

Credit Counselling : An Indian Perspective¹

Mr. Chairman, distinguished guests and friends,

I am thankful to Mr. Balachandran for providing this opportunity to be with this eminent gathering assembled for a noble cause. Bank of India has been among the banks known to be a pioneer in several areas of commercial banking. In this context, the initiative by the bank to establish credit counselling centers on a pilot basis highlights the pro-active role being played by our banks. In fact, a major reason for my agreeing to participate in this ceremony is to demonstrate the Reserve Bank of India's commitment to the cause of credit counselling - a recent initiative in our country.

In my remarks on this occasion, some introduction on the importance of this topic would be in order. An overview of the global practice in this area could then be followed by a discussion of the Indian context with regard to credit counselling. Any mechanism of credit counselling has to reckon with the processes, costs and benefits. The concluding thoughts are in the nature of illustrative issues towards initiating and popularising credit counselling in India.

Introduction

With the changing growth dynamics of the economy, it is not difficult to envisage situations where certain segments of the population become susceptible to excessive borrower optimism or even to vicissitudes in the economic environment. Such susceptibility could also arise from unforeseen shocks or emergencies that make repayment difficult. By providing sound advice to arrest the deterioration of incomes and restructure their debt, credit counselling offers a meaningful solution for borrowers to gradually overcome their debt burden and improve their money management skills. In this regard, the question is whether there is a role for public policy in matters relating to credit counselling?

We must recognise that financial intermediaries, the corporates and high net worth individuals generally possess in-house knowledge of matters relating to financial management and can afford to employ outside expertise as appropriate in regard to their investment decision and management of distressed loans. Public Policy has enabled an operational mechanism in the form of Corporate Debt Restructuring (CDR) in regard to loans by banks and development financial institutions to large corporates. Somewhat similar framework has also been provided to small and medium enterprise. In regard to agricultural loans and most of the small borrowers,

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however, only broad guidelines are issued to banks from time to time on parameters for restructuring. The extent of active interaction between individual borrowers and banks is, therefore, not clear.

It is increasingly felt that individuals are not in a position to take full advantage of the guidelines issued to the banks for variety of reasons. These may include inadequacies in managing their finances especially delinquent accounts. Further, individuals may not be able to articulate their financial situation adequately to the banks. It will be in the interest of the banks themselves to help individual borrowers through appropriate credit counselling. Public policy could, therefore, have an advisory role in encouraging mechanisms in the form of credit counselling in regard to individuals. There are a variety of ways in which this has been accomplished in different countries, but in India we are just beginning to address the situation. Some urgency has been lent to this issue in India in view of rapid growth in consumer loans, housing loans and the more recent emphasis on financial inclusion. It is interesting to note that the terms of reference of the Financial Inclusion Task Force initiated by the Treasury of the United Kingdom to consider solutions to the problem of financial exclusion identifies three key areas. This includes face-to-face money advice in addition to access to banking and access to affordable credit.

Global practice

The first well-known credit counselling agencies were created in 1951 in the United States when credit grantors created the National Foundation for Credit Counseling (NFCC). Their stated objective was to promote financial literacy and help consumers to avoid bankruptcy. Credit counselling, however, came into its own as a result of the passing of the Housing and Urban Development Act in 1968. Under this Act, the US Department of Housing and Urban Development was allowed to authorize public and private organizations to provide counselling to mortgagors. The resulting services and infrastructure to provide them led to the development of the credit counselling industry.

In 1993, the Association of Independent Consumer Credit Counseling Agencies (AICCCA) was founded in the United States, citing a need for industry-wide standards of excellence and ethical conduct. This formally organized the NFCC's competition. The AICCCA was formed from the group of counselors who favored telephone delivery of debt management programs. The NFCC was, in the beginning, strongly opposed to this telephone business model, primarily favoring face-to-face counselling as a more effective solution. Eventually, all organizations practiced both phone and face-to-face processes with some agencies using large inbound call centers driven by mass media advertising.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 made credit counselling a requirement for consumer debtors filing for bankruptcy in the United States. In order to meet this requirement, during the 180-day period preceding the filing of bankruptcy, the debtor must complete a program with an approved non-profit budget and credit counselling agency. Such a program may include, but is not limited to, one counselling session conducted by phone or over the internet.

Quickly, the concept caught the attention of other countries and over the last several years, a whole host of countries have undertaken significant initiatives towards credit counselling. The *Consumer Credit Counseling Service (CCCS)* in the UK, established in 1993, helps consumers with budgeting and better money management as also their debt repayment plans. Funding for CCCS comes from the businesses in the community which benefit from repayment they would not receive if the debtor defaulted. In addition, there is also a National Debt Line through which a bank customer can get free financial advice. In fact, the Banking Code in the U.K. provides that member banks shall discuss financial problems with customers and together evolve a plan for resolving these problems.

Canada established a non-profit counselling organization in 2000. Termed *Credit Counseling Canada (CCC)*, the organization seeks to enhance the quality and availability of not-for-profit credit counselling for all its citizens. The Bank Negara Malaysia has established a *Credit Counseling and Debt Management (CCDM)* agency to provide credit counselling and loan restructuring advice to individuals. The arrangement is expected to be a prompt and cost-effective means of debt settlement based on the repayment plan between creditors and the debtor without intervention of courts. With rising personal bankruptcies, primarily on unsecured debt, Credit Counseling of Singapore (CCS), established in 2003, is meant to assist financially distressed consumers.

Indian context

In India, there has been a sharp growth in credit to household in recent years. According to the all-India Debt and Investment Survey 2003, nearly a fourth of the households were indebted in 2002. The per cent of indebtedness households in rural areas increased sharply from 23 in 1991 to 27 in 2003; the corresponding figures for urban areas during the same period were 19 and 18, respectively. At end-March 2004, the total number of loan accounts under direct finance to farmers was nearly 20 million, comprising over 95 per cent of total number of loan accounts under the priority sector; the amount involved was well over 70 per cent of total priority sector loans.

Even taking into account the changes in classification and coverage, bank credit to housing and consumer durables witnessed an exponential growth rate of over 50 per

cent during 2001-2006, nearly double the growth recorded in overall non-food credit over the same period. As a consequence, the share of housing and consumer durables in overall non-food credit by scheduled commercial banks increased from around 5 per cent in 2001 to nearly 14 per cent in 2006.

Rapid economic growth coupled with demographic dynamics has led to a significant change in consumers' perceptions in our country. With a burgeoning middle-class and changing lifestyle aspirations, more and more people are resorting to debt to finance their consumption and asset creation. At some stage in some cases, this could potentially lead to excesses, precipitating defaults. Such defaults could also be the fallout of circumstances beyond one's control. Costly medical emergencies, retrenchment from job, hardening of interest rates could inadvertently raise debt burdens in some cases not easily manageable within a given income stream. This is partly reflected in the growing number of customer complaints against banks in the recent past. Over the period January 2003 to June 2005, the number of complaints relating to loans, credit cards and harassment in recovery aggregated nearly 34 per cent of total number of complaints, which reinforces the need for credit counselling in a dynamic economic environment.

The proportion of people dependent on agriculture still remains high in our country. With a predominantly rain-fed agriculture, monsoonal vagaries coupled with lack of adequate risk mitigation policies could sometimes lead to hardship for the rain-dependent segment of the population. This needs to be considered in conjunction with the fact that the levels of literacy in our country are still relatively modest at 65.4 per cent in 2001, with wide differentials between urban and rural areas. For instance, in 2001, the proportion of rural literate was about 59 per cent as compared with 80.3 per cent in the urban areas. Additionally, the organised sector employment presently comprises less than 10 per cent of the workforce, leaving the vast majority of the working population with irregular income streams and paucity of defined safety net, making them susceptible to unforeseen contingencies. This assumes even greater relevance in situations where the penetration of formal finance is less than adequate, presumably compelling people to take recourse to costly informal finance, often in conjunction with loans from banks.

While the 'arithmetics' of extending credit are often diligently followed by lenders, in the absence of consistent credit histories, banks are often at a loss in case of non-repayment by borrowers. Given the growing indebtedness, there is an increasing need to develop follow-up services to enable distressed borrowers overcome credit delinquencies. Credit counsellor thus offers a viable task-specific, advisory *ad hoc* intermediary between the borrower and the bank concerned.

Counselling on the above lines generally serve three purposes. First, it examines ways to solve current financial problems. Second, by creating awareness about the costs of misusing a credit, it improves financial management and develops realistic spending plans. Third, it advises the distressed people to gain access to the structured financial system, including banking. However, such counselling will be appropriate only if it addresses unique situations of households in different parts of India.

Processes, costs and benefits

It is technically possible for credit counselling to be ex ante or ex post. Ex ante counselling helps borrowers to decide upon the quantum of loans they can avail, based on their income profile and stream of cash flows. More importantly, ex ante counselling attempts to influence the stability of the borrowers' flow of income and expenses, thereby lowering the probability of default. Ex post counselling typically occurs after a crisis event, when the borrower has already missed one or several payments. The purpose of such counselling is to prevent default and foreclosure. It is, therefore, curative in nature.

Credit counselling in practice generally tends to be ex post in nature. Such counselling involves one-on-one meetings, allowing the counsellor to observe the level of maintenance of the debt and other issues relevant to the stability of the borrower's situation. It includes advice on not only crisis management, and budgeting but also exploring avenues and networks that can provide succour in the interim. Owing to these reasons, such counselling can be expensive, owing to the not-so-insignificant administrative costs involved.

A credit counselling agency often receives most of its compensation from the creditors to whom the debt payments are distributed. This funding relationship could lead to the impression that credit counselling agencies are merely collections wings of the creditors. It is therefore essential to guard against these undesirable possibilities.

In many instances, nurturing a borrower back to health after a default can be a time-consuming process, besides causing severe inconvenience for the distressed families. Traditional banking technologies rely mainly on a set of pre-assigned standards to determine whether a potential borrower will be able to service a loan. This lack of knowledge on low-income household circumstances restricts the banks ability to objectively assess whether the expected loan can be sustainable.

Sometimes, a two-track approach towards mitigation of borrower risks is advocated. In the near-term, credit counselling can constitute an integral part of banks' loan application, which can facilitate better assessment of credit risk and repayment capacity. In the urban areas, where people are more techno-savvy, such counselling

can take place over the internet or the phone. In the rural areas, such interface could be made more personalised through direct face-to-face interaction with the affected clientele. Such preventative counselling would enable the borrower to determine the optimal level of sustainable debt and pre-empt deterioration of accounts at a future date. This is also likely to lower the incidence of customer complaints against banks.

An important consequence of the counselling process may be that, as potential borrowers learn more about the way financial markets function, they may learn to behave more strategically and to prepay more often when interest rates are benign. If such behavior becomes prevalent, together with a positive effect of counselling on default, it may be an additional argument that counselling helps low-income borrowers.

Issues

It is necessary to recognise that there are several issues which require to be addressed in identifying possible approaches to initiate and popularise credit counselling for individual borrowers. Let me flag some of these issues for your consideration.

First, how well can we combine credit counselling with some elements of financial literacy?

Second, should credit counselling concentrate on ex ante or only on ex post elements or some combination of both?

Third, should credit counselling agencies devise differential mechanisms to take into account different credit segments such as housing loans, consumer loans, farm loans as well as different categories of individual borrowers such as salaried, self-employed, seasonally employed etc? Is it better to have more general credit counsellors?

Fourth, given the differential nature of cash flows and consumption patterns in rural and urban areas, is there a need for a segmented approach towards credit counselling?

Fifth, should there be accreditation of credit counsellors? If so, who should do it - industry association or individual banks? Should counselling be a full-time or part-time work for the credit counsellors?

Sixth, what should be the elements of confidentiality that are assured in this process to gain the confidence of distressed borrowers in need of counselling?

Seventh, how do we select the credit counsellors, equip them to do the work and make them accountable? What type of training - both in terms of knowledge and attitude - could be imparted to make credit counsellors effective? Can the training colleges of banks be of help in this respect?

Eighth, should there be a role for non-governmental organisations (NGOs) and consumer organisations in order to expand the outreach of counselling practices?

Finally, should the findings emanating from the discussion of credit counsellors constitute part of the agenda for the District-Level Bankers' Committees?

I have only touched upon some of the issue germane to the initiation of the process at the present juncture. What is, however, important is to recognise that instead of a 'one-size-fits-all', banks should be free to experiment and evolve their own mechanisms and adopt approaches best suited to their business philosophy. Since financial counselling pertains primarily to individual borrowers at the local level, a decentralised approach could prove useful. Being a relatively new area whose potential is still to be proved, it is imperative to proceed in measured steps and reassess the situation based on the experience gained. In progressing towards this laudable objective, we, however, should not create another cadre of employees or potentially avoidable intermediaries between banks and their borrowers.

We, in Reserve Bank are happy to note the initiative taken by Bank of India in starting credit counselling centres on a pilot basis. The involvement of trust 'Abhay' lends value and credibility to this pilot project. It is also noteworthy that one each in urban and rural areas is being initiated. We are looking forward to learn from the experience of this laudable initiative. I commend other banks to attempt some pilot projects, as considered appropriate by them, to explore the potential for beneficial use of credit counselling.

Thanking you.