	NGO (MFI)	President	March 10	00:43:45

<sup>281</sup> In ten cases more than one interviewee participated at the same interview. These cases are disclosed by naming the different positions of the interview partners.

<sup>282</sup> 11a and 11b are interviews with representatives of the same organization while the interviews have been held separately.

25	COOPAC (MFI)	Director of deposits and finance	March 16	00:40:40
26	CMAC (MFI)	Director of deposits and finance	March 16	00:53:13
27	EDPYME (MFI)	Director of administration and finance Chief of finance and treasury	March 18	01:27:32
28	Accredited Rater	Managing director Senior analyst	March 23	00:59:47
29	MFI Federation	Chief of projects	March 23	01:08:37
30	NGO (MFI)	Chief manager – credits	March 24	00:39:05
31	Financiera (MFI)	Managing director	March 25	01:07:25
32	CMAC (MFI)	Sub-director credits	March 26	00:53:42
33	Bank (MFI)	Director of treasury and finance	March 29	00:55:02
34	State-owned Bank	Analyst Chief of division financial services	March 29	00:38:05
35	Accredited Rater	Project director Financial analyst	March 30	01:43:37
36	Commercial Bank	Business officer	March 30	00:23:11

### **Annex 3 – Interview guidelines**

The following interview guidelines were developed to structure the interviews with the different stakeholders. They were adapted according to the information collected about single institutions prior to the interviews. Furthermore, the questionnaire cannot be considered exhaustive. As the interviews were semi-open, questions varied between one institution and another depending on the course of the specific interview.

#### **Interviews with microfinance investors (including MIVs, local commercial banks and development banks)**

##### **A) Investors' characteristics**

- How do you characterize your fund / institution?
- What is your mission and vision regarding the development in microfinance?

##### **B) Microfinance investments**

- What is your most common form of investment?
- In how many MFIs are you currently investing (globally, in LAC, in Peru)?
- What is the minimum, maximum and average amount you invest in MFIs? What is the duration of your loans?
- In what kind of institution do you usually invest (size, legal form etc.)?

##### **C) Due diligence and the use of ratings**

- In the process of identifying new investees, what are the most important sources of information?
- Once a possible investee is identified: How does the due diligence process look like? How many days does it take? Are you realizing on-site visits? What kind of information are you looking for?
- Regarding the due diligence and/or the monitoring process (before and after investing into an MFI): Do you use external rating reports? Why? How?
- Is it obligatory for your MFIs to count with an external rating? Or do you have any plans to make it obligatory in the future?
- Does the external rating have any influence on the interest rate charged or on any other covenants in the debt contracts? Do you have plans to integrate ratings into debt contracts in the future?
- According to you, are MFIs with or without external ratings different in any regard?
- Do you think that counting with an external rating has any (positive) effects for/on an MFI?

##### **D) Comparison of rating agencies**

- Do you compare different rating reports of the same MFI?
- In case you are familiar with different rating agencies and their ratings: What are the differences (in terms of methodology, indicators and report style)?

- According to you, what are the major differences between the specialized rating agencies and the established Peruvian rating agencies?
- Do you have any preferences regarding the rating agency? Which and why?
- Have you ever found a rating report not adequate? Why? In which sense?

**E) Other services provided by rating agencies**

- Are their important aspects concerning the performance of an MFI which cannot be reflected in an external rating?
- How important would regular updates be to you? Would a “watch-list” be of any use for you? With what regularity?
- Do you think that the country specific risk factors important for MFIs should be included in the rating? Why / why not?

**F) Social ratings**

- How important is the social performance of MFIs to you?
- How do you define social performance? What are the most important indicators?
- Is it important for your fund/institution to report on the social performance of you investees?
- Do you know the social performance ratings of the specialized rating agencies? What do you think about them? According to you: What role will these ratings play in the future?

**Interviews with microfinance institutions**

**A) Characteristics of the microfinance institution**

- What is the vision and mission of your institution?
- What is the position of your institution within the Peruvian microfinance market?
- Where do you see your institution within five to ten years?
- Comparison of rating history of the MFI

**B) Rating process**

- General: How was the rating process?
- How and to which extend did you participate in the rating process?
- How long did it take and how would you evaluate the time and effort for your institution?
- According to you, what were the challenges your institution faced during the rating process?
- Did you ever have any specific problem during a rating process? How did you solve it?

**C) Motivation to receive an external rating**

- Why did your institution receive a rating?
- Who do you think is interested in reading the rating reports of your MFI?
- How did you choose your rating agency? Why did you decide to get a rating by this specific rating agency?

- How do you publish your ratings and why? Do you (and to which extent) actively use your rating reports?
- Do you receive a rating on a regular base? How often?
- Is it obligatory for your institution to receive a rating? In which sense?
- Was your rating ever integrated into a debt contract with one of your investors? How?
- What are your most important funding sources?
- What did you expect from receiving an external rating considering the funding side?
- Did you ever receive any type of subsidy for your rating? Which? How did this influence your decision for obtaining a rating? Are you still getting subsidies for this purpose?
- How much did it cost you institution to get a rating?

**D) Satisfaction with the external rating**

- Were you satisfied with the final grade your institution received after the rating process?
- Do you feel that there was important information missing in the final report?
- What do you think about the level of preparedness of the rating analysts?
- Could you influence the rating process anyhow? Were the different critical points discussed with you during the process?
- Did you ever change your rating agency? Why? What are the differences between one rating agency and another?

**E) Effects of the rating**

- According to you, what was your rating good for? To which extent were your prior expectations fulfilled? Especially, do you feel that counting with a rating eases your funding constraints?
- What were the most important observations the rating agency did about your institution?
- Has your institution faced any major changes because of the observations made by the rating agencies? Or more generally, how do you incorporate / treat the rating agency's observations? Did they have any effects on the management of your institution?

**F) Social ratings**

- What are your objectives in the social area?
- According to you: What are the most important indicators for evaluating the social performance of a microfinance institution?
- How important is it for your MFI to measure its social performance? How do you do it? What tools do you use?
- How do you evaluate the interest of third parties for such kind of evaluation?
- Do you know about the existence of social ratings for MFIs? What do you think about them?
- Have you ever received a social rating? Why?
- Do you think that the methodologies of the specialized rating agencies adequately cover the most important indicators for your social objectives?
- What do you think about your social rating (grade)?

- What were the effects of the rating on your institution (internal and external)?
- Are you planning to receive (another) social rating in the future?

### **Interviews with rating agencies**

#### **A) Characteristics of the rating agency**

- What is the vision and mission of your company?
- What is the role of ratings of microfinance institutions in Peru?

#### **B) Activities of the rating agency**

- When, why and how was your rating agency founded?
- What is the link of your company and [name of U.S. rating agency]? What is the cooperation model?
- How many employees and rating analysts does your rating agency have?
- What is your principle business? Why?
- How would you describe the position of your company in the Peruvian rating market?
- Since when does your company rate MFIs?
- Which is the percentage of ratings assigned to MFIs relative to all your rating activities? How important is the business of rating MFIs for your company?
- Can you characterize the type of MFIs which receives ratings from your company? Any reasons?
- How much does a rating cost and how are these costs calculated?
- What is the role of the rating fund and other subsidies for the ratings you assign to Peruvian MFIs?

#### **C) Rating process and methodology**

- Can you describe the rating process of an MFI?
- How many analysts participate in the process?
- Which kind and level of education is required to be a rating analyst? Do you ask for any type of special education?
- How do you take the final decision? How is the rating committee organized and composed?
- How did you define the relevant rating areas and indicators?
- How important is the experience of the company and/or single rating analysts for the final decision?
- To which extent are qualitative indicators counted for?
- How long does the whole process take?
- If applicable: Is there any major difference in the process and methodology between an MFI rating and a rating of any other financial institution? Do you need any special knowledge? What are the specific challenges when rating MFIs?

#### **D) Validity**

- How do you validate the ratings of your company? Do you have any type of quality control? Do you have any studies on rating movements or defaults?
- Did you ever make major changes to your rating methodology? Why? Which?
- Do you follow the development of your rated companies of bonds on a regular basis? Do you publish any related information? How (watch-list)?

#### **E) Other services**

- Does your company offer any other (complementary) services apart from ratings?
- If applicable: Have you ever thought of applying at CONASEV for an official accreditation of your rating agency?

#### **F) Social ratings**

- If applicable: Are you aware of the existence of social ratings for MFIs? What do you think about them? Have you ever thought of offering a similar service?
- If applicable: What do you think is the importance of social ratings now and in the future? Who (could) have a special interest in social ratings?
- If applicable: Repeat questions about process and methodology for social ratings.

### **Interviews with financial regulators**

#### **A) Introduction into legal framework for microfinance institutions in Peru**

- How did the regulation of microfinance institutions in Peru evolve? What were the major steps and challenges?
- As there is only one legal framework for financial institutions including MFIs: What are the specific points important for MFIs? What are the regulatory differences between MFIs and other financial institutions? Why?

#### **B) Ratings and regulation of microfinance institutions**

In the article 136 of the banking law it is stated that any financial institution collecting deposits from the public has to count with a credit rating of two external rating agencies every six months.

- Since when does this rule exist?
- Does this rule also apply in the case of MFIs? To any MFI? What are the specific consequences for an MFIs operations?
- What does this mean for the supervision of MFIs? To which degree does the banking supervision rely on the ratings provided by external rating agencies? Why?

#### **C) Regulation of rating agencies**

- Since when do rating agencies in Peru exist? Since when are external ratings incorporated into financial market regulation?
- Since when are rating agencies regulated?
- Which are the most important points regarding the regulation of rating agencies? How did

these points evolve? Which were the examples to develop these principles?

- Apart from the established rating agencies: Did other raters try to receive an accreditation? Which was the result and why? Could the rating agencies specialized on microfinance easily receive an accreditation? Why / why not?
- How are rating agencies supervised? On a regular basis?
- Have you ever experienced any irregularities with your accredited rating agencies? What were the regulatory consequences?

### **Interviews with experts or microfinance supporting organizations**

- Could you describe the development of the Peruvian microfinance sector in the last five years?
- How important is the regulatory environment for the development of MFIs in Peru? In which sense?
- What is the mission of the different MFIs in Peru?
- According to you: What is the role of external ratings in the Peruvian microfinance sector?
- Specialized rating agencies also offer ratings to measure the social performance of MFIs. What do you think about it?

Annex 4 – Questionnaire MIV survey February 2009<sup>283</sup>

**1. How many Microfinance Investment Vehicels are you working with?**

Please note:

*If you are working with more than one MIV, please refer to only one answering the following questions.*

**2. How long has the vehicle been operating in the microfinance market?**

1    2    3    4    More than 5 years    More than 10 years    No answer

**3. If possible, please indicate the total asset size of the MIV.**

Total assets: USD  as of 12/2008. *Please specify, if other date is applicable:* as of

Alternatively:

< USD 20 million    > USD 20 million    > USD 50 million    > USD 100 million  
 > USD 250 million    > USD 300 million    No answer

**4. If possible, please indicate (roughly) the percentage of the portfolio dedicated to microfinance:**

%

**5. If possible, please indicate (roughly) the percentage of type of investor (portfolio held)**

%   Public  
 %   Institutional (professional)  
 %   Retail  
 %   High Net Worth Individuals  
 %   Other  
   No answer

<sup>283</sup> The questions listed here are those used in the present study. Additional questions solely related to the work of Kathleen Welvers were removed.

**6. Barriers: Comparing the environment and conditions to invest in microfinance today and in 2004, how would you evaluate the following barriers that investors may face?**

*You can tick more than one answer.*

BARRIER	Has been overcome	Still a minor obstacle	Still an important obstacle	Will be an important obstacle in the future	No answer
Small deal size	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Insufficient social impact measurement	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Lack of transparency on the industry level	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Lack of transparency on the MFI level	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Lack of sufficient investment opportunities in sustainable MFIs	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Local market regulation in target countries	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Appropriate supervisory framework by central banks in target countries	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

**7. Opportunities: Looking at the development of private microfinance investments from 2004 until today and future development: Which developments have contributed to or will contribute to the rise of private investments in microfinance?**

*You can tick more than one answer.*

OPPORTUNITY	Little influence until today	Strong influence until today	Strong driver in the future	No influence at all	No answer
General rise of Socially Responsible Investments (SRI)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
General rise of emerging market investments	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Publicity for microfinance through Nobel Peace Prize etc.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Improving risk adjusted returns of microfinance investments	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Risk profile of microfinance discovered by investors (default rate, correlation, volatility)	<input type="checkbox"/>				
More MFIs becoming sustainable institutions	<input type="checkbox"/>				
Improving transparency of the sector	<input type="checkbox"/>				

### **8. How do you assess the performance of MFIs?**

*You can tick more than one item.*

- Microfinance performance ratings by specialized agencies (MicroRate, PlaNet Rating etc.)
- Conventional – credit risk rating by international agencies (Fitch, Moodys, Standard & Poors)
- Conventional – credit risk rating by local agencies
- Own ratings / risk assessment of MFIs
- Assessment by external advisors
- Other, please specify:
  
- No answer.

### **9. If applicable, how important are ratings in your investment decision?**

*You can choose on a scale from 1 to 5, with an ascending level of importance.*

1 <i>Not important</i>	2 <i>Of little importance</i>	3 <i>Somewhat important</i>	4 <i>Important</i>	5 <i>Very important</i>
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

- No answer

**10. “Ratings influence the decision-making process regarding costs of funding for MFIs considerably.” Do you agree?**

*You can choose on a scale from 1 to 5, with an ascending level of agreement.*

1 <i>Disagree</i>	2 <i>Tend to disagree</i>	3 <i>Undecided</i>	4 <i>Tend to agree</i>	5 <i>Agree</i>
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

No answer

**11. How do you assess social performance?**

*You can tick more than one item.*

- Impact studies of selected MFIs
- Social performance ratings by specialized rating agencies
- Own measurement of social performance, using the following criteria:
  - 1.
  - 2.
  - 3.
- No assessment of social performance
- Other, please specify:
  
- No answer

**12. “There is an increasing interest among our investors in the measurement of the social impact of microfinance investments within the last four years.” Do you agree?**

*You can choose on a scale from 1 to 5, with an ascending level of agreement.*

1 <i>Disagree</i>	2 <i>Tend to disagree</i>	3 <i>Undecided</i>	4 <i>Tend to agree</i>	5 <i>Agree</i>
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

No answer

**13. “Increasing critique towards microfinance (e.g. Compartamos debate) is a severe danger for the image of microfinance as a SRI.” Do you agree?**

*You can choose on a scale from 1 to 5, with an ascending level of agreement.*

1 <i>Disagree</i>	2 <i>Tend to disagree</i>	3 <i>Undecided</i>	4 <i>Tend to agree</i>	5 <i>Agree</i>
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

No answer

**14. How important will social ratings be in the future, in the decision-making of microfinance investors?**

*You can choose on a scale from 1 to 5, with an ascending level of importance.*

1 <i>Not important</i>	2 <i>Of little importance</i>	3 <i>Somewhat important</i>	4 <i>Important</i>	5 <i>Very important</i>
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

No answer

## Annex 5 - Rating grades and rating scale definitions of the four specialized rating agencies

Planet Rating		MicroRate		M-CRIL		MikroFinanza Rating	
Grade	Rating Scale Definition	Grade	Rating Scale Definition	Grade	Rating Scale Definition	Grade	Rating Scale Definition
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.	α++	Those MFIs with an ongoing stable relationship among the financial, operational and strategic considerations of sound microfinance practice as compared to an international set of similar companies and standards of the micro-finance industry. Optimal efficiency and effectiveness. Very low risk / risk excellent managed, leaving company minimally susceptible to variability during economic cycles.	α+++	Highest safety, excellent systems --> most highly recommended	AAA+, AAA, AAA-	Excellent operations and performance. Exposure to risks is minimum and risks are very well monitored and managed. Very stable and highly unlikely to be adversely affected by foreseeable events.
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 limited impact on the institution's financial condition given its ability to quickly adjust its strategies and/or take corrective actions.	α+	Those MFIs that have successfully balanced the financial, operational and strategic considerations of sound microfinance practice as compared to an international set of similar companies and standards of the microfinance industry. Excellent efficiency and effectiveness. Low risks / risk well managed, leaving the company minimally susceptible to variability during economic cycles.	α+	Very high safety, good systems -> highly recommended	A+, A,-	Very good operations and performance. Exposure to risks is minimum and risks are well monitored and managed. Stable even if it could be affected by major internal or external events.
A,	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 very 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 conditions that should however remain moderate.	α,	Those MFIs working to define a relationship among the financial, operational and strategic considerations of sound microfinance practice as compared to an international set of similar companies and standards of the micro-finance industry. Good efficiency and effectiveness. Moderate risk / incipient risk management, leaving the company subject to some variability during economic cycles.	α	High safety, good systems --> highly recommended	BBB+, BBB, BBB-	Good operations and performance. Exposure to risks is limited and risks are quite well monitored and managed. Quite stable even if it could be affected by major internal or external events.
A-	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 very 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 conditions that should however remain moderate.	α-	Those MFIs working to define a relationship among the financial, operational and strategic considerations of sound microfinance practice as compared to an international set of similar companies and standards of the micro-finance industry. Good efficiency and effectiveness. Moderate risk / incipient risk management, leaving the company subject to some variability during economic cycles.	α-	Reasonable safety, good systems --> recommended	BB+, BB, BB-	Adequate operations and performance. Exposure to risks is limited and risks are monitored and managed. Stable even if it could be affected by internal or external events.
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 very 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 conditions that should however remain moderate.	β+	Those MFIs working to define a relationship among the financial, operational and strategic considerations of sound microfinance practice as compared to an international set of similar companies and standards of the micro-finance industry. Good efficiency and effectiveness. Moderate risk / incipient risk management, leaving the company subject to some variability during economic cycles.	β+	Reasonable safety, reasonable systems --> recommended, needs monitoring	B+, B, B-	Sufficient operations and performance. The institution is exposed to some risks and they are sufficiently monitored and managed. Not completely stable and vulnerable to internal or external events.
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 very 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 conditions that should however remain moderate.	β	Those MFIs working to define a relationship among the financial, operational and strategic considerations of sound microfinance practice as compared to an international set of similar companies and standards of the micro-finance industry. Good efficiency and effectiveness. Moderate risk / incipient risk management, leaving the company subject to some variability during economic cycles.	β	Moderate safety, moderate systems --> acceptable, needs improvement to handle large volumes	CCC+, CCC, CCC-	Basic operations and performance. The institution is exposed to some risks even if they are in part monitored and managed. Potentially unstable and vulnerable to external or internal events.

## Rating grades and rating scale definitions of the four specialized rating agencies (continued)

Planet Rating		MicroRate		M-CRIL		MikroFinanza Rating	
Grade	Rating Scale Definition	Grade	Rating Scale Definition	Grade	Rating Scale Definition	Grade	Rating Scale Definition
B-	Current institutional, operation 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.	β-	Those MFIs lacking a clear relationship among the financial, operational and strategic considerations of sound microfinance practice compared to an international set of similar companies and standards of the microfinance industry. Acceptable efficiency and effectiveness. Moderate risk / inadequate risk management, leaving the company subject to significant variability during economic cycles.	β-	Significant risk, poor to moderate systems --> acceptable only after improvement	CC+, CC, CC-	Very basic operations and performance. Exposition to risks and weak capacity to monitor and manage risks. Potentially unstable and vulnerable to external or internal events.
C++, C+, C, C-	Current institutional, operational and financial performances are below 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.	β-	Those MFIs with financial, operational or strategic weaknesses that have the potential to threaten their viability, now or in future, as compared to an international set of similar companies and standards of the microfinance industry. Poor efficiency and effectiveness. High risk, with high variability during economic cycles.	γ	Highest risk, poor systems --> not worth considering	C+, C, C-	Poor operations and performance. Relevant exposition to risks and poor capacity to monitor and manage risks. Potentially unstable and vulnerable to external or internal events.
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.	γ	Those MFIs with financial, operational or strategic weaknesses that have the potential to threaten their viability, now or in future, as compared to an international set of similar companies and standards of the microfinance industry. Poor efficiency and effectiveness. High risk, with high variability during economic cycles.	γ	Highest risk, poor systems --> not worth considering	D+, D, D-	Very poor operations and performance. Relevant exposures to risks and very poor capacity to monitor and manage the risks. Unstable and very vulnerable to external and internal events.
E	Immediate risk of default: Existing operational and/or financial and/or strategic weaknesses create outstanding risk of default. Performance is very poor in most evaluation areas.						

Source: Own elaboration based on Planet Rating (April 2008: 16) , MicroRate (September 2008: 17) , M-CRIL (2009b) and MikroFinanza Rating (September 2009b: 36) .

## Annex 6 - Rating categories and sub-categories covered by the four specialized rating agencies

Sub-categories covered (and disclosed) by the four specialized rating agencies:						
Category	Sub-category	Planet Rating	MicroRate	M-CRIL	MicroFinanza Rating	
<b>Context</b>	Macroeconomic context	Political and economic environment	Subdivision not further disclosed	Country overview	Political and macroeconomic context	
	Microfinance sector	Microfinance sector			Microfinance sector, Regulation and supervision	
<b>Governance &amp; Planning</b>	MFI background and presentation	Institutional presentation	Not covered	Microfinance Operations, Microfinance Policies	Institutional background	
	Governance structure and quality	Decision-making	Subdivision not further disclosed	Governance structure	Ownership and governance	
<b>Management</b>	Strategy & Planning	Planning		Operational and Growth Strategy	Strategic objectives and strategies, Financial projections, Financial needs	
	Management composition	Management team	Not further disclosed	Second line of leadership	Organization and structure	
<b>Risk Management</b>	Human resources management	HR management	Human resources	Human resources quality & management	Human resources	
	Procedures & Controls	Procedures and internal controls	Not explicitly covered	Internal control systems	Risk management and internal control, Accounting and external audit	
	Internal audit	Internal audit	Not further disclosed			
<b>Management Information System</b>		Information system design & Data quality	Management Information System	Accounting and MIS, Tracking system for overdue	Management Information System	

**Rating categories and sub-categories covered by the four specialized rating agencies  
(continued)**

Sub-categories covered (and disclosed) by the four specialized rating agencies:						
Category	Sub-category	Planet Rating	MicroRate	M-CRIL	MicroFinanza Rating	
<b>(Microfinance) Activities</b>	Asset deployment	Not explicitly covered	Not explicitly covered	(partly explicitly covered by) Infrastructure	Asset structure	
	Microfinance products	(covered in institutional presentation)		Loan product	Lending products	
	Market position / Competition	Not explicitly covered	Not further disclosed	Competition	Market positioning	
	Lending policies and procedures	Financial Services Management	Subdivision not further disclosed	(partly explicitly covered by) Quality of clients / member groups	Lending procedures	
	Portfolio quality	Credit risk		Credit performance and portfolio quality	Portfolio structure, Loan portfolio quality	
	Credit risk coverage	not further disclosed	Not further disclosed	Not further disclosed		
	<b>Funding &amp; Liquidity</b>	Funding structure	Capital adequacy and funding strategy	Subdivision not further disclosed	Mobilization of funds & capital quality	Liabilities and equity structure
		Capital adequacy			Asset, liability & equity composition	
		Market risks	Market risks		Not explicitly covered	Assets and liabilities management
		Liquidity risk	Liquidity risk		Financial planning	
<b>Financial Sustainability</b>	Profitability	Return on asset, Revenue quality	Productivity and Efficiency	Profitability and sustainability	Financial and operational results	
	Efficiency	Operational Efficiency, Asset optimization		Operating efficiency		
<b>Social Performance</b>		Not covered	Social Results, Social Commitment	Not covered	Not covered	

Source: Own elaboration based on Planet Rating (April 2008; July 2010; March 2010), MicroRate (2011c; December 2008; September 2008), M-CRIL (April 2009; December 2008a; December 2008b) and MicroFinanza Rating (May 2009; September 2009b; 2009).

Note: The denomination “[subdivision] not further disclosed” means, that the information was (in most general terms) found in the reports reviewed. “Not explicitly covered” indicates that the information was not found in the reports and “not covered” means, that the rating agencies explicitly do not assess this category. The table has to be interpreted with some caution as the number of reports reviewed for this assessment is limited. That some information was not found in the report does not necessarily mean that the respective rating agency totally ignores that area in general but might rather reflect the level of detailedness of the report.

## Anex 7 – Categories and sub-categories covered in social ratings by the four specialized rating agencies

Categories and Sub-categories				
Dimension	Planet Rating	MicroRate	M-CRIL	MicroFinanza
<b>Context</b>	<ul style="list-style-type: none"> <li>• Microfinance sector</li> <li>• Socio-economic environment</li> </ul>	not further disclosed and very brief on socio-economic environment	<ul style="list-style-type: none"> <li>• Development indicators</li> <li>• Microfinance</li> </ul>	<p><b>Institutional Presentation:</b></p> <ul style="list-style-type: none"> <li>• Institutional profile</li> <li>• Financial performance</li> </ul> <p><b>Context:</b></p> <ul style="list-style-type: none"> <li>• Socio-economic context</li> <li>• Microfinance sector</li> </ul>
<b>Process (Intent and Design &amp; Internal Systems / Activities)</b>	<ul style="list-style-type: none"> <li>• <b>Social Performance Management (25%):</b></li> <li>• Definition of social mission</li> <li>• Institutionalization of social mission</li> <li>• Social performance monitoring</li> <li>• <b>Client Protection and Ethical Finance (30%):</b></li> <li>• Prevention of over-indebtedness</li> <li>• Transparency of services</li> <li>• Responsible pricing</li> <li>• Appropriate collection practices</li> <li>• Ethical staff behavior</li> <li>• Mechanisms for redress of grievances</li> <li>• Privacy of client data</li> <li>• Ethical finance</li> <li>• <b>Human Resources Policy (20%):</b></li> <li>• Equal rights</li> <li>• Compensation policy</li> <li>• Labor conditions</li> </ul>	<p><b>Social Commitment:</b></p> <ul style="list-style-type: none"> <li>• Mission, communication and management</li> <li>• Strategic planning</li> <li>• Monitoring</li> <li>• Client protection</li> <li>• Customer service</li> <li>• Recruitment and training</li> <li>• Incentive system</li> </ul>	<p><b>Intent and Design:</b></p> <ul style="list-style-type: none"> <li>• Mission: <ul style="list-style-type: none"> <li>- Clarity</li> </ul> </li> <li>• Alignment of systems: <ul style="list-style-type: none"> <li>- Model for service delivery</li> <li>- Market strategy (incl. breadth of outreach)</li> <li>- HR (social commitment of staff and incentives)</li> <li>- Information and reporting</li> </ul> </li> <li>• <b>Social responsibility:</b></li> <li>• Client protection: <ul style="list-style-type: none"> <li>- Transparency</li> <li>- Avoiding over-indebtedness</li> <li>- Costs to clients</li> <li>- Client interaction</li> <li>- Non-financial services and linkages</li> </ul> </li> <li>• <b>Other social responsibility:</b></li> <li>• Gender approach: <ul style="list-style-type: none"> <li>- Client level</li> <li>- Staff</li> </ul> </li> <li>• Responsibility to staff</li> <li>• Responsibility to community &amp; environment</li> </ul>	<p><b>Social performance management systems:</b></p> <ul style="list-style-type: none"> <li>• Mission, social objectives and strategy</li> <li>• Tracking and monitoring system</li> <li>• Alignment of the systems to the mission</li> </ul> <p><b>Social responsibility:</b></p> <ul style="list-style-type: none"> <li>• Social responsibility towards personnel</li> <li>• Social responsibility towards clients</li> <li>• Social responsibility towards community and environment</li> </ul>
<b>Output</b>	<ul style="list-style-type: none"> <li>• <b>Financial Inclusion (25%):</b></li> <li>• Outreach to the underserved</li> <li>• Adaption of services</li> <li>• Cost of services</li> <li>• <b>Social Change (Notch up):</b></li> <li>• Health, education and basic services</li> <li>• Gender equity and women empowerment</li> <li>• Democracy and human rights</li> <li>• Job creation</li> <li>• Environmental sustainability</li> <li>• End poverty</li> <li>• Environmental sustainability</li> </ul>	<p><b>Social Results:</b></p> <ul style="list-style-type: none"> <li>• Depth and diversity of services</li> <li>• Cost, efficiency and sustainability</li> <li>• Institutional social responsibility</li> </ul>	<p><b>Results and Outputs:</b></p> <ul style="list-style-type: none"> <li>• Outreach <ul style="list-style-type: none"> <li>- Areas of operation</li> <li>- Financial inclusion (the unbanked, the poor, the vulnerable)</li> <li>- Employment</li> <li>- Client profile</li> <li>- Client awareness</li> <li>- Group systems</li> <li>- Client feedback</li> <li>- Client satisfaction</li> <li>- Client exit</li> </ul> </li> </ul>	<p><b>Outreach:</b></p> <ul style="list-style-type: none"> <li>• Operational areas</li> <li>• Clients reached</li> </ul> <p><b>Quality of services:</b></p> <ul style="list-style-type: none"> <li>• Variety</li> <li>• Adequacy</li> <li>• Non-financial services</li> </ul>

Source: Own elaboration based on Planet Rating (January 2010; September 2009), MicroRate (July 2008), M-CRIL (2007; 2008b), MicroFinanza Rating (December 2010b; July 2009).

## Annex 8 - Rating scales and definitions for social ratings

Planet Rating		MicroRate			M-CRIL		MicroFinanza Rating	
Rating Scale	Rating Definition	Rating Scale	Rating Definition	Rating Scale	Rating Definition	Rating Scale	Rating Definition	
		Social Rating Stars (1 to 5): Measures the social return on investment in an MFI through the assessment of Social Performance and Social Commitment.						
		Social Performance:		Social Commitment:				
		Excellent	Very good social results focusing on the poorest microfinance niche. Excellent social efficiency, consistency and outstanding institutional responsibility	High	High social commitment and low probability that the institution will deviate from its social mission.	Σ <sup>5</sup> AAA	Excellent capacity to effectively translate its mission into practice and to promote social values. Very high likelihood to achieve social goals.	
5+ 5 5-	<b>Advanced:</b> Long-commitment to social goals; efficient management of social performance and social responsibility risks; institution very likely to achieve a positive social impact.	Good	Good social results focusing on a poor microfinance niche. <b>Good</b> social efficiency, consistency and a moderate institutional responsibility			Σ <sup>5</sup> AA	<b>Very good</b> capacity to effectively translate its mission into practice and to promote social values. Very high likelihood to achieve social goals.	
4+ 4 4-	<b>Convincing:</b> Clear commitment to social goals; reasonable management of social performance and social responsibility risks; institution likely to achieve a positive social impact.					Σ <sup>5</sup> A	<b>Good</b> capacity to effectively translate its mission into practice and to promote social values. Very high likelihood to achieve social goals.	
3+ 3 3-	<b>In progress:</b> Clear intent to reach social goals; social performance management systems being implemented.	Adequate	<b>Acceptable</b> social results focusing on the middle microfinance niche. An <b>acceptable</b> social efficiency, consistency and acceptable institutional responsibility.	Medium	<b>Medium</b> social commitment and <b>medium</b> probability that the institution will deviate from its social mission.	Σ <sup>5</sup> BBB	<b>Completely adequate</b> capacity to effectively translate its mission into practice and to promote social values. High likelihood to achieve social goals.	
2+ 2 2-	<b>Incipient:</b> Clear intent to reach social goals; low capacity to manage social performance.					Σ <sup>5</sup> BB	<b>Adequate</b> capacity to effectively translate its mission into practice and to promote social values. High likelihood to achieve social goals.	
1+ 1 1-	<b>Intangible:</b> Intention to reach social goals is non tangible; low level of management of social performance.	Poor	<b>Poor</b> social results that focus on an undefined microfinance niche. <b>Low</b> social efficiency, consistency and a lack of institutional responsibility.	Low	<b>Low</b> social commitment and <b>high</b> probability that the institution will deviate from its social mission.	Σ <sup>5</sup> C	<b>Fairly adequate</b> capacity to effectively translate its mission into practice. And to promote social values. Reasonable likelihood to achieve social goals.	
0+ 0	<b>Negative:</b> No intention to reach social goals; mismanagement leads to negative social performance.					Σ <sup>5</sup> D	<b>Inadequate</b> capacity to effectively translate its mission into practice and to promote social values. Low likelihood to achieve social goals.	

Source: Own elaboration based on MicroFinanza Rating (December 2010b:24), M-CRIL (2008b:16), Planet Rating (January 2010:17), MicroRate (July 2008:9)



## Weitere Anhänge laut Prüfungsordnung

### Kurzfassung der Ergebnisse auf Deutsch

Mikrofinanzinstitutionen existieren in den meisten Entwicklungs- und Schwellenländern und zielen auf die Bereitstellung angepasster Finanzdienstleistungen für einkommensschwache Bevölkerungsschichten ab. Seit den 1980er Jahren hat sich der Mikrofinanzsektor in vielen Ländern zu einer wirtschaftlich nachhaltigen Industrie und integralem Bestandteil des Finanzsystems entwickelt. Um ihren hohen Refinanzierungsbedarf zu decken, dabei gleichzeitig die Abhängigkeit von öffentlichen Geldgebern und Spendern zu verringern und somit für immer breitere Schichten der Bevölkerung den Zugang zu Mikrokrediten sicherzustellen, begannen eine zunehmende Anzahl von wirtschaftlich erfolgreichen Mikrofinanzinstitutionen damit, sich internationalen, auch kommerziellen Investoren zuzuwenden. Dieser Prozess der Professionalisierung und Kommerzialisierung wurde von Akteuren der internationalen Entwicklungszusammenarbeit auch dadurch begleitet, die nötige Infrastruktur auf der Meso-Ebene zu schaffen oder zu stärken. Die Maßnahmen reichen von der Beratung zur Etablierung eines geeigneten, regulativen Rahmens auf nationaler Ebene bis hin zur Schaffung von auf internationale Visibilität und Transparenz abzielende Informationsdienste. Die politische und finanzielle Unterstützung von auf Mikrofinanzinstitutionen spezialisierte Ratingagenturen ist hier ein weiteres Beispiel.

Die vorliegende Dissertation zielt darauf ab, den möglichen Beitrag von Ratingagenturen für die nachhaltige Entwicklung von Mikrofinanzinstitutionen zu ergründen. Gleichzeitig wird die Frage gestellt, welche besondere Rolle den spezialisierten Ratingagenturen dabei zukommt und was dies für mögliche Entwicklung der Mikrofinanz-Rating-Industrie bedeuten könnte.

Den theoretisch konzeptionellen Rahmen für die Analyse bildet die Herausarbeitung der Funktionen von den drei großen, international anerkannten U.S. Rating Agenturen: Moody's, Standard & Poor's und Fitch. Aufbauend auf existierenden theoretischen Ansätzen zur Erklärung der verschiedenen Funktionen von Finanz- und dann vor allem Informationsintermediären (inklusive Ratingagenturen), werden darüber hinausgehende theoretische Überlegungen angestellt, um schließlich auch Aussagen über die mögliche Funktionalität von Ratingagenturen treffen zu können. Neben den (mikro-) ökonomischen Theorien basiert diese Arbeit auf Ansätzen aus der Psychologie und (Wirtschafts-) Soziologie, welche die ökonomischen Theorien an einigen Stellen ergänzen, an anderen wiederum hinterfragen. Ein zentrales Element ist dabei die Auseinandersetzung mit dem Risikobegriff und der damit einhergehenden, möglichen Verlässlichkeit von Ratingagenturen hinsichtlich ihrer Einschätzung von zukünftigen Zahlungsausfällen. In einem zweiten Schritt, wird die Debatte hinsichtlich kritischer und kritisierter Aspekte in Bezug auf die Aktivitäten und das Verhalten der drei großen Ratingagenturen dargestellt. Diese Analyse liefert weitere, wichtige Anhaltspunkte in Bezug auf die Funktionalität von Ratingagenturen im internationalen Kapitalmarkt.

Schließlich wird das so erarbeitete Analyseraster auf den Fall der Mikrofinanzindustrie angewendet. Mit einem vergleichenden Ansatz wird zum einen der Frage nachgegangen, welche Funktionen von Ratingagenturen zum gegenwärtigen Zeitpunkt innerhalb der Mikrofinanzindustrie relevant sind. Zum anderen wird analysiert, inwiefern sich die auf Mikrofinanzen spezialisierten Ratingagenturen von konventionellen lokalen und internationalen Ratingagenturen unterscheiden. Diese Unterschie-

de lassen wiederum Rückschlüsse auf die Kontext-spezifische Relevanz der verschiedenen Funktionen sowie die Funktionalität unterschiedlicher Ratingmethoden und –produkte zu.

Der empirische Teil basiert auf der Analyse von qualitativem Datenmaterial vor allem in Form von Rating Reports, Strategie- und Leitfadepapieren aus der Praxis, bestehenden Umfragen, Webseiten und Zeitungsberichten. Die Auswertung ausgewählter, quantitativen Daten in Bezug auf die Eigenschaften von Mikrofinanzinstitutionen und die Mikrofinanzinvestitionslandschaft untermauern zentrale Argumente. Zudem stützt sich die Arbeit auf einer im Rahmen dieser Dissertation durchgeführten Umfrage unter spezialisierten Mikrofinanz-Investmentfonds. Für eine tiefergehende Analyse wurden schließlich eine Reihe qualitativer Interviews mit Akteuren im peruanischen Mikrofinanzsektor durchgeführt. Diese umfassen sowohl Mikrofinanzinstitutionen, Investoren, lokale Banken, die zuständigen Regulierungsbehörden als auch lokale, konventionelle und spezialisierte Ratingagenturen.

Der theoretische Teil arbeitet vier zentrale Funktionen von Ratingagenturen heraus, die jeweils weiter in verschiedene Unterfunktionen (im Folgenden in Klammern) aufgeteilt werden können: 1) Die Informationsfunktion (Informationsausgabefunktion, Informationssammelfunktion, Orientierungsfunktion), 2) die Zertifizierungsfunktionen (Qualitäts-/Transparenzzertifizierungsfunktion, Risikoklassifizierungsfunktion und Regulierungsfunktion), 3) die Kontrollfunktion (Monitoring- und Disziplinierungsfunktion) und 4) die Koordinationsfunktion. In Bezug auf die Funktionen und Funktionalität von Ratings im Mikrofinanzsektor können die nachfolgenden Hauptergebnisse festgehalten werden:

1. Ratingagenturen veröffentlichen in vielen Fällen Informationen über Mikrofinanzinstitutionen, die anderweitig nicht oder nur schwer zu erhalten sind. Die Informationsausgabefunktion ist damit von besonderer Relevanz und möglicherweise relevanter als im Falle großer Unternehmen, die sich über Anleihen auf dem internationalen Kapitalmarkt refinanzieren. Rating Reports werden von Investoren zur Vorbereitung ihrer eigenen Informationsbeschaffung und –prüfung geschätzt und senken unter Umständen die Refinanzierungskosten von Mikrofinanzinstitutionen. Spezialisierten Ratingagenturen kommt dabei eine besondere Rolle zu, da sie sich weniger auf leicht verfügbare Informationen innerhalb der Institutionen und Interviews verlassen und stattdessen eigene Auditing-Anstrengungen unternehmen. Desweiteren generieren und prüfen spezialisierte Ratingagenturen auch Informationen über die soziale Leistungsfähigkeit von Mikrofinanzinstitutionen. Letzteres hat insbesondere aufgrund der anhaltenden Kommerzialisierung und der damit verbundenen Kritik über Mikrofinanzen als sozial-verantwortliche Investition an Bedeutung gewonnen. Die Erreichung größerer Skaleneffekte ist jedoch dadurch beschränkt, dass der Mikrofinanzinvestitionsmarkt einen geringeren Grad der Disintermediation aufweist als der internationale Kapitalmarkt und Investoren, einschließlich lokaler Banken, zum gegenwärtigen Zeitpunkt eher langfristige Finanzierungsbeziehungen mit Mikrofinanzinstitutionen eingehen.

Dennoch leisten insbesondere die spezialisierten Ratingagenturen einen Beitrag zur Setzung von Standards im Mikrofinanzsektor, und Akteure aus Politik und Praxis greifen in ihren Bemühungen der Weiterentwicklung und Förderung des Mikrofinanzwesens auf das so generierte Wissen zurück. Die Standardisierung von als relevant identifizierter Information sowie deren Zusammenfassung in einem Ratingurteil (einer Note) ist eine Grundvoraussetzung im Hinblick auf die Erfüllung der Orientierungsfunktion. Diese kann Investoren in hoch disintermedierten Kapitalmärkten helfen, auf effiziente Weise mögliche Investitionsziele zu identifizieren. Im Hinblick auf die Orientie-

rungsfunktion sind die Ratings von spezialisierten Ratern wenig funktional für solche Investoren, die Mikrofinanzen mit anderen Anlageformen vergleichen möchten. Desweiteren sind auch die Ratingnoten von den verschiedenen spezialisierten Ratingagenturen untereinander schwerer miteinander zu vergleichen als die der großen U.S. Ratingagenturen, was die Funktionalität in diesem Sinne weiter einschränkt. In Bezug auf die Sozialratings gestaltet es sich zudem schwierig, ein sehr hohes Maß an Standardisierung in Form einer aussagekräftigen Note zu erreichen und dabei gleichzeitig den Interessen und Wertvorstellungen von heterogenen Akteuren einschließlich Investorengruppen gerecht zu werden.

2. Neben der Informationsfunktion haben Ratings auch eine Zertifizierungsfunktion. Insbesondere in weiter entwickelten Mikrofinanzmärkten wie dem peruanischen erscheinen Ratings schon jetzt ein Zeichen von Transparenz und Integrität zu sein, dem sich Mikrofinanzinstitutionen zu entziehen nicht mehr oder nur schwer in der Lage sehen. Zwar stellt das Rating derzeit oft (noch) keine formalisierte Zugangsvoraussetzung zu Refinanzierungsmitteln von Seiten der Investoren und Banken dar, doch sind die meisten Mikrofinanzinstitutionen davon überzeugt, dass dies implizit der Fall ist. Dass Ratings den Zugang zu Refinanzierung ermöglichen, wird von den spezialisierten Ratingagenturen aktiv als Werbebotschaft genutzt, wobei die Erwartungshaltung von Investoren in Bezug auf die Verfügbarkeit von Rating Reports auch von dem Verbreitungsgrad von Ratings in einzelnen Ländern und Regionen abzuhängen scheint. In weniger entwickelten Mikrofinanzmärkten stehen Mikrofinanzinstitutionen dem Nutzen von Ratings in diesem Sinne skeptischer gegenüber. Einzelne quantitative Studien zeigen, dass Ratings in der Tat zum gegenwärtigen Zeitpunkt keinen oder nur einen sehr geringen Einfluss auf die Menge der Refinanzierungsmittel für Mikrofinanzinstitutionen haben.

In Bezug auf die Rating Noten als verlässliches Risikomaß bleibt festzuhalten, dass insbesondere spezialisierte Ratingagenturen nicht die nötige Reputation haben, so dass Investoren sich in großem Maße auf sie verlassen wollen würden. Das hängt auch damit zusammen, dass die spezialisierten Ratingagenturen bis jetzt keinen Nachweis in Form von quantitativen Studien erbracht haben, der eine Korrelation zwischen Rating Noten und der Ausfallwahrscheinlichkeit von Mikrofinanzinstitutionen herstellt, obgleich ihre Evaluationen meist auf Recherchen basieren, die über die Anstrengungen von lokalen höchst wahrscheinlich auch international, konventionellen Ratingagenturen und sogar Mikrofinanzinvestoren hinausgehen. Bei einer genaueren Betrachtung der angewandten Ratingmethoden und einer tiefer gehenden Auseinandersetzung mit dem Risikobegriff wird klar, dass die direkte Übersetzung von Rating Noten in quantitative Ausfallwahrscheinlichkeiten irreführend und auch nicht ohne weiteres auf sehr unterschiedliche Sektoren übertragbar ist. Letztlich können aber auch ein Mangel an Transparenz bei den großen, konventionellen Ratern hinsichtlich ihrer Methoden und der Glaube an die Aussagekraft ihrer Korrelationsstudien dazu geführt haben, dass sich Investoren unverhältnismäßig stark auf die Urteile von Ratingagenturen verlassen haben. Dies geschah trotz der immer wieder aufkeimenden Kritik hinsichtlich ihrer Intransparenz und der vorherrschenden Interessenkonflikte aufgrund ihres Vergütungsmodells, ohne dass die Ratingagenturen für eventuelle Fehlurteile haftbar gemacht werden könnten. Ob spezialisierte Ratingagenturen verlässliche oder zumindest verlässlichere Urteile als ihre konventionellen Konkurrenten abgeben bleibt abzuwarten. Schon jetzt zeichnet sich ab, dass unterschiedliche Risikofaktoren fortwährend ausbalanciert werden müssen und auch spezialisierte Ratingagenturen ihre Risikoeinschätzungen an sich verändernde Kontexte und Dynamiken anpassen müssen, und dies auch tun. Ob diese Anpassungen eher pro- oder reaktiver

Natur sind, ist bis dato unklar. Investoren kritisieren bisher, dass die spezialisierten Ratingagenturen Länderrisiken zu wenig Betrachtung schenken.

Ein weiterer, wichtiger Grund dafür, dass Investoren sich zu stark auf die Ratingagenturen verlassen haben, ist ihre Einbettung in die Regulierung von Finanzmärkten, was es Investoren zuweilen unmöglich oder zumindest sehr teuer machte, diese Risikobewertungen zu ignorieren. Desweiteren scheint die Wachsamkeit von Akteuren in Bezug auf das Geschäftsgebaren und die angewandten Methoden von Ratingagenturen zu sinken, sobald sie sich a) im Markt etabliert haben und b) durch die Anerkennung von Regulatoren ihrerseits einen Qualitätsstempel erhalten haben. Dies zeigte sich auch in Peru, wo Marktteilnehmer aus dem „mainstream“ Finanzmarkt zudem viel, auch blindes Vertrauen in die Marke der großen U.S. Ratingagenturen setzen und lokale Ratingagenturen von der engen Verbindung mit letzteren profitieren.

Überhaupt spielt die Einbettung von Ratings in regulative Richtlinien auch eine große Rolle in Bezug auf die Nachfrage nach diesen Produkten, insbesondere nach der kontinuierlichen Erneuerung von Ratings. In Peru sind Mikrofinanzinstitutionen, die Spareinlagen einnehmen, mittlerweile verpflichtet, sich regelmäßig bewerten zu lassen. Bis vor kurzem war keine der spezialisierten Ratingagenturen von den peruanischen Aufsichtsbehörden anerkannt, und große Mikrofinanzinstitutionen gingen dazu über, sich nur noch von den akkreditierten Ratingagenturen evaluieren zu lassen. Es ist daher wenig verwunderlich, dass spezialisierte Rater ihrerseits nach regulatorischer Anerkennung streben und Regulierungsbehörden auch (in mindestens einem Fall) aktiv davon überzeugen zu versuchen, Ratings für Mikrofinanzinstitutionen überhaupt erst verpflichtend zu machen.

3. Der Grad, zu dem sich Investoren auf Ratingurteile verlassen und deren Effekte auf Refinanzierungsmittel hat weiterhin Auswirkungen darauf, inwiefern die Kontrollfunktion greift und Mikrofinanzinstitutionen dazu anhält, sich im Sinne der Ratingagenturen und möglicherweise Investoren zu verhalten. Es ist unklar, ob und inwieweit Ratingagenturen ein bestimmtes Verhalten von Seiten der Mikrofinanzinstitutionen erzwingen können, obgleich die spezialisierten Ratingagenturen zumindest in Peru bis zu einem gewissen Grad als Autoritäten wahrgenommen werden. Erste existierende, quantitative Studien legen nahe, dass Ratingagenturen keine oder nur sehr geringe Effekte auf die Leistung von Mikrofinanzinstitutionen haben, zumindest was ihre Auswirkungen in Bezug auf quantitative Leistungsindikatoren betrifft. Jedoch wurden die Evaluierungen der spezialisierten Rater insbesondere von kleineren Mikrofinanzinstitutionen geschätzt, so dass man hier auch von einer Beratungsfunktion sprechen kann. Um diese im Hinblick auf kleine, weniger professionelle Mikrofinanzinstitutionen wahrnehmen zu können, bieten spezialisierte Ratingagenturen zudem darauf abgestimmte Vorprodukte an, die auf mehr Partizipation von Seiten der Mikrofinanzinstitutionen setzen. Einige spezialisierte Rater bieten zudem auch direkt Beratungsdienstleistungen an, wobei festzuhalten bleibt, dass dies einen möglichen Interessenkonflikt noch verstärkt. Insbesondere im Hinblick auf die Beratungsfunktion scheint die Spezialisierung und insbesondere die Analyse der Kreditvergabetechnologien zentral, da dies Faktoren sind, die Mikrofinanzinstitutionen auch kurz- bis mittelfristig beeinflussen können. Die lokalen, konventionellen Ratingagenturen legen mehr Gewicht auf Faktoren wie Liquidität und eine starke Eigenkapitalbasis, die stark mit der Größe der Institutionen einhergeht.

Die angebotenen Sozialratings betreffend, geben auch größere Mikrofinanzinstitutionen an, von den Kenntnissen der Ratingagenturen lernen zu wollen, wie sie ihre soziale Leistungsfähigkeit verbessern können. Das gilt insbesondere dann, wenn erwartet wird, dass sich die soziale Leis-

tungsfähigkeit auch auf die finanzielle Leistung auswirkt. Jedoch wurde im Rahmen dieser Dissertation auch festgestellt, dass es zu möglichen Fehlanreizen kommen kann und Mikrofinanzinstitutionen sich entweder gezwungen sehen könnten, ihre sozialen Ziele hinsichtlich ihrer Messbarkeit auszurichten oder aber dazu verleitet werden, Ressourcen in das Aufpolieren ihres sozialen Erscheinungsbildes zu stecken, die möglicherweise anderweitig besser eingesetzt wären.

Schließlich dienen Ratings im internationalen Kapitalmarkt nicht nur dazu, das Verhalten von Institutionen mit Refinanzierungsbedarf zu beeinflussen sondern auch das Wirken von Anlageverwaltern, also denen, die im Auftrag von Primärinvestoren Investitionsentscheidungen treffen. Anlageverwalter könnten in Aussicht auf höhere Gewinne risikofreudig agieren, ohne jedoch im gleichen Umfang von möglichen Verlustrisiken betroffen zu sein. Primärinvestoren, aber auch Regulierungsbehörden, können mit der Aufstellung rating-basierter Anlageregeln Anlageverwalter kontrollieren. Im Mikrofinanzkontext spielen diese Funktionen eine untergeordnete Rolle. Dies ist wahrscheinlich auch damit zu begründen, dass insbesondere kommerzielle Investitionsgesellschaften eine eher konservative Investitionstrategie verfolgen und Investitionen langfristiger Natur sind und nicht an liquiden Sekundärmärkten gehandelt werden. Zudem wurde das Vertrauen von Investoren bisher eher selten durch Kreditausfälle erschüttert und so galten Mikrofinanzen lange Zeit als relativ sichere Anlageklasse. Inwiefern sich dies in Zukunft ändert, auch in Bezug auf jüngste, krisenhafte Entwicklungen in einzelnen Mikrofinanzmärkten, bleibt abzuwarten. Das Gleiche gilt für die mögliche, darauf bezogene Rolle von Ratingagenturen. Einige spezialisierte Ratingagenturen werben schon jetzt damit, dabei helfen zu können, zukünftigen Krisen im Mikrofinanzsektor vorzubeugen.

4. Mit der zunehmenden Autorität der großen U.S. Ratingagenturen kam einer weiteren Funktion eine zentrale Bedeutung zu: der Koordinationsfunktion. In hoch volatilen Kapitalmärkten, in der Investoren die Anlageentscheidungen anderer Investoren nicht oder nur schwer beobachten können, diese jedoch Einfluss auf die Ausfallwahrscheinlichkeit einzelner Anleihen haben (multiple Gleichgewichte), können Ratings eine stabilisierende Funktionen haben. Sie perpetuieren die im Markt vorherrschenden Risikoeinschätzungen und koordinieren die damit verbundenen Anlageentscheidungen hin zu dem stabile(re)n Gleichgewicht. Dies gilt, solange Ratingagenturen nicht ihrerseits sprunghaft auf sich im Markt temporär einstellende Zins- und Preisschwankungen reagieren. Ein absolutes, unverwerfliches Risikomaß existiert jedoch nicht und zukünftige Entwicklungen sind immer von einem hohen Maß an Unsicherheit geprägt. Zudem entstehen und potenzieren sich Risiken (nicht nur) im Finanzmarkt auch oder gerade durch menschliche Interaktion. Sobald ein sich einsetzendes Misstrauen im Markt einmal den Grad erreicht hat, bei dem auch Ratingagenturen zwecks Reputationserhalt gezwungen sehen, oftmals scheinbar plötzlich auf dem im Markt vorherrschenden Glauben zu reagieren, wirkt ihre zunächst stabilisierende Funktion eben so plötzlich pro-zyklisch. Dies kann mitunter ganze Volkswirtschaften in Bedrängnis bringen. Im Mikrofinanzsektor ist diese Funktion bis jetzt von wenig oder keiner Relevanz, insbesondere, was die Einschätzungen von spezialisierten Ratingagenturen betrifft.

Abschließend kann festgehalten werden, dass Ratings im Mikrofinanzsektor zum gegenwärtigen Zeitpunkt eine nützliche, zusätzliche Informationsquelle für Investoren darstellen, sie jedoch bei Weitem nicht die Bedeutung von Ratingagenturen im internationalen, „mainstream“ Kapitalmarkt erlangt haben. Der Nutzen von Ratings insbesondere für kleine Mikrofinanzinstitutionen steht höchst

wahrscheinlich nicht im Verhältnis zu ihren Kosten. Ob deswegen pauschale Subventionen von Ratings gerechtfertigt sind, ist fragwürdig, selbst wenn die Nachhaltigkeit der Mikrofinanz-Rating-Industrie auf dem Spiel steht. Mikrofinanzinvestitionsgesellschaften sollten nicht dazu verleitet werden, sich zu sehr auf die Urteile von Ratingagenturen zu verlassen (oder verlassen zu müssen) und dabei ihre eigenen, treuhänderischen Pflichten zu vernachlässigen. Gerade auch in jüngster Zeit, insbesondere im Zusammenhang mit der anhaltenden europäischen Schuldenkrise, wird auf politischer Ebene versucht, die Macht der Ratingagenturen zu brechen. Auch wenn stärkere, regulative Eingriffe in die Mikrofinanz-Rating-Industrie zu diesem Zeitpunkt überzogen wären, würden spezialisierte Ratingagenturen sowie deren Unterstützer gut daran tun, auch von den negativen Erfahrungen mit Ratingagenturen auf den internationalen Kapitalmärkten zu lernen.

## **Tabellarischer Lebenslauf**

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