THEME 3: ALLEVIATION OF DEBT DISTRESS

After detailed discussions about the means of preventing and identifying debt distress among low-income households, the conference proceeded to its third theme of discussing ways to alleviate the distress of such borrowers. Two staging presentations laid out some of the recent thinking and conceptual developments in the domain of debt distress alleviation.

In the first staging presentation, titled "**An Overview of Approaches to Alleviate Debt Distress**", Dwijaraj Bhattacharya from Dvara Research focused on outlining how India's Insolvency and Bankruptcy Code (IBC) can evolve to tackle distress resulting from idiosyncratic and system-wide shocks. The presentation discussed the need for balancing clemency and moral hazard in deciding when, why, and how debt could be forgiven. Further, it discussed the contours of a fresh start mechanism for asset-light, low-income, low-debt borrowers that could offer respite and a dignified restart for a subsection of borrowers who might need and deserve it the most.

In the second staging presentation, titled "**Debt Moratoria in the Pandemic: Experiences & Lessons**", Patrick Meagher from CGAP summarised the main challenges posed by borrower relief measures during the pandemic. The presentation informed the audience about how policymakers, financial service providers and borrowers grappled with the multiple challenges that came with the implementation of the debt moratorium that was introduced in many countries as a relief measure during the COVID-19 pandemic. It detailed how they dealt with the challenges from initiation and operationalisation to providing a suitable ending to the moratoria. The design of the moratoria had to contend with not just borrower protection but also lender solvency and systemic stability. The presentation offered key lessons and suggestions for providers and regulators to set measures that promote good customer outcomes.

This was followed by a break-out session where delegates discussed outstanding issues vis-à-vis alleviation of debt distress and presented ideas on how various stakeholders can work together to alleviate distress among borrowers. The key points that emerged from the discussions are as follows:

1. **Customer centricity**
    - The view of default should not be myopic, with a focus on ensuring repayment. Financial Service Providers (FSPs) should instead determine the lifetime value of the customer's economic enterprise while trying to address default.
    - Debt alleviation measures must ensure that borrowers are not excluded from subsequent rounds of lending. Nevertheless, there will still be a cohort of borrowers for whom subsequent debt would be impossible, and they would not be able to access further debt.
    - Lenders should explore avenues for providing top-up loan options to customers. While this could be construed as evergreening, in some contexts of seasonal distress, evergreening itself could be an alleviation strategy. However, evergreening or top-up loans with the intent of collecting processing fees or

growing the lenders' loan books can lead to mis-sale and unsuitable credit uptake.

- Repayment history of customers could act as a proxy for the customer's intent whether the default is wilful or one arising from a change of circumstances. FSPs should use such information to tailor restructuring or provide tide-over loans for borrowers in genuine distress. However, the scalability of such customer-centric alleviation processes could be challenging. Leveraging technology could help reduce the costs and time involved in personalised alleviation measures.
- Human consideration must temper the market's race for growth in the lending space. Financial service providers should inculcate organisational and cultural ethos of empathy towards their clients. This will result in not expecting clients to undertake inhuman and sub-optimal coping strategies (such as cutting back on food, education or health care expenses, etc.) to service overdue loans.

2. Burden of responsibility

- Early or prompt payment by borrowers should be appropriately incentivised and recognised since it mitigates the risk of unforeseen events and defaults for the lender.
- Lenders should be held accountable for not conducting proper due diligence when sanctioning loans – credit should not be an option where households' income stream does not support it. In South Africa, for instance, the regime states that borrowers who default in distress do not have to repay a loan if they can show that the lender did not make proper assessments before lending.
- While a fresh start mechanism for a sub-section of deserving borrowers might be helpful, it carries the risk of moral hazard. The cost of a fresh start (its impact on credit score, for instance) could be aligned to mitigate moral hazard.
- A structured process for one-time settlement can involve multiple lenders, and any insolvency framework should provide for the fair assignment of responsibility and losses.
- Loan officers could act as a crucial lynchpin in the system and help identify and effectively deal with distress before it spins out of control. FSPs need to evaluate and incentivise loan officers accordingly. Their mandate should go beyond chasing targets and volume to ensuring asset quality and lasting client relationships.
- Given that this customer segment cannot possibly bear the cost of counselling or mediation, providers or even SROs can pay for such support mechanisms as they have the benefit of reducing the number of delinquencies lenders will have to deal with.

- Investors have a substantial role in dictating the value of an FSP. Social performance indicators of companies could encourage more customer-centric investment behaviour.
- While finance has become individualistic, traditionally, the community has played a crucial role in counselling the overindebted. In the UK, church-driven organisations and evangelical groups sensitised members about sound financial practices and acted as counsellors. Similarly, financial products could be designed to incorporate the active participation of community or civil society organisations. For example, leveraging a community of farmers through a Farmer Producer Organisation (FPO) to lend to an individual farmer.

3. Arbitration channels

- Mediation and ombudsman mechanism should be implemented as the first measure to address debt distress. Clear escalation channels should be laid out – from mediation to ombudsman to moratoriums and then to insolvency and recovery.
- This raises the need for a robust debt counsellor infrastructure that can help low-income households navigate the debt alleviation architecture. The existing debt counselling system in the United Kingdom is a case in point. Also, the credit counselling program in South Africa was formulated as a response to the loan sharks who became commonplace after the end of the apartheid and the resultant problem of unsustainable debts among poor households.
- Debt counselling can start at the time of lending or when the credit score drops below a certain threshold and not necessarily at the time of default. Counselling should address both the financial and psychological aspects of debt burden.
- Rules of mediation and clear ethical guidelines have to be put in place for the mediation ecosystem to function optimally and to prevent any gaming of the system. The regulator or customer protection forum can oversee the implementation of such rules.
- A pre-approved strategy for predictable emergencies such as earthquakes, storms, floods, etc., could avert en masse defaults and the resultant mass loan waivers. This will help avoid bad loan culture and ensure optimal credit discipline even during tough times.
- Access to redress mechanisms for complaints against arbitrators, debt collectors, and counsellors is also essential and must be considered carefully. The decentralised para-judicial body, Lok Adalat, could be considered for grievance redress. The digital lending space makes borrowers particularly vulnerable as they have no avenues for requesting restructuring or recourse to predatory lending practices.

- Documenting successful debt relief cases could be a good reference for FSPs and motivate them to implement rewarding yet customer-friendly practices in dealing with debt distress.

4. **Safety nets**
   - For low-income customers, a detailed stock-taking of the different government schemes they are eligible for could be part of the debt assessment process. While it is unclear what the incentive for the lender might be, it could provide a modicum of support to families that start experiencing debt distress and are looking for ways to ease their expense and debt repayment burden.
   - Augmenting social security could help alleviate some of the distress for this customer segment. For instance, additional sources of income through MGNREGA and guaranteed living essentials such as ration, health care and education could act as robust safety nets for those households that face debt distress. However, conceiving government schemes as a tool for alleviating debt distress could have ramifications for the country's design and sponsoring of welfare schemes.
   - There is merit in considering a common fund that lenders can create as a buffer to write-off loans for those borrowers eligible for a fresh start mechanism. There is a case for even the regulator to set up such a fund. However, lenders might sometimes find it cheaper to write off some loans (especially small-ticket ones) than expending the time and energy to restructure and rehabilitate distressed borrowers. Therefore, any write-off protocol must recognise agent incentives to ensure good customer outcomes and not just good balance sheets.

5. **Regulations**
   - Since distress is always situational and subjective, industry-wide context-agnostic protocols might not work to alleviate debt distress. Instead, regulators can opt for contextual frameworks and protocols for lenders to deal with different debt distress situations.
   - Regulators should be in close and regular contact with civil society. There is a need to form a representative customer forum that could act as the voice of customers from this segment.
   - Mitigation and alleviation protocols should consider the proximity or nearness of default, the severity of insolvency, and the temporal characteristics of the client’s financial state in their design.
   - Fresh start will require more awareness and political buy-in to become a policy or regulatory reality. Advocacy around the need for a personal insolvency code will help build consensus. By some estimates, a mechanism like a fresh start can immediately provide respite to around 2 to 3 crore people as against a 35-lakh portfolio under the Insolvency and Bankruptcy Code (IBC).

- Arriving at the contours of eligibility criteria for a fresh start mechanism would also be fraught with multiple subjective challenges. A balance must be struck between customer-centric design and cost of implementation in any debt distress protocol.
- The actual versus the intended impact of different product design interventions on preventing, identifying, and alleviating debt distress need to be monitored for responsive policy measures. The cultural and behavioural aspects that contributed to the success or failure of any scheme or product feature must be studied and documented to build more robust credit market regulations.