Unit 10

Formulating and Implementing Guidelines for Loan Repayment

General Objective

After studying this Unit, you should be able to help participants in your training session to build the capacities of trainees to describe and apply procedures for formulating and implementing guidelines for loan repayment.

Specific Objectives

This Training Unit will help you to enable trainees to:

- describe the process of formulating guidelines for loan repayment;
- discuss the procedure which should be followed in repaying loans;

Planning

Time : 3 hours

Training Methodology : Participatory discussions, group exercises, games

Training Materials : Charts, markers, flip charts

Trainer's Preparation : Reading through the background material and other references

Preparing training aids or identifying existing training aids available

Background Material

We will now consider the following aspects in greater detail:

- Repayment
- Non-repayment of loan

Death of the member

Failure of the member

Recovery of the default amount

- Risk fund

Repayment

The three components – savings, borrowing and repayment – are inseparably linked in an SHG. Problems in one automatically lead to problems in others. When a loan is sanctioned, the group decides the period of loan and the

installment amounts. If the repayment is not received as per the schedule, repayment rate of the group goes down, morale of the members is affected and the performance of the group as a whole suffers.

Loans are considered as sticky and under default when any portion of loan is last due, which means that the amount has not been paid even though the due date has passed.

The major reasons for default are:

- Unrealistic repayment schedules;
- Borrower not being creditworthy;
- Lack of credit policy;
- Improper use of the loan;
- Loan was not sufficient for the project;

- High interest rates;
- Illness, disease of borrower and failure of business;
- Borrower not fully aware of the commitments made;
- Inadequate credit monitoring by the group; and
- Inadequate loan collection methods.

In this regard, conflict occurs because of non-repayment / default of loan and attempts by the group to recover the default amount.

Effect of Non-repayment of loans

Non-payment of loans can result in major problems for the group. Some of these are:

- Lack of funds to approve new loans;
- Adverse impact on the financial planning of the group;
- Fall in income;
- Loss of confidence in the group and members;
- Non-availability of loans from outside institutions if the group is not able to repay their loans due to defaults of some members; and
- Withdrawal of members.

The conflicts due to non-payment or default can be avoided by adopting the following steps:

First of all, the group has to understand whether the member is a willful defaulter.

Willful default

Willful default occurs when a member is capable of repaying the loans defaults but does not make the repayment. The members may not have confidence in the group. Hence she will take a loan equivalent to her savings and will not repay the loan. Willful default may also occur when a member has some problem with the group and she considers her default as a way of punishing the group.

The group should identify the underlying reasons for the default and try to address them with the help of the facilitator. In extreme cases, the defaulting member can be removed from the group.

Demonstration effect

Some people do not repay the loan even though they have the money to repay since other members are not paying back their loans. They undertake to repay the loan only when others have repaid. In order to solve such a conflict, the situation of genuine members can be explained. The group can reschedule the loan in genuine cases. The group should, however, penalize the willful defaulter.

Default due to genuine difficulties

Some members are keen to repay but due to reasons beyond their control they may not be able to repay. The reasons could be:

- Improper scheduling of loan;
- Not earning expected income;
- Diverting the loan for emergencies in home, agriculture, etc;
- Death of the member; and
- Failure of the activity.

Scheduling of loan

While drawing the repayment schedule for the loan, the member’s opinion and convenience and the likely income and expenses from the activity needs to be considered. The leaders and facilitator should explain the importance of scheduling and make the member commit to a realistic schedule. The members should know the implications of not repaying the loan in time.

Rescheduling of loan

If the member is unable to pay because of improper scheduling or due to emergencies beyond her control, rescheduling should be done. Rescheduling of loans involves changing the payment schedule so that the borrower is able to pay back the installments. Rescheduling should be done in genuine cases.

Case Study 1

The members of a group availed loans for undertaking mango cultivation and dairy. The group fixed the repayment period as three years and Rs. 200 as monthly installment for both the activities. The members involved in horticulture became defaulters. The group analyzed the reasons. Horticulture activity generates income only after three years. Members cultivate pulses as intercrop in mango plantations. The income from the intercrop and agriculture are the only source of income for them in the initial three years. Dairy activity provides income regularly for seven months in a year. Hence a new repayment schedule was drawn for the members involved in horticulture activity.

Death of the member

In unforeseen circumstances like the death of the member, the loan has to be recovered from their kith who are using the asset. If the relatives do not undertake the responsibility for repayment, the loan can be recovered by the sale of assets.

Failure of activity

Due to natural calamities or any other risks involved, the activity may not generate sufficient income. The member may find it difficult to pay back the loan as scheduled.

Probable solutions

- The group with the help of the worker should analyze the reason for nonpayment and find out alternate ways;
- If there is no chance of reviving the business, the assets purchased for the activity can be sold and part of the loan amount can be repaid by the member and the remaining amount can be rescheduled; and
- If the member wants to restart the business, the group should analyze the possibility for success and can give her a second loan. A fresh schedule for repayment of both the loans needs to be made.

Case Study 2

In Mannoothu village of Kadamaliakundu block, the members of several groups were given loans for horticulture. Each member got a loan of Rs. 8000 for land improvement and planting of mango seedlings. Unfortunately, failure of monsoon and a prolonged dry spell resulted in severe mortality of planted seedlings. Members could not repay the loan for more years. Considering the situation of the members, the group decided to waive the interest of loans and rescheduled the repayment of the principal.

Recovery of the default amount

If the member is not repaying even after rescheduling, the group should take stern measures such as sale of assets to recover the amount.

Case Study 3

A group disbursed Rs. 5000 to a member for lease of land. The loan was to be repaid in monthly installments within three years. Her husband fell sick and died. The member did not pay both interest and principal to the group. After three years, when the group questioned her, she did not give any commitment to repay. So the entire group harvested the paddy in her field, sold the produce and effected repayment of her dues.

In another group a member got a loan for purchase of a milk animal. She did not repay the loan and lavishly spent the amount on her son's marriage. The group gave her a month's time to repay the full amount with penal interest. She did not respond. The group locked the door of her house and kept the key with them. Immediately the member assured the group to repay her dues within a week and kept her promise.

Risk funds

The group borrows money from other institutions such as banks and federations to satisfy the credit needs of members. The group is responsible for the repayment of the loan. If any loss occurs in the activity or if any member does not pay back the loan due to migration, unexpected circumstances, natural calamities, etc., the group has to repay the amount to other institutions from their corpus. In order to avoid such a loss a separate fund called risk fund can be created which will:

- avoid depletion of capital;
- create security for the corpus;
- give confidence to other banking institutions; and
- provide a sense of safety among members.

Thus, the risk fund is the creation of a common fund to compensate the unexpected loan loss in case of default of members.

When the concept of a risk fund is introduced, conflict occurs between the facilitator and the group. The members may feel that they are already paying interest for the loan and they may not appreciate the need for the risk fund. The facilitator should explain the need for the risk fund and, if possible arrange an exposure visit to a group which had to use the risk fund to pay back some of the loans and hence be benefited by the fund.

Frequency of loan repayment installments

The loans granted to members may be returned in weekly or monthly installments or in a lump sum at the end of the loan period. Repayment depends mostly on the paying capacity of the borrower and the purpose for which the loan was taken. Some groups insist that the interest should be paid every month irrespective of whether the loan is returned in installments or in a lump sum.

For seasonal activity like cultivation, it is suggested that the loan should be returned only when the activity is completed. The SHG may also consider asking for the disbursement of such loans in installments, the final installment being paid after the activity has been completed.

Working capital and fixed asset loans

Working capital loans are meant to meet routine business expenses. For example, the cost of food or vegetables purchased for sale in the market is working capital expenditure. A loan for working capital should be repaid when the product is sold in the market and the member has got her investment back. In general the duration of these loans is two to twelve months.

Fixed asset loans should be used to acquire an asset that will serve the business through out its existence. For example a machine, a bicycle, a rickshaw, a sewing machine and so on. Those requesting loans for fixed assets generally ask for larger amounts with repayment schedules spread over a longer duration than those taking a working capital loan.

Examples of loan uses

Activity Fixed Assets Working Capital

Vendor Food stall Merchandise
Refrigerator Plastic bags
Weighing scale Paper bags
Dress maker Sewing machine Fabric
Sewing tables Patterns
Thread and needles
Carpenter Saw Lumber
Lathes Nails
Sand paper
Poultry Incubator Purchase of eggs
Baskets Electricity cost
Wire and holder Wrapping clothes
Thermometer Sterilization of eggs
Shelves

Problems caused by defaults on repayments

- They result in slower recycling of group funds. If the group does not recover its loans in time, other members cannot borrow the money they need in the future.
- Problems arise when the loan has been granted by a bank.
- Delays in repayment mean a serious loss to group funds and a loss of interest money and
- They may also result in a higher rate of interest on new loans so that the lost money is recovered from other members. Alternatively, the group will have to sanction additional loans to generate enough profit to replace the money lost on the defaulting member.

How to control loan default

Default management requires a detailed review of the group’s lending and operational methods. It has been proven that the main reason for members repaying their loans promptly is their desire to receive a subsequent and larger loan. However, this incentive is not effective unless the members value the group’s services. A valued loan must have the following characteristics:

- The loan amount should suit the members’ needs.
- It should be available in time of need.
- It should be available without complicated procedure.
- The loan repayment schedule should suit the member’s financial position

and repayment capacity; and
- The member should be assured that the group cares about her and is willing to support her in times of need.

Potential members must be carefully screened before a group is formed. All the women in a group should be like-minded and committed to an achievable goal.

All members must understand that late payments will not be tolerated and that repayment schedules are binding. Some groups impose penalties for tardy payments. Others offer rewards in terms of interest rebates to members who respect repayment schedules. The rebate is given when the loan is fully paid up. Loan repayments should be regularly monitored. It has been proven that most defaulters would have paid their installments on time had they been reminded to do so. Loan repayments should be reviewed at every group meeting so that borrowers are routinely reminded to update their installments. The facilitator and the NGO can also exercise control over defaulters, especially when there are more than 5% loans in default.

The repercussions of defaulting on payments are serious. Defaulters, therefore, need effective follow-up procedures. Pressures and penalties may be applied by:
- Visiting the defaulting member periodically;
- Bringing pressure to bear from village elders and officials;
- Repossessing the assets bought with the loan; and
- Organizing a sit-in (dharna) outside the defaulter's home.

Penalties could include:
- No further loans
- Expulsion from the group; and as a last resort
- Forfeiture of the defaulting member's savings.

The group's administrative procedures should be reviewed in case large sums are in default. It is possible that they are due to policy errors such as:
- The practice of maintaining dual accounts, in keeping the group's funds and external loans separately.
- Caution about giving loans from their own savings, the group could treat external funds and with less care, inadvertently encouraging defaults.
- External loans may be obtained at a subsidized rate of interest, creating the impression that this money is free and need not be repaid;
- Richer, more domineering members could corner the larger loans, leading to resentment in the rest of the group, which may cause dissent and defaults;
- The low interest rate charged by the group could lead to a member passing on her loan at a higher rate of interest. This could result in delayed loan reimbursements; and
- The group should be stabilized before it sanctions loans to its members.

Rescheduling loans

When a group member is unable to repay the loan because of problems beyond her control (illness, business losses etc); the group may consider rescheduling the loan.

Risks of rescheduling

Rescheduling loans should be treated as a last resort to recover the money borrowed. This particular solution should be considered only in those rare cases where it is clear to the group that without rescheduling the member can never pay the loan, nor remain in business. There is, moreover, no surety that even after the loan is rescheduled she will repay her loan in time. Rescheduling loans must not be encouraged and when undertaken, must be monitored carefully.

Frauds

The decentralized nature of micro-finance activities has a significant potential for frauds. Frauds could be perpetrated because:

- The loans taken are fictitious.
- Loans are granted from the revolving fund before the group has received the money.
- The group's installment payments to the revolving fund have not been recorded.
- The contributions to the group's savings account has not been recorded.
- The sums disbursed to the borrower are less than the amounts recorded in the books.

Market rates should apply to the interest charged on loans or paid on savings. This would reduce the possibilities of making undue profits. Those in charge should ensure that no financial service is subsidized and that funds available from subsidy-based government schemes are not directly handed over to the group. Decision makers can be corrupted, particularly when a subsidized project is at stake. The borrower can afford to pay a bribe and still retain the major benefits of the scheme. Moreover, it is easy to divert subsidized loans for other purposes.

It is important that the administrative rules governing the functioning of the SHG and the revolving fund are sufficiently simple to be understood and retained by all the members of the group and that they are not constantly changed. Details of these rules and procedures should be printed in simple language and made available to every member.

A proper accounting system developed jointly with the groups needs to be put in place from the beginning, and the women familiarized with loan and recovery concepts.

Also, organizing simple external audits of SHG accounts at regular intervals would be useful to check frauds.

A loan of Rs. 3000/- which was payable in 46 weekly instalments at an interest rate of 15% per year, defaults after 14 weeks. In order to make up for the lost principal and interest, 16 new loans of Rs. 1000/- each need to be granted by the group.

(Source: Sustainable Banking with the Poor. The Microfinance Handbook, World Bank)

Five steps to handle loan repayment defaults

1. Review the group's loaning policies, recording system, group's rules and monitoring system;
2. Design an incentive system to discourage defaults and ensure prompt repayments;
3. Set strict deadlines for defaulters to return the loans;

4. Judiciously re-finance some members who have a genuine problem in repaying loans, but will be in a position to settle their debts at a later stage; and
5. The group's lending system should be broad-based i.e several members should have benefited from loans, both big and small, so that a few defaulters do not affect the group's financial position.

Work Plan for Your Training Session

Organize a brain-storming session with the participants for designing an incentive system to discourage defaults and ensure prompt repayments. You can use meta plan charts or stickers so that each individual or group member can put up her ideas. A chalkboard can also be quite helpful.

Acknowledgements

Department of Women and Child Development
Ministry of Human Resource Development Publications

1. Network of Self Help Groups: A Guide Book written by Tara Sinha, Friends of Women's World Banking, India
2. Resource Book for Group Building
3. Swa Shakti: Guide Book for Field Workers
4. Training of Self Help Groups: A Guide Book written by Girija Srinivasan
5. Organizing Self Help Groups – A Resource Book

Rashtriya Mahila Kosh (RMK)
National Bank for Agriculture and Rural Development (NABARD)