



# What Happens to Microfinance Clients who Default?

An Exploratory Study of Microfinance Practices

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Keeping clients first  
in microfinance

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## Acronyms

<b>AMFIU</b>	Association of Microfinance Institutions of Uganda
<b>ASPEC</b>	Asociacion Peruana de Consumidores y Usuarios
<b>BOU</b>	Bank of Uganda
<b>MFIN</b>	Microfinance Institutions Network
<b>NABARD</b>	National Bank for Agriculture and Rural Development
<b>NBFC</b>	Non-Bank Financial Companies
<b>PAR</b>	Portfolio-at-Risk
<b>RBI</b>	Reserve Bank India
<b>SHG</b>	Self-Help Group
<b>SBS</b>	Superintendencia de Banca, Seguros y AFP

# Preface

At the Smart Campaign, a global campaign to embed a set of client protection principles into the fabric of the microfinance industry, we recognized a need for an industry-wide conversation about what happens to clients who default. To provide a basis for that conversation, we went looking at how default unfolds in three very different, but hopefully representative countries—Peru, India, and Uganda.

Default is particularly challenging because it pits the lender's need for institutional survival against the difficult circumstances of the defaulting customer. As a microfinance lender, how would you think about a customer who stops repaying?

- As a potential threat to the institution's financial health?
- As someone to penalize to set an example, so other customers will know you are serious?
- As someone who is taking advantage of good borrowers who pay on time?
- As someone with many excuses, not all believable?
- Or, as a case to turn over to a collections agency and never worry about again?

These are often the ways lenders characterize non-paying clients as they dispatch collections officers to do whatever they can to get the money back. Lenders with conscience find this part of the business unsettling, but unavoidable.

Many a lender who started out softhearted soon realized that having flexible, or 'soft' strategies led to rising risk. The loss of any single loan is a small threat, but many defaults

can destroy the business. When word gets out that a lender is lenient, mass default can infect the whole market. We've all seen it happen.

The defaulter's perspective may be completely different. Most serious defaulters are in financial distress and often in the midst of other life crises. A sick child, spouse, or parent needs expensive medical treatment. Another borrower's entire crop was lost due to drought. Another elderly borrower was robbed of her goods while exiting from a two-hour bus ride to the market.

Defaulting customers are already likely to be full of anxiety because their lives are not working as planned. The consequence of non-payment may be only one among many major concerns. Jessica Schicks interviewed borrowers in Ghana who reported that they often make sacrifices they consider "unacceptable" in order to stay current on their loans.<sup>1</sup> They skip meals, sell possessions, or take their children out of school to save on school fees. These sacrifices happen on the way to default, so it is safe to presume that most defaulters have already applied similar patch-work remedies. And as they struggle to remain current on their debts, say by taking another loan, the chains may only get tighter. Ordinary people in bad situations are not liars and cheats—at least not until pushed by crisis into desperate measures. Clients like these need help and compassion.

All these issues were on our collective radars when our researchers went to Peru, India, and Uganda and talked with managers and staff from microfinance institutions.

What we found was a very striking insight, which in retrospect should have

<sup>1</sup> Jessica Schicks, *Overindebtedness of Microborrowers in Ghana* (Washington DC: Center for Financial Inclusion, 2011).

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been expected: The quality of treatment clients receive during collections depends somewhat on the good practices of individual financial institutions, but it depends even more on the local environment. Humane collections can happen when a country has three things: good regulators, a credit bureau that works well, and a culture that upholds fulfillment of debt obligations. When these features are weak or one or another is missing, lenders are pushed by the demands of the market (such as the need to avoid being the last in line to collect) into harsh practices. The collections environment begins to resemble a Hobbesian jungle.

And Hobbesian is a good description of what we found in Uganda. Borrowers who can't pay often run away to the next town or change their name. They get away with it because there are no government IDs or credit bureaus to help lenders find them. Fearing such flight, lenders jump on the first late payment—even on the same day. Many bypass due process. Enforcement is unlikely—perhaps they paid off the magistrate—and so they swoop in to seize collateral. They sell household furniture on the side of the road, or stash it in overflowing *godowns* (warehouses). Defaulters often have several creditors, so lenders know that if they are too slow, another lender may get there first. Fearing harsh tactics, borrowers flee when they realize they can't pay, and so the cycle escalates. No effective consumer protection enforcement constrains the spiral. In fact, the country's Constitution and supporting summary debt collection legislation heighten the atmosphere of fear. In Uganda, defaulting debtors can be put in jail—and we found that this is not uncommon.

India is not quite so dire, but also has the potential for very harsh treatment, often involving social shame. Most microloans in India are group loans in rural villages. They feature weekly group meetings with the loan officer where group members sit watching the money-counting while children run in and out and neighbors hang about the doorways straining to listen. Debts not paid become matters of public knowledge. What's more, lenders rely on groups to enforce repayment during the first few weeks of delinquency. With group and possibly the village's access to credit

jeopardized by a single defaulter, it's not hard to imagine the severe pressure groups can inflict on their members. The social humiliation can be intense, and according to interviews with borrowers in other settings, the loss of face can sometimes affect a person for years.

In Peru the picture is dramatically better. Peru has competent regulators with enforcement powers and sensible rules. Lenders can no longer publicize debtors by painting red marks or words on the sides of houses as they once did. Collection proceeds privately, often starting with a simple reminder by phone or text. Peru's credit bureau has complete and up-to-date records. Borrowers know that lenders see their defaults on their credit reports, so they carefully preserve their good name. Lenders know that borrowers know, which gives them confidence that few people default willfully. When they trust that borrowers will repay if at all possible, lenders don't need such harsh tactics. They give people a few extra days. They negotiate settlements. By giving borrowers a stake in their personal credit histories, the Peruvian credit bureaus may be the heroes of this story. They enable lenders to be more humane.

The Smart Campaign champions a humane approach to debt collection. The elements of a humane approach seem intuitive: Do not shame or humiliate people. Speak to them privately and with respect. Do not deprive them of their basic survival needs or tools of work. Be flexible if you can. And help defaulters to rehabilitate themselves over time.

But, these standards are easier to advocate for than to apply. Our colleagues in the microfinance industry could start by remembering that defaulting customers are also people facing very difficult circumstances who probably need several kinds of help. Findings and recommendations in this paper suggest some specific ways practices can be strengthened. But to create a setting in which the system as a whole encourages them to treat clients humanely, lenders will have to work together with each other, with their own investors, and with governments to put effective regulation and credit bureaus in place.

**Elisabeth Rhyne**

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# Introduction

This study was launched to explore how microfinance institutions (MFIs) treat microfinance clients who are unable to repay their loans. It was motivated by a dearth of information on the client-facing actions MFIs take when a borrower moves into default.

Despite the microfinance industry's progress on prioritizing client protection, there is a surprising lack of shared information on what happens when the contractual relationship breaks down between the lender and the borrower. While there are many studies on the causes of over-indebtedness, there are far fewer on the consequences. A multitude of decisions occur between the time when the MFI first observes a delinquency and when it makes the determination that the lender-borrower relationship is irreparably broken and terminates contact with the client.

The Smart Campaign wanted to understand the client-facing decisions made by a provider throughout the default process, the drivers behind them, and the implications for client protection. Do MFIs offer flexible repayment terms like restructuring or loan forgiveness? Do they continue collecting after write-off? What procedures are taken when collateral must be seized? Given the potential for client harm during the default period, we at the Smart Campaign felt compelled to learn more.

This study looks closely at MFI practices in three focus countries with diverse legal systems, market conduct regulators, credit bureaus, and local actors. The research team dug deeply into three very different markets in order to challenge the notion that MFI responses to default are universal or standard.

This analysis attempts to understand the practices, and whether and how they are influenced by the market context, regulation, or incentives which influence MFIs.

The timing of the study coincides with an increased awareness of client protection as fundamental to microfinance. During the early years of microfinance, providers did not openly discuss sensitive internal practices like collections or what happened to clients who defaulted. Now, there is more willingness to discuss default management, due in large measure to the emergence of industry codes of conduct, various high profile repayment crises, and the MFIs' real desire to learn how their peers are handling the issue. Nonetheless, the research team is deeply grateful to the participants in this survey for their openness to discussing their practices, and their trust in us to preserve their anonymity.

## **What Are the Responsibilities of MFIs?**

The intent of this study is to inspire MFIs to reconsider their treatment of clients in default, and specifically to define acceptable parameters for humane treatment of clients during the default process. Clients who are facing default may very well be in the most precarious financial position of their lives, which is often accompanied by an equally fragile mental state. Therefore, the obligation falls squarely on MFIs to handle these clients with care.

We appreciate that handling clients with care may be very difficult in practice, and of course we affirm the need for MFIs to have the ability to collect. In order to remain viable and sustainable, MFIs must keep PAR in check.

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However, if MFIs do not handle delinquent clients with care, they may risk losing a client. And, if many delinquent clients are lost, that is not a sustainable business practice either. Thus, the purpose of collections is to preserve the client relationship (if at all possible).

When a loan falls into arrears, a fairly standard set of management procedures come into play. Overdue loans are categorized and managed according to the age of arrears. Depending on local regulation and institutional policy, the institution takes steps for partial and full provisioning, and finally writes off the loan.

Yet, within a fairly general set of procedures, there is a lack of information on MFI practices or behavior towards defaulted clients during the process. While the Smart Campaign's Client Protection Principles provide some basic touchstones for appropriate practices around default, there is no set of comprehensive guidelines on how to treat clients during each stage of the process.

In examining default, the Smart Campaign's main focus is on the principle Fair and Respectful Treatment, under which most of the Campaign's guidance regarding collections falls. However, other principles are certainly relevant; including *Transparency*, *Privacy of Client Data*, and *Mechanisms for Complaint Resolution*. Further, defaults, especially if a significant number of clients are involved may result from MFI failure to adhere to the principle, *Prevention of Over-Indebtedness* prior to making the loan.

The possibility that MFI over-lending may contribute to default raises this question: Do MFIs have an implicit responsibility to assist over-indebted clients who can no longer repay? And, should MFIs with a social mission be held to a higher behavioral standard than purely commercial financial institutions when clients become over indebted? In this study we examine whether MFIs have assistive methods in place such as refinancing, rescheduling, forgiveness, or debt counseling. The study also asks whether measures are taken to protect clients' privacy, given the potential for humiliation and social damage that could be associated with publicity about default.

Information regarding the MFI's default management policies should be provided to

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**“It must be recognized that poor people live on the edge of disaster and frequently fall into it.”**

Excerpt from credit manual of an Indian microfinance institution

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**“Conserving the client relationship is the purpose of collections.”**

Peruvian credit collections officer

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the client at the beginning of the relationship (e.g., fines, credit bureau notification of a late payment, collateral seizure, etc.). If a client is aware that should he fail to pay a loan, his land is subject to seizure and sale, he might reconsider taking the loan. Finally, during the sensitive period of a client delinquency or default, clients must still be treated fairly and with respect. As other researchers have noted, an overly harsh response to a client's failure to repay can actually worsen the situation versus aid in collections.<sup>2</sup>

The Smart Campaign is in a position to provide a useful framework for acceptable default management conduct. This study contributes to a public discussion regarding default management practices and policies, seeking greater international consensus about what constitute *fair and respectful treatment*. While conclusions from this work are relevant for MFIs, there are perhaps more implications for market and regulatory level actors and consumer advocacy organizations.

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<sup>2</sup> Schick and Rosenberg state, “Once borrowers get into [repayment] trouble, over-aggressive collection practices can worsen their problem,” in J. Schick and R. Rosenberg, “Too Much Microcredit? A Survey of the Evidence on Over-Indebtedness?” Occasional Paper 19. CGAP, September 2011.

# 1

## Research Methods

The research was developed in discussion with the Smart Campaign’s Client Voice Task Force, a group of microfinance industry professionals convened to find ways to bring client views and perspectives into the Campaign. The study began with initial desk research on default management, followed by an informal web-based poll of Smart Campaign—endorser MFIs on default management practices. More than 300 practitioners responded, signaling a healthy interest in the topic, as well as a desire to learn good practices (see Annex 1 for a summary of results). The survey helped identify topics and countries for the next phase of the project, in-country research in three countries, each from a different region: Peru, India, and Uganda. These countries were selected first to provide diversity, but also because of the availability of MFIs and actors willing to engage with the researchers.

Prior to each country visit, we also reviewed the legal and regulatory framework related to consumer protection, financial services market conduct, and insolvency or bankruptcy legislation. In addition, we conducted interviews with researchers and professionals working in the targeted markets to better understand the country context.

A detailed questionnaire was developed for interviews during the country visits (see Annex 2). In-country interviews were conducted between November 2013 and March 2014. In total the research team interviewed 44 MFIs as well as numerous regulators, credit bureau, microfinance associations, consumer advocacy organizations, sector consultants, and debt collection companies. We tried to include an array of MFIs, from small and new

NGOs to large banks with hundreds of thousands of microfinance clients. Of course, we could only interview those MFIs that agreed to participate and talk candidly about their policies and practices. Although many people cooperated, quite a few MFIs we were interested in did not want to speak with us.

MFI interviews were triangulated, with third parties such as researchers, consumer organizations, regulators, credit bureaus, debt-collections agencies, and in some cases ex-employees of MFIs in order to have as many perspectives as possible. In this regard we found the credit bureaus especially accommodating, well prepared with data, and helpful in understanding local context. This research is MFI-focused with the objective of understanding the common client-facing *practices* of institutions; it is also exploratory. Therefore the research team did not investigate the consequences or outcomes of MFI practices on clients. We sincerely hope that this project will contribute to an industry dialogue that leads to additional demand-side research to understand the consequences on clients of default.

There are several limitations in the approach of this study. In particular, the self-selection of MFIs willing to speak with the research team probably led to a sample bias towards MFIs with better practices than the average. Further, the research lacked field-based verification of MFI practices. Nevertheless, when the research team was able to talk to field staff or MFI clients, results were always illuminating and sometimes quite unexpected.

We spoke primarily with management at most MFIs. Though we tried to speak to a sampling of loan and collections officers,



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this was not always possible. Thus, the research may not pick up inconsistencies between the aspirational policies management may have on the books and actual staff comprehension or behavior. Another limitation was that we were not always able to obtain copies of MFIs' internal policies or loan agreements containing clauses relevant to arrears collection, particularly in Peru and Uganda. For example, sample loan agreements were obtained from only five of the participating 44 MFIs. Loan agreements are especially useful because they often contain information about operational procedure in the event of a default. However, if this information is not discussed with clients, they may not be aware of the implications of loan clauses. For example, we saw one loan agreement that stated that the MFI can declare a default if it has information that the borrower may not be able to repay. Another agreement stated that in event of default, the MFI can seize or sell client collateral without involvement of public authorities (in contravention of existing legislation intended to protect consumers). One loan agreement from India even bound the heirs of a borrower (without the heirs' signatures as a guarantor). Unfortunately, it was impossible to obtain more of these contracts.

A final limitation is that, due to time constraints, most interviews were in the urban capitals. Only in Peru were we able to spend several days in Huancayo, a rural, mountainous region, and that helped us to appreciate differences in practices. In India, we visited six cities, but stayed within the urban lending context for our interviews.

Despite these limitations, however, this project is an important investigation into a little-studied area of microfinance practice. The three countries selected provide interesting comparisons and contrasts due to the differences in microlending methodologies, legal frameworks, credit bureau status, and engagement of regulators. We have engaged the microfinance industry from the early planning stages to identify issues of interest and importance to practitioners. And, as far as we can tell, this research is among the first to explore the topic of default management in microfinance across a wide range of MFIs and from a client perspective.

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# 2

## Questions Examined and Structure of Country Case Studies

Each of the country reviews is structured around the most important research questions we examined. The analysis progresses temporally from pre-loan prevention through post-default rehabilitation or termination of the client relationship. The country reviews are generally structured as follows:

**1. Status of the sector, main actors, market framework.** MFI behavior is the primary focus of this study. However, MFI policies and actions are strongly conditioned by local norms, actors, and institutions. Each country review introduces the microfinance market context and main actors, especially client protection regulators and credit reporting systems (credit bureaus).

Questions asked include: Does the country have strong client protection regulation in place? How is it enforced? Is over-indebtedness a problem in this market?

**2. Default prevention.** The actions MFIs take before default occurs—such as the credit analysis and approval process, communications with clients, and monitoring of client status—influence how often and how severe default is. These steps set the stage for the subsequent handling of defaults.

Questions asked include: How do credit bureaus influence the underwriting process? How thoroughly do MFIs inform clients about what will happen in case of default? Do MFIs in highly indebted markets take preventative steps, such as limiting the number of loans one client can have with other MFIs?

**3. Management of delinquency and early stage default.** Delinquency management begins when the borrower misses a scheduled

payment. Standard practice is for MFIs to initiate an escalating schedule of actions that depend on the time elapsed since the payment was missed. At first, prospects are good that the borrower will catch up and ultimately complete repayments, but these prospects diminish over time. In this report, we define delinquency as the early portion of the process, often handled in a very routine fashion, but our focus is on default. And default is the turning point for the MFI when prospects seem to decline for a successful collection, and as a result, it steps up actions, such as collateral seizure. These turning points differ from one MFI to another, and in fact, we found few MFIs who make an active distinction in terminology between delinquency and default.

Questions asked include: When does the MFI believe a debtor has a serious problem? When does the case move from loan officer to collections team? Does the MFI outsource to third-party collection agencies? How do MFI practices differ for group and individual loans?

**4. Collateral, guarantors.** For serious defaults, collateral may be seized, or guarantors called upon. These processes are generally guided by the legal framework, and MFIs also have rules and procedures of their own.

Questions asked include: What rules govern the process of seizing collateral? Are law enforcement or the courts involved?

**5. Restructuring, refinancing, and forgiveness.** For loans that are seriously late, the best solution for both lender and borrower may be to restructure, or even to refinance or forgive a portion of the loan. Yet, MFIs have strong incentives to avoid such solutions, particularly if the appearance of leniency

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might influence other borrowers to engage in strategic default, or if mandated provisioning or risk management limits their use.

Questions asked include: Do a client's reasons for default determine the leniency of their treatment (e.g., "can't pay" versus "won't pay")? How often and when do MFIs offer restructuring, refinancing or forgiveness? Is there a written policy or is this left to an employee's discretion?

#### **6. After default: ongoing recovery, mediation.**

Once a loan is written off, it is no longer on the books of the lender. However, the MFI's decision to write-off the loan is often driven by prudential accounting or regulatory requirements and is not necessarily a signal that the debt has been forgiven. Therefore, the lender may continue to attempt to recover it, and so the borrower is not free from the prospect of a collections call or visit. The borrower may be barred from future borrowing from the same MFI, or (if reported to a credit bureau) other MFIs. At the microfinance level, bankruptcy is not an option. And, in most developing countries debt counseling or rehabilitation services are not available to assist defaulters.

Questions asked include: Do MFIs pursue post-write-off recovery? What are the long-term consequences of default for the borrower? How long does a default appear on a client's credit bureau record? Are debt counseling facilities available from MFIs, consumer organizations, or state-affiliated debt counselors?

### **Country Selection and Comparisons**

The research team selected three markets where we expected to find diverse MFI practices, in addition to legal system diversity and varying levels of market development. An analysis of only three countries is not representative of the entire microfinance industry's practices, but it does enable broader comparisons. We selected a Latin American civil code country (Peru) and two common law jurisdictions (India and Uganda). Peru is an upper middle income economy with fairly stable GDP growth, India is a lower middle income economy with a (recently) stagnant economy, and Uganda is a low income country.

The microfinance delivery mechanisms are distinct in each of the three countries.

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In Peru, individual lending dominates, while in India group lending is the preferred model and is almost exclusively delivered to women. In Uganda, both individual and group lending exist, but individual lending was the preferred product of the majority of the MFIs we interviewed.

A critical country difference relates to the maturity of the credit reporting industry. Peru's microfinance industry has been reporting to private credit bureaus for over 10 years. There are four private companies and a state-run data registry housed at the Superintendent of Banking, Insurance, and Private Pension Funds (SBS). Both regulated and some larger, unregulated microfinance lenders report to credit bureaus. In India, credit reporting for microfinance has been in existence for only a few years, and has yet to fully penetrate the market (particularly for self-help groups). In Uganda, 25 commercial banks and three microfinance deposit-taking institutions, all report to just one credit bureau, Compuscan, which to date holds a monopoly in the sector. However, in Uganda there are thousands of non-reporting, unregulated MFIs.

Market regulation and types of regulators monitoring market conduct are also notably distinct in the three countries. Peru has a unique approach composed of two institutions that supervise the financial industry for market conduct: the SBS (Superintendent of Banking, Insurance and Private Pension Funds) and INDECOPI (National Institute for Defense of Competition and Protection of Intellectual Property), the latter of which is not specialized in financial services but it responsible for consumer protection across all goods and services sectors. The SBS also monitors market conduct through

activities like data collection and mystery shopping. In India, the regulator is the Reserve Bank of India, which until the 2010 Andhra Pradesh crisis did not invest much in oversight of the microfinance sector. Recently it has begun to enlist the aid of a microfinance association to act as a Self-Regulatory Organizations (SROs).<sup>3</sup> The Bank of Uganda, on the other hand regulates only the few leading MFIs, and, while it has published consumer protection guidelines, it does not appear to monitor or enforce market conduct actively.



Peru has a mature and well-regulated microfinance sector which took root in the 1990s and has grown into a multifaceted industry serving up to 4.1 million borrowers. It features a wide range of MFIs, from small, rural NGOs to mainstream banks.

**Regulatory agencies.** Responsibility for financial consumer protection is shared by the lead financial services regulator, the SBS and INDECOPI. According to the Consumer Protection Law, INDECOPI has enforcement powers in all sectors including financial services, consumer protection rules, competition, and intellectual property rights. For its part, the SBS has regulatory, enforcement, and sanctioning powers in a broad number of issues ranging from transparency to service quality, but does not have legal authority to resolve individual cases except regarding pension funds. The SBS collects complaints data from institutions, which it supplements with secret shopping research and industry monitoring.

While each institution has its own legal mandate, both have the role of supervising and sanctioning the financial industry's market conduct. During interviews, practitioners were very aware of INDECOPI's role to sanction bad practices and impose corrective measures. At the same time, it was hard for them to clearly differentiate the responsibilities of SBS and INDECOPI. According to practitioners, INDECOPI's dispute resolution process is a great alternative to the judiciary, which is widely perceived as time-consuming, ineffective, and an expensive channel by most. Use of the judiciary for dispute resolution is currently too expensive for use by typical microfinance borrowers.

**Credit reporting agencies.** SBS maintains a financial data registry by collecting information on a monthly basis from regulated institutions regarding clients' current, contingent, and total debt. This public registry keeps track of positive and negative debt status of all formal clients and shares the information with the private credit bureaus and regulated lenders. There are four private credit bureaus active in microfinance. The credit bureaus cover all of the regulated financial institutions, as well as a significant number of unregulated financial institutions. Unregulated institutions can join private credit bureaus, but cannot access the SBS registry directly.

While SBS requires regulated institutions to use the information it provides to prevent over-indebtedness, some regulated institutions alleged that the information they receive from the SBS is not always timely enough to meet that requirement, and therefore, all work with private bureaus in addition to SBS.

Regulated institutions noted that private credit bureaus provide thorough analyses, dynamic reports, and specialized indicators that are far more useful than those of the public registry. Competition to provide more complete information drives the credit bureaus. One credit bureau representative mentioned that "financial institutions can't be seen any longer as clients that just want reports. Institutions are looking to work with the private credit bureau that generates the most value." With so many high quality credit bureaus at their disposal, institutions in Peru

<sup>3</sup> As of publication, one entity in India, the Microfinance Institutions Network (MFIN), was officially recognized as a Self-Regulatory Organization (SRO) for non-bank financial companies (NBFC) microfinance institutions in India.

enjoy lower report costs than the regional average and relatively timely information.<sup>4</sup>

Certain private bureaus have been especially proactive in collecting data from unregulated institutions, offering discounts on reports for those who share timely and high quality information. One bureau claimed that by 2005, it succeeded in aggregating data on borrowers from 85 percent of the unregulated institutions. The unregulated institutions are players in the market that regulated lenders simply cannot afford to ignore. One private credit bureau mentioned they had tried to partner with Copeme in order to motivate and train MFIs on the best and most useful ways of using their information. Such partnerships have been a trend in the country and have resulted in an increased number of credit bureau consultations, ultimately reducing the price of clients' consulting costs, and at times even allowing for unlimited consultations per month.<sup>5</sup> Another credit bureau indicated that it was even interested in developing products for the clients of financial institutions. This

gives one an idea of how competitive the Peruvian credit sharing market is.

In addition, the regions also have *camaras de comercio* (chambers of commerce), which play an important role of registering notices of protest for defaults on promissory notes and bills of exchange, providing important input for credit bureaus. Some MFIs mentioned that they report defaults to the *camaras* using a notary as the filing agent. This is an important tool to monitor the repayment history of farmers and borrowers from lenders like the *caja rurales* or *municipales*.

Overall, the microfinance sector has comprehensive, widely disseminated, and timely information available about borrowers and their debt, and the presence of credit reporting helps shape default management practices.

### Default Prevention

The Peruvian microloan market is dominated by individual lending, with repayment capacity assessed for each client. Nevertheless, the market is highly competitive and there

TABLE 1

### Key Facts on the Microfinance Sector in Peru

<b>MFIs reporting to MIX<sup>6</sup></b>	Approximately 57 institutions including regulated banks and deposit-taking financieras, MFIs; unregulated NGOs and regulated CRAC, CMAC, Cajas Municipales de Credito Popular, Cooperativas de Ahorro y Credito, and EDPYMEs.
<b>MF borrowers, per MIX</b>	4.1 million
<b>Regulators</b>	SBS—Comprehensive financial services regulation INDECOPI—Consumer protection complaint resolution for all types of goods and services including financial
<b>Credit Reporting Agencies</b>	Financial data registry operated by SBS. Four credit bureaus: Experian, Equifax, Sentinel, and Certicom
<b>Entities surveyed for this research</b>	12 MFIs: 3 banks, 3 financieras, 5 NGOs, 1 EDPYME 1 collections agency; 3 credit bureaus 3 MFI associations (ASOMIF, COPEME and FPCMAC) and 2 government ministries and ASPEC (consumer protection organization)

<sup>4</sup> Two credit bureaus, while explaining the process and flow of clients' credit information, mentioned that there is still room for improvement for all credit bureaus (including the public credit registry) to reduce the information gap. For more details, see: MicroRate, "Public Credit Registries, Credit Bureaus, and the Microfinance Sector in Latin America," available at [www.microrate.com/media/downloads/2013/06/MicroRate-Report-Public-credit-registries-credit-bureaus-and-the-microfinance-sector-in-Latin-America-v2.pdf](http://www.microrate.com/media/downloads/2013/06/MicroRate-Report-Public-credit-registries-credit-bureaus-and-the-microfinance-sector-in-Latin-America-v2.pdf)

<sup>5</sup> Ibid.

<sup>6</sup> Christian Etzensperger, "The Role of Microfinance in Development," *ResponsAbility Research Insight* (March 2012); and MFIs Reporting to MixMarket.com in FY2013.

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**Overall, the microfinance sector in Peru has comprehensive, widely disseminated, and timely information available about borrowers and their debt, and the presence of credit reporting helps shape default management practices.**

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are concerns about saturation. Two credit bureaus offer reports showing hot spots in Peru where debt levels are rising and the market shows signs of saturation. Credit reporting information is available but may not always be used prudently. Moreover, while the SBS sanctions institutions that do not use its information, we noticed throughout our fieldwork that its information is not always applicable. Two unregulated NGO/MFIs expressed concern that their reports on defaults were ignored by regulated institutions that still lend to those clients. Such a situation was confirmed by a credit bureau representative who showed us a randomly selected credit report which illustrated that a client had an unresolved default with a *caja*, but subsequently still received a loan from another regulated lender.

Loan and collections officers indicated that they were aware that their clients had multiple loans, and generally, MFI acceptance of borrowers with multiple loans seemed quite liberal, compared to what we found in India where there is a cap on the number of loans an individual can take. Three surveyed MFIs indicated that their policies allowed them to be the fourth lender to a client; three others indicated they could be the fifth, and two of those indicated that they could consider being the sixth lender in exceptional instances.

Compared to peers in India and Uganda, Peruvian MFIs expressed more concern regarding, and explicit policies to prevent over-indebtedness. In fact, this is a requirement for regulated institutions, although the exact characteristics of the MFI policy are up to the MFI to determine. The SBS has outlined prudential risk measures for managing

over-indebtedness, which include requiring MFIs to monitor their small-scale borrower portfolio annually for signs of debt stress and risk of over-indebtedness.<sup>7</sup> The SBS also specifies that the risk unit in each financial institution must have a quarterly reporting system, take preventive and corrective actions, and make such reports available to the SBS. Other measures complement this effort such requiring institutions to disclose vital information to clients like the effective annual cost and the risks of not paying on time.

One MFI mentioned the following measures to avoid over-indebtedness: 1) Its policy included a strong and realistic assessment of client earnings; 2) Credit managers went to the field with loan officers; 3) It had an extended training period of six months for loan officers; and 4) It could be the third lender to clients, but only the second in saturated markets. A collections manager from another large MFI also told us that there were “no bad clients just bad loans,” and if there was a default it was probably the MFI’s fault. Thus, his institution dedicated substantial attention to over-indebtedness prevention, including investing in a social performance unit and conducting a joint study on over-indebtedness of its group clients with a local university. Another EDPYME lender mentioned that their strategy is to focus on “incubating the talent” of their members, and attributes very low delinquencies with their group loan product to this strategy.

#### **Standard Practices for Early Stage Delinquency**

In Peru, where individual loans dominate, MFIs respond to a delinquency on average between one week to 15 days after a missed repayment. The normal MFI intervention is simply a telephone call, text message, or email to the debtor, often from the client’s loan officer. Telephone contact is favored, especially by larger MFIs, because of the significant cost of home or market visits. Larger MFIs generally have in-house call centers that do this work. Additionally, a common practice among MFIs in Peru was for the loan officer to be responsible for collections generally for up to 30 days. Several MFI interviewees stated that if loan officers bore no responsibility for collections of arrears, they would become too distant from the reality that some loans go bad.

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<sup>7</sup> SBS Resolucion No. 6941 of 2008, available at [www.sbs.gob.pe/.../0/0/jer/sf.../res\\_14353-2009.doc](http://www.sbs.gob.pe/.../0/0/jer/sf.../res_14353-2009.doc)

Smaller NGOs operating in rural areas indicated that they may not take any action in the first week of arrears, because as one agricultural lender explained, the borrower may simply have had problems with transportation, or a multitude of issues unrelated to capacity or willingness to repay. For a client, making a loan repayment may mean a long journey to the branch office. The same journey in reverse is costly for a loan officer visit. An NGO operating in Huancayo noted that it could easily take more than an hour to reach just one rural client thus, visiting just two or three clients could easily occupy a rural loan officer's entire day.

We speculate, as discussed further in the final section, that Peruvian MFIs may respond relatively slowly to initial missed payments in part because of the presence of efficient and comprehensive credit reporting. MFIs underscored that during the collection process, they tell clients that failure to repay will result in a negative credit report, and that clients are aware of the implications of a bad credit report. Practices included brochures warning that the borrower would not be able to get loans with other big MFIs if the present obligation was not repaid.

On the other hand, when MFIs are cognizant that their clients have multiple loans, they may become more stringent. One loan officer explained that his collections strategy was to have a stronger and more persuasive relationship with clients compared to other lenders, such that the client would repay the loan officer's employer first, at the expense of other lenders.

If a delinquency continues, nearly all MFIs dispatch a loan officer to visit the client. Six MFIs referenced 30 days as a milestone for this step. And with several of these MFIs, 30–60 days also marked the milestone at which the loan officer turns collection responsibilities over to the collections department. Two MFIs noted that they regard 90 days is a critical timeframe for collections; thereafter, the likelihood a debt will ever be collected diminishes significantly.

For the smaller Peruvian MFIs that do not outsource loan collections, the loan officer is normally responsible the delinquency period, even up to 90 days of delinquency. Generally, after one month, a loan officer visits the client,

accompanied by senior employees such as a credit analyst or a branch manager. One MFI noted that it uses the 'good cop, bad cop' strategy to collect in this manner with at least two staff visiting.

In Peru, a traditional recovery system based on public humiliation involved *hombrecitos amarillos* (literally "little men dressed in yellow," or abusive collection agents or loan officers) who follow the client around in the neighborhood or workplace with humiliating signs or calling out personal information and amount owed. Under Law 29571 (Article 62), collections conduct rules prohibit the use of collection methods that affect a client's reputation, violate the privacy of their home or affect their work activities or image with third parties.<sup>8</sup> MFIs informed us that this type of conduct no longer occurs because of the strong market conduct regulation now in place, including sanctioning by INDECOPI and SBS.

### Collateral and Guarantors

The majority of the Peruvian MFIs interviewed offer unsecured loans without guarantors. Further, the debtor must demonstrate proof of domicile and usually, a light bill will suffice because borrowers rarely reside in property for which they have a registered title deed. If the potential borrower has a business, then financial records must be shown for a period of six months or more. Start-up loans were not offered by the majority of regulated institutions we surveyed.

While there is no law that forbids MFIs from taking collateral and substantial efforts have been made to make the process easier, it is still cumbersome and costly. Small MFIs reported that they cannot afford to lose time registering property, in which time they might lose customers, or selling collateral, since courts are slow and costs to pay public notary are very high. Some MFIs request that the borrower sign a promissory note or *titulos valor* for purposes of moral persuasion. The promissory notes were preferred to procuring a court order because these notes are faster and therefore a stronger mechanism to ensure repayment. Additionally, these promissory notes can be more easily discounted in exchange for cash. Finally, if a loan is not paid and there is a promissory notes, the MFI can register it in the *camara de comercio* which, as

<sup>8</sup> Código de Protección y Defensa del Consumidor, Law N° 29571, Chapter III (Abusive collections methods) available at [http://portal.andina.com.pe/EDPEspeciales/especiales/2010/setiembre/codigo\\_consumidor.pdf](http://portal.andina.com.pe/EDPEspeciales/especiales/2010/setiembre/codigo_consumidor.pdf)

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mentioned in an earlier section, smaller MFIs regularly check prior to approving a loan.

Nevertheless, the threat of collateral loss is sometimes a collections tactic. One loan officer of a *financiera* admitted to openly making notes of TVs and other items in the borrowers' homes, because this makes the client believe that the lender will seize these goods; even though they do not have the legal right to do so without initiating court proceedings.

### Collections Companies and Courts

In Peru, the use of external collection companies was common, primarily among the larger MFIs, like *financieras* and banks. Three large *financieras* and two banks mentioned that they outsource delinquent debts to a collection company after 90 to 180 days. One bank indicated that it had established its own collections company. The bank representative cited the need for control over the entire collections process.

A large EDPYME recently conducted a study on whether its own staff, or external collectors were more efficient in collections. After receiving mixed results, today some of its branches outsource collections, and some handle collections in-house.

There are four large collection companies in Peru and we interviewed an executive from one of these companies who indicated that collections is quite a profitable sector.<sup>9</sup> He added that his company has multiple offices in Lima, 11 offices in the provinces, 600 staff members, and 32 clients—primarily banks, *cajas*, and *financieras*. This company has about one-third of the market share, and 20 percent of its business could be classified as microfinance. It also has begun purchasing non-performing loans (NPLs) from MFIs. According to the executive, six MFIs in Peru out of approximately 70 are selling NPLs. Additionally, Peruvian debt collectors also offer related services, like sending reminders to debtors (prior to late payments) and helping NGOs locate clients in remote rural areas.

Unregulated Peruvian MFIs, can notify the regional *camaras de comercio* of a bad debt, where there is a procedure for filing a notice of protest for the bad debt. Filing such a protest at the chamber of commerce requires the use of a notary, and sometimes this creates a difficulty for the MFI when the debtor lives in a rural area so remote that it is not served by any notary.

Filing a notice of protest is also a necessary precursor to filing a legal action to recover the debt. All interviewed, however, agreed that they almost never filed a judicial action due to the cost and inefficiency of the judicial proceedings. One NGO noted that it had been four to six years since they had used the courts and it would probably take about that long for a judgment. He also noted that filing a notice with the *camara de comercio* was a fairly effective alternative to debt collection as it serves a low cost way to impose pressure on the client.

### To Restructure or Not to Restructure?

Few Peruvian MFIs indicated that they distinguish among delinquencies based on the reason for default. Three providers that do were small, development-oriented NGOs. A fourth provider that sought to understand the reasons was a staff member at local branch of a commercial bank. This staff member cited a specific incident that necessitated sympathetic treatment: several borrowers had their stores destroyed in a market fire. The bank offered six additional months to repay. This staff member added that in recent years they have become increasingly aware of a need to have more tools at their disposition for assisting good clients. The bank now allows clients who have been paying on time to suggest changes to the agreement, in terms of adding more time to repay.

Larger institutions, however, normally do not distinguish based on the reason for the default. The large providers are seeking to standardize processes and reduce costs with the help of IT. For an extreme example of this, a bank executive told us that the bank was experimenting with a tool that would discern the risk of default from behavioral patterns, which could correlate with borrowers' eventual missed repayments. Armed with this information, the bank would pre-emptively terminate the client's credit line even before a late repayment. The executive stated that an earlier pilot focused on borrowers with multiple loans which (unsurprisingly) showed that cutting access to the line of credit provoked default. This example illustrates a strong tendency to standardize all processes based on data analysis *à priori*.

In Peru, while financial institutions do not attempt to determine the reasons for default, they do have restructuring systems in place.

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<sup>9</sup> One bank collections manager estimated that the collections companies paid 10 percent of the loan value and recovered up to 50 percent.



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And, restructuring is preferred over refinancing because clients know that a refinanced loan would be flagged in their credit reports. Providers would also have to change the client's standing from the "normal risk," to the "with potential problem" category.<sup>10</sup> As a result, institutions will be required to provide more, a cost that will often be transferred to the client via higher interest rates. Practitioners mentioned that clients seem to understand how "lethal" it is to be downgraded.

In 2009, the SBS authorized banks to reschedule debts from clients who may face payment difficulties in the future, without affecting their risk category.<sup>11</sup> That became an extremely important tool in handling cases of clients who were current in their loan payments, but faced imminent repayment challenges. Most Peruvian MFIs reported a willingness to reschedule, waive a significant amount of interest, or accept a reduced amount to pay off the debt. Loan officers generally have incentives to reduce non-performing loans with restructuring.

While eight providers stated that they would be willing to restructure or refinance a delinquent loan, the providers differed over *when* they would consider restructuring delinquent loans. Some mentioned that restructuring could occur when the loan payment was 61 days past due, while others put the time period between 90 and 120 days. Six of the eight MFIs indicated that they could also reduce, and on occasion forgive, a major portion of the interest owed as part of the restructuring negotiation, though collections staff members try to minimize concessions. When referring to restructuring cases, most providers mentioned that clients feel empowered by having input on the new loan conditions. Restructuring helps the relationship between client and lender because institutions have the freedom to handle defaults on a case-by-case basis, as long as they follow their institution's credit risk management policies. According to MFIs, clients greatly value the fact that their good standing in credit bureaus is not affected.

The NGO-MFIs were less likely than MFIs to negotiate a restructuring or offer other concessions. One NGO-MFI indicated that it routinely offered restructuring at 120 days, noting that if the borrower failed to maintain the new agreement, then the

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**When Peruvian providers were asked if they offered special assistance for the over-indebted (e.g., debt counseling), only one institution, an NGO-MFI, indicated that it was in discussions with a professional specialized in conciliation to add financial counseling services.**

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terms would revert back to the old agreement. One NGO-MFI stated that it could forgive interest and penalties only if the client was making a one-time pay-off of the entire debt. For example, the MFI sometimes sends one-time offers of arrears settlement to delinquent clients. The staff member interviewed showed an example where a delinquent borrower owed 2,278 soles, and the one-time repayment offer to close the obligation was 800 soles. Another NGO-MFI mentioned that they could restructure in cases where there were many borrowers affected by a natural disaster and provided the example of coffee blight. In this instance, the NGO-MFI refinanced all of the farmers' debts. Only one MFI (a group lender) stated that it categorically refuses to restructure delinquent loans.

A large *financiera* mentioned that when a restructuring is done, the vast majority of borrowers successfully complete the restructured agreement. An employee of a large bank that offered restructuring indicated that it was not so much the substance of the restructuring that mattered, the important point was to get the debtor to recommit to the new agreement in writing. In such a case, he said, you could be sure that the client would honor the new agreement. And, several MFIs indicated that a debtor who had defaulted but then recommitted and subsequently followed through with repayments was someone they would bank on in the future.

#### **After Default: Ongoing Recovery, Mediation**

Peruvian providers said that they continue collection efforts after write-off, which is obligatory at 120 days late, and that unpaid debt is never expunged from the credit bureau record. Private credit bureaus must expunge

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<sup>10</sup> Superintendencia de Banca, Seguros y AFP. *Términos Indicadores del Sistema Financiero* (2011), available at [www.sbs.gob.pe/app/stats/Glosarios/Glosario\(Abril2011\).docx](http://www.sbs.gob.pe/app/stats/Glosarios/Glosario(Abril2011).docx)

<sup>11</sup> Superintendencia de Banca, Seguros y AFP. *Resolución SBS N°14353-2009* (2009), available at [www.sbs.gob.pe/repositorioaps/0/0/ger/sf\\_csf/res\\_14353-2009.doc](http://www.sbs.gob.pe/repositorioaps/0/0/ger/sf_csf/res_14353-2009.doc)

## An Example for the Microfinance Sector? INDECOPI's Work on Business Default

The Peruvian consumer protection regulator, INDECOPI, has a division where insolvent persons with a commercial activity can participate in a restructuring with their creditors, trying to establish a repayment plan. If an agreement cannot be reached, either the creditor or debtor can still file for bankruptcy in the courts. To start an insolvency process with INDECOPI the filing fee is US \$685 and the entire process could cost US \$1,500. An SBS official indicated that while this procedure may have been created with small businesses in mind, it is virtually unheard of amongst individuals or microfinance clients. We are inclined to agree that without some way to reduce costs and fees, the service is irrelevant to the microfinance community. However, if properly promoted and costed, such a procedure could be helpful to both MFIs and clients.

**Source:** Data from interview with attorney Sara Sotela, November 2013.

the debt after seven years, but the public credit registry maintains the data ad infinitum. Only one MFI (a bank) indicated that they would not try to collect post-write off if the loan were less than 20,000 soles (about US\$7,145). One NGO/MFI indicated that it would forgive a loan only in the event of the borrower's death.

For the majority of Peruvian MFIs surveyed, the MFI tries to collect forever, with one *financiera* stating that management sets annual targets and seasonal strategies for collection of arrears. An EDPYME referenced a reward for the collection of debts after write-off. All staff members (including the receptionist) are permitted try their hand at collections, and if successful, they receive 10 percent of the amount recovered.

Another Peruvian NGO MFI indicated that holiday seasons were especially good times to send out offers to clients to repay their arrears because people tend to have set aside some spare cash for the holidays. A loan officer with another NGO that continues collection efforts indefinitely indicated that it is persistence and a conciliatory attitude that eventually breaks down client resistance. He reported that his oldest debt was 3,000 days old, but he still

passes by the client's place of business. He expressed confidence that the debtor would eventually repay.

When Peruvian providers were asked if they offered special assistance for the over-indebted (e.g., debt counseling), only one institution, an NGO-MFI, indicated that it was in discussions with a professional specialized in conciliation to add financial counseling services. This institution recognized that in many default cases there was also an element of family dysfunction. The manager of collections at the same NGO-MFI who participated in this interview indicated that he was also a trained social worker, and those skills came in handy on the job. This was the only MFI interviewed in the survey of all three countries that had a program in place to assist over-indebted clients.

## INDIA



As many as 30 percent of the world's microfinance clients are Indian (most of them women) and India represents 7 percent of the global microfinance portfolio.<sup>12</sup>

Indian microfinance is characterized by several distinct delivery mechanisms and institutional types: non-bank financial companies (NBFC) which are regulated by Reserve Bank of India (RBI) and unregulated NGOs, generally Section 25 companies, trusts, or cooperatives. Most of these institutions offer loans through the group guarantee lending methodology (GGLS), adapted originally from Grameen Bank of Bangladesh. In addition, the self-help group (SHG) model is also prevalent, wherein a group of 15 to 20 women forms to save and

<sup>12</sup> Arjun Kashyap and Anurag Kotoky, "Some Facts About Indian Microfinance Sector," *Thomson Reuters* (Oct. 28, 2010).

lend internally and is later linked to a bank for savings and credit. The government, NGOs, and SHG federations have promoted the SHG model, which now links more than 4.5 million groups to formal credit.<sup>13</sup> Both models are group-based. Roughly 40 percent of microfinance loans outstanding are disbursed through the GGLS model and approximately 60 percent via SHGs.<sup>14</sup>

Following the 2010 microfinance crisis in Andhra Pradesh (AP), in which rapid lending growth induced over-indebtedness and a political backlash, the Indian microfinance industry experienced a period of slow growth. However, more recently, a clearer regulatory framework, evidence of RBI support, and continued strong financial performance (outside of Andhra Pradesh) has brought funding into the sector and enabled growth. During fiscal year 2013–2014, NBFC-MFIs received debt funding of Rs. 150.30 billion (approximately US \$2.5 billion), an increase of 49 percent from 2012–2013.<sup>15</sup> Recent data from the Microfinance Institutions Network (MFIN) indicate that PAR for its member

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TABLE 2

**Key Facts on the Microfinance Sector in India**

<b>MFIs reporting to MIX<sup>16</sup></b>	41 institutions including NBFC-MFIs, NGOs, Section 25 companies and cooperatives
<b>MF borrowers, per MIX<sup>17</sup></b>	Approximately 28 million borrowers (GLG only; excludes SHGs)
<b>Regulators</b>	Reserve Bank of India (RBI)—banks and NBFCs NABARD—SHG and cooperatives
<b>Self-Regulatory Organization</b>	MFIN with 49 members (as of September 2014)
<b>Credit Reporting Agencies</b>	High Mark, Equifax, and Experian (coming soon)
<b>Associations</b>	Sa-Dhan for NGOs, with 155 members
<b>Entities surveyed for this research</b>	22 MFIs: 17 NBFCs; 3 Societies and 2 Section 25 Companies 3 credit bureaus 1 network (MFIN) and MoneyLife Foundation (consumer advocacy non profit)

<sup>13</sup> Tara Nair and Ajay Tankha, *Microfinance India: State of the Sector Report 2013* (Sage Impact, 2013).

<sup>14</sup> *Ibid*, page 30.

<sup>15</sup> MFIN, *MFIN Micrometer*, May 2014.

<sup>16</sup> MFIs reporting to MixMarket in FY2013.

<sup>17</sup> MFIs reporting to MixMarket in FY2013.

NBFC-MFIs (other than MFIs under Corporate Debt Restructuring) remains under 1 percent of gross loan portfolio.<sup>18</sup>

The Reserve Bank of India (RBI) is the sector's main regulator, and following the AP crisis it has asserted more active oversight of the sector. The Indian Parliament also reacted to the AP crisis, but a draft bill languished and was eventually rejected in committee in early 2014. Draft microfinance legislation has been pending in India in some form since at least 2006. NABARD, the government's agricultural bank (which reports to the RBI) oversees financial cooperatives and the SHG-bank linkage program.

In the past few years the RBI created a specialized NBFC-MFI category, and holds these entities accountable in areas including pricing, margin, provisioning, and methods of recovery, among others.<sup>19</sup> The RBI further specified the application of the Fair Practice Code for NBFC-MFIs and required that they have membership in at least one Credit Information Company.<sup>20</sup>

After the AP crisis, the RBI passed new regulations limiting borrowers to no more than two institutional relationships, a requirement that is enforceable due to the growing use of credit bureaus. Today, there are two main private credit bureaus (High Mark and Equifax) engaged in the microfinance sector and a third (Experian) which at the time of our research visit in December of 2013 was preparing to enter the market. There are more than 130 million client records and a volume of approximately 2 million inquiries per quarter.<sup>21</sup>

In addition, efforts to improve market conduct by networks such as MFIN and Sa-Dhan through a jointly agreed Code of Conduct were amplified by SIDBI, which in 2011 introduced a Code of Conduct Assessment tool. Moving forward, MFIN, with the unique status of a 'Self-Regulatory Organization,' will be responsible for ensuring that its members comply with regulation and the Code of Conduct through surveillance, investigation, enforcement, and recourse mechanisms.<sup>22</sup> However, this oversight role is quite new, and its actual mandate and powers remain to be defined.

### Default Prevention

As mentioned above, group lending to women dominates in Indian microfinance,

in part due to RBI's loan size restrictions,<sup>23</sup> though some providers offer limited individual lending. Today, the average loan size to an Indian borrower is approximately 15,000 rupees (about US \$240). In Indian microfinance models, group decision-making and pressure have historically been the main mechanisms for preventing default. In general, groups are expected to ensure that borrowers are capable of repayment. The lender does not verify an individual's capacity to repay.<sup>24</sup>

However, credit reporting is now emerging as an important driver in MFI practices and client behavior, although it is fairly new in India for the microfinance sector, and only regulated NBFC-MFIs are required to report. To date, data from over 130 million loans has been reported.<sup>25</sup> MFIN mandates that its 49 members report to at least the two main credit bureaus. Impressively, MFIN has transitioned its reporting requirements for members from monthly to fortnightly to weekly. Though others types of entities are not currently mandated to report, interviewees from many smaller institutions said they reported to and used credit bureaus. There was a split in preference between Equifax and High Mark based on issues of formatting, reliability, cost, and institutional momentum.

Unfortunately, credit bureau data does not include bank lending to SHG members, and research has shown that MFI borrowers often have formal and informal loans from other sources.<sup>26</sup> Additionally, the credit bureaus have grappled with the lack of a national ID, though the acclaimed Aadhaar program is rapidly issuing biometric identification cards to hundreds of millions of Indians.

Providers are already welcoming the default deterrent of the credit bureaus. One Mumbai-based NBFC-MFI indicated that they regularly inform clients that "each group member gets a bad mark in the event of a default." Another large NBFC-MFI indicated that defaults were rare because clients have been informed from inception about the implications of having a bad credit report. He noted that for this reason the MFI does not bother with restructuring, because with the credit bureau, old clients will eventually come back to pay off old debts. A third provider stated that a small percentage of its previously written off defaulters had

<sup>18</sup> MFIN, *MFIN Micrometer*, March 2014.

<sup>19</sup> Reserve Bank of India, *Introduction of New Category of NBFCs—'Non Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs)—Directions*. DNBS. PD.No.234/CGM(US December 02, 2011, and subsequent modifications August 2012. Available at <http://rbidocs.rbi.org.in/rdocs/notification/PDFs/CC250021211.pdf>

<sup>20</sup> Reserve Bank of India, *Master Circular, Fair Practice Code*. DNBS.CC.PD.No.266/03.10.01/2011-12. July 1st 2011. Available at <http://rbidocs.rbi.org.in/rdocs/notification/PDFs/26MFP010711F.pdf>

<sup>21</sup> Communication with MFIN, July 2014.

<sup>22</sup> Reserve Bank of India, "Self-Regulatory Organization for NBFC-MFIs—Criteria for Recognition," available at [http://rbidocs.rbi.org.in/rdocs/content/pdfs/IEPR1066A1113\\_1.pdf](http://rbidocs.rbi.org.in/rdocs/content/pdfs/IEPR1066A1113_1.pdf)

<sup>23</sup> Reserve Bank of India, *Introduction of New Category of NBFCs—'Non Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs)—Directions*. DNBS. PD.No.234/CGM(US December 02, 2011, and subsequent modifications August 2012. Available at <http://rbidocs.rbi.org.in/rdocs/notification/PDFs/CC250021211.pdf>

<sup>24</sup> The Smart Campaign has developed several tools around good practices in individual repayment capacity as well as an example of one MFI in India who monitors individual repayment within a group guarantee mechanism.

<sup>25</sup> Data posted on MFIN website at <http://mfinindia.org/development/credit-bureau>. MFI data submitted to multiple bureaus.

<sup>26</sup> Doug Johnson, and Sushmita Meka, *Access to Finance in Andhra Pradesh* (IFMR LEAD, 2010).

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returned to pay off their debts because they wanted to get a new loan from another institution and needed to clear the default from their records. Thus, as in Peru, client awareness of credit reporting appears to provide additional security to MFIs giving it significant leverage with delinquent clients, and acts as a tool to prevent clients from becoming over-indebted.

In addition, providers, particularly in West Bengal, appear to monitor each other using credit bureaus and cry foul to their regional or national network when a competitor becomes a 'third lender,' in violation of the RBI. This dynamic was not as apparent in South India.

### Early Stage Delinquency Management: Groups First

In the early stages of delinquency there is a strong reliance on the group liability mechanism, with groups handling initial missed payments internally. Indeed the mechanism works so that if one member cannot meet her obligation, the other members must cover the repayment of the defaulter if they want to access future credit. Group members regularly contribute for each other and despite extremely low PARs reported by MFIs, intra-group delinquency is actually often much higher. For example, a small study around Delhi of 27 centers found that 22 percent of the clients were defaulters, while the participating MFIs reported zero default.<sup>27</sup>

Seven of the Indian MFIs surveyed stated that they would not take any action vis-à-vis a delinquent borrower until there were at least two missed installments (with weekly repayment obligations), and most would intervene between two and four weeks. One MFI interviewed stated that (because group members are covering for each other), "we might not even find out about it until the second or third missed payment."

Of course, there was variation. Two MFIs stated that they monitored attendance at group meetings, equating a missed meeting with a missed repayment, and used this as an indirect means to capture individual repayment information. Another mentioned that by four days after the first missed payment, the MFI dispatched the branch manager to visit.

There was an admitted reluctance by the MFI staff to track, or intervene in the workings

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**In Indian microfinance models, group decision-making and pressure have historically been the main mechanisms for preventing default. However, credit reporting is now emerging as an important driver in MFI practices and client behavior, although it is fairly new in India.**

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of the joint liability group (JLG) model, provided the group continues to pay the MFI back on time. This is grounded in the basic business underpinnings of JLG, which is to lower risk and transaction costs by shifting the screening, selection, and monitoring of borrowers from the institution to fellow group members.<sup>28</sup>

Yet, this hands-off stance included scenarios presented in interviews by the MFIs when, in our opinion, groups were acting inappropriately, such as taking a delinquent borrowers' belongings or locking her out of her home. By projecting an attitude of non-interference in group dynamics, the MFIs appeared to believe they were instilling group discipline, which was frequently referenced by Indian MFIs. One MFI manager stated that groups are "our first line of defense, and we deal with defaulters through the group. If we hear of abuse of a client by other clients, we don't intervene. It's between them." Another MFI branch manager stated that they 'more or less' do not interfere with groups and that intervention would be a case by case decision. When asked for an example of conduct that would spur MFI intervention in group dynamics, he cited a fraud related complaint.

While this study did not involve direct interviews with clients, limited research has uncovered hardships among groups for both the defaulter and fellow group members. Hardships among group members who pay for delinquent members causes a steep increase in the cost of borrowing and can engender the social hardships, bitterness, and tension for the defaulted member.<sup>29</sup> Given that these intra-group dynamics are generally not tracked by

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<sup>27</sup> Mani Nandi, *Incidence of Loan Default in Group Lending Programme* (IMFR LEAD, 2010).

<sup>28</sup> See discussion in Gine et al., "Strategic Default in Joint Liability Groups: Evidence From a Natural Experiment in India," preliminary draft, November 2011.

<sup>29</sup> Ibid and also see *Self Help Group Bank Linkage: Through the Responsible Finance Lens A Study on State of Practice in SHG Bank Linkage in Madhya Pradesh, Bihar and Karnataka* by IFMR Lead 2013 and published by ACCESS-Assist for discussion of intra-group conflicts. In addition, early stage results from the Smart Campaign and BFA "Client Voice" project in Pakistan found troubling dynamics within group members.

MFIs in their systems, it is unlikely that senior management would become aware or take corrective action in cases of abuses.

However, one of the 22 Indian MFIs surveyed stated that its groups were for moral support only, and that it did not enforce a joint liability guarantee for the group loans.

Beyond the groups, the trigger for intervention of the MFI itself seemed not to be individual missed payment, but the breakdown of the group's joint liability, that is, when the group effectively ceases to repay for its delinquent member. A breakdown of group liability in the event of default seems to be anticipated by some Indian MFIs after a certain point. Several indicated that group liability was considered temporary versus permanent. This was not a question we posed to all the MFIs focused on group lending, but there seemed to be different versions of group liability in operation within India and from country to country, which could be interesting to explore further.

At a certain point in delinquency, usually if several missed payments are not covered by the group, the Indian loan officer visits the borrower, often accompanied by higher-ups—either branch, regional, or area managers. These initial visits were framed as both an opportunity to exert pressure, and to understand the reason behind the default. As a result, the lender pulls in its own staff, group members, and defaulter family members or neighbors to pressure the individual for repayment, which seems to impinge on the debtor's right to privacy. One MFI stated that it was normal for such a collections group to sit at a delinquent borrower's house for five to six hours until she repaid. In fact, in a meeting with this particular MFI, when asked how often they have to spend 5–6 hours at a delinquent borrower's home, the 20 loan officers present stated it happened as often as once per week, because "some borrowers are regular late repayers." Interestingly, none of the MFIs or loan officers mentioned the use of cell phones to connect with delinquent client, as was the case in Peru, which could be a more cost-effective option over a lengthy sit-in.

In the aftermath of the AP crisis, the RBI placed restrictions on NBFC collections practices in an effort to correct market conduct. It was specified that collections must take place at the center meeting location (where groups

gather weekly to carry out their transactions) and MFI staff are not to visit the borrower's homes or place of work to collect repayments, unless they have missed two successive meetings.<sup>30</sup> These norms are further elaborated in the industry's Code of Conduct, where a major driver of aggressive collections prior to the AP crisis, a zero PAR policy, was forbidden. The RBI's Fair Practice Code also contains language against the use of external collections agencies, stating that "generally only employees and not outsourced recovery agents be used for recovery in sensitive areas."<sup>31</sup> None of the 22 institutions interviewed said that they used external agents or were aware of such practices among competitors.

### Collateral and Guarantors

As noted above, during later stages, more senior MFI staff—even occasionally CEOs—visit the client. As one Indian MFI executive put it, "Nobody respects or fears the normal guy (the loan officer) that they see all the time, but when the higher ups, like the BM (branch manager) come, they are more likely to repay." And, when management comes calling, the group is enlisted by the MFI to participate in pressuring the delinquent borrower and her family. In effect, the group has shifted its function from an instrument of solidarity to a collection mechanism.

Beyond the group members as guarantors, MFIs also draw upon family members and neighbors to find solutions to delinquency. Two providers specifically mentioned the family, one relaying a story whereby the MFI staff convinced a delinquent client to move in with her mother so that the daughter could rent her own house to earn money to repay her loan.

Five Indian MFIs noted that their concept of joint and several liability extends beyond the group to the center level (a center is the group of up to 10 small groups which meets together weekly to carry out business with the MFI). One MFI even mentioned that liability went all the way to the village and grand panchayat levels as well, implying that several hundred persons could in effect be held liable as guarantors for each other's loans. This issue of extended liability came up later versus earlier in the research, and, as a result, we were not able to pursue it in depth. At least four MFIs stated that they considered a center liable for a group level default, and a

<sup>30</sup> Reserve Bank of India, "Non-Coercive Methods of Recovery" section of Fair Practice Code, DNBS.CC.PD. No.266/03.10.01/2011-12. July 1st 2011. Available at <http://rbidocs.rbi.org.in/rdocs/notification/PDFs/26MFP010711F.pdf>

<sup>31</sup> Ibid.

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fifth stated that should a group fail to repay, it would 'blacklist' the entire village as a result. Another provider indicated that it went beyond the village level to the grand panchayat, or the SHG federation for liability purposes. Thus, this may not be a direct guarantee, but there are still negative consequences to the whole village for group level defaults. These actors provide a means of control over borrower conduct via social pressure from the borrower's entire community.

Legal action against a typical JLG defaulter was non-existent at all but one MFI, with all others echoing the sentiment that "taking legal action is tantamount to throwing good money after bad." The costs of hiring a lawyer and filing a claim simply outweighed the potential recovery in almost all cases, the exception being large-scale fraud or 'ghost loans.'<sup>32</sup>

The one MFI that did take legal action against group borrowers saw it as an important demonstration effect targeted only at those defaulters who are able, but unwilling to repay. The legal process commences after the third missed group payment and, if unresolved, ends in the client being called in front of the District Court. The same MFI manager said that the financial and non-financial cost of appearing in front of the District Court is a powerful deterrent. Five thousand such cases had been initiated in the last year alone at this MFI against such defaulters.

### Rescheduling

Only one of the 22 MFIs interviewed stated that it treated all delinquencies the same, whatever the reason. The remainder of providers reported that once it was brought to their attention, they would try to understand the reason for the default, often stating that they would use the group to ascertain whether the default was willful. If the delinquency was deemed for good reasons, then a more customer-friendly repayment practice would be implemented such as allowing one to two additional cycles to repay, or a rescheduling. Some MFIs even built in flexibility to the product; one MFI in West Bengal gave the client the option to choose three weeks out of a 50-week loan to designate as a repayment 'holiday.'

Overall however, very few MFIs had formal policies to govern how to negotiate with defaulters. One MFI staff member reported

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**Despite the industry Code of Conduct requiring a "board-approved debt restructuring product/program for providing relief to borrowers facing repayment stress," actual practices seem ad-hoc and there are no common standards on rescheduling.**

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that there were really only three genuine reasons for default: migration, drought (which induces migration), and health emergencies. In these circumstances, the regional manager could decide to give more time to repay. However, the policy was ad-hoc and not formalized. One provider referenced the issue of slum evictions and forced relocations, which are common in India. None of the providers referenced business failure as a 'genuine' reason for debt delinquency.

The majority of providers mentioned that natural disasters or health emergencies would merit the provision of concessions such as a grace period, but such concessions did not appear particularly generous nor sufficient to compensate for the severity of the borrower's situation. For example, one MFI stated that when a borrower's house burned down, the regional manager made the decision to give her more time to repay her loan: one extra week. Another provider stated that in the event of default due to death of the borrower, it would give the debtor's group members or heirs an additional week to repay.

Despite the industry Code of Conduct requiring a "board-approved debt restructuring product/program for providing relief to borrowers facing repayment stress," actual practices seem ad-hoc and there are no common standards on rescheduling.<sup>33</sup> It was also difficult to determine the real drivers of rescheduling decisions, because only one provider gave explicit reasons why it did not offer restructuring. This particular provider was one of only two that categorically did not allow restructuring. The executive explained that they simply wrote off the loan

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<sup>32</sup> Suits are filed under Civil Procedure Code and Section 138 of the Negotiable Instruments Act—an act dating from British colonial rule that went into force in 1881.

<sup>33</sup> Sa-Dhan and MFIN, "Code of Conduct for Microfinance Institutions in India," available at <http://mfinindia.org/wp-content/uploads/2014/06/IndustryCodeofConduct.pdf>

because they knew that the credit bureau will incentivize most clients to (eventually) come back to settle old debts. With a negative report on one's credit report, other providers will not grant new loans.

Another large Indian MFI noted that it did not generally offer restructuring, but in exceptional cases in the past it has done so. One example of such an exceptional case was when the Commonwealth Games caused thousands of slum dwellers to be evicted by government. Another MFI that stated that while it did not allow restructuring per se, it would consider a waiver of the interest owed on a loan, or alternatively, it would simply give a fresh loan to allow the borrower "to catch up" on repayments.

Eight other Indian MFIs indicated that they would allow restructuring on a case-by-case basis: one citing that "headquarters" would have to approve. In addition, front-line staff such as loan officers and even branch managers were generally not empowered to allow rescheduling.

### After Default: Continued Collections and a Lack of Mediation

In India, while there are no strict guidelines, most institutions write off their loans after 365 days. Many MFIs interviewed indicated that they still make efforts to contact and collect from debtors long after loans are written off. As one practitioner put it, "We simply park it in another book, but we don't even use the words *write off*—it is no different." Another interviewee stated that they keep trying to collect, with oldest debt on record written off in 2011. However, not all MFIs pursue older cases energetically or indefinitely. One MFI indicated that "it's just not worth the effort," and another indicated that if they suspected intent to defraud the MFI, then they would analyze the merits of legal action. A third MFI indicated that this was a board level decision based on the likelihood of collection.

In the aftermath of the AP crisis and other instances of mass default, collection efforts continue, but often on a community level rather than individually. One MFI in West Bengal indicated that a team of its staff makes weekly visits to a zone where a mass default occurred to determine whether the clients would be receptive to repaying old debts in their region.<sup>34</sup>

The arrival of credit bureaus has changed the perception of the value of chasing longer term defaults, because with the credit bureaus in operation, it is much harder for defaulters to get new loans. One Indian provider indicated that a small percentage of previously defaulted debtors had returned to pay off their loans due to a negative credit report and their desire to get a new loan. Some clients seek a letter from the provider stating that the debt has been repaid so they can get a loan from another institution.

None of the providers interviewed cited any special efforts internally or through third-party referrals toward assisting their clients who had become over-indebted. The development bank NABARD mentioned that it had begun a pilot debt-counseling project in Hyderabad for persons who had multiple loans in early 2013. The project counseled debtors to increase their savings, consider how they might increase their earnings, and instructed that they should pay off their high interest rate loans first. It did not engage in debt mediation efforts with creditors.<sup>35</sup>

Additionally, in 2009, the RBI disseminated an approach for banks in India to create financial literacy and credit counseling centers (FLCC) to help in preventative and 'curative' counseling for distressed, low-income borrowers. These centers could, in theory, assist distressed borrowers to negotiate a debt management plan, subject to approval by one or more creditors.<sup>36</sup> However, an evaluation in 2012 revealed that FLCCs were underutilized, poorly promoted by the banks, and not reaching the target clients.<sup>37</sup>

The consumer advocacy organization Moneylife Foundation, with operations in Mumbai, offers debt counseling, primarily for middle-class loan customers, a different demographic than microfinance borrowers. Moneylife founder Sucheta Dalal indicated that they offer weekly debt counseling through support by the RBI and ICICI Bank (mandated to participate by the RBI due to past illegal conduct in collections practices).<sup>38</sup> Moneylife is now partnering with Experian to ramp up its debt counseling services significantly and possibly expand into other cities. They would be interested in offering counseling to microfinance clients too, but this would take additional time and a significant budget.

<sup>34</sup> According to our sources, in a number of districts that border Andhra Pradesh, MFIs withdrew staff following the AP crisis, leaving borrowers no way to repay outstanding loans. Many of these loans were recorded in the credit bureau as defaults, jeopardizing the future access of these borrowers to credit. One provider interviewed was investigating the feasibility of a service agreement with the original MFI to collect the outstanding debt on its behalf.

<sup>35</sup> Interview with Dr. Suran, Chief General Manager, MicroCredit Innovation Department, NABARD, December 18, 2013.

<sup>36</sup> This is laid out in the "Financial Literacy and Credit Counseling Centres (FLCCs)—Model Scheme 2009."

<sup>37</sup> Reserve Bank of India. Financial Literacy Centres (FLCs)—Guidelines. RPCD.FLC. No.12452/12.01.018/2011-12. June 6th 2012. Available at <http://rbidocs.rbi.org.in/rdocs/notification/PDFs/CER590FL060612.pdf>

<sup>38</sup> KP Narayana Kumar, "Despite RBI Guidelines, Significant Number of Banks' Recovery Agents Harass Defaulters in the Age-Old Way," *The Economic Times*, July 21, 2013.



## UGANDA



### Status of the Sector, Main Actors, Market Framework

The formal microfinance sector in Uganda began in the early 1990s with a handful of donor-supported MFIs such as Uganda Women's Finance Trust, FINCA, and Pride. As of 2010 there were more than 2,000 MFIs in the country, including Savings and Credit Cooperative Organizations (SACCOS).<sup>39</sup>

Ugandan microfinance currently involves both group and individual loans with half of

the institutions interviewed reporting that they have financial products for groups. Ugandan microfinance appears to have started mainly with group lending, subsequently switching to individual lending. Several MFIs indicated in interviews that they are trying to 'revive' their group lending portfolios.<sup>40</sup>

There is no generally applicable consumer protection law in Uganda, nor a market conduct regulator with the specific mandate of financial services consumer protection for the institutions that are not prudentially regulated. Since 2004, bills for a competition law and a consumer protection law, drafted by the Ugandan Law Reform Commission, have awaited Cabinet approval and passage in Parliament. In 2011, the Bank of Uganda published guidelines on financial services consumer protection, applicable only to the regulated institutions and their agents.<sup>41</sup> For example, these guidelines indicate that provider behavior cannot be unfair, aggressive, intimidating or humiliating towards a consumer.<sup>42</sup> However, these guidelines only apply to a minority of regulated providers. Supervision of these guidelines and of

TABLE 3

### Key Facts on the Microfinance Sector in Uganda

<b>MFIs</b>	4 micro-deposit-taking institutions (MDIs) (Tier III); 21 banks (Tier II); 2 credit companies (Tier II), and 2,100 total MFIs including SACCOS (mainly unregulated "Tier IV") <sup>43</sup>
<b>MF clients</b>	550,000 borrowers <sup>44</sup>
<b>Regulator</b>	Bank of Uganda
<b>Network</b>	AMFIU—134 members
<b>Credit Reporting Agency</b>	Compuscan
<b>Entities surveyed for this research</b>	10 MFIs: 3 regulated MFIs; 5 unregulated MFIs; 2 SACCOS 1 MF association AMFIU (Association of Microfinance Institutions of Uganda); one private debt collection company; and Compuscan and Bank of Uganda

<sup>39</sup> Solomon J. Kagaba and Julia Kirya, *The State of Microfinance in Uganda 2012/2013* (AMFIU, 2013), available at [www.amfiu.org.ug/images/docs/Studies/State%20of%20Microfinance%20in%20Uganda.pdf](http://www.amfiu.org.ug/images/docs/Studies/State%20of%20Microfinance%20in%20Uganda.pdf). N.B. Seven institutions reported to the Mix in FY2013.

<sup>40</sup> *Ibid.*

<sup>41</sup> "Microfinance Mapping Project—Uganda," available at <http://ds.haverford.edu/wp/mappingmicrofinance/files/2012/07/Microfinance-Mapping-Project-Uganda.pdf>

<sup>42</sup> The last available MIX report was from 2012 which stated the PAR 30 had remained below 5% over the previous four years.

<sup>43</sup> Available at [www.bou.or.ug/bou-downloads/Financial\\_Literacy/Guidelines/2011/Jun/Consumer\\_Protection\\_Guidelines\\_June\\_2011.pdf](http://www.bou.or.ug/bou-downloads/Financial_Literacy/Guidelines/2011/Jun/Consumer_Protection_Guidelines_June_2011.pdf)

<sup>44</sup> Available at (as well as on Bank of Uganda site): [www.dfcugroup.com/consumer-protection-guidelines-2011](http://www.dfcugroup.com/consumer-protection-guidelines-2011)

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**The formal microfinance sector in Uganda began in the early 1990s with a handful of donor-supported MFIs such as Uganda Women's Finance Trust, FINCA, and Pride. As of 2010 there were more than 2,000 MFIs in the country.**

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providers' practices is weak and enforcement relatively low. The lack of legal protection and sanctions for both clients and providers heightens aggressive measures and mistrust from both parties.

Credit reporting is new to Uganda and coverage is far from comprehensive, with one active player, Compuscan, a South African company. However, only four regulated MFIs report to Compuscan, while there are thousands of unregulated NGO-MFIs and SACCOs in the country, representing the bulk of microfinance debt. The national ID card system in Uganda was launched in the spring of 2014 and registration is ongoing as of the writing of this report, though Compuscan has created a biometric financial card for users of regulated institutions. At present, credit reporting costs are significant and often prohibitive for MFIs, with a single report priced at about US \$6, far above rates in Peru or India, which are less than US \$1 per report.

Local councils play an interesting role in the Ugandan microfinance sector. The local councils were initially established by Yoweri Museveni's National Resistance Army

(NRA) to support NRA combatants. Following Museveni's rise to power in 1986, councils were implemented in every district. Local councils are responsible for education at the nursery and grammar school levels, health care, police and fire protection, and provide other services for their communities. Ugandan MFIs utilize the local councils to assist in debt collection and mediation, and as a source of verification of information on clients' assets and earnings.

There are two consumer organizations of significant scale—CONSENT and Consumer Protection Association of Uganda. Although CONSENT no longer works on financial services issues, it did in the past, in particular on pricing transparency. It is interested in financial services consumer protection, but at present lacks the budget to work on the topic.

The microfinance association, AMFIU, has published a consumer code of conduct and offers complaints handling to the public for complaints regarding its 134 member institutions.<sup>45</sup>

#### **Default Prevention**

The microfinance market in Uganda is characterized by very low trust between lenders and borrowers, and we conclude that this results in part from the lack of a strong legal, regulatory, and credit reporting framework. We observed a spiral of low trust leading in turn to harsher measures, inflexibility, and opportunistic behavior. Accordingly, participants in the market were more prepared to talk about their inability to prevent default than about successful strategies for prevention.

Given the low coverage of credit reporting in Uganda and the historic lack of national identification, it is difficult for lenders to verify basic information about clients. Not only is it impossible to verify the outstanding debt of a client, it may be difficult even to verify the client's identity. The price of credit reporting inhibits its use and because these records exclude unregulated institutions, the information is partial at best. Several MFIs mentioned that obtaining forged identity documents, including passports, is quite easy for clients (at a price). Lenders struggle to overcome these credit information gaps

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<sup>45</sup> See [www.amfiu.org.ug](http://www.amfiu.org.ug)

with alternative sources. In addition, many compound their problems with lax credit analysis. Industry consultants described a perfunctory check with limited analysis prior to disbursing loan as common.

More than half the MFIs interviewed expressed the view that their clients most likely or certainly had multiple loans. One MFI executive responded that “zero percent” of clients have loans only with its institution. The existence of a potentially serious problem with multiple lending in Uganda was confirmed by a 2013 data analysis done by Compuscan, which culled 534 client files from a regulated microfinance deposit taking institution and confirmed that while these individuals had a small microloan from a Microfinance Deposit Taking Institution, they also had much higher credit amounts from other regulated institutions. In fact, 83 percent of the survey sample had a micro loan as well as debt exposure at other institutions of between US\$1,000 and \$10,000. Compuscan classified 40 percent of these loans as high risk, with a likelihood of default.<sup>46</sup>

It is MFIs’ widespread perception that clients frequently borrow with fraudulent intent and will take flight when facing repayment difficulties. For instance, several MFIs and a private investigator/debt collector asserted that borrower flight represented the majority of defaults. When Ugandan borrowers flee to another locality, they have a good chance of dodging past debts and incurring new ones without being discovered. Borrower flight was also attributed by several stakeholders, including MFIs and consumer groups, to poor product transparency and multiple borrowing. This combination results in borrowers discovering after the fact that they cannot afford the loan and fleeing to neighboring towns and their ancestral villages.

Default management practices are highly influenced by the perception that the debtor could flee at any moment. In turn, delinquent borrowers believe MFIs are going to respond harshly to all delinquencies, regardless of the reason, and perceive their options as limited to flight when they cannot repay. As we discuss in the next section, this climate of mistrust limits clients’ attempts to work out a solution

TABLE 4

**Group Lenders in Uganda: Time to First Contact After Missed Payment (Weekly Repayments)**

MF1	MF2	MF3	MF4
2–3 weeks	3 weeks	3 days	On missing meeting

with the MFI, particularly if they are newer clients and have limited history with an institution. Further, borrowers are influenced by knowledge of Ugandan civil procedure which allows for incarceration of defaulting debtors for up to six months.<sup>47</sup>

Numerous examples of pyramid schemes exist, such as COWE, Frontpage, Dutch International and Team. COWE (Caring for Orphans Widows and the Elderly) principals pretended to be an MFI and took an estimated US \$7 million in deposits without a deposit-taking license from thousands of victims. To date, no criminal involved has been successfully prosecuted and no victims reimbursed. The Bank of Uganda was aware of the scheme but unsuccessful in shutting it down or freezing its accounts.<sup>48</sup> Such experiences contribute to an atmosphere of wariness on the part of clients.

**Management of Delinquency and Early Stage Default**

Among Ugandan MFIs there were significant differences with regards to the timing of contact with a delinquent client. While two of the four group lenders we surveyed allowed groups to manage delinquency for the first several weeks, two others contacted late borrowers within the first week.

For individual lenders, responses appeared to be faster. Upon a missed payment, the MFI staff is dispatched for a field visit. One MFI mentioned that they call clients one day before a payment is due; if a problem is expected they plan a loan officer visit. Other

<sup>46</sup> The case study summary is available at <http://ciskenya.co.ke/wp-content/uploads/2013/03/An-Insight-into-Multi-Borrowing-of-Selected-MDI-Borrowers-in-Uganda.pdf>

<sup>47</sup> “Uganda Debts Summary Recovery Act, 1937” available at [www.ulii.org/ug/legislation/consolidated-act/74](http://www.ulii.org/ug/legislation/consolidated-act/74)

<sup>48</sup> Interview with Flavian Zeija, Makerere University Law Faculty, February 2014.

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**We were unable to verify that collateral seizure was the norm with the majority of MFIs, but, if this is systemic, it suggests that MFIs believe that they lack a viable alternative to ensure repayment. In all four MFI loan agreements we reviewed, the practice of seizing and selling collateral without following legal processes was visible.**

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MFIs mentioned that at three and seven days late actions would be taken, including a field visit.

MFI response time to a missed payment could certainly be influenced by the knowledge that clients are juggling multiple loans, thus several loan officers are pressuring clients for repayment.

This could very well instill a mentality of “the early bird gets the worm.” Two former MFI executives mentioned that due to multiple lending, as soon as the MFI gets news of a missed repayment, loan officers rush to the debtor to seize assets before loan officers from other lenders arrive on the scene. One interviewee called this the “race to the bottom of the pyramid.”

The difference in response times between delinquencies in group and individual lending might be explained by the use of the group as a default shield and a collection tool. Individual lenders, lacking the group guarantee, are likely to feel insecure in their ability to protect their rights as a creditor. Therefore, it is understandable that they respond more quickly to a missed payment.

### **Third Parties**

While none of the MFIs interviewed mentioned that they used external collections companies or private investigators, we heard a different story from one external collections company. The private investigator/debt collector interviewed for this research stated that six

large MFIs in the country were his company’s clients, including two that participated in this research. We also interviewed an executive who indicated that collections work for financial services providers was growing due to debtor flight.

Another popular debt collection strategy in Uganda is to engage local councils. More than half of the Ugandan MFIs surveyed stated that they use local councils to assist in collections. One MFI mentioned that a local council can call on police to assist in collections. Another MFI indicated that it would need approval of the local council if it were to seize a delinquent borrower’s property. Another noted that the local council’s inside knowledge about the debtor was extremely helpful in collections, giving the example of a delinquent borrower who claimed insolvency, despite owning multiple rental properties. The local council informed the MFI of this, allowing it to garnish the rental payments of the debtors’ properties until the debt was repaid. A smaller NGO/MFI stated that the local council played an important role as mediator, usually advocating for more time for the borrower to repay. NGO/MFIs stated that in exchange for the local council’s services, they often give council members gifts such as air time or lunch (“but never dinner”).<sup>49</sup>

In addition to the local council, three of the larger Ugandan MFIs indicated that they use external lawyers to send demand letters to delinquent clients and that they work in concert with bailiffs and auctioneers to seize and sell debtors’ properties.

### **Collateral Seizures and Incarceration**

In Uganda frequent complaints related to the treatment of collateral, including savings, appeared in interviews. A bill before Parliament aims to govern the “giving of personal property or chattels other than land as security for a loan or debt.”<sup>50</sup> The memorandum accompanying the bill notes that “chattels as collateral for repayment of a debt are not well developed in Uganda. They are mostly used by individual lenders rather than banks. Banks usually only accept land as security. The current law has not therefore been put to much use.” In any event, the lack of

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<sup>49</sup> The researchers interpretation of this statement was that dinner is more elaborate, thus more expensive and they were only providing a small token of their appreciation.

<sup>50</sup> “The Chattels Securities Bill of 2009,” available at [www.ulii.org/ug/legislation/bill/2009/no-12-2009](http://www.ulii.org/ug/legislation/bill/2009/no-12-2009)

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market conduct supervision allows MFIs, and in some cases group members, to easily confiscate debtors' chattels.

Additionally in 2012, a mortgage regulation introduced some changes to the creation, registration, and enforcement of mortgages, which spelled out clear procedures for financial institutions selling client property. It did not appear from conversations with MFIs that they were aware of this law and applications that would violate it. It did not appear that they were being forced or incentivized to abide by it.

Much of Ugandan micro-lending is unsecured from a strictly legal perspective, although many MFIs make note of client household possessions, which are often a requirement to obtain both group and individual microloans. Ownership of assets used as collateral may be hard to verify, as such ownership is not documented during the loan process. Further, land and car title documents can be fraudulent, and the land registry does not function well. In some cases, local councils may have information to verify land titles and ownership.

We were unable to verify that collateral seizure was the norm with the majority of MFIs, but, if this is systemic, it suggests that MFIs believe that they lack a viable alternative to ensure repayment. In all four MFI loan agreements we reviewed, the practice of seizing and selling collateral without following legal processes was visible. In one case, the loan contract authorized the MFI to seize the debtor's land, and extended the their rights "to all the borrower's property and other income from all other sources until the debt due to it is fully repaid."

We came across many other examples. A MFI focused on agricultural lending required collateral in the form of land or other chattels for group and individual loans. The MFI's contracts stated that in the event of default, the MFI could seize and sell the borrower's land "through a private treaty... without recourse to the court and shall not be answerable for any loss or expense occasioned thereby." In such a case, a client is unlikely to receive a fair value for the land. One MFI's loan agreement also stated that the MFI could seize borrower savings in the event of default

(despite the fact that the MFI in question did not have a deposit taking license). A former general counsel at another regulated MFI confirmed that her institution was also "dipping into client's savings" in the event of default, and that the MFI's loan agreements also stated that seizure and sale of goods could be handled institutionally without recourse to public proceedings.

We also understand that in the case of group loans, the groups themselves often seize and sell delinquent borrowers' assets. One MFI indicated that group members can keep the excess of property sales from seized collateral even after the outstanding loan balance has been paid. The contractual language empowers the group to seize and sell the delinquent borrower's property. One interviewee stated that debtor assets are often sold along the roadside before the loan officer returns to the office.

These examples circumvent Ugandan law, which provides for sale by public auction with a bailiff presiding.<sup>51</sup> Appropriate valuation and seizure/sale notice provisions to the borrower should be followed. A debtor's other property, if not specifically used as collateral, should not be accessible to the creditor without either the debtor's consent or a court order. Further, debtors' tools of the trade and chattels owned by the household like beds, pots and pans are normally exempted from seizure under most common law systems such as Uganda's.

Ugandan law sets a harsh standard and leads to a severe imbalance of power. A particularly troubling aspect is the civil procedural law that allows for the incarceration of a defaulting debtor, guarantor, or spouse.<sup>52</sup> The sentence is generally for six months, but local lawyers mentioned that it is possible to be granted 'extensions.' If the MFI has the power to incarcerate the borrower, who has virtually no equivalent power, lack of trust between provider and client is exacerbated.

There is evidence that MFIs occasionally go beyond the law through payoffs to officials, either magistrates (for issue of arrest warrants) or police (for actual arrest and jailing).<sup>53</sup> Partly in response to advocacy efforts by debtors incarcerated in Luzira prison, supported by law students from Makerere University, the Ministry of Justice

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<sup>51</sup> Order 22 of Rule 70(2) of Ugandan Civil Procedure.

<sup>52</sup> Per Ugandan Debt Summary Recovery Act of 1937, available at [www.ulii.org/ug/legislation/consolidated-act/74](http://www.ulii.org/ug/legislation/consolidated-act/74)

<sup>53</sup> Documented by Flavian Zeija, Makerere University Law School.

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recently ordered that magistrates can no longer issue arrest warrants, and that only a court has the requisite authority.<sup>54</sup> A paralegal working at the Jinja prison informed the students that incarcerations decreased this year because creditors must now get a judicial order as opposed to simply getting an order from a magistrate.

### Restructuring

Restructuring is uncommon in Uganda. One Ugandan MFI indicated it never restructures and five other MFIs indicated that while it was technically possible per their internal policies, use is severely limited. For example, two MFIs stated that the board of directors must approve the restructuring. A former manager at a large deposit-taking MFI confirmed that the bureaucracy involved in proposing restructuring to the board ensured that it almost never happened. Another large, regulated provider indicated that if a field investigation determined that the loan was recoverable, a restructuring could be recommended to management.

One regulated MFI stated that if the borrower had paid off half of the debt, the provider could waive the interest and any penalties, whereas if only 25 percent had been repaid, the analysis would be on a case-by-case basis. A CEO at another MFI implied that its policies were changing to become more client-friendly. He stated that while they used to not be concerned about the clients' reason for default and would use private collection agents, the head office now invites delinquent clients to come in and discuss the reason for their delinquency with MFI staff. The provider can then extend the loan term, or offer other options on a case-by-case basis, dependent upon how much of the loan is paid off.

There were some exceptions. One small Ugandan MFI indicated that they could reschedule a loan. This NGO/MFI that targets a more agricultural population stated that

it would consider rescheduling when the problem was genuine, with branch manager sign-off. It estimated that it had restructured 12–13 loans during the first two months of the year. This is an indication that in practice restructuring is truly available, as opposed to respondents who state that the policy is in place but cannot remember ever restructuring a loan. Yet another NGO/MFI interviewed stated that it would allow the borrower more time to repay, but only upon the intervention of the local council. Also, an employment-based SACCO indicated that it would reschedule, provided the borrower signed a new written commitment.

### After Write-Off

In Uganda, as in other markets, a write-off does not end the MFI's attempts to collect on a loan. In general, write offs in Uganda tended to occur anywhere between 100 days and 271 days overdue. However, eight of the 10 surveyed MFIs indicated that they continue with collections efforts until they collect or sell assets to cover the debt. Three of the Ugandan MFIs indicated that only the death of the delinquent borrower would allow them to forgive a loan.

One of the larger deposits-taking MFIs indicated that post write-off, it would begin recovery proceedings if there were assets to attach. A former executive of another large MFI added that write-off is the point at which the provider's conduct may become very aggressive because it considers the relationship with the borrower to be terminated.

Ugandan borrowers who have defaulted have few places to go for assistance. There are no third party debt counseling, or other debt relief mechanisms available. AMFIU offers complaints handling (not debt counseling) to the public regarding its members but it appears this system is not often used. None of the surveyed institutions had any special procedures in place to counsel or rehabilitate defaulting clients.

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<sup>54</sup> See <http://msserwanga.blogspot.com/2011/06/petition-of-civil-debtors-against.html> and *Report on Causes of Debt, Interviews with Prison Inmates in Jinja, Lugazi and Luzira Prisons*, January 20–27, 2014, Makerere University Law School.

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## Cross-Country Findings & Recommendations

# 3

This section will discuss some key findings across the three, very different markets. It will underline particular areas of conduct identified as concerning from a client protection perspective and, where applicable, make suggestions for remedial steps or encourage additional investigation.

### The Influence of Market Infrastructure on Provider Behavior

Across the phases of a delinquency and default, the influence of market conduct regulation and supervision as well as credit information infrastructure on practices was a striking, common refrain. The project examined a market with extremely well developed regulation and long-standing credit bureau (Peru), as well as a market where regulation and infrastructure is developing (India) and a market with a significant regulatory and information vacuum (Uganda).

We noted that in Peru the presence of two energetic and effective market-conduct regulators with an overlapping mandate appeared to support good practices. Providers were very much aware of the rules and the penalties for not following the regulations. This did not appear to be the case in India or Uganda, though there is promise in the designation of the association MFIN as a self-regulatory organization in India, and MFIN is equipping itself to actively monitor its members with the oversight of the RBI.

Credit bureaus also appear to significantly influence market behavior, not only at the front-end (allowing providers to make more-informed credit decisions), but perhaps more importantly for this issue, at the collections

end by assuring lenders that the value of a clean credit report gives clients a strong motivation to repay. The speed and intensity of reactions to delinquency is influenced by this assurance. In Peru, nearly all microfinance providers are covered, data quality is good, and providers uniformly check credit reports. In India, the change in the presence and use of credit bureaus in the microfinance market over the past two years was particularly impressive, with all the NBFC-MFIs reporting to two credit bureaus. In Uganda, conversely, credit bureau coverage is inadequate, and as a result, it is clear that client-provider trust is lacking.

In Peru, where credit information was available, response times to early stage delinquency were not immediate. We posit that this is due to MFIs feeling secure as creditors, perceiving the deterrent effect of the credit reporting system. Response times are also not immediate in India, but this is largely due to the use of groups as first line of defense in collections. We observed that the Ugandan providers were the quickest to respond, with an almost immediate visit to the debtor. It seems that Ugandan providers felt less secure about their position as creditors. Ugandan MFIs cannot rely on credit reports as deterrents, nor do they have the group structure to minimize late repayments, and they have a valid fear of debtor flight.

These issues must be addressed at a market level. A single MFI can certainly decide to apply good practices, but if it operates in an environment without supportive regulatory and information infrastructure, market forces will push it towards more

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aggressive behavior. MFIs must work together, and they must work with regulators and credit reporting organizations to help establish a supportive environment.

**Findings: Issues for Discussion**

The elements of humane collections are straightforward and intuitive:

- Treat clients with respect even when insisting on repayment.
- Keep collections private to the extent possible.
- Do not deprive clients of their basic human needs or ability to earn a living.
- Be flexible when it is warranted and feasible, and find ways to assist clients to rehabilitate themselves over time.
- And, of course, carry out collections in compliance with domestic law.<sup>55</sup>

We found many examples of lapses in humane collections, especially in India and Uganda. Recognizing that few providers set out intentionally to apply bad practices, but are propelled by market conditions, our findings suggest that the following issues should be highlighted for industry discussion.

**Problems with Loan Contracts**

Despite asking every institution that participated in the study, the team only received five sample loan contracts. Each of those contracts, upon deeper review, was

missing essential content to adequately inform the borrower of terms and conditions or contained illegal or harmful terms.

Loan contracts can be a good means of communicating essential information to clients, where MFIs can ensure that clients receive all the terms and conditions of their loans, including the consequences of nonpayment. The Smart Campaign's principle on Transparency places explicit emphasis on conveying complete cost and non-cost attributes of products—including what happens in the case of delinquency or default. In cases where there are literacy problems, the Campaign suggests reading the contract orally to clients prior to disbursement. These measures mitigate against clients making an ill-informed decision, in this case not understanding the potentially long-term implications of a default.<sup>56</sup> However, the few agreements we saw did not clearly communicate actions that the lender would take to collect on a delinquent loan, including notifying a third party of default or taking action to seize collateral.

Our interviews and review of the handful of loan agreements further revealed various conflicts between MFI practices and commercial law, in areas such as duration of collection efforts, use of guarantors, and collateral practices. For example, one Indian contract attempted to pass the debt to borrower's heirs, holding them personally liable for payment without the heirs being notified or consenting to act as guarantors. If the MFI attempts to continue collection efforts across generations, that would probably imply collections well beyond the three year legal limit to enforcement. In Ugandan contracts, we also noted a conflict with regulation regarding collections and seizures of collateral. Loan agreements clearly expressed that 'regardless of the law' they would have immediate right to seize and sell client assets without any recourse for clients' damages or low price per value received. One agreement even assigned the profits from the sale of the defaulting borrower to the group.

**Flexibility Toward Distressed Clients**

As the quote at the beginning of this report states, "microfinance clients live on the edge

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<sup>55</sup> For some examples of good practices see Smart Campaign's tools including "Best Practices in Collections Strategies"; "Smart Note: Collections with Dignity at FinComun"; "Collections Guidelines for Financial Service Providers"; and "Code of Conduct for Collections and Collections Practices for Group Loans" all available at [www.smartcampaign.org/tools-a-resources](http://www.smartcampaign.org/tools-a-resources)

<sup>56</sup> For more information on Principle #3 Transparency, please see the Smart Campaign Client Protection Standards at [www.smartcampaign.org](http://www.smartcampaign.org)



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of disaster and frequently fall into it.” Thus, from a client perspective, more flexibility and concessions should be the norm when borrowers are genuinely in difficulty. By showing a willingness to restructure, or offer other concessions to enable the client to continue to make repayments, the provider is making a determination to salvage the client relationship. From a business perspective, it costs more to seek out new clients than to retain existing clients, and so restructuring could make sense.

We were concerned by the significant number of providers that do not offer restructuring to clients in distress, particularly in Uganda and India. In Uganda, borrowers seem least likely to obtain a restructuring due to the problem of flight. Comparatively in India, restructuring and other concessions could be obtained, but normally only when there was a known event such as a natural disaster or political event that affected a multitude of borrowers, despite the requirements of the RBI’s Fair Practice Code. Lenders are most willing to restructure in Peru.

The Smart Campaign believes that providers should seek to understand the root cause of the delinquency and suggest alternative solutions to the client, or ask the client to propose potential solutions. The use of restructuring, refinancing, and ultimately settlement with some forgiveness is a very challenging area for lenders because of the risks involved—such strategies can be used too often and hence create moral hazard among borrowers or used by loan officers to disguise delinquency. Of course, the point at which restructuring is offered is also critical: If offered too late, it does not prevent borrower duress, but if offered too soon, a borrower could be tempted to take undue advantage. In addition, micro-lenders do not operate in a vacuum and clients talk amongst themselves and thus whatever concessions are made cannot be done for only one of a few. However, it does make sense for lenders to have such policies and to use them when needed, taking into account the borrower’s past performance and current circumstances. It also makes sense for lenders to build the expectation that such strategies will be used from time to time into their projections of financial performance. Similarly,

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it may make sense to build some flexibility into loan agreements (for example, an agreement that allows borrowers to be late three times with a rebate if they are never late.)<sup>57</sup>

Thus the Smart Campaign calls for providers to have a process in place for rescheduling as well as some form of communication to clients, prior to signing a contract, that in the case of hardship they should approach staff to figure out a solution; however it does not specify the details of such communication nor the timing at which rescheduling or other forms of flexibility should be offered. Further dialogue on restructuring policies, other tools to help clients in debt distress and the outcomes could be very beneficial to the industry.

### **Inappropriate Seizure of Collateral**

The use of collateral appeared starkly different between markets. In India collateral was not permitted for JLG loans, though we did hear anecdotal evidence of groups seizing delinquent borrowers’ household goods. In Uganda, the seizing of collateral by MFIs appeared to be standard, but procedures often did not appear to adhere to legal requirements for use of a bailiff and licensed auctioneer.

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<sup>57</sup> For more on this, see the Smart Campaign’s Client Protection Principles.

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While the Smart Campaign agrees that collateral and guarantors can be appropriate repayment motivators and a useful way to minimize MFI risk, they cannot replace sound repayment capacity assessment. In addition, collateral should be important to the borrower but not a source of livelihood, the deprivation of which could make a default even worse. In its standards, the Smart Campaign requires institutions to define acceptable pledges of collateral as well as clear guidelines for how collateral is registered and valued. In addition it requires that collateral seizing is done legally and with respect for clients rights. Guarantors must be made aware of their obligations and responsibilities in the case of default.<sup>58</sup>

#### **Use of Third Parties in Collections**

In each country, MFIs rely on third party actors in some manner. In Uganda, the third party is the local council, which is incentivized by gifts of nominal value, and which is also provided the opportunity to assert its influence over the people it governs. In India, the third party is the solidarity group and the center, as well as in some cases the entire village. In Peru, this actor is the professional collections company, which earns a percentage of what is recovered, or, for unregulated MFIs, the *camara de comercio*, which publishes notices of default for a small

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<sup>58</sup> For more, see the Smart Campaign Client Protection Principles, particularly Principles 1 & 5.

<sup>59</sup> Ibid.

fee. The external actors in each country have different motivations and incentives and they engage in different parts of the process, but the end result is that the MFI receives crucial assistance with collections, often without spending a lot of money. The Smart Campaign requires that any collaboration with a third party during collections requires training and compliance with the FI's own internal ethical codes and professional conduct requirements.<sup>59</sup>

We were intrigued by the potential value of the locality-based institutions, the *camaras de comercio* in Peru and local councils in Uganda, and we speculate that organizations such as these could be equipped to take on more formal roles (if they have the will to do so). However, it is clear is that because use of local institutions to heighten pressure on customers can be socially damaging to clients, such practices must be carefully designed, executed, and monitored.

The group liability mechanism is used differently across markets and providers, with some demanding strict liability and others enforcing a more temporary liability for only two or three missed payments. A question that emerged from this research was how to preserve the role of the group in incentivizing repayment, while ensuring that members do not use inappropriate, harmful tactics. This question emerged most strongly in India, where MFIs often take a hands-off policy to intra-group dynamics as a matter of instilling group discipline. This approach allows MFI staff to close their eyes to abuses.

To the extent that the MFI is aware of bad conduct and does not intervene, it is sanctioning the group's conduct. Open discussions need to take place to develop measures to help group members adhere to the client protection principles and systems for staff to respond to abuse by groups. It would be interesting to research what mandate MFIs give to groups, how they are instructed, and what level of monitoring providers have over group actions. It would also be interesting to ascertain whether MFIs regularly intervene and if so, at what point and with what triggering events.

There were several examples of consequences of default going beyond the initial joint liability group members and

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escalating to centers and even villages. Even if these groups are not bound contractually, if MFI staff threaten their future access to credit if they cannot wrangle a payment from a defaulting client, it has both severe implications for the unofficial guarantors and for the client. While the researchers did not investigate this dynamic in depth, it would be important to understand practices in a more systematic way.

### Lack of Rehabilitation

Unfortunately for borrowers, there are not many resources available to clients who have defaulted in these three markets. And, as evidenced by interviews, defaulters are often pursued by their creditors even long after write-off. Existing legal/regulatory frameworks and codes of conduct in the microfinance industry generally do not suggest rehabilitative, or curative efforts to be taken to assist defaulters. Neither Ugandan nor Peruvian regulations mandate that MFIs should take curative actions.

In most countries, there are limitations on the legal right of debtors to enforce a contract in the courts. In the countries we studied, limitations range from three to six years.<sup>60</sup> In both Uganda and India, colonial-era bankruptcy laws allow companies to obtain debt relief, but these are not intended for use by individuals. In India, a voluntary, extra-judicial, ‘fast-track’ procedure (Corporate Debt Restructuring, championed by the RBI in 2001) allows distressed companies to deal with insolvency when they have multiple creditors called.<sup>61</sup> In fact, there are six Indian MFIs currently undergoing corporate debt restructuring as a result of the Andhra Pradesh crisis. The CDR process illustrates recognition that corporate bankruptcies and failures are a normal risk of doing business, for which a rehabilitative solution is necessary. Yet, similar solutions are not available for low income clients of microfinance.

In the three focus countries, there is no affordable or widely available system in place for defaulted clients to receive debt counseling, or mediation assistance with multiple creditors in order to develop repayment plans or receive debt relief. Peru’s existing INDECOPI procedure, can cost up to \$1,500 and, therefore, is

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unaffordable for a microfinance debtor. It also seems to be little known among the public. The Indian RBI’s scheme of financial literacy and credit counseling centers (FLCC), while well-intentioned, has not been extensively promoted or used by target clients. Also in India, the consumer advocacy organization, Money Life Foundation has begun expanding its credit counseling services, but not to microfinance clients per se.

From a client protection perspective, when the industry knows that a percentage of its clients will fail in their efforts to repay, there should be a process for debtor rehabilitation that respects the debtor’s need for a financial future. However, there is little evidence that MFIs and regulators in these three countries have spent much effort considering, let alone providing debt rehabilitation. Borrowers who default are left without assistance from MFIs or government at a time when they probably most need it.

The Smart Campaign does not currently address this issue, nor do industry codes of conduct in the microfinance sector. Should debtors be on the hook for life? Or, should we recognize that some borrowers might deserve the chance towards a clean slate after a default? See Annex 3 for some examples of default mediation in European and middle-income markets which include tactics such as cost-sharing for mediation between governments and MFIs.

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<sup>60</sup> Under section 3 (i) of the Uganda Limitation Act, actions founded on contract shall not be brought after six years from the date the cause of action arose. According to the Indian Limitation Act, 1963, an action for breach of contract must be brought within three years from the date of the breach. The Peruvian statute of limitations is three years on commercial documents.

<sup>61</sup> More details available on the official CRD website at [www.cdrindia.org](http://www.cdrindia.org)

# 4

## Recommendations for Collective Action

**Improve credit information systems across all three markets.** Even for the most advanced country, Peru, the quality of credit reporting is not the problem, but rather getting MFIs to appropriately utilize warning reports from the bureaus containing data on saturated markets. In India, the inclusion of data from SHG lending model will be a key, major undertaking, so that MFIs have a more complete picture of clients. In Uganda, in addition to increasing the purview of Compuscan (or of competition in the credit reporting market), MFIs might consider a private agreement to share default information among those with significant market share. Any increase in information sharing between borrower and provider will serve to improve the overall distrustful environment.

**Encourage regulators to monitor and enforce market conduct, reward good behavior and when capacity-constrained, outsource these functions.** While regulations studied here mention sanctioning for bad market conduct, we found few examples where this had occurred, except in Peru. In developing markets regulatory bodies often have capacity constraints in supervision and monitoring. In India, the RBI has recently decentralized some of these functions to MFIN as a self-regulatory body.

Regulators can employ third parties to help ensure good market conduct, and they can recognize, require and reward good conduct in the form of third-party validations such as the Smart Campaign Certification Program or the Indian Code of Conduct Assessment. These programs are a practical response to limited supervisory capacity, and they incentivize good practices.

**Increase understanding of intra-group dynamics and measures to reduce abuse in group lending.**

While joint liability is an important tool for uncollateralized group lending, the *laissez-faire* attitude of many institutions towards harsh group behavior is a concern. More research is needed to better understand these dynamics and develop recommendations for MFIs on how to train against, monitor, and sanction abuses. The Smart Campaign has partnered with BFA in Pakistan, Benin, Peru, and Georgia to conduct demand-side research that will likely contribute to this discussion.

**Shed more light on loan contracts.**

While most institutions did not share their contracts with the researchers, the few that did showed many problematic aspects in terms of transparency regarding default processes, and in Uganda in particular, the legality of practices. An important research

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effort would collect and review sample loan contracts within the sector to shed light on client protection implications and share good practices. The Smart Campaign has a number of sample contracts on its website, but this research has uncovered the need for much deeper review and discussion.<sup>62</sup>

**Develop greater clarity on the use of restructuring and more flexible debt relief.** It is not easy to design and communicate a restructuring or rescheduling policy that both fulfills the need to act sympathetically towards genuinely distressed borrowers and avoids creating moral hazard. More tactics and tools should be developed and shared to help strike that balance.

**Do not incarcerate delinquent microfinance borrowers.** Even if it is legal in some countries, as in Uganda, it is not a good or healthy practice for the industry.

**Create mediation and debt counseling mechanisms that work for base-of-the-pyramid (BOP) clients.** In Peru and India, the project found examples of default mediation for consumer debt, as well as one instance of a BOP initiative that had not worked. Annex 3 provides examples of mechanisms that have worked in Europe and middle-income markets. It would be

important to discuss the application of these models at the BOP, including how to make them affordable for both mediation providers and users.

**Encourage MFIs to set policies on when debt obligations to the institution will eventually end, such that the debtor's obligation ends when a default has occurred and it is clear that further collection efforts would be futile.** This would allow defaulting debtors who do not have access to debt rehabilitation measures to have closure and effectively be allowed to participate again in the financial services sector. MFIs might consider utilizing the country's own time bar on the use of courts for collection of debts.

**Encourage consumer organizations to shed light on abuses and raise awareness among clients of their rights and responsibilities.** Organizations like MoneyLife in India and the team of Dr. Flavian Zeija, Makerere University Law Faculty, provide examples of how consumer organizations can advocate for and bring attention to clients in distress. Clients should be made aware of their rights and responsibilities and given the ability to share grievances in a way that contributes to advocacy and policy formulation.

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<sup>62</sup> See [www.smartcampaign.org/tools-a-resources/comprehensive-list-of-tools](http://www.smartcampaign.org/tools-a-resources/comprehensive-list-of-tools)

## Summary of Responses from Online Survey on Default Management

With more than 300 replies (198 from Anglophones, 59 from Francophones, and 74 from Hispanophones), the survey illustrated that there is significant diversity in how MFIs deal with defaults beginning with when collections procedures are triggered (for many, it coincides with the first missed payment); what form those collection efforts take (group pressure; taking individual or group savings; seizing collaterals or guarantors' assets; offering debt rescheduling/restructuring; or using the courts to collect overdue debts) and whether debt collection is outsourced (yes, in 29 percent of the respondent institutions).

Close to 30 percent of MFIs<sup>63</sup> treat default as a *strict liability* offense, meaning those borrowers who have defaulted due to illness or natural disaster are treated the same as those with perhaps less sympathetic motives (e.g., losing money at cards or fraud). For the majority of MFIs that do treat unintentional defaulters differently than those deemed to have intentionally failed to repay, steps for unintentional defaulters include giving more time; restructuring loans; granting bridge loans if necessary; and considering debt forgiveness (mentioned by a single MFI).

Further, it appears that the majority of the respondents offer restructuring options to clients who have defaulted.<sup>64</sup> However, a deeper analysis is required to understand at what point in time this option is offered

(e.g., after savings or collateral or guarantors' assets are seized or before?), whether rescheduling is discretionary, or if a standard operating procedure exists and can be viewed in staff training manuals, and is subsequently explained to clients (and if it is explained to clients, when and how?).

Another item of interest from the survey is that only a slight majority of respondent practitioners conduct exit surveys with departing clients, with approximately 52 percent responding "yes." This is another area we would like to explore further—what significant information comes from the exit survey that could be used to better inform business processes or prevent default? Why are institutions not doing these—lack of resources; unable to find/convince debtors to participate?

Also, the majority of MFI respondents continue to collect on debts after they have been written off as defaults, with some 85 percent indicating that they keep the debt files open post write-off, and about 40 percent keep client files for more than seven years. About one-third of respondents maintain files on defaulting clients from one to three years. Seventy five percent of respondent MFIs are taking collaterals, and nearly 92 percent of those polled responded that they have specific policies on what is acceptable as a collateral. In some states, legislation dictates what is possible.<sup>65</sup>

<sup>63</sup> 27.5% of the respondents indicated that they did not distinguish between unintentional defaulters and those who intentionally default. And Hispanophone respondents were more likely than their Francophone and Anglophone peers to distinguish based on reason for default.

<sup>64</sup> Almost 78% of the respondents offer restructuring, however, the question regarding *how often restructuring had actually been done in the last year* elicited a wide variety of responses from 'one time' to '80%.' For the latter institution, however, it is unclear if they meant 80% of their loans in default were rescheduled, or 80% of their loan portfolio.

<sup>65</sup> We did not however ask if MFIs take multiple collaterals; at what ratio to loan value and whether these practices have evolved or changed with experience.

## Questions Used in Interviews with MFIs

### What happens to Microfinance clients when they default?

#### I. Documents requested:

- ☑ Staff policies on collections
- ☑ Standard form borrower loan agreement for group & individual loans (include a list of prerequisites for the loan such as collaterals and guarantors)
- ☑ Agreements with external collections agencies
- ☑ Organization's policies on restructuring/rescheduling and loan forgiveness

#### II. Institutional Questions:

##### 1) What is the legal structure of the MFI?

- ☑ Size of loan portfolio and average loan size
- ☑ Current PAR 30 and PAR 90 data
- ☑ Restructured/rescheduled loan portfolio (number of loans & amount per in past year)
- ☑ No. Of write-offs (for 12 month period)
- ☑ No. Of loans forgiven in past year
- ☑ Percentage of group loans in portfolio
- ☑ Percentage of individual loans in portfolio

2) Describe the terms of the institution's leading microfinance product (checking all that apply):

- ☑ Has a group guarantee feature (i.e. joint and several liability)
- ☑ Requires an external guarantor
- ☑ Requires more than one external guarantor
- ☑ Requires a salaried guarantor
- ☑ Requires physical collaterals which are moveable goods
- ☑ Requires physical collateral which is real estate
- ☑ Requires savings as a prerequisite to obtain a loan (*please indicate the percentage of savings required*)
- ☑ Requires additional savings during the loan cycle (*if yes please indicate %*)
- ☑ Requires the purchase of an insurance product (*if yes please indicate what specifically that insurance covers*)

#### III. Collections Practices:

3) Do you have different collections policies for individual loans vs. group? If yes, please specify how they are different:

4) Do you monitor the collection activities of the group? Are they provided with guidelines to follow when collecting debts? Has your organization ever had to intercede with the group to correct inappropriate collections behavior? If yes, please provide examples of when this has occurred.

5) Does your institution outsource debt collection to an external third party (other than the lending group?)

- If yes, at what point do you outsource?
- To whom do you outsource collections, and based on what criteria were they selected?
- Do you provide the third party with guidelines to follow on acceptable practices? What is the compensation rate?
- How effective are they?
- What level of monitoring does the MFI maintain over these parties? Do they submit regular reports to you?
- Has the MFI always outsourced collections or did this evolve over time?

6) What actions do you take once a loan is a day late: please describe the order of the actions taken until the debt is collected or written off?

7) What type of late fees or penalties do you assess for delinquent accounts? Do you assess additional interest for post-due balances (i.e. in addition to scheduled interest payment)? For how long do fees/penalties/interest accrue?

8) Is there an *in duplum* law in place in the country?

9) Does the institution have a written collections policy for staff?

- How do you monitor compliance with the policy? Could we obtain a copy?
- What types of incentives do you offer to staff responsible for collections?

10) Describe how you communicate client responsibilities regarding debt repayment? What are the consequences of delinquency that are communicated to clients? Do you inform clients of their rights if they fall delinquent? (verify by asking a loan officer what info is communicated to the client)

11) Has the institution's collections policy changed over the past 2 years, and if yes, please specify how:

#### IV. Treatment of Collateral(s) & Guarantors

12) Is your institution required to follow legislation or regulation on the treatment of collaterals, including registration with the appropriate authorities or registries; rules regarding seizure; valuation protocol and the sale of collaterals for clients in default? If yes, could you explain the implications for your operations?

13) If your institution seizes/sells collaterals for unpaid debts, can you describe the valuation and sale process? Is there a written policy? Can we have a copy?

- Does the institution maintain documentation on the collaterals that have been seized/sold? Can we have this information?
- Do you store seized collaterals prior to the sale and if so, where are the goods stored and what is the cost to the organization?

14) In the past year, how many debt defaults were paid for by the loan guarantors?

- When a guarantor is unable to pay, what actions does your institution take (e.g. report to credit bureau; seize assets)?

15) Do you have a client complaints hotline? If yes, please describe how this operates (client awareness, chain of responsibility):

- How many client complaints have you handled in last 3 months and were any of them specifically about collections? Were there any related to the manner in which collaterals were seized, valued or sold?

#### V. Composition of Special Collections or Recovery Unit:

16) How many staff are assigned to special collections? Which part of the organization does the unit reside in?

17) Is your institution required to follow legislation or regulation that provides guidance on acceptable collections practices?

18) Does your institution have full-time legal staff? If yes, how many and what percentage of their time is allocated to debt collection?



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19) Do you use outside lawyers to assist with collections? Please describe the nature of their work (note to interviewers: clarify that this should be separate from outsourcing collections, i.e. external lawyers may assist the MFI to collect, but don't take on the direct responsibility themselves).

20) Are you able to use the courts or public authorities to collect debts?

☑ If yes, how does this work, and what are the costs to use the system, and how long does the process take?

☑ In the past 12 months, how many times have you relied on the courts/public authorities to collect debts?

## VI. Defaults:

21) Does your institution distinguish between defaults which are intentional (i.e. the borrower could repay but doesn't want to) and those borrowers who would like to repay but are truly unable?

☑ If yes, how do you make this determination? Is there a written policy? Who makes this determination?

☑ Are clients informed about the policy? If so, when?

22) Does the institution have a debt restructuring or rescheduling policy? If yes, is it written and can we have a copy?

☑ Who makes the decision and at what point is it offered to the client in difficulty?

☑ Of the restructured debts, what percentage of clients successfully repay in general? In the past year?

23) Can clients request a modification of the repayment schedule (e.g. a grace period) before they fall delinquent?

☑ If yes, can you please describe (when can clients request it, what's the approval process, and how such loans are monitored)?

24) Once a client has defaulted, can she get another loan from your institution and if yes, under what circumstances?

☑ Do you lend to clients who you know have defaulted on a loan to another financial institution? If yes, under what circumstances?

25) Once the institution has written off a debt, what specific actions does it take to collect on the debt and for how long?

26) Based on the law in your country, how long is a debt obligation valid? Does the law distinguish between secured and unsecured obligations?

27) Does your institution offer debt forgiveness?

☑ If yes, on what grounds? To how many clients has it been offered in the past year (estimate if necessary)?

## VII. Availability of Debt Counseling & Future of Defaulter

28) Do you provide debt counseling services to clients?

☑ If yes, please describe the related procedure (i.e. when, how long and what is the substance?)

29) Are there external services for borrowers who are over indebted that you are aware of which provide debt counseling? (e.g. government agencies or civil society/consumer orgs.?)

☑ If yes, what services are offered specifically to help borrowers? Do you refer clients to these services?

30) What happens to former clients who have defaulted in the long term? (If respondent seems perplexed, then add over the years, how does the default affect the borrower and his family?) Can you give examples?

## VIII. Anything to Add?

31) Are there any practices with regard to debt collection or default management in the industry which concern you?

32) Do you have any recommendations for us with regard to this research?

Thanks for your participation!

## Default Mediation Examples to Draw From

Throughout Europe, the last decade has witnessed increased financial deregulation, rising levels of consumer debt, and a resultant increase in legislative reforms to deal with consumer over-indebtedness and default.<sup>66</sup> The general trend among EU legislators has been to relax the demands formerly placed on distressed borrowers in order to qualify for state-assisted debt relief (e.g., adherence to a strict ‘no frills’ budget and multi-year repayment plans), combined with a new willingness to provide state financing for debtor relief.

Belgium in particular has taken a particularly pro-consumer stance with its 2005 legislative changes, including addressing the fundamental problem of who pays for the debt relief provided to the insolvent debtor.<sup>67</sup> The Belgian system provides that financial institutions must contribute *pro rata* to debt counseling costs based on how many over-indebted consumers using the system were their clients. Fundamentally, this seems equitable given that the banks’ lending contributed to the consumer’s over-indebtedness, and it is in a better position to pay for such services than the debt-distressed borrower.

There is a budding awareness among international donors and investors in microfinance that debtor counseling, including mediation with multiple creditors and ultimately rehabilitation of defaulters, is important. In 2010, the international donor community implemented a debt counseling center in Bosnia Herzegovina following its

microfinance repayment crisis.<sup>68</sup> The center offers a nationwide credit information hotline, one-on-one counseling, and mediation with creditors regarding repayment issues. The center’s services are in demand, and it has expanded to several cities beyond the original location, adding financial education programs. The IFC reports that approximately 40 percent of over-indebted microfinance clients were able to work out a financial plan to repay their loans.<sup>69</sup> A limiting factor is that center cannot mandate creditor participation in mediation. The debt-counseling duties of the center are being transferred to municipalities, who presumably will have greater ability to oblige creditors to participate in a restructuring.<sup>70</sup> The proposed change is based on the Austrian system which in turn, resembles legislative debt rehabilitation solutions in other EU states, including France, Sweden, and the Netherlands.

South Africa was also an early mover on debt counseling. In response to almost half of its credit-active population being credit-impaired, South Africa enacted the National Credit Act which also established the figure of the debt counselor. A consumer can now initiate debt counseling when over-indebted. However, the cost is borne by the consumer and fees can accumulate. Related fees include an application fee of SAR 50 (US \$5) and a restructuring fee up to SAR 6,000 (US\$ 600).<sup>71</sup> If the matter goes to court on a contested basis, the costs could rise much higher due to legal fees. The process as implemented has been criticized because it is costly and does

<sup>66</sup> Jason Kilburn, *Two Decades, Three Key Questions and Evolving Answers in European Consumer Insolvency Law: Responsibility, Discretion and Sacrifice*, (Hart Publishing, 2008).

<sup>67</sup> In 2005, Belgian legislators passed a law allowing for debtors to obtain an immediate and total discharge of their debts if they would not realistically be able to pay down any of their existing debts over a five year period. See Kilburn, p. 9.

<sup>68</sup> [www.uplusu.ba](http://www.uplusu.ba); See coverage of the Center’s work here [www.smartcampaign.org/news-a-highlights/whats-happening/8-2010/86-answering-the-tough-credit-questions-bosnias-center-for-financial-and-credit-counseling](http://www.smartcampaign.org/news-a-highlights/whats-happening/8-2010/86-answering-the-tough-credit-questions-bosnias-center-for-financial-and-credit-counseling)

<sup>69</sup> *Reducing Over-indebtedness for Bosnia and Herzegovina’s Microfinance Borrowers*, International Finance Corporation, October 2013 available online at [www.ifc.org/wps/wcm/connect/8de4ea0041d72b6b8df4ad13bbf0fc5c/Case+study\\_Bosnia+and+Herzegovina+Responsible+Finance\\_+October2013.pdf?MOD=AJPERES](http://www.ifc.org/wps/wcm/connect/8de4ea0041d72b6b8df4ad13bbf0fc5c/Case+study_Bosnia+and+Herzegovina+Responsible+Finance_+October2013.pdf?MOD=AJPERES)

<sup>70</sup> Email from Mejra Jusbasic an investment banker at Finance in Motion (fund manager of EFSE), on March 7, 2014.

<sup>71</sup> Interview with Magauta Mphalele, CEO of the National Debt Mediation Association of South Africa, October 25th 2013.

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not necessarily result in rehabilitation for the consumer,<sup>72</sup> and there are proposals by the government for revisions, including allowing financial services providers to offer free debt counseling services.<sup>73</sup>

At about the same time frame, in 2006, the Central Bank of Malaysia (Bank Negara) established Agensi Kaunseling dan Pengurusan Kredit (AKPK) a financial education, debt counseling, and debt management program. Services are free and participation is voluntary. Per the Center's CEO, Mrs. Koid Swee Lian, some 80,000 consumers were enrolled at the end of 2013, and 200,000 have enrolled in credit counseling since AKPK started in 2006.<sup>74</sup>

In our focus countries, existing infrastructure could possibly be adapted to offer microfinance debt counseling and mediation services. In Uganda, this could possibly be handled by the local councils or consumer organizations. In Peru, the *Camaras de Comercio* could be interested (and a feasibility study was done on the issue several years ago in collaboration with the Huancayo Camara de Comercio). There is also a system in place with the regulator INDECOPI in Peru, if it can be made affordable for microfinance clients. In India, the consumer organization Moneylife may be an option in Mumbai or alternatively, the financial ombudsmen of the RBI in each large city, again, if costs can drop to a level that is feasible for microfinance borrowers. Alternatively, credit bureaus may be interested to offer this service.

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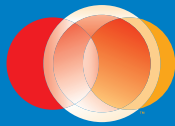
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<sup>72</sup> See: [www.ncr.org.za/publications/DC%20Impact%20Assessment%20Report-2012.pdf](http://www.ncr.org.za/publications/DC%20Impact%20Assessment%20Report-2012.pdf)

<sup>73</sup> Compuscan, *Government to Assist the Over indebted Households*, available at [www.compuscan.co.za/government-moves-protect-consumers-assist-indebted-households/](http://www.compuscan.co.za/government-moves-protect-consumers-assist-indebted-households/)

<sup>74</sup> [www.akpk.org.my/about-us](http://www.akpk.org.my/about-us)



## The MasterCard Foundation



The Smart Campaign is a global effort to unite microfinance leaders around a common goal: to keep clients as the driving force of the industry. The Smart Campaign consists of microfinance leaders from around the world who believe that protecting clients is not only the right thing to do but the smart thing to do. By providing microfinance institutions with the tools and resources they need to deliver transparent, respectful, and prudent financial services to all clients, the Smart Campaign is helping the industry maintain a dual focus on improving clients' lives while attaining financial sustainability. The Campaign is headquartered at the Center for Financial Inclusion at Accion. Learn more at [www.smartcampaign.org](http://www.smartcampaign.org).



CENTER for  
FINANCIAL  
INCLUSION

ACCION



Keeping clients first  
in microfinance