

THEME 1: PREVENTION OF DISTRESS

The first theme of the conference focused on prevention of distress among borrowers. The session commenced with a staging presentation by Deepti George of Dvara Research, titled **“Operationalising Suitability in Credit Sale: Imperatives and Challenges”**.

The presentation highlighted that the credit decisioning process, especially for low-income households, is skewed by lenders’ focus on minimising their loss in the event of default, and no meaningful attention is paid to the ability of the households to repay. There is a narrow focus on annual income that misses seasonal variability and inadequate attention to household or spousal incomes and liabilities. Further, the onus of understanding the implications of taking credit is passed on to the borrower. Credit suitability assessment is the cornerstone of ensuring customers’ ‘ability to repay’. However, beyond ensuring that the loan is “not unsuitable” at the point of sale, there is a need for higher suitability standards. Such a standard would consider a borrower’s ability to meet each repayment under a loan without having to realise security or assets or resorting to non-transient credit-dependent behaviour. India’s regulatory framework around microfinance loans was presented by Deepti to exemplify some of these issues. While the regulations now cap repayment outflows on all loans of microfinance borrowers to 50% of household income, the absence of such criteria for non- ‘microfinance’ loans such as secured loans were highlighted. Further, the appropriateness of a *fixed* debt-to-income threshold for low-income households and the use of *income* rather than *disposable income* as a measure was questioned.

The presentation then discussed how lenders could potentially undertake such suitability assessments. Estimating a household’s debt-servicing capacity (DSC) (monthly debt outflow/ monthly disposable income) would be the starting point and the key parameter on which the decision to lend would stem from. Lending decisions would then need to address situations of deficit income and varying levels of DSC (deficit, borderline, and surplus) of a household through the tenure of a loan. Setting a threshold DSC and delineating mechanisms through which even borderline DSC households can successfully service loans would be a subsequent consideration.

The capabilities of lenders will also have to be considered while requiring them to undertake cashflow-based suitability assessments. A three-tiered approach – basic, intermediate, and advanced was proposed depending on the level of technology investments the lender can make and, thereby, the scope for loan customisation. Finally, the idea of a ‘suitability engine’ that would provide suitable product recommendations was presented. Here, household repayment capacity, risk management, and day-to-day money management are essential aspects that such an engine would consider. More importantly, the fact that the financial lives of households do not occur in a void and that their relationships with their communities and

families play an integral role in their lives was recognised and highlighted. The presentation ended with customer stories highlighting borrowers' experiences with credit and lenders' challenges in ensuring suitability given different borrower profiles.

This was followed by a break-out session where delegates discussed outstanding issues concerning debt distress prevention. The key points that emerged from the discussions are as follows:

1. Market incentives for responsible lending

- There is a need for setting proper incentives for lenders to collect data for credit decisioning and conduct meaningful household repayment capacity assessments.
- Institutional perspectives on loans and loan processes need rethinking. The markets should ideally reward the most responsible. However, that is currently not the case. This begets the question - which lender would the market be quick to reward? A lender who makes suitability assessments and therefore takes time with loan disbursements or a lender who is quick to provide loans without such assessments?
- Regulatory capacity in ensuring customer protection needs to be expanded.
- Philanthropy has a clear role in setting aspirational goals by differentiating lenders by the principles of responsible lending.

2. India's regulatory framework for microfinance loans

- Regulatory cap on household income for microfinance loan eligibility is misaligned with reality, and there is potential for suppression of income. Further, the current definition of repayment capacity does not consider household expenditure.
- The prescription of credit decisioning rules could be construed as paternalistic. It might fail to account for the aspirations, ambitions, entrepreneurial spirit, and motivations of the individual or the household.
- Household definition should be broadened to reflect variability in family structures and relationships.
- Taking a household view of finances could also have its downside. The household capacity to repay might seem far worse compared to individual borrowers. For instance, a woman's portfolio might be stellar, but the spouse of the same household could have many defaults leading to adverse credit decisions.

3. Assessing household repayment capacity – Data concerns

- Centralisation of data is needed, more so in the case of low-income households. Household data is distributed across multiple financial service providers, which can pose a challenge in getting a wholesome picture of the household balance sheet.

- Lenders can undertake voluntary income and expenditure surveys to create baseline data for reference.
- Availability and use of non-financial data can also strengthen underwriting.
- Credit bureau reporting should happen more frequently than is currently the case.
- Relying solely on last-mile data collection by loan officers may lead to errors. There is perhaps a role for APIs to validate the data.
- Knowing the household composition, including any dependent members, is an important data point for credit decisions.

4. Assessing household repayment capacity – The process

- Cashflow-based underwriting will be the most appropriate for this segment. However, even in that case, the process should incorporate indicators for predicting shocks to household finances.
- Mechanisms are needed to bring informal loan repayment obligations of households and their associated stress into credit decisioning conversations.
- Assessing the ability to pay can start with offering small-ticket loans and graduating to higher-value loans based on customer repayment behaviour.
- Standardisation of data collection by requiring all lenders to capture a set of indicators and household experiences might be helpful. However, this may also stifle innovation and competition in the market.
- Borrowers may be uncomfortable sharing household information or vulnerabilities, as observed in the gig economy.
- The 3Cs of credit – capacity, collateral, and character - could be judged through carefully designed questions at the time of underwriting. However, the length of administering such questions is an important consideration.
- Credit decisioning process should not end with just a yes or no decision. It could be made more nuanced by providing options for ticket size and other terms of the product based on customer profile.

5. Product design

- Most products are created with the salaried class in mind and don't appreciate that low-income households manage financial shocks differently. Identification of borrower needs is crucial for credit decisioning, and there should be reliable tools for accurately identifying such needs, even at the product design stage.
- Lenders should take a demand-side perspective (e.g., borrower needs) when designing products and not just focus on loan origination. This may also help resolve data inadequacy issues. For example, while loan products are typically designed for a 6–9-month horizon, a borrower lens would mean 60–90-day loans. Borrowers may be able to provide more data points in case of the latter, e.g., their 90-day transactions. However, customisation may not necessarily be customer friendly as they may not

have the financial literacy to understand that their loan has terms that deviate from the standard.

- Suitability assessments should be a process and not a point-in-time exercise. There should be a continuous dialogue between borrowers and lenders to understand their repayment experience and identify restructuring needs. Therefore, product design with its flexibility features should be a factor not just at the loan origination stage but also throughout the product life cycle.
- Conversations with borrowers may allow differentiation between unintentional and intentional default and lead to appropriate solutioning.
- In the event of a default, lenders should revisit their lending processes and ask what they could have done better. For example, sales incentives for loan officers.
- Ensuring the suitability of loan products entails a trade-off between customisation and scale.

6. Underwriting consumption credit vs. Enterprise credit

- The DSC for consumption loans should be higher than the enterprise or income generation loans.
- Businesses in low-income context are mostly household enterprises. In other words, there is fungibility between household assets and enterprise assets in the case of low-income households. Therefore, underwriting for consumption or enterprise would require a near-similar approach.
- Monitoring the end-use of loans and separating customers' household activity from their business activity can be cumbersome, inefficient, and expensive.

7. Need for non-credit products

- Not all issues can be solved by credit. There is a need for non-credit products such as insurance that might be more relevant than credit in meeting specific household needs. For example, where difficulty in making repayments arises from a health risk or risks associated with agriculture, combining insurance with credit may help.

8. Building the capability of borrowers

- The space for building customers' capability, i.e., understanding a credit product and its implications before they are offered a product, has shrunk over time. Between different suitability levels, i.e., do no harm vs do better, providers are not competing based on customer outcomes but on how fast or easy it is to make credit available.
- There is a need to collectively create a space for capability building, especially in the digital era. However, the challenge lies in setting up the right incentives for providers to expend time and energy in the capacity building of borrowers. There is a role for

an external party, maybe the regulator, to decide what kind of capability the customers need in interacting with FSPs and undertake to impart such capabilities.

- While digital credit is highly valued because of fewer frictions in obtaining a loan, there is also a case for creating friction where necessary. For example, at the point of evaluation of loans by customers, there is a need for higher friction to ensure customers understand what they are getting into. Voice messages which pose questions could be included in the process, which might make a customer pause and consider before taking on a loan.

9. Role of loan officers and last-mile staff

- Incentives to loan officers and mechanisms through which we hold them accountable need careful attention.
- External regulation of processes can be challenging because loan officers may be incentivised to help households 'manage' income or expenditure figures.
- Prevention of distress also depends on the capacity of the loan officers and last-mile staff to engage meaningfully with clients. This needs substantial investment, conviction, and commitment at higher levels of the business teams in training and incentivising staff on the ground.

10. Role of industry associations, self-regulatory organisations, and consumer associations

- Customer panels and surveys can play a significant role in taking stock of customer outcomes from credit products. This is a strength that the regulator needs to build.
- A community of intermediaries having a sense of the ground reality is much needed. They can intervene and act in the capacity of community-based mediators. This is an investment that the lenders should collectively make and has the potential to bridge the trust deficit in formal credit providers.
- Certification of lenders compliant with responsible lending practices can be one approach through which lenders can be encouraged. 'Smart Campaign' is one example.
- While Self-Regulatory Organisations (SROs) have codes of conduct for responsible lending, it comes with limitations as they are not enforceable.

11. Transitioning to digital lending

- With microfinance going digital, there is a need for continued field presence and human touch.
- Post-pandemic, there has been a shift in how customer meetings are being conducted. While earlier, there was space for social and cultural counselling, which played an important role in cases of debt distress, they have now become more transactional.

12. Debt counselling

- Debt counselling in the Indian context should go beyond just debt and should aim to educate borrowers about their rights, good money management practices, etc. This will bring a sense of ownership to the community.
- The costs of such counselling should be borne by lenders. For example, lenders compensate debt counsellors in South Africa and the United States.