

The development of a credit union rating system in Ukraine

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The credit union movement in Ukraine is relatively young, and until recently no single performance monitoring tool has been used, with the result that it has been impossible to compare individual credit unions for the benefit of their members.

This paper describes the process by which a rating system was designed, tested out on a number of credit unions whose actual performance was known from experience, and is now being adopted by member credit unions in Ukraine. The system is described: it includes 15 indicators, which was seen to be manageable by credit unions with volunteer boards reporting on a voluntary basis. The rating system only covers financial indicators: an additional assessment of sound management is made when a credit union first applies to join the movement.

PRIOR TO THE FALL OF 2001, credit unions in Ukraine did not have a practical unified system to measure their financial and institutional strength. No standards existed during the credit union movement's first few years. Without government laws or other external standards, credit unions had few means by which to evaluate and compare their policies. In the late 1990s, two greatly divergent rating systems were implemented as a result of advice from different international partner organizations, and credit unions followed one system or the other. The result was that one credit union could not be compared with all the rest. Later, components of each system were merged with selected financial indicators developed in Ukraine. However this combination of indicators proved to be unsuccessful in the Ukrainian context.

From this confusing situation emerged several challenges for the Ukrainian National Association of Savings and Credit Unions (UNASCU). How could UNASCU bring about overall improvement to credit unions without a means of comparing and contrasting credit unions due to the lack of a standardized rating system? How could the average Ukrainian evaluate the quality of credit unions? Credit unions were able to manipulate statistics to their benefit, so how was UNASCU to evaluate credit unions that misrepresented, misunderstood, or ignored critical financial indicators? In answer to these questions, UNASCU worked with World Education, Inc. and Ukrainian-American credit union specialists to produce a practical unified rating system.

The Ukrainian National Association of Savings and Credit Unions

UNASCU is the only apex body for representation and coordination of credit union activities in Ukraine. UNASCU's membership consists of 122 credit unions registered with the National Bank of Ukraine. The Association provides ongoing assistance to member credit unions on top-

How could UNASCU bring about overall improvement to credit unions without a standardized rating system?

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ics such as bookkeeping, legal and regulatory issues, and questions of tax compliance. The staff of the UNASCU Training Centre offers credit unions a series of courses on a regular basis.

As a relatively young voluntary association established in 1994, UNASCU lacks enforcement mechanisms. A central tenet of UNASCU's work is to attract viable new member credit unions, but UNASCU also requires member credit unions to comply with standardized reporting of financial indicators such as assets, liabilities, delinquencies, or liquidity. At the outset UNASCU did not insist that all indicators have the exact same meaning for each credit union nor that financial reports be interpreted for the purpose of evaluating credit union progress.

Essentially UNASCU mandated standardized reporting without an accompanying unified rating system. Reporting is composed of a variety of numbers that can be presented according to the interests of the audience. A rating system takes these numbers, clarifies and standardizes the meaning of the indicators, and establishes a specific format to identify the meaning of financial reports. A rating system judges the financial health of credit unions and allows a number of audiences to judge the quality of individual credit unions.

While developing a unified rating system, UNASCU lobbied the Ukrainian Government for government-regulated reporting, financial ratios, and enforcement standards for credit unions. While awaiting their response, UNASCU created standards using stringent application and reporting processes, although enforcing these processes was not possible.

The recently approved Ukrainian Credit Union Law contributes to the standardization of credit unions in Ukraine. Published in 2002, the Law provides guidelines for establishing and operating credit unions as well as a few general standards for selected financial ratios. The Law further stipulates that a regulatory body for credit unions should be established; it is to be hoped that the government adopts UNASCU's regulations once a regulatory body is created. In the meantime, UNASCU is focusing on implementation and enhancement of their rating system.

Formulating a rating system

UNASCU made a first attempt at creating a unified rating system in 1998. Two international rating standards were combined with a selection of financial indicators developed by UNASCU. However, this amalgamation of various rating systems was, in UNASCU's words, 'found to be too complex and not to be effective' (UNASCU 2002, personal communication). Opting to create their own system, UNASCU decided to base the new rating standards on those of the Polish National Association of Co-operative Savings and Credit Unions. The Polish system, known as KAPER, was gradually adapted for the Ukrainian situation in 2000. By 2001, UNASCU recognized a strong need to link the rating system even more closely to the evolving credit union movement in Ukraine.

In November 2001, UNASCU began working with World Education, who solicited the support of the Ukrainian National Credit Union Association of the United States (UNCUA), to complete modification of the rating system using 'bottom-up' participatory methodology to adapt the system specifically for the needs and capabilities of Ukrainian credit unions. First existing credit union reports, many containing illogical and incompatible numbers, were analysed. Extensive interviews were held with various individuals to provide a better perspective on the financial reporting process. The result was an acknowledgement that financial

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reporting of member credit unions of UNASCU contained anomalies. As an example of the peculiar nature of the reports, a credit union might report zero loan delinquency but then would not report an adequate amount of interest income from loans. In this context, a rating system was formulated to reduce discrepancy among the definition of credit union indicators and improve accurate information regarding the financial health of each member credit union.

As a first step in the development of a rating system, baseline data were collected and analysed. Due to familiarity with each member credit union, UNASCU knew which credit unions were healthy and which credit unions were likely to produce poor financial ratios. With 20 years of experience working with credit unions in the United States and in Ukraine, UNCUA's representative used practical knowledge, based largely on NCUA (National Credit Union Administration) standards in the United States, to develop appropriate categories and ratios. Some indicators are universally relevant. For example, a high ratio of loans to total assets, assuming most loans are not delinquent, is always positive regardless of the country context. A credit union reporting no delinquent loans might receive a lower rating for the 'Loan Delinquency' category, whereas a credit union reporting some delinquent loans might receive a higher rating since all credit unions in Ukraine have some delinquencies.

Ratios were adjusted to take into account varying definitions of financial indicators in Ukraine. Some credit unions set up 'Allowance for Loan Losses' and may eventually write off bad loans against this allowance. Other credit unions do not establish an allowance for loan losses but write off bad loans against their income statement. By taking into account credit unions that use allowance for loan losses and those that do not, the rating system adapts to earlier anomalies. After calculating credit union ratios based on existing reports, UNASCU compared the value of the rating categories with knowledge of the status of the credit unions. A test of the rating system with well managed and poorly managed credit unions gave positive results. The system worked.

The cost of developing and implementing the rating system is borne by UNASCU. The rating of credit unions is a service offered by UNASCU to members, and UNASCU is funded through membership fees and international donors. Credit unions are encouraged to submit rating information, however, as they will be eligible for loans from external organizations once rating information is submitted to UNASCU.

By developing a rating system UNASCU and the average Ukrainian are able to examine rating reports and easily identify the progress of credit unions. Member credit unions are no longer able to shield unfavourable data. For example, the majority of credit unions record interest income from loans on the actual interest received during the period. Some credit unions, however, accrue interest due on loans and show that amount as interest income for the period. This overstates their income compared to the majority of credit unions that are not on an accrual basis.

Rating credit unions

According to the Consultative Group to Assist the Poorest (CGAP), credit rating 'measures the credit risk of an institution', and credit risk is defined as the 'likelihood of timely repayment of debts' (CGAP, 2002). However, to identify this likelihood, CGAP recommends that rating systems measure institutional capacity in addition to financial strength. Specific qualitative and quantitative issues to be addressed include capital adequacy,

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To test the system, the rating categories were compared with what was known about the individual credit unions

Table 1. The UNASCU rating system

<i>Category</i>	<i>Indicator</i>
Income	Undivided income to total assets Income to expenses
Capital	Reserves to total assets Delinquent loans to equity Total capital to total assets Total capital less member share to total assets
Assets	Earning assets to cost-bearing liabilities Earning assets to total assets Fixed assets to total assets Loans outstanding to total assets Loans outstanding less ALL to total assets
Delinquency	Loans outstanding less delinquency to total assets Delinquent loans to loans outstanding Delinquent loans less ALL to total assets
Liquidity	Liquid assets to total assets

Credit unions must demonstrate institutional capacity during the application process and financial strength during the rating process

liability structure, liquidity portfolio quality, credit policy, operations, governance, and adequacy of systems and organization processes.

Rather than subscribe exactly to CGAP's recommendation, UNASCU decided a better option for their membership would be to focus on financial strength during the rating process and on institutional capacity during the application process. Therefore, when a credit union applies for membership in UNASCU, the credit union must demonstrate the institutional capacity of the organization as indicated by the various committees in the credit union, the number and identity of borrowers, the number and identity of depositors, and a variety of other institutional factors.

The rating system, on the other hand, evaluates credit risk as a solely financial variable. Five categories were included consisting of 15 financial indicators broken down into the following topics: two income, four capital, five asset, three loans and delinquencies, and one liquidity (see Table 1). After statistics are provided for each category, UNASCU applies a score to each credit union. Scores range from -90 to +100. The minimum rating for acceptance as a member in UNASCU is 50.

Table 2 demonstrates the rating of a credit union. Assuming the numbers are positive, the two income categories produce a score of +20. The four capital categories result in scores between -40 and +40. For example, if Total Capital to Total Assets ratio is greater than 30%, the result is +10. However, if the same ratio is 12-15%, the result is +4.

The five asset categories range from -20 to +25. The three delinquency categories range from -10 to +10. A credit union that establishes an allowance for loan losses would receive a higher score than a credit union that did not establish an allowance for loan losses. This is true because the ratio of Delinquent Loans less Allowance for Loan Losses (ALL) to Total Assets of the first credit union would result in a lower percentage and therefore a higher score.

The Director of Finance at UNASCU provides oversight of the rating system. With UNASCU management, she tracks the progress of member credit unions during the course of each year. She also helps members with understanding the reporting standards and the manner of rating credit

Table 2. The progress of an Ukrainian credit union March 2001 to March 2002

Category	Indicator	Goal	3/31/01		6/30/01		9/30/01		12/31/01		3/31/02	
			Ratio	Score	Ratio	Score	Ratio	Score	Ratio	Score	Ratio	Score
Income	Undivided income to total assets	>0	11.5%	10	8.2%	10	6.4%	10	10.6%	10	11.7%	10
	Income to expenses	>100%	140.9%	10	138.5%	10	164.7%	10	157.5%	10	155.6%	10
Capital	Reserves to total assets	>=11%	35.6%	10	27.6%	10	30.2%	10	36.8%	10	36.9%	10
	Delinquent loans to equity	<30%	41.5%	7	37.4%	8	36.9%	8	18.7%	10	19.0%	10
	Total capital to total assets	>=30%	27.3%	9	21.9%	7	25.7%	8	30.1%	10	32.6%	10
	Total capital less member share to total assets	>=10%	23.9%	10	19.6%	10	22.7%	10	28.8%	10	29.2%	10
Assets	Earning assets to cost-bearing liabilities	>115%	185.2%	5	199.3%	5	208.7%	5	157.2%	5	156.5%	5
	Earning assets to total assets	90%	84.6%	3	87.4%	4	87.5%	4	79.6%	2	80.3%	3
	Fixed assets to total assets	3-5%	8.8%	3	8.2%	3	7.6%	3	8.0%	3	8.4%	3
	Loans outstanding to total assets	85%	91.6%	4	89.0%	4	89.0%	4	87.6%	4	81.8%	5
	Loans outstanding less ALL ¹ to total assets	85%	79.9%	4	80.9%	5	81.5%	5	79.6%	4	74.1%	3
Delinquency	Loans outstanding less delinquency to total assets	>80%	76.8%	2	78.6%	2	77.9%	2	80.8%	3	74.8%	2
	Delinquent loans to loans outstanding	<4%	16.1%	0	11.6%	0	12.5%	0	7.9%	1	8.6%	1
	Delinquent loans less ALL ¹ to total assets	<3.5%	3.1%	4	2.3%	4	3.6%	3	-1.2%	4	-0.7%	4
Liquidity	Liquid assets to total assets	10%	9.7%	5	9.7%	5	9.3%	5	10.3%	5	11.2%	5
	TOTAL			86		87		87		91		91

1. ALL= Allowance for loan losses

unions. However, each credit union is responsible for obtaining the necessary technical assistance to improve the organization's ranking.

Why invent a new system?

UNASCU elected not to adopt an existing rating system such as CAMEL, GIRAFE, or PEARLS in part because international rating systems are more often targeted at microfinance institutions (MFIs) than at credit unions. MFIs largely exist in isolation whereas credit unions are members of a network. Credit unions may borrow money but usually only from their network's central liquidity facility. MFIs borrow money from a wide variety of financial institutions and receive grants from donors. Because credit unions are intricately tied to their network, the network works to ensure the safety and soundness of all affiliated credit unions. A credit union rating system therefore facilitates the monitoring of individual credit unions through the network in order to detect possible problem areas before these problems become too serious. An MFI rating system measures the quality of the MFI in question with a primary goal of soliciting external funding for onlending.

PEARLS is widely used by credit unions around the world (though not universally: CUNA in the United States, anglophone Canadian credit unions, Australian credit unions, and the Irish League of Credit Unions all use other rating systems). PEARLS was not judged to be suitable for Ukrainian credit unions at present for a number of reasons. It does not allow for an overall index of individual credit union financial health: credit unions can only be ranked against other credit unions in the database. Thus UNASCU member credit unions are not able to ascertain their status in relation to model credit unions outside of Ukraine. Likewise, PEARLS does not enable credit unions to chart the progress of key ratios.

Rating systems such as PEARLS also assume that financial indicators are standardized and enforceable, whereas currently that is not the case for Ukrainian credit unions. The 45 ratios included in PEARLS are too burdensome for UNASCU's members, for whom reporting is voluntary. If UNASCU required reporting of 45 ratios, many credit unions, particularly those operating through volunteer boards and committees, might resort to not submitting reports at all.

Furthermore, the National Bank of Ukraine informally expressed full support for UNASCU's rating system, but not for PEARLS, which is one of the main reasons why UNASCU had to produce a new system. Additionally, the rating system in Ukraine evolved in an extremely participatory manner that is easily understood by the credit union users. Hence, the system in Ukraine is user-friendly, fulfills the needs and specific context in Ukraine, and is a viable system adhering to international standards.

The impact of UNASCU's rating system

The benefits of the rating system are many. As an objective means of evaluating credit unions, the rating system largely prevents the intrusion of human subjectivity. Political manoeuvring cannot replace statistics: the Board of Directors of a credit union cannot force UNASCU to accept the credit union unless it has a score above 50. With standards in place, politics and diplomacy lack the strong roles they might otherwise play.

The rating system can also help international partner organizations to focus resources properly and thereby best support UNASCU and Ukrainian credit unions. Just as a medical evaluation indicates overall health, the

UNASCU's monitoring system is less burdensome for credit unions who are often run by volunteer boards

Political manoeuvring cannot replace statistics

The rating system has already proved to be effective in soliciting external support

UNASCU rating system evaluates the financial health of credit unions. For example, if loan delinquency is above the norm, then partner organizations can work with the credit union system to lower delinquency rates. Or, if the capital to asset ratio (CAR) is too low or too high, partner organizations can recommend policy changes and/or modification in product pricing, which would improve the CAR. The rating system has already proved to be effective in soliciting external support. The International Foundation for Social Adaptation (IFSA) provided \$200 000 in loans to 15 selected credit unions of UNASCU.

As a result of the rating system, Ukrainian credit unions affiliated with UNASCU must now use standardized rating categories and indicators. UNASCU can now confirm the financial status of a credit union without sending a staff member to the field to investigate and justify statistics. For example, to countercheck a zero delinquency rate, UNASCU can examine if the interest was actually received or if the interest was accrued. If the income is accrued rather than actually received and deposited in the bank, then a portion of loans have not been repaid on a timely basis.

Furthermore, the rating system provides UNASCU with a means to evaluate credit unions. Because the Ukrainian Government has only recently instituted general regulations of credit unions standards and still no regulations regarding enforcement and verification, UNASCU can at least classify credit unions fairly and discontinue membership to unsuccessful credit unions with scores of less than 'Fair'.

Conclusion

CGAP notes: 'The proliferation of financial ratios and other indicators in microfinance has produced considerable confusion, especially when the same name is used for indicators that are calculated quite differently. There is an urgent need to agree on the definition of a set of core indicators...'. To alleviate confusion and effectively evaluate credit unions, UNASCU, with the assistance of World Education, Inc. and its partner organization UNCUA, developed a unified rating system to standardize indicators and to help Ukrainians and partner organizations discern the quality of individual credit unions. Composed of five categories, each focused on specific financial ratios, the rating system evaluates the soundness of member credit unions and the movement overall.

The rating system has proved to be extremely useful to UNASCU and Ukrainian credit unions. The bottom-up participatory methodology used in creating the rating system ensures ownership of the system by UNASCU and Ukrainian credit unions. As a result, UNASCU and credit unions are committed fully to utilizing and efficiently implementing the rating system. As the Ukrainian government creates enforcement mechanisms such as a regulatory body, the rating system and UNASCU are expected to play more widespread, prominent roles within the Ukrainian credit union movement.

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