**Loan Portfolio Assessment**

**Overview**
The loan portfolio is the primary income generating asset for Financial Institutions (FIs), but is often subject to misstatement. Most failures amongst financial institutions stem from the deterioration in the quality of the loan portfolio. An assessment of the risks inherent in a financial institution’s portfolio therefore assumes tremendous importance, and this is the most important objective of a “loan portfolio assessment”. FI credit (lending) operations, especially retail and micro segment, have unique characteristics that portfolio assessors must first understand and this loan portfolio assessment framework exposes them to these special characteristics so that they can understand the inherent risks, in an appropriate manner. MicroSave’s experience has shown that there are many challenges in maintaining a healthy loan portfolio, including:

- Difficulty in maintaining portfolio information due to: a) the large number of small loans, and very large number of (repetitive) small repayments and b) dispersed operations.
- Decentralisation could lead to deviance in following the credit policy and result in fraud, error or manipulation since relatively few staff members are involved in approving, disbursing, monitoring, and collecting each loan.
- The pressure for efficiency may result in lesser controls, procedures, information and client supervision.
- Rapid growth in portfolio could result in the failure of established systems. Such growth puts pressure on systems and can camouflage repayment problems, particularly when growth exceeds the administrative capacity to manage the rapid expansion.
- Restructuring (rescheduling and refinancing) of delinquent loans often camouflage portfolio quality.
- Weak information systems may not even allow MFIs to recognise delinquency.

These issues, among others, make the loan portfolio assessment a very crucial exercise. Assessors will need to allocate significant time to review loan portfolio and to carry out field visits. This service is designed to help portfolio assessors, branch managers and field staff to conduct an effective assessment of an FI’s loan portfolio.

The assessment of an FI’s portfolio includes an audit of the systems and procedures and associated lending internal controls. It not only provides essential feedback to safeguard the FI’s primary asset - the loans to its clients – but more importantly, it enables stakeholders to understand the risks in the FI’s loan portfolio and systems, and the procedures used to mitigate this risk. This information could prove useful in two ways: (1) facilitate prudent decisions within the FI and regarding investing in the FI (either directly or indirectly); and more importantly, (2) help isolate specific areas for capacity building and technical assistance to enhance portfolio management by the FI.
Benefits

- **Equity Bank** used the loan portfolio assessment tool to address their long term portfolio problem and prepare for rating by Global Credit and a CGAP review of the bank’s portfolio. The assessment highlighted several areas where Equity could tighten controls and procedures, and helped the bank refine specifications for the credit management modules in the new IT system that it was installing at the time of the assessment. The bank also used the MicroSave checklists to develop a credit compliance checklist that is now rigorously applied throughout the institution. Through this, and related improvements in the credit management (particularly assigning responsibility for loans to individual credit officers so they are held accountable for their portfolio) and IT systems, Equity was able to reduce its Portfolio at Risk (PAR) >30 from over 25% to less than 5% in 18 months.

- In 2007, **ABN Amro Bank** commissioned the use of the loan portfolio assessment tool to review the credit management systems, policies and procedures of both Bandhan and SKS in India. The reports were positive, thus giving ABN Amro Bank the confidence to make substantial investments in these rapidly growing institutions. The assessment was also useful for Bandhan and SKS as it identified some areas where improvements could be made in processes and compliance; and made recommendations on issues likely to arise as these institutions grew still further.

- In a SHG federation in north India, the loan portfolio assessment intervention revealed the extent of hidden and latent delinquencies, thus enabling management to take stock of the situation and commence remedial measures.

- In another large SHG federation, in the south of India, the model under the mutually aided cooperative society had delinquencies at different levels. Thus, while reported PAR was less than 10%, the actual levels were more than 30%. The delinquency at the level of the borrowers was very high as was reflected in the repayments made to the local federations. However, these delinquencies were being made up by the local federations in their repayments to the state unit. This aspect came out in the loan portfolio assessment exercise.

- In an Indian MFI, the loan portfolio assessment highlighted the aspect of ever-greening of loans by sanctioning repeat loans in the guise of emergency loans. This practise adopted at the field level did not have approval from the management and would have affected portfolio quality quite adversely in the long run.

*Understand the true dynamics of your loan portfolio and the systems in place to manage and control it; and in doing so strengthen your institution and its ability to borrow funds – conduct a loan portfolio assessment!*