FIGI FINANCIAL INCLUSION GLOBAL INITIATIVE

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Consumer Risks of Fintech

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Introduction

New World Bank publication

Introducing presenters

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Consumer risks along with benefits

Fintech: Advances in technology that have the potential to transform the provision of financial services, spurring the development of new business models, applications processes, and products (*WBG and IMF Bali Fintech Agenda*)

Key enabler for financial sector development worldwide: market competitiveness and efficiency + expanding access for the underserved consumers

Along with many benefits, fintech offerings can pose a range of risks to consumers: Some are new, but many are new manifestations of existing risks

Both benefits and risks highlighted during the COVID-19 pandemic

Challenge for policy makers

Challenge for policy makers: Determining consumer protection measures that may help to address these new manifestations of risk

An even more challenging task for developing country authorities, if implementing baseline FCP regulatory frameworks at the same time

Focuses of this session and the new Paper

What are significant new manifestations of consumer risks from key fintech products?

What regulatory approaches have been emerging aimed at addressing these risks?

Which risks (and regulatory approaches) are cross-cutting?

What are key implementation considerations when considering regulatory measures?

Selected fintech products

Discussed during this session

1. Fintech examples that can address key basic needs of first-time, inexperienced financial consumers — making payments, borrowing, or saving/investing money

2. Selected products also represent different stages in the development of fintech offerings and corresponding FCP responses

There are of course other emerging fintech offerings…

Agenda

- New manifestations of consumer risks in:
  - Digital microcredit
  - Peer-to-peer lending
  - Investment-based crowdfunding
- Cross-cutting risks
- Implementation considerations
- Q&A

Digital microcredit

Digital microcredit: Definition

Credit products that are:

1. ***Short-term (one week to a few months)***
2. ***Low-value***
3. ***Accessed via mobile devices***
4. ***Typically involve automated credit scoring and/or fast approval***

- Focus is on innovative microcredit products given significant uptake by consumers, particularly in EMDEs
- Unique characteristics of these products give rise to new risks specifically linked to such characteristics
- Such risks have already translated to instances of real harm to consumers
- While broader online and digital lending not explicitly covered, similar risks may apply

Digital microcredit: Consumer risks and regulatory approaches

a) Poor disclosure and transparency
b) Aggressive marketing practices
c) Unfair lending
d) Discrimination due to algorithmic scoring
e) Gaps in regulatory perimeter

Digital microcredit:
Poor disclosure and transparency

Risks to consumers

- Info on pricing often incomplete or not transparent (range of different methods to convey pricing, finance charges and fees not disclosed separately, etc.)
- Inadequate access to complete info about terms & conditions (T&C)
- Poor format of disclosure, particularly via mobile phones
- Info provided too late in process during a mobile transaction
- User interface (UI) difficult to navigate

➢ ***Poor transparency for digital microcredit has been shown to correlate with higher levels of late repayment and default***

Digital microcredit:
Poor disclosure and transparency

Regulatory approaches

- Require prominent disclosure of both total cost metrics + breakdown of costs
- Encourage greater standardization in presentation of pricing & terms
- Adapt for digital channels, such as bite-sized chunks of info consistently presented and secondary layers and offline channels for further info
- Require disclosure of key T&C in channel being used for transaction and access to full T&C, including after transaction completed
- Require order and flow of info to enhance transparency; disclose pricing and key T&C earlier in transaction process
- Leverage behavioural insights to encourage consumers to engage with info and require user-friendly UI

For retail banking via digital channels, providers in Portugal must assist customers to obtain further info via hotline, live chat, or other tools

Consumer testing in Kenya showed that providing summary T&C within mobile channel led to better consumer comprehension and comparison shopping

Digital microcredit:
Aggressive marketing practices

Risks to consumers

- "Push" marketing and unsolicited offers encourage impulse borrowing
  - In study by Central Bank of Kenya, many first-time users of popular digital microcredit product indicated they tried it out "for no reason at all"
- Exploitation of behavioural biases (e.g. encouraging borrowing the maximum possible, trivializing loans)
- Misleading ads targeting vulnerable consumers

➢ ***Remote nature of digital channels and rapid speed of transactions increase consumer vulnerability to aggressive advertising, which can lead to poor decision-making***

Digital microcredit: Aggressive marketing practices

Regulatory approaches

- Explicit warnings on risks of short-term, high-cost credit
- Ban sales practices that focus on ease of obtaining credit, trivialize credit, or target vulnerable consumers
- Slow down process of transacting digitally to allow consumers more time for reflection or deliberation
- Presentation of loan options that is beneficial (or at least neutral) to consumers and not exploitative
- Ban or limit pre-approved, unsolicited offers

In Australia, payday lenders must display a warning that borrowing small amounts is expensive, suggest alternatives to such loans, and provide resources on debt help

Payday lenders in the UK must refrain from advertising that trivializes the nature of payday loans

In Portugal, financial institutions must refrain from using pre-ticked boxes to lead customers to choose certain options

Digital microcredit: Unfair lending

Risks to consumers

- ***The design and business model of some digital microcredit products poses increased risks of unfair lending***
- High prices, with APR in some cases as high as 621%
- Mass marketing to consumers with little assessment of individual consumer circumstances or ability to repay (“lend-to-learn” models, default rates as high as 40-50% for blind offers)
- Certain business models based on high loss rates
- Poor practices such as rolling over loans or encouraging multiple loans to repay other loans, creating endless cycle

Digital microcredit: Unfair lending

Regulatory approaches

- Require providers to assess the ability of prospective customers to repay loans and only grant loans where affordable to consumer
- Require enhanced monitoring of loan portfolios, particularly where automated credit scoring utilized
- Apply product design and governance rules to digital microcredit
- Limit rollovers and multiple borrowing to decrease risk of over-indebtedness

In South Africa, FSPs are prohibited from entering into a credit agreement without first taking reasonable steps to assess a consumer's financial circumstances

New EBA rules going into effect in June 2021 will require FSPs ensure the performance of automated models in credit decision-making is continuously monitored and measures taken if issues are detected

In the UK, maximum of two rollovers for short-term, high-cost credit

Digital microcredit:
Risk of discrimination due to algorithmic scoring

- ***Big data analytics and algorithmic scoring one of core innovations driving digital microcredit***
- ***Obvious benefits for financial inclusion, but raises new manifestations of fair lending risks***

- Risk of biased outcomes due to poor algorithm design, incomplete or unrepresentative input data, biased input data
- Risk of discrimination based on proxies reflecting sensitive attributes
- Consumers unaware or powerless regarding use of algorithm
- Regulators lack technical expertise to evaluate algorithmic systems; proprietary nature of algorithms

Digital microcredit: Emerging approaches for algorithmic accountability

- Apply fair treatment and anti-discrimination rules to algorithms
- Require appropriate procedures, controls, and safeguards during development, testing, and deployment of algorithms to assess and manage risks related to bias and discrimination
- Require regular auditing of algorithmic systems by external experts
- Ensure transparency to consumers regarding use of algorithms
- Provide consumers with right not to be subject solely to automatic processing and the right to request human intervention

New guiding principles from Hong Kong Monetary Authority state that FSPs should ensure big data analytics and AI models produce fair outcomes that comply with applicable laws, including related to discrimination

EBA guidelines require FSPs have adequate documentation of automated credit scoring models and internal policies and procedures to detect and prevent bias and ensure quality of input data

In Portugal, FSPs required to inform bank customers when creditworthiness assessments rely exclusively on automated decision-making processes, particularly AI models

Digital microcredit: Regulatory perimeter gaps

Risks to consumers

- Unlevel playing field for different types of providers, with often weaker rules for non-bank lenders
- Regulatory gaps for app-based lenders, who may not be covered by any regulatory authority and/or may be based in another country

Regulatory approaches

- Ideally, establish activity-based framework covering all providers of digital microcredit (banks, MNOs, non-bank lenders, etc)
- Where not feasible, be opportunistic and leverage other existing powers (e.g. competition authority in Kenya, data privacy authority in Philippines)
- To address cross-border issues, explore options such as:
  - Coordinating with domestic and international regulatory authorities
  - Regulating domestic agents of foreign fintech companies
  - Applying FCP framework to foreign fintech providers offering products/services to domestic consumers
- Pursue complementary, non-regulatory measures such as industry CoCs, working with platform operators to establish rules for app developers

Peer-to-peer lending (P2PL)

What do we mean by peer-to-peer lending?

- Many terms used internationally – e.g.: marketplace lending, loan-based crowdfunding, crowdlending, social lending etc. – encompassing many business models
- For the purposes of this discussion:

Credit facilitated by online platforms that match borrowers with consumers acting as lenders, ranging from…

…platforms that facilitate consumers lending directly to each other …

…to platforms that allow consumers to invest indirectly in loans (or in loan portfolios / pools of loans)

P2PL: Key consumer risks covered

Risks for both lenders / investors and borrowers	
• Gaps in regulatory perimeter • Conflicts of interest • Fraud or other misconduct • Platform / technology unreliability or vulnerability • Business failure or insolvency of platform operator • Inadequate credit assessments	
Additional risks for lenders / investors	**Additional risks for borrowers**
• Inadequate investment-related information • Harm from lack of sophistication or inexperience • Borrower fraud	• Inadequate loan-related information • Risks from digital distribution of P2PL credit (equivalent to those discussed for digital microcredit)

Will discuss some of these today

P2PL: Gaps in regulatory perimeter

Risks to consumers

- P2PL may not be adequately covered by a country's existing FCP framework (if one exists)
- Borrowers and lenders/investors may receive less protection than applies to traditional lending

Regulatory approaches include…

- Applying FCP requirements on an activities-basis
- Extending existing FCP requirements to P2PL or developing new regimes
- Issuing regulatory guidance to address uncertainty

Australia regulates 'credit activities' (lending side) and 'financial services' such as dealing or providing advice (investment side)

Mexico's Financial Technology Institutions Law both extended existing FCP requirements to P2PL and allowed for new rules

P2PL: Conflicts of interest

Risks to consumers

- Conflicts of interest between operators (or their related parties) and lenders/investors or borrowers
- May lead operators to engage in conduct not in the interests of consumers – for example:
  - imprudent lending assessments
  - unfair or inappropriate loan pricing or allocation
  - intra-platform arrangements favoring related parties over consumers

P2PL: Conflicts of interest

Regulatory approaches include…

- General conflict-mitigation obligations on operators

In Australia, operator subject to such obligations as credit and financial services licensee

- Targeted obligations regarding fair loan pricing and fees and charges policies consistent with consumers' interests

In Brazil, an operator must adopt fees and charges policies consistent with viable lending. The UK FCA has detailed rules on loan pricing and loan allocation / portfolio composition

- Creditworthiness assessment obligations on operators regardless of whether they are the lender of record

In Korea and the UK an operator must assess affordability / creditworthiness

- Restrictions on operators or associates investing in loans facilitated by their platforms

In China operators are prohibited from making any loans themselves (and disguising own lending)

- Best interests duties

P2PL: Fraud or other misconduct

Risks to consumers

- Consumers may suffer loss or other harm from fraud or misconduct by:
  - platform operators and related parties
  - third parties

Regulatory approaches include…

- Licensing/registration, vetting and competence requirements

In India the RBI requires operators to meet fit and proper criteria at the start and on an ongoing basis (with periodic reporting)

- Risk management and governance arrangements

The UK FCA requires operators to have effective processes to identify, manage, monitor, and report risks and appropriate internal risk-control mechanisms. Mexico has similar rules, generally and for fraud prevention

- Segregation of consumers' funds and client money rules

- Potentially, compensation funds

(Technology risks discussed next)

P2PL: Platform/tech unreliability or vulnerability

Risks to consumers

- Platform/technology unreliability or vulnerability causes or facilitates loss, inconvenience, or other harms

Regulatory approaches include…

- General risk management and governance arrangements requirements for operators

China requires operators to address a range of security and reliability matters, including firewalls, intrusion detection, data encryption and broader IT risk management and resourcing concerns

- Targeted risk management and operational reliability requirements for technology-related risks and outsourcing

The RBI imposes specific outsourcing oversight, DD, and risk management obligations.
The EU's new regulation expressly provides for legal responsibility for outsourced functions

- Specific competence requirements relating to technology-related risks

OJK in Indonesia expressly requires operators to have in place staff with appropriate IT expertise and background

P2PL: Operator business failure/insolvency

Risks to consumers

- Business failure or insolvency of an operator may cause loss, such as of:
  - lenders/investors' existing capital or future income on loans
  - borrowers' committed loan funds or repayments

Regulatory approaches include…

- Operators required to segregate consumers' funds and deal with them only in prescribed ways

In Korea and India an operator must keep separate / escrow accounts with a bank or similar.
Brazil prescribes transfer timeframes (1 day/5 days)

- Operators required to have in place business continuity and hand-over/resolution arrangements

- Recordkeeping requirements to support business continuity

- Vetting and competence requirements on operators and related parties

In France operators must have a contract with a third-party payment institution to ensure business continuity.
The UK FCA requires an operator to have a 'P2P resolution manual' (living will equivalent) and appropriate continuity arrangements in place

P2PL: Inadequate investor information

Risks to investors/lenders

- Unbalanced or misleading marketing regarding P2PL investment/lending opportunities that encourages poor investment decisions, particularly given more novel nature
- Inadequate up-front information that means lenders / investors lack an adequate basis to make informed investment decisions
- Inadequate ongoing information about the performance and status of investments/loans that impairs being able to make appropriate ongoing decisions and react to adverse events
- An inadequate format can mean information is not conveyed effectively to consumers, even if the content is appropriate

P2PL: Inadequate investor information

Regulatory approaches include…

- for unbalanced or misleading marketing:
  - general prohibitions on misleading information
  - specific regulatory guidance on the application of such prohibitions to marketing of P2PL opportunities
  - targeted restrictions on specific P2PL circumstances presenting higher risk of misleading investors
- for inadequate up-front information:
  - provision of information highlighting key matters relating to P2PL, such as expected risks, factors affecting returns, and restrictions on early exit
  - key precontractual information about individual loans in business models allowing individual loan selection
  - warnings or disclaimers in key contexts to highlight risks and assist in balancing out inappropriately optimistic perceptions

P2PL: Inadequate investor information

Regulatory approaches include…

- for inadequate ongoing information:
  - ongoing information to lenders/investors at prescribed times or frequencies regarding matters affecting their investments/loans specifically, such as defaults, changes to borrowers' circumstances, adverse events etc.
- for inadequate format through cycle:
  - appropriate prominence to key information on electronic channels
  - standardized formats to assist clarity and comparability
  - digital disclosure approaches already discussed in the context of digital microcredit

P2PL: Investor inexperience/lack of sophistication

Risks to investors/lenders

- Lenders'/investors' lack of sophistication or inexperience may lead to bad decisions such as taking on risk of loss they cannot afford or do not understand

Regulatory approaches include…

- Lending/investment caps and related restrictions for less sophisticated or more vulnerable lenders/investors

Caps widespread in the EU – e.g. in Spain caps on a per-loan (€3,000) and total annual (€10,000) basis for 'unaccredited' investors.
Korea recently reduced its investment cap per investor given higher credit risk from COVID-19 crisis

The UK FCA extended to P2PL restrictions on promotion to unsophisticated investors that already applied to investment-based crowdfunding

- Caps on amounts individual borrowers may borrow, as another way to reduce risk of loss to lenders/investors

RBI has imposed a cap of ₹1 million on aggregate P2P loans taken out by a borrower at any point in time

- Potentially, compensation funds

P2PL: Inadequate loan information for borrowers

Risks to borrowers

- Borrowers not receiving adequate information to understand rights and obligations under P2P loans, including if P2PL is not adequately covered by existing credit disclosure/transparency requirements

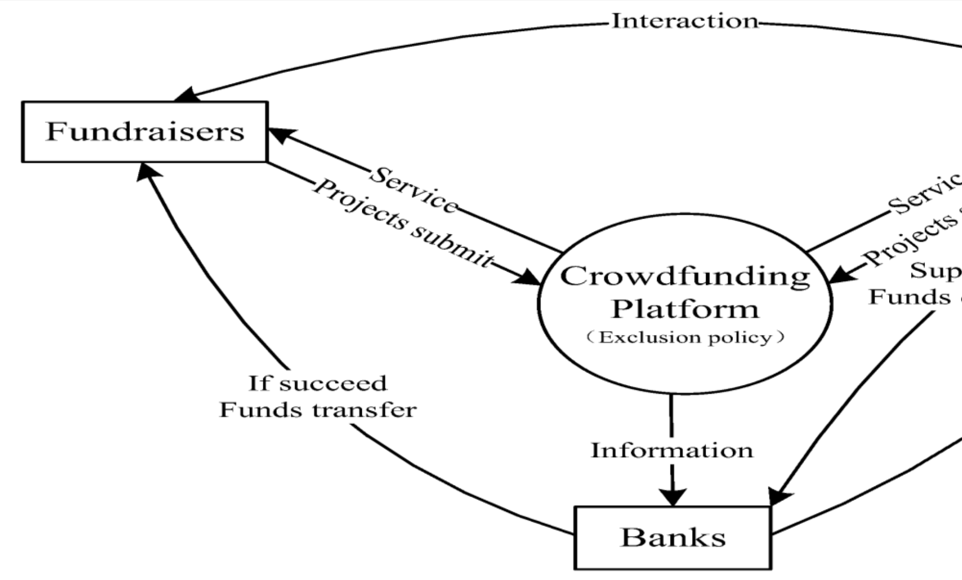
Regulatory approaches include…

- Apply credit-disclosure requirements to operators even when they are not the lender of record
- Address gaps in existing borrower-disclosure regimes
- Borrower disclosure approaches already in the context of digital microcredit

Investment-based crowdfunding

Investment-based crowdfunding: Definition

Alternative finance solution to address financing gaps not addressed by capital markets



Source: https://www.mdpi.com/2071-1050/10/4/1053

The main idea

to enable retail investors (crowd) to invest in SMEs

Equity / Debt

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Investment-based crowdfunding: Regulatory obstacles

In order to facilitate such activity

Decrease the costs

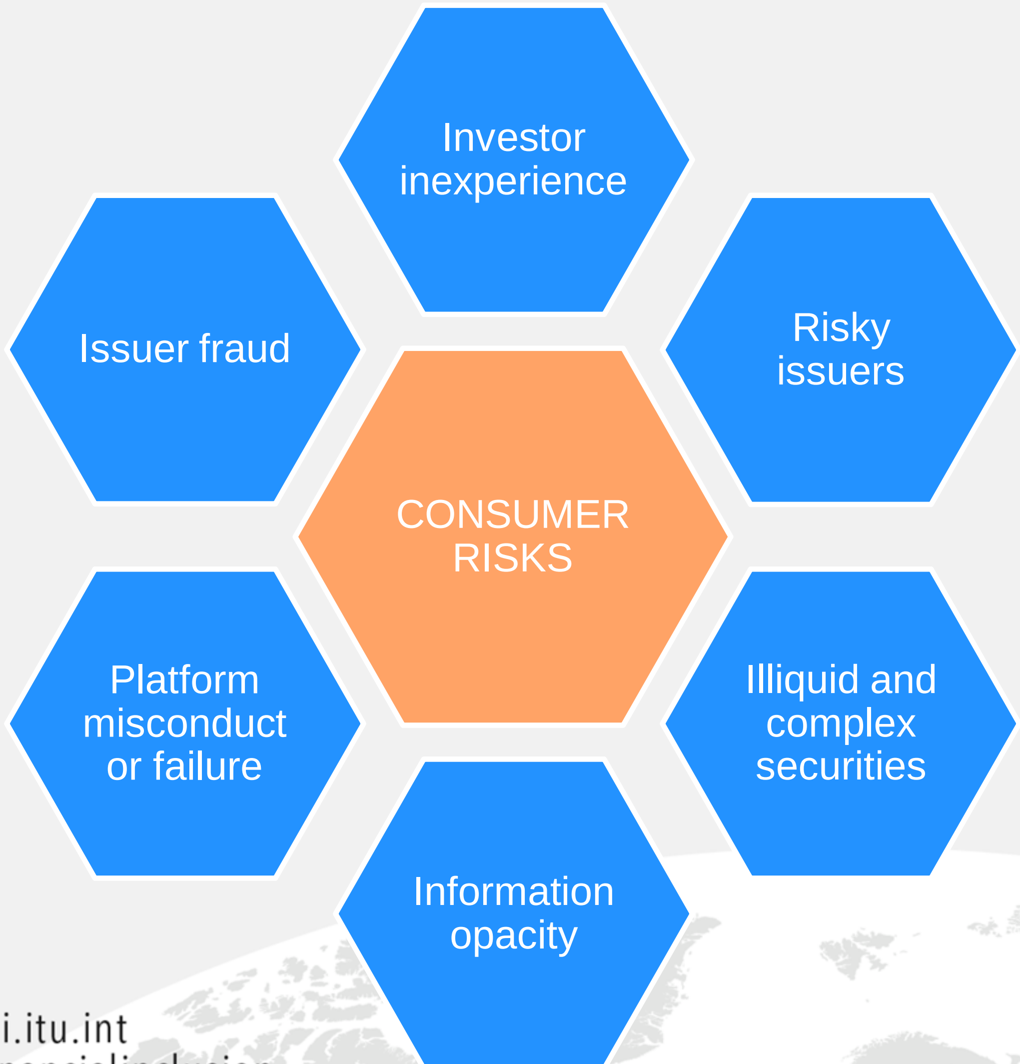
USA, Australia, EU, Brazil, Malaysia, Dubai, Nigeria …

For SME issuers
- Simplified issue documentation
- Simplified approvals

For investment intermediaries / trading facilities
- Simplified regulatory frame

- **Investing culture among retail investors**
- **Steady stream of investment opportunities (accelerators)**

Investment-based crowdfunding:
Key consumer risks covered in the paper



Relaxing regulatory requirements can also enhance / introduce risks

Investment-based crowdfunding: Investor inexperience / issuer riskiness

Risks to consumers:

- Investors are often unlikely to possess sufficient knowledge to assess offer / lack access to financial advice
- Small business / start-up investee companies may constitute a riskier investment for retail investors

In Australia limited only for small unlisted companies and start-ups

- Investees may have majority shareholder and management arrangements that present risks for minority shareholders such as external crowdfunding investors

Investment-based crowdfunding: Investor inexperience / issuer riskiness

Regulatory responses include …

- **Risk warnings** and disclosures about key aspects
- **Issuer caps**—limitations on the size of an issue
- **Investor caps**—limitations on individual investments
- Investor assessment **testing**
- **Cooling-off** periods

EU – 5 million EUR
US – 1.07 Million USD now increased to 5 million

Malaysia - RM 5,000 per issuer / RM 50,000 over 12 months
Australia - A$10,000 per issuer / no annual total

US – 48h before the end of offering period
EU – 4 day cooling off
Dubai – 48h after commitment period

Investment-based crowdfunding: Nature of securities offered

Risks to consumers:

- **Illiquidity** - Securities rarely traded on any kind of organized market and may have limitations on transferability

US, Australia – trading after 12 months allowed
Malaysia – after 6 months

- Creation of **complex hybrid securities** by incorporating rights and restrictions for security holders to match issuer's needs

Investors may not understand complexities or are unable to deal with risk of being unable to exit their investment

Investment-based crowdfunding: Nature of securities offered

Regulatory responses include … :

- Disclosure of the illiquid nature of issued securities
- Facilitating information exchanges and secondary trading
- Restrict the types of securities that can be issued
- Targeted product intervention / Targeted warnings

***Italy** – platform operator to disclose the risk that it may be impossible to cash in an investment immediately*

***UK** – FCA changed the name from " unlisted security" to "non-readily realizable security"*

***Australia** – only fully paid equity securities*

***France** – only plain vanilla bonds and ordinary shares*

***Dubai** – shares, debentures and sukuk*

***UK** – ban on "mini-bonds"*

***US** – warnings about "SAFE" securities*

Investment-based crowdfunding: Consumers with inadequate information

Risks to consumers:

- Issuers with a limited track record, limiting the availability of information
- High separation between crowd and parties that control issuers—potential lack of information provided to crowdfunding investors
- Misleading marketing practices, increasing risks as a result of issuers being new to making public offers

Investment-based crowdfunding: Consumers with inadequate information

Regulatory responses include … :

- Investment-related disclosure requirements
- Regulation of bulletin boards to assist information accuracy
  - *Limiting posting of comments*
  - *Equal access to all clients*
  - *Disclose ID of person posting*
  - *Rules for preventing manipulation*
- Fair marketing rules
  - *Restrict and regulate advertising outside of platforms – US, Dubai*
  - *Indicate clearly advertising - EU*
  - *Directing investors to check the relevant offer document*
  - *Include general risk warnings to balance*
  - *Ensure that advertisements do not mislead or deceive – UK*

Cross-cutting risks

Cross-cutting risks (1)

Digital environment poses inherent challenges to disclosure and transparency for all fintech

- Adapt format for digital channels, such as bite-sized chunks of info and access to offline channels
- Require order and flow of info and user interface that enhances transparency

Increased access to range of more complex fintech products increases risk of product unsuitability

- Limits on individual investments or borrowing on P2PL and investment-based crowdfunding platforms
- Prominent warnings to consumers re: risks of product
- Requirements to assess affordability or suitability of a product for a particular consumer

Use of automated algorithmic scoring in fintech can lead to discrimination

- Apply anti-discrimination rules to algorithms
- Require appropriate procedures, controls, and safeguards during development, testing, and deployment
- Require regular external auditing of algorithmic systems

Gaps in regulatory perimeter result in lack of protection for consumers

- Use activity-based approach to ensure comprehensive coverage and legal playing field
- Leverage powers of other regulators and coordinate on cross-border basis

Cross-cutting risks (2)

Business failure / insolvency - Inexperience of new entrants and riskier or novel business models increase risk of loss

- Require operators to segregate consumers' funds and deal with them only in prescribed ways
- Require operators to have in place business continuity and handover / resolution arrangements

Fraud / misconduct - Opaqueness or complexity of platform arrangements and lack of consumer awareness can increase risk of consumer harm

- Impose licensing / registration, vetting and competence requirements on operators and related parties
- Internal risk management and governance obligations as well as segregation of funds

Platform/technology unreliability or vulnerability - can expose consumers to heightened risks of loss or other harm

- Introduce targeted risk management and operational reliability requirements, including for IT and outsourcing risks (in addition to general risk management obligations)
- Impose targeted competence requirements

Conflicts of interest - Fintech-enabled business models can give rise to consumer harm from conflicts of interest in new circumstances

- Impose conflict mitigation obligations on operators
- Require operators to comply with duties to act in consumers' interests
- Introduce requirements targeting key conflict types

Implementation considerations

Striking the right balance

Need to strike an appropriate balance and take a proportionate approach

Consumer risks and fair outcomes essential consideration

But other important considerations include, for example, impact on industry and market development, implications on access to finance, etc.

Taking a step-by-step approach

- Assess the market, consumer experiences and current framework
- Determine approach, including considering alternatives
- Effective supervision critical to impact
- Complementary measures, including awareness and capability building

Questions?

Thank you


POLICY RESEARCH PAPER
Consumer Risks in Fintech
New Manifestations of Consumer Risks and Emerging Regulatory Approaches
APRIL 2021
DIGITAL MICRO-CREDIT
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