A Proactive Tool for Monitoring the Microloan Portfolio

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Overview

The Challenge and the Solution
Monitoring Tool Development Process
Implementation Strategy and Policy Requirements
The Challenge

Case Study

Favorable economic trends determined many MFIs and other FIs to focus mainly on loan production, while the loan monitoring was rather weak and inappropriate. In this context, the significant change in the economic environment caused an important deterioration of the microloan portfolios.

Sample 1: Microloan Portfolio and PAR Trend

Sample 2: Microloan Portfolio and PAR Trend
The Solution Proposed

Case Study

Most financial institutions would choose to monitoring the loan portfolio based on the number of days past due. But this is rather a reactive attitude. Our experience showed us that there are a number of Early Signs or Red Flags that can predict a loan’s default and which should be considered in the loan monitoring process.

Typical Approach:

- Implementation of a standardized and semi-automated monitoring tool for portfolio risk management and monitoring
- The tool would categorize clients into three types: Standard, Watch List and Problem Loans
- Based on the monitoring tool’s risk assessment, specific monitoring actions will be recommended.

Our Recommendation:
Overview

The Challenge and the Solution

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Diagnostic

Time spent monitoring means time and money saved later.

The recent economic and financial crisis represents a test for the quality of the loan appraisal conducted by the loan officers. Any monitoring tool development process should start with the identification of the good-performing loan officers.

Sample distribution of delinquency per LO

Needs identification questions:

- What is the desired level of effort for monitoring for the officers in the branches?
- What is the size of the current client base?
- What client data is captured in the current MIS?
- What is the frequency of data collection?
- What are the options for implementation (extending existing applications, new application etc.)?
A structured approach should be used in order to capture the existing lending experience at the MFI, while ensuring consistency with international best practice.
Sample components

Look for the Early Signs and Red Flags!

Within the non-financial components, our experience showed us that the behavioral indicator are particularly relevant for the analysis.

<table>
<thead>
<tr>
<th>Non-financial components</th>
<th>Financial components</th>
</tr>
</thead>
<tbody>
<tr>
<td>Behavioral indicators</td>
<td>Fixed assets trend</td>
</tr>
<tr>
<td>Maximum number of overdue days (last 6 months)</td>
<td>Operational profit trend</td>
</tr>
<tr>
<td>Overdue frequency (with the MFI)</td>
<td>Average monthly turnover trend</td>
</tr>
<tr>
<td>% of overdue amount in business turnover</td>
<td>Inventory turnover current period (days)</td>
</tr>
<tr>
<td>Maximum nr of days of current account garnishment</td>
<td>Accounts receivable current period (days)</td>
</tr>
<tr>
<td>Payment incidents</td>
<td>Accounts payable current period (days)</td>
</tr>
<tr>
<td>Number of tax payment overdue days</td>
<td>Cash cycle trend</td>
</tr>
<tr>
<td>Other</td>
<td>Current ratio trend</td>
</tr>
<tr>
<td>Changes in the business management</td>
<td>Debt to Equity trend</td>
</tr>
<tr>
<td>Requests for lien release on collateral/pledge</td>
<td>Collateral coverage</td>
</tr>
<tr>
<td>Foreign exchange risk exposure</td>
<td></td>
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Monitoring Tool Structure

The risk management process should not stop after the loan approval.

A structured approach for loan monitoring through the use of a monitoring scorecard ensures the availability of portfolio information in real time and a better time management for the loan officers.

1. Data collection
   - Financial Information
   - Non-financial Information

2. Risk Identification
   - Ratio calculation
   - Client score
   - Client category
     - Standard
     - Watch List
     - Problem loan
   - Database
   - Portfolio reports

3. Loan Monitoring Strategies
   - Loans under observation
   - Problem loans
   - Measures to take
   - Portfolio improvement
Overview

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Implementation Strategy and Policy Recommendations
Implementation Strategy

Monitor all your clients, including the good ones!

The interpretation of the final score depends on a number of criteria, but the focus should be on ensuring a better loan monitoring using more efficiently the existing resources.

Typical client categorization

<table>
<thead>
<tr>
<th>Client category</th>
<th>Other aspects to consider</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard</td>
<td>• The cut-offs should be established based on the level of effort the LOs can allocate to the loan monitoring process</td>
</tr>
<tr>
<td>Watch List</td>
<td>• The usage of knock-out criteria is recommended so that a client is automatically categorized as ‘under observation’ or ‘problem loan’ in case an indicator has worsened over a certain level</td>
</tr>
<tr>
<td>Problem loan</td>
<td>• Minimum monitoring actions for a ‘Watch List’ loan should include:</td>
</tr>
<tr>
<td></td>
<td>1. site visit and monitoring report</td>
</tr>
<tr>
<td></td>
<td>2. action plan (if necessary),</td>
</tr>
<tr>
<td></td>
<td>3. restructuring (if necessary),</td>
</tr>
<tr>
<td></td>
<td>4. review of financials every 6 months.</td>
</tr>
</tbody>
</table>
Policy Recommendations

Monitor all your clients, including the good ones!

A thorough review of the existing monitoring policies and procedures at the project outset provides a good image of where the organization is and helps in identifying those areas that may require changes after the monitoring tool implementation.

Policy decisions to be made:

- How often will the score be calculated?
- How often will the indicators and cut-offs be revised?
- How will the loan monitoring tool be integrated into existing MIS?
- Who will be responsible for producing reports on the loan portfolio and loan monitoring?
- What parts of existing documentation need to be revised?
- What new reports need to be created?