DVARA Research

A Practical Note on Operationalising Suitability in Microcredit

This Note has been prepared for regulated lending institutions who are in the business of offering small-ticket short-term unsecured loans with equated monthly or weekly repayment schedules, to low-income individuals and households in India.

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1. Background

The objectives of sustainable businesses are well-aligned with ensuring the financial health of households, and this holds true for all types of lending businesses. In the specific context of microfinance businesses of NBFC-MFIs, this translates to the business objective of avoiding over-indebtedness of borrowers because of lending to them. Since the universe of borrowers can be characterised as belonging to low-income and vulnerable or potentially vulnerable backgrounds, lending institutions need to be particularly careful in ensuring this business objective is met as a matter of business process. This is particularly so given that the history of the microfinance sector has been chequered with political risk events that have exacerbated business risk in the absence of due process that exhibited an intent by providers to prevent households from becoming over-indebted because of lending to them.

However, a more important reason for why a transition to better creditworthiness assessments that can help to prevent over-indebtedness of households is one that is closely linked to the future of the microfinance business model itself. Servicing through customer life-cycles is more sustainable than lending low ticket loans as prescribed for the NBFC-MFI licensing model and skimming geographies in search of borrowers who are not already being served by existing MFIs (and who cannot be lent to on this account).

This Note provides a set of ideas for operationalising Suitability in microcredit. These ideas can be incorporated into existing business workflows based on the level of sophistication each institution desires for itself given its unique context.

2. Current Status

NBFC-MFIs follow RBI's micro-prudential regulations that prescribe what loans can be considered as Qualifying Assets on the MFI's books. Borrowers to whom such loans are given must not have more than two such loans and not from more than two NBFC-MFIs at any point in time. There are also limits on the quantum of absolute debt, and this is to be within the RBI's prescribed cut-off of Rs.1 lakh at any point in time[2], which the MFIN, the Self-Regulatory Organisation of NBFC-MFIs, further set to a stricter limit of Rs. 80,000[3]. All these prescriptions are to be met through the mandatory reporting to credit bureaus and the use of data on loan records of borrowers from such credit bureaus. While all these prescriptions are for the individual borrower, regulations also require that such borrowers must come from households that have annual incomes below Rs.100,000 and Rs.160,000 depending on their location (rural, or semi-urban and urban, respectively). Besides this, there has been an articulated bias against giving microfinance loans for consumption purposes[4].

In the context of serving vulnerable and/or low-income households, MFIN has articulated clearly, a requirement of 'Avoiding over-indebtedness' in the 'MFIN Mutually Agreed Code of Conduct'. To comply with this requirement, member NBFC-MFIs 'need to conduct proper ***due diligence*** as per their internal credit policy to assess the ***need and repayment capacity*** of the client before making a loan

[2] Pg 4, Master Circular- 'Non-Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs) - Directions, 2016

[3] Pg 4, MFIN Mutually Agreed Code of Conduct, 2016

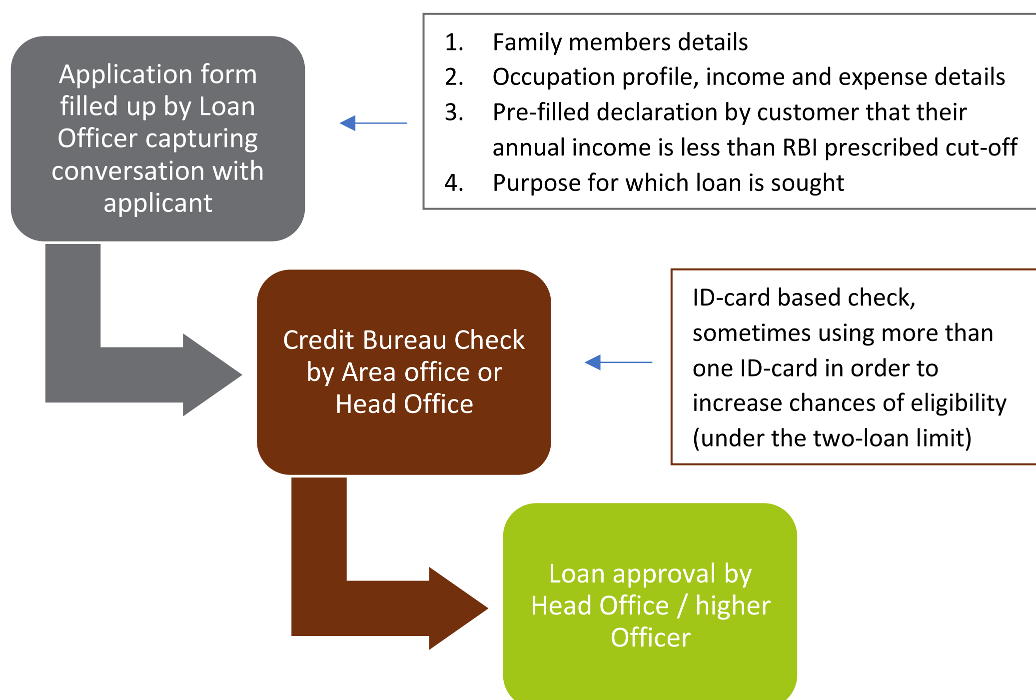
[4] "NBFC-MFIs are expected to be prudent and responsible in their lending activity besides educating their borrowers on the dangers of wasteful conspicuous consumption." Pg 14, Master Circular- 'Non-Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs) - Directions, 2016

and must only make loans commensurate with the client's ability to repay". Also, entities must have 'Internal checks (reviewed by Board) including through sampling of clients to ensure the efficacy of their processes relating to avoidance of over-indebtedness'.

While the requirements above provide a clear principle around which to build a process workflow, NBFC-MFIs have largely relied on credit bureau checks to ensure adherence to both RBI and MFIN prescriptions. One bottleneck to investing in greater efforts on this front is cost, and lenders are rightly wary of expensive data collection processes to ensure that due process has been followed for preventing over-indebtedness due to lending decisions taken.

Therefore, today, the process of pre-sale and point-of-sale assessment for credit-worthiness and for avoiding over-indebtedness can be broken down into the following main steps, over and above which various entities have introduced their own variations to suit their unique business environment.

Figure A: Current Workflow for Loan Decisioning in MFIs



However, the current regulatory prescriptions and the downstream processes adopted by NBFC-MFIs have been found to be inadequate to prevent over-indebtedness[5] among a subset of borrower households even when many households are able to make repayments comfortably.

[5] See Prathap and Khaitan (2016) for evidence

3. Operationalising Suitability in Microcredit

This Note provides a practical approach to operationalising Suitability as a process that financial institutions can incorporate into their operations to reduce and prevent instances where loan disbursements push borrower households into a state of over-indebtedness (and its consequent negative outcomes). It outlines four steps to do so:

- **Step 1**: Defining Suitability in Microcredit
- **Step 2**: Assessing Suitability at a Household level
- **Step 3**: Determining a workflow for decisioning
- **Step 4**: Setting System-level Capabilities based on Organisational Capacity

4. Step 1: Defining Suitability as a Process and Not a Customer-level Outcome from the Loan

Step 1 of the four-step process is to define what constitutes a suitable loan and what conditions would determine whether a particular offering of credit to a household is not unsuitable. Hence, we define suitability in microcredit in the following manner:

"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."

In other words, at Point-Of-Sale, the lender must conduct due diligence to ascertain the ability of the retail customer

- To meet his/her repayment obligations when they are expected to fall due (this is for both unique repayment obligations as well as the total repayment obligation under the credit arrangement),
- To meet these repayment obligations out of own income and savings without having to realise security or assets

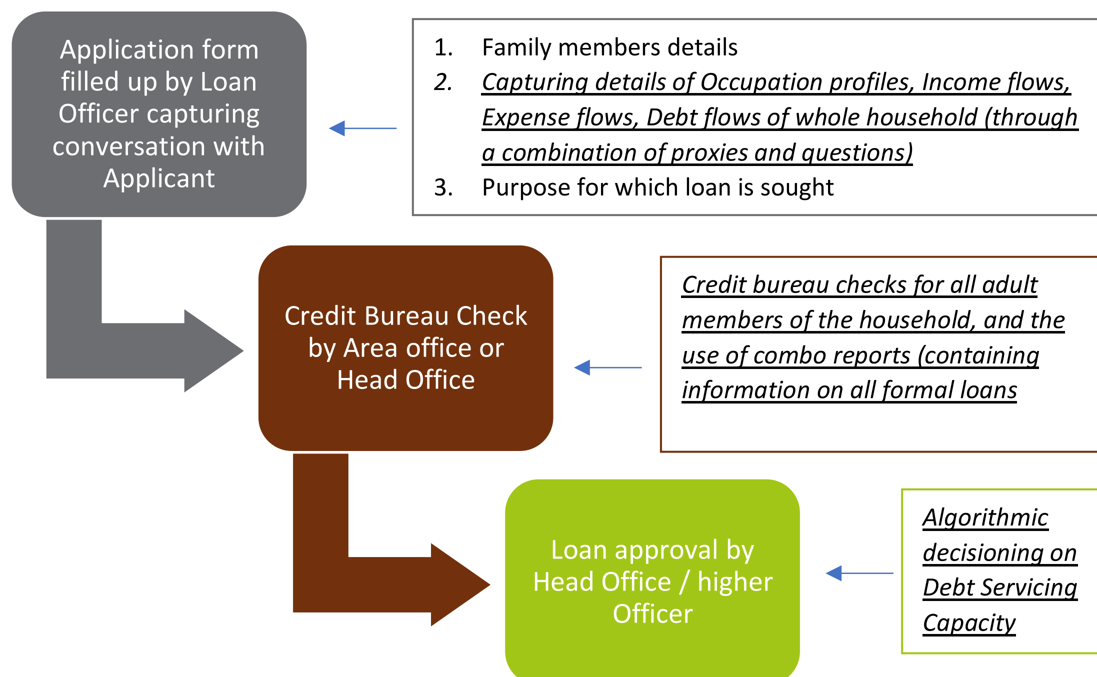
Therefore, lenders must have a point-of-sale assessment process that must reasonably ensure that because of the specific loan, customers will not find themselves in a situation where

- they have to prioritise 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. This obligation does not apply to any loans that the borrower may avail from other lending institutions further to availing this loan in question. Such loans taken downstream of this suitability assessment may or may not result in the household of the borrower experiencing over-indebtedness, and if the household does experience financial stress from such loans, it would have material implications on the borrower's ability to repay the loan in question. The suitability assessment process that this Note provides, therefore, helps lenders to meet their suitability obligation at the Point-Of-Sale of the loan in question.

Keeping the above definition of Suitability in mind, this Note proposes a modified workflow that incorporates three additional elements into the current workflow (covered in Figure A). The proposed workflow is described in Figure B.

Figure B: Proposed Workflow for Loan Decisioning in MFIs



The primary differences between the current workflow commonly followed by most NBFC-MFIs and the one proposed in this Note are as follows:

- **At the Loan Application Stage:** In the proposed workflow, occupation profiles of the family and income, expense and debt cash flows of the household are captured. This is done either by directly asking the applicant or through suitable proxies, or a combination of both.

- **At the Credit Bureau Check Stage:** The proposed workflow involves a credit bureau check for not just the loan applicant in question, but also for all other adult members of the household. Such a credit check is to be carried out using "combo reports" to get a complete picture of the total formal debt of each adult member of the household.

- **At the Loan Approval Stage:** The proposed workflow has an algorithm that uses as inputs, the information obtained in the previous two stages to calculate the current (with an existing debt of the household) and new (debt of the household including the new loan) levels of debt servicing capacity of the household and to make a decision on whether to approve the loan in question.

5. Step 2: Assessing Suitability at a Household Level rather than at the Borrower Level

Suitability is to be assessed not for the loan applicant in isolation but for the applicant's household. This, therefore, requires an understanding of the ability to make repayments at the level of the household and building a picture of the household's formal and informal debt and its repayment capacity.

Box A: Household-level Assessment of Indebtedness

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 cashflows 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"[6]. Measuring cashflows at a household level, therefore, provides a more realistic picture of the household's financial conditions[7]. When over-indebtedness is measured at a household level rather than at an individual level, the incidence of over-indebtedness is lower[8]. Indeed, RBI regulations applicable to NBFC-MFIs places an annual household income cap for borrowers to become eligible for microcredit.

Cashflow Picture: A cashflow assessment of the household captures cashflows relating to three components – Income, Expenditure and Debt. Table A below presents how we propose that these cashflows be captured at point-of-sale.

TABLE A: Month-wise Financial Flows of the Borrower Household			
	Nature of data capture	**The lever in assessment controlled by the Lending Institution**	**Source of data**
A. Month-wise Picture of Household Cashflows (excludes DEBT in & outflows)			
Month-wise Income across 12 months	• Data to build an 'Expected Pattern' of levels, seasonality and volatility in known income sources of the household, including remittance income, social security payments and pensions.	• An approximation to capture important income streams • A decision on dropping minor income streams that have no	Proxies/ Questions/ Combination of both

[6] Over indebtedness in Britain: A DTI report on the MORI Financial Services Survey (2004)

[7] In Europe, a study by the European Commission titled "Towards a common operational Definition of Over-indebtedness" suggested that "*the unit of measurement should be the household because the incomes of individuals are usually pooled within the same household". (*'Towards a Common Operational European Definition of Over-indebtedness' (2008), a Study by the European Commission)

[8] Drivers of Over-Indebtedness (2008), Report submitted to Dept of Business, Enterprise and Regulatory Reform, by Center for Policy Evaluation, University of Nottingham

	• Incomes captured must generally be gross of interest expense, but net of operating expenses for the income-earning activity	material impact on the overall picture[9] • Refinement for seasonality	
Month-wise Expense across 12 months	• Data to build an 'Expected Pattern of levels, in minimum essential expenses (these generally exhibit sticky/inelastic nature, irrespective of income volatilities) – these include for food, rent, electricity; and are fairly uniform across households of same socio-economic, cultural and geographic boundaries. • Data to build an 'Expected Pattern of levels, (seasonality and volatility in unique essential expenditures, such as on education, health and social purposes.	• An approximation to capture critical expenses • An approximation to capture non-critical expenses • A decision on dropping minor non-recurring expenses	Proxies/ Questions/ Combination of both
B. Month-wise Picture of Existing Household Debt-related In & Outflows			
Month-wise Debt Inflow across 12 months	'Expected' loans the household will receive will go into the cashflow pool and may or may not result in immediate increases in income. Larger the loan, more likely it is to be used for multiple purposes	An approximation to capture inflows from 'expected' loans such as crop loans	Information from Credit Bureau Checks for all adult members of the household (combo report); supplemented by questions
Month-wise Debt Outflow across 12 months	On existing formal loans combined with self-reported and self-attested informal borrowings	An approximation to capture outflows for 'expected' loans such as crop loans	Information from Credit Bureau Checks for all adult members of the household (combo report); supplemented by questions

Tenure: Cashflow assessment is to be carried out for a period that can reasonably be expected to repeat itself (a year in this context, as seasonality is typically a yearly phenomenon[10]). The cashflow assessment is to be carried out for each period that is demarcated by an expected repayment

[9] For instance, income such as one-off income from sale of timber from tree within household's premises, can be considered immaterial for the calculations even if it has high recall for the borrower

[10] An exception may be cash flows associate with crops such as sugarcane, cash crops such as coconut, cashew, and so on

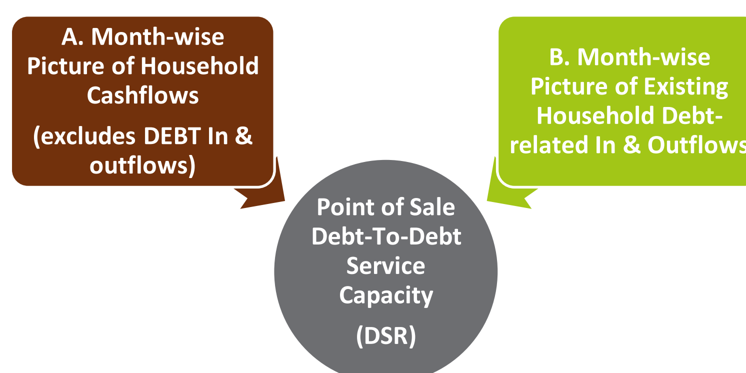
instalment for the loan in question, i.e.; weekly or monthly (for EWI / EMI type repayment schedules). In this Note, we choose to carry out cashflow assessments with a monthly cadence.

Seasonality and Volatility in Cashflows: Examples of such patterns across income, expenditure and debt are given below. While some seasonality can be considered predictable and therefore can be built into assessment models, some forms of volatility are unpredictable and cannot be planned for by the household. While due consideration is given to the former, the latter is managed through emergency liquidity buffers and insurance for income-earning assets.

	Seasonality (Expected)	Volatility and Non-recurring Shocks (Unexpected)
Income	• Cropping cycles such as Rabi and Kharif • Highest sales of inventory just before regional festivals	• Cyclones, floods, earthquakes • Unknown pest attacks • Accidents such as fire, poisoning • Death of income-earner
Expenditure	• School fees in June • Festival expenses for predominant regional festivals (October/November for Diwali, January for Pongal)	• Medical expenses for health shocks, critical illnesses • Marriage expenses • Emergency house repairs
Debt	• Crop loans at the beginning of each cropping cycle • Working capital loans to stock up inventory before festival sales	• Emergency borrowings to tide over expense shocks above

An assessment of the household's expected income and expense flows would provide an understanding of the overall debt-servicing capacity of the household. Assessing the current and expected debt inflows and outflows would provide an idea of how much of the household's debt-servicing capacity is already utilised at the point-of-sale of a micro-credit product. Taking the three components together for each month over 12 months, namely the cash inflows and outflow in relation to income, expenses and debt, we arrive at the Point-of-Sale Debt Service Capacity of the household, measured by the Debt-To-Debt Service Capacity (DSR).

Figure C: ***Point of Sale Debt-to-Debt Service Capacity Indicator (DSR)***



For each month of a period of 12 months, we ascertain the following:

Month's Income – Month's Minimum Living Expenses = **Maximum Disposable Income for the Month**
Maximum Disposable Income for the Month = Debt Service Capacity for the Month
Monthly Average Debt Repayment Outflow of Existing loans / Debt Service Capacity = **Debt-To-Debt Service Capacity Ratio (DSR)**

6. Step 3: Determining a workflow for decisioning based on DSR

The decision to lend based on the Debt-To-Debt Service Capacity Ratio (DSR) Indicator for the household is to be arrived at using the below decisioning logic, also described in detail in Annex A (first suggested by Prathap & Khaitan, 2016). The decisioning logic requires the calculation of the surplus cashflows of the household and the existing and new DSR of the household, at current and proposed/ new levels of debt (if the requested loan was to be availed by the household). The decisioning logic is as follows:

- If the household has **Deficit income for all 12 months**, microcredit is **unsuitable** for the household → DO NOT LEND
- If the household's **Maximum Monthly Disposable Income > 0 for at least 1 of the 12 months** → Calculate DSR for EXISTING LOANS (This is denoted as $DSR_{EXISTING}$)
- If the household's **$DSR_{EXISTING}$ < 0.8 for at least 8 out of 12 months** → Calculate the NEW DSR by including monthly repayments on the NEW LOAN sought (This is denoted as DSR_{NEW}), else, Deficit DSR → DO NOT LEND
- If the household's **$DSR_{EXISTING}$ <0.8 and the DSR_{NEW} < 0.8 for all 12 months** → Household has Surplus DSR → **LEND**
- If not, if the household has **DSR_{NEW} < 0.8 for at least 8 out of 12 months** → Microcredit is suitable once additional protections are in place → **LEND WITH ADDITIONAL PROTECTIONS**, else, Deficit DSR → DO NOT LEND

7. Additional Care for Borderline DSR Households

As outlined in Step 3, in the specific case where the point-of-sale suitability assessment results in a new DSR that falls below 0.8 for at least 8 out of 12 months, the microcredit offering is suitable only if the household is also provided with additional protections. Such protection would prevent the household from slipping into a condition of being over-indebted and having to cut down on basic expenses to meet its debt commitments. Such additional protection could take the form of building elements of flexibility in repayment schedules aligned with periods of expected household cashflow stress[11]. Some ways of building in flexibility in repayment are as below.

[11] '*Proceedings of the Participant Sessions at the Workshop on Suitability in Microcredit*' (2018), Dvara Research

- A repayment holiday in the form of freedom to skip an instalment as chosen by the borrower at Point-Of-Sale or skip-repayment coupons (akin to mobile recharge coupons) for a small service fee levied
- EMI "credits", i.e., the borrower can pay an amount greater than their EMI at no additional cost
- The household can choose flexibility in when they want to repay one or two of the instalments (50 EWI/12 EMI), in exchange for accepting a slightly higher cost to service their loan
- A line of credit/overdraft that can be accessed in times of high expected/predictable cash flow constraints
- Facility for short term (one week or one month) top-up loan to the household to tide over cash flow mismatches
- Portfolio insurance that will pay for one repayment holiday of the household's choice in return for a small fee for the flexibility
- Features of flexibility can be made accessible to households where more than one member opts in to co-sign the loan documentation (co-borrowers)

8. Step 4: Setting System-level Capabilities based on Organisational Capacity

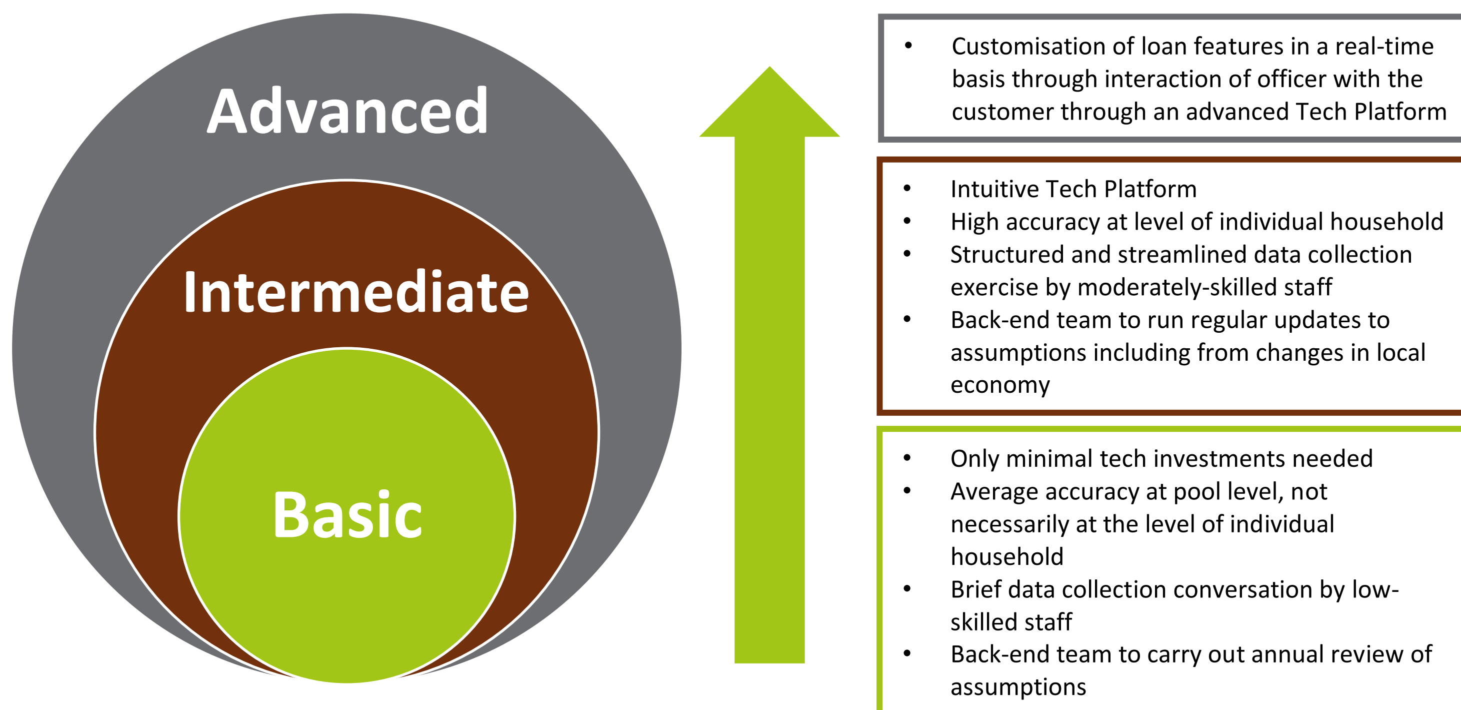
We understand that NBFC-MFIs exist at various scales, have different geography-based and cultural realities and field staff capabilities, and it may not be possible for all of them to operationalise one single uniform suitability assessment process. For this purpose, we propose three levels of sophistication of the suitability assessment process to choose from, to build organisational capacity.

There are some underlying requirements that an organisation will need to build for, irrespective of which level of sophistication gets chosen. These are:

- Capacity to capture demographic details of all household members. This includes:
    - Names, age, the gender of all members of the household, and
    - Nature of occupations for each earning member.
- Technology to enable automated decisioning algorithm outlined in Step 3.
- Building a basic data analytics team at the Head-Office to arrive at cash flow profiles of occupation types in the service area, which is then to be used to pre-populate income caps, floors and seasonality patterns as required. This will require a lenders' location survey to be conducted before beginning operations in any area and triangulation with external datasets to make realistic estimates pertinent to the region of operation.
- Capacity to obtain and utilise credit reports for all members of the household.

Once these are in place, Figure D below provides a quick overview of the organisational capacity required for each of the three levels:

Figure D: 3 Levels of Organisational Capacity



The details of the business process for suitability assessment based on the three levels of organisational capacity are outlined below.

8.1. 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[12] 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 from Credit Bureau for all adult members of the household to be fed into back-end automated decisioning for assessment (excluding members who cannot be lent to).

8.2. 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

8.3. ADVANCED LEVEL PROCESS: In addition to the INTERMEDIATE level, this level requires the business process to allow for customisation of loan features using an advanced Technology platform. The additional features of the business process for this level are outlined below.

[12] NSSO KI (68/1.0): Key Indicators of Household Consumer Expenditure in India (June 2013), a bi-decadal survey

- Customisation of loan features on a real-time basis through the interaction of officer with the customer using an advanced Tech Platform
- 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.

9. Overcoming Challenges to Operationalising Suitability

The above outlined 4-step process for operationalising suitability for micro-credit would require significant changes in the business process of the respective institutions, and consequently, this will have certain cost implications for the business.

A. Capital Expenditure on Technology: A tech-enabled Management Information System (MIS) is needed that can analyse customer data and execute on the loan -decisioning algorithm. This does not necessarily have to mean that the data needs to be collected through a purely digital platform. Loan officers can use paper forms to capture minimal information such as that in the BASIC LEVEL PROCESS and feed it into the MIS which has pre-populated proxies to build the full picture of household cashflows. The MIS will also have to be fed, as input, the information from credit bureau reports on all adult members of the household.

   While larger banks and NBFC-MFIs are more likely to have built and incorporated such MIS platforms into their business processes, smaller institutions may require some level of capital expenditure to incorporate the required level of technological capacity into their systems. Even for these smaller firms, in our view, adopting technology at various stages of their business processes can allow for improved efficiencies and reduction in other costs which will over time be able to cover any capital expenditure on such MIS platforms.

B. Operating Expenditures: This pertains to training and salary costs of trained loan officers and costs for running a data analytics team that does active monitoring and updating of local geography proxies built into the MIS. While many institutions may already have the required personnel to carry out such processes, some institutions may need to build these.

C. Incremental Costs of using Combo reports for each household: 'Combo' reports that give a full picture of an individual's formal credit are more expensive than 'MFI-only' bureau reports. However, this cost can be negotiated down once adequate volumes are obtained. Further, MFIN can negotiate on behalf of MFIs to bring down costs for the entire sector.

D. Liquidity Management Costs: For institutions that decide to lend to BORDERLINE DSR households after providing additional protections, there will be incremental costs for liquidity management due to the various solutions offered in the form of repayment holidays and flexible schedules. In our view, this cost is not likely to be very large as MFIs already manage repayment schedules for top-up loans and short-term emergency loans offered to existing MFI customers and the operating considerations for such additional protections for BORDERLINE DSR households will be very similar to that for these loans.

Business capabilities around the collection of realistic data about customers, building of technology platforms to collect, store and analyse data, and the building of human resource capacity for data analytics, will equip MFIs to serve their existing customer base with a suite of products and expand the universe of possible income streams on a long-term basis.

10. Way Forward

NBFC-MFIs are organisations which have in the past exhibited a high degree of 'nimbleness' as compared to their banking counterparts in their ability to adapt to a regulatory environment that has constantly been changing and in assimilating technological support into day-to-day business operations. This makes NBFC-MFIs well-poised to incorporate suitability assessments into their processes.

By doing so, MFIs now face an opportunity to proactively disrupt traditional creditworthiness assessments prevalent in India with the use of intensive customer data and new technologies, while keeping in mind suitable outcomes for the customer. The adoption of such processes demonstrates positive intent on the part of the MFI sector to help ensure that customers do not face over-indebtedness and can serve as an input to the regulator for the removal of any distortionary micro-prudential restrictions applicable to NBFC-MFIs, which further strengthen the MFI model as a credible credit provider among target borrower segments.

Annex A: Schematic Diagram of the Decisioning Workflow