Nepalese Journal of Management Research
ISSN 2738-9618 (Print), ISSN 2738 -9626 (Online) **Website: http://balkumaricollege.edu.np/journal**
Volume : 2 January 2022, Page No. 37-43

Loan Delinquency in Microfinance Institutions (MFIs): Ways to Overcome the Problem

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ABSTRACT

Microfinance institution (MFI) deliquency management is a new topic in the world of microfinance. The major goal of the article is to examine at delinquency management strategies in MFIs in Nepal, as well as the causes of loan delinquency and how to improve loan delinquency. The study's goal necessitated an evaluation of relevant literature. In Nepal, the ratio of non-performing loans (NPLs) in the microfinance sector has been rising. The study found that adopting governance in loan delivery procedures, client identification, effective credit appraisal, and review of client credit history, professional knowledge of clients, client literacy, and identification of clients over indebtedness, credit monitoring and controls, and loan utilization can reduce MFI delinquency. The aim of this research is to help MFIs improve the quality of their loan portfolios. It shows that institutionally efficient MFIs may be able to meet both their social and financial goals. The conclusions of this article will aid MFIs in reducing NPL and better managing delinquency.

Keywords: *cash flow analysis, credit monitoring, financial literacy, governance in loan delivery system, loan delinquency,* JEL classification code: G21

Introduction

Microfinance institutions (MFIs) provide financial services to the poor, particularly impoverished women, such as credit, savings, microinsurance, and remittance, which help to alleviate poverty for those who would not otherwise have access to banking services (Dhakel, 2012). Microfinance is a type of credit union that is established in the economy for the poor's economic gain and to alleviate poverty. Microloans assist the underprivileged in producing income, accumulating capital, and improving their living standards. In general, people confuse microfinance and microcredit. Microcredit is a key component of microfinance, entails providing extremely modest loans to low-income clients with no collateral and, in many cases, no written contract.

Loan delinquency is the situation where loan repayment is overdue. It indicates payments to be made on due date. It can be defined in two ways. The first situation is emerging delinquency which is the early stage of delinquency when a borrower unable to repayment installment, and it is the state of possibility of delinquency. Whereas there is also another form of delinquency named endemic delinquency. If emerging delinquency is not dealt on time it will become where the borrower does not take repayment as a bearing matter reasoning in way becoming endemic delinquency. Usually, delinquency can be measured in three ways-repayment rate (RR), overdue rate, and portfolio at risk (PAR).

Interest income from lending is the major source of income of any bank and financial institution. If a loan installment recovery is not on time, it arises credit risk due to loan delinquency. Delinquent loan does not generate income but it increases expenses such as loan loss provision, recovery cost, and other costs. An institution must lose opportunity cost due to loan delinquency. High level of delinquency loan may have negative effect on institutions reputation. The chances of increase in loan delinquency due to imitation of negative learning by good borrowers.

Dhakel (2012) stated causes of loan delinquency and expressed their views about delinquency. Loan delinquency in microfinance can be broadly grouped into two ways: (1) External and (2) internal causes. External causes relates to national calamities, social, political and health crises, and disease factors while internal factors are either related to MFIs or Clients or both. The internal factors are related to MFIs image and philosophy of the MFIs, ineffective methodology of borrowing selection, untimely disbursement, ineffective information system,

lack of follow-up, lack of staff incentives and loan products do not fulfil the client needs while those related to clients agrees to household emergency that is illness, death, and project failure.

The effect of delinquency on MFIs clearly reflect on its profitability and sustainability. The profitability of a MFIs is affected if interest is not received on delinquent loan. The effect of delinquent loan is provision must be made according to regulatory norms and regulation. If invested loan is not returned on time the entire principle amount goes to a loan loss provision. As a result it gratelly affects the profitability and sustainability of MFIs. Sometimes the loan product offered by MFIs do not match with the expectations and needs of borrowers. If the features of product offered i.e. nature, objective, tenure, repayment frequency etc. does not meet with borrowers' needs it may arise delinquency in loan. One of the major causes of loan delinquency is over financing. So, MFIs need to identify actual loan repayment capacity of borrower. If borrowers' actual cash flow does not meet his/her loan installment it is called over indebtedness.

In microfinance sector, regular monitoring and follow up is required to make credit secure. Regular visit to clients is necessary to know performance of the clients' business. Proper utilization of borrowed amount decrease the chance of being default. If clients utilized the borrowed amount in predetermined ways, it generates the cash and make it easy for loan repayment. Another major causes of loan delinquency is low level of staff motivation. When staffs are not motivated, it adversely effects on their performance. Low motivated staffs cannot maintain good portfolio quality, which increases loan delinquency.

Management information system (MIS) plays an important role for delinquency management. Poor record keeping and information system cannot provide actual information about credit management which ultimately increases loan delinquency. Clear and proper credit management policy and procedures provide guidelines for delinquency management. If there is no clear policy, there may be confusion on dealing and managing delinquency loan.

One of the major factors of loan delinquency is improper compliance of credit delivery process and channels. There are defined credit lending process, procedures, and channels. Proper and adequate compliance of these process may decrease the chances of loan delinquency.

Proper utilization of borrowed amount may generate income. If the amount used in unproductive sector, clients' cash flow mismatched with credit repayment, and it may arise delinquency. Hence, MFIs need to provide training to their clients about how to utilize the borrowed amount. Proper documentation informs MFIs about recovery status on time and makes aware about loan repayment. Timely communication and follow up with borrowers decreases the chances of loan delinquency.

Microfinance is a type of social enterprise that aims to promote social change and alleviate poverty. Many MFIs are now more concerned with business than with social transformation.Their aim was distracted by the profit motive, and they focused on more lending rather than better investment, which resulted in increased loan default. Due to heavy profit-oriented pressure from microfinance institution investors, good governance practices are weakening.

The remaining parts of the paper is structured as follows. Section 2 includes review of literature. Section 3 includes research gap, section 4 includes objective of the study, and section 5 includes research methodology. Section 6 includes findings of the study. The paper is finally end up with a discussion and conclusion of the study.

Statement of Problem

The credit provided by MFIs needs to be recovered within predetermined period. The loan may not be received on predetermined time. When a borrower fails to pays his/her loan installment it is called overdue loan. Normally, the overdue loan can be classified in different category as per regulatory as well as risk mitigation requirement that is pass, watch list, sub -standard, doubtful, and loss (Bad). When the period of installment move than one year it is called bad loan, and is expected at highest level of risk and chances of recovery is low. It is actually overdue amount invested by MFIs to their borrower based on guidelines. Currently, Neplease MFIs are facing loan delinquent problem which needs to manage properly through policy intervention and credit management functions.

According to loan delinquency data published by Nepal's central bank, the average NPL (non-performing loan) of Nepalese MFIs was 17.14 percent in mid-July 2020, compared to 8.10 percent in mid-April 2021.

Generally, industry level overdue rate is below 5%. Here, the data shows the more than 5% which is higher than industry level. Therefore, MFIs need to manage portfolio quality.

If a client unable to repay their loan installment and increase loan overdue of MFIs which increase the costs of MFIs and adversely affects the revenue and profit. So, loan overdue negatively effects on the sustainability of MFIs. In other hand, there is also another dangerous negative learning on regular clients towards not repaying loan installment on time. So, these above situation are the adverse condition for loan portfolio quality.

Objective of the Study

The general objective of this study is to examine the factors affecting loan delinquency management in Neplease MFIs. Specific objectives are:

- To analyze the current portfoilio quality of Nepalease microfinance institutions (MFIs).
- To evaulate the factors affecting loan delinquency management in MFIs.

Literature Review

Many research has been conducted related to loan deliquency in microfinance sector at different country with different dimention. Most of the study has been also focusing dimention of loan delinquency management in microfinance sector. In this background, following related literature are available from the different sources which are classified and presented herewith.

Theoretical Review

The paper was guided by adverse selection theory and theory of portfoilio management and theory of information asymmetry. Stringlitz and Weiss (1981) have developed the adverse selection theory of portfolio management. According to the theory, clients/borrowers of credit providers/Banks and financial institutions (BFIs) have different features and characteristics, which are not observable and measurable by bank and MFIs while lending, which directly affect the revenue and profitability as well. The theory assumes that the lenders unable to distinguish properly bankable clients and different risk. The adverse selection theory describes the situation of bank that cannot be distinguish the safer clients from riskier clients. In this theory, the lenders that is, banks and MFIs have inadequate information about their own clients and riskier clients. BFIs would charge high interest rate on risky clients and less interest rate on safer clients which is guided by risk based costing system. The theory has focused on review their clients for differentiating between creditworthy and non-creditworthy borrowers by analyzing past credit information, collateral, financial characteristics, and private information about local credit applicants. Reduction of informational asymmetries can reduce adverse selection problems in the lending, as well as change borrowers' incentives to repay, both directly and by changing the competitiveness of the credit market. Information asymmetries are the main obstacle for MFIs to provide loans to clients (Nawai et al., 2010). To mitigate adverse selection problems, BFIs need to take take their loan applicants through an elaborate screening procedure before providing a loan, this has been able to reduce loan default in Bank and financial institutions (BFIs) .

Emperical review

Deliquent directly affect the financial viability, financial management isues that ultimately affect the financial viability of MFIs. Deliquent loan play a critical role in the MFIs expenses, cashflow, revinue and profitability. Deliquent loan usually maximize supervision cost, staff cost, more time, effort, and resources into controlling delinquency (Ledgerwood, 1999).

Njeru Warue (2012) has studied on factors affecting loan delinquency in microfinance institutions in Kenya. The study investigated factors of loan delinquency in microfinance sectore by using multiple regression method. For identification of causes of loan delinquency, the study statistically analyzed the internal and external factors of loan delinquency in microfinance institutions. The study conculed that internal and external factors both are critical drivers of loan delinquency. Therefore, MFIs need to have maintain quality related factors that is, good governance in loan delivery system, management of loan, effective management of solidarity lending mechanism, and review of credit risk, credit monitoring and controls, and effective portfoilio assessment for proper management of loan delinquency. Likewise, Cheng (2021) has investigated the determinants factors of loan delinquency in Malaysian commercial bank and non-bank financial institutions adopting with primary data

collection with structured survey technique. The study found the borrower-lender distances factor, collateral factors, clients education level, loan obligation on time, loan supervision, reference for new clients by reputed borrower, financial planning of clients, identification of loan repayment behavior of clients are the important factors to prevent loan delinquencies. Credit is not a bad, it is good as it allows the financial flexibility, and it may bad, if it was not managed properly in productive sector (Cheng, 2021).

Abdulai et al., (2020) states that the effect of corporate governance on delinquency management of microfinance banks in Southwest, Nijeria with the aim to examine the impact of board size and board composition on delinquency management with statistical panel regression obtained from annual financial statement of respective microfinance banks. In the paper, they concluded that, there is no relationship between board size and loan default rate and board composition has a negative and insignificant effect on loan default rate, board should not be large and must consists of highly skilled, competent and professional oversight the organizational function. They recommend that management of MFIs should engage in the development and implementation of strategic trainng for board member and senior managers.

Tiwari et al. (2020) have analyzed the reason of delinquency on personal loan. They collected primary data with structured questionnairs through evaluating SPSS a statistical tool for social science. They explore major factors of credit crime i.e. incorrect choosing of loan customer, poor follow-up, unhealthy banking competitions, inproper project examination, higher fund cost, overfinancing and underfinancing, inaddiquate financial circumstances and understanding irregularity. They suggested some key factors for loan delinquency management that is governance to loan regulation, loan visit after disburshment, collateral assessment, past loan services, past repayment record, training for loan utilization and effective loan delivery services.

Rahman and Sarker (2018) have examined delinquency management in private Commercial Banks (CBs) in the context of Bangladesh with self-administered questionnaire using a simple randim sampling methods. In this paper they explores that improper selection of a loan client, lack of follow-up, unhelathey competition among the banks, lack of proper analysis of project viability, higher intrest rate, under financing, over financing, poor economic condition and information irregularity are the main causes of loan delinquency. They recommend some strategies for loan delinquency management i.e. governance in credit delivery, clients visit, proper valuation of security/collateral, timely loan disburshment, training to clients for how to use money, and proper documentation before loan release which are similar strategies of improving loan delinquency in MFIs.

Mohapatra and Mishra, (2010) have studied on innovative delinquency management with structured questionnaire by applying regression statistical methods. They concluded that evaluation of credit worthiness is very most challenging aspect of any MFIs and need to apply credit scoring card regarding the loan repayment. Furthermoer, they they auggested that MFIs have to analyzed clients related attributes i.e. monthly income, liabiality, occupation, assets, education level and family size before loan disbuesement decision.

Research Methodology

This paper is mainly based on second hand information which were collected from various journals, and periodicals. Besides secondary data, some already published interviews, reports have been employed as secondary sources of information and an informal chatting were also made with some finance academicians and practitioners as primary sources of information. In this paper, descriptive research technique has been used as a major part of the research; no quantitative tools have been employed. The researcher has reviewd litereature related to loan delinquency management in microfinance institutions at different terriotory. Information used in this report was obtained through a review of the relevant literature, telephonic interview conducted by the author with Chief Executive Officer (CEO), Deputy Chief Executive Officer, and Credit Department Head of the some microfinance professionals on Nepal and reflection of the own experiences of the researcher.

Findings

One of the most essential factors affecting the method of loan application, loan evaluation, loan approval procedure, and loan sanction to clients is adherence to governance in loan delivery systems. The loan delivery method must be used in compliance with the competent authority's institutional credit guidelines. Credit monitoring and controls, for example, are a system that ensures the quality of a loan portfolio on a daily basis and takes corrective action. It is the process which includes loan utilization verification, clients visit/follow up, and portfolio reports based on regulations guidelines. Good monitoring and controls mechanism helps to maintain

good portfolio quality and ultimately reduce loan deliquency. Loan delinquency can occur when a loan product is not suitable for the client's needs, there is overfinancing, there is a lack of proper monitoring, there is a lack of staff motivation, there is no proper record keeping, and there are no proper policies and procedures in place to manage loan delinquency. According to Nepal Rastra Bank's prudential rules, MFIs must have a governance framework in place, such as classification of loan portfolios and loan losses reserve for future loan losses.

Strategy for loan delinquency management in MFIs

Loan delinquency can be controlled using a variety of credit management procedures, such as a detailed and formalized credit evaluation/appraisal process, a client's source of repayment, their track record and repayment history, a credit risk management department for risk identification, a management information system, loan portfolio quality monitoring and early warning, and performance reviews. MFIs must design a training program for field staff in the areas of credit risk management and the development of microfinance customers' entrepreneurial potential in order to generate regular income.

i. Identification of Clients

Client identification is an important task for delinquency management. MFIs need to develop rigorous mechanism to identify their client. Clients' geographic, demographic, financial discipline, business, income source, educational, age, taste, family background etc. determine the chances of loan default.

ii. Effective credit appraisal

Inadequate credit appraisal increases the chance of loan default. So, at the time of lending MFIs need to assess borrower on the basis of his/ her regular cash flow, expected cash flow from the project, chances of project success, and ntention of the borrower.

iii. Review of credit history of clients

Credit history is one of the major parameters for lending. Clients' history indicates future chances of default. Credit history shows clients' repayment capacity and his/her intention to repay loan.

iv. Professional knowledge of clients

Good credit history and good intention of client indicate future chances of good repayment. Sometimes, borrower can't repay the loan due to project failure. So, lender needs to identify the skill of the borrower to make project success. If a borrower does not have the required skill and knowledge of about the business he/she is going to start, there is high chance of project failure, and loan delinquency.

v. Identification of clients over indebtedness

One of the major causes of default in microfinance sector is over indebtedness of borrower. So, MFIs need to identify actual loan repayment capacity of borrower. If borrowers' actual cash flow does not meet his/her loan installment it is called over indebtedness.

vi. Governance in loan delivery procedures

An organization has its own lending procedures depending on their credit policy. The procedure guides from the process of client identification to final loan disbursement. Fully following and compliance of lending process and procedure decrease the chance of loan delinquency.

vii. Credit monitoring and controls

In microfinance sector, regular monitoring and follow up is required to make credit secure. Regular visit to clients informs performance of the clients' business.

viii. Loan utilization

Proper utilization of borrowed amount decrease the chance of being default. If clients utilized the borrowed amount in predetermined ways, it generates the cash and make it easy for loan repayment.

Conclusion & Discussion

Microfinance has long been acknowledged as a critical component of socioeconomic development, poverty alleviation, and entrepreneurial promotion. This suggests that the majority of MFIs contribute to a reduction in

poverty in Nepal.

My conclusion is supported by good governance in the loan delivery system, loan management, effective management of solidarity lending mechanisms, credit risk evaluation, credit monitoring and controls, and effective portfoilio assessment for the management of loan delinquency (Njeru Warue, 2012). Second, the borrower-lender distance factor, collateral factors, client education level, loan obligation on time, loan supervision, referral for new clients by a reputable borrower, financial planning of clients, and identification of client loan repayment behavior are all important factors in preventing loan defaults (Cheng, 2021) which is also similar line with my findings. Credit crime are mainly depend on incorrect choosing of loan customer, poor follow-up, unhealthy banking competitions, inproper project examination, higher fund cost, overfinancing and underfinancing, inaddiquate financial circumstances and understanding irregularity. They suggested some key factors for loan delinquency management that is governance to loan regulation, loan visit after disburshment, collateral assessment, past loan services, past repayment record, training for loan utilization and effective loan delivery services (Tiwari, Somani, & Mohammad, 2020) which is also similar with my findings. Improper selection of a loan client, lack of follow-up, unhelathey competition among the banks, lack of proper analysis of project viability, higher intrest rate, under financing, over financing, poor economic condition and information irregularity are the main causes of loan delinquency which are similar strategies of improving loan delinquency in MFIs.

Rahman and Sarker, (2018) have also explores factors affecting delinquency in microfinance institutions i.e. governance in credit delivery, clients visit, proper valuation of security/collateral, timely loan disburshment, training to clients for how to use money, and proper documentation before loan release which are similar strategies of improving loan delinquency in MFIs. Stringlitz and Weiss (1981) stated that MFIs and banks need to observe loan repay capacity of their borrower before deciding loan approval. They further more focused banks and MFIs should introduce risk based costing methodology for lending and they should conduct systematic collection of clients information i.e. clients history, character, worthiness and financial discipline which is in lined with this finding.

MFIs need to have a comprehensive and systematic identification of credit risk systems. Credit risk is the potential that a borrower will fail to meet its obligations in accordance with agreed terms. The major task of credit risk management is to limit the exposure within acceptable level. MFIs need to develop detailed and formalized credit evaluation/appraisal process that can easily understand clients' requirement. The credit risk management department (CRMD) needs to establish systems and procedures relating to risk identification, risk evaluation, risk analysis, management information system, monitoring of loan portfolio quality and early warning. The department needs to develop credit risk management framework/guidelines. The credit appraisal and approval process needs to be rigorous, and on the basis of track record, repayment history, chances of project success, future cash flows, and borrowers' intention.

The management of MFIs need to review the overall performance on regular basis. MFIs need to invest on training and development program in the areas of credit risk management for the development of highly qualified personnel in credit risk management area. Credit scoring of clients may be an effective tool for lending decision. MFI need to fix Single Obligor limit (SOL) at controllable level and avoid concentration risk. Concentration risk is also a part of credit risk, the concentration may be on geographic basic, on industry basis, on group basis, or at any. Sufficient amount of loan provision to be made for possible loss due to default, and it is one of the tools to mitigate credit risk. The institution can make appropriate mechanism to identify customer (Know your customer) guidelines. It provides the information about your current and prospective customer. Rules based and principle based regulatory is required for good governance and mitigate credit risk. Human capital and technological capital are important for delinquency management. Through proper development and utilization of human as well as technological capital credit risk can be mitigated.

The regulatory authority must play a role in ensuring that MFI governance rules are followed. Policymakers, regulatory agencies, economists, MFIs, and BFIs will benefit from the study's conclusions.

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