

# CODE OF CONDUCT FOR MICROFINANCE RATING AGENCIES

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

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

## 1. INTEGRITY: RATINGS THAT ARE CHARACTERISED BY INTEGRITY ARE OBJECTIVE, INDEPENDENT AND TRANSPARENT.

a. *Best practice rating agencies actively take steps to mitigate any compromises to the integrity of ratings that might arise out of the “issuer-pays” business model,<sup>1</sup> both in case of first ratings and rating updates.*

- Rating agencies seek a **diversification of income streams** beyond relying exclusively on MFIs to pay for ratings.
- Rating agencies **disclose** in rating reports **the prior ratings**, given to rated MFIs by them and other rating agencies.
- Rating agencies provide information to their subscribers on **MFIs which have determined not to receive a rating** after having started the rating process.
- Rating agencies occasionally **change the leadership of their rating teams** for repeat customers.
- When rating a repeat customer, rating agencies test and, if appropriate, **correct prior opinions** even if such correction results in a downgrade from prior ratings.
- Rating agencies **maintain control over their rating reports** so as to avoid any tampering with the report’s conclusions.
- To avoid prior rating bias, rating agencies highlight to their rating committees not only prior grades given to a rated MFI but also any **significant changes in peer benchmarking since the last rating**.

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<sup>1</sup> An “issuer pays model” is a business model whereby the rated institution (here the MFI) pays the costs of procuring a rating.

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

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

### a. *Best practice rating agencies are fair and transparent.*

- Rating agencies deliver **opinions** that are **supported by all relevant facts**. They offer rated MFIs adequate **time to comment on their draft opinions**.
- They **disclose to MFIs their rating methodology**, processes, and fees before beginning the rating process.
- They **use labels** for their rating products that are **consistent with the intended scope of their ratings**.
- They **seriously consider criticisms** offered by their customers.
- Rating agencies provide MFIs with a **transparent and complete explanation of the full cost of ratings** prior to the execution of rating contracts. In addition to the rating fee, all other charges and fees also are disclosed in writing to the rated MFI. The rating contract clearly provides the amount of payment, currency of payment, and conditions of payment.

### b. *Best practice rating agencies, within the time limitations of a rating mission, conduct fact-driven analyses of their rated MFIs' performance and level of risks.*

- Rating agencies are fact driven. Their rating processes include **spending time onsite** with rated MFIs, but they also **travel beyond MFIs' headquarters**. They look at **other stakeholders** of the rated MFI for information. They **crosscheck data** and **seek verification** of information.

### c. *Best practice rating agencies use straightforward and clear language in their rating reports to express fact-based opinions.*

- Rating agencies structure their rating reports so that each offered opinion is supported by facts. They offer context for their ratings. They use easily understood language in their reports. They clearly identify what is being measured in the rating process and the scope of the rating. They document their rating methodologies as well as the actual rating.

### d. *Best practice rating agencies ensure that their rating missions are conducted by skilled rating analysts.*

- Rating agencies invest in the **recruitment, training and retention** of their rating analysts. They install only **skilled and experienced analysts as the leaders of rating teams**.

### e. *Best practice rating agencies develop internal procedures to ensure that ratings are consistent across rated customers and standardised product-by-product.*

- Rating agencies clearly **document** the rating methodologies for each of their rating services and products. They continually **train** staff in the use of such methodologies.
- Rating agencies employ the use of a **committee of senior, experienced staff** (often called the Rating Committee) to screen for consistency across rated MFIs and across rating products.

f. *Best practice rating agencies aim for **completeness** in their ratings.*

- Rating agencies take great care in clarifying the **scope of their ratings**. The scope of a rating informs what facts and issues are necessary and relevant to review in order to ensure the completeness of a rating. Complete ratings address risk probabilities, and performance of the rated MFI.
- Rating agencies share with the applicable Rating Committee information about any **disagreements** with the findings contained in the rating report that may have been raised by the rated MFI, and also inform the Rating Committee about how those disagreements were resolved.
- The **time-bound nature** of ratings also impacts their completeness. Rating agencies indicate a validity period for their rating, which is usually of one-year, provided that no significant change occurred in the operating environment or institutional or operational set-up of the MFI. To ensure the completeness of a recent rating, rating agencies encourage recently rated MFIs to report changes that could impact adversely the recent rating's validity or completeness.

## IMPLEMENTATION:

### *EVOLUTION*

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

### *SELF CERTIFICATION AND COMPLIANCE ASSESSMENT*

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

### *DISCLOSURE OF COMPLIANCE LEVEL*

The current of Code of Conduct constitutes an ideal that microfinance rating agencies are striving to comply with. For each of the practices spelled out in this Code, the self-certification and related compliance assessment will rate the level of compliance on the following scale:

- **Green light:** full compliance with the best practice.

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

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

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

#### Appendix - EXAMPLES OF COMPLIANCE LEVELS

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

##### **Integrity – Ownership ties**

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

##### **Integrity – Provision of non-rating services**

- **GREEN:** Rating agencies do not provide technical assistance or professional advice to MFIs.
- **ORANGE:** Where rating agencies receive direct financial revenues from MFIs for paid training services, rating agencies actively avoid a conflict of interest (or appearance of

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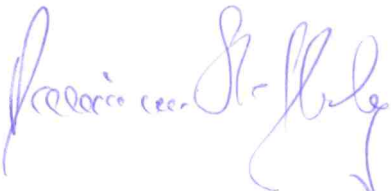


such a conflict) by ensuring that the training revenue that they receive directly from MFIs is a relatively insignificant proportion of the rating agency's overall annual revenue (less than 5%). Rating agencies also avoid arrangements that link, intentionally or unintentionally, the delivery of non-rating services to rating services and products (and vice versa).

**Integrity - Issuer-pays model; Diversification of revenues**

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

**Integrity – Governance structure; Sound administrative and accounting procedures**

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

Name and Title:	Damian von Stauffenberg <del>ALDO</del>	Otho Warmingoor	ALDO MOURO
Rating Agency:	Micro Rate	Planet Rating	MICROFINANCE RATING
Date and Place:	Sept 2, 2011	02/09/2011 Luxembourg	Sept 2, 2011
Signature:			

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