A Report on Addressing Debt Distress in a Post-COVID World

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Executive Summary

Access to credit enables an individual and her household to achieve financial well-being and results in economic welfare outcomes for the entire society. However, excessive debt diminishes all developmental gains, and negatively impacts overall economic growth and stability. Debt also poses a unique paradox in the Indian case. On the one hand, India's credit-to-GDP ratio stands at 56 percent, and on the other, large-scale instances of over-indebtedness (OI) keep emerging. Further aggravating the situation is the economic impact of the COVID-19 pandemic, which has hurt borrowers' capacity to service debts without having to face distress. Thus, it is critical to focus on the three themes across the key lifecycle stages of credit. These themes are Prevention of Distress, Identification of Distress, and finally, Alleviation of Distress. The interventions proposed under each theme range from regulatory and legislative tools that safeguard borrowers from distress or provide them with a pathway out of distress, to tools that credit providers may adopt to prevent, detect and address debt distress.

To minimize the likelihood of distress, it is pivotal to design guardrails against it at the first point of interaction between a potential customer and a provider. This pertains to the first theme, under which we focus on the decision-making process of providers. Currently, the regulations around credit appraisal processes do not require all providers to uniformly consider the impact of credit on their borrowers, resulting in detrimental outcomes for borrowers. However, given the differing business models of providers, there is a need to identify an appropriate set of regulations that simultaneously protects the customer while also allowing for business model flexibility. However, before discussing the regulatory or provider-level approaches, we outline the key customer outcomes that must be targeted. Thereafter, we propose moving away from a fragmented regime of conduct regulation to a universal one. Finally, we conclude by discussing how providers may operationalize suitability by taking the example of the microfinance sector, which had seen overheating, especially in eastern India, before the pandemic had hit.

The second theme, identification of distress, is crucial for the other two strategies of prevention and alleviation. With existing distress identification frameworks enabling only ex-post measures with their focus on tracking defaults and insolvencies, more effective frameworks are the need of the hour to detect early signs of distress by tracking a range of quantitative and qualitative distress indicators and enable regulators and providers to take both ex-ante and ex-post measures. We check two such frameworks. CGAP's Early Warning System relies on collecting data on a range of stress indicators among borrowers, during their loan tenure, to not just monitor their stress levels at different points in time but also to see if these stress indicators are a reliable predictor of their repayment performance. Dvara Research's framework enlists various indicators that must be captured and analysed by providers and regulators in India so that real-time insights are available on levels of indebtedness at a reasonable level of granularity, i.e., at the district level. Dvara Research has also reviewed the existing regulatory and supervisory processes of regulators and providers in India and proposed a pathway for them to shift to its framework in a phased manner.

While these frameworks propose ways to monitor the credit market and identify debt distress by addressing the concerns of traditional lending models, newer forms of lending further complicate matters. Digital lending, especially, has grown exponentially in developing countries, including India, in the last few years. CGAP's market monitoring work across different African and South American countries, as well as in India, have highlighted aggressive debt collection practices, the rampant increase in fraud, misuse of personal data for debt shaming, and lack of proper and accessible grievance redress channels as some of the outstanding concerns, all of which have resulted in high levels of distress among digital borrowers. Dvara Research's workshop with different stakeholders in the digital lending chain saw many additional issues being highlighted in the Indian context, such as concerns emerging out of modularization. While CGAP has demonstrated the usefulness of social media analysis to monitor the digital credit market and identify such concerns, there are also practical limitations to it that necessitate researchers and regulators to think of other ways to hear the voices of customers.

Once debt distress has been identified, the question of how it can be mitigated or alleviated and the role regulators, providers, and borrowers can play in tackling debt-induced distress becomes important. Starting with the individual or household level, a borrower must be empowered to seek refuge under an insolvency and bankruptcy regime if they so desire. They must have the necessary tools in place in the form of a well-designed statutory mechanism for modifying or discharging their debt obligations. Providers, on the other hand, should be able to intervene within the bounds of the credit contract and provide resolution for their customers once debt distress has been identified. Assuming that providers know and understand the needs and circumstances of their customers, they should be able to reorganize the debt contract in a manner that suits both parties involved. Lastly, in the event of a system-wide shock, as in the case of COVID-19, providers are ill-suited to address large-scale distress prevalent among borrowers. In such instances, regulators need to play a prominent role by introducing policy-level interventions in a timely manner. The COVID-19 pandemic saw regulators issuing special permission to Financial Service Providers (FSPs) to provide moratorium and other debt restructuring solutions to their customers. The design of such policies is critical to ensure that they meet the targeted dual objectives of systemic stability and minimizing borrower distress. The section concludes by describing the principles that providers and regulators should be guided by while implementing and designing policies to tackle debt distress.

This report synthesizes key learnings across the three themes described above based on past and ongoing research conducted by Dvara Research and CGAP. We hope that this report can generate meaningful discussions among sector stakeholders around the feasibility of the recommendations made for both financial service providers and regulators to address concerns of over-indebtedness.

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List of Abbreviations

USD – United States Dollars
INR – Indian Rupees
SCB – Scheduled Commercial Bank
LIH – Low-income household
OI – Over-indebtedness
GDP – Gross Domestic Product
CGAP – Consultative Group to Assist the Poor
HNI- High Net-worth Individual
FSLRC – Financial Sector Legislative Reforms Commission
RBI – Reserve Bank of India
SEBI – Securities and Exchange Board of India
IRDAI – Insurance Regulatory and Development Authority of India
PFRDA – Pension Fund Regulatory and Development Authority
IGR – Internal Grievance Redress
MFI – Micro Finance Institution
DSR – Debt-To-Debt Service Capacity Ratio
AIDIS – All India Debt and Investment Survey
NBFC – Non-banking Finance Company
FSP – Financial Service Provider
CIC – Credit Information Company
MFIN – Micro Finance Institutions Network
CBS – Core Banking System
LMS – Loan Management System

GST – Goods and Services Tax
IBC – Insolvency and Bankruptcy Code
BSR – Basic Statistical Return
FCA – Financial Conduct Authority
DRO – Debt Relief Order
TLTRO - Targeted Long-Term Repo Operation

In India, encompassed within the agenda of financial inclusion, much progress has been made towards credit inclusion. This growth has been more so in case of microcredit[1] (small-ticket unsecured loans (amounting up to INR 60,000 [~USD 800] [2] or INR 100,000 [~USD 1,333] or INR 125,000 [~USD 1,667])[3] delivered with an intent to be majorly deployed for productive purposes)[4], which witnessed over a 12-fold increase in portfolio size in only seven years between 2012 and 2019, considerably more than the 2-fold increase of total bank credit[5]. Over the five years preceding the pandemic, the household sector credit too grew faster at an average annual growth of 13 per cent compared to the 9 per cent for total bank credit.[6]

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[1] In certain cases, the term "microfinance" is used instead of "microcredit", especially in the Indian context, since the Reserve Bank of India refers to the predominantly microcredit granting institutions as "microfinance institutions"

[2] Exchange rate considered in the document is 1 USD =75 INR

[3] The loan limit threshold has changed over the years; see: RBI Directions titled "Introduction of New Category of NBFCs - 'Non Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs) – Directions (2011)" accessible at: https://rbi.org.in/scripts/NotificationUser.aspx?Id=6857&Mode=0#234 , RBI Notification titled "Non-Banking Financial Company-Micro Finance Institutions (NBFC-MFIs) – Directions – Modifications (2015)" accessible at: https://rbi.org.in/Scripts/NotificationUser.aspx?Id=9651&Mode=0 and RBI's "Consultative Document on Regulation of Microfinance (2021)" accessible at: https://www.rbi.org.in/Scripts/PublicationsView.aspx?id=20377

[4] *ibid.*

[5] Calculated from 2019 and 2014 data of bank credit outstanding and microcredit outstanding sourced from Basic Statistical Return - Credit by SCBs, RBI Database on Indian Economy, and Micrometer report, MFIN respectively. Accessible at: https://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications https://mfinindia.org/Resources/micrometer

[6] Calculated from 2019 and 2014 data of organization wise classification of bank credit sourced from Table No. 3.2 – Organization-Wise Classification of Outstanding Credit Of Scheduled Commercial Banks According to Occupation. Retrieved from: https://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications

As of March 2020, i.e., right before the COVID-19 pandemic hit, the household sector had 263.7 million credit accounts with Scheduled Commercial Banks (SCBs), thus representing 96.7 per cent of all credit accounts with SCBs[7]. The analysis further shows that most of the accounts of the household sector (77.5 per cent of accounts) had credit limits below INR 200,000 [~USD 2,700]. However, even for large borrower accounts (accounts with credit limit greater than INR 200,000 [~USD 2,700]), the household sector accounted for 94.2 per cent of the credit accounts (Reserve Bank of India, 2015). The value of credit outstanding of the household sector with the SCBs, on the other hand, stood at 50.9 per cent. Therefore, even with a lower value of per-account credit outstanding than the private corporate sector, the household sector sees a significant amount of credit flowing to it from the SCBs.

While the ability to access credit enables an individual and her household to gain better welfare outcomes, an excess of credit has the potential to diminish any developmental gains, leading to detrimental outcomes for the borrowers, especially for the low-income households (LIHs), which are characterized by multiple and irregular income streams. In addition to the deterioration of households' social and economic well-being, excess household debt negatively affects the growth and stability of the economy in the long run (Alter, Feng, & Valckx, 2018).

Lenders may disburse excess credit for several reasons. Some of these are incorrect assessments of individual credit demand, lack of information regarding the true levels of indebtedness of borrowers, perverse incentives placed on loan officers, and lack of, and inability to undertake, adequate assessments of repayment capacity, among others (Kappel, Krauss, & Lontzek, 2010). Excess credit, when coupled with a lack of adequate repayment capacity, may lead to over-indebtedness of the borrower and her household.

This phenomenon of over-indebtedness is not unique to India. However, here it often presents a unique paradox. On the one hand, India's credit-to-GDP ratio stands at 56 per cent[8], and on the other, large-scale instances of over-indebtedness keep emerging. Several other jurisdictions have experienced the problem in one form or another. For example, advanced economies like the United Kingdom[9], and other parts of Europe[10] are currently experiencing rising indebtedness levels among retail borrowers.

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[7] The RBI publication of data on DBIE titled, *Table no. 1.6* - Outstanding Credit of Scheduled Commercial Banks According to Organization, March - 2020, accessible at: https://dbie.rbi.org.in/DBIE/dbie.rbi?site=home

[8] Business Standard (June 2021), "*India's bank credit-to-GDP ratio inches up to 56% in 2020: BIS data*"; Accessible at: https://www.business-standard.com/article/finance/india-s-bank-credit-to-gdp-ratio-inches-up-to-56-in-2020-bis-data-121062401341_1.html

[9] Financial Times (February 2020), "Millions of indebted Britons are at risk of exploitation, says FCA"; Accessible at: https://www.ft.com/content/51dae15c-5261-11ea-90ad-25e377c0ee1f

[10] Eurofound (2020), "*Addressing household over-indebtedness*", Publications Office of the European Union, Luxembourg; Accessible at: https://www.eurofound.europa.eu/sites/default/files/ef_publication/field_ef_document/ef19044en.pdf

Unlike several jurisdictions, especially in Europe, India does not have a clear definition of over-indebtedness. In the UK, for instance, over-indebtedness is defined as a situation "*where households or individuals are in arrears on a structural basis, or at a significant risk of getting into arrears on a structural basis*" (Oxera, 2004). In Germany, it is defined as a situation where household income "*in spite of a reduction of the standard of living, is insufficient to discharge all payment obligations over a long period of time"* (Haas, 2006). Although several frameworks exist, there continues to be no commonly agreed-upon definition of over-indebtedness and how to measure it. The European Commission, in its research note on over-indebtedness, put forth a unified definition of an over-indebted household as "*one* [Household] *whose existing and foreseeable resources are insufficient to meet its financial commitments without lowering its living standards*" (European Commission, 2010). Also, in the case of developing economies and emerging markets, definitions of overindebtedness are often present. For example, South Africa's National Credit Act states in Section 79 that "*A consumer is overindebted if the preponderance of available information at the time a determination is made indicates that the particular consumer is or will be unable to satisfy in a timely manner all the obligations under all the credit agreements to which the consumer is a party, having regard to that consumer's— (a) financial means, prospects and obligations; and (b) probable propensity to satisfy in a timely manner all the obligations under all the credit agreements to which the consumer is a party, as indicated by the consumer's history of debt repayment*"[11].

Further, studies which attempted to identify household over-indebtedness have used a variety of both quantitative and qualitative indicators. While quantitative measures, such as the household debt to income ratio, are easier to measure and employ as a compliance criterion, qualitative measures, such as perceived financial and non-financial burden and indicators of distress have however been shown to better capture the true state of over-indebtedness at the household level (Schicks, A Customer-Protection Perspective on Measuring Over-indebtedness 2013).

These indicators of distress remain undetected by conventional reporting requirements due to the nature of the measures that the household takes to repay in time, ranging from mild coping mechanisms such as borrowing from family/ acquaintances/ informal lenders, temporarily cutting down on unnecessary expenses, to extreme ones like skipping meals and discontinuing their children's education. From a borrower's perspective, such a household/borrower who continuously struggles to repay and is forced due to the debt obligation to make unduly high sacrifices is considered to be over-indebted (Schicks, 2013). Therefore, when default does occur, it often signals a stage of severe and unmanageable distress. Thus, relying on default indicators as the only measure of household over-indebtedness would be inadequate, and this could potentially affect the stability of the financial system as well (D'Alessio & Iezzi, 2013).

Should the state of over-indebtedness persist for a longer period and escalate beyond just one at a (few) household(s') level to one at a regional/sectoral level, it could subject various market participants to considerable levels of systemic risk. The ramifications of such crises may go beyond

[11] National Credit Act of South Africa (2005); Accessible at: http://www.thedtic.gov.za/wp-content/uploads/National_Credit_Act34of2005.pdf

just the economic losses incurred by lenders due to defaults and can cause severe social unrest due to the borrowers' over-indebtedness and their perception of lender exploitation. This could also have political antecedents and repercussions, as witnessed in the case of Nicaragua (2009)[12] and in Bolivia's repayment crisis (1999-2000) (Rhyne, 2010), and recently in the states of Assam and West Bengal in India.[13] A volatile socio-political environment could act as a significant deterrent to future entrants in the credit market, thereby negatively impacting access to credit for households and enterprises.

Strategies for addressing over-indebtedness may be of two forms (ex-post and ex-ante) depending on whether over-indebtedness has already manifested or not. While most of the ex-ante tools are equally applicable for cases where over-indebtedness has manifested, their application is not dependent on such manifestation. For example, asset provisioning regulations will continue to exist agnostic of over-indebtedness status, though the proportion may change depending on the level of indebtedness. Thus, such indicators are classified as solely ex-post. The table below (**Table 1**) highlights the different tools that can be adopted at different levels – statutory, supervisory, regulatory and/or at the practitioner level.

Table 1: Potential Tools to Address Over-indebtedness

Statutory Approaches	
Ex-post statutory tools	- Robust personal insolvency and bankruptcy code to enable debt discharge
Regulatory Approaches	
Ex-ante macro-prudential tools by the regulator	- Risk-weighting approaches to asset-class level capital adequacy requirements under Basel[14] - Placing prescriptions on asset provisioning - Placing caps on Loan-To-Value (LTV) such as for gold loans, housing loans
Ex-ante micro-prudential tools by the regulator	- Mandatory credit bureau checks on borrower and other members of household, co-borrowers, guarantors, joint liability groups - Placing absolute and relative loan exposure limits

[12] Regulatory options to curb debt stress, CGAP Focus Note, Gabriel Davel, 2013; Accessible at: https://www.cgap.org/sites/default/files/Focus-Note-Regulatory-Options-to-Curb-Debt-Stress-Mar-2013.pdf

[13] The Economic Times (February 2020), "It all began with a few defaults. Then, suddenly it was full-scale microfinance mayhem in Assam"; Accessible at: https://economictimes.indiatimes.com/industry/banking/finance/as-anti-caa-protests-quieten-assams-microfinance-troubles-are-back-in-focus/articleshow/74089389.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst

[14] For example, in India banks providing individual housing loans with an LTV of less than 80% are required to have a risk weight of 35%. In the case of NBFCs, the required risk weight is 100%. See: RBI Notification on "Individual Housing Loans – Rationalization of Risk Weights" (October, 16, 2020); Accessible at: https://www.rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11984 and Chapter IV – Capital Requirements of the "RBI Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016" [Updated as on May, 02, 2022]; Accessible at: https://rbidocs.rbi.org.in/rdocs/notification/PDFs/45MD01092016B52D6E12D49F411DB63F67F2344A4E09.PDF

	- Placing caps on household income levels, above which certain types of lending are not permitted[15]
Ex-ante customer protection tools	- Prohibition of aggressive or misleading advertising and selling practices - Limitations in charges (e.g., compounding of penalty fees) - Requirement of ongoing suitability checks for credit provision - Product governance rules to ensure credit features are tested and modified based on consumer insights - Requirements on officials responsible to monitor and act on customer outcomes - Prohibition of aggressive or misleading advertising and selling practices - Limitations in charges (e.g., compounding of penalty fees) - Requirement of ongoing suitability checks for credit provision - Product governance rules to ensure credit features are tested and modified based on consumer insights - Requirements on officials responsible to monitor and act on customer outcomes
Supervisory approaches	
Ex-ante supervisory tools	- Monitoring of regional Credit-to-GDP - Monitoring of market saturation, number of players, AUM growth unsupported by new-to-credit customers (aggregate), EMI/individual[16] - Heat-maps - Continuous/regular offsite supervisory reporting in a granular, templatized manner by all credit market participants, including credit bureaus - Quality of credit risk management teams to be assessed and scored - Consolidated annual reporting or review by regulator/supervisor on overall retail credit markets (in addition to segment-wise analysis)[17]

[15] For example, in pre-pandemic India, NBFC-MFIs were largely restricted from lending to rural households with an annual income of greater than Rs. 1 lakh and urban and semi-urban households with an annual income of greater than Rs. 1,60,000. However, this did not lead to credit starvation of the excluded households, since other institutions like all categories of NBFCs and banks could lend to such customers.

[16] Number of MFIs and number of loans are poor proxies for over-indebtedness

[17] UK Financial Conduct Authority (FCA)'s 'Sector Views' contains a discussion of the trends and performances of each sector including retail lending. Source: Feb 2020. *Sector Views*. FCA Publications. Retrieved from: https://www.fca.org.uk/publication/corporate/sector-views-2020.pdf;
In 2020, the FCA also launched a review of the unsecured credit market to work on how regulation can better support a healthy unsecured credit market. Source: September 2020. *Christopher Woolard to chair review of unsecured credit market regulation.* FCA Press Releases. Retrieved from: https://www.fca.org.uk/news/press-releases/christopher-woolard-chair-review-unsecured-credit-market-regulation;
The Central Bank of Ireland publishes annually the 'Household Credit Market Report' to provide an up-to-date picture of developments in the household credit market in Ireland. Source: *Household Credit Market Report*. Central Bank of Ireland Publications. Retrieved from: https://www.centralbank.ie/publication/household-credit-market-report;
Bank of Zambia publishes annual 'Credit Market Monitoring Reports' to provide an overview of Zambia's credit market with particular focus on access to credit and debt stress. Source: *Credit Market Monitoring Reports.* Bank of Zambia Research and Publications. Retrieved from: https://www.boz.zm/credit-market-monitoring-reports.htm

	- Market monitoring tools to assess consumer credit risks, eg: analysis of consumer complaints, analysis of consumer contracts, phone surveys, mystery shopping
Ex-post supervisory tools	- Upon identification of potential hotspots (through a matrix approach), supervisory interventions to limit further lending - Review and revision of loan classifications during onsite supervision - Requiring relevant enforcement actions, e.g., ordering changes in product features or advertising practices based on effects on borrowers - Requesting additional information of specific borrower portfolios as part of onsite inspection follow-up
Practitioner-led approaches	
Ex-ante tools	- Cash flow analysis and repayment capacity analysis of borrower to arrive at the debt-servicing capacity - Risk-based pricing by providers - Demand-side data collection
Ex-post tools	- Restructuring of loans

Several of these practices, in different combinations, have been adopted by policymakers across the world to tackle the problem of over-indebtedness, and minimise debt distress. Additionally, many innovating approaches have been adopted by providers, often in collaboration with the Consultative Group to Assist the Poor (CGAP) to detect the prevalence of over-indebtedness. Despite these strides, it is unlikely that every such policy or practice is transposable across jurisdictions, since policies are seldom context agnostic. In the next three chapters of the report, we discuss many of these approaches clubbed under three distinct themes, *Prevention of Distress, Identification of Distress, Alleviation of Distress.* The next chapter focuses on the first theme, *Prevention of Distress,* and discusses ex-ante mechanisms available to regulators and providers for prevention of over-indebtedness, and debt distress.

2.Preventing Debt Distress

To minimize the likelihood of distress, it is pivotal to design guardrails against it, starting at the first point of interaction between a potential customer and a provider. In this chapter, we focus on the decision-making process of providers. Following the global discussion, we focus on the Indian context, where the regulations around credit appraisal processes do not require all providers to uniformly consider the impact of credit on their borrowers, and this may result in detrimental outcomes for borrowers. However, given the differing business models of providers, there is a need to identify an appropriate set of regulations that simultaneously protects the customer and allows for business model flexibility. Before discussing such provider-specific interventions, we argue the need to develop a metric or a benchmark through which such interventions may be adjudicated. Such a benchmark can be designed by outlining the *Key Customer Outcomes.*

2.1 Key Customer Outcomes

The first point of the investigation, therefore, must be the customer outcomes that each jurisdiction and provider should strive for. Such an outline of desired customer outcomes is presented in the paper *Making Consumer Protection Regulation More Customer-Centric.* The paper identifies six core outcomes from the customer perspective: "*suitability and appropriateness*", "*choice*", "*safety and security*", "*fairness and respect*", "*voice*", and "*meets purpose*" (Izaguirre, Making Customer Protection More Customer Centric 2020). **Box 1** discusses these outcomes in detail.

Box 1: The CGAP Customer Outcomes Framework

CGAP research has identified six core outcomes from the customer point of view:
1. **Suitability and appropriateness**: Customer has access to quality services that are affordable and appropriate to her preferences and situation. She receives advice and guidance appropriate to her financial situation.
2. **Choice**: Customer can make an informed choice among a range of products, services, and providers based on appropriate and sufficient information and advice that are provided in a transparent, non-costly, and easy-to-understand way.
3. **Safety and security**: Customer's money and information are kept safe. The provider respects her privacy and gives her control over her data.
4. **Fairness and respect**: Customer is treated with respect throughout her interactions with the provider, even when her situation changes, and she can count on the provider to pay due regard to her interests.
5. **Voice**: Customer can communicate with the provider through a channel that she can easily access and have her problems quickly resolved with minimal cost to her.
6. **Meets purpose**: By accessing and using products designed and delivered in accordance with the principles outlined above and by getting the services the customer needs, she is in a better position to increase control over my financial life, to manage a shock, or to attain other goals.

Source: Making Consumer Protection Regulation More Customer-Centric

To operationalize the outcomes, especially in the context of India, where financial sector customer protection initiatives are fragmented across regulators, and touch points, among others, it is important to have a set of uniform guidelines that adequately protect customers. The frameworks for customer protection in financial products and services that exist today have been inadequate to protect the interests of households and enterprises.

Continuing in the Indian context, the design of the universe of customer-touch points for the sale of financial products has not sufficiently enhanced the abilities of customers to access unbiased advice and sales practices that keep their best interests in mind. While elements of financial advice are embedded in the sale process, regulators have kept these two offerings separate. This separation is intended to ensure that financial advisors act in the best interest of the customer by eliminating commercial interests that may surface from incentives linked to the sale of specific products. While the idea is noble, in reality, the sale process embeds incidental financial advice, where often the sales agent masquerades as an expert financial advisor. As a result, there is a conflict of interest that the sales agent faces, often leading to detrimental outcomes. Confounding the issue further is the fact that financial consumers have the freedom to move between institutions for their financial needs but are subjected to differential standards based on the institution types they engage with[18]. These issues get amplified further with the new waves of disruption happening in financial services and where the distinction between the distributor and the manufacturer is getting progressively blurred in terms of liability for harms and/or losses to the customer.

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[18] A Strategy for Comprehensive Financial Inclusion (Dvara Research, 2020); accessible at: https://www.dvara.com/research/wp-content/uploads/2020/01/A-Strategy-for-Comprehensive-Financial-Inclusion.pdf

different design and implementation strategy than what is present currently. However, before discussing the universal obligations that must be placed on providers, it is essential to discuss the intended beneficiary of such obligations.

2.2 Defining the Customer

Not all customers of the financial sector are alike. The financial sophistication and bargaining power of a corporate seeking credit or other financial product is very different from that of an individual consumer, as well as micro and small entrepreneurs (MSEs). Thus, policies designed to protect the latter can inadvertently introduce friction in the case of the former. Similarly, policies targeted to the former segment are seldom applicable to the average individual consumer and MSEs, who neither have the bargaining power, nor the sophistication to often understand complex products. Thus, it is important to define the segments a financial consumer protection regime applies to.

In India, the Financial Sector Legislative Reforms Commission (FSLRC) was the first to put forward a carve-out for the 'retail customer', for whom customer protection standards were expected to be more stringent[19]. However, it is essential to go a step further to define the "retail customer" in a manner that is unambiguous yet flexible enough to accommodate all foreseeable possibilities. Dvara Research, in the past, has put forth such a definition in the note titled, "*Universal Conduct Obligations for Financial Services Providers Serving Retail Customers*" (George, Universal Conduct Obligations for Financial Services Providers Serving Retail Customers 2019). In the note, a retail customer is defined as *a natural person, or an eligible entity who (or which) is not a professional customer* and who *has availed, avail or intends to avail a financial product by engaging with a financial services provider.* The definition ensures that all natural persons, and legal entities are covered, provided certain exclusion criteria are not met.

Such exclusion is drawn on the basis of two factors, the annual turnover of the entity, and the expected expertise of such entities. The "eligible entity" is defined as *a limited or unlimited liability company, corporation, partnership (whether limited or unlimited), proprietorship, Hindu undivided family, trust, union, association, society, cooperative society, government or any agency or political subdivision thereof or any other entity that may be treated as a Person under Applicable Law, and with a turnover not greater than Rs. 250 crores".* The second exclusion factor leads to the exclusion of professional customers, defined as:

> "*A professional customer is one who meets any of the following criteria:*
>
> > *i. a financial institution regulated by one by one or more of the financial sector regulator, namely RBI, SEBI, IRDAI, and PFRDA*
> > *ii. a qualified institutional buyer as defined by SEBI in SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009*
> > *iii. central or state governments*

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[19] Report of the Financial Sector Legislative Reforms Commission (March 2013), vol. 1, Section 5.5, p. 48; Accessible at: https://dea.gov.in/sites/default/files/fslrc_report_vol1_1.pdf

iv. a local public authority or municipality which has prior experience in accessing the debt capital markets"

The inclusive definition and the exclusion criteria ensure that all natural persons and small businesses are adequately protected while simultaneously allowing sophisticated customers to engage with more complex financial products. For retail customers, the note also underlines eleven key conduct.

Box 2: Universal Conduct Obligations Proposed by Dvara Research

1. **Obligation to act with Professional Diligence:** To carry out business that follows the general principle of good faith, with an intention to be fair and in line with *honest market practices*

2. **Obligation of Fiduciary responsibility:** In the case where the retail customer's *monies are entrusted* to the FSP for purposes of investment (and is not a bank or e wallet deposit)

3. **Obligation of Suitability:** That the product or service that the FSP deals in or attempts to deal in with respect to the retail customer is *not unsuitable* for the customer, considering the customer's needs, objectives and financial situation

4. **Obligation of Aligned Incentive Design:** Design of all forms of performance measurements and incentives *to not compromise the ability of FSP or its representatives* in discharging its duties under these obligations

5. **Obligation to Avoid & Manage Conflict of Interest:** Arising from misalignment between business objectives & customer objectives, that may cause a representative to inadequately perform one's duties. It is not enough to solely disclose to customer, but *demonstrate additional efforts to manage the conflict*

6. **Obligation to ensure Customer Data Protection:** Such that the decision to seek any information from the retail customer must be taken based on whether it is for a *legitimate purpose*, i.e., it is lawful, is necessary for the provision of the product or service, and is proportionate, i.e., balanced against the rights of the retail customer

7. **Obligation to Disclose Relevant Information:** about the product or service to the retail customer before she decides to purchase, on an on-going basis (and wherever an impending material financial impact is expected for the customer), in a manner that is *intended to improve understanding* of the product by the customer

8. **Obligation to ensure Capabilities through Training:** that one's representatives are trained adequately to have the *necessary capabilities to uphold these obligations*, and such training is provided both at the time of employment, and on an ongoing basis including when an inadequacy of capabilities is identified

9. **Obligation to have Technological Capabilities:** Needed for maintaining the integrity of customer records, solutions for real time/near real time authentication and posting of transactions, and *unique identification of its representatives* responsible for transactions, to minimize chances of operational fraud and conduct violations

10. **Obligation to maintain effective Internal Grievance Redress:** Such IGR be independent of the sales and operations and its functioning is visible to at least one member of the governing board. It must clearly define complaint and dispute, and *deal in a manner that is fair, consistent, and responsive to the retail customer.*

obligations are discussed in **Box 2**.

Source: Universal Conduct Obligations for Financial Service Providers Serving Retail Customers

In addition to outlining the obligations, Dvara Research, in the past, has also outlined approaches for their implementation. Since the obligation of ensuring suitability is key to preventing debt distress, in the next section, approaches to operationalising suitability are discussed. The discussion is limited to the context of microcredit, especially since the customers of microcredit often represent the most likely customer segment to face debt distress. However, before discussing operationalization of suitability, it is important to underscore the context of microcredit in India. Dvara Research studied household-level indebtedness through a monthly household-diaries study between February 2015 and May 2016, administered to 400 households who are active borrowers of microcredit in the district of Krishnagar in Tamil Nadu, India. Krishnagiri was chosen because of a higher rate of formal lending compared to the then all-India rural outreach (29 per cent versus 22 per cent), and it exhibited much higher median outstanding debt as well (INR 34,606 [~USD 460] versus INR 18,488 [~USD 247]). The authors observed high levels of over-indebtedness (21 per cent of sample households), financial distress and debt dependence in the sample and concluded that "e*ven fully compliant lenders* [are likely] *to mis-sell credit to at least 33 per cent MFI clients in the sample*" (Prathap & Khaitan, 2016).

This is not to say that customers otherwise do not face over-indebtedness or debt distress. However, given that microcredit is specially targeted towards low-income households, and in the past there have been many significant cases of overheating of the microcredit market, we limit the discussion to microcredit or microfinance[20]. Finally, the principles proposed in the next section are also scalable across other credit products, after appropriate modifications, keeping in mind the product design and distribution mechanism.

2.3 Operationalising Suitability in Microcredit

In Dvara Research's note titled *A Practical Note on Operationalising Suitability in Microcredit*, a four-step process is laid out as a guide to enabling providers to operationalize suitability. These four steps include — defining suitability as a process which is not merely restricted to a customer-level outcome, but includes approaches to assessing suitability at a household level, processes to determine debt service capacity and additional care requirements for households with borderline debt service capacity, and finally, setting up of system-level capabilities based on the organizational capacity (George, 2019).

Before discussing suitability as a process, it is important to define it in the context of a credit product, especially microcredit. Hence, the definition of unsuitability in microcredit adopted in the report reads:

> *"A loan is unsuitable for a borrower if, based on an assessment of her financial situation at the point of sale, she is likely to face substantial hardship in servicing that loan through the tenure."*

[20] The terms microfinance and microcredit have been used interchangeably in the document. Both the terms carry the meaning assigned to microcredit in the introductory chapter.

This suggests that, at the point of sale, the lender must conduct due diligence to ascertain the ability of the retail customer to discharge their debt obligations (arising out of the new loan) in a manner that the repayment does not compromise the debtor's security or assets, and is serviceable from her own income and savings. Therefore, lenders must have a point-of-sale assessment process that must reasonably ensure that because of the specific loan under consideration, customers will not find themselves in a situation where they have to prioritize repayments over essential expenditures; or they end up in non-transient credit-dependent behaviour in order to make repayments.

Under such a definition, the obligation of ensuring that a loan is not unsuitable for the borrower's household is restricted to the specific loan that the borrower has solicited from the lending institution. Thus, it is not expected to apply to any loans that the borrower may avail in the future from other lending institutions. Such future loans taken downstream of this unsuitability assessment may or may not result in the household of the borrower experiencing over-indebtedness. If the household does experience financial stress from such future loans, it is likely to have material implications on the borrower's ability to repay the current loan in question. However, since there is no reliable approach to predict the future loan requirements, the process outlined only helps lenders meet their suitability obligation at the point-of-sale of the solicited loan. This does not mean that post-sale suitability assessment is not required. To the contrary, post-sale suitability assessment while including all the new liabilities contracted by the customer and assets are critical to understand the customer’s debt service capacity. These ongoing assessments have also been implemented internationally, especially in case of investment products, to ensure that products offered remain “*appropriate to individual customers and [are] adequately understood*” (Izaguirre, Making Consumer Protection Regulation More Customer Centric 2020).

Intertwined with the first step, is the second step, where household level assessments are mandated, instead of borrower level assessments. A household level approach to assessing indebtedness is not new to microcredit or for retail lending businesses. It is well known that cash flows are managed at the level of a household rather than at the level of the individual borrower, and any credit availed by a member of the household is in most cases, added to the overall cash flows of the household, while repayments most commonly come from pooled cashflows of the household. "There is a possibility that the debt-service income indicators have identified individuals who have little or no income but who have borrowing that is repaid by their partners or family. Unfortunately, these individuals cannot be separated from those who are experiencing high levels of debt service that they themselves are accountable for. This is a disadvantage of analysing debt-service at the individual level". Measuring cashflows at a household level, therefore, provides a more realistic picture of the household's financial conditions. When over-indebtedness is measured at a household level rather than at an individual level, the incidence of over-indebtedness is lower.[21] In the case of India, the new RBI regulations applicable to microfinance loans incorporated this approach, and placed assessment requirements at a household level (Reserve Bank of India, 2022).

[21] Centre for Policy Innovation (October 2008), “*Drivers of Over-Indebtedness*”; Accessible at: http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.514.9586&rep=rep1&type=pdf

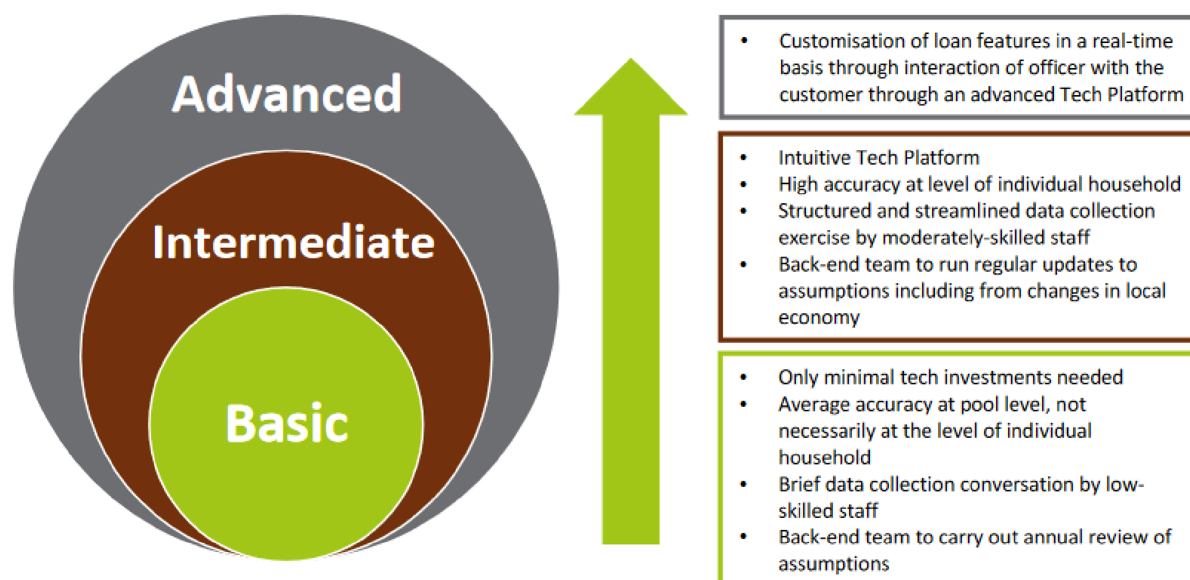
The third step discusses the critical aspects of how credit providers must approach the computation of debt service capacity. The debt service capacity is a derivative indicator, determined by the income of the customer (cash inflows), expenditure of the customer (cash outflows), and the debt obligations on the customer. Thus, it is critical to capture these aspects at a granular level. Resorting to annualized computation obfuscates the provider's understanding regarding periodic and seasonal cash-flow volatility, thus, these indicators are proposed at a monthly level. **Table 2** presents an indicative list of the various expected recurring and seasonal changes in income, expenditure and debt obligations along with non-recurring and unexpected shocks that may introduce volatility.

As may be evident from the table, sophisticated systems, with adequate information regarding the borrower household's economic activity and familial circumstances may reasonably predict the seasonality of income, expenditure and debt outflows. However, predicting cashflows accounting for shock events leading to volatility is a difficult, if not impossible task. Thus, in the third step, it is proposed that the provider takes the three components together for each month over 12 months, namely the cash inflows and outflows in relation to income, expenses and debt, to arrive at the point-of-sale Debt Service Capacity of the household, measured by the Debt-To-Debt Service Capacity Ratio (DSR). **Figure 1** represents the system level capabilities that different providers, depending on their scale and scope, can build to effectively operationalize suitability. This also represents the fourth step in the process of operationalising suitability in microcredit and is discussed in detail in **Annexure 1**.

Table 2: List (non-exhaustive) of events that may lead to seasonality/volatility of repayment capacity

Cashflow	Seasonality (Expected)	Volatility and Non-recurring Shocks (Unexpected)
Income (reductions)	Cropping cycles such as Rabi and Kharif Highest sales of inventory just before regional festivals	Weather events (including earthquakes) Accidents such as fire, poisoning, loss of crops Death of the income earner National disruptions (e.g., pandemic, debt crises)
Expenditure (increases)	School fees in June Expenses during regional and national festivals	Medical expenses, funerals Marriage and other similar expenses Emergency house repairs
Debt (increases)	Crop loans at the beginning of the cropping season Working capital loans to stock up inventory	Emergency borrowings as a result of the higher expenses owing to the earlier discussed shocks

Figure 1: System Capabilities Proposed across different levels of providers



With the proliferation of digitization across the entire financial services ecosystem, building such capabilities, at scale, has become easier than ever before. As CGAP's Gerhard Coetzee notes in the post titled, "*It's Time to Change the Equation on Consumer Protection*", *doing no harm is necessary, but it is not enough. To achieve positive results for customers at scale, policymakers must incentivize FSPs to deliver positive outcomes for the customer* (Coetzee, 2019). This digital transformation also presents a set of unique challenges, in addition to data protection and privacy concerns. One example of this is the proliferation of push-marketing, which when combined with the easy-to-use digital credit models with artificially short timelines may force borrowers to make too quick and unconsidered decisions, potentially leading to detrimental outcomes (Owens, 2018). In Tanzania, for example, a study by the CGAP and the Busara Center for Behavioral Economics, at the request of the Bank of Tanzania, showed that there are a large number of persistently late repayers who were likely to not be able to pay the next loan on time and incur high cumulative fees[22].

Dvara Research, has studied this subject in detail, and has responded to the RBI's *Report of the Working Group on Digital Lending including Lending through Online Platforms and Mobile Apps*, outlining approaches to regulate various practices that are currently prevalent in the market, or may arise out of the proposals laid out in the RBI's Working Group report (Prasad, et al., 2022). The current scope of this chapter prevents a more detailed discussion on the subject; however, it is important to underscore that in addition to the proposed conduct guidelines and customer outcomes, it is critical to contextualize these obligations with the broader market structure. Despite any such contextualization, and stringent adherence by providers, the circumstances of a household may deteriorate while servicing a loan, resulting in debt distress. Thus, in addition to the guardrails proposed in this chapter, it is also important to develop robust systems to allow providers and

[22] Slide Deck: Digital Credit Market Monitoring in Tanzania (CGAP, 2018); accessible at: https://www.cgap.org/research/reading-deck/digital-credit-market-monitoring-tanzania

regulators to detect debt distress, and design strategies to tackle it. The next two chapters discuss the debt distress detection approaches, and alleviative approaches, respectively.

3. Identifying Debt Distress

Credit is a vital instrument for households, especially low-income households, to achieve their life-cycle goals, managing their cashflows and smoothing their consumption. But when households are burdened with debt beyond their repayment capacity, i.e., over-indebted, it can turn counter-productive, not only leading to increased distress but also forcing households to adopt negative coping mechanisms. Increased incidence of over-indebtedness among borrowers affects the sustainability of lending for lenders and the overall financial stability of the market and economy for regulators. It can also cause social and political unrest. Identification of distress thus becomes important from the point of view of all three stakeholders (Bhattacharya, Neelam, & George, 2021). Moreover, identifying signs of distress is crucial to the other two strategies for tackling debt distress: prevention and alleviation of distress.

Distress due to high levels of indebtedness has been a common phenomenon in India. It has led to system-wide distress and political unrest in states like Andhra Pradesh in the past and, more recently, in eastern and northeastern states like Assam. According to the All-India Debt and Investment Survey (AIDIS), indebtedness levels increased by 84 per cent among rural and 42 per cent among urban households between 2012 and 2018. On average, a rural household has an outstanding debt of INR 60,000 [~USD 800] and an urban household has an outstanding debt of INR 120,000 [~USD 1,600] (Ponnathpur, 2021).[23] To put these numbers in context, the bottom half of India's population earns INR 53,000 [~USD 707] on average annually, as per the 2022 World Inequality Report released by the World Inequality Lab (Chancel, Piketty, Saez, & Zucman, 2022). The AIDIS 2018 report notes that the poorest 10 percent of rural and 20 percent of urban Indian households are especially burdened with high levels of debt, as shown by their high debt-to-asset ratios in **Table 3**. These figures are bound to have increased further because of the prolonged impact of COVID-19.

[23] IndiaSpend (October 2021), "Even Before Pandemic, Debts Had Soared By 84% In Rural & 42% In Urban India"; Accessible at: https://www.indiaspend.com/economy/debt-burden-on-rural-households-up-84-in-6-years-urban-poor-hit-too-782065

Table 3: Debt-to-asset ratio

Income segment	Debt-to-asset ratio	
	Rural	Urban
Bottom 10%	**39.1%**	**549.7%**
10-20%	9.4%	**75.4%**
Overall	3.8%	4.4%

Source: All India Debt and Investment Survey 2018

The RBI, as India's banking sector regulator, has already introduced new microcredit regulations that aim to reduce over-indebtedness, among other objectives. These new regulations cap the loan commitment of borrowers to 50 per cent of their income and mandate concerned FSPs to assess the incomes of their borrowers at regular intervals to measure risk better and ensure their loan commitments do not overwhelm them.[24] The new regulations may still not be adequate to prevent over-indebtedness and distress, as they do not mandate FSPs to collect and report information on borrowers' consumption and debt repayment commitments that are equally essential, alongside information on income, to estimate their cashflows and repayment capacity accurately. A Dvara Research study of the financial diaries of 400+ borrowers of a non-banking financial company (NBFC) in rural Tamil Nadu (a state in southern India) revealed that more than a fifth of the respondents were over-indebted (Prathap & Khaitan, 2016). There are many reasons for this, such as incorrect assessment of individual credit demand, incomplete information on the levels of indebtedness of borrowers, perverse incentives placed on loan officers, and lack of and inability to undertake adequate assessments of repayment capacity. Existing distress identification frameworks mainly employ quantitative approaches such as tracking default rates and debt-to-income ratios. While they are useful, they alone cannot capture the full scale of distress without incorporating other qualitative strategies (Bhattacharya, Neelam, & George, 2021).

Moreover, most of the distress identification mechanisms are centered around tracking instances of defaults and insolvency cases filed. Those are often the last resort for borrowers after exhausting other coping mechanisms such as tapping into their social networks, reducing food intake and consumption, and even denying themselves of essentials like healthcare and education. Distress identification frameworks centered on tracking defaults can only facilitate late-stage interventions to alleviate distress, but they cannot help providers and regulators in preventing borrowers from suffering extreme forms of distress. There is a need to design detection frameworks that can help providers to identify early signs of distress among their borrowers and regulators to detect early signs of distress at a systemic level (Bhattacharya, Neelam, & George, 2021).

[24] Reserve Bank of India's new Master Directions for Regulation of Microcredit; Accessible at: https://m.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12256

CGAP has studied markets in different jurisdictions and come up with such a framework. While studying the credit market in Kenya, CGAP has developed an Early Warning System (EWS) framework that provides a range of tools to monitor markets and detect signs of distress among customers. Drawing from this framework and a comprehensive literature review of how India and other jurisdictions monitor their credit markets, Dvara Research has also proposed a framework for providers and regulators in India to monitor the credit market and identify over-indebtedness. We discuss both the frameworks below in greater detail.

3.1 CGAP's Early Warning System

The famine early warning systems deployed in several countries to predict possible food insecurity risks months in advance inspired the idea to develop a similar system to detect financial distress among borrowers. Such a system shall enable FSPs and market conduct supervisors to take both ex-ante and ex-post measures to prevent and mitigate financial distress arising out of over-indebtedness. CGAP has tested and designed this EWS in parallel, through their collaboration with a Kenyan FSP called 4G Capital.

The system is based on the hypothesis that stress levels among borrowers are related to their subsequent repayment behaviour and can hence predict future defaults and delinquencies. The framework requires constant tracking of various indicators of stress among borrowers to detect signs of distress. Here, the indicators of stress are the different coping mechanisms adopted by customers, ranging from reducing their discretionary spending to cutting down on their food intake and critical education and healthcare expenses. Once there is data on both customer stress indicators and their repayment behaviour, statistical tests can be deployed to test if the former can predict the latter with reasonable accuracy.

CGAP and 4G Capital deployed surveys through messaging, telephone calls, and personal visits to customer homes to collect data on coping mechanisms adopted by them. Even though 4G Capital has consistently recorded high repayment rates on its credit products, an SMS survey of about 700 customers showed 83 per cent of them facing some level of financial stress and resorting to coping mechanisms like reducing the quality and frequency of food intake, and even sale of essential assets and durables in some cases. Since 4G Capital conditions its lending on usage of loans for productive purposes, there is high likelihood that other lenders who do not stringently apply such conditions may have an even higher share of borrowers suffering from varying levels of distress.

Availability of such data enables lenders and supervisors to track borrower stress levels in real-time and take suitable measures accordingly. Providers and supervisors across the globe already have mechanisms in place to collect some of these data points and it will be a useful and cost-effective exercise to build on them and design similar early warning systems for tracking distress among their customer bases. This will enable providers to micro-analyse the relationship between stress levels and repayment performance of their customers and design appropriate management strategies, while regulators can macro-analyse the borrower stress levels in their jurisdiction and evaluate the

management strategies adopted by different providers (Simanowitz, Hennessy-Barrett, & Izaguirre, 2021).

3.2 Detecting over-indebtedness and monitoring credit markets

In India, RBI uses various regulatory and supervisory tools and mechanisms to regulate and monitor the credit market. The regulatory tools include norms for regulated FSPs regarding the assignment of differential risk weights for different asset classes based on the classification of exposure. It has also mandated FSPs to submit credit-related information to Credit Information Companies (CICs) at periodic intervals. Both regulatory measures help both prevent and detect debt stress. After incidents of large-scale over-indebtedness and default among microcredit borrowers surfaced in the state of Andhra Pradesh in early 2010s, RBI intervened by instituting a separate class of microcredit lenders called the NBFC-MFIs and imposed specific norms on credit pricing and limits on lending and loan amounts. In 2014, RBI released the Charter of Customer Rights that includes the right to suitability for borrowers, and in 2015 updated the Fair Practices Code, to direct all NBFCs towards ensuring their borrowers do not borrow beyond their repaying capacities. The microcredit sector's self-regulatory organizations such as MFIN and Sa-Dhan have also issued their own code for responsible lending. These organizations publish periodic data including regional heat-maps that make it easy to identify areas of high lending and borrowing activity (Bhattacharya, Neelam, & George, 2021). In addition to these regulatory and self-regulatory efforts, RBI also supervises the credit market through off-site study of returns filed by regulated institutions, on-site inspections, and by gathering market intelligence through periodic interactions with various stakeholders such as statutory auditors, credit rating agencies, CICs, and FSPs.

While these regulatory and supervisory mechanisms together enable regulators and providers to have some visibility over the credit market and ensure borrower indebtedness levels are kept in check, these are not adequate to fully detect the prevalence and extent of over-indebtedness. This is because of various factors. Different regulations exist for different types of FSPs regarding the reporting of their credit-related information and the number of loans that they can lend to a borrower. Because of these inconsistencies, it is very difficult to accurately measure the indebtedness and debt-serviceability levels of borrowers at different points in time. FSPs that do collect information on borrowers' incomes, expenses, and loan commitments rely on self-reported numbers (by borrowers) and do not have robust verification mechanisms in place. These data points are collected only during loan origination and are not updated at regular intervals during the loan tenure, making it difficult to track subsequent indebtedness and debt-serviceability levels of borrowers. Beyond debt-serviceability, there are also other quantitative and qualitative data points that need to be captured to effectively monitor the credit market.

The report by Dvara Research titled '*Detecting Over-Indebtedness while Monitoring Credit Markets in India*', has proposed a framework (**Figure 2**) that will simultaneously enable RBI to monitor the credit market and detect any prevalence of over-indebtedness among Indian borrowers. The framework enlists various indicators that must be captured by all lending institutions and reported to the

regulator so that district-level insights on the credit market can be drawn at three crucial levels: market, provider, and borrower.

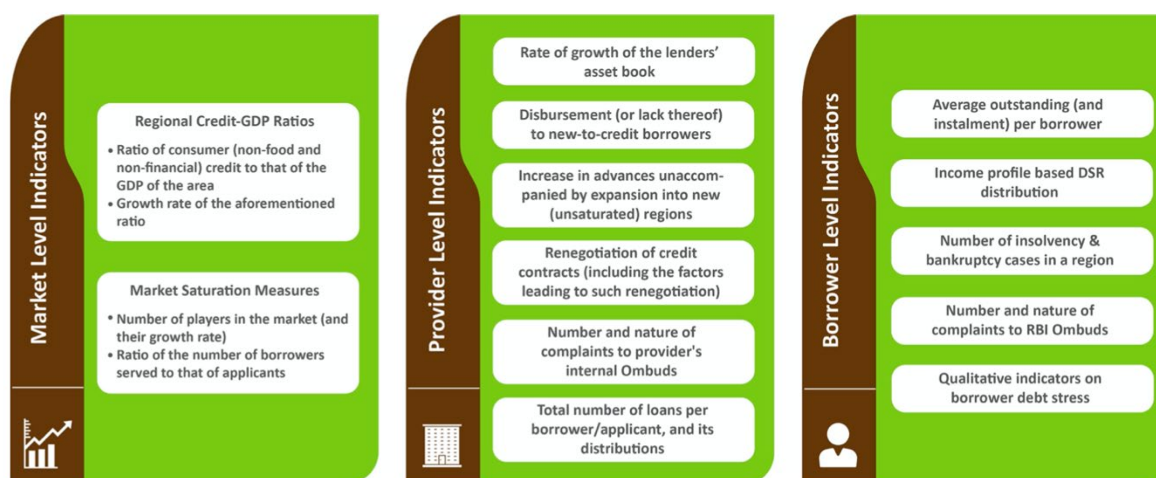
Market-level indicators give an overview of the credit market at a national and regional levels by informing the regulator on the value and performance quality of loans, including by type of credit and different customer segments (income, occupation, gender, etc.) at a market level. These can be aggregated by the RBI from reports/data by providers or credit bureaus. In addition, periodic national macroeconomic and life standard surveys can be commissioned to generate total credit and household debt data at national and regional levels.

Provider-level indicators go a step deeper and give insights on the growth rate of the loan portfolio per provider, number of loans per borrower on average, share of non-interest fee income per provider, complaints received by the providers about different credit products, and other such records usually documented by providers in their asset books. These records enable the regulator to monitor unusual growth of providers' loan portfolios and signs of impending borrower distress in certain regions or product segments.

Borrower-level indicators provide the most granular level of information on the indebtedness levels of borrowers. One obvious indicator here is the **debt service capacity ratio** which compares the disposable income of borrowers with their repayment obligations. For business loans, the expected returns in future can also be considered while measuring this indicator. Analysing these ex-ante indicators across different segments will enable the regulators to identify segments that are at risk of over-indebtedness. On the other hand, analysing ex-post indicators like incidents of delinquency and default and number of insolvency cases filed at a regional level will enable them to measure the prevalence of over-indebtedness and take corrective action.

Feedback mechanisms and validation strategies are essential to improve this framework iteratively. For this, the RBI must conduct qualitative and thematic reviews at regular intervals based on the warning signals received from the framework. The data currently collected by the RBI from FSPs are inadequate to implement the proposed framework and changes are required in statutory reporting formats to capture all the necessary data. For capturing some of the indicators, changes in legislation are needed, while FSPs must make changes to their Core Banking Solutions (CBSs) and Loan Management Systems (LMSs). In Dvara Research's policy brief titled '*A Framework for Detecting Over-indebtedness and Monitoring Indian Credit Markets*', a pathway for the regulator and providers to implement this framework in a phased manner is chalked out (**Table 4**). Successfully implementing this framework shall enable the regulator to achieve the twin goals of customer protection and financial stability through effective monitoring of credit markets and early identification of distress (Bhattacharya, Neelam, & George, 2021).

Figure 2: Framework for Credit Market Monitoring and Detecting Over-indebtedness



Source: Detecting Over-Indebtedness while Monitoring Credit Markets in India, Dvara Research Report

$$\textbf{Debt Service Capacity Ratio} = \frac{\textbf{Income of the Borrower} - \textbf{Expenditure of the Borrower}}{\textbf{Repayment obligation of the Borrower}}$$

Table 4: Transition Pathway to the Proposed Framework

Chronology	The RBI Must:	Priority	Ease
Phase-1	Record fresh disbursements at a district level from all providers	Very High	High
	Redesign BSR-1B format in the lines of BSR-1A format	Very High	High
	Collect data in a manner that allows for combined analysis of various parameters, like geography of disbursement, type of credit, etc.	Very High	High
Phase-2	Propose a standard approach for the calculation of debt serviceability (for reporting purposes only)	Very High	Moderate
	Collect data on debt serviceability of borrowers at District Level	Very High	High
	Commission subject-specific surveys, akin to FCA surveys	Very High	High
Phase-3	Develop a uniform definition of OI in India	High	Moderate
	Operationalise the Framework	Very High	Moderate
	Collect data points mentioned in the Framework	Very High	Moderate
	Aggregate data thus collected under the Framework	Very High	Moderate
Phase-4	Design and deploy an algorithm to detect patterns of localised overheating in credit markets and under-supply of credit	High	Low
	Commission sample surveys for validation of results and the algorithm	High	High

Source: A Framework for Detecting Over-indebtedness and Monitoring Indian Credit Markets, Dvara Research Policy Brief

While the framework and pathway proposed in the report are good starting points, they are not exhaustive. The RBI, as India's credit market supervisor, can do more to monitor the credit market.

Further, there are multiple additional indicators, like the age, gender of the borrower, and non-interest income per customer, among others, that can be further added to the list of indicators being reported to the RBI. Similarly, additional sources of data may be leveraged to further shed light on the status and evolution of the market.

For example, CGAP, as part of its market monitoring toolkit, has demonstrated the usefulness of social media monitoring[25] to identify different forms of borrower distress, including over-indebtedness, in different jurisdictions, such as Portugal and Ireland, among others.[26] Since social media monitoring may not be exhaustive due to its methodological and practical limitations, other complementary mechanisms can also be explored to hear the voices of customers and to enable the prevention and alleviation of various forms of distress (Duflos, Venkatesan, Neelam, & Stanley, 2021). CGAP's toolkit also illustrates the efficacy of other market monitoring tools, such as phone surveys[27] and analysis of granular market-level data[28] through case studies in Kenya[29] and Tanzania[30] respectively. The supervisor can use a combination of these tools to gather periodic data on credit-related issues focused on customer experiences without relying on information submitted by providers.

But across the board, from policymakers and regulators to providers, there is a need for customer protection to move beyond mere enforcement of rules and regulations and include monitoring, supervising, and enforcing actions related to customer outcomes. This outcomes-based approach will consider the experiences and results of customers' access to and usage of financial services, which are consequences of an FSPs' products, delivery, conduct, and practices. CGAP has designed and tested this approach in South Africa in partnership with regulators, providers, customer representatives, and other stakeholders.[31] Deploying such an approach will require a partnership between all the stakeholders, including customers, to first decide on the indicators that must be measured and to then find ways to measure them. The set of indicators should be exhaustive, ideally include both qualitative and quantitative measures, and help the authorities evaluate the experiences and outcomes of customers at different stages in their journey with the FSPs. In the context of credit, deploying such an approach to measure borrower outcomes can help the authorities get a more forward-looking view of the experiences and results of different segments of borrowers using various credit products.

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[25] Social media monitoring, Market Monitoring Toolkit by CGAP (February 2022); Accessible at: https://www.cgap.org/research/publication/market-monitoring-tool-social-media-monitoring

[26] Social media monitoring by Central Bank of Ireland, Country Case, Market Monitoring Toolkit by CGAP (February 2022); Accessible at: https://www.cgap.org/research/publication/market-monitoring-ireland-country-case

[27] Phone surveys, Market Monitoring Toolkit by CGAP (February 2022); Accessible at: https://www.cgap.org/research/publication/market-monitoring-tool-phone-surveys

[28] Analysis of regulatory reports, Market Monitoring Toolkit by CGAP (February 2022); Accessible at: https://www.cgap.org/research/publication/market-monitoring-tool-analysis-regulatory-reports

[29] Phone survey in Kenya, Country Case, Market Monitoring Toolkit by CGAP (February 2022); Accessible at: https://www.cgap.org/research/publication/market-monitoring-kenya-country-case

[30] Analysis of regulatory reports in Tanzania, Country Case, Market Monitoring Toolkit by CGAP (February 2022); Accessible at: https://www.cgap.org/research/publication/market-monitoring-tanzania-country-case

[31] Customer Outcomes-Based Approach to Consumer Protection: A Guide to Measuring Outcomes, Reading Deck by CGAP (June 2022); Accessible at: https://www.cgap.org/research/reading-deck/customer-outcomes-based-approach-consumer-protection-guide-measuring-outcomes#:~:text=According%20to%20CGAP%2C%20a%20%E2%80%9Ccustomer,delivery%2C%20conduct%2C%20and%20practices.

3.3 Emerging Challenges: Digital Lending and Over-indebtedness

In addition to monitoring traditional credit markets and lending models, there are also emerging challenges for regulators to monitor a new form of lending, i.e., digital lending. Digital lending has grown exponentially in recent years with higher penetration of digital financial services, aided by increased accessibility of smartphones and internet data. While this has deepened financial inclusion in many regions hitherto suffering from high levels of financial exclusion and low levels of digital and financial literacy, it has also brought along with it many challenges, including increasing cases of fraud, concerns related to data privacy, and high levels of over-indebtedness among borrowers. CGAP's studies in countries such as Kenya, Tanzania, and Ivory Coast have shown more than half the respondents to be over-indebted, and several of them incurring defaults and cutting down on their food intake to protect their credit score (Duflos, Venkatesan, Neelam, & Stanley, 2021).

Digital lending has also picked up drastically in India, especially after COVID-19. While the share of digital loans in the total loans lent by banks increased from 1.5 per cent to 6 per cent between 2017 and 2020, the rise was even steeper for NBFCs, from just 0.7 per cent in 2017 to 53 per cent in 2020.[32] As per CGAP's estimates, there are over 150 digital lending applications active in India that are run directly by NBFCs, or by fintech companies in partnership with NBFCs, or by unregulated digital lenders using the digital medium to lend their own funds. In their analysis of customer complaints and feedback on Twitter and Google Play Store, CGAP identified aggressive debt collection practices, instances of fraud, misuse of personal data for debt shaming, and lack of proper and accessible grievance redress channels as some of the outstanding concerns expressed by borrowers (Duflos, Collins, Venkatesan, & Izaguirre, 2021). While these concerns were reiterated by practitioners and researchers in the workshop that Dvara Research organized on Emerging Customer Risks in Digital Lending, they also outlined other concerns like risks emerging from a highly modularized lending model, information asymmetry about the terms and conditions at the time of loan origination, lack of knowledge about implications of late payments and defaults on the credit score, opacity of creditworthiness assessments undertaken by digital lenders, and instances of borrowers falling into debt trap or suffering from over-indebtedness because of lack of suitability assessments (Dvara Research, 2021).

These concerns around digital lending are bound to complicate the process of monitoring the Indian credit market. Modularization has introduced many unregulated entities at various layers of the lending chain, and it will be an added challenge for the regulator to have visibility over them without imposing a standardized set of regulations. Some fintech companies are already using innovative ways to collect soft information on borrowers, like their GST returns and invoices to track their repayment capacities not only during loan origination but throughout the loan tenure. But the regulator must encourage all digital lenders to improve their risk assessment strategies while developing its own internal capacity to analyse the same at a broader level.

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[32] Outlook India (December 2021), "Digital Lending In India: More Than 60% Loans Came From NBFCs"; Accessible at: https://www.outlookindia.com/website/story/business-news-digital-lending-in-india-more-than-60-loans-came-from-nbfcs/405252

4. Alleviating Debt Distress

This theme deals with the question of how debt distress can be mitigated or alleviated once it has been identified and the role regulators, providers and borrowers can play to tackle debt distress. The role and impact of each stakeholder differ depending on the nature and cause of debt distress. Starting with the individual or household level, a borrower must have access to debt counselling services and must be empowered to seek refuge under a personal insolvency and bankruptcy regime, if they so desire. They must have the necessary tools in place in the form of a well-designed statutory mechanism for modifying or discharging their debt obligations. However, functional and modern personal insolvency regimes are often not present in EMDEs.

Providers, on the other hand, should be able to intervene within the bounds of the credit contract and offer resolution for their customers once debt distress has been identified. Assuming that providers know and understand the needs and circumstances of their customers, they should be able to reorganize the debt contract in a manner that suits both parties involved. This includes restructuring debt by extending the tenure of loan, providing grace period on the repayment of loans, etc. Additionally, providers can also invoke the provisions under the personal insolvency and bankruptcy regime, and offer debt counselling services to the borrower.

Finally, in the event of a system-wide shock, such as the COVID-19 pandemic or the microcredit crises in countries like Bolivia, Bosnia and Herzegovina, and Nicaragua pertaining to multiple borrowing and high levels of indebtedness,[33] providers are ill-suited to address large-scale distress prevalent among borrowers. In such instances, regulators need to play a prominent role by introducing policy-level interventions in a timely manner. The design of such policies is critical to ensure that they meet the

[33] Regulatory options to curb debt stress, CGAP Focus Note, Gabriel Davel, 2013; Accessible at: https://www.cgap.org/sites/default/files/Focus-Note-Regulatory-Options-to-Curb-Debt-Stress-Mar-2013.pdf

targeted dual objectives of systemic stability and minimizing borrower distress. This section outlines the steps that borrowers, lenders and regulators can take to alleviate debt distress.

4.1 Borrower-level intervention

The ability of low-income households to manage risks and shocks, either idiosyncratic risks like personal accident, hospitalization and business failure, or systematic risks like drought and pandemic- remains extremely poor. A statutory mechanism for the restructuring or discharge of debt is a crucial instrument through which borrowers can seek refuge.

In India, the Insolvency and Bankruptcy Code, 2016 (IBC) outlined formal mechanisms that can play a crucial role in helping borrowers alleviate their debt distress. With the IBC, insolvency resolution of debtors can happen in a time-bound manner and give certainty of process, time and outcome to all parties concerned. The purpose of IBC is to consolidate and amend the laws relating to reorganization and insolvency resolution of corporate persons, partnership firms and individuals in a time-bound manner for maximization of value of assets of such persons with a stated objective *"to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders".* However, presently, the IBC has only been notified[34] for corporate borrowers and individual guarantors of corporate debt. There is thus a clear and urgent need for the operationalization of the remaining sections of Part-III of the IBC, which deals with insolvency resolution and bankruptcy for individuals (as well as partnership and proprietorship).

In the Indian context, the insolvency and bankruptcy processes are not independent of each other (Bhattacharya & Ananth, 2021). The borrower is required to file for an insolvency resolution process before getting an opportunity to discharge their debt through the bankruptcy process. The IBC introduces protections that prevent the insolvency-related liquidation of an unencumbered dwelling unit and other assets for sustenance and maintenance of the profession. Further, for individuals with low income (less than INR 60,000 [~770 USD] annually), few assets (worth less than INR 20,000 [~257 USD]) and without homeownership, the IBC provides for a Fresh Start Process, whereunder debt up to INR 35,000 [~450 USD] may be discharged without any impounding of assets. Alongside rescuing borrowers from debt distress, the IBC provides the unique feature of debt rehabilitation, whereby the borrower is able to restart their credit lives once the distress passes.

In spite of these provisions, estimates suggest that only 7 out of every 100 households qualify under the debt ceiling proposed in the Fresh Start Process (Bhattacharya, 2020). Moreover, the income criterion of INR 60,000 [~770 USD] is severely restrictive (by cross verifying it with various poverty level and minimum wage threshold) in the case of Fresh Start Process, leading to potential exclusion. It is, therefore, important for the government to articulate who its target audience is for the Fresh Start Process. A closer examination of the process highlights the need for redesigning few aspects of the policy to ensure that the process is capable of safeguarding borrowers through a more inclusive set of criteria.

[34] In India, a statute passed by the legislature remains on the books, but is not operational unless it is *notified* to be such by the executive/government.

When comparing the provisions of bankruptcy and the Fresh Start Process, key loopholes in the design of the Fresh Start Process are further revealed. First, the quantum of asset protection under the bankruptcy process (personal jewellery up to INR 1,00,000 [1,260 USD], unencumbered single dwelling unit with a value of INR 20,00,000 [25,180 USD] in urban areas and INR 10,00,000 [12,590 USD] in rural areas) is greater[35] than that of the Fresh Start Process (INR 20,000 [252 USD]). Further, under the bankruptcy process, all assets that are essential for the profession of the debtor will be protected.. While the cost of applying for Fresh Start Process is lower compared to applying for bankruptcy (INR 1000 [~USD 13] versus INR 2000 [~USD 27]), the applicant may get a larger debt discharge under the bankruptcy process by incurring the additional costs. Thus, the promised benefits of the Fresh Start Process tend to dilute upon closer scrutiny of remedies available under the IBC.

A comparison of India's IBC with the insolvency and bankruptcy regime of other advanced economies highlights key differences. Firstly, in jurisdictions such as the UK, Canada, Singapore and Australia, the borrower can file for insolvency or bankruptcy once they default on a loan and are therefore not required to go through an expensive insolvency resolution process. Similarly, under UK's Debt Relief Order (DRO), which is comparable to India's Fresh Start Process, the eligibility criteria in terms of income limits and outstanding debt are much greater, effectively covering more than half of the indebted households in the UK. UK's DRO also accounts for disposable income therefore determining the eligibility based on the debt repayment capacity of borrowers rather than absolute levels of income, as is the case in India.

Given this context, there is a need to strengthen the design of India's IBC by reviewing lessons from other economies. In spite of its weaknesses, the IBC puts in place a mechanism that relies on the interaction between creditors and borrowers (i.e., a market-based mechanism) and therefore is a useful and empowering tool for borrowers to alleviate their debt distress.

In addition to the tools offered by the personal insolvency and bankruptcy regime, borrowers must also have access to debt counselling services. Debt counselling can be defined as counselling that explores the possibility of repaying debts outside bankruptcy and educates the debtor about credit, budgeting and financial management.[36] Debt counselling often involves discussions with creditors to establish a debt management plan so that the credit contract can be reworked. In India, there is no institutional body that systematically provides debt counselling services to its citizens. Other countries, such as the United States, for instance, have mandated taking up credit counselling for a consumer[37] filing for bankruptcy under the Bankruptcy Abuse Prevention and Consumer Protection

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[35] The quantum of asset protection applies only to natural persons guaranteeing corporate debt. For other categories of natural persons, IBC is yet to come into force. Thus, these numbers are used as proxies, rather than precise figures associated with the legislatively mandated remedy. This observation is applicable to the next few segments where the application fee and other administrative details are discussed.
[36] Financial Literacy and Credit Counselling Centres, RBI Draft Report, 2008. Accessible Here: https://www.rbi.org.in/scripts/PublicationDraftReports.aspx?ID=526#annexII
[37] The words "customer" and "consumer" are used interchangeably, given the different nomenclature followed by different jurisdictions and authors.

Act of 2005. Countries such as the UK, Canada and Malaysia on the other hand have set up agencies that offer credit counselling services including loan restructuring, budgeting and money management advice to individuals.

4.2 Provider-level intervention

In case of an idiosyncratic shock faced by the borrower, providers should be able to intervene within the bounds of the credit contract and provide resolution for their customers once debt distress has been identified. Assuming that providers know and understand the needs and circumstances of their customers, it would be prudent to place the onus on the providers to identify borrowers facing debt distress and offer a customized solution. Providers should be able to reorganize the debt contract in a manner that suits both the parties involved. This includes restructuring debt by extending the tenure of loan, providing grace period on the repayment of loan, reducing the interest rate on the loan, etc. Providers can also offer the option of refinancing loans. Refinancing in this context refers to a process wherein the borrower has the option to transfer their total outstanding loan from one provider to another. This usually happens when the new provider offers more favourable terms and conditions on the loan outstanding, typically in the form of reduced interest rates, thus lowering the overall debt burden of the individual. Additionally, providers can also offer debt counselling services to the borrower and as a last resort can invoke the provisions under the personal insolvency and bankruptcy regime.

Restructuring and refinancing of loans are beneficial from a borrower's perspective, as it offers them greater flexibility on their debt repayment obligations and helps them ease their liquidity constraints. It also helps lenders realize a greater recovery rate on the loan than what they might have recovered in the absence of restructuring. On the other hand, restructuring of loans in the event of an idiosyncratic shock faced by a borrower results in a change in the status of the loan and a reduction in the credit score of the borrower, hence impacting the borrower's credit worthiness in at least the short and medium term. For providers, restructuring comes with regulatory constraints in terms of downgrade in account classification and associated capital costs. It also requires additional time and cost in ascertaining whether the borrower is indeed under stress or whether they have strategically defaulted.

On the other hand, instances of systemic shock such as the one presented by the COVID-19 pandemic requires prominent support from the regulator, as providers without any regulatory support are ill-suited to manage large-scale distress prevalent among borrowers. Given this backdrop, providers were permitted by the regulators in more than 100 countries to restructure borrowers' debt, thereby enabling FSPs to offer their customers flexible terms on the loan contracts without changing the status of loans from 'standard' to a 'default' or a 'non-performing loan' (unlike in normal times, when restructuring in loan account leads to a change in the status of the loan). Restructuring essentially enabled borrowers to reschedule their loan payment, or get a limited holiday period, or lower interest rates on their existing loans, based on mutual agreement with the banks.

The pandemic posed a unique situation for lenders as different sectors and geographies were affected differently. In a fast-changing ecosystem where regulators periodically announced policy measures to ease the financial system and reduce financial distress among borrowers, lenders were required to manage their balance sheets while also complying with the regulatory mandates, announced during COVID-19 in letter and spirit.

In India, the RBI permitted providers to offer debt restructuring in two windows. The first one was announced following the end of debt moratorium during wave 1 of COVID-19, while the second round of the loan-restructuring window was announced during wave 2 of COVID-19. The original window lasted for four months, and lenders restructured only 0.9 per cent of their outstanding debt. India's GDP shrunk by 7.3 per cent during the financial year 2020-2021, yet the value of restructured loans remained at less than 1 per cent. This brings into question the efficacy of the debt restructuring framework. According to media reports, customer apprehension and stigma relating to restructuring, fear that restructuring will impede future availability of funds, and steady economic recovery, were some of the reasons for low demand for restructuring among individual borrowers.[38] The fact that loan restructuring during the pandemic period did not affect the loan status does not seem to have provided lenders with enough incentive to offer restructuring for its borrower at a large scale.

For lenders to effectively manage borrower distress, it is important to be guided by principles that can help in designing effective tools to tackle debt distress. This section discusses these general principles in the context of provider-led tools (Bhattacharya, 2021) (Rhyne, 2020).

- While providing debt distress solutions, lenders can templatize decision making, since it is impractical for the lender to offer infinitely customizable solutions to their borrowers primarily because customization will be cost-intensive. The components of such a matrix can include features like disposable income of the borrower, debt serviceability ratios (pre and post restructuring), type of credit facilities (secured/unsecured), etc. Conversely, the regulator, may issue such a matrix as part of a guiding-principle document, while allowing the lender to make suitable customizations on a case-by-case basis. This principle is not only followed by international regulators but has also been echoed by the Indian parliament in the recent amendment to the Insolvency and Bankruptcy Code 2016, where it offered a pre-packaged solution for smaller enterprises. These approaches will also enable the RBI to effectively monitor the activities in the credit market, and at the same time audit entities to measure their adherence to the templates' letter and spirit.
- All lenders must ensure that the decision on whether to offer customers a remedy align with their best interest. Lenders must account for all the debts of the borrower and his/her disposable income (not total income) to arrive at a solution that is in the best interest of the customer. Further, it is possible that in certain cases, borrowers may need additional credit to

[38] The concerns that kept moratorium and restructuring requests down. Accessible here: https://www.business-standard.com/article/finance/the-concerns-that-kept-moratorium-and-restructuring-requests-down-121010501389_1.html

resume economic activity. In such cases, the lenders should be allowed to extend fresh credit as part of the restructuring plan.

- Lenders should follow uniform, universal and robust conduct guidelines designed to ensure that lenders' actions remain in the best interest of the customer.
- Providers should proactively communicate with their customers and should inform them about the various options available to manage debt distress with the objective of ensuring that borrowers understand the terms and conditions of each of the available options. Communication should be clear, consistent, and easy to understand.

In the context of a system-wide crisis such as the COVID-19 pandemic, in addition to the above-mentioned principles, FSPs should consider the following:

- Evaluate the impact of an economic shock on different sectors and its expected recovery trajectory while deciding on the eligibility of the borrower for any restructuring. For example, the RBI's Kamath Committee (2020), acknowledges that "*Impact of COVID-19 is pervasive across several sectors but with varying severity – mild, moderate, and severe*". In this context, the committee proposes "*simplified restructuring for mild and moderate stress"*, whereas, *"comprehensive restructuring*" for severe stress cases.
- Offer various debt relief measures as announced by the regulators broadly and easily so as to reach eligible borrowers at scale, depending on the scale of the economic shock.
- Seek clarity around credit bureau treatment given the lack of clarity on recording requirements of loan repayment data during the moratorium period. Providers should ensure that customers are not treated unfairly based on whether they availed moratorium, restructuring or other debt relief measures and should not be penalized through their credit scores.
- Extend fresh credit to households from low-income and vulnerable communities. Underwriting can be done based on past and expected business performance for those running enterprises and social capital can take precedence over collateral-based lending, so that formal financial institutions can help these segments recover.

4.3 Regulator-level intervention

In times of a system-wide crisis like the one presented by COVID-19, the regulator's role gains paramount importance in both protecting customer's interest and ensuring financial stability of the system. For example, in countries like Nicaragua and India between 2009 and 2010, there were widespread reports of multiple borrowing and over-indebtedness and growing protests from borrowers pertaining to harsh collection practices and high interest rates. The issue became increasingly politicized, leading to an erosion of the repayment culture and eventually a huge setback for the microcredit sector with repayment rates dropping drastically. In both these countries, the regulator mandated certain guidelines pertaining to lending limits, interest rate caps, among others to contain the damage caused by the crisis. However, it is argued that regulators must implement

appropriate monitoring mechanisms to identify stress at an early stage in the credit market, thereby avoiding risks to financial markets and customers.[39]

In the context of the COVID-19 pandemic, given the economic shock and the resultant impact on the financial lives of millions of households, regulators globally announced a series of policy measures to ease debt distress among borrowers that had unique implications for both borrowers and lenders. According to CGAP, financial regulators in at least 115 countries in March and April 2020 issued special permission to FSPs to provide moratorium and other debt restructuring solutions to their customers. This section discusses the efficacy of debt moratorium as one of the most widely adopted policy tools globally, with the objective of understanding its efficacy as well as its implications for both consumers and lenders.

4.3.1 COVID-19 and Debt Moratorium

During the COVID-19 pandemic, regulators from several countries across the world permitted financial institutions to provide their borrowers with a debt moratorium on repayment of their loans. Regulators were confronted with questions around the design of the moratorium policy in terms of its duration, cost, and the modalities of such a moratorium. Broadly, debt moratorium helped regulators achieve their short-term objective, that of easing liquidity constraints for borrowers and protecting FSPs' balance sheet from deteriorating.

In the Indian context, debt moratorium was widely adopted by lenders and in most cases, lenders applied a blanket moratorium for their customers with an option of opting out of moratorium should they choose to do so. According to the Financial Stability Report released by the RBI, as on April 30, 2020, 49 per cent of customers across all lending institutions accounting for 50 per cent of the total outstanding loans opted-in to avail the moratorium. However, given the speed with which regulatory solutions had to be announced and the scale at which moratorium was deployed, several aspects of its design and delivery were less than optimal from the perspective of both borrowers and lenders.

First, the guidelines pertaining to moratorium were not communicated clearly with the borrowers. Moreover, the regulators did not play an active role in directly communicating with the borrowers, nor did they provide any guidelines for FSPs about the manner in which the terms and conditions of the moratorium had to be disseminated. There is suggestive evidence that customers did not fully understand the terms and conditions of debt moratorium, and more importantly did not recognize the cost associated with opting in for a moratorium. Second, regulators failed to recognize the implications arising from the cost associated with the moratorium in a timely manner and assumed borrowers to bear the burden. This led to uncertainty in the minds of consumers about the benefits of opting in for a moratorium, thereby reducing its efficacy. Eventually, the Supreme Court of India, required the Government to bear the additional interest cost. Third, providers, especially NBFCs, faced

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[39] Regulatory options to curb debt stress, CGAP Focus Note, Gabriel Davel, 2013; Accessible at: https://www.cgap.org/sites/default/files/Focus-Note-Regulatory-Options-to-Curb-Debt-Stress-Mar-2013.pdf

difficulties in servicing their outstanding debt (from banks, market, etc.) since they were mandated to provide moratorium to their borrowers, whereas their creditors had no such mandate. This imposed a significant burden on institutions that were not carrying sufficient liquidity to cover the repayments. Therefore, a lack of end-to-end liquidity transmission led to challenges in implementing the moratorium by lenders (Bhattacharya, Dasgupta, & Sharma, 2020).[40]

A research report by CGAP on the lessons from deploying debt moratorium in Uganda, India and Peru highlight similar findings in terms of limitations in the design and delivery of the moratorium. On the one hand, FSPs faced challenges in communicating with their clients to ensure that consumers understood their rights and made an informed choice about moratorium. Moreover, FSPs that did not use digital systems for client communication, transactions and customer management, struggled to manage their business operations, during the lockdown. On the other hand, regulators left much to be desired, given the lack of clarity in guidelines around communication with customers, costs of moratorium, and reporting to credit bureaus, potentially reducing the efficacy of moratorium.

4.4 Guiding principles to tackle debt distress

Finally, we lay out the following principles that regulators must be guided by when implementing policies to tackle debt distress (Rhyne, 2020) (Bhattacharya, 2021) (Rhyne & Duflos, 2021) (Bhattacharya, Dasgupta, & Sharma, 2020).

- **Continuity of regulation**: It is important for regulators to set in place policies that help borrowers and lenders navigate different stages of a system-wide economic shock. It is not sufficient to just announce measures that provide quick and short-term relief–it is also key to implement policy measures both in the immediate aftermath of a shock as well as once the shock event has passed away. In the India context, regulators deployed debt moratorium in the first phase of the pandemic, while announcing measures relating to restructuring of debt in the second phase. Once the temporary measures announced by the regulators have lapsed, lenders and borrowers should be able to use traditional mechanisms that exist during the normal course of business, such as the IBC, under which the borrower may seek refuge.

- **Clarity of regulation and proactive communication**: In addition to continuity of regulations, the regulations must be designed and conveyed to all stakeholders with utmost clarity, as lack of clarity could have implications for lender's and borrower's decisions and potentially lead to adverse outcomes. For instance, CGAP's research found that several clients were unaware of or unable to access relief that was intended for them. Therefore, policymakers and regulators should be responsible for informing the citizens about available debt relief measures and should create channels for people to raise their questions, complaints, or concerns. Regulators should aim to communicate directly with the consumers through the use of mass media tools

[40] Refer to Annexure 2 for key takeaways that emerged from implementing debt moratorium in the Indian microfinance sector.

for greater consumer awareness. Clear communication guidelines should also be provided by the regulators to FSPs about the modalities of various policy measures announced during the pandemic.

- **Temporal convergence:** Regulators must take into account the duration of economic disruption following a system-wide shock and the time needed for recovery from these shocks. The policy measures designed should thus have a timeline that aligns with the impact period of a shock event.

- **Equitable cost distribution:** Cost distribution of remedial measures to alleviate debt distress should be a key consideration for regulators. Given the extensive evidence on the impact of lockdown on the livelihoods of households, the financial distress it has caused, and the expensive coping strategies adopted by households, it is amply clear that COVID-19 has proved most detrimental to the financial lives of households, particularly low-income households. In the absence of access to adequate formal financial services and social security combined with factors such as volatile cashflows, the lockdown has led to a massive economic shock in the lives of low-income households. In such instance, burdening consumers with additional cost such as the accrued interest on debt moratorium can prove to be detrimental to their well-being. Similarly, in India, NBFCs were allowed to offer a debt moratorium as well as a restructuring window to its customers. However, the creditors of NBFCs were not required to do so.[41] This led to a disproportionate cost-sharing burden of the remedy on NBFCs, wherein NBFCs were forced to service their own debts despite dwindling cashflows. It is therefore important for the regulators to ensure that the cost is borne equally by all market participants in the credit ecosystem, while at the same time making special provisions for those from the vulnerable and low-income communities.

- **Incentive alignment:** Regulators must also ensure that lenders are provided with sufficient incentives to offer remedial measures such as debt moratorium or restructuring of loans. A misalignment of incentives will create an inertia on the part of lenders to offer the debt-remedial measures, as envisioned by the regulators. For example, in India, RBI allowed FSPs to offer moratorium to their customers without changing the status of loans from ‘standard’ to ‘restructured’, which proved to be a useful incentive for FSPs, since they would not have to allocate additional capital for such loans.

- **Consumer Protection:** It is important to place protecting consumers as the first and foremost objective of any policy measure designed especially in the context of a system-wide crisis. The needs of consumers especially from low-income communities should be given priority. When designing policy measures such as restructuring and debt moratorium, regulators must incorporate the following features as part of their policy response.

[41] NBFCs however received funds since banks had access to Targeted Long-Term Repo Operation (TLTRO) scheme funds to boost credit flow to the last mile in various sectors. This helped NBFCs ease their liquidity stress during the pandemic. However, the impact of TLTRO was limited since the first tranche of TLTRO did not have NBFC specific requirements, and the second tranche contained was inadequate to cover the majority of outstandings of NBFCs and their funding requirement.

- Consumers should always have the right to accept or reject a change in their loan terms, even if the change is intended to benefit them.
- No imposition or mandate must be made with regard to availing the remedial measure such as debt moratorium for example.
- Suspension of interest accrual must be considered and if not, the cost must be borne by the Government, especially for those from low-income customer segments.
- Fees or penalties should not be associated with processing restructuring or moratorium.
- Regulators should ensure that customers are treated fairly and that opting for these measures does not adversely affect the credit records of customers and their ability to obtain credit in future at standard interest rates. For example, in India, the guidelines issued by regulators on reporting to Credit Information Companies were misinterpreted by lending institutions. There was lack of clarity on recording requirements of loan repayment data during the moratorium period. Therefore, it is important for the regulators to investigate if and how opting in for moratorium effected borrower's credit worthiness and take necessary steps accordingly.
- Future discrimination against borrowers who avail these debt relief measures such as moratorium or restructuring should be strictly prohibited. Regulators must check fair treatment practices by lenders, as instances of discrimination against certain customer segments may surface.

Use of market monitoring tools to mitigate consumer risks: Market monitoring is a core component of consumer protection approaches focused on customer outcomes and financial health (Izaguirre et al., 2022).[42] Regulators and supervisors should be better equipped to mitigate consumer risks through the use of market monitoring tools. Tools specific to the debt alleviation stage can be useful in assessing the efficacy of debt relief measures for borrowers. There are both supply and demand side tools. On the supply side, analysis of regulatory data, complaints data, consumer contracts can be undertaken, while on the demand side, consumer surveys and mystery shopping can be used, among various other tools. For example, analysis of complaints data would be useful to learn about emerging risks, even while acknowledging that consumers might face barriers in accessing the complaints channel. Policymakers should also make efforts to reach out to a larger base of customers and therefore conduct consumer surveys to assess the landscape and diagnose the problems that consumers are facing. These surveys can assess how customers are doing in terms of their repayment capacity, their awareness with regards to the debt relief measures put in place by the regulators, and issues they are facing with regards to their interaction with FSPs. It will also be useful to collect data pertaining to consumer outcomes such as their ability to manage day to day finances, manage medium-term and long-term goals and their resilience to shocks. Overall, collecting information about customer's financial wellbeing can be especially useful in the context of pandemic and other such crises. Customer data should ideally be disaggregated by various segments to bring out greater nuance in the data collected.

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[42] Market Monitoring for Financial Consumer Protection. CGAP 2022. Accessible here: https://www.cgap.org/topics/collections/market-monitoring

5. Conclusion and Next Steps

This report has synthesized key learnings across the three lifecycle stages of credit, namely *Prevention of Distress*, *Identification of Distress*, and *Alleviation of Distress*. The interventions discussed under each theme range from regulatory and legislative tools that safeguard borrowers from distress or provide them with a pathway out of distress, to tools that credit providers may adopt to prevent, detect and address debt distress.

To further the discourse towards a more nuanced understanding of the issues in debt distress captured in this report, it is proposed that a convening of international experts and stakeholders such as regulators, ex-regulators, practitioners, academics, and researchers, be co-organized by Dvara Research and CGAP. The conference will focus on the three themes across the key lifecycle stages of credit, covered in this report, namely the *Prevention of Distress*, *Identification of Distress*, and *Alleviation of Distress*. The interactions between these themes, interventions proposed, and lifecycle stages of credit are diagrammatically represented in **Annexure 3**.

The proposed conference will be a platform to (i) disseminate high-quality and policy-relevant research on key themes surrounding debt distress in households, and (ii) to bridge the gap between knowledge and strategic action by practitioners and policymakers, with the **desired end outcome of improving the design and delivery of credit to minimize instances of debt distress**. In particular, the conference will serve to:

- Facilitate a rich and deep dialogue on the subject among academics, practitioners and policymakers, who bring very different perspectives and experiences to the table,
- Provide a venue for cross-border exchange of insights and best practices by facilitating dialogue between international and domestic experts, practitioners, and regulators,
- Develop a deeper understanding of the causes, symptoms, and results of debt distress, and their interactions with providers, broader financial markets, and the economy,
- Encourage multidisciplinary policy and action research to develop levers through which the prevalence of debt distress can be minimized,
- Sensitize stakeholders, including regulators and policymakers from several jurisdictions to the scope and scale of the problem surrounding debt distress, and incentivize them to adopt solutions to tackle it, and
- Sensitize (and incentivize) providers to novel approaches that detect brewing distress among their borrowers, enabling them to intervene promptly.

It is envisaged that the conversations and possible collaborations that such a conference will facilitate, can usher in a new era of customer-focussed policy and provider interventions that keep household interactions with debt at the centre of all decisioning and activities.

Annexure 1: The Outline of the Differentiated Processes for Operationalising Suitability depending on Organizational Capacity

1. **BASIC LEVEL PROCESS:** This level involves minimal investments in technology and the least amount of time spent on data collection through loan officer conversation with the loan applicant. The data collection for suitability assessment is to be carried out to a large extent by using appropriate assumptions and proxies regarding income and expense for a similar household in the geography, obtained from the lender's Location Survey. These assumptions would need to be reviewed on an annual basis to check for their validity. Some of the data that is expected to be pre-populated using assumptions is outlined below. Such an approach will provide average accuracy at loan pool level, but not necessarily at the level of individual households.

Income	• Conversation to capture the nature of income streams of household (Ex: for cultivation, the name of crop and acreage of cultivation the household engages in on a regular basis). • Pre-population of incomes for occupation types, using relevant units for measurement. (Ex: acre*crop's Minimum Support Price or MSP). • Pre-population of known seasonality of these incomes (as % increase/reduction of average monthly incomes for specific months) (Ex: September-to January is festival season in Tamil Nadu and shops have higher incomes during this period).
Expense	• Capture of minimal data points through a conversation where assumptions are not possible (Ex: cashflows of a tailoring unit): Capture of income frequency based on comfort with recall from memory by the borrower. • Pre-population of Minimum Essential Expenses for members of the household from the Monthly Per Capita Consumer Expenditure (MPCE) data for service area (State, Rural/Urban, chosen cut-offs, adjusted for inflation). • Pre-population of expenses for education of school-going children (private/public schooling), obtained from the lender's location survey. • Pre-population of known seasonality (as % increase in average monthly expenses for specific months) (Ex: Festival expenses during festival season in the region)
Debt	• Information on formal monthly debt outflows from *combo* reports (i.e., reports covering both MFI and non-MFI exposure) from credit bureaus for all adult members of the household to be fed into back-end automated decisioning for assessment (excluding members who cannot be lent to)

2. **INTERMEDIATE LEVEL PROCESS:** This level has a higher level of accuracy in assessing suitability for each sale of microcredit and requires an intuitive technology platform for a structured and streamlined data collection by trained staff. Any assumptions/ proxies used would be of a higher quality and managed by a more sophisticated data-analytics team for inputs and monitoring against field sample surveys to ensure its validity. The differences in the business process when compared to the BASIC LEVEL PROCESS are outlined below.

Income	• In addition to BASIC LEVEL, pre-population of floors and caps for income based on occupation types, with freedoms to accommodate for outlier households (anything <80% or >120% of floor and cap respectively). • More detailed conversation to capture seasonality - Month-wise recall of income flows in addition to built-in expected patterns in the BASIC LEVEL. • Seasonality to be captured/confirmed without pre-empting borrower (Lender must have knowledge of expected volatilities).
Expense	• In addition to BASIC LEVEL, pre-population of floors and caps for minimum essential expenses to limit under-reporting by the borrower, with freedoms to accommodate for outlier households (anything <80% or >120% of floor and cap respectively). • More detailed conversation for data capture: seasonality in patterns in expenses for Education, Health, Social Purposes. • Layer on non-essential expenses as a % of minimum essential expenses • Layer on an 'emergency liquid buffer' equal to Minimum Essential Expenses for a 2-month period (to tide over shocks).
Debt	• As in BASIC LEVEL, capture of repayment schedule information on existing formal loans through Combo reports from credit bureaus for all adult members of the household. This can be verified with the borrower. • Capture of self-reported and self-attested informal borrowings that have expected repayments during the tenure of the loan solicited

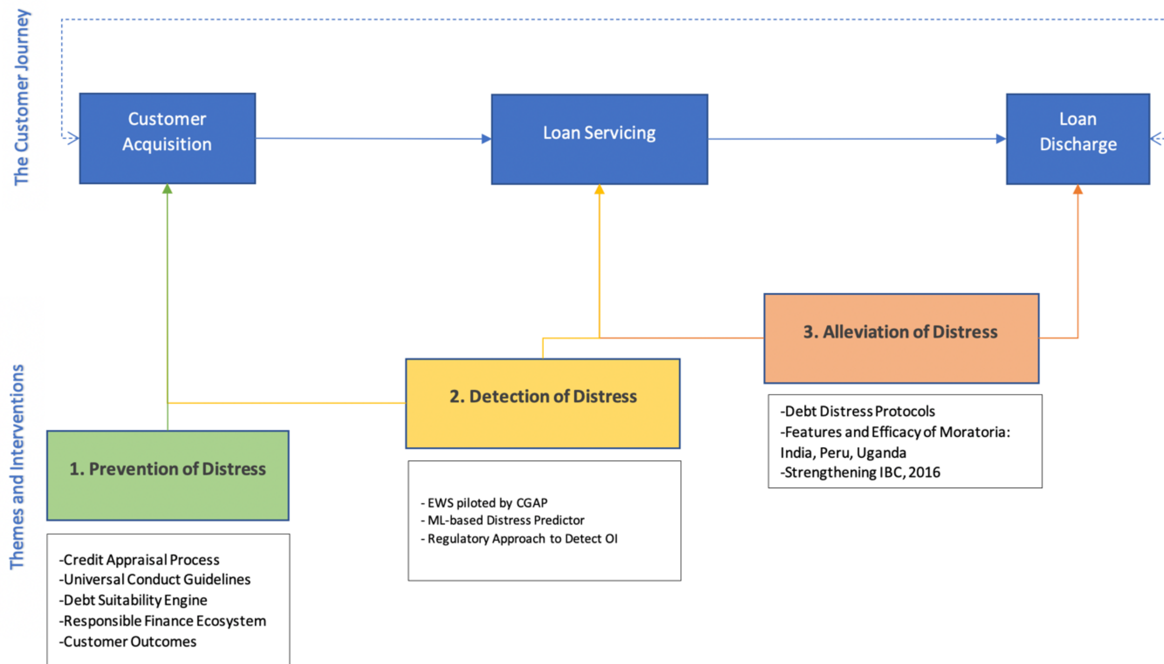
3. **ADVANCED LEVEL PROCESS:** In addition to the INTERMEDIATE level, this level requires the business process to allow for customization of loan features using an advanced technology platform. The additional features of the business process for this level are outlined below:
    a. Customization of loan features on a real-time basis through the interaction of officer with the customer using an advanced Tech Platform
    b. For cases of borderline DSR as identified through Step 3, the process should offer a separate workflow to tailor the loan features with options like different loan amounts, different repayment schedules, repayment holidays, flexible repayment moratoriums, pre-payment options, and so on. This can be extended to all cases.

Annexure 2: Key takeaways from implementing moratorium in the Indian microcredit sector

1. Debt Moratorium on formal retail loans proved to be effective in achieving its intended objective of easing liquidity constraints for the end consumer, and relaxing debt repayment requirements in times of financial distress. As on April 30, 2020, 49% of customers across all lending institutions accounting for 50% of the total outstanding loans opted-in to avail the moratorium.
2. In the case of microcredit lending institutions, close to 98% customers availed moratorium in April and roughly 70% availed moratorium in May, based on data from some of India's top MFIs, suggesting that moratorium came as a much-needed relief measure, especially for low-income households.
3. Availing moratorium while beneficial in the short run, is a costly affair in the medium to long run. The accrued interest during the moratorium period and the compounding of interest post the moratorium period can come as a huge blow to already vulnerable segments, making the repayment of their outstanding loan extremely burdensome with a risk of increase in defaults. Therefore, burdening low-income and vulnerable households with the cost of moratorium can prove to be detrimental to their well-being.
4. Moratorium was offered universally to all microcredit borrowers and those choosing to repay where considered to have opted-out of moratorium. Thus, the group model per se did not impose a barrier on collections efficiency of microcredit service providers.
5. Providers interpreted RBI's guidelines pertaining to recording of moratorium through Credit Information Companies (CICs) in different ways, thus resulting in nonreporting to CICs. Further, technical hurdles in providers' core banking systems (CBSs) and loan management systems (LMSs) in capturing the moratorium led to non-reporting to CICs. However, there was consensus about the relevance of credit bureaus and need to shift to more advanced systems in CICs.
6. Effective communication with customers was key in ensuring that expectations from moratorium were clear. Customers understood that moratorium was simply a deferment of loan repayment and not a loan waiver. The role of suitable financial advice in this context can be crucial in guiding customers to make a choice that suits their financial capacity and circumstances.
7. Simultaneously, it is important for policymakers to effectively communicate the features and terms and conditions of moratorium as well as issue clear communication guidelines for lending institutions for greater awareness on the implications of moratorium, else it could be subject to misinterpretation by different parties involved.
8. The digitization journey for microcredit service providers should be continued to be prioritized and can prove to be critical during periods of uncertainties such as COVID-19. While lending institutions have taken leaps and bounds in transitioning to digital operations, extremely low adoption of digital financial services among last mile customers continues to be a challenge.

9. End to end liquidity transmission is a must for sustainability of lending institutions. The asset-liability mismatch due to differential deployment of moratorium for end customers and microcredit providers (largely MFI-NBFCs and other NBFCs) can lead to liquidity crisis, spike in NPAs, potential downgrading of credit ratings and an increase in the cost of fresh borrowing.
10. Uniformity in approach by announcing a universal moratorium across all lending institutions helped protect consumer’s interest and increase awareness about the terms and conditions of moratorium.

Annexure 3: The Interactions between Customer Lifecycle Stages and Interventions Proposed



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