

**Best Practices in Collections Strategies**

Past-due or non-collectible loans are part and parcel of the financial sector. As past-due rates surpass expected limits, though, this piece of the credit cycle can become a true problem.

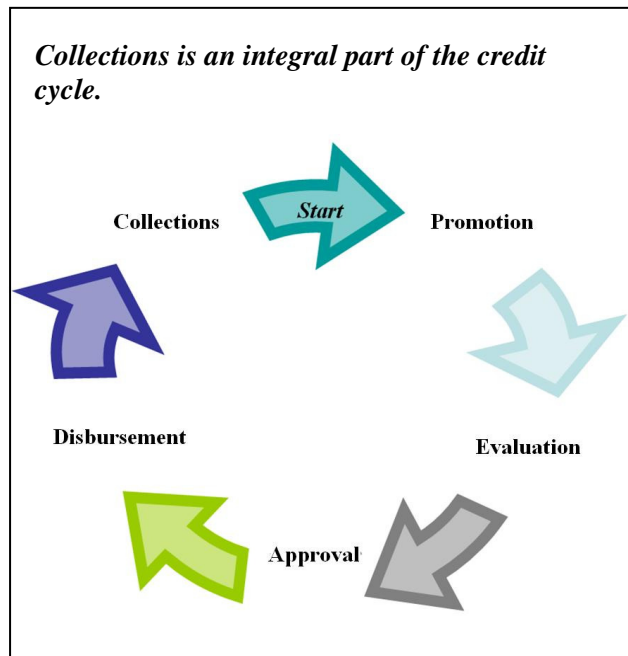
While often seen as a final step in the lending cycle, collections<sup>1</sup> actually plays a much more integral role in the overall process. In recent years microfinance institutions (MFIs) have sought to develop new and more effective strategies for collections. This increased attention to collections is in part due to an industry-wide emphasis on credit promotion and analysis as well as to the changing and increasingly competitive environments in which MFIs are operating.

Drawing from the experiences of collections programs throughout Latin America<sup>2</sup> and through the implementation of initial collections activities in India that are mainly focusing on Individual lending methodology, this *InSight* explores “best practices” and considerations that an MFI should take into account when attempting to successfully implement collections activities.

**I. The Role of Collections**

Collections is an important service that helps to both maintain clients and free up money for lending again. It is a strategic process that is key to generating good habits and a payment culture among clients. It can also be seen as a business activity whose primary objective is to generate returns for the institution, converting losses into income.

MFIs should view collections as an essential piece of the credit cycle, not just the final step. During the collections process, institutions receive feedback on policies and activities within each sub-process of the lending cycle: promotion, evaluation, approval, and disbursement.



<sup>1</sup> Note that the term “collections” used in this *InSight* refers to both activities to recover past-due loans (loans with one or more days of default) and activities to prevent delinquency within the institutions. In Asia, situations of “due-date collections” have been referred to as “on-time collections” activity.

<sup>2</sup> Banco Solidario, Ecuador; Financiera El Comercio, Paraguay; RealMicrocrédito, Brazil; Banco Columbia, Argentina.

## Why is there delinquency in Microfinance Institutions?

There is a belief that delinquency starts when a client misses a payment date, resulting in a collections problem. However, many delinquency problems would be avoided if MFIs ensured that the earlier lending processes were conducted correctly. Following are several examples of common errors in lending sub-processes occurring prior to collections:

- **Promotion:** The product does not meet clients' real needs; there is no clear definition of the target client; clients' use of the loan does not match foreseen uses of the loan funds included in the product definition; there is no emphasis on a "long-term lending relationship" based on punctual payment; loan officers, credit agents, promotion officers, etc., lack necessary training.
- **Evaluation:** Failure in the methodology application including loan amounts that exceed clients' capacity to pay and over-indebtedness; client has poor references or a poor attitude towards paying on time; there is no cross-checking of information to verify consistency, or documentation control; there are no clear policies for renewal; lack of risk-management tools to improve the understanding of default probability of the client, to identify the environmental causes that may affect the proper collections of the disbursed loan, and to alert management about the multiple events associated with a weak identification of operational risk (e.g. frauds, weak infrastructure, process gaps).
- **Approval:** Decisions are influenced by pressure to meet goals; decisions are subjective, based on the level of trust in the loan officer and lacking an objective credit analysis.
- **Disbursement:** Failure to conduct objective analysis to determine best loan conditions, such as loan amount, term and installment amount, and selection of the repayment date; clients lack motivation to pay on time due to unclear payment instructions and expectations at the point of loan disbursement; few alternative payment channels, such as the Internet-payment options and third-party agents, that could reduce transaction costs for clients; operating errors, such as failure to identify the account holder or a lack of signatures on contracts and loan documents, as well as delays in disbursement preventing the client from making use of the loan as intended (e.g. a lost investment opportunity results in the loan being used instead for consumption purposes).

In addition to the errors that may occur in the sub-processes, high delinquency rates may also stem from an overall lack of collections forethought. Collections is often seen as a secondary or, in some cases, nonexistent activity and lacks a defined strategy. Delinquency rates may also be spurred by external factors over which an MFI has no control, such as problems related to the sector, social concerns, illness, theft, fraud, natural disasters, and other emergencies.

When MFIs see an increase in delinquency it is important to carefully analyze the past-due portfolio in order to more accurately identify the origin and causes of the delinquency and estimate the probability of repayment, while at the same time defining the most effective and efficient collections strategies. Risk-management tools contribute to the identification of threats and menaces to the operations to mitigate their impact.

## II. The Collections Process

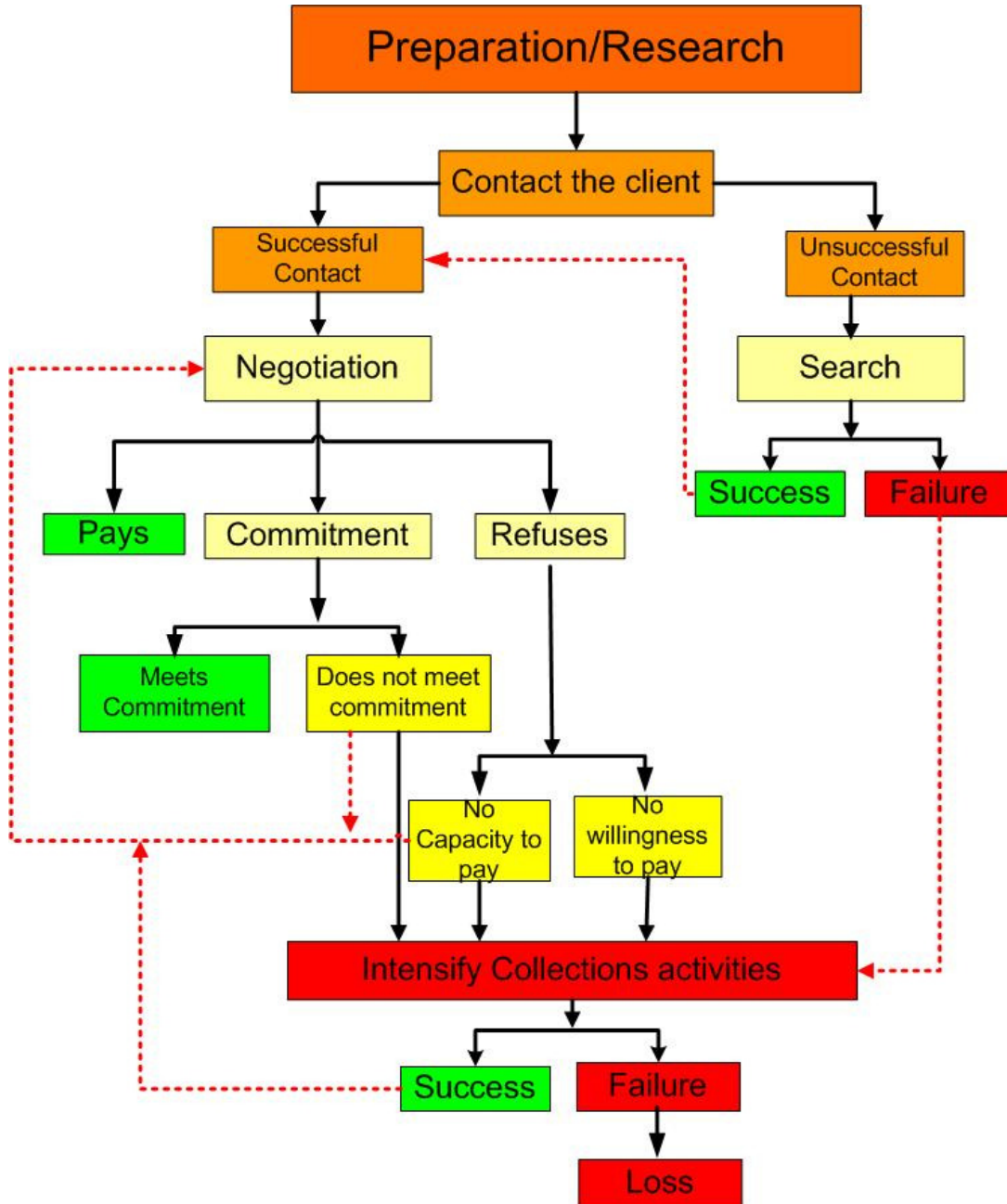
The collections process is defined as the set of coordinated, appropriate, and timely activities aimed at full collection of loans from clients. The process is intended to convert the MFI's receivables into liquid assets as quickly and efficiently as possible, while at the same time maintaining the goodwill of the client in case of future transactions.

As such, the collections process requires significant interaction with the client, beginning with a careful analysis of the client's situation and continuing through timely and frequent contact over the duration of the loan. Clients should be offered payment alternatives that are timely and appropriate to each situation, and all collections activities should be recorded to facilitate continuous monitoring and follow-up as well as control of client compliance with negotiated agreements. Some typical collections activities are described below, followed by a flowchart illustrating the collections process:

- a) **Analysis of the particular case:** Who is the client? What is his situation? What were the original loan conditions? Why did the loan fall past-due? Consider internal and external sources of information such as credit bureaus and bad-debtor lists.
- b) **Contact with the client:** What information does the client provide? Where is the client located? What actions were taken previously?
- c) **Assessment:** What problem is at the root of the current delinquency? What type of client are we dealing with?
- d) **Suggesting an alternative:** What are the possible solutions? The objective here is to sell the benefits of paying on time in order to foster a positive payment culture with the client.
- e) **Securing payment commitments:** Area we negotiating effectively? The MFI must clearly identify when, where, how, and how much the client will pay and must remember, for example, how a client in a situation of over-indebtedness or decreased income will prioritize the payment of his bills. Are we able to get the client to commit to prioritizing repayment of this loan?
- f) **Compliance with payment commitments:** Did the client pay on the agreed-upon date? Does the client demonstrate a desire to repay the loan? The objective here is to demonstrate consistency throughout the collections process. It is not enough to reach an agreement and depend on the client's apparent goodwill and positive attitude; collections staff must follow up on payment commitments.
- g) **Recording collections activities:** Are collections activities carried out in a coordinated manner? Put yourself in the position of the staff member next in line for collections activities with that client.
- h) **Follow-up on the case:** Are we aware of the client's situation and the collections activities the case has been subject to?
- i) **Intensification of collections activities:** What is the best action to secure collections of the loan in the most immediate manner? What assets does the client possess? How much can be collected through legal action? The sole objective when a past-due loan reaches this point is collections, even if it means losing the client.

j) **Defining a loss:** The MFI must also clearly define the conditions under which a credit is deemed a loss; that is, when to cease collections activities. This may be when all possible attempts to recover the funds have proven unsuccessful and/or when the probability of payment is very low. The MFI must measure the cost/benefit of legal action, reporting past-due client and other actions permitted by law.

### The Collections Process



The client should see collections as an ongoing rather than sporadic activity, which means that it is very important that the various actors in the process—such as call centers, loan officers, and collections agents—act in a coordinated and timely manner. The client must feel that the MFI has its finger on the pulse of the situation at all times, acting quickly, flexibly, and definitively to control the situation. It is also extremely important that collections activities be directed at all individuals involved in the loan—including spouse, guarantors, family, or friends who served as references—in accordance with the client’s risk profile and probability of repayment.

Generally, microentrepreneurs do not provide collateral guarantees to MFIs. Therefore, many institutions develop non-traditional mechanisms that are basically a type of psychological pressure, called “non-traditional guarantees.” Often, these non-traditional guarantees cannot be executed for legal reasons or because the cost of executing them is greater than the value of the guarantee itself. This makes it even more important that collections activities are founded on efficient strategies and timely negotiations prior to recurring to legal collections, unless all previous actions have proven inefficient for reasons external to the collections process.

A poorly defined or understood collections process can lead to inadequate, costly strategies and the breakdown of the process itself. Below are some common errors:

- ***Tendency to restructure, refinance, or disburse a new loan to repay a past-due loan without the proper analysis and monitoring of the client’s current situation:*** These are poor practices that temporarily mask the true state of the portfolio and inevitably will worsen the situation. Refinancing should require a new evaluation, including a complete and objective analysis of each particular case, and should never be applied as a general strategy or campaign, which do not change payment behaviors. It is also important to note when such a policy might be appropriate (e.g. natural disaster, market fire—when a whole subset of clients has been affected).
- ***Tendency to seize goods from the business or home as a means to collect on the loan:*** This practice could distract collections agents from their main responsibility, basically turning them into something akin to an intermediary or salesperson. The MFI incurs high storage and administration costs as a result of receiving these goods and sends the wrong message to the client with respect to the client’s financial obligations. Oftentimes the client prefers to lose the assets without making an effort to repay the loan, thus weakening the institution’s position and image in the market.
- ***Tendency to be subjective:*** Considering certain clients and cases as a total loss or placing too much trust in the goodwill of the client can detract from the collections process and lead to a loss of time and money for the institution.

It is vital to the long-term health of an MFI that it recognize each client requires a considerable investment of time, money, and effort from the different parties participating in collections. Attracting new clients is more expensive than maintaining existing ones.

### **III. Best Practices in Collections**

In order to achieve healthy, sustainable growth, MFIs must plan collections strategies prior to launching a new program or product. The following subsections discuss the “best practice” for collections as well as examples, where applicable, of Micro finance institutions in which they have been implemented. These practices come into play well before the loan is delinquent,

striving to create proactive strategies to diminish the occurrence of overdue loans. They recognize the valuable role that well-trained internal and external collections staff perform. They offer suggestions for the precise collection and maintenance of data, segmentation of clients and offering of “collections products” or payment alternatives tailored to the needs of the client. And, finally, they provide a listing of policies and procedures that contribute to successful collection of delinquent loans.

### **Best Practice #1 – Adopt Proactive Strategies to Quell Delinquency Before it Starts**

Addressing the problem before there is a problem proves to be one of the most effective strategies available in reducing delinquency. Preventive action is less costly, and the best collections activities are those that manage clients who are not yet past due carefully. There are a number of proactive strategies that a MFI may employ in the management of those clients before their loans are due.

#### ***Educate Borrowers about Product Features and Collections Fees and Charges***

Borrower education can go a long way towards reducing default rates. Prior to disbursement, institutions should educate and train the client and guarantor about the implications of obtaining a loan, how the product works, the benefits of paying on time and the payment schedule, while also providing information about the closest and easiest way for this particular client to make loan payments.

Expenses related to the collections process must be transferred back to the client. It is important to stress during the client-education stage both the benefits received due to punctual payments as well as the costs incurred by the client for late payments. Some institutions communicate this as a “reward for punctual payment,” offering discounts. In other situations, such as in India where the predominant method of “on-time collections” involves payment at the client’s place of work or home, it becomes important to provide incentives or other rewards to clients who actually do make payments at the branch or via payment agents.

#### ***Establish Mutually-Agreeable Payment Dates***

Involving the client in the establishment of mutually-agreeable payment dates may increase the probability of repayment. Generally this date must match the date on which the client experiences peaks in revenue

#### **In Practice – India**

*In India, where the group-loan methodology (Grameen Bank methodology) is widespread, institutions recommend that each client meeting includes the reading of a type of “code of conduct” or “code of ethics,” in the local language. The code emphasizes, among other points, the importance of punctual payments, the solidarity that binds each member to an obligation to pay if one of the other members cannot make a payment, the importance of saving, and the value brought by the investment of the loan in productive activity that generates additional income.*

#### **In Practice – Ecuador Banco Solidario**

*Banco Solidario emphasized the importance of educating clients about good payment practices, handing out printed material on the benefits of paying on time and the responsibilities of the guarantor at customer service windows prior to disbursement. Another pro-active strategy was the development of a point system to reward clients who paid on time by conducting “solidarity” raffles and reminding clients of their payment dates via the internal call center and loan-officer visits.*

or liquidity. At the same time, it should be far enough away from payment dates for other important obligations, such as rent, school fees, and other debts.

#### ***Address Customer-Service Complaints Quickly***

In the development of new loan products linked to the purchase of assets, such as mobile phones and computers, it has sometimes been the case that the item bought turns out to be defective and/or the client did not receive adequate customer service from the supplier, resulting in cessation of client payments. By timely attention paid to complaints, staff members may be able to address clients' concerns before they result in a late payment. A similar situation could also be the result of fraudulent staff action, etc. In this case the institution must analyze the situation and, if it determines that late payment is due to problems with the good or service, propose a timely solution in order to "reactivate" the client.

#### ***Use Positive Reinforcement***

Positive reinforcement, as simple as it seems, also plays a valuable role. The lending institution can recognize and reward clients who pay on time by offering them immediate access to renewals, larger loan amounts, preferential (lower) interest rates, certificates of good payment, training, and prizes. These actions should be implemented with the support of the marketing department and integrated into the sales strategy.

### **Best Practice #2 – Improve Internal Productivity of the Collections area**

It could be said that a collections department is only as good as the staff working in it. A well-designed collections strategy weighs the strengths and weaknesses of the institution, addressing general questions such as whether collections should be handled internally or externally through a third party as well as considering what measures should be in place to ensure staff are properly trained, motivated, and measured. Also, it can promote healthy competition among the collections employees.

#### ***Determine the Appropriate Collections Procedures***

Collections activities command an immense amount of time and resources in order to be implemented well. MFIs have a choice to make—whether to hire a specialized collections agency or to create an internal collections unit. Before deciding, however, the MFI must analyze its options carefully, noting available resources, costs, and benefits associated with each path and the existence of collections agencies in the market. The following tables list potential advantages and disadvantages of both.

*Option 1: Outsourcing to Collections Agencies*

<b>Advantages</b>
<ul style="list-style-type: none"><li>▪ Collections agencies offer trained and specialized staff that are able to dedicate the appropriate time to collections activities.</li><li>▪ Costly control and supervision of collections activities are transferred to the collections agency.</li><li>▪ The client is often intimidated by the appearance of a new collections agent or company.</li><li>▪ The agency is more prepared to work through a variety of collections approaches, including call centers, collectors, on-site collections agents, and collections points.</li></ul>
<b>Disadvantages</b>
<ul style="list-style-type: none"><li>▪ Collections agencies lack experience with the low-income sector.</li><li>▪ Agencies may not be available in all markets or countries.</li><li>▪ They have little interest in client relationships, making client “reactivation” difficult.</li><li>▪ Communication between the MFI and the collections agency may become complicated. There may be duplication of efforts or contradictions presented to the client.</li><li>▪ The collections agency’s direct contact with the client may reveal problems within the MFI, resulting in a loss of confidentiality.</li><li>▪ External collections agents may have less success collecting if the client fails to “acknowledge” them, alleging they have no authority in their case.</li><li>▪ External collections agents may not adhere to the same ethical standards as promoted by the MFI when dealing with clients.</li></ul>

**In Practice – Brazil  
Real Microcrédito**

*Real Microcrédito (RMC) employed the services of Banco ABN AMRO REAL(Call Center) for loans that had fallen at least five days past-due, as well as the services of a specialized collections agency. One of the lessons learned from this experience was that by using dedicated staff in the call center as well as with the specialized collections agency, RMC was able to provide a more personalized and appropriate service to its microfinance clients. These channels provided by Banco ABN-AMRO REAL had traditionally been reserved for mainstream, high-income clients. RMC was thus able to increase and improve the quality of contact with clients. For example, a special collections speech was personalized for RMC clients, and guarantors were called, a practice which had not used by the bank in its traditional collections activities. Communication between internal collections agents and the collections agency also improved, facilitating negotiations with the client.*

*Option 2: Creating an Internal Collections Unit*

<b>Advantages</b>
<ul style="list-style-type: none"><li>▪ Internal units have more thorough knowledge of the client and the market.</li><li>▪ They are careful to maintain a relationship with the client, leading to possible client reactivation.</li><li>▪ Internal units facilitate internal feedback on the lending process as a whole.</li><li>▪ Staff feels more committed to the organization and to its objectives.</li><li>▪ The MFI's internal database holds information for the development of predictive collections.</li><li>▪ The MFI retains control over the client interface, thus having more direct control over ensuring collections practices remain in line with institution's ethical standards.</li></ul>
<b>Disadvantages</b>
<ul style="list-style-type: none"><li>▪ Internal units require specialized staff training that few MFIs have the time or resources to offer. The control and supervision of collections activities and staff also imposes high costs.</li><li>▪ There is a lack of personal and professional recognition for collections staff. Collections has a reputation of being not very enjoyable, and, in some cultural contexts, quite negative.</li><li>▪ An internal unit distracts from promotion and analysis activities, especially during periods of expansion.</li><li>▪ MFIs have little experience in collections.</li></ul>

**In Practice – Paraguay  
Financiera El Comercio**

*The shareholders and board members of the Financiera El Comercio in Paraguay created their own external collections agency, called “Gestión,” which managed past-due loans over 180 days from El Comercio by using specialized collections officers and lawyers. The company also provided call center services for loans past due up to 30 days to support El Comercio loan officers in their collections activities. After some years of operations, El Comercio has actually reinstated its collections activities within the institution. The main reasons behind this decision were high operating costs to maintain two separate administrative structures (two accounts, two boards), separation between both institutions (they did not speak the same language), and the absence of feedback channels between “Gestión” and the risk-management unit of El Comercio to review policies and procedures.*

**Select and Train Staff Members**

Once the decision is made to either create an internal collections unit or work with an outside collections agency, the MFI must identify the position and roles in the collections process, if any, that should be filled by internal staff and selected accordingly based on the appropriate profile for each position. It is important to define the roles and responsibilities of each participant in the collections process (e.g. field agents, call center, collections agencies, attorneys). This includes

exact levels of participation. For example, call-center staff may contact the client, but should not negotiate payment, as they are not trained to take on this task.

Training is vital to achieving successful loan collections and good customer service. It is important to educate staff members in techniques and strategies, such as how to address the typical arguments of the delinquent client, how to relate to difficult people, what types of clients exist, tips and verbal cues for communication, the typical profile of the delinquent client, and negotiation techniques. Additionally, MFIs must ensure staff members have a full understanding of the accurate application of collections tools and knowledge of relevant legal resolutions.

### **In Practice – Ecuador Banco Solidario**

*Banco Solidario developed a training plan for collections staff based on ACCION's knowledge and experience. The training plan aimed primarily at providing the institution with a 360-degree view of the role of collections in the overall lending cycle, for example collections as a loan-renewal and customer-service tool as well as training in collections strategies.*

#### ***Create Staff Incentives***

Incentives are established to motivate staff to direct their considerable talents to obtaining desired results. In addition to improving the effectiveness of collections, incentives may also promote a workplace environment of healthy competition. The incentives could be defined based on results of collections activities, according to changes in percentages of past-due amounts at each different stages of delinquency. A simple system of “commission for collections” could be designed to include higher commissions for the collections of more delinquent loans. Incentives could be monetary or in-kind, depending on what form best suits the environment. Alternatively, the collections goal could be measured based on the reduction of monthly provision expenses.

Identification of clear and objective targets and parameters are crucial in order to define incentive systems/schemes, design of collections policies and strategies as well as measure success and compliance. In order to comply with these objectives, it is important to use earlier warning signals as preparedness for delinquency, such as a PAR (portfolio at risk) of 1 day or 2,3, and 5 days, rather than the traditional PAR of 15, 30, and 60 days. Earlier delinquency targets and parameters aid to establish a collections culture of zero delinquency tolerance and also contribute in identifying past-due loans quickly where the possibility of recuperation of delinquent loan are higher during early stage and will help to avoid the masking of an increase in delinquency through portfolio growth, allowing immediate actions to take place.

### **Best Practice #3 – Ensure Quality Information Gathering and Management**

The precise and opportune information about the delinquent clients, loan situation and important information that bring feedback about the credit cycle is relevant for the successful on collections

#### ***Develop Efficient Information and Support Systems***

To properly analyze collections activities, it is necessary for the institution to have in place an efficient information system to facilitate the monitoring of past-due clients and the production of clear and precise reports. Generally there are three kinds of reports:

- ***Management reports***, such us lists of past-due clients to visit by loan/collections officer, list of past-due clients by amount and days late, or daily collections report, used by field staff to follow up with clients These reports are usually generated daily.

- **Monitoring reports**, such as delinquent portfolio by product, ratios of efficiency on collections, and summaries of portfolio by ageing and zone, used by middle and high management to analyze and address delinquent portfolio performance. These reports are usually generated weekly or monthly.
- **Risk-Management reports**, which monitor collections impact over portfolio performance by tracking indicators for normalization, billing cycles, recovered balances, and individual roll down ratios. These reports can be generated daily to track seasonality or monthly for forecasting purposes and performance management.

The system should also maintain a history of actions taken and collections activities implemented. This is especially important when there are many potential channels for collections (loan officers, collections agents, call centers, collections campaigns, etc.) in order to ensure continuity in terms of collections activities carried out by each participant and avoid duplication of efforts and contradictions.

#### ***Ensure Quality of Client Information***

Just as regular client contact is key to an effective collections process, so is the collection of quality client information necessary for successful client location. During the initial application process, the MFI should request several pieces of information, including the client's full name, address and clear instructions on how to locate the client (map of location), telephone number and personal and commercial references. During each step of the collections process and by each participant in it, this information should be verified and updated as necessary in order to facilitate seamless contact with the client throughout the process. MFIs must develop tools and strategies for updating client information in the database, without compromising secure access controls or quality of information. One possible way to ensure integrity of the information is through the development of an incentive system for staff to encourage timely and accurate database updates.

#### **In Practice – Paraguay El Comercio**

*El Comercio in Paraguay used client information to solve a common problem of client location. MFIs have a difficult time locating clients who have closed their businesses and moved. To address this problem, El Comercio began to review the clients' files and contact the personal references noted in order to locate the client. Previously thought to be useful only in the clients' character analysis during the evaluation process, these references are usually family or close friends who are able to provide information on the whereabouts of the missing clients, information vital to the collections of past-due loans.*

#### ***Establish an Internal Past-Due Committee***

A past-due committee is made up of branch staff who participate in the collections process, including loan officers, collections agents, branch managers, and others. Periodic meetings are held to discuss and analyze specific past-due clients and collections strategies and processes. During committee meetings suggestions may be offered, and participants learn from the errors identified in the evaluation and approval process/phase. The committee also discusses and analyzes portfolio statistics, challenges and achievements.

The past-due committee is useful to develop a culture of good collections practices within the institution and helps provide feedback to management on the MFI's collections strategies,

policies, and procedures. It also helps to control delinquency, encourages good decision-making practices, and provides a valuable forum for learning/training from the field.

#### ***Establish Internal Methodological Control Units***

Internal methodological control units, or methodological audit units, are strategic units created within MFIs to address the lack of a monitoring and control system for the specific products and services of the microfinance industry. During an individual loan assessment by an MFI, the typical formal-sector documentation used to support the credit analysis is substituted by a report generated by the loan officer in the field detailing the client's family and business situation. Traditional banking-sector audit systems have proven to be inadequate for the microfinance industry, thus increasing the motivation for internal audit departments to monitor not only the collections process but address all sub-processes of the lending cycle.

Methodological control is an important tool for obtaining ongoing feedback and assessment. It is used to keep management informed regarding the quality of operations in the branches and the correct application of credit policies and processes. Methodological control should then prevent deviations from the established methodology that could potentially have a negative impact on portfolio quality. Methodological-control-units have been successfully implemented to decrease delinquency in institutions such as Financiera El Comercio, Banco Columbia, Real Microcrédito, and Banco Solidario.

#### **Best Practice #4 – Develop Well-Defined Strategies for Collections of Delinquent Loans**

Developing a strong collections unit requires clearly defined, documented and consistent policies and procedures that guide staff through the collections process and instruct them on how to respond in particular situations. Such policies and procedures should include a variety of strategies.

#### ***Establish Client-Contact Policies***

When should the MFI make initial contact? Is the best way to contact the client through telephone, email, postal service or visits? The key to selecting the best method is weighing the costs and benefits of each available method based on number of days past-due and the probability of total debt collections. Contact policies may include preventative strategies, such as a payment reminder, and should include a plan defining dates of future contact and the steps to be taken in the collections process.

#### ***Risk-Based Collections***

Any financial institution faces an enormous volume of decisions that must be made every day. In collections, we must decide when to contact the client, who should contact him, how to approach him, what product to offer, how to deal with broken promises, how to deal with lost or missing clients, what to do in cases of tragedies or natural disasters, and many other decisions that cannot be entirely delegated onto the experience of a loan officer. Risk-based collections strategies provide valuable tools for the decision-making process.

Implementing a risk-based collections strategy requires at least the preparation of the following:

- A thorough review of the external information available regarding regulatory environment, limitations, competition, the target market, etc;
- The design of the databases to support the construction of risk-management reports for performance monitoring and for the development of the tools aiding collections decisions;

- Training for staff responsible for risk management and collections strategy definitions;
- Definition of the tool for calculating the level of risk the client presents, whether that client is recoverable, and the best strategy for recovery.

The first tool for identifying the probability of default of a client is data mining. Alberto Teskiewicz defines data mining as:

The process of identifying significant correlations, patterns and trends that are hidden among the wealth of information in the database, through the combination of statistics, mathematics, and recognition of patterns. It is an interactive process that allows the institution to convert data into knowledge, generating benefits that translate into lower costs and higher income.<sup>3</sup>

While many institutions currently consider data mining vital to portfolio evaluation, it is still not used as an important tool to maximize the effectiveness of collections activities. Data mining allows MFIs to forecast the probability of recovery and provides them with a score useful in prioritizing past-due loans based on recuperation probability.

Another tool available for risk management of collections is the “Collections Scorecard,” a system for assigning points based on the characteristics of a client in order to obtain a numeric value that reflects how likely this client is to default relative to other individuals. It is important to note that a collections scorecard does not indicate how much risk you should expect; instead, it indicates how a particular loan is expected to perform relative to other loans.

After segmenting clients based on their probability to repay, the MFI develops a set of strategies for collecting from the different segments, while optimizing its financial, human and infrastructure resources. The success of risk-based collections depends not only on the

**The Collections Scorecard in Practice – Optimizing the sending of debt-collection notices to clients both with and without credit scores.**

<b>Without Score</b>	<b>With Score</b>	<b>With Score</b>	<b>Activity</b>
No. days past-due	High Priority – No. days past-due	Low Priority - No. days past-due	
7	5	15	First letter
15	10	20	Second letter
40	30	45	Third latter
60	45	60	Legal notice

*Traditionally, collections notices are sent based on the number of days past-due, without establishing priorities and probabilities. When applying a collections score, timing when the collections notice is sent depends primarily on the priority determined based on client risk and the probability of collections.*

<sup>3</sup> Alberto Teskiewicz, “Modelos predictivos para cobranza y refinanciación” [Predictive Modeling for Collections and Refinancing]. First Collection Summit, Credit Management Solutions, Buenos Aires, Argentina 2007.

development of the score used to forecast repayment probability and the optimized collections strategies, but also on the appropriate implementation and monitoring of the defined strategies. Such strategies are now very common in consumer credit (individual credit) but are still not very advanced within the microfinance sector.

### ***Segmentation***

Another methodology used to implement successful collections strategies is client segmentation. Not all clients are the same, nor are their reasons for delinquency. Effective client segmentation results primarily from identifying the cause of delinquency and classifying the client based on attitude, capacity to pay, solvency and location.

Effective client segmentation is not achieved early on; classification is a difficult task, which is why it is important to follow up with clients and monitor the number of days any client falls past-due. As the number of past-due days increases, strategies should change as the MFI and collections agents come to know the client better. At the beginning the focus is on retaining the client, but as the number of days past-due increases the focus changes to recovering the loaned funds.

Segmentation is additional to the risk-level determination (data mining or score-based methodologies discussed above). However, if the institution does not have access to additional tools, the MFI can apply a simple classification strategy, such as the following:

- ***Clients who are willing and able to pay*** require simple collections activities. In many cases effective negotiation of new payment conditions is enough to recover the past-due amount and maintain the client. These individuals are usually clients who forgot to pay, did not receive the payment schedule indicating payment dates, or asked someone else who did not follow through to deposit their payment for them.
- ***Clients who are willing but unable to pay*** require feasible alternatives and options. In these cases the most effective negotiating involves changing the loan conditions (restructuring, refinancing, etc). Depending on the payment behavior after re-negotiating the conditions, this client could also be a candidate for renewal. Generally these clients have experienced an unforeseen emergency, are going through a difficult situation, are victims of an investment gone bad, or are outspending their income.
- ***Clients who are able but not willing to pay*** require MFIs to ponder a question—is the lack of payment due to problems with the quality of service offered to this client? If the answer is “yes,” such problems must be immediately resolved. If the answer is “no,” collections must involve an immediate and more intensive strategy. If the new strategy is unsuccessful, then immediate legal action is recommended. It is not unusual to discover that these clients initially received erroneous information, that they disagree with the loan conditions or that payments were made but were not applied because of operational errors.
- ***Clients who are neither willing nor able to pay*** require immediate legal action. Generally these are fraudulent clients with a bad credit history or poorly evaluated/approved credits. However, before moving forward it is important to determine their degree of solvency—that is whether the clients possess sufficient assets to obtain repayment. If they do not, any actions taken could be counterproductive. The MFI must evaluate the cost/benefit of any action taken with these clients.

It is evident from this proposed segmentation that there is a direct relationship between the client's intention to pay and the probability of recovering the loan—as the client's intention to pay diminishes over time, so does the probability of loan collections. For this reason, action must be taken immediately on past-due loans in order to increase the effectiveness of collections.

### ***Payment Alternatives***

Payment alternatives are important negotiating tools and key to the ultimate success of the collections process. MFIs must offer various payment alternatives adjusted to fit the diverse needs and situations of clients. This is akin to arming collections agents so they can win the debt-collections battle. The timely use of these tools is also important and demonstrates the institution's capacity to react and respond to delinquency.

Traditionally, MFIs have used restructuring and refinancing as the only payment alternatives. These two options do not necessarily address the needs presented by the wide gamut of client situations and imply a need for innovations and the creation of other alternatives. To be able to offer innovative alternatives, MFIs need the support of a strong and flexible information system. In general, if it is not possible to collect the loan in a single payment, valid alternatives should be identified. This should occur even if it means extending the loan term, implementing periodic evaluations or collecting minimum installment payments for a specified period of months and the remaining balance upon maturity. The client's repayment behavior should be evaluated towards the final repayment, always considering the costs and benefits.

Payment alternatives may also include discounting late fees and charges from the total amount of the loan; if the loan is paid off more quickly rather than over a longer period of time the discount should be greater. For example, a client who is able and willing to pay the total amount past-due would receive a greater discount in fees than a client who requests 15 months to repay, thus creating an incentive for quicker loan repayment.

### **In Practice – Brazil Real Microcrédito**

*Real Microcrédito (RMC) developed an innovative system called “agreement to pay” based on a system of discounting penalty interest and fees in direct relation to the new term established for total repayment. In this way, for example, the client who chooses the shortest repayment term received a greater discount. This collections product was designed as a campaign within a pre-established timeframe; it is not an ongoing service. This option was offered to clients with a certain minimum number of days past-due and needed to be managed with discretion since, for example, if the minimum number of days past-due was set at 90, a client who is 60 days past-due and desired to pay back the debt could potentially be required to wait until the loan is 90 days past due to receive the benefit.*

## **IV. Additional Collections Concerns**

While the implementation of the collections best practices is a vital first step to creating an effective collections strategy, there are a number of additional concerns that must be addressed, including the role that consumer protection plays in the overall collections strategy as well as the analysis of the collections cost structure.

## Consumer Protection and Collections

Emphasizing the importance of long-term client relationships is key to designing and developing efficient collections strategies. Though it is true that timely loan collections is vital to the MFI's survival, achieving client repayment must never include inappropriate coercion or intimidation techniques, such as physical force, humiliation, contact at inappropriate hours of the day, or the seizure of assets that are basic to the client's daily survival. The current regulatory framework related to consumer protection in each country must be taken into account when establishing collections strategies.

To maintain a healthy balance between consumer protection and collections, the MFI must develop a culture of professional service and respect for clients. This includes selecting staff with the right profile, offering regular training opportunities, and implementing clearly defined processes backed by accurate information and information systems.

A recent ACCION publication<sup>4</sup> on consumer protection mentions the development of "appropriate debt collections practices" as a fundamental principle of customer service. MFIs can ensure that staff respect and practice this principle by:

- **Monitoring collections activities:** Through internal audit and control units, MFIs may conduct random visits to a representative sample of past-due clients from each branch in order to supervise the application of appropriate collections policies and procedures in the field and to obtain client feedback regarding service quality.
- **Forming "focus groups":** Focus groups comprised of delinquent clients not only allow MFIs to obtain feedback on service quality, but also allow institutions to understand client's payment priorities, which can be influenced by the quality of service provided by the institution.
- **Requiring frequent and detailed reporting:** Collections staff should report regularly on their interactions with clients and present reports to branch managers and other relevant parties as a part of the overall analysis and evaluation of collections activities.
- **Setting a time limit for interaction:** MFIs should impose time limits for loan-officer interaction with a delinquent client, after which the case should be transferred to a different loan officer. The involvement of different actors (loan officers, collections agents, branch managers) in the collections process may help to reduce the possibility of fraud and/or mistreatment of the client.

It is important to clarify that interviewing or surveying delinquent clients must be managed carefully. Mishandling could be counterproductive, as experience has shown that mishandled client interaction can be used by the client as a solid argument for non-payment. Often it is much better to ask indirect questions or even to interview clients through a third party in order to obtain accurate and objective feedback about service provided during collections activities. The delinquent client is in an extremely delicate situation, and the quality of customer service provided to them is fundamental to maintaining client loyalty and recovering the full amount of the debt.

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<sup>4</sup> Patricia Lee Devaney, "Bringing Pro-Consumer Ideals to the Client—A Consumer Protection Guide for Financial Institutions Serving the Poor" (ACCION Monograph No. 14, ACCION International, May 2006).

## Promotion and Collections

Consumer protection also plays a role in the relationship between promotion and collections, as does the long-term health of the MFI. Financial institutions clearly define their main activities as loan disbursement and collections. The more efficient they are at performing these activities, the better their results will be. Promotion, or sales, and collections are closely related. It is exactly because of this interdependence that MFIs cannot focus on only promotion or only collections. They must be managed together in an efficient manner in order for an MFI to achieve sustainability. One basic principle is “loan disbursement is not complete until the debt has been completely recovered.”

Maintaining an appropriate balance between promotion and collections is a key factor critical to the MFI’s survival and ultimate success. In the rush towards mass expansion to new markets and client retention via more financial services, many institutions have introduced new products—such as credit cards, parallel loans, seasonal loans, and home-improvement loans—and entered new markets. Often these changes have been introduced when there is already an increase in the level of client indebtedness due to a rise in banking opportunities in the sector. This combination of changes has led to heightened loan-portfolio deterioration, for which traditional collections strategies have proven insufficient. As a result, many MFIs have seen the need to develop and implement new collections strategies at the same time as they were introducing expansion programs.

## Collections Cost Analysis

To calculate the cost of the collections process, the MFI must first determine a number of factors, including the size and number of participants in the process, number of collections agents or collectors, salaries, incentives, commission of staff members and whether specialized services will be used. Generally, the number of on-site collections agents represents over 50% of the total staff of the collections area, since this type of collections allows for better client location and is directly proportionate to the size of portfolio (number of clients). This also applies to the call center, law firms, etc.

Following is a typical breakdown of expenses for a collections unit that outsources some collections activities:

Concept	Percent of total expense
Salaries & incentives	40 – 60%
Other operating expenses (transportation, rent, etc.)	20%
Fees to collections agencies or specialized services <sup>5</sup>	20 – 40%

Source: “Riesgo y Rentabilidad, Banca al consumidor y proceso de adquisición de cuentas,” collections training course presented by Empresa Winners, 1998.

The total cost of the collections process (CCP) is the sum of all of the above:

$$\text{CCP} = \text{Salaries} + \text{Other operating expenses} + \text{Fees for services}$$

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<sup>5</sup> In this example the authors are assuming that the MFI has a mixed collections strategy, outsourcing some of the collections activities.

Loan-loss and provision expenses, including actual loan losses (LL), are also related to past-due loans. Therefore, the total cost of collections (TCC) could be represented as:

$$TCC = CCP + LL$$

To optimize the efficiency of the total costs of collections the institution must consider the costs of the collections process vs. loan losses and provisions. The two must be inversely proportional—as collections costs increase, loan losses and provisions must decrease. A hypothetical example is provided in the following table:

Period	Cost of Collections Process (CCP)	Loan Loss & Provisions (LL)	Total
1	0	10,000	10,000
2	2,000	8,000	10,000
3	3,000	6,500	9,500
4	4,000	5,000	9,000
5	5,000	4,500	9,500
6	6,500	4,000	10,500

Source: “Riesgo y Rentabilidad, Banca al consumidor y proceso de adquisición de cuentas” (Collections training course presented by Empresa Winners, 1998).

From this example we can conclude that the objectives of a typical collections unit are:

- to obtain optimal results through the collections process and
- to increase collections costs (CCP) vs. loan-loss and provisions expenses (LL).

## V. Conclusion

Collections is a customer service that MFIs must consider before launching new credit programs. Not only does it play an integral role in the overall lending cycle, but it is also a valuable source of feedback on the processes that take place prior to collections. Contrary to the popular belief that delinquency starts only when a client misses a payment date, in many cases it is the processes themselves are the original catalysts of delinquency.

The best practices presented here do not represent a comprehensive list of strategies that may be employed to address and reduce delinquency, but they are, from the authors’ experiences, the most effective. Additionally, institutions should be aware of the consumer protection concerns relating to collections as well as the appropriate cost structure in place to ensure appropriate allocation of funds. What should be taken away is the understanding that excellent collections strategies should begin before there is a delinquency problem and end only after the loan is deemed a loss.

## **Glossary of terms**

**Collections**—Actions taken within a financial institution to both prevent delinquency and recover past-due loans.

**Refinance**—Modifications of an existing loan made by a lender in response to a borrower's long-term inability to pay the loan. This usually involves modifications on the current loan conditions that would include additional money. Borrowers are often requested to fulfill some compulsory requirements.

**Restructure/reschedule**—Modifications of an existing loan in response to a borrower's short-term inability to pay the loan. This action usually involves only modifications on the loan term and frequency.

**Past-due/delinquent loan**—Loans with at least one payment installment not made on or before the agreed upon payment date. Usually MFIs define a loan as past-due or delinquent if payment is one day late.

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