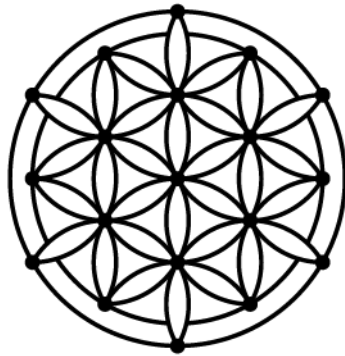


Digital Lending: Issues, Challenges and Proposed Solutions

A White Paper by Indicus Centre for Financial Inclusion



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White Paper on Digital Lending: Issues, Challenges and Proposed Solutions

Authors: V. Anantha Nageswaran, Sumita Kale, and Laveesh Bhandari¹

Introduction: The Emergence of the Fintech Platform

Ever since the NDA Government made the opening of bank accounts ('Jan Dhan Yojana') for the unbanked millions in India a success story, it has opened up several other possibilities, perspectives and problems as well. For instance, the ubiquity of bank accounts has played an important role in enabling direct transfer of benefits from the government. That came in very handy for the government to support the poor with cash support in 2020, the year of Covid lockdowns. Even as millions opened bank accounts and a portion of them began using them, India simultaneously experienced another revolution. That was the evolution of the Fintech ecosystem and the use of smartphones. According to a recent report by Credit Suisse ('India Fintech Sector: a guide to the galaxy', 22nd February 2021), the number of smartphone users in the country exceeds 600 million.

The same report points out that "the Fintech sector in India has been the second largest recipient of PE/VC funding over the last decade with payments being the leading sub-segment raising US\$4.2 bn followed by digital lenders raising US\$2.5 bn." Digital retail lending has grown at 43% CAGR, from USD9.0 bn in 2012 to USD110.0bn in 2019. On the positive side, digital channels have made the objectives of financial inclusion, especially that of availing credit, easily achievable for the unbanked populace of India. A strong consumer momentum in favour of digital payments and online banking is already in motion, which is driven by a very well-developed ecosystem. Digital loans are not made just to retail borrowers but also to micro, small and medium enterprises. However, not all consumers are able to perceive the advantages and disadvantages of different digital payment platforms and their products, signalling an information disequilibrium between the supply side and demands of consumers.

As Covid struck in 2020 resulting in lockdowns and near-total cessation of economic activity, concerns over excess lending, repayments and extortionary collection practices have surfaced. Whenever a sector experiences such a rapid growth over several years, funded by investor money, ethical issues follow. Return expectations on the part of investors influence the business practices of the entities funded. Consumer welfare is often given short shrift. It happened before in the microfinance sector around 2010. Excess lending, multiple loans and aggressive collection practices on the part of some microfinance institutions led to the Andhra Pradesh Government coming down heavily on such institutions. The regulations swung to the other side, encouraging delinquencies, defaults and moral hazard. The Reserve Bank of India eventually stepped in with regulations. The sector took several years to recover. Therefore, it is unfortunate that concerns over microloans have resurfaced. This time it is in Assam.

A similar pattern is repeating itself in the digital lending space. It may or may not be unique to India but commonly prevalent in many developing economies.² However, that is small consolation for the affected people. Second, regardless of whether such challenges arise in other countries, India can and

¹ Dr V. Anantha Nageswaran is Distinguished Visiting Professor, Krea University. Sumita Kale and Laveesh Bhandari are with the Indicus Centre for Financial Inclusion. We would like to thank Ammaar Mohammad at Indicus for his research and analytical support.

² See 'Asian authorities clamp down on digital lenders', Financial Times, 15th February 2021 (<https://www.ft.com/content/b72c33a4-b6af-4a8d-8475-256fb7075546>)

should strive to learn from previous experiences rather than repeating the cycle of bad business practices provoking a regulatory backlash and overkill, retarding not only growth for the businesses but also the provision of a valuable service for low-income earners especially with irregular cashflows. We can and should do better.

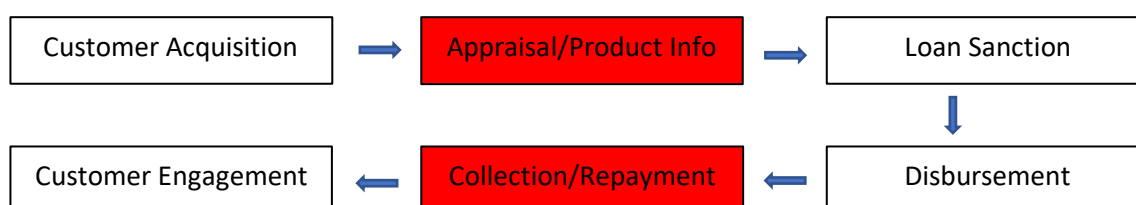
Digital lending: the players and the process

Digital lending can broadly be defined as the process of offering loans that are applied for, disbursed, and managed through digital channels. In this process, lenders use digitised data to make credit decisions and build intelligent customer engagement. As it has evolved in India, Digital Lending, with high interest rates and aggressive collection practices, appears to be the blending of technology with old-fashioned unorganised retail lending.³

According to a study by [IFC and Intellectap](#), digital lenders can also be classified based on the source of their funds, as given below:

- Marketplace Lenders - intermediaries connecting borrowers to institutional or even retail credit suppliers
- Balance Sheet Lenders - those lending themselves, often as NBFCs
- Marketplace Hybrid Lenders - entities that offer loans both directly from their own balance sheets in addition to offering marketplace funding option

The Process: A description of the [typical process of digital lending](#) in India is shown below through a flowchart:



Customer acquisition through digital modes utilises short message service (SMS), social media advertising, or through partnerships with a data rich entity such as a mobile network operator or an e-commerce portal. The second step involves customer appraisal and provision of product/service information by the lender, which upon satisfaction from both sides leads to loan sanction (based on creditworthiness) and eventual disbursement to the consumer bank account or mobile wallet. Digital lenders tend to leverage the customer data, along with algorithmic capabilities in order to anticipate and design an optimum collection process.

Déjà vu: aggressive lending and collection

Earlier in the year, news reports⁴ broke out of aggressive lending and collection practices and the resultant tragic suicides. While the news-stories cited here refer to the role played by apps developed

³ See “Debt trap: Inside the world of shady digital lending apps, which promise a loan in a minute”, Economic Times, 16th January 2021, <https://economictimes.indiatimes.com/industry/banking/finance/banking/loan-trap-inside-the-world-of-shady-digital-lending-apps-which-promise-a-loan-in-a-minute/articleshow/80304632.cms>

⁴ See (a) ‘India’s instant loan app crisis is made in China’, The Ken (<https://the-ken.com/story/indias-instant-loan-app-crisis-is-made-in-china>), 11th January 2021;
(b) ‘How a Chinese-run NBFC built a Rs 1,300 crore business in a year’, The Morning Context, 4th February 2021,

and managed by operators in China, the blame has to be apportioned to others in the network, especially the Non-Banking Financial Companies in India. The reason is that “there are over 12,000 registered NBFCs in the country, of which only a few hundred are rated as “systemically important”. So all that any app needs to do is ‘partner’ with any willing NBFC as some kind of a licence-candy—the route the Chinese apps mostly took.”

Around the same time, in Assam, reports of harassment of borrowers of micro loans from microfinance institutions (MFI) resulted in the local state government in the state passing a legislation (Assam Microfinance Institutions (Regulation of Money Lending) Bill, 2020) in December 2020.⁵ As a consequence of this, the Reserve Bank of India announced, as part of its statement⁶ on developmental and regulatory policies on the 5th February that it would explore a unified framework for all microfinance lenders. Currently, however, regulations and conditions that apply to NBFC-MFIs are different from those that apply to banks that offer microloans.

Searching for the fine line between innovation and regulation

Although unrelated to the problems associated with digital lending in India, the controversy surrounding Ant Financial, originally a payment company but later that morphed into a company that intermediated small loans from Chinese banks to the public is insightful. Regulators in China stopped the firm from issuing shares to the public in an initial offering days before it happened. Then, they launched an investigation into its lending practices. They have required the platform to have its own skin the game in retail lending. That is, at least 30% of the loans must come from its own balance sheet. This will come into effect next year. Otherwise, the fear was that unbridled sub-prime lending could threaten financial stability in China and, by extension, global financial stability.⁷

In relatively poorer India, unbridled growth of digital lending would have both economic and political fallout. Hence, there is a need for regulators to ensure that not too many loans are offered to or taken by the same borrower, that the terms of repayment of such loans are reasonable and that the collection methods are non-intrusive and non-violent as well. Digital loan apps force the borrower, who do not pay attention to such requests when they are desperate for loans, to share a lot of information on their phones. Such information has been used to harass the borrower through harassment of the contacts on their address books. In extreme cases, such harassments have resulted in suicides committed by borrowers.⁸

(<https://themorningcontext.com/internet/how-a-chinese-run-nbfc-built-a-rs-1300-crore-business-in-a-year>);

(c) ‘Inside the scramble to cut off Chinese loan apps’, The Morning Context

(<https://themorningcontext.com/internet/inside-the-scramble-to-cut-off-chinese-loan-apps>), 3rd February 2021 and

(d) ‘Fifth case of suicide in Telangana due to alleged harassment by loan app’, The News Minute

(<https://www.thenewsminute.com/article/fifth-case-suicide-telangana-due-alleged-harassment-loan-app-140745>), 3rd January 2021

⁵ See ‘Assam shakes up the micro loans universe’, Mint, 1st March 2021 (<https://www.livemint.com/news/india/assam-shakes-up-the-micro-loans-universe-11614531955512.html>)

⁶ See https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=51078

⁷ See “China tightens online lending rules in fresh blow to Jack Ma’s Ant Group”, 21st February 2021 (<https://www.ft.com/content/bc95392c-80db-4065-addd-40319b7024d1>)

⁸ See “Digital Lending Turns Into Nightmare: Loan Recovery Harassment Blamed In Recent Suicides”, 21st December 2020, (<https://inc42.com/buzz/digital-lending-turns-into-nightmare-loan-recovery-harassment-blamed-in-recent-suicides/>)

Anecdotes and stories are always more powerful than reams of statistics. Hence, such stories naturally provoke both political and regulatory backlash. An article⁹ in 'The Economist' written in the context of the regulatory action on Ant Financial offers a note of caution on regulatory overreach given the other advantages that they offer. Citing international studies, the article points out three advantages of Fintech, of which digital lending is a part:

- i. Fintech firms reach borrowers that are under-served or not served by banks;
- ii. The loan-loss rate on Fintech loans is far lower than on loans made by traditional lending institutions given that they rely on data and algorithm that constantly update borrower information and hence their credit quality assessment is superior and
- iii. Fintech firms do not tie their loans to collateral values as banks do but to other measures of risk assessment such as repayment history, earnings and, in the case of businesses, transactions volumes. Therefore, they do not shrink their credit during business cycle downturns as traditional banks do. Consequently, they are a useful counter-cyclical force unlike banks whose behaviour is more pro-cyclical, amplifying both booms and downturns.

Most of these would apply in the Indian context as well in a few years if not now. Therefore, the regulatory framework that is applied to digital lending must, of necessity, be forward looking and long-term. It cannot be an ad-hoc response to short-term anecdotal issues.

This was the context in which the Reserve Bank of India announced the constitution of a working group to study all aspects of digital lending activities in the regulated financial sector as well as by unregulated players to help evolve an appropriate regulatory framework. The terms of reference for the working group are comprehensive and include the recommendation of a Fair Practices Code, measures for enhanced consumer protection and measures for data governance.¹⁰

It cannot be stressed enough that, in the long-run, the answer to the cash and liquidity needs of the poor and the daily wage workers is more economic growth, employment opportunities, assured living wages and insurance policies that offer risk mitigation against health and other contingencies. However, it is beyond the scope of this white paper to offer an economic blueprint. It will confine itself to proximate issues.

The terms of reference for the working group constituted by RBI are in alignment with the issues that were considered specifically for writing this paper:

- i. What should or what can the Non-Bank Financial Corporations (NBFC), who refinance or lend through digital lenders, do to ensure sustainable business practices?
- ii. What are the regulatory measures needed to keep digital lending safe?
- iii. Can some of the measures put in place against usurious moneylending (if they exist) be applied here?

The rest of the note considers the three questions above and discusses the proposed solutions before concluding with specific recommendations.

⁹ See 'Is China right to tame Ant?', The Economist, 2nd January 2021 (<https://www.economist.com/finance-and-economics/2021/01/02/is-china-right-to-tame-ant>)

¹⁰ See RBI, 13th January 2021 (https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=50961)

The role of the NBFCs

Digital lending companies cannot lend directly. NBFCs can set up digital lending apps (DLA) and lend directly to the borrowing public and small businesses. Otherwise, DLA tie up with NBFCs which provide refinancing to DLA. Clearly, NBFCs provide the lifeline to DLAs and earn their income from the lending that DLA undertake. Since they enjoy the fruits of the lending activity directly or indirectly through the DLA, much of the onus on ensuring a smooth and orderly conduct of the lending and collection business should fall on them. It is a sound principle that responsibility and accountability go hand in hand with authority, rights and profits. A recent evidence-based article in BloombergQuint makes the same point.¹¹

The due diligence that NBFCs undertake before lending their names (and funds) to the DLA is of critical importance. How much of time is spent by NBFC in either checking the antecedents of the DLA, their ownership, their track record, the personal qualities of the promoters (character assessment), their attitudes towards borrowers and whether they are focused on margins versus scale based lending, etc.? Second, do NBFC devote time, attention and resources to training and orienting the DLA properly? For example, NBFCs can insist on the DLA providing clear information to borrowers on grievance redressal. The loan application documentation and the approval message can and should clearly state procedure and contact number for grievance redressal. The DLA are not from the financial sector but they have cracked the acquisition channel. They need to be educated about lending.

Given that the bulk of the borrowers is poor and inadequately literate, it is not enough to comply with the above on paper. They need to be user-friendly both with respect to the language used (local instead of English) and the visual cues used such that borrowers can easily take recourse to these mechanisms rather than be bewildered.

All DLA that deal with money should link to bank/NBFC and display the bank/NBFC certificate. The RBI rules state that the certificate should be displayed. The logo of bank/NBFC should be on the app and the borrower should be able to click on that to see the NBFC registration certificate. Alternatively, clicking on the logo could enable the certificate to pop up on the RBI website. Clear visibility and display of the NBFC behind the DLA is a strong statement of moral responsibility on the part of the NBFC to the borrower.

It is understandable that the capacity of NBFCs for monitoring and supervision in the digital world is very limited. An NBFC from Gujarat can now lend in Assam - the physical connect with the customer is gone. But when it comes to recovery, the connection has to be physical often and here bad practices can come up. So, the question is whether NBFCs have the resources to undertake periodic and/or random checks on the DLA companies and their collection practices? For example, 'mystery shopping' is a good way to ensure that good practices and code of conduct are adhered to.

Further, to check and control app-based fraud, the transaction activity has to be monitored and both ends of the transaction need to be supervised, to check aggressive lending and reckless or multiple borrowing. Bank/NBFC analytics have to be upgraded to flag abnormal/suspicious activity.

¹¹ See "BubbleLoan' To 'Rupee Factory', Loan Apps That Allegedly Defrauded Borrowers', BloombergQuint, 16th March 2021 (<https://www.bloomberquint.com/business/bubbleloan-to-rupee-factory-loan-apps-that-allegedly-defrauded-borrowers>)

Upgradation of technology on the part of NBFC to tackle these challenges associated with digital lending goes with the turf. NBFCs should invest in such capabilities. The regulator, on their part, must be equipped to undertake similar check on the NBFCs investing in and acquiring those capabilities.

Lastly, NBFC should not hesitate to pull the plug on DLA that display errant behaviour with their borrowers. It will be a strong signal to the remaining DLA on their platform. De-platforming is a powerful weapon in the hands of the NBFC parent and the parent should use it to discipline their DLA 'children'. Disciplining one would usually do the trick for making other children fall in line.

The role of the Digital Lending Apps (DLA)

DLAs are the front end of the digital borrowing experience. The industry is growing at a healthy rate. The country is big and the number of poor or marginally poor still run into hundreds of millions. So, a market for short-term credit products to tide over cash flow problems will exist for quite some time. So, those players who are in it for the long haul will reap rewards.

Most of the issues that have cropped up in recent times have to do with lack of transparency on the interest rate charged, on the hidden charges and deductions and on the collection methods deployed that invade privacy and destroy personal pride, resulting in suicides. Therefore, DLAs must be upfront about their business practices.

For example, the annual percentage rate (APR) that is charged on the loan should be displayed in Font 12 on the telephone screen. This was mandated in the case of credit card purchases and loans. This can be voluntarily adopted by DLA. Particularly, those NBFCs that lend directly to end-borrowers through their apps can take the lead and set an example for other DLAs to follow. This is one way of crowding in good business practices.

DLA, along with clarity and transparency on APR, other terms and conditions of the loan, can also offer basic financial planning tips that include, among other things, warnings on the dangers of excessive borrowings. In other words, similar to the statutory warnings displayed on the packaging of tobacco and alcohol products, credit is a product whose overconsumption can be harmful to the consumer. That information can be part of the loan documentation, right up front, in bold letters and in bright colours.

Responsible digital lenders who are aware that they should not kill the goose – the end-borrower – can come forward to set up a self-regulating organisation for the digital lenders. The organisation can formulate a code of good conduct and ethical practices that each DLA must sign on to and share with the borrowers. The code and their signature must be on display even before the borrower begins to provide their Know-Your-Client (KYC) details to the lender on screen.

We are well aware that many of the above proposals are unlikely to be taken seriously, let alone implemented, by those fly-by-night DLA that are intent on making short-term gains. However, those NBFCs that undertake direct lending through digital platforms in their own name have much stake and so they can up their game – ethically and morally. It is in their self-interest. In doing so, they will not only be raising the average level of ethics in the business but also show others as to what is possible, in terms of good governance and good business practice.

What can borrowers do?

There is a misconception that, based on anecdotal stories, the bulk of the digital lending happens between unscrupulous promoters of DLA and informal labour on casual work with irregular incomes. They borrow for unavoidable purposes and find themselves in financial hot water with stress and ruin to follow. That is true but is not the whole truth. Many borrowers are forced to borrow for short-term exigencies because they do not undertake rudimentary financial planning and lack discipline. They have the formal education and awareness to understand the dangers of excessive borrowing but are unable to resist the temptation to do so, to satisfy a short-term want or greed.

As with addictions and mental health issues, redemption starts with acknowledgement of the problem and voluntary seeking of help from financial helplines. This is where other players in the ecosystem need to have them set up. But, if they are available, borrowers must make use of them.

Where they do not understand, they should ask questions and demand clarifications. If they do not understand the terms of the loan and if the terms and conditions are in English, they should insist on local language versions.

The role for Google and Apple

Almost all of the apps available on smartphones are controlled by Apple and Google. They fiercely resist apps being made available to smartphone users other than through their stores and they charge a huge commission for apps to be made available on their platforms. Therefore, invoking the same principle that we applied to NBFC – where there are benefits, there are responsibilities – we believe that Google and Apple have obligations.

For financial products, including credit, that are sold through apps listed on their platforms, they can insist of fulfilment of conditions prior to featuring them on their platforms. Declarations of clear ownership with contact address, telephone numbers and proofs of address of promoters or owners of the app must be insisted. The NBFC parent that refinances the DLA must be required to provide a certificate of good governance on the part of DLA at the risk perjury. Similarly, both Google and Apple must insist on a set of declarations of ethical business practice from the DLA, again, at the risk of perjury. Regardless of enforcement, insistence of such declarations and self-certification will, in and of themselves, act as a deterrent.

The role of the regulator

In India, as is often the case, the burden falls disproportionately on the agencies and institutions of government to enforce good governance even in the private sector. While there is much handwringing among the public and the commentariat on standards of public governance, many of them are rather happy to throw the problem at the regulator to enforce standards of good behaviour. Evidently, the capacity for self-policing and self-regulation is conspicuous by its absence. Of course, to be fair, it is not just an Indian failing. The global financial crisis of 2008 is due, among other things, to the failure of self-regulation among American financial institutions both with respect to the growth of their own balance sheets and with respect to their sale of sub-prime mortgages to unworthy borrowers and the sale of securitised sub-prime mortgages to institutional investors. So, it is a failing of the financial sector where greed almost always trumps prudence, discretion and ethical practice.

The second consideration or principle that the regulator must concern itself with is one of fostering or not standing in the way of innovation vs. consumer protection. Given that the private sector has enough incentive to continue to innovate and given that consumers are not on the level playing field with the producers in terms of language, information, sophistication and product knowledge, especially in the context of a developing country, the regulator has to err more on the side of consumer protection than worry about stifling innovation.

The demands on the regulator are rising exponentially. The big concern is with respect to capability. Technological sophistication and skills available in the private sector will always be a step or two ahead of the regulator. The profit motive is a big incentive for the former. The latter will always be a follower as it might find it difficult to attract talent with its government pay scale and relatively limited growth opportunities. Therefore, the speed with which innovation and evasion happens will always be greater than the ability of the regulator to manage and regulate both.

In India, the regulator is increasingly being called upon to manage multiple players – from traditional banks to non-banking finance companies to microfinance institutions to urban cooperative bodies to digital lenders, etc. The list keeps growing. Unfortunately, for reasons unique to finance as mentioned above, the regulator has no choice.

These two factors force the regulator to opt for smart rather than comprehensive or blanket regulation. It is a necessity. A fallout of this necessity is to deploy regulated entities as agents of the regulator!

One of the suggestions that can have an impact is that the DLA must have prior approval from the regulator before being offered to smartphone users via the app platforms. This would stretch the capability of the regulator. It is far better and more effective to put the onus on the NBFCs that finance the DLA. NBFCs are regulated entities. In other words, the regulator should outsource some of its functions to a regulated entity for greater effectiveness. If the consequence is that the NBFC would be stripped of its status, it is likely to do a more effective job than the regulators themselves!

However, should the regulator opt to undertake the job of approving DLA itself, the framework adopted by the Financial Conduct Authority in Britain offers a useful template. FCA wants¹² all the applicants seeking regulatory approvals to be 'ready, willing and organised'. One of the indicators of readiness includes being able to clearly articulate their regulatory obligations. In other words, the application should include a mandatory recitation of the regulatory obligations and a signature at the bottom with acknowledgement and awareness of the consequences of the failure to comply.

Apart from that, the regulator has to apply its mind on the proper documentation for KYC done on borrowers. By allowing Aadhaar to become a card proof of id and address, duplication for fraud has been made easier now without misrepresentation. The reliance on a piece of paper (the Aadhaar ID) rather than the unique biometric identification not only encourages fraud but also encourages excessive borrowing.

The big concerns that the regulator has to address relate to the interest rate charged on such loans and the short repayment cycles. In both instances, there appears to be no substitute for the central

¹² See <https://www.fca.org.uk/firms/authorisation> (accessed on 8th March 2021)

bank other than to mandate clear interest rate ceilings and minimum repayment cycles with severe penalties, including revocation of license, for violations.

Finally, responsible lenders invest heavily and regularly in technologies to offer data security, consumer confidentiality and privacy management. But the rising demand for credit and multiple policy loopholes have given rise to a number of malicious digital platforms who exploit the vulnerable populace. Many of these illegal instant loan apps have their roots in China with the incubation investment coming from platforms and NBFCs based there. According to a research by Cashless Consumer, who analysed 1000 instant loan apps at the end of last year, 80% of them were found to have Chinese links, and are illegal at many levels. The customer data is stored in China. Clearly, the RBI-appointed working group has to come up with guidelines on data privacy and data security.

In the final analysis, the responsibility lies with NBFCs and, in turn, commercial banks who refinance NBFCs. It is a well-known idiom that killing the chicken to scare the monkey into dancing works almost always. The regulator should not fight shy of resorting to that tactic to ensure consumer protection. Commercial entities will be fearful of the reputation risk, once reprimanded and fined publicly by the regulator.

There is no doubt that digital lending holds promise both as a business and as a source of short-term liquidity for micro and small businesses and individuals. Its growth rate in the last decade attests to that. It is important to lay down the rules of the game clearly such that the game is played fairly by all players concerned. In other words, the onus is on the regulator to convey, in unmistakable terms, to all the market participants that the onus is on them and it is in their own interest to look after borrowers' interests.
