6th Dvara Research Conference on

Making Credit Work for the Poor

in collaboration with CGAP

PREVENTION OF DISTRESS

"Operationalising Suitability in Credit Sale: Imperatives and Challenges"

DVARA Research

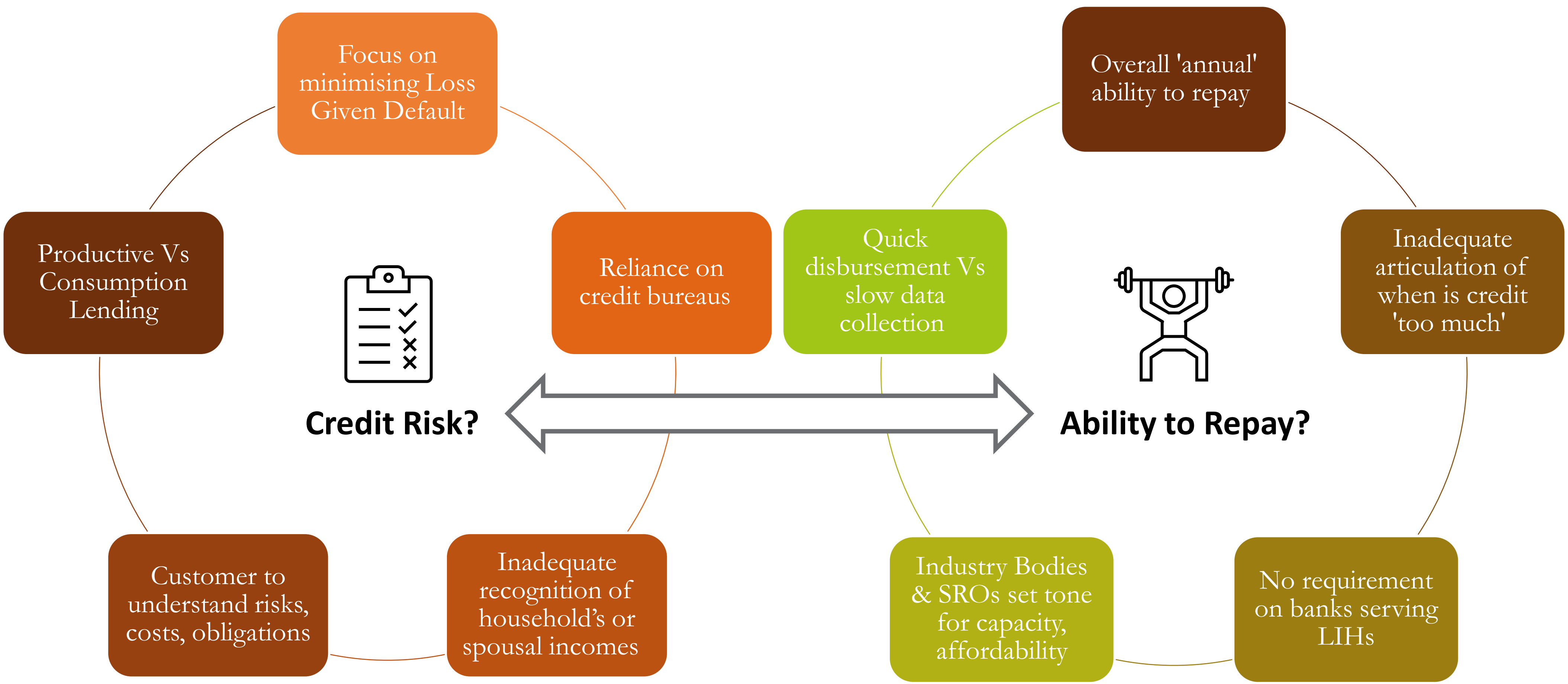
Credit Decisioning Process

Establishing 'Ability to Repay'

DVARA Research

Credit Decisioning for India's Households

Creditworthiness: Having enough money for banks to be willing to lend you money (Cambridge Dictionary)



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Credit decisioning, especially in the low-income context, continues to be an inexact science. How can the gap between what can be assessed and what needs to be assessed be reduced?

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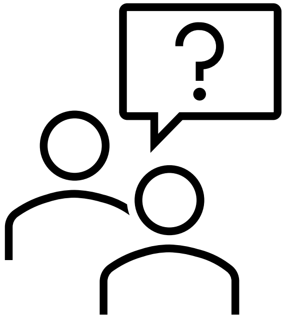
Credit Decisioning Process

Establishing 'Ability to Repay'

Defining Suitability as a Point-of-Sale Process

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



The Process must reasonably ensure the borrower will not find themselves in a situation where

- They have to prioritise repayments over essential expenditures

Is it enough to only ensure that the loan is "not unsuitable"?

Do we need a higher standard? If so, what might it be?

At Point-Of-Sale, ascertain the ability of borrower to meet repayment obligations…

- when they are expected to fall due (both unique and total)
- out of own income (existing or new) & savings without having to realise security or assets
- without resorting to non-transient credit-dependent behaviour in order to make repayments

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"Ability to Repay" in Microfinance

Collateral-free loans to 'households' with annual income of <=₹300,000 (~$3600)

Repayment outflows <= 50% of gross income @ monthly basis

Built-in option for repayment flexibility

Lenders to report 'income' to bureaus, reconcile divergences

Non-'microfinance' lending has no such assessment

What about secured loans & those that warrant a bullet repayment?

Monthly Debt Outflow – To – Disposable Income a better indicator of 'Ability to Repay'?

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Are fixed thresholds appropriate for households whose incomes are dynamic, volatile, and stretchable?

Must the purpose of loan or the source of repayment matter?

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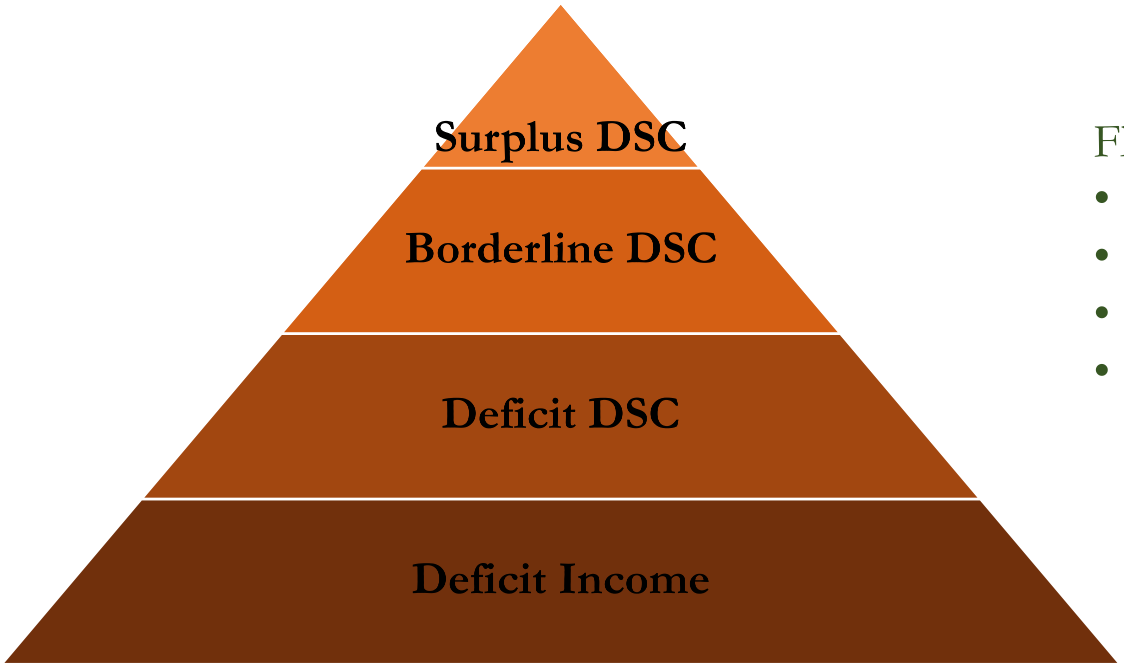
Suitability Assessments:
Debt Servicing Capacity

DSC = Monthly Debt Outflow / Monthly Disposable Income



Flexibility during cashflow stress:

- Repayment holiday for a fee
- EMI "credits"/ prepayment options
- Customised repayment schedules
- A line of credit / overdraft

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How must providers set a threshold DSC for their borrowers?
What checks & balances can providers build in, to lend to 'borderline DSC' households?
Could risk hedging devices make credit suitable for such households?

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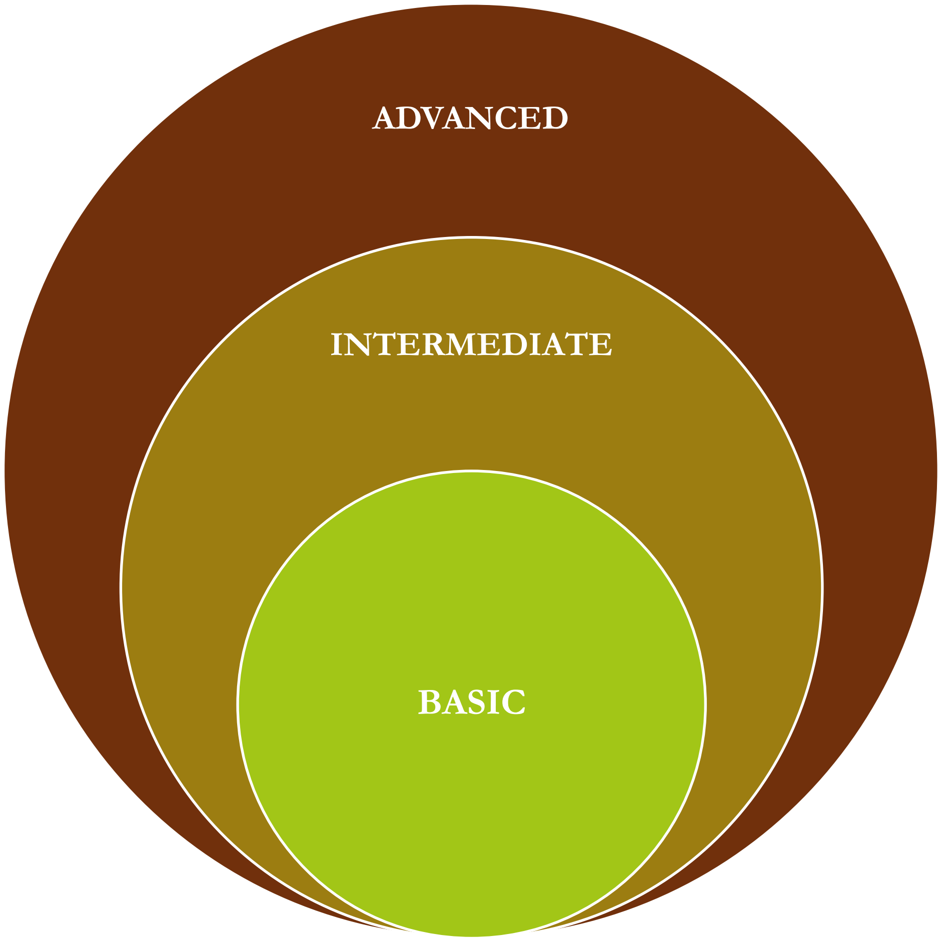
Suitability Assessments:
Provider Capability



1. **BASIC**: Minimal technical investments to support assessments at pool level based on brief data collection processes and annual reviews of assumptions.

2. **INTERMEDIATE**: Intuitive technical platform to generate assessments at the household level based on structured and streamlined data collection and regular reviews.

3. **ADVANCED**: Highly technical platforms that allow customisation of individual loan features in real time based on officer's interaction with customer.

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A shift in provider perspective from minimising Loss Given Default to assessing suitability for the customer is desirable for both secured and collateral-free loans.

How can such a shift be brought about?

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"Ability to Repay" in other cases?

Relationship-based	Lender discretion	Less amenable to scale-up	Ability to Repay?
Financing Goods Purchase	Asset, inputs purchase	Check-out financing	Interest-free Vs fee-based
Cash-flow based	New insight where none existed before?	Cash-flow trapping	Loss of control over own monies?

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Are there instances were lending to low-income households need not entail an 'Ability to Repay' assessment?

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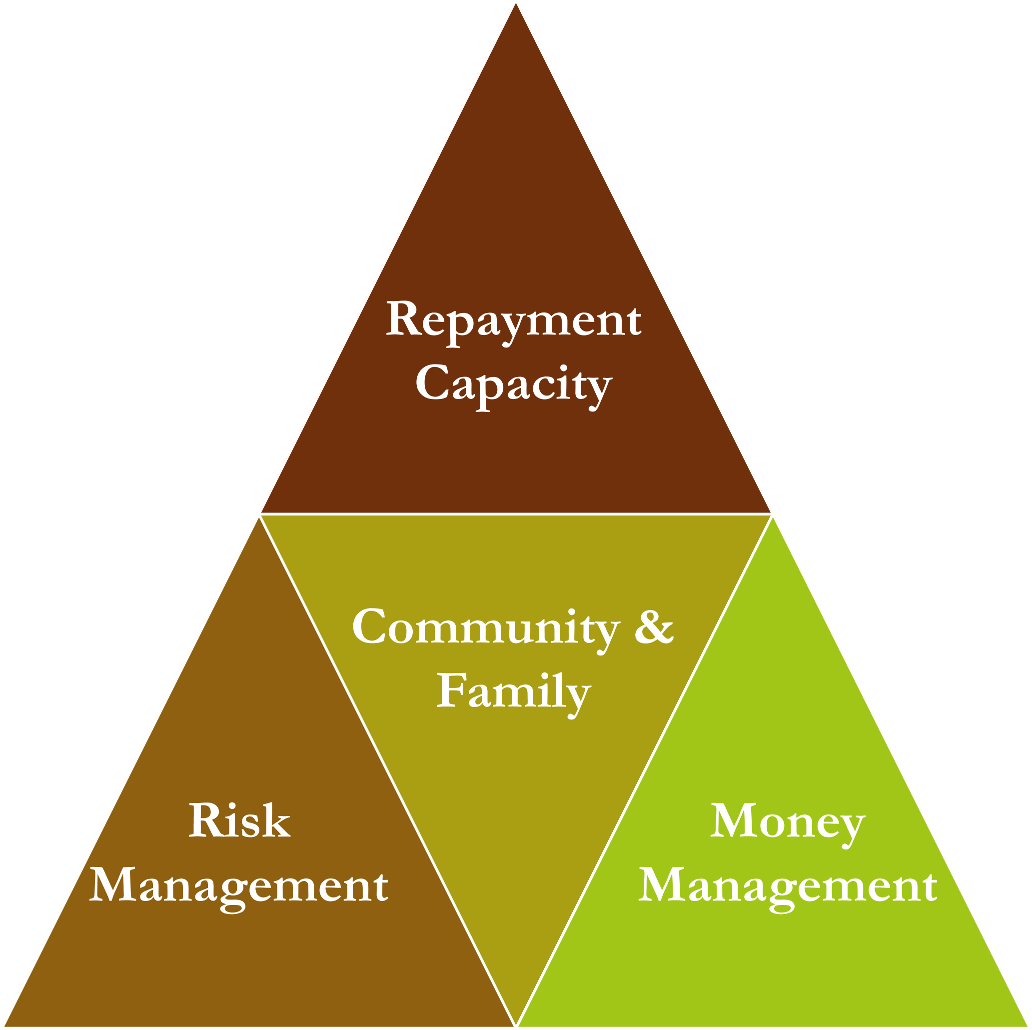
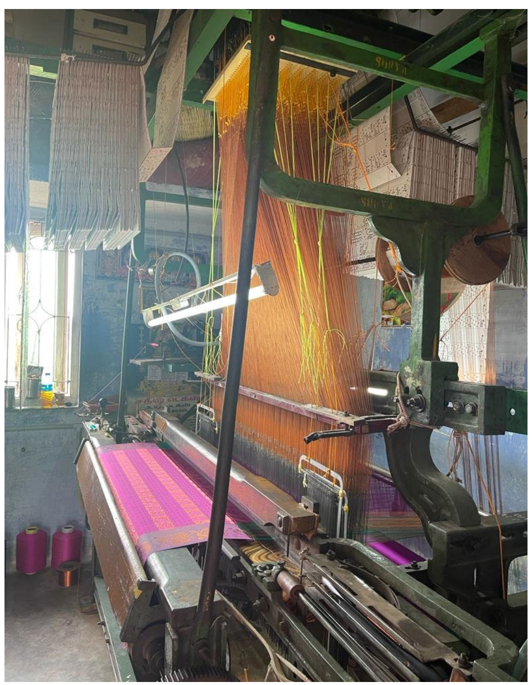
Suitability Engine



Customer Story #1: Kavita

- Kavita and her husband are power loom weavers; cultivate corn & groundnut
- 4-member household (2 earning members, 2 children), ~₹15-20,000 income p.m
- Own 2 power looms, weave two sarees a day @ ₹200-₹300 per saree
- The utility of the design assemblies depend entirely on the contractor

Jan 2021	Mar 2021	Jun 2021	Dec 2021
₹50,000 (NBFC)	₹145,000 (NBFC)	₹50,000 (NBFC)	₹40,000 (Informal)
Design Assembly	Power Loom	Design Assembly	Home expenses, repayments



Borrowing Experience

- Group/Lender concluded business's viability
- The burden of multiple loan repayments made them take an informal loan to tide over temporary difficulties
- Total monthly repayment burden between ₹7,000 -15,000

Challenges for Lenders

- Enough experience with weaving, and yet schedules needed to be altered for all loans
- When livelihood is heavily linked to her home cash flows, should assessment be based solely on the business's ability to generate enough returns?
- Lack of a 'buffer' became apparent

Customer Story #2: Vandana

- Vandana works as a public works supervisor and is estranged from her husband
- 5-member household (4 earning members including 2 brothers, mother); ~₹31,000 income p.m

Dec 2018	Feb 2019	Nov 2019	Jun 2022
₹60,000 (SHG), now ₹110,000	₹75,000 (SFB)	₹30,000 (NBFC)	₹50,000 (Informal)
Power loom	Power loom	Loan Repayments	Health shock

Borrowing Experience

- Bad luck with pandemic; loom sold; Vandana left to bear the entire repayment burden; estranged from husband
- Lost own gold jewellery due to inability to repay old loans; smaller loans closed
- Incurs heavy medical expenses to deal with chronic illness; availing rest is not an option - will add to interest burden

Challenges for Lenders

- Moratoria availed for all loans; one loan restructured
- 'Family unit' confounding; repayments limited to respondent's income; brothers have other loans
- makes part-payments and continues to repay slowly and steadily – but this is too little to reduce the mounting interest burden

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Questions for Discussion

- Are there any other considerations under this theme that have not been covered in the staging presentation?
- How can providers deploy credit decisioning mechanisms that take a household perspective and that are more sensitive to existing debt levels within the household?
- How must underwriting for consumption credit be different from that for enterprise-set-up/expansion credit in the context of low-income households? These enterprises are seldom distinct or ring-fenced from the household's financial dealings. How must regulators consider this question?
- What role can industry associations and self-regulatory organisations play in encouraging providers to adopt more suitable/responsible credit decisioning mechanisms? In both traditional microfinance and digital lending? What role can consumer associations play?