Habitat for Humanity®

Terwilliger Center for Innovation in Shelter

mastercard foundation

Delinquency Management Technical Brief

Introduction

The Building Assets, Unlocking Access project has seen substantial growth of the housing microfinance loan portfolio, both in number of loans and value. Collectively, the financial institutions participating in the project have advanced over 47,000 loans to low-income households, cumulatively valued at US$43million and impacting over 237,000 people. The demand for housing products remains strong in both Kenya and Uganda. (December 2017)

The first year of institutional technical assistance offered to each of the financial institutions in Kenya and Uganda focused on developing the housing microfinance products. This was followed by implementation of the pilot, during which Habitat's Terwilliger Center for Innovation in Shelter monitored the product uptake to help develop promotional strategies, trained loan officers to sell the product, and closely followed the product's overall operational performance. The goal was to identify which variables – both external and internal – were supporting or hindering the potential expansion of the product before it was rolled out. Once the product was rolled out, the Terwilliger Center customized its support to handle key, pressing issues the

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Why did we design and implement a training on loan delinquency management to help reduce the PAR?

A microfinance institution's biggest and most important asset is its loan portfolio. Keeping the portfolio healthy is essential to reaching and maintaining profitability. A good indicator of portfolio quality is "portfolio at risk," or PAR. It shows the portion of the portfolio that is "contaminated" by arrears and therefore at risk of not being repaid. In the case of housing microfinance portfolios, recent research conducted by Habitat's Terwilliger Center has revealed that the PAR over 30 days, or PAR30, and write-off ratios of housing microfinance products are usually lower than those of the general portfolio. [1]

Definition of key terms

Delinquency is a deviation from the expected behavior, and in the case of loans, it starts when the loan amount due is not settled in full or the loan is not serviced per the terms of the contract and when due. It is a direct measure of risk exposure for the lender.

Portfolio at risk is the value of all loans outstanding that have one or more installments of principal past due more than a certain number of days. This item includes the entire unpaid principal balance, including both past-due and future installments, but not accrued interest. It also does not include loans that have been restructured or rescheduled.

At the end of 2016, the Terwilliger Center team and a financial institution we will refer to here as "MFI1, noticed a decline in the housing microfinance portfolio quality revealed by the growing PAR, which went from 2.9 percent in early calendar year 2016 to 11 percent during the first quarter of CY2017." An increase in the PAR was identified at the other financial institutions of the project around the same period, which was the first indicator that some macro-

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financial institutions may face as they continue to expand the products.

In 2016, the financial institution we will here refer to as "MFI1" saw a significant increase in the portfolio at risk, or PAR, of the housing microfinance portfolio, from 2.9 percent to 11 percent – an alarming rise. Through analysis, the general factors that could have contributed to the rise in the PAR were identified as macroeconomic factors such as prolonged drought and political uncertainty, coupled with institutional factors and, based on discussions with the institution, loan diversion.

The rapidly rising delinquency of the housing microfinance portfolio of MFI1 was especially alarming, as it could jeopardize the overall sustainability of the institution and affect its ability to continue to offer the housing microfinance loan product. To stem this rise in PAR, a focused delinquency management training was designed and implemented by Habitat's Terwilliger Center to support MFI1. In addition, as a preventive measure, the training is being provided to the other financial institutions of the project regardless of their current portfolio performance. As a result of the training and advisory support from the Terwilliger Center team, the management at MFI1 recognized the need for ongoing internal training and change management as keys to managing delinquency. The following sections of this technical brief will dig deeper into why the training was implemented, what was included in it, and the impact of this support on MFI1 and its housing microfinance portfolio.

economic factors were impacting the microfinance sector at large. Some of the larger macroeconomic factors that could have contributed to this rise in delinquency are:

- A general rise of nonperforming loans in the industry, mainly resulting from a prolonged drought that affected the entire products range. In the case of MFI1, the small and medium enterprise, or SME, portfolio, which accounted for 5 percent of the overall portfolio, was also experiencing an increased and significant PAR of about 38.81 percent against 4.9 percent of housing microfinance loans at the end of December 2016.
- The drought also meant diminishing disposable incomes for the customer, which compelled them to take smaller loans for immediate consumption needs, rather than focusing on longer-term products like housing loans that require monthly repayments.
- Uncertainty in the political environment also contributed to a volatile economic situation, which affects the earning potential for entrepreneurs.

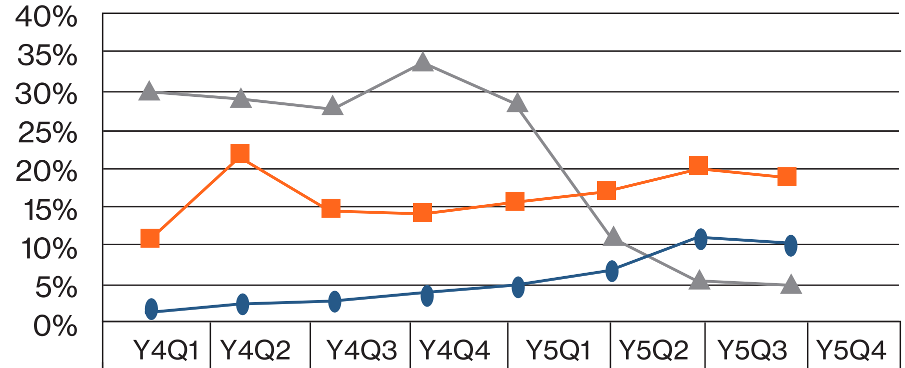
Further analysis at MFI1 showed that the increase in PAR was much faster and more significant. An internal review with the support of Habitat's Terwilliger Center team highlighted some institutional factors that may have contributed to the rising PAR. These include:

- The alarming increase in PAR of the SME loans led MFI1 to focus more resources and staff time to follow and recover delinquent SME loans, which in turn reduced the focus on monitoring the housing microfinance loans, which were at an early stage and required close monitoring.
- In addition, clients had several concurrent loans, which could have surpassed their affordability levels, consequently impeding their repayment of all the loans.
- During product design, the loan term of the housing microfinance loan was kept similar to that of other loan products, which was not appropriate in the case of housing microfinance loans that usually have larger sizes and, consequently, require larger tenors to be repaid, especially in comparison with working capital loans. The shorter tenor resulted in larger installments for the clients.
- Inappropriate due diligence and loan assessment by loan officers, evidencing their lack of technical expertise to evaluate the cost estimates according to the type of home improvements and their urgency to meet outreach goals.

A closer examination of the overall portfolio of MFI1 revealed that the PAR30 had been steadily growing for the past two years, which had a direct impact on the financial returns of the housing microfinance product in the form of loss in interest income and increased collection costs. Figure 1 shows the trend of how the overall growing PAR of MFI1 contributed to the decline in the housing microfinance portfolio's yield, which started out at a healthy 30 percent in the first quarter of year four but was down to less than 5 percent in December 2017.

The decline in the portfolio yield had to be looked at closely because it could directly impact MFI1's ability to offer new loans and reach new housing microfinance clients. If the trend continued, it could affect other parts of the portfolio, as the institution might have to tap into other revenue sources to make up the shortfall.

Figure 1: Impact of increasing delinquency



	Y4Q1	Y4Q2	Y4Q3	Y4Q4	Y5Q1	Y5Q2	Y5Q3	Y5Q4
HMF product PAR	1.31%	2.30%	2.9%	3.66%	4.90%	7.00%	1.00%	0.12%
Institution PAR	10.40%	22.00%	14.40%	14.12%	15.52%	17.00%	20.00%	18.70%
HMF yield	30.00%	29.00%	28.30%	24.02%	28.74%	1.00%	5.33%	5.06%

What was the focus of the support provided by Habitat's Terwilliger Center to help MFI1 manage the PAR?

It is impossible to keep delinquency at zero, but institutions can implement strategies that will address some of the causes of delinquency. To address the rising delinquency at MFI1, the Terwilliger Center team supported the development of a focused curriculum and the delivery of training on loan delinquency and risk management for MFI1's staff in March and April 2017. The goal of the training was to allow MFI1's field staff, including managers and loan officers, to review the performance of the housing microfinance loan portfolio, understand the trends in declining portfolio quality, and examine the causes of this decline. The training was designed with specific objectives, with the expectation that at the end of the training, the staff would be able to:

- *Describe housing microfinance and its related benefits to both clients and the institution.*
- *Internalize the performance of the MFI1 housing microfinance loan portfolio.*
- *Define loan delinquency by industry best practices.*
- *Analyze the causes of loan delinquency within their respective financial institutions.*
- *Appreciate, analyze and internalize the implications of the costs of delinquency to a financial institution.*
- *Describe the controls and the measures of loan delinquency available to a financial institution like those represented at the MFI1 training.*
- *Identify and analyze the delinquency management options, related challenges and legal implications.*

Although the topics in the training were not much different from the ones covered for managing the delinquency of any microfinance product, the content was tailored to focus on the housing microfinance product and the possible reasons of housing microfinance loan delinquency at MFI1. The training started with an overview of the purpose of housing microfinance, followed by how low-income clients use housing microfinance loans; the differences among mortgage loans, microenterprise loans and housing microfinance loans and the implications of these differences regarding product design, marketing and promotional strategies; loan assessment, which includes the analysis of the type of home improvement vs. the affordability levels of the client; and monitoring product performance to prevent delinquency. The box on the next page includes a full list of the topics covered during the training.

Outline of the loan delinquency management training curriculum

- Introduction to housing microfinance
    - o What is the difference between housing microfinance and formal mortgages?
    - o What is the difference between housing microfinance and microenterprise credit?
    - o What benefits does housing microfinance provide to clients and financial institutions?
    - o How do low-income populations build?
- Overview of MFI1's housing microfinance loan product
    - o What are the benefits and key features of the MFI1 housing microfinance product?
    - o What are the different lending options for housing microfinance, and which was chosen for MFI1's loan product?
- Housing microfinance loan product credit cycle
    - o Describe the housing microfinance credit cycle: prospecting, origination and follow-up.
    - o Identify the risks associated with each of the three steps in the credit cycle.
    - o Define the mitigating strategies on how to manage each of the identified risks.
- Housing microfinance loan product performance
    - o Understand how to monitor housing microfinance loan product performance in terms of sales, client retention, new customers and any increase in demand for loans.
    - o Measure client satisfaction.
- Housing microfinance loan product delinquency management
    - o Define delinquency in the context of housing microfinance loans.
    - o Analyze the causes of loan delinquency for the housing microfinance loan product at MFI1.
    - o Understand the costs and implication of delinquency on MFI1's financial performance and on the housing microfinance clients.

The training sessions were highly interactive, promoting the active engagement and participation of MFI1's staff. The training was attended by 101 staff members of MFI1, including loan officers, deposit-taking managers, branch managers and regional managers. The post-training evaluation results were very positive, and 90 percent of the participants indicated that the training was useful and that they hoped it will help reduce the portfolio at risk. At the end of the training, the participants developed individual action plans outlining short-, medium- and long-term strategies that could be implemented to reduce delinquency and improve portfolio quality at each functional level. The training focused on identifying preventive strategies, rather than managing loan delinquency.

Participant feedback on the training

"Training helps me understanding delinquency management and how to control."

"The trainers were highly qualified, equipped and possessed high levels of subject knowledge."

"Training is relevant to the daily challenges."

"I know now how to manage and control delinquency."

"The trainers were practical and could elaborate and go to the ground level."

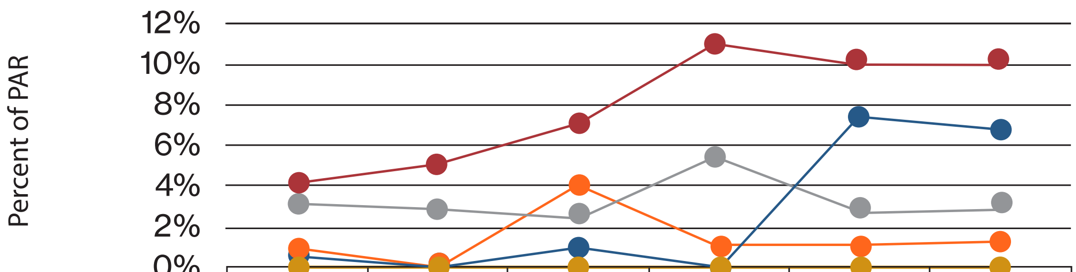
What has been the impact of the training in reducing the PAR of the housing microfinance portfolio?

Discussions during the training revealed that MFI1's field staff was spending over 70 percent of their time managing the existing portfolio, which included the SME portfolio that had a significant PAR, and spending less than one week per month trying to market and promote the housing microfinance loan. The initial benefit of the training has been to balance the goals of loan officers so that they dedicate a percentage of their time to client outreach and monitoring of loan use. The long-term effect was that outreach reduced the PAR30.

The discussions at the training also highlighted that the causes of the housing microfinance loan delinquency were largely internal, and therefore within MFI1's control. The unit managers, who have on average eight years of experience in the microfinance industry, were able to identify themselves as the primary controllers of the portfolio at risk within their respective operational areas, and they have started to implement measures to support their loan officers in assessing and promoting housing microfinance products.

Since the first round of delinquency management training, the housing microfinance PAR30 has decreased slightly in MFI1, from 11 percent in the third quarter of year five to 10.12 percent in the fourth quarter (See Figure 1). Other microfinance institutions have seen a faster decrease of PAR, as seen in Figure 2. Although it is too early to see the full effects of the training or to fully attribute the small decrease at MFI1 – or the decrease at the other financial institutions – to the training efforts, it could be one contributing factor.

Figure 2: Trend in housing microfinance percentage of PAR30 per institution



	Y4Q4	Y5Q1	Y5Q2	Y5Q3	Y5Q4	Y6Q1
MFI1	3.66%	4.90%	7.00%	11.00%	10.12%	10.16%
MFI2	3.00%	2.60%	2.55%	7.37%	2.89%	3.02%
MFI3	1.00%	0.20%	3.80%	0.90%	0.80%	1.10%
MFI4	0.41%	0.30%	0.90%	0.00%	7.54%	6.65%
MFI5	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

The change management efforts resulting from the delinquency management process at MFI1 have led to the reallocation of all staff members concentrating on SME debt collection back to housing microfinance. Based on some internal reviews, the leadership realized that the reallocation of staff members to focusing on the recovery of delinquent SME loans might have contributed significantly to the deteriorating housing portfolio.

The table below summarizes specific delinquency management strategies that have been identified for MFI1 and are being implemented.

To ensure consistency across MFI1 as it implements its delinquency management measures, the Terwilliger Center team has worked with MFI1's leadership to create delinquency management manuals for the institutions' credit officers. These quick reference guides focus on loan appraisal processes, the collection process and timing, the capacity of the staff to sell and collect over busy periods, trends on how clients pay, and the impact of delinquency on the institution, along with strategies to prevent delinquency. Using this manual, the project is conducting training of trainers on delinquency management within MFI1 with the goal of systematically addressing the delinquency challenges.

Policies and procedures	Management and staff	Product and client
• A clear written definition of delinquency, how it is measured, and what level is acceptable to your institution, e.g., PAR30 less than 5 percent. • State how you make provisions for loan loss (per Central Bank regulations), and when you should write off a bad loan. • Indicate the extreme cases in which you may consider rescheduling a loan. • Make sure you have policies on what incentives you will provide to staff members who perform well. These should regularly be paid to reinforce good performance, e.g., monthly. • Have clear procedures for loan appraisal and eligibility that in the case of housing microfinance include an understanding of the type of home improvement and the estimated costs vs. the affordability levels of the client. • Specify the steps you will take as soon as a loan becomes late, and when to follow up.	• Ensure that everyone knows the policies and is made aware of changes. • Monitor portfolio quality (using PAR and aged arrears) at least monthly and report to the board and the staff. • Track delinquent loans in a separate register. Hold weekly meetings to review and address issues. • Ensure that the management information system provides reliable, accurate and timely data. Prepare separate reports for different levels of use, e.g., board of directors, management, credit staff. • Establish internal controls and an internal audit function to ensure that all policies and procedures are followed. This is critical!	• Ensure your loan size, terms, delivery and repayment mechanisms are based on clients' stated needs vs. their affordability levels, but also conduct periodic client satisfaction surveys to make sure their preferences are considered. • Ensure that there are incentives for clients to pay on time and disincentives to pay late or divert the loan. • Ensure that clients fully understand their obligations and the consequences of repaying late or diverting the loan. • Strive to ensure clients are satisfied by regularly monitoring client satisfaction and dropout rates (and reasons). • Ensure the staff is trained on how to interact with clients and negotiate timely repayment. Always be firm but fair in dealing with delinquent clients.

What are the lessons of this process for the financial institutions?

The conversations with staff members during the training identified specific causes for loan delinquency, along with potential solutions to address it. While a lot of the causes and challenges are the same as those experienced with any microfinance product, some related specifically to housing microfinance products are:

- **The credit assessment process:** Housing microfinance credit assessments calculate repayment based on the borrower's current income, unlike a microenterprise loan, which accounts for future income that will be generated from a business.
- **Fund diversion:** Money is fungible, and if clients are having cash flow issues, they might use the housing microfinance loan funds for other immediate needs. To ensure this doesn't happen, the loan disbursement and monitoring process should include regular follow-ups from MFI1's staff to check on loan use, which in the case of housing microfinance should happen within the first month of loan disbursement.
- **Product education:** As the housing microfinance product is new for both the clients and the staff, it is important to provide periodic refresher trainings to staff members on the purpose of the loan, how to market it, and loan processing, in addition to the full suite of nonfinancial housing support services that can help clients invest the loan appropriately.
- **Delinquency training as part of product rollout:** It is better to include the delinquency training as part of product rollout to ensure that the staff has the tools to prevent delinquency.
- **Using best performers to incentivize high performance:** Having staff members with low-PAR portfolios share practical experience with their colleagues and model the marketing, promotion and loan assessment are good measures to help reduce credit risk.
- **Making managing delinquency an organizational practice:** Managing delinquency is not a one-time activity. Financial institutions need to invest in a change management process to maintain a focused delinquency management culture within the institution.

End notes

[1] Prieto, S., and Simmons, E. *The 2016-17 State of Housing Microfinance: Understanding the Business Case of Housing Microfinance*, page 36, published by Habitat for Humanity International's Terwilliger Center for Innovation in Shelter, 2017.

The Building Assets, Unlocking Access project is implemented by Habitat for Humanity International's Terwilliger Center for Innovation in Shelter in partnership with the Mastercard Foundation to develop housing microfinance products and non-financial support services for people living on US$5 to $10 per day. The aim is to enable these people to secure adequate and affordable housing and improve their living conditions.

To learn more about the partnership between Habitat for Humanity's Terwilliger Center and the Mastercard Foundation, and about the lessons emerging from the Building Assets, Unlocking Access project, visit

habitat.org/impact/our-work/terwilliger-center-innovation-in-sheltershelter-solutions-for-people-in-sub-saharan-africa.

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