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Addressing the Challenges of Digital Lending for Credit Markets and Financial Systems in Low- and Middle-Income Countries

Summary

The demand for digital financial services has risen significantly over recent years. The COVID-19 pandemic has accelerated this trend and since the focus has shifted towards economic recovery, digital lending has become central. Digital credit products exploit traditional and alternative financial and non-financial data to provide access to finance for households and micro, small and medium enterprises (MSMEs). While it makes lending more inclusive for underserved or unserved households and firms, its increasing influence also brings forth challenges that need to be addressed by policy-makers and regulators in order to guarantee well-functioning credit markets and broader financial systems that foster sustainable economic development.

A central concern is the adverse effect of digital lending on the stability and integrity of credit markets (and potentially the wider financial systems). The rise in non-performing loans, even before the COVID-19 crisis, has been associated with an increase in digital credits. New players with little experience enter the market and exploit regulatory arbitrage, but often these players have no (or only a partial) obligation to report to respective systems for sharing credit information or to supervisory bodies, which introduces severe vulnerabilities.

In addition, the low entry threshold of digital financial products, due to their convenience and simplicity for customers, provides fertile ground for exploitative financialisation. Underserved households and MSMEs with limited financial literacy may be lured into taking up unsuitable and unaffordable digital credits, leading to over-indebtedness and bankruptcy.

The last challenge arises from significantly shorter loan maturities in MSME lending if current forms of digital lending are scaled up. This is problematic, as firms need loans with longer maturities to realise productivity-enhancing medium- and long-term investments, many of which include complementary investments in labour, thereby contributing to an improvement in job quality.

Governments and regulators need to strike a balance between leveraging the potential of digital lending for inclusive finance and economic recovery from the COVID-19 crisis, and mitigating associated risks. In particular, they should, together with providers of technical and financial development cooperation, consider the following:

- **Fostering the integrity of (digital) credit markets.** Regulators should establish specific licenses and regulations for *all* digital financial service providers, and introduce obligatory reporting requirements to supervisory bodies and national systems for sharing credit information.
- **Preventing exploitative financialisation.** Regulators need to require digital lenders to present the costs and risks of their loan products in a manner comprehensible to consumers with little financial literacy, and extend consumer protection policies to digital financial services.
- **Ensuring availability of loans with longer maturities.** Development finance institutions and other national and international promoters of (M)SMEs should assist local banks in the provision of longer-term loans, e.g. by offering respective funds or partial credit guarantees.
- **Establishing regulatory sandboxes.** Regulators should launch regulatory sandboxes to test legislation in a closed setting and to learn about risks without hindering innovation.

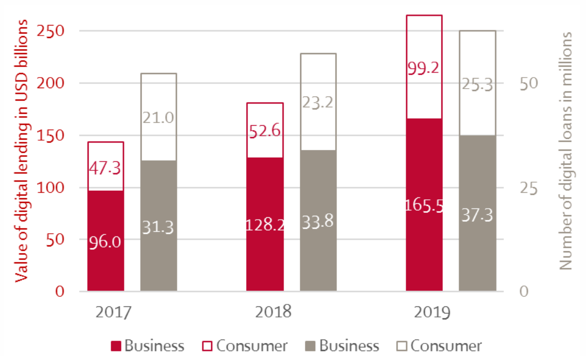
The growing importance of digital financial services

Over recent years, demand for digital lending has risen significantly. This is part of a wider trend of rapidly expanding digital financial services. Alongside traditional financial institutions that started gradually to transform some of their financial instruments into online and digital services, fintechs and other new players have entered the market. The adoption of digital instruments differs across countries and regions. It tends to be particularly high in regions where conventional financial systems are less developed and less competitive. Hence, digital financial services are particularly important in low- and middle-income countries.

Digitalisation holds great potential for the supply of, access to, and diversification of lending to MSMEs and households for at least three reasons. First, it drastically reduces transaction costs associated with lending instruments; second, it broadens access to more and alternative data (e.g. transaction data from mobile payment platforms, mobile savings accounts or other financial footprints, or even non-financial data from mobile phones, social media and other sources) and thus allows the extension of loans to previously underserved groups without requiring collateral; lastly, it increases the simplicity and convenience for customers by providing almost instant service, without paperwork, anywhere with mobile phone or internet coverage. Consequently, digital lending has grown substantially over recent years. The digital loan portfolio of fintechs, for instance, increased by 57% worldwide between 2017 and 2019, as depicted in Figure 1 (numbers constitute lower-bound estimates due to incomplete data). In Kenya, one of the frontrunners in digital finance, the number of digital credits already surpasses that of traditional loans (but the portfolio size of traditional lending is still much larger since digital credits tend to be very small and short-term).

The COVID-19 pandemic further accelerates the use of digital credit. Governments and international institutions have shifted their focus towards building momentum for economic recovery such that digital lending becomes central. The forthcoming *World Development Report* 2022, for example, will explore the role of finance for equitable recovery and commit a whole chapter to overcoming information asymmetries and other challenges in MSME lending – assigning technology and digital lending a key role in this process.

Figure 1: Growth in digital lending (only fintechs)



Source: Author, based on figures from Agur et al.(2020)

This briefing paper, instead, focuses on the challenges associated with increasing digital lending and how policy-makers and regulators can address them to guarantee a well-functioning and stable credit market (and broader financial system) that fosters sustainable economic development.

The challenges for credit markets and financial systems from digital lending

Digital lending complements other credit instruments and enriches financial systems. Yet certain developments associated with an increase in digital credits need to be addressed in order to safeguard the stability and integrity of credit markets, to prevent exploitative financialisation, and to avoid increasing short-termism in loan durations and the associated adverse effects on borrowing firms and their employees.

Beyond the three fundamental challenges discussed in this briefing paper, there are additional issues with digital financial (credit) products that need attention (see Disse & Sommer, 2020). These include, but are not limited to, data privacy and protection (transparency around the (type of) data being collected and its intended use), cybersecurity (limited capacities of smaller financial institutions and fintechs to set up and maintain cost-intensive cybersecurity systems), and digital divide or even discrimination (exclusion of groups with limited digital literacy or network coverage; implicit algorithmic biases with regard to gender, race, etc.).

Stability and integrity of digital credit markets

Digital lending practices may undermine the integrity and stability of (digital) credit markets or even of wider financial systems. The latter might happen only in the future, since even in countries with mature mobile money markets digital credits have constituted – up to now – only a small share of the overall loan portfolio, so digital lending can hardly pose a serious risk to wider financial systems. Yet building a suitable legal framework is essential to guarantee healthy and sustainable market development and to prevent future risks to financial systems – especially as digital lending is expected to become more predominant.

Evidence from several countries indicates that non-performing loans were on the rise even before the COVID-19 crisis and that this development is associated with the increase in digital lending. In Kenya and Tanzania, for instance, loan defaults were connected to irresponsible digital lending practices. Compared to default rates of 11.7% for overall private credit in Kenya in 2018, defaults amounted to 16% of all digital credits between 2016 and 2018 (27% among active digital credits) (MicroSave Consulting, 2019). Moreover, non-bank digital credit providers are often not obliged to (fully) report loan information and performances to the national systems for sharing credit information. Across-the-board exemptions from such reporting require-ments for non-bank financial service providers may introduce vulnerabilities, especially as the share of digital lending by non-traditional players increases. Unreported defaulting borrowers are free to engage in further borrowing, augmenting the problems of over-indebtedness and fraud.

Some economists argue that fintechs and other new players introduce vulnerabilities into financial systems through at least three additional channels. The first channel is formed by the (potential) undermining of the solvency of established financial institutions as overheated competition may lead to falling profitability and increases in overall risk taking. The second is exploitation of regulatory arbitrage and risk shifting due to different (national) regulatory requirements for banks and fintechs in relation to capital and liquidity. The third channel results from new players with little experience in finance entering the market, leading to suboptimal outcomes and heightened levels of default and insolvency.

Exploitative financialisation

Financialisation describes the expanding role of finance and financial institutions in an economy. In general, increasing access to financial services is beneficial for households and firms. Nevertheless, extending such services to groups that were previously unserved and have little financial literacy introduces the risk of exploitative financialisation. The low entry threshold of digital financial products due to their convenience and simplicity for customers provides a fertile ground to lure households and MSMEs with poor financial literacy – or simply imprudent actors – into the take-up of digital credits that expose them to substantial costs and risks.

Often, product information is not presented in a format that allows for consumer comprehension, as underlined by anecdotal evidence from various countries (e.g. Bangladesh, Kenya, Philippines, Russia, Rwanda, Tanzania and Uganda). A substantial share of borrowers exhibited little knowledge about the product and its central features such as fees, interest rates and other loan terms. In other cases, cost structures are deliberately designed to be opaque, or to utilise behavioural biases in order to downplay or conceal associated costs and risks.

Any of these scenarios increases the likelihood that firms and households end up with credit products that are unsuitable and unaffordable for them. The situation is aggravated, first, by the fact that effective interest rates (i.e. when considering all fees) can be quite high (e.g. between 40.8% and 365% in Kenya (Biallas et al., 2019)); worldwide, monthly interest on digital credits tends to be 6%–10%, translating into annual rates of 72% –120%, which is more expensive than loans from microfinance (annual rate of 30%, on average) or conventional banks (Mazer & McKee, 2017). Secondly, not all digital services fall under the consumer protection policies applicable to banks and financial institutions in the respective country. As observed in microfinance earlier in this century, these are the ingredients for over-indebtedness of already disadvantaged groups.

Short-termism in lending

Some digital credit providers offer loan sizes and repayment periods that allow MSMEs to meet liquidity and working capital needs, which is an essential and extremely valuable financial service – especially during the COVID-19 crisis.

However, the loan maturity structure will become significantly more short term if current forms of digital lending are scaled up quickly in order to increase access to finance for economic recovery. Across the world, the design of digital lending instruments tends to be characterised by short repayment periods of months, weeks or even days – partly because of the type of customers and market segments that are targeted. Yet a study on French fintechs found that, even after controlling for the quality of the applying firms and other confounding factors, loan maturities are approximately two years lower compared to bank loans. This is problematic, as short-term loans do not include some of the benefits that longer-term finance can provide. Recent evidence, for instance, underlines that longer loan maturities have a role to play in enhancing job quality. Sommer (2021) uses data from 73 mostly low- and middle-income countries to show that longer-term finance allows firms to pursue long-term growth strategies based on productivity-enhancing investments intended to result in higher returns in the more distant future. Examples thereof are R&D projects, technology adoption and fixed assets, many of which comprise complementary investments in labour, such as human capital accumulation, staff training and the like. This contributes to better jobs, characterised by training and skill development, higher wages and more stable employment relations. Yet these effects only materialise for repayment periods of more than two years – in some cases, such as training and skill development, effects only become more pronounced for maturities of more than three years or longer.

Since digital credits generally exhibit much shorter maturities, they may undermine the positive effects loans can have on job quality. This could become a legitimate concern if national and international finance for promoting (M)SME finance were channelled primarily into digital lending, without paying attention to loan maturities, with the result that national (M)SME loan portfolios increasingly exhibit shorter maturities.

Regulatory answers to the challenges associated with digital lending

Digital lending holds great potential for the inclusiveness and availability of finance, especially during recovery from the COVID-19 crisis. Yet it also poses considerable challenges to governments and regulators that have to keep up with the innovative dynamism of digital lenders and need to strike a balance between leaving space for innovations and mitigating associated risks.

Fostering stability and integrity of (digital) credit markets. Regulators need to introduce or modify specific licenses and regulations for *all* digital financial service providers to create a level playing field for digital lenders (fair competition) and to safeguard the integrity and stability of the credit market. This includes removing loopholes for unlicensed and unregulated products (i.e. curbing predatory lending) and requiring digital lenders to undertake adequate creditworthiness assessments, irrespective of their business model. In addition, regulators may want to consider obligatory reporting requirements to national systems for sharing credit information, as this raises incentives for on-time repayment, curbs over-indebtedness and fraud and increases efficiency. Vulnerabilities can be further reduced by mandatory information disclosures to financial supervisory bodies, by banning high-risk business models and practices, and fining (or even withdrawing the licence from) digital lenders who repeatedly surpass a specified threshold of non-performing loans. Development cooperation should engage in capacity building for credit bureaus/registries and financial supervisory bodies to manage the extended responsibilities and workload (e.g. by enhancing digital processes and efficiency).

Preventing exploitative financialisation of unserved groups with little financial literacy. National regulatory authorities need to ensure that customers are sufficiently educated about digital credits and their associated costs and risks by requiring digital lenders to comply with a specified format for presenting the central loan terms in a consistent and clear manner that is comprehensible even to (potential) consumers with limited financial literacy. Bilateral and multilateral donors can foster digital and financial literacy through financial and technical cooperation. Furthermore, national regulatory and supervisory bodies should extend existing consumer protection policies for banks and financial institutions to comparable digital lending products offered by non-bank financial service providers. Technical assistance by organisations with experience in consumer protection in digital finance, such as GIZ, can facilitate these reforms.

Increasing availability of longer-term loans. Development finance institutions (DFIs) and other national and international promoters of (M)SMEs have to play a central role here. They can provide longer-term funds to local banks for on-lending to (M)SMEs with the conditionality that some of the resulting loans have a maturity of more than one year and some a maturity of more than two years. They can also offer partial credit guarantees for loans above these thresholds to cushion local credit providers against the risks of longer-term lending and to incentivise provision of longer loan maturities.

Establishing regulatory sandboxes. Even though it is advisable not to overburden new players with the full set of banking regulations, the above challenges underline the necessity for regulatory interventions. Yet it is difficult to spell out in detail the differentiated requirements in line with the respective digital financial services and business models. Regulatory sandboxes are "controlled, time-bound, live testing environment[s]" (World Bank, 2020; see also for best practices and evidence) with close interactions between participating innovative firms and regulators, where regulators can learn about risks without hindering innovation. They can provide an evidence base for policy-making, can guide and amend regulation, and simultaneously foster innovation, private sector development and consumer-centric products.

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Christoph Sommer
Researcher
"Transformation of Economic and Social Systems"
German Development Institute / Deutsches Institut für Entwicklungspolitik (DIE)

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Tulpenfeld 6 · 53113 Bonn · Germany · Tel.: +49 (0)228 94927-0 · Fax: +49 (0)228 94927-130
die@die-gdi.de · www.die-gdi.de · twitter.com/DIE_GDI · www.facebook.com/DIE.Bonn · www.youtube.com/DIEnewsflash
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