LAND INVESTMENT FOR TRANSFORMATION PROGRAMME

TECHNICAL ASSISTANCE SUMMARY

AUGUST 2019

Building healthy portfolios:

Technical assistance on default management system for partner microfinance institutions

Improving access to finance through SLLC-linked loans

Land Investment for Transformation (LIFT) is an Ethiopian government programme funded by UK Aid. LIFT started in March 2014 and is due to run until August 2020 in four regional states (Amhara, Tigray, Oromia and the Southern Nations, Nationalities, and Peoples' Region (SNNPR)), to improve the incomes of the rural poor and enhance economic growth. The programme has three key pillars:

1. To issue second level land certification (SLLC).
2. To improve rural land administration through the implementation and operationalisation of **improved rural land administration systems (RLAS)** in more than 140 woredas (districts).
3. To **increase land productivity** following the making markets work for the poor approach (M4P) by undertaking interventions that focus on **access to finance, rural land rental** and **conservation agriculture** – these are implemented through the Economic Empowerment Unit (EEU).

Aware of the role financial access plays in catalysing enhanced productivity of land and improved livelihoods for rural residents, LIFT has developed and introduced innovative credit and non-credit financial services to the rural finance market in Ethiopia. This was necessary because over the past two decades, despite tremendous progress in creating financial access in rural areas, reach is still limited: the credit product offering is dominated by group-based lending. However, this seems to be changing with the new individual credit product introduced by LIFT in collaboration with its seven partner microfinance institutions (MFIs). LIFT has piloted the individual SLLC-linked loan product to provide farmers with the option of using their land use rights as collateral for accessing individual loans that are adapted to their financial needs. With this product farmers are now accessing loans of up to ETB 100,000 (GBP 2,860), with terms of one to five years. As of August 2019, the seven partner MFIs had made 13,131 individual loans worth ETB 398.3 million (GBP 11.4 million). The pilot has demonstrated that enabling farmers to leverage their land rights and access improved credit services opens up new opportunities to rural communities. Additionally, it allows them to go beyond group loans and income-smoothing loans to engage in productive on-farm/off-farm investment.

What is loan default?

Generally, a loan is in *arrears* if the borrower is late in making a scheduled payment. A borrower is *delinquent* when they are late in making the required payments; this term applies to the entire amount of the unpaid loan balance as opposed to a single payment. Mostly, a loan is in *default* if it is seriously delinquent and the rights of the borrower have been cut short because, for example, they have missed several payments and/or have violated other terms of the loan agreement. The term *non-performing loan (NPL)* also means the borrower has made no interest or principal payments for an extended period, usually 90 or 180 days.

The SLLC-linked loan also holds huge potential for the rural financial intermediaries in general and for the MFIs specifically. It enables the institutions to reach segments of the rural population not addressed through group loans, bring back the dropouts and move clients on from group loans. By enabling MFIs to stratify their client segments and offer customised credit products to individual farmers, the product is contributing towards achieving the institutions' social and financial missions. This pursuit of the double bottom line (both financial and social) is also strengthened by other key considerations such as keeping healthy portfolios.

For LIFT partner MFIs, as with the introduction of any new financial product, there are risks and therefore the need to adjust policies, processes and procedures to realign their risk management and business models. Because the SLLC-linked loans are offered on an individual basis and the loan terms are longer than the usual single harvest season, the MFIs need to conduct regular follow-up and monitoring well in advance of repayment periods. In addition, the SLLC-linked loan product was launched prior to the existing supportive legal framework that clearly recognises the SLLC-backed land use right as a collateral asset. Presently, the regional land proclamation in Amhara and the *Movable Property Security Right* proclamation of the National Bank of Ethiopia (NBE) have been ratified by the regional and federal level parliaments, respectively. Other supporting proclamations, regulations and directives are currently in the drafting stages at the federal and regional levels.

The commitment to maintaining a healthy portfolio while managing the changes and risks associated with the introduction of a new product requires MFIs to build robust preventive and monitoring systems, including boosting staff capacity. Accordingly, based on demand from partner MFIs, LIFT contracted Internationale Projekt Consult (IPC) to provide technical assistance in loan-default management to five partner MFIs, namely Amhara Credit and Saving Institution (ACSI), Oromia Credit and Savings Share Company (OCSSCO), Wasasa, Aggar and Omo Microfinance Institution (OMFI). The technical assistance was provided between January and April 2019.

Why technical assistance on default management?

After introducing the new type of loan, and at the request of the partner MFIs, LIFT decided to provide technical assistance to the MFIs to help them improve their overall loan-default management and to help ensure the quality of the SLLC loan portfolio. Another justification for the technical assistance is that defaults can have major adverse effects on lenders. Defaults usually result in loss

General effects when clients default

... on MFIs	... on clients
Slower portfolio turnover, so fewer new or repeat clients have access to finance.	**Clients may:**
Raises loan loss provisions (reserves set aside to cover late payments on loans).	Invest less in productive assets and human capital.
Delinquency postpones interest income, yet costs remain, so viability of MFI can be threatened.	Reduce consumption.
Costs are much higher for delinquency and process defaults, including legal routes.	Sell assets, including productive assets.
Can spread quickly and adversely affects an institution's image.	Use savings for loan repayment.
	Take new loans to pay off current debt.
	Search for help from family, depleting relatives' assets.
	Work longer hours.

Figure 1. General effects of default on MFIs and borrowers

of income, cash flow and assets. Having to deal with defaults can lower staff morale. In addition, it is harmful to the lender's reputation in the community and thus limits staff from investing in good borrowers and generating additional loan volume. The main consequences of defaults for the financial institution as well as for the client/community are illustrated below.

Methodology

IPC used a three-step approach to provide the technical assistance for default management: (1) desk research; (2) field assessment and staff training; and (3) validation of the loan-default management guide. To address the legal aspects of default management from the SLLC-linked loan perspective, IPC hired an experienced senior local consultant/attorney who specialised in banking and commercial law. Accordingly, IPC drafted a loan-default management guide (LIFT Programme Ethiopia – Arrears and Default Management Guidelines for SLLC Secured Loans), which provides guidance for partner MFIs to enhance their default-management practices.

Key findings

The LIFT partner MFIs have managed to keep the SLLC-linked loan portfolio in good health, with a portfolio at risk that is well below NBE's 5% benchmark. Yet there are areas where the MFIs need to improve their default-management practices and embed a robust system. Accordingly, the default-management technical assistance exercise helped the MFIs to be aware of the key drivers of defaults, the gaps in their back-office default-management system and the legal framework areas.

The key findings from the assessment conducted by IPC are listed below.

1. The default drivers are diverse, but the most common ones include:
   - Limited staff capacity.
   - Clients' improper use of the loan proceeds and/or loan diversion to non-productive activities.
   - Poor loan appraisal and follow-up.
   - Crop failures, landslides and other natural disasters.
   - Political instability and ethnic conflicts in some woredas.

2. Some gaps in the back-office system and some practices, and the lack of simple and appropriate manuals and policies are limiting MFIs' capacity to manage defaults robustly:
   - Loan files appeared to be in order but there was no loan/client file checklist.
   - Good knowledge of cases by branch managers and loan officers but this was not documented or recorded in the client file. Notes of client visits, written records of causes and steps taken in loan-default cases and various legal documents (such as demand letters and revised loan agreements) were not consistent.
   - Very limited data in the management information system, for example the concentration reports by crop, which is related to the weak core banking system.
   - Renegotiated loans done informally.
   - Loan agreements unclear or weak.
   - No clear and simple delinquency policy or path indicators.
   - Unclear collateral valuation process.

3. A well-structured and comprehensive legal and regulatory environment is essential for enforcing loan contracts.
   - The supporting legal framework for SLLC-linked loan is at a very early stage on issues such as the modality of land use right transfer during defaults.

Recommendations

MFIs should adopt strong preventive systems to avoid loan defaults and properly manage existing default cases. The policy recommendations from the technical assistance outline basic and advanced default-management techniques – legal steps and systems that the MFIs need to develop to robustly manage arrears. The following are some of the key recommendations from the loan-default management guide.

- **Formation of an arrears and default committee (ADC)** at different levels of the MFI (branch/zonal/head office) that regularly discusses and approves steps for handling loan defaults. Regular meeting of an ADC helps to formalise and institutionalise the default-management practices and decide which actions to initiate by reviewing the status of loans in arrears, loans in default, restructured credit exposures, credit exposures under intensified management, problem credit exposures, written-off credit exposures, recoveries and credit exposures under court or foreclosure proceedings.

- **Early detection of credit default risks**. Since the probability of successful debt recovery diminishes rapidly with time, the MFI should implement a process for the early detection of credit default risks that covers all its credit exposures. The responsibility for identifying events and circumstances that indicate a deterioration of the client's repayment capacity lies with the relevant customer relations officer (CRO). In line with this, the guide identified and recommended various **disbursal and loan-repayment monitoring and follow-up actions**.

- If the measures for the early detection of defaults are unsuccessful, and the client is still in default after 30 days, it is recommended that the credit exposure should be put under **intensified management**, which involves financial and collateral monitoring.
  - For financial monitoring: a CRO sets up a new cash-flow projection to fit the client's current circumstances. The CRO also verifies the information provided/obtained, completes a financial analysis form and present the results to the ADC.
  - Collateral monitoring: a CRO physically inspects the collateral, reassesses its fair market value and presents this to the ADC, which in turn decides on the next steps. For SLLC-backed loans, a CRO should use the IPC template, 'Land collateral monitoring and re-valuation', which can also be adapted for use with other loan products.

- The other crucial step in dealing with defaults is **categorising delinquent borrowers**. This involves distinguishing those who cannot pay from those who will not pay (based on willingness and capacity to pay parameters) while also identifying the cause of delinquency. This helps the MFIs know which route to pursue in dealing with delinquent clients.

- In order to **institutionalise and formalise various options** for dealing with default loans, the guide provides decisions that could be followed based on the client segmentation. The MFI may formally decide to negotiate land rental or the sale of produce (or other forms of collateral in the case of defaults on credit products other than SLLC-linked loans) or other client assets; restructure or reschedule the loan (to be decided by the head office's ADC); voluntarily rent the land; and finally go to legal action (foreclosure or court).

- In order to provide clear and simple guidance for MFIs on the legal action for default loans, IPC provided detail coverage on **foreclosure** in the sections on legal aspects in the guide, in a separate draft Foreclosure Guide and in a **court process** chart. It also notes that legal action should be a last resort and hence a negotiated settlement is preferable. In addition, the importance of having experienced lawyers manage all aspects of any legal, court or foreclosure proceedings related to the SLLC-linked loan product is highlighted, primarily because there is still very little legal precedent for this loan type. Given an evolving legal framework for the SLLC-linked loans, the partner MFIs will need to follow developments carefully and update their policies and procedures as laws and regulations are enacted or revised.

- Finally, to facilitate the **embedding of good record keeping and robust default-management systems** within the MFIs, tools such as loan monitoring and visit logs, loan-default information templates, sample notice letters and action logs in client files are included in the guide. Moreover, a standard loan contract template is included to address the gaps in the current SLLC-linked loan contracts.

Next steps

- Leverage the default-management guide and tools provided – MFIs need to fully adopt the policy recommendations and mainstream the tools.
- Enhance the credit-management system of the MFIs. Credit-management systems in turn will help further develop the risk-management systems of the MFIs. This may require support for the MFIs to improve the outreach of their core banking system across all branches.
- Continue advocacy work on the part of LIFT, partner MFIs and other stakeholders to hasten the approval of the federal and regional proclamations, which are crucial for such an innovative credit product to thrive.
- Clarify the provisions in the existing regional proclamations regarding the procedures for dealing with defaults.
- Offer crop-insurance services to clients to help MFIs and borrowers transfer risks that arise from natural disasters (which are some of the common default drivers). LIFT has piloted an area yield index crop-insurance product with ACSI and Abay Insurance Share Company. The next phases will be scaling up the pilot with more partners to additional woredas and regions, and sharing the lessons learned.

Three-step approach

1. Desk research	2. Field assessment and staff training	3. Validation of the loan-default management guide

Key findings

Default drivers include: limited staff capacity; clients' improper use of the loan; poor loan appraisal and follow-up; natural disasters; political instability and ethnic conflicts.

Gaps in the system, manuals and policies limit MFIs' capacity to manage defaults robustly.

A well-structured, comprehensive legal and regulatory environment is essential for enforcing loan contracts.

Recommendations

Set up an arrears and default committee.

Detect credit default risks early on.

Put any credit exposure that has been in default for more than 30 days under intensified management.

Categorise delinquent borrowers based on attitude/willingness to pay and capacity to pay, and why.

Follow the options given in the guide for dealing with default loans.

Use the clear guidance given in the guide on legal action.

Use the tools for embedding good record-keeping and robust default-management systems.

Figure 2. Summary of the IPC three-step approach to providing technical assistance for default management

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About the Technical Assistance Summary series
This series summarises technical assistance carried out by the UK Department for International Development-funded Land Investment for Transformation (LIFT) programme. LIFT aims to improve the incomes of the rural poor in Ethiopia by securing the land rights of households through Second Level Land Certification (SLLC); improving Rural Land Administration Systems (RLAS); and increasing productivity by leveraging SLLC through a ‘making markets work for the poor’ (M4P) approach, in Oromia, Amhara, the Southern Nations, Nationalities, and Peoples’ Region (SNNPR) and Tigray regions.

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