

Merrill Grabs New Microfinance Tool

CARS quantifies credits the rating agencies won't

The Nobel Peace Prize awarded to Bangladeshi economist Muhammad Yunus for his work in microcredit isn't the only thing transforming the microfinance industry this year. A new ratings tool recently picked up by **Merrill Lynch** has the potential to spur growth in the capital markets for this nascent industry.

Merrill Lynch Community Development Company (MLCDC) recently announced it was using a new ratings tool dubbed CARS to help it place some \$93 million in new investments with entities known as community development financial institutions, or CDFIs, and community development entities, or CDEs. In the world of microfinance, CDFIs and CDEs are on the front line of lending to developing communities and financing individuals or groups that fall outside the usual credit norms.

CARS — which stands for CDFI Assessment and Ratings System — is the first tool to rate these segments of the US microfinance industry. However, the groundbreaking product wasn't created by the usual rating agency suspects, but instead by the Opportunity Finance Network (OFN), a leading institution in US-based microfinance.

Back in 2002, **Mark Pinsky**, CEO of the Opportunity Finance Network, received some friendly advice from a banker who didn't have any ties to microfinance. He told Pinsky that the industry needed a rating system. OFN asked several rating agencies to draw up a tool for microfinance but, despite the goodwill associated with microfinance lending, all declined to do so.

"The overall conclusion was to come back when there was more to rate," says Pinsky.

However, with the rating agencies

balking at the small size of the industry, "we said we'll do it ourselves. It's based on our little \$20 billion world, and it offers a tremendous amount of transparency and efficiency," Pinsky says of CARS.

Grants from **JPMorgan**, **Fannie Mae**, the **Ford Foundation**, the **MacArthur Foundation** and the **Heron Foundation** helped fund the construction of CARS over the past three years. The system is structured similarly to mainstream ratings. CDFIs pay to be rated and investors pay a subscription fee. Pinsky said the ratings tool is likely to be profitable in three years but noted that down the road, the OFN would prefer to spin CARS out.

"The ratings provide a base of analysis for these institutions, so we don't have to start at square one each time," says **Dan Letendre**, director at MLCDC. "We can focus on the questions we need to ask that are particular to the deal. CARS allows us to do our work a lot faster."

It's also a huge leap forward for microfinance in terms of speaking the language of the capital markets. While the Street enjoys credit analysis of esoteric assets — as evidenced by the enormous growth of the structured finance market — it's been difficult for microfinance to gain the attention of capital market investors. While **Merrill Lynch**, **Citigroup** and **JPMorgan** in recent years have set up initiatives that work with CDFIs, broader Street attention will come only through the opportunity to create deal flow out of CDFI lending.

Evaluating CDFIs

CDFIs provide financing that involve a lot of technical assistance beyond lending the money. And that, sources say, is what has made drumming up interest among institutional investors so difficult.

"CDFIs are making loans that tradi-

tional retail banks can't or won't make," Letendre says. For example, loans to fund construction of a charter school carry a significantly different risk profile than construction of a community healthcare facility. For one, construction loans are typically several years longer in maturity, yet charter schools often receive only short-term charters and are subject to political risk. And when financing healthcare centers in low-income communities, "you have to have expertise in public sector funding as well as the individuals coming to these facilities," Letendre says.

CARS provides a standard template to evaluate CDFIs and transparency into the loans they make. Ratings are of two types: financial performance ratings, which are straight-forward credit risk assessments of a CDFI's capital, management and portfolio, and impact performance ratings, which assess the social benefits of the loans. For example, how many students were served each year by the charter school and what was their grade performance?

CDFIs can also obtain a "policy plus" notch on their rating by demonstrating contributions to public policy, from speaking engagements to research papers.

With a ratings tool now available, more institutional investors will probably start to look at microfinance investments. Many institutions charge high interest rates to help offset the cost of servicing these loans, a tempting prospect for yield-starved investors. Other allures can be gleaned from the data. For example, the charge-off rate is less than 1% — in an industry deemed too high risk for mainstream banks.

Colleen Marie O'Connor
Colleen.Oconnor@sourcemedia.com

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