MicroSave India Focus Note 22

Provisioning for Loan Impairment in MFIs[i]

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The loan portfolio is the biggest asset of an MFI. On the basis of the inherent risks prevalent in the portfolio, MFIs make a provision for the estimated loan loss that might occur. This note stresses the extent of variance amongst MFIs in India in terms of nomenclature, methodologies and quantum of provisioning. It concludes by highlighting the need to move towards a consistent and standardised approach, while adopting the latest prudential norms to provide for possible portfolio risks.

Presentation in the financial statements:
At a very basic level MFIs differ in terms of presenting the impairment allowance and provision for impairment. The differences in presentation figure right from the usage of the terms "provision" and "allowance".

As per SEEP	Provision for loan impairment	Impairment loss allowance
MFI 1	Loan loss provision	Loan loss reserve
MFI 2	Provision for non performing assets	Provision for non performing assets
MFI 3	Provision for standard and non-performing assets	Provision for standard and non-performing assets

From the above examples it is difficult to clearly distinguish reserve (allowance) amounts (shown as contra-assets or liabilities on the balance sheet) from provisions (expenditure items). Moreover, provision accounts often include other kinds of provisions (for example provision for gratuity and taxation) and thus do not give an instant picture of how much reserve has been created in the loan portfolio exclusively.

Provisioning methodologies:
Different MFIs adopt different methodologies to arrive at the loan loss reserve and a consequent provision required to be charged to the MFIs income. Two broad methodologies are provided in Box below. Some microfinance institutions blend these two approaches, effectively creating a third.

Within the ageing based approach MFIs also use different time buckets to arrive at impairment loss allowance (even within the same methodology or repayment frequency) which adds to the confusion.

1. ***Blanket approach:***
MFIs create an *a priori* loan loss reserve which is a percentage of the loan portfolio outstanding at the end of the financial year. A general rule of thumb adopted by the MFIs in this regard is to maintain the reserve at 2-3% of the total loan portfolio outstanding. Some MFIs also take into consideration the historical loan loss.

2. Ageing based approach:
This is a more scientific method. MFIs track ageing of past due loans and assign weights for provisioning based on the age of the loans past due. The methodology is recommended because it results in a provision that reflects the quality of the portfolio.

Regulatory Requirements:
Indian Accounting Standard AS4 deals with the provision for loan impairment[1]. The Guide also refers to recommendatory standard AS30 according to which the provision should be calculated as the difference between the loan's carrying amount and the present value of estimated future cash flows at the original effective interest rate on the loan.

The Reserve Bank of India has prescribed minimum provision requirements for advances of NBFCs[2] by classifying them based on the time that they are overdue. An asset becomes non-performing when instalment and/or interest of a term loan is overdue for a period of six months or more. RBI has laid down the following criteria for classification of various types of advances, including the term loan:

1. *Sub-standard asset*: a non-performing asset for a period not exceeding 18 months. 10% provision is required
2. *Doubtful asset*: which remains a sub-standard asset for a period exceeding 18 months. 100% provision (on unsecured loans) required
3. *Loss assets*: asset where loss has been identified by the bank or internal or external auditors or the RBI inspection that the amount has not been written off wholly. 100% provision is required

The practice of provisioning varies across the Section 25 Companies, Trusts, Societies and Cooperatives as there are no statutory guidelines available. Therefore, the MFIs follow either the blanket approach or arrive at the

[1] The explanation of AS4 in the Technical Guide on Accounting for Microfinance Institutions published by The Institute of Chartered Accountants of India recommends an ageing analysis to make provisions based on their loan repayment cycle etc. with NBFCs subject to the prudential norms issued by the RBI.
[2] RBI Notification No. DNBS. 193 DG(VL)-2007 dated February 22 , 2007

reserve requirement through the ageing analysis of the loans, which in many cases again differs based on the delivery methodology (individual/JLG) and the repayment term (weekly/monthly).

Rating frameworks

MFI evaluation frame works and rating agencies use loan portfolio quality as one of the criteria for assessing MFIs' performance. Due to the variance in the treatment of provision for loan impairment all these frameworks make adjustments to the financial statements to enable comparisons among the different institutions. For example CAMEL performs six adjustments, one of which is provision for loan impairment.

Industry Bench Marks

Sa-Dhan[3] considers loan loss reserve as a rough indicator of the overall quality of the portfolio and as a measure of an MFI's strategy to tackle current and future delinquency. According to Sa-Dhan, normally sustainable institutions have a loan loss reserve less than or equal to 3%. However, there are yet no clear guidelines on how to calculate the reserve requirement for different methodologies.

SEEP network[4] offers a portfolio ageing schedule on which to create a reserve; adopted by some MFIs. The age brackets for provisioning are 0 days, 1-30 days, 31-60 days, 61-90 days, 91-180 days, 181-365 days and greater than 365 days. However provisioning rates vary widely across the brackets.

The *MicroBanking Bulletin*[5] considers any loan "at risk" when payment is over 90 days late. It provisions 50% of the outstanding balance for loans between 90 and 180 days late, and 100% for loans over 180 days. In case of re-finance or rescheduling of delinquent loans due to high probability of default, 50% of all rescheduled balances are taken as provision. All loans are fully written off within one year of their becoming delinquent.

Implications:

It is apparent that the provision for loan impairment helps to assess the true profitability of an MFI. An inappropriate provisioning method will likely distort the asset quality and financial performance. MFIs use inconsistent language to define loan loss provision and also use different methods to calculate loan loss. Differing provisioning methodologies and bases of presentation will not allow comparability between different MFIs and therefore will make it difficult for lenders and investors to take sound decisions. This is also likely to result in an erosion of investor confidence in the way MFIs report their profitability.

The absence of clear reserve standards has both internal and external implications. One, it poses a systemic risk to the sector as a whole. Much microfinance is still delivered through MFIs which are not regulated. RBI's provisioning norms are not applicable to them. Given that non-collaterised lending requires higher risk reserves, it is important to agree upon common standards of provisioning. This should include not only common terminology, but also loan portfolio classification and provisioning required in each classification. To this end, even for the NBFC MFIs, the RBI-prescribed provisioning requirements may not be sufficient. The microfinance sector will need to develop its own provisioning norms.

Minimum standards must easily meet the regulatory requirements prescribed by the RBI (in case of NBFC MFIs), and yet provide adequate cover for risk. The minimum standards must be responsive to diverse lending methodologies and repayment frequencies. These standards should also adopt counter-cyclical provisioning. The G-20 Working Group on Enhancing Sound Regulation and Strengthening Transparency recently recommended that loan loss provisions should be built up while the economy is healthy in order to enhance the ability of financial institutions to withstand the impact of economic downturns. The Reserve Bank has been encouraging banks to build floating provisions as a buffer for the possible stress on asset quality later.[6] This is surely appropriate for MFIs as well.

Minimum adequate provisioning standards will not only hedge against the individual institutional risk at the MFI level, but also the potential collective systemic risk in the sector. A standardised approach will allow MFIs to benchmark their own performance against peers while enhancing the confidence of lenders and investors in the sector. MFIs would, of course, still be free to provision beyond the minimum standards.

The sooner the Indian microfinance sector comes together to create some consistency and clarity on terminology and standards, the better for all involved.

[3] Sa-Dhan Microfinance Manager Series:- Technical Note #4 "How to use the Loan Loss Ratio in Microfinance".
[4] Referenced from SEEP network and Alternative Credit Technology, LLC publication "Measuring Performance of Microfinance Institutions: A framework of Reporting, Analysis and Monitoring".
[5] Microbanking Bulletin, Issue 17, Autumn 2008.
[6] Annual Policy Statement for the Year 2009-10 by Dr. D. Subbarao Governor, Reserve Bank of India. Date of Publish: May 11, 2009

[i] This IFN uses the terminology suggested by the SEEP network for loan loss provision and loan loss reserve as used generally in India