MicroSave Briefing Note # 54

Loan Portfolio Assessment in Practice

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Why Assess a Loan Portfolio?

The loan portfolio is the primary income generating asset for an MFI[1] and it is most commonly subject to material misstatement. Most MFI failures stem from the deterioration in the quality of the loan portfolio. A periodic assessment of the risks and inadequacies inherent in an MFI's portfolio is essential, and this is the most important objective of a "Loan Portfolio Assessment". In addition to providing essential feedback on the MFI's primary asset, the assessment exercise enables stakeholders to understand the risks in the MFI's loan portfolio and the systems/procedures used to mitigate this risk.

MicroSave's work with its Action Research Partners and on behalf of banks lending to MFIs, has demonstrated that this information is useful to:

1. Facilitate prudent decisions regarding investing in the MFI (either directly or indirectly); and more importantly,
2. Help isolate specific areas for capacity building and technical assistance for enhancing the portfolio management by the MFI.

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 the 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 management, processes and compliance; and made recommendations on issues likely to arise as they continued to grow.

Equity Bank used the loan portfolio assessment tool to address their long term portfolio challenges 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. The bank also used the checklists in the toolkit 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 PAR>30 by two-thirds in 18 months.

What is Loan Portfolio Assessment?

MicroSave's Loan Portfolio Assessment Toolkit for MFIs offers a simple step-by-step approach to examine systems, processes and guidelines which determine portfolio quality and also look at a sample of the actual portfolio spread across branches in MFIs. Comparing the portfolio management system actually in place with organisational guidelines and internationally accepted best practices not only brings out systemic inadequacies, but also exposes ineffective controls and resulting risks in the processes.

The sample assessment of the portfolio investigates

actual portfolio quality, and compares this with the portfolio quality being reported. In assessing portfolio quality, emphasis is placed on flow of cash in quantitative terms and the time lag between cash flow at various stages. Thus the loan portfolio assessment will help an MFI to:

- Understand the real **risks** in its portfolio and to mitigate them;
- Locate process and systems flaws affecting **portfolio quality**;
- Isolate systems flaws creating unnecessary **risk** that could be avoided at a reasonable cost;
- Identify areas to improve **internal controls** to protect the loan portfolio;
- Increase **efficiency** by streamlining and improving portfolio monitoring; and
- Specify processes/systems that need to be strengthened or reengineered for better portfolio **management.**

[1]The term MFI is broadly used to include traditional NGO-MFIs, Commercial Banks, NBFCs/NBFIs, Cooperatives/Credit Unions and other such entities involved in delivering financial services to low income people

How Do You Conduct a Loan Portfolio Assessment?

Before commencing the loan portfolio assessment, sample branches have to be identified. Sample size depends on the size of the MFI and the purpose of the assessment exercise (general assessment of the MFI or specific study directed at a region/selected branches), as well as the financial and human resources available to the assessment team. The sampling methodology can consider issues like urban/rural branches, operational regions, representation of different loan products in the portfolio, etc.

The first step in the loan portfolio assessment exercise is to trace a sample of loans (initially 50-100, but this may be extended in the event of irregularities being detected) from Head Office downwards through the branch accounts to borrowers' accounts/passbooks. This is then followed up by tracing another sample from the borrowers' passbooks upwards through branch accounts to the Head Office. The assessors look at consistency in cash flows as reported in different records and also look at the dates on which money has been transferred as well as the consistency in dates across records.

Subsequently, for the loan accounts sampled, the assessment process looks at cross verifying the loan disbursements/ repayments with other accounting records like cash book, receipts and vouchers and also verifies the records with entries in the loan ledgers. The next step involves verification of loan management processes and documentation to check for consistency and completeness, and to compare it with international best practices. The loan portfolio assessment exercise pays special attention to roll-over and restructuring of loans as a means for hiding delinquency. Towards the end, the assessment exercise looks at portfolio management policies, systems and procedures to ensure that they are in line with best practices. To ensure that adequate safeguards are built into the system, the internal and external controls used to manage the loan portfolio are also reviewed as part of the loan portfolio assessment exercise.

Issues that Typically Arise from a Loan Portfolio Assessment

Loan portfolio assessments often reveal some of the following issues:

1. Amount sanctioned or disbursed is more, or less, than the amount actually sanctioned or disbursed as reflected in the borrower's passbook.
2. Loans have been disbursed before or after the date stated in the MFI records, or have not been disbursed at all.
3. Repayment schedules do not exist for loans, or they keep changing.
4. Instalment amounts received are more, or less, when compared to the amount due.
5. Higher/lower interest is being charged as compared to interest rate quoted in the offer letter.
6. "Ghost" (non existent) clients are taking loans.

In a Self Help Group (SHG) Federation in North India, the loan portfolio assessment toolkit revealed the extent of hidden and latent delinquencies, thus enabling management to take stock of the situation and initiate remedial measures.

In another large SHG federation, in South India, the model under the mutually aided cooperative society had delinquencies at different levels. Thus, while the reported PAR was less than 10%, actual levels were upward of 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 problem came out in the loan portfolio assessment exercise.

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

Conclusion

Traditional ratings often fail to explore the primary asset of MFIs in enough detail. *MicroSave*'s loan portfolio assessment has almost always uncovered important issues in the management, control and policies of loan portfolios – thus allowing MFIs to respond to them. The loan portfolio assessment has proved a valuable tool both for investors in MFIs, as well as MFIs committed to optimising their primary asset – their loan portfolio.