# Arohan Financial Services Limited

## Pricing Policy for Microfinance Loans

**Prepared by**
Executive Committee

**Version No.**
4.2

**Date**
February 2025

Approved by the Board of Directors



| Issue Date | Version No. |
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| November 2024 | 4.1 |
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# Context

Arohan Financial Services Limited (also referred to as 'Company' in this document) is registered as a Non-Banking Financial Company – Micro Finance Institution (NBFC-MFI) with the Reserve Bank of India (RBI).

Prior to April 2022, as per the RBI, the interest rates charged by an NBFC-MFI to its borrowers was the lower of the following:

- Cost of funds plus a margin cap of 10% for MFIs with portfolio of ₹100 crore or above & 12% for others
- The average base rate of the five largest commercial banks by assets multiplied by 2.75 for the next quarter.[1] The average of the base rates of the five largest commercial banks shall be advised by the Reserve Bank on the last working day of the previous quarter, which shall determine interest rates for the ensuing quarter.

Among various entities serving microfinance customers in India, particularly only NBFC-MFIs were under the above imposed restrictions. Universal or Scheduled Commercial Banks, Small Finance

[1] The average of the base rates of the five largest commercial banks shall be advised by the Reserve Bank on the last working day of the previous quarter, which shall determine interest rates for the ensuing quarter.



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Banks, NBFC and other entities like non-profit ventures historically had not been under any similar pricing restrictions.

On 14th March 2022, RBI released Master Direction – Reserve Bank of India (Regulatory Framework for Microfinance Loans) Directions, 2022, with effective from 1st April, 2022 applicable to all the regulated entities (REs) including Banks, Small Finance Banks (SFBs), Non-banking Financial Companies (NBFCs) and NBFC-MFIs[2]. One of the key guidelines in the document include deregulation of the pricing of NBFC-MFIs to ensure that the interest rates charged to customers is fair, transparent and competitive. The document under clause 6, Pricing of Loans, states:

*6.1 Each RE shall put in place a board-approved policy regarding pricing of microfinance loans which shall, inter alia, cover the following:*
*(i) A well-documented interest rate model/ approach for arriving at the all-inclusive interest rate;*
*(ii) Delineation of the components of the interest rate such as cost of funds, risk premium and margin, etc. in terms of the quantum of each component based on objective parameters;*
*(iii) The range of spread of each component for a given category of borrowers; and*
*(iv) A ceiling on the interest rate and all other charges applicable to the microfinance loans.*
*6.2 Interest rates and other charges/ fees on microfinance loans should not be usurious. These shall be subjected to supervisory scrutiny by the Reserve Bank.*
*6.3 Each RE shall disclose pricing related information to a prospective borrower in a standardised simplified factsheet.*
*6.4 Any fees to be charged to the microfinance borrower by the RE and/ or its partner/ agent shall be explicitly disclosed in the factsheet. The borrower shall not be charged any amount which is not explicitly mentioned in the factsheet.*
*6.5 The factsheet shall also be provided for other loans (i.e., collateralized loans) extended to borrowers from low-income households.*
*6.6 There shall be no pre-payment penalty on microfinance loans. Penalty, if any, for delayed payment shall be applied on the overdue amount and not on the entire loan amount.*
*6.7 Each RE shall prominently display the minimum, maximum and average interest rates charged on microfinance loans in all its offices, in the literature (information booklets/ pamphlets) issued by it and details on its website. This information shall also be included in the supervisory returns and subjected to supervisory scrutiny.*
*6.8 Any change in interest rate or any other charge shall be informed to the borrower well in advance and these changes shall be effective only prospectively.*
*6.9 As part of their awareness campaigns, SROs/ other industry associations may publish the range of interest rates on microfinance loans charged by their members operating in a district. SROs/ other industry associations may also sensitize their members against charging of usurious interest rates.*
*6.10 RBI would also make available information regarding interest charged by REs on microfinance loans.*

The above guidelines will lead to a level playing field with the same set of rules for all player categories. This will make it easy for NBFC-MFIs who until now are bound by a cost of funds plus a

[2] Source: Master Direction – Reserve Bank of India (Regulatory Framework for Microfinance Loans) Directions, 2022 (https://rbi.org.in/Scripts/NotificationUser.aspx?Id=12256&Mode=0)

margin formula price for risk and to compete with these institutions as the same regulations will be applicable to all players in the industry.

In view of the same, Arohan presents a new pricing policy for approval by the Board, before implementation.

## Background

Currently, the microfinance industry is being catered by different types of RBI-regulated lending institutions like:

- Scheduled Commercial Banks/Universal Banks
- Small Finance Banks
- Non-Banking Financial Companies
- Non-Banking Financial Companies – Micro Finance Institutions
- Other entities, like not for profit ventures.

The lending rate for some of these institutions is in the range of 21% to 26.5% with average lending rate of 23.97%:

## Pricing Framework for Qualifying Assets

The pricing framework will have two main components: interest rate and other charges/fees for customers. Company aims to have a customisable pricing framework factoring historical data across products and customer segments. The approach for the framework is as below:

The Company had on March 17, 2022 put in place a Board approved Pricing Policy for Microfinance Loans, covering a comprehensive interest rate model for arriving at the rate of interest. The model delineates various components of the interest rate such as cost of funds, operating expense, credit risk premium and margin, in terms of the range of spread of each component for a given category of borrowers and all other charges applicable to the microfinance loans. The Asset and Liability Management Committee (“ALCO”) is also the appointed Pricing Committee and reviews the pricing every quarter.

The Company’s Pricing Framework has three key components:

- The first is an auditable data verified pricing model that looks at past trends to project the pricing guidance.
- The interest rate number coming out of the pricing model is overlaid with a Board approved Pricing Range Guidance and a Board guided position in the Peer Review Framework. The Board directed pricing guideline as of last quarter offered a narrow range of movement between 24.00%-25.25%.
- The peer comparative sheet including listed and unlisted NBFC MFIs, Universal banks, SFB’s and the Board guidance is to be in the middle of that pricing peer group.

The Arohan Pricing Model for Qualifying MFI loans as of September works out to a minimum rate of **25.90%** but with the benchmarking discipline, we priced it between 24.00% to 25.25% across the various products.

**Pricing Calculation for Qualifying Assets:**

| Particulars | Pricing Calculation for Q3 FY25 | | |
|---|---|---|---|
| | Lower Interval | Forecast | Upper Interval |
| ***Risk premium Computation*** | | | |
| Organic PC POS as of Sep'24 | 6440.61 | 6440.61 | 6440.61 |
| Projected Net PAR 0% for Mar'25 | 5.61% | 6.46% | 7.32% |
| Projected Net PAR 90% for Mar'25 | 1.15% | 2.49% | 3.83% |
| **Net** Projected Provision for Mar'25 | 2.45% | 3.56% | 4.68% |
| **Credit Risk Premium** | **2.45%** | **3.56%** | **4.68%** |
| ***Pricing Computation*** | | | |
| Borrowing Cost net off interest on lien marked FDs | 11.79% | 11.79% | 11.79% |
| Opex | 7.24% | 7.24% | 7.24% |
| ROA | 3.50% | 3.50% | 3.50% |
| **Reference rate** | **22.53%** | **22.53%** | **22.53%** |
| *Liquidity Risk Premium* | *0.92%* | *0.92%* | *0.92%* |
| *Credit Risk premium* | *2.45%* | *3.56%* | *4.68%* |
| **Reference Rate post Risk Premium** | **25.90%** | **27.01%** | **28.13%** |

For the month of September, 2024 the actual disbursements were at a blended interest rate of **24.58%** per annum on a reducing balance basis. The Key Fact Statement, which also mentions Annual Percentage Rate (APR) as required by RBI circulars, was implemented w.e.f. 1st Oct'24.

As per guidance received from the Reserve Bank of India, the company needs to look beyond just the past or current trends and to challenge the pricing framework to consider a future forward stance by looking at efficiency driven targets that challenges the Management to solve for the problem rather than transmit the cost to the customer.

The company has decided to insert a "Spirit of Pricing Framework" to the current Pricing Policy Framework as per the following:

### Arohan's Spirit of the Pricing Framework

The Microfinance borrower is a vulnerable borrower. She is exposed to multidimensional risks and hence the Pricing Framework for such a borrower must take into account the context of her livelihood, her income and risks surrounding her. The spirit of the framework is enshrined to sensitize the pricing committee to the segment of the population and to design our pricing guidance accordingly.

Board believes that Arohan Pricing Framework should be forward looking and designed such that in case of favourable Marco-economic tailwinds the customer should see beneficial flow in form of reduced cost, and during macro headwinds the customer should be shielded from risk of increased costs. The Pricing Framework while considering past trends, would also take into account forward conditions to achieve a balanced pricing output.

Drawing from the above spirit, the core component of the Pricing Framework is being amended.

On the basis the spirit of the Pricing Framework deployed in November 2024, the company decided to introduce a reduced pricing **range of 22.00% - 22.99%** from the earlier range of 24% - 25.25% for all new loans.
The Board's guidance on Peer Review Framework is that Arohan should feature amongst **the lowest five NBFC MFI's on blended pricing.**
Further, the Board has also advised in the new "Spirit of MFI Pricing" approach a self-imposed margin cap of 12% over the cost of funds for Microfinance Qualifying assets.

**BROAD STRUCTURAL COMPONENTS OF RISK BASED PRICING**

## 1. Interest Rack Rate

Given the microfinance customer segment and that microfinance loan products are unsecured, of relatively small amounts and short tenures, Company will offer fixed interest rack rate to customers. The interest rack rate will be based on various factors for consideration, including but not limited to:

- Cost of funds pertaining to borrowings
- Operational expenditure on manpower and occupancy
- Business risks including credit costs & liquidity risk premium
- Desired Return on Assets (ROA) to be a sustainable & viable business.

### 1a. Reference Lending Rate

Company may factor the following costs indicators to arrive at the reference lending rate:

| S No | Indicator | Explanation |
|---|---|---|
| 1 | Cost of funds | |
| A | Borrowing | Company borrows funds through various means (i.e. term loans, debentures, subordinated debt, etc.) and considers the weighted average cost of borrowing, including the processing fee paid on the borrowing. |
| B | Fund raising | Company will factor in costs related to fund raising, such as brokerage /advisory/ market intermediation, rating, hedging, legal services, commissions, etc. |
| C | Negative carry on investments | Company may pledge investments to raise borrowings and maintain liquidity buffer in the form of investments into liquid and other funds to manage its liquidity risks. These have a bearing in terms of negative carry on investments and increase the overall costs of funds. |
| 2 | Operational expenses | Company incurs costs related to operations, employees, physical infrastructure (fixed and variable costs), sales and marketing, technology, and other items. |
| 3 | Return On Assets | Company aims to have expected return on assets, in order to sustainably deliver its services to customers as a going concern. |

## 1b. Risk premium

### Product/Customer Segment, Market Dynamics & Liquidity

Post defining the base lending rate, Company will aim to define variable risk premium based on its product and customer segments, historical data for its own products, industry products and customer segment risks, prevailing market rates of competition, etc. Also, the cost to maintain liquidity as per RBI regulation and lenders requirements would be derived.

In addition, Company aims to have a differential approach to pricing based on customer segment and profile (i.e. nature of employment, income segment, age, location, credit history, vintage with the Company, etc.). Company will also factor in prevailing market rates to stay competitive.

Reference Lending Rate + Credit Risk Premium + Liquidity Risk Premium = Interest Rack Rate

Some factors for consideration are:

| S No | Indicator | Explanation |
|---|---|---|
| 1 | Product specific risk | Type of loan: Group/Individual/SME, loan size, loan tenure |
| 2 | Customer segment risk | The type of customer segment (employment history, income level, educational qualification, location, vintage of formal credit, indebtedness history), based on Company-level and industry-level data. |
| 3 | Subvention/guarantee | Subvention/guarantee coverage discounts to customers provided by the any government or regulatory authority |
| 4 | Pricing in the market | Rate of interest charged for similar loans to similar segments by other entities in the industry. |

### Individual risk profile of Customer[3]

Another deciding factor for pricing is the individual customer's profile, and Company may factor in several factors on this, such as:

| S No | Indicator | Explanation |
|---|---|---|
| 1 | Vintage | Customer's relationship with the Company i.e. years/vintage, number of loans taken |
| 2 | Past repayment track record or Credit Score | Customer's repayment record with various lenders through Credit Bureau reports or score |
| 3 | Customers & Product Segment | Risk pricing is driven by Customer category such as New-to-Credit, Used-to-Credit and product category. Additionally, microfinance Saral customers under Used-to-Credit & Repeat segment is also offered differential price based on Arohan's NIRNAY Credit score thresholds |

[3] including co-borrower

### 2. Other Fees and Interest

Company will define the fee and charges associated with a loan product in percentage or absolute terms.

| S No | Indicator | Explanation |
|---|---|---|
| 1 | Processing | Initial application fee to cover for processing the loan application, to cover sourcing, credit appraisal, documentation, verification etc. The Processing fee to be charged will be decided in the ALCO-Pricing Committee and will be in line with competitive landscape / industry players. Processing fees will be in the range of 1 – 1.5% plus GST as applicable. |
| 2 | Interest on Delayed Payment | Interest arises due to delay or failure in payment (like cheque/NACH/digital payment failure due to insufficient balances in the bank account or other issues at the customer end). |

## Pricing Framework for Non- Qualifying Assets

To cater to the diverse spectrum of borrowers, Arohan is also engaged in funding to non-MFI borrowers who does not qualify as MFI customers as per the RBI regulations. The business under this segment would be restricted as per the RBI regulations for NBFC-MFIs, which is 25% currently.

The pricing for these segments of borrowers will be as decided by the Asset Liability Committee (ALCO) or the Credit Committee in case of Term Loans to borrowers other than to individuals.

The interest rack rate will be based on various factors for consideration, including but not limited to:

- Cost of funds pertaining to borrowings
- Operational expenditure on manpower and occupancy
- Business risks including credit costs & liquidity risk premium
- Desired Return on Assets (ROA) to be a sustainable & viable business.

The Interest Rate cap for Non-Qualifying Assets lending will be capped at a Max rate of 29%. Similarly, the Loan processing fee will be capped at a max rate of 3% of the Loan amount.

## Proposal

In order to be fair and competitive in the microfinance industry on one side while being sustainable & viable on the other, the Company aims to have a revised interest rack rate for pricing of its microfinance loans.

Company aims to have a rack rate of pricing, which is competitive across different entity types in Indian microfinance.

Customer behaviour, which may impact the back-ended discounts and promotions given to customers, may depend on a variety of factors, including but not limited to:

- Loan size
- Loan vintage
- Digital/cashless repayment behaviour
- Regular repayments during stressed times (E.g.: COVID-19 Waves I and II)
- Regular attendance at centre meetings
- Loyalty to Arohan with higher number of credit relationships with the Company
- Referrals of other customers
- Credit score arising from Company's proprietary credit scoring model
- Desired centre attendance and regular repayment behaviour of customers

Effective interest rack rate and discounts offered therein will be finalized by the Company's Asset Liability Committee (ALCO) which will also be the Pricing Committee. There may be changes in the interest rates offered to customers to align with regulations, market developments and external environment from time to time. ALCO, at its sole discretion, may offer certain benefits to customers, who are attending centre meetings and making payments on time and regularly, by providing them with higher loan amount and/or offer lower interest rates in subsequent loan cycles. ALCO may also choose to offer flexible interest rates to all/select customers, if so desired.

Composition of the ALCO/Pricing Committee for the Company stands as below:

| Asset Liability Committee | Members |
|---|---|
| Chairperson | Managing Director |
| Vice Chairperson | Chief Financial Officer |
| Member | Chief Business Officer |
| Member | Chief Risk Officer |
| Member | Head of Credit |

Interest rates along with minimum, maximum and average interest rates will be published & made available on the Company's website, at every microfinance branch, as well as in loan documentation to customers, in line with prevalent RBI guidelines and any change in interest rate or any other charge will be informed to the borrower well in advance. Every meeting the ALCO will apprise the Executive Committee and Board of Directors of the Company of the interest rates charged on its products last quarter and its competitive positioning in the market.

## Submission

This document is being presented to Arohan's Board for discussion and noting.



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# Annexure I. Specimen of Lending rate

The table below showcases the pricing policy transmission to various products as below with effect from 31st October 2024

**Pricing for Qualifying Assets:**

| CURRENT RATES | | | | | REVISED RATES | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Reporting product Group | Min Rate | Max Rate | Avg. Rate | | Min Rate | Max Rate | Avg. Rate | | Rate REDUCTION |
| MFI Saral Repeat | 24.25% | 24.75% | 24.26% | | 21.99% | 22.49% | 22.26% | | 2.00% |
| MFI Saral U2C | 24.75% | 25.25% | 24.75% | | 22.49% | 22.99% | 22.75% | | 2.00% |
| MFI Saral N2C | 25.25% | 25.25% | 25.25% | | 22.99% | 22.99% | 22.99% | | 2.26% |
| Micro Enterprise Loan | 25.25% | 25.25% | 25.25% | | 22.99% | 22.99% | 22.99% | | 2.26% |
| MFI Inorganic S&C | 25.25% | 25.25% | 25.25% | | 22.99% | 22.99% | 22.99% | | 2.26% |
| Arohan Privilege Digital Lending | 24.00% | 24.00% | 24.00% | | 21.74% | 21.74% | 22.00% | | 2.00% |
| Others | 24.25% | 24.25% | 24.25% | | 21.99% | 21.99% | 22.25% | | 2.00% |
| | | **Blended rate** | **24.58%** | | | **Blended rate** | **22.53%** | | **2.05%** |

The above table suggests that the Simulated blended monthly interest rate for the month of September 2024 with the application of the above framework will be at **22.53%** p.a. on a reducing balance basis**.** We expect the monthly headline price to range between **22.45% to 22.75%** depending on the application received in various product categories. Based on our peer review this price would **place Arohan as amongst the five lowest priced MFIs in the Country.**

The ALCO-Pricing Committee will remain authorized for calibration all Product Pricing in the spirit of this policy.



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