

Toolkit for

**Individual Lending
for Credit Managers**



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INDIVIDUAL LENDING TOOLKIT FOR CREDIT MANAGERS¹

Target Users: MFIs who previously only gave group loans, and/or those who want to beef up management of their credit departments.

Participant Identification: newly appointed heads of credit, heads of credit in MFIs introducing individual lending products, any MFI head of credit; and newly appointed regional credit managers and/or Branch Managers, managers new to individual lending, or managers wishing to refresh credit skills. (Note: While the individual lending Toolkit points out the advantages of having all participants from the same MFI, the opposite is true with the Credit Managers toolkit; middle managers may be intimidated by presence of more senior credit managers. On the other hand, the breadth of experience to draw on is increased with a diversity of participants).

Introduction and Overview

This and the following sessions, although included as part of the Individual Lending Toolkit, may be treated as a standalone toolkit for Credit Managers, from the Head of Credit to a Credit Manager in a branch. While this module is intended to guide credit managers in MFIs that are diversifying from group lending methodologies to individual lending, it is also a refresher course for all credit managers. This module of the toolkit assumes some basic credit knowledge on the part of those people charged with managing credit, and limits its focus to the more fundamental aspects of Portfolio Management common to MFIs. The sessions listed below take a risk management perspective of the administration of the credit function and delivery of credit products.

Session 1, Adding Individual Lending to your portfolio.

In the first part of this session, the salient points made in the preceding ten sessions with respect to Individual Lending are summarized for the benefit of users who have not gone through the Individual Lending Toolkit and training course. The second part of this session identifies what changes may need to occur in portfolio management to reduce risks associated with the introduction of an individual lending product into an MFI that has previously only used a group lending methodology. In Part 3, as a refresher, the basic principles of credit are reiterated.

Session 2, Institutional Risk Management for Credit Managers

This session discusses the institutional aspects of risk management and analysis with a primary focus on risks pertinent to the Credit Manager job. Users are encouraged to refer to *MicroSave's* "Institutional and Product Risk Analysis Toolkit" for an in depth presentation of institutional risk management.

Session 3, Managing Credit Risk through the Step by Step Loan Process

Risks and risk reduction tactics in Portfolio Management are identified throughout the Step by Step Loan Process, from marketing and client selection to monitoring.

Session 4, Collections and Problem Loans from a Manager's Perspective

Building upon the credit officer toolkit, this session instructs from the manager's point of view. It informs the management about collection issues and what to do about them by delving deeper into: the costs of write offs, causes of delinquencies and problem loans, and ways to address problem loans and workout from the manager's perspective.

Session 5, Reporting

This session discusses reports necessary for managing a portfolio, both quality and productivity, and how to use these to reduce risk and achieve MFI objectives.

¹ Please note that this Training Manual can be used as a stand-alone manual for Managers of Lending Programs or as a continuation of the Individual Lending for Credit Officers' Training.

Session 1: Adding Individual Lending to your Loan Portfolio

This session consists of three parts:

Part 1: What is Individual Lending?: Provides an overview of the Individual Lending Product

Part 2: Organizational Effects of Adding Individual Lending to your Portfolio: Identifies areas in which individual lending may change your department's functioning

Part 3: Credit Principles for a Successful Lending Program: A refresher of the basic credit principles

Part 1: What is Individual Lending?

Q. Why Individual Lending?

Individual lending is a market-driven product. Many group borrowers ask for individual loans. Individual lending has a lower transaction cost to both the MFI and the borrower.

Individual lending makes credit accessible to small businesses that have been historically “unbanked” by evaluating repayment ability using cash flow based analysis as the predominant way to determine creditworthiness. Because small businesses are a source of employment in their markets, helping to expand the business also helps to expand the job market. Lastly, we also provide a return to our own MFIs.

Five things differentiate individual loans versus group guaranteed loans:

- Lending to a single person
- Larger loans than group
- More security required
- More thorough analysis process using cashflow
- Monitoring of business

Everyone in the MFI must have some familiarity with the individual lending product, from internal audit who must be informed of risks, policies, procedures and reporting, to board members who have overall risk responsibilities. Naturally, the staff in the credit department requires a more in-depth knowledge.

Good due diligence (market, management, suppliers, customers, etc.), a realistic cashflow analysis, basic balance sheet information, good security and a well informed and prepared loan officer are all that is needed.

Q: Why is the cashflow the most important tool in individual lending?

What repays the loan? CASH. Thus, we need to know when and how often it comes in and flows out to determine the repayment capacity of the client. Without this, we cannot answer the question: will the borrower be able to repay?

Simple Cashflow Formula:

+ Total Business Income
- Total Business Expenses
<i>= Net Business Income (Business Income - Expenses)</i>
+ Total Household Income
- Total Household Expenses
<i>= Net Household Income (HH Income - Expenses)</i>
<i>= TOTAL NET INCOME (Net Business Income + Net HH Income)</i>

Total Net Income is multiplied by the Adjusted Repayment Capacity which ranges between 25% and 75% depending on the organization and environment. This adjusted Repayment Capacity is basically the maximum amount that the client can afford to pay per period (daily, weekly or monthly) towards a loan payment. This Adjusted Repayment Capacity multiplied by the number of payments will give the total maximum loan plus interest amount. **Note that this is not necessarily the amount that the client will receive. This loan amount depends on the institution's policy, the client's project needs, and structuring of the loan.**

Q: How is the Step by Step Process a Risk Mitigating Tactic?

As a credit manager, you are the primary Credit Risk Owner, and through policies and procedures you develop tactics to reduce risk. But Loan officers have to understand their role as risk owners, and understand why/how policies and procedures reduce risks. Their ability to manage credit risk is usually rewarded as a component in an incentive scheme.

The drive to be efficient needs to be balanced by necessary risk mitigation strategies. Every loan involves some level of risk. Because of this, the role of the loan officer is to identify, assess and measure this risk for each loan. Risks taken during the loan process should be thoroughly assessed and **managed**.

The level of risk increases along the loan process continuum. First interview with client – very little risk...as time progresses – more at stake for all parties, more 'blindness' by loan officers who become 'attached' to their deal or their client.

The 'Step by Step Process' is to reduce the time spent both by the applicant and the institution on the entire process before loan disbursement, while ensuring that there is a standardized set of procedures and policies that are respected in order to manage credit risk appropriately. These measures will reduce credit risk by improving the institution's overall productivity and customer satisfaction. And you, as credit managers, are responsible, are the Risk Owners, of this process.

Steps of Lending process: This step-by-step guide, once designed, should be incorporated in the institution's operations manual. All steps require decision points by credit managers in developing the

individual lending product, policies and procedures. Each step should be assigned a maximum time period for completion and be planned by the MFI for each loan product.

Steps of the Lending Process	Characteristics
Step 1: NEW CUSTOMER INTRODUCTION	
1.1 First client contact – screening	<ul style="list-style-type: none"> -Using a screening form is highly recommended because it screens out the unsuitable clients and businesses and does not waste the MFI or the client’s time. -credit officers should reject clients sooner rather than later. -Screening form can be used to cross reference information client gives you to confirm during site visit, reference visit, and surprise visit.
1.2 Information session (optional)	<ul style="list-style-type: none"> Purpose to inform a larger group of potential borrowers about the individual lending program, the loan products and the loan process. -Information sessions are also a form of marketing and advertising
1.3 Completion of Application Form	<ul style="list-style-type: none"> -Client completes form -Credit Officer validates during appraisal process
1.4 Credit officer obtains more information by phone, if necessary, about business and client, reviews with supervisor and decides to move forward or not.	
1.5 If the information is favorable, the credit officer starts a file for client and fills in appropriate items on the Checklist.	

Step 2: LOAN APPRAISAL	Review <u>Market</u> (for the applicant), <u>Management</u> (applicant's capacity, skills and experience in the business) and <u>Money</u> (sources of finance, loan use, cash flows).
	Loan appraisal answers 3 key questions: <ul style="list-style-type: none"> • Is there a GOOD FIT between the customer and the company? • Will the customer BE ABLE to repay? • What are the key RISKS?
2.1 Credit officer conducts site visit to business and reviews collateral options	-Inspect the business premises to confirm activity -Interview management and employees -Gather financial data to evaluate the potential of the business
2.2 External checks and references	-If the customer has borrowed before, check whether the loan was repaid as agreed. -NEVER take for granted what the customer says. For every loan, talk to at least three independent references: suppliers, customers, competitors.
2.3 Credit officer completes Loan Appraisal form and Cashflow form	-May have in-house or outsourced appraisers, not loan officers - Cash Flow Analysis Statement Tool
2.4 Surprise visit to the company (for loans over \$3,000 only)	A surprise visit is much more likely to match a typical day in the business.
2.5 Final analysis and loan structuring.	-Credit analysis is the process of understanding and analyzing the credit customer to evaluate the level of credit risk they represent. The credit officer is responsible for this process. The result of the process is usually a conclusion that is presented to the decision makers about whether or not to make the loan. Credit analysis helps us define the level of risk and evaluate whether it is a risk worth taking. -Loan structuring ensures that: <ul style="list-style-type: none"> ✓ The right amount of money is lent, ✓ for the right amount of time, ✓ with the right repayment frequency, and ✓ under the right circumstances.
2.6 Final review by credit manager.	"2 Pair of Eyes" As a general rule, it is important that every loan be looked at by someone who has not been involved in the loan process thus far. When dealing with new customers on larger loans, a second person should not only review the loan, but visit the customer before loan approval.

Step 3: APPROVAL	
3.1 Submission to Credit Committee	<p>If rejected, the credit officer should be very careful how this is communicated to customer to avoid negative perceptions of the institution spread in the same community.</p> <p>-Communicate to client in written form for documentation purposes, and either deliver promptly, or phone the client and follow with letter.</p> <p>If a customer has been approved, the forms are approved and signed, including loan conditions. The client is informed by phone of the decision and an appointment made to sign the loan documentation.</p>
Step 4: DISBURSEMENT	
4.1 Loan documentation	<p>Even though the loan has been approved, there may still be some outstanding issues that need to be cleaned up—additional documentation, etc. The credit officer requests any additional loan documentation required for closing. Loan agreements are then prepared.</p> <p>If required, the credit officer, with the lawyer, arranges for collateral registration and insurance documentation. The lawyer prepares the loan and collateral agreements. The credit officer completes the closing checklist. The program manager checks all documentation, conditions, and completes Condition of Fulfillment/Disbursement Request. The documentation is signed with the client and the guarantors. A repayment schedule is provided to the client.</p>
4.2 Appropriate authority reviews all documentation and signs disbursement request. Loan disbursed	<p>The credit officer ensures that all disbursement conditions have been met. Finally, the loan officer instructs the client on the process of monitoring.</p> <p>-decide on the monitoring schedule for the client.</p>
Step 5: MONITORING	
5.1 Monitoring and follow up of the client after disbursal	<p>-make sure the loan funds were used for the correct purpose.</p> <p>-frequency depends on the credit history of the client and the high risk periods of the project</p>

Credit Analysis and Collateral

Credit risk is the risk that the borrower may not meet the terms of the loan and that secondary sources of repayment such as collateral or other family income will be insufficient to cover the losses.

Loan officers are there to understand and manage risk, not to avoid it or deny it. Credit analysis helps us define the level of risk and evaluate whether it is a risk worth taking. The loan officer is responsible for carrying out this process, but management establishes the process itself.

Although collateral is one of the 5 C's of lending, cash flow analysis and the ability to manage the business are far more important than collateral in individual lending.

Although it is a very important component of Individual Lending and the loan analysis process that the loan officer undertakes, collateral should not be the only basis for making a loan decision, either rejection or approval. It should be the policy of the MFI to evaluate the merit of a loan, based on commercial

viability, the commitment and character of the borrower. Loan decisions should NOT be based solely on collateral.

MFIs now accept many different forms of collateral besides property/fixed assets, such as personal guarantees, third party guarantees, chattel, post dated cheques, equipment (pasta producing machine, mechanical car lift, sewing machine, etc.), and vehicles. These other types of collateral, called **collateral substitutes** or non-traditional collateral, are pledges of assets or guarantees that either take the place of traditional collateral or are used in combination with traditional collateral.

Throughout the MF industry, various types of collateral are used with the Individual Lending product. Collateral and collateral substitutes are not used exclusively. Many MFIs will allow several types of collateral to guarantee their loans, thus allowing more borrowers access to larger loans. Generally items can be classified in the following manner:

COLLATERAL	COLLATERAL SUBSTITUTES
Gold	Personal guarantees
Savings	Third party guarantees
Business Assets	Chattel
Vehicles	Post dated cheques
Mortgage of Real Estate/Fixed assets	(Group lending - peer pressure also here)

Collateral substitutes are easier for the borrower to pledge and for the MFI to take. The process is less costly, quicker, and can have high psychological value to the client. They are usually used in combination with other pledged collateral items for larger individual loans.

Psychological value is extremely important in enforcing repayment, but not easy to measure. The psychological value of particular items differs widely from client to client. So the credit manager as well as the loan officer must understand what drives his/her culture and each client. This is an important point for the loan officer to understand and learn through experience.

Part 2: Organizational Effects of Adding Individual Lending to your Portfolio

Risk Analysis

Some Credit risks may be the same as in a group lending product, but your risk mitigating strategies will change with the changed methodology. The risk mitigants of group lending, such as credit analysis and appraisal, collateral and collateral/substitutes, reporting and monitoring, all continue to be a part of individual loans, but your client has changed, the securities have changed, risks have increased and your loan monitoring and reporting activities need to change to help you as credit managers monitor risk levels. To do this, you need to start with a risk analysis. Risk management is discussed in Session 2. Policies will need to be reworked, products developed, priced and tested, procedures, forms, staff training, IT systems, MIS, and incentive schemes will all have to be reviewed and modified to accommodate the changes in product and the consequent change in the risks associated with the introduction of individual lending in your MFI's portfolio.

Risk management is the key to portfolio management. It includes all steps in the loan process from: Making high quality loans to enforcing no tolerance for delinquency from the very early stages. Throughout the process, monitoring plays an important role in risk management. In the monitoring process:

- There is no substitute for direct contact with the borrower.
- Frequent visits are important;

- **Managing risks** along the way prevents problem loans.

Change in Marketing Focus

Marketing for a microfinance institution is **the study of the client**. It is an analytical tool that helps the MFI:

- increase the number of clients and/or
- determine how to keep clients

Marketing addresses:

- new product development
- pricing
- location of operations
- promotion of the institution and its products.
- getting the information on the MFI's products to its client base

Marketing aims to strengthen the institution by maintaining focus on the client. Marketing is a continual process. Loan officers are at the heart of a microfinance institution because the portfolio is the largest and most important asset of an MFI - without it, there is no business. Usually loan officers are evaluated based on the size and quality of their loan portfolio. These are the two most important factors for a successful program.

Marketing is an on-going process. It is not a department, it is your business.

There is a need for market-driven products, not the "one product fits all" approach. Existing clients who are graduating from group loans to individual loans require a change in the services offered for their credit needs. To retain clients, a focus on methodologies for repeat borrowers is required. MFIs should be aware of these results and track these graduating clients to see if they follow the same trends. Products may need to be redesigned for this specific group of clients.

Change in types of Clients/Graduating Group Clients

A note on graduating clients from group loans to individual loans:

MFIs around the world have found that granting individual loan products to graduating current micro credit members is higher risk. This higher risk and delinquency is attributed to:

- a lack of other sources of cash to draw on during 'difficult' times;
- an inability of the member to handle a larger loan;
- diversion of funds into other economic activities or family needs;
- inadequate analysis of the business by loan officers who usually handle group loans; and
- poor borrower selection, due to the 'good character' reference from the many micro-credit loans.

(ShoreBank Report in Bangladesh 2001)

Change in Customer Service

A change in your methodology has great implications for how customer service is affected. Procedures and risk mitigating tactics may make all kinds of sense from an operational and business point of view, but it may not make sense from the customer's point of view. The customer has a need, and is looking to the MFI for the money to meet that need. Poor service usually results from delays in meeting that need. Typical reasons for delays include:

- Long delays in receiving credit committee approval from the head office - some loan officers will give the maximum locally authorized amount for this reason.
- The client takes a long time to submit all necessary documents.
- Lengthy legal and collateral registration processes in some countries.

- Delays in receiving information from clients to fulfill conditions of disbursement.
- Client delays in finishing part of a project so that the MFI can disburse the next part of the loan.

Expanded functions within the Credit Department

With the changed lending methodology, your support functions change as do your staffing requirements, both in terms of specialization, skills, knowledge and numbers. It is likely that loan officers, for risk mitigation as well as practical reasons, cannot perform all the necessary functions. Examples include:

Collateral Appraisal: The appraiser in a MFI is often the loan officer who underwrites the loan. This is time and cost efficient, but does not always produce the best valuations, as the loan officer is often not properly trained. Alternatives to having the loan officer as the appraiser include: another loan officer; an external, contracted, qualified appraiser; or in busy offices, perhaps an internal qualified appraiser can be justified. These alternative methods also serve as an internal control to keep the valuation more objective.

Collateral and loan documentation (Loan Administration): Will documents be held in branches, or will they be centralized in the Head Office? If they are held in the branches, will they be sufficiently secure in fireproof cabinets under proper dual control? Is there sufficient staff in the branches to monitor the often lengthy process of collateral perfection? And is there sufficiently qualified staff in the branches to review documentation to ensure it is properly perfected and complete? Who will be responsible for periodic verification of collateral values?

Collection Department: While the loan officer is responsible for collecting his/her own accounts when they fall in arrears, specialized focus, skill and dedicated time may be required to try to recover the more seriously delinquent accounts. Credit staff specially trained in collecting bad loans may need to be situated regionally or in the head office to deal with problem loan management (discussed in Session 4). This can be a time-consuming process, and a MFI may not want their loan officers' time spent away from generating more loans. Collection staff can be a good source of feedback to the Credit Manager when it comes to analyzing why loans go bad, and suggesting ways to reduce risk.

Back office operations: Reporting data needs to be obtained, and in many MFIs, consolidated from the various branches. Who will do this? Credit files for designated borrowers may be housed centrally; who will manage these? Who will provide support to the Credit Committee in the discharge of its functions? Who will actually provide the support for new product development once addressed by marketing? Or, if there is no marketing department, who will perform the market research for loan products?

Branches: The physical layout of the branches may need updating as well: anything from expanding and improving loan officer/customer desk space, to increasing the number of safeguard collateral documentation in fire proof cabinets, to whether the documents should be housed in the branch or transferred to the Head Office. New signage may be required, and expanded space for marketing brochures and customer waiting areas.

Part 3: Credit Principles for a Successful Lending Program

Reminder: Basic tenets of credit are often summarized and referred to as the 3M's and 5 C's of credit; these are discussed and cited throughout this document and the Individual Lending Toolkits.

The 3 Ms are: Market, Management, and Money;

The 5 Cs are: Character, collateral, capacity, conditions and capital, and cash flow underwriting

Market –	Is this a good business opportunity? Is there a market? Are there customers?
Management –	Is this the right business owner for the business. Is he/she a good fit? Is the borrower reliable?
Money –	Is this the right amount and structure of financing? What future sources of cash will the customer have to repay?

The 5 Cs and 3 Ms of credit form the basic information required for credit analysis. Willingness and ability to repay are the two keys to lending. If you knew the answers to these questions before giving a loan, there would not be any risk. A cashflow statement helps to answer the second question: “Will the client be ABLE to repay?” A realistic, conservative cashflow will help the loan officer make their decision. Only cash pays.

Why do many businesses fail? Not because they are unprofitable. Not because they do not have adequate equity. Not because they don’t have enough collateral.

Most businesses fail because they are not able to meet their obligations. They don’t have enough **cash**.

Six key ingredients to a successful lending program include:

1. An adequate supply of capital to ensure continuity of lending operations;
2. Honest and dedicated staff;
3. A well-designed product with features that meet customer needs, a well-designed and documented loan operations manual that is followed by staff, and sound credit analysis (5 Cs and 3Ms, above.);
4. Customer focus;
5. Supportive operations, management and MIS teams with adequate reporting mechanisms; and
6. Proactive risk management strategies.

1st Key Lending Ingredient: Capital

- To run operations/cover daily business costs
- To safeguard against any losses that may arise (capital available to cover risk)
- Must distinguish between debt & equity
- MFIs must have a minimum amount of capital relative to the value of their assets

One of the “5 C’s of Credit,” capital is obviously a key ingredient to our organizations. If we don’t have it, we simply cannot continue our core operation of giving loans. As with any business, capital requirements must be watched carefully to avoid running low or running out at any given moment. Capital must be capable of being converted to cash. Imagine 20 clients lined up with loan approvals and there is no cash in the MFI’s bank account to lend! There would be a coup!! Since the microfinance community is often very donor driven, this subject can become critical at times, with demand often more than the supply.

An international standard has been developed which recommends minimum capital adequacy ratios for financial intermediaries and international banks. The purpose of having minimum capital adequacy ratios is to ensure that organizations and banks can absorb a reasonable level of losses before becoming insolvent, and before depositors funds are lost. This ratio is usually set by Central Banks. Central Banks also typically set a maximum loan limit based on the institution’s capital.

Capital adequacy differs from liquidity, as liquidity refers to the actual cash on hand available to lend. A MFI may meet capital adequacy requirements, but run short of actual cash to meet loan demand. It is

important for management to regularly monitor their cash resources. Cash flow projections are usually prepared with periodic financial statements for presentation to the Board of Directors. These projections, typically part of Asset/Liability Management, identify sources of funds to support loan demand and projections, as well as other capital expenditures. The Credit Manager's ability to identify loan demand and to ensure there is sufficient funding to meet the demand is essential. Central Banks may also set a minimum Liquidity Reserve Requirement, limiting the extent to which depositors funds can be on-lent.

In summary, MFIs will need to develop capital raising plans when necessary. For larger organizations, the MFI may be able to hire a development officer or someone responsible for writing grant proposals or negotiating additional credit. But in most cases, the primary responsibility for capital raising is with the CEO, who often delegates to the credit manager. The manager might use a committee or use the assistance of others to help in fund raising, which is a time intensive process.

At an institution in East Africa all loans were approved by the senior management team. Clients would go through a very lengthy analysis process then be approved after a few months; sometimes up to 6 months. The senior managers could only approve between 5 and 10 loans per month due to insufficient funds. Since there was a lack of funding everything had become very lengthy and inefficient in the screening, analysis and approval processes. In 2003 the institution increased its savings tremendously when the public saw the institution as a safe haven for deposits. The institution became very liquid all of a sudden. They had a few loans lined up to be disbursed, but new clients were taking 6 months to screen, analyze, approve and register collateral. The board quickly saw that there was a need for drastic change and requested the management to develop a new methodology or consider leaving the MFI. The senior managers scrapped their old, slow way for a new methodology which proved to be very effective in decreasing the liquidity of the institution by getting loans out the door more quickly.

Capital can sometimes play a part in mission drift (donors determine target clients) and delinquency (too much capital too fast can make loan officers careless and/or give too large of loans) of an institution.

2nd Key Lending Ingredient: Staff

- MFIs must employ honest, competent and confident personnel
- Human resource management is a critical element to control operational risk management
- The MFI should have a personnel policy manual for its employees
- Sound management of human resources is important to *prevent* operational risks

The quality and capacity of human resources are a critical part of successful product delivery in microfinance, as is true in any service-based industry. At issue here is both the staff skill level (in terms of experience and education) and the MFI's ability to train, supervise, and motivate staff as their jobs may be modified in execution and/or accept increased responsibilities. Handout 11.3.1 shows sample job descriptions for Credit Department staff.

Why are your employees here? What motivates them? Is it because of the mission of the institution? Is it just income? Are you and your employees motivated by the development finance mission of the organization? Or is it "just another job"? Often it is found that as an employee develops with the organization, his/her motivation changes. For example, an administrative assistant may not feel the "development" part of the job because of simply doing daily tasks. If that person is promoted to a loan officer level and understands the bigger picture, s/he may realize that it is more than just a job. The mission statement will become more relevant.

Good staff is the most critical factor for success in an MFI. Every employee must understand the core values, vision and mission of the institution and commit to them. Without this, risks will increase and the institution will likely face a struggle.

It is management's responsibility to motivate their employees by keeping them satisfied with their jobs. From the moment they are hired, they must be made to feel important within the organization. Without commitment and dedication to the job, employees will lose interest and overall performance will decline.

3rd Key Lending Ingredient: Products

- A well-designed product with features that meet customer needs
- A well- designed and well-utilized loan operations manual
- Sound credit analysis (3 Ms, 5 Cs, cash flow underwriting)
- A well-structured loan that is consistent with the borrower's ability to repay

MFIs must constantly ensure that their products answer the needs of the clients, while realizing the MFIs' strengths and competitive advantages. MFIs should follow a process that will help minimize wasted resources and expand opportunities with the end goal of improved products – which of course means higher customer satisfaction.

Questions to ask about the product or service:

- What are we selling and what is the demand for this product or service?
- What is the quality of the product and can it be copied by others?
- How is price determined, and how do competitors price their products? Is it easy or difficult to raise prices?

A good product is only as good as the methodology used to sell it. There is a long checklist of items for MFIs to go through during the lending process which will help make for a stronger and more attractive product. However, compared to methodologies from other MFIs or financial institutions, product features are a lot easier to copy. (*MicroSave's* Institutional and Product Risk Analysis Toolkit is an excellent guide through the product development process. On their website, *MicroSave* also offers other toolkits to support not just the facets of product development, but also other functional aspects within a MFI. A current list is shown at the end of the References section of this toolkit.)

Having a solid methodology is important to:

- Mitigate risk: policies and procedures must be in place for systematized lending procedures;
- Standardize credit operations: less room for individual negotiation of terms and fraud; and
- Standardize products: multiple loan products or non-standardized products also leave room for client-staff negotiations.

Elements of a Strong Lending Methodology

- | | |
|--------------------------|---|
| • Character references | • SWOT analysis |
| • Cash flow projections | • Collateral |
| • Balance sheet analysis | • Controlled disbursements |
| • Business plan | • Penalty fees for late payment/Rewards for good payments |
| • Market analysis | • Individually tailored lending |
| • Business history | • Monitoring |

It is extremely important for loan officers and managers as well as for the whole organization to learn and reflect. They should constantly review their products and methodology through an established feedback system.

Managers and loan officers should always reflect and learn from their products and clients. They should keep asking themselves:

- Is our loan methodology working?
- Are our loans appropriately structured (size and terms)?
- How might we review and improve our lending process?

4th Key Lending Ingredient: Customer Focus

As credit managers, do you feel your organization has a strong customer focus? For example, do your organizations conduct periodic focus groups, client satisfaction surveys, exit interviews, and express concern with streamlined, efficient service delivery?

Credit managers must realize the importance of customer satisfaction, and the loan officer's marketing role:

- 1) Loan officers are the first point of contact with the customer and create the MFI's reputation.
- 2) Marketing experts have long demonstrated that it costs five times more to get a new customer than to keep an old one. Financing relationships are built on trust between the customer and the MFI. Trust takes time to create, and it is done by establishing a polite but friendly and comfortable working relationship with customers. The customers of a MFI are its assets and should be treated this way.
- 3) Contented customers are willing to refer others to the MFI.
- 4) If the customers feel the MFI is treating them well, this increases their desire to be a good customer.

This means higher repayment rates and more deposits.

Ten Rules of Customer Service

*Every potential customer is powerful –
This is YOUR reputation!*

1. Polished first contact.
2. Polite with ANY potential customer.
3. Prepared for every meeting with a customer.
4. Professional presentation.
5. When you ask a customer for information, be aware of how you phrase your request.
6. Do not create false (unnecessarily hopeful) expectations.
7. Preserve confidentiality.
8. React quickly to the requests and needs of your customer.
9. Approach customer complaints in a professional manner.
10. Rejections – polite and pleasant but firm!

This subject is covered in detail in Session 3 and in MicroSave's Marketing Toolkit.

5th Key Lending Ingredient: Supportive operations, management and MIS teams with adequate reporting mechanisms

This key ingredient will be covered in depth in the upcoming Session 5, Reporting. Several options for tracking the portfolio and ideas for reporting mechanisms will be reviewed including:

- Information Management and Management Information;
- Report charting: who does what;
- Report charting: what reports go to whom;
- Reporting Portfolio at Risk (Par); and
- Learning how to use a Pipeline Report.

Basic Requirements for a simple and effective Management Information System (MIS):

It is essential that MFIs have efficient and practical MIS for loan portfolio management. Computerized systems are nice, but manual system can work as well. The MIS is a tool that is used to analyse the data to evaluate performance with targets, and identify problems early to enable the management to act quickly. There are four basic requirements for a simple and effective MIS:

1. Complete: accurate and adequate information must be collected through analysis, monitoring and repayment processes
2. Correct: information must be correct and processed correctly
3. Timely: information must be received and responded to quickly
4. Efficient: processing and communication of information must be quick

If management assures that this is done, the information will be useful.

A MFI in Armenia made its collections through a local bank due to the security risk of collecting large amounts of repayments at the MFI's office. The local bank would collect the repayments during the month, process them and then give the MFI reports on a weekly basis for the previous week. So the MFI would receive reports on Wednesday for the previous week. Thus, the report for a client repayment due on Monday would not be received until 10 days later. This created a problem for the loan officers as the policy clearly stated that they should follow up within 2 days of non-payment. After 10 days, when the loan officer followed up with delinquent clients, the clients were usually less cooperative because they did not think the MFI cared. In the end the MFI solved the problem by setting up its own teller window in the local bank which was open from 8am – 2pm, entering the information into its MIS in the afternoon and giving loan officers same day feedback of delinquent clients. This worked extremely well and brought the PAR for 1 - 30 days down significantly.

[6th Key Lending Ingredient: Proactive risk management strategies](#)

We have devoted the entire next session to this critical topic.

Session 2: Institutional Risk Management for Credit Managers

Session Overview:

In this session, we make the case for adopting a proactive risk management program in your MFI. We will first look at risk management at an institutional level. You, as a credit manager, depend on others in the MFI to manage their risks because their ability to do so impacts the performance of the credit function. And what you do, or don't do, to manage risk in the Credit Department impacts institutional objectives.

Several different aspects of managing risks will be covered including:

- Portfolio Management and Risk: What can we do to minimize risks?
- Various types of risk and how to keep them in check.
- Prevention of potential problems
- Early detection of actual problems
- Correction of actual problems
- Prioritizing risks
- Implementing strategies to avoid or reduce risks

Q: What is a Mission Statement and why is it important?

The reason we will briefly review the mission statement is because it should bring the key ingredients for a good lending methodology together. The Mission Statement should be the MFI's guide to conducting a well run business. It is a guide to mitigate the risk of mission drift. A well written mission statement should accurately explain what your organization aims to achieve at the present time, as well as in the future. It states the organization's core values and purpose for being in operation.

A MFI's mission statement should be a written statement with its core values, goals, objectives and vision for the future. The statement should be clearly written and easily understood, and it should be **VISIBLE**.

The Mission Statement must be up-to-date and periodically reviewed to ensure that it is still in line with current operations. It should express what the organization's purpose is in a way that will encourage commitment among the employees.

The Mission Statement should address three key questions:

1. What is the purpose of our organization?
2. What is the business of our organization?
3. What are the core values of our organization?

Q: What is Risk Management and why do Credit Managers need to review it?

Risk Management is the process of implementing policies and an overall strategy to diminish risks faced by the organization in accomplishing their mission.

The core of risk management is making educated decisions about how much risk to tolerate, how to mitigate those that cannot be tolerated, and how to manage the real risks that are part of the business. For MFIs that evaluate their performance on both financial and social objectives, those decisions can be more challenging than for an institution driven solely by profit.

MFI should not discourage risk taking within the organization, but rather encourage prudent risk taking. The benefits of effective risk management include identifying positive opportunities as well as avoiding negative threats.

(MicroFinance Network and ShoreBank Advisory Services, Inc., 2000.)

The increased emphasis on risk management reflects a fundamental shift among MFI managers and regulators to better anticipate risks, rather than just react to them.

Proactive risk management is essential to the long-term sustainability of MFIs. For financial institutions, effective risk management has several benefits:²

- Early warning system for potential problems: A systematic process for evaluating and measuring risk identifies problems early on, before they become larger problems or drain management time and resources. Less time fixing problems means more time for production and growth.
- More efficient use of capital: A good risk management framework allows management to quantitatively measure risk and fine-tune the capital adequacy ratio to match the on and off balance sheet risks faced by the institution, and to evaluate the impact of potential shocks to the financial system or institution.
- More cost-effective treasury (or funds) management: As MFIs seek to maximize earnings from their investment portfolios while minimizing risk of loss, they sometimes need to use more complex financial strategies for treasury and funds management (e.g., interest rate and currency swaps, letters of credit and other credit enhancements); they become more sensitive to interest rate and currency shifts and need to better forecast operating cash needs
- More successful new product development and roll-out: Benefits of systematically addressing the risks inherent in new product development and roll-out can include: enhanced corporate reputation; improved loyalty of existing customers; easier cross-selling of existing services; improved internal knowledge for developing future new services; and ability to attract new customers to existing service offerings more easily.

² All bullets on this page, except the last, are drawn from: A Risk Management Framework for MFIs by J. Carpenter and L. Pikholtz, ShoreBank Advisory Services and A. Campion, MFN. Published by GTZ, July 2000. The source of the last bullet is: Product Development for the Service Sector by Cooper and Edgett. Perseus Books, 1999.

Integration of Risk Management into all MFI Activities: The Corposol/Finansol Crisis (Iglesias and Castello)

In 1996, Finansol, a regulated financial intermediary in Columbia, suffered from severe deterioration of its loan portfolio. While a lack of transparent and separate accounting from its parent NGO, Corposol, added to the problem, the MFI's rapid growth and poor risk management were initial culprits. In 1995, Finansol's microfinance portfolio grew from \$11 million to \$35 million. Many of the loan officers who delivered this growth were new and not well trained, and were simultaneously responsible for promoting three new untested microfinance products for Corposol. There was no mechanism to prevent clients from receiving multiple loans from the MFI; in fact, many clients had two to three loans outstanding. The new products were mostly unsuccessful and the management information system had difficulty managing the diversity of products. As a temporary measure to reduce the negative impact on the income statement resulting from provisioning, Finansol refinanced loans on a wide scale and extended loan terms. This further concealed Finansol's deteriorating asset quality. Under pressure to generate revenue for Corposol, whose operating revenues were heavily dependent on training fees from new clients, loan officers continued to expand their loan portfolios by adding new clients without much regard for credit risk. To circumvent a government policy that limited the asset growth of regulated financial institutions to 2.2 percent per month, Corposol retained a significant portion of Finansol's loan portfolio on its balance sheet, which further distorted Finansol's financial statements.

It wasn't until July 1995, when ACCION International conducted a formal evaluation of the entire microfinance operation that the problem came to light. A recapitalization plan called for an end to the relationship between Corposol and Finansol and the recruitment of new investors to raise the level of capital high enough to meet the Superintendent's requirements and to fuel future growth. With the assistance of private and non-profit sectors, the recovery plan successfully saw Finansol through its institutional metamorphosis into what is now FINAMERICA, S.A. FINAMERICA began operations in 1997, and as of year-end 1998, it had achieved financial solvency with 9,800 active clients and a loan portfolio of \$13.4 million. This crisis demonstrates the need to integrate risk management in all an MFI's activities.

Q: Why is operating an MFI such a risky business?

There are several reasons why MFIs are very vulnerable to risk, and you are certainly going to uncover different risks as your organization grows. Whenever many transactions take place, especially those involving cash, there will be a high risk factor. The temptation for people handling cash is just too strong for things not to sometimes go wrong.

MFIs are vulnerable to risk because of the following reasons and more!

- Many small transactions, often cash
- Decentralized and dispersed operations
- Rapid growth
- Inadequate manager training
- Pressure to cut costs
- Lack of MIS
- Weak internal controls
- High employee turnover
- Multiple loan products
- Changes in external environment (markets, economy, regulatory)

Obviously there are more reasons why MFIs are very vulnerable to risk; these are just the top few.

Q: What does Risk Management Include?

The risk management feedback loop has six key components³:

- 1) Identifying, assessing, and prioritizing risks. The assessment of these risks is approved by the board of directors. This step requires the board and management to determine the degree of risk the MFI should tolerate and to conduct assessments for each risk of the potential negative impact if not controlled.
- 2) Developing strategies to measure risks. The board approves policies for measuring and tracking risks and monitors the MFI's adherence to them. Management identifies key indicators and ratios that can be tracked and analyzed regularly to assess the MFI's exposure to risk in each area of operation. Management sets the acceptable range for each indicator, outside of which would indicate excessive risk exposure. Management also determines the frequency with which each indicator should be monitored and analyzed.
- 3) Designing policies and procedures to mitigate risks. Management develops sound procedures and operational guidelines to mitigate each risk to the degree desired. Sound policies and procedures clearly instruct employees how to conduct transactions and incorporate effective internal control measures.
- 4) Implementing and assigning responsibilities. Management selects cost-effective controls and seeks input from operational staff on their appropriateness. The MFI assigns managers to oversee implementation of the controls and to monitor the risks over time. Ideally, each major risk area has an identified 'risk owner' who is responsible for managing and monitoring the identified risks that fall into his/her work area.
- 5) Testing effectiveness and evaluating results. The board and management review the operating results to assess whether the current policies and procedures are having the desired outcome and whether the MFI is adequately managing risk. Some indicators require weekly or monthly monitoring, while others require less frequent monitoring.
- 6) Revising policies and procedures, as necessary. This component includes managing risks through close oversight and evaluation of performance. Results may suggest a need for some changes to policies and procedures and possibly identify previously unidentified risk exposures. In these cases, management designs new risk control measures and oversees their implementation. After the new controls are implemented, the MFI tests their effectiveness and evaluates the results.

Highly successful MFIs perform well because they have internal early warning systems and management responses that prevent small problems from exploding into large ones.

Q: What does Risk Management accomplish?

Risk Management accomplishes three things:

- Mitigates key risks
- Identifies potential problems
- Provides management and board with information to manage risks

³ Source: Adapted from A Risk Management Framework for MFIs by ShoreBank Advisory Services and MFN. Published by GTZ, 2000.

Q: What are the guidelines for implementing a risk management structure?

Ten Guidelines for Risk Management:

1. Lead the risk management process from the top
2. Incorporate risk management into process and systems design
3. Keep it simple and easy to understand
4. Involve all levels of staff
5. Align risk management goals with the goals of individuals
6. Address the most important risks first
7. Assign responsibilities and set monitoring schedule
8. Design informative management reporting to board
9. Develop effective mechanisms to evaluate internal controls
10. Manage risk continuously using a risk management feedback loop

(MicroFinance Network and ShoreBank Advisory Services, Inc., 2000.)

Red Flags:

- ☒ Strong staff, good products and a sound lending methodology must be in place for an organization to sustain and succeed.
- ☒ Managers should periodically calculate their capital adequacy ratios to ward off potential crisis.
- ☒ An organization's lending methodology must be systematized to provide less room for errors, which reduces overall risk.
- ☒ Strong policies & procedures must be in place and enforced to keep the organizations methodology sound.
- ☒ Trends in an organizations portfolio must be watched not only to ward off risk, but to promote growth in the successful sectors.
- ☒ Customer focus is an easy subject to give low priority to. Organizations must keep the focus on customer satisfaction.
- ☒ Loan officers must understand the importance of satisfied customers from the very first meeting, until the very last payment.

Q: Who is Responsible for Risk Management?

The Head of Credit has often been the repository of risk management in many MFIs; consequently risk management has been focused on just credit risk with respect to the loan portfolio, not credit risk in its broader implications, including settlement risk.

In reality, *everyone* in the organization has a responsibility in controlling risks. Each employee has his/her set of responsibilities.

Board of Directors⁴ (risk responsibilities may be delegated to a Board Risk Management Committee)

- Business strategies and significant policies
- Understand the major risks
- Set appropriate level for those risks

⁴ Refer to Handout 12.1 for a full description of the role of a Board of Directors

- Approve organizational structures
- Oversee senior management
- Adequate and effective systems are established and maintained

Senior Management (risk responsibilities may be managed through an Executive Risk Management Committee)

- Implement strategies approved by the board
- Develop the processes that identify, measure, monitor and control the risks
- Maintain a clear organizational structure
- Follow up on delegated responsibilities
- Set appropriate internal control policies
- Monitor

In Eastern Europe, an MFI was faced with a large tax bill from the authorities. It came as a big surprise to the Director, who, although new, had discussed the sensitive situation with the former Director upon departure, and had been assured that the tax office was satisfied with the MFI's reporting and that all financial obligations had been met. An external audit was requested and it was determined that the former auditor had been paying off the tax officials to lower the tax bill for the organization.

Accounting Department

- Ensure regulatory compliance
- Reporting to management on financial results

Internal Auditor Responsibilities

- Test compliance
- Report (summarized) audit results to board
- Report deficiencies and recommend solutions
- Assist external auditors

"... all MFIs should incorporate client visits into their internal audit functions. Client visits entail an internal auditor or employee other than the loan officer going out to meet with clients to verify the balances and transactions associated with their savings and loan accounts. An internal audit is incomplete without the use of visits to reconcile clients' records with those of the MFI. It is only by conducting client visits that MFIs can uncover most types of fraud."

(MicroFinance Network and ShoreBank Advisory Services, Inc., 2000.)

Credit Manager and Other Staff Responsibilities

- Carry out job functions within guidelines
- Create an environment where controls are respected and understood
- Suggest and document areas for improvement

Credit Managers and senior managers should prioritize field visits. Not only are these visits appreciated by staff, but they help to improve monitoring and reporting systems by letting the credit officers and branch teams know that this is important. A regular and systematized pattern of senior staff field visits with a defined focus by all senior managers, rather than only at times of crisis, is essential to knowing and understanding the operations, products, problems and building a relationship with staff.

Q: How can we mitigate risks?

Techniques to mitigate risks

- Top level controls
- Activity Controls
- Physical controls
- Compliance with exposure limits
- Approvals and authorizations
- Verifications and reconciliations
- Segregation of duties
- Policies and Procedures
- Diversification
- Conversion
- Enforcement
- Reporting and Testing

1. Top Level Controls: “Routine and specific reporting to Board of Directors”, or senior management in which major initiatives are tracked (e.g. improved processes, cost reduction, marketing thrusts) to measure the extent to which targets are achieved. Examples:

- Budget-to-actual reporting
- Board questions senior management about results that are above or below projections
- Implementation plan of new product development
- Internal auditor reports summary of findings

2. Activity Controls: “Functional and performance reviews on a consistent basis by department or division management”

Examples:

- Delinquency reports reviewed daily
- New business reports
- Questions asked of accountants for data entry completeness and of loan officers for monitoring issues used to spot problems

3. Physical Controls: “Restrict access to assets.” Examples:

- Car keys are controlled by one person
- Controlled safe access
- Two check signers
- Inventories made of cash, controlled stationery or fixed assets, for example, and compared with control records

4. Compliance with Exposure Limits: “Establishment of prudent limits on risk exposure”

Examples:

- Client profile is understood by all
- Maximum loan amounts by loan cycle
- Head office purchases fixed assets

Example of Exposure Policy:

Maximum exposure to the ten largest borrowers and/or groups of borrowers

The maximum permitted allowable combined outstanding exposure of the MFI’s 10 largest borrowers will be limited to a total of \$1,000,000, or 20% of the total outstanding portfolio, whichever figure is higher.

5. Approvals and Authorizations (Limits): “Assures management awareness of a certain level of transaction.” Examples:

- Invoices are authorized before paid
- Salaries are reviewed by Executive Director before paid

Example of Credit Approval and Authority Levels from Shore Overseas Azerbaijan Financial Institution (a ShoreBank Affiliate):

Loan approval authority policy

Loan approval authorities are established for managers as follows:

- Head of Lending – up to \$5,000
- Director – up to \$10,000
- Head of Risk Management – up to MFI limit
- Senior Managing Director – up to MFI limit

These levels being established, the following credit committee practices will be observed:

- All loans over \$10,000 must be signed by two of the above
- All loans over \$15,000 must be signed by three of the above

6. Verifications and Reconciliations: “Periodic reconciliations may identify activities and records that may need correction.” Examples:

- Bank account reconciliation identifies transfers not entered in the accounting system
- Reconciling credit and accounting system may disclose any unposted loan payments

7. Segregation of Duties: Duties are divided among different people to reduce the risk of error or fraud

- Custody – Check signer
- Accounting – Book and record keeping
- Authorization – Approval of invoices
- Operation – Loan officers

8. Policies and procedures should be:

- Written
- Simple and clear
- Readily available
- Easily understood
- Relevant
- Implemented and enforced

9. Diversification

- Spread risks within loan portfolio among different kinds of borrowers and/or sectors;
- Diversity credit risk by taking guarantees (spreading risk from just the borrower to borrower as well as guarantors)

10. Conversion: Turning one risk into another, lesser risk. For example: insurance turns operational risk into credit risk (that insurance company will pay you)

11. Enforcement: Disciplinary action for offenders

12. Reporting and Testing: Ensuring procedures are adhered to and that the procedures work through management reports, internal audit, external audits, and regulatory audits.

13. Performance Indicators: Relating different sets of data, operating or financial, to one another, together with analyses of the relationships, and investigative and corrective actions. Examples:

- Staff turnover rates by unit
- PAR by product
- Market penetration by product

Red Flags:

- ☒ MFIs policies and procedures must include serious efforts to minimize risks.
- ☒ MFIs are very vulnerable to many types of risk due to the nature of the business; thus reporting and monitoring within the organization need to be continuously carried out.
- ☒ Incidents of fraud must be acted upon quickly in order to minimize damage to the organization.
- ☒ Failing to use proper controls will significantly increase chances for fraud, leading to losses for the organization.

Q. Why do we measure risk?

We want to know if what we are doing is effective in controlling risk to acceptable levels. Acceptable levels are set by the Board of Directors, and monitored by Senior Management, of which you, as Head of Credit, are a member.

There is a cost/benefit to risk management – the costs of the mitigating strategies should not exceed the expected cost of not mitigating the risk.

Q: How do we measure risk?

Without data capture, you cannot manage risk and you cannot devise appropriate effective controls. Risks can be measured quantitatively and/or qualitatively, and both types of measurements are needed in order to provide balance. The indicators must be relevant to what it is you want measured. You should know why you want to measure an activity, and what exactly it is that you want measured. You need to define who will measure the activity, where will it be measured, and how it will be measured.

The measurements selected should be objective, verifiable, and valid. Data that is routinely and automatically collected as a by-product of the activity is the most accurate. Data generated by anecdotal methods will probably not yield objective or valid results. If there is not a quantitative measure available that is a valid means of measuring the effectiveness of tactics to control risk, then the MFI should consider developing a research study in order to assess how well the risk is being managed. This would most likely be needed in order to understand customer-related risk events.⁵ Handout 12.2 lists possible risk indicators and the types of risk they may measure.

In measuring risks, we must first determine acceptable limits. These limits are your MFI's tolerance for loss, and are set by the Board of Directors. You need to know if the exposure is within limits, and what the trend is. If it is within limits, but trending upwards (i.e., the risk exposure is increasing), corrective action is indicated. However, if it is above limits, but is trending downwards (i.e., the risk exposure is decreasing), your corrective actions are most likely working and you may not want to take further action at this time.

Various ratios are often used to measure risks within an MFI. Several are shown below along with benchmarks from a few MFIs which can be used as a guide in your organization, to help set acceptable limits, as shown in the box below. (Refer to Handouts 12.3 and 12.4 for a more exhaustive list of ratios and their definitions, and Benchmarks. Benchmarks for peer groups are also available on www.themix.org).

⁵ MicroSave "Institutional and Product Risk Analysis Toolkit.

Sample Benchmarks:**Credit Risk:**

- PAR < 5%
- Effective Repayment Rate \geq 97%
- Number of Late Payers to Total Payers for Month – start tracking and then determine acceptable tolerance level.
- Total Value of Savings Transferred Divided by Scheduled Loan Repayments – start tracking and then determine acceptable tolerance level.
- Concentration –as no more than 1% of total portfolio to any individual and no more than 5% of total portfolio to group or related parties.
- Branch Concentration – review concentration if any one branch's portfolio is greater than 30% of total loan portfolio.
- Loan Loss Reserves must be a minimum of 1% of Loans Outstanding.

Special event triggers that increase risks to a MFI

Rapid growth strains an organization due to overburdening loan officers with a heavy work load, promoting inexperienced personnel before they are ready, lack of time for proper training of personnel, and mission drift due to loan officers trying to keep their PAR low and then picking wealthier clients.

MFI's use several risk management strategies when faced with rapid growth:⁶

- Pay careful attention to staff recruitment and training. The MFI can reduce operational risk by carefully growing staff and ensuring that employees' interests are aligned with those of the goals of the organization.
- Control growth to allow time to develop internal systems and prepare staff for changes resulting from the expansion.
- Carefully monitor loan growth and portfolio quality to better understand growth (e.g., number of loans per client, average loan size, growth in number of borrowers) and to not let growth mask increases in delinquency.
- Use good communication from senior managers to reinforce the MFI's culture and commitment to quality service and integrity. These efforts should motivate new employees, as well as existing employees who are being asked to do more.

Mini-Case: K-Rep's Growing Pains⁷

Reader should think about: What should K-Rep's management do? How should they react to this situation?

During 1991 to 1996, K-Rep (Kenya) experienced rapid growth, growing from 1,253 active loan clients with an outstanding loan portfolio of \$580,607 at the end of 1991 to 12,885 clients representing a loan portfolio of over \$4.5 million at the end of 1996. Despite increased profits in 1996, management feared rapid growth was hiding a deterioration of the loan portfolio, and therefore decided to contain growth until it could identify the cause of increasing arrears. By slowing lending, management found that growth had in fact concealed a diminishing portfolio quality; portfolio at risk (over 30 days past due) soared from 5.0 percent at the end of 1995 to 18.3 at the end of 1997. An analysis of the situation indicated that K-Rep's loan officers had gradually expanded their portfolios through larger loan sizes, which led to higher delinquency and client desertion as many group clients were uncomfortable co-guarantying larger loans. In addition, loan officers had found it difficult to provide adequate follow up to effectively manage their increasing loan portfolios in this period of rapid growth.

⁶ MicroFinance Network and ShoreBank Advisory Services, Inc., 2000.

⁷ Campion and White, 1999

K-Rep’s solution:

In January 1998, K-Rep implemented a program that brought employees “Back to Basics,” which reemphasized the fundamental principles of microfinance and its commitment to the microentrepreneur. K-Rep lowered the maximum initial loan size from \$431 to \$238, reduced the rate of increase for subsequent loans, and shortened loan terms. In addition, K-Rep enhanced management’s supervision of loan officers, and increased the amount and frequency of loan portfolio monitoring. These changes returned the focus to the original target population and discouraged the participation of higher income clients. By the end of 1998, K-Rep had delinquency under control and reduced its portfolio at risk ratio to 8.8 percent. By controlling growth, K-Rep prevented a larger crisis from occurring in the future. K-Rep demonstrated its dedication to proactive risk management by its willingness to address this issue at a politically difficult time, when the NGO was in process of transforming into a formal bank.

Management succession: If MFIs do not plan and groom for management succession, they will have inexperienced management which increases the operational risks resulting from poor decision making and ineffective leadership. This will have the rippling affect of hurting employee morale and motivation, resulting in productivity declines and increased staff turnover, both of which result in direct costs to the MFI.⁸

New product development: This is the serious risk which can result due to product failure or a product that causes harm to the MFI and/or cannibalizing its other products. *Refer to MicroSave’s Institutional and Product Risk Analysis Toolkit for in depth treatment this subject, and strategies and tools to mitigate these risks.*

Q: What types of risks do MFIs encounter?

Most risks can be grouped into three categories: financial risks, operational risks and strategic risks.

Three Categories of Risk:		
<i>Financial Risks</i>	<i>Operational Risks</i>	<i>Strategic Risks</i>
Credit Risk Settlement Risk Portfolio Risk	Transaction Risk Human Resources Risk Information & Technology Risk	Governance Risk Ineffective oversight Poor governance structure
Liquidity Risk Market Risk Interest Rate Risk Foreign Exchange Risk	Fraud (Integrity) Risk Legal & Compliance Risk	Reputation Risk External Business Risks Event Risk
Investment Portfolio Risk		

(MicroFinance Network and ShoreBank Advisory Services, Inc., 2000.)

All of these types of risks may be present in managing the Credit Department, not just Credit Risk.

Liquidity Risk

Liquidity risk is the risk of loss arising from the possibility that the MFI may not have sufficient funds to meet its obligations or not be able to access adequate funding. Inadequate funding could result from the

⁸ MicroFinance Network and ShoreBank Advisory Services, Inc., 2000.

MFI's inability to liquidate assets (turnover the loan portfolio to make new loans or repay liabilities) or obtain funding through deposits, borrowings or equity.

Liquidity Risk: the risk arising from the MFIs inability to meet its obligations or to access adequate funding.

Liquidity risk can negatively affect the interests of owners, customers and other stakeholders of the financial institution, resulting from an inability to meet current cash obligations in a timely and cost-efficient manner.

Liquidity management is how an organization forecasts demand for cash (through marketing, monitoring and understanding potential clients) in all areas of banking, investments, and funding. Liquidity management is not a one-time activity in which the MFI determines the optimal level of cash it should hold. Liquidity management is an ongoing effort to strike a balance between having too much cash and too little cash. If the MFI holds too much cash, it may not be able to make sufficient returns to cover the costs of its operations, resulting in the need to increase interest rates above competitive levels. If the MFI holds too little cash, it could face a crisis of confidence and lose clients who no longer trust the institution to have funds available when needed. Effective liquidity management protects the MFI from cash shortages while also ensuring a sufficient return on investments. Cash management refers to the mechanics of consolidating cash at the head office and investing it at the local bank in interest bearing accounts.

Effective liquidity risk management requires a good understanding of the impact of changing market conditions and the ability to quickly liquidate assets to meet increased demand for loans or withdrawals from savings. Credit managers should be attuned to external market conditions that may create unanticipated loan demand as well as have a good understanding of the MFIs liquidity position.

Some principles of liquidity management that MFIs use include:

- Maintaining detailed estimates of projected cash inflows and outflows (notably, larger loan disbursements, investing, and asset acquisition) for the next few weeks or months so net cash requirements can be identified.
- Using branch procedures to limit unexpected increases in cash needs. For example, some MFIs with savings programs have put limits on the amount of withdrawals that customers can make from savings in an effort to increase the MFI's ability to better manage its liquidity.
- Maintaining investment accounts that can be easily liquidated into cash, or lines of credit with local banks to meet unexpected needs.
- Anticipating the potential cash requirements of new product introductions or seasonal variations in deposits or withdrawals.

Market Risk

Market Risk:

- Often out of the MFI's control but must be recognized and mitigated:
- Can be regulatory, competitive, demographic and/or macroeconomic in nature;
- Includes interest rate risk - "The ability to re-price loans (assets) when the interest costs of borrowing obligations increase (debt)."
- Includes Foreign Exchange risk

Market risks due to changes in prices and rates include interest rate risk, and foreign exchange risk. For many MFIs, these risks affect the ability to reprice loans when the cost of borrowing increases. When MFIs take on foreign exchange obligations, the risk of loss due to fluctuations in foreign exchange should also be monitored.

Principles in practice to reduce foreign exchange risk include:

- Due to the potential severity of the downside risk, an MFI should avoid funding the loan portfolio with foreign currency unless it can match its foreign liabilities with foreign assets of equivalent duration and maturity. In Ghana, the appreciation of the dollar actually caused many MFIs that were dependent on dollar-denominated loans to begin mobilizing local savings in 1999 to reduce the currency mismatch of assets and liabilities.
- Some MFIs have used interest rates swaps or futures contracts to “lock-in” a certain exchange rate, which protects the MFI from uncertainty.

BRI Survives the Indonesian Economic Meltdown (Patten, 1999)

The economic crisis in Asia in the late 1990's had a profound effect on the Indonesian economy and its financial industry. Forced write-offs left several Indonesian financial institutions severely undercapitalized and resulted in many bank closures. BRI's Unit Desa also felt the impact of the financial crisis, but unlike many institutions, the Units persevered in spite of the damage due to the following three external causes:

1. There was a severe drought in 1997/98, to which an entire rice crop was lost. This caused a rise in prices and a shortage of demand by farmers for products and services.
2. Comparatively high interest rates in Indonesia caused a flood of short-term investment in the banking sector which quickly departed when confidence dropped and triggered Bank Indonesia's decision to allow the market to set the exchange rate for the Indonesian Rupiah.
3. Large Indonesian businesses had borrowed a significant amount of dollars abroad, which ran up a short-term foreign exchange debt. The central bank, Bank Indonesia, was not able to track this debt or to anticipate short-term demands for foreign exchange reserves if the loans were not renewed.

Despite these external risks, BRI's Unit system fared fairly well through the crisis. As of June 30, 1999, over 97 percent of all microloan clients were repaying on time and the twelve-month loss ratio remained steady at 1.49 percent. BRI's microsavings increased, as savers rushed to move savings from failing private institutions to public institutions, such as BRI, where clients trusted their funds would be safe.

Four factors explain the BRI Units' success in maintaining strong repayment throughout the crisis:

First, BRI's microenterprise loans are installment loans linked to the borrower's cash flow. Over time, many of the microenterprise clients built up their equity and lowered their loan leverage, thereby reducing their vulnerability to external crisis.

Second, microenterprise clients are more likely to be engaged in the purchase and sale of domestically-produced essential goods and services, which are less sensitive to fluctuations in the exchange rate and to economic downturns.

Third, BRI's Units operate primarily in rural areas where the impact of the monetary crisis is less than in urban areas because of a greater reliance on the agricultural economy. However, the drought had a greater impact in rural areas, but has subsequently been mitigated by two good rice crops since then.

Fourth, BRI's Unit clients value their access to microfinance services and do not wish to lose their banking relationship, even if it means reduced consumption in the short-run. BRI has reinforced this relationship by ensuring that on-time repayers have rapid access to another loan.

Operational Risk

Operational risk: *“The risk of losses or unexpected expenses associated with fraud, inefficiency, errors, and unforeseen contingencies.”*

Operational risks are faced daily by MFIs mainly because of the human or computer error involved. An institution needs to discover where the key operating risks are by examining current practices and processes, including forms and documentation. This would include examining the separate credit operations (from application through to collection), savings, overall portfolio quality, and loan loss provisioning.

Operational risk arises on a daily basis as transactions are processed. Operational risk transcends all divisions and products. Inadequate information systems, operational problems, unforeseen external events, fraud and security breaches could potentially result in unexpected losses.

Transaction risk exists in all products and services. It is a risk that arises on a daily basis in the MFI as transactions are processed. Transaction risk is particularly high for MFIs that handle a high volume of small transactions daily. When traditional banks make loans, the staff person responsible is usually a highly trained professional and there is a very high level of cross-checking. Since MFIs make many small, short-term loans, this same degree of cross-checking is not cost-effective, so there are more opportunities for error and fraud.

The loan portfolio usually accounts for the bulk of the MFI’s assets and is thus the main source of operational risk. As more MFIs offer additional financial products, including savings and insurance, the operational risks multiply and should be carefully analyzed as MFIs expand those activities.

MFIs should design operational policies and procedures to mitigate risk:⁹

In most cases, a MFI lives with certain risks and designs a lending methodology and system of controls and monitoring tools to ensure that a) risk does not exceed acceptable levels, and b) there is sufficient capital or liquidity to absorb the loss if it occurs. These controls might include:

- Policies and procedures at the branch level to minimize the frequency and scale of the risk (e.g. dual signatures required on loans or disbursements of savings).
- Technology to reduce human error, speed data analysis and processing.
- Management information systems that provide accurate, timely and relevant data so managers can track outputs and detect minor changes easily.
- Separate lines of information flow and reconciliation of portfolio management information and cash accounting in the field to identify discrepancies quickly.

These are all examples of the internal controls MFIs use to maintain reasonable levels of risk in their activities ex-ante, before operations. They are built into program design, procedures and daily operations.

Legal/Compliance Risk exists especially for MFIs regulated by central banks. Central banks often have regulations that affect credit management directly:

- Identifying and reporting insider loans
- Identifying and reporting of loans to related parties
- Maximum loan size as a percent of capital

⁹ MicroFinance Network and ShoreBank Advisory Services, Inc., 2000.

- When loan income can no longer be accrued
- When loans must be written off the MFIs books
- Restrictions/reporting on loans with preferential interest rates
- Liquidity Reserve Requirements may not allow you to tap all the savings deposits as a source of loan funding to meet loan demand
- Reporting on loans by sectors or other demographic information required for economic activity analysis by central bank.

While the CFO may be the risk owner for some of these compliance points, the credit manager must also be well-versed in regulatory requirements, as need to comply if not already in compliance will affect your portfolio, and penalties to the MFI for noncompliance will not reflect well on the credit manager.

Human Resource Risk

The internal environment within the MFI sets the tone for ethical behavior and integrity, values that the MFI wants to project in its market place and that go beyond mere compliance with laws and regulations. The internal environment is the foundation for all other components of enterprise risk management, providing discipline and structure. Ethical behavior begins with management, who translates it into standards of behavior. Ethical behavior and management integrity are by-products of corporate culture. The internal environment should reflect a commitment to competence, which reflects the skills and knowledge needed to perform assigned tasks. Management decides how well these tasks need to be performed. Human Resource practices pertaining to hiring, orientation, training, evaluating, counseling, promoting, compensating, and taking remedial actions send messages to employees regarding expected levels of integrity, ethical behavior, and competence. Standards for hiring the most qualified individuals, with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior demonstrate a MFIs commitment to competent and trustworthy people. Components of a transparent human resource policy include:

- Code of Conduct, agreed to by all new staff, and renewed annually for all staff.
- Training to reinforce expected levels of performance and behavior, through classroom instruction, self-study, on-the-job training including schools and seminars, simulated case studies, and role-playing exercises.
- Promotions driven by periodic performance appraisals demonstrate commitment to advancement of qualified staff.
- Competitive compensation programs that include incentives motivate and reward outstanding performance, through appropriately structured incentive systems. (Incentive Schemes are discussed in more detail in Session 5.)
- Disciplinary actions send a message that violations of expected behavior will not be tolerated. These should be clearly communicated to staff and documented in the Human Resource Manual.¹⁰
- Clear job descriptions (Handout 11.3.1 shows 4 sample job descriptions in the Credit Department).

Fraud Risk

Fraud Risk is the risk that funds are intentionally diverted for the benefit of persons within or external to the MFI, or to the detriment of the MFI.

“Two principles are paramount:

- i) the use of preventive measures to reduce fraud, and

¹⁰ COSO (Committee of Sponsoring Organizations of the Treadway Commission), “Enterprise Risk Management – Integrated Framework, September 2004.

ii) the importance of client visits to verify branch information, as described below.

- *Preventive measures to reduce fraud.* Fraud prevention should be built into the design of operational policies and procedures and then tested and checked by thorough internal audits. (See K-Rep's approach to reduce fraud risk in its lending operations in Kenya below.)
- *The use of client visits to reduce fraud.* Experience has shown that while a small number of staff is often inclined to be dishonest, most avoid unethical behavior if their internal sense of right and wrong is reinforced by suitable external controls and sanctions. ***The best way to discover fraud (and deter loan officer abuse) is for someone other than the loan officer to visit the client to verify account balances. This person should have a sound understanding of the lending process and know how fraud can occur. (i.e. the manager should go on monitoring visits!)***

(MicroFinance Network and ShoreBank Advisory Services, Inc., 2000.)

Typical types of fraud associated with individual lending products include:

- actions by credit officers to ensure loans are approved in order to meet targets or increase incentive payments, such as: falsifying collateral values, falsifying client income information, submitting fictitious applications
- credit officers request fees (kickbacks) from clients for submitting applications, which are pocketed
- credit officers divert loan proceeds for their own use.
- Collecting and pocketing delinquent loan payments and the loan is eventually written off.

Q: What are some possible corrective actions when fraud risk is identified?

Every MFI should have a plan in place to respond immediately to all incidences of fraud, whatever the size of the loss. The MFI should then also make an effort to recoup losses. Examples of corrective actions should include one, or several, of the following:

1. Most importantly, whatever the size or scope of the misdeed, management must act quickly.
2. Have a plan in place to respond;
3. Make an effort to recoup losses;
4. Explain problem to clients;
5. Address the problem with donors;
6. Engage in legal proceedings if needed;
7. Identify a person to be in charge of implementing policy changes if needed;
8. Document and communicate changes to all affected personnel; and/or
9. Request feedback from employees regarding the changes.

Depending on the case, it may need to be explained to the clients. In cases where knowledge about the incidence of fraud is widespread, an MFI may also have to address the problem with its donors and the public at large to avoid any reputation issues.

If an MFI responds quickly and decisively to occurrences of fraud, it will reinforce the existence of an environment that adheres to its core values and does not tolerate fraud. Prompt "corrective" action is also the best "preventive" measure to reduce future occurrences because of the clear message it gives to all stakeholders.

K-Rep's Controls to Reduce Fraud in Kenya

The box below describes the approach of a Kenyan MFI, K-Rep, to reduce fraud risk in its lending operations.

To reduce its exposure to fraud risk, K-Rep employed the following mechanisms:¹¹

1. Introduced an education campaign to encourage clients to speak out against corrupt staff and group leaders.
2. Standardized all loan policies and procedures so staff cannot make any decision outside the regulations.
3. Emphasized management training to increase managers' capacity and to introduce strict supervision processes.
4. Established an inspection unit that performs random operational checks.
5. Enforces the following human resource policies:
 - fire staff involved in fraud immediately
 - maintain a profile of fraudulent staff and use it to refine recruitment
 - refrain from posting staff to home areas to reduce the opportunity and temptation to collude
 - make loan products available to staff
 - pay staff well relative to other available job opportunities in the area
 - rotate staff regularly within a branch
 - transfer staff periodically to other branches

Operational Risk Summary: Often operations are a separate function within the MFI and may not fall directly under the supervision of the Credit Manager. This does not absolve the Credit Manager from responsibility for portfolio quality and MFI strategic objectives/mission. Failure to address operational risks within the delivery of your credit products will affect income and may result in reputation risk. Loss of clients will mean you cannot meet your growth objectives. You must therefore be knowledgeable about your back office operations and know exactly how they affect and influence your portfolio. These elements include, but are not limited to:

- IT infrastructure
- Loan software with sufficient controls built into the software
- Maintenance of loan documentation, including collateral, and periodic collateral valuations
- Transaction processing (repayments, fees, disbursements)
- Sufficient MIS

Reputation Risk

Reputation Risk:

- The risk that legal disputes, unenforceable contracts, *negative* publicity and *negative* perceptions *negatively* impact the institution.

Reputation risk is the risk to earnings or capital arising from negative public opinion, which may affect the institution's ability to sell products and services or to access other funding. This is commonly experienced in MFIs in the form of poor customer service, customer complaints in the market area dispersed by word-of-mouth, crowded banking halls and lengthy transaction times.

¹¹ Mabwa, 1998

Loan officers incur reputation risk when loan applications are not efficiently processed, when loan rejections are not courteously handled, and when they do not exhibit the skills required.

Credit Risk

Credit Risk: The risk of financial loss resulting from a borrower's late or non-payment of a loan obligation or a guarantor's failure to meet the obligation.

Credit Risk in its broadest definition is the risk that someone or some party will not pay you. This applies to your loan portfolio, obviously, but consider all aspects of your MFI's operation in which you expect payment: payment on demand of balances in your correspondent bank accounts, settlement of Western Union or other remittance systems, such as ATM networks, and clearing of cheques. We will, however, focus on credit risk with respect to your lending operations as reflected in your loan portfolio, from here on out.

Session 3: Managing Credit Risk through Step by Step Loan Process

In this session, we will look at the sub-functions and responsibilities that reside in the credit function. Please note the dependence and interfaces of these functions with other functional responsibilities within the MFI: the Board of Directors, Human Resources, Finance, Internal Audit, Operations, IT, and Marketing. As noted in the discussion above, while these managers are primary risk owners of non-credit risks, the Credit Manager may have responsibilities for Operations risk (fraud, human resource, transaction), Liquidity risk, Market, Reputation, and External risks. In other words, a Credit Manager cannot ignore all the risks that are present in his/her processes.

Credit Risk is the risk of financial loss resulting from a borrower's late or non-payment of a loan obligation or a guarantor's failure to meet the obligation. Credit risk applies to lending and investing activities. It also includes the risk that related collateral and loan loss provisions are not adequate to cover losses. It is your responsibility, as Head of Credit, to manage credit risk.

Effective approaches to managing credit risk in MFIs include:

- Well-designed borrower screening, careful loan structuring, close monitoring, clear collection procedures, and active oversight by senior management. Delinquency is understood and addressed promptly to avoid its rapid spread and potential for significant loss.
- Good portfolio reporting that accurately reflects the status and monthly trends in delinquency, including a portfolio-at-risk aging schedule and separate reports by loan product.
- A routine process for comparing concentrations of credit risk with the adequacy of loan loss reserves and detecting patterns (e.g., by loan product, by branch, etc.).

The importance of a "credit culture" in minimizing problems and increasing operational efficiencies cannot be overstated. MFI senior managers need to set up systems that compel and offer incentives to loan officers to prevent, disclose, and respond to problem loans quickly, so as to limit potential credit-related losses.

ASA's Approach to Managing Credit Risk (Pankaj, 1997)

ASA uses the following tactics to manage credit risk and safely expand operations:

- ✓ Simple products and standardized procedures
- ✓ A strong credit culture pervades the organization
- ✓ Products and processes structured to reduce credit risk
- ✓ Transparency in credit operations through regular reporting
- ✓ Strict organizational control over loan transactions
- ✓ Operating systems designed for maximum performance:
 - located close to borrower
 - limited information processing and decision making
 - reasonable work loads
 - clear expectations for 100% on time repayment
 - minimal complexity means less learning demands on staff
 - minimization of accounting and administrative procedures
 - on-going checks and balances for transactions (e.g. reconciling cash and program numbers)
 - borrowers make frequent repayments of small amounts

Credit Manager and Other Credit Staff are responsible to:

- Carry out job functions within guidelines
- Create an environment where controls are respected and understood

- Suggest and document areas for improvement

Q: Can an MFI ever make a loan without taking a risk?

The answer is no. Every loan involves some level of risk. Managers, as credit professionals have the responsibility to take *calculated* risks, using the support and personal experience/expertise of staff and the institution. Loan officers are there to understand and manage risk, not to avoid it or deny it. You, as Credit Managers, guide risk management in everything you do in your department to support this function.

Q: What is Portfolio Management and why do MFIs need to use it?

Portfolio Management is everything you do at your organizations to ensure a high quality portfolio. This includes everything from having a sound lending methodology and putting it into practice to approving high quality loans, monitoring, and finally working out problem loans. Portfolio management includes the tools and reports your organization uses to track and monitor the process and to keep a clean portfolio.

Policies

A high quality portfolio begins with sound Credit Policies. Policies, drafted by Head of Credit and approved by the Board of Directors, guide credit staff in risk management. These policies are generally updated annually by the Head of Credit, based on a risk assessment, and modifications are submitted to the Board for approval. Policies cover every facet of managing credit risk, from authority to grant credit, to whom, and under what conditions, to monitoring risk exposures and tactics to reduce excessive exposures. (Refer to Handout 13.1 for a Sample Table of Contents of a Credit Policy Manual).

Examples of Policies that Address Risk in MFIs

Risk Category	Policies By The Board	Management Responsibility
Credit Policies	<ul style="list-style-type: none"> ➤ Permitted lending activities ➤ Portfolio diversification (e.g. % of capital to one product, maximum exposure to any borrower, etc.) ➤ Reserve requirements and reserve ratios 	<ul style="list-style-type: none"> ➤ Detailed underwriting guidelines or procedures ➤ Portfolio monitoring and reporting on asset quality ➤ Operational procedures designed to mitigate transaction and credit risk
Investment Policies	<ul style="list-style-type: none"> ➤ % in cash or cash-equivalents ➤ Risk parameters for portfolio (e.g. % in treasury bills, equities, bonds, credit risk of individual instruments) ➤ Maximum currency exposures ➤ Maximum asset and liability mismatch (usually as % of capital) 	<ul style="list-style-type: none"> ➤ Investment management guidelines and procedures ➤ Test the portfolio's sensitivity to interest rate changes ➤ Balance risk of loss of principal with income
Liquidity Policies	<ul style="list-style-type: none"> ➤ Minimum cash reserves equal to a certain percentage of deposits (for client cash withdrawals)¹² ➤ Maintain cash balances or lines of credit equal to cover new loan demand and potential cash losses from delinquency ➤ Maintain operating reserves equal to 2-3 months operating expenses 	<ul style="list-style-type: none"> ➤ Choose how cash management will be centralized or decentralized among branch offices; ➤ Choose short-term investment instruments (treasury bills, staggering terms, etc)
Capital Adequacy	<ul style="list-style-type: none"> ➤ Minimum capital adequacy ratio 	

¹² Insert footnote 28 here (KENYA banking regulation (same as US banks))

(sufficient cushion if the loss occurs)

(MicroFinance Network and ShoreBank Advisory Services, Inc., 2000.)

Procedures

A MFI needs detailed procedures to implement policies for loan officers and other credit staff to follow. A key element of portfolio management is managing risk starting from the first steps of the loan process to monitoring and site visits. This includes all steps in the loan process from making high quality loans and enforcing no tolerance for delinquency from the very early stages all the way up to monitoring (there is no substitute for direct contact with the borrower.) Managing risks along the way helps to prevent problem loans, and frequent visits are an important step in this process. Modifying the Step by Step Lending Methodology in this toolkit to suit your MFI's particular situation should provide a basis for the documentation of your Individual Lending procedures in an operations manual. Below, we will discuss specific risk mitigating strategies for aspects within each of the 5 steps in the Individual Lending Process. This is not an exhaustive list; the purpose is to get you started, or to encourage you to rethink your current methodologies and processes to examine why you do what you do, and whether it makes sense in a risk management context.

Step 1, Sound Lending Methodology

A solid methodology is important for several reasons:

- To mitigate risk, policies and procedures must be in place for systematized lending procedures;
- Standardized credit operations: provide less room for individual negotiation of terms and fraud; and
- Standardized products: multiple loan products or non-standardized products also leave room for client-staff negotiations.

A sound lending methodology begins with good client selection. Possible risk reduction tactics for marketing include:

- Ensure that resources are not wasted in pointless marketing; therefore ensure that appropriate market research is conducted.
- Ensure that there are different levels of authorization in the MFI between loan officers and advertising companies (when appropriate) to avoid corruption and collusion of interest.
- In order to ensure loan officers have large portfolios with only a few problem loans, loan officers need to have good client selection. Selection is more efficient if the right sorts of clients are coming in for loans in the first place.
- Use Marketing Plans to reinforce and monitor loan officer marketing. They help loan officers see if they are meeting their plans and review which marketing strategies are working well. These plans can help the loan officer manage his/her own time between marketing, analyzing, and monitoring loans.

Organisations need to constantly review their methodology and process and see where it makes sense to improve the systems. Sometimes risks are worth accepting because the mitigating actions are more costly than the actual risks involved.

Keep in mind, when designing the steps to the lending process, including screening, loan appraisal, approval and disbursement, that there should be a balance between controlling the process, efficiency and timeliness. Too many steps, documentation and controls can add significant time delays to the process.
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Step 2: Credit Analysis

Q: What influences a MFIs' collateral policy and requirements?

There are nine factors that an MFI should consider when designing its security and collateral policies. The interdependence of these factors must be accounted for if the policies are to be correctly designed. Further, it is necessary to pay attention to the MFI's national and institutional attributes, as these will further inform the nine factors of collateral policy.

Influencing Factors: (Churchill, 1999)

1. Institutional mission: Many institutions do not allow collateral to become a deal breaker if the client is credit worthy in every other sense. The institution will find other methods of securing the loan, such as through third parties. It can reduce risk by reducing the loan size, loan term, frequency of repayments, and/or nature of repayments (e.g. through automatic deductions).
2. Loan size: Smaller loans rely more heavily on collateral substitutes and informal or unregistered collateral. The larger a loan, the more the MFI should expect to use registered assets and fixed assets as collateral. Loan size is usually the most significant determining factor for collateral requirements in most MFIs and banks.

Example of how loan size influences a MFI's policy.

Alexandria Business Association (ABA) Loan Eligibility Requirements	
<i>Loan size (\$)</i>	<i>Requirements</i>
< 900	Personal ID card; fixed business address
> 900	Ability to read and write; business license
1,500	Certificate indicating workers are covered under the social security system
2,200	Tax card indicating that they are complying with business tax laws
3,000	Checking account
4,500	Financial statements for the business

With each increased level of loan size, the ABA requires that the business is in greater compliance with all the local laws.

(Churchill, 1999)

This example does not, literally, include collateral criteria. It makes the point that it is easier for the MFI to take the borrower to court and confiscate collateral, if the business is more formalized. For example, if a business that is registered and complies with all the government regulations, it is easier to take legal action against it. This assumes that regulations are enforced. When regulations are not enforced, or when they are enforced very slowly, this causes the MFI great expense and effort. The usefulness of a policy of more formal collateral with larger loans loses its potency without proper government enforcement.

3. Income level of clients: Many MFIs give lower income clients a break by requiring less collateral/less formal collateral in hopes of giving lower income clients a fair chance of obtaining access to larger loans.
4. Type of business: The type of business can influence the type of collateral required by the MFI. For example, clients with fixed business addresses, as would be the case with most Individual Lending clients, could be allowed to pledge non-perishable business assets other than fixed assets (i.e. equipment, inventory, vehicles, etc.) and household assets.
5. Type of loan: Fixed assets purchased with the loan can be used as collateral. In many countries, such as Kenya, the MFI can retain official ownership of the equipment until the loan is fully repaid making ownership issues and confiscation easier.
6. Registration of the business: If a business is registered, it is easier to take legal action against the client in the event of default.

7. Legal environment: The availability of collateral registration and ability to efficiently (time and cost) enforce contracts is country-specific. In many countries, MFIs use post dated cheques to ensure repayment (post dated cheques are explained below). It is pertinent that MFIs understand the legal environment, work within it and understand what laws may actually aid or limit the MFI before setting policy. Every country is different. The MFI must determine the best method for their legal environment.

Ugandan regulatory system aids the MFIs:

In Uganda, a person who bounces a check is arrested. This makes it easy for the MFI to find the client and to demand repayment. It also is a good psychological deterrent for the client.

8. Land Tenure systems: In countries where land ownership is common and clear and title liens are easily obtainable, traditional collateral (i.e. land) is most effective in securing loans. Gender constraints can be an impediment to lending in societies where husbands own the land.
9. Character/Status of the Borrower: Where the borrower has a strong image in the community, collateral may play a less significant role, as there are other substitutes. Social exposure and pressure plays a large role in this as well.

MFIs and loan officers must strike a balance between the amount/type of collateral required and the benefits/risks to the MFI. Every effort should be made by the MFI to make collateral a secondary requirement to receiving a loan. While maintaining the security of the loan, the MFI should use the least costly collateral possible and expedite the process as much as possible. To do this, the MFIs and loan officers should use a combination of collateral and collateral substitutes that can cover the loan, but not overburden the borrower.

It is pertinent to take guarantees from spouses always.

Requiring only traditional collateral can significantly increase the costs of the loan to the borrower and consume a considerable time period to undertake the registration. In many instances, registering collateral can delay the loan disbursement by many days or even months.

MFIs who take traditional collateral for individual loans rely on its legality, resale value and psychological value, but sometimes do not factor in the expense to the client as part of the transaction cost, time to register the collateral as lost interest income to the MFI, and the future potential high cost of repossessing the collateral. MFIs should consider the collateral transaction costs as a part of the effective interest rate.

Most MFIs have a collateral coverage policy that is similar to the following:

Loan to Value < 75%: This value (loan amount/total liquidation value of the collateral) is less than or equal to 75%. In other words, the loan amount can only be a value of 75% or less than the forced sale value of all the collateral combined.

Another way to state this is **Value to Loan > 130%**, which means that the total liquidation value of the collateral/loan amount is greater than or equal to 130%. In other words, the forced sale value of all the collateral combined must be at least 30% greater than the loan amount.

Tips for MFI Collateral policy and implementation:

1. Use professionals or trained staff to value collateral, especially for land and property.
2. Value according to real market values using comparison data.
3. Update comparison data regularly.
4. Standardize your method and procedures. Be consistent.
5. Set the maximum ratio around Loan to Value = 80%, OR Value to Loan = 125%
6. Randomly control collateral valuation by including it in the internal audit & control function
7. Reassess collateral value during monitoring visits.

(Tjossem, 2004)

Possible Risk Reduction strategies at the Policy Level

Some of the risk reduction strategies used include:

- Salary-based lending against terminal benefits (EA) – Basically, in South Africa, EA is giving loans to clients and using their terminal (or life insurance) benefits as collateral. In case of default, EA has the right to claim the outstanding balance and interest owed from the terminal benefits. MFIs need to very clearly understand their legal environment. As in most countries, terminal benefits and pension funds are protected and can not be used as security.
- Account flags to prevent withdrawal of savings – Many MFIs have savings or cash deposit requirements for loans (sometimes called voluntary savings). These are for the purpose of securing part of the loan in case a client does not repay. Usually the amount is not sufficient to cover the whole outstanding balance. In case of delinquency, the bank needs to be able to automatically flag and stop withdrawals from the savings account to make sure these monies are not withdrawn. In case of non-payment, the savings will be used to offset the amount owed.
- Guarantors – Friends and relatives who have regular salaries serve as guarantors for clients. In case of delinquency, the guarantors are used to help find the clients and pressure them into repaying. Guarantors are expected to help repay the loan in case of prolonged delinquency. In some countries, MFIs are able to automatically deduct the payments from the guarantors' salaries. MFIs must be careful, as often guarantors can get overburdened, guaranteeing many loans at the same MFI and/or multiple MFIs.
- Spouse as guarantors – MFIs should always take guarantees from spouses stating that the spouse understands the loan contract and terms and agrees to these. There have been far too many cases where the spouse has not signed an agreement. The MFI had a lien against a property that was jointly owned and therefore could not collect.
- Having a clear policy that spells out collateral guidelines clearly and unambiguously.
- Monitoring collateral – It is important for the MFI to have a policy for monitoring collateral that can be a part of their overall monitoring policy. It is suggested that the loan officer examines the collateral at least every 6 months and definitely before a new loan is disbursed. S/he should pay particular attention to the changing nature of collateral, including the level and condition of inventory, equipment that is still on the premises, condition of the building or residential property, ownership of collateral and the overall environment it is kept in.

Process Risks associated with Collateral

1. The loan officer overstates the collateral values to enable a larger loan amount to be approved. In this case, the MFI runs the risk of not being able to recover the full amount of the outstanding loan balance if they had to go to court to recover the funds. Plus, if the whole portfolio is made up of under-collateralized loans, this is very risky in case of a major default of multiple borrowers. Tactics: MFIs and managers need to be careful and check the collateral valuation periodically. An external appraiser should do random checks, the internal auditor should follow up on questionable items and managers should do their own random checks.

2. Failure to perfect collateral. Perfection of collateral refers to the legal procedure one must follow to insure one's legal rights to collateral and to make one's right to that collateral a matter of public record. If collateral is not perfected (registered properly), MFIs run the risk of not having a last resort for collecting on delinquent loans. Also, another entity could possibly place a first lien on the collateral if it is not perfected. Tactics: MFIs need to know exactly how to perfect collateral in their own country. To do this they should consult with attorneys to find out the specifics. Also, they should try to figure out ways to make the process less expensive, cumbersome and time consuming for their clients. If they are able to help their clients in these ways, they will have a market advantage.

MFIs can reduce costs and expedite the collateral process in the following ways:

1. Use pre-selected, pre-approved law firms/notaries to provide affidavits and other legal services at a reduced bulk rate for your clients.
2. Hire an in-house lawyer/professional to check/verify contracts, and provide file reviews and advice to the MFI and clients.
3. Hire a "Loan Expeditor" to aid clients through the bureaucracy and demystify registration, as well as reduce costs per client.
4. Provide clients with a written "Step by Step Process to Register Collateral" for each type of collateral.
5. Use collateral contracts that can cover multi-loans over an extended period so the client registers once, but can use the collateral for several consecutive loans.
6. Arrange for borrower discounts for regularly used services, such as insurance and notary services.

(Tjossem, 2004)

Risk Reduction Strategies or Guidelines that a loan officer should follow:

1. The owner should always invest their portion either BEFORE or AT THE SAME TIME as the MFI loan. The loan officer verifies the investment before disbursing the loan.

Policy: If the owner fails to put their agreed investment into the business, the loan will not be disbursed.

2. For moveable assets, sometimes the MFI can retain the title to the equipment bought with the loan proceeds, so that it is easier to repossess the collateral, if needed. The equipment belongs to the entrepreneur ONLY once the loan is repaid. MFIs must determine if this is legal in their specific country.
3. Wherever possible, the loan payment can be paid directly to the supplier of the inventory, equipment or property being purchased. Otherwise, the loan officer should go with the entrepreneur when they use loan funds to make a purchase, or at least check within one week that the items to be purchased were actually purchased.

It is very important to ensure that the loan funds are used for the purpose of the loan. Disbursing the funds to the supplier of the inventory, equipment and/or property is a risk reduction strategy to ensure that the funds are not diverted and items are priced properly.

4. In addition to other collateral, all items purchased with the loan should be taken as collateral.

This is just to indicate to the borrower that the items are not owned until the loan is fully repaid. (In reality, the MFI should not take part of the business assets from the borrower to repay a delinquent loan. If the MFI takes the plastic moulding equipment, for example, the borrower will have no way to earn money to repay the loan. On the other hand, if the borrower is not repaying even though s/he is making an income, then the MFI should seize the asset as a last resort.)

5. If the loan is for a series of purchases or for a building project, it should be disbursed in small pieces called ‘tranches’ – as the entrepreneur needs the funds. The disbursements should be controlled and limited to a maximum 3 tranches (otherwise it becomes somewhat cumbersome to manage – operational risk).

This ensures that the project, especially a building or renovation project, is completed as it was planned. The loan officer checks each stage of the project. This is also done where the owner is investing. For example, if the owner contributes first, the items should be checked before providing the loan.

MFIs lower risk by giving loans in tranches. Thus, the entire loan amount is not outstanding until the project is almost complete. Construction loans always seem to go awry and this is one way of controlling them.

6. Always take personal, spouse and business guarantees.

Guarantors should sign that they ‘personally’ guarantee the loan. Don’t get caught without the spouse’s or other business partners’ guarantees, as they could potentially be unaware of the loan.

Risk: Collateral may be uncollectible if the spouse, who is a joint owner, did not give a guarantee.

If the business is managed by someone other than the owner, take a personal guarantee from the manager and all others who are responsible for the business! If the manager easily gives a personal guarantee, this is a good indication that s/he thinks that the business is doing well and s/he trusts the owner.

Red Flags:

- ☞ Beware of clients who do not wish to sign a personal guarantee and have difficulty obtaining third party guarantees from tribal chiefs, local officials, relatives and/or friends.
- ☞ If a current owner of a business does not want to pledge collateral or sign a third party guarantee, there may be internal disputes that can negatively affect the business.
- ☞ Be sure that ownership and titles match the borrower’s name and that spouses also sign collateral agreements.
- ☞ Make sure to check collateral when monitoring. Collateral that has disappeared or significantly lost its value can be one of the first signs of trouble.
- ☞ Make sure to use collateral that fits the country’s conditions and legal system.
- ☞ Overvalued collateral is a typical problem to watch out for.

Q: How does proper Loan Structuring Reduce Risk?

Proper loan structuring reduces the risk to the lender and the borrower. It can determine good repayment or delayed repayment/non-payment. Loan structuring is the last and one of the most important steps of analyzing and disbursing a loan.

The risks associated with loan structuring are:

- ✓ The larger the loan, the larger the risk
- ✓ Too much money is lent
- ✓ Too little is lent to complete the project
- ✓ The longer the term, the larger the risk
- ✓ The right conditions are not set for disbursing or securing
- ✓ The payment frequency does not match the business' operating/cash cycle

The repayment capacity determines the maximum loan amount, but does not determine the right loan amount!! Besides the type of **cashflow** (regular, irregular or Seasonal), the loan has to also fit the **type of loan** and business needs, such as: Working Capital (shorter term) or Fixed Asset (longer term). Good loan structuring can determine good repayment or delayed repayment/non-payment. Loan structuring is the last and one of the most important steps of analyzing and disbursing a loan.

Policy and Procedural Guidelines for structuring a loan:

1. Keep interest-only periods to a minimum.

Grace periods are NOT recommended! The client needs to get into the habit of at least paying a little bit to the MFI on a regular basis. It is also important that the client comes to the MFI and feels some connection with the institution.

2. Do not set overly tough conditions for the client. Risk: either the loan will not be disbursed at all or the client will have difficulty in repaying.
3. Train the client to make repayments on time.

By making this part of the MFI's culture and also giving 'carrots' for good repayment behavior, a MFI can reduce the amount of time spent on collecting delinquent loans and use this time for new loans. Instill on-time repayment in the client during the analysis, disbursement and monitoring processes.

4. Repayment terms should correspond to the type of business, cashflows, and loan purpose. Don't just give the client what they ask for.
5. Repeat Borrowers: Some due diligence is still required...things change. And because loans usually get larger, the risk to the MFI increases. (See **Handout 4.8, Repeat Loan Steps** from Credit Officers Training).

Example of Improved Loan Terms for Repeat Borrowers

	Repeat Loan Terms
Loan size	Maximum 20% increase in loan size
Eligibility requirements	Must have 90% on time repayments on first loan
Loan terms	Up to 3 months longer for next loan
Loan purpose	Working capital finance or fixed asset acquisition
Interest rate	2% pa decrease for 2 nd loan

	4% pa decrease for 3 rd and subsequent loans
Loan Processing Fee	1 % of loan amount plus VAT (if applicable) None for 3 rd time borrowers
Payment Scheme	Equal monthly installments
Documents required	Updated application form (client), loan appraisal and cashflow (done by loan officer)
Collateral/Security requirement	Same requirements as initial loan
Guarantors	2 Guarantors, one of which must not be related to borrower

Q: How are penalties regulated and applied?

Penalties for non-performance should be included in the loan structure. Penalties in an institution should be standardized. There are several things an institution can do to make it easier to apply these:

- Build the penalties into the MIS so that they are automatically calculated.
- Make sure that all clients understand the penalties and know they must pay them.
- Set precedent of late clients to pay the penalties (no easy breaks).
- Manager can override in extreme cases, but must document and internal audit should review these overrides.
- Set a period which is reasonable where the penalties will not accrue as the penalties could become so large that it deters the client from ever repaying (i.e. 90 days non-accrual).

Applying penalties to delinquent loans can be based on:

- Outstanding balance
- Number of payments late
- Number of days late
- Flat amount
- Percentage of the amount
- Combination of the above

Example of Penalties Shore Overseas Azerbaijan (a ShoreBank affiliate) from the Individual Loan Contract:

“The Borrower is responsible to pay Shore Overseas Azerbaijan a daily Late Penalty Fee for any delay in payment for each day of non-payment until the scheduled full repayment is made. The Daily Late Penalty Fee is equal to 0.2% of the outstanding loan balance.”

(Tjossem, 1999)

Q: What about Staff Loans?

While staff loans are often treated as a benefit, allowing staff access to loans is a risk mitigating tactic, as this access may prevent/deter staff from unauthorized lending and/or outright theft. These loans should be designed, structured, and managed as carefully as any credit product. It is very tempting to relax standards, after all, these are your staff, who you hire to trust, but the same risk management practices should apply.

Staff loans may, in stable loan portfolios, be limited as a percent of the portfolio. Eligibility may be linked to satisfactory completion of a probationary period, acceptable loan purposes with maximum loan terms set accordingly, total indebtedness of staff (at MFI as well as to other creditors) to not exceed a specified multiple of staff's monthly or annual salary, and collateral requirements.

MFI's may offer reduce rates or fees on staff loans yet still cover costs plus a minimal profit margin, or may price at market rates. A word of caution: It is hard for clients to be convinced that their rates are

reasonable when the loan officers are themselves not paying a market rate. In some countries, central banks have rules about staff loan rates being set at market rates.

Parameters for staff loans should include a maximum cap based on a percent of salary, such as 25% of net monthly pay, with payments automatically made as salary deductions, to encourage financial responsibility and to help staff from becoming overextended, with very clear rules as to how loans are to be repaid in the event of the staff's termination. Examples of arrangements for payment at point of termination include: deduction from severance pay or other accumulated allowances not yet paid; pay out by the new employer, liquidation of collateral (if any).

Staff loan policy further needs to be very clear with respect to delinquencies in its staff loan portfolio. How can staff expect to demand punctual repayment from clients if they are themselves not prompt payers? Staff delinquencies should be reported to the CEO immediately in addition to other established delinquency reporting streams within the MFI, as this is a red flag that a staff is experiencing financial difficulty and may be susceptible to unethical activities.

Step 3: Loan Approval

Approval limits are an important credit risk management tactic. There are other risk considerations, though, that should be considered when establishing your loan authorities, such as operational and reputation risks. Cumbersome approval mechanisms are operationally inefficient, and customers experience long delays in getting their loans. On the other hand, some MFIs do not allow the loan officer or manager to reject any loans after the application stage. They want all loans to go through the credit committee. The purpose of this is to give every client a chance to be heard by the credit committee, as well as for internal control purposes (to stop clients from having to pay to get their loans through to credit committee). However, sending every loan application through to credit committee is very inefficient and the manager should be able to reject a loan before the credit committee, based on criteria set out by the MFI, such as poor credit history, inadequate cashflow, and lack of guarantors and/or collateral.

Credit Committee Operations

The Credit Committee serves as the higher loan authority within the MFI, outside of the Board of Directors. The Committee also serves as the repository for credit policy and credit risk management. The Committee may itself, or delegate to a Problems Loan Committee, manage and/or monitor problem loans.

The credit committee not only reviews loans, but also serves as a regular review of the loan products and their performance (Ledgerwood, 2001). The Committee may also have oversight responsibilities for new product development. New product development has many inherent risks covering all manner of risks. Managing these risks is covered in step by step detail in *MicroSave's* "Institutional and Product Risk Analysis Toolkit." Suffice to say here, that new product development, as well as refurbishing existing products, warrants special attention and should be handled by a cross-functional product team.

The credit committee is therefore an important aspect of the loan process because it allows not only a thorough review of all loan applications, but also a regular evaluation of the individual lending products' performance. The following guidelines aim to standardize the conduct of credit committee meetings.

The credit committee can take on a few different forms:

1. It can be made up of several managers, who sit together and discuss loans and who have authorization to approve loans up to a certain limit (recommended).
2. Several managers who review the loan individually, give their decision and then pass it on to the next manager for review.
3. In some MFIs, the credit committee can be a single person.

We recommend that MFIs have a 'committee' who sits together and discusses the loans. One purpose of this type of credit committee is to provide a setting where loans are presented and can be discussed,

questions answered and feedback given on the analysis and risks presented. Loan officers learn new skills and what to expect by having a 'live' credit committee. In this respect, the Committee has a mentoring role. In this option (#1 above), the credit committee should be made up of 3 – 5 members to keep the decisions quick, yet give good feedback and analysis. The credit committee usually has various members for increasing levels of authority. In the case of larger loans, the loan may be approved at the branch level and then sent to a Head Office Credit Committee, also made up of 3 – 5 members, for final approval.

General rules that the Credit Committee should follow are:

- ✓ Appoint a chairperson to facilitate
- ✓ Limit the number of loans to review in one session
- ✓ One meeting should not be more than 2 hours
- ✓ All write-ups on loan applicants are to be received in advance
- ✓ Start and end meeting on time
- ✓ Set time limit expectation for presentations – 5 minutes
- ✓ Standardize loan officers' presentations
- ✓ If the loan officer is not prepared, defer the loan to the next meeting when the loan officer is prepared
- ✓ Save all Questions & Answers until after the presentation
- ✓ Limit Q&A session for each loan – 10 minutes
- ✓ Chairperson records outcome of CC and all members sign – approve, defer, or reject with comments

Thus, in a 2 hour period, the credit committee can review 8 loans if each loan review is not more than 15 minutes. If there are additional loans to be reviewed, take a break and come back. Over two hours of reviewing loans is too much time to retain focus.

The credit committee has four decision options:

1. Approve with existing structuring and conditions
2. Approve with alternate structuring and conditions
2. Defer
3. Reject

Votes are recorded in the client's file, as well as in a credit committee summary Sheet. This creates a double check for decision verification, if needed later. The chairman summarizes committee decisions and then all members sign in agreement.

It is important to keep a separate record of the credit committee's decision which is recorded by the chairman and locked in a file cabinet. Loan files are known to be doctored (loan, amount, term and/or frequency, changed).

If the loan is rejected, a record is made in the loan file and on a credit committee summary. The loan officer must prepare a loan disapproved letter, detailing the reason for the rejection and if there is anything the client can do in the future to change the decision, such as increase the owner's contribution by starting a savings account. The loan officer should have the letter signed by the manager and give a copy to the client. A copy of this should be registered and filed in the client file.

Credit Committee should look beyond applications themselves to the loan officers. MFI should track the level of rejections after application to see if too many clients are making it through the screening and then being rejected before credit committee (over 20% would be too many). If this is happening, then the quality and level of screening is not adequate and should be improved.

Through the loan deferment process, the loan officer should learn to not repeat the same mistake twice. If there are repeated mistakes by the same loan officer, the manager needs to address this problem as s/he is wasting credit committee's time.

Step 4: Loan Documentation

Why is this information important? Because it is controllable by the loan officer, manager and credit committee. These are not product or methodology issues. You can control them!

In ShoreBank's management experience, managers reviewing or auditing files, very often find that forms are missing, incorrectly completed, miscalculated, contradicting, and missing signatures. The loan officers must be detail-oriented and thorough in their documentation. Documentation errors can lead to losses for the MFI.

The manager discusses the client with the loan officer and understands the client, project, business, loan appraisal and cashflow details, as well as the loan officer's opinion. The manager then questions and probes the loan officer for unverified, incomprehensible, missing, or incomplete information. Also, the manager may recommend alternative loan structuring and collateral combinations with the loan officer.

The manager reviews the loan application documents to make sure: (Ledgerwood, 2001)

- All forms are correctly completed;
- All financial computations are correct;
- All information and data gathered is consistent;
- Cashflow and repayment capacity are correct and comparable to other similar businesses;
- Loan structuring fits the business, capacity, and project;
- All signatures are valid, consistent, and correctly placed on all the forms;
- The process from loan application to credit analysis is timely; and
- All forms needed for the credit committee are in the client's file.

To ensure all needed documents are obtained, we strongly recommend MFIs to develop a Documentation Checklist, which is placed in the front of each completed loan file. By going through the step-by-step process (or a process map), each MFI will be able to determine the appropriate forms and steps needed on the checklist. The sample checklist in Session 9 (Handout 9.0) can be used as a starting point, but the MFI will need to alter it according to its own eligibility criteria, environment, market, legal requirements, and policies regarding loan appraisal, collateral, credit committee, and disbursement procedures.

Step 5: Loan Monitoring

Regular monitoring is the key to maintaining a healthy portfolio and can save time in the long run. It helps to know your client, in case a loan goes bad, so that you can try to work with him/her to solve the problem together. Very often monitoring is forgotten or not done. It is the step that very often receives the lowest priority for loan officers and credit managers. They tend to focus on new deals and building their portfolio, not maintaining a healthy portfolio, until it is too late. Loan officers, with the help of credit managers, must find a delicate balance between the two duties, building and maintaining a healthy portfolio.

Monitoring policy:

The monitoring schedule for each client will vary slightly according to the business and key risk events. In general, a new loan should be monitored to verify the use of loan proceeds, before the first repayment, every quarter (as long as the repayments are on time), and then two weeks before final repayment. A trusted client with more than 2 loan cycles repaid, completely and on time, should be monitored to verify the use of loan proceeds, then every 6 months, and finally two weeks before final repayment. Some

MFIs require monthly monitoring for the life of the loan or, at a minimum, for the first 6 months of the loan. MFIs may want to monitor large loans more often as well.

Using the loan funds according to the project is the first critical step in making sure the client spends the funds as planned and is therefore able to repay the loan. Loan officers should always monitor this phase of the loan.

There is always a very real risk that the client may divert the loan funds to other needs (personal or even another business). Not using loan proceeds according to the loan appraisal plan is the first warning sign of a potential problem loan and control point for the loan. If all the loan proceeds do not go into the business, all the planned cash will not come out of the business to repay the loan.

The loan officer should also schedule visits when certain key risk events occur. For example, the loan officer may be aware when the loan is made that a very large supplier contract will end in a certain month. Thus, the loan officer should verify with the company that the contract was renewed or that they have obtained another supplier contract.

More frequent monitoring is advised in the case of high risk loans such as start ups, restructured loans, problem loans, or very large loans. For example, if the business is involved in construction, importing of goods and/or equipment, or has high receivables, it should be monitored more closely.

VITAL TIP: Loan officers should always visit delinquent clients within one day of repayment delay. This also applies to repeat clients, even if the client has, in the past, paid on time. It is a fact that the more quickly a loan officer follows up on a delinquent loan, the more likely loan recovery is.

Q: Why do managers need to be involved in the monitoring process on a regular basis?

Managers need to monitor for 6 reasons:

1. Let the loan officer and client know that the MFI is taking an interest in their work and business. The manager needs to inculcate a strong and healthy credit culture amongst the loan officer and the clients. Both the loan officer and customer should understand that repayment is important to the MFI. The relationships should be supportive - it is in the interest of both the customer and the MFI that the business should develop successfully.
2. Catch any potential problem early - why?
 - Still time to try to work out the situation
 - MFI can act before collateral disappears
 - Show loan officer the importance of catching problems early on
 - To be sure the problem is with the customer, not the loan officer
3. Supervise proper documentation to keep updated credit files – why?
 - Recording the date of visit helps to ensure next visit will be made at necessary time.
 - Good records aid quick decisions in the future
 - Help when changes are made among loan officers. Possible replacements will quickly understand the entire history of the loan and easily continue the relationship with the customer, if original loan officer leaves
4. Marketing – finding other customers through current clients and building a good name for the MFI

5. Build a relationship with both the loan officer and client of trust and honesty
6. Check the product, policies and procedures to make sure everything is in order accordingly

Q: When should managers participate in the monitoring process and how often?

During the loan closing, the loan officer and manager agree, according to the MFI's policy, when the borrower should be monitored. The schedule is tailored to the type of business, loan purpose and key risk events. The Credit Manager will prioritize monitoring visits according to what clients s/he feels pose higher risk

The monitoring schedule for each client will vary slightly according to the business and key risk events. Credit Managers should review monitoring reports done by the Loan officer and base his/her decision on when to accompany the loan officer, based on the status of each loan, and according to the MFI's monitoring policy.

The manager should also schedule visits with the loan officer when certain key risk events occur. For example, the manager may be aware when the loan is made that a very large supplier agreement will end in a certain month. Thus, the manager wants to check with the company to make sure it was renewed or that they have obtained another supplier contract.

Additionally the manager will have set quotas for the number of visits they must make to random clients every month in order to check on the clients, products, policies and procedures.

Lastly and very importantly, the manager should **always** insist that the loan officer contact the client within 1 day if a client is late in repaying. This also applies to repeat borrowers even if they have, in the past, paid on time but are late in repaying one installment. The MFI should have guidelines for credit officers in handling late payers. The first contact may be a telephone call from the credit officer. If payment is not received as promised, the credit officer makes a personal visit. If payment is not received as promised, the head of credit in the branch accompanies or by himself visits the client.

Sample of one MFI's Manager Monitoring Policy:

Credit Managers must monitor clients and audit files every month:

- Visit at least 10 clients with loan officers
- Visit at least 5 clients on their own
- Audit at least 10 loan files at different stages (analysis, approved, disbursed and repaid)

These monitoring visits and audits need to be recorded on a Monitoring Form and Audit Form.

Q: How does the credit manager know/remember when the loan officer should monitor?

To ensure the appropriate scheduling of monitoring for each client this should be decided upon at the time of disbursement of the loan with the loan officer. The monitoring schedule should be documented at the bottom of the File Cover Sheet/Closing Checklist. This schedule should then be transposed into the loan officer's daily planner and be periodically checked by the manager.

Credit Managers can use a simple summary form to take with them on a site visit with the loan officer to record their own visit and insight. Should they then become aware of any potential problems, they can make notes on what specific actions need to be taken, and also make a note of when the next visit should take place.

Sample Credit Manager Monitoring Tracking Form							
Date	Name of Client	Loan officer Responsible	Comments and Concerns (client current?) (business operating well? problems?)	Client on site? (Y/N)	Financials Collected ?	Any specific actions to take?	Follow-up: When will be next visit?

Q: What does the loan officer or manager do on a monitoring visit?

Credit managers must remember to allow the loan officer to lead the visit and be a ‘guest’ until s/he recognizes the need or importance to make a comment. This boosts the confidence of the loan officer and makes the client feel comfortable with your employee. Managers should be careful not to correct or offers suggestions to the loan officer during the course of the visit. A debrief should be held after the site visit between the loan officer and loan officer to discuss their thoughts on how the meeting went and what could have been done differently or better.

During the site visit, the loan officer and/or manager should:

1. Be open and talk to the client to find out about his/her current situation – this should be done so that the client feels comfortable with the loan officer & manager so that the client will trust him/her and let them know the real situation. The loan officer should not just bury their heads in their monitoring form, but show interest and engage the client in conversation about the business.
2. Be sure the loan officer completes the monitoring form
 - a. Collect current financial information
 - b. Compare reality with the original analysis
 - c. Ask additional probing questions
3. Watch for warning signs and observe the workplace for changes (for better or worse)
4. Market the MFI/sell your next loan – this is important as it is much easier to analyze and disburse subsequent loans than the get the first loan. In addition, subsequent loans are usually better payers, improving the quality of the MFI’s portfolio.
5. Make sure that what the loan officer is saying is correct and there are no problems.

When a manager goes on a monitoring visit with the loan officer, s/he should also discuss the visit with the loan officer when they leave the site. It is important to walk through what happened during the visit so the loan officer understands any details s/he may have missed.

Mini-Case Scenario from Bangladesh:

Upon reviewing one loan officer's portfolio it was discovered that his portfolio at risk compared with other loan officers' PAR was much higher. The manager had questioned the loan officer many times about the delinquent clients and he always seemed to have good explanations. Many of the clients cleared their delinquencies, but new ones were always appearing and the loan officer's PAR did not improve.

The manager visited many of the clients and their stories were similar to the loan officer's explanations, although always with a little difference. Finally, one of the clients explained that he was never late and the loan officer had told him to tell some story. The client did not understand why. The manager had happened upon a case of fraud where the loan officer was shifting money from client to client repayment without ever having anyone later than 30 days, but always a poor PAR.

Q: What are the most important factors to monitor?

When the credit manager makes a visit with (or without) the loan officer, they must always look for all the things that the loan officer is reviewing **plus** the credit manager must note the relationship between the borrower and the loan officer. The manager must be sure there are a good rapport and an element of trust between them. On a site visit, the loan officer and manager would monitor the **changes** (both positive and negative) in:

1. Business physical condition, inventory, raw materials, etc.
2. Sales trends and trends in inventory stocks, accounts receivables and payables (if applicable)
3. Overall cash flow (sales and expenses) compared to analysis. (The ratio of cashflow analysis numbers to actual figures in the business currently may be one of the first signs for the credit manager that the client is not doing as well as they stated originally. This should then be discussed with the loan officer and a plan put in place to control possible problems.)
4. Changes in assets and liabilities
5. Major sums in or out of the business – purchases/sales
6. Major increases/decreases in receivables, payables or inventory
7. Competition
8. Suppliers and buyers
9. Collateral condition

Also, refer to Session 10 for more details on monitoring.

Q: Does the monitoring visit need to be documented?

Absolutely! And you as managers should periodically check the files to make sure this is done! Every contact with the client should be documented including the monitoring visit. For the monitoring visit the credit officer should complete a Monitoring Tool form to document the visit and current situation of the borrower. The purpose of this is to ensure that anyone picking up the file can understand the current situation of the client.

Credit managers should use the Monitoring Tool to review how well his/her credit officers are documenting their visits. It is used to document the visits made to the client during the loan repayment by the credit officer. Each visit should be recorded on the form.

Q. What is the role of Internal Audit?

Internal Audit is an important control function that can assist Credit Managers with monitoring their performance. Internal Auditors should be included in training sessions for credit staff, to ensure the most

informed audit results. Internal auditors must perform client visits in order to adequately assess the credit process. Sample loan audit programs can be downloaded from *MicroSave's* website, Loan Audit Toolkit, to bolster your MFIs internal audit of your portfolio. However, as Credit Manager, you have certain responsibilities in response to internal audits:

- Have you honestly evaluated the audit findings to ascertain what the true weakness is that led to the finding?
- What is the best course of action for a cost-effective resolution?
- Have you determined that the recommendation has been properly implemented?
- Have you tested to determine that the recommendation is fixing the problem?

Audit, however, does not need to be confined to the internal audit department. Remember, internal control is a management responsibility. The credit department can perform self-audits, to measure how well policies and procedures are working. In larger MFIs, there may be a Loan Administration or Loan Review function, which subjects loan documents to scrutiny to catch unauthorized loans, incomplete collateral documentation, poor lending practices, wrongly executed loan agreements, etc. These reviews are often done from checklists, so they are easy to use and understand. This helps to provide consistent results, and minimizes the opportunity to overlook a document that should be checked. *MicroSave's* "Loan Audit Toolkit" contains several checklists you can modify to suit your environment, and use to administer your own self-audits.

Credit Managers and senior managers should prioritize field visits. Not only are these visits appreciated by staff, but they help to improve monitoring and reporting systems by letting the loan officers and branch teams know that this is important. Regular and systematized patterns of senior staff field visits with a defined focus, rather than only at times of crisis, are essential to knowing and understanding the operations, products, problems and building a relationship with staff.

Q: What are alternative ways to monitor?

In *MicroSave's* and *ShoreBank's* experience, there have been several examples of monitoring alternatives, which do not involve visiting the business regularly (saving time for the credit officer). Although these have worked for some MFIs in various countries, they may or may not be appropriate in your culture. A MFI must test these before fully employing. The safest way to establish a good customer base and healthy portfolio is to be more conservative in the beginning by performing on site monitoring. Later, once the credit culture has been established, and the individual lending product is working well, more lenience can be allowed. The alternative methods have included:

- ✓ Exception Monitoring – MFIs try to cut cost by cutting corners on monitoring. Thus, they only monitor when a client is late. In some cultures where the overall repayment rates are very high (e.g. Bosnia), this works very well. In a culture where overall repayments rates are lower, this method is not appropriate. In general, this method is not recommended.
- ✓ 'Watch List' Monitoring – Through analyzing trends in the portfolio arrears and creating a "Watch List" Report, which identifies key problem areas, MFIs are able to post warnings for staff about endemic problems within the institution. The 'Watch List' is then circulated throughout the MFI. This allows the credit officers and management to be on the look out for the 'Watch List' problems. For example, a 'Watch List' could be comprised of the following problems:
 1. Over financing of loan proposal
 2. Diversion of funds
 3. Business related to the poultry industry due to the bird flu
 4. Increased business competition
 6. Too many debts of the borrowers
 7. Borrowers are not the real owners of the collateral offered

(ShoreCap Exchange, Micro and SME Training, Manila, 2005.)

- ✓ SMS reminders (CI) – SMS reminders are sent to the client on the day before repayment is due. This method is used to encourage good repayment without expensive on-site visits.
- ✓ MIS Monitoring (ACLEDA) - Credit officers monitor clients extensively through several reports generated by its MIS. Some of the reports are as follows:
 - Loans Outstanding classified by amount
 - Percentage of Outstanding and PAR by Sector
 - Loans Outstanding by Gender
 - Loans Outstanding by Balloon
 - Loans Outstanding by Loan Products
 - Portfolio Concentration
 - Loans Outstanding - Actual vs. Planned

Although at most MFIs these reports are used by managers, at ACLEDA credit officers are able to gain key information about high risk businesses and risks within their own portfolio by having access and using these reports. Then they make monitoring decisions based on these reports. For, example, if loans with balloon payments are showing an increase in delinquencies, then the credit officer may want to make a visit to these clients to see what the situation is. This is in addition to monitoring of delinquent accounts more than one day overdue.

Session 4: Collections and Problem Loans from a Manager's Perspective

Session 10 examined monitoring and problem loan management from a loan officer's perspective. The credit manager's perspective parallels the loan officer perspective, though their respective roles differ. Credit managers are expected to be more experienced and be able to effectively guide loan officers through the process of collecting problem loans. Credit managers are also more likely to shape credit policies and procedures.

Q: What are problem loans?

Problem Loans are:

- Clients with missed payments are considered "overdue"
- Extent of the problem is measured in terms of length of time of delay.

Managers should understand that solid systems in place will help avoid loan problems in the future.

Each organization will have its own policy or definition for what constitutes a "bad" loan. Technically, a loan is "overdue" when a client misses a payment by one day. The extent of the problem is then measured in terms of length of time of delay, amount involved, and situation.

Q: How does an MFI cope with problem loans?

Many MFIs use their Credit Committees at the branch levels to discuss problem loans. Other MFIs have developed a special Problem Loan Committee to discuss strategies to deal with loans that are more than 120 days overdue. Some policies regarding the Problem Loan Committee could include:

- The Problem Loan Committee would be comprised of at least one senior staff member from Operations, Internal Audit, and Finance departments.
- The committee should meet at least once per month.
- Agenda items could include:
 - Review of PAR Reports and Credit Risk Reports for the entire portfolio, including trend reports looking for changes
 - Review of findings and recommendations of branch review
 - Required deadlines and disciplinary actions necessary
 - Recommendations to senior management required changes to policy, procedures and credit methodology

Another method for collections would be to create a Collection Department. Collection officers would solely work out serious problem loans and allow the loan officer to concentrate on building business and relationships. By passing the loan to a higher authority, this lets the client know that the bank is serious and will fight until the end to recover the loan. (A sample job description for a Recoveries Officer is shown in Handout 11.3.1).

Collections Department Example in a MFI:

After a period of 30 days the loan officer turns the delinquent loan over to a collection officer who covers two branches. When this happens the loan is reassigned from the loan officer's portfolio to the collection officer's portfolio. The loan officer is incentivized by the total number and amount of loans in his/her portfolio and PAR. The collections officer is incentivized by the amount of loans s/he recovers.

Q: How does delinquency impact the MFI?

Delinquency impacts the MFI's sustainability, directly and indirectly.

Cost of Delinquency and Write-off: There is a direct link between an increase in delinquency and decrease in MFI profitability or sustainability.

The direct costs of delinquency have an impact on sustainability in the following ways:

- There is cash shortfall at the branch. If a MFI does not have enough cash inflows from loan repayments, there may not be enough funds to make new loans and it will not be able to serve its target market.
- To make up for the shortfall in cash as a result of delinquency, the cost of funds increases because the branch now has to borrow money from head-office or from the private sector
- Interest income is forgone (although the MFI may collect penalties)
- A potential loss of savings deposits
- An increase in loan loss reserve and additional loan loss provision

A financial institution in Tanzania introduced a new microcredit product. The new product development risks were not addressed, the pilot site was an 8 hour drive over poor roads making it difficult to monitor, accounting systems were inadequate. You get the picture. The institution suffered fraud at the hands of the credit officers, clients understood that the funds were grants, not loans, and did not repay, and as a consequence, suffered very high losses. The institution no longer met capital adequacy standards required by central bank. The other department managers could no longer exercise their budgets, expenses normally in their power to grant were now submitted to the CEO for approval, and corporate objectives could not be met, as there were no funds for the supporting strategies.

The indirect costs of delinquency have an impact on sustainability:

- The loan officer's time is spent on following up on past-dues
- The loan officer's time is taken away from developing new business
- The Head-Office, Regional and Branch Managers' time is spent on addressing problem loans
- A decrease in motivation of staff
- A decrease in motivation of other borrowers to pay on time
- A loss of reputation
- An inability to raise capital from the private sector in the future

Skeletons in the Closet

Upon prosecution of a very delinquent client, a bank in the Caucasus discovered in court that the title for the collateralized property was actually still held by the former owner and not held by the delinquent client. Under further investigation the lawyer found that the loan officer had deliberately scammed the bank. He did follow one of the credit committee conditions, "to disburse the loan proceeds to the former owner and obtain title directly at disbursement." Instead the loan officer authorized disbursement to the client and took a cut of the funds. The loan officer had since left the bank. The bank did not want to sue the loan officer or bring the case into the lime-light due to the reputational risk. Instead they wrote off the loan and followed up on all of the other the loans the loan officer had disbursed to make sure there were no other skeletons in the closet.

Q: What are the causes of delinquency?

Two of the most common causes of delinquency are: (1) granting too large of a loan and (2) diverting loan proceeds away from the planned project. Although most managers may blame the clients for delinquency, closer attention must be paid to the MFI's design of lending product and inefficient methods of collections. Most high levels of delinquency within an institution are a result of internal MFI products, policies and procedures.

Delinquency

Most high levels of delinquency within one institution should not be blamed on the borrower, but on the institution for poor design of lending product and ineffective and inefficient methods of collections. (Stearns, 1991)

Top causes of loan going bad:

1. Granting larger loan amounts than necessary
2. Diversion of loan proceeds to other uses

Q: How do you prevent delinquency and problem loans?

Although a MFI and/or loan officer cannot prevent clients from not telling the truth, or emergency problems in a family, a MFI and loan officer can be proactive and prevent (or at least foresee) potential delinquency by:

- ✓ Using good lending practices
- ✓ Conducting thorough due diligence
- ✓ Structuring the loan properly
- ✓ Monitoring closely
- ✓ Evaluating internal and external environment
- ✓ Accurate market analysis
- ✓ Healthy evaluation of management
- ✓ Accurate product evaluation
- ✓ Correct loan documentation
- ✓ Sufficient monitoring practice

For borrowers, delinquency can happen very easily. A birth, marriage, serious medical ailment, or death in the family can prevent a member from producing his/her income. Clients have little savings to buffer these events.

A household or small business has little "slack" in its personal, financial and physical resources and is often far less able to predict future problems. This means that the small business is very vulnerable to outside factors like a natural disaster or a change in the supply of inputs, because it has fewer resources to buffer the impact of those changes.

Serious changes can happen in a very short time. Time, or time lag, is your enemy. The sooner you catch delinquent borrowers, the less your portfolio will be hurt.

Q: How do you develop an effective, institutionalized collection culture and why is it important?

A MFI can establish an effective culture by:

(Stearns, 1991)

- ✓ Making the institutional philosophy: ZERO tolerance of late payments
- ✓ Proper monitoring by management and internal control are established for early detection
- ✓ Establishing policies and procedures for staff that strongly encourage on time repayments
- ✓ Reiterating to clients at the time of disbursement the importance of on time repayments
- ✓ Ensuring that the MIS is sufficient to produce timely reports for non-payment/delinquency follow up

It is important that the MFI establishes a 'collection culture' from within and then projects that to its clients.

Maintenance of a proper MFI credit culture is the job of management, and a vital one. Management should begin by insisting that its loan officers address all the standard items that the MFI has agreed comprise part of the underwriting process. When lenders become sloppy and fail to perform all the required due diligence, the fault typically lies with the laxity of management.

- The downside of an insufficient credit culture is problem loans, diversion of lender and management time, and unanticipated charge-offs.
- The upside of a carefully-constructed and maintained credit culture is higher profit.

Management should strive for a proper balance between the 'small picture' detail of credit analysis and the 'big picture' consideration of issues relating to the national and world economy. Management likewise bears ultimate responsibility for ensuring that certain difficult and often uncomfortable questions are posed before the bank makes its final decision on a loan request. (MicroFinance Network and ShoreBank Advisory Services, Inc., 2000.)

Backfire!!!: ABA's Zero Tolerance Policy toward Late Repayment (El Shami, 2000)

While a zero tolerance policy for loan default can be a powerful way to communicate to microfinance clients that the institution takes repayment seriously, the Alexandria Business Association (ABA) found this policy may be crippling to the institution when it is applied in an unvarying, resolute manner. A zero tolerance policy means that once the client has made one late repayment, he or she is ineligible to take out another loan from the institution. Such a policy aims to reduce risk by eliminating clients who have demonstrated even the slightest degree of propensity toward default, and by categorizing them as high risk. However, even the most successful microfinance client comes upon difficult times. Whether it is a slow month for business due to endogenous factors such as climate or economic uncertainty, or more private matters such as a death in the family or personal illness, a historically good client can at some time find it impossible to pay an installment.

After applying a zero tolerance policy for several years, ABA realized that it was losing some of its best customers because of its strict approach. ABA wanted to regain some of those customers, but it wanted to ensure that only its best customers were allowed back. The institution employed the following cautious method to win back its customers, while testing the right tolerance level for risk:

1. **ABA determined which lost customers were the least risky and then allowed them to pay a penalty to rejoin.** From its database, ABA determined which clients paid their installment within ten days of the due date. More than 35 percent of these clients accepted the penalty of paying late charges and were given a second chance.
2. **Once the program demonstrated success, the institution expanded it.** ABA then extended the offer to clients who had been ten to 15 days late on repayment. Many of them, too, accepted penalties and rejoined ABA. By cautiously and gradually implementing the program, ABA ensured its success.
3. **Then, ABA implemented a program to avoid losing the best clients due to occasional economic hardships.** ABA adopted a policy that aimed to keep its best customers from leaving due to occasional economic hardships, while still maintaining the zero tolerance policy. Instead of trying to win back customers who were shut out due to late payment, ABA now allows clients to avoid ineligibility altogether by offering a loan installment shift. Clients with good repayment records can now shift all loan installments forward one month without compromising their repayment histories. If a client comes to the branch before the due date of the installment, has already received at least three successive loans from ABA, and has a clean track record, the branch manager will allow the client to shift all installment due dates. At the time of the installment shift, the client pays one month's interest so that ABA does not lose any interest income by allowing the client this concession.

ABA determined the root of the problem, tested a solution, and expanded the solution's range in order to determine the appropriate tolerance level for clients who may be only slightly risky. By implementing the installment shift program, ABA reduced risk by holding customers responsible for their late repayments, while at the same time giving them allowances based on their previous payment records. Because of the program, ABA has increased client retention and is able to continue to retain its most profitable customers while still preserving its reputation as a serious institution.

Q: What are typical collection issues?

Typical collections issues follow the warning signs of a loan that is going bad. The loan officer/MFI may encounter several of the following issues:

- Slow payments
- Borrower refuses to answer or return calls
- Borrower is not open about the business' situation
- Borrower does not keep promises to pay
- Borrower cannot be located
- Family problems make collection awkward

Managers need to constantly collect information to realize and understand when there any problems with the portfolio. One of the ways they can do this is by using a PAR, a Portfolio at Risk Report.

Example from a large MFI in Bangladesh:

A client from the slums of Dhaka could not be located as he had no address and the loan officer was new. The former loan officer had quit without notice and manager had never visited this client. Although the client had asked the cashier to let him know when the client came in to make the payment, it was not until the client made his third payment that the loan officer caught him in the office. The loan officer wanted to meet him face to face and follow up on a previous problem the client was having according to the monitoring records.

Tips for controlling fraud and tracking clients:

- Include maps to the client's residence and business in the file if your MFI operates in areas where addresses and/or street names are non-existent or hard to locate (e.g. slum areas)
- Switching Loan officers/clients
- Having the credit manager visit more clients and spend a day each month with each loan officer

Q: What are the warning signs of potential problems loans?

The credit manager must know the business, notice details and ask questions about the situation. It is important to find out why the change has occurred.

Even positive changes in the business can be warning signs for repayment. *Changes* in the following areas are warning signs of a potential problem loan.

Collection

- Are payments slow?
- Does the borrower return calls?
- Does the borrower give specific information about the situation?
- Are promises to pay kept?

Financial and business data

- Can you get financial information?
- Changes in sales trends
- Changes in gross margin trends
- Cash flow compared to projections?
- Inventory growing compared to sales?
- Who does the business owe? When is/was it due?
- Any salaries or taxes "deferred"?
- Funds being lent to projects or persons outside of this business?
- Changes in assets and liabilities - major sums in or out of the business – purchases/sales
- Major changes in receivables and/or payables
- Major changes in inventory
- Changes in competition
- Changes in suppliers and buyers

Attitude

- Avoiding your calls?
- Not able to acknowledge problems
- Anger at MFI for collecting

- Is substance abuse or addictive behavior evident?
- Is the owner there - physically? Psychologically?

Business plan/project

- Project not working
- Borrower has changed project
- Borrower doesn't know/understand his/her cash flow
- Business appears disorganized (risks: hidden losses, quality control difficult to maintain)

General economic conditions

- Is there a "recession"?
- Is there a problem in this industry?

Personal Problems

- Personal problems taxing capacity to function
- Personal problems draining funds
- Family situation draining funds

Final Step: Assessing loan quality/risk

- Is the collateral still there? Can it be moved?
- Do you still trust this person? ("gut" feeling)
- Is the problem temporary? Really?
- Can the borrower solve the problem with current resources (money and talent)?
- Is the loan file in good shape; i.e., documentation complete and correct?

Q: What do you do when a loan becomes a problem?

What is the manager's first act when a loan becomes a problem (sometimes before delinquency)?

Assess the true situation and don't over react!

The manager must first assess and then act. After a loan becomes a problem, sometimes even before delinquency, the MFI must make an assessment of the situation **prior** to deciding on a workout strategy. MFIs must determine whether this is a temporary problem or if there is an actual weakness in the company. In keeping with conservative underwriting principles, **it is better to plan for the worst than the best case scenario. Caution rather than alarm is the better view when first encountering a past due loan.** A deliberate gathering of information will lead the MFI to the true cause of delinquency or problem. Some causes can be avoided by the actions of the MFI and some cannot. Further, sometimes the borrower has retained the capacity to repay but does not want to. These are the most difficult types of delinquent borrowers.

The MFI must keep open lines of communication with the borrower **BEFORE** the loan becomes delinquent. A work-out strategy should begin while the borrower has an opportunity to make adjustments to their business.

Red Flags:

- 🚩 Monitoring needs to be a routine part of the manager's responsibilities. Without it, the portfolio can go bad quickly.
- 🚩 Managers must impress upon the loan officers the importance of a visit to the client immediately upon notification of a late repayment.
- 🚩 Management needs to act quickly when a loan goes bad to contain the seriousness of the problem
- 🚩 Managers constantly need to gather information and reports to keep informed of any potential problems with the portfolio or the loan officers.

Q: What is risk grading and why is it used?

Portfolio assets are usually graded to reflect proportions of more risky and less risky investments in the portfolio in order to determine the profitability of the lending activities and the loan loss reserve.

Loans that repay on time comprise less risky and more profitable investments for credit institutions. Delinquent and problem loans are more risky; they are associated with financial losses for a lender.

A Risk Grading system is used to quickly be able to assess the quality of loans within a portfolio. It takes many different factors into consideration including the PAR.

Factors of Risk Grading

- Management experience and technical expertise
- Competition situation
- Suppliers relationships
- Customers relationships
- Market of the products
- Re-investment of profits
- Growth potential of the company and industry
- Profit potential
- Length of business operations
- Credit history and repayment rate
- Collateral status

What does the aging report or PAR consider? ONLY repayment history! PAR may not capture potential problems and allow loan officers and management to take proactive measures to address delinquency before it happens. PAR Reports do not allow the manager to see the complete risk of the portfolio.

All loans will be classified under 8 Risk Grade in three general groups.

Risk Grades:

General Risk	Credit Risk Grade	Description
Low Risk	Grade 1 – Excellent Grade 2 – Good Grade 3 – Satisfactory	Loans that develop according to or better than the cash flow projections, and problems with repayments have been rare, never occurred and are not anticipated.
Potential Risk	Grade 4 – Watch List	Loans that show deviations from the projected business development scenario and problems with repayments can be anticipated.
High Risk	Grade 5 – Substandard Grade 6 – Doubtful Grade 7 – Loss Grade 8 – Written Off	Loans with different terms of delinquency, they are associated with different probabilities of being fully repaid. The longer a loan is delinquent, the less likely it is that its balance would be repaid in full.

Higher Risk Grades also reflect higher costs associated with the lost investment opportunities, lost profits and potentially lost investments. Knowing your portfolio and trends very well will help keep it healthy.

SAMPLE Risk Grades are shown in Handout 14.2. Each MFI should adjust this system to fit their environment and situation. This could be adjusted based on lessons learned. Changing the Risk Grades is confusing to the MFI employees, so it should not be often and the new system should have an exact date by when all loans should be re-graded.

The information contained in this section is offered only as a guideline; no loan will exhibit all of the elements enumerated in any one grade. Whenever a loan grade is in question, use the lower grade to guide the approval process. Points about collateral depend on MFI policy.

Q: What is loan work out?

Loan Workout is a decision between liquidation and giving the borrower additional time to improve performance. *Refer to Session 10.*

What should you do?

- Act quickly
- Check your documents
- Develop a plan
- Be sure of your legal position
- Check your collateral position
- Set realistic deadlines and keep them!

Loan workout is an exercise or series of steps that a manager and the loan officer undertake to find options for recovering the loan. The first step is to act quickly in assessing the borrower. Prompt action can mean the actual recovery of a loan or not. Next the manager must check the credit file to make sure all documentation is in order and ready in case necessary for legal proceedings including contracts properly completed and signed, monitoring forms up to date, etc. The manager together with the manager and client should develop a plan for business recovery and on time repayment. The manager should speak with the internal lawyer to check the legal position and also physically see the collateral to

make sure it still exists. Lastly, deadlines set should be kept. The client should understand that the MFI is serious and will recover its funds. It is very important to set a precedent for all the clients.

Workout Assessment Questions

1. What is the company's current situation?
2. What are the problems?
3. How are you working to solve the problems?
4. When can you make the past due payment and how can we avoid this occurring again?
5. How many items are currently produced? Daily, weekly
6. How many items are currently sold? Daily, weekly
7. What is the current selling price?
8. What is the current level of inventory, length of time?
9. What is the current cost of raw materials?
10. How many employees are working at the company? Are the employees receiving their salaries?
11. How much are the accounts receivable? How old is each item and what are the prospects for collecting? What steps are you taking to collect?
12. Do you have any taxes due or overdue? Will you be able to pay your taxes?
13. Do you have any other accounts payable? When are they due? Are they overdue?
14. Have you changed accountants?

Q: What is the course of action?

The best work-out strategy will grow directly from a clear understanding of the real problem. The goal is to turn the situation around and **not** turn the customer out!

The best course of action will depend on the following:

- Cooperation of the borrower - a workout plan can only be effective with the real cooperation of the borrower. The manager can best secure this cooperation by responding quickly and firmly to warning signs but focusing on understanding the problem rather than threatening the client.
- How bad is the situation? The manager's plan should be appropriate to the seriousness of the problem. Over-reaction or unnecessary aggressiveness will result in loss of the customer's cooperation. The bank will then be left without information and with limited alternatives for obtaining repayment.
- The strengths and weaknesses of the bank's position - this depends upon the value and liquidity of the collateral, the adequacy of the documentation on the loan and the bank's legal position in terms of collection.
- What caused the problem? The potential courses of action are as numerous as the types of problems which can arise. Each case should be dealt with individually.

Q: What are the stages of workout?

There are four stages to workout:

Stage 1 – Watch List

A problem loan is identified and placed on a "Watch List" and the loan grade is adjusted accordingly. Payments at this point may well be current, but the MFI has received some adverse information or there has been, for example, a change in the business or political environment that gives cause for concern. At this point, the MFI may require that the loan be taken to a "Problem Loan Committee." This committee

is usually composed of the same members as credit committee. At this stage, the credit officer presents the client's situation and suggests options for the action plan. Then the committee discusses the options.

The loan will require very close monitoring, and status reports should be included in a monthly Problem Asset Report provided to the MFI management.

Stage 2 – Workout Arrangements

Stage 2 is for loans that need “work out” arrangements, but full repayment is expected from cash flow, although payments may be delayed.

There may well be logical and acceptable explanations for this situation, for example:

- delayed collection of receivables that are still considered good
- late delivery of equipment financed by the loan

In such cases the underlying project should still be sound but the payment terms are too ambitious. Penalty interest might be applied and/or the loan may be refinanced, depending upon the circumstances of each particular case.

As with any past due loan, the credit officer must have a specific, approved plan of action for repayment.

Stage 3 – Non-Accrual

(1) Repayments have slipped past 60 days and there are underlying problems with the loan that indicate that the business is no longer capable of repaying this loan within a reasonable period of time and/or repayment will probably depend upon the sale of collateral.

At this point the MFI should place the loan on a “**Non-Accrual**” basis. This decision is made by the credit committee or ‘arrears’ committee if there is one.

(2) The loan is on a non-accrual status and as such, specific action will usually be required on the part of the MFI in order to obtain repayment of the loan. Such action may include the repossession of collateral and/or foreclosure on real estate and/or enforcement of guarantees, etc. Speed of action is often of paramount importance.

Loan Accounting - Non Accrual

According to international accounting practices, a loan is placed on a non-accrual basis because it is now a work-out loan and can no longer be regarded as an interest-earning asset of the bank. Repayment of the principal is far from certain and therefore all payments received should be applied to principal. Only after the principal is repaid can payments be applied to interest.

This policy may depend on the regulations of the National Bank.

Stage 4 – Write-off

The loan is “Written-Off” after 90 days. The credit officer will continue to work towards recovery and provide written progress reports quarterly or at such other times requested by management. Sometimes the credit officer is unaware that the loan has been written off.

Important Note: The credit officer, collections officer, or other designated MFI staff member should continue to follow up and apply pressure to delinquent clients, **even when the loan has been written off.** The client should never believe that the MFI has given up collecting.

Q: How do you develop an action plan?

There are no exact steps; because each and every workout situation is unique, it is difficult to give exact plans for the MFI. Instead the loan officer together with the manager and client must work to come up with a suitable plan where the client can actually repay the loan. The loan officer and manager must understand the client and be creative in their plan. There are a few rules for developing the plan:

1. Must be realistic.
2. Both client and MFI must agree to the same plan.
3. Issued in writing and signed so the client has one copy and the other is in the client file.
4. MFI must commit to following and monitoring the plan.

The client should receive one copy and another should be filed in the client's file. This will help to remind the client of his/her obligations and document the situation in case it ends up in court. As indicated in the restructuring section below, any extension of terms or grace period must be approved by the credit committee.

Remember, a legal settlement is the last resort as it is very time consuming and extremely costly. If a viable repayment arrangement cannot be developed, then it will be necessary to liquidate assets. At this point a "cooperative borrower" may well cease to cooperate. The client must be made to realize that a workout is always better than repossession of collateral – both for him/her and the MFI.

One MFI in the horn of Africa had difficulties with loan recoveries after a vast flood lasting 2 months in some areas. After a year they were still having difficulties. The MFI wanted to take action and try to help the flood affected victims, but felt that not all delinquencies were due to the flood. They mapped loan recovery in the various flood affected and food unstable areas and overlaid these maps with PAR maps of the same areas. As expected, several of the problem areas were in fact in areas highly affected by the flood or had a very unstable food supply. However, there were about 6 regions where there had been minimal flood impact and minimal food insecurity, but these regions had portfolios performing at well below target repayment levels. In contrast, there were regions where the exact opposite happened, high flood impact and high food insecurity with high repayment rates. The MFI was astounded at the results. They came up with a plan to intervene:

- implement refinancing to those clients in areas that were highly affected by the flood or had a very unstable food supply (they realized this should have been done immediately after the flood);
- implement lower interest rates for next loans to reward clients in areas with high flood impact and high food insecurity with high repayment rates; and
- start strict collection efforts in areas with minimal flood impact and minimal food insecurity, but high PAR by using a collection team to evaluate the situation and aid in training the loan officers and branch management as well as implementing some new strict collection policies.

Q: What is restructuring?

Restructuring is when the lending institution adjusts the original loan repayment schedule to compensate for extraordinary events faced by the client. This procedure is called restructuring due to the loan actually taking on a new form and shape (i.e. the loan will have different conditions from the original loan: term, interest rate, amount paid per month and/or collateral).

In Eastern Europe, an MFI encountered high delinquency in a small village due to extraordinary weather. Rain washed away much of the produce which microentrepreneurs relied upon for sales. The MFI restructured the payments of most of the entrepreneurs and also helped by providing additional seeds for another attempt at sowing. Word reached a village about 100 kilometers away where producers used greenhouses to grow most of their sellable crop. Several of the green house producers thought it unfair that the other village got free seeds and “better” payment terms, so stopped full payments. The MFI immediately sent the loan officers and managers to the greenhouse village to explain the circumstances and to get the clients back on normal payment terms. The villagers understood the extenuating circumstance of the weather struck village and started to pay again.

MFI's must be cautious when dealing with large groups of clients in need. They need to assess the situation very clearly in order to aid the clients in need while at the same time avoid misunderstandings with clients who are not in the affected areas.

Q: What are the risks of restructuring?

Restructuring can be a seductive trap that helps keep portfolio measures looking good, and avoids tough borrower issues. It is often overused and misused, and any improvement that appears may be short-term and counterproductive.

Q: What clients qualify for restructuring?

There are very few cases in which a client qualifies for restructuring. Some of the exceptions are:

- ✓ Severe damage to business or house as a consequence of a *force majeure* situation such as a natural catastrophe, war, riot or coup attempt
- ✓ After an extraordinary event give the borrower some time to demonstrate their willingness to repay
- ✓ For clients who have lost all their working capital

Q: Is restructuring part of a regular workout procedure?

Important to Remember!!

- Restructuring should only be offered to those clients who were up-to-date on their payments on the date of the loss.
- If they were not up-to-date, then the loan should go through the workout procedure.

No, restructuring is not part of a regular workout procedure; it is the last resource for response to a devastating problem. Loans that become problems and are under 'workout' usually are associated with the examples of loans NOT appropriate for restructuring. The problems with these loans are typically controllable by the client. This does not mean that because restructuring is the last resource that it should take a long time to come to the decision. The quicker you are able to get the client back on track, the quicker the client is able to pay the MFI!

Restructuring can be a successful financial tool, but it only applies to very few cases and the percentage of good quality restructured deals in a portfolio is usually low, namely not more than 5%.

In basic terms, restructuring means granting a new loan (i.e. you trust the client to repay). Your loan officer must go through the same due diligence as with a first time borrower. Clients may face additional problems if a loan is not restructured properly. Improper restructuring will only delay the problem. If the MFI has any doubts about the borrower or the borrower's future business, the loan should not be restructured.

Q: If that is restructuring, then what is refinancing and when is it used?

Refinancing is replacing one loan with another, usually larger, loan.

MFI's could use refinancing when the business has grown far beyond the cash flow, and the client's growth will be stunted unless the existing loan is refinanced with a larger loan. The MFI issues a second loan which is larger than the outstanding balance of the first loan. The second loan is used to pay down the balance of the first loan or refinance, and then the extra funding for may be used for additional projects. Refinancing can also be used when an MFI is taking over a client from another institution. In this case, the new loan is used to refinance the original loan at the same outstanding amount.

* WATCH OUT: The other time that refinancing is used is in workout situations by institutions or clients themselves. When there is a problem loan another MFI may try to get the client to take out another loan or the clients themselves may initiate this process to repay the problem loan. It is extremely important that you check clients thoroughly and that this is not happening. A Credit Bureau would be a very good solution to aid in this predicament. If there is not a credit bureau and you know that other MFI's are operating in your region, loan officers and MFI's should exchange 'black lists' or call other MFI's before disbursing loans.

Red Flags:

- Ⓜ Any changes in the loan officer's reports will be the manager's clue to potential problems
- Ⓜ Poor collection culture and product design can lead to high institutional PAR.
- Ⓜ The number one cause of delinquency and non-payment is giving a client a loan which is too large.
- Ⓜ Be aware of clients coming from another MFI as they may be trying to refinance a bad loan.

Session 5: Reporting

Q: How well do you know your portfolio?

If your MFI has a strong methodology in place, it will be less susceptible to problems with the portfolio. Taking it one step further, managers and loan officers need to know their own portfolio very well. They should know off the top of their head:

- total outstanding
- portfolio at risk
- loans refinanced
- potential problems
- trends (at least by general sector: trade, services, production and agriculture)
- what types of businesses are high risk

If the manager and loan officer do not know their portfolio, how will s/he and the MFI learn from the analysis and their mistakes? The manager should also know this information for the district or region AND whole organization. How is their district or region fairing compared to the whole organization and, if available as a benchmarking indicator, other MFIs in the country/region? Information is needed to answer these questions.

Q: What Does It Mean to Manage Information?

Management needs to decide what reports they need in order to be able to make appropriate management decisions and to provide reports to stakeholders—board, donors, investors, regulators, etc. Reporting is critical to risk monitoring and measuring. The reports should be designed to show all levels what is happening and whether tactics to improve outcomes are working.

To enable the top managers to have the reports they need, information must be properly collected, recorded, and input into the system.

Q: Is there a difference between management information and information management?

Management information and information management are not the same. Management information is the *type* of information-THE DATA; Information management is the *system* of management. We are focusing on the latter – information management.

Information management is the process of analyzing and using the information collected to enable managers to make informed decisions.

Management Information is the information needed in order to make management decisions.

Management Information is important to:

- Make decisions necessary to improve management of facilities and services; and
- Implement participatory planning, implementation, monitoring and evaluation.

How to Use Information Management:

To be able to use information to make management decisions, the information should be managed (*collected, stored and analysed*).

Management information therefore involves:

- determining information needed;
- collecting and analyzing information;
- storing and retrieving it when needed;
- using it; *and* disseminating it.

A good management information system (MIS) should therefore assist loan officers and other staff to know the information they need to collect for different management decisions at different times.

This information is collected during the planning and implementation phases. The information helps to detect if anything is going wrong in the project. Management can therefore find solutions to ensure success.

Collecting and Analyzing Information for Information Management: Information can be obtained from financial reports, market reports, forms filled by the different players, community meetings, interviews, and general observation.

Storing Information: It is important to store information for further reference in a computer or place where it can be easily retrieved. Management will need to decide who may have access to what information.

Dissemination or Flow of Information: For information to be adequately used it needs to be shared with anyone in the organization who might find it useful. This information can then be used for decision making and in turn can be improved for the one collecting information to better understand exactly what information is needed to make good management decisions.

Information can be used for helping to solve the organizations problems, determining resources and advocating their support and assisting in budgeting and yearly planning.

In summary:

Whereas management information (*the information needed to make informed decisions*) and information management (*the process of collecting and storing information*) are different; they always reinforce each other and cannot be separated in day to day operations.

Q: Who reports what and to whom?

Report Charting

- Design your office hierarchy
- Reporting & Responsibilities
- Frequent Updates

A summary of reporting, including forms used, persons responsible, dates due of all internal reports can help ensure that the information provided meets the following criteria:

Management must determine if the information is:

1. Applicable—Does it provide what is needed?
2. Usable—Does the recipient need all the information? Will they use it?
3. Timely—Is it delivered in time to be useful?
4. Accurate—Is the information correct?
5. Properly distributed?—Are the right people getting the information they need?
6. Accessible—Is access to the reports limited to the users?

7. Simply written—Is it easy to read and understand?
8. Properly filed—Are reports filed in standard formats and locations?
9. Traceable—Is the information on the reports able to be audited?

Managers mainly receive reports and process the information. The reports they generate will be to donors, and the Board of Directors. They are responsible for monthly reporting (or what is required per donor or Board) and contributing to the annual report.

Leaders cannot manage what they cannot measure. As a result, the leader needs to have a number of different reports. These reports also needed to preserve institutional history and experience.

In terms of qualitative performance, staff performance reports should be done at least annually and at least one or two “check-in reports” in between would be valuable. Each department head will be responsible for staff performance report. They are then reviewed by senior management and the Board if necessary.

Reports	Who Prepares	Submitted to and reviewed by	Produced
Marketing Plan	Loan officer	Credit Manager	Quarterly
Pipeline Report	Loan officer	Credit Manager	Monthly
All loan documentation (client screening form, loan application, loan appraisal, etc)	Admin Assistants and Loan officer	Credit Manager, Credit Committee	Daily basis
Problem Loan Report	Loan officers and Managers	Managers, Problem Loan Committee, Board of Directors	At least monthly
Monitoring Reports	Loan officer	Credit Manager	As needed
Organization's Financials	Chief Financial Officer	Manager, Board	Monthly
Branch Profit and Loss Statement	Branch Manager	Senior Managers	Monthly
Policies & Procedures	Credit Manager, Branch Manager, CFO, CEO, Internal Auditor	Board	Yearly
Internal Audit Report, Annual Audit & Reports for external auditors	Internal Auditor (and external auditors)	CEO, Board	Monthly, Yearly
PAR Report	Loan officers and Managers (Info generated from MIS)	Credit Manager and Senior Managers	Bi-weekly
Trend Reports (Sector, location, gender, loan officer, etc.)	Credit Managers (Info generated from MIS)	Senior Managers	Monthly
Training Schedule	Human Resource Department	Senior Managers	Quarterly
Staff Turnover	Human Resource Department	Senior Managers	Quarterly
Monthly MFI Report	Senior Managers	Board, Donor	Monthly
Quarterly MFI Report	Senior Managers	Board, Donor	Quarterly
Staff Performance Reports	Heads of Department	CEO	Yearly
Annual Report	CEO, CFO, CEO, Auditor, et al.	Board	Annually

The MicroFinance Network survey sent out to 22 leading microfinance institutions (11 for-profit MFIs and 11 non-profit MFIs) revealed that the following reports are the most frequently monitored by board directors:

Portfolio report. According to the survey, of all the institutional performance reports, board directors of both non-profit and for-profit MFIs most frequently use the portfolio report, which provides information on the aging and quality of the loan portfolio. Most MFIs produce this report every month and send it to the board and senior management for review. The report should demonstrate the portfolio quality by showing the aging of arrears (in amounts and percentages of the portfolio) and by showing trends (allowing comparisons with past months).

Balance sheet and income statement. The second most common reports are balance sheets and income statements, which many MFIs produce monthly. Based on the survey, microfinance boards receive updated balance sheets and income statements five times per year on average, with some receiving them monthly and others receiving them only once per year.

Cash flow. The third report most frequently used by non-profit MFI boards is the cash flow report, which they receive four times per year on average. Of the for-profit MFIs surveyed, their boards only received cash flow reports two times per year on average. The difference in emphasis on the cash flow report between for-profit and non-profit MFIs perhaps reflects non-profit MFIs donor dependence and the relative difficulty they have in securing access to capital funds to support their lending operations.

Internal audit report. In for-profit MFIs, the third most frequently distributed report is the internal audit report, which is sent to the board three times per year on average. Of the 11 non-profit MFIs surveyed, their boards received internal audit reports only two times per year on average, with some boards receiving monthly reports and others receiving no internal audit reports. The difference between for-profits and non-profits in internal audit reporting reflects a greater level of formalized internal controls in for-profit MFIs, perhaps resulting from regulatory requirements or from increased responsibility for safeguarding client deposits as a board of a financial intermediary.

Other reports. Some MFI boards also receive and review the following additional information on institutional performance: loan product performance reports, strategic plans, external audit reports, market share information, social impact studies, and marketing plans.

(Campion, 1998)

In this session, we will focus on a few very important reports used by nearly everyone in the organization.

Q: Is your portfolio diversified? Does it need to be?

The ability to meet loan demand is dependent on your funding sources, which ultimately determines the size of your portfolio. However, the actual composition of your portfolio is affected by 4 factors:

- Number of loans: Are these loans group or individual?
- Average loan size
- Term mix of loans
- Collection and repayment rates

Keeping a close watch on the portfolio will give clues to possible negative trends, and promote positive trends. Along with managing risk by showing specific areas of higher risk concentration, knowing the trends will also show you what is driving the growth in the loan portfolio. Ideally, managers should be able to produce reports from their MIS which will be able to reveal all of these trends. Realistically, most

software programs don't generate such reports at the push of a button, due to inconsistent data capture, or lack of data fields within the system in which to record specific data. Spreadsheets are typically used to record summary data to show trends, which can then produce trends in graph formats.

Trends can also show you if your problem loans are clustered in any way, such as by:

- Sectors
- Types of businesses
- Product lines
- Geographic areas
- Loan officer
- Regional manager
- Gender
- Graduating group clients versus new individual loan clients

Then you need to ask the questions:

- Where was there a marked improvement? What got better? What got worse?
- Are there any unexpected trends developing? Did loan disbursement go up far more than expected over the past few months? In which sectors?
- Are the trends temporary or permanent?

Here is the analysis of one MFI regarding high risk businesses within their individual loan portfolio and the problems borrowers face:

Higher Risk Business	Problems borrowers face
Silk Scarves	Cheaper imported goods from competitors; expensive imported inputs
Tomato Paste (Food Processing)	Seasonality of business; difficult to get stock of inputs; price of inputs fluctuates; subject to natural disasters
Agro Based businesses	Seasonality of business; difficult to get stock of inputs; price of inputs fluctuates; subject to diseases and natural disasters

It is important that the managers analyse which businesses are higher risk and have higher PAR as well as understand why it is happening to see if there are any corrective measures to be taken in the design of the lending product or advice to clients.

Your MFI should set a cap on certain loan types that are more risky. To reduce risk, your MFI might set the following guidelines:

Example of Portfolio Makeup Trend Guidelines

- Not more than 30% of outstanding should be in agriculture and farming related business.
- Not more than 20% of outstanding should be to start up businesses (which generally have a higher risk than existing businesses).
- Not more than 10% of outstanding to be structured as balloon loans (an all loans to pay interest on a monthly basis).
- Loans over a certain amount (this depends on the market and environment) must be secured with a certain percentage of formal collateral.
- Only 20% of loans are allowed to be over a maximum amount (this depends on the market and environment), to ensure that the MFI is reaching poorer borrowers and to keep the risk lower (one large delinquent loan could have a devastating affect on the entire portfolio).
- The maximum permitted allowable combined outstanding exposure of the MFI's 10 largest borrowers will be limited to 20% of the total outstanding portfolio
- Not more than 20% of the borrowers can have more than one loan outstanding (borrowers that have more than one loan outstanding are more likely to default as it is more difficult to manage the larger cash flow and make larger payments, especially when difficulties strike).

The bottom line is that loan officers and managers need rules and guidelines to help them. It is up to managers to suggest and senior managers to ensure that appropriate rules are set, followed and adapted when need to be.

Example of Portfolio by Type of Business:

MFI in Southeast Asia	2001	2002	2003
	PAR(%)	PAR(%)	PAR(%)
SEEDS	10	23	45
VET SERVICES	19	30	46
LIVESTOCK RAISING	11	15	20
APICULTURE	22	24	29
SERICULTURE	18	25	60
FISHERIES	2	2	22
NURSERY	9	25	31
HANDICRAFT	7	11	21
WEAVING	2	19	12
GROCERY	7	24	18
POWER TILLER	14	12	22
Average	11	19	30

This table can be used as a monitoring tool to show which sectors are higher risk concentrated to limit loans in those sectors.

Q: What is PAR and why is it important?

Portfolio-at-Risk (PAR) is the outstanding principal amount of all loans that have at least one installment past due for one or more days.

PAR is the MFI's main measure of loan delinquency. Loans are classified depending on the number of days they are overdue. The outstanding principal balance of each loan classification is divided by the outstanding principal balance of the gross loan portfolio. (Before deducting the loan loss allowance.) The amount includes the unpaid principal balance but does not include accrued interest. Under PAR, loans are considered past due if a payment has fallen due and remains unpaid. Loan payments are applied first to any interest due, and then to any installment of principal that is due but unpaid, beginning with the earliest installment. The number of days of lateness is based on the due date of the earliest loan installment that has not been fully paid.

Calculating Portfolio-At-Risk

$$\% \text{ Delinquent} = \frac{\text{Outstanding Balance of Loans with Payments over due 1 day}}{\text{Total Principal Outstanding (TPO)}}$$

$$\% \text{ Current} = \frac{\text{Outstanding Balance of Loans current}}{\text{Total Principal Outstanding (TPO)}}$$

$$\text{Repayment Rate} = \frac{\text{Amount Collected During Period}}{\text{Amount Due} + \text{Amount Past Due}}$$

Managers should also have guidelines in place concerning write-offs. CGAP's guidelines concerning write-offs are as follows:

Write off Policy for loans with terms of six months to two years (according to CGAP):

Loans more than 360 days late, as well as rescheduled and refinanced loans more than 180 days late, are automatically written off.

Some MFIs have stricter guidelines due to their internal guidelines or government regulations:

Loans more than 180 days late, as well as rescheduled and refinanced loans more than 90 days late, are automatically written off.

An example: Which portfolio is riskier?

1. A portfolio with 20% of loans more than 30 days late. The portfolio consists of three month loans with weekly repayments OR
2. A portfolio with 20% of loans more than 30 days late. The portfolio consists of two-year loans with monthly repayments.

First of all, it must be said that neither portfolio is great, but that if you had to choose, option #2 would be less worrisome. In #1, 20% of the clients have missed more than 4 out of 12 payments whereas in #2, 20% have missed one out of 24 payments.

It is very important to know and understand the practices of the individual MFIs' definitions of PAR and delinquency when interpreting a PAR Report. The key is that these loans must be documented and reports must be precise. It must be clear as to when a loan is first treated as being late, as well as what is included in the balances (principal, principal & interest?). If a loan is considered late after 1 day of non-payment then the policies should support this and manager should be following up with the loan officer after one day.

For example, an MFI with an average loan term of 9 months, collecting monthly payments, claims to have a 95% repayment rate. (The rate was measured by taking the cash paid divided by cash that fell due during the reporting period.) A 95% collection rate looks great on paper and sounds nice in discussion. However, upon closer inspection, the 95% was based on 9 month loans with monthly installments, meaning it would actually be losing a much greater percentage on a yearly basis. A delinquency report can be very misleading unless it describes, in detail, the MFIs practices on PAR, restructured and refinanced loans.

Note: Individual loans will most likely have 6-24 months terms with monthly (or bi-weekly) repayments.

Q: How do we use a PAR, Portfolio at Risk Report?

The key question is: How much of the portfolio is at risk and what is the trend?

Look at 4 main indicators:

1. *What portion of the portfolio is totally current (100% on time repayment on the exact date that the payment was due)?* This is the portion of the portfolio that is good.
2. *What portion of the portfolio is overdue at least one day (this is 100% minus the answer to #1 above)?* The total outstanding principal of every delinquent loan (even only by one day) is included and added together to give you your total portfolio at risk. The percentage that it represents of your entire portfolio can be found by dividing the PAR by the average (or total) loans outstanding.
3. *What is the quality or aging of your delinquent portfolio?* What percentage of these loans (in number and monetary amount) is still within their original loan terms (i.e. they have not reached the end of their loan term?) Where are your concentrations of delinquencies? Are most borrowers' payments one day overdue or one year overdue? Do this analysis across different products, geographical locations and sector concentrations to see whether delinquency is concentrated in any particular areas.
4. *What is the trend in your Portfolio at risk?* What was the portfolio at risk percentage last period? Is it improving (even if it is still below your target), is it deteriorating (even if it is still within your target)? Your corrective actions will be different based on these answers, thus the importance in knowing the direction of portfolio at risk over a period of time.

Sample PAR Report:

Sample MFI Individual Loan Portfolio in one branch			
# of Days Delinquent	# of loans	Outstanding balance	% of Portfolio
Current	2,300	4,600,000	93.4%
PAR			
>1 day	76	152,000	3.1%
> 30 days	34	68,000	1.4%
> 60 days	41	82,000	1.7%
> 120 days	12	24,000	0.5%
Subtotal of delinquent loans			6.7%
Total	2,463	4,926,000	100%

Q: How can you make the PAR more useful?

Breaking down the PAR report into smaller units, by loan officer, geographic location, product line or other (loan size, loan term), is probably one of the most useful management tools.

Additionally, by comparing PAR Reports monthly, quarterly and annually management can see changes aiding in the evaluation of the portfolio. Changes over time often reveal trends helping managers to ask the right questions about his/her portfolio. A good understanding of trends allows the manager to be proactive in managing future potential losses. Graphic representations that show trends over a period of time are much more effective in displaying problem areas, rather than pages of detailed data.

To track the risk in the loan portfolio where borrowers repay monthly the same PAR categories would be used:

- current loans (e.g. loans that are completely current and therefore low risk)
- 1-30 days overdue (e.g. loans that are minor risk, but need watching)
- 31- 60 days overdue (moderate risk)
- 61-90 days overdue (significant risk)
- 91-120 days overdue (serious risk, lots of collection effort by staff)
- 121-180 days overdue (highest level of risk, very low chance of repayment)
- Over 180 days overdue (loss)

If the terms are weekly or bi-weekly the PAR report can list the amount of principal outstanding according to the number of payments missed. To track the risk in the loan portfolio, the following categories could be used where borrowers repay weekly or bi-weekly:

- no payments missed (e.g. loans that are completely current and therefore low risk)
- 0 - 4 payments missed (e.g. loans that are minor risk, but need watching)
- 5 - 12 payments missed (moderate risk)
- 13 - 26 payments missed (significant risk)
- 27 - 50 payments missed (serious risk, lots of collection effort by staff)
- 51 - 100 payments missed (highest level of risk, very low chance of repayment)
- greater than 100 payments missed (loss)

In the tracking system, if a borrower misses a payment, the entire loan principal shows up as “past due” because the entire loan is at risk. This method allows a MFI to monitor how much of the portfolio is at risk at any one time and how that risk changes over time (increasing or decreasing).

Two important facts:

1. In lending, the likelihood of repayment decreases as the borrower misses more and more payments.
2. Experience demonstrates that loans that have missed payments are less likely to resume repayments.

Example PAR by Product: This is the same PAR report as above with the numbers broken down further by product line. What information is now visible compared with the simple PAR report?

# of Days Delinquent	Housing		Group		Individual		TOTAL		
	# of loans	Outstanding balance	# of loans/groups	Outstanding balance	# of loans	Outstanding balance	# of loans	Outstanding balance	PAR
Current	230	257,370	1,380	621,000	690	3,721,630	2,300	4,600,000	93.4%
>1 day	8	8,952	46	20,700	22	122,348	76	152,000	3.1%
> 30 days	3	3,357	20	9,000	11	55,643	34	68,000	1.4%
> 60 days	4	4,476	25	11,250	12	66,274	41	82,000	1.7%
> 120 days	1	1,119	7	3,150	4	19,731	12	24,000	0.5%
Subtotal of delinquent loans	16	17,904	98	44,100	49	263,996	163	326,000	6.7%
Total							2,463	4,926,000	100%

Example PAR by sector. This next example demonstrates a way to monitor positive or negative trends by breaking down missed payments according to the categories which make up their portfolios.

Distribution of Principal Outstanding								
How are your loans distributed in your portfolio according to delinquency?								
What areas missed the most payments?								
Sector	Month 1	% of missed	Month 4	% of	Month 7	% of	Month 10	% of
	% TPO	payments	% TPO	payments	% TPO	payments	% TPO	payments
Agriculture								
Production								
Start-up Businesses								
Fisheries								
Livestock & Poultry								
Services								
Rural Transport								
Rural Trading								
Food Processing								
Health								
Housing								
Miscellaneous								
Total Portfolio	100%		100%		100%		100%	

* TPO stands for total principal outstanding

Q: How can you apply the information in a PAR Report to your daily job?

YOU, THE PORTFOLIO MANAGER, NEED INFORMATION IN ORDER TO ACT.

The goal is to help the manager take the right action as quickly as possible, before problems grow too big or too serious. The credit manager should have all the weekly reports and summary reports prepared by the loan officers as well as the monthly (or quarterly) trend report (often generated by the MIS department of a MFI).

Example from Romania:

A couple of years ago a credit manager at a MFI noticed a trend of higher delinquency among building and construction loans. What was the reason for this? Was it something that the manager could control? The PAR Report helped the managers spot the concentrations of risk in this sector and ask the right questions.

For the building and construction loans, the credit manager figured out that the term of the loan was too long and that many borrowers could not keep up the level of payments and commitment for so long. Once the manager understood this, she recommended policy changes to the regional manager. The problem was resolved by shortening the term of the loan to 1-2 years instead of 5 years.

These reports provided the manager with a big picture view. Any surprising change, positive or negative, in a ratio or trend report says to the manager, **“Look more closely here!”**

Positive changes should also be monitored. For example, a manager may see that repayment and voluntary savings in some areas have suddenly improved. The manager should then ask more specific questions to find out why. Perhaps the loan officer has found a special method that s/he uses to encourage savings. Maybe it is something that can be replicated in other places where savings are lower.

Q: What are Productivity Tools and why do MFIs use them?

To help better manage the day to day activities of our institutions, to become more productive, and to help us monitor the portfolio, we focus on tools that help streamline and standardize the credit process.

1. **Checklists:** We use checklists as a support to help us remember the specific steps in several sub-processes which form the credit making process. This is both a productivity and risk management tool. For instance, think about the books of checklists that commercial pilots must complete prior to each and every flight.
2. **Standardized Forms:** From the first instance when the clients' information is captured to the presentation of the loan request to the Credit Committee, the forms should resemble each other and contribute to a streamlined flow of data. In a computerized environment this would lend to a "cut and paste" approach of information flow.

Following is an example of a checklist of standardized items in a report which improved efficiencies and managers' ability to "track changes in member enrollment and dropout, monitor savings and lending activities, and to assess the overall financial health of the MFI." This report is very concise, gives pertinent information and allows the senior management to see the big picture in a one page report!

ASA's One Page Report on Performance Indicators

The Association for Social Advancement (ASA), a leading microfinance NGO in Bangladesh, is known for its efficient microfinance operations. ASA demonstrates its commitment to efficiency by integrating it into all levels of the institution, including MIS and reporting systems. To improve efficiency in management decision making and to reduce the risk of information overload, ASA recently streamlined its management information processing and condensed reporting on performance indicators from units to headquarters into a one-page, user-friendly report. Regional managers are responsible for collecting the following information from unit offices, compiling it and reporting to headquarters on a monthly basis:

Savings activity:

1. Number of groups
2. Number of members
3. Number of savers
4. Amount of savings deposits
5. Savings withdrawals (number and amount)
6. Interest paid on savings
7. Net savings at end of month.

Lending activity:

1. Number and amount of loans disbursed
2. Loan repayments due
3. Actual payments collected
4. Past due loans (number and amount)
5. Outstanding loans (number and amount)

Additional operational activities:

1. Funds received and transfers
2. Other receipts and payments
3. Insurance premiums received and payments
4. Financial costs
5. Operating costs
6. Opening and closing balance sheet
7. Future cash-flow projections.

ASA's senior management uses this information to analyze the units' progress toward their six-month operational plans. This information is adequate for senior management to track changes in member enrollment and dropout, monitor savings and lending activities, and to assess the overall financial health of the MFI. If negative trends are identified, management can quickly recognize them and focus its energy on conducting additional analysis of the specific problem areas. ASA provides an excellent example of a reporting system that uses a minimum number of indicators and yet provides satisfactory results.

(MicroFinance Network and ShoreBank Advisory Services, Inc., 2000.)

3. **Red Flags:** A red flag is a warning that there may be additional risk associated with a particular borrower that could preclude an approval or that would at least necessitate further scrutiny into the application. Having a process in place to find these risks early and deal with them quickly is an invaluable tool that can save time. Not all red flags will preclude an approval, but they do identify areas which must be addressed immediately.

While credit committee (managers) reviews a loan file for approval a small red flag can be placed anywhere on the documentation and financial statements to show there may be an issue. For example, identifying cashflow which is insufficient to make repayments would "earn" a red flag. This would stop the process early so time is not wasted on further analysis. It should be noted though, that not all red flags will kill the deal. The red flag symbol can be used simply to alert you to be a bit more diligent and possibly ask a few more questions.

Below is a simple template which can be used to keep red flags noted.

RED FLAG	POSSIBLE CAUSE	QUESTIONS FOR BORROWER

Q: How long does it take to process a loan from first contact to disbursal?

If a solid lending methodology is in place with well written, simple forms, policies and procedures, this process should take about an average of three to five days. These steps are covered in detail in Session 2.

In order to monitor this, managers can use the Pipeline and Tracking Reports to understand how the loan officer uses his/her time.

During a review of an individual lending product in Uganda it was noted that the loan officer had to complete 9 separate forms before the loan was sent to credit committee. Many of the forms had duplicate information, such as personal, guarantors, collateral, household and business information. By combining several of the forms, cutting the number down to 4, the MFI was able to save loan officer and credit committee review time, unnecessary errors due to filling the same information in several times, and paper.

Q: What is a Pipeline Report and how is it used?

In order to monitor potential loans which are developing or 'coming through the pipeline', managers use the Pipeline and Tracking Reports to understand how the loan officer uses his/her time. Managers use the pipeline to track stages of the loan process or due diligence and their loan officer's timings. These reports clearly show how long each step of the process takes and where loan officers are lagging.

Pipeline Report Tool:

This is a management tool for tracking the status of loans. All loans/clients should be entered into the Pipeline once an application has been submitted or purchased. This should be updated at least 3 times per week. Managers use the Pipeline report to conduct weekly or twice per week meetings with the loan officer to discuss status of loans and help loan officers prioritize their work.

Pipeline Report Management Productivity Tool For:

- Tracking loans
- Used to gauge effectiveness of loan officers
- Helps manage loan processing measurement
- Used for documentation purposes
- Assists loan officers in prioritizing loans

Sample Pipeline Report: (Tjossem, 1999)

The following tool can be used in your organization if one is not currently in place. It can be easily modified to meet your needs.

As of: 30-Jan-05				Pipeline - Bank Branch 1							
#	Status	Appl. No.	Loan Officer	Date Appl.	Company	Sector	Type of Business	Owner	Loan Requested		
				Submitt.					Amount	Type	Term (Mo.)
1	Disbursed	Del 146	xx	25-Jan	xx	Trade	Grocery Shop	xx	\$ 2,000	WC	7
2	Disbursed	Del 26	xx	20-Jan	xx	Service	Beer Bar / Market	xx	\$ 11,000	Cexp/WC	14
3	Disbursed	Del 19	xx	23-Jan	xx	Prod	Shoe Production	xx	\$ 3,000	WC/Equip	6,5
4	Disbursed	Del 58	xx	24-Jan	xx	Trade	Grocery Shop	xx	\$ 1,500	WC/Cexp	6
5	Approved	Del 107	xx	20-Jan	xx	Trade	Grocery, Drug store	xx	\$ 5,000	WC	12
6	Approved	Del 85	xx	27-Jan	xx	Prod	Sausage Production	xx	\$ 2,000	WC	8
7	Approved	Del 127	xx	27-Jan	xx	Trade	Grocery Shop	xx	\$ 2,000	WC	12
8	Approved	Del 125	xx	19-Jan	xx	Trade	Grocery Shop	xx	\$ 4,000	WC	12
9	Approved	Del 115	xx	27-Jan	xx	Trade	Mixed Shop	xx	\$ 3,000	WC	12
10	Approved	Del 126	xx	27-Jan	xx	Trade	Grocery Shop	xx	\$ 1,500	WC	12
11	Approved	Del 129	xx	27-Jan	xx	Trade	Drug Store/Glasses	xx	\$ 4,000	WC	12
12	Approved	Del 124	xx	17-Dec	xx	Trade	Drug-Store	xx	\$ 3,000	WC	12
13	Approved	Del 128	xx	10-Jan	xx	Prod	Wood Processing	xx	\$ 2,000	WC	12
14	Due Diligence	Del 142	xx	27-Jan	xx	Trade	Radio,TV Shop	xx	\$ 2,000	WC	10
15	Due Diligence	Del 136	xx	24-Jan	xx	Trade	Beauty Saloon	xx	\$ 3,000	WC, C/exp	12
16	Due Diligence	Del 140	xx	29-Jan	xx	Trade	Grocery Shop	xx	\$ 1,000	WC	5
17	Due Diligence	Del 139	xx	28-Jan	xx	Prod	Bakery	xx	\$ 6,000	WC	12
18	Due Diligence	Del 137	xx	25-Jan	xx	Prod	Sweets Producing	xx	\$ 4,000	WC	12
19	Due Diligence	Del 148	xx	27-Jan	xx	Trade	Grocery Shop	xx	\$ 1,500	WC	18
20	Due Diligence	Del 138	xx	26-Jan	xx	Trade	Grocery Shop	xx	\$ 1,500	WC	12
21	Due Diligence	Del 150	xx	27-Jan	xx	Trade	Grocery Shop	xx	\$ 2,000	WC	12
22	Due Diligence	Del 141	xx	25-Jan	xx	Trade	Grocery Shop	xx	\$ 2,000	WC	12
23	Wait for Application	Del 135	xx	20-Jan	xx	Trade	Grocery Shop	xx	\$ 3,000	WC	12
24	Wait for Application	Del 145	xx	27-Jan	xx	Prod	Grocery Shop	xx	\$ 2,500	Cap. exp.	12
25	Wait for Application	Del 144	xx	27-Jan	xx	Trade	Grocery Shop	xx	\$ 5,000	WC/Cap exp	12
26	Wait for Application	Del 143	xx	19-Jan	xx	Prod	Silk Production	xx	\$ 40,000	WC C/exp	24
27	Wait for Application	Del 146	xx	27-Jan	xx	Trade	Mixed Shop	xx	\$ 2,000	WC	12
28	Wait for Application	Del 147	xx	27-Jan	xx	Trade	Grocery Shop	xx	\$ 5,000	WC	12
29	Wait for Application	Del 149	xx	27-Jan	xx	Trade	Grocery Shop	xx	\$ 2,000	WC	6
30	Wait for Application	Del 151	xx	27-Jan	xx	Trade	Drug Store	xx	\$ 1,500	WC	24
31	Wait for Application	Del 152	xx	27-Jan	xx	Trade	Tea products sales	xx	\$ 2,000	WC	3
32	Wait for Application	Del 156	xx	27-Jan	xx	Prod	Tea processing	xx	\$ 40,000	WC/Cap exp	12
33	Wait for Application	Del 159	xx	27-Jan	xx	Prod	Tea processing	xx	\$ 20,000	WC	24
34	Wait for Application	Del 153	xx	27-Jan	xx	Trade	Grocery Shop	xx	\$ 1,500	WC	12
35	Wait for Application	Del 119	xx	9-Dec	xx	Trade	Grocery Shop	xx	\$ 2,000	WC	12
36	Wait for Application	Del 120	xx	10-Dec	xx	Prod	Bakery, Café	xx	\$ 3,000	C/exp	12
37	Wait for Application	Del 134	xx	17-Jan	xx	Prod	Bakery	xx	\$ 10,000	C/exp	12
38	Wait for Application	Del 114	xx	23-Nov	xx	Prod	Meat Processing	xx	\$ 3,000	C/exp	6

Loan deals develop at different rates given the type of business, willingness and openness of the borrower and legal process that the borrower must pursue to close the loan. Given these variations, loan officers are taught to continuously prioritize their potential clients, which allows for easy review by the credit managers.

The managers must instill the importance of time management in the loan officers so that faster moving transactions may be underwritten and disbursed more quickly and the slower ones may be moved down the priority list. With supervision from Credit Managers, Loan officers must continuously set priorities within their own pipelines and move all clients through the process in the quickest manner possible. The final priority is, of course, the client, whose number one priority is to receive the loan. Management can easily check the process and priorities of the loan officer with a pipeline report. It should constantly be updated and questions pertaining to the stage of the loan can easily be answered with a review of the pipeline report.

What other information can be obtained from the pipeline report?

Average days to approve and disburse loan, and where the process maybe improved—they can see at what stage the loan process is delayed and learn from it.

Loan Tracking Report:

This is a simple tool to help managers identify bottle necks in processes. Each of the steps is listed and dates given for the accomplished task. Then the average between the dates is taken and listed at the bottom. This tool is used for new loan officers, or, if there are problems with timing, it can be used for all loan officers.

Sample Loan Tracking Report: (Tjossem, 1999)**Number of days for DEL loans**

Project #	Client	Application Purchased	Application Submitted	Site Visit	Credit Analysis Completed	Approval	Disbursed	Total # of days
1	A	01-May-03	03-May-03	04-May-03	04-May-03	05-May-03	05-May-03	2
2	B	11-Jun-03	13-Jun-03	14-Jun-03	16-Jun-03	18-Jun-03	19-Jun-03	7
3	C	11-Jul-03	12-Jul-03	13-Jul-03	14-Jul-03	14-Jul-03	15-Jul-03	5
4	D	28-Jul-03	1-Aug-03	02-Aug-03	2-Aug-03	4-Aug-03	10-Aug-03	9
5	E	30-Jul-03		02-Aug-03	2-Aug-03	4-Aug-03	9-Aug-03	8
6	F	20-Jul-03	21-Jul-03	22-Jul-03	26-Jul-03	28-Jul-03	10-Aug-03	20
Average Days per step:		2	1	1	2	4	8.50	

Q: How do we increase productivity, but maintain quality standards?

We:

- Manage and control growth
- Are aware of limitations – the human factor
- Make necessary changes in information systems

Do you have incentive programs implemented at your organizations? Do these programs include all levels of staff or only the loan officer? How is your staff incentivized?

Credit products must be sold. The people trying to sell these products need to be motivated to produce. However, since we have just spoken about dealing with risks for the past 2 hours, the next question will be: How can we motivate for productivity while keeping the quality of the portfolio above our benchmarks? We have already determined that we must have both risk and sales goals, to insure we grow a sound portfolio. It is thought that unless there is separation of production and analysis, it makes sense to always have this mix.

With regards to the leadership, (to credit managers & their bosses) they must be incentivized to create a sales culture amongst their employees. Part of the managers' work performance indicators should be devoted to achieving a certain growth in the MFI's portfolio. But they must also be dis-incentivized for taking on too much risk. Again, we must be sales driven, and risk controlled. How do we do this?

1. Delinquency and sales growth measurements must have EQUAL weight in work performance indicators.
2. At least quarterly, the MFI should be "risk rated." And these ratings should be broadcast throughout the organization. Using PAR over 30 days, for example, we could rate each loan officer (or branch) and identify who are the biggest risk takers and more risky branches. Those considered the riskiest may simply be those which have PAR 30 above that of the organization as a whole, or above the established risk range. Our goal is to create competition based upon the control of credit risk.
3. Again, sales and risk are not exclusive, they are complementary. Sound risk management allows the organization to sell more loans.
4. The sales targets must also be reviewed. The manager should also create a marketing plan, which is reviewed quarterly.
5. Discretionary funds should be made available to managers for sales promotion within their operating areas. More discretionary funds can also be an incentive for increased production.

Staff incentive plans are a risk management tool or control (Chu)

“The fundamental principle behind incentive plans, whether it is for the staff at large or top management, is to align what is good for the individual with what is good for the institution and, by extension, the shareholders. The need for such incentive plans arises because in most organizational structures of the private sector ultimate ownership of the assets may reside in the shareholders, but day-to-day control of those assets rests in the hands of the employees that comprise management. Accordingly, absent specific and very deliberate mechanisms, there is no natural assurance that management's agenda will coincide with that of the institution or the shareholders.” If there is no alignment, the MFI is at risk of not achieving its objectives.

Really hard management decisions are not difficult because large sums of money are involved, but because they deal with people. Good incentive plans recognize that managers are not driven by economic incentives alone, especially in mission-driven institutions like MFI's. However, experience has shown that monetary compensation is often synonymous with family responsibility, and that is a powerful addition pulling on the side of institutional aims, especially when management must make the difficult decisions that leave "dead and wounded" in its wake.

With compensation and ownership working in tandem to ensure that management's agenda and the shareholders' agenda are aligned, the full power of the staff can be channeled to fulfill the institution's mission.

The table below lays out some basic principles for staff incentive schemes. Participants are encouraged to refer to *MicroSave's* toolkit, “Designing and Implementing Staff Incentive Schemes.”

Basic Principles for Staff Incentive Schemes (Chu)

In designing an incentive scheme for senior management (or any other staff member), it is important to consider the following principles:

- Key indicators in the incentive scheme must be limited to those few factors that really matter. In microfinance, portfolio size and quality are obvious choices, but for senior management institutional factors such as profitability, number of clients, and staff turnover may also be considered.
- Incentives should reward people for issues that are within their span of control and for a behavior that they can directly affect.
- Incentive systems should be simple. No more than five, and preferably fewer, variables should be selected.
- The rationale for the selected indicators should be clear for them to have legitimacy.
- The targets set must be achievable and measurable. It is no use to select a variable that everyone agrees is very important, like customer service, but no one knows how to reliably measure or for targets to be set so high that they cannot be reached.

Top management, however, is responsible for tactical and strategic issues. In deciding whether to open or close branches, to turn an NGO into a bank, or to develop new financial products, the potential for conflict between individual and institutional goals is both more prevalent and more difficult to detect as the issues become more complex. Top management incentive plans must therefore combine both current compensation (to cover the tactical or short-term impact of the function) and ownership (to take into account the strategic or long term dimensions).

Part of sales targets are reached through marketing and Loan officer's Individual Marketing Plans. Loan officers must concentrate on marketing for the following purposes:

- Loan officers are the first point of contact with the customer and create the MFI's reputation.
- The customers of a MFI should be seen and treated as its assets.
- Contented customers are willing to refer others to the MFI.

- Satisfied customers mean higher repayment rates and more deposits.

Creating the sales culture in the branch requires a sales and marketing plan, supported by the correct management incentives. Taking this one step further, “down” the branch, we can design individual marketing plans for our credit officers. Again, supported by adequate incentives and monitored on an ongoing (quarterly or bi-annual) basis.

Below is an example of a loan officer’s individual marketing plan. Some MFIs require their loan officers to complete them monthly and then meet to measure their success in meeting their plans and review which marketing strategies are working well. These plans can help the credit manager to understand how the loan officer is managing his/her own time between marketing, monitoring loans and analyzing new ones.

Loan officer's name _____ **LOAN OFFICER MARKETING PLAN**
 Branch: _____
 Today's Date: _____
 Previous Review Date: _____
 Next Review Date: _____

Responsibilities and reasons	Goal	Actual result	Planned action
1			
2			
3			
4			
5			

Management gives each loan officer a monthly target for loan disbursement based on the initial business plan and targets set by the manager. Actual accomplishments versus planned targets should be reported every month as part of the MIS report. To ensure that targets are reasonably achieved or accomplished, each loan officer prepares a work plan covering the next 14 day period for submission to his/her supervisor or manager. This work plan includes a list of new prospects to be visited during the coming 2 weeks. Then at the end of the 2 weeks the manager reviews the plan with the actual achievements of the loan officer. These marketing calls are then tracked to see which marketing methods (e.g. cold calls, town hall presentations, word of mouth, brochure distribution through shops, etc.) produce the best results ... disbursed loans.

Loan officers are mainly responsible for effectively marketing and selling the different loan products which the MFI wishes to push. Promotional materials, such as product brochures and flyers, should be provided to support the marketing efforts.

In summarizing, the reader should think about ideas to increase productivity while maintaining quality.

Some of the ideas should include:

- Ensure that the staff is accountable for its activities.
- Efficiency management – focus on managing and reducing costs where possible.

- Larger loan sizes if necessary to meet demands of the clients. (Must first determine demand and if the clients can handle larger loans.)
- Each MFI should have an optimal number of clients per loan officer. (Based on the methodology and average loan terms.)
- Increase the number of clients per loan officer in order to improve an MFI's efficiency and productivity.
- Develop Management Information Systems – Loan officers must know on a daily basis if there are any delinquent loans.

Loan officer Targets:

Management should set out specific job descriptions with marketing and loan targets for loan officers. The targets which would be included in the initial hire agreement or in the annual evaluation would depend on the loan officer's experience and MFIs targets and methodology. They would include how s/he is to build his/her portfolio to a certain level and over what time period.

Sample of loan production expected for new loan officers:

Month	1	2	3	4	5	6	7	8	9	10	11	12
Loans per Loan officer	Training	Shadow senior loan officer	4	8	12	12	12	12	12	12	12	12
Cumulative loans outstanding			4	12	24	36	48	60	72	84	96	108
average loan term (months)			12	12	12	12	12	12	12	12	12	12
Average loan size (US\$)			4,000	4,000	4,000	4,000	4,000	4,000	4,000	4,000	4,000	4,000
Total Portfolio Outstanding (US\$)			16,000	48,000	96,000	144,000	192,000	240,000	288,000	336,000	384,000	432,000

Q: What is Exception Reporting?

Exception reporting is a report philosophy and approach that *supports management by exception*. Exception Reports are designed to display significant deviations from the norm, or exceptions, in results and data. The idea is to flag important information and bring it quickly to the attention of managerial users of the report. Exception reporting can be implemented in any type of reporting.

For example, a loan officer has a client who s/he wants to bring to credit committee, but the client does not fit one of the eligibility criteria (e.g. does not have the right combination of collateral). The loan officer would flag this as an exception by telling the credit committee the situation and asking this exception to be waived based on certain mitigating factors. The loan officer should not hide the exception (or any risk for that matter), but bring it to the attention of management and ask them to evaluate the situation. If the loan officer does not bring the exception (or risk) to light, later there may be problems.

In management reporting, examples of exceptions reports include:

- Daily list of payments expected but not made
- New Loans over a specified limit
- Rescheduled loans

In performance reporting, an example of an exception report might include a list of loan officers performing below targets.

Red Flags:

- ☞ Managers cannot make sound decisions unless they have adequate information about the situation.
- ☞ Managing information at an MFI is critical to keeping risk levels low.
- ☞ Each employee must know what s/he is responsible for and to whom to report.
- ☞ To maintain quality, while producing high numbers of loans, management must ensure that staff is accountable for its activities.
- ☞ Incentive programs need to be monitored closely to keep the quality of the portfolio high.
- ☞ Growth must be in check to risk levels.

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Final Exercise

Action Plan Format

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(**Note:** also refer to Individual Lending Credit Officer Toolkit for other references)

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www.MicroSave.org: *MicroSave* Toolkits available for downloading from website:

1. Corporate Brand and Identity
1. Costing and Pricing of Financial Services
2. Customer Service
3. Designing and Implementing Staff Incentive Schemes
4. Institutional Culture Change
5. Market Research for MicroFinance
6. Planning, Conducting and Monitoring Pilot-Tests for MFIs - Savings/Loans
7. Process Mapping
8. Institutional and Product Risk Analysis
9. Product Marketing Strategy
10. Product Roll-out
11. Strategic Marketing for MicroFinance Institutions
12. Loan Portfolio Audit
13. CGAP ABC Costing
14. Human Resource Management

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