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Does rating help microfinance institutions raise funds? Cross-country evidence

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Abstract

This paper studies whether microfinance rating agencies were able to impose market discipline on microfinance institutions (MFIs) during the period 1998–2002. The results indicate that not all rating agencies had the same impact. Rating by some rating agencies helped MFIs raise funds, while rating by other agencies did not. The evidence also suggests that subsidizing rating did not help MFIs raise more funds.

JEL classification: G21; G24
Keywords: Rating agencies; Microfinance institutions; Microfinance; International development; Financial institutions

1. Introduction

Development of financial institutions boosts economic growth and, moreover, benefits the poor more than other segments of the population (Beck, Demirguc-Kunt, & Levine, 2004; King & Levine, 1993). Worldwide, microfinance institutions (MFIs) expand the frontier of finance by providing loans and other financial services to the under-served entrepreneurial poor. In recognition of the microfinance industry impact, and in an effort to attract more attention by governments and potential donors, the United Nations proclaimed 2005 as the International Year of Microcredit. In addition, the 2006 Nobel Peace Prize was awarded to the founder and the first microfinance bank— Dr. Muhammad Yunus.

The emergence of agencies specializing in rating MFIs indicates that the industry has reached a certain level of maturity and that there is a need to identify effective mechanisms of market discipline (The Economist, November 6th, 2005). Microfinance rating agencies generate independent information and could improve efficient allocation of funds. Ratings may be especially important in the absence of developed equity and debt markets for microfinance and because there are few alternative mechanisms that can help donors and investors to support the most appropriate MFIs. In addition, microfinance institutions themselves could benefit from rating if it helps them attract more funds. On the other hand, rating may have a limited role since similarly to mainstream rating agencies, microfinance rating agencies have little competition and, since most have both consulting and rating operations, are rigged with conflict of interest problems (The Economist, May 26, 2005). To date, however, it is not clear whether rating played its usual disciplining role and, in particular, whether it helps MFIs raise funds.

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From policy perspective, a study on the impact of microfinance rating agencies and their ability to serve as an effective mechanism of external control is timely and important because policymakers have supported rating even without much empirical evidence about its benefits (Hartarska & Holtmann, 2006). In 2001, for example, to promote rating, the Inter-American Development Bank and the Consultative Group to Assist the Poor (CGAP) established a special fund called Rating Fund with the purpose of subsidizing rating of MFIs which could not afford to pay for it (see http://www.ratingfund.org).[1] Anecdotal evidence indicates that in the absence of sufficient technical assistance subsidized rating could help identify shortcomings and areas that need improvement but the impact of subsidizing rating on fundraising is yet unknown.

This paper develops a new database of about 130 MFIs operating in 62 countries and studies whether rating helped MFIs raise funds. It adopts an empirical approach used in studies on the impact of market forces, rating, and regulation on performance of financial intermediaries. The main conclusion is that the rating agencies differ greatly in their impact on MFIs' ability to raise funds. The evidence on the impact of subsidized rating is somewhat weak but it indicates that subsidizing rating did not help MFIs raise more funds.

The rest of the paper is organized as follows: Section 2 reviews the literature on rating as it applies to microfinance raters, Section 3 describes the empirical specifications, Section 4 describes the data, Section 5 discusses the results, and Section 6 offers concluding remarks.

2. Microfinance rating in the context of general rating practices

Credit rating agencies such as Moody's and Standard & Poor's help impose market discipline by rating companies' creditworthiness (and probability of default) which in turn affects their securities' prices. The literature on the impact of credit rating is substantial.[2] Most of the research focuses on non-financial firms, although credit rating agencies also rate financial intermediaries usually because regulators require it for some types of activities. For example, in the US banks need rating to issue letters of credit (DeYoung, Flannery, Lang, & Sorescu, 2001). In banking, the market influence of credit rating can be in the form of *direct market discipline* through the cost of capital as a function of banks' risk profile, and *indirect market discipline* through the impact of supervisor's actions motivated by the yields on banks' risk sensitive sources of funds (Kwast & Passmore, 1999).

Since financial intermediaries are subject to regulations and supervision, and since the regulator may provide explicit or implicit guarantees (for example, that the bank will be recapitalized to protect a country's payment system), credit ratings may not be able to adequately play a direct disciplining role. While some empirical evidence suggests that rating agencies are able to discipline banks as well as non-financial firms, the main contribution of rating banks may be to help regulators identify problem banks and take the necessary measures to strengthen them. (Morgan, 2002; Morgan & Stiroh, 2000).

It is yet unknown if microfinance rating can impose market discipline (Hartarska, in press). MFIs differ from banks and other financial intermediaries because the asset baseof most MFIs was created through grants by donors and because most MFIs do not have widely held equity and are not publicly traded companies. Moreover, MFIs do not usually issue bonds, do not necessarily collect deposits, and may or may not be regulated.

The expectation is that microfinance rating can play disciplining role because, similarly to other organizations, an MFI survives if it is able to raise funds and have sufficient liquidity to meet current obligations. Therefore, the willingness of donors and other creditors to provide liquidity and fund future projects is important. MFI stakeholders base their funding decision on information on the performance of MFIs, usually available through audited financial statements (Hartarska, 2005). In addition to this information, credit and global risk rating provided by independent raters may affect donors' willingness to provide additional funds for an MFI. Thus, rating in microfinance may play the same disciplining role as rating in banks and other financial institutions. Therefore, it is important to find out if microfinance rating played the disciplining role by helping rated microfinance institutions raise capital.

[1] The European Union joined the Rating Fund in 2005.

[2] A survey of recent developments of credit rating research is published in a special issue of the *Journal of Banking and Finance*, 2004. In its editorial, Cantor states that although research has produced valuable insights, some important issues are still outstanding. These include identifying the natural structure of the industry (oligopoly or more competition), understanding whether ratings in regulation entrench existing players or subsidize marginal players, how raters should be paid, and whether the stability of rating agencies and their lag in following securities prices diminishes or enhances the rating's usefulness (Cantor, 2004 p.2572).