MicroSave Briefing Note # 62

Benefits of Loan Portfolio Audit for MFIs

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> "Loan Portfolio Audit brought to the surface many of the problems we thought we had. Once we saw our problems clearly it was easy to address them. It saved time, money and a lot of reputation".
> *– Mr. K.C Mallick, Director BISWA, Orissa, when contacted four months after LPA was completed*

"Do you want a Loan Portfolio Audit?" is often met with questions such as: "We already have a top notch credit rating, why again Loan Portfolio Audit (LPA)?" and "What are the benefits?" Concerns emerge too, for example "Are there any 'side effects'?"; "What if LPA stumbles on our portfolio incidents last month?" and "Should we open our trade secrets?" The more curious want to know, "Can it help us raise funds?"; "Will our staff learn from it?" and "Will we have assistance to implement the results?"

In the year 2007, *MicroSave* India conducted the LPAs of seven large Indian MFIs[1] and the benefits of these were greatly appreciated. On the other hand, because the clients wanted the LPA reports to be confidential, the knowledge of these benefits is not widely appreciated within the microfinance community. Further, since the 'Audit' in LPA asserts its invasive nature, MFIs are usually deterred from voluntarily opting for this exercise. Thus, it is not surprising that most of the support for LPA has come from banks lending to the MFIs[2]. To start with, they viewed LPA as an appealing addition to their routine due diligence processes for client MFIs. However, in practice, the tool has produced much more, and is now also regarded as the main foundation for extending capacity building support. This note highlights the key benefits which LPA has produced so far and has been prepared with the objective of further promoting its adoption amongst Indian MFIs.

What is a Loan Portfolio Audit?

The loan portfolio is the primary income-generating asset for MFIs but is often subject to misstatement. Most failures amongst financial institutions stem from the deterioration in the quality of the loan portfolio. An LPA provides an assessment of the risks inherent in a financial institution's portfolio and the controls the MFI uses to manage them. LPAs are therefore extremely useful for investors seeking a more detailed understanding of the key asset of the MFIs in which they placing their money (debt or equity). But, well conducted, LPAs provide immensely valuable information for the MFIs too.

How has LPA helped the client MFIs?

- ***Pin-pointed gaps in policy and procedure and solutions for these*:** MFIs often have an inkling of gaps in their procedures and systems, but do not have supporting evidence to pin-point the causes. LPA has assisted MFIs to precisely identify the root cause of problems by detecting and investigating real cases such as: a) disbursement of loans without necessary approvals and in violation of the approval limits; b) not tracking and using credit history for making credit decisions; c) approving loans in spite of poor group ratings and d) disbursing parallel loans to the same group. The MFIs found that that they could use the real evidence of the problems and fine tune their internal controls to make their systems water tight.

- ***Identified internal audit and control system risks and ways of reducing these*:** Most MFIs tend to feel safe once they have a functional internal audit unit that generates regular reports. LPA uncovered cases, undetected by routine internal audits and also examined why internal audit had missed these gaps. A variety of reasons for undetected risk emerged, and these included: a) horizontal portfolio growth of the MFI outpacing the internal audit unit's growth; b) frequent turnover of internal audit staff; c) narrowly focused audit procedures; and d) weak auditors' training systems.

- ***Solved gaps related to the MIS*:** As in the case of internal audit, MFIs often believe that their computerised MIS is an automatic solution to all reporting challenges. LPA pointed out the need for valuable modifications such as: a) aligning the reporting frequency to the repayment frequency; b) modifying the software to reflect changes in policy; c) enhancing the quality of credit history reports; d)

[1] Including Bandhan-West Bengal, SKS-Andhra Pradesh, Cashpor-Uttar Pradesh, BWDA-Tamil Nadu and BISWA-Orissa

[2] Increasingly ABN Amro, Axis, Standard Chartered Banks and SIDBI are insisting on Loan Portfolio Audits of MFIs in which they are making larger investments.

strengthening the loan tracking system; e) reconciling mismatches between Head Office and field level portfolio records; f) minimising time delay in reporting repayments deposited at the branch level and g) avoiding parallel computerised and manual MIS.

- ***Assisted tailor-made solutions instead of generic ones*:** For example, one MFI had suspected fraud as the reason behind the spurt in recent delinquency levels in remote branches and had increased the frequency of monitoring visits to these branches. LPA revealed that the main reasons why the centralised MIS reported higher delinquency levels, was the information asymmetry between the Head Office and the fast expanding branch network in remote areas. Because of rapidly changing policies, the delinquency ratios at the Head Office were being calculated using new rules that had not yet been communicated properly to the branches.

  Similarly, in order to improve efficiency, one MFI had designed an incentive system which revolved around enhancing outreach and minimising delinquency, without giving adequate weight to the quality of processing, documentation, follow up and customer service. LPA revealed that following the implementation of this incentive system, rate of loan utilisation checks had plummeted leading to serious client-level frauds.

- ***Supplemented rating reports*:** Contrary to rating exercises which are designed to comment on the overall creditworthiness of MFI and appeal to funders, LPA is aimed at the MFI itself for use as a capacity building tool to improve its performance. A LPA report is a vital supplement to a rating report and often a reality check for the rating. In this context, it is noteworthy that because of the anomaly between the budget/time resource constraints and the volume of work involved, rating methodologies often rely on data reported in by the MIS and the audit systems of the MFI, which themselves are sometimes imperfect. In the case of one MFI, more elaborate and in-depth analysis by LPA revealed that the actual portfolio at risk was ten times higher that the rating report estimates … the rating given was clearly optimistic and misleading for the MFI, as well as those lending to it. On the basis of the LPA, the MFI was able to make significant progress in strengthening its systems and real institutional creditworthiness.

- ***Established transparency and enabled fund raising*:** Armed with a LPA report one of the MFIs has already raised capacity building funds from a European Donor. Moreover, LPAs have boosted MFIs' image as transparent and creditworthy institutions and have been invariably followed up by higher levels of credit supply to such MFIs. Of late, growing numbers of debt and equity investors have also shown a keen interest in the LPA reports – LPA reports provide important documentation for their internal credit committees, and thus allow them to increase the volume of credit they can offer to MFIs.

- ***Assisted capacity building inputs negotiation with service providers*:** Often MFIs are unable to clearly identify, prioritise and articulate their specific capacity building needs to technical service providers resulting in generic inputs from the latter, which have a limited impact. On the other hand, a LPA report can enable a MFI to better negotiate a customised capacity building package, resulting is higher levels of effectiveness, efficiency and impact of such inputs. In one particular MFI, *MicroSave* India itself followed up the LPA with technical assistance for process mapping, which resulted in the restructuring of the operations of the institution to enable its rapid but secured growth.

Conclusion

Financial institutions investing in MFIs use the LPA to gain a better understanding of its primary asset and, in particular, what is necessary to do to protect and strengthen the quality of that asset. An LPA provides valuable insights that other quicker assessment tools do not – thus allowing the MFI and its investors to focus on how best to support the institution.

Since LPA is primarily a diagnostic tool used to help MFIs target capacity building/institutional strengthening efforts, it does not use the findings to judge the quality of an MFI. Instead, the focus is on determining why gaps have occurred and how can these be solved. The 'Audit' word in LPA is the first step in the entire exercise and is used to diagnose the gaps. Consequently, the MFIs with an open attitude to the tool, who articulated their problems and participated in uncovering gaps, have benefited the most. *MicroSave* India hopes that with the popularity of the tool, MFIs can internalise the concepts and use these as an in-house means to improve their performance, and thus their creditworthiness with the banks that want to increase their lending to them.