

DIGITALLY DELIVERED CREDIT: CONSUMER PROTECTION ISSUES AND POLICY RESPONSES TO NEW MODELS OF DIGITAL LENDING

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BACKGROUND

Following the issuance of the Policy Guidance Note on Digitally Delivered Credit¹ in 2015, the AFI Consumer Empowerment and Market Conduct Working Group (CEMC) conducted a follow-up survey on the performance of digitally delivered credit products, with a focus on repayment (over-indebtedness risks), credit assessment models, and pricing and disclosure (contracts provisions). The follow-up survey also covered evolving regulatory oversight mechanisms.

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¹ The Guidance Note is available online at: <https://www.afi-global.org/publications/2012/Guideline-Note-17-Policy-Guidance-Note-and-Results-from-Regulators-Survey>

INTRODUCTION: EMERGING TYPES OF DIGITAL CREDIT PRODUCTS AND BUSINESS MODELS

Across the globe, we are seeing how the rapid expansion of digital financial services (DFS) is driving the growth of inclusive finance. Policymakers and regulators are recognizing the importance of DFS for financial inclusion, as highlighted in the G20 High-Level Principles for Digital Financial Inclusion: “While tremendous gains in financial inclusion have already been achieved, digital financial services, together with effective supervision (which may be digitally enabled), are essential to close the remaining gaps in financial inclusion.”²

A new generation of DFS is emerging based on scalable and innovative business models that target the bottom of the pyramid—the most difficult to reach communities. Digital finance platforms are offering new ways to pay, transfer, save and borrow money, as well as new ways to create livelihoods and to access capital goods and productive assets. Inclusive business models are also evolving to serve low-income individuals as entrepreneurs and producers, employees and consumers. Disruptive innovations are breaking down barriers between the financial sector and other sectors, such as energy,³ agriculture, education, health care and housing, and are therefore an important driver of inclusive growth.

However, these innovations also bring new risks to consumers. Some of these risks resemble those we have seen in the microfinance sector as that sector expanded and commercialized rapidly over the last two decades.⁴ Recent studies in Kenya have highlighted the growing risks of over-indebtedness arising from digitally delivered credit.^{5,6}

OVERVIEW OF EMERGING REGULATORY/ SUPERVISORY AND BUSINESS MODELS

The analysis of the survey responses indicates that a majority of regulators have been taking a cautious approach to new DFS players and products. Many jurisdictions allow new players to provide payment services with set transaction and account limits, while holding deposits and providing credit is only allowed in collaboration with a regulated lender or financial institution.⁷ The issuance of new regulations and licenses for e-money issuers in many DFS markets has provided the necessary payments infrastructure to offer digital credit at scale. In many digital credit models, licensed e-money issuers have partnered with banks or semi-regulated lenders, with the e-money issuer providing the payments channel and the bank or semi-regulated lender holding the loan book.

In most jurisdictions where MNOs have partnered with a semi-regulated lender to provide mobile money services, this has been permitted through the issuance of a specific license for the MNO (i.e. MNO-led model), such as Jumo Zambia and MTN Zambia with the Kongola Loans product, or the mobile money operator’s registration as a non-bank financial institution (i.e. MMO-led model), such as afb Ghana Ltd, which had to obtain a non-bank financial institution license to offer the QwikLoan product in partnership with MTN Ghana. However, there is also an increasing number of app-based digital credit providers that do not have direct product partnerships with e-money issuers, and limit their relationship to the lender’s use of a paybill or bulk payments account with the e-money issuer to disburse and collect loans.

As national regulations vary, so do the business models. For the purpose of this Policy Guidance Note, the AFI CEMC Working Group conducted a member survey to identify which business models are operational in their markets and the respective regulatory and supervisory frameworks in place, with a particular focus on market conduct and consumer protection. The business models of digital lenders can be categorized into four types:⁸

- > **Model 1 (MNO + regulated lender):** for example, MoKash by Commercial Bank of Africa and MTN in Uganda
- > **Model 2 (MMO + regulated lender):** for example, Billetera Personal by Personal S.A. in Paraguay
- > **Model 3 (MNO + semi-regulated lender):** for example, Tigo Nivushe by Tigo Money and Jumo Tanzania in Tanzania
- > **Model 4 (app/internet-based lender):** for example, Mobidram in Armenia

2 G20 High-Level Principles for Digital Financial Inclusion: <https://www.gpfi.org/sites/default/files/G20%20High%20Level%20Principles%20for%20Digital%20Financial%20Inclusion.pdf>

3 Preliminary discussion on the PAYGo Solar Finance potential is covered by the FIBR Briefing Note: <https://static1.squarespace.com/static/5682a94969a91ad70f60a07c/t/5968d184e45a7c330fcea1ec/1500041609397/FINAL+FIBR+Briefing+note+PAYGo+Solar+July+2017.pdf>

4 For example, the case of the 2010 India (Andhra Pradesh) microfinance crisis. See Reserve Bank of India, “Report on Issues and Concerns in the MFI Sector”, <https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/YHMR190111.pdf>

5 See CGAP Blog by Michelle Kaffenberger and Patrick Chege: <http://www.cgap.org/blog/digital-credit-kenya-time-celebration-or-concern>

6 See Mustafa, et al, 2017. “Where Credit is Due: Customer Experience of Digital Credit in Kenya”, http://www.microsave.net/files/pdfWhere_Credit_Is_Due_Customer_Experience_of_Digital_Credit_In_Kenya.pdf

7 In our survey, six out of eleven respondents allow digital deposits and digital lending only to business models that include a regulated financial institution.

8 See also Mazer and Chen, 2016.

Table 1 below shows the digital lending business models currently operational in the eleven AFI member markets participating in the survey

MARKET CONDUCT CHALLENGES WITH DIGITAL CREDIT

Digital credit introduces several new consumer protection risks and challenges in areas such as disclosure, marketing, product suitability and data protection.⁹ Many lenders send unsolicited invitations to consumers to apply for digital loans, which can trigger borrowing with limited need or intention and, in turn, increases the risk of non-repayment and over-indebtedness. Once a prospective borrower seeks a loan, they are often not told the total cost of the loan on their mobile phone handset and are not able to review other key terms and conditions easily. Since most digital credit products are still short term and small value, there is little diversity of product types or customization based on the type of consumer seeking the loan or their reason for the loan. This raises questions about product suitability beyond individual or household consumption needs.

Finally, despite the importance of digital data—including telecommunications data, financial transaction data, and often social media data—for assessing risk in digital credit, consumers often do not know what data is being used or how this data is being used and shared, nor can they easily access and control how lenders and their partners use this data. This risk is exacerbated by a lack of comprehensive credit reporting requirements for digital lenders in some markets, leading to incomplete borrower histories in credit bureaus and information asymmetries across digital lenders. In markets where reporting requirements for digital credit are in place, a new risk has emerged: the potential exclusion of small-scale borrowers due to growing numbers of blacklisted digital credit clients.¹⁰

EMERGING RISKS FOR FINANCIAL MARKET REGULATORS AND SUPERVISORS¹¹

The high cost of digital credit and the ability to scale digital credit quickly make addressing market conduct risks an urgent priority for policymakers. During the 1990s, the emergence of microfinance introduced new challenges for rule-setting and oversight of new provider types and lending models¹² and the accompanying risks of market saturation and over-indebtedness,¹³ all of which required new policy approaches.

Similarly, digital credit may bring new risks requiring specific rules and oversight of digital credit models. These risks for policymakers include:

- 1 Different levels of oversight**, as well as different requirements for product approval and reporting across digital credit providers. The mix of regulated and unregulated providers in digital credit markets means that firms offering similar products to similar consumer segments will have different compliance requirements, which may give unregulated lenders an advantage.
- 2 Unequal application of consumer protection rules across provider types**. Since many jurisdictions have incomplete consumer protection rules in place, digital credit users may not always receive the same level of

9 Rafe Mazer and Kate McKee, 15 August 2017, “Consumer Protection in Digital Credit”, CGAP, available online at: <http://www.cgap.org/publications/consumer-protection-digital-credit>

10 For an overview of the potential exclusion risk facing digital credit borrowers in Kenya, see Graham Write on the Kenyan digital credit experience: <http://blog.microsave.net/key-new-year-resolutions-for-the-success-of-digital-financial-services/>

11 A survey was sent to members of the CEMC Working Group. AFI received answers from Angola, Armenia, Ghana, Paraguay, Peru, Philippines, Rwanda, Tanzania, Uganda, Zambia and Zimbabwe.

12 CGAP, 2012, “A Guide to Regulation and Supervision of Microfinance: Consensus Guidelines”, available online at: https://www.cgap.org/sites/default/files/Consensus-Guideline-A-Guide-to-Regulation-and-Supervision-of-Microfinance-Oct-2012_0.pdf

13 CGAP, February 2010, “Growth and Vulnerabilities in Microfinance”, available online at: <https://www.cgap.org/sites/default/files/CGAP-Focus-Note-Growth-and-Vulnerabilities-in-Microfinance-Feb-2010.pdf>

TABLE 1: DIGITAL LENDING BUSINESS MODELS IN COUNTRIES WITH AFI MEMBERS

	MODEL 1 MNO + REGULATED FINANCIAL INSTITUTION	MODEL 2 MMO + REGULATED FINANCIAL INSTITUTION	MODEL 3 MNO + SEMI-REGULATED LENDER	MODEL 4 APP-/INTERNET-BASED UNREGULATED LENDER
ANGOLA	✓	✓	-	-
ARMENIA	-	-	-	✓
GHANA	-	✓	✓	-
PARAGUAY	-	✓	-	-
PERU	-	-	-	✓
PHILIPPINES	✓	✓	-	✓
RWANDA	✓	-	-	-
TANZANIA	✓	-	✓	-
UGANDA	-	-	-	✓
ZAMBIA	-	-	✓	-
ZIMBABWE	✓	-	-	-

consumer protection in areas such as disclosure of costs and key terms, protection of personal and account-level data, and rights to recourse and redress.

3 Lack of competition in the digital credit market.

This can include insufficient sharing of consumer data and loan performance by incumbent providers, higher costs to access mobile money and MNO channels or even restricting access for new lenders. These are particular concerns when MNOs and MMOs in a telecommunications or mobile money market form exclusive partnerships with only a few lenders and offer them access to their customer base and data while restricting access to other lenders.

4 Risk of over-indebtedness.

An easy and automatic enrollment process, compelling marketing strategies that include unsolicited loan offers, and misleading disclosure of terms, can all encourage borrowers to take on loans without considering whether they need the loan and how they will repay it.

5 Unfair payment collection practices.

In most countries covered in the survey, digital lenders can automatically sweep the amount due from the borrower's mobile wallet or bank account.

6 Risk of market saturation due to fast-scaling products.

The use of algorithms for digital credit-scoring models and digital delivery channels make it possible to provide millions of loans instantly and simultaneously. This introduces potential prudential risks for providers if their scoring models are not well designed and they expand their loan portfolio too quickly. There is precedent in examples such as microfinance in Nicaragua and payroll lending in South Africa, where mass market consumer credit products have led to the failure of financial institutions. Better monitoring of digital credit models and loan portfolios will be necessary to avoid market saturation and prudential risks. (Note: this risk was not covered in the current survey and is therefore not discussed in detail below.)

While specific rules and oversight of digital credit products to date is limited, the survey revealed several useful approaches being taken by policymakers that could be adapted by other policymakers in their jurisdictions.

1. CONSUMER PROTECTION OVERSIGHT AND PRODUCT APPROVAL

It is important for the various authorities regulating and overseeing digital lenders to have clear mandates and responsibilities. Especially with regard to consumer protection, the mandate is not always clear. In nine of the eleven countries surveyed for this Policy Note, the central bank is in charge of overseeing consumer protection for these providers.¹⁴ In Rwanda, oversight of consumer protection is shared between the central bank and the telecommunications authority. In Peru and Paraguay, consumer protection is regulated under a national law and, therefore, overseen in collaboration with a separate consumer protection authority.

In most markets, the central bank is responsible for reviewing and approving digital credit products,¹⁵

with some central banks considering issues unique to the delivery of digital credit. For example, survey respondents noted that special attention is given to how the provider(s) plan to manage customer due diligence (or Know-Your-Customer (KYC) for AML/CFT protections), protection of customer funds, customer data protection and privacy, IT security,¹⁶ reliable customer access to funds, risks of internal and external fraud, credit-scoring approaches and overall consumer protection. In Ghana, digital lenders are required to present and demonstrate their product, the identified risks, and risk mitigation strategies to a panel at the Bank of Ghana for assessment and approval. In Zambia, the regulator also assesses the contractual framework of the business partnership. In Zimbabwe, these types of products are reviewed by a committee consisting of representatives of the National Payment Systems and the Banking Supervision and Financial Intelligence Units.

2. EQUAL APPLICATION OF CONSUMER PROTECTION ACROSS PROVIDER TYPES

Consumer Protection Laws and Regulations for Financial Services

The survey revealed there are few consumer protection rules specific to digital credit products, or that would cover all digital credit provider types equally. In most cases, the rules that would apply to digital lenders are often provisions included in regulations that define specific types of DFS used to administer digital credit products (payment systems rules, e-money issuance rules, etc.). For example, the national payment system law and/or rules regarding e-money issuers in Ghana, Tanzania, Zambia and Zimbabwe include basic consumer protection provisions such as disclosure and recourse which, while not explicitly referencing digital credit products, could be argued to apply to digital credit due to reliance on the e-money channel. Only a few jurisdictions have explicit financial consumer protection laws¹⁷ or regulations for specific consumer risks, such as credit disclosure and consumer recourse.¹⁸

14 Angola, Armenia, Ghana, Philippines, Rwanda, Tanzania, Uganda, Zambia and Zimbabwe

15 Except for Armenia, Paraguay and the Philippines. In Armenia, the central bank does not approve these/any products or their designs. In Paraguay, digital credit products are being reviewed during the supervisory processes of the Superintendence of Banks. In the Philippines, where the only available digital lending models are crowdfunding and peer-to-peer lending services, the review is being done by the Securities and Exchange Commission. App-based lending models in Peru operate under no regulatory or supervisory framework.

16 allAfrica, 14 February 2017, "Kenya: CBK Sees Cyber Risks as Banks Eye Mobile Money Platform", available online at: http://allafrica.com/stories/201702150006.html?utm_content=bufferc55fd&utm_medium=social&utm_source=twitter.com&utm_campaign=buffer

17 Of the survey participants, the Bangko Sentral ng Pilipinas has specific sections on consumer protection in their Manual of Regulation for Banks (Section X705 "Consumer Protection for Electronic Banking" and Section X1001-1003 "BSP Regulations on Financial Consumer Protection") and the National Bank of Rwanda is currently drafting a Financial Consumer Protection Law.

18 For example, the Bank of Ghana has issued a Directive for Financial Consumer Recourse and Grievance Redressal and a Directive for Consumer Credit Disclosure, and the National Bank of Rwanda has Credit Disclosure Requirements, while Uganda has non-binding Guidelines for Credit Disclosure.

These provisions are often limited to certain credit products, leaving loopholes for other credit providers. For example, the Banking and Financial Institutions (Disclosure) Regulations, 2014, require banking institutions in Tanzania to disclose lending rates, fees and other charges, in addition to procedures for complaints handling.¹⁹ However, the disclosure requirements only apply to credit products offered by regulated deposit-taking institutions.

Two markets from the survey have providers that are not covered by a consumer protection framework. Crowdfunding and peer-to-peer lenders in the Philippines fall under the regulations and oversight of the Securities and Exchange Commission, and app-based lenders in Peru operate outside regulatory oversight. Some of the respondents also mentioned the challenge of enforcing the rules for these lenders, especially internet- and app-based ones. In fact, Paraguay was the only jurisdiction to report issuing an explicit requirement for digital lenders to follow the same or additional rules as traditional credit providers (see Box 3).

Disclosure and Transparency

A key challenge highlighted by regulators and supervisors was the disclosure of key terms and conditions of digital credit products. This includes timely disclosure of the costs of the loan, bundled products, and any other charges and borrower responsibilities. A first step toward more responsible sales practices is setting certain minimum standards in transparency and disclosure that digital credit providers can and should follow. Given the new delivery channels and interfaces, merely extending the disclosure rules for traditional branch-based lending practices to digital lenders is not always sufficient. Policymakers need to develop additional requirements specific to digital delivery and remote KYC processes.²⁰

In the majority of markets surveyed, there are general disclosure rules based on traditional lending models that apply to all regulated financial institutions. However, in six of the eleven countries surveyed (see Table 1), there are digital lending models that do not involve an institution regulated by a financial sector authority, and are therefore not explicitly required to adhere to these rules. Some jurisdictions require basic disclosure standards in their regulations for payment service providers and e-money issuers,²¹ however, these do not include disclosure rules specific to credit products. Rules enforcement is also weak, with only Armenia, Zimbabwe, and to a limited extent Tanzania, reporting cases where misconduct was identified and the digital lender ordered to review its practices.

High Costs and Fees

The costs associated with digital credit products are typically high, often in excess of 100% APR. However, even in markets where there are interest rate caps, these rules have not always applied to, or been enforced for, digital credit. In Kenya, for example, the interest rate cap enacted in 2016 does not cover lenders not regulated by the Central Bank of Kenya. Also, some banks offering digital credit products have not complied with the interest rate cap, arguing that they charge a “facilitation fee”,

not interest on their digital credit products. Only Paraguay and Zimbabwe have caps on the amount digital (and non-digital) providers can charge for late fees.

Credit Reporting and Credit Information Sharing

There are significant discrepancies in the rules followed by traditional and digital lenders when reporting borrowers' credit histories to the credit bureaus in their market. In about five of the eleven countries surveyed, digital lenders are mandated to report both negative and positive data to the credit bureau.²² In the other countries, only regulated financial institutions are required to report, and it is either optional or not expected that digital lenders share that information with the bureaus. In one country, lenders are only mandated to share negative, but not positive, data. It is important that consumers, especially those new to formal financial services, understand and are able to leverage their data and borrowing history to access a wider range of financial services and products, and policymakers should improve the coverage of credit bureaus to include more digital lenders.

Data Privacy and Protection

The digital data trails consumers create when they use DFS are the engine driving the scoring models for digital credit scoring, enabling lenders to assess and manage the risk of lending to people with whom they have had no prior interaction or credit relationship. Yet, consumers are usually not aware of the data that is being used for their credit scoring and they have no control over it, preventing them from capitalizing on the data they generate. Not owning their own data trails also prevents them from sharing their data with other lenders to receive comparable credit offers and it also restricts competition.²³

Most jurisdictions responding to the survey reported having rules on customer screening and rating procedures for traditional delivery models, which theoretically apply to digital lenders as well, for example, the data that is to be consulted and shared with credit bureaus. Beyond this, digital lenders and alternative credit scoring providers can generally use any data available to them (e.g. airtime, mobile money transactions, personal data) for their scoring models. For all survey respondents, the only requirement is that the model sufficiently captures the credit behavior and repayment capacity of targeted borrowers.

19 [http://www.bot.go.tz/BankingSupervision/documents/New%20Docs/The%20Banking%20and%20Financial%20Institutions%20\(Disclosures\)%20Regulations,%202014.pdf](http://www.bot.go.tz/BankingSupervision/documents/New%20Docs/The%20Banking%20and%20Financial%20Institutions%20(Disclosures)%20Regulations,%202014.pdf)

20 See also CGAP's “Digital Credit Focus Note” (2017) for more information and recommendations for more responsible digital lending, based on consumer research and testing.

21 For example, Ghana and Tanzania

22 These countries are Armenia, Ghana, Philippines, Uganda and Zimbabwe. In Rwanda and Zambia, it is on a voluntary basis for mobile lenders.

23 Rafe Mazer and Philip Rowan, January 2016, “Competition in Mobile Financial Services: Lessons from Kenya and Tanzania”, CGAP, available online at: <http://www.cgap.org/sites/default/files/Working-Paper-Competition-in-MFS-Kenya-Tanzania-Jan-2016.pdf>

Eight of the eleven countries had some type of rules in place to safeguard customer data, seven of which stipulated that consumers have the right to prevent a provider from sharing their credit score and other personal information with third parties, with the exception of credit bureaus.²⁴ There are data protection laws in five of the countries, with Armenia, the Philippines and Zambia having a specific data protection law for banking and/or credit reporting. The other two countries are currently working on their own regulatory framework. Yet, the specific protections for sharing and using personal data in existing regulations do not sufficiently address several of the risks and harm created by the digitization of financial services delivery.²⁵ Only one regulator in the survey required lenders to disclose to customers which data was used for their credit scoring. In another country, providers need to share this information only upon request and, in a third country, lenders are prohibited from sharing this information with the customer. The other eight markets surveyed do not have rules on informed consent and disclosure of data usage. However, some markets require that consumers be informed about the reasons why their credit was not approved.²⁶

3. LACK OF FAIR COMPETITION IN THE DIGITAL CREDIT MARKET

The range of digital credit providers, combined with a lack of comprehensive coverage of digital lenders by existing consumer protection rules, creates the risk that certain providers will have unfair competitive advantages that hinder competition and consumer welfare. Seven of the eleven markets responding to the survey have competition authorities that oversee competition among digital credit providers, two markets give this authority to the central bank, and two markets do not have any authority with a mandate to oversee competition issues among digital credit providers. Most competition regulations are not specific to the financial sector, with only Angola and Armenia reporting having specific financial sector regulations on competition. While competition authorities have not played a leading role in digital credit regulation and oversight to date, they should play a greater role in many digital credit markets going forward. In many cases, competition authorities have the advantage of applying their rules and orders across all provider types, including unregulated digital lenders. The mandates of competition authorities also often include stronger provisions for consumer protection, consumer welfare and market dominance that could be used to address several priority issues in digital credit, such as transparency of pricing, data protection and sharing of consumer data, channel access and cost of access, and reducing barriers for consumers to move from one lender to another easily and effectively.

4. THE RISK OF OVER-INDEBTEDNESS

An easy and automatic enrollment process, compelling marketing strategies that include unsolicited loan offers and misleading disclosure of terms, encourage some borrowers to take on loans without considering whether they really need the loan or how they will repay it.²⁷

Poor repayment rates are not only affecting the sustainability of the lender and the stability of the market—they can also have significant consequences for borrowers when they are blacklisted (often unknowingly) and unable to borrow from providers due to their credit history.²⁸ This is compounded by credit reference system procedures that tend to have relatively high penalties to clear blacklisted defaulters, which risks expanding the proportion of credit markets that are excluded.²⁹

Half of the regulators covered in the survey did not capture or analyze digital lenders' data on their clients' repayment performance, echoing the early days of microcredit when several microfinance institutions went bankrupt due to defaults. The survey showed that regulators receive and monitor levels of indebtedness only when a regulated institution is involved in the business model. Levels of indebtedness for Model 1 and Model 4 customers are neither reported nor monitored in any of the jurisdictions, and no market was found to have specific mechanisms in place for monitoring levels of indebtedness for digital lending. There have been no cases of enforcement or intervention arrangements on this matter.

To mitigate the risk of over-indebtedness, it is imperative that both consumers and lenders are aware of these consequences and that regulators promote responsible practices by monitoring levels of over-indebtedness. In addition, product design needs to be reconsidered to support responsible lending and reduce incentives for irresponsible borrowing.

5. UNFAIR PAYMENT COLLECTION PRACTICES

One of the primary methods of collection in digital credit is pulling money from a mobile money wallet or bank account. Nine of the eleven survey respondents allow for automatic sweeping of loan payments from borrowers' mobile money wallets or bank accounts. In most cases this is not allowed without the customer's consent. Yet, customers often consent unwillingly or unknowingly, as providers simply include it in the lengthy and difficult-to-read contract terms, and design it as an opt-out rather than opt-in option. In Rwanda, however, the provider is only allowed to access a customer's account for repayment if a debt remains unpaid beyond the contractual term. Paraguay and Zimbabwe have instituted caps on late payment fees.

24 These countries are Angola, Armenia, Ghana, Peru, Philippines, Rwanda and Zambia.

25 See also CGAP's blog series on data privacy and protection: <http://www.cgap.org/blog/series/data-privacy-and-protection>

26 In Angola, Armenia, Ghana, Uganda and Zambia, lenders are mandated to disclose to a customer why their credit was not approved. In the Philippines, Rwanda and Zimbabwe, it is voluntary but seen as good practice.

27 This may help explain why, in conversations with CGAP, some digital lenders noted default rates as high as 40 percent or 50 percent in their first round of loan offers, when they send out invitations to a wide swath of prospective borrowers.

28 <http://www.nation.co.ke/business/Pain-of-Kenyans-blacklisted-for-amounts-as-small-as-Sh100/996-3374952-k2dkdvz/>

29 See Graham Wright, 2016, <https://www.linkedin.com/pulse/we-really-financially-excluding-27-million-digital-credit-wright>

EMERGING SOLUTIONS FOR EFFECTIVE REGULATION AND ENFORCEMENT OF MARKET CONDUCT ON DIGITAL CREDIT

Several market conduct enforcement cases have emerged to address consumer risks arising from digitally delivered credit. The first example is the issuance of an **order by the Competition Authority of Kenya** in October 2016³⁰ to all providers of mobile financial services to disclose transaction costs prior to purchase, which drew on **research of consumer price awareness and sensitivity**³¹ (see Box 1). Although these rules do not include specific requirements for digitally delivered credit, it is a first step toward enabling customers to automatically receive information on the cost of a product or service.

However, rules are not enough to ensure more responsible practices in the marketplace. Providers need to see and feel that non-compliance with the rules is being punished by the supervisor. As mentioned above, enforcement of the rules is still weak, especially with these new business models that seem to pose less risk to market stability due to the small amount of capital they handle. However, from a financial inclusion perspective, it is vital to ensure these new players have responsible practices and are stable, as they often target lower income segments, for whom they are often the first and only formal providers of financial services. Misconduct of these providers can therefore have a negative effect on the confidence and trust of the newly banked as they use their services. The Central Bank of Armenia, for example, is increasingly concerned about the disclosure and marketing practices of digital lenders and has already had a few cases in which they ordered a DFS provider to remove or revise their marketing materials and terms and conditions (see Box 2).

Another model of market conduct enforcement is collaboration between consumer protection agencies and financial services regulators. The arrangement allows consumer protection agencies to use their broad mandate to enforce fair market conduct in the credit market, including digital credit. For example, in Paraguay, the Consumer Protection Bureau collaborates with the central bank to enforce market conduct in the financial services sector. This arrangement also extends to the handling of consumer complaints (see Box 3). Tanzania is pursuing a similar approach with the Fair Competition Commission and entered a Memorandum of Understanding (MoU) with the central bank and other financial services regulators (see Box 4).

BOX 1: KENYA'S EXPERIENCE: ENFORCING DISCLOSURE REQUIREMENTS FOR DIGITAL CREDIT

The Competition Authority of Kenya (CAK) in 2016 issued an order to all digital financial services providers to provide the full price of DFS transactions on a customer's mobile handset prior to completing the transaction.³² This order was issued in response to the poor price disclosure practices in the Kenyan DFS market where many providers, including digital credit providers, did not disclose to consumers the cost of their product or transaction before the consumer accepted the transaction on their mobile device.

This ruling was issued under the CAK's authority established in the Competition Act (2012), which applies to all firms in the Kenyan market. This means that the implementation of, and compliance with, this order was not affected by the large number of unregulated financial service providers operating in Kenya. In the case of digital credit this means that, unlike rules enforced by central banks, CAK's order indisputably applied to all digital credit providers, regardless of whether they are a regulated bank, app-based lender or any other type of firm.

29 <https://www.cak.go.ke/images/docs/Competition-Authority-of-Kenya-Newsletter---Quarter-3-Issue-No.-1-2017.pdf>

30 <https://www.cak.go.ke/images/docs/Competition-Authority-of-Kenya-Newsletter---Quarter-3-Issue-No.-1-2017.pdf>

31 <http://www.cgap.org/blog/price-sensitivity-and-new-m-pesa-tariffs>

32 <http://www.cgap.org/blog/kenya-ends-hidden-costs-digital-financial-services>

BOX 2: ARMENIA: TRANSPARENCY AND DISCLOSURE RULES

Digital credit offers appeared in Armenia in 2015 and are primarily provided through the internet. The first digital lenders to appear on the Armenian market took a collaborative approach, with the central bank seeking to comply with, but also negotiate, more flexibility on transparency and disclosure rules. In 2016, the Central Bank of Armenia (CBA) revised their transparency and disclosure rules to make them suitable for digitally delivered financial services.

Along with the new rules, CBA is also adapting their supervisory processes to ensure that digital providers' practices are being monitored and misconduct is penalized. The enforcement process is the same as those used for traditional providers. First, to identify misconduct among providers, CBA receives and analyzes consumer complaints, conducts mystery shopping and assesses providers' offers and product terms and conditions. When they identify a practice that violates the rules, CBA first issues a warning to the provider, alerting them to their malpractice and asking them to adjust or remove the product. In the rare case that a provider does not resolve the violation, CBA will penalize and charge the provider, depending on the precedent. Only if a provider continues to violate the law after being penalized would CBA suspend their license. All decisions and penalties issued by CBA are published on their website.

With digital lenders, there have only been a few such cases of enforcement so far. One example was in early 2017, when CBA received multiple complaints about a misleading advertisement and information on the website of a new digital lender. The lender advertised interest-free loans of up to AMD 100,000 (around USD 200). However, customers who applied for this offer complained that they were only given a loan of AMD 50,000 (around \$100) with the explanation that they were not sufficiently creditworthy. When customers requested more information on how their creditworthiness had been determined, the provider did not respond. CBA investigated using information from creditworthy customers. The information was misleading, as the lender would have received complaints, conducted mystery shopping, spoke with the credit organization and analyzed the customer's portfolio. The lending decision was not based on a credit report and customers were not sufficiently creditworthy.

BOX 3: PARAGUAY'S APPROACH TO CONSUMER PROTECTION

In Paraguay, consumer protection is primarily based on a National Consumer Protection Law by the Consumer Protection Bureau (SEDECO), and the central bank collaborates closely with SEDECO to address consumer protection issues related to financial services. The advantages of mandating consumer protection through a nationwide law is the conformity and coverage of both financial and non-financial service providers, including unsupervised payment providers, money lenders or pawnshops. Consumers can direct complaints about financial service providers to both the central bank and SEDECO, which will handle them on a case-to-case basis. With the digitization of financial services and increasing integration of financial services in commercial services, the business models are becoming more and more blended, and the central bank sees an even stronger collaboration with SEDECO in the future: "This collaboration provides us the ability to apply rules to all these new players and learn from similar business models in the commercial space. Therefore, we are more flexible and able to react quickly to innovations in the financial services sector."³³

In a circular from 13 January 2015, Paraguayan regulators made sure to explicitly call on digital lenders to adhere to the established rules for traditional financial intermediation and lending:

"The Superintendence of Banks [...] requires all those entities that carry out loan operations through ATMs or other technological means—and which are usually called dynamic, agile, rotating, or similar loans—to arbitrate the necessary measures to ensure that said product is offered within an adequate framework of information transparency, as established in Article 107 of Law No. 861/96 "General de Bancos, Financieras y Otras Entidades de Crédito".³⁴ In this context, the information provided to customers through said means shall contain the minimum and basic data related to the characteristics and conditions of the product, such as the credit line granted, amount of capital granted, the interest rate, the amortization period, the amount of its share, associated expenses and any other additional terms related to the product, or other particular conditions related to the credit. Further, the provider must offer the possibility for the client to have the final option of rejecting or accepting the terms and conditions, prior to the conclusion of the loan contract and disbursement, thus facilitating freedom in decision."

[Translated from the original Spanish.]

33 Quote is from the survey response of the Superintendencia de Bancos de Paraguay.

34 http://www.oas.org/juridico/spanish/mesicic3_pry_ley861.pdf

BOX 4: EMERGING DIGITAL CREDIT FINANCIAL CONSUMER PROTECTION ARRANGEMENTS IN TANZANIA

Digital Credit Products

Like other markets in East Africa, digital finance dominated by a mobile money platform is playing a growing role in extending the reach of financial services in Tanzania, through funds transfer, savings, credit, securities trading and microinsurance. In terms of digitally delivered credit, three mobile network operators have introduced products: Vodacom (M-Pawa), Airtel (Timiza) and Tigo (Nivushe).³⁵

M-Pawa is a digital credit product linked with a savings account, offered through VodaCom in collaboration with a commercial bank. Timiza and Nivushe are digital credit products offered through a collaboration between MNOs and a non-deposit-taking credit provider, Jumo, which operates on a license issued by the Ministry of Industries and Trade.

Financial Consumer Protection Arrangements

The Fair Competition Commission has a broad mandate³⁶ to promote and protect competition, as well as prevent unfair and misleading market conduct. In pursuance of that mandate, the Commission issued Standard Form (Consumer Contracts) Regulations, 2014³⁷ to govern business contracts and prevent unfair market terms in the contracts. The regulations provide a basis for reviewing the terms and conditions of contracts, including digital credit products. Section 36 of the Fair Competition Act requires all terms and conditions governing consumer transactions to be registered with the Commission.

However, the Commission has limited capacity to enforce market conduct across all sectors. The operations of banking, payments systems and financial cooperatives are governed by separate laws that contain some elements of financial consumer protection. For example, section 49 of the Banking and Financial Institutions Act, 2006 deals with fair lending in terms of loan repayment, changes in the terms of lending and indexing of interest rates. Disclosure of the terms and conditions of bank credit products is governed by Banking and Financial Institutions (Disclosure) Regulations, 2014. The Bank of Tanzania also has a Complaint Handling Desk.³⁸ However, the disclosure regulations and the consumer recourse mechanism cater to bank credit products, while all payment services providers are licensed and regulated by the Bank of Tanzania under the National Payments Systems Act, 2015.³⁹ In this regard, MNOs are required to set up a legal entity for the provision of mobile money. The Act, together with the respective regulations,⁴⁰ has provisions dealing with consumer protection requirements for payment services.

Coordination Arrangements

The range of financial services in the market and the multiple agencies involved in licensing, regulation and supervision necessitates inter-agency cooperation in the enforcement of fair market conduct, and complaints handling becomes critical.⁴¹ To that end, the Fair Competition Commission is working on arrangements for financial services regulators to collaborate through a Memorandum of Understanding (MoU) mechanism. The Ministry of Industry and Trade, which is responsible for the licensing of non-deposit-taking credit providers such as Jumo, is also covered in the envisaged collaborative arrangements. The MoUs will also address potential conflicts among regulators in the enforcement of market conduct regulations.

35 March 2017 Tanzania Financial Stability Report available online at <http://www.bot.go.tz/Publications/Fin-stability/Financial%20Stability%20MARCH%202017.pdf>

36 http://www.competition.or.tz/PUBLISHE_DOCUMENTS/FCA/fca_no_8-2003.pdf

37 The Standard Form (Consumer Contracts) Regulations are available online at http://www.competition.or.tz/public_notes/Standard_%20Form_%20CONSUMER%20CONTRACTS_%20Regulations_2014.pdf

38 Press release on the desk establishment is available online at <http://www.bot.go.tz/Adverts/PressRelease/dawati-%20matatizo.pdf>

39 The Act is available online at <http://www.bot.go.tz/PaymentSystem/NPS%20Act%202015.pdf>

40 The Act was followed followed by issuance of Payments Systems Licensing and Approval Regulations and the Electronic Money Regulations which are available online at <http://www.bot.go.tz/PaymentSystem/GN-THE%20PAYMENT%20SYSTEMS%20LICENSING%20AND%20APPROVAL%20REGULATIONS%202015.pdf>

41 This was also observed by the Tanzania Country Financial Consumer Protection Diagnostic study which was conducted by the World Bank, available online at <https://openknowledge.worldbank.org/handle/10986/25883>

OUTLOOK: NEW TOOLS FOR MARKET CONDUCT AND EMERGING DIGITAL FINANCIAL SERVICES

As digital finance continues to advance and innovative products and delivery channels enter markets, tools for enforcing market conduct will need to be redesigned to address the new risks. For example, the growing number of new digital credit models is putting pressure on market conduct regulators in terms of resources for conducting on-site and off-site surveillance and timely identification of consumer risks. Regulatory gaps are also appearing in consumer complaints-handling mechanisms as the number of digital services clients in developing markets increases. The small value and high frequency of digital financial transactions only amplify these resource constraints. These innovations will require high-tech tools to be developed to enforce market conduct (e.g. RegTech or SupTech), and parallel innovations will be needed to provide affordable, accessible and convenient mechanisms for complaints handling and resolution. A framework for continuous monitoring of the new risks arising from financial service and product innovations needs to be put in place.

CONCLUSIONS AND RECOMMENDATIONS

The increasingly diverse business models of financial services providers require closer and deeper collaboration and coordination among the various market authorities. Inter-agency cooperation on the conduct of business supervisors, prudential supervisors, payment systems regulators and other relevant entities at the domestic and international level is essential to mitigate the emerging risks in the digital finance space.⁴² In some markets, central banks need to cooperate with insurance regulators, too.⁴³

There are several examples of countries where such agreements are in place. In Ghana, there is a Memorandum of Understanding between the central bank and the National Communications Authority (NCA) to share information about mobile money providers and channel all mobile money-related complaints to the central bank. The Bank of Ghana and the NCA also have an MoU with the National Insurance Commission. The Data Protection Commission was created as a joint effort by various authorities and industry associations, including the Bank of Ghana, the NIC and NCA, among others, which are board members. In a couple of other markets there is an authority or government ministry responsible for the promotion of fair competition and monitoring market dynamics, which can have a market-wide mandate, particularly when it comes to pricing, disclosure and fair treatment.⁴⁴ However, a key issue is the relative power of competition authorities to act independently from regulators when they intervene in the financial services and digital finance space.

In addition to improving the regulatory architecture of financial systems, the design of digital credit products needs to be urgently reconsidered to mitigate emerging risks and harness the potential of the platform to accelerate financial inclusion and develop appropriate products to meet the needs of low-income households, smallholder farmers and small businesses.

⁴² See FinCoNet report, "Online and mobile payments: Supervisory challenges to mitigate security risks", available online at: http://www.finconet.org/FinCoNet_Report_Online_Mobile_Payments.pdf

⁴³ In cases where credit products are sold along with an insurance product and vice versa, i.e. product bundling.

⁴⁴ The survey found that Armenia, Paraguay, Peru, Philippines, Tanzania, Zambia and Zimbabwe have a competition authority or Ministry with a mandate.

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