



Microfinance Briefing Paper: Delinquency Management

A microfinance institution’s biggest asset is its loan portfolio. The loan portfolio is also its primary source of income, through collection of interest income and fees. It therefore makes sense to protect this asset, and ensure it is healthy and growing.

What does a healthy loan portfolio look like?

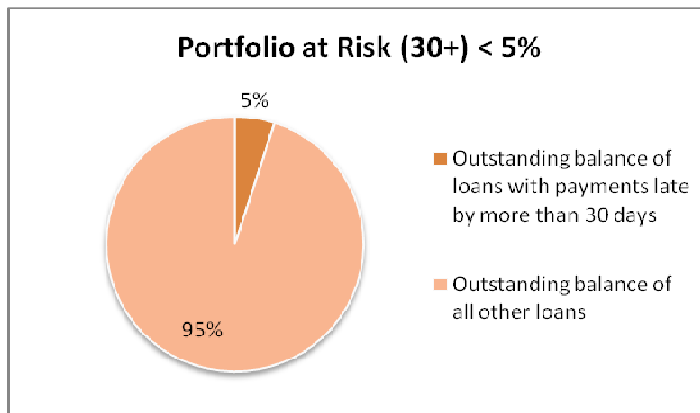
A healthy portfolio is like a healthy body, it is active and keeps moving, and it has no bad parts or sickness. Bad loans are like a sickness that can quickly spread through the body if the causes of these are not identified and effectively treated.

A healthy portfolio should keep revolving at its maximum capacity. Every time a loan repayment is late this slows down the health of the portfolio. It also costs the MFI money, due to lost interest income and increased costs of collection. In the worst cases, if a borrower defaults, then you lose part of the portfolio. This puts people’s savings at risk, and it can take a long time to replace lost capital.

The best way to assess the health of a portfolio is to look at how much is bad (in arrears), and use this to work out how much is at risk of being lost (default). We then know how much of our portfolio is at risk (Portfolio At Risk = PAR). The international standard measure of PAR(30) says that for any loan with a payment that is more than 30 days late, then the whole outstanding principal of the loan is at risk.

Portfolio at Risk (30+) = Outstanding balance of loans with payments late by more than 30 days

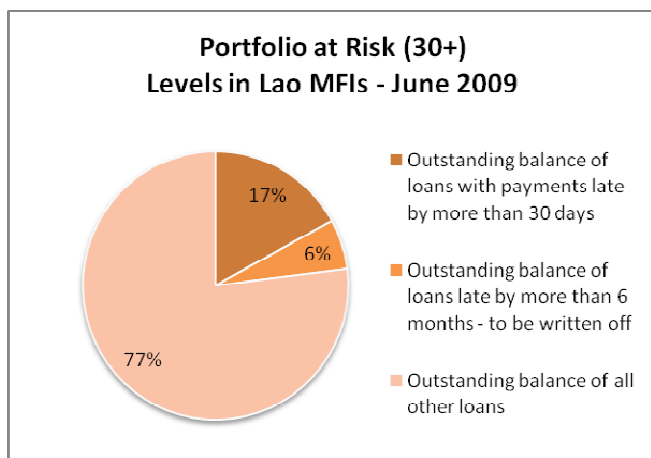
Gross loan portfolio



A healthy portfolio has PAR(30) of less than 5%. If your PAR(30) is higher than this level then it is not healthy. Most investors and donors would not want to invest in an unhealthy portfolio, because this could make a small problem into a larger problem.

How healthy are loan portfolios in Lao MFIs?

We conducted a survey to assess current levels of delinquency in Lao MFIs.¹ The survey revealed that average PAR(30) levels were 17%, well above the international standard of less than 5%. In addition, on average 6% of the portfolio is more than 6 months delinquent and should be written off. If they are not written off then PAR(30) levels would be more than 23%!



While some of the 6% of written off loans may in future be collected, the majority most likely will not be collected. **For a portfolio of 1 billion kip, this equates to 60 million kip in lost capital, plus all of the past and future lost interest revenue on these funds.**

This loss of money is ultimately paid for by clients, through their interest payments. MFIs with poor loan management practices have to charge higher interest rates to cover their loan and interest losses. If the MFI keeps losing

money, clients may ultimately lose their savings. This has been the case in many village funds, where borrowers (often better off people) do not repay, and savers (often poor people) cannot get their money back. MFIs have a responsibility to maintain a healthy portfolio to ensure that this does not happen.

What are the main causes of delinquency?

In September 2009, managers from 25 Lao MFIs came together to discuss delinquency in their MFIs and learn about techniques to reduce delinquency levels. They identified that, contrary to common perceptions, **the number one cause of delinquency is not the clients but rather the MFIs themselves.**

"I discovered for the first time that the major cause of delinquency is the MFI. Previously I assumed it was due to the client or other factors, but now I understand that it is caused by the MFI's own policies and practices." Mr Thongchanh, Board member, Mittaphap SCU

The managers identified that it is the MFI's responsibility to offer a suitable product, to make sure clients understand their obligations, to determine whether the client can afford the repayments and is likely to repay, to decide whether or not to lend, to provide incentives for repayment, and to take action to collect the loan in a timely manner.

¹ The survey was based on June 2009 data for 8 leading MFIs that report to Bank of Lao PDR

What steps should MFIs take to reduce delinquency?

Here are some tips on areas to review when tackling delinquency. This is not an exhaustive list, but should be enough to get you started.



Policies & Procedures:

- Make sure you have a clear written definition of delinquency, how it is measured, and what level is acceptable to your MFI. e.g. PAR(30)<5%
- State how you make provisions for loan loss (per BoL regulations), and when you should write off a bad loan
- Indicate the extreme cases in which you may consider rescheduling a loan
- Make sure you have policies on what incentives you will provide to staff who perform well. These should be paid regularly to reinforce good performance e.g. monthly
- Have clear procedures for loan appraisal and eligibility
- Specify the steps you will take as soon as a loan becomes late, and keep following up

Management & Staff

- Ensure that everyone knows the policies and are made aware of changes
- Monitor portfolio quality (using PAR and aged arrears) at least monthly and report to Board and staff
- Track delinquent loans in a separate register. Hold weekly meetings to review and address issues
- Ensure that the MIS provides reliable, accurate, and timely data. Prepare separate reports for different levels of use e.g. Board of Directors, Management, Credit staff
- Establish internal controls and an internal audit function to ensure that all policies and procedures are followed – this is critical!

Products & Clients

- Make sure your loan size, terms, delivery and repayment mechanisms are based on clients' stated preferences / needs (conduct a client survey)
- Ensure there are incentives for clients to pay on time and disincentives to pay late
- Ensure that clients fully understand their obligations and the consequences of repaying late
- Strive to ensure clients are satisfied by regularly monitoring client satisfaction and drop-out rates (and reasons)
- Ensure staff are trained in how to interact with clients and negotiate timely repayment. Always be firm but fair in dealing with delinquent clients

I want to do something about our delinquency problem. How should I get started?



1. Identify the problem. Measure your current level of PAR(30).
See if delinquency issues are concentrated in certain areas, particular loan products, or with certain credit officers.
2. Identify the causes. Hold a workshop with your credit team. Try to identify the causes of delinquency. You may wish to group these under the categories: policies & procedures, management and staff, and products and clients. *(The Catalyzing Microfinance for the Poor project has developed self assessment tools for MFI Delinquency Management and Loan Product Assessment, to help identify delinquency issues. Contact the project office for a free copy.)*
3. Create an action plan. Set targets and timelines, and assign responsibility *(The Catalyzing Microfinance for the Poor project has a standard format you may wish to use)*
4. Identify obstacles or challenges to implementing the plan, and develop strategies for managing these. Include these in the action plan.
5. Seek approval of the plan from the Board *(i.e. submit the action plan for Board approval)*
6. Regularly monitor and report progress against the plan. Adjust strategies as required.

Good luck, and remember – there is no such thing as a bad client, only a bad loan!

Shane Nichols

Team Leader

BoL-ADB Catalyzing Microfinance for the Poor

For further information contact the Catalyzing Microfinance for the Poor project office at:

Tel/Fax: (021) 264 616

Email: uhammerich@maxwellstamp.com

Bank of Lao PDR, Yonnet Rd, Vientiane

PO Box 4030