Digital Lending: Overview of current regulatory framework

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*Views are personal

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Evolution of digital lending in India (1/2)

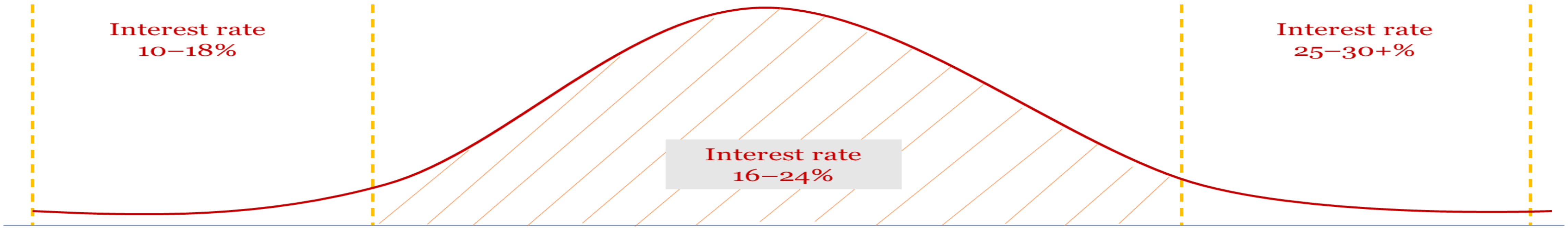
The gap in lending due to lack of credit information and / or high cost of customer acquisition has created a white space for Digital/ Fintech Lenders

	Conventional lending examples	Limitation of access to underserved markets	How FinTech lending overcomes the limitations
FORMAL	**Banks**	Requirement for **physical Banks verification and high costs**	Utilizes digital footprint as a substitution for physical documents
FORMAL	**NBFCs**	The underwriting process requires a **credit history or proof of a steady income or an asset-based collateral**	Processes underwriting assessment through digital processing platform
FORMAL	**Cooperatives**	Cooperatives are relatively **small in size** and **lack of competitiveness** to attract money suppliers in the market	Developed simple and convenient platform for attracting investment
INFORMAL	**Loan Sharks**	**Risk of irrational credit and limited funding opportunities**	Customised credit assessment models

Source: PwC FICCI Report - A wider circle: Digital lending and the changing landscape of financial inclusion

Evolution of digital lending in India (2/2)

Varying interest rates of credit lending across Indian markets



Banks and NBFCs	Unaddressed Market	Niche/ informal lending
• Typically with credit scores above 700 • Can get pricing of 10-18% • Existing business and credit history	• Scores 600-700 or default score – careful but quick evaluation needed • Varied product needs – short-term and medium term • Lack of available suitable products from banks • May not have sound financial history, past credit records or usage of credit card	• Credit scores below 600 or non-existent • Pricing for >25-30% from niche/ local lenders • Typically need short-term loans
Able or willing to address <5% of the market	90% of the market unaddressed by existing financiers	Able to address <5% of the market

Source: PwC FICCI Report - A wider circle: Digital lending and the changing landscape of financial inclusion

Current operating models and product offerings (1/2)

Prevalent models

Business models undertaking credit risk exposure viz., online/ digital lenders

Other models focused on facilitation of lending products viz., P2P platforms, account aggregators, credit scoring platforms, etc.

Mechanics governing the entities falling within these two models

Online/ digital lenders

- Customers download app or visit fintech NBFCs webpage for registration and avail credit;
- Fintech NBFCs partner with third-party entities for customer leads or assistance for registration process;
- No brick-and-mortar presence

P2P lending platforms

- Act as an intermediary to provide loan facilitation services via online medium;
- Lenders and borrowers enter into an arrangement with an NBFC-P2P to lend on it and to borrow respectively using the platform

Account Aggregators

- Collate and process financial information obtained from Financial Information Provider and share it with the Financial Information User, only after obtaining explicit consent from the customer through a digital platform.

Market place for loans

An extension of P2P lending, Banks/ NBFCs enter into arrangements with fintech companies:

- Connecting borrowers with banks/ NBFCs and acts as a loan originator, provides additional services viz., collection of KYC documents, EMI, etc. Ultimate decision/ responsibility rests with partner bank/ NBFC;
- Acts as an origination platform between borrowers and their in-house NBFC.

Alternative credit scoring platforms

- Assesses borrower's digital footprints viz., mobile bill payments history, online shopping history, social media profiles, etc.
- Act as a referral platform that generates credit scores leveraging big data and AI technology.

Source: Public domain (news article, reports, etc.)

Current operating models and product offerings (2/2)

Target Segment

- New-To-Credit Borrowers
- Blue-collar salaried professionals
- Millennials including gig workers
- Small and Medium Enterprises (SMEs/ MSMEs)

Consumer focused loans

Personal Loan

Short-term tailored loan including payday loans, consumer loans for retail, electronic and travel expenditures, etc.

Buy now pay later

Lenders that disburse instant, small-ticket sized loans with the 'buy now and pay later' model for meeting customers' purchases

Embedded Financing

A service offering that integrates credit products into non-financial digital platforms.

SME/ MSME focused loans

Invoice Financing

A short-term working capital credit to SMEs/ MSMEs, based on their unpaid invoices, to meet MSMEs' short-term liquidity requirements

Supply Chain Financing

Marketplaces tie up with direct lending NBFCs to target merchants selling their goods and services online, by leveraging the huge amount of merchant data residing on these channels

Cash flow based financing

Offered to SMEs/ MSMEs who are looking for hassle-free funds, fast processing of loans with easy documentation and underwriting based on cash flows generated by these SMEs/ MSMEs

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Regulatory Framework – Licensing regulations (1/3)

NBFC Categories

- Core Investment Companies
- Infrastructure Finance Company
- Factoring
- Investment and Credit Company including Fintech (Mobile based) Co.
- Housing Finance Companies
- Peer to Peer Lending
- Micro Finance Institution
- Account Aggregator
- Mortgage Guarantee Companies

Trigger points for licensing:

1. *Principal Business Criteria (PBC) or 50:50 Test*
2. *On-Balance sheet vs. Off-Balance sheet*
3. *First Loss Default Guarantee (FLDG) ?*

Regulatory Framework – Licensing regulations (2/3)

Licensing/ application process framework for Fintech-focused NBFCs

Registration as a public or a private limited company

Minimum NOF of INR 2 crore

Robust documentation related to director, shareholder, group company, etc.

Online and Hard Copy application submission

RBI's key diligence area:
- Promoters/ substantial shareholders and group entities
- Board of directors of the applicant company
- Business Plan covering product offering, target customer, typical operating model (fintech v. brick and mortar), financial projection, etc.

2-Step Approval if the NBFC operating model is solely mobile-app based

Technology based licenses (AA) require adherence to technology specifications/ design as prescribed by Reserve Bank Information Technology Private Limited (ReBIT)

Regulatory Framework – Operating Regulations (3/3)

Credit Life Cycle

Origination → KYC & Registration → Underwriting → Disbursement → Servicing & Monitoring → Collection

Key Operating & Governing Regulations

- Fair Practices Code
- Outsourcing Guidelines
- KYC Guidelines (e-KYC, Video based KYC, etc.)
- Information security standards (Data Privacy)
- Credit Policy
- Risk Management Framework
- Guidelines on Fair Practice Code
- Grievance Redressal Mechanism
- Master Direction - Monitoring of Frauds in NBFCs
- Asset Classification & Provisioning Norms
- Reporting (RBI, FIU, Credit Bureaus, CRILC)

As a regulated entity, NBFCs are primarily governed by the RBI Act, 1934 along with various master directions and circulars as issued by the RBI from time to time.

Growth drivers and key regulatory developments to watch out for

Accelerators facilitating growth

01 Account Aggregator (AA) is the construct/framework that provides a digital platform for easy sharing and consumption of data with user consent.

02 Open Credit Enablement Network (OCEN) is an initiative to democratize access to credit in India. It is a framework of standard APIs for interaction between small borrowers, lenders, loan service providers, and account aggregators.

03 TReDS is an electronic platform for facilitating the financing / discounting of trade receivables of Micro, Small and Medium Enterprises (MSMEs) through multiple financiers.

04 Reserve Bank Innovation Hub (RBIH or the Hub) is recently set up to promote innovation across the financial sector by leveraging on technology and creating an environment which would facilitate and foster innovation.

Key regulatory developments to watch out for

Regulatory Sandbox

- RBI announced opening of cohorts: 'MSME Lending' for third cohort; 'Prevention and Mitigation of Financial Frauds' for Fourth Cohort

Revised Regulatory Framework for NBFCs

- Introduction of a four-tier scale-based approach: NBFC-Base Layer, NBFC-Middle Layer, NBFC-Upper Layer and NBFC-Top Layer
- Proposed to increase the minimum NOF requirement of INR 2 crores to INR 20 crores

Public Credit Registry

- RBI has proposed a platform that will work as single place to store and access borrowing history of all borrowers across India.

RBI's Working Group (WG) on digital lending

- Evaluate and assess penetration of outsourced digital lending activities in RBI regulated entities;
- Identify risks posed by unregulated digital;
- Suggest regulatory changes to promote orderly growth;
- Recommend measures for expansion of specific regulatory or statutory perimeter;
- Suggest role of various regulatory and government agencies;
- Recommend a robust Fair Practices Code for digital lending players, insourced or outsourced;
- Suggest measures for enhanced Consumer Protection; and
- Recommend measures for robust data governance, data privacy and data security standards for deployment of digital lending services.

Thank You