Fact Sheet 6

Work-Out Strategies for Delinquent Loans

Every loan officer will eventually face the challenge of managing a loan in serious trouble. The key to successful handling of this situation lies in swift and decisive action from the loan officer and the lending institution.

"Work-out" is a term used by microfinance practitioners to describe the steps taken to minimize or prevent financial loss to the institution when a loan is undeniably in trouble. Successful MFIs make work-out a top management priority. A loan officer must feel confident that by immediately reporting a delinquency in his portfolio, he engages a support system designed to get the situation back on track as quickly as possible.

WORK-OUT TECHNIQUES

Stage One -- "What's Going on with This Loan?"

No two problem loans are exactly alike; therefore work-out must be flexible and dynamic process. In the earliest stages of work-out, the loan officer and a management representative analyze information specific to the loan, including causal factors, extenuating circumstances and legal ramifications. Once these elements of the equation have been examined, a customized action plan is created.

The loan officer must be prepared to answer the following questions for management.

What is the nature of the problem? (missed payment, borrower failed to show up for monitoring appointment, inventory theft, fire, serious illness)

Are the loan documents and monitoring records in order and ready for review?

How is the borrower's relationship with the loan officer at present? (cooperative, hostile?)

What are the status and location of the loan collateral and/or loan guarantors?

Has the loan been graded appropriately using the Credit Risk Grading System? (see Fact Sheet 5)

Gathering this key information prior to the first meeting will facilitate the rapid development of an action plan. Just as no two problem loans are alike, action plans will vary in accordance with the nature and the severity of the problem. The direct involvement of an experienced management representative is required to map out an appropriate course of action.

Stage Two - Communicating with the Borrower

Implementation of an action plan for a troubled loan begins with opening a frank dialogue with the borrower. The borrower must understand that the MFI considers the loan to be in trouble, and that it is prepared to initiate steps to protect its investment. At the same time, it is not usually helpful to intimidate or alienate the borrower. The borrower's cooperation will greatly improve chances for a successful work-out.

Here are a few illustrative questions that should be answered at the first work-out meeting with the borrower.

What is the borrower's explanation for the status of the loan?

What is the borrower's current cash flow situation?

What steps has the borrower taken to correct the problem?

When does the borrower anticipate that payments will resume?

Does the borrower understand that failure to repay the loan will result in the loss of credibility and will negatively affect his ability to borrow in the future?

An important factor to remember is that the lender must establish control of the situation immediately. The borrower cannot be permitted to dictate the course of action at this point. This is the responsibility of the lender. In many instances, the lender's rapid and well-prepared response, using the steps laid out in Stages 1 and 2 above, can successfully resolve a delinquency. But what if it doesn't? At this point, the MFI is faced with a potential financial loss, and more serious action is required.

Stage Three - "Non-Accrual and Write-Off"

Moving the Loan to "Non-Accrual" Status

When recovery of the loan principal is doubtful, loans are considered to be in "non-accrual" status. Non-accrual means that the loan principal is no longer considered to be an asset of the MFI. At this stage, the work-out team may consider various incentives may be employed to encourage eventual repayment, including restructuring of the loan terms or a rebate of interest paid. These strategies are often only marginally successful, and should only be implemented under the guidance and with the approval of management.

Engage Participation of Loan Guarantors

In Stage 3, the loan's guarantors must be called in to assist in collection efforts. In community-based microlending, peer pressure is a highly effective tool. Many borrowers consider loss of reputation more important than the loss of collateral. For this reason, loan officers should not hesitate to engage the participation of the loan's guarantors when a loan payment is delinquent