3. Designing Social Security Floors For India

There is a need to envisage a framework that assigns responsibility to different en...
1. Introduction

A Convening on ‘Emerging Customer Risks in Digital Lending’ was conducted on April 22nd and 23rd, 2021, by Dvara Research Foundation in collaboration with the Consultative Group to Assist the Poor (CGAP). This virtual roundtable aimed to have a conversation with the ecosystem players about the nature and extent of customer risks in the digital lending space. The workshop saw participation from five unregulated fintechs that partner with lending institutions, four non-banking financial companies (NBFCs) that either specialise in digital loans or partner with fintechs for providing digital loans, one small finance bank (SFBs), one scheduled commercial bank, academics, researchers, and consumer protection advocates. This document summarises the discussion that occurred during the workshop. As the discussion was bound by Chatham House Rules, the document does not make any attributions to individual participants.

2. Digital Lending in India: Context

In recent years, there has been a considerable change in the landscape of retail financial services. Technological developments have led to the diversification of activities of financial service providers, with several non-traditional technology service providers now intermediating in the delivery of financial services. While digitisation has created a convergence of processes, platforms, and financial infrastructure, it has also created a divergence in the form of modularisation, i.e., an unbundling of the financial value chain into different modules. This kind of modularisation can enable better access to convenient, customised, efficient, and affordable services.

In the digital lending value chain, we see two dominant models emerging, i.e., one where NBFCs and banks lend on their own books, and the other where fintech entities partner with NBFCs and banks to originate, assess borrowers’ creditworthiness and recover loans. Currently, in the Indian regulatory landscape, only regulated entities such as banks, NBFCs and registered money lenders can engage in lending activities. It is only these entities that can hold credit risk on their books, thus, referred to as ‘holders of risk.’ While third-party providers can be engaged by credit risk holders in the consumer lending process, they fall partially outside this regulatory scope as they do not strictly hold credit risk on their own books. Therefore, such third-party providers are referred to as ‘non-holders of risk’. Both these categories - risk holders and non-holders of risk - generate or are faced with distinct kinds of issues that concern customers.

The customer protection concerns raised by these entities may be entirely new or existing concerns resurfacing in a digital format. Typically, customer protection concerns of unfair conduct arise at points where either the credit risk holders, their agents, or their partner non risk holders’ interface with customers, either directly or indirectly. These can include privacy violations and misuse of borrowers’ personal data, unfair discrimination, unfair exclusion, and borrower harassment. Concerns may also arise due to data quality issues or inadequate provision of digital services such as due to infrastructure failure or due to inappropriate behaviour, especially that of unregulated and/or weakly regulated non-holders of risk. These risks are made more complex in the digital ecosystem as it becomes difficult for a borrower to ascertain whether they are interacting with a regulated or unregulated entity. Moreover, additional consumer risks get generated due to the modularisation of financial services or the inadequate monitoring of third-party providers to which certain lending activities are outsourced.

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1. Under the current regulatory system, the lending activities of only banks, non-banking financial companies and money lenders are regulated, with the former two under the purview of the Reserve Bank of India. Therefore, any other third-party, whether operating through an app or a platform or through any other means, and/or by partnering with these regulated lending institutions is characterised as ‘unregulated.’

2. For the purposes of this document, they would be referred to as fintechs.
These concerns have long been an area of priority for consumer advocates, such as Dvara Research and CGAP. However, the recent spate of unfortunate events surrounding the experiences of Indian borrowers with digital lending has shined a light on the gravity of the problem and the urgency with which it needs to be solved.

3. Scope of the Discussion

The workshops were moderated to elicit a discussion and a sharing of viewpoints on the following broad questions:

i. What are the emerging customer protection risks in digital consumer lending in India?

ii. What measures are providers taking to address these risks?

The workshop brought to the fore diverse views about these questions based on the nature of the entity. As set out in the preceding section, this document recognises that the digital lending value chain consists of two different kinds of entities, i.e., holders and non-holders of credit risk. Based on their nature, the entity’s interpretation of risks, as well as their approach to measures for tackling customer concerns, varied. The nuances in their approaches have been fleshed out throughout the document.

4. Emerging Customer Risks Identified by Practitioners and Researchers

Below we summarise the emerging customer risks highlighted by the participants in the digital lending ecosystem in India:

4.1 Risks from Modularisation

The risk holders observed that the Reserve Bank of India (RBI) has taken a light-touch approach towards the regulation of digital financial services in India, and that there has been a proliferation of various lending models in the digital lending space. Modularisation is quite prevalent in this space, with every part of the lending spectrum being outsourced to different entities. A transaction is now multi-layered, as opposed to earlier, where a customer could go to a bank and conduct only a bilateral transaction. In such a multi-layered transaction, with regulated and/or unregulated entities, customers find it challenging to identify the appropriate avenues or processes for grievance redressal.

Embedded finance is a model which is becoming increasingly common. For instance, in embedded finance, an e-commerce platform is supported by a tech platform that provides the fintech module(s) behind the operations. The fintech modules help collect customer information and employ analytical capabilities to provide lending services. These fintech modules are further backed by the capital provider or the lender, which is the regulated entity. While conducting a transaction in such a scenario, the customer may be aware of only the e-commerce brand and the embedded finance brand but not the multiple other players involved in the chain. Another prevalent model is the platform model, where algorithms match borrowers to lenders. In these instances, potential harms to the customer can arise due to the ‘black box’ logic of the algorithm.
The ease of modularisation has allowed lenders to outsource several activities in the lending spectrum, thus creating efficiencies in the process. However, this has also created a grey area allowing significant components of the value chain of financial services to go under the regulatory radar. For instance, in the outsourced digital lending model, sometimes, there are tripartite agreements where there is a first loss default guarantee (FLDG) arrangement between a fintech and the regulated lender. The defaults that occur within the FLDG limit are taken care of by the fintech (this is sometimes as high as 50%), which provides relief to the primary lender. However, this results in adverse behaviour towards the customer at the time of collection.

Modularisation also allows for the capture of customers by unregulated lenders, which follow rogue practices such as falsely advertising partnerships with scheduled commercial banks on their websites. This is a cause for concern as several digital lenders source customers digitally, which, unlike mainstream advertising, is unregulated. It is also unlikely that the customer is aware of the regulatory status of the lender that is sourcing them. In addition to this, the customer might also be unaware of the answers to several questions of material importance, such as where their data resides, which entity to contact or hold liable in case of a grievance, or which forums to approach to seek redress.

Research conducted on daily high-frequency meta-data about app downloads in India and elsewhere indicated the presence of a high proportion of predatory apps. The researchers found that a large number of predatory apps were seen to displace the market for legitimate lenders, especially during the period when the lockdown was imposed. While legitimate lenders had around 50,000 downloads of their apps in a day in pre-COVID times, predatory lenders accumulated hundreds of thousands of downloads per day, especially during the peak lockdown period. Analysis of the data indicated that even after complaints were received about apps, they remained on Google Play Store for some time before being completely removed. It was also common for new apps with different names to re-emerge in the place of the apps that were removed.

Some holders of risk were of the view that the regulatory grey areas may continue to grow in tandem with the consequent risk posed by them. However, since the digital lending space is relatively new, the players should be given a free hand to continue their operations, at least in the initial phases, to promote innovation. The modularisation scenario present in the digital lending space is similar to the format of the credit card space where there are multiple players involved, such as the issuer bank, the merchant, the network provider and an acquirer bank. However, in the case of credit cards, the rules and regulations – such as the interchange fees framework of regulation - were standardised and well defined globally. Therefore, the fintech space too could be allowed to innovate for a while, after which a basic set of standardising regulations can come into force.

Risk holders also acknowledged that the principal, i.e., the entity which is taking the credit risk, remains accountable for the activities of the vendors. However, they also noted that smaller financial entities cannot afford to conduct due diligence and monitoring of third-party vendors compared to their larger counterparts.

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3 First loss default guarantee is a risk-sharing mechanism whereby the provider of the guarantee compensates lenders, up to the extent of an agreed upon guarantee limit, if the borrower defaults (IFMR Lead, 2004).
4.2 Information asymmetry at the time of loan origination

Non-holders of risk, such as digital originators, credit risk scorers and loan recovery providers, were of the view that, increasingly, terms and conditions of loans are becoming complex. This increases the risk of the customer signing up for a loan without completely understanding the terms of repayment. It appears that customers do not always comprehend the cost of the loan, which often comprises of, among others, the interest rate being charged, the processing fees, and the annual percentage rate5. They also lack an understanding of the repercussions of non-repayment, such as the adverse implications on their credit bureau scores. Often the payment recovery practices that the entities can adopt are also unclear to the borrowers at the time of taking the loan. These information asymmetries obstruct borrowers from making a well-informed choice and disproportionately affect those who are new to credit.

The holders of risk too concurred on the nature of information asymmetry present in the digital lending space. It was highlighted that the speedy disbursement of loans often precludes the customer from gaining a full comprehension of the charges involved, as well as the implications of non-repayment.

4.3 Adverse implications for credit history

Several non-holders of risk noted that the customers are often unaware of how non-repayment of even their small-ticket loans could affect their credit records6. Non-repayment adversely affects prospects of future borrowing and requires drastic corrective measures on the part of borrowers to become eligible for future loans. This appears especially relevant for rural areas, where borrowers’ ability to get formal loans has been severely impaired after defaulting on loans where the contracts were technically inappropriate for them. Consequently, further inclusion becomes a challenge when bad loans lower credit records.

4.4 Lack of adequate communication and opacity about creditworthiness assessments

Non-holders of risk indicated that while traditional lending utilises the relationship between the lender and the prospective borrower to assess creditworthiness, digital loans do not. There appears to be little investment in thoughtful communication. Typically, digital lenders inundate customers with advertisements through digital channels, such as text messages or social media, offering them pre-qualified loans. In this process, borrowers remain unaware of how the lenders arrived at the decision to lend to them, or the data used to offer them the loan. In the absence of this information, borrowers may find it hard to determine if they are being provided with a loan through some kind of mass targeting, or if they have qualified for a loan based on their favourable repayment history.

Risk holders remarked that, akin to traditional lending, credit appraisals in digital lending also seek to measure two aspects: the ability to pay and intention to pay. Any appraisal process that circumvents the use of traditional credit bureaus would need to find surrogates for these aspects. As highlighted throughout the discussion, one of the key differentiators of digital lenders is their use of alternate data models for credit appraisals. Data points such as the number of friends/contacts (say on social media) are used to assess if the borrower is genuine. Other data points such as the length of the diagonal of the customer’s mobile phone screen is used as a proxy for ‘ability to repay’. However, most of these models are ‘discontinuous’ in nature,

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5Annual Percentage Rate (APR) is a broader measure representing the borrower’s total cost of credit as it includes additional items such as fees and charges. ([Reserve Bank of India, 2015](https://www.rbi.org.in/Scripts/Page.aspx?Id=33184))

6While not all digital lending is captured by credit bureaus, some fintechs report loan performance data to credit bureaus through the regulated entity they partner with.
i.e., they use historical data, often operating on a lag of two-three months, which reduces their reliability. The pandemic has further revealed the unreliability of some of these models. During the pandemic, several pre-existing factors, such as the employment status/cashflows of the customer, were found to be non-representative of the customer’s altered circumstance. Notwithstanding the shortcomings of such discontinuous models, any new model - such as one using alternate data for credit appraisal - needs time and data points to get trained. The model and its performance need to keep being monitored and tweaked to improve results.

4.5 Issues of over-indebtedness, debt traps and the absence of suitability assessments

Non-holders of risk opined that a lack of information about the loan process, and the repercussions of non-repayment can encourage customers to take loans simply because they are readily available. In several instances, loans are taken without any specific purpose, forcing borrowers to take fresh loans to repay previous ones, making them vulnerable to falling into a debt trap. Another cause for concern is the high rates of interest charged on very short tenure loans. The tenures range between 7 and 180 days, with the interest rate largely ranging from 25% to 400%. The annualised interest rate for some of the shorter tenure loans between 7-14 days tenure goes up to around 3600%. Such high interest rates cause over-indebtedness, forcing borrowers to take on further loans to meet their repayment obligations. These causes of over-indebtedness point to the need for loan-suitability assessments. Instances of borrowing to service existing loans underscore the need for providers to be more careful in assessing the borrowers’ creditworthiness.

4.6 Unethical collection practices

Non-holders of risk brought out that there is a growing recognition of unfair provider-side practices with respect to collections. Incidents have been widely reported in media articles, and was also highlighted in the discussion, about entities contacting people from the borrower’s contact list to pressure them into getting the borrower to repay. These practices harass the borrowers and violate their privacy. Though these practices are considered criminal offences under the existing regulatory framework, such as the Information Technology Act, 2000 (IT Act), they continue to be used. Practitioners are concerned about the adverse implications of these practices on the customers and are also worried that it will affect the trust that customers place on digital lenders.

The risk holders observed that several digital lenders do most of their collection digitally, save for the last leg, which might need some manual support. The need for this manual support has increased, especially during the pandemic. However, it was highlighted during the discussion that several of the fintech entities advertise that they lend across various locations in the country, to segments that are typically not serviced by banks due to the lack of a local collection infrastructure. But many of these fintech lenders are small players, who are bootstrapped or have only raised an initial seed fund and are therefore looking for alternative ways to recover their loans.

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7Suitability is defined as the degree to which the product or service offered by the intermediary matches the retail client’s financial situation, investment objectives, level of risk tolerance, financial need, knowledge and experience (Dvara Research, 2012).

8As per Section 43 and Section 66 of the IT Act, downloading data from a ‘computer system’ without the permission of the owner is considered a punishable offence. The IT Act also specifies a compensation for failure to protect data under Section 43A, punishment for violation of privacy under Section 66E.

9Bootstrapping is the process of building a business from scratch without attracting investment or with minimal external capital (Corporate Finance Institute, n.a.).
Further, the risk holders also noted instances of borrower harassment by making use of their personal data. They emphasised that lending is the business of collecting and knowing how to collect. Therefore, building ethical collection practices into the operating models is key. It was also indicated that the impact of coercive collection practices on customer outcomes is greater due to the incomplete nature of financial market regulation in the country owing to the current lack of a consumer bankruptcy framework.

4.7 Lack of proper grievance redress mechanism

Non-holders of risk were of the view that the existing grievance redress framework is inadequate. There is concern that grievance redressal is not as quick as the process of disbursing loans. There is also a lack of visibility or transparency for the users, which curbs their trust in the system. These concerns are further amplified in the digital lending ecosystem due to the multitude of players within the chain, having different customer care systems interacting with each other, which finally leads to failed redress. The Ombudsman Scheme in place for digital lenders is also fairly new, and its effectiveness cannot be assessed yet. It was highlighted that the existence of a grievance redressal officer within a financial institution, and that of an Ombudsman within the RBI is just a step towards the right direction and not the solution.

The risk holders opined that for most fintech lending, the only available redressal option is either through a chatbot or a WhatsApp window. Most often, there is neither a contact number visible on the website or app of the customer-facing entity, nor is there a physical location that borrowers can approach to seek redressal. Another factor that further reduces the approachability of the redressal options is that any available information is in English and not provided in any vernacular languages.

4.8 Personal data risks

Risk holders felt that one of the unique selling points of many of the digital lenders is their use of alternate data in the onboarding and credit appraisal processes. For instance, several loan apps capture a facial selfie instead of doing a formal KYC process. This circumvention of the credit bureaus may even work in favour of a customer who wishes to keep away from having a credit record, a key feature of the traditional lending process.

The alternative data collection models adopted by some entities entail accessing borrowers’ contact list, call registry, text messages and phone gallery, and a whole host of permissions to modify storage or record screens. In several instances, these data points are also sourced from external data brokers that are seemingly innocuous ones, such as gaming apps and children education apps. So, in the case of digital lending happening through a third-party service provider, the borrower enters into two user agreements. The first is a user agreement between the app provider and the borrower. This app provider may be an entity different from the lender. The second agreement is between the borrower and the lender, which is a regulated financial entity. Under this structure, the unregulated third-party service provider may be collecting several points of information, many of which may not even reach the lender. The lending entity collects only a minimum set of information mandated by regulation. At the time of signing up for the loan, customers do not fully appreciate the potential for misuse of these data points.
5. Measures taken by individual players and the industry as a whole to address challenges

5.1 Focusing on risk assessment

Some non-holders of risk stressed the importance of the risk assessment process. They highlighted their efforts to make use of the information they have about borrowers to improve their underwriting practices. These assessments were stated to rely not only on the borrowers’ existing ability to pay but also the effect of the loan on their ability to pay. Fintechs are attempting to use different sources of information to help with this process. These different data points include soft information on borrowers, transaction information such as invoices and GST data, transportation data such as E-Way bills. All of these data points help improve the quality of underwriting and thereby reduce dependence on collections.

5.2 Improving trust in the ecosystem

Non-holders of risk noted that entities were trying to secure the trust of the customer by making processes more transparent. The focus was on inverting information asymmetries by explaining to customers the need for certain types of information and how it contributes to improving underwriting, and the quality of the product or service. Customers are also being provided with greater control over their data. Product designs are aiming to allow borrowers to delete their data at the end of a lending relationship. Providers hope these practices will engender borrower trust.

Some non-holders of risk are also building better tools to help borrowers understand the factors that lenders use to assess their creditworthiness. The tools can, in turn, be used to help borrowers understand the payment cycles of their own customers, and their likelihood of recovery and thereby ease frictions in cash flows.

5.3 Using and sharing real-time information on borrowers

Developing real-time information sharing systems can help borrowers and lenders gain more information, reduce information asymmetries, and better assess suitability. Having real-time information can help lenders assess the repayment capabilities of borrowers efficiently. This will help in better risk management for the lenders and reduce the risk of lending to borrowers who may already have multiple live loans. This can also help borrowers provide their information to more lenders at the same time and enable them to show a positive repayment history to receive better products and better interest rates on loans.

5.4 Assessing suitability and offering greater choice and flexibility in products

Non-holders of risk are attempting to better understand the needs of the customer in order to direct them to products or services that are suited to them. They are also attempting to take the customers through journeys that are designed specifically for them. This is possible in a digital context as opposed to a traditional environment. Digital lenders can try to leverage the digital ecosystem to give customers access to

\[\text{An E-Way bill is an electronic document generated on the GST portal evidencing the movement of goods which acts as a permit for inter- and intra-state transportation of goods worth more than a certain value. (Central Board of Indirect Taxes & Customs, n.a).}\]
various choices and guide them in making decisions. For instance, based on the needs of the customer, the lender can help design the appropriate tenure for repayment, the EMI amount, any amount of flexibility required, and even price, to a certain extent.

5.5 Improving communication

The non-holders of risk deliberated on two pathways to improving communication with the borrowers.

The first was using an assisted lending model in place of a completely digitised model. Frictions come up in a digital ecosystem because new-age lenders directly approach borrowers who have either not interacted with a formal financial institution or have not taken a loan. Therefore, some form of non-digital engagement can help those who are new to credit or those who are new to the digital ecosystem. The entities should also look at alternatives to a completely digital process, such as having an agents’ network.

The second was improving the existing terms and conditions. Borrowers should be provided with a context and particulars about why they qualify for a loan, what the methods for repayment are, what are the repercussions of delaying payment or non-payment etc. This approach would help create an ecosystem where lenders compete on providing a safe and customer-centric digital lending experience to the customers and not just compete on shorter turnaround times.

A key point highlighted throughout the discussion by the risk holders was the importance of the intelligibility of the terms and conditions, and features of the product. One of the ways in which this can be done is by ensuring the standardisation of the charges and features across different lenders and products. This uniformity of scale would help the customers better comprehend the charges of the loan and its implications. Another method adopted by one of the participating lenders to improve comprehension was to convert the loan applications and loan agreements into vernacular languages. Another form of standardisation suggested for adoption was to have a short, highlighted consent that can be presented to the customer during the onboarding process.

5.6 Improving grievance redress mechanisms

There is a renewed focus on improving the quality of grievance redress, and lenders’ associations appear to champion better redress mechanisms. Lenders’ associations emphasised that members have a grievance redress cell, the details of which are required to be clearly published on the website or app through which they operate. With respect to grievance redress, it was suggested that the lenders should build some self-regulation standards that set out accessibility, response time, and escalation or third-party adjudication. These are steps that can be undertaken before the regulator enforces more robust standards.

5.7 Improving outsourcing mechanisms

One of the risk holders underlined the need to thoroughly check whether the agencies/platforms to whom they outsource follow responsible lending practices. Suggested measures include checking the processes followed by the agencies/platforms with respect to acquisition and onboarding, disclosures and advertisements placed on their websites, the kind of options made available to customers etc. Another method adopted by a risk holder was to have loss-sharing agreements with partnered entities so that the entire burden and risk does not fall on the principal lender.
The discussion also highlighted the need for training the outsourcing entities, so that the collection agents employed by them are more responsible and empathetic towards the borrowers during the collection process. The risk holders also noted that, as entities who outsource several of the lending activities, it is important for them to ensure that the fulfillment agencies are trained, educated, and regularly monitored so that they follow responsible practices.

5.8 Personal data management

One of the risk-holders highlighted that they are only the custodians of the customers’ personal data and not the owners. Therefore, in an attempt to mitigate the personal data risks to the customer, they set an internal course to decide how much of the customers’ data they retain or collect in the lending process.

Another measure to ensure maintenance of customer’s data privacy is by making sure that lenders delete customer data after completing the loan tenure.

5.9 Facilitating customer education

One of the key themes highlighted by the risk holders and academicians throughout the discussion was the importance of customer education given the inadequacies of financial regulation in ensuring full consumer protection. Several of the participants agreed that it is the lender’s responsibility to educate the customer, before lending, on the implications of borrowing. Importance must be given not just to consent from the customer’s side, but to informed consent. One of the ways this can be done is by highlighting certain key and relevant portions of the consent documents and ensuring this is made understandable by presenting it in vernacular languages. Another research-backed method is training the customer to follow a ‘rules of thumb’ approach where they are given a resource (such as a set of five questions) which they can ask any financial service provider before availing the service. While the customers themselves may not initially understand the answers to these questions or their implications, these questions may signal some extent of financial awareness to the provider/distributor. Additionally, the questions could also instigate the customers themselves to seek the answers to these questions or approach somebody more knowledgeable. However, during the discussions, it was also pointed out that the financial literacy route is expensive and time-taking, and eventually, may still not produce the desired outcomes.

6. Conclusion

The conversation with the diverse set of participants helped to bring to light customer protections risks inherent to the various aspects of digital consumer lending, and the motivations behind existing practices in the industry. The importance of such a discussion is in setting the way forward for progress in the industry and towards financial inclusion goals while also keeping in mind the interests and well-being of customers.

Based on our reflections of the workshop discussions, we conclude that bridging the following gaps will help in designing solutions to strengthen customer safeguards in digital lending.
i. **What is the size and scale of the problem, and how do we measure it?** One of the key issues in the digital lending space is that one does not know the size of the industry or the scale of the risks to customers. Therefore, any agenda for future work must first understand the size of the market, the cost to consumers of digital credit and details of the borrowers in the market such as their age profile, geographic variation, and gender divide. The precursor to understanding this problem is to design appropriate tools for measurement which can help measure the scale and extent of the problem.

ii. **Creating a business case for digital lenders to adopt responsible lending practices.** The RBI's current light-touch regulatory model is to foster innovation in the digital lending space. Until a regulatory steady state is achieved, the risks to customers from digital lending remain. Therefore, it is crucial that the lenders themselves adopt practices that could help mitigate the risks. The impetus for such self-regulation by the lenders could be provided by demonstrating that ensuring customer protection would be beneficial to their businesses for sustained profitability.

iii. **Engaging with the RBI to further the consumer protection agenda.** A balanced set of considerations keeping in line with the views of all stakeholders, including practitioners, researchers, and the interests of customers, can be presented to the RBI so that the current regulatory mechanisms for consumer protection can be bolstered.

iv. **Understanding the large-scale usage and exchange of data through Account Aggregators for furthering digital financial services.** In India, data intermediaries in the form of Account Aggregators were licensed by the RBI for the purpose of data aggregation and sharing. This consent-based data sharing infrastructure was created to address the concerns arising around ownership, use, and collection of data. However, there is a need to unpack the impact of such a data-sharing model on financial inclusion.