

# Operational Tools for Funders




## Terms of Reference—Guidance and Samples

### Due Diligence Guidelines for the Review of Microcredit Loan Portfolios: A Tiered Approach

*Developed by Robert Peck Christen, with assistance from Patricia Mwangi, CGAP*

Microfinance institution (MFI) portfolio reviews are critical for management, regulators, and the growing number of commercial investors in microfinance. External audits, ratings, and evaluations generally fail to accurately quantify the primary risk facing investors: misrepresentation of microcredit portfolio quality. The following guidance on Terms of Reference (TOR) for a loan portfolio review is based on Due Diligence Guidelines for the Review of Microcredit Loan Portfolios which evaluates the accuracy of reported levels of repayment and the extent to which the MFI employs sound loan management practices.

The tool suggests three levels of review that give increasing degrees of certainty about the quality of loan portfolios and are explained below. The TOR should define which levels the assignment would include.

	Range from 2 days in the field to 5–6 weeks in the field plus preparation and report write up. See descriptions of three tiers below.
	Tier I and II do not require specialized audit or financial analysis skills; Tier III requires a local team of auditors.
	Ranges from low to high, depending on which tiers are undertaken.

#### Related Operational Tool

Christen, Robert Peck. *Due Diligence Guidelines for the Review of Microcredit Loan Portfolios: A Tiered Approach*. Washington, D.C.: CGAP, January 2005.

#### Additional Resources

CGAP. *External Audits of Microfinance Institutions—A Handbook*. CGAP Technical Tool Series, no. 3. Washington, D.C.: CGAP, December 1998. [www.cgap.org](http://www.cgap.org).

Microfinance Audit Information Center.

[www.microfinancegateway.com/section/resourcecenters/auditcenter](http://www.microfinancegateway.com/section/resourcecenters/auditcenter).

MicroFinance Consulting Group, *Loan Portfolio Audit for Micro-Finance—A Practical Toolkit*, MicroSave (September 2005). [www.microsave.org](http://www.microsave.org).

Rating Fund, [www.ratingfund.org](http://www.ratingfund.org), features completed rating reports on more than 150 MFIs.

## How to develop a TOR for a Loan Portfolio Review

Microfinance institutions (MFIs) can be risky propositions for investors. External audits, ratings, and evaluations generally fail to identify the primary risk investors face: misrepresentation of microcredit portfolio quality. Many microfinance networks repeatedly discover, too late, that one of their most important institutions has a far more serious problem with loan delinquency than it previously stated. By the time discrepancies are discovered, loan-loss levels are almost universally revealed to be far greater, and go back further, than initially presented. These incidents have cost institutions millions of dollars and, in many cases, have forced donor agencies to recapitalize or shut down operations in which they have invested for years.

The microfinance industry is flush with information-gathering tools that are effective at assessing an MFI's overall financial performance. Yet, it is portfolio quality that underlies MFI financial results, and investors need to have confidence in the quality of an MFI's loan portfolio. Bad loans potentially produce the highest risk to expected returns.

Before establishing the TOR for such a review, the commissioning organization should identify the key purpose(s) and scope of the assignment. The Due Diligence Guidelines for the Review of Microcredit Loan Portfolios evaluates the accuracy of reported levels of repayment and the extent to which the MFI uses sound loan management practices. The tool is designed around three levels of review that give users increasing degrees of certainty about the underlying quality of loan portfolios:

- **Tier I** is a two-day field review by one analyst, who meets with senior management at the head office of an MFI to assess credit policies and general documentation. This level of review is recommended for donor agency staff who are considering making a small grant.
- **Tier II** is a two- to five-day field review by one or two analysts, conducted at the branch level. It entails a qualitative assessment of credit policies, procedures, and practices and a verification of management information system reports. This level of review is recommended for appraisals, audits, and ratings related to sizeable grants or investments in an MFI.
- **Tier III** is a two- to four-week review by a team of local auditors to evaluate, measure, and quantify asset quality through statistical sampling and detailed analysis. This level of review is recommended for equity investors and regulators concerned with the soundness of an institution.

## Sample Terms of Reference—Loan Portfolio Review

### Introduction

The Board of Directors [or other commissioner] of \_\_\_\_\_ invites your firm to submit a technical and financial proposal for the special review of \_\_\_\_\_ financial institution loan portfolio. The review is intended to give assurance to \_\_\_\_\_ [regulators/investors] for \_\_\_\_\_ [specific purposes, if any]. It will also assist management by evaluating and reporting to them the level of compliance and effectiveness of the loan portfolio management practices and controls for which they are responsible.

### Background

[Give institutional background and events leading to the request for the review and the specific use of the results. Include a description of the institution's branch structure, number of staff, and number of credit clients.]

### Scope

The detailed loan portfolio review will be performed using mainly, but not exclusively, the approach developed under the leadership of the Consultative Group to Assist the Poor (CGAP) known as the Loan Portfolio Review Tool.

The tool is a three-tiered approach for discovering, with varying degrees of precision and certainty, the soundness of the financial institution's loan portfolio. The tiers build on each other progressively. The first tier establishes a basic level of confidence about the quality of portfolio management policies and performance. The second tier provides a fair amount of confidence that manager and staff practices at the branches reflect head office policies and that information systems at branches yield credible data that support the portfolio performance presentation at the head office. The third tier provides a higher level of confidence using statistical or nonstatistical sampling.

The review aims to obtain reliable information on the condition of the loan portfolio, the accuracy of portfolio reports by \_\_\_\_\_ [the financial institution's] information system, adherence to general credit management policy, and the absence of fraud and of substantial risky practices that undermine credit risk controls. The scope of work covers all loan portfolio management procedures from client administrative procedures, credit risk management procedures, transactions recording and reporting, and the adequacy of controls necessary to secure propriety, economy, efficiency, effectiveness, and particularly fraud prevention. The contractor is required to plan and develop a detailed work program that will yield the required level of confidence to satisfy \_\_\_\_\_ [the specific aim].

The contractor may also make any special adaptations to the tool to fit the specific needs of the Board Directors (or other commissioner) and the nature of our operations, provided such changes are discussed and approved beforehand and do not compromise the objectivity of the results.

### Approach

In achieving its objectives, the contractor will carry out all three tiers of the due diligence procedures laid out in the CGAP Due Diligence Guidelines for the Review of Microcredit Loan Portfolios and the table in the annex. All three tiers aim to reflect the following:

1. The loan portfolio, as reported by the financial institution, reflects its fair value.
2. Adequate provisions have been made for possible loan losses.
3. Management and staff have sound policies and the proper skills, resources, and systems to originate, monitor, and collect loans.

The contractor will discuss with the commissioning organization and the MFI the findings of each tier before proceeding to the next. The findings of Tier I or Tier II may reveal a reasonably high likelihood of improper credit management practices that the Board of Directors [or other commissioner] may determine is adequate for its objectives and preclude the need to perform any further work. The table in the annex represents potential decision points.

If all three tiers are necessary, the contractor will, after finalizing tier 2, evaluate prior findings to identify areas of concern for discussion with the Board of Directors [or other commissioner] and for shaping the detailed work plan of the next tier.

## Reporting

The contractor is required to give a written opinion to the Board of Directors [or other commissioner] on the adequacy and soundness of the procedures and controls of the loan portfolio of the whole MFI and on the extent to which they can be relied on to produce accurate reporting of the loan portfolio condition. This report will include a conclusion about the incidence of dangerous deviations in credit practices at a 95 percent confidence level.

To provide the required assurance, the contractor will undertake a program of work that has the following objectives:

**Tier I—Head office.** Employ analytical procedures to understand the financial institution’s performance and the factors affecting its business. Through inquiry, assess the adequacy of credit policy, accounting processes, and loan portfolio management.

**Tier II—Branch offices.** Assess the functionality of the financial institution’s information systems and the soundness of internal controls to general credible loan portfolio data at the head office. Through inquiry and testing loan files, verify compliance with credit policies, appropriateness of staff incentives and management controls to support sound credit practices, and the validity, accuracy, and completeness of transactions recording.

**Tier III—Detailed testing.** Sample a range of 400+ loans using the discovery method to incrementally explore loan samples in the event that dangerous deviations from credit policy occur, to confirm or estimate their incidence.

The contractor will also submit detailed working papers, which may be bound separately.

## Timing

This work is to be completed within \_\_\_\_\_ weeks of initiation. This time frame can be modified by mutual consent during the implementation process, should difficulties arise.

## Standards

The contractor’s work will be performed with due professional care, in accordance with appropriate professional auditing practice.

## Independence

The contractor must be independent of any member of the Board of Directors of the financial institution and any staff members. Independence means that no staff or owner of the contracting firm that would be directly involved in the review serves as a director of the financial institution or has any personal, financial, or close business relationship with the financial institution.

## Access

The contractor will have rights of access to all the financial institution’s records and information it considers necessary to fulfill its responsibilities.

Annex

