Pakistan Microfinance Network

MicroNOTE

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UNRAVELING THE DELINQUENCY PROBLEM (2008/2009) IN PUNJAB - PAKISTAN

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INTRODUCTION

Pakistan's Microfinance sector expanded outreach at an average annual rate of 49.6% in the period 2000-2007[1] while improving its portfolio quality to globally competitive level with Portfolio at Risk for loans overdue for more than 30 days (PAR>30) at 3.1%[2] in 2007. By year end 2008, Pakistan's microfinance outreach stood at 1.7 million active borrowers but the sector began to witness recovery challenges, specifically in its most microfinance fecund province Punjab. Groups of borrowers of one of Pakistan's largest microfinance provider (MFP) - referred in this report as MFP-X - refused to repay loans amidst rumors of mass loan write offs. Other MFPs operating in Punjab began to fear deterioration in their borrowers' repayment behavior as some of their clients tried to replicate the behavior of MFP-X's borrowers to have their loan obligations towards other MFPs waived off as well.

This report is based on the research commissioned by Pakistan Microfinance Network (PMN) to understand the nature, extent and seriousness of the delinquency "problem". The research is to specifically answer the following questions:

1. Why and how the "problem" started?
2. The extent of the "problem" to date?
3. The potential spillovers of the "problem" for the sector.
4. Recommendations for sector stakeholders to contain the problem and prevent similar situation recurring.

How this Report is Structured

Following this brief Introduction and an overview of the methodology used, the report provides an overview of some salient dynamics in Pakistan's microfinance market and the macro-economic environment in the backdrop of the current delinquency problem. The subsequent assessment of the nature and extent of the problem is based on the analysis of branch-wise portfolio data for majority of MFPs operating in Punjab; and on the discussions with the management and staff of these MFPs. The next section

PMN thanks its members for contributing to this study. Our gratitude also extends to our donors for their continued support.

1. When total active borrowers stood at 1.3 Million by 2007- end. (MicroWatch. Issue 7. PMN)
2. Pakistan Microfinance Review 2007. Pakistan Microfinance Network.

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presents the antecedents of the delinquency uprising and organizes series of possible causes of the problem into: sector-wide structural factors, exogenous shocks, triggers, factors that caused the problem to snowball massively, and the “entrenchers” making the problem difficult to contain. Based on the research findings, the paper highlights risks posed by this problem to Pakistan's microfinance stakeholders. Finally, the paper puts forth conclusions and recommendations for containing the problem and preventing similar crisis in the future.

RESEARCH APPROACH AND METHODOLOGY

To answer the above questions, the research team triangulated the information and data from both the senior management and loan officers of key microfinance providers in Punjab, the delinquent borrowers and the repaying borrowers. (For details on research approach and the sample see **Annex A**).

The research was based primarily on qualitative data collected through structured focus groups with borrowers and face to face interviews with senior management as well as loan officers of key MFPs in Punjab. This methodology has inherent limitations, as with any focus groups based research. The research team however discovered at an early stage of the research that even if resources for the research had allowed for a representative sample based quantitative survey, the potential for response error on structured interviews with individual borrowers was huge. The research team found that a borrower (whether delinquent or not) was not willing to commit herself individually to even acknowledging the delinquency problem that was spreading quickly from group to group, and across cities.

In a group, however, the borrowers revealed much more as the borrowers in each focus group built upon each other's discussion points. Hence, although the research findings may not be based on “empirical” evidence, the assessments presented in this paper are based on only those findings and feedback that appeared consistently from one end of Punjab to another.

The research team used three broad approaches to answer the research questions constituting the study's “scope of work”:

- To collect range of hypothesis regarding the nature and causes of the delinquency problem, the team conducted interviews with senior management and microfinance loan officers of 9 MFPs (3 Microfinance Banks (MFBs) and 6 NGO-MFPs) operating in Punjab.
- To analyze the extent of the delinquency problem, the team collected branch-wise data (December 2007 and February 2009) on portfolio size and quality, from 7 of the 10 key MFPs operating in Punjab. The 7 participating MFPs include 2 MFBs and 5 NGO-MFPs. Together the participating MFPs, excluding MFP-X[3], account for approximately 51% of total active microfinance borrowers in Punjab.
- For insights into the nature, causes and extent of the problem, the team also met microfinance borrowers (both repaying and delinquent) through random walks and focused discussion groups (FGDs). The team held its research with borrowers and loan officers from 4 different districts in Punjab, and from 5 different MFPs, including MFBs and NGO-MFPs. The team conducted 7 random-walk interviews and 2 Focus Group Discussions (FGDs) with borrowers in Muridke, the Tehsil[4] (in District Sheikhupura) from where the problem first erupted. Fourteen (14) more FGDs were

3. MFP-X accounted for close to quarter of total active borrowers in Punjab at the time of this research.
4. Tehsil is the second lowest administrative unit of government in Pakistan. The largest administrative unit is the **Province** which is divided into several **Districts**. Each district consists of several **Tehsils** and each Tehsil is made up of **Union-councils.**

conducted in 3 other Districts[5] (both close to and distant from Muridke) to assess the "extent" to and the "means" by which the "problem" had travelled within Punjab. Of the 200 microfinance clients the research team met, 188 (94%) borrower were met as clients of MFPs other than MFP-X, while 12[6] as clients of the latter. However, as the research progressed it was found that approximately 70% of clients that the team had met as clients of other MFPs were current defaulters of MFP-X. Thus the research sample of borrowers includes 130 MFP-X borrowers and 70 borrowers from other MFPs in Punjab.

MICROFINANCE EXPANSION IN PAKISTAN

Pakistan is among the largest potential microfinance markets in the world[7] with an estimated size between 10 million to 20 million adults as potential active clients. A relative newcomer in Microfinance, Pakistan initiated a concerted effort to develop its Microfinance sector in 2000 when the Government of Pakistan recognized microfinance as a priority tool for poverty alleviation in its official Poverty Reduction Strategy. Since 2000, microfinance outreach has expanded 23 folds: from approximately 76,000 active borrowers by year end 2000, to 1.73 million active borrowers by year end 2008. See **Exhibit 1** for Pakistan's Microfinance outreach characteristics.

Exhibit 1: Outreach Characteristics of Pakistan's Microfinance Sector (As of Dec 2008)[8]

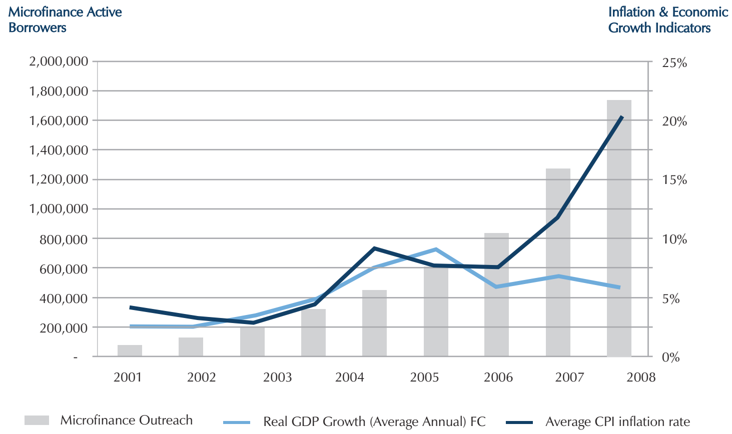
Total Number of Active Borrowers: 1,732,879 Total Gross Loan Portfolio Outstanding: PKR 18,752 million[9] Average loan outstanding per Borrower: PKR 10,821		
1. Urban vs. Rural Outreach (as % of total outreach)	Urban Outreach: 51%	Rural Outreach: 49%
2. Outreach by lending Methodology (as % of total outreach)	Group Lending Model: 92%	Individual Lending Model: 8%
3. Punjab outreach vs Rest of Pakistan (as % of total outreach)	Punjab Outreach: 67%	Rest of Pakistan: 33%
4. Outreach of MFB vs. Outreach of Non-Bank MFPs	Microfinance Banks' Outreach: 35%	Non-Bank MFP Outreach: 65%

During most (2000-2006) of the period of microfinance growth and development in Pakistan, the country experienced high economic growth with low inflation. In fact, Pakistan's economic performance was considered only second to that of China during the same period. Despite the economic growth, structural imbalances in Pakistan's economy remained: growth outpaced energy supply, economy remained sensitive to agricultural output (specifically food crop output) and export base remained weak. The effect of structural weaknesses and rising global commodity prices began to show on Pakistan's economy and by year 2006 the economic growth rate began its slide downward and inflation began to rise. Pakistan's real GDP growth rate plummeted

5. The sample of borrowers and loan officers was selected from the following districts:
   1. District Sheikhupura
   2. District Lahore
   3. District Gujranwala
   4. District Multan
6. Due to initial access limitations the research team could not include a larger sample from MFP-X.
7. Robert P. Christen, MFT 2005, The Boulder Institute of Microfinance.
8. MicroWATCH: Issue 10, December 2008. PMN.
9. US Dollar @ PKR 80

from 9% in 2005 to 5.8% in 2008, productivity sky dived,[10] and average annual inflation[11] rose from 7.9% in 2005 to 20.5% in 2008. For an average Pakistani this meant decline in real incomes due to fall in productivity and in the purchasing power of Pak Rupees.

Exhibit 2: Microfinance Growth in the Macro-Economic Context (2001 - 2008)



Dynamics of Microfinance Expansion in 2006

Despite economic slowdown and the slump, Pakistan's microcredit outreach of year end 2005 tripled by the end of 2008. The growth came through geographical and product expansion by MFPs. In 2006, PMN and ShoreBank International conducted a joint study[12] on the characteristics of microfinance growth in the most microfinance dense district of Pakistan. The study revealed that:

- **MFPs were vying for same clients:** MFPs tended to piggy back on their competitors efforts in market development, thus locating their operations in markets where their peers had already set up operations. As a result, microfinance was becoming heavily clustered in selected pockets in any given district. A typical microfinance branch in an urban market like Lahore, was seen to be competing against three or more MFPs.

- **Sensing increasing competition in existing market segments, MFPs had begun to identify and serve new markets.**

- **However, MFPs internal controls lagged expansion:** Because of pressure on staff for quick outreach, coupled with multiple responsibilities of loan officers, inadequate staff incentive systems, and weak internal monitoring and control systems: some microfinance loan officers across various key MFPs, appeared to be short-circuiting operational procedures and risk control systems. The study observed that the following practices were becoming common amongst MFPs' staff:

  - Delegating their responsibilities of client selection and application verification to leaders of borrower-groups or other non-staff members such as local activists.

  - "Hijacking" groups of borrowers of competing MFPs through tactics including offering incentives to borrower-groups' leaders to shift patronage and hiring competitor MFPs loan officers for accessing the staff's portfolio during the employment with competing MFP.

10. Large Scale Manufacturing growth rate, 8.3% in 2005, decelerated to -5.4% in 2008.
11. Measured by Consumer Price Index (CPI).
12. Burki, Hussan-Bano & Shah, Mehr. 2006. The Dynamics of Microfinance Expansion in Lahore. PMN. **http://www.microfinancegateway.org/content/article/detail/41669**

- **MFPs' marketing and new client mobilization strategy relied heavily on use of local activists/group leaders.** Consequently, the information on MFPs' terms and conditions was being spread unevenly, based upon the local activists' preferences and social outreach, within a target community. But more significantly, this heavy reliance by MFPs on local activists and group leaders was creating a situation whereby most of the potential clients tended to see the local activist / group leader rather than the specific MFP as the source of credit. This was creating an extraordinary leverage for the local activists on MFPs and clients, and was creating venues for commission agents / group leaders / activists to seek commissions from borrowers for providing access to microfinance loans. Group-leaders / commission agents were also providing borrowers access to multiple loans from different MFPs.

- **MFPs were adjusting terms and conditions to make larger loans accessible on easier terms.** To compete with growing competition in ventured market segments, MFPs were trying to lure or retain borrowers by increasing loan size, reducing application processing time and simplifying documentation requirements. In the absence of compensating risk control measures, the research warned that such adjustments could increase credit risk for MFPs.

- **Many borrowers were expanding their credit exposure by taking parallel loans from multiple MFPs.** The research estimated that 40% to 70% borrowers in mature, saturated markets had taken parallel loans.

The 2006 assessment of the dynamics of microfinance expansion suggested that the microfinance expansion was increasing financial services outreach across geographies and market segments; MFPs were becoming more clients responsive; and that competition amongst MFPs was pushing down on transaction cost for borrowers. However the expansion was accompanied by weak internal controls and risk management systems that: allowed a shadow system of commission agents (including activists and group leaders) to control access to loans as well as loan recoveries; and facilitated borrowers to take multiple loans.

To harness the benefits of microfinance expansion over the long term, the study recommended coordination amongst microfinance stakeholders for tighter internal controls and compliance monitoring; efficient human resource management system; and client information verification and sharing system to control parallel borrowing and potential over-indebtedness of the microfinance clients.

Current Practices in the Sector

This current research, conducted in April/May 2009, suggests that the market dynamics identified three years earlier as potential credit risk for microfinance sector remain uncorrected. The research revealed that:

- **MFPs continue to expand by tailing their competitors to new markets and vie for the same clients** despite the fact that the average microfinance penetration rate of Pakistan is less than 12% and that of Punjab (the most enterprise rich province) less than 8%.[13] This research found that the odds of finding a branch of any MFP, in any district, were close to being a sure shot if one knew the location of the distribution network of competing MFP/s in the respective district.

- **Parallel borrowing by clients not only remains high but is increasingly tolerated.** Borrowers across the province of Punjab[14] estimated that on average, 70% of microfinance borrowers in their respective communities have parallel loans

13. MicroWATCH: Issue 10, Dec 2008. PMN.

14. Punjab accounted for 67% of microfinance clients in Pakistan as of December 2008.

from competing MFPs. The findings from the research suggest that a typical borrower with parallel loans has taken loans from more than three MFPs simultaneously. The estimate of the incidence of parallel borrowing does not differ much from that of the 2006 research. However this research observed a noticeable difference in the acceptance of parallel borrowing: borrowers were now more open and less apologetic (even in front of MFP staff) of having taken multiple loans; and MFP staff certainly showed tacit tolerance of parallel borrowing by their clients.

- **The shadow system of commission agents / activists / touts has become more entrenched.** Commission agents / activists / touts are often all found in a role of a center manager or group leader of MFPs' solidarity-groups. Group leaders and activists get an opportunity to turn into commission agents primarily because the MF staff, lending through solidarity groups, tend to delegate significant portion of their client selection responsibility to group leaders or activists. Having a de facto power to accept or reject a potential borrower in a group, the group leader has the power to provide or refuse access to financial services to potential clients. This power allows group leaders to charge commission from borrowers for access into a group.

  Group leaders / activists/ commission agents get the opportunity to work around MFPs' client selection criteria due to several interfacing factors including: the delegation of client selection process by MFP staff to the group leaders; inadequate screening and verification by MFP staff of loan applicants; and MFPs' internal control systems that allow informal delegation of responsibilities and fail to identify weaknesses in client verification processes.

  The research team observed that often, the group leader had accessed more loans from an MFP than the MFP had record of by borrowing through a “dummy” or “ghost” borrower. In some cases the group leader and the “ghost” borrower had subdivided the loan amount and thus the repayment responsibility as well.

  Microfinance field staff claims that it is difficult to remove the influence of commission agents / group leaders simply by raising borrowers' awareness that they can access MFP loans directly from MFP without paying commission. This is because many borrowers depend on commission agents to provide them access to multiple loans from different MFPs. Thus the borrowers who want to access parallel loans from multiple MFPs are willing to pay a commission to access multiple loans through the commission agents. The fact that the commission agents can provide access to parallel loans suggests lacking ability and/or willingness on the part of MFPs, or their staff, to prevent lending to borrowers already in debt.

THE NATURE AND EXTENT OF THE DELINQUENCY “PROBLEM”

The current delinquency problem is a revolt of microfinance solidarity groups[15] against repayment of microfinance loans. The revolt is primarily against one MFP (MFP-X) currently. MFP-X has one of the largest microfinance outreach in Pakistan and accounts for approximately a quarter of total active borrowers in Punjab. Like majority of MFPs in Pakistan, it lends through borrowers' solidarity-groups.

The delinquency problem was triggered in October 2008 when MFP-X's borrowers in Tehsil Muridke, claiming inability to meet loan-repayment obligations and their weariness of resulting pressure of loan recoveries from the MFP's loan officers, approached a local politician to solicit his help in having their debt owed to MFP-X waived off. The tacit support of local politicians encouraged borrowers to withhold repayments from MFP-X. The opportunity to have MFP loans written off was specifically

15. Solidarity groups refers to groups of microfinance clients organized so to access microfinance services under the Grameen or Latin American style group lending model.

attractive to:

- Mature clients who had been borrowing from MFP-X since close to a decade and thus owed MFP-X larger amount than they owed any other MFP,
- Opportunists who had taken multiple loans from the same organization either in their own name or in the name of some other borrower.

The incentives for the borrowers and opportunists (including political activists vying for political mileage and commission agents / group leaders grabbing at an opportunity to sweep their own hidden debts from the organization under the rug) were strong enough for them to fabricate rumors of general write-offs by MFP-X.

The news of borrowers' revolt in Muridke; the perceived inability of MFP-X to contain the initial revolt; and the rumors of general write-off of loans owed to MFP-X, spread quickly and wide across Punjab, primarily through social networks of borrowers themselves. As borrowers sought "proof" to support their refusal to repay MFP-X, another class of opportunists arose: those who saw an opportunity to make money by "selling" borrowers the "proof". Thus documents seen to be supporting the borrowers' decision to default began to be sold to borrowers for anywhere between PKR 500 (USD 6.25) to PKR 3000 (USD 37.5)[16] a piece per person. Such documents include: copies of newspaper article announcing the death of MFP-X President and the general loan write-off; illegible letters with MFP-X's logo announcing, on behalf of MFP-X, general waiver of loan repayment obligation; stay orders from local lawyers supporting withholding repayment of loan; copies of letters or notes written on behalf of local politicians encouraging borrowers not to repay. The research team observed that while the belief amongst the borrowers about the authenticity of these documents and the different rumors has waned over the past eight months, borrowers are currently and primarily withholding repayments because they feel they can for they believe that everyone else in the country is not repaying. As one group put it: "(they) will repay MFP-X when they (the borrowers) hear that everyone else in Pakistan has begun to repay".

Delinquencies soared: MFP-X's PAR>30-days rose from less than 1% before October 2008 to more than 20% by February 2009. Feedback in April 2009 from borrowers in Punjab suggests that the borrowers believed that approximately 80% of MFP-Xs borrowers were still withholding repayments.

This research suggests that although the delinquency problem is focused around one MFP, the risk that the revolt spills over to other MFPs is very real - especially since many MFP-X defaulters are also clients of other MFPs.[17] Furthermore, because MFP-X accounts for a significant market share (approximately quarter of active microfinance borrowers in Punjab), the revolt presents a risk to the credit discipline in the whole market.

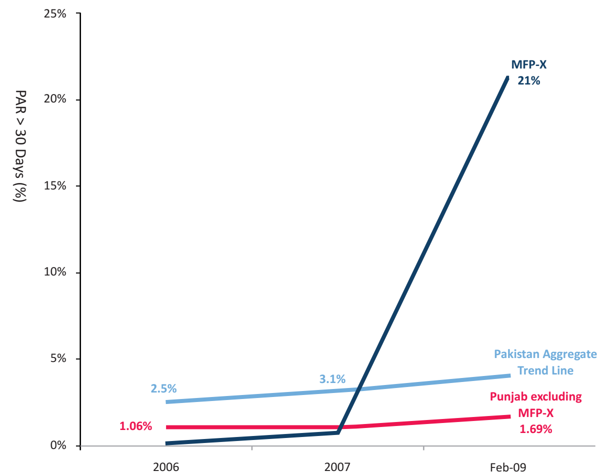
According to the management and loan officers of MFPs operating in Punjab, lately, it takes more effort and time to get loan recoveries on time than it did before the revolt. Since the revolt, clients of other MFPs occasionally attempt to mimic the tactics and excuses used by borrowers while revolting against MFP-X. Thus other MFPs are being sporadically affected by the delinquency problem, but not to the same extent (yet) as MFP-X as reflected in their PAR numbers.

Though MFP staff may be putting more effort than before in getting loan recoveries on time, latest trends data **(Exhibit 3)** show that except for MFP-X portfolio, the remaining

16. An average a microfinance borrower in Pakistan owes PKR 1,050 (USD 13) in monthly installments on PKR 10,000 (USD 125) loan - Data Source: Pakistan Microfinance Review 2007. PMN.
17. During the research, on average 70% of randomly selected clients of MFPs competing with MFP-X admitted to be clients of MFP-X.

microfinance portfolio at risk in Punjab was within acceptable level at the time of this research (and eight months since the revolt started in Muridke). However the portfolio quality data for other MFPs in Punjab indicates an upward trend in risk. This trend is explained by MFPs as due to declining repayment capacity of borrowers due to fall in real incomes; microfinance outreach expansion and the corresponding “natural” increase in PAR; and to some extent by the spillover of MFP-X's borrowers' revolt.

Exhibit 3: Impact of the Delinquency “Problem” on Portfolio Quality (PAR >30 Days)[18]



To manage imminent spill-over risk, MFPs operating close to MFP-X have begun to dig trenches. They have immediately strengthened “pre-loan disbursement” and “at the time of disbursement” documentation to include:

- Signed undertaking on legal “stamp paper” by borrower to repay
- Post dated checks as guarantee from group leader responsible for collecting recoveries from group members
- Photos taken by MFP staff of borrowers together with guarantors at time of loan disbursement so guarantor or borrower does not refute having taken or guaranteeing loan

MFPs have also slowed new loan disbursement and claim to be weary of increasing loan sizes. In general, MFPs are now taking longer to screen and approve new loan applications.

If the defaulting clients get away with their revolt without affecting their access to credit from other MFPs, there is a solid risk that this delinquency problem will spill over to erode borrowers' credit discipline for the whole microfinance market in Pakistan, specifically for group based microfinance.

ANTECEDENTS OF THE PROBLEM

Research suggests that there are multiple factors that allowed the delinquency problem to erupt and snow ball into a crisis for the sector's key MFP. Each factor contributes differently to the nature and scale of the crisis. The antecedents of this crisis can be organized as the market factors that created an environment ripe for the problem to erupt; the trigger from which the crisis began and spread; factors that caused the trigger problem to contaminate portfolio at large scale, defying distance; and factors that have anchored the problem, turning the crisis sticky to manage.

18. The December 2007 and February 2007 PAR data was provided by all MFPs other than MFP-X for the purpose of this research. The Punjab average is based on sample representing 51% of microfinance outreach in Punjab and does not include MFP-X portfolio. The PAR>30 days of 21% for MFP-X quoted here is based on a statement given to the research team by MFP-X. This research team did not have branch-wise data for calculating PAR directly as it did for other MFPs in Punjab.

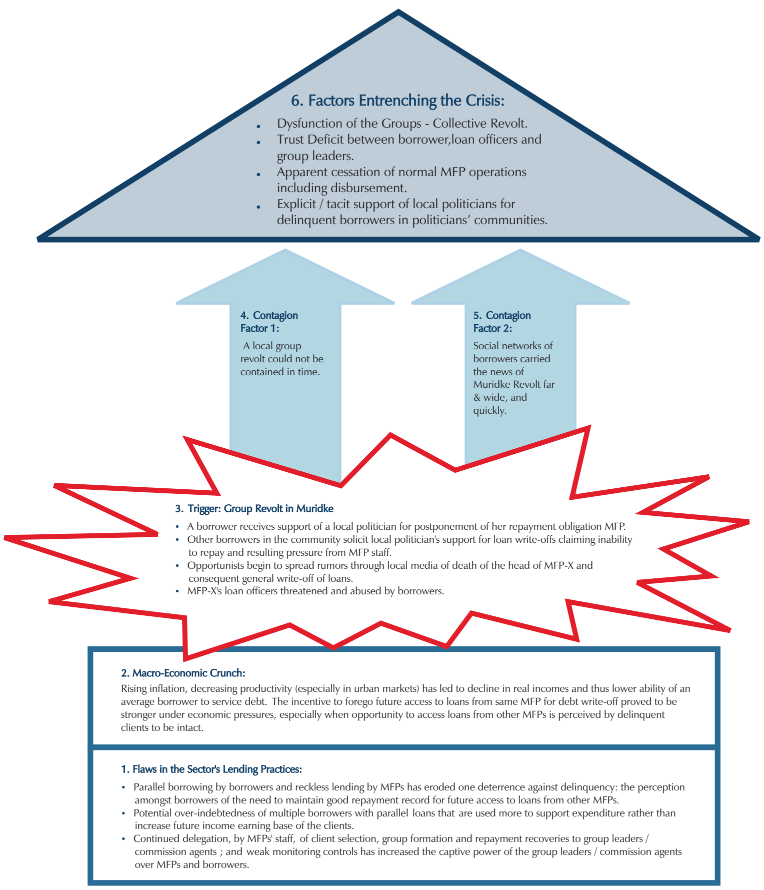
In brief, the nature and scale of the delinquency "uprising" can be explained thus:

Fundamental weaknesses in the structure of microfinance lending; and macro-economic pressures on real income, created an environment ripe for repayment crisis at massive scale. The delinquency "revolt" was triggered in one community - and in a perfect world it could have been an isolated incident. But the trigger evolved into a widespread contagion that traveled rapidly due to a host of factors including: the time allowed for the original local revolt to gain momentum; the swiftness with which the news of the revolt and the "perceived" success of the latter spread through social networks; and deliberate sabotage by those with vested interest in sustaining and spreading the revolt. The Group Revolt became sticky to manage due to the dysfunction of the solidarity groups; the trust deficit between the delinquent borrowers, loan officers and group-leaders; because of apparent cessation of the affected MFP's normal microfinance activities; and where given, due to the support of local politicians.

It needs to be noted here that the delinquency crisis did not hit the affected MFP because the clients were disgruntled by MFP-X. In fact both delinquent and repaying borrowers were unanimous in their view that MFP-X offered them the easiest service in terms of quickest disbursement of loan, larger loan size, and multiple loan products. Furthermore, nowhere did any borrower mention high interest rates as a justification for inability to repay: instead even the delinquent borrowers admitted that microfinance provided them an option other than money lenders for accessing loans that their family and friends cannot provide. The key reason given by most delinquent borrowers for not repaying was that "no one else was repaying".

Exhibit 4 is a summary of the contributors to this delinquency "problem" while the subsequent sub-sections explain the factors in more detail.

Exhibit 4: Factors behind the Nature and Scale of the Borrowers' Revolt



Flaws in the Microfinance Lending Practices of MFPs in General

The problem, though severe for and centered around one MFP, has roots grounded in the dynamics of Pakistan's microfinance sector and the lending practices within it.

MFPs continue to expand by tailing each other and then vying for same clients - while the potential microfinance market remains untapped. This, coupled with aggressive outreach targets (to be achieved from markets shared by multiple other MFPs) seems to make microfinance loan officers more pragmatic regarding operational shortcuts that would help them meet their outreach targets more easily.

Such pragmatism of MFPs' staff (and unless the internal control systems are so weak so as not to detect operational shortcuts, of MFPs as well) has allowed parallel borrowing to become ubiquitous. It has also allowed leaders of the solidarity groups and / or commission agents to entrench their influence on MFPs as well as borrowers.

Parallel (or multiple) borrowing allows borrowers to patch loans from different organizations in order to access larger total debt. Clients take parallel loans either because their need is not met by one loan from one MFP, or because they rely on debt from one MFP to pay off current loan repayment dues of other MFP (and in a sense run mini pyramid schemes). In either case, if the loan is not used to increase the income generating capacity of the borrower, multiple borrowing can lead to over-indebtedness.

When MFPs allow parallel borrowing by their clients regardless of the clients repayment record with other MFPs, access to parallel loans and ability to patch up smaller loans from various MFPs erodes the incentive for a borrower to maintain a good repayment record with one MFP to access loans from another MFP. Of the 200 microfinance clients the research team met, 94% were met as clients of MFPs other than MFP-X; and of these 94% of the randomly selected sample, 70% clients admitted to be current defaulters of MFP-X and yet were very confident of their future access to loans through other MFPs.

In every randomly selected group of clients belonging to MFPs competing with MFP-X, on average 70% of the borrowers admitted to being current defaulters of MFP-X also. These borrowers were very confidently expecting disbursement of larger loans from other MFPs.

Source: 2009. Focus Group Discussions. Unraveling the Borrowers Revolt 2008/2009.

As an alternative to foregoing new clients, or tightening their control systems and sanctions, MFPs have been agnostic about the role of commission agents/group leaders in client selection and loan recoveries. One reason for this is that the enhanced role of group leaders / commission agents has allowed MFPs quick access to new clients; while group-leaders / commission agents have ensured smooth repayments to access next loan disbursements to base their commission on. Commission agents/ group leaders have not only maintained a captive power over the MFPs by having control over the flow of repayments from the clients they are responsible for; but by providing borrowers access to loans that the borrowers would not be eligible for under due diligence criteria, the group-leaders / commission agents can influence behavior of borrowers they control.

This research observed that an average group leader in the urban market of Punjab manages groups for around 3 MFPs operating in the respective area. Also, the research suggests that group-leaders/commission agents, like other borrowers, take multiple loans and some take them for on-lending at higher rates.

Thus commission agents can not only influence the flow of loan repayments and borrower behavior but when their mini-pyramid schemes are stressed either by economic pressures or from the threat of cessation of future loan disbursements from an MFP, they also have an incentive to fire the revolt till portion of what is owed by them is written off.

Sample Portfolio of a Group Leader:

During this research, the team met a group leader through a microfinance bank (MFB). Discussions with her revealed that she was also a group leader of 9 other MFPs, both NGOs and MFBs. She herself owed PKR 168,000 (USD 2,100) together to 10 MFPs.

She was also responsible for recovering the repayments from her group members and passing the recoveries to respective MFPs. Every month she collected approximately PKR 115,000 (USD 1,438) as repayments from her group members.

At the time of the interview, she and her group members had started repaying MFP-X in but had become delinquent on the repayments to the MFB through which we met her.

Source: 2009. Interview with MFB's group leader. Unraveling the Borrowers Revolt 2008/2009.

Macro-Economic Crunch

Pakistan's macro-economic performance began its decline in 2006 and it plunged in 2007/2008 when, at 3% real GDP growth, economic growth hit its lowest in last 7 years. Energy shortage caught up with economy leading to 12 – 20 hours of load shedding per day, as a result of which productivity of businesses declined. Inflation rose to 20.5% in 2008, further reducing an average man's purchasing power.

Microfinance borrowers in urban markets, where economy is tied to non-agricultural enterprise, have been affected by stag-inflationary pressures. A PMN study on the impact of recent inflation[19] on Pakistan's microfinance sector suggests that while the real incomes of microfinance borrowers in rural areas may have stayed the same if not improved due to rising food crop prices, the purchasing power of borrowers in urban towns has spiraled downwards: urban incomes have lagged rise in cost of living.

Under such dire economic pressures, the demand for consumption loans tends to increase initially as more borrowers seek additional cash-flows to maintain their expenditures. However, in the long run, these non-productive loans pose more credit risk for MFPs. As declining purchasing power begins to stress borrowers' ability to service their debts, borrowers under economic stress[20] may begin to put more value on reducing claims on their current cash flows (by loan waivers or postponement of repayments) than they put on future access to services of any one MFP - especially when most MFPs offer services with similar terms and conditions. While macro-economic pressure is not the overwhelming reason for the delinquency crisis (or else other MFPs would have been facing crisis to the same extent faced by MFP-X) it, together with the flaws in market lending practices, ripened the environment for mass borrower collusion against repayment of debt.

Trigger: Group Revolt in Muridke

Muridke is a major Tehsil in District Sheikhupura, in Punjab. It is located along the Grand Trunk Road and is approximately 84 KMs from the Punjab's provincial capital – Lahore. Microfinance first came to Muridke nearly a decade ago when MFP-X set up its first microfinance branch in the Tehsil.

19. Zaidi, S Akbar et. al. The Impact of Inflation on Microfinance Clients and its Implications for MFPs. 2008. PMN.

20. The more frequent the installment period, greater the stress on borrowers cash flow in times of economic crunch. Discussions with borrowers during this research showed that fortnightly (as opposed to monthly) repayment obligations had begun to lead to more frequent delays in installment payment since the economic stagflation set in, and hence more frequent stand-offs between clients and loan-officers.

In October 2008, MFP-X's borrowers revolted and refused to repay their loans.[21] There are several anecdotal versions of the incidence that led to revolt but the essence is the same: a woman borrower in Muridke, working for a local politician, received the support of the local politician for some relaxation in the terms of her loan repayment obligations. The politician's support to one woman encouraged other borrowers to approach the same politician to request him to support write-off of their loans owed to MFP-X. The protesting borrowers claimed inability to repay their loan installments due to economic pressures and expressed their weariness of microfinance loan officers' pressure for recoveries.

The politician, not aware of microfinance and its principles - and sensing an opportunity for political mileage – lent his support to the protesting borrowers. This initial political support triggered rumors of mass write-offs of loans owed to MFP-X and emboldened clients against loan-officers who pursued recoveries.

The Rumor

The main rumor fabricated and which spread province wide was that of the death of the head of MFP-X, who (according to the rumor) waived all loans due to MFP-X just before her death. This rumor was spread through word of mouth carried by borrowers' social networks, and through province wide sale of photocopies of an article of local newspaper, being sold to borrowers for PKR 500 (USD 6.25) to PKR 3000 (USD 37.5) per copy.

As borrowers became more confident of their stance against the MFP, they began to threaten MFP-X's loan officers in Muridke: some loan officers were physically attacked by the borrowers. The resulting hesitancy of the MFP loan officers to manage the revolting borrower groups created a sense amongst the borrowers that they could get-away with defaulting, especially since the borrowers had access to loans from competing MFPs that lent on easier repayment terms (monthly installment period as opposed to fortnightly).

Contagion Factors

Before Muridke Revolt could be contained within Muridke, it turned into a mass revolt across Punjab. As the revolt spread, it became more entrenched: Delinquent groups got tacit sanction to continue with their revolt through similar behavior of other groups across the country. Because the “stickiness” of the delinquency problem increased progressively with the spread of the revolt, it is necessary for all MFPs to explore strategies and tactics that could have been effective for keeping the revolt localized till it fizzles out. However, given the speed of communication within borrower's social networks across the country and the given the fact that many people realized vested interest in spreading the rumor and instigating revolt in other areas, containing the revolt in Muridke would not have been a mean task. The three key agents of spread of the crisis are described below.

A Local Revolt Could Not be Contained before it Spread Further

Discussions with borrowers (both delinquent and repaying) and with loan officers suggest that in situations where borrowers act en-mass against repayment, it is imperative that the MFP strengthen its staff presence in front of the borrowers immediately. Without delay, the senior management from regional office and / or head-office supervising the troubled branch must arrive at the trouble-spot for dialogue with borrowers. Experienced staff, thought to be capable of handling volatile groups, should be identified and placed in the area to support the local staff.

21. Tehsil Muridke was one of the first markets tapped by MFP-X close to a decade ago. For several years, till only recently, MFP-X had been the only source of microfinance in the Tehsil. Although at the time of this research there were 3 other MFPs serving Tehsil Muridke, more than majority of community members interviewed through random walk could only recall MFP-X's name.

While the MFP in such a situation will have many “players” to manage, the contact of senior management with the troubled market needs to be strengthened so that:

- The borrowers feel that the loan officers have strong support of their higher ups
- The senior management have the effective power to negotiate with the borrowers directly while the loan officers do not, for the latter cannot sanction on behalf of their MFP any change in normal processes on their own
- The visible head count support of MFP staff accent MFP's message to all borrowers and reflect the seriousness of the situation.
- Feedback from the field suggests that even a short lull in MFP's follow-up of delinquent clients can create a perception of MFP's helplessness / powerlessness against the borrowers.

Social Networks of Borrowers is the Primary Means by which the Revolt Spread

Consistent feedback from the field suggests that the revolt spread through borrowers' social and professional networks that span the entire Province Punjab if not the country. These social and professional networks carried the news of borrower's revolt across geographical boundaries, primarily through accessible and cost effective communication media including ubiquitous cellular phones.

All microfinance borrowers (both delinquent and repaying) met during the research said that they first heard of the rumors of write-off through family and friends, and then, as groups, decided to withhold payments lest the rumors were true.

Deliberate Sabotage to Encourage and Instigate the Revolt for Vested Interest

While the wind that spread the fire of revolt wide was borrowers' social networks and communication with each other, the fire was also fanned intentionally by people who saw monetary advantage or political mileage in supporting and/or spreading the revolt. Although the research does not have conclusive evidence pointing at who the specific saboteurs are, borrowers and MFP staff and managers suggest several suspects including:

- Community members who found ways of making money by selling to delinquent borrower doctored “proofs” of loan write-offs
- Local lawyers who saw a new class of potential clientele to whom they offered to sell court stay orders against loan repayment
- Political activists who tried to earn money from delinquent groups by promising them access to influential politicians
- Local politicians sensing political mileage
- Commission agents / group leaders who owed large amount of debt in their own and under someone else's application and valued the opportunity to default with little consequence to them personally
- Staff trying to hide corruption or hidden delinquencies and disgruntled former staff

The researchers were told by the borrowers that group-leaders/commission agents actively identified and contacted MFP-X borrowers that they themselves did know directly to encourage / pressurize them into to colluding into delinquency. The team heard of many instances in which opportunists traveled to neighboring cities to collect money from borrowers against the promise of access to influential politicians' for support of write-off. Opportunists have also gone out town to purchase copies of the newspaper article carrying the fabricated news of the death of MFP-X's president, to sell them at profit in their communities. Some borrowers claim they saw banners announcing MFP-X's loan write-offs posted in front of local grocery shops.

It is to note here that the sabotage tactics provided additional props and excuses for borrowers to default but cannot be seen as the primary persuaders for borrowers to default. Majority of borrowers defaulting were defaulting because other borrowers they knew of were refusing to repay.

Factors Entrenching the Crisis

The key reason for the stickiness of the problem is the dysfunction of the solidarity groups: individual borrowers are seen to be hiding behind group-decision to default; and groups are encouraged to maintain their position for they perceive “other groups” doing likewise. The problem is further entrenched due to trust deficit between borrowers, group leaders and staff; and due to apparent cessation of normal operations by the affected MFP.

Group Dysfunction

Discussions with borrowers suggest that, by the time of the research, very few borrowers really believed the rumors of loan write-offs. In fact, individually, the delinquent borrowers claimed not to be in favor of defaulting on loans on moral grounds. Despite this, the delinquent borrowers justified their delinquency on group behavior, saying that they will act as their group and other groups do: once others begin to repay, they will too.

The group pressure, thought to provide social collateral and ensure repayments of loans in group-lending model, could be seen working in the opposite direction during this delinquency crisis: During this delinquency revolt, group pressure forced group consensus for withholding repayment of loan installments. Two factors below, that characterize a microfinance borrower group, are also the factors that allow distinct groups to arrive at an explicit or tacit consensus.

- High cohesiveness, as borrower groups tend to be homogenous, with members with similar background and having strong communal ties from hailing from same community / neighborhood.
- Directive leadership, often by center manager or group leaders who has a strong influence on the membership of the group, including in terms of group members' repayment behavior.

Exhibit 5 draws parallel of typical group dysfunction with behavioral symptoms observed amongst the delinquent groups in this delinquency crisis.

Exhibit 5: The Dysfunction of the Group in the Delinquency Uprising

Typical Symptoms of Group Dysfunction	Parallels Observed in the Delinquency Uprising
1. Illusion of Invulnerability: Members ignore obvious danger, take extreme risk, and are overly optimistic.	Individuals gain strength from group consensus and common group behavior across the province.
2. **Collective Rationalization:** Members discredit and explain away warning contrary to group thinking.	Despite appearing to be not truly bought into the rumors of loan write-offs, groups rationalize the rumors to be true by questioning sudden change in recovery practice from the norm or grasping at “weak” proofs such as doctored news articles.

3. **Illusion of Morality:** Members believe their decisions are morally correct, ignoring the ethical consequences of their decisions.	Delinquent borrowers claim moral ground in some cases as being victims of microfinance's zero tolerance policy for delinquency; or claim that they want to repay and have tried to negotiate repayment terms and have thrown the ball in the MFPs court to reciprocate.
4. **Pressure for Conformity:** Members pressure any in the group who express arguments against the group's stereotypes, illusions, or commitments, viewing such opposition as disloyalty.	The peer pressure on individual borrowers to not to repay but conform to group decision has been observed to be very strong. A borrower with only 4 installments outstanding claimed she is deterred by her community members not to repay for if she sets an example from breaking away with group decision others will have to repay as well.
5. **Illusion of Unanimity:** Members perceive falsely that everyone agrees with the group's decision; silence is seen as consent.	Groups believe that no one is repaying the MFP and are secure in the fact that no one else is repaying across Pakistan.
6. **Self-Censorship:** Members withhold their dissenting views and counter-arguments.	When spoken to individually borrowers do not condone default. But when in group they tend to rationalize as a group.

More often than not, social collateral through solidarity groups has worked for both clients and microfinance institutions across the world. Yet some of world's most iconic microfinance markets provide us examples where solidarity groups became dysfunctional and led to borrowers' revolt very similar to the current revolt in Pakistan. Two stark examples include:

1. The 1999-2000 crises in Bolivia when “Professional” union organizers gathered borrowers into debtors associations to protest against microfinance lenders. The revolt affected the solidarity group based lending the most, due to which the MFP that was most affected was Bancosol (that used both group lending model and individual lending model) as opposed to its peers who lent only through individual lending model.

2. Unzipping of groups in Bangladesh during 1994-1998. At the end of 1995, Grameen experienced an unusual repayment problem: clients in Grameen's most fecund area, Tangail, held a widespread strike demanding access to their compulsory group savings funds. By 1995-end 56% of loans lent in 4 of Grameen's model villages in 1994 were overdue. The repayment rates among the borrowing groups varied from 28% to 56% (Matin 1997). The Grameen Group Revolt was coined as “unzipping” of groups, and the phenomenon was explained as groups, burdened by excessive or multiple default, see no further hope for continuing loans and elects to default en masse, thus causing the group to “unzip”(Wright, 2000).

   Global examples of unzipping of group liability suggest that solidarity groups and reliance on group rather than individual liability becomes ineffective during the mix of following factors:

   1. Market saturation and overlapping of competition
   2. Multiple borrowing[22]
   3. Economic pressures[23]

22. In mid-2000, analysis of Bolivian Microfinance sector showed that among the financial service providers specializing in microcredit, 28% of total number of loans and 34% of the value of the portfolio was held by clients with loans in more than one institution (Rhyne, 2001). Extent of multiple borrowing in Bangladesh was estimated to be around 30%.
23. At the time of the crisis, Bolivia in midst of larger Latin American financial crisis was experiencing heightened social unrest, with mass protests about things like water and electricity prices. Microfinance, too, felt the anger of the powerless. In Bangladesh, the unzipping of groups overlapped with a devastating cyclone.

Trust Deficit

In crisis such as this revolt, MFPs would need to change their recovery tactics, somewhat drastically. MFPs may have to try to bypass the groups and appeal to individual borrowers for recoveries; or in extreme situation try to salvage what they can by urging borrowers to pay even partial installments due where earlier they were not tolerant of partial payments.

Tactics that drastically breakaway from normal practices and if implemented without a preceding systematic communication or formal introduction from the senior management, can put the recovery staff / loan officers under suspicion of fraud by borrowers.

The research team also observed that tactics to incentivize only group-leaders to collect repayments from their respective group members would be ineffective if the group members suspect their group leader to be receiving better terms from the MFP than they are. The team observed that group leaders / members who tried to persuade their peers to repay had fallen under their peers' suspicion of having been “bribed” by the MFP.

The study also indicated that in a situation such as this revolt, borrowers tend to be increasingly mistrustful of an MFP if the MFP is perceived to be going back on its promises made during negotiations with the borrowers. For example: groups / group leaders who perceived a promise by the affected MFP to disburse another loan if borrowers repay their current debt tested the promise at a “small scale”. Where the promise is not delivered “soon” the borrowers become mistrustful themselves and spread the mistrust among their peers, making future negotiations between MFP and delinquent borrowers more difficult.

Apparent Cessation of Normal Activities and Future Disbursement

Apparent cessation of MFP's activities (including: loan disbursement, group meetings and loan recoveries) seems to have created a perception amongst the borrowers that the delinquents have gotten away with their revolt, that the borrowers have overwhelmed the MFP, and that the latter is helpless against the group power of the former.

Furthermore, because access to future disbursements is an incentive for borrowers to repay previous debt on time, many activists/ center managers/commission agents saw the cessation of loan disbursements by the affected MFP as a threat to their ability to manipulate the MFP's system for their own rent seeking opportunity. Many activists / group leaders / commission agents spoken to during the research expressed their desire that the MFP resume lending as before and thus allow previous market dynamics based on shadow groups to continue.   These commission agents claimed that would guarantee repayments from members if disbursement of new loans is resumed.

Politicians' Support to Delinquent Borrowers

Field feedback (from both loan officers and borrowers across Punjab) suggests that it was always the case that borrowers first decided to revolt, and then tried to receive the support of politicians. In many of the communities of the borrowers sampled, there was no role of politicians in the revolt, but only the borrower's determination not to repay.

Yet when local politicians did extend their explicit or tacit sanction to the borrowers to withhold repayments, their support became potent cement to the borrowers' resolve to default. It also emboldened the borrowers to become more aggressive and attack MFP staff following up for loan recoveries.

The subsequent exhibit **(Exhibit 6)** presents the list of specific factors (both observed directly in the field and those mentioned by senior management of MFPs) with brief explanation to drive a point that the factors behind this delinquency problem are many, and at various levels: implying that solutions have to be multipronged as well.

Exhibit 6: List and Explanation of Specific Causality Factors Observed During the Field Research and / or Mentioned by MFPs' Management

S. No	Factor	Assessment and Explanation
1	Mismatch between market maturity and lending practices	92% of microfinance loans are lent through Grameen style solidarity groups of borrowers. This model is based on lending through group liability. Under this model the MFP and borrowers' group share the burden of client screening and debt capacity assessment before providing a group guarantee for that client. Often the MFP does not conduct applicant's business assessment and verification under the group model. Also, screening and client verification is not stepped up for applicants for repeat loan: in fact the disbursement to repeat borrowers is usually quicker. Another feature of typical group based lending is the standardization of loan size and loan terms for all borrowers in the same group, regardless of individual borrower's actual need and timing of cash-flows. The research findings suggest that the borrowers in Punjab know how to outsmart the typical group lending processes that may have been adequate for a nascent market, but not so in a mature saturated market. The microfinance market in Punjab matured while the underwriting principles of microfinance did not catch up. Many clients had been in the microfinance system long enough to have learned to outsmart it.
2	Inadequate internal controls and compliance within MFPs	The realization of operational risk in terms of staff fraud or short-circuiting of MFP's lending processes is always ultimately traced back to either inadequate internal controls and compliance monitoring systems or to the willingness of MFP as a whole to take a decisive action against non-compliance or fraud. The research observed lending to borrowers with multiple loans to be ubiquitous (FGD estimates to be as high as 70%). It also observed that MFPs internal controls were inadequate to prevent the exploitation of the MFP systems by rent seeking opportunists such as commission agents.
3	Parallel borrowing by borrowers from different MFPs	Parallel borrowing, coupled with weak underwriting practices increases the probability of over-indebting a borrower. Also, the research strongly suggests that it has eroded a key deterrence against default in that the delinquent borrowers did not feel that they need to maintain a good repayment record in general to access future loans from any MFP.
4	Macro-economic pressures on real income and debt servicing capacity	Falling productivity and rising inflation has put pressure on an average Pakistani's real income, and thus on the debt servicing capacity of microfinance borrowers in general. Borrowers that may have been on the brink over indebtedness may have fallen below that brink.

		Macro-economic pressure coupled with flaws in lending practices at least created an environment of mass delinquencies as many borrowers found themselves constrained for cash to meet their current repayment obligations and to maintain their current expenditure levels.
5	Grape-vine based on borrowers social networks	Borrowers social networks were the main vehicle through which the contagion of the delinquency crisis spread. Of the 16 focus groups discussions held, 14 FGDs claimed that borrowers heard of the rumor through their relatives and friends across Pakistan.
6	Targeted sabotage for vested interest	There was clear evidence of targeted sabotage by fabricating rumors and then spreading them through media. Many elements had the incentive to spread the rumors and spread the crisis wide. Commission agents, group leaders, over-indebted borrower etc had the incentive in terms of having their repayment obligations written off; local politicians had the incentive in terms of political mileage. Senior management of MFPs met also believes that disgruntled ex-employees and staff that had been hiding delinquencies could have had a hand firing up and spreading the rumors of loan write-offs. Though this may be so, given the limitations of this research, we do not have the evidence to either support or to disregard this factor. Any operational fraud or non-compliance however, should be traced back to MFPs' internal controls and compliance monitoring systems. Also, an important finding of this research is that with weak lending fundamentals a delinquency crisis can be triggered and extended by multiple factors and stakeholders.
7	Intervention of politicians	Political intervention provided strong support to borrowers to dig their heels deeper against repayments. It also provided confidence to borrowers to physically confront loan officers pursuing recoveries. However, in a substantial majority of groups studied, the delinquent groups admitted that it was the borrowers themselves, upon hearing the rumors of delinquency by other groups across Punjab, who made the decision to default first and then sought politicians' support as backup.
8	Interest Rate	Another important finding was the absence of attributing the credit risk to interest rate level. Neither the borrowers nor the loan officers mentioned interest rate as a reason for lack of willingness or ability of delinquent borrowers to repay their loan.
9	Crisis management by MFPs	Feedback from clients as well as the MFPs field staff suggested following factors that may hinder crisis management in such delinquency crisis: • Relatively young and inexperienced staff that could not, on their own, manage and stand-off borrowers' threats. · Breakaway from normal recovery practices without prior communication from senior management to community. Lull in MFPs' normal operations, and inability to recover delinquent loans as time passed created a perception amongst borrowers of MFPs' powerlessness.

10	Zero tolerance policy against delinquency: Harsh recovery practices	Harsh recovery practices were cited as a reason for revolt only by few borrowers, and that too only in Muridke from where the revolt triggered. For borrowers in any other area, the key reason given by borrowers for delinquency was that they were withholding repayments because they believed no one else across Punjab was repaying. At the time of this research, the perception amongst the borrowers in the FGDs was that approximately 80% of the borrowers in their community were not repaying their loan installments to MFP-X.
11	Dysfunction of solidarity groups	Solidarity groups, formed to provide peer pressure to ensure recoveries, had reversed their role. The research observed that the borrowers tended to justify their behavior by referring to group decision not to repay, or at least wait till the group is sure that other groups are repaying too. Multiple anecdotes were heard, in which the group leader had collected the recoveries from borrowers, but was withholding passing the repayment on to the MFP till the group leader was sure that other groups had begun repaying the MFP. The group-leader, in some cases, also proved to be ineffective in persuading member borrowers to repay. Borrowers mentioned of ensuing distrust , during this revolt, between group-leaders and their members if the group leader was seen to be supporting MFP against the members regarding repayment of loans.

IMPACT AND RISKS FROM THE DELINQUENCY CRISIS

The delinquency problem may be a crisis for one MFP currently, but the nature and scale of the problem suggest that it has long term implications for Pakistan's microfinance sector, including microfinance clients and service providers.

The following table touches upon the potential impact of the current delinquency revolt on the clients, MFPs and the sector as a whole. Briefly, the revolt can potentially risk access to financial services for many potential clients. As MFPs' outreach growth slows down, so will the growth in the revenue. Yet cost of operations of MFPs is likely to increase as MFPs strengthen their due diligence processes and introduce additional risk control measures such as smaller groups and re-focus of lending practice towards individual liability. If the MFPs do not take the latter corrective measures, they may still find increase in administrative cost as more time and resources are spent on recoveries or else see its PAR indicators increase (in which case the cost of funding will likely to increase after readjusting for higher risk). Thus microfinance sector may need to re-assess the net income projections from microfinance service delivery: increase in microfinance expenses is likely to outstrip growth in revenue in coming years.

Exhibit 7: Potential Impact and Risks

Microfinance Stakeholder	Near Term Impact	Long Term Impact
Microfinance Clients	1. Erosion of credit discipline 2. Access to credit made more restrictive (greater documentation requirement, greater monitoring and verification period before disbursement 3. Access to larger loans less easy 4. Slower growth in access to financial services for the poor	1. Reduced confidence in borrowers repayment capacity and willingness 2. Gap between unmet demand for financial services and supply remains significant

Microfinance Service Providers	1. Increase in operational cost • Greater staff effort required for on time recoveries • Increased risk of default become, higher loan loss expense • Increased monitoring and verification expense 2. Slower growth, possibly negative growth in outreach 3. Decline in financial sustainability as revenues decline and expenses rise	1. Slower Growth 2. Cost of providing microfinance services higher 3. Pressure to lend through smaller groups or to individuals - need to incur restructuring cost and bear increased administration cost 4. Risk of repeat client revolt if defaulters get away by defaulting with MFP-X 5. Access to commercial sources of funds more difficult as funders question the market or methodology 6. Sustainability of MFPs challenged
Microfinance Sector	1. Declining in outreach growth 2. Possible contraction of outreach 3. Fall in confidence in Pakistan's microfinance market or MF approach	1. MF perceived as high risk market 2. Reduced investor confidence in MFPs 3. Declining investment in MF 4. Access to financial services remains limited

CONCLUSIONS AND RECOMMENDATIONS

To mitigate the potential risks from the current delinquency problem, MFPs must take steps to correct the flaws in lending practices and to restore clients' credit discipline. Other stakeholders such as networks, donors and the government can support the MFPs, in the latter's effort to correct the fundamental flaws and restore credit discipline, through effective incentives and effective monitoring. Investors and funders can be instrumental in directing microfinance growth through tying respective performance targets with access to funds. More specifically, donors and other funders (which also includes government and semi-autonomous organizations), can tie access to subsequent funds to ensure that latter achieve the intended social or commercial targets.

Subsequent subsections put forth conclusions and recommendations for MFPs, Networks, Fund Providers (including donors and investors), and the Government, either to contain or to prevent such problem occurring in the future.

Conclusions and Suggestions for MFPs

The research suggests that multiple factors (both within MFP's control and without) triggered, extended and entrenched the delinquency crisis. The key research observation is that the problem began, and rose to scale, because the borrowers preferred to default and forego services from an MFP (that they themselves considered to be the "best" service provider[24]) for the chance to reduce their debt repayment obligation. The delinquency highlights the importance for MFPs to:

1. Know the borrower: The importance of independent screening, assessment, and monitoring of loan use cannot be stressed enough. It is not sufficient to build strong relationships with the group leaders – building the institution's link with individual borrowers is more important. The group leader may be used for coordination

24. MFP clients, including delinquent clients, have been unanimous in stating MFP-X to be the best service provider in terms of quick application to loan disbursement period; low documentation requirement for application for a loan, access to larger loan and access to variety of loan products including small emergency loan and home improvement loan.

purposes but a direct connection, assessment and follow ups with each individual client is needed. This does mean higher administrative cost than lending through activists but in the long run this cost may prove much less than seeing quarter of MFP portfolio being wiped out.

2. Maintain strong client and loan disbursement documentation to support recoveries: This research showed that even a perception amongst clients that an MFP has strong documentation to base legal or police action on is a deterrent against default. Sitting amidst a group of MFB borrowers, of which all were delinquent against MFB-X, one woman was still repaying the latter and was not under peer pressure to not to pay. Her group leader explained that this lone woman had signed a legal paper (stamp paper) declaring her obligation to repay and thus has no choice but to repay. MFPs would also need effective documentation proof to support their last resort: court action to set an example for other delinquents.

3. Maintain strong compliance monitoring and control system: Borrower selection, verification, loan use monitoring and maintaining strong documentation cannot be effectively implemented unless there is strong compliance monitoring and control system in place within the MFP. Risk management and audit functions need to be strengthened. A good HR system for hiring, monitoring and tracking staff can add tremendous value in this sector where the field staff's integrity is of such importance.

4. Propose a strong benefit or impact of loan / MFP service to clients: This cannot be done by disbursing loans regardless of the impact of the loan on the borrower, no matter how low the MFP brings down the transaction cost for the borrower. If clients see access to MFP services resulting in future broadening of their capital base (through income generating loans, education loans or home improvement loans) clients may be less tempted to forego access to that service. Randomly used consumption loans help borrowers to maintain their expenditures, but under economic pressure the repayment of such unproductive loans can become a threat to the borrowers' consumption standards.

   This is not to say that MFPs do not offer consumption loans, but it would make sense for MFPs to manage their credit risk through offering loans more productive for borrowers and monitoring the actual use of the loan. If clients begin to perceive microfinance services as indispensible, then perhaps microfinance will be perceived as a public good beyond being threatened by political interference eroding credit discipline.

Exhibit 8 lists down some recommendations for MFPs to correct the flaws in lending practices and to improve MFP capacity to manage crisis such as this revolt at initial stages, before it gathers momentum and becomes “sticky” to manage.

Exhibit 8: Recommendations for MFPs

Recommendation	Detail	Cost and Benefits
A. Cautious Growth	1. Maintain internal control systems and internal monitoring capacity with pace of growth 2. Measure quality of growth by indicators for first outreach to untapped markets and avoid the 'numbers game'	**Cost:** • Higher administrative cost as monitoring staff strength and systems are developed to meet growth pace **Benefit:** • Higher confidence of potential funders on institution, thus perhaps easier access to funds

B. Rely on Individual Liability: Maintain group based lending for low administration cost but rely less on group liability and more on individual liability. In other words, strengthen loan underwriting within group lending methodology	1. Smaller groups of size between 3 to 5 2. Increased direct screening and selection of clients by staff instead of total reliance on group leaders Individual's repayment capacity based lending and stronger cash flow analysis of individual clients	**Costs:** • Higher cost of service delivery • Slower growth, perhaps decrease in number of active borrowers **Benefits:** • Better MFP capacity to manage and control smaller groups • Stronger risk assessment of clients • Reduced power and influence of activists in client selection and repayment
C. Refresh Credit Discipline: Revive the incentive to maintain good credit history for access to loans	1. Communicate and repeat to clients the message that access to loan will be based on overall credit history, and not just the repayment record of the client with your MFP 2. Enforce the message by visibly rewarding those with good credit history and penalizing those who do not either by smaller loan size or application refusal 3. Use Credit Bureau system when available and increase client's awareness of use and purpose of the system	**Cost:** • **Slower portfolio and borrowers growth if rate of refusal increases; and borrowers with weak credit history are weeded out** **Benefits:** • **Credit discipline revived** • **Influence of activists and commission agents reduced** • **Increased confidence in the market and methodology** • **Potential willful defaulters avoided at the onset**
D. Avoid overlapping operations with those of competitors	1. Target untapped markets and clients 2. Include, in performance targets and indicators, access to first time clients / or clients with no outstanding loan	**Cost:** • Higher cost of client acquisition • Higher market entry cost as first entrant **Benefits:** • Lower client exit rate due to competition • Lower incidence of parallel borrowing by clients • Lower risk of default due to over-indebtedness • Lower risk of moral hazard
E. Retrain staff in Recovery Practices and Conflict Management	1. Revise and refresh the Dos and Don's of recovery tactics and conflict management in situations similar to delinquency revolt	**Cost:** • Normal operations and responsibilities are interrupted • Cost of training / workshop **Benefits:** • Staff well prepared to take effective steps efficiently • Delinquency problem prevented from escalating from individual case of delinquency to mass confrontation

F. Introduce Client Complaint Channels between Clients and Senior Management / MFP Head Office	1. Establish client complaint redressal system 2. Establish a call center, shared or internal 3. Market the client complaint facility to clients	**Cost:** • Additional set-up and operating cost **Benefits:** • MFPs protected from irresponsible staff action by transforming the position of senior management into impartial arbitrators rather than collaborators of staff by default • Create first recourse to MFP rather than local influential / politicians • Provide a defense against complaints of mistreatment of clients to politicians • Provide an early warning signal channel
G. Use of Technology	1. Improve MIS and reporting systems to allow for early warning and efficient information dissemination 2. Need to relate reports with the purpose and use	**Cost:** • Customization cost **Benefit:** • Can help identify problems before they become systemic • More efficient use of the available information

Conclusions and Suggestions for Microfinance Networks

Microfinance networks exist to promote healthy microfinance sector as much as to support the network members in their collective effort. One of the key roles a network does is to track sector performance; advocate best practices to MFPs and other microfinance stakeholders; and build sector capacity where gaps exist.

The research shows the overarching microfinance performance indicator, active micro-credit outreach,[25] is no longer a correct measure of access of microfinance services to the marginalized. If we are to go by the research findings that suggest that approximately 70% of active borrowers are taking parallel loans, then Pakistan's microfinance sector currently publicized outreach of 1.7 million borrowers is an overstatement. To measure the actual growth in access to microfinance services, microfinance networks would need to track growth of first time microfinance clients.

A prerequisite to being able to track growth in first time microfinance clients is the ability of MFPs to do the same for themselves. The first step to the latter would be a client information sharing system for MFPs to tap in. Since the advantage of a client information sharing system to the sector as a whole may outweigh the benefit to any single MFP, the network should take a lead in setting up and promoting the use of a comprehensive client information sharing system.

Also, elevating the image of microfinance sector to that of a “public good” can gradually immunize the sector against detrimental interference of opportunists including politicians. This can be done by promoting client impact and subliminally projecting the social benefit of the sector to the public at large. **Exhibit 9** lists three main recommendations for microfinance networks:

25. Which is a simple aggregate of number of active borrowers of all MFPs.

Exhibit 9: Recommendations for Microfinance Networks

Recommendation	Detail	Cost and Benefits
A. Monitor actual sector outreach	1. Monitor market saturation and associated credit risk. 2. Monitor growth in first time microfinance borrowers compared to repeat borrowers or borrowers who have switched patronage from other MFPs	**Cost:** • Monitoring, benchmarking and communicating cost **Benefit:** • Stronger market intelligence for MFPs and funders • Realistic outreach assessment
B. Support Sector wide Credit Bureau and Awareness of its significance to clients, staff and MFPs	1. Support the design and development of credit bureau that is effective in assessing client's repayment history as well as outstanding debt 2. Market the use and participation of Credit Bureau amongst MFPs to ensure complete and updated information, and effective use 3. Support marketing of concept and implications of credit bureau to clients	Cost: · Role of stakeholders may expand into monitoring the development of the sector more closely. Stakeholders may need to re-rationalize their role and work-plans · Effectiveness of CIB is not guaranteed by mere existence of CIB: it is based on the quality of data provided to the Bureau and how the MFPs use the CIB information · Increase cost of application processing by MFPs Benefits: • Provide a potentially powerful tool for avoiding over-indebtedness of client and potential defaulters • Support transition of MFPs from group-liability focused lending to individual-liability focused lending
C. Implement Code of Conduct	1. Support MFPs implementation of Code of Conduct and Client Complaints Redressal System 2. Include in microfinance public communication strategy, awareness of MF sector's initiative to protect consumers	Cost: • Set-up and operational cost of system /mechanism for implementing code of conduct effectively Benefits: • Stronger public image of microfinance: Microfinance sector closer to being perceived as a public good line of defense against attempts to politicize MF

Conclusions and Suggestions for Funders (including donors and investors)

Microfinance in Pakistan is primarily funded by multilateral donors and social investors in lieu of social and / or monetary return and to some extent by profit oriented commercial funders.

This research indicates that funders (whether social investors, donors or commercial fund providers) need to conduct stronger assessment and due diligence of MFP funding proposals, especially in the light of:

- Credit risk inherent in the market where the operations for which funding is requested are located

- MFP's internal risk management systems

An underlying factor beneath the delinquency crisis and weak microfinance lending practices is the universal drive of MFP's, in general, to show scale in terms of their borrowers outreach. In many instances the desire to demonstrate ability for fast growth and scale has been fueled by the incentive for larger funding from donors.

Donors tend to measure the success of their funding through one predominant indicator: number of active borrowers accessing microfinance services. This invariably translates into direction of donor/ social investor funds to those MFPs that can give bigger outreach numbers quickly.

Donors and funders have the power to shape the outcome of their investment for optimal impact. The tool for shaping should be primarily the terms of access to funds and the performance indicators, both of which should be aligned with the goals and objectives of the investment.

The objectives of Microfinance funders can be broadly categorized as following:

- Poverty alleviation
- Access to formal financial services as a matter of individuals' right and key to equal opportunities
- Profit

Donors and funders supporting microfinance need to be mindful of the use and impact of microfinance services funded through them. They may get higher return on investment (in terms of their specific objective) if they concentrate their funding on microfinance services that expand the capital base of microfinance clients over the long run. Such services would include income generating loans, education loans, home building / improvement loans and deposit services.

Funders aiming for expansion of access of formal financial service can rely on higher return on investment with respect to their objective, if their funding increases the number of new clients in the microfinance sector in general. In other words, if their funds are merely supporting parallel borrowing or cannibalization of clients between MFPs, the potential impact of their support is being compromised.

Profit oriented funders (including commercial debtors and investors) need to assess the MF institutions as well as their markets much more diligently to protect their returns from the risk of default of clients and thus, potentially, the investee MFPs.

In short, donors need to be more responsible in terms of having a clear purpose to their support of MFPs and then ensuring, through devising adequate performance indicators and monitoring system, maximum social returns from the public money that funds their support. Commercial investors need to strengthen their due diligence.

All funders have the opportunity to leverage their support to direct the sector towards best practices. Regular ratings of MFPs irrespective of whether these are deposit taking institutions to systematically monitor the systems and strength of these institutions. There should be minimum benchmarks that funders need their partners/investees to meet.

There also needs to be better donor coordination in the sector with varying strategies for MFIs and MFBs, where MFIs need more support for institutional strengthening in areas of establishing compliance functions and improving controls since there is no formal oversight for them.

Exhibit 10 suggests three key measures to support and / or direct the sector to correct its flaws in lending practices.

Exhibit 10: Recommendations for Funders

Recommendation	Detail	Cost and Benefits
A. Align MFP performance targets with funding objective. Demarcate use of public funds / subsidy for those MFPs that either aim for true growth in outreach through growth in number of first time microfinance clients, or who focus on providing financial services such as enterprise loans, savings products or insurance that contribute to build-up of or protection of the capital base of the poor.	1. For increased access of financial services, monitor growth in first time borrowers 2. For poverty alleviation, monitor loan use and impact	**Cost:** • Monitoring and benchmarking cost **Benefit:** • Prevention of mission drift of MFPs in pursuit of growth and expansion
B. Strengthen due diligence of funding / investment proposals	1. Among other things, assess the credit risk of the MFP from market competition and assess MFPs risk management systems' ability to monitor and manage all types of risks 2. Use covenants to influence and limit MFP's risk enhancing behavior 3. Regular ratings of MFPs (deposit and non-deposit taking)	Cost: · More resources spent on due diligence · Higher cost of capital for MFPs operating in competitive markets Benefits: · Provide a potentially powerful tool for avoiding over-indebtedness of client and potential defaulters • Support transition of MFPs from group-liability focused lending to individual-liability focused lending, for the latter requires greater reliance on stronger client assessment by MFP staff and also stronger documentation requirement
C. Use funding price or available amount to encourage tapping clients new to microfinance vs targeting mature microfinance clients	1. Social and commercial funders may want to incorporate adequate risk premium on funds to MFPs for operations in concentrated / competitive markets 2. Incentivize MFPs to choose untapped market over tapped microfinance market with similar effective potential by making larger loans available for MFPs / branches pioneering in respective markets	Cost: · Set-up and operational cost of system / mechanism for implementing code of conduct effectively Benefits: • Stronger public image of microfinance: Microfinance sector closer to being perceived as a public good line of defense against attempts to politicize MF

Conclusions and Suggestions for Policy Makers and Regulators

Although governments across the world have moved away from provision of financial services, they can be instrumental in creating an enabling environment and infrastructure for the private sector to expand the breadth and depth of the financial sector in a country.

The State Bank as an overarching custodian of credit discipline in the market and networks as promoters of best practices for a healthy and vibrant sector should work together to speed up the process of setting up a comprehensive credit information bureau. Because MFBs share their market, and in many cases the clients, with non-bank MFPs, any credit bureau system for the microfinance sector will be ineffective unless it encompasses all types of MFPs. Furthermore, at the risk of encouraging interventionist steps, it may still be worthwhile to explore incentives and dis-incentives that Government / State Bank can introduce to prevent over saturation or clustering of operations in some localities at the expense of wider outreach.

At the policy level, there needs to be a clear understanding that microfinance is provision of financial services on a sustainable basis and should not be treated as a safety net program for the poorest of the poor. In presence of the perception that microfinance is similar to financial assistance for the poor rather than a service helping expand access to finance and thus increase opportunities for people, the sector will remain vulnerable to clients' demand for write-offs, political interference to support such demands and find it difficult to become sustainable.

Another key role for governments and regulators is in the area of consumer protection and financial literacy. In presence of competition, these can be strong tools to protect clients' rights and ensure a healthy microfinance sector.

Lastly, in Pakistan, there is a broad dichotomy in the way microfinance is regulated: MFBs are actively regulated by the State Bank of Pakistan that has set minimum institutional, procedural and capacity standards for MFBs to operate. The same standards of doing business do not apply to MFPs not regulated by SBP. However all MFPs whether MFBs or NGO-MFPs operate in overlapping markets. The policy makers and regulators should consider developing a regulatory and supervision framework for the non-bank MFPs as well to introduce some standard rules of operation to create a more level playing field in the sector.

ANNEXURE A: RESEARCH APPROACH AND SAMPLE

1

Research Approach: Management Interviews

- Nature of recent "problem in punjab
- Opinion on factors leading to jump indelinquency in Punjab
- Preceived impact of the situation on other MFPs and the sector
- Possible strategies to manage and prevent similar crisis
- Recommendations to MFPs,PMN and other stakeholders

Contributing MFPs:

1. Asasah
2. Khushhali Bank Ltd.
3. National Rural Support Programme (NRSP)
4. Urban Poverty Alleviation Programme (UPAP)
5. CWCD
6. First MicroFinanceBank Ltd. (FMFB)
7. Tameer Microfinance Bank
8. Kashf Foundation
9. RCDS

2

Research Approach: Branch wise Data for Punjab

- MF branches in Punjab
- Active Outreach
- GLP Outstanding
- PAR Trends from December 2007 to February 2009

Contributing MFPs:

1. Asasah
2. National Rural Support Programme (NRSP)
3. Urban Poverty Alleviation Programme (UPAP)
4. Punjab Rural Support Programme (PRSP)
5. First MicroFinanceBank Ltd. (FMFB)
6. Tameer Microfinance Bank
7. RCDS

3

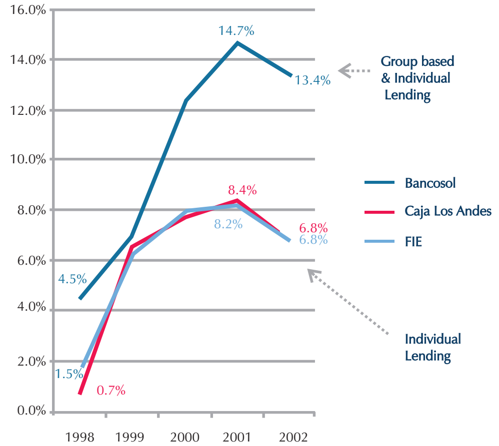
Research Approach: Field Research:Staff and Clients

- Reasons behind initial delinquencies
- Cause of spread of the crisis
- Possible spill over effects
- Potential Solutions to manage and prevent similar crisis

Contributing MFPs:

1. Asasah
2. Urban Poverty Alleviation Programme (UPAP)
3. First MicroFinanceBank Ltd. (FMFB)
4. Kashf Foundation
5. Tameer Microfinance Bank
6. RCDS

Exhibit: Regulated Microfinance Institutions, 1998-2002
Portfolio at Risk



"...In a recession group lending may actually be more risky thanindividual lending.When one group member encounters difficulties, her colleagues,already on the edge,may be unable to step in and the group as a whole may default.Accordingly, at BancoSol, delinquency was highest in the solidarity group portfolio"

(Rhyne, 2002)

**** Source:** Competitive Environment in Uganda:Implications for Microfinance Institutions and their Clients - Wright and Rippey - 2003

Evolution of MF in Bolivia	Pre-crisis Market Fundamentals
1. In early 80's, the beginning of microcredit with NGOs 2. In early 90's, formalization of microfinance institutions for greater sustainability. Transformation of NGO into commercial bank, and Formal Financial Providers (FFP) 3. In mid 90's, entrance into the market of consumption credit institutions	4. Market Saturation and Overlapping of Competition– Penetration of enterprise market by MFPs more than 50%. 5. Focus on growth with less emphasis on quality: Incentives mechanism for the staff aimed at promoting growth of portfolio without concern for its quality. 6. Piggy Backing on Competitors Client screening by identifying competitors clients and assuming that the competitors have screened the clients well. Consequently the providers began making quicker disbursements by short-cutting on due diligence and client screening. 7. Multiple Borrowing[27]*: "Clients took advantage of the offer of quick and easy credit from so many institutions to borrow from multiple lenders, maintaining two or more loans outstanding at a time. " Some let repayments slip, or in worst cases, they began bicycling loans—using the proceeds of one loan to pay off another. Such behavior seriously damaged the carefully constructed culture of repayment in microcredit" – Rhyne 2001. 8. Economic Crisis: Overindebtedness due to fierce competition coincided with Bolivia's economic slide propelled a significant problem to crisis proportions.

26. Source: Rhyne, 2001
27. In mid-2000, analysis showed that among the FFPs specialized in microcredit, 28 percent of total number of loans and 34 percent of the value of the portfolio was held by clients with loans in more than one institution. – Rhyne. 2001.

1. In early 80's, the beginning of microcredit with NGOs 2. In early 90's, formalization of microfinance institutions for greater sustainability . Transformation of NGO into commercial bank, and Formal Financial Providers (FFP) 3. In mid 90's, entrance into the market of consumption credit institutions	Bolivia began to experience heightened social unrest, with mass protests about things like water and electricity prices. Microfinance, too, felt the anger of the powerless. 9. Relationship between Clients and MF Staff began to sour as loan officers spent more and more time wheedling collections from customers faced with too much debt and shrunken demand. These conditions set off a backlash against microcredit.

Borrowers Revolt	Impact of the Crisis
1. “Professional” union organizers gathered borrowers into debtors associations to protest against microfinance lenders. These associations grew quickly because organizers promised new recruits debt forgiveness. 2. The associations carried out protest against MF institutions. The also approached authorities accusing lenders of using harsh and unfair recovery practices. 3. Microfinance institutions formed their own association Asofin for joint legal action and negotiation with the debtors association. 4. Debtor associations forced their way into a dialogue with the Superintendency of Banks and Asofin, in which the microfinance lenders agreed to consider debt relief to association members on a case by case basis. Only a handful of cases were ever resolved, however. 5. Debtors Associations through their own leadership in jail after finding out that one association was a true pyramid scheme where leaders illegally collected debt service payments due to the microlenders and used them to make new loans. Some leaders of other associations mishandled membership dues. 6. Associations ultimately moderated their aims slightly: they acknowledged their obligations to repay but asked for extended grace periods, longer loan terms, and annual interest rates of 2 percent.	1. MF portfolio growth declined : No microlender recorded sizeable growth between 1999 and 2000. BancoSol lost 25 percent of its clients and Prodem lost 45 percent during this period. The combined outreach of BancoSol and Prodem fell from 129,000 at year-end 1998 to 87,000 by year-end 2000. It is presumed that much of this reduction represents elimination of clients with loans from multiple institutions. 2. Delinquency: Every microlender experienced rise in delinquency from 1999 and continued into 2000. The rate of overdues of regulated microfinance institutions rode from only 2.4% 1997-end to 12.6% by 2000-end. 3. Lower returns: Slower growth and higher delinquency hit the bottom lines of all the microlenders. BancoSol's return on equity dropped from 29 percent (1998) to 4 percent (2000). Fassil's profits dropped from 12 percent (1998) to 1 percent (2000). “The major importance of the debt protestors has been to politicize microfinance, changing attitudes about credit and damaging Bolivia's once-excellent repayment culture. The microfinance industry will have to live with the debtors associations, or at least the attitudes they represent, for the foreseeable future.” – Rhyne 2001

Microlender's Internal Response	Cooperation of External Stakeholders
1. Regular Use of Credit Bureau: A first line of defense was greater use of the Superintendency's Central de Riesgo, or credit bureau. 2. Greater emphasis on movable collateral: A new law established registry of movable collateral allowing clients to mortgage their equipment. 3. Less reliance on Group Selection and Screening: Greater emphasis on repayment capacity relative to past group performance. 4. Revision of Key Performance Indicators for Staff: Affected institutions realized that their incentive systems base d simply on growth and recovery generated perverse results when delinquency worsened. Staff worked harder, spending inordinate amounts of time on collections, but still failed to meet the targets needed to earn incentives. The organizations had to reformulate staff performance targets and incentives to focus narrowly on collections. 5. Rescheduling of loans: Until 1999, the microfinance lenders rarely rescheduled or refinanced loans, considering such practices highly risky. But in the midst of economic crisis they saw few alternatives. The Microlenders began to use rescheduling.	Strengthening of Credit Bureau System: Prior to the crisis Superintendency's Central de Riesgo was never sufficiently complete or up to date to provide a water-tight reference, thus was not good enough to prevent lending to clients with multiple loans. The system was improved and further developed after the crisis. • Creation of registry of movable collateral • Increased requirement for documentation to support client's application

Grameen hit by Repayment Snag

- By 1995-end 56% of loans lent in 4 of Grameen's model villages in 1994 were overdue. The repayment rates among the borrowing groups varied from 28 to 56 percent. (Mantin 1997).
- On-time loan recovery in the same 4 villages steadily deteriorated from 89 percent in 1993 to 41 percent in 1996 (Matin, 2000).
- In two northern districts of Bangladesh that have been used to highlight Grameen's success, 50% half the loan portfolio was overdue by at least a year in 2001, according to monthly figures supplied by Grameen. For the whole bank, 19% of loans were one year overdue. Grameen itself defined a loan as delinquent if it still isn't paid off two years after its due date. Under those terms, 10% of all the bank's loans are overdue, giving it a delinquency rate more than twice the often-cited level of less than 5% – Wall Street Journal, 2001.
- At the end of 1995, Grameen experienced an unusual repayment problem - clients in Tangail held a widespread strike demanding access to their compulsory group savings funds. Before the strike was settled and Grameen provided greater access to savings, some 60,000 borrowers with payments more than 25 weeks overdue had an unpaid amount of over Tk. 82 million or US$2 million (Wright, 1999).
- Borrower groups had become lobbying groups, and Mr. Yunus hadn't noticed the change, says Muhammad Yahiyeh, former director of Grameen Trust. "An entire group would say, 'Unless you pay this person 5,000 taka, we will all stop paying' ".

"The "unzipping" effect* Matin refers to is when the entire group, and indeed often the entire Kendra [the larger assembly of 6-8 groups of 5 members], burdened by excessive or multiple efault, sees no further hope for continuing loans and elects to default en masse, thus causing the group or kendra (and the group guarantee that held it together) to "unzip". It is this risk that drives MFI field workers to continue to give loans to the good payers in the longer established groups or kendras - after all they have developed a long credit history - and thus to negate the group guarantee principle. And it is for this reason that, despite all the rhetoric, the effectiveness of the group guarantee principle is limited to the first few loan cycles"

(Wright, 2000).

* A term first coined by Rutherford during 1992.

Factors contributing to Repayment Crisis

1. Growth Pace
2. Increasing Competition and Overlap
3. Multiple Borrowing and Deterioration of incentive to maintain good repayment record to access to progressive loans
4. 1998 Floods

Reaction to Crisis

1. **Borrowed with Sovereign Guarantee to Disburse new loans to 1998 Flood affectees:** Massive floods in 1998 hit Grameen's borrowers hard. The bank let borrowers skip several payments. Grameen borrowed $80 million from Bangladesh's government banks, with a sovereign guarantee, and used the money to make new loans to borrowers. Informally, it forgave the old loans.
2. **Hid Default by Rescheduling and Issuing New Loans to Delinquent Clients:** Grameen also bailed out borrowers whose problems had nothing to do with the flood. Ms. Begum, for instance, stopped paying when she had to provide dowries for two daughters. She skipped group meetings, but Grameen workers came to her door asking for her 200-taka weekly payment, she says. "Let us make some income and we'll pay you," she told them. Grameen came up with a proposal: pay just 50 taka a week for six months, and then take a new Grameen loan for twice the amount she repaid. Ms. Begum accepted. Grameen calls the program a "flexible loan," and treats the old, delinquent loans as back on schedule, as long as some regular payment is being made. – Wall Street Journal. 2001.
3. **Stress on Individual Liability vs. Group Liability:** Organizations such as ASA , while maintaining, group lending as means to maintain low administrative cost, emphasized individual liability.

Fig. 1. Scale, Subsidy, and Over-dues

1 Increased dependency on subsidy

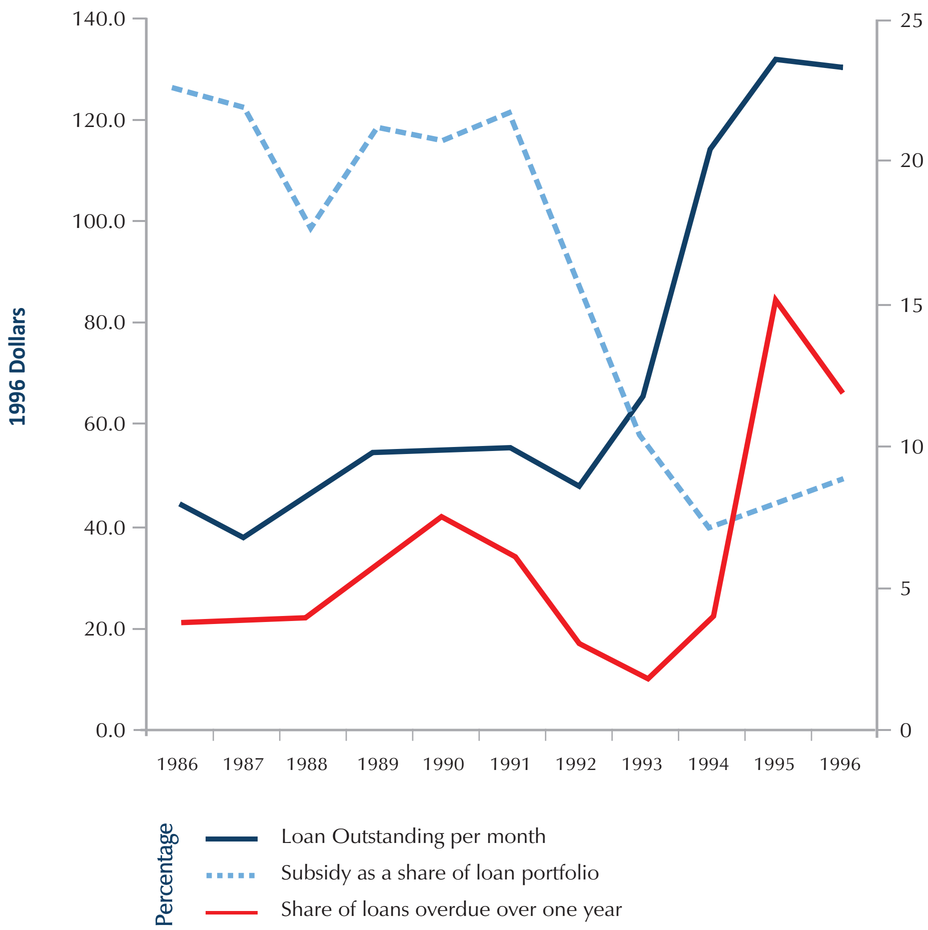
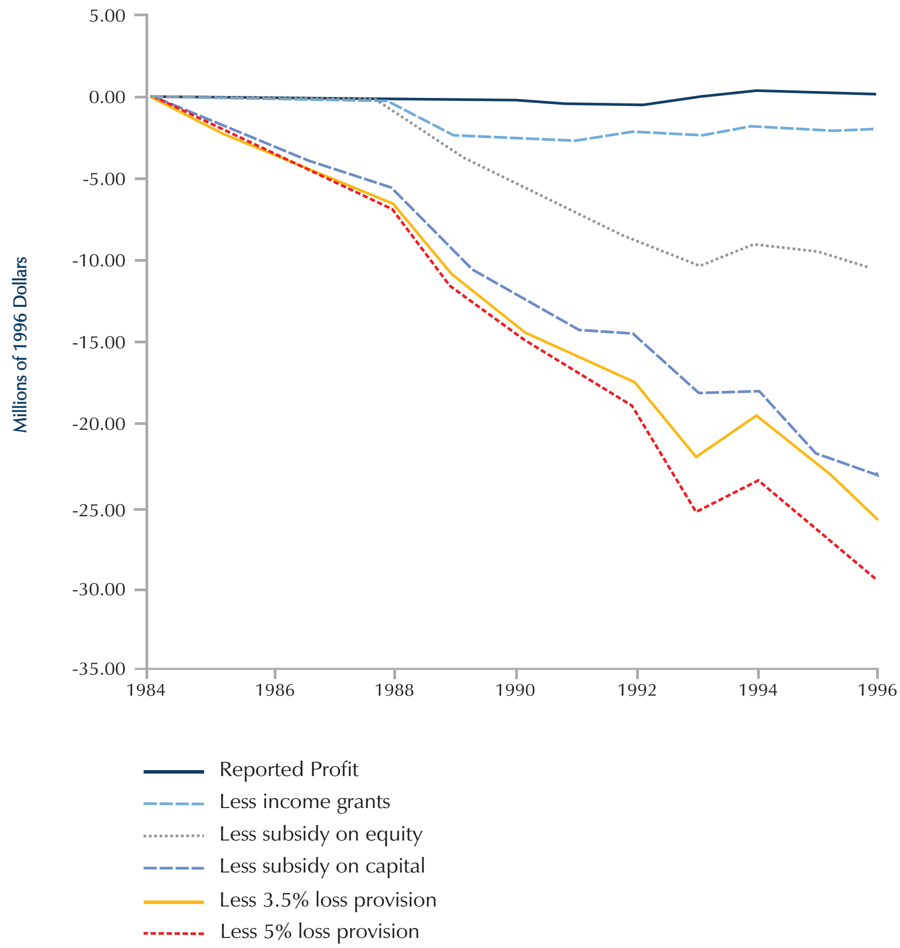


Fig. 2. Reported Profit and Adjust Profit

2 Deep Losses



Source: J. Morduchr / Journal of Development Economics 60 (1999) 229-248

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