



Response to RBI's Consultative Document on Regulation of Microfinance

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Contents

Summary of Recommendations	1
A. General Comments	4
A.1. Moving Towards Activity-based Regulation	4
i. Addressing concerns of over-indebtedness	5
ii. Applicability of conduct obligations	6
iii. Use of information with Credit Information Companies.....	7
iv. Bringing all non-for-profit microfinance lenders under RBI's regulatory ambit	7
A.2. Revisiting the Need for a Separate NBFC-MFI License	8
A.3. Moving towards a Modernised Regulatory Regime for Retail Lending	9
B. Responses to Points for Discussion Laid Out in the RBI Consultative Document	10
B.1. Chapter 3: Proposed Framework to address the Concerns of Over-indebtedness and Multiple Lending.....	10
i. Whether any other criterion can be adopted for identification of low-income households?	10
ii. Is the proposed definition of 'household' appropriate? If not, which alternative definition can be adopted for identifying a 'household'?	10
iii. Can a uniform methodology for household income assessment be adopted?	11
iv. Whether the proposed measures adequately address the concerns around over-indebtedness of microfinance borrowers?	12
v. Does the proposed definition sufficiently capture the essence of microfinance loans? Are there any other measurable factors which should be considered?	14
vi. Is the criterion prescribed for exemptions to 'not for profit' companies engaged in microfinance activities appropriate?	15
vii. Is the proposed minimum NOF of ₹20 crore for NBFCs under scale-based regulations appropriate for NBFC-MFIs?	15
B.2. Chapter 3: Review of Regulations Applicable to NBFC-MFIs only	16
i. Is the proposed approach appropriate to enable the competitive forces to bring down the lending rates? If not, is there any alternate mechanism which will be appropriate for all REs operating in the microfinance sector?	16
ii. Does the suggested factsheet capture all relevant parameters on pricing of microfinance loans in a simplified manner?	16
iii. Whether this simplified factsheet can be made applicable to other loans provided by the REs?	17
Annexure.....	18
Toolkit for FSPs to capture annual income, expenditure, and debt obligations at the household level	18
Constraints in implementing the toolkit.....	19

Summary of Recommendations

1. Measures to address over-indebtedness of low-income households

- ✓ Any measure aimed at addressing concerns of over-indebtedness for low-income households (LIHs), including the requirement to assess household-level income and debt, should be made applicable to all loans extended by all registered entities (REs) to the segment. These include microfinance loans or other retail credit and secured and unsecured loans.
- ✓ RBI should clarify the reasoning behind the proposed 50% debt-to-income limit to facilitate further discussion. A possible alternative could be to define a 'debt-to-disposable income' threshold which would be a better indicator for debt serviceability than gross income. Disposable income here would be net of routine expenses, including debt repayments, and a liquidity buffer.
- ✓ RBI should also require all REs to – 1) have a board-approved policy in place detailing the circumstances under which a prescribed debt-to-disposable income threshold can be exceeded, and 2) publicly disclose on a yearly basis its loan portfolio across different 'debt-to-disposable income' bins, including the proportion of the borrowers who fall outside the prescribed debt-to-disposable income threshold.
- ✓ Since the feature of equated instalments seems to have been kept away from the definition of microfinance loans (as defined in the consultative document), RBI should clarify whether all unsecured loans lent to LIHs would fall under the ambit of microfinance loans.
- ✓ RBI should clarify whether, at the point of sale, REs are required to ensure adherence to the 50% debt-to-income/ debt-to-disposable income limit on an annual basis or for each instalment of the repayments.

2. Applicability of conduct obligations

- ✓ Conduct obligations, through Fair Practices Code of Reserve Bank of India (RBI) or Codes of Conduct of Self-Regulatory Organisations (SRO), should be applied uniformly across all REs to ensure LIHs experience the same level of institutional conduct regardless of the type of RE they approach for their credit needs.
- ✓ RBI should rationalise the distinction between guidelines contained in the main regulations and those in the FPCs. It should also provide clarity on how it intends to hold REs accountable for violation of conduct obligations.

3. Use of information with Credit Information Companies

- ✓ RBI should track whether comprehensive credit information reports are made available to all REs at affordable prices and that the use of such comprehensive reports are becoming industry practice.

4. Regulation of not-for-profit microfinance institutions (MFIs)

- ✓ RBI should consider whether not-for-profit MFIs, including Section 8 companies and trusts, which undertake financial activity as their primary business (or, in other words, pass the 50-50 test) should be brought within its regulatory ambit.
- ✓ The RBI can consider applying on the not-for-profit MFIs, the scale-based approach to regulating the NBFC sector¹. Given their small size, not-for-profit MFIs would have to meet only the minimum Net Owned Fund (NOF) criterion and adhere to limited supervisory reporting pertaining to their capital position, credit concentration and other details of the portfolio that allow the RBI to oversee the health of the credit markets.
- ✓ Regardless of whether not-for-profit MFIs pass the 50-50 test, RBI should require them to adhere to the conduct guidelines as well as those intended at addressing over-indebtedness of LIHs.

5. Revisit the need for a separate NBFC-MFI license

- ✓ Given the harmonisation of the regulations applicable to the microfinance sector across all REs and the proposal to move towards a scale-based approach to regulating the NBFC sector, RBI should consider phasing out the separate license that exists for NBFC-MFIs.
- ✓ Alternatively, all non-deposit taking NBFCs, regardless of the type of loan product they offer, should be regulated and supervised based on their asset-size, and for those beyond Rs. 5,000 crore in asset size, based on their systemic significance.
- ✓ The proposal to enhance the minimum NOF requirement for NBFC-MFIs to Rs. 20 crore at par with other NBFCs is reasonable.
- ✓ The current cap on the microfinance loan portfolio, at not more than 10% of the total assets, applicable to non-MFI NBFCs, can be removed with phasing out of NBFC-MFI license.
- ✓ The current distinction between loans provided to NBFC-MFIs and other NBFCs for on-lending to individuals/ members of SHGs or JLGs should be removed to ensure that bank loans to all NBFCs qualify for PSL credit as long as they have been established to be reaching the intended borrower segment.

6. Guidelines on pricing

- ✓ With removal of price cap, RBI should continue to remain vigilant of any potential cartelisation among the existing lenders, specifically in regions which are served by one or very few microfinance lenders, which might keep interest rates at very high levels.

¹ In our response to the RBI's Discussion Paper on Revised Regulatory Framework for NBFCs - A Scale-Based Approach, 2021, we had proposed an alternative framework where all non-deposit taking NBFCs with less than Rs. 5000 crore in asset size could be considered as small NBFCs posing no systemic risk. Beyond this asset size, such NBFCs would be regulated and supervised based on their systemic significance.

See 'Our Response to RBI's Discussion paper on Revised Regulatory Framework for NBFCs - A Scale-Based Approach, 2021', March 2021, Dvara Research. Available at: <https://www.dvara.com/research/wp-content/uploads/2021/03/Our-Response-to-RBIs-Discussion-paper-on-Revised-Regulatory-Framework-for-NBFCs-A-Scale-Based-Approach-2021.pdf>

Also see 'Regulatory and Supervisory Approaches for NBFCs' by George et al., March 2021, Dvara Research, Available at: <https://www.dvara.com/research/wp-content/uploads/2021/03/Regulatory-and-Supervisory-Approaches-for-NBFCs.pdf>

- ✓ RBI should encourage microfinance lenders to employ risk-based pricing models in which cost components such as provision for expected losses are linked to individual customer level risk, to ensure borrowers who have built a clean credit history over a number of loan cycles are able to access loans at lower interest rates.
- ✓ While RBI already allows banks to co-lend with NBFCs, with the removal of the price cap, it should encourage and incentivise NBFCs in the business of providing loans to LIHs to further employ these arrangements. This can help bring down the pricing for LIHs through reduced lower cost of funds from banks for NBFCs.
- ✓ The cost of insurance, which is currently one of the components of pricing of microfinance loans, today mostly includes cost of credit life insurance for lenders. This should not be charged to the borrowers as no claim payout benefits accrue to the borrower family upon the borrower's death, but is instead, a portfolio cover to bring down the loss given default for lenders.
- ✓ For more transparency and better-informed decision making by the borrower, the simplified factsheet should also include information on the method used for interest rate calculation, i.e., whether flat or declining balance.
- ✓ Contingent charges such as pre-payment penalty and penalty for delayed payment should also be included in the simplified factsheet regardless of whether they are levied or not.

7. Move towards a modernised regulatory regime for retail lending

- ✓ RBI should consider moving away from the current prescriptive approach to regulating the microfinance sector to a regulatory regime which places emphasis on responsible lending by all providers to ensure customer protection and suitability in credit.
- ✓ The proposed regime would require lenders to put in place processes to collect necessary information on the borrower households' income, expense, and debt flows and carry out cashflow based underwriting based on such information to arrive at the repayment capacity. Such an assessment must differ based on whether a loan is being availed for consumption smoothing or for productive investment. For example, when a microfinance loan is proposed to be used for the latter, such as for setting up a new business or expanding an existing one, the new cashflows must be used to assess repayment capacity.
- ✓ Given the cost considerations in putting in place the required frontline capacity, technical skills, and IT infrastructure, RBI can consider implementing this in phases, and lenders can be allowed to choose from different sophistication levels to build their organisational capacity depending on their operational realities.
- ✓ RBI should also articulate an overarching set of principles for how suitability in credit should be necessarily upheld by providers in serving LIHs. Such articulation should go beyond just microfinance loans and include principles to be considered by providers in extending any type of retail credit to LIHs, including collateralised loans, loans for productive activities, and those for consumption.

The Reserve Bank of India (RBI) released a **Consultative Document on Regulation of Microfinance** (hereinafter referred to as the consultative document) in June 2021 for public comments. It includes an overview of the microfinance sector in India and the developments it has witnessed over the past two decades. The consultative document notes that the regulatory framework for microfinance is currently applicable to only Non-banking Financial Companies – Microfinance Institutions (NBFC-MFIs) constituting only 30% of the microfinance portfolio, increasingly exposing microfinance borrowers to multiple lending, over-indebtedness, and coercive recovery practices. It also observes that the present pricing cap for microfinance loans extended by NBFC-MFIs has hindered competition in the sector, created a non-level playing field, and compromised customer protection. The consultative document places the need for a review of the current regulatory framework in the context of these issues and proposes a new framework (hereinafter referred to as the New Framework) to be made applicable to all regulated entities (REs) in the sector.

In this document, we provide our responses to the points for discussion posed in the consultative document, as well as our general comments on other gaps and issues as identified by us in the New Framework. We also propose a broad outline for a modernised regulatory regime for retail lending to low-income households that RBI can consider moving towards.

A. General Comments

The New Framework marks a significant departure from the current prescriptive regulatory approach, which has restrictions on pricing, loan amount, indebtedness limit in absolute terms, and the number of NBFC-MFIs that can lend to a borrower. It proposes to remove these restrictions and instead require lenders to assess household incomes and lend within the prescribed debt-to-income limit of 50%. These, along with the proposal to replace the current approach of assessing indebtedness at an individual level with a household level assessment, constitute an important move towards strengthening customer protection measures in lending to low-income households (LIHs).

While the New Framework proposes to bring in the above-mentioned commendable changes, it still contains prescriptive provisions and raises concerns around continued 'lending-to-limit' behaviour by lenders. Additionally, while it is proposed to be made applicable to all REs of RBI in the microfinance sector, it continues with a product-based approach to regulations and, in some respects, an entity-based approach as well. This cuts across prudential norms, measures aimed at addressing over-indebtedness, as well as conduct obligations.

A.1. Moving Towards Activity-based Regulation

The current regulatory framework applicable to microfinance takes an entity- and product-based approach to regulations, with a disproportionate focus on regulating NBFC-MFIs. However, there are other entities, both regulated and unregulated by RBI, which deliver microcredit to LIHs. These include banks and non-MFI NBFCs under RBI's regulatory ambit, and trusts, co-operative societies, and Section 8 companies outside of its ambit. As a result, the current framework has been ineffective in protecting microfinance borrowers from multiple lending and over-indebtedness².

² See 'Let's stop kicking the can down the road: Highlighting important and unaddressed gaps in microcredit regulations' by Nishanth Kumar & Deepti George, October 24, 2019, Dvara Research. Available at: <https://www.dvara.com/blog/2019/10/24/lets-stop-kicking-the-can-down-the-road-highlighting-important-and-unaddressed-gaps-in-microcredit-regulations/>

i. Addressing concerns of over-indebtedness

The New Framework defines microfinance loans as “collateral-free loans to households with an annual household income of Rs. 1,25,000 and Rs. 2,00,000 for rural and urban/ semi-urban areas, respectively”. It also provides a set of instructions applicable to microfinance loans to address the concerns of over-indebtedness and multiple lending. These include the requirement to put in place board-approved policies to ensure household income assessment and capping of debt-to-income threshold at a maximum of 50%, as well as instructions around transparency of pricing and interest rate information. These new guidelines are proposed to be made applicable to all REs of RBI³.

Therefore, while the proposed guidelines move away from an entity-based approach within the microfinance lending space, it continues to be driven by a product-based approach, as the protections intended to be built for LIHs as mentioned above are available only if they avail microfinance loans. This can make the proposed measures to address over-indebtedness ineffective, as exemplified here. The need to ensure that debt-to-income ratio for a LIH does not exceed 50% can potentially play out in the following two ways:

- a. Where a borrower from a LIH approaches a bank for a collateral-free loan, satisfying the criteria of a microfinance loan, the bank is required to ensure that the outstanding interest and principal repayments on all loans do not exceed 50% of the household income.
- b. Where the same borrower approaches a bank for a non-microfinance loan (e.g., a collateralised loan), there is no obligation on the lenders to ensure such a repayment capacity.

In this scenario, there is a possibility that the outstanding obligations of a LIH could breach the 50% threshold were the household to avail a non-microfinance loan. It is unclear why non-microfinance lenders must not be subjected to the same limits, given that the debt-to-income ratio will have breached the 50% cap. It does not matter if these were collateralised loans, as the household will still need to repay using its cashflows rather than its collateral.

Therefore, based on the provisions contained in the New Framework, we conclude the following -

- a. There is a presumption that LIHs, as identified by the RBI, can only afford to avail microfinance loans on account of not possessing valuable assets to provide as collateral⁴. This might not necessarily be the case as microfinance borrowers can potentially have a variety of loans from banks and other financial institutions secured by gold jewellery, co-operative shares, or other documents, such as property titles⁵.
- b. There is an implicit assumption that where there is a reliance on collaterals in the case of non-microfinance loans, the debt-to-income assessment is not necessary. This is problematic as in the absence of prudent repayment capacity analysis, LIHs can undergo significant distress in meeting repayments and protecting their collaterals from being realised. It should be noted

³ “Other instructions applicable to microfinance loans of all REs”, see *Summary of Proposals*, pg. 27 of the consultative document.

⁴ “Low-income borrowers often lack the type of collateral often preferred by the lenders and what they have for pledging, instead is of little value for the lenders but is highly valued by the borrower (e.g., household items, furniture, etc.)”. See Section 2.3.4, *Need for Collateral*, pg. 13 of the consultative document.

⁵ See ‘When Is Microcredit Unsuitable?: Guidelines using primary evidence from low-income households in India’ by Vaishnavi Pratap & Rachit Khaitan, December 2016, Dvara Research. Available at: <https://www.dvara.com/research/wp-content/uploads/2017/01/When-is-Microcredit-Unsuitable-Guidelines-for-Lending.pdf>

that, although the lenders are protected by the loan-to-value (LTV), an inability to repay a collateralised loan can also mean that the borrower might potentially be under distress to make repayments on their other borrowings, including microfinance loans.

Therefore, we are of the view that any measures aimed at addressing concerns of over-indebtedness for LIHs should be made applicable to all formal loans by all REs to the segment, regardless of the type of loan (microfinance or otherwise) and the availability of collaterals⁶.

ii. Applicability of conduct obligations

The Report of the Sub-Committee of the Central Board of Directors of Reserve Bank of India to Study Issues and Concerns in the MFI Sector (hereinafter referred to as Malegam Committee Report) had recommended that provisions of the fair practices code (FPC), as applicable to NBFC-MFIs, should be introduced for banks and other financial institutions providing credit in the microfinance space⁷. However, this remains to be actualised as there is a mismatch in applicable conduct guidelines across NBFCs, banks, and NBFC-MFIs. For example, while the FPCs for banks and NBFC-MFIs require them to carry out due diligence on the creditworthiness of the borrowers, no such guidelines have been explicitly prescribed for NBFCs⁸. Similarly, with the removal of price caps, the New Framework proposes to align a set of conduct obligations applicable to NBFC-MFIs with that of NBFCs but does not extend the same to banks. These obligations are specifically meant to address the issue of fairness and transparency around the pricing of microfinance loans in the interests of LIHs.

Additionally, important guidelines that are required to be followed by REs are split between the main regulations and those contained in the FPC. This becomes an issue as the current regulations are not clear on how RBI holds REs accountable for any violation of the guidelines contained in FPCs, raising concerns on the relative importance placed by REs on adherence to FPCs.

Further, RBI places considerable reliance on Self-Regulatory Organisations (SROs)/industry associations for enforcing conduct guidelines. However, while the current regulations *encourage*⁹ NBFC-MFIs to become a member of at least one SRO and follow the conduct guidelines set by the SRO, such a requirement is absent for banks and other NBFCs. Therefore, it appears that membership with SROs is voluntary in nature. RBI should therefore ensure that conduct obligations are applied uniformly across all REs, including on the requirement to become a member of SROs, and that they

⁶ See Section B.1 for a discussion on the issues that might arise from regulatorily prescribed debt-to-income limits and Section A.3 on how the RBI can potentially address these issues.

⁷ See Section 12, Customer Protection Code, pg. 22 of the Malegam Committee Report. Available at: <https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/YHMR190111.pdf>

⁸ "Lenders should ensure that there is proper assessment of credit application by borrowers. They should not use margin and security stipulation as a substitute for due diligence on credit worthiness of the borrower". See *Guidelines on Fair Practices Code for Lenders*, Master Circular- Loans and Advances – Statutory and Other Restrictions, July 2015, RBI. Available at: https://m.rbi.org.in/scripts/BS_ViewMasCircularDetails.aspx?id=9902#25

"Due diligence shall be carried out to ensure the repayment capacity of the borrowers". See Fair Practices Code (FPC) for NBFC-MFIs, Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, Available at: <https://rbidocs.rbi.org.in/rdocs/notification/PDFs/45MD01092016B52D6E12D49F411DB63F67F2344A4E09.PDF>

⁹ "All NBFC-MFIs shall become member of at least one Self-Regulatory Organization (SRO) which is recognized by the Bank and shall also comply with the Code of Conduct prescribed by the SRO". See *Formation of SRO* in Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016. Available at: <https://rbidocs.rbi.org.in/rdocs/notification/PDFs/45MD01092016B52D6E12D49F411DB63F67F2344A4E09.PDF>

"Membership to the SRO is not mandatory. However, NBFC-MFIs are encouraged to voluntarily become members of at least one SRO". See Q26 in Frequently Asked Questions, Non-Banking Financial Company - Micro Finance Institutions (NBFC-MFIs). Available at: <https://m.rbi.org.in/Scripts/FAQView.aspx?Id=102>

are held accountable for any violations to ensure fair outcomes for LIHs regardless of the type of RE they approach for their credit needs.

iii. Use of information with Credit Information Companies

Given that the New Framework requires all REs to undertake a household level assessment of income and indebtedness before extending a microfinance loan, it becomes important to ensure that they use comprehensive reports that capture all institutional debt in their lending decisions. The current lending practices of NBFC-MFIs indicate the usage of MFI-only bureaus, and the high costs of acquiring comprehensive reports have often been cited as one of the reasons for not incorporating the use of comprehensive credit records of the borrower in appraisal processes. Additionally, to the extent credit information from unregulated entities is not captured in the database of Credit Information Companies (CICs), the borrowing profile of a low-income borrower/ household would remain incomplete. These issues can lead to a situation where borrowers are wrongly classified as being eligible for a new loan, when in reality, they have either crossed the prescribed debt-to-income threshold or are over-indebted¹⁰.

The consultative document touches upon the importance of REs providing timely and accurate data to CICs and using such data to ensure compliance with debt-to-income limits. However, it only requires REs to ensure this through its board approved policy and does not discuss the above-stated issues. Therefore, it is also important to track whether comprehensive credit information reports are made available to all REs at affordable prices and that the use of such comprehensive reports are becoming industry practice.

iv. Bringing all non-for-profit microfinance lenders under RBI's regulatory ambit

As mentioned at the beginning of the section, even within the microfinance sector, the New Framework does not propose to apply the guidelines discussed above to entities which are unregulated by the RBI, except to a limited extent to Section 8 companies (see Section B.1). Unless it is extended to these entities as well, it may not adequately address the customer protection issues present under the current regulatory framework, even if they are not motivated by profits or hold only a fraction of the market share.

With RBI proposing to move towards an entity-agnostic and activity-based approach to regulating the microfinance sector, it is important to consider whether entities such as trusts, co-operative societies, and Section 8 companies pass the 50-50 test¹¹, regardless of whether they distribute profits or not. If they do pass the test, RBI should consider whether they should be brought within the regulatory ambit of the RBI since not doing this would result in regulatory arbitrage being enjoyed by NGO-MFIs. However, the prudential norms and supervisory processes can be made applicable using the scale-based approach proposed in our response¹² to the RBI's Discussion Paper on Revised Regulatory Framework for NBFCs - A Scale-Based Approach, 2021. In this approach, we proposed an alternative

¹⁰ See 'When Is Microcredit Unsuitable?: Guidelines using primary evidence from low-income households in India' by Vaishnavi Pratap & Rachit Khaitan, December 2016, Dvara Research. Available at: <https://www.dvara.com/research/wp-content/uploads/2017/01/When-is-Microcredit-Unsuitable-Guidelines-for-Lending.pdf>

¹¹ 50-50 test applied by RBI to determine whether or not a company undertakes financial activity as its principal business, i.e., when a company's financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income. See Frequently Asked Questions, All you wanted to know about NBFCs. Available at: <https://www.rbi.org.in/Scripts/FAQView.aspx?id=92>

¹² See 'Our Response to RBI's Discussion paper on Revised Regulatory Framework for NBFCs - A Scale-Based Approach, 2021', March 2021, Dvara Research. Available at: <https://www.dvara.com/research/wp-content/uploads/2021/03/Our-Response-to-RBIs-Discussion-paper-on-Revised-Regulatory-Framework-for-NBFCs-A-Scale-Based-Approach-2021.pdf>

framework¹³ where non-deposit taking NBFCs with less than Rs. 5000 crore in asset size could be considered as small NBFCs posing no systemic risk. Such NBFCs would have no prudential requirements except to meet the minimum Net Owned Fund (NOF) criterion. On the supervisory front, given that they do not pose any systemic risk, they would be required to only adhere to limited reporting pertaining to their capital position, credit concentration and other details of the portfolio that allow the RBI to oversee the health of the credit markets.

However, as discussed earlier, conduct obligations should be uniformly applied across all these entities regardless of their size, legal form, or the systemic risk they pose. Therefore, an entity determined to be a not-for-profit entity, but is in the business of extending microfinance loans, should also be required to adhere to conduct obligations and apply the measures proposed in the New Framework to address over-indebtedness.

A.2. Revisiting the Need for a Separate NBFC-MFI License

In addition to conduct obligations and measures aimed at addressing over-indebtedness discussed in Section A.1, activity-based regulations or, in other words, regulation based on the financial function performed by an entity, can be extended to prudential norms as well. This leads us to question the continued need for applying a different prudential regulatory framework for NBFC-MFIs compared to other NBFCs, and consequently, the need for a separate NBFC-MFI license.

Malegam Committee Report had broadly cited three main reasons for the introduction of a separate category of NBFCs operating in the microfinance sector – 1) to encourage the growth of the sector through credit and special facilities or dispensation to such NBFCs, 2) to protect the interests of microfinance borrowers who are particularly vulnerable, through adequate regulations, and 3) significant interconnectedness of such NBFCs to the financial system and the potential risks they pose¹⁴. The New Framework, while proposing to harmonise measures aimed at improving outcomes for customers across all REs of RBI, refrains from applying such harmonisation to micro-prudential regulations, thus indicating the continued use of a separate NBFC-MFI license with a modified 'qualifying asset' criterion¹⁵.

Despite extending unsecured microfinance loans, NBFC-MFIs perform the same financial function as other non-deposit-taking NBFCs such as NBFC-ICCs, i.e., extending retail credit while accessing wholesale funds. The FSLRC recommended micro-prudential regulation of financial firms to be based only on the financial function performed by the firm and thus, to be institution neutral. Therefore, in our response to RBI's Discussion paper on Revised Regulatory Framework for NBFCs - A Scale-Based Approach, 2021, we had argued that the trigger for proportionality in regulation should be based only on risk-perception and size of the operations of a financial firm and not activity as defined by RBI in its Revised Regulatory Framework for NBFCs - A Scale-Based Approach. Alternatively, we propose a scale-

¹³ See 'Regulatory and Supervisory Approaches for NBFCs' by George et al., March 2021, Dvara Research, Available at: <https://www.dvara.com/research/wp-content/uploads/2021/03/Regulatory-and-Supervisory-Approaches-for-NBFCs.pdf>

¹³ See Section 3, *The need for regulation*, pg. 4 of the Malegam Committee Report

¹⁴ See Section 3, *The need for regulation*, pg. 4 of the Malegam Committee Report

¹⁵ "While introducing lender agnostic and activity-based regulations in the microfinance sector, the Reserve Bank is also conscious of the fact that certain prudential norms specific to NBFC-MFIs should not be harmonized with other REs to address the idiosyncratic risks on account of concentrated exposure of NBFC-MFIs to unsecured microfinance loans". See Section 1.4, *Need for Review of the Current Regulatory Framework*, pg. 6 of the consultative document.

based regulatory framework that is consistently applied across all NBFCs where the level of regulations would be determined only by the size of the NBFC, and beyond a certain size, its systemic significance.

Therefore, given that the RBI has recognised the need for harmonising customer protection measures for microfinance borrowers across all REs of RBI and that the systemic risk posed by NBFC-MFIs is sought to be addressed through the scale-based regulatory approach, we propose that a separate category of license for NBFC-MFIs be phased out gradually. Accordingly, the current regulations which require non-MFI NBFCs to cap their microfinance loan portfolio to not more than 10% of their total assets can also be removed. Additionally, the current distinction between loans provided to NBFC-MFIs and other NBFCs for on-lending to individuals/ members of SHGs or JLGs should be removed to ensure that bank loans to all NBFCs qualify for PSL credit as long as they are reaching the intended borrower segment. If implemented, these recommendations can also ensure that REs having the capacity to absorb the risk from lending to LIHs as well as with the necessary expertise to underwrite such risks are free to lend unsecured loans to LIHs without being restricted by the type of license they hold.

A.3. Moving towards a Modernised Regulatory Regime for Retail Lending

In a regulatory regime which is concerned with preventing over-indebtedness for LIHs, it is important to move away from prescriptive regulations to obtain such outcomes and instead emphasise on point-of-sale assessment of borrower's repayment capacity (see Section B.1). This would require lenders to put in place processes to collect necessary information on the borrower households' income, expense, and debt flows and carry out cash flow-based underwriting based on such information to arrive at their repayment capacity. The New Framework makes a significant move in this direction with the proposed changes but does not yet place primary responsibility on the lenders to ensure that such capacity to repay exists. We recognise that for a mandate such as this, cost is a consideration as lenders would have to put in place sufficient frontline capacity, technical skills, and IT infrastructure to undertake such processes to determine the creditworthiness of borrowers. However, we believe that responsible lending should be emphasised for borrower protection, and any regulation should be directed at building such a system.

Therefore, RBI can consider mandating this in phases, and lenders can choose from different sophistication levels to build their organisational capacity depending on their operational realities¹⁶. In this regime which places considerable reliance on responsible lending by providers, it also becomes important for the regulator to articulate an overarching set of principles for how suitability in credit should be necessarily upheld by providers in serving LIHs. Such articulation should go beyond just microfinance loans and include principles to be considered by providers in extending any type of retail credit to LIHs, including collateralised loans. However, this is currently missing in the current regulatory regime, and RBI should consider this as a next step in moving towards a modernised regulatory regime for retail lending in India. Other jurisdictions already have such guidelines in place, which the providers have to necessarily adhere to. The European Banking Authority's Guidelines on loan origination and monitoring, 2020 require lenders of unsecured consumer loans to assess and verify the source of repayment capacity, and to carry out sensitivity analysis. Australia's much older 'Responsible Lending Conduct' section under its National Consumer Credit Protection Act, 2009 has clear and overarching lender's obligations for consumer credit and prohibitions on unsuitable

¹⁶ For a detailed description of business processes that lenders can adopt, see 'A Practical Note on Operationalising Suitability in Microcredit' by Deepti George, February 2019, Dvara Research. Available at: <https://www.dvara.com/research/wp-content/uploads/2019/02/Operationalising-Suitability-in-Microcredit.pdf>

outcomes, including defining 'substantial hardships'. Both these guidelines have been issued with ensuring customer protection as one of the main objectives¹⁷.

B. Responses to Points for Discussion Laid Out in the RBI Consultative Document

In this section, based on the key themes around activity-based regulations articulated in Section A, we provide our responses to the points of discussion laid out in the consultative document.

B.1. Chapter 3: Proposed Framework to address the Concerns of Over-indebtedness and Multiple Lending

i. Whether any other criterion can be adopted for identification of low-income households?

The New Framework proposes to continue using the annual household income criterion for identifying LIHs, thus effectively defining who is eligible to avail microfinance loans. The Malegam Committee Report had suggested an annual household income limit of Rs. 50,000 in 2011 based on the experience of MFIs in extending such loans, which it observed to be a reasonable definition to accept¹⁸. This limit has been revised thrice over the years to include separate thresholds for rural and urban households. However, from both Malegam Committee Report as well as RBI's subsequent decisions to increase the threshold, it is not clear why microfinance is considered suitable only for households within the proposed annual household income limits. While we acknowledge the intent to employ micro-credit to serve vulnerable sections of the population, it is unclear why households with incomes above these income cut-offs should not be eligible to avail microfinance loans even when such loans can potentially suit their needs. A study of Indian household income quintiles from CMIE Consumer Pyramids data of 2019 by Dvara Research indicates that only 20% of the rural households and 40% of urban households would be eligible as per the New Framework (refer to Table 1 on pg. 9).

In place of the current approach, which targets microfinance loans to a specific set of households, we propose that RBI move to a regime where lenders are free to decide the suitability of extending a microfinance loan to a borrower, irrespective of what their income is. It is best to let lenders decide which customer segments they want to offer microfinance to. If the concern is that lenders will move away from LIHs, it may very well be possible that group structures may not work in the context of higher incomes or higher loan sizes.

ii. Is the proposed definition of 'household' appropriate? If not, which alternative definition can be adopted for identifying a 'household'?

Yes, the proposed definition of 'household' is appropriate and is also broad enough to allow REs to make a judgement based on the actual composition of a borrower's household.

¹⁷ See 'Guidelines on loan origination and monitoring', May 2020, European Banking Authority. Available at: https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Guidelines/2020/Guidelines%20on%20loan%20origination%20and%20monitoring/884283/EBA%20GL%202020%2006%20Final%20Report%20on%20GL%20on%20loan%20origination%20and%20monitoring.pdf

See 'Responsible Lending Conduct' under its National Consumer Credit Protection Act, 2009, ASIC. Available at: <https://asic.gov.au/media/5403117/rg209-published-9-december-2019.pdf>

¹⁸ See Section 5, *Regulations to be Specified*, pg. 5 of the Malegam Committee Report.

iii. Can a uniform methodology for household income assessment be adopted?

Research has shown that expenditure of LIHs typically tends to be higher than their income due to multiple factors – recall bias, consumption smoothening using debt or charitable transfers, and so on. However, knowing both the income and expenditure of the household could act as a check and help lenders ascertain the reasonableness of the income figure reported. The following factors should be considered to reasonably capture household level cashflows¹⁹.

- a. **Inflows**- Inflows of LIHs, apart from being volatile, are also seasonal in nature. A farming household might see income flow from their primary activity only at the time of harvest, while they might depend on other secondary sources of income during the intermittent periods. Similarly, a migrant household that migrates for certain months of the year will see income peak during those months. We need to capture these ebbs and flows in income. Moreover, households with a migrant family member might receive regular cash transfers, or a woman-headed household might be receiving government transfers such as widow pension. Therefore, we need to capture inflows such as remittances from friends and family, government, and so on.
- b. **Outflows** - Households tend to smoothen consumption by borrowing and saving. However, peaks in expenditure during festivals, family functions or health emergencies result in a future stream of outflows. Therefore, we need to understand three categories of expenses:
 1. regular consumption expenditure such as routine household expenses on food, housing, utilities, education, health, loan repayment, and so on.
 2. any seasonal peaks that the households typically face, such as lending to family/friends, festival expenses, etc.; and
 3. unanticipated expenses such as medical emergencies, house repairs, and so on.
- c. **Occupation** – LIHs are often employed in the informal sector. Information on the nature of occupation of employed family members during the year and the volatility of income is important for determining the household income.
- d. **Family Size** – Consumption needs of families tend to vary with size though not at constant proportion. Each additional member adds to the expense but at a diminishing rate due to intra-family optimisation of resources. However, we need to assess the number of members in the household to arrive at the total income earned by the household.

We propose two approaches to collect information on households for income assessments –

1. **Questionnaire** – This approach uses a short survey for asking the households a set of questions to capture information on their income, expenditure, and debt position. This short survey is laid out as a toolkit for lenders (see Annexure). This would enable FSPs to ascertain the financial ecosystem of the household and thereby aid credit assessment. We have proposed this method since it is the most comprehensive approach to arrive at household income conceptually. However, this is prone to certain inherent biases (see Annexure).

¹⁹A Practical Note on Operationalising Suitability in Microcredit' by Deepti George, February 2019, Dvara Research. Available at: <https://www.dvara.com/research/wp-content/uploads/2019/02/Operationalising-Suitability-in-Microcredit.pdf>

2. **Templates** – This method would entail FSPs creating templates for different categories of households (as per location, occupation, crop yield, remuneration from different work, family characteristics, etc.) through an initial survey of a representative sample. Survey data can be corroborated with data from other sources such as NSSO, CMIE, etc., in order to arrive at income for each template. This can then be used to predict income of any prospective client matching a particular template. For example, an agricultural household farming onions in Kurnool district of Andhra Pradesh can be matched to an arid-horticulture-agricultural household template. This exercise can either be carried out by each of the FSPs individually or by a consortium providing templates to all FSPs.

iv. Whether the proposed measures adequately address the concerns around over-indebtedness of microfinance borrowers?

The New Framework proposes to address the concerns around over-indebtedness of microfinance borrowers through three main mechanisms – 1) requirement for household-level assessment of income and debt, 2) prescribing the maximum permissible debt-to-income ratio at 50% at a household level, and 3) applying the Framework to all REs engaged in microfinance.

As discussed in Section A, all three measures are much needed to protect microfinance borrowers' interests. However, the prescribed maximum indebtedness limit raises the following concerns -

1. The consultative document cites the following reasons as the basis for the 50% threshold – 1) given low savings of LIHs, at least half of their income should be available for other expenses, 2) LIHs might have other informal loans which might need repayment, and 3) tendency to inflate income in the absence of documentary income proof²⁰. We find that the first reason provided may not be reasonable.

A study of Indian household income quintiles from CMIE Consumer Pyramids data of 2019 by Dvara Research indicates roughly that households in the first quintile in rural India and first and the second quintiles in urban India would satisfy the annual household income criteria to avail a microfinance loan. For these sets of households, the monthly expenditure as a proportion of their monthly income is quite high (minimum 70%; rural quintile-1 households show an income deficit), indicating that the 50% threshold might be too high and not suitable for LIHs (See Table 1).

Table 1: Debt to Debt Service Capacity Ratio and Expenditure to Income Ratio for Urban and Rural Households Across Income Quintile

Income Quintile	Mean Monthly Income (Rs.)	Annual Average Income (Rs.)	Mean Expenditure (minus EMIs) (Rs.)	Monthly EMIs (Rs.)	Debt Service Capacity (Rs.)	Debt to Debt Service Capacity Ratio	Expenditure to Income Ratio
	(A)	(A)*12	(B)	(C)	(D)=(B)-(A)	(C)/(D)	(B)/(A)
Rural Households							
Q1	5,735	68,820	7,562	1,741	-1,827	-1.0	1.3
Q2	12,531	1,50,372	8,776	1,489	3,755	0.4	0.7
Q3	17,436	2,09,232	10,387	1,699	7,049	0.2	0.6

²⁰ See Section 2.3.3, *Limits on Household Indebtedness*, pg. 12 of the consultative document.

Q4	26,042	3,12,504	13,266	2,064	12,776	0.2	0.5
Q5	66,138	7,93,656	14,393	3,178	51,745	0.1	0.2
Urban Households							
Q1	7,576	90,912	6,515	1,550	1,061	1.5	0.9
Q2	12,694	1,52,328	8,524	1,760	4,170	0.4	0.7
Q3	17,474	2,09,688	10,212	2,061	7,262	0.3	0.6
Q4	26,470	3,17,640	11,639	3,371	14,831	0.2	0.4
Q5	56,872	6,82,464	15,948	5,767	40,924	0.1	0.3

Source: CMIE-CPHS, 2019

There are all-too-common situations where consumption credit may be unsuitable for a household with, say, a 30% debt-to-income. Where the 'dependents-to-earning members' ratio is very high, routine expenditures would be greater than income from a single earner, and surplus, non-existent. Factors such as high reliance on informal loans (ascertained during credit appraisal, verified from other members in the group), a high probability of health shocks or regional weather shocks, imply that households without risk management tools (liquidity buffers, insurance) will likely find debt unsustainable. Therefore, as with prescribing annual income limits, any regulatorily prescribed debt-to-income limit could end up over-indebting LIHs.

Additionally, repayment capacity analysis for loans must differ based on whether it is being availed for consumption smoothing or for productive investment. When a microfinance loan is being used for the latter, such as for setting up a new business or expanding an existing one, the new cashflows must be used to assess repayment capacity. Here, even if a household has crossed the prescribed 50% threshold of debt-to-current income, it could be in a position to repay the loan from the expected future cash flows from the investment.

The proposal to introduce an assessment of debt-to-income levels is a significant improvement over the current approach, which relies on absolute indebtedness levels. However, by capping the 'debt-to-income' limit at 50%, it continues with a prescriptive approach followed by the current regulations, which restricts 'debt' per borrower at Rs. 1,25,000. This will likely result in continued 'lending-to-limit' behaviour by lenders since there is no direct responsibility being placed on them to ensure lending decisions are based on assessing the true repayment capacity of households, as long as they record compliance with this criterion. Additionally, the issue of borrowers under-reporting their borrowings using multiple identity documents will likely persist, which CICs might not be able to address²¹.

As discussed earlier in this section (see response to the question (i)) and in Section A.3, the responsibility of ensuring repayment capacity of households should be on the lenders. However, as RBI moves towards this ideal scenario and until lenders have the required systems in place to operate under such a regime, a possible alternative could be to define a 'debt-to-disposable income' threshold instead of the proposed debt-to-income threshold. Disposable income here would be net of routine expenses, including debt repayments, and a

²¹ See 'Examining the adequacy of MFI multiple lending directive in India: A study of slum dwellers' loan-related choice', Kanish Debnath and Priyanka Roy. Available at: https://archives.nseindia.com/research/content/NSE-IFF_Paper_3.pdf

liquidity buffer, and would hence be a better indicator for debt serviceability than gross income.

In order to allow flexibility for lenders to determine the suitability of extending a new microfinance loan on a case to case basis as well as ensure regulatory oversight of lending practices, RBI should also require all REs to – 1) have a board-approved policy in place detailing the circumstances under which the prescribed threshold can be exceeded and 2) publicly disclose on a yearly basis its loan portfolio across different 'debt-to-disposable income' bins, including the proportion of the borrowers who fall outside the prescribed threshold.

2. In prescribing the 50% threshold, the consultative document uses the following language –
 - "...payment of interest and repayment of principal for all outstanding loans of the household *at any point* of time shall be capped at 50 per cent of the household income."²².
 - "...capping the payment of interest and repayment of principal for all outstanding loan obligations of the household as a percentage of the household income, subject to a limit of maximum 50 per cent"²³.

From the above two statements, it is unclear whether, at the point of sale, REs are required to ensure adherence to the debt-to-income limit on an annual basis or for each instalment of the repayments (weekly/ monthly). Ideally, the latter would be more effective in bringing down the probability of the household experiencing downstream over-indebtedness.

3. While the New Framework is proposed to be made applicable to all REs, the measures requiring household income assessment and the need to lend within the prescribed debt-to-income limit becomes applicable only if it is a microfinance loan. Additionally, entities not regulated by the RBI are not proposed to be covered by the New Framework except for Section 8 companies to a limited extent (see Section B.2). As discussed in Section A.1, this opens the possibility of a microfinance borrower's debt-to-income breaching the 50% limit if lent to by these providers, making the proposed guideline ineffective in preventing over-indebtedness.

v. Does the proposed definition sufficiently capture the essence of microfinance loans? Are there any other measurable factors which should be considered?

In laying down the criteria for a loan to be classified as a microfinance loan, the extant regulatory framework draws from the essential features of credit for microfinance mentioned in the Malegam Committee Report. These include – "1) the borrowers are low-income groups, 2) the loans are for small amounts, 3) the loans are without collateral, 4) the frequency of repayments is greater than for traditional commercial loans, 5) the tenure of the loans is short, and 6) the loans are generally taken for income-generating activities."²⁴.

However, the New Framework proposes a definition that hinges on only the annual household income and collateral-free nature of loans. Repayment frequency (weekly/ fortnightly/ monthly) has been left out and is now to be ensured through a board-approved policy only if the loan satisfies the microfinance loan definition. Therefore, it is unclear if all collateral-free loans such as personal loans would also come under the ambit of microfinance loans.

²² See Section 2.3.3, *Limits on Household Indebtedness*, pg. 12 of the consultative document.

²³ See *Summary of Proposals*, pg. 27 of the consultative document.

²⁴ See Section 2.4, *The Microfinance Sector*, pg. 2 of the Malegam Committee Report.

vi. Is the criterion prescribed for exemptions to 'not for profit' companies engaged in microfinance activities appropriate?

The New Framework proposes to make Section 8 companies ineligible for exemption if their asset size is equal to or more than Rs. 100 crore arguing that their interconnectedness with other financial intermediaries can potentially pose risks to the financial system²⁵. However, this threshold is inconsistent with RBI's Revised Regulatory Framework for NBFCs - A Scale-Based Approach, where NBFCs are considered to be of systemic significance only if their asset size is equal to or more than Rs. 1000 crore.²⁶ As discussed in Section A.1, all Section 8 companies, trusts and societies passing the 50-50 test should be brought under the regulatory ambit of RBI and required to adhere to regulatory and supervisory guidelines based on their asset size and the systemic risk they pose.

The New Framework also proposes to apply only the requirement to ensure that the 50% debt-to-income threshold is not breached for exempted Section 8 companies. Other proposed measures, such as disclosing pricing related information and disclosure of interest rates charged, have not been made applicable. Again, as discussed in Section A.1, conduct obligations and measures to address over-indebtedness of LIHs should be uniformly applied across all entities irrespective of their size, systemic risk they pose, or their legal form.

vii. Is the proposed minimum NOF of ₹20 crore for NBFCs under scale-based regulations appropriate for NBFC-MFIs?

In our response to RBI's Discussion paper on Revised Regulatory Framework for NBFCs - A Scale-Based Approach, 2021²⁷, we had opined that the decision to increase the minimum NOF from Rs. 2 crore to Rs. 20 crore is reasonable. We believe that this would ensure that prospective NBFCs have the resources to put in place necessary IT systems, including systems that can enable good quality automated supervisory reporting to the RBI. Given this, it seems reasonable to extend the same minimum requirement for NBFC-MFIs as well.

It would be more prudent to have uniform NOF regulations for all NBFCs and to have microfinance asset class-related risk weighting, NPA recognition, and provisioning norms applicable on any lender holding this asset class (till such time Ind-AS becomes applicable to all REs). For instance, the Committee on Comprehensive Financial Services for Small Businesses and Low Income Households had articulated that –

"different customer-asset combinations behave very differently from each other, and it is recommended that the regulator specify NPA recognition and provisioning rules, including for standard assets, at the level of each asset-class and require that all NBFCs conform to these mandates... On standard assets, provisioning levels, as well as asset classification guidelines specified by RBI, would

²⁵ See Section 2.4, *Definition of 'microfinance' for 'not for profit' Companies*, pg. 14 of the consultative document.

²⁶ See 'Discussion Paper on Revised Regulatory Framework for NBFCs – A Scale-Based Approach', Reserve Bank of India, January 2021. Available at: <https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/DP220121630D1F9A2A51415B98D92B8CF4A54185.PDF>

²⁷ See 'Our Response to RBI's Discussion paper on Revised Regulatory Framework for NBFCs - A Scale-Based Approach, 2021', March 2021, Dvara Research. Available at: <https://www.dvara.com/research/wp-content/uploads/2021/03/Our-Response-to-RBIs-Discussion-paper-on-Revised-Regulatory-Framework-for-NBFCs-A-Scale-Based-Approach-2021.pdf>

need to reflect the underlying level of riskiness of each asset class (combination of customer segment, product design, and collateral) and not be uniform across all the asset classes''²⁸

B.2. Chapter 3: Review of Regulations Applicable to NBFC-MFIs only

- i. Is the proposed approach appropriate to enable the competitive forces to bring down the lending rates? If not, is there any alternate mechanism which will be appropriate for all REs operating in the microfinance sector?***

The New Framework proposes to bring in price competition by introducing a simplified factsheet containing pricing information and removing the pricing cap on microfinance loans, which is currently applicable to only NBFC-MFIs. As rightly observed by the RBI, this cap has caused market distortions on account of 'lending-to-limit' behaviour by lenders where the interest rates charged have tended to be at or near the regulatory limit set by the RBI for NBFC-MFIs. In the case of banks, this has been observed despite their access to comparatively lower cost of funds. In the case of NBFC-MFIs, too, economies of scale have not translated into lower cost of borrowing for customers.

While removing the pricing cap can help correct market distortions by allowing competitive forces to come into play, it is important to note that this might not translate into a lower cost of borrowing for all microfinance customers. In regions which are served by one or a very few microfinance lenders, customers might not realise lower interest rates until the market becomes competitive. In such regions, it is important that RBI continues to remain vigilant of any potential cartelisation among the existing lenders, which might keep interest rates at very high levels²⁹. This can especially affect borrowers who have built a clean credit history over a number of loan cycles and should ideally be able to access loans at lower interest rates (see below). It should be noted that in such markets, borrowers would also be constrained by the availability of a limited choice of lenders.

In addition to the effects of cartelisation, lower interest rates might not accrue to borrowers who have built clean credit history unless risk-based pricing models are employed in which cost components such as provision for expected losses are linked to individual customer level risk rather than the loan portfolio. Here, on account of lenders having a better insight into repayment behaviour of the borrower, loan losses provisions are expected to be lower. In addition to the above individual-level benefits, ideally, economies of scale should also lead to lower interest rates for all borrowers at a portfolio level as lenders are able to spread their overhead costs over a larger customer base.

While RBI already allows banks to co-lend with NBFCs, with the removal of the price cap, it should encourage and incentivise NBFCs in the business of providing loans to LIHs to further employ these arrangements. This can help bring down the pricing for LIHs through reduced cost of funds from banks for NBFCs.

- ii. Does the suggested factsheet capture all relevant parameters on pricing of microfinance loans in a simplified manner?***

The proposed factsheet is intended to be a simplified document providing relevant pricing information to prospective borrowers before onboarding. The effective annualised interest rate (in percentage) in the factsheet, which is to be calculated based on interest charge plus all other charges, would capture

²⁸ See Section 4.3, pg.9 and Section 4.21 pg.10 of the report of the committee. Accessible at: <https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/CFS070114RFL.pdf>

²⁹ This is also one of the reasons for the current 'lending-to-limit' behaviour by NBFC-MFIs as under the current regime there is a limit on the number of NBFC-MFIs (at two) that can serve one customer.

the actual interest rate a borrower would end up paying regardless of the method used to calculate it, i.e., flat or a declining balance method. This would also ensure a direct comparison of the terms on which different lenders are offering a loan amount as required by a prospective borrower. However, for more transparency and better-informed decision making by a borrower, it would also be useful to mention the interest rate calculation method that would be applied (whether flat or declining balance).

In addition to the information on pricing, we propose that contingent charges be also included in the factsheet. As per the current FPC, NBFC-MFIs are not permitted to charge any penalty for delay in payment and are required to disclose this in the loan agreement. However, it appears from the FPC under the New Framework that NBFC-MFIs are now allowed to charge penal interest for late repayment and are required to indicate the same in bold in the loan agreement³⁰. Additionally, the New Framework does not permit REs to charge microfinance borrowers a penalty for pre-paying their loans. However, there is no requirement for them to make it known to the customer. Therefore, we propose that both these charges, which constitute important information, be added to the factsheet.

Related to the pricing of microfinance loans itself, there are currently only three components allowed – 1) interest charge, 2) processing charge, and 3) actual cost of insurance premium. While the New Framework does not discuss this, the proposed simplified factsheet includes a separate line item for insurance charges. Generally, costs incurred by lenders for purchasing credit life insurance go into these charges. These policies are meant to mitigate the credit risk for the lender in the event of the death of a borrower, and the borrower's household itself does not benefit from the insurance proceeds. Therefore, we, propose that the cost of credit life insurance be not charged to the customer.

iii. Whether this simplified factsheet can be made applicable to other loans provided by the REs?

The simplified factsheet aims to ensure transparency of pricing related information to customers to enable price comparison and informed decision making. Given the value addition, it brings in from a customer protection perspective, there is no reason why the factsheet must not be extended to other loans provided by the REs.

³⁰ See *Extant Regulations vis-à-vis Proposed Changes*, pg. 30 of the consultative document.

Annexure

Toolkit for FSPs to capture annual income, expenditure, and debt obligations at the household level

I Household Size Information	
1	How many members are there in your household?
II Income Information_Memberwise	
2	Member No. (Questions 2 to 10. a5 to repeat for each member of the household)
3	Name
4	What has been your employment status in the last 12 months?
5	What is your primary source of income in the last 12 months? If you have more than one source, mention the occupation you spend most of your time on.
6	How often do you receive income from your primary source?
7	What is your annual income from your primary source? (If income varies, kindly mention expected average income) ³¹
8	What is the lowest possible income you can earn from your primary source per year?
9	What is the highest possible income you can earn from your primary source per year?
10	Apart from your primary occupation, do you receive income from any other activity? (If yes, move to question set 10a, otherwise move to Section III) If Yes
10. a1	What was your secondary source of income in the last 12 months?
10. a2	How often do you receive income from your secondary source?
10. a3	What is your annual income from your secondary source? (If income varies, kindly mention expected average income)
10. a4	What is the lowest possible income you can earn from your secondary source per year?
10. a5	What is the highest possible income you can earn from your secondary source per year?
III Income Information_Household	
11	Annual rent received by the household from leased out land/housing?
12	Annual remittance regularly received by the household from any family member?
13	Annual government transfers received by the household such as pension, widow/old age/disability assistance, scholarship, etc.?
IV Expenditure Information_Household	
14	What is the average monthly expense incurred regularly for your household? (For food, clothing, schooling, housing, regular medical costs, utilities, transport, etc.) ³²
15	What was the amount you spent on unplanned expenses (unforeseen medical expense, emergency expense for house repair, etc.) in the last year? ³³

³¹ The FSP can then arrive at average annual income from primary and secondary source by adding up incomes for the year. For example, an agricultural household might earn farm income twice a year, one Rs. 40,000/- and another Rs. 32,000/- while also earning Rs. 3,000/- every month from livestock. The annual income would then be Rs. 40,000 +32,000+36,000 = Rs. 1,08,000 /-.

³² Monthly expense is being asked for ease of recall. FSPs can then multiply by 12 to arrive at annual expenditure.

³³ Additional unplanned expenses incurred in the last year can be used as a proxy for possible unplanned expense this year. Divide by 12 to arrive at possible unplanned expense per month.

16 Is there any additional expense you expect to incur this year (for festivals, family gift commitments, education, etc.)?³⁴

V Debt Information_Debtwise

17 How many outstanding debts does your household have at this point? (Questions 18 to 20 repeats for each loan of the household)

18 What was the source of this debt?

19 What is the amount still outstanding on this loan?

20 What is the amount that is due on this loan this year?

Choice Set				
Q4*	Q5*	Q6*	Q10	Q18**
Employed	Self Employed: Agriculture	Hourly	Yes	Bank
Not Employed	Self Employed: Non-agriculture	Daily	No	MFI
Retired	Wage employment: Agriculture	Weekly		MBFC
Others, Specify	Wage employment: Non-agriculture	Monthly		SHG
	Regular salaried/wage employee	Quarterly		Money Lender
	Others, Specify	Half Yearly		Friends/Family
		Yearly		Employer
		Others, Specify		Shops

Constraints in implementing the toolkit

Any new addition to administrative process takes time and energy to streamline. This will be particularly true of the Microfinance sector, which is cost-sensitive and caters largely to a non-salaried heterogeneous population. Income measurement is a crucial component of credit appraisal mechanism, and the task of coming up with a reasonable measure of income for a varied consumer base is a work-in-progress. In the toolkit we have set up above, various factors might undermine the quality of the data generated. We list out some of the possible concerns so that FSPs might be aware of them and thereby tweak their processes to take cognizance of such shortcomings while at the same time use the data to make meaningful credit assessment.

Response Bias

Innate cognitive biases in respondents might affect the accuracy of the data being reported. This could be due to a variety of factors. Some situations are explained below to illustrate some of the possible reasons for incorrect responses:

- i) A farmer might report his/her income as the market value of his/her produce. However, actual income would be the profit earned over and above input costs.
- ii) Inability to accurately report income/expenditure since the person is not in the habit of keeping tabs on inflows and outflows.
- iii) General tendency in respondents to under report income while over reporting expenditure.

³⁴ Divide by 12 to arrive at additional expense per month.

*For each member of the household.

**For each loan taken by the household

- iv) Own account workers and sole proprietorship entrepreneurs might have overlapping personal and professional accounts, and it hence becomes difficult to report income and expenditure data accurately.

Response bias can be minimised by a well-constructed survey that allows for data triangulation. The toolkit proposed here tries to do this by nudging the respondent to think along different aspects of the same income/expenditure data, which helps to reduce bias.

Untrained administration

Given the fact that the customers of MFIs are LIHs with minimal financial sophistication, the task of making the survey/questionnaire easy and comprehensible falls on the FSPs. This requires trained staff who would understand the exact needs of the questions being asked (what information needs to be captured and for what purpose) and articulate it in the most suitable manner to the customer. The accuracy and utility of data captured using this toolkit would depend on the nuanced administration of the questions. This involves training and capacity building on the part of the MFIs.

Incentive mismatch

There is an incentive for both the FSP and customers to tweak income and expenditure figures to fall within the regulatory ceiling of microfinance loan eligibility. However, the responsibility of capturing data as precisely as possible rests with the FSPs. Therefore, the pressing need to accurately measure income (and thereby repayment capacity) while disbursing loans should be strongly advocated and reiterated among the stakeholders to ensure long-time stability of the ecosystem.

Technological Core Solutions by Dvara Solutions

Any intervention to improve the quality of household income measurement and thereby credit assessment entails additional costs to FSPs. While the costs can be spread over a large clientele for FSPs operating at scale, the same might not be possible for a smaller player. Technology can act as an aid to cut costs or at least make costs commensurate with scale. Dvara Solutions is one such technology service provider which has created a digital architecture that enables customer onboarding, credit underwriting, automatic to semi-automatic product processing, statutory reporting, etc. Such a technological support can make it easier to administer questions to prospective clients, feed data into a centralised registry or template immediately and validate the data on a real time basis. This can act as a starting point for simplifying processes, improving credit decisions and provide risk-based pricing to customers.