The failure to control loan delinquency, which often leads to default, is probably the largest single downfall of institutions that provide credit to microenterprise entrepreneurs; the risk of delinquency and default must be continually addressed. Most commonly, loans are considered delinquent or past due when two payments have been missed. A lending institution’s largest asset is its loan portfolio, the total amount (of principal) owed by borrowers. The portfolio generates income in interest and fees. Because a lending institution cannot always be sure that it will get its money back, the loan portfolio is always at risk to some extent. Protecting the portfolio allows the institution to continue to provide credit services to microenterprise entrepreneurs. Three measures for the quality or amount of risk of loan portfolios are widely used — default rate, repayment rate, and delinquency rate. These terms mean nothing if everyone calculates them differently. The following definitions and formulas have been tested and proved in commercial banking, and are the most helpful in providing timely information to microfinance program managers. Each has a different purpose or use and tells us something different about the portfolio.

Definitions and Formulas

**Default Rate** measures the amount the institution has declared non-recoverable as a percentage of the portfolio (also referred to as loan loss rate). This is the part of the portfolio that can no longer generate income.

\[
\text{Default Rate} = \frac{\text{amount declared non-recoverable in period}}{\text{average portfolio in period}}
\]

**Repayment Rate** measures the amount of payments received with respect to the amount due. It does not measure portfolio quality or risk.

\[
\text{Repayment Rate} = \frac{\text{amount received in period}}{\text{amount due in period} + \text{amount past due}}
\]

**Delinquency Rate** measures the percentage of a loan portfolio at risk. The entire balance of a loan is considered at risk when any portion of the loan principal is past due. The percentage should be broken down by age, such as the percentage with payments past due 31-60 days, 61-90 days, and more than 90 days, to determine the level of risk.

\[
\text{Delinquency Rate} = \frac{\text{balance of loans with payments past due}}{\text{total amount outstanding}}
\]

Costs of Delinquency

Delinquency affects a program in both measurable and unmeasurable ways:
- Postponed or lost income;
- Slower portfolio rotation, which lowers asset productivity;
- Lower staff morale;
- Higher costs of fighting delinquency;
- Diminished program image;
- Higher likelihood of default; and
- Increased cost of loan loss reserve.
Preventing Delinquency

It is easier to prevent delinquency than to cure it. Methods for preventing delinquency depend on the context. In general, they are grouped into three critical areas:

**Image and Philosophy**
Microenterprise lending programs should differentiate themselves from the “give-away type of development programs that may be familiar to microentrepreneurs” and “create an institutional culture in which late payments are simply unacceptable”.

**Methodology**
Three aspects of credit methodology help limit delinquency:

i. **Borrower Selection** - Guard against giving bad loans to respond to slow demand. Group loans and character-based loans are effective mechanisms for selecting trustworthy borrowers.

ii. **Loan Sizes and Terms** should be geared to the borrower’s repayment capacity. Base decisions on current capacity to repay rather than on projections.

iii. **Incentives to Repay** - Poor incentive structure encourages poor payment. The lending institution must make it worthwhile for borrowers to repay on time. Possible incentives for timely repayment include larger follow-up loans, penalty fees for late payments, and potential legal problems for not paying.

**Information Systems** that help field staff follow up with their borrowers and management analyze the portfolio, preferably on a daily basis.

Curing Delinquency

Curing delinquency is extremely difficult but can be accomplished by examining and changing the institution’s image, philosophy, and methodology. The examination should lead to the identification of trends. For example:

- If certain activities are more delinquent than others, loan sizes and terms may be wrong for these activities.

- A high delinquency rate for a certain loan officer suggests poor performance, insufficient training, or possibly fraud.

- If loans made during a specific month are more delinquent (for example, before a major holiday), the institution may consider not making loans in that month.

New loans are not a solution to a delinquency crisis, but loans to borrowers who pay on time can continue.

**Rescheduling and Refinancing**

Rescheduling and refinancing should never be considered a cure for delinquency or a primary tool for controlling it. Rescheduling and refinancing serve only as a short-term solution and may not reduce the risk of the portfolio. In fact, they may encourage delinquency because both reward the borrower for falling behind. These methods should be used only as a last resort in justified cases when well-meaning borrowers cannot pay.

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