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REGIONAL

**CONSOLIDATION OF THE RATING MARKET FOR
MICROFINANCE INSTITUTIONS**

RG-M1142

DONORS MEMORANDUM

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CONSOLIDATION OF THE RATING MARKET FOR MICROFINANCE INSTITUTIONS (RG-M1142)

I. EXECUTIVE SUMMARY

Beneficiary countries	Regional	
Executing Agency	MIF headquarters	
Beneficiaries:	The project's objective is to contribute to the consolidation of the rating market for microfinance. The specific objectives are to make rating services available to underserved markets as well as to improve the transparency of the microfinance sector.	
Financing:	Modality:	Non-reimbursable
	MIF non-reimbursable	US\$ 986,161 (61%)
	<i>Co-financing and counterpart</i>	
	CAF	US\$ 200,000 (13%)
	<u>Microfinance Institutions</u>	<u>US\$ 400,000 (26%)</u>
	Total	US\$ 1,586,161 (100%)
Objectives:	The project's objective is to contribute to the transparency in the microfinance sector. The specific objective is to strengthen the microfinance rating sector. These objectives will be accomplished by broadening the geographic outreach of ratings, supporting smaller MFIs to afford initial ratings, and improving the understanding of the market of the benefits and limitations of different types of rating products.	
Execution timetable:	Execution period: 30 months; Disbursement period: 36 months	
Special contractual Conditions:	None	
Exception to Bank Policy:	None	
Environmental and Social Review:	The abstract was cleared by the ESR Secretariat on July 7, 2008.	
Coordination with other Development Finance Institutions:	CAF will contribute US\$200,000 to the Fund facility. MIF will coordinate with a similar initiative championed by the Luxembourg Development Cooperation.	

II. BACKGROUND AND JUSTIFICATION

- 2.1 **Microfinance and Ratings.** Microfinance institutions (MFIs) have had an unprecedented success in expanding financial services to low-income populations. In consequence, interest from leading players in the global economy has soared. The universe of potential funders of microfinance programs has become broader and deeper every year. Following the lead of multilateral institutions, governments and Non-Governmental Organizations (NGOs) focused on microfinance, many foundations, private philanthropists, and commercial investors are now including microfinance as a portfolio option.
- 2.2 Microfinance ratings and assessments emerged in the late 1990s and have evolved on their own. Probably the first tool specifically designed to assess MFIs' financial health and overall performance was the CAMEL (Capital adequacy, Asset quality, Management, Earnings and Liquidity) method of ACCION International. The original CAMEL was developed in 1978 by the U.S. Federal Reserve to evaluate the solvency of U.S. banks. In 1993, ACCION International adapted the CAMEL to microfinance. This diagnostic tool has been mostly used within the member institutions of the ACCION network.
- 2.3 In 1996, the idea of a diagnostic tool for external users by a fully specialized microfinance rating agency was realized. The pioneer agency was MicroRate (now followed by agencies such as Planet Rating, Microfinanza Rating or CRISIL), which offered a product known now as performance assessments. These ratings seek to evaluate the overall capacity of MFIs to meet their goals. Compared to traditional credit risk ratings, performance assessments put more weight on operational elements such as appropriateness of lending methodologies and governance issues and allow comparability to other MFIs. This emphasis seems to reflect the fact that performance assessments were originally designed to satisfy the needs of donors. Today, the sphere of investors has widened greatly to include commercial investors. The need to mobilize these investors and expand the flow of sustainable capital to effective microfinance institutions is a key challenge facing the industry. Additionally, as LAC MFIs enter into the sphere of financial regulation and supervision, specific regulatory requirements for ratings need also to be taken into account. Clearly, microfinance includes now a much more diverse group of stakeholders that demand products- such as ratings- adapted to their own requirements.
- 2.4 Today in LAC there are three main approaches to ratings MFIs. The first one refers to specialized microfinance raters offering a product -performance assessments- that have gained industry recognition but have not yet been accepted by regulatory authorities (*e.g.* Microrate, Planet Rating). The second approach is followed by domestic rating agencies that offer credit ratings—mostly in a mandatory basis- to regulated MFIs (*e.g.* Apoyo y Asociados – Perú, BRC Investor Services - Colombia). The third approach refers to the increased interest of mainstream rating agencies that are working in approaches that take into account microfinance particular characteristics (*e.g.* Standard and Poor's, Fitch Ratings)

- 2.1. **Project approach and justification.** MIF has been working with the microfinance rating industry since 2001 (ATN/ME-7593-RG – *The Rating Fund*). The total amount committed to the project was US\$1,470,000. The project had two components. The first component was a facility to provide matching grants to assist MFIs to purchase rating services. The second component consisted in setting up a website to serve as a virtual marketplace for institutions (MFIs), rating agencies and other interested parties (investors, donors, etc.) The website also served as a depository of all rating reports co-financed by the facility, therefore increasing the transparency and availability of information in the industry. The initiative was fully coordinated and cosponsored with CGAP (Consultative Group to Assist the Poor) and the European Union (EU). The project also included a preliminary diagnosis of ratings and regulation in Bolivia, Ecuador and Peru.
- 2.6 The project -which ended June 15, 2007- reached 146¹ MFIs in Latin American and Caribbean countries in the region. The large majority of the ratings (close to 85%) co-funded were performance assessments. The balance (15%) corresponded to credit ratings mainly carried out by local rating agencies. An evaluation of this project was recently concluded and the findings point out the following: (i) Success in supporting globally acceptable credit ratings was somewhat limited. (ii) Performance assessments are still very relevant tools for smaller MFIs and their promotion should be supported. (iii) Local regulatory bodies still need to be greatly improved to make a better use of ratings as an instrument for investment decisions and transparency.
- 2.7 The first finding was addressed by a recently approved project that seeks to support the development of a global rating criteria for microfinance (ATN/ ME -10783-RG - *Enabling Access to Capital Markets for Microfinance Institutions*). Through the project, MIF will support Standard and Poor's (S&P) in the pilot phase of the development of new rating criteria in addition to the dissemination of findings among microfinance industry and global investors. Pilot testing has already started and preliminary results are expected for early 2009. The current builds on the second and third finding of the evaluation in addition to consultations with microfinance stakeholders.
- 2.8 **MIF additionality.** The initial Rating Fund sponsored the rating of an entire segment of the market that was heretofore unrated, contributed to create a culture of transparency in the sector as well as supporting specialized microfinance and mainstream raters. The microfinance rating industry, however, is still in a nascent stage and requires to increase outreach, consolidate the sustainable supply of products and further clarify the benefits and limitations of the products offered. MIF, through a new Rating Fund initiative, can be the catalyst of this process helping underserved MFIs to overcome the cost barrier of initial ratings and devoting much needed resources to build common standards, sponsoring an information clearinghouse for the microfinance ratings industry and overall support to continue clarify the benefits and limitations of different type of ratings for microfinance.

¹ Includes ratings co-financed with CGAP resources.

- 2.9 This effort would not be complete if not coordinated with similar initiatives in other parts of the world since raters do not work exclusively in LAC. For this, MIF will coordinate with a similar initiative championed by the Luxembourg Development Cooperation. This partnership will allow MIF to have a significant role in this market beyond LAC and also to ensure that particularities of our region are taken into account.

III. PROGRAM DESCRIPTION

- 3.1 **Objective.** The project's general objective is to contribute to the transparency in the microfinance sector. The specific objective is to strengthen the microfinance rating sector. These objectives will be accomplished by broadening the geographic outreach of ratings (e.g. Central America), supporting smaller MFIs to afford initial ratings, and improving the understanding of the market of the benefits and limitations of different types of rating products. To accomplish its objective the project will be composed of the following components:
- 3.2 **Component 1. Establishment of a Matching Grant Facility (MIF US\$419,400; CAF US\$200,000; MFIs US\$400,000).** The purpose of this component is to finance a grant facility that will enable partial financing of over 100 initial ratings (performance assessments and credit risk ratings) for an estimated 60 small Latin American and Caribbean institutions² over a three-year period. As new rating products emerge and gain market recognition, the Facility will also consider co-funding (e.g. social ratings). Following the successful methodology utilized during the first rating project, MIF will be the executing agency responsible for basic oversight supported by an external unit in charge of the day-to-day implementation and administrative support. Therefore, the activities of this component will be: (i) Establishment of external unit to administer project; (ii) Development of criteria for MFI and raters participation and; (iii) Co-financing ratings.
- 3.3 **MFI and raters participation³.** The conditions for MFIs to access the Fund will be established based on the following guidelines: (a) Have provided financial services for at least three years in some institutional form; (b) Have total loan portfolio between US\$ 1,000,000 and US\$ 15 million in Latin American and Caribbean countries; (c) Have an average outstanding loan size of less than US\$ 3,000 in Latin America and the Caribbean. Exceptions may be made for MFIs operating in moderate-income countries. If a financial institution also offers non-micro loan products, at least 30% of the loan portfolio should be dedicated to microfinance loans; (d) Are not required by local regulation to undertake the rating exercise for which the subsidy is being requested; (e) An MFI may apply for co-financing from the Rating Fund up to three times, and there must be a minimum of 9 months between each rating/assessment funded; (f) The Fund will co-finance up to the third initial rating of an MFI. If an MFI had already three ratings, then it will not be eligible; (g) Full public disclosure of the rating/assessment

² Small institution is defined as one with US\$15,000,000 in loan portfolio or less.

³ The conditions listed in this section are preliminary and will be refined during the first activity of the project.

report prepared by the rater; (h) have external auditors (i) For the application of the above criteria, the ratings already financed by the Rating Fund also count.

- 3.4 The conditions for the raters to participate will be based on the following principles: First, a sufficient condition to participate in the Fund will be the recognition as a rating agency by a financial supervisory authority in the country of operation. Second, if the rater is not yet recognized it must demonstrate enough and relevant experience (have conducted at least twenty microfinance ratings or assessments in the last 24 months), independence and absence of conflict of interest and to be duly incorporated. In all cases, raters will need support and document their application to pre-qualify.
- 3.5 **Component 2. Promote Policy Dialogue on Regulation and Ratings (MIF US\$113,500).** To do this, the project will focus on two major areas: regulation and rating scales.
- 3.6 Regulation. A singular characteristic of LAC is the growing importance of regulated MFIs⁴. One consequence has been that ratings with different features –depending on each particular country and type of operation and institution– are required. In addition, in countries in which ratings yet required, regulators are considering them. It is important that the project invests resources in helping regulators, MFIs and other market participants, learn about experiences in other countries, understand the potential impact of new rules and regulations and have an opportunity to dialogue. Activities will include:
- 3.7 (i) Conduct country diagnoses and recommendations on regulatory frameworks for MFI ratings. Building on the methodology utilized in the earlier MIF rating initiative, the project will update and expand country studies of Bolivia, Peru and Ecuador in addition to new comprehensive studies of two additional Central American countries; (ii) Organize a discussion Forum on appropriate regulatory frameworks for MFI ratings. The project will sponsor a regional Forum with key microfinance stakeholders, to disseminate country studies and provide a discussion on regulation and ratings.
- 3.8 Specialized microfinance rating scales. While mainstream credit raters have developed equivalences tables for ease of comparability, microfinance specialized raters have not. Microfinance specialized raters offer a relatively new product – performance assessments – that does not yet have clear and simple equivalences. This is a much-recognized need. The project will sponsor- in collaboration with specialized raters - an effort to bring about a minimum level of standardization among scales of utilized in performance assessments. To work on this, the facility will require commitment from all the interested specialized raters. Specific activities will include: (iii) Organize a consultative meeting among specialized microfinance raters to bring about a minimum level of standardization and comparability; (iv) Sponsor consulting services based on the results of the consensus –building consultative meeting.

⁴ In fact, according to a recent MIF estimate, most microfinance portfolio (70%) and clients (55%) correspond to financial institutions fully regulated and supervised by a financial authority (*IDB. Microfinance in LAC: 2008 Data Update*).

- 3.9 **Component 3. Dissemination of the Rating Fund. (MIF US\$29,250).** Through this component, the project will provide discussion forums on the benefits and limitations of different rating products. It will also encompass targeted promotion of the services offered by the project to MFIs. While underserved institutions and regions will be prioritized, the project will also reach other important microfinance stakeholders such as investors, regulators, and local and international networks. The activities of this component will be: (i) Development of the project website⁵; (ii) Organization of events on rating products, and; (iii) Participation in key microfinance events to promote projects services.

IV. COST AND FINANCING

- 4.1 The total cost of the project is US\$1,586,161 from which MIF will contribute with US\$986,161 of non-reimbursable resources, Co-financing and counterpart will consist of US\$200,000 from CAF and US\$400,00 from participating MFIs. The break-down of expenses is as follows:

Components	Amount (US\$) ⁶			
	MIF	CAF	Microfinance Institutions	Total
Component 1: Establishment of a Matching Grant Facility	419,400	200,000	400,000	1,019,400
Component 2: Promote Policy Dialogue on Regulation and Ratings	113,500			113,500
Component 3: Dissemination of the Rating Fund	29,250			29,250
Management and Evaluation	418,000			418,000
- Management	368,000			368,000
- Audit, mid-term and Final Evaluations	40,000			40,000
- Miscellaneous	10,000			10,000
TOTAL PROJECT	980,150	200,000	400,000	1,580,150
Percentages (%)	61%	13%	26%	100%
Impact Evaluation Account 0.005	6,010			6,010
GRAND TOTAL	986,161	200,000	400,000	\$ 1,586,161

- 4.2 This project will have built-in mechanisms to expand coverage if resources from other sources are available.

⁵ It is expected that the website will be running 24 months after the last rating report is received to ensure that each rating is available in the website for the same minimum period of time.

⁶ Due to the multiplicity of stakeholders and activities, and previous experience, the final allocation of resources for each line item may vary. Transfer of resources from one line item to the other may be requested by project manager as activities develop.

V. EXECUTING AGENCY AND MECHANISM

- 5.1 Following the model of the first rating initiative, MIF headquarters will be the executing agency responsible for basic oversight and project implementation. Nonetheless, the day-to-day implementation and administrative work will be delegated to an Administrative Unit. MIF is planning to contract International Consulting Consortium (ICC) to perform these services. ICC was the consulting company which was in charge of administering the initial rating fund project (Rating Fund) in the period 2001-2007 with excellent results. ICC has already working relationships with hundred of MFIs, rating agencies and regulators across the region. Its performance has been positively reviewed by an external evaluator and a hundred institutions. Therefore, the appropriate contracting mechanism is single-source selection because activities of this project represent a natural continuation of services previously provided by the firm.
- 5.2 MIF headquarters will be the responsible for performing oversight, monitoring fulfillment of contractual conditions, processing disbursement requests, and receiving audited financial statements. The Administrative Unit will submit semiannual status reports to MIF in accordance with the Bank's standard reporting requirements. A closing workshop will be scheduled for the end of the project to evaluate outcomes and determine the actions needed to enhance the project's impact.
- 5.3 **Procurement and Contracting.** The execution of procurement and contracting will be carried out in accordance with the Policies for the Procurement of Goods and Works Financed by the Inter-American Development Bank (GN-2349-7 and current version) and the Policies for the Selection and Contracting of Consultants Financed by the Inter-American Development Bank (GN-2350-7 and current version).

VI. MONITORING AND EVALUATION

- 6.1 **Monitoring and reporting.** MIF headquarters will be responsible for supervision and oversight activities, monitoring compliance with contractual clauses, processing disbursement requests, and receiving audited financial statements. The Administrative Unit will be responsible for preparing semiannual progress reports and will present them to the MIF headquarters within 30 days after the close of each six-month period. They will also prepare and present a final report 30 days after the last disbursement. These reports will follow a format agreed upon with the MIF and will cover project activities and finances and the results, measured in terms of the execution indicators identified in the logical framework. The MIF will use these reports to monitor progress in project execution and prepare Project Status Reports (PSRs) and the Project Completion Report (PCR) within three months after the last disbursement.
- 6.2 **Auditing.** Administrative Unit establish and be responsible for maintaining effective project financial accounting, internal control, and record-keeping systems, in accordance with the MIF's accounting and auditing rules and policies. Administrative

Unit will present the project's financial statements at the end of the project. MIF will contract independent auditors to audit those financial statements. The cost of the final audits will be financed with funds from the MIF. .

- 6.3 **Independent mid-term and final evaluations.** The MIF will hire individual consultants to evaluate the project. . Two evaluations will be performed: one when 50% of project funds have been disbursed or when half of the execution period has elapsed; and the second, one within three months after the program ends. During the project, the Administrative Unit will compile supervisory and evaluation indicators of the project. These indicators are presented in the logical framework, and the MIF and the Administrative Unit will use them to gauge the general impact and evaluate the results.

VII. BENEFITS AND RISKS

- 6.1 **Benefits.** *Reaching small MFIs.* One of the most important benefits of this project will be to reach small MFIs that have not been rated yet. For this purpose, eligibility criteria to access the Fund will be adjusted so that the ratings go to the lower trenches of the market. Some small MFIs lack previous ratings as a result of scarce economic resources to pay for this service or because these are not yet aware of the importance that ratings have in the industry. As in the previous project, MFIs will be reached through awareness campaigns to recognize the merits and benefits of ratings, aiming that small MFIs acknowledge the process as a positive exercise (as larger, formalized and more mature institutions do). In doing so, MFIs will be propelled to continue using ratings in the future.
- 6.2 As investors value the transparency and analysis that ratings provide, encouraging smaller MFIs to get a first time rating should help them to increase the amount of funding available (volume and diversity of capital resources), as well as to improve the terms of funding (price) in both local and global markets.
- 6.3 *Methodology Equivalences.* One key finding and a recognized need from the previous project is that microfinance specialized raters have yet to developed equivalences tables for ease of comparability as mainstream credit raters do. Microfinance specialized raters offer a relatively new product – performance assessments – that does not yet have clear and simple equivalences. The envisioned activities, including a consultative meeting with the specialized raters, aim to close this gap. As an end result, this standardization should encourage greater demand for services and an improvement of the quality of supply.
- 6.4 **Risks.** The project most important risks are the following: (i) Small MFIs are not aware of the Facility. To mitigate this, the project will invest resources to reach potential beneficiary MFIs – especially in Central America; (ii) Participation of raters in the project. To ensure raters participation and buy-in, raters were consulted during the

preparation of the project. A meeting during the XI IDB Microenterprise Forum in Paraguay, was especially organized for this purpose.

VIII. SOCIAL AND ENVIRONMENTAL IMPACT

- 8.1. This project will fund credit ratings to MFIs which are based on analysis of financial statements and on-site visits. It will also finance studies and awareness and promotional activities. Therefore, the project does not present adverse potential environmental risks. In addition, the project has been classified as category “C” operation following guidelines set forth in the “Sustainable Finance Toolkit” (www.idbtoolkit.org) so no environmental assessment studies or consultations are required.

LOGICAL FRAMEWORK

**REGIONAL-
CONSOLIDATION OF THE RATING MARKET FOR MICROFINANCE INSTITUTIONS
(RG-M1142)**

II. OBJECTIVES	INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS (RISKS)
A.- GOAL			
To contribute to transparency in the microfinance sector	Two years after project two-thirds of MFIs are being rated	<ul style="list-style-type: none"> - Project website - Mix Market Website - Raters websites - Regulatory authority portals - Midterm and Final Evaluation 	<ul style="list-style-type: none"> - Ratings have become a widely-used instrument used by MFIs, investors and regulators.
B.- PURPOSE			
To contribute to the consolidation of the rating market for microfinance.	<ul style="list-style-type: none"> - By project end, 100 initial ratings for an estimated 60 small Latin American and Caribbean (LAC) MFIs have been conducted.¹ - Regulators understand the benefits and limitations of different rating products. - Rating scale equivalences for specialized raters has been developed. 	<ul style="list-style-type: none"> - List of MFIs in the region with performance assessments and credit risk ratings. <p>For all components:</p> <ul style="list-style-type: none"> - Midterm and Final evaluation by external consultant - Project Status Reports (PSR) - Semi-annual progress and final project reports by administrative unit (consulting firm) 	<ul style="list-style-type: none"> - There is still a large number of smaller MFIs that have not yet been able to afford ratings - Benefits and limitations of different rating products are understood by microfinance stakeholders - Raters, financial regulators, MFIs and other stakeholders are interested and willing to cooperate with the effective implementation of initiatives.

¹ Understood as the first rating (up to the third) of a MFI.

C.- COMPONENTS			
1.-Establishing a Matching Grant Facility			
A grant facility established that provides partial financing for ratings of LAC MFIs	<p>By end of year 1, 20 ratings have been conducted</p> <p>By the end of year 2, 70 ratings have been conducted</p> <p>By project end (year 3), 100 initial ratings for an estimated 60 small LAC MFIs have been conducted</p>	<ul style="list-style-type: none"> - Ratings completed and publicly available - Contrast subscribed with consulting firm for administering the Fund 	<p>Small MFIs find the terms of the Facility attractive for their participation</p> <p>Rating agencies are interested and willing to provide their services to the Fund</p> <p>Both MFI s and rating agencies meet the criteria to participate in the Fund</p>
2.- Promote Policy Dialogue on Regulation and Ratings			
<ul style="list-style-type: none"> - Appropriate regulatory frameworks for MFI ratings reviewed - Improved understanding of specialized microfinance rating scales and its comparability 	<p>By the end of month 10 of the project (October 2009-XII Inter-American Microenterprise Forum in Lima), two previous country diagnoses on appropriate regulatory frameworks for MFI ratings updated</p> <p>By end of month 15 of the project, two other country (Central America) diagnoses studies and discussion forum on regulatory frameworks for MFI ratings completed</p> <p>Equivalence tables for specialized raters developed</p>	<ul style="list-style-type: none"> - Five country diagnoses and recommendations distributed to regulators during the Forum - Forum participants list - Equivalence tables for specialized raters 	<ul style="list-style-type: none"> - Financial regulators, MFIs and other stakeholders interested and willing to participate in studies and discussion forums - Specialized microfinance raters willing to participate in consensus-building efforts

3.- Dissemination of the Rating Fund			
Improved awareness of the benefits and limitations of different rating products	By month 3, project website up and running	<ul style="list-style-type: none"> - Project website - Number of website visits 	<ul style="list-style-type: none"> - Awareness and promotional activities reached desired stakeholders
Services provided by the project are known, understood and utilized n by all stakeholders	At the end of the project all the rating reports uploaded and available	<ul style="list-style-type: none"> - Awareness and Promotional materials Minutes of events organized and attended - Number of MFI applications 	<ul style="list-style-type: none"> - Event organizers are willing to accept project participation in their activities
C.- ACTIVITIES			
1.-Matching Grant Facility Established			
1.1 Establishment of external unit to administer project	<ul style="list-style-type: none"> - Administrative support unit in place 	Rules and regulations for Facility operations as well as criteria for MFIs and rating agencies participation well-defined and available	
1.2 Development of criteria for MFI and raters participation	<ul style="list-style-type: none"> - Rules and regulations developed and shared with stakeholders 		
1.3 Co-financing ratings	<ul style="list-style-type: none"> - Matching grant facility in operation 		
2.- Promote Policy Dialogue on Regulation and Ratings			
2.1 Update country diagnoses and recommendations on appropriate regulatory frameworks for MFI ratings in Bolivia, Ecuador and Peru	<p>By the end of month 10 of the project two previous country diagnoses updated</p> <p>By end of month 15 of the project, two other country (Central America) diagnoses completed</p>	<ul style="list-style-type: none"> - Material and minutes discussion forum on regulatory frameworks for MFI rating - Minutes from consultative meeting among specialized microfinance 	<ul style="list-style-type: none"> - Specialized microfinance raters engaged and participating in consensus building effort
2.2 Carry out new country diagnoses and recommendations	<ul style="list-style-type: none"> - By month 6, consultative meeting among specialized microfinance 	Consultancy report on specialized microfinance scales and its comparability	

<p>on appropriate regulatory frameworks for MFI ratings in two Central American Countries</p> <p>2.3 Organize a discussion Forum on appropriate regulatory frameworks for MFI ratings</p> <p>2.4 Organize a consultative meeting among specialized microfinance raters to bring about a minimum level of standardization and comparability</p> <p>2.5 Sponsor consulting services based on result of consensus –building resulting from consultative meeting</p>	<p>raters conducted</p> <ul style="list-style-type: none"> - By month 12, consultancy on standardization and comparability of specialized raters finalized 		
3.- Dissemination of the Rating Fund			
<p>3.1 Development of the project website</p> <p>3.2 Organization of events on rating products</p> <p>3.3 Participate in key microfinance events to promote project services</p>	<ul style="list-style-type: none"> - Project website developed and functioning - By month 12 organization of one awareness event and participation in one key microfinance event - By month 24, organization of the second awareness event and participation in two additional key microfinance event 	<ul style="list-style-type: none"> - Number of participants in each of the events 	