ANNEXURE-I

Guidelines for Reviewing Credit Portfolio of NGO-MFIs Interested in Transformation into MFBs

Introduction

The legal framework for MFIs was enacted in October 2001 with the objective to allow private sector entry into banking with the poor. The framework provides for and encourages NGOs-MFIs, which have demonstrated ability to manage the MFIs on sustainable basis and have capacity to mobilize local savings and expand outreach, to transform into regulated Microfinance Banks. The MFIs licensing policy and criteria prescribed by the Central Bank under legal framework allows NGOs to contribute up to 50% of required capital in the form of credit, investments and other assets portfolio (free of losses) subject to review by a Chartered Accountancy firm from amongst the panel of auditors maintained by SBP.

The peculiar nature of MFIs credit portfolios e.g. small tickets but large volumes, large number of small disbursements and recoveries, dispersion over wide geographic areas, non collateralized nature and practical difficulties in legal enforceability of claims on borrowers, necessitates a different approach and methodology and test procedures to review the portfolios. The objective of issuing the guidelines for reviewing NGO-MFIs' credit portfolios interested in transformation is to ensure a reliable assessment of the portfolio quality based on pre-defined parameters. The guidelines however, prescribe the minimum requirements/parameters to be completed during the review process, the auditors may apply additional procedures and tests to reach at a reliable assessment of the portfolio quality and adjustments required, if any.

Guidelines

Characteristics of MFIs Credit Portfolio

The major characteristics of microfinance lending, which makes the MFI 's portfolio risk different from that of conventional financial institutions are given hereunder; the auditors while planning a review of MFIs' credit portfolio and designing test procedures should take into consideration these characteristics:

- MFIs grant a large number of small loans, and so receive an even larger number of small repayments. Further the microfinance operations are often dispersed over a wide geographic area and to be efficient, MFIs need streamlined and decentralized operating structures. These issues make it harder to maintain effective portfolio information and management systems.

- Decentralization implies that relatively few staff members are involved in approving, disbursing, monitoring, and collecting the loans. This pattern can increase the opportunity for deviation from approved policies and for fraud.

Decentralization can also increase the risk of error or manipulation in transferring information from branches to headquarters.

- To handle small transactions efficiently, MFIs face great pressure to cut costs sometimes at the expense of adequate portfolio controls and information, as well as sufficient supervision of clients and loan officers.

- Many microfinance portfolios grow rapidly, which puts pressure on systems and can camouflage repayment problems. A rapidly growing portfolio has a higher percentage of loans that are in the early stages of repayment; the delinquency problems are more likely to appear at later stage.

- MFIs generally feel, not always correctly, that writing off loans from their books would send wrong signals both to the borrowers and credit officers that the MFI is no more interested in recovering the loan. Further most MFIs do not pay taxes and as such provisioning & write off doesn't produce any tax savings for them.

Review of Credit & Interest Accrual/Non-Accrual Policies

The Auditor shall review MFIs' credit policy/manual covering target market (s) characteristics, loans origination, appraisal, approval, disbursement, monitoring and recovery processes and procedures, loan classification and provisioning and policies for interest accrual/non-accrual to develop a detailed understanding of the policies as well as to test compliance thereof. He shall also interview the credit officers on sample basis to assess compliance with policies and obtain their feedback / opinion on the policies and systems. A brief description of main features of the policies and their impact on quality of the MFIs' loan portfolio shall be made part of the portfolio review report.

Review of Accounting and Information Systems

The accounting, loan tracking MIS and loan administration are the three important systems/areas, which affect the MFIs credit portfolio quality. The accounting system and loan tracking MIS produce information whereas the loan administration systems define policies and procedures, which govern the loan operations. The accounting system receives data about individual loans transactions to generate aggregate financial information whereas the loan tracking MIS focuses on individual loans information including client identity, amount disbursed, loan terms such as interest rate, loan period, repayment schedule, repayment history, aging of delinquency, outstanding balances etc. Ideally there should be seamless integration of loan tracking MIS with the accounting system; however, this is not the situation in most of the MFIs operating in different countries including Pakistan and generally the two systems are not fully integrated due to which there are issues of reconciliation of MIS data with the accounting system data.

The Auditor shall review the MFI's accounting and information systems and make an objective assessment about their capacity, reliability and effectiveness for generating portfolio related information and reports. The capacity refers to systems' ability to handle the transaction volumes; the MFI is generating, and the variety of reports and information including client payment history, loan delinquencies and their aging, branch/geographic area/sector/credit officer wise break-ups, details and trends, details of rescheduled loans etc. The accuracy and reliability means that the system correctly reflects loans disbursed, payments received and current repayment status of outstanding balances and that the system has built-in safety features, satisfactory external safety environment with access restricted only to the authorized users. For the purpose the auditor shall examine a statistically significant number of loans, segmented by branch office, chosen on the basis of materiality criteria or at random, compare the loan documents and transaction records with ledger accounts, planned repayment schedules, the MFI's credit policies and the delinquency reports generated by the loan tracking MIS. The auditor shall test amounts disbursed, amounts received, and dates of payments and current repayment status of the loans. He/she shall also check whether the institution accurately records the loan transactions on the dates they occur, whether the tracking system correctly distributes the payment among relevant accounts and whether the outstanding loan balances in the tracking system are in conformity with the institution's credit policies.

The Auditor shall test whether the loan tracking MIS data reconciles with accounting system data; due to large volume of transactions, inconsistencies in the data generated by the two systems are common in MFIs. However, if over time a large number of transactions hang in suspense accounts, there may be a material weakness in the loan administration system and should be looked into carefully by the auditors.

The capacity and reliability of the system wouldn't be of great value unless people at all levels of the organization are receiving timely reports in an intelligible form and using the data they contain; the auditor therefore, should also assess the effectiveness of the systems.

The overall assessment of the systems' capacity and reliability, level of integration and reconciliation issues and severity thereof shall be made part of the portfolio review report and shall form an important basis in deciding the depth of portfolio review and sample sizes for testing the portfolio.

Review of Internal Audit Function

The Auditor shall review whether the internal audit function is in place in the NGO-MFI and whether its size and capacity is compatible with the level of development and size of the MFI. He/She shall assess the scope, coverage and effectiveness of the audit particularly with respect to MFIs-loan portfolio, the quality of reports and enforcement thereof. The assessment of the internal audit function shall be described in the portfolio review report. The assessment shall among others form the basis of depth of portfolio review.

Portfolio-Related Fraud Controls

The auditor shall review whether the MFI have an effective operational audit function capable of detecting the types of fraud most common in MFIs loan operations. Such fraud often occurs "off the books" e.g. loan payments are stolen before they are registered leaving no paper trail for the auditor to follow other than an eventual delinquency report, loan officer creates fictitious groups or borrowers and makes disbursements etc. The Auditor while assessing MFI's operational safeguards and other internal controls shall make an assessment of controls devised by MFI to check such incidences.

Depth of the Portfolio Review

No single set of portfolio review procedures is appropriate for all MFIs. The Auditor shall, based on the review of credit and allied policies, accounting and information, systems and controls, internal audit functions of the MFI, and conducting interview from loan officers to ascertain their awareness and hurdles observed during implementation of policies and procedures, decide the depth of the portfolio review and tests etc. For MFIs having well defined credit policies with effective mechanism and culture to ensure compliance, reliable accounting and information systems and effective internal audit function, the testing could be limited to branches covering 25% of the outstanding portfolio; for rest of the portfolio, reliance could be made on internal assessment of the MFI. The MFIs having relatively larger instances of non-compliance with the policies, limited capacity information and accounting systems, weak control structures and ineffective internal audit function, the testing will have to be increased to the branches covering 35-50% of the outstanding portfolio or even ***more*** depending on the severity of weaknesses in the systems and control functions; for the remaining portfolio, the results of the reviewed branches will be extrapolated.

Review of Loan Files

The loan files shall be reviewed for completeness, adherence to the MFIs loan policies and procedures and assessing quality of the MFI claims appearing in its books of accounts. The loan file normally contain, original loan application, identity card and address of the borrower, nature of business, references/guarantors and collateral information (depending on MFI policy), signed loan document stipulating loan terms and conditions, the clients' credit history and documentation of follow-up steps in case of delinquent loans. The auditor shall review 10%-15% loan files of each branch selected for review or more depending on his/her assessment about the overall control environment at the branch, level of completeness of files reviewed etc. Major observations/findings of the files review process shall be made part of the portfolio review report.

Client Visits

Client visits is an important and integral part of MFIs portfolio review. The visits are made to verify that the clients exist and loan details provided in the files as well as the MFIs claims appearing in its books are valid. The sample size for the clients to be visited shall be 5% to 10% of the clients outstanding in the branch records as of portfolio review date depending upon the auditor's assessment about the overall control environment and experience gained during the initial visits i.e. the sample size would be increased beyond these limit in case materially large number of borrowers remains untraceable or deny having taken any loan from the NGO-MFI. The auditor may recommend provisions/adjustment based on review of loan files and the client visits. Major observations/findings of the client visits shall be reported in the portfolio review report.

Adjustment lending/Repeat Loans

Adjustment Lending/Repeat Loans is another very common feature of MFIs, particularly the MFIs having weak control structures and inefficient monitoring systems. It refers to the practice of adjusting/liquidating an existing loan with a fresh loan with the objective to present a rosy picture viz. good portfolio quality, recovery rate and fresh disbursements, to the stakeholders. The auditor shall apply tests to determine the level of adjustment lending in the reviewed branches and recommend adjustments/provisions against such loans.

Rescheduling

The auditor shall review the details of rescheduled cases and repayment patterns after the rescheduling. The rescheduled loans against which even a single installment is overdue shall attract 100% provision, whereas the rescheduled loans whose first installment after the rescheduling is not due by the finalization of audit shall attract 50% provision.

Loans Outstanding Whose Term Expired

The auditor shall test the loans appearing in the books of accounts as current (performing) but whose original term is expired, determine the amount of all such loans and provisions held, if any, examine the reasons for the same and recommend additional provisions, if any required based on the test results and the reasons identified.

Interest accrual

The auditor shall examine whether the MFI stops accrual of interest and reverses previously accrued but unpaid interest, on Non-Performing Loans. He/She shall test the accrued interest receivable balances in conjunction with the loan balances and determine whether the MFI stops accruing further interest, and reverses previously accrued but unpaid interest, on Non Performing Loans. He/She shall also assess whether the accrued interest is shown in the books separately as other assets or made part of the loans outstanding. In case it is clubbed with the principal loan amounts, the auditor shall determine its level and compute the portfolio net of interest accrued besides recommending reversal of interest accrued on NPLs.

Interest Income Testing Through Yield Gap Analysis

The Yield Gap Analysis is an important analytical tool to review the loan portfolio as well as the interest accrued by the MFI. It compares actual interest income with an independent expectation of what the portfolio should be yielding, based on the loan terms and the average portfolio over the period and investigates material mismatch, if any. It is advisable that the auditor should test/evaluate the results achieved through substantive testing through analytical tools such as yield gap analysis.

Loan Loss Provisions Using Aging Criterion

The auditor shall, based on the reviews and tests applied, determine the level of adjustments/provisions required against the MFI's credit portfolio. In addition to the provisions determined through various tests as discussed above, the portfolio shall be grouped into following categories using the aging criterion and provisions be determined as per the rates given against each category:

Sr. No.	**Category**	**Criteria**	**Provision Required**
1.	***Current***	*All loans with no payment of principal or interest (mark up) are over due by 30 days or more.*	0%
2.	***OAEM***	*All or part of principal or interest (mark up) is over due by 30 days or more but less than 90 days.*	0%
3.	***Substandard***	*All or part of principal or interest (mark up) is over due by 90 days or more but less than 180 days.*	20% of outstanding principal *net of cash collaterals / liquid securities**
4.	***Doubtful***	*All or part of principal or interest (mark up) is over due by 180 days or more but less than 365 days.*	50% of outstanding principal *net of cash collaterals / liquid securities**
5.	***Loss***	*All or part of principal or interest (mark up) is over due by 365 days or more*	100% of outstanding principal *net of cash collaterals / liquid securities**

***** *Liquid securities which are easily encashable without recourse to law.*

General Provisions

In addition to the provisions determined/identified during the course of review, a General Provision equivalent to 2% of the net outstanding portfolio (net of specific and other provisions identified during the review) should be determined.