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Comments to the Reserve Bank of India on the Report of the Working Group on Digital Lending including Lending through Online Platforms and Mobile Apps dated 18 November 2021

Dvara Research[1] is an independent, non-partisan, not-for-profit policy research institution based in India. Our mission is to ensure that every low-income household and every small enterprise has complete access to suitable financial services and social security through a range of channels that enable them to use these services securely and confidently. Our work addresses emerging issues in policy and regulation for consumer protection, given the sweeping changes that are reshaping retail financial services in India. Disintermediation in finance and user protection in digital financial services are a core area of our recent research.

In this Response, we present our comments to the Report of the Working Group on Digital Lending including Lending through Online Platforms and Mobile Apps (Reserve Bank of India, 2021(a)) (hereafter "The Report"). Our comments are organised into two sections.

Part I presents overarching thoughts on the Report and a summary of our recommendations.

Part II offers four specific recommendations with a view to bolster the consumer protection framework set out in the Report:

1. Activity-based regulation may better complement the objectives of consumer protection.
2. Consider bringing LSPs in the fold of BC regulation and subjecting them to light touch, risk proportionate regulation.
3. Consider creating a financial consumer protection enforcement body to meet the aspiration set out in the Report. This could be further complemented by an integrated grievance redress agency.
4. Risk proportionate regulation can help strike a balance between the participation of new entities in the ecosystem and stability concerns.

This Response seeks to support the objectives set out in the Report. We hope that the concerns we raise and the recommendations we suggest, will be considered, and addressed in future iterations of the Report. We welcome any opportunity to present these views or respond to questions and comments on our research to the Working Group.

[1] Dvara Research has made several contributions to the Indian financial system and participated in engagements with key regulators and the Government of India. We were the technical secretariat to the RBI's Committee on Comprehensive Financial Services for Small Businesses and Low-Income Households chaired by Dr. Nachiket Mor. We acted as peer reviewers for the customer protection recommendations made by the Financial Sector Legislative Reforms Committee. Our recent research has given us the opportunity to consult on and extend discrete research inputs to various Committees set up by the RBI, SEBI and the Government of India, including the Working Group on the Social Stock Exchange, the Joint Parliamentary Committee on the Personal Data Protection Bill, 2019, the Committee of Experts (on data protection) under the Chairmanship of Justice B.N. Srikrishna, the RBI's Expert Committee on Micro, Small & Medium Enterprises and the RBI's Committee on Deepening of Digital Payments.

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PART I: OVERARCHING THOUGHTS ON THE REPORT AND A SUMMARY OF RECOMMENDATIONS

1. Overarching thoughts on the Report

The Report's stance of examining issues and setting out recommendations along the three dimensions of (i) regulatory policy approach, (ii) technology standards and (iii) financial consumer protection framework is very welcome. This multidimensional approach will help tackle the multifarious issues around digital lending, including those of the regulatory perimeter, consumer data protection and privacy, and suitability (Chugh, Raghavan, & Singh, 2019; Financial Conduct Authority, 2021). The Report's emphasis on consumer protection is well-noted. Recommending measures such as explaining reasons for declining credit and ensuring that distributors of one-click loans assess creditworthiness of borrowers before advertising these loans to them, can shore up consumer protection. We also welcome the focus on simplifying loan disclosure instruments and the creation of a key fact statement (KFS) that sets out all conditions and costs in an effective, comprehensible manner in vernacular language. Our work in the past shows that simplifying disclosure instruments yields positive implications for consumers' financial decision making (Aggarwal, Dasgupta, Halan, Sharma, & Srinivas, 2021). The Report's stance on ensuring that regulated entities are transparent about debt collectors enrolled by them and their LSPs, recommending that debt collectors undergo suitable training to avoid consumer harassment and expanding the fair practice code to describe and ban harassment in debt collection are welcome. Further, ensuring that all participants in the value chain conform to technological standards and align their practices in a manner that upholds consumers' data protection and privacy is a much-needed guidance for the sector. We look forward to the sector adopting this guidance. In this regard, the sector will also benefit from the identification of measures that are needed to be put in place in the immediate term. This will help rein in unscrupulous practices that are underway currently.

The Report's vision of bringing Lending Service Providers (LSPs) in the fold of SRO regulation, enhancing market monitoring mechanisms, improving coordination across different financial sectors, and creating a Consumer Financial Protection Regulation hold potential for creating a sound regulatory architecture for safeguarding consumers' interest in digital lending. Our recommendations focus on further bolstering the effectiveness of these measures, minimizing gaps in consumer protection frameworks and better coordinating activities across different agencies. Overall, our recommendations focus on creating a strong uniform consumer protection regulation framework, regardless of the type or size of the lender. Our recommendations also present policy alternatives to supplement supervision and enforcement of consumer protection in the country, given the constraints of capacity. We summarise our recommendations in the following sub-section. The second part of this document discusses each recommendation in detail and presents research on the experience of similar experiments in other jurisdictions.

2. Summary of recommendations to the Working Group

2.1. Activity based regulation may better complement the objectives of consumer protection.

As the Report sets out, the emerging discourse on regulation suggests that a combination of activity-based and entity-based regulation may be needed to comprehensively regulate digital financial services. There is also growing consensus that activity-based regulation may better meet the objectives of consumer protection while prudential regulation may warrant entity-based regulation (Restoy F., 2021). In line with this intuition, we propose:

i. **Defining the activity of credit:** Given that consumer protection concerns are closely tethered to the activity (than to the entity providing the credit), we recommend that the RBI define the activity of credit. Any entity (regardless of its technological nature, ownership, or size) that engages in the activity of credit (as defined by the RBI) will invite baseline consumer protection regulations and conduct obligations. This will have the benefit of (a) ensuring that

consumer protection safeguards do not vary across entities, and (b) regulating new entities, that may not be on the RBI's radar because they do not pose prudential risks, for consumer protection. Further, when defining credit, the endeavor should be to define the activity in a manner that new age products that pose risks similar to credit (such as BNPL) also get covered in the scope of the definition.

When considering prudential risks posed by different entities, the RBI could consider a risk proportionate and, if warranted, differential prudential regulation accounting for entity-based risks.

2.2. Consider bringing LSPs in the fold of Business Correspondent (BC) regulation.

The Report suggests bringing LSPs in the fold of self-regulation by the creation of Self-Regulatory Organisations (SROs). Further, the regulated entities would be responsible for the conduct of their LSPs. The need for regulating LSPs for their conduct and technological standards cannot be over-emphasised. Emerging discourse on regulation of LSPs shows merit in having light-touch regulation of LSPs, considering the growing concern over concentration risk among LSPs given their limited substitutability (such as in cloud services). Observers also recommend that a light touch, prudentially minimal (unless otherwise warranted) regulatory regime can improve the regulators' visibility of activities of LSPs, give them direct access to LSPs and encourage observance of codes of conduct. Further, from our conversations with financial service providers, it appears that there are significant overlaps between functions of BCs and LSPs such as customer acquisition, bringing applications to the balance sheet lender, disbursement, monitoring and collection. Therefore, maintaining two separate regulations for these two entities could risk creating both duplication and regulatory arbitrage. Given these aspects, we recommend:

i. **Activity-based regulation of financial service providers (including BCs & LSPs) by defining "Credit-related activities":** We recommend an activity-based regulatory approach of regulating all BCs and LSPs. This can be done by defining *"Credit-related activities"* as the universe of all activities that comprise the value chain of credit except balance sheet lending. The regulation of credit-related activities could focus on minimum conduct and technological requirements that all third parties must conform to. Those balance sheet lenders that also perform any of the credit-related activities will also come in the fold of this regulation. The advantage of such an approach will be to cast an even regulatory net across different third parties and ensure that they provide uniform consumer safeguards. This will also imply that the regulation need not define a digital lending app separately, and any entity or app engaged in one or more credit-related activities will automatically come in the fold of regulation.

ii. **Bring the regulation of LSPs within the fold of BC regulations and Outsourcing regulations:** The Report suggests regulating LSPs as a distinct class of entities through new regulatory frameworks.[2] Treating LSPs as a distinct set of entities appears redundant considering their similarities with Business Correspondents and outsourced third parties, which are regulated under the Business Correspondent Guidelines (BC Guidelines) and the Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services (OS Guidelines). Creating new regulations for LSPs alongside these existing regulations could risk regulatory arbitrage and create many gaps in consumer protection. We propose that the BC Guidelines should be suitably revised to regulate for the risks posed by BCs and LSPs in the digital ecosystem and both BCs and LSPs should be regulated by the same Guidelines. We discuss the considerations for these Guidelines in the recommendations below.

[2] For instance, see recommendation 3.4.1.2, recommendation 3.4.2.2, recommendation 34.2.5, recommendation 3.4.2.6, and recommendation 3.4.3.3 in the Report.

iii. **A light-touch, risk-proportionate registration regime for third party providers (BCs & LSPs) in addition to self-regulation:** The regulation of credit-related activities could be predicated on a light-touch registration regime. This regime will be risk proportionate, resorting to prudential regulation only when the risks warrant it. This registration mechanism could provide greater incentives to third-party providers (LSPs & BCs) to conform to good conduct, provide visibility on their activities, and any emerging concentration among third party providers etc. to the regulator. It will also provide levers of direct regulation to the regulator should circumstances warrant. It is worth noting that a registration regime is lighter than a licensing or authorising regime which has onerous requirements. To reiterate, the rationale for a registration regime is to bring visibility to third parties, surface any risks that may be emergent and provide the regulator with a potential pathway to access the third-party provider, directly, if need be.

iv. **Principles for designing the Agency Financial Services Regulation (AFSR):** We welcome the initiative to create conduct guidelines for those third parties that interface with consumers. We propose that these AFSR could apply to consumer-facing entities that participate in credit-related activities as defined in Section 1.2.1 of Part II of this response. Some principles that could be considered for shaping these AFSR include (a) suitability, (b) transparency, (c) governance, (d) fair treatment, due care, and professional diligence, (e) safety and security, (f) maintaining effective grievance redressal, and (g) compliance. We discuss the methods to implement these principles in greater detail in Section 2.2.2.3 of Part II of this response.

2.3. Consider creating a consumer financial protection and enforcement body and a unified grievance redress agency.

2.3.1. A consumer financial protection supervision and enforcement body to realise the aspirations set out in the Report.

The Report recommends creating a legal framework for creating consumer financial protection under the existing Consumer Protection Act, 2019. There is indeed an urgent need to turn attention to consumer financial protection. We submit that using the apparatus of the Consumer Protection Act, 2019 could still leave important gaps in supervising for and enforcing consumer protection in the country. First, the Consumer Protection Act can investigate matters only *after* violations of consumer rights have occurred. It cannot be triggered ex-ante to *prevent* violations of consumer rights. Second, handing out consumer protection enforcement to the Consumer Protection Act, will not address the important aspect of coordinating with different agencies on market intelligence and acting on that market intelligence. The Report envisages multiple market monitoring mechanisms but falls short of creating a central coordinating body to helm the multi-agency market monitoring set up. There may be merits of creating a central body that can coordinate market intelligence from different agencies, use that intelligence for supervision and enforcement. For these benefits we propose:

i. **Creating a financial consumer protection body** with powers to supervise and enforce financial regulations/laws created by financial regulators/governments. This would create a system for comprehensive for supervision and enforcement of consumer protection. This body could have the following functions:[3]
   a. creating rules to enforce consumer protection regulations set out by various regulators and government;
   b. enforcing laws and regulations that relate to financial consumer protection;
   c. supervising regulated entities for their conduct;

[3] Many of these functions are also performed by similar financial consumer protection enforcement bodies, such as the Consumer Financial Protection Bureau. See more here.

d. researching experience of consumers in using financial products and creating market monitoring mechanisms;
e. surfacing new risks to consumers;
f. receiving complaints from consumers and routing them to relevant grievance redress institutions (ombudsmen as they stand currently),
g. sharing insights on consumer protection, systemic risks with relevant financial regulators, and,
h. educate businesses on consumer protection and good conduct.

2.3.2. A unified grievance redress agency

Digital financial services are known to be more modular. Intermediaries often serve more than one financial service and therefore, a unified grievance redressal agency which is capable of accepting grievances from across the different sub-sectors of the financial sector (banking, payments, insurance, investment etc.) is needed to ensure a comprehensive consumer protection regime. It is advisable to create a redress agency which is independent of financial sector regulators and dedicated to the function of grievance redress. Further, this agency should be capable of addressing complaints from across the financial sectors (Financial Sector Legislative Reforms Commission, 2013).

One such blueprint for a unified redress agency in the financial sector was the Financial Redress Agency (FRA) proposed by the Report of the Financial Sector Legislative Reforms Commission (FSLRC) (Financial Sector Legislative Reforms Commission, 2013). The FRA was envisaged to provide a consumer-facing front-end at the district level where complaints regarding all financial products can be registered. Following registration, the FRA would channel the complaint to the appropriate regulator, and entity in the backend through technology-intensive processes for resolution via mediation and light-weight adjudication (Task Force on Financial Redress Agency, 2016; Dvara Research, 2020).

2.4. Risk proportionate regulation can help strike a balance between the participation of new entities in the ecosystem and stability concerns.

i. **Creating a risk-based framework for Credit Enhancements:** The Report suggests doing away with First Loss Default Guarantees (FLDG) to prevent off-balance sheet lending by LSPs. We submit that the need for LSPs to provide FLDG keeps a check on moral hazard by ensuring that LSPs have a skin in the game. We also agree with the Report's analysis of the risks that accompany high FLDGs. We therefore propose a risk-based regulation of credit enhancements, where the quantum and form of credit enhancement corresponds to the services offered by the LSP. In summary, we recommend:

    a. **Risk-based computation of quantum and form of credit enhancement:**

Service offered by LSP	Regulation
LSP (an RE or not) offering services using lender's underwriting criteria	Any credit enhancement sought/offered (including any form of FLDG) must only be to cover for any operations risk/servicer risk of the LSP, as all credit risk is ascertained by the lender's own models and held on lender's books.
NBNC LSP offering services using own underwriting criteria and giving credit enhancements	The credit enhancement (including FLDG) sought/offered should not be more than the historical expected credit loss of the portfolio. In the case where historical data does not exist and the RE is dependent on LSP for computation of expected credit loss, the relevant authority should mandate an audit by the RE

	of the LSP's valuation models, and the overall levels of credit enhancements provided by it in the market before deciding what level of FLDG can be sought from the LSP. Emerging principles on algorithmic accountability that include auditing the outcomes of the algorithms for bias, interviewing employees to understand the logic of the algorithm and piloting the algorithm before scaling its use are some implements to audit algorithms (Shah H. , 2018). The RE (bank or NBFC holding credit risk) must be able to establish that the risks undertaken are aligned with the risk appetite and strategies laid out through its board-approved policies.
REs such as banks and NBFCs offering LSP services using own underwriting criteria and giving credit enhancement.	REs can offer LSP services involving credit enhancements in three ways – i. Offer a financial guarantee or cash collateral determined as in the scenarios explained above. ii. Sell the portfolio they have originated through direct assignment, in which case MHP would apply and no credit enhancement would be permitted (Reserve Bank of India, 2021(c)). iii. Sell the portfolio they have originated through securitisation and offer credit enhancement. Here, the extant regulations on securitisation would be applicable in determining the quantum and nature of FLDG. Over-collateralisation becomes permissible (Reserve Bank of India, 2021(b)).

b. **Publication of credit enhancement:** The credit enhancement for a digital lending service that is a collaboration of an RE with an LSP should be published in a public register maintained by the body in charge of enforcement of consumer protection (as set out in Section 2.3). In addition to the quantum of the credit enhancement, the modality of providing the credit enhancement (through lien marked FDs/corporate guarantees/ cash collaterals holdback on service fees, a combination of these) should also be published. This transparency allows better accountability. It also offers visibility to the regulator for monitoring agreements and identify emergent concentration risks (ASBA, 2020).

c. **Leveraging technology solutions:** LSPs can use algorithms for originating loans for the lender. However, the LSP's algorithmic underwriting processes can be opaque. In these cases, it appears that the LSP (and not the lender) is underwriting the loan. The credit enhancement would help in holding the LSP accountable in such instances. Additionally, where the REs are dependent on the underwriting of the LSP, the WG should consider mandating technology solutions, like increasing transparency and explainability of underwriting algorithms, to address the concern (Prenio & Yong, 2021) (Monetary Authority of Singapore, 2018).

ii. **Prohibiting LSPs' access to CICs could impede financial inclusion and delivery of suitable credit:** Presently, the Report suggests that only regulated entities should be granted access to Credit Reports. The objective of this recommendation is to prevent unauthorised access to consumers' credit information and protect their personal data. We submit that the use

of Account Aggregators[4] and other mechanisms that allow for consented flow of data, including compliance with the proposed Data Protection Bill 2021, could resolve for the issue of unauthorised access to credit information. Further, drawing upon our recommendation in Section 2.2 of Part II to regulate LSPs, regulating LSPs will help bring them in the fold of the Credit Information Companies (Regulation) Act, 2005 (Government of India, 2005). This will bind them to uphold the same standards of data protection as regulated entities. By subjecting LSPs to similar data protection responsibilities, the gap in consumer data protection can be narrowed. Further, allowing LSPs to access such data will help in ensuring suitability at different levels of the value chain.

iii. **Using suitability assessments in push-marketing can prevent over-indebtedness:** The Report suggests prudential requirements to cover for default risk in loans originated through push marketing (recommendation 3.4.4.1). The combination of push marketing, easy-to-use digital credit models and artificially short timelines may force borrowers to make too quick, unconsidered decisions (Owens, 2018). Ex-post measures such prudential requirements may not be sufficient to regulate unsuitable loans created through push marketing. There may be merit in ensuring that regulations limit the occurrence of sale of unsuitable credit instead. Therefore, suitability assessments to ensure that consumers are only advertised loan amounts suitable for them could be considered.

[4] The RBI defines the business of an Account Aggregator as, "*the business of providing under a contract, the service of, retrieving or collecting information of its customer pertaining to such financial assets as defined by the Bank from time to time*". Read more here.

PART II: SPECIFIC RECOMMENDATIONS FOR CONSIDERATION

1. Activity-based regulation may better complement objectives of consumer protection.

In its present form, the Report seems to follow a product-based regulatory regime. It appears to suggest different regulatory frameworks for activities that could produce similar risks for consumers. For instance, there are several regulations specifically aimed at Buy Now Pay Later (BNPL) Activities and Short-Term Consumer Credit (STCC) Products. Section **3.4.2.2** of the Report proposes defining and regulating STCCs and expanding the extant/proposed MFI codes to include them. Similarly, Section **5.4.3.1** recommends specific lending norms for STCC providers, standard definitions for these products, as well as market monitoring mechanisms.

In the following sections, we first present our specific concerns with the approach in the Report. Then, we present our recommendations that may help achieve the objectives of consumer protection.

1.1. Concerns with the approach to consumer protection in the Report.

1.1.1. Legal distinctions between credit products do not mean consumers use them for distinct purposes (Financial Conduct Authority, 2021(a)). Consumer protection concerns appear more closely related to the type of activity being performed as opposed to the entity that is offering them. Specifically, in lending, requirements are placed for providing transparency in terms and conditions, information transmission to third parties, accessibility criteria that is non-discriminatory, and affordability tests. These rules apply equally to different providers of a credit service, even if they provide different products or partake in other activities (Restoy, 2021). Consumer financial protection may be better served by activity-based regulation, while prudential concerns could warrant entity-based regulation. There is emerging consensus that suggests that activity-based regulation, focussing on lending and lending-related activities, can create uniform consumer safeguards and close out the gaps in consumer protection in the ecosystem (ASBA, 2020; Restoy, 2021).

1.1.2. Product-based regulation can create a pacing problem in the regulatory framework. A product-based regulation approach to consumer protection could cause regulators to play catch-up with innovation and new financial products. By focussing on the product, regulators would be forced to create new regulations *after* new digital credit products are created (Chugh, Raghavan, & Singh, 2019; Financial Conduct Authority, 2021). Regulators would be unable to respond to consumer protection concerns until after the fact.

1.1.3. Product-based regulation increases the risk of regulatory arbitrage. Further, product-based regulation could also lead to categorical arbitrage, wherein "*a legal discrepancy between the treatment of two types of activity or products that are functionally similar*" could be exploited. Opportunities for categorical arbitrage are especially increased because of innovations in technology. This is because innovations use processes that were previously unanticipated by the regulatory regime to create functional equivalents that accomplish the same result as regulated products and services (Allen, 2020).

1.2. Recommendations: Harmonize the definition of credit.

1.2.1. Harmonize the definition of credit.

The Reserve Bank of India in its circular on "Harmonisation of Banking Statistics" defines consumer credit as the loans provided to individuals, which comprises (Reserve Bank of India, 2018) –

i. *loans for consumer durables,*
ii. *credit card receivables,*
iii. *auto loans (other than loans for commercial use),*
iv. *personal loans secured by gold, gold jewellery, immovable property, fixed deposits (including FCNR(B)), shares and bonds, etc., (other than for business / commercial purposes),*

v. personal loans to professionals (excluding loans for business purposes), and
vi. loans given for other consumptions purposes (e.g., social ceremonies, etc.).

However, the definition excludes (a) education loans, (b) loans given for creation/ enhancement of immovable assets (e.g., housing, etc.), (c) loans given for investment in financial assets (shares, debentures, etc.), and (d) loans given to farmers under KCC. As the discussions in the Report suggest, the definition also excludes newer credit-like products such as BNPL. This definition, therefore, takes a product-based view on the definition of credit.

We propose that the RBI could consider activity-based regulation for strengthening consumer protection. This could be achieved by defining credit. As such, any entity that engages in the activity of retail credit should be subjected to a similar consumer protection framework. By retail, we mean all legal persons and entities except regulated financial institutions, qualified institutional buyers, central, state or local governments and businesses above a certain size, as has been adopted in the UK (George, 2019).

The Financial Conduct Authority (FCA) in the UK, defines consumer credit activity as activities that can be undertaken by a licensee, firm, payment service provider or an electronic money issuer. These activities include (Financial Conduct Authority, n.a.) –

1. *provision of credit or otherwise being a creditor under a regulated consumer credit agreement;*
2. *the bailment or (in Scotland) the hiring of goods or otherwise being an owner under a regulated consumer hire agreement;*
3. *credit brokerage in so far as it is the effecting of introductions of:*
    a. *individuals desiring to obtain credit to persons carrying on a consumer credit business; or*
    b. *individuals desiring to obtain goods on hire to persons carrying on a consumer hire business;*
4. *in so far as they relate to regulated consumer credit agreements or regulated consumer hire agreements:*
    a. *debt-adjusting;*
    b. *debt-counselling;*
    c. *debt-collecting; or*
    d. *debt administration;*
5. *the provision of credit information services; or the operation of a credit reference agency*.

A similar approach of defining the activity of credit could help in setting a uniform, minimum floor for consumer protection in the country regardless of the entity that is engaged in it. By applying this recommendation, it will be easier to identify and introduce fintech entities into the perimeter of financial protection regulation and supervision. Further, those entities that carry out the same functions and, therefore, potentially cause same risks will fall within the perimeter of the regulator's consumer protection framework (ASBA, 2020; Restoy, 2021). In summary, the definition will include activities that perform the function of credit, regardless of their form or the entity providing them, and apply the same consumer protection framework across such activities.

If prudential concerns are warranted, then prudential regulation can be refined for different categories of lenders to reflect product and entity-specific risks. Thus, a combination of entity-based and activity-based regulation might be taken for prudential regulation, but for consumer protection similar activities could attract similar regulations (ASBA, 2020; Restoy, 2021).

2. **Consider bringing LSPs in the fold of BC regulation and subjecting them to light touch, risk proportionate regulation.**

The Report defines[5] LSPs as, "*An agent of a balance sheet lender who carries out one or more of lender's functions in customer acquisition, underwriting support, pricing support, disbursement, servicing, monitoring, collection, liquidation of specific loan or loan portfolio for compensation from the balance sheet lender.*" It further recommends that an SRO should be created to ensure that members conform to good conduct practices.[6] The regulated entity continues to be in-charge of the supervision of the LSP. This is in line with existing practices across other jurisdictions, which converge on the point of holding financial service providers accountable for the functioning and governance of and managing risks that emerge from outsourcing parties. Globally, regulators are reassessing this approach in the context of increased third party reliance in digital finance (Financial Stability Board, 2020).

In the following sections, we first present our specific concerns with the approach in the Report. Then, we present our recommendations for improving regulation of LSPs in the digital lending ecosystem.

2.1. Concerns with indirect supervision of third parties via regulated entities and SROs.

2.1.1. The difference between "Material" and "Non-material" seems to be blurring.

In India, as in other jurisdictions, supervisory attention is allocated to "Material outsourcing" (Alliance for Financial Inclusion, 2021). Materiality refers to the disruptive impact that impairment of any outsourcing activity would have for the regulated entity (Reserve bank of India, 2011; Reserve Bank of India, 2017). The RBI sets out qualitative criteria to assess materiality. It comprises indicators such as the extent of data sharing between the regulated entity and the third party, the nature and size of functions, the ease with which the regulated entity can substitute for the third party etc.

In digital finance, it appears that the suite of functions that are being outsourced to third parties is wide and expanding. By the Report's own estimates,[7] more than 40 percent of lending of NBFCs is through third party apps. Scheduled commercial banks also exhibit increasing reliance on third party apps. Further, sharing of sensitive personal data with third parties, letting them interface with consumers on a regular basis is also a common syntax of modular value chains of digital financial services. This blurs the line between "Material" and "Non-material" outsourcing.

2.1.2. Concentration of outsourcing activities among few third-party providers is common.

An important criterion for assessing materiality is the ease with which entities can substitute third party providers (Reserve bank of India, 2011; Reserve Bank of India, 2017). There is a growing consensus that concentration of a few third parties is common. While cloud services may be an extreme example of extremely high concentration of activities among few third parties, concentration in other functions also appears to be increasing (Financial Stability Board, 2019). Increasing concentration has the potential to transform into concentration risk, where many regulated entities rely on one or small number of third parties for critical services (Financial Stability Board, 2020). Currently, regulator or the regulated entity are limited in their ability to monitor for this potential concentration risk because there appears little publicly available data on financial institutions' dependencies on specific third-party service providers (Financial Stability Board, 2021).

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[5] *See* page 7 of the Report.
[6] *See* recommendation 3.4.2.4 on page 45 of the Report.
[7] *See* page 27 of the Report.

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2.2. **Recommendations for effectively regulating FSPs (including BCs and LSPs) in credit markets.**

2.2.1. Define "Credit-related activities" to create a foundation for activity-based regulation of LSPs.

The purpose of suggesting a definition for "Credit-related activities" is to bring LSPs (and *de facto* applicable to all regulated credit providers engaging in one or more such activities) under the umbrella of the RBI or of a suitable new body as recommended in this note (Section 3.2 of Part II). Some other jurisdictions follow this approach.

For example, the FCA in its Consumer Credit Sourcebook expands on "Credit-related" regulated activities. These comprise (Financial Conduct Authority, n.a.) –

1. *consumer credit lending,*
2. *credit broking,*
3. *debt counselling,*
4. *debt adjusting,*
5. *debt administration,*
6. *debt collecting,*
7. *providing credit information services,*
8. *providing credit references,*
9. *operating an electronic system in relation to lending, and*
10. *consumer hiring.*

The FCA also provides examples of firms that offer "Consumer credit" products and services. These comprise (Financial Conduct Authority, 2016):

1. *credit card issuers;*
2. *credit brokers;*
3. *payday loan companies (including home collected credit);*
4. *pawnbrokers;*
5. *businesses offering hire-purchase agreements;*
6. *logbook lenders (lenders who offer loans secured against your vehicle);*
7. *peer-to-peer lenders;*
8. *debt management and collection firms;*
9. *rent to own;*
10. *guarantor lenders;*
11. *consumer hire;*
12. *overdrafts.*

Next, the Parliament of Kenya in its Draft Financial Markets Conduct Bill, 2018 also sought to define credit services. It stated that a "Credit service" is provided if a person directly or indirectly, as or as part of a business (The National Treasury of Kenya, 2018) –

1. *provides suggestions or recommendations to a retail financial customer for the application of credit from a particular lender;*
2. *aids a retail financial customer for the application of credit from a particular lender;*
3. *provides suggestions or recommendations to a borrower or a lender under a regulated credit contract that the borrower applies for, or the lender agrees to an increase in the credit limit under the contract;*
4. *aids a borrower who is a retail financial customer in the application for a credit limit increase under a regulated credit contract or otherwise change a regulated credit contract;*
5. *provides suggestions or recommendations to a borrower, under a regulated credit contract, that the borrower remain in the credit contract;*
6. *provides credit reports;*

7. *provides a debt counselling service to a person who is a retail financial customer*.

These definitions are then used as the basis to set out minimum criteria or detailed obligations that are specific to the activities carried on by firms. The advantage of starting with defining the activity is that it provides the opportunity for all entities undertaking credit or credit-related activities to fall under the supervision of a single regulator, thus doing away with regulatory arbitrage. Needless to say, this will also obviate the need for treating DLAs as a separate category (for instance, in how the Report recommends mandating DLAs to report credit information to CICs). While illegal DLAs will come under the radar for the proposed Banning of Unregulated Lending Activities Act, any app will automatically come under the definition of "Credit-related activities" discussed above. Similarly, the activity of providing guarantees to a consumer credit lender in relation to services offered to it can automatically be brought under the said definition.

2.2.2. Bring the regulation of LSPs within the fold of BC regulations and Outsourcing regulations.

The Report suggests regulating LSPs as a distinct class of entities through new regulatory frameworks.[8] Treating LSPs as a distinct set of entities appears redundant considering their similarities with Business Correspondents and outsourced third parties, which are regulated under the Business Correspondent Guidelines (BC Guidelines) and the Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services (OS Guidelines). Creating new regulations for LSPs alongside these existing regulations could risk regulatory arbitrage and create many gaps in consumer protection. Alternatively, the WG could regulate LSPs through the existing BC Guidelines by adapting the regulations to the nuances of the digital lending ecosystem in the following manner:

2.2.2.1. The WG could recalibrate BC Guidelines and OS Guidelines to include LSPs.

The Report defines LSPs as:

> "[A]*n agent of a balance sheet lender who carries out one or more of lender's functions in customer acquisition, underwriting support, pricing support, disbursement, servicing, monitoring, collection, liquidation of specific loan or loan portfolio for compensation from the balance sheet lender*."

The BC Guidelines envisage a similar role for BCs. BCs can undertake a variety of activities in relation to lending including (i) borrower identification (ii) collection and preliminary processing of loan applications (iii) debt counselling (iv) promoting, nurturing and monitoring of borrowers (v) post-sanction monitoring (vi) debt recovery and (vii) small value credit disbursement (Cl.I.8.D). Like LSPs, BCs are compensated with commissions or fees from the bank to which they provide their services (Cl.I.8.J) (Reserve Bank of India, 2014). It is clear that the activities of LSPs and BCs overlap significantly. Creating a new regulatory framework for LSPs in this context would mean duplicating regulation that can aggravate regulatory arbitrage between BCs and LSPs (Alliance for Financial Inclusion, 2020). Further, creating a new framework for LSPs could create an uneven regulatory landscape and give LSPs a competitive advantage: the BC Guidelines only enable banks to engage BCs (Cl.I.8.ii) (Reserve Bank of India, 2014), but LSPs can partner with both banks and NBFCs (Christoph, 2021; Claessens et al., 2018; Reserve Bank of India, 2021). Similar issues exist with having separate regulations for Direct Sales Agents and other outsourced activities.

The Report of the Committee on Comprehensive Financial Services (CCFS) in 2014 recognised the potential for BCs to provide loan origination services. At the same time, the CCFS took note of the risks of moral hazard, adverse selection and user harm that could stem from engaging BCs to provide loan

[8] For instance, see recommendation 3.4.1.2, recommendation 3.4.2.2, recommendation 34.2.5, recommendation 3.4.2.6, and recommendation 3.4.3.3 in the Report.

origination services. This Committee proposed a variety of risk-proportionate measures to mitigate these risks, including robust risk-sharing mechanisms between BCs and banks, stronger supervision and management, and capital commitments from BCs in the nature of an FLDG (Committee on Comprehensive Financial Services for Small Businesses and Low Income Households, 2015).

Globally, approaches to regulating third party service providers in lending and other financial services also rely on similar measures for mitigating risks from outsourcing (Crisanto et al., 2021(a), 2021(b); Ehrentraudet et al., 2020). Regulators emphasise well-defined policies on control and management of technological risks, robust risk monitoring and management frameworks, supervisory processes, swift response measures, robust strategic and business planning processes, sound product approval and change management processes (Ehrentraud et al., 2020), better coordination between entities and regulators, stronger data protection measures, and stronger due diligence and conduct obligations (like better affordability assessments, disclosures, auditable credit assessment processes etc.) (Basel Committee on Banking Supervision, 2017; Crisanto et al., 2021(b); Prenio & Yong, 2021). Some financial authorities have complemented their laws and regulations with technology-specific provisions to address the use of new technologies in lending services (Ehrentraud et al., 2020). Specifically, regulators emphasise developing and adopting frameworks to govern the use of AI systems (Claessens et al., 2018; Prenio & Yong, 2021). Some other authorities like the European Commission and the Central Bank of Kenya are creating new and comprehensive regulations governing how financial institutions and LSPs can conduct their activities in a manner that mitigates risks (Central Bank of Kenya, 2018; European Commission, 2020). Many of the WG's recommendations recognise the importance of such measures.

Fortunately, most of these approaches are already captured in the BC Guidelines and the OS Guidelines (Reserve Bank of India, 2014; Reserve bank of India, 2017). However, the frameworks could be harmonised and complemented with stronger provisions by drawing from global regulatory developments highlighted above, including (a) recognising LSPs as BCs (b) making necessary amendments to the BC Guidelines to allow NBFCs to engage LSPs as BCs, and (b) creating stronger governance frameworks for AI systems, standardised conduct regulations and robust data protection regulations (Central Bank of Kenya, 2018; Crisanto et al., 2021(a), 2021(b); Ehrentraud et al., 2020; European Commission, 2020). The RBI could also explore other overlapping regulations that could create room for regulatory arbitrage. Similar to credit-related activities, the RBI could scope out similar regulations on other banking-related activities to fold them into the revised BC regulations.

2.2.2.2. Consider a light-touch, risk-based registration regime for LSPs in addition to self-regulation.

The Report recommends establishing a self-regulatory organisation (SRO) for overseeing LSPs. The Report also recommends regulating LSPs through regulated entities in the sector. However, there may be merit in considering light touch regulation of LSPs to complement the SRO oversight. This is because many activities can choose to stay away from SRO membership and the SRO will not have oversight over them. Even when membership may be possible, the relationship may only be voluntary or more relaxed for certain types of members[9]. Establishing regulatory mechanisms that can ensure direct oversight from the regulator over risky LSPs, in addition to other oversight measures, can help in promptly identifying and mitigating stability risks from digital lending activities.

Globally, there is growing consensus that a risk-based, light-touch, entity-based regulatory approach is necessary for addressing stability and operational risks stemming from LSPs. For instance, some regulators need LSPs to be licensed and authorised before they can provide lending services (Crisanto

[9] For instance, banks and non-MFI NBFCs are associate members of MFIN while NBFC-MFIs are primary members.

et al., 2021(a), 2021(b); Ehrentraud et al., 2020). Brazil, China and Luxembourg are examples of some jurisdictions that are adopting licensing and authorisation regulations to strengthen oversight and mitigate stability risks (Crisanto et al., 2021(b)). Chinese regulations require any technology entity holding two or more kinds of financial institutions to be licensed by the central bank (Crisanto et al., 2021(b)). The Chinese regulations on online micro-lending also require the technology service provider intermediating online micro-lending to be registered with a regulated entity (Crisanto et al., 2021(b)).

In Luxembourg, regulators require primary and secondary IT system operators to be approved and supervised (Commission de Surveillance du Secteur Financier, 2017). Other regulatory approaches include financial regulators directly supervising and monitoring third party providers, conducting on-site investigations, and calling for information (Financial Stability Board, 2020)

2.2.2.3. *The Agency Financial Services Regulations (AFSR) can be developed into a comprehensive framework of conduct obligations for consumer-interfacing intermediaries.*

The report suggests that the RBI may develop a separate framework styled as the "Agency Financial Service Regulation" (AFSR) for all customer-facing, fully outsourced activities of REs including the services provided by LSPs.[10] The AFSR could be developed into a comprehensive framework of conduct obligations for consumer-facing FSPs in the digital credit ecosystem. The key provisions that the AFSR could include are presented in Table 2, drawing from literature on conduct obligations and upcoming universal conduct regulations in Kenya and the European Union and our work[11] in the past (Alliance for Financial Inclusion, 2016; Central Bank of Kenya, 2018; European Commission, 2020; George, 2019).

Table 2: Key conduct obligations that must be part of the AFSR

Conduct obligation buckets	Implications for FSPs
Suitability Consumers must be offered products that are affordable, and suited to their needs, objectives and financial situation.	FSPs should - • Not provide financial products or services to consumers recklessly. • Not create products and services that are *un*suitable for the consumer. • Create products through a clear understanding of the consumers' situation and needs. • Take all reasonable actions to prevent the consumer from being overly indebted or/and prevent harm to consumers' financial well-being.
Governance Consumers should be able to trust that their FSPs will protect consumers' interests.	FSPs should – • Meet the fit and proper criteria in appointing personnel to key positions. • Design their processes and incentive structures to mitigate conflicts of interest. • Design all forms of performance measurements and incentives to not compromise the ability of their representatives in discharging their duties under these obligations • Adequately train representatives to fulfil these obligations at the time of employment, and on an on-going basis when inadequacies are identified.
Transparency Consumers are aware of all information they need for making an effective and informed financial decision.	FSPs should– • Inform consumers in a clear, fair and on-going manner about all the necessary information consumers require to make an informed decision, without misleading consumers. • Make these disclosures in a manner that enhances the consumers' ability to understand terms and conditions.

[10] *See* recommendation 3.4.2.3 of the Report.
[11] *See* Universal Conduct Obligations for Financial Services Providers Serving Retail Customers, accessible here.

	• Not promote, market, distribute or provide advice regarding a product or service in a way that is misleading or coercive.
Fair treatment, due care and professional diligence Consumers must be treated fairly, with due care and diligence, according to professional ethics and acceptable standards, throughout the entire duration of product usage (and beyond where necessary).	FSPs should - • Conduct its business responsibly and fairly, in good faith with an intention to be fair, especially when they interact with consumers and when they handle consumer complaints. • Offer to consumers, products that perform as the FSP has promised, and the associated service must be of an acceptable standard that consumers expect. • Not engage in abusive practices towards consumers. • Provide reasons for terminating or refusing to provide a financial product or service. • Design and practise debt collection practices in a respectful way. • Conduct collateral realisation in a fair manner. • Compensate the consumer when the value realised from the collateral exceeds the value of the remaining loan amount.
Data protection and security Consumers and their financial assets should be protected from different kinds of harm that can emerge from breach or misuse of personal data	FSPs should – • Have a fiduciary responsibility to act in the best interests of the consumer. • Take measures including incorporating adequate data security measures into their processes and systems, providing professional indemnity. • Process consumers' personal data only for a lawful purpose when it is necessary for the provision of the product or service, and in a manner that is proportionate to the rights of the retail consumer. • Have robust processes and institutional mechanisms for maintaining oversight over third parties and their use of personal data. • Have and implement policies and protocols for data protection and data security, ICT risk management processes, incident management, resilience testing and sound management of third-party risk. • Have processes for seamless sharing of information and intelligence regarding cyber threats and vulnerabilities.
Maintain effective internal grievance redress Consumers have their concerns and grievances attended to and are compensated for non-delivery of the services in the way they were informed they would.	The FSP provides grievance redress to the customer independently of sales and operations. This internal grievance redress should – • Clearly define complaint and dispute. • Be fair, consistent and responsive to the customer. • Treat the grievance with due seriousness depending on the severity of the issue and the level of financial risk to the retail customer.
Compliance	FSPs must –

Consumers should feel confident that the FSPs comply with applicable legal frameworks.	• Take measures to comply with conduct obligations. These measures must be proportionate to the consumer risks from their services, assessed based on the nature, scale and complexity of the business. • Have a board-approved policy for adhering to the AFSR. • Demonstrate the availability of adequate resources to comply with the obligations. • Create effective internal control and feedback mechanisms to monitor compliance with the obligations.

3. Consider creating a financial consumer protection enforcement body to meet the aspiration set out in the Report.

In the regulatory policy approaches to digital lending, the WG makes several suggestions to the RBI, to a proposed SRO and to the Government of India (GoI) for enhancing the supervision of the operations of digital lenders and ensuring the protection of consumers that engage with digital lending entities.[12]

In addition to the suggestions on market monitoring made by the WG, one of the suggestions in the Report is for the GoI is to develop a separate National Financial Consumer Protection Regulation under the existing Consumer Protection Act, 2019 (CPA)[13] that covers banking, financing, insurance as "Services" under its ambit (Ministry of Law and Justice, 2019). As per the Report, the establishment of this regulation would cover all financial sector regulators and enable dispute resolution bodies to handle a larger number of service and financial disputes/complaints in a more objective and decisive manner.

This is a welcome step. Financial products are more complex than physical products and consumers are vulnerable to problems of imperfect rationality and information asymmetry between them and the provider (Bar-Gill & Warren, 2009). Appropriate financial consumer protection along with access to adequate financial products and good quality financial education is crucial for consumer trust and confidence in the digital lending sector (Organisation of Economic Co-operation and Development, 2018). Therefore, we appreciate the WG's recommendation to create a regulation specific to consumers of financial products.

However, we note that such a regulation and the existing financial consumer protection apparatus can benefit from the creation of an institutional mechanism dedicated to supervising conduct of regulated entities, enforcing financial consumer protection and market monitoring. In the following sections, we set out the merits of this recommendation by illustrating the gaps in the operations under the existing CPA and explore models of similar institutional design for consumer protection from different jurisdictions.

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[12] The recommendations and suggestions pertaining to consumer protection and market monitoring made to the GoI are as follows:

i. A proposed independent, nodal agency styled as Digital India Trust Agency (DIGITA) that ensures the authenticity and trust of digital lending applications (DLA) by providing a 'verified' signature to them and publishing the list of the same publicly (s.3.4.2.1);
ii. The proposed DIGITA will also support with digital market intelligence on potentially harmful public apps interacting with the regulated financial system on an ongoing basis (s.3.4.2.1);
iii. The functions of the proposed Digital Intelligence Unit of Government, the existing Telecom Analytics for Fraud Management and Consumer Protection (TAFCOP), and Telecom Commercial Communications Customer Preference Regulations (TCCCPR) 2018 be expanded to all regulators and their regulated entities to enable identification of unscrupulous lenders. Name of such identified unscrupulous lenders should be made available to Regulated Entities (REs) to enable them to do Enhanced Due Diligence (EDD) while allowing customers to use banking, payment and telecom channels for such activities (s.3.4.3.3(b);
iv. Creation of a National Financial Crime Record Bureau (NFCRB) (similar to (or as a subset of) the National Crime Records Bureau (NCRB)) and a data registry that is accessible to REs to supplement the onboarding diligence in the FinTech-based ecosystem (s.3.4.3.3(c));
v. Strengthening non-traditional market marketing using social media and media monitoring, and web-scraping to identify the conduct issues with DLAs (s.3.4.3.3.6(e)), and
vi. Monitoring all publicity material and direct advertisements circulated on the internet by unverified DLAs using appropriate detection techniques to be done by the Government of India and the relevant SROs (s.3.4.3.3.6(e)).

[13] *See* recommendation s.3.4.2.6 in the Report.

3.1. Concerns with using the existing CPA for enforcing financial consumer protection.

3.1.1. The framework does not provide for ex-ante supervision.

Bringing in financial consumer protection under the fold of the CPA leaves out the important dimension of supervision of conduct of regulated and unregulated entities. The CPA only has enforcement powers, which can be used to investigate violations; however such a mechanism is essentially *ex-post* in nature and comes into motion after sizeable violations of consumer protection have already unfolded. The discussion in the Report suggests[14] that NBFCs with asset size under Rs.1000 crores account for a significant share of complaints under the Sachet portal. One potential reason that RBI has historically relied upon to explain this is that these NBFCs are subject to lighter prudential regulations. From a systemic stability perspective, a risk-based prudential logic may appear sound. However, as discussed in section II.1 of this response, the potential for consumer protection concerns is not tightly correlated to the size of the entity, or the type of entity. At the consumer-behavioural level, specific products and services may carry similar risks for the consumer, regardless of the institution providing them, and should be regulated accordingly (ASBA, 2020).

Therefore, an independent institution that is in-charge of supervising regulated entities for conduct would be an important design approach to bolstering consumer protection in India. It appears to solve for overlapping or conflicting responsibilities of different departments within a single agency (like in the case of RBI who has the mandate of both systemic stability and consumer protection), of multiple agencies involved in financial consumer protection (like in the case of RBI, SEBI, PFRDA, IRDAI, and the Central Consumer Protection Authority (CCPA)) and has the potential for greater effectiveness in consumer protection by separating consumer protection supervision and prudential supervision (Jaeger et al., 2015).

3.1.2. Procedural barriers exist in realising rights under the Consumer Protection Act, 2019.

Under the CPA, aggrieved consumers (or a class of consumers) may file a complaint against a service with the relevant consumer forum. Before filing the complaint, aggrieved consumers must identify the relevant consumer forum (District, State or National Commission) that has the territorial and pecuniary jurisdiction for the dispute. In addition, all complaints must be made in writing (Ministry of Law and Justice, 2019).

In the case of digital financial services, consumers may not be in the position to correctly identify which entity they may be aggrieved by due to the modularised nature of financial services (Chivukula, 2021). The identification of the location of the relevant entity can add to this conundrum at the time of filing the complaint with the consumer forum. Additional barriers such as poor access to the internet and low literacy rates (especially amongst low-income consumers) can deter consumers from being able to file a complaint (Chapman & Mazer, 2013).

Additionally, consumer dispute courts face high rates of pendency. The Consumer Disputes Redressal Commission established under the act at the district, state and national level (called the District, State and National Commission respectively) were created to ease the load on the National Commission (Datta, 2020). However, Khan (2021) notes from data from the Computerisation and Computer Networking of Consumer Forums in Country (ConfoNet) that there has been a steady increase in pendency of cases in the National Consumer Disputes Redressal Commission (NCDRC) and the State Commissions (Khan, 2021; Muringatheri, 2019; The Hindu, 2021).

The WG suggests that creation of the National Financial Consumer Protection Regulation under the CPA would enable "*dispute resolution or grievance redressal bodies to deal with large number of service and financial disputes/complaints in a more objective and decisive manner*". In the light of the

[14] Page 27 of the Report.

bottlenecks for consumers identified in this section, it remains unclear how the proposed new regulation would supplement the existing apparatus for handling consumer complaints at a larger volume unless the capacity of this apparatus is enhanced in terms of increased personnel and specialised knowledge.

3.1.3. Ambiguity in the coordination between proposed market monitoring efforts and the National Financial Consumer Protection Regulation.

Presently, the Report proposes several inter-agency efforts to shore up consumer protection. These include independent, nodal agency, DIGITA that ensures the authenticity and trust of DLAs and gathers market intelligence, the Digital Intelligence Unit to identify unscrupulous lenders, creation of a National Financial Crime Record Bureau (NFCRB) amongst others. Currently, there is no dedicated institution to coordinate between these agencies, which risks reducing their effectiveness. It also remains unclear how insights from these market monitoring efforts will inform enforcement action, thus reducing the disciplining effect of market intelligence (Organisation of Economic Co-operation and Development, 2018).

3.2. Recommendations.

3.2.1. Creating a supervisory and enforcement body dedicated to financial consumer protection.

The recommendations and suggestions given by WG involve a combination of establishing new institutions and regulations and using existing institutional mechanisms to improve the protection of consumers of finance. Together, these recommendations are aimed at providing improved market monitoring and redressal procedures for consumers. Given that these functions are presently assigned to different bodies, inter-agency coordination between these bodies becomes imperative for effective consumer protection (Alliance for Financial Inclusion, 2020). Accordingly, we submit that there is scope for the creation of an independent agency that addresses market monitoring, supervision of consumer protection and its enforcement. The focus of such an independent body solely on consumer protection and without having to balance prudential functions can enable the early identification of those entities engaging in consumer protection violations despite being compliant with prudential requirements (Lumpkin, 2020).

It has been found that combining both the functions of supervision and enforcement can result in more effective consumer protection as consumer complaints can highlight emerging detrimental facets in the market that require attention and subsequent action (Mukherjee et al., 2015). Consumer protection agencies in other jurisdictions such as the United States of America (USA) (Consumer Financial Protection Bureau (CFPB)) take such an approach.

Box 3.1: Consumer Financial Protection Bureau (CFPB) in the US

In the USA, the CFPB is an independent agency that is tasked with consumer protection and holds the jurisdiction over banks, credit unions, securities firms, payday lenders, mortgage-servicing operations, foreclosure relief services, debt collectors, and other financial companies operating in the country. It combines functions of supervision, enforcement and public advocacy for consumers of finance (Malpass & Mogilnicki, 2013).

As an independent authority, the CFPB has the authority to write rules, conduct examinations of supervised entities and impose civil penalties. The CFPB also undertakes monitoring of tools used by financial service providers (FSPs) such as algorithms and social media marketing to target consumers, which is relevant in the businesses of FinTechs (Loo, 2018). With robust market monitoring functions, the CFPB also receives and helps resolve consumer complaints with respect to supervised financial entities. Their key features are as follows:

(i) *Market monitoring*: The CFPB houses the departments of Supervision, Enforcement & Fair Lending (SEFL) and Research, Markets & Regulations that are responsible for supervising market participants and bringing enforcement actions where appropriate (Consumer Financial Protection Bureau, n.a.) and monitoring consumer financial markets, conducting research and writing rules respectively (Consumer Financial Protection Bureau, n.a.). Together, the functions of these departments are responsible for ensuring compliance by supervised entities. The findings from these departments are published publicly.

(ii) *Consumer education and protection*: The department of Consumer Education and External Affairs (CEEA) housed under the CFPB carries out engagement and communication with consumers, policymakers, and other stakeholders. They also handle consumer complaints by means of mediating disputes between the FSP in question and the consumer. After resolution, data on complaints is aggregated and published publicly. This data informs supervision activities (Consumer Financial Protection Bureau, n.a.).

(iii) *Administrative adjudication*: Where the CFPB finds supervised entities in violation of consumer protection statutes, it initiates administrative adjudication proceedings before an administrative agency tribunal. An administrative law judge presides over these trials. As a result of the trial, the administrative law judge issues a recommended decision to the director of the CFPB, who takes it as is, or modifies it to issue an implementable final decision (Consumer Financial Protection Bureau, n.a.).

An independent agency created with a view of facilitating holistic consumer protection by supervising regulated entities and ensuring enforcement of consumer protection regulations and laws made by regulators/governments can help achieve better consumer outcomes. To begin with, the agency could focus on digital and non-digital lending activities and gradually expand its scope to supervise consumer protection across financial services. It could use technology to surface system level inconsistencies through active monitoring of the market and the consumers' complaint database. Accordingly, a body so created could embody the following features (Organisation of Economic Co-operation and Development, 2018; Alliance for Financial Inclusion, 2020; Consumer Financial Protection Bureau, 2021):

i. **Having adequate resources and capabilities to operate in the digital environment:** When operating especially in the digital financial sector, such a body will have to ensure that its resources and staff have the capability to identify, understand and possibly mitigate risks unique to the sector.

ii. **Having adequate knowledge about the financial sector:** This can be achieved by conducting market reviews and research to understand the new developments of the market, engaging

regularly with lending-related entities, industry bodies (such as the SRO recommended in the Report by the WG) and consumers.

iii. **Ensuring that existing supervisory tools are adapted to operations in the digital environment:** This can be achieved by identifying and upgrading systems to collect, process and analyse relevant data from supervised entities to inform regulatory and supervisory efforts.

iv. **Ensuring inter-agency coordination:** Given that such a body will interface with market concerns and consumer complaints that could potentially carry themes of finance, data protection and competition, the framework for operation created for this body must ensure clear scope and responsibilities of each thematic representative. It must also establish a common platform for data reporting amongst the different agencies involved.

v. **The functions of this body could include** a combination of supervision, market monitoring and enforcement functions. Some of these functions, based on survey of similar organisations include:

   a. enforcing laws and regulations that relate to financial consumer protection;
   b. supervising regulated entities for their conduct;
   c. researching experience of consumers in using financial products and creating market monitoring mechanisms;
   d. surfacing new risks to consumers;
   e. receiving complaints from consumers and routing them to relevant grievance redress institutions (ombudsmen as they stand currently);
   f. sharing insights on consumer protection, systemic risks with relevant financial regulators; and
   g. creating rules to enforce consumer protection regulations set out by various regulators and government and,
   h. educate businesses on consumer protection and good conduct.

3.2.2. Create an integrated grievance redress agency

Our work surfaces issues that current grievance redress apparatus poses for consumers. In digital financial services, as value chains become modularised and witness the participation of several financial entities, sometimes from across the financial sector, seeking redress can be quite onerous. Consumers are often not able to identify the point of failure in the transaction and determine the entity against which they need to seek redress. The Integrated Ombudsman of the RBI is one step in the direction of integrated redress. However, its scope is limited to integrating the Ombudsmen under the RBI only. We submit, that there is a need for greater integration in grievance redress apparatus of the financial system. This is especially true because consumer-facing intermediaries as envisaged in this report could be engaged in several financial services at the same time. Therefore, having a unified grievance redress, capable of accepting grievances from all sectors within the financial sector, will be instrumental to creating a uniform consumer protection regime.

Further, the Financial Sector Legislative Reforms Commission (FSLRC) recommends that from an institutional design perspective, the grievance redress agency must be independent of the regulator. This ensures fairness and reduces conflicts of interest. However, there must be procedures to ensure that the meta-analysis of complaints conducted by the grievance redress agency is shared with the regulator. This will help the regulator to identify any systemic concerns and revise any policies as needed (Financial Sector Legislative Reforms Commission, 2013).

One such blueprint for a unified redress agency in the financial sector was the Financial Redress Agency (FRA) proposed by the FSLRC (Financial Sector Legislative Reforms Commission, 2013). The FRA was envisaged to provide a consumer-facing front-end at the district level where complaints regarding all financial products can be registered. Following registration, the FRA would channel the complaint to the appropriate regulator, and entity in the backend through

technology-intensive processes for resolution via mediation and light-weight adjudication (Task Force on Financial Redress Agency, 2016).

Such a sector-neutral grievance redressal structure would considerably reduce the burden on users to identify the points of liability, identify the regulator or entity and then lodge a complaint. Additionally, the FRA was envisaged to serve as an efficient feedback mechanism which can identify points of weakness in the financial system based on the complaints received and inform better regulation making (Financial Sector Legislative Reforms Commission, 2013; Dvara Research, 2020).

The Report of the FSLRC envisaged the FRA would perform two functions (i) mediation of complaints and (ii) adjudication where mediation fails. Therefore, the current Integrated Ombudsmen of the RBI, the Insurance Ombudsmen and others which perform these functions can be brought into the fold of the FRA (Financial Sector Legislative Reforms Commission, 2013).

4. **Risk proportionate regulation can help strike a balance between the participation of new entities in the ecosystem and stability concerns.**

Some of the recommendations in the Report appear disproportionate to the risks that they are trying to address. These recommendations, discussed below, could impede innovation, financial inclusion and suitable credit delivery.

4.1. Creating a risk-based framework for Credit Enhancements.

The Report recommends that arrangements like FLDG, where LSPs provide credit enhancement to partner REs, should be banned as it is "Akin to off-balance sheet portfolio" of the LSP without having to maintain any regulatory capital.[15] While this by itself is not called out as illegal in the Report since this is not explicitly prohibited by the RBI, it points to some cases where non-banking non-financial (NBNC) entities providing FLDGs would cross the 50:50 test for falling under RBI's NBFC licensing requirements if such credit enhancements were construed as partaking in holding credit risks. The WG also states the concern that FLDG increases external operational risks for the RE through reliance on third-party service providers. However, banning FLDG may not perfectly allay that concern.

Banning FLDG may be a disproportionate measure to address the above concerns. Risk management is essential in enabling holders of credit risk, namely banks and NBFCs to collaborate with fintech and other entities to extend digital and non-digital forms of credit. While considering the impact of a risk-sharing mechanism like FLDG, the two extreme possibilities should be assessed –

i. Banning the FLDG model can have the following consequences (Reserve Bank of India, 2005; Shah, 2021; Lui, 2016) –
    a. *Moral hazard to the LSPs involved in originating loans:* In the absence of liability, the LSPs incentive is not aligned with maintaining strict suitability standards in credit assessment and underwriting
    b. *Adverse implications for credit expansion:* The absence of FLDG discourages many REs from lending to creditworthy borrowers. This affects the financial inclusion benefits that can be created with such lending.
ii. On the other hand, unchecked and high FLDGs provided by unregulated entities can lead to adverse debt collection practices by the guarantee providers.

It is important to note that cases (i) and (ii) increase costs for the bank or NBFC and the LSPs respectively, which will ultimately be transferred to the borrower (Mazer & Rowan, Competition in Mobile Financial Services: Lessons from Kenya and Tanzania, 2016). The WG's recommendation of

[15] *See* recommendation 3.3.1.2 of the Report.

the RE bearing the entire risk leads to higher costs of credit for individual borrowers where such costs had already been reduced (on both operating costs as well as loan loss provisions) as well as reduces equity participation in LSPs trying to find innovative solutions for the last-mile exclusion challenge. We therefore propose the following recommendation. The WG must also consider the existing regulatory context around other forms of credit enhancements such as unencumbered cash collateral which are in practice today in BC arrangements, as well as servicer arrangements in loan markets.

4.1.1. Recommendation: Creating a risk-based framework for credit enhancements.

The extension of FLDG and other forms of credit enhancement enables traditional REs to participate in the digital lending market. Prohibiting FLDG could create an uneven playing field among providers as the smaller FinTechs and other LSPs are driven out and only the more well-established entities with large digital infrastructure supported by capital and high volumes of transactions will survive. Additionally, provision of credit enhancements by LSPs mitigates moral hazard as LSPs have greater skin in the game. As financial inclusion is aided by improved quality and diversity of DFS products, it is important to ensure a competitive ecosystem that enables entry into the market (Mazer & Rowan, 2016). To prevent unscrupulous risk shifting to the LSP, a proportionate regulation would be to regulate the amount and nature of credit enhancement and require better creditworthiness assessments, thus allowing for healthy competition while penalising and banning high-risk business models (Financial Stability Board, 2019; Sommer, 2021).

4.1.1.1. Measures that can be explored in regulating credit enhancement agreements.

i. A risk-based set of criteria for setting credit enhancements: To prevent unchecked off-balance sheet portfolio lending by LSPs, regulations should require the amount and form of credit enhancement to be subject to certain criteria and corresponding to the role played by the LSP (Table 1). Supervisory inspections and reporting must check for compliance of these activities against these criteria.

Table 1: Credit Enhancement Regulations based on the services offered by an LSP engaged in "Credit-related activities"

Service offered by LSP	Regulation
LSP (an RE or not) offering services using lender's underwriting criteria	Any credit enhancement sought/offered (including any form of FLDG) must only be to cover for any operations risk/servicer risk of the LSP, as all credit risk is ascertained by the lender's own models and held on lender's books.
NBNC LSP offering services using own underwriting criteria and giving credit enhancements	The credit enhancement (including FLDG) sought/offered should not be more than the historical expected credit loss of the portfolio. In the case where historical data does not exist and the RE is dependent on LSP for computation of expected credit loss, the relevant authority should mandate an audit by the RE of the LSP's valuation models, and the overall levels of credit enhancements provided by it in the market before deciding what level of FLDG can be sought from the LSP. Emerging principles on algorithmic accountability that include auditing the outcomes of the algorithms for bias, interviewing employees to understand the logic of the algorithm and piloting the algorithm before scaling its use are some implements to audit algorithms (Shah H. , 2018). The RE (bank or NBFC holding credit risk) must be able to establish that the risks undertaken are aligned with the risk appetite and strategies laid out through its board-approved policies.
REs such as banks and NBFCs offering LSP services using own	REs can offer LSP services involving credit enhancements in three ways –

underwriting criteria and giving credit enhancement.	i. Offer a financial guarantee or cash collateral determined as in the scenarios explained above. ii. Sell the portfolio they have originated through direct assignment, in which case MHP would apply and no credit enhancement would be permitted (Reserve Bank of India, 2021(c)). iii. Sell the portfolio they have originated through securitisation and offer credit enhancement . Here, the extant regulations on securitisation would be applicable in determining the quantum and nature of FLDG. Over-collateralisation becomes permissible (Reserve Bank of India, 2021(b)).

ii. Publication of credit enhancements: The credit enhancements provided by LSPs should be published in a public register maintained by the authority in charge of enforcement of consumer protection. In addition to the quantum of the credit enhancement, the modality of providing the credit enhancement (through lien marked FDs/ corporate guarantees/ cash collaterals holdback on service fees, a combination of these) should also be published. This transparency allows better accountability and enables the authorities to monitor these agreements. This also helps other REs that are looking to collaborate with the LSP to assess it better (Reserve Bank of India, 2005). Further, it can help various regulators to identify emergent concentration risks (ASBA, 2020).

iii. Leveraging technology solutions: LSPs can use algorithms for originating loans for the lender. However, the LSP's algorithmic underwriting processes can oftentimes be opaque to the lender. In these cases, it appears that the LSP and not the lender is underwriting the loan. The credit enhancement would help in holding the LSP accountable in such instances. Additionally, where the REs are, either fully or substantially, dependent on the underwriting of the LSP, the WG should consider mandating technology solutions like increasing transparency and explainability of underwriting algorithms, to address the concern (Prenio & Yong, 2021) (Monetary Authority of Singapore, 2018)

4.2. Prohibiting LSPs' access to CICs could impede financial inclusion and delivery of suitable credit.

The report recommends mandatory reporting by Digital Lending Apps to CICs. However, given that a digital lending app of an RE is not reporting to the CIC denotes a failure on the part of the RE to comply with this requirement and is already a violation of existing regulations. The Report also prohibits LSPs from directly accessing credit information (recommendation 3.4.1.4) These prohibitions can have counterproductive effects on financial inclusion and delivery of suitable credit products.

The Report raises the concern that unfettered access to consumers' credit reports leads to violations of data protection and privacy. We submit that issues of data protection can be resolved by regulating LSPs (Section 2.2.1) and bringing them under the fold of the Credit Information Companies (Regulations) Act, 2005 (CICRA). This will ensure that LSPs are bound by the same obligations that operate on other regulated entities in relation to consumers' credit reports. Further, frameworks such as Account Aggregators can help in sharing credit information with the due consent of the consumer.

LSPs should be able to perform the function of credit scoring for REs, and this requires access to the credit information of individuals they are assessing for credit risk. Alternative data sources for credit risk assessment in digital lending is an important innovation for financial inclusion, allowing consumers with little or no formal credit history to be assessed by a lender (Wyman, 2017). Therefore, alternative credit scorers should be permitted to use traditional credit data and build on them with alternative data like mobile usage, social media usage and payments data.

Denying access to credit information to LSPs will mean web aggregators and online marketplaces, which are important delivery channels for digital credit, cannot perform suitability assessments to match customers to suitable digital credit products. Difficulty in comparing different digital credit products poses a consumer risk (Owens, 2018). Digital credit marketplaces play an essential role in the ecosystem by allowing borrowers to compare different digital credit products and without knowing fully, credit-worthiness of the borrower, they will be limited to providing partial offerings that take longer to execute. A more proportionate measure could be to rely on data protection provisions to regulate how LSPs use credit information by bringing them under the fold of the CICRA, using account aggregators to promote consented flow of information.

4.3. Requiring suitability assessments in push-marketing can prevent over-indebtedness:

The Report suggests prudential requirements to cover for default risk in loans originated through push marketing. (3.4.4.1) Push marketing notifications for pre-approved loan amounts are common in digital lending. When combined with push marketing, easy-to-use digital credit models with artificially short timelines may force borrowers to make too quick, unconsidered decisions (Owens, 2018). Exploiting behavioural biases is made more possible with the limitations posed by small-screen mobile devices with respect to accessing the loan terms and conditions (Mazer & McKee, 2017).

Ex-post measures like prudential requirements are not sufficient to regulate unsuitable loans created through push marketing. Regulations should focus on limiting the occurrence of unsuitable credit being taken on by individual borrowers. The RBI has highlighted how product suitability concerns should be applicable to digital lenders, including the obligation that lenders accurately assess individual consumers' needs and capacities and sell only those products that are appropriate to meet the needs of the consumer (Alliance for Financial Inclusion, 2015; Reserve Bank of India, 2015). Thus, requiring LSP and lender to conduct better suitability assessments even before advertising loans through unsolicited credit offers may be a better safeguard for the consumer.

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