Agricultural Lending - Self Study Guide for Loan Officers

LESSON SEVEN

Managing Late Repayments and Loan Defaults

Objective: to examine the role of preventive strategies and show how immediate and effective action as soon as any repayment is late can significantly reduce default rates.

1. LOAN RECOVERY STRATEGY

Loan recovery is essential for all financial institutions involved in lending money. It is recommended that lending procedures are consolidated into an integrated strategy aimed at reducing late payment and default in loan portfolios.

AGLEND has compiled the following summary of their strategy:

<table>
<thead>
<tr>
<th>AGLEND Strategy to Ensure Repayment and Reduce Default</th>
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</thead>
<tbody>
<tr>
<td>1. Design client selection mechanisms which screen out applicants with a lack of repayment capacity and/or willingness to make repayments.</td>
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<tr>
<td>2. Match repayment capacity and repayment plans as closely as possible to avoid repayment complications.</td>
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<tr>
<td>3. Accept that default problems generally do not occur because of bad clients but because of bad lending methods.</td>
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<tr>
<td>4. Establish a reporting system which allows for timely monitoring and follow-up action by loan officers.</td>
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<td>5. Establish a reporting system which gives up-to-date information about portfolio quality, trends and possible default risk factors.</td>
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<tr>
<td>6. Instil an ethos in the institution that makes late payments unacceptable.</td>
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<tr>
<td>7. Establish an incentive system for on-time repayments. The benefits of paying punctually should clearly exceed the benefits of late repayment.</td>
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<tr>
<td>8. Set maximum levels for late payments and default as benchmarks for the institution. These levels should be based on a detailed analysis of the costs that arise from late payments and defaults.</td>
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<tr>
<td>9. If substantial late payment and default problems prevail, set strict but realistic target levels to gradually reduce the numbers.</td>
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<tr>
<td>10. Reschedule and restructure loans only after a well-defined loan re-assessment procedure has been completed.</td>
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</tbody>
</table>

The first five steps have been covered in Lessons 1 - 6. We will now focus on the remaining five steps which make up the total strategy.
2. PREVENTING AND MANAGING LATE PAYMENT

Late payments are unacceptable for financial institutions. Not only do they signal cash problems, unreliability or unwillingness to repay, they also interfere with liquidity planning and therefore immediately produce financial costs for financial institutions. Financial institutions should use “carrots” and “sticks” to keep late payments to a minimum.

Let's look at three “carrot” strategies.

1. Loan graduation

A major repayment incentive used by a wide variety of financial institutions consists of the reward of access to subsequent loans. Specifically in rural areas with less competitive financial markets, access to subsequent loans provides strong motivation for repaying. Some institutions use “stepped lending” as an additional incentive. First-time borrowers start with a low loan amount and gain access to higher loan amounts once they have successfully repaid their loan. In order to make this incentive effective, access to follow-up loans needs to be contingent upon achieving a high level of on-time performance.

AGLEND makes access to future loans contingent on a maximum of two late payments in the past three loan contracts.

In the case of the following customer, this rule has prevented an increase in loan size three times as a result of the number of late payments recorded by the loan management system.

CLIENT LOAN HISTORY

<table>
<thead>
<tr>
<th>Name:</th>
<th>Client Number:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Loan contract</th>
<th>Date of disbursement</th>
<th>Termination date</th>
<th>Loan Amount</th>
<th>Loan term</th>
<th>No. of late instalments</th>
<th>Qualification for higher loan amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>11.10.03</td>
<td>11.01.04</td>
<td>2,000</td>
<td>3 Months</td>
<td>1</td>
<td>Qualified</td>
</tr>
<tr>
<td>2</td>
<td>02.02.04</td>
<td>02.07.04</td>
<td>2,500</td>
<td>5 Months</td>
<td>3</td>
<td>Not qualified</td>
</tr>
<tr>
<td>3</td>
<td>10.07.04</td>
<td>10.11.04</td>
<td>2,500</td>
<td>4 Months</td>
<td>0</td>
<td>Not qualified</td>
</tr>
<tr>
<td>4</td>
<td>11.10.04</td>
<td>11.01.05</td>
<td>2,500</td>
<td>3 Months</td>
<td>0</td>
<td>Not qualified</td>
</tr>
</tbody>
</table>

2. Access to preferential services

On-time repayment can be used to trigger access to services otherwise not available to the customer. Examples of such services could be “parallel loans” and “easy-access loans”.

Parallel loans may be given for short-term financing needs, e.g. for working capital requirements of non-farm enterprises, such as buying additional stocks for a small shop, or consumption needs such as school expenses or social events.

Easy-access loans are granted with reduced red tape in the loan appraisal procedures. These loans may take the form of an overdraft facility or shorter, simpler application forms and fast appraisal procedures. For the agricultural lender, this is an important way of reducing administrative costs on loans to clients who are likely to maintain a good repayment performance.
AGLEND uses the rating system described in the table below to determine whether someone qualifies for an easy-access “automatic” loan. It combines an automated calculation of the average days for which payments were late on earlier loans with a qualitative evaluation by the loan officer. This system takes advantage of the personal knowledge which a loan officer has of his/her loan client.

### RATING SYSTEM FOR PREFERENTIAL SERVICES

<table>
<thead>
<tr>
<th>Rating</th>
<th>Computer rating: Average no. of days late per payment</th>
<th>Loan officer rating: Client performance</th>
<th>Benefits and Penalties</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0 to 5</td>
<td>Excellent</td>
<td>Repayment of standard loans with a 1 or 2 rating allows access to preferential products</td>
</tr>
<tr>
<td>2</td>
<td>6 to 10</td>
<td>Good</td>
<td>No access to preferential services</td>
</tr>
<tr>
<td>3</td>
<td>11 to 20</td>
<td>Regular</td>
<td>No access to preferential services; reduced loan amounts.</td>
</tr>
<tr>
<td>4</td>
<td>21 to 30</td>
<td>Poor</td>
<td>Disqualified from credit</td>
</tr>
<tr>
<td>5</td>
<td>&gt; 30</td>
<td>Disqualified</td>
<td>Disqualified</td>
</tr>
</tbody>
</table>

3. Financial incentives

Clients may be offered a financial discount for repaying all instalments on time. This discount may be in the form of a cash reimbursement once the full loan amount has been repaid or when each instalment is paid. These repayment incentives, of course, need to be calculated into the overall interest rate applied to the loans in order to maintain the profitability of the institution.

**Repayment Incentives in Bank Rakyat Indonesia**

In Bank Rakyat Indonesia’s Unit Desa system, a client who receives a $1,064 loan for one year is eligible for a $32 transfer to his/her savings account after making on-time repayments over six months. Subsequent loans may be more than a year away and therefore provide little incentive for borrowers to repay on-time. This mechanism, however, provides an effective short-term incentive for borrowers. It is estimated that around 90 percent of Bank Rakyat Indonesia small loan clients are eligible for the incentive in most months.

Churchill, C.  *Client Focused Lending*  1999

Now let’s look at some “stick” strategies which may need to be applied if, despite the existence of “carrot” strategies, late payments occur.

1. Immediate on-site visits

One delinquent client can have a profound influence on the repayment behaviour of others. Rumours can spread quickly if it is thought that a lender is lenient about repayments. Other borrowers are then likely to delay their payments as no serious action is feared.

Immediate on-site visits after a short time of delayed payment is, therefore, an effective means of instilling the idea that late payments are unacceptable. They ensure a speedy appraisal of the reasons for the late payment. In the case of AGLEND, overdue borrowers are visited within 5 days of the loan becoming overdue.
As you saw in Lesson 6, it is advisable to make visits to clients even before problems in repayment have occurred. AGLEND loan officers visit borrowers who have had repayment problems in the past, prior to the due date of an instalment.

When AGLEND loan officers visit delinquent borrowers for the first time, they are friendly, but firm and decisive. Maintaining a good client relationship is important also after a delay in payment has occurred. In fact, strict delinquency follow-up is in the interest of the client. The AGLEND loan officer is helping the client to maintain a good credit history with the bank. Advice may also be given on how the client can manage liquidity better to be able to service his / her financial obligations on time.

A clear policy should be in place regarding further follow-up after the immediate on-site visit. A decision-tree can be useful to provide guidance on which steps are to be followed to increase pressure on the borrower to repay and what additional information on the reasons behind the late payment should be collected.

**Immediate on-site visits at Alexandria Business Association (ABA), Egypt**

Loan clients come into face-to-face contact with ABA every time they make a repayment. Repayments are made at the bank, and customers are asked to bring their receipt book for the officer’s signature. This contact is considered an important psychological reinforcement and it provides an opportunity to discuss problems. However, few loan officers visit their good clients regularly. They visit delinquent clients as top priority and only if time permits or they are in the neighbourhood for other reasons, do they visit well-performing clients. If a payment is late, loan officers deliver a friendly letter signed by ABA’s Executive Director which emphasises the need to maintain on-time repayment for continued access to ABA’s service.

Churchill, C. *Client Focused Lending* 1999

2. **Financial penalties**

Delayed payments cause financial and administrative costs for the lender. To cover (at least part) of these costs and to provide an incentive for punctual payments, delinquency fees should be applied. These fees can either be charged on the total amount or be restricted to the loan instalment due for payment. The penalty may apply either from day one of the late payment or following some additional leeway. AGLEND has introduced a tiered system, increasing the penalty rate with the number of days in arrears.

Losing access to subsequent loans is a very powerful penalty. However, lenders need to consider whether the repayment problems are so severe that the established client relationship should be discontinued. On the other hand, if this sanctioning mechanism is never implemented, no signal is being sent that loans should be repaid on time. It must be made clear when access to subsequent loans will be denied and when there is scope to discuss the circumstances and consider further lending. It is also important not to create an impression of automatic right to further loans, however, even if punctual repayments are being made, as loan appraisal must still be adequate. Regulations for first-time borrowers should be stricter than those for long-time clients of the bank.
1. The consequences of the rating system applied by AGLEND are quite severe. Clients with payments more than 30 days overdue will be denied any loans in the future. What are the consequences of this for agricultural loans, e.g. if weather conditions delay harvest for a month? How should an agricultural lender deal with such repayment problems caused by factors beyond the farmers' control?

2. What factors would you incorporate in a client rating system? What set of criteria could make the qualitative judgements on the part of the AGLEND loan officers as objective as possible?

3. What other “carrot” strategies would be useful to encourage on-time repayment?

4. What other “stick” strategies would you recommend?

5. Try to draw up a decision-tree for the current procedures followed in managing late payment and default in your institution. Do the current procedures allow for timely action?
3. MANAGING DEFAULT

If the immediate action taken by the loan officer when repayment is late does not bring the desired result, further action is needed. A systematic process is needed to help officers decide whether to initiate debt collection mechanisms or whether to enter into negotiations with a client to reschedule or restructure the loan.

**Procedure for Deciding How to Solve Problem Loans**

The first step in handling loans that have turned problematic is to undertake an analysis of the borrower's situation. If the result of this analysis is a lack of repayment willingness, quick and prompt debt collection measures should be initiated.

If a lack of repayment capacity prevails, the future prospects for the borrower's business, the importance of the customer to the bank and the value of a continued business relationship with the customer should be evaluated.

If this analysis appears negative, debt collection measures should be initiated. If the analysis is positive, a rescheduling plan needs to be established in order to get the business and the loan back on track.

**Situation Analysis**

Gathering information about the reason for default is critical. Particularly in agricultural lending, default may occur due to a wide variety of reasons.

The following diagram gives a summary of possible reasons for default and danger signals that should alert loan officers to problems.
The customer is the best source of information on the reasons for default. Additional sources, such as neighbours, suppliers, clients, other financial institutions, should also be consulted to confirm the validity of the information given. This information-gathering process is usually done by the loan officer.

Some banks place the responsibility for the situation analysis with a specialised group within the bank. This approach can offer a more objective approach, less influenced by the existing customer relationship. Information collection, however, will be more time consuming, expensive and less effective. Because of this, many banks hand over to the specialised unit only those cases which are most problematic and represent significant risk exposure. Others opt to hand over only those problem loan customers who are not considered future clientele. A “no holds barred” approach is then much easier to follow.

**Rescheduling and restructuring**

Once a borrower’s problem has been analysed, a recovery plan may be put in place. The first decision to be made in this context is who will establish and carry out this recovery plan. Some banks decide that the loan officer responsible for the loan should also set-up the recovery plan. This is the case in AGLEND. A major rationale for this decision is the idea that the loan officer who has carried out the initial loan appraisal should be responsible for collecting the loan. In addition, the loan officer has an indispensable and unique body of knowledge about the customer’s situation.

Rescheduling refers to a change in the term structure of an existing loan. Restructuring takes it a step further, with a possible “refuelling” of the borrower by adding fresh loan money to the existing obligation. Both options are extremely delicate and should be handled with the greatest care.

Many micro-finance institutions whose clientele consists mainly of traders with a quick turnover often do not allow any rescheduling or restructuring of loans. In agricultural lending, however, both options need to be considered due to the high level of external influences on repayment capacity. If harvest is delayed, rescheduling may be the only option to ensure loan repayment.
It is important to bear in mind, that both rescheduling and restructuring are extremely costly for the financial institution. These options should only be chosen if the value generated by maintaining the client relationship and bringing in the outstanding loan exceeds the costs incurred by the loan process. It is also important to understand that the extra time spent on a problem loan is basically unproductive - it serves to protect bank assets but it does not generate additional revenue.

If a delay in harvesting causes the repayment problems, rescheduling the loan is a sensible proposition. Analysis and re-planning activities should, in this case, specifically be designed in a way that minimises unnecessarily excessive re-evaluation costs.

Let's look at AGLEND procedures for dealing with problem loans in more detail:

1. **Meet and re-evaluate the borrower.** A competent borrower who has fallen victim to an adverse event beyond his or her control is considered worth a concerted effort of revitalisation. Today’s problem borrower may be tomorrow’s solid, profitable business relationship. The on-site visit by the loan officer is the key element in identifying the reasons for repayment problems. If the loan default is clearly due to a lack of repayment capacity, a more in-depth analysis of the business prospects of the borrower is carried out.

2. **Review documentation.** All loan documents are re-examined to assess the original loan justification and client situation.

3. **Re-evaluate the collateral situation.** A comparison of the availability and value of the collateral (if material collateral exists) against the outstanding indebtedness of the borrower is carried out. This helps to evaluate the amount at risk.

4. **Monitor the borrower’s bank accounts.** Deposit accounts may be frozen to prevent uncontrolled withdrawals.

On the basis of the in-depth analysis of the situation and business prospects, the loan officer designs a plan of action to be implemented by the bank and borrower. Key criteria for the decision about whether to reschedule or even restructure a loan include the following:

- Reasonable prospects that the borrower can again generate enough profits to repay the debt within a stated period of time;
- Clear definition of an appropriate financial plan and cash-flow projections (an update of the loan appraisal analyses should be carried out);
- Full borrower commitment to resolving the problem;
- Improvement of the lender’s control over the lending situation (e.g. strengthening the collateral situation by adding guarantors or other forms of collateral).

The basis for rescheduling or restructuring loans is a realistically revised cash-flow projection for the borrower. Revised repayment plans are designed according to these new projections.

Rescheduling and/or restructuring is normally only one component of a recovery action plan. Easing financial tensions alone does not suffice to revitalise a borrower’s repayment capacity in most cases. Accordingly, the action plans may also include:

- Selling unnecessary assets;
- Changing the borrower’s marketing strategy;
- Seeking advice from an agricultural extension service or business advisory services.

Continuous and close supervision of the implementation of recovery plans is important. AGLEND’s on-site inspections are increased, both in frequency and intensity. All actions taken are carefully documented in the loan files for full transparency.
Once a loan is restructured, AGLEND never considers these loans for further restructuring at a later point in time. There is a clear policy to avoid the possibility of “ever-greening” loan portfolio quality by repeatedly rescheduling and restructuring loans. Internal control measures also ensure that this phenomenon does not materialise.

**Debt collection**

If measures taken to collect late payments do not provide the results needed and rescheduling or restructuring is either not wanted or not possible, debt collection is the final step in following up on problem loans.

Collecting pledged collateral through the courts is often a costly and lengthy procedure, especially if registers are sketchy or collateral is unregistered. Debt collection through claiming collateral items may take months, sometimes even years. So financial institutions in many countries have found ways to avoid involving the courts and increase the speed of debt collection.

AGLEND avoids these problems by asking the borrower to sign an agreement through which ownership over a group of assets is transferred immediately to AGLEND. With this document, AGLEND has full control over the assets until the loan is paid back. This allows AGLEND to speedily collect collateral.

Excellent days for collateral collection are the days when big football games are scheduled to take place. First of all, the majority of farmers are then at home to watch the games. Secondly, removing a TV-set on the day when the national football championship is to be decided, causes a serious upset and may stimulate a “last-minute” repayment!

4. **IN CONCLUSION**

Failure to conduct proper loan appraisal is a major reason for default and the existence of problem loans. A high number of problem loans should, therefore, be taken as good reason for reassessing lending procedures.

AGLEND, for example, has carefully reviewed its problem loans and identified various errors. This is what they found to be the key weaknesses in their procedures:

1. **Poor loan interviews.** Loan officers need to ask precise, probing questions about the customer’s financial situation. A friendly conversation does not suffice.
2. **Inadequate financial analysis.** Serious problems arise when financial analysis is not the core of the lending decision. There is no substitute for a thorough financial analysis.
3. **Failure to understand the customer’s business.** Loan officers must have a good understanding of the dynamics of the customer’s business and agricultural production. If this is not the case, the result may be inappropriate cash-flow projections and inappropriate repayment plans.
4. **Inadequate collateral.** Accepting collateral that has not been properly evaluated regarding the value, marketability and ownership leaves AGLEND unprotected in the case of problems. Personal guarantees need thorough analysis and cross-checking with records as well.
5. **Failure to document accurately.** Full documentation of loan appraisals, credit committee decisions, supporting documents and repayment plans is the basis for managing - if not avoiding - problem loans.
1. Describe the possible reactions of borrowers who are visited by a loan officer because their loan payments are overdue. How should the loan officer deal with them?

2. What are “acceptable” reasons for a delay in repayment? How should a lender respond to such reasons?

3. What factors should be taken into consideration when deciding whether to liquidate collateral or not?

4. What challenges or constraints in debt collection exist in your country? What mechanisms does your institution employ to overcome these challenges?

5. What common errors in lending procedures cause problem loans in your experience?