Digital Lending – Paths to Regulatory Policy Landing[1]

Introduction

It's a common knowledge that internet protocols are about routing data in packets. In 1980s, an unnamed economist is said to have famously told David Clarke, Head of Internet Architecture Board that internet is about routing money; routing packet is a side effect. The economist further added that internet designers really bungled up the money transfer protocols. When David Clarke protested that internet was never designed for money routing protocols, the economist replied that this was right where internet designers bungled. Four decades of bits and bytes later, one would appreciate in retrospect, how cryptic the economist's premonitions were. The amount of money that flows literally and figuratively through digital web is humongous, digital lending forming a small part of it though. The appearance of current share of digital lending from a regulatory perspective may statistically be deceptive, given their scalability and ability to masquerade. To all present in today's conference, it is unthinkable to unlink internet or digital mode from any business, much less that of financial services. To cut a long preface short, even Merchants of Venice of middle age, not to speak of banks, are digital lenders today.

Financial Regulation in Platform Economy

2. The cliché goes that the any term dealing with 'digital regulation' faces embedded challenges from the word go, as 'digital' is always global and 'regulation' always local, which has been amply demonstrated in many of the digital lending scam episodes in India. The four sequential moving parts in the coming into being of a digital service regulation are (a) introduction of technology, (b) adaptation of processes, (c) evolution of policies and (d) framing appropriate laws. While the first two parts assume frenetic pace to reap the first-mover rents, the slow and slower progress of the last two parts are explained as 'pacing' problem.

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[1] Key Note Address by Jayant Kumar Dash, Executive Director, Reserve Bank of India

3. Platform businesses enable bargained collaboration of traditional service providers with new age (mainly, FinTech) partners and bring together different categories of services and hence customers, creating large, scalable networks of users. Their entry into finance promises potential benefits to consumers in the form of wider products choice, competitive prices and enhanced consumer experience. At the same time, their new business models, ecosystem and technologies potentially threaten the dominant or controlling position of traditional financial services providers and create challenges for regulators. For example, platform businesses can use their preferential access to customer data to shepherd loans of varying quality to different lenders based on algorithms. Their ability to offer complementary non-financial services that cannot be supplied by banks, and often by FinTech start-ups, can make it unattractive for customers to switch to alternative providers. This danger assumes further acuteness when BigTech firms have monopoly power in other markets that complement financial services and their revenue model may not be initially dependent on financial services. In its regulatory policy approaches, RBI has been conscious of data-monopolistic business models or those that target effective control over the layer involving bank's customer acquisition and interface for its implications in long term. The jury on the desirability and sustainability of business models that cross-subsidizes high customer acquisition cost for financial services from established non-financial service business is still out. That said, it will be a good starting point to set regulation of digital lending in context on two central planks:

(a) Any new technology or innovation always develop with good intentions and to solve a valid human problem or create a new need. But they also say that the road to hell is paved with good intentions. At the risk of sounding a cynic, it's the invisible-to-public cloak of 'business model' around the new digital technology, particularly digital lending, that needs to be understood better for making effective regulation than digital technology *per se*. I am tempted again to cite Sergei Brian and Larry Page, co-founders of Google, what they had to say in the context of search engines. In a paper published in 1998, they had mentioned that "advertising funded search engines will be inherently biased towards the advertisers and away from the needs of the consumers". In 2004, while taking Google to public they changed their narratives to, "serving our end users is at the heart of what we do and remains our number one priority". Cut

to the chronicles of digital lending, without any generalization, it will be hard to miss some parallels, pitches and of course, the paradoxes.

(b) A constantly evolving subject, laws, and regulation of lending activities by various types of financial service providers and lending market are mature in Indian context. As a part of the evolutionary passage, the foreground of regulation of digital lending could not have been broached a day too late. The need for, if I may call it so, an 'augmenting' regulation for digital lending arises from the fundamental paradox of a highly regulated public activity being performed largely over an unregulated and powerful private infrastructure with little accountability. To boot, the velocity of growth in the industry leaves the traditional regulators with less time compared to pre-digital days of lending products to understand / respond to implications of such credit alternatives. By extension, that also characterizes the limitations of regulations around digital lending – a factor which might have cast its shadows on RBI for having taken its time in articulating opening set of guidelines on digital lending.

4. In the above backdrop, the general principles that guide regulatory developments in the space of digital activities or services follow certain considerations:

- Regardless of the provenance of the adopted technology, regulation in India cannot blindly clone that of other countries. Technological feasibility of regulatory interventions and acceptable techno-managerial compliance burden need to be the key characteristics of regulatory developments. The regulations are better kept as simple as possible, rather than adding complexities.
- Another overarching regulatory principle is to distinguish between technology itself and technology regulation. It must be recognized that on-line and off-line activities are irretrievably intertwined and developing different regulations for those could be traps. It is always a safe bet to focus on the principles and outcomes rather than focus on technology or process details which can be delegated to, if necessary, sub-regulatory vehicles.
- Helming the fintech innovations to maximize the highest economic and social benefits for the system is an important challenge before the financial sector regulators. Promoting digital lending approach to types of lending where it is more efficient may pay higher social dividends may also be used for regulatory distinction. An ideal regulatory framework for India could be one which

promotes innovation in digital financial inclusion with more democratized credits on all fronts with identifying, assessing, and managing new risks.

- Regulation should help develop and expand the digital financial services ecosystem—including financial and information and communications technology infrastructure—for the safe, reliable and low-cost provision of digital financial services to all relevant geographical areas, especially underserved rural areas.

5. With the above underpinnings, the high-level regulatory landing would logically center around (i) Financial Consumer Protection and (ii) Limiting risks to the financial system, which also happened to be the broad theme of the report of the Working Group on Digital Lending. The systemic aspects of digital lending manifest in the form of minimizing scopes for regulatory arbitrage, positive implications for competition, addressing disintegration of direct relationship between the lender and borrower with an 'as a service' buffer to many of the core banking functions, a tight rope balancing of access and consumer protection at the same time, to name a few. While emerging and thriving trends in digital lending are bound to change the shape of future business of lending, it will be interesting to distinguish between the outcomes of disruption by technology and disruption by regulation. While the formers may generate unicorns, the latter always spin some unique concerns.

Regulation and Innovation

6. One of the first critical argument usually made towards introduction of any type of regulation in technology or innovation space is to paint it as a prohibitive barrier to innovation. Hence an innovation friendly regulatory framework, coming in a bouquet, would be an ideal choice. Innovation is about finding new and better ways of doing things. It has been critical to the success of humanity and is vital for our continued, sustainable prosperity. However, successful innovation is also fragile. It often banks on a chain of connections and coincidences that enable ideas realize. The success of technological innovation, the extent to which it creates societal, economic, or environmental benefits, is highly sensitive to the circumstances and context into which it is born. It may be important to recognize that technological innovation does not come up in isolation and regulation as well as joint efforts of government, regulators and innovators have been key enablers usually forms a virtuous cycle. Regulation enables

and add to market confidence for significant investments in products and services at early stage. Regulation that proportionately accounts for the risks and benefits associated with new technologies can also boost public confidence and acceptability, which is an important prerequisite for widespread adoption. Importantly, regulation can also contribute to building public trust in the uses of innovative technologies. In India, several factors have aided the regulator-driven development of digital lending, including (a) enabling frameworks for the provision of payments, (b) widespread use of digital payments, and (c) regulations allowing the use of correspondents/ agents by banks etc.

7. Considering above factors as tailwind for innovation, the modulation of Indian regulation towards technology in general and digital lending in particular would appear to be following certain tenets such as (i) adoption of a nuanced consideration of risks and benefits to develop a proportionate approach. (ii) grounding the regulations not to entirely negate commercial viability to attract capital and investments (iii) designing and implementing alternative forms of regulatory tools to blend with hard coded laws / rules for imparting necessary flexibility, though concepts like After sand boxes Scale boxes / Regulatory nurseries are yet to be adopted (iv) positioning the 'pacing problem' just right, regulations do not come too early or too late and finally (v) an open / consultative process and growth mindset for developing regulations have been adopted. It will be easy to see that in case of recent regulatory framework for digital lending by RBI did largely conform to above considerations.

Opening Regulatory Framework for digital lending of RBI

8. Progressive use of digital technology in lending and other financial services has been practiced in India over decades. As a matter of fact, India was one of the first countries to have a comprehensive regulation on marketplace digital lending, also known as P2P lending, back in 2019. So, the current buzz about digital lending in India can be loosely explained through rather a cliché – if lenders use digital technology, it's not a news but if digital technology creators start lending, that becomes some news.

9. In a highly blended financial world, regulators are trying to re-equip their approaches among entity-based, activity-based and risk or outcome-based options. The proponents of activity-based regulation or risk/outcome-based regulation would side

with ‘regulation’ for digital lenders, but the entity-based regulation school might be temporarily puzzled as to how to assimilate ICT-led entities within regulatory scaffolding built for financial intermediaries. An answer can be found in the recent approach of RBI where some workarounds to and augmentation of existing frameworks have been outlined as stance to be implemented across different time horizons. Those will essentially serve further as policy and regulation enablers. The reasons for terming these as augmented regulation basically owe it to the absence of (i) an overarching digital financial service or FinTech regulations covering diverse offering in financial services sector, (ii) a comprehensive data protection / privacy law and (iii) final take on certain critical parts of the recommendations lying outside the scope of RBI. The regulatory stance / guidelines in the subject for short haul have been designed to be implemented through the regulated entities, particularly banks, as the path and passage of any financial service would flow through them at some point in time. The primacy of banks in the core of lending, digital or otherwise, still remains an outstanding point in the opening framework while allowing new players in the ecosystem is enabled. In a nutshell, the general principles adopted for the recommendations under different sections of the report were (a) graded legal and regulatory measures; (b) regulatory approach being technology and business model agnostic and (c) protection of consumer interest weighing heavier than the interest of innovation. Further, different authorities / regulatory agencies need to play complementary roles to achieve a state of best-fit regulation for digital lending.

10. In order to render a comprehensive regulatory framework for responsible digital lending, the key principles that have been assimilated in some proportion into the delivery for terms of reference of the working group can be summarized as (i) an enabling and proportionate legal mandate to address the regulatory overlaps of the entities, activities / channels, and outcomes, (ii) a more aligned and comprehensive credit information system commensurate with the demands of the digital lending services (iii) effective transparency and disclosures by digital lenders should be focused for the potential borrowers without distractionary overloads (iv) an industry code of conduct vehicle for all the players of the ecosystem (v) consumer data use, protection and privacy specific to digital lending (vi) requirements of effective anti-fraud, cyber security and resilience requirements (vii) balancing enhanced competition and collaboration (viii) neutralizing some of the vectors for digital lending

abuse (ix) focused delivery of digital financial services education and literacy. At the same time, recognition of necessary institutional capacity with regulators / supervisors in terms of technical skills, resources, tools and systems remains a constantly moving target. Stronger regulatory capacity to comprehend the evolution of financial services and handle the additional risks brought by innovations and new business models will continue to throw challenges at the forefront.

11. To help the regulated entities using the services of third party FinTech players for digital lending stay the course, RBI has also issued draft guidelines on outsourcing of IT services in last June. Certain interpretational issues in use of PPIs for delivery of credit lines have also been clarified recently. The definition of digital banking and treating that as a different segment has also been notified. The impact of such related developments along with the stance taken on regulation of digital lending would encourage systematization and consolidation of the digital lending activities with clearer role plays by different players in the ecosystem. Hence the debutant regulations, though may appear as augmented version of existing frameworks, would acquire more comprehensive form when many other aspects of the subject are addressed.

12. As regards forthcoming impact of the regulations on the lenders, it would be dependent on their existing operating model and the nature of digital ambition. Nonetheless, it is not expected to significantly change disbursement speed or overall digital experience or more importantly, the total cost to borrowers despite some upticks in IT change spending. I must add here that the most demonstrative pitch of reduced cost by adopting digital technology in lending is yet to be proven from a consumer point of view. Under ‘lending as a service’ operating model, credit administration costs goes up for the sheer increase in the layers of ‘ecosystem players’ as the consumer experience a seamless journey. A few familiar points for banks to raise the bar to the FinTech digital credit offerings, include legacy IT systems; a general lack of trust in automated decision making; insufficient cooperation between businesses and risk, IT, and operations functions; limited data access; and scarce digital talent with problems in retention. Moreover, there is no single “owner” of the credit process with the discretion to drive change at scale. A number of stakeholders need to align and remain constantly aligned over a prolonged period for successful ownership.

13. Repurposing of credit enhancement concepts such as first loss guarantee, at loan or portfolio level, potentially heightened the credit cost. By corollary, cross subsidization of sub-prime borrowers by prime borrowers would seem to be an outcome of engineered parts of the digital lending in many cases. The opportunity for the banks to leverage on the cross-support / scale of different credit portfolios to deliver a balanced performance stands diminished now as more banks depend on different Lending Service Providers (LSPs) with a gross cost approach to each. The non-bank digital lenders / FinTech entities have, to a large extent, been persuaded to believe that dependence on FinTech is a one-way street although in the business of lending, it's the latter that operates on banks or NBFCs as host, at this stage of developments. It is important to note that the vast majority (85%) of global digital credit services were partnerships between a Mobile Network Operator (MNO) and a financial institution. In India, the role of MNOs is largely assumed by FinTech start-ups as the Payment Banks are not permitted to lend. These are important roles to distinguish as they determine the extent of responsibilities over digital credit risks between regulated and unregulated entities which has implications for financial stability.

Digital Lending Regulation – Future Questions

14. Given the powerful benefits, some tested and some untested, a serious segment of digital lending will be the new normal and with regulatory reinforcements serious and responsible digital credit providers would scale up. Digital lending services must move in tandem with the overall digitalisation / development of financial system to avoid regulatory asymmetry. It may not be out of place to broach a couple of regulation-linked questions that is globally discussed currently :

(i) Licensing of Digital- only banks

The surrogate digital bank / open banking operations are already being experienced in Indian context in different forms. Recent guidelines on setting up of DBUs by RBI give further directions to the course in near future.

(ii) Affiliation of non-financial / technology companies with banks

Digital domination by platforms and the network effect is another live topic that every jurisdiction is trying to address and sooner or later, Indian regulatory too may have to take their call. The risk dimensions relevant to such a question span across their implications for conflict of interest, competition, contagion and systemic risk, challenges of consolidated supervision and finally volatility factors in parent company support. An FSI analysis of 2020 bucketed the tech firms, based on their primary business lines, engaged in financial service activities into three groups viz. (i) Stand-alone FinTechs, (ii) Diversified FinTechs and (iii) BigTechs in the same order of their potential risk from regulatory perspectives. A strategy of advancing various policy goals through induction of tech firms into banking must be conscious of introduction of new risks and amplification of existing risks. The regulatory focus would possibly have to cover not only financial leverage but also data leverage factors. Further, sustained support by highly valued tech firms still running on lossmaking model may leave some iffy marks on bank's capital strength. While some public policy goals can be advanced through direct entry of Tech firms into the banking system, it might potentially introduce newer risks and amplify the existing ones. The new risks from the last two groups above emanate from easily scalable business models riding on a large and captive user base. In the present Indian context, ensuring competition would seem less expedient than preventing abuse of market dominance.

Conclusion

15. There is no gainsaying that a well-regulated market offers better environment for any business by imparting confidence to consumers and leads to orderly development of markets for that product or service. However, a fine balance is always desirable as regulations can potentially create a false sense of security among consumers and lead them to take excessive risk (known as Fence Paradox). Overregulation increases costs of compliance and tend to drive smaller players out of the market. As has been the case of digital lending in India, in a technology-led world, regulation leads to some players shift to low or zero regulation markets or segments. In regulatory prioritisation, there is a fundamental approach called 'harms-based' approach. It essentially identifies and solves 'harms' under three classes of issues viz. (i) legal but harmful (ii) Illegal but not harmful and lastly (iii) illegal and harmful. The last one warrants the

highest priority intervention. The participants of the conference can easily relate this theory to the regulatory approach to digital lending episodes in India.

16. With the RBI's initial regulatory stance on digital lending known, an important question still sticks around for answer: if the types of problems that had triggered the constitution of the Working Group on Digital Lending would be resolved. The reference here is to the 'fringe' lenders mentioned in the working group report or the malicious players in the digital ecosystem. The answer is a qualified 'Yes' at the moment but it is an emphatic beginning for an absolute 'Yes' as the full suite regulatory frameworks for digital lending evolve and unfold. The opening regulations, along with minor tweaks and enhancements in other cross-cutting guidelines, would iron out wrinkles that lent elbow rooms for some amount of regulatory arbitrage to both regulated and unregulated players. Further, the law enforcement agencies will now have more handles to isolate the malicious players or unauthorized or misguided play by regulated entities. While the opening regulatory framework for digital lending does not aim to make it perfect, it has taken care not to heighten the existing imperfections and inequities.

Thank you very much; wishing a day of very productive deliberations to all.