PORTFOLIO AND DELINQUENCY MANAGEMENT IN MICROFINANCE INSTITUTIONS

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1. Background

Microfinance Institutions (MFIs) provide financial services (credit, savings, micro-insurance etc.) to the poor so as to reduce the credit rationing they face and help reduce poverty. Should it be profit oriented or not, each MFI tries to maximize repayment performance. High on time repayment rates may allow the MFI to lower the interest rate it charges to the borrowers thus reducing the financial cost of credit and enabling more borrowers to have access to credit. Improving the repayment rate could also help reduce the dependence on subsidies leading to a better sustainability level. It is also argued that high repayment rates reflects the adequacy of MFI's services to clients' needs and limit the incidence of cross subvention[2] across the borrowers. Repayment performance also acts as an important positive signal when the MFI has to raise new funds. For all these reasons, higher repayment rates are largely associated with benefits both for the MFI and the borrower[3].

The MFI will try to reach a first best level of on time repayment rate (100%). If it cannot reach such a level of repayment performance, it will try to allocate larger loans to borrowers with lower probability of default and reduce the lateness in repayment. Understanding what MFI should do to meet these objectives vary on factors influencing repayment. The main factors influencing repayment are either related to information asymmetries, to adverse shocks or to a low performance of institutions such as justice or education. Information asymmetries arise when gaining information on the characteristics or on the behavior of the borrower are costly for the MFI. Information asymmetries may generate problems of adverse selection - allocation of loans to borrowers with undesirable characteristics such as a high level of risk or inability to take advantage of the loan - and problems of moral hazard - the borrowers behaved in an undesirable way (made little or insufficient efforts to take advantage of his loan or used his loan for unproductive purposes). Adverse selection and moral hazard will increase the proportion of borrowers who can not repay their loans on time. Borrowers might also have enough money to reimburse their loan but still default strategically. Cost of strategic default might indeed be low if the lending institution has low collateral requirements and if the legal system gives little power to the MFI to enforce contracts. MFIs will try to restrict the occurrence of those situations in designing appropriate credit schemes.

This paper attempts to discuss further on the issue of portfolio quality and delinquency management that are so important for continuity and sustainability of the MFI's services.

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[2]As borrowers have different probability of default and as it is difficult for the MFI to charge a different interest rate to each borrower relative to his probability of default, borrowers who are more prone to default will be subsidized by lower risk borrowers.

[3]If a good repayment performance is a prerequisite for financial sustainability, they are not a sufficient condition of financial health as high administrative costs or high borrower turnover could be the counterpart of those high repayment rates.

Information used in this report was obtained through a review of the relevant literature, telephonic interview conducted by the author with Chief Executive Officer (CEO) of the some microfinance practitioners on Nepal and reflection of the experiences of the author over last two decades in this field.

This paper is organized into four sections. After this introductory section, section two provides discuss on issue related to portfolio management while various aspects related to loan delinquency management are addressed in section three. The paper winds up with conclusion in section four.

2. Portfolio Management

Like their commercial counterparts, the assets of the MFI's are in various form including cash balance, bank balance, outstanding loan balance, receivables and durable assets. In most MFIs, outstanding loan balance constitutes over 90% of their assets. Asset of the microfinance loan portfolio is the amount owned by clients to the institution. Loan portfolio is also refereed as the loans outstanding or current, active actual loans. The major income earning asset for MFI is the loan portfolio. This is the main product of the business and the reason for MFIs existence. Hence it is imperative for MFIs to maintain very high portfolio quality for the long term financial viability.

2.1 Risks in Portfolio

Maintaining quality portfolio is not that simple as it is exposed to different risk. A MFI must balance many different types of risk within its portfolio. Common risks include:

- **Credit risk**: This risk originates due to client's unwillingness or inability to repay their loans. Credit risk results in a deterioration of the MFI's portfolio, reduced revenues, and increased operating expenses;

- **Interest rate risk**: Any changes in the level of market interest rates during the term of a loan relates to interest rate risk. This risk originates from the mismatch of the maturities of the MFI's assets and liabilities and is particularly important for those MFIs that rely on savings deposits or commercial sources of financing; and

- **Liquidity risk**: A MFI's difficulty in obtaining needed cash at a reasonable cost.

The largest source of risk for any financial institution resides in its loan portfolio. The loan portfolio is by for a largest asset of the microfinance institution (MFI). In addition, the quality of that asset and therefore, the risk it poses for the institution can be quite difficult to measure. For MFIs, whose loans are typically not backed by bankable collateral, the quality of the portfolio is absolutely crucial. Fortunately, many MFIs have learned how to maintain loan portfolios of very high quality. In fact, leading MFIs typically outperform their commercial banks peers in many countries.

2.2 Credit Risk

Credit risk results from a client's unwillingness or inability to repay its loans. Because a MFI's most important asset is the loan portfolio, one of the MFI's key concerns is the amount of credit risk it has in the portfolio. Product pricing must reflect credit risk, and the MFI must build and maintain the institutional capacity to manage that risk. Risk should not necessarily be seen as negative. Lending is the business of making money from taking risks for which borrowers will pay. The key to making money from risk is careful management, not elimination of risk. Thus, measuring and managing risk in the portfolio are crucial to managing future earnings.

2.2.1. Measuring credit risk

Portfolio at risk (PAR)is the amount of outstanding loans with one or more payments past due/ the amount may not be recovered by the MFI. The amount of risk depends upon the no. days the payment are due. The longer a loan in arrears, the lower is the chance of receiving it. PAR is the key ratio that assists in evaluating credit risk in the portfolio by comparing the outstanding balance of all loans that have one or more past due payments with the current portfolio.

$$\text{Portfolio-At-Risk} = \frac{\text{Outstanding Balance of All Loans with One or More Past Due Payments}}{\text{Current Portfolio Outstanding}}$$

Some MFIs measure credit risk by including only the past due payments instead of the full balance of the loan in its ratios. This only serves to hide the magnitude of the true risk in the portfolio from the MFI's management and outside parties. If a loan has past due payments, the whole balance of loan is at a higher risk of non-payment than a similar loan that is current. It is imperative that managers not deceive themselves or anyone else, into thinking that their organisation is more secure than an accurate reporting of the true risk would reveal.

Despite the usefulness of the PAR as an indicator of the level of credit risk, the financial manager must be cognizant of its limitations and how it can change over time. Changes in the terms of loans being provided could account for changes in this ratio over-time. For example, MFI that has in the past provided instalment loans (interest and principal paid in periodic instalments) might begin to offer balloon loans or loans with grace periods[4].

If the size of the portfolio is increasing rapidly, the PAR may understate the risk in the portfolio. After a loan has been disbursed, it takes time before the borrower might begin to fall behind in payments. Therefore, if there is a sudden surge in lending activity, the impact on the portfolio quality might not be known for some time. The financial manager

[4]Typically, commercial banks define period as the period in which interest payments are required but principal repayments are deferred. Many MFI define grace period as the period when no payments are required. In the later case, this ratio will not measure the potential risk in the portfolio. Without change in credit management, the risk of loss for these "un-measurable" loans should remain constant. Managers should be should be aware of circumstances that might affect this percentage.

interpreting this ratio must be aware of any changes in lending policy or volume that might affect this ratio.

It is also important to be aware of the MFI's policy on writing-off loans as well as any changes in procedures. An unwillingness of write-off loans once they are determined to be in default overstates the value of the portfolio. A financially disciplined MFI will set-up an adequate reserve for possible losses and write-off loans against that reserve as soon as collection is deemed unlikely.

PAR as an indicator alone, does not age the past due loans or otherwise classify them according to risk. Aging of past due loans is the classification of their "lateness". Usually past due loans are divided into groups depending on how many payment periods have been missed. The process of creating an aging schedule of past due loans is vital to managing risk in the portfolio as well as eliminating the level of provisions to be made to the loss reserves. Updating the aging schedule of past due loans should be done as frequently as the payment cycle.

A solid definition of at risk is critical to the usefulness of this ratio. Loans at risk should be defined in terms of the average payment cycle - defining at risk as 30 days for a program whose average loan terms is two months and payments are made weekly is not helpful. In this case, the term of the loan is almost over before the program would recognize the loan at risk. Since the age of past-due loans is an important indicator of the risk than the loan will not be repaid, loans are at risk if one complete payment cycle has been missed.

2.2.2. Managing credit risk

In conjunction with the calculation of the PAR, the analyst should evaluate the adequacy of the reserve for possible losses. These reserves are funded through a change to earnings in the current period as specific, or general, provision of current loans or as accrued interest that may become uncollectible in the future. A MFI should have clear policies for creating loss reserves that accurately reflect the level of risk in the portfolio and for subsequently writing off loans and accrued interest against those reserves.

The reserve ratio, which compares the reserves with the current portfolio, can serve as a quick check on the adequacy of MFI's reserve policies, especially when analysed in relation to the loss ratio. The reserve ratio compares the total reserve for possible losses on the balance sheet with the current portfolio, whereas the loss ratio compares the amount of principal and accrued interest written off during the period with the average portfolio balance during the period.

$$\text{Reserve Ratio} = \frac{\text{Reserve for Possible Losses}}{\text{Current Portfolio}}$$

$$\text{Loss ratio} = \frac{\text{Amount Written Off in Period}}{\text{Average Portfolio in Period}}$$

To calculate the loss ratio accurately, losses must be applied to the period from which losses arose, not necessarily the period in which they were written off. In this paper, it is assumed that loans are written off in a disciplined manner, and that the write-off occurred in the period that the losses arose. The net amount of loans written off can be determined from the balance sheet by taking the balance in the reserve for possible losses at the beginning of the period, adding to it the provision for possible losses from the Income Statement of the period, and subtracting the balance in the reserve at the end of the period, also from the balance sheet. The result will be the net amount of the loans written off during the period.

The actual loan losses should be compared with the reserve set aside on an annual basis. Reserve should be significantly greater than write-offs. If the reserves are deficient, this is a sign of improper, or too optimistic, approach to setting the level of the reserve. Many MFI do not write offs loans on a timely basis and, thus, tend to under-reserve for losses. If a MFI stops writing off defaulted loans, the portfolio results in a higher percentage of loans that will ultimately have to be written off, thus decreasing true value of portfolio. MFIs must manage their at risk loans carefully and constantly evaluate and adjust their reserve to cover potential losses.

Credit risk represents the potential loss resulting from the poor quality of the MFI's assets, particularly its loan portfolio. Credit risk is by far a most important of risk categories and is discussed below under delinquency management.

2.3 Monitoring portfolio quality

As the MFI matures, it focus more consistently on the importance of portfolio quality: how well are MFI recovering the money they lend? Loan recovery is, after all, the most basic ingredient of long-term sustainability. In view of this it is important for MFIs to prepare the portfolio Reports according to the age of the payments due regularly. This would help the MFI to monitor the quality of the loan portfolio and manage the loan delinquency in time. The amount of time a loan has had an amount past due is an important indicator of the likely repayment.

2.3.1. Loan Loss Reserve

In order to protect the loan which are over due and may not be recovered (also refereed as doubtful debts) a percentage of loans outstanding should be transferred to loan loss reserve. It is the recorded as a negative asset in the balance sheet as a reduction of the outstanding portfolio or can be shown as a liability. MFI usually show a loan less provision as an expense in income and expenditure statement. The loan loss reserve can be determined by MFI based on past loan history if it is not regulated by the Government.

2.3.2. Loan Write-offs

When the MFIs are sure that a loan is not going to be repaid, such loans are written off against the loan loss reserves made. In many cases MFIs continue to show non recoverable loans as part of the portfolio as they do not have any write-off policy. This is not a good practice as their portfolio loses value over a period of time. A written off policy also help the MFIs to present accurate financial statements, it is always advisable to write-of of the loan which are not repaid over and above a period of one year. The MFI should continue its efforts to recover the loans even though they are written off from the books. If they are received at a later stage this amount cab be shone as other income.

2.3.3. Loan Loss Ratio

Loan loss ratio relate to the ratio of amount written off in a period to average portfolio outstanding. It is an important indicator to measure portfolio quality. When compared with delinquency rate, the loan loss ratio helps to understand the quality of the portfolio.

3. Delinquency Management

Delinquency is the situation where loan repayments are over due. Some of the definitions of loan delinquency are mentioned below:

A delinquent loan (or loan is arrears) is a loan on which payments are past due. (CALMEADOW).

Delinquent loan are refereed to as arrears or late payments, measure the percentage of a loan portfolio at risk (GEMINI).

Delinquent payments/payments in arrears are loan payments which are past due, delinquent loans are loans on which any payments are due (SEEP).

Delinquent loans play a critical role in an MFI's expenses, cash flow, review and profitability. Additional effort to collect delinquent loans usually mean additional expenses for closer monitoring, more frequent visits to borrowers, more extensive analysis of the portfolio, and so forth. The more time, effort, and resources that are put into controlling delinquency, the less there are available for the MFI to reach new borrowers ands expand services or outreach.

Delinquency can result is slower turnover of the loan portfolio and an inability to pay expenses due to reduced cash flow. In loan principal is not recovered at the scheduled time, loans to other borrowers can't be made, and payment of some expenses may also have to be delayed. Also, with reduced cash flow, the MFI may be unable to make timely repayment of borrowed funds or meet the demand for savings withdrawals.
Delinquent loans also result in postponed or lost interest *revenue*. To determine the amount of postponed revenue resulting from delinquent loans, the interest received in a given period is compared with the expected revenue in the period. This is done by multiplying the effective yield by the average portfolio outstanding in the period and comparing the result with interest received:

$$\text{Expected revenue for the period} = \text{Period of effective yield x amount outstanding during the period}$$

The difference between the amount actually received in the period and the expected revenue is the amount of postponed or lost revenue for the period.

3.1 The Effect of Delinquency on an MFI's Profitability

Clearly, the profitability of a MFI is affected if interest revenue is not received on delinquent loans. However, the most significant effect on profitability occurs when the loan principal is not repaid and loan loss provision must be made. For every loan lost, many additional new loans must be made to generate enough revenue to replace the lost loan capital. In other words, when a loan is not recovered, the entire principal (and if capitalised, the interest) must be expensed through a loan loss provision. This greatly affects the profitability of the MFI and consequently affects the profitability of the MFI and consequently the amount the amount transferred to the balance sheet as equity. If the MFI records a net loss, the equity is reduced, resulting in fewer funds available to finance additional loans. If operations are to continue, the equity will have to be increased at least to its level before the loss was recorded. Since investors or donors are not likely to be willing to invest in the long term in a MFI that is losing money, the MFI must work toward generating enough income net of expenses to replace the lost capital (equity). Note that even if loans are funded with debt, the debt still needs to be repaid regardless of whether or not the loans (assets) made to borrowers are repaid to the MFI. If not enough revenue is generated to repay the debt, the equity will be reduced.

To accurately determine the full cost of replacing lost loan principal, the variable costs associated with disbursing and managing a loan must be taken into account. To do this, the annual contribution margin is calculated reducing the revenue per 1000 outstanding by the variable costs per 1000 outstanding (variable costs include the cost of funds, operating costs, and provisions). This presents a much more accurate analysis of the costs of delinquency by determining the total costs to the MFI of replacing the last principal. Thus there is significant cost that delinquency has for an MFI both in terms of revenue and lost capital as well as additional expenses incurred to both make new loans and attempt to recover delinquent loans.

3.2 Measuring Delinquency

There are three board types of delinquency indicators:

- ***Repayment rates***: measures amount actually paid against the amounts that have fallen in due.

- ***Arrears rate***: measure overdue amounts against total loan amounts.

- ***Portfolio at risk rate***: measure the outstanding balance of loans that are not being paid on time against the outstanding balance of total loans (discussed above).

3.2.1. Repayment Rates

Repayment rates measures the amount of payment received with respect to the amount due. It measures the rate of loan recovery and indicates the recovery performance. It does not indicate the quality of the portfolio. Two formulas are shown below to measure the rate of payments received as against the payment due and also past due:

$$\text{On time repayment rate} = \frac{\text{Amount received on time}}{\text{Total amount due}}$$

$$\text{Repayment rate} = \frac{\text{Amount received (due and past due)}}{\text{Total amount due plus amount past due}}$$

3.2.2. Loan Delinquency

To measure the loan delinquency, the following is the commonly used formula:

$$\text{Delinquency} = \frac{\text{Amount past due}}{\text{Amount outstanding}}$$

These formulas consider only payments, which have become over due. It doesn't give the actual amount of risk involved because of the missed payments.

- Payments that are past due may be small relative to total loan amounts; thus an arrears rate is usually a small number. Hence problems often go unnoticed until it is too late to correct them.
- When a client misses a payment on a loan, the arrears rates consider only the missed payments, but there is also an increased risk that the MFI will lose all the subsequent payments as well. It is this later risk much larger that the arrears rate fails to capture.

Arrears rate vary on how MFI define "late payment"

- Some MFIs do not include a payment in the calculation unit it is 30 or 90 or 180 days late
- Other program does not count any payment as late unit the entire term of the original loan has expected.

3.2.3. Portfolio at Risk

When one or more payments of a loan are not paid on time and become overdue, the full amount of the loan will be at risk. In other terms the total loan outstanding with the borrower may not be received. The portfolio at risk formulation helps to identify the default risk on the total portfolio (see section 2.2.1). It is the international standard for measuring loan delinquency. It measure compare apple with apples. Both the numerator and the denominator of the ratio are outstanding balance.

3.3 Causes of Delinquency:

There are diverse causes of delinquency. These can be broadly grouped into two: external and internal causes. External causes relates to national calamities and social political factors while internal factors are either related to MFIs or Clients or both. The internal factors related to MFIs are image and philosophy of the MFIs, ineffective methodology of borrowing selection, untimely disbursement, ineffective information system, lack of follow-up, lack of staff incentives and loan products do not fulfil the client needs while those related to clients corresponds to household emergency (illness, death etc.), project failure, etc.

Ultimately the MFI itself is responsible for delinquency (even when the proximate cause seems external to the MFI) because it sets its own principles, promotes its own repayment culture, instils credit discipline in staff and borrowers, and must plan for events beyond its control. There are many stakeholders in delinquency, but only the MFI can do something about it.

3.4 Benefits and Costs of Delinquency

There are both benefits and costs of delinquency to the clients. Following table summaries costs and benefits of on-time and late/no payments to the clients in a comparative formats.

On-time and Late/No Payments

Particulars	On-time payments	Late or no payments
Benefits	♦ Probability of immediate, larger follow-up loans, ♦ Development of positive credit history ♦ Positive reputation among peers, ♦ Access to training, savings, or other programmes and advice from credit officers, and ♦ Awards and prizes for timely payment.	♦ Maintenance of capital (or portion) from loan in business, ♦ Lower expenses if interest payments not made, ♦ Fewer or no trips to branch to make payments (lower transaction costs) and ♦ Lower transaction cost for attending meetings.
Costs	♦ Payment of interest and capital of current loans, and ♦ Time and transportation costs (transaction costs) to make payments	♦ Loss of access to other programme services, ♦ Delay of future loans or loss of access to future loans, ♦ Possible legal actions and costs, ♦ Frequent visits credit officers, and ♦ Pressure from group members.

There are no benefits of loan delinquency to MFI however it affects MFI in both measurable and un-measurable ways as under:

- Postponed or lost income,
- Slower portfolio rotation, which lowers asset productivity,
- Lower staff morale,
- Higher costs of fighting delinquency - it is cheaper to prevent it,
- Diminish MFI's image,
- Higher likelihood of default, and
- Increased cost of loan loss reserve.

3.5 Controlling Delinquency

The failure to control loan delinquency, which often leads to default, is probably the largest single downfall of MFI; the risk of delinquency and default must be continually addressed. International best practice reveals that loans are considered delinquent or past due when two payments have been missed. The portfolio generates income in interest and fees, because MFI cannot always be sure that it will get its money back, the loan portfolio is always at risk to some extent. Protecting portfolio allows MFI to continue to provide credit services to its clients.

3.5.1. Preventing Delinquency

It is easier to prevent delinquency than to cure it. Methods for preventing delinquency depend on the context. In general, they are grouped into three critical areas as under.

Image and Philosophy: MFI should differentiate themselves from the "give-away type of development programme that may be familiar to its clients" and "create an institutional culture in which late payments are simply unacceptable".

Methodology: Micro-lending methodologies adopted by MFI matters a lot in preventing delinquency. Following three aspects of credit methodology help limit delinquency.

- **Borrower selection**: Guard against giving bad loans to respond to slow demand. Group loans and character-based loans are effective mechanism for selecting trustworthy borrowers.

- **Loan size and terms**: Should be geared to the borrower's repayment capacity. Base decisions on current capacity to repay rather than on projections.

- **Incentive to Repay**: Poor incentive structure encourages poor payment. MFI must make it worthwhile for borrowers to repay on time. Possible incentives for timely repayment include large follow-up loans, penalty fees for late payments, and potential legal problems for not paying.

Information systems: that help field staff follow-up with their borrowers and management analyse the portfolio, preferably on daily basis.

3.5.2. Curing Delinquency

Curing delinquency is extremely difficult but can be accomplished by examining and changing the institution's image, philosophy and methodology. The examination should lead to the identification of trends. For example:

- If certain activities are more delinquent than others, loan sizes and terms may be wrong for these activities,
- A high delinquency rate for a certain loan officer suggests poor performance, insufficient training, or possibly fraud.
- If loans made during a specific month are more delinquent (for example, before Dasain and Tihar), the MFI mayt consider not making loans in that months.

New loans are not a solution to a delinquency crisis, but loans to borrowers who pay on time can continue.

3.5.3. Rescheduling and Refinancing

When a client is unable to repay a loan due to illness, disaster, mis-management, or some other crisis, it may be appropriate to reschedule or refinance loan. Rescheduling a loan refers to extending the loan term or changing the payment schedule or both. Refinancing a loan refers to providing an amount of loan funds in addition to the original loan amount. This allows clients to begin making the loan payments again and it is hopped, to continue payments until the loan is paid in full.

MFIs should be cautioned against rescheduling or refinancing loans. When it is ultimately done to encourage repayment of loans, it is risky and must only be carried out under extreme circumstances. Furthermore, it affects the reported quality of loan portfolio and the cash flow of the MFI. Rescheduling or refinancing loans reduced the arrears in a portfolio by converting a delinquent loan into one that appears to be a healthy loan. This happens even though the risk has not necessarily been reduced. In fact, the risk may be higher due to the rescheduling or refinancing. MFI should ensure that they monitor all the rescheduled or refinanced loans separately from the rest of the portfolio and with additional care. They should not be reported as healthy loans in the portfolio.

When loans are rescheduled, previously expected cash inflows from the loan repayment do not occurs. If many loans are rescheduled, the MFI may run into liquidity problems, which may means that loan disbursement must be reduced or stopped. This in turn will leads to delinquency problems. Thus rescheduling and refinancing should never be considered a cure for delinquency or a primary tool for controlling it. Rescheduling and refinancing serve only as a short-term solution and may not reduce the risk of the portfolio. In fact, they may encourage delinquency because both reward the borrower for falling behind. These methods should be used only as a last resort in justified cases when well-meaning borrowers cannot pay.

3.6 Essential Elements of Managing Delinquency

Delinquency management requires a comprehensive review of the lending methods, operational procedures and institutional image of the MFI. Delinquency is often a result of the poorly managed loan products and delivery mechanisms. There are six essential elements to managing delinquency.

- **The credit service must be valued by clients**: The main reason that clients repay a loan is that they want to receive a subsequent and larger loan. This incentive is not effective unless the client value the loan service. Therefore, the loan product should suit the client's needs, the delivery process should be convenient, and the clients should be made to feel that the MFI respects and cares about them.

- **Clients must be screened carefully**: The borrowers selection process should as much as possible weed out unreliable borrowers or entrepreneurs whose activities will not enable them to repay a loan. Once borrowers are selected, it is important that they receive loans structured in such a way as to enable them to repay in accordance with their repayment capacity.

- **Field staff and clients must understand that late payments are not acceptable**: MFI's image as a lending institution rather than a social development organisation is very important. Borrowers must clearly understand that in accepting a loan they agree to a financial contract that must be respected by repaying the loan according to the payment schedule. Some MFIs charge a late payment penalty after a certain number of days have passed without payment. There is evidence to show that this works well in discouraging late payments, but if the clients are substantially late with their payments, an accumulating penalty could result in too great an additional cost and may cause them to default on their loans altogether. Other MFIs, charge a higher rate of monthly interest and return a portion of it if the client repays the entire loan on time. Clients are thus encouraged to repay their loans as agreed and receive a lump sum payment at the end of the loan term to invest as they wish. This is similar to the compulsory savings required by many MFIs but is designed as an on-time payment incentive rather than as a means of obtaining credit. Often, MFIs encourage on-time repayments by offering successively larger loans to borrowers who repay promptly.

- **MFIs need accurate and timely management information systems**: Staff must be able to quickly identify borrowers who are delinquent through a MIS that accurately reports and monitors loan repayments. The easier it is for field staff to figure out whose payments are due and when and who is late and by how much the more time they spend with borrowers. Credit Officers should review their portfolio daily to see which borrowers are behind in their payments.

- **Delinquency needs effective follow-up procedures:** Once a delinquent borrower is identified, MFI staff must immediately follow-up with the borrower to communicate the message that delinquency is unacceptable. It is crucially important that other borrowers see and understand the consequences of delinquency, so that they do not begin to miss payments (the domino effect). Follow-up procedures may involve getting the group or village leaders to put pressure on the borrowers, visiting the client, repossessing as asset, or publicly announcing that borrower is delinquent. Furthermore, MFIs should schedule weekly staff meetings to discuss problem loans and decide on the correct action. Sometimes, depending on the context in which the MFI is working, delinquent loans are passed on to a collection or police are brought in and criminal charges are pressed.

- **The consequences of loan default must be sufficiently unappealing to clients:** These consequences could include no further access to loans (for borrowers or the entire group), a bad credit rating, collection of collateral, legal action, visit by debt collectors, penalties, and public announcements.

Ultimately, MFIs should understand that delinquency is not usually the result of borrowers who cannot pay. More often it is the result of borrowers who will not pay. Borrowers who request and value the services offered by MFI and understand that delinquency is not tolerated will repay the loans. Those who view the MFI as providing a charitable service will not repay their loans.

3.7 Steps to be Taken in a Delinquency Crisis

Following steps are recommended to follow for taking care in case of delinquency crisis. These steps are outcomes of review of the best practices on delinquency management adopted by different MFIs around the universe (Economic Institute 1996).

- *Review credit policies and operations* for their compliance with basic principles and methodology.

- *Evaluate* the extent to which loan officers are complying with a sound methodology, look for deviations.

- *Design an incentives system* that will maintain the type of performance sought.

- *Lay off loan officers and other field staff* who have particularly poor performance and who will most likely reject the manner of improving performance.

- *Separate the poorest loans* from the rest and give them to a specialised collection department. Leave loan officers with an acceptable level of delinquency.

- *Review information system* to ensure that it gives adequate management information for day-to-day operations and implementation of incentive systems.

- *Lay out* the reviewed policies and operational procedures along with an incentive system to field staff.

- *Set deadline* for improving performance and achieving incentives.

- *Set-up ex-post control capacity* to measure refinancing requests, delinquent accounts, and a sample of on-time accounts against new policies.

- *Review the performance of new versus old loans* after about six months under new policies. If necessary, proceed with following steps: If not, repeat, prior steps from the beginning.

- Judiciously *refinance* some clients who have a genuine potential to repay loans.
- *Write off* the major number of loans that are more than six months late. Continue collection efforts through a specialised department (in those cases where the money involved is significant).

- *Promote strong growth* both in amounts and number of clients.

- *Move clients* out who have had poor records as they pay off their loans.

- *Remove loan officers* who continue to perform poorly or who drag down the entire concept.

4. Conclusions

In this paper various theory and principles related to portfolio and delinquency management has been discussed in greater details based best practices adopted MFI in Nepal and outside.

Various argument presented in this paper reveals that a MFI must balance many different types of risk within it portfolio, of which credit risk is most significant. The key to making money from risk is careful management, not eliminating risk. An unwillingness to write off loans once they are determined to be in default overstates the value of the portfolio. Loans are at risk if one complete payment cycle has been missed. MFI must create reserve to counter balance against such risk on portfolio and it should evaluate the adequacy of the reserve for possible losses. In fact, reserve should be significantly greater than write-offs. It is irony to mention that most MFIs do not write offs loans on a timely basis and tends to under-reserve for losses. MFI should develop a portfolio information system that enables management to conduct timely and useful analysis of portfolio quality, determine trends in the portfolio over time, and identify possible causes of delinquency.

Most delinquency is caused not by bad borrowers, but by MFIs that have not implemented an effective methodology. Clients must value the credit services. Loan products should suit client's needs, the delivery process should be convenient and clients should made to feel that the MFI respects and cares about them. Incentives won't work if the clients do not value the access to the credit. For effective delinquency management, follow-up are procedures are needed. MFI should develop policy that lists the steps one takes when a loan becomes past due. Examples included activating the group to follow up, visiting clients, holding frequent staff meetings to discuss problem loans, etc. MFI should establish a target level of acceptable delinquency based on through understanding of the costs and effects of delinquency on the MFI. Further, it should establish prudent loan loss reserves and write off policies and ensure that income and assets are accurately reflected in the financial statements.

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