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INTERNATIONAL CONSULTING CONSORTIUM, INC.

THE PHILIPPINES

Bangko Sentral ng Pilipinas

AMENDMENTS TO BSP's EXAMINATION AND CAMELS MANUAL FOR MICROFINANCE LOANS

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THE PHILIPPINES: AMENDMENTS TO BSP's EXAMINATION AND CAMELS MANUAL FOR MICROFINANCE LOANS

INTRODUCTION

The General Banking Law No. 8791 of 2000 recognizes the need to promote the expansion of microfinancing and the Bangko Sentral ng Pilipinas (BSP) has issued several circulars that recognize microfinance as a specialized banking service, allow less rigid regulatory requirements for microfinance operations of banks, and create incentives for the banking system to go into microfinance. BSP has also created a high-level Microfinance Committee in charge of policy and regulatory issued and an advisory Microfinance Unit; as well as a Microfinance Core Group of examiners that will be in charge of supervising the activities of microfinance-oriented banks as well as the microfinancing units of rural and thrift banks.

In order to properly supervise the growing number of banks involved in microfinance, BSP is interested in developing appropriate examination policies and procedures to better measure the institutional risks and performance of the microfinance operations of banks.

ICC Inc. has been assigned (under contract with Chemonics Inc.) the task of developing such examination procedures and to field-test them in coordination with the Microfinance Core Group. Specific activities of the consultancy are to introduce amendments to the existing instruments at BSP, to better analyze and evaluate banking institutions involved in microfinancing, namely:

a) The bank examination manual.
b) The CAMELS model.

In order to prepare for the drafting of these amendments, eight banks engaged in microfinance lending were visited in order to interview some of its directors, executives, area and branch managers and loan officers, as well as to conduct a review of their financial statements, information systems and operations manuals[1]. Institutions engaged in individual and group lending were included in the visits.

The policies and procedures suggested in this report place particular emphasis on the evaluation of the risk management structure of the institution, its information systems and its internal controls. Initial versions of the report were discussed on February 21st with the Microfinance Core Group and the Microfinance Unit, and their valuable comments taken into account to produce the present version.

[1] Four institutions were visited in October 2002 and four in February 2003. The latter were subject to a more in-depth review, particularly with regards to their MIS systems and operations manuals.

THE BUSINESS OF MICROFINANCING

The risk profile of microfinancing is substantially different from commercial lending since the two key elements that support a traditional credit decision –repayment capacity information and tangible collateral- are lacking. Microfinancing can be succinctly defined as:

> "unsecured or clean loans to self-employed persons –microentrepreneurs- who do not keep formal operational or accounting records of their economic activity".

Lending to microentrepreneurs is very profitable when done under proper policies, procedures, internal controls and incentives. Otherwise, it is a very risky activity and many banks the world over have experienced significant losses when trying to serve this market without proper the proper technology package and personnel training. In the Philippines, the risk of microfinancing is compounded by the fact that most microentrepreneurs do not have a secure means of identification (driver's license or passport); many institutions are thereby forced to adopt group-lending technologies, where members of the group are supposed to know each other and to ensure that regular payments are made by each loan beneficiary belonging to the group.

Microfinancing is different from commercial lending. It is organized on a decentralized basis, where committees composed of loan officers and branch managers take most of the credit decisions, or client themselves organize into groups and guarantee each other's loans. Successful microfinancing institutions have well-tested lending and internal control methodologies, capable of handling a loan portfolio composed of thousands of small and largely unsecured loans to clients of the informal sector, and still maintain high repayment rates. While banks often base their lending on formal financial information and registered assets as collateral or guarantee to secure repayment, microfinancing institutions rely on the evaluation of the character of the client and on the family/business cash flow and the business net worth, through information collected by the own institutions' loan officers through standardized procedures; other rely on peer pressure to promote good repayment. Successful institutions have also a timely and client-oriented service in order to reinforce the willingness of the clients to repay.

Microfinance companies usually grant small loans to new clients, and successively larger ones to those who show good payment behavior. Clients' motivation to repay, and the institution's ability to reach economies of scale, lies on a large extent in the establishment of this long-term relationship in which the client recognizes that future loans are not only dependable but also quick. This motivation to repay is reinforced by a firm, even aggressive, attitude toward late payments, where it is not uncommon that a client who has been late for more than 20 or 30 days in any payment of capital or interest becomes ineligible to receive any new loans from the institution. Most successful institutions have training sessions for new clients to teach them about their low tolerance policies for late or non-performance and to underline the expectation of timely repayment.

Timely and efficient service to very small clients requires a significant degree of decentralization in credit decisions and portfolio management, including daily information on payment performance by clients. The timeliness and accuracy of the information systems becomes of paramount importance for the efficient administration of the microfinance company, as well as for the practice of internal control by branch managers, area managers, head office executives and ultimately by the board of directors. Microfinance companies must have good loan tracking systems; if delinquency reporting and information on restructuring of loans is late or misleading, directors and even senior managers will be left in the dark until delinquency is out of control. Internal control and internal audit measures should also be clearly designed and implemented, since in many cases significant losses to these institutions have risen from internal collusion to commit fraud.

Some of the most common, and costly, mistakes made by banks entering into microfinancing are:

- Not having a clear strategy and plan for expansion of their activities and for reaching within a reasonable period of time a loan portfolio of at least 5000 to 8000 clients or P75 to P100 million. Economies of scale in microfinancing are a fundamental part of the business, since it allows the bank to lower the lending rates and retain good clients in the long term. Banks persistently engaged in microfinancing on a "trial basis" should be encouraged to either adopt a consistent policy or to disengage from the business altogether.

- Not having a proper lending technology, particularly in the case of banks that have been engaged in consumer lending and are entering microfinancing with the same "assembly-line" approach to generating loans: one person who promotes or sells the loan and collects basic information, another who analyzes the client and another who calls on delinquent clients. In microfinancing, clients do not have a fixed salary nor formal financial information or any other information to prove their repayment capacity, therefore loan promoters, who generally work on commission basis, become involved in a conflict of interest between prudence in collecting client information and the need to have more clients approved, that ultimately turns into an unbearable risk for the bank.

- Not having established proper incentives for the staff, particularly loan officers whose work is conducted "in the street" and can only become an asset for the bank when seriously engaged in combining safety and productivity while generating their loan portfolios, and middle managers who have the task of controlling the transparency of loan officers' operations and reports. Incentive structures should be in place and be clearly understood by the different levels of staff, as well as proper control mechanisms.

- Lacking a firm stance about internal controls, particularly in the light that most credit decisions are taken on a decentralized fashion, at the branch level. Deterioration over time of internal controls policies or their true observance, lead to microfinance institutions that are in fact managed by the loan officers.

- Not having the proper income and expense structure, which may be reflected in excessive administrative expenditures (high salaries or high number of administrative personnel) that can be paid either from subsidies or donated funds or from excessive lending rates emerging from a quasi-monopoly position in the market, which may be unsustainable in the medium or long term. In other cases, having a lending rate that

Examination procedures

The examination of microfinancing portfolios will involve two weeks and five activities organized chronologically as established in these procedures.

Activity 1: *Review of the management information system and evaluation of the consistency of the data and reports*

a) Testing the security of the information systems and ruling out the possibility of unauthorized access and manipulation or adulteration of microfinance loan portfolio data (APPENDIX).

Responsible:	Examiner in Charge (EIC) and Information Systems Examiner (ISE)
Schedule:	First week of the examination
Product:	Assessment of the security and reliability of the information systems; to be considered in the Management component of the CAMELS rating.

b) Validating the accuracy and reliability of the information system of the institution to generate complete and correct information for risk tracking, decision-making and administration of the loan portfolio. Includes i) correctly track the aging of arrears and rescheduling of the microfinancing loans, ii) calculating portfolio at risk statistics for the purpose of quantifying credit risk and iii) issuing all the pertinent reports for every level of the organization, including loan officers, branch managers, coordinators and supervisors and senior management, iv) controlling that any loan rescheduling or refinancing at the branch level are being properly recorded as such in the information system and reported to the head office (ANNEX 1).

Responsible:	Examiner in Charge (EIC) and Information Systems Examiner (ISE)
Schedule:	First week of the examination
Product:	Assessment of the consistency and the effectiveness of the information systems; to be considered in the Management component of the CAMELS rating.

c) Validating the reliability of the information that is reported to BSP, particularly related to the quality of the loan portfolio, including determination of past-due accounts and portfolio at risk indicators (ANNEX 2).

Responsible:	Examiner in Charge (EIC) and Information Systems Examiner (ISE)
Schedule:	First week of the examination
Product:	Assessment of the consistency and the effectiveness of the information systems; to be considered in the Management component of the CAMELS rating.

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Activity 2: Assessment of the potential impact of microfinance operations on the net worth of the bank

Credit risk is the most important risk that affects the microfinancing portfolio. Microfinancing portfolios may be very solid if properly administered, but the repayment performance of the clients can be much more volatile than that of commercial banks. Loans are not collateralized and delinquency, if not addressed immediately, may get out of control very quickly.

The purpose of this activity is to assess the level of credit risk in the microfinance loan portfolio, by analyzing portfolio-at-risk statistics at the 1, 30, 60 and 90-day levels, as well as statistics for rescheduled or refinanced loans.

In case the MIS does not compute portfolio-at-risk statistics, the Examiner-in-Charge will make sure that the information system personnel of the bank generate such information during the first week of the examination and will have the results and the procedure reviewed by the Information Systems Examiner. Otherwise, the Examiner in Charge will be responsible to generate this information (directly or delegating to another examiner) through the use of a spreadsheet or any other computer-assisted audit technique (CAAT) such as ACL or other.

Responsible:	Examiner in Charge (EIC)
Schedule:	First week of the examination
Product:	Estimation of the credit risk of the microfinancing portfolio, to be used for the Capital Adequacy and Asset Quality components of the CAMELS rating.

Activity 3. Review of the microfinance lending policies, procedure and internal controls and audit

Microfinancing methodologies can be divided into *individual* lending models and *group-based* models. Some banks extend loans under both methodologies, utilizing different policies, procedures and information systems.

The purpose of this activity is to identify possible causes for any instances of portfolio problems observed in the evaluation of credit risk. It is likely that high delinquency rates or high incidence of rescheduling will be connected to policies and/or procedures for extending, monitoring and collecting the microfinance loans, that are either not adequate or are not being observed at the branch level. By and large, group lending should be characterized by an emphasis on group guarantee and peer pressure to ensure good client selection and repayment performance, while individual lending should be characterized by detailed analysis of the cash flow and build up of assets of the microenterprise business/family unit, as well as its reputation and credit history in the community.

ANNEX 3 contains Technical Notes for the review of individual lending methodologies and for the Grameen group methodology, the most common group methodology in the Philippines. In the evaluation of lending policies and procedures, special care must be taken to identify instances where the bank does not operate in conformity with standard practice for the given methodology and assess whether adaptations of the methodology to local conditions may not in fact be cases of breakdown of any of its fundamental elements. The

Technical Notes are designed to contain a summary of standard practice with regards to most fundamental aspects of each methodology, its internal controls and its information systems.

ANNEX 4 contains a Technical Note for the review of the internal audit.

Responsible:	Examiner in Charge (EIC)
Schedule:	First week of the examination
Product:	i) Preliminary assessment of the soundness of policies and procedures established by the bank, in the context of standard or best practices for every given methodology and ii) establishment of the specific policies and procedures to be tested by examiners at the branch level, in the review of internal controls and the cases included in the sample of clients; to be considered in the Management component of the CAMELS rating.

Activity 4. Review of the observance of microfinance policies and procedures at the regional and branch level.

The purpose of this activity is to review, in the field, the work performed by regional supervisors or coordinators, branch managers and loans officers, particularly in actual decision-making (loan approval, collection and delinquency management) and in the internal controls exercised during the whole loan cycle.

The examination is to assess whether the policies and procedures established by the institution for the proper approval, management and collection of loans are being properly observed. Microfinancing business is highly decentralized and it is not uncommon to find regions or branches that are applying methodologies that deviate from approved or established practice. While this might not be reflecting yet on the quality of the loan portfolio, it should be detected and its risk assessed.

Most of this activity involves review of loan files and visits to clients in the case of individual loans and review of center information documentation and visit to center clients in the case of group loans. For adequate coverage, statistical sampling in individual loans is done at the 95% confidence level and a 5% margin of error. However, in the case of institutions where the number of clients is small (five hundred or less) the margin of error can be increased to 10% so as to reduce the relatively high proportion of clients that would have to be otherwise reviewed (ANNEX 5). Both new clients and repeat clients should be reviewed, the former with emphasis on the evaluation of the activity of the client and the cash flow and the asset buildup analysis, and the latter on the monitoring of the payment history and the use of any locally available credit reference information. In the case of banks where the loan officers do the physical collection of payments, an alternative method is to accompany, unannounced, each loan officer in at least two daily collection rounds. In banks where group lending is practiced, the method consists in accompanying, also unannounced, each loan officer in at least two center meetings where collection takes place.

It is not the objective of the examination to detect instances of fraud by loan officers or branch managers (phantom clients, kickbacks, collusion, etc.), even though such instances may represent substantial risk. The examination has the objective of ensuring that proper lending policies and procedures exist and are properly implemented, and that the information that the head office utilizes and presents to Bangko Sentral, is fundamentally accurate. An area of particular interest for examiners is to make sure that significant numbers of loans are not being rescheduled or refinanced at the branch level, without being recorded and reported as such. Clients that pay their loans in advance when more than 25% of the original principal is still outstanding and are then granted a new loan within a week or less, should be considered as rescheduled or refinanced.

This activity also involves reviewing the work of the regional supervisors or coordinators, who most often play the key role in preventing (or detecting) fraud and controlling the compliance of loan officers and branch managers with established policies and procedures. The latter, it should be noted, have a natural interest in presenting the branch information in the best light possible, since most often loan portfolio quality and efficiency indicators determine their own salaries and incentives. Internal auditors may also play a key role in ensuring proper internal control; however, they do not often engage in detailed fieldwork and visits to clients, particularly in the case of institutions that do not have a substantial portfolio in microfinance.

Specific procedures for review of individual and group loan technologies are contained in ANNEX 6.

Additionally, a test for compliance with lending policies (amount disbursed, interest rate, term to maturity, repayment terms, collateral, etc.) can be performed for the whole portfolio with the use of computer assisted audit techniques (CAATs), if available.

Responsible:	Examiner in Charge (EIC) and designated examiners
Schedule:	Second week of the examination
Product:	Assessment of the observance, at the branch level, of established policies and procedures; to be used for the Management component of the CAMELS rating.

Activity 5. Evaluation of liquidity management and sensitivity to market risk

The policies of the institutions on liquidity management and its implementation should be reviewed. Reputational and even credit risks in microfinance institutions may be present, when liquidity constraints do not allow timely disbursement of loans, particularly repeat loans to clients with good payment history.

The information system of the bank should produce daily asset/liability and liquidity reports as well as cash flow projections on which to perform sensitivity analysis, as well as other aspects contemplated in the CAMELS model.

Responsible:	Examiner in Charge (EIC) and designated examiner
Schedule:	Second week of the examination
Product:	Assessment of the liquidity management policies and situation; to be used for the Management and Liquidity component of the CAMELS rating.

SUGGESTED AMENDMENTS TO CAMELS INSTRUMENT

This section is intended to provide a basis to adapt the current CAMELS instrument for the analysis of microfinancing operations of both microfinance-oriented banks and microfinance units of commercial, thrift or rural banks. It is based on the fact that microfinancing is a distinct credit risk that must be evaluated and administered properly in order to be a profitable and stable business.

Component 1: Capital adequacy

Current model:

Based on twenty questions and sub-questions whose answers are added when "negative", and eight ratios whose individual rating is averaged. A "NO" answer to Question 3 regarding compliance with statutory capital requirement (Sec. 22 of RA 337) or a net worth-to-risk assets ratio (ratio a) below the statutory minimum, give by themselves a score of "1" to the whole component.

Suggested modification:

Question 11a: do not include unsecured microcredits in "high-risk assets", unless evidence is found during the examination of substandard policies, procedures or internal controls.

Suggested addition:

New ratio to measure the impact of portfolio at risk on the level of available capital. The ratio should be calculated, as follows[4]:

$$PAR_{RR} / \textit{Adjusted net worth}$$

Where PAR_{RR} are defined as "Portfolio At-Risk Required Reserves" and calculated as follows:

$$PAR_{RR} = [(\textit{Gross portfolio} - PAR_1 - RP_1 - RP_2) * 0.01] + [(PAR_1 - PAR_{30}) * 0.05] + [(RP_1 + PAR_{30} - PAR_{60}) * 0.2] + [(PAR_{60} - PAR_{90}) * 0.5] + PAR_{90} + RP_2 - \textit{Adjusted reserves}$$

For the computation of $PAR_{(1,30,60,90)}$ the outstanding balance and accrued interest of microcredits shall be considered in their entirety on the 1st, 30th, 60th and 90th day after any single agreed payment of principal or interest goes unpaid. Such date should remain unchanged until enough money is paid to return the microcredit to its original repayment schedule. In

[4] In the case of banks that are not microfinance-oriented, only loans, interest and reserves related to microfinancing should be computed.

the case of group loans, the outstanding balance and accrued interest of the whole group is computed as *PAR* when any member of the group defaults and the amount due is not paid by the group. For the computation of *RP*, the outstanding balance and accrued interest of microcredits shall be considered in their entirety when not repaid in accordance with the agreed schedule but subject to a first or second (or more) renewals, reprogramming, rescheduling, rollovers, refinancing or any other modification that defers, delays or postpones effective repayment. However, microcredits that were partially applied to cancel other microcredits shall not be computed as RP as long as the client was in good standing and all the interest and at least 75% of the principal had been paid in accordance with the originally agreed terms.

Interpretation: Provided Question 3 or ratio a. have not already determined a score of "1" to the whole component, this ratio by itself would give scores of "1" or "2" to the whole component as follows:

Score 1:	*if more than 20%*
Score 2:	*if between 10% and 20%*
Not applicable:	*if less than 10%*

Component 2: Asset quality

Current model:

Based on twenty-one questions and sub-questions whose answers are added when "negative" and twenty ratios whose individual rating is averaged. No question or ratio is considered of sufficient importance to grant a low score to the whole component.

Suggested modification:

Question 3: all microcredits should not be considered as a single type of loan;
Question 5: do not include unsecured microcredits in "high-risk assets", unless evidence is found during the examination of substandard policies, procedures or internal controls.
Question 12: a NO answer determines by itself a score of "1" for the whole component, if 3% of the gross microfinancing portfolio (a proxy reserve for general risk) is equivalent to 20% of the adjusted net worth or more. The report of examination should contain (even when the 20% has not been reached) specific instructions and chronograms to improve microfinancial policies, procedures and practices (which include diverse aspects such as information systems and personnel training and incentives) or to disengage from

microfinance altogether, particularly in the case of banks that are not specialized in microfinance.

Ratio c.: microcredits should not be computed as unsecured loans, unless evidence is found during the examination of substandard policies, procedures or internal controls.

Suggested addition:

New ratio: to measure the trend of bad loans during the previous 12 months, in relation to the capacity of the bank to generate positive profits. The ratio should be calculated as follows[5]:

$$\frac{\dfrac{\textit{Current }(PAR_{RR} + \textit{Acquired assets} - \textit{Write-offs})}{\textit{Previous }(PAR_{RR} + \textit{Acquired assets} - \textit{Write-offs})} - 1}{ROE_{\text{Previous 12 months}}}$$

Interpretation: Provided Question 12 (new interpretation) has not already commanded a score of "1" for this component (or vice versa), the interpretation will depend on how involved the bank is in microfinancing. If the gross microfinance portfolio is more than twice the adjusted net worth, then this ratio by itself would give a score of "1" or "2" to the whole component, as follows:

Score 1:	*if 130% or more*
Score 2:	*if between 110% and 130%*
Not applicable:	*if less than 110%*

If the gross microfinance portfolio is less than twice the adjusted net worth (i.e. banks that are not specialized in microfinance) but the ratio exceeds 110%, the report of examination should still set a target date for performance turnaround or for disengaging from microfinance altogether

Alternative ratio and interpretation: if *ROE* is negative, the ratio to be analyzed is the following:

$$\frac{\textit{Current }(PAR_{RR} + \textit{Acquired assets} - \textit{Write-offs})}{\textit{Previous }(PAR_{RR} + \textit{Acquired assets} - \textit{Write-offs})} - 1$$

If the gross microfinance portfolio is more than twice the adjusted net worth, then this ratio by itself would give a score of "1" or "2" to the whole component, as follows:

Score 1:	*if 10% or more*
Score 2:	*if between 5% and 10%*

[5] In the case of banks that are not microfinance-oriented, only loans, interest and reserves related to microfinancing should be computed.

Not applicable:	*if less than 5%*

If the gross microfinance portfolio is less than twice the adjusted net worth (i.e. banks that are not specialized in microfinance) but the ratio exceeds 5%, the report of examination should still set a target date for performance turnaround or for disengaging from microfinance altogether.

Component 3: Management

Current model: Based on ninety-two questions and sub-questions whose answers are added when "negative". No question is considered of sufficient importance to grant a low score to the whole component.

Suggested modification: The following issues should warrant scores of "1" or "2" to the whole component:

- Lack of timely and truthful reports on delinquency and loan reprogramming, with adequate internal controls to prevent data manipulation in the branches[6].
- Lack of involvement of the board in monitoring the quality of the loan portfolio and the performance of the loan officers, both through internal control mechanisms and through internal audit.
- Deterioration of loan practices or technology, evidenced through random samples and visits to clients.
- Dependency on donations or subsidies to cover operating expenses.

Component 4: Earnings

Current model: Based on eleven questions and sub-questions whose answers are added when "negative" and eight ratios whose individual rating is averaged. No question or ratio is considered of sufficient importance to grant a score to the whole component. Ratios are based on an adjusted trial balance, where one important adjustment, if not the main one, is the difference between booked reserves and reserves required according to Circular 247 of June 2, 2000.

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6 ANNEX 7 contains a tentative format for reporting of microfinance operations, that shows some of the consolidated information that should be readily available to board and managers.

Suggested modification: In the case of microfinance-oriented banks, the whole trial balance should be further adjusted for the following concepts:

a) Subsidies in the form of "soft-loans": a "shadow" interest expense should be added in the case of medium and long term liabilities that bear an interest rate significantly below market rate. The amount should be calculated as follows:

$$[(i_s - i_l) * k_l] / 12 * n_m$$

where i_s is the shadow interest rate or the weighted average cost of funds of the bank, i_l is the nominal interest rate of the soft-loan, k_l is the average principal of the soft loan and n_m is the number of months the soft loan was outstanding during the period.

b) Donations and in-kind subsidies accounted as income must be subtracted from the income statement

c) Devaluation adjustment: a "shadow" interest expense should be added to account for the loss of purchasing power of owners' net worth, as follows:

$$Net\ worth_s * [(Fx_e / Fx_s) - 1]$$

Where $Net\ worth_s$ is the net worth in local currency at the start of the period, Fx_e is the exchange rate at the end of the period and Fx_s is the exchange rate at the start of the period. This adjustment should be calculated as an "inflation adjustment" ($Net\ worth_s$ * *inflation rate for the period*) in case inflation was higher than devaluation during the period.

d) Credit risk adjustment: an "shadow" expense to take into account the growth in credit risk during the period should be included as follows:

$$PAR_{RR(e)} - PAR_{RR(s)} - \textit{reserves booked during the period}$$

Where $PAR_{RR(e)}$ are the PAR required reserves at the end of the period and $PAR_{RR(s)}$ are the PAR required reserves at the start of the period. This adjustment would replace the current adjustment related to Circular 247 requirements (which is still applicable and applied when computing Question 3 of Capital Adequacy component

In the case of banks that are not microfinance-oriented, segmental information (in accordance to IAS) should be prepared or estimated and the adjustments applied to the microfinance segment.

Suggested new interpretation: Ratio a.: when calculated with the adjustments described, this ratio should be considered of sufficient importance to grant a microfinance-oriented bank a score of "1" or "2" to the whole component in case it is under 0.5%, as follows:

Score 1: if ROA is negative
Score 2: if ROA is below 0.5%

If greater than 0.5%, it can be averaged with the other ratios, utilizing the following scoring: "3" of between 0.5% and 1.5%, "4" if between 1.6% and 3% and "5" if above 3%.

In a bank that is not microfinance-oriented, a ROA under 0.5% for the segment of microfinancing should prompt for chronogram for adequacy or for disengaging from this business.

Component 5: Liquidity

Current model: Based on nineteen questions and sub-questions whose answers are added when "negative" and fourteen ratios whose individual rating is averaged. No question or ratio is considered of sufficient importance to grant a low score to the whole component.

Suggested modification: Questions 1-5: should be considered of enough relevance to assign by themselves, anyone of them, a score of "1" to the whole component in case of negative answer. In the analysis of these questions, it should be noted that best practices require that liquidity policies and instruments should take into account the cash flow impact of at least the following elements: projection of loan disbursements, projection of loan recoveries (adjusted for credit risk), interest income (adjusted for credit risk) and expense, operating expenses, volatility of deposits and other funding sources, as well as branch structure and dispersion. They should also take into account clear policies of limiting risk on investment of excess liquidity from savings accounts, particularly with regards to medium and long term deposits in other banks (analysis and concentration limits).

Component 6: Sensitivity to market risk

Current model:	Based on seventeen questions and sub-questions whose answers are added when "negative"; no ratio analysis is conducted. No question or ratio is considered of sufficient importance to grant a low score to the whole component. No question exists that inquires about issuance of loans in foreign currency and therefore the risk of non-repayment in the event of large devaluation.
Suggested addition:	None for the moment.

APPENDIX ON INFORMATION SYSTEMS AUDIT

(Pending)

ANNEX 1

EVALUATION OF THE QUALITY OF INFORMATION GENERATED BY THE MICROFINANCE LOAN PORTFOLIO SYSTEM

<u>Examination objective:</u>

Validate the accuracy and reliability of the MIS to generate complete and correct information for risk tracking, decision-making and administration of the loan portfolio.

<u>Examination procedure:</u>

i) Identify and assess the internal control measures in the information system (access controls, generation of due dates, handling of payments, etc.)

ii) Correct tracking of aging of arrears and income recognition.

- Verify that the information system is utilizing the correct date to compute the number of days that a loan is past due or delinquent.
- Verify that interest and other charges are recognized as income according to the payment schedule and performance.
- Verify that payments are assigned automatically and correctly to penalties, interest and principal, without a possibility of data manipulation.

iii) Correct calculation of portfolio at risk statistics (1, 30, 60 and 90 days)

- Verify that the outstanding principal of loans behind in payment is being utilized to calculate portfolio at risk indicators.

iv) Control that any loan rescheduling or refinancing at the branch level are being properly recorded as such in the information system and reported to the head office.

- Crosscheck the database of cancelled loans with the database of current loans, to identify operations that may have been reprogrammed or refinanced without reporting. Prepayments of principal when more than 30% is still outstanding should be considered a rescheduling.

v) Issuance of all the necessary reports for every level of the organization, including loan officers, branch managers, coordinators and supervisors and senior management

- Loan officer: daily delinquency reports with correct number of days, daily collection sheets, pending applications, etc.
- Branch managers: delinquency by loan officer, pending applications, pending disbursements, etc.

- Coordinators and other senior management: summarized information by branch and loan officer including delinquency, rescheduling, disbursements, pending applications, pending disbursements, loan rejections, etc.

v) Verify that compliance with loan loss provisioning as established in Circular 24[7]

- Loans should be considered past due when 20% (monthly installments) or 10% (less than monthly) of the principal is in arrears; or when 3 installments are in arrears.

[7] Or current regulation.

ANNEX 2

REVIEW OF INTEGRITY AND ACCURACY OF REPORTS TO BSP

Examination objective

To verify that the data contained in periodic reports to BSP reconciles with the information systems of the institution and that the reporting process is free from any type of manipulation that could affect the integrity or accuracy of the data.

Examination procedure

1. Review the timeliness and accuracy of the bank or financial institution regarding information reporting (financial statements and credit reference databank) during the past 10 months. Determine frequency and type of reporting problems, if any.

2. Get the BSP copy of the electronic files containing the financial statements and credit reference databank information, reported by the bank or financial institution for the examination cut-off date and for the previous month.

3. At the bank or financial institution, determine whether the information reported originates only from computerized applications or if it originates also from information kept in manual records (including spreadsheets or word processing documents).

4. Identify the computerized applications that handle information that has to be ultimately reported to BSP, including interface applications.

5. Request the following information/documentation for all identified applications:
   - Platform in which they are run
   - Programming language
   - IT person responsible for maintenance
   - Block diagrams of all processes
   - Entity relation diagrams
   - Files and tables nomenclature
   - Data dictionaries
   - Codes utilized and description
   - File retention periods
   - Number of register in the files
   - Source programs reports

6. Review the information obtained and clear any doubts with the IT person responsible for maintenance, as well as end-users of any application.

7. Prepare block diagrams and flow diagrams that describe the processes for generating the reports to BSP and determine all risk points.

8. Review source programs that convert/transfer the data from the base applications to the interface application and verify the correct use of criteria.

9. Review the source programs of the interface applications that modify or alter (e.g. consolidate) information, as well as the generation of the actual report for BSP, and verify its proper operation.

10. Evaluate the internal IT norms and controls and determine it they provide reasonable confidence that the source programs reviewed correspond to the same version that is utilized in actual operations.

11. Identify the files with which to work and coordinate its conversion and transfer to the assigned stations for the audit work.

12. Review the reconciliation procedures and obtain the consolidated totals that allow for reconciling the transferred files.

13. Form an opinion of the reliability of the reconciling procedure that is applied to the base and interface applications.

14. Determine if there are delays in the process of updating the information of the base applications or in the process of transfer to the interface applications.

15. Obtain the total amounts on each application that generates information and verify that it reconciles with the accounting records of the same date. Also verify that such total amounts reconcile with the information contained in the files reported to BSP for the same date.

16. Apply specific procedures to validate each one of the files reported to BSP, to the corresponding files contained in the base application at the bank or financial institution. In the case of credit reference databank, the emphasis should be in consistency of the registers regarding identification of clients and status of individual lending operations, as well as reconciliation of the net variations in loan balances between two reports, with the movements registered in the files of accumulation of transactions in the base application. In the case of financial statements, reconciling at groups and subgroups of accounts, as well as reconciling net differences in accounts between two different reports, with the files of debit and credit total movements in the base application of the bank or financial institution.

17. If necessary, a sample of individual transactions/movements should be verified in coordination with the financial examiner."

ANNEX 3

TECHNICAL NOTES FOR EVALUATION OF THE LENDING METHODOLOGIES

In the case of institutions engaged in microfinance lending, the policy making and the internal control roles of the Board gain additional importance. As opposed to corporate lending, Directors are seldom, if ever, involved in the actual evaluation of individual clients and the approval of loans.

Most credit decisions are decentralized (taken at the branch level) and Directors must exercise special care in ensuring that the credit policies and procedures are clear and unambiguous and that all personnel are properly trained to implement them.

They should clearly spell out, at least, the client qualifications (including type and number of years in business), credit history and character, purpose of the loan (working or investment capital, family expenses), loan conditions (amount -principal and installments- term, interest rate), collateral (registered, non traditional, personal guarantees), approval levels (branch, regional, head office), incentives to good clients.

In case of group loans, key policies relate to the existence of a legitimate bond and reasonable homogeneity among the members of a group, the serious enforcement of the group guarantee in case of arrears by any member, including the use of the individual savings of other members to repay loans in default.

1. GRAMEEN METHODOLOGY

GRAMEEN STANDARD PRACTICE		ADAPTATION INTRODUCED BY THE BANK	EFFECT ON CREDIT RISK
Exclusive focus to the "very poor"	Screening procedure, loan amount and repayment methodology ensure that the "better off poor" are weeded out from participating		
Credit design elements	Small loans and weekly repayments		
	Individual, self-chosen activities by borrowers		
	Formulation of small groups (five with an elected leader) and centers (five to ten groups), encouraging the grouping of "like-minded" individuals, not related among themselves		
	Compulsory group training with emphasis in jointly liability and responsibility for screening, monitoring and repayment		

GRAMEEN STANDARD PRACTICE		ADAPTATION INTRODUCED BY THE BANK	EFFECT ON CREDIT RISK
	Staggered loan releases, following the 2-2-1 scheme, where the poorest two are the first to receive the loans		
	Physical collateral not required given the presence of the joint liability and the small loan amount		
	Transactions (releases and collections) are conducted in the village		
	Loan progression from cycle to cycle does not exceed 15%		
Strict credit discipline and close monitoring	Center meetings are held weekly and loan officer reports to his manager on attendance, collections and defaults		
	Peer pressure is secured through enforcement of the credit guarantee		
Conditions for repeat loans and for client replacement	Group guarantee is enforced and attendance to meetings is above 95%		
	Drop-out clients are replaced with full understanding of the group guarantee		
Forced savings	Even from the start of the training period (before the person even qualifies as client-borrower)		
Political neutrality	To maintain an image of independence and entrepreneurial orientation		

2. INDIVIDUAL LENDING METHODOLOGIES

INDIVIDUAL LENDING STANDARD/BEST PRACTICE		POLICY OR PROCEDURE ADOPTED BY THE BANK	EFFECT ON CREDIT RISK
Client eligibility	Successful experience of at least one year in the business to be financed		
	Homeowner or resident in the same house for at least one year		

INDIVIDUAL LENDING STANDARD/BEST PRACTICE		POLICY OR PROCEDURE ADOPTED BY THE BANK	EFFECT ON CREDIT RISK
	Of legal age to subscribe contracts; maximum 60 years old unless loan fully collateralized		
Identification of the client	Sufficient documentation for undisputable identification		
Workplace and domicile verification	On site visit to both by loan officer and drawing of proper sketches in case nominal address nonexistent or impractical		
Payment history and investigation of other liabilities	All available credit reference sources consulted prior to approval; neighborhood and workplace check adequately documented		
Proper evaluation of repayment capacity	Estimation of the net available cash flow and the net assets of the business; cross checking of consistency among both estimations		
	Verification of alternative source of repayment in case business experiences difficulties; this source preferably not considered in the cash flow for purpose of determining the loan or installment amount		
Loan amounts and terms with respect to the client's level of cash flow and asset buildup	Installment not in excess of 50% of the net available cash flow of the business, minus family expenditures		
	Loan amount not in excess of the net assets of the business.		
Repayment schedules and practices	In accordance with the client's cash flow, although clients encouraged to adopt discipline of weekly and monthly repayment		
	Long grace periods (over two months) and term loans only in exceptional cases; even agricultural loans subject to periodic repayment schedule		

INDIVIDUAL LENDING STANDARD/BEST PRACTICE		POLICY OR PROCEDURE ADOPTED BY THE BANK	EFFECT ON CREDIT RISK
	Collection at the bank; by loan officer only exceptionally and in the context of pressuring clients that are on arrears		
Collateral requirements with respect to loan amounts	Loans in excess of 1% of net worth of the bank or US$5.000 (equivalent) fully collateralized with registered security		
	Loans under amount mentioned secured by non-registered collateral (household or business equipment or goods) or by personal guarantors		
	Personal guarantor undergoes similar analysis as client, particularly when self-employed		
	Clear procedure for approval of exceptional conditions to prime clients		
Loan approval	All loans approved by a loan committee composed of experienced peers and middle managers; loan officer recommends and defends loan applications but has no authority to approve any loans		
	Autonomy levels in accordance to loan amounts		
Relending and restructuring policies	Relending to good clients when at least 75% of the loan has been paid in accordance to agreed payment plan		
	Restructuring only in exceptional cases and under proper overview by higher management and through established procedures and limits		
Client monitoring policies	Loan officer responsible for monitoring clients and exercising collection efforts on delinquent clients		
	Incentives to loan officers based on productivity and loan portfolio quality		

INDIVIDUAL LENDING STANDARD/BEST PRACTICE		POLICY OR PROCEDURE ADOPTED BY THE BANK	EFFECT ON CREDIT RISK
Information systems capable to providing information to every decision-making level of the organization	Loan officers have daily and complete delinquency reports and other reports for administration of loan portfolio		
	Branch supervisor or branch manager has timely delinquency and productivity reports for each loan officer and branch profitability		
	Area supervisor or credit manager has timely delinquency and productivity reports for each branch and officer		
	Senior management and board of directors has timely reports on delinquency, productivity, profitability		
Management of arrears	Established policy and procedures for arrears depending on aging		
	Arrears committee to advise and act according to established procedures		

ANNEX 4

REVIEW OF INTERNAL AUDIT

Examination objective:

To verify that the internal auditor work programs are risk-based and contribute to the establishment of an environment of control at the head office and branch level.

Examination procedure:

1. Verify internal auditor has adequate experience.

2. Verify that work programs emphasize on detecting breaches in internal control procedures, due to weaknesses in procedures or training, negligence or intention to commit fraud.

3. Verify that information systems are reviewed for accuracy of reporting or aging of arrears, income accruals and rescheduling or refinancing of loans.

4. Verify that work plan involves a substantial presence at the branch level (at least twice a year in every branch) and includes a review of a random sample of clients of each loan officer.

5. Verify that loan files are reviewed for completeness and compliance with credit policies and procedures and visits to clients confirm key elements such as the quality of information on the client file, the quality and thoroughness of the evaluation of the character and repayment capacity of the client and the non-existence of unauthorized or unreported rescheduling or refinancing of loans.

6. Review responses and actions by Board Members and senior management to the internal auditors findings and recommendations on improvement of policies, procedures or internal controls.

ANNEX 5

SAMPLE SIZE FOR INDIVIDUAL MICROFINANCE LOANS
(Confidence level of 95%)

Total number of clients	Margin or error					
	2%		5%		10%	
	No. Clients	As % of total clients	No. Clients	As % of total clients	No. Clients	As % of total clients
100,000	1,653	2%	**268**	**0%**	67	0%
50,000	1626	3%	**268**	**1%**	67	0%
40,000	1613	4%	**267**	**1%**	67	0%
30,000	1592	5%	**266**	**1%**	67	0%
20,000	1551	8%	**265**	**1%**	67	0%
10,000	1439	14%	**262**	**3%**	67	1%
5,000	1258	25%	**255**	**5%**	66	1%
4,000	1184	30%	**252**	**6%**	65	2%
3,000	1078	36%	**247**	**8%**	64	2%
2,000	914	46%	**237**	**12%**	64	3%
1,000	627	63%	**212**	**21%**	63	6%
500	386	77%	175	35%	**59**	**12%**
400	323	81%	161	40%	**58**	**15%**
300	255	85%	142	47%	**55**	**18%**
200	179	90%	115	58%	**51**	**26%**
100	94	94%	73	73%	**40**	**40%**

Methodology is simple random sampling without replacement; the formula used is as follows:

$$n = Z^2 \sigma^2 N \;/\; (N-1)\varepsilon^2 + Z^2 \sigma^2$$

Where:

n = sample size
N = population size
Z = table value of normal distribution at the level of confidence chosen (95% = 1.96
σ = standard deviation
ε = margin of error allowed

ANNEX 6

EXAMINATION PROCEDURES FOR REVIEW OF SAMPLE CASES AT THE BRANCH LEVEL

1. GROUP LOAN PORTFOLIOS

Policy or practice	Associated risk	Examination procedure
1. Confirmation of poverty level of client conducted prior to engagement in the program	1) Admitting clients who will not accept the disciplines of the program, 2) Admitting clients who might leave the program shortly, 3) Admitting clients who might have other occupations who prevent her from attending group meetings.	EIC: a) reads loan policies, b) defines specific requirements. Examiner: a) attends center meeting and chooses at random three clients for visit to home
2. Peer groups of five (+ or -) are self formed and incorporated into barangay centers of eight to ten groups	1) Client selection by the own financial institution might be too costly or prone to mistakes due to lack of adequate information on the client identity or payment history, 2) Collection efforts on an individual basis might be too costly or difficult on an individual or group basis, 3) Group guarantee may be unenforceable in the case of groups not self-formed or consisting of individuals not like-minded	EIC: a) reads loan policies, particularly with regards to replacement of drop out clients, b) defines review criteria. Examiner: a) attends center meeting and interviews members of at least half of the groups
3. Mandatory attendance to group training meetings and to retraining meetings after each cycle	1) Inadequate knowledge of repayment procedures or cross-guarantee responsibilities may affect normalcy of collection, 2) Member screening before lending and peer pressure at collection may not be weakened, 3) New member in the group or center that are recruited to replace drop-outs have not gained acceptance by old members which might affect enforcement of group guarantee	EIC: reads policy for training and for replacement of dropouts and defines review criteria. Examiner: a) reviews attendance sheets of at least two centers
4. Savings must be contributed for four to eight weeks prior to receiving a loan and for the duration of the loan	1) Admission of members with no capacity to generate surpluses and therefore with no evidence of capacity to repay loan from current income, 2) Lack of accumulated savings may reduce the incentive to pay own debts and to exercise peer pressure on other members	EIC: reviews mandatory savings policy. Examiner: verifies compliance through interviews during center meetings and by review of passbook and subsidiary ledger of at least one member in each center visited.

Policy or practice	Associated risk	Examination procedure
5. Group members guarantee each other's loan and are held legally responsible for the repayment of the other members	1) Lack of group guarantee would relax client screening, 2) lack of group guarantee would annul peer pressure for repayment	EIC: verification of policy. Examiner in every center in the sample, interviews clients of all groups with members that show irregular attendance and/or have fallen behind (in the past or presently) in their payments.
6. No further loans are available if all members do not pay back on time	1) Further lending to members of groups where peer pressure has not served to insure prompt repayment would erode client behavior within the group and generate contagion to other groups.	EIC: reads policy on loan monitoring and collection. Examiner: a) verifies that policy is being enforced in all the centers in the sample.
7. Collection at weekly center meetings	1) Lack of public disclosure of payment misbehavior of other members would encourage defaults, 2) Costs of individual collection would be too costly or hard to enforce given the relatively small information the financial institution holds on the client	EIC: a) reads policy on collection and determines review methodology. Examiners: a) participate in collection meeting in all the centers in the sample.
8. Enforcement of group guarantee when delinquency by one member arises	1) Incentive to pay and peer pressure might be reduced when group guarantee is not enforced, 2) delinquency might soar	EIC: reviews policy. Examiner: interviews group and center members on the payment plan that the group and center has decided to cover the debt of any delinquent member(s).
9. Internal control by regional supervisor or coordinator and Internal audit	1) Complete decentralization of lending operations might leave branches to establish their own policies, 2) Branch managers might not enforce strict controls or may even collude with loan officers in questionable practices, 3) Branch information sent to head office may not be transparent	EIC: reviews policy for internal control and internal audit and determines examination criteria. Examiner: 1) reviews reports by regional supervisors or coordinators and internal auditors, 2) confirms highlights or findings of reports at the branch level.

2. INDIVIDUAL LOAN PORTFOLIOS

Policy or practice	Associated risk	Examination procedure
1. Proper verification of residence and workplace, and updated information datasheet, including means of identification	1) Credit officer involved in fraudulent operations (nonexistent or "ghost" clients, even in the case of group loans), sometimes with the complicity of other officials or employees, 2) Credit officials that approve operations "from the desk," without clear evidence of having visited and analyzed the client first-hand (business and domicile), situation which invalidates any further analyses on repayment capacity and character	EIC: a) reads loan policies, b) defines specific requirements. Examiner: a) verifies id documentation, cross-validates signatures or fingerprints with those stamped on the loan application, contract, and disbursement receipt, b) analyzes the sketch plus any other evidence (according to policy requirements) that the client has been evaluated in his/her workplace and domicile
2. Verification of credit history with other financial entities and other creditors	1) Grating loans to clients whose behavior shows or suggests lack of willingness or capacity to repay; it may occur when an institution grants repeat loans without checking the current status of the client, 2) Granting loans without a verification of liabilities declared by the borrower, a situation that invalidates further analyses of the repayment capacity and character	EIC: a) reads loan policies, b) defines review criteria including credit reference databank information. Examiner: a) cross-checks id information with that of credit reference databank report and verify dates, b) cross-check credit reference databank information with the liabilities declared by the borrower
3. Adherence to levels of autonomy	Given the high degree of loan granting decentralization, loan policy adherence is neglected by specific branches or loan officers.	EIC: reads policy on loan approval levels. Examiner: a) verifies that the appropriate level of discretion according to the institution's internal regulations has approved the operation and that the ceilings on maximum installment (e.g. as a % of net cash flow available) or maximum loan principal (e.g. as a % of borrower's business equity) has been observed.
4. Adherence to policies on loan restructuring		EIC: review restructuring policies. Examiner: For restructured loans: a) review of report of visit to client by loan officer and branch manager, b) review re-assessment of repayment capacity and willingness, c) confirm restructuring approval by higher-rank official of the institution, d) verify conditions of restructurings within approved policy, e) verify restructured loan properly classified. For repeat loans: verify that they are not restructured loans

Policy or practice	Associated risk	Examination procedure
5. Adherence to policies on loan amounts/terms, repayment schedules, interest rates and others		EIC: detailed verification and crosscheck of adherence to policies utilizing specialized software for computer-assisted auditing Examiner: receives and reviews some loans with apparent transgression to policies, to further review with the loan officer /branch manager
6. Regular client monitoring	1) Loan officers not able to monitor clients on a regular basis due to poor zonification (officers' area of influence too large) or any other reason 2) loan officers do not visit a past due client within a reasonable period of time (or fails to document it in the loan file), even though untimely collection efforts increase credit risk.	EIC: reads policy on loan monitoring and collection (some entities establish minimum amounts for actual monitoring to be mandatory Examiner: a) verifies that the client belongs to the officer's assigned zone, b) for clients more than 15 days past due, checks the file for signs or evidence that payment collection is being enforced
7. Verification of financial standing and character of loan guarantors	1) Loan officers not enforcing the institution's policy on requirements for loan guarantors or accepting any guarantors presented by the client "just to comply with formalities", which may results in insolvent guarantors or guarantors with no verified domicile, workplace or capacity to assume the debt.	EIC: a) reads policy on loan guarantees, b) defines mechanisms other than credit reference databank. Examiner: a) cross-checks id information with that of the credit reference databank and verify dates, b) analyze the documentation related to guarantor.
8. Verification of proper valuation and conservation of registered collateral	1) Loan officers accept any kind of collateral offered by the client just to "formally" comply with the policy, 2) loan officer involved in virtually fraudulent operations, wherein collaterals –real estate or movables– are grossly overvalued.	EIC: reads loan policies on collaterals. Examiner: a) examines value of collaterals, crosschecks with other appraisals, b) verifies documentation of registered collaterals.
9. Proper estimation of repayment capacity and avoidance of questionable practices	1) Loan officers lacking enough training or competence to evaluate borrowers, 2) Loan officers not complying with evaluation guidelines, 3) Loan officers who "window-dress" the client's financial situation in order to gain approval by the credit committee by: a) misrepresenting the client's profile to simulate compliance with lending policy, b) overstatement of income/equity or understatement of liabilities/expenses in order to increase loan amount, 4) Loan officers involved in questionable practices.	Examiner confirms, on a personal visit to the client: a) the client's identity, b) the personal information that is contained in the loan file, especially items that bear heavily on loan approval, c) the information about his or her business and other sources of cash flow that appears in the loan file to justify loan and payment size. The examiner also takes this opportunity to confirm: a) that the client has in fact an outstanding loan with the MFI, b) the client's understanding of the loan amount and terms, including timing and

Policy or practice	Associated risk	Examination procedure
		amounts of payments that he or she is supposed to make, c whether the client made any other payments, to loan officers or other employees, in connection with getting the loan, d the client's understanding of his or her outstanding loan or savings balances, e the client's understanding of whether he or she is current on the loan and, if not, how long the loan has been delinquent, f the client's passbook, if applicable, as well as other records regarding savings or loans, g what collateral or guarantee he or she provided for the loan and verifies its present condition, h whether the clients' previous loans were paid in full in cash—as opposed to being canceled using the proceeds of a new loan, payment by check, or delivery of collateral; checks this information against what is recorded in the bank's loan tracking MIS, i whether any of the client's relatives have outstanding loans with the MFI.

ANNEX 7

REPORTING FORMATS (DRAFT)

Name of Bank	
Name, title and email address of person responsible for microfinance operations	
Lending methodology (ASA, GRAMEEN, MABS, other)	
Institution where training was obtained	
Company or Institution that provided MIS System for microfinance administration	

	Last month	Last end of year	Previous end of year
1. GENERAL INFORMATION			
Total loan portfolio (million pesos)			
Microfinance portfolio (million pesos)			
No. of branches where microfinancing is offered			
No. of loan officers			
2. MICROFINANCE PORTFOLIO SITUATION			
Rescheduled or refinanced loans			
Loans written off			
Loans past-due maturity date			
Loans with past-due three or more installments			
(Other)			
(Other)			
(Other)			
Portfolio at risk (if available)			
For 1 day or more			
For 30 days or more			
For 60 days or more			
For 90 days or more			
Portfolio at risk (alternative means to calculate: by installments, tranches, etc.)			

3. ANALYSIS OF PORTFOLIO STRUCTURE OF GROUP LENDING PORTFOLIOS

Date:		1st cycle	2nd cycle	3rd cycle	4th cycle	Nth cycle	Total
Loan amounts							
Number of clients since start of program							
Outstanding Clients	Number						
	%						100%
Outstanding Amount	Pesos						
	%						100%