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How Should the RBI Respond to the Microfinance Crisis?

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Summary

Debt distress among microfinance borrowers is on the rise, sufficiently so that it may be characterised as a crisis for the sector. This is driven by factors across the supply- and demand-sides, as well as factors inherent in the nature of the credit cycle, where periodic booms and busts have been present throughout history. To address this, we propose two sets of recommendations for the regulator: a set of recommendations that can be initiated in the short-term and another set that can be initiated over the medium-term. In the short-term, the first action should be assessing the true extent of the distress, thereafter, revisiting microfinance regulations is key, and finally, to balance lenders' and borrowers' interests, two programs are proposed. Over the medium-term, we recommend developing the requisite infrastructure for identifying distress and monitoring credit markets more effectively, strengthening supervisory mechanisms, creating a whistleblower forum, and ensuring that self-regulatory organisations (SROs) are strengthened. These recommendations aim to (a) contain the fallout from the present condition of distress/crisis, and (b) minimise the incidence of debt distress among microfinance borrowers in the future.

Introduction

There are worrying signs of over-indebtedness in Indian households. Specifically, there has been an increase in delinquencies in the microfinance sector, which has witnessed an increase in its non-performing assets (NPAs) by 100 basis points, from a post-pandemic low of 0.9% in September 2023 to 1.9% in September 2024[1]. During the same period, Portfolio-at-Risk (PAR) 31-60, PAR 61-90, and PAR 91-180 increased by 60, 70, and 90 basis points, respectively[2]. Further, the Reserve Bank of India (RBI), in its latest Financial Stability Report from December 2024, has also flagged these growing signs of stress in the microfinance sector, with rising delinquencies across all types of lenders and ticket sizes. Another alarming aspect is that approximately 6% of borrowers have exposure to four or more lenders as of November 2024, which indicates a heightened likelihood of over-indebtedness[3].

Worsening delinquency rates indicate a decline in the asset quality of microfinance providers, but for borrowers, delinquency reveals only a part of the underlying stress, as debt distress may arise before or even without repayment defaults. Qualitative research on household debt reveals that borrowers often resort to extreme coping strategies, such as postponing necessary medical care or pulling children out of school to make timely repayments[4]. Given that the delinquency rates are already high, the level of accumulated (and hidden) distress could be even more alarming.

Analysis at the household and borrower levels reveals clear signs of financial distress. The nationally representative Centre for Monitoring Indian Economy's (CMIE's) Consumer Pyramids Household Survey (CPHS) data reveals that repayment obligations have been the most common purpose for outstanding borrowings in both urban and rural households. In January 2021, only 10.82% of households borrowed to repay, but in May 2024, over 26.77% borrowed to repay. This churning of debt is often indicative of a situation where the existing surplus of the borrowing household is inadequate to meet the existing financial obligation. Additionally, another telling sign observed in the microfinance lending space was borrowings for consumer durables taking a much larger share in outstanding borrowings than previously, having increased to 25% by May 2024 from an average of 9.2% in the previous 4 years. Thus, it would appear that

[1] Micrometer Q2 FY 2024-25. (2024). Microfinance Industry Network.
[2] PAR depicts the portfolio at risk (i.e., amount outstanding) that has not been repaid and are overdue by a by the denoted days
[3] Maloo, M., Kothari, A., & Fatakia, H. (2024). Microfinance sector sees 6% borrowers holding loans from multiple lenders: Alok Misra . CNBCTV 18. https://www.cnbctv18.com/business/microfinance-sector-sees-6-pc-borrowers-holding-loans-from-multiple-lenders-mfin-alok-misra-19517397.htm
[4] Neelam, A., Nambiar, A., & Bhattacharya, D. (2023, April 14). Debt Distress Protocols. Dvara Research. https://dvararesearch.com/debt-distress-protocols/

households are borrowing more often for purposes that do not generate cashflows and as their debt burden becomes unsustainable, they must borrow more to repay what they were struggling to repay earlier.

For a closer examination of borrowing patterns and the underlying debt distress, Dvara Research conducted a household-level survey in January 2024 involving 1,124 microfinance customers of an NBFC across three districts each in Odisha and Tamil Nadu, to analyse the characteristics of borrowers experiencing distress. At a surface level, visible signs of debt distress, such as defaulting on repayments or availing any formal assistance regarding indebtedness, were low among the interviewed borrowers. However, the survey also included additional indicators that sought to uncover hidden signs of debt distress among borrowers, such as the use of a range of coping strategies, like depleting savings, borrowing to repay, pulling children out of schools, etc., to enable timely repayments. Based on the presence of one or more distress indicators, a household can be classified as distressed or not. The survey[5] revealed that up to 68% of the borrowing households could be flagged as distressed. Similar results were also observed from a joint study initiated by Dvara Research and Sa-Dhan[6] for a different sample of microfinance borrowers spread across multiple (13) lending institutions. 13.9% of those who paid their instalments on time were found to face difficulties in repaying those instalments, primarily due to various financial shocks. These findings underscore growing debt distress among microfinance borrowers, a trend that needs to be understood within the context of the inherent dynamics of a credit cycle.

The rising levels of debt distress, as seen above, are not new. Similar patterns of credit and distress have been observed in past credit cycles, driven by a positive feedback loop between the supply and the demand sides, which, left unchecked, snowballs into a crisis. On the supply side, several challenges arise in following the letter and spirit of the regulations, from unreliable income data to incomplete liability data shared by Credit Information Companies (CICs). Thus, though lending institutions are supposed to follow protocols for risk and repayment assessment, they instead succumb to the temptation of relaxing the assessment of repayment capacity since this is an easy route to growing the loan portfolio. Our study with Sa-Dhan revealed that lenders often end up accounting for the maximum permissible income, or they ignore some members of the household, thus deflating the debt outstanding. Lenders are able to relax their vigilance because borrowers are known to churn loans, i.e., borrow from one lender in order to repay another. In turn, lenders' relaxation of proper risk and repayment assessment protocols amplifies the churning on the borrowers' side. The overall result is a lending mania in the credit market, or a credit boom that is not grounded in any fundamental growth of repayment capacity.

With several creditors waiting to lend to them, borrowers increase their demand for social consumption, like consumer durables and other status goods. For example, the CPHS survey by CMIE shows that in January 2021, 71% of indebted households used their borrowings for consumption of daily provisions, which decreased to 47% in December 2023. Conversely, the share of indebted households that used their borrowings for wedding ceremonies increased from 2% to 4%, on durables increased from 4% to 9%, and on vehicles increased from 8% to 19%. A study by Guérin et al. (2024) among 450 households across three districts of Tamil Nadu found that the majority of borrowings by the study's sample households were for "social reproduction" purposes, such as ceremonies (accounting for 45% of borrowings) and social obligations such as receiving guests and helping others (accounting for another 28.6%).

The role of microfinance in escalating the scale and extravagance of so-called social consumption is understudied, but the above numbers give some indication and also call for more nuanced data collection efforts to substantiate the nature of the link. For it would appear that in the absence of easy credit, households prioritise needs over wants, but the easy availability of microcredit allows wants to also be satisfied. Industry participants and commentators often characterise this change as a transformation in the

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[5] The survey report was submitted to Sa-Dhan. Synopsis of the findings were presented during the Sa-Dhan National Conference on Inclusive Growth (23rd and 24th October 2024); the video may be accessed at: https://www.youtube.com/watch?v=JgYzp-_n1YM

[6] Parts of this study were presented at the Sa-Dhan annual conference in October 2024. We will be publishing a full report of our findings very soon on our website (www.dvararesearch.com).

"aspirational culture" of rural customers, especially among youth. The implication for the microcredit market is that such a transformation leads to ever-increasing demand, since status goods competition (yet another name for social consumption) can ratchet up very quickly, thus (mis-) signalling to the lender that the market is far from saturation[7]. Further, since the credit tap is often also used to meet the needs of consumption smoothening, medical expenses and other such cases, borrowers continue to churn and repay despite difficulties because they know that once they default, the credit taps will close.

The regulatory environment in which credit operates can place the necessary safeguards against the tendencies on both sides of the market. A balanced regulatory approach that considers both supply and demand side concerns is essential to address the cyclical and reinforcing nature of the issue of debt distress.

Actions to Address Debt Distress

Regulatory actions can encourage desirable interventions and sanction dangerous behaviour. The following recommendations capture various approaches in this vein. They have been grouped into short-term measures that are immediately actionable, and medium-term measures that may take a little time to initiate. Taken together, both types of measures are intended to a) diagnose the extent of the problem, b) provide a short-term respite upon identification of significant distress, and c) safeguard the system from periodic crises in the long run.

Recommendations Implementable in the Short-Term

1. **Assessing the Extent of the Debt Distress**

As discussed earlier, debt distress is unobservable; as such, the first step to solving the crisis is to estimate the extent of debt distress. Currently, there is no way to estimate the extent of debt distress by solely relying on administrative data. The expected credit loss (ECL) computed by some lenders may come close, but such models are often based on historical data, and as such, their predictions tend to be erroneous in volatile times (i.e., non-typical scenarios). Further, such data is not universally available. Only a select cadre of lenders are required to compute and report ECL. Thus, it is critical to collect the data from the borrowers. It is therefore recommended that the RBI conduct a short sample survey, possibly administered over the phone, to collect data on indicators of distress. Annexure-1 provides a sample questionnaire for the same. Further, such an exercise should be repeated periodically to help monitor the health of the credit market, as discussed below in the medium-term recommendations.

2. **Providing Relief to the Deserving**

Once the extent of distress is identified, the immediate action would be to provide relief to borrowers and the industry.

In the absence of an insolvency and bankruptcy regime for the borrowers, relief can be only in the form of restructuring or amnesty for defaulting borrowers provided by the lender. Despite the relief, this will adversely impact a borrower's ability to borrow. Thus, it is proposed that if a borrower's debt owed is restructured or written off, then such data be shared with lenders for a maximum period of 2 years by the CICs. Further, both the SROs explicitly prohibit its members from lending to delinquent customers of other MFIs. Thus, it would be critical to remove this blanket ban and let microfinance

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[7] For a more detailed discussion of the phenomena described in this para and the preceding one, please refer to *Exploring the Phenomenon of Debt Distress and Possible Solutions* by Dwijaraj Bhattacharya and Indradeep Ghosh, published as Chapter 4 in *Inclusive Finance India Report 2024*; accessible at: https://dvararesearch.com/wp-content/uploads/2024/12/IFI-Report-2024.pdf

lenders decide whether to lend to borrowers who have sought refuge under the restructuring or amnesty programs.

It is possible that the RBI may consider establishing a liquidity window to ensure that the sector does not have to borrow at a) exorbitant costs, and b) with competing priorities. Currently, given the state of the sector, lenders to the MFIs are likely to charge high risk-premiums, thus increasing the cost of funds for the MFIs, who will then have to pass it on to the customers. Alternatively, if an MFI borrows internationally to avail liquidity, then it may have to subscribe to objectives beyond inclusion, such as green financing, which may not always align with the objective of inclusion or the needs of the borrowers. It must be noted that the liquidity window may breed moral hazard. To mitigate this, it is critical to establish guidelines to ensure that only MFIs with the highest standard of compliance and risk management are allowed to avail the facilities under the window. For example, rejection rates of the MFIs, and downward revision of income reported to CICs, among other such indicators, may be used for the purpose. Finally, it would also be essential to monitor these MFIs to ensure that they remain compliant and manage risk appropriately.

3. Revisiting Regulatory Directives (Sandbox)

Mitigating debt distress requires a robust regulatory focus on the supply-side provision of credit. An effective pre-emptive strategy is to ensure that credit disbursement aligns with the household's financial situation, that is, their repayment capacity. This involves accurately assessing household cash inflows and outflows – a process that is currently fraught with challenges, as evidenced by the aforementioned study conducted by Dvara Research and Sa-Dhan.

To encourage the proper assessment of a household's financial situation, the RBI may need to reconsider its regulatory guidelines. At the same time, implementing any new guidelines at a scale and in a rush may result in unintended consequences. Thus, instead of significantly altering the regulatory regime, it is suggested that the RBI incentivises the use of the regulatory sandbox to test out the efficacy of a variety of new approaches, and then based on the outcomes of the sandbox trials, the successful approaches can become a mainstay for the sector. The following approaches are suggested as appropriate test cases:

i) Income Assessment

Accurately assessing household income is a critical yet challenging task, particularly in the context of microfinance borrowers, who generally have informal and irregular income sources. Income assessment mechanisms can be strengthened by:

a. Establishing clear benchmarks for household income assessment which can be developed from nationally representative datasets like the All-India Debt and Investment Survey (AIDIS) or the CPHS. These benchmarks can provide a baseline for cross-checking self-reported income.
b. Leveraging MFI field officers' tacit knowledge to create borrower personas that estimate household income flows based on variables like region and occupation. Techniques such as asset imaging can contribute to the development of reliable personas.
c. Developing heuristics to flag discrepancies – for example, significant divergences between self-reported data and persona-based estimates can trigger closer scrutiny or refinement of the income estimation algorithms.

ii) Liability Assessment through Comprehensive Credit Information

Reliable credit information is essential for evaluating household liabilities and repayment capacity. To tackle the challenges of incomplete CIC records, the following measures can be adopted:

a. Expediting loan reporting to CICs for lenders giving microcredit loans – mandating daily reporting of microfinance loans instead of the current 15-day reporting period so as to provide lenders with up-to-date credit information. Currently, several lenders are querying the CICs in real-time and are updating repayments daily, so operationalising daily reporting may not be too arduous.
b. Reporting borrower-level data of SHG loans outstanding to the CICs to ensure that the full spectrum of a household's formal debt liabilities is visible to the industry. This reporting should be done irrespective of the principal amount of the group loan.
c. Sharing CIC data (appropriately anonymised) with researchers to enable the crowd-sourcing of approaches that can help identify duplicate records of borrowers, which can, in turn, lead to better capturing of all debt obligations of the household.

iii) Thresholds for Microfinance Credit

Establishing debt-to-income thresholds for credit disbursement is a key step in preventing borrower over-indebtedness. Currently, the threshold is set at 50% of the income, i.e., it is permissible for lenders to consider up to half of the household income for the purpose of debt servicing. While thresholds risk encouraging "lending to the limit" behaviour, a well-rationalised, data-backed approach to setting such thresholds is preferable to no thresholds or arbitrary limits. Therefore, such debt-to-income thresholds must account for the varied financial situations of different borrowing households. The proposed guidelines for these thresholds should base these thresholds on regional and economic benchmarks, such as poverty lines or minimum wages, to reflect regional variations in expenses and incomes. Finally, the need for such debt-to-income thresholds may be eliminated in the longer run as the sector develops the capacity to adequately and appropriately capture expenditure data at the household level. This would allow debt-to-income thresholds to be customised for each household by lending only against the disposable income[8].

Recommendations Implementable in the Medium-Term

1. Institute mechanisms to detect debt distress

In the medium-term, a continuous and early detection of distress would enable necessary regulatory action or allow specific remedial measures by providers. At a provider level, regular monitoring of their portfolio by appropriate statistical measures or advanced machine learning models that can predict distress can be leveraged. A more straightforward approach to identifying potentially distressed customers is conducting regular telephonic surveys (using a survey instrument such as the one provided in Appendix 1) that capture a set of key distress indicators. Once potentially distressed borrowers are identified, the provider may offer support such as restructuring or financial counselling. This proactive approach with early detection of distress can help mitigate risks and promptly assist borrowers.

At the regulatory level, secondary data sources, like the growth of lenders' books, new-to-credit customers, and credit bureau records, among others, can be analysed[9]. Further, to identify debt distress, a nationally representative survey may be carried out that captures loan details and repayment behaviour, along with socio-economic and consumption details. Considering that such surveys would require substantial investments, deploying state-specific surveys may be less time- and resource-intensive. These can identify regions that have seen a substantial increase in household credit or that have experienced a wave of defaults, particularly in the microfinance sector. By focusing on state-level

[8] This is an idea discussed earlier in *A framework for microfinance regulation that would suit India*, V. Anantha Nageswaran, Deepti George Livemint, July 2021; accessible at A framework for microfinance regulation that would suit India

[9] For further details, please refer to *A Framework for Detecting Over-indebtedness and Monitoring Indian Credit Markets* (Dvara Research, 2021); accessible at: https://dvararesearch.com/a-framework-for-detecting-over-indebtedness-and-monitoring-indian-credit-markets/

data, these surveys can provide more granular insights into regional economic vulnerabilities, such as agricultural production loss or industry-wide downturns in a particular area. This can inform region-specific alleviation mechanisms and help fine-tune regulations such that the economic context of the state is considered.

2. Strengthening Loan Underwriting Processes of Non-MFIs

It must be acknowledged that MFI customers are seldom solely MFI customers. Often, the household will have consumer durable loans, gold loans, two-wheeler loans, and agricultural loans, among other types of loans. Thus, even if an MFI adheres to all the processes laid out by the RBI, the household it lends to may find itself in distress since other types of lending institutions lending to that household may not perform proper repayment capacity assessment, sometimes because they are not required to do so. For example, a household may have saturated its repayment capacity, but when it borrows against gold, there is no repayment capacity assessment. The gold loan may come with a bullet repayment schedule, but there is still (at least) an annual interest repayment needed. Often, MFI borrowers borrow further to service such interest, which initiates and exacerbates distress. It is, therefore, critical to revisit the regulatory frameworks governing entities other than MFIs to ensure that their underwriting policies do not inadvertently lead to distress.

It is also suggested that in the longer term RBI reconsiders activity-based regulations.

3. Strengthening Supervisory Environment

The regulatory prescriptions discussed earlier relate to the rigorous and careful assessment of a borrower's repayment capacity. However, such regulations without robust supervision may not be fruitful. Currently, there is a clear need to enhance the scale of oversight that regularly identifies violations and sanctions for violators. Enhancing the scale would entail more regular surprise audits of records and policies adopted by the MFI and anonymous field visits to cross-check collected information, which can act as a deterrent against flagrant flouting of regulatory requirements.

Similarly, the SROs may be given an additional and explicit responsibility to surface ground realities of borrowers affected by dishonest lending practices in addition to surfacing hurdles faced by providers in adhering to regulatory guidelines. This may be considered either as an interim measure while the RBI develops in-house capacity or as a more permanent measure. In the longer-term approach, devolution of some of the supervisory responsibilities (like surprise field and branch audits) to an independent committee within the SROs may be considered.

4. Creating a Platform for Whistleblowers within Microfinance Institutions

While most providers endeavour to minimise over-lending, some institutions may encourage the same through their field and branch staff. In such cases, employees should have an avenue to report such instances outside of their institution. The RBI could create a dedicated whistleblower forum through which violations of credit underwriting norms can be reported anonymously by employees of the concerned MFI. Depending upon the frequency and seriousness of the reports, the regulator may conduct audits of such specific MFIs to ensure compliance and to prevent the accumulation of non-performing assets (NPAs) in their balance sheets. This initiative will promote a culture of integrity and protect systemic stability by empowering staff to voice concerns without fear of retaliation.

Conclusion

Instituting the above-outlined recommendations in the short and medium term can identify the scope of distress, allowing the RBI to adopt appropriate policies that may help alleviate distress. However, once such

measures are implemented, it is critical to strengthen the regulatory and supervisory regime for the sector. Otherwise, the cyclical nature of the industry means that another crisis will come knocking within the next decade or so. While regulations cannot stop another round of over-indebtedness from arising (the cyclical history of credit markets is a testament to that), they can reduce the amplitude of the cycle and thereby contain the negative fallouts of the surfacing of over-indebtedness.

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Appendix-1: Questionnaire (Telephonic) for Surfacing Distress

Household Information

1. Which state/village are you living in?
2. How many members are there in your household?
3. How many of the household members are employed and earning?

Perception-Based Questions

4. Please indicate your level of agreement with the following statements (as completely agree, somewhat agree, somewhat disagree, completely disagree):
    a. I am unable to enjoy my life because of money related worries.
    b. I feel that I will not be able to achieve my financial goals in life.
5. Over the last quarter, did you struggle to make ends meet? (Y|N)
6. Over the last quarter, did you struggle to repay debt obligations? (Y|N)

Liabilities

7. How many loans does your household currently have?
8. For each of these loans, can you provide the following details?

S. No.	i. Type of loan[10]	ii. Name of lender	iii. Date of disbursement (MM/YY)	iv. Principal	v. Tenure of loan	vi. EMI/EWI	vii. Outstanding Balance	viii. Restructuring of loan?

9. If yes to 8.viii., how was the loan restructured?
    a. Additional loan amount granted
    b. Modified interest rate
    c. Modified loan tenure
    d. Other modifications, pls specify _________
10. Have you missed repayments towards any of your current loans?
    a. If yes, what were the consequences of the same?
        i. shamed or insulted
        ii. threatened or harassed
        iii. assets seized
        iv. payment by others in group
        v. penalised
        vi. others, please specify ________

Occurrence of Shocks/Events

11. Over the past quarter, have you faced any events or shocks for which you incurred expenditure?
    a. Health shock
    b. Social event

[10] This can be a categorical variable with categories like: Micro-finance loan, SHG Loan, Consumer Durable Loan, Vehicle Loan, Agricultural Loan, Gold Loan, etc.

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   c. Damage to assets
   d. Issues affecting livelihood
   e. Others, please specify ___________
12. Did the shock/s affect your repayment ability? (Y|N)
   a. If yes, for how long?

Sacrifices

13. Have you engaged in any sacrifices or coping mechanisms to make repayments?
   a. Depleted savings
   b. Worked more than usual
   c. Postponed planned expenses
   d. Skipped festival celebrations
   e. Postponed child/children's marriage
   f. Pulled child/children out of school
   g. Sold or pawned assets
   h. Chose to forego medical procedures to save expenses
   i. Skipped Meals
   j. Others, please specify ___________

Perception-Based Question

14. How would you characterise the level of distress you experience due to your current loan obligations?
   a. Excessive
   b. High
   c. Moderate
   d. Low
   e. Don't know