A Critical Analysis of the Digital Lending Market in India and its Future Prospects

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Abstract: Developments in technology has paved way for several initiatives and changes in the norms of finance. The pandemic has further exacerbated the role technology in the banking sector. Digital Lending has become an attractive channel to borrowers due to its ease of access. The global Digital Lending Market is expected to reach a size of USD 20.5 billion by 2026 (Marketresearch.com 2021). Though Digital Lending can be seen as an important milestone achieved by the financial sector, in an imperfect market economy, it can impose significant negative externalities and threaten consumer welfare. This paper analyses the current performance, the pros and cons of Digital Lending Market in India and its future prospects, in the light of existing guidelines and its potential effects on consumers' welfare. Reports published by RBI and other financial institutions provide the trends, the present scenario of Digital Lending Markets and the prevalent guidelines to regulate these markets. The reports and research papers on the benefits and problems with Digital Lending have been analysed in this paper to provide a comprehensive understanding of its implications on consumer's welfare. The discussions in the paper would provide insights on gaps prevalent in the existing system of Digital Lending and helps in identifying measures to address the same and protect the consumers from predatory practices.

Keywords: Digital Lending, FinTech, Digital Applications, Consumer welfare

INTRODUCTION

In India, several banks and non-banking financial institutions have adopted the practice of lending through digital modes. Though the scheduled commercial banks in India are in their initial stages of development in digital lending process, the non-banking financial institutions have taken a lead with a relatively higher proportion loans being offered through digital mode. The RBI defines Digital Lending as "A remote and automated lending process, majorly by use of seamless digital technologies in customer acquisition, credit assessment, loan approval, disbursement, recovery, and associated customer service" (RBI 2021). Digital lending has promoted efficiency in the financial sector by improving productivity and profits. Since the entire process from application to disbursement of loan has been automated, digital lending delivers quick service to borrowers in contrast to the traditional lending which involves cumbersome time-consuming procedures. The total retail loans disbursed digitally is expected to hit one trillion dollars (BCG 2018) in India over the next few years. Financial Inclusion is the spotlight of various reforms introduced in the financial sector at present. The rapid expansion of digital lending platform is expected to contribute towards achieving this goal. Financial inclusion improves the quality of life of the poor and the vulnerable. The extent to which digital lending helps in achieving this goal, its effects on well-being of the consumers is the crux of this study. The study presents the different types of digital lending models available and the growth of digital lending in India. It also delves into the challenges in the existing framework and the opportunities for improving efficiency that would promote financial inclusion and improve consumer well-being.

OBJECTIVES OF THE STUDY

The study has been carried out with the following objectives:

a. To examine the present status of Digital Lending Market in India and its advantages.
b. To analyse the implications of Digital Lending Markets on consumer well-being and its future growth prospects.
c. To identify measures required to address the gaps, in the existing process and regulations in order to protect the interests of the consumers.

REVIEW OF LITERATURE

Financial Technology commonly referred to as FinTech, which is a blend of Finance and Technology has revolutionized the lending market providing efficient financial services to the stakeholders. There has been no universally accepted definition of Digital lending. In simple words Digital Lending refers to provision of credit facilities through digital platforms. Digital Lending has been considered as a powerful force for financial inclusion as it enables providing financial services to the underserved consumers in an efficient manner (ACCION 2018).

The Digital Lending is considered to be time saving and customer friendly as it facilitates faster disbursal of loans with less paper work compared to the traditional loans offered by commercial banks (Ravikumar T. et. al. 2019).

Digital Lending also offers financial solutions to Micro and Small and Medium Enterprises (MSME) as an alternative lending model when formal credit is rejected by commercial banks and non-banking financial institutions. MSMEs can now access unsecured loan products, with minimal procedures and without much regulatory obligations through FinTech (IFC 2018).

Yet the dangers arise when there is excessive borrowing by consumers to satisfy a short term want or greed. In many instances the digital loan applications force desperate borrowers in need to finance, to not pay attention to the terms and conditions regarding access to information of borrowers. This results in harassment of borrowers and even the contacts in the address books of the borrowers leading to suicides (Nageswaran et al. 2021).

Digital loans are also said to improve the subjective well-being of applicants in short-term when it has the feature of auto-approval. Yet does not significantly affect income and expenditure, resilience or women empowerment (Björkegren et. al. 2022). Digitisation is said to provide powerful benefits to banks in the form of better decisions, improved customer experience, and significant cost savings (Dietz et. al. 2019). Yet persistent issues such as, high interest rates, information asymmetry, recovery process etc. can affect the welfare of the consumers and may also create financial instability. The discussions below brings out the benefits of digital lending and also explores the prevailing gaps which may have a negative impact on the digital lending market.

MATERIALS AND METHODS

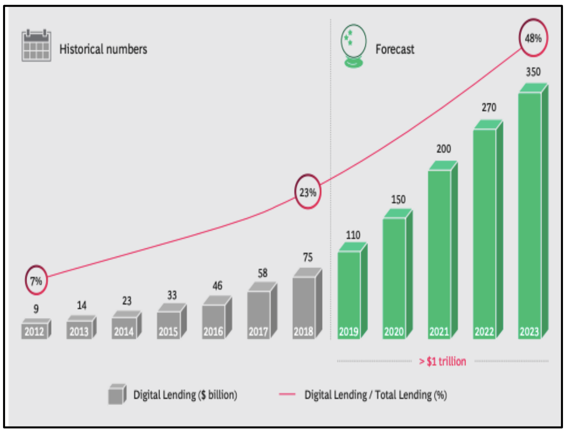
The present study adopts an exploratory approach to understand the implications of Digital Lending on consumer welfare. The Reserve Bank of India's 'Report of the Working Group on Digital Lending including Online Platforms and Mobile Aps' (RBI 2021) provides a comprehensive information on Digital Lending in India and globally and existing guidelines and regulations for consumer protection in Digital Lending. Inputs from stakeholders has also been analysed to understand the gaps and measures required to be implemented to promote efficiency and to protect consumers from being exploited by lenders in Digital Lending platforms. The report of the International Finance Corporation (IFC 2018) provides information on services offered by Digital Lending markets to MSMEs, and also provides insights on its structure and process of credit provision. The report of the Indicus Centre for Financial Inclusion (Kale et. al. 2021) provides information about the players in the digital lending market and the role of Non-Banking Financial Institutions and the regulator. Further, information has also been gathered from some of the digital lending websites regarding interest rates, conditions for credit, availability of credit and consumer reviews. The study is completely based on the secondary information gathered from various sources as mentioned above.

RESULTS AND DISCUSSION

The traditional banking system has been inaccessible to many individuals and organisations due to its cumbersome procedures and norms in sanctioning of credit. The Digital Lending promotes financial inclusion by providing access to credit facilities to those individuals and institutions that remained out of the purview of traditional lending due to several reasons such lack of credit score, collateral, poor past performance etc. Financial inclusion is one of the development objectives of the Government that could help in addressing the problems of poverty and inequality and foster economic growth. The Pradhan Mandtri Jan Dhan Yojana (PMJDY) was launched in August 2014 with the objective of providing financial products and services at affordable cost to the unbanked, unsecured and unfunded. It is a national mission towards financial inclusion. The number of PMJDY accounts increased at a remarkable rate from 14.72 crore in March 2015 to 46.25 crore in August 2022 with a deposit balance of Rs.1,73,954 crore. With the introduction of Rupay debit cards and mobile based payment system the digital transactions have increased from 978 crore in 2016-17 to 7,195 crore during 2021-22. The UPI financial transactions increased from 1.79 crore to 4,596 crore and the card transactions and e-commerce increased from 28.28 crore to 151.64 crore during the same period (MoF 2022). Such initiatives of the Government are expected to bring the poor into the formal financial system and to save them from the exploitative informal money lenders.

MSMEs in India play a crucial role in generating significant employment opportunities, bringing balanced regional development and contributing towards socio economic development. MSME's in India contribute to about 38 percent of the GDP (IBEF 2022). The MSMEs are rapidly adopting digital transactions with more than 90 percent value of their transactions done through digital mode (Ministry of MSME, 2021). Lack of access to formal credit was a major impediment to MSMEs. However, with the advent of financial technology MSME's that were earlier devoid of credit facilities are now being served through innovative financial mechanisms. The figure below presents the growth of digital lending in India and the estimated growth over a period of five years. There is a dramatic increase in the amount of digital transactions since 2012 and the Indian market for digital lending is expected to reach USD 350 billion in 2023.

Fig.1 Growth of Digital Lending in India (in USD billion)



Source: CIBIL, Boston Consulting Group, Digital Lending Report 2018.

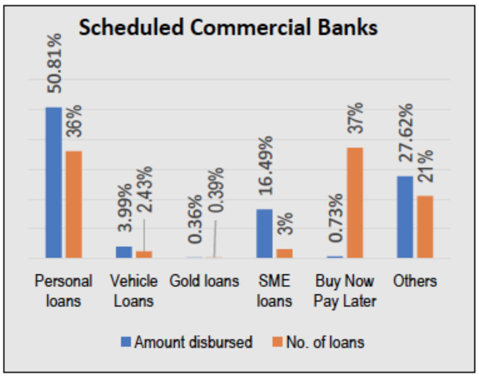
The features of some of the predominant digital lending models in India are discussed below:

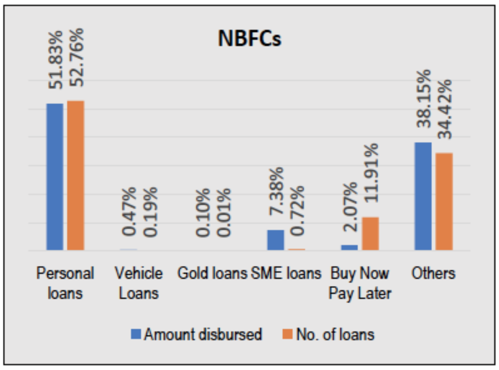
1. Peer-to-peer (P2P) lending: In this model the online platform matches the lenders and borrowers facilitating unsecured lending. It connects the borrowers and the lenders providing quick access to credit to individuals, small and medium enterprises without going through a bank. India's P2P lending market size is expected to reach $10.5 billion by 2026 (IndustryARC). According to RBI there is no credible data available on P2P lending. The lenders and borrowers register on the website, post which a due diligence is done by the platform. Those found acceptable are permitted to participate in the lending or borrowing activities. The RBI guidelines on digital lending is applicable to all commercial banks, primary (urban) cooperative banks, state co-operative banks district central co-operative banks and non-banking financial companies including housing finance corporations). The P2P lending platforms are majorly offered by technology companies that are registered under companies act. RBI has the power to regulate these companies. However, when P2P platforms are operated by individuals, proprietorship, partnership or limited liability partnership, they do not come under the purview of the RBI. Many such companies declare to be holding a valid registration certificate issued by the RBI along with the clause that RBI does not accept any responsibility or guarantee about the financial soundness of the company or for the authenticity of any declaration or information given by the company pertaining to repayment of deposits or discharge of liabilities by the company.
2. Crowd Funding: In crowd funding the businesses and individuals can borrow funds from multiple lenders. This model is generally applicable for generating funds for businesses, projects or charitable activities. Startups and SMEs can raise funds through the crowd funding model at a lower cost without complex paper work and other procedures. However, the default risk is high when the investments are made in startups. Information asymmetry is a major threat to this model. This model transfers the risk that is generally borne by venture capitalists and private equity investors financing these companies to retail investors whose risk tolerance is poor (SEBI 2014).
3. Invoice Financing: It provides credit for short-term liquidity requirements of MSMEs based on unpaid customer invoices that acts as collateral. The transactions are processed through Trade Receivables Discounting System (TReDS). The RBI has prescribed the guidelines for setting up and operating TReDS.

4. Pay-later loans: These are small size loans offered to consumers for their purchases. The consumers buy the product and pay for it on a later date or in Equated Monthly Instalments (EMI) as prescribed by the lender. India's Buy Now Pay Later (BNPL) market is said to have recorded a compounded annual growth rate of about 321 percent by Gross Merchandise Value (GMV) during the financial year 2019 to 2021 (Research and Markets 2022). The demand side analysis by Research and Markets indicate that individuals in the age group of 26 to 35 years are the prime users contributing to 40 percent market share of GMV. The young bachelor population and e-commerce users in the metro cities have been identified as early adopters of BNPL. The estimated worth of BNPL market in India is about three to three and a half billion dollars and is expected to reach $45 to $50 billion by 2026. Consumers conveniently choose BNPL mode of payment by a click during the purchase, and often neglect the terms the conditions. Many end up paying late payment charges and higher rates of interest and face overextension and accumulation of debt. A number of BNPL users are new borrowers with no credit record. According to financial experts such borrowers have multiple credit lines leading to overleveraging. Further, BNPL could anytime strain the financial system, as Non-Performing Assets (NPA) are generally higher in case of unsecured lending (Business Today, January 07, 2022).
5. Mobile lending: Financial inclusion, mobile-based delivery service, digital lending and data processing capabilities are considered as the forces that have shaped the financial services and telecommunication industries (Sorrentino et al. 2017). Borrowers use their mobile phones to apply and receive approvals for their loans. The entire loan process is carried out through a mobile device. Mobile operators, banks and fintech companies are the major lenders in this model. In mobile lending, the lenders assess the creditworthiness of the borrowers using their mobile phone data and offer them loans. The lending applications seeks permissions of the users to access location, camera, contacts, make phone calls, record audio etc. which are sensitive and has high risk of misuse (RBI 2021). Many such applications lack transparency with respect to information collected and recovery agents are said to use borrowers' information collected from their mobile devices and contact their friends and family to recover the debt in case of a default.
6. Digital Mortgage: These are similar to the traditional mortgage loans, but eliminates numerous manual procedures of traditional mortgage financing. Digital mortgage lenders are said to offer attractive rates of interest and process the loans through e-signatures and other digital documentation procedures. It significantly reduces the high turnaround time involved in traditional mortgage systems.
7. Point-of-Sale (PoS) lending: The PoS financing takes place at the time of purchase. The lenders provide loans to the shoppers based on conventional bank statements provided by the purchasers or based on their online transaction record. The customers while completing their payment selects the financing option, accepts the terms and conditions of the lender and gets the loan approved. PoS financing is said to reduce purchase abandonment rates, thereby increasing the sales (Sharma N, 2022). However, all PoS lenders do not adhere to the KYC norms increasing the risk of default.
8. Supply Chain Finance: In supply chain finance buyers approve the invoices of the suppliers which is financed by a bank. It is a technology-based lending process that aims at reducing the cost of finance. Suppliers receive quick payments while buyers get time to make their payments, reducing supply disruptions, addressing short term liquidity and working capital requirements of buyers and sellers.

According the report of the RBI, lending through digital mode relative to physical mode has a greater share in case of NBFCs than scheduled commercial banks.

Fig. 2 Share of different types of loans in total loans disbursed through digital channels





Source: Report of the Working Group on Digital Lending including lending through online platforms and Mobile Apps (RBI 2021)

Fig 2 shows that majority of the loans disbursed by scheduled commercial banks and NBFCs are Personal Loans followed by the category 'others' which primarily refers to consumer finance loans. Further, the volume of loans under the category 'buy now pay later' is also relatively higher indicating large number of loans availed for consumption purposes. The RBI working Group has reported that there are about 1100 lending apps available for Indian Android users. The report also highlights that about 2562 complaints were received against the lending apps of which the majority of the complaints are pertaining to lending apps which are not under the regulation of RBI (RBI 2021). Empirical evidence shows that digital lending increases borrowing opportunities, wherein people who do not have access to the conventional credit markets can access financial facilities through digital platforms. However, it was also found that digital credit is mainly responsible for black listings due to digital credit defaults relative to defaults in other credit markets (Johnen et al., 2021).

Digital lending has relieved borrower s, providing them hassle free access to small credits. It offers several benefits such as ease of access to credit and lower transaction costs, technology paves way for efficient handling of customers from different locations, quick validation of borrowers' information and disbursal of loans, multilevel network where technology links different institutions forming huge network, quick and efficient services also contribute to better borrower satisfaction (Gawande and Deshmukh, 2018). However, adequate financial literacy among the consumers is essential to prevent exploitation by lenders. Poor financial literacy, lack of household budgeting, borrowing at high interest rates through digital platforms can affect financial discipline and thereby leading to financial instability. Digital lending is known to provide instant loan disbursal, greater accessibility to credit, financial inclusion, hassle free and paperless borrowing to the consumers. Yet they can instigate financially harmful consumer behaviour (Financial Express, August 03, 2022). Absence of a comprehensive regulatory framework, safeguarding mechanism against fraudulent lending platforms and lack of monitoring mechanism increases the risk of digital lending markets (Business Today. March 06, 2022). A research study conducted by Dvara Research Foundation on 'Emerging customer risks in Digital Lending' (Dvara Research 2021) identifies some of the risks that the consumers of digital loans face. The terms and conditions laid down by the Digital lending apps are often quite complex for consumers to understand, thereby increasing the risk of customers signing up for a loan without understanding the terms and conditions pertaining to repayment, interest rates, repercussions of non-repayment, recovery procedures, etc. completely. There is no in-person communication between the lender and the borrower in a digital lending transaction as in traditional loan procedures. The interest rate for loans offered through digital mode is said to range between 25 percent to 400 percent. As a result of which some consumers fall into a debt trap and often borrow fresh loans to repay the existing ones. Use of alternate data from the phones of the customers such as number of friends or contacts, size of the mobile screen etc. to assess the credit worthiness of the borrowers can contribute to information breach and threat to personal data, which the consumers may not even be aware of. Unethical collection practices adopted by the lenders often harass the borrowers and it was observed to be very high during the pandemic.

The proportion of broadband subscribers in India is just over 50 percent. And only about 29 percent of the rural population in India are broadband subscribers as compared to 95 percent in urban India

(Deloitte 2020). Though digital lending promises to promote financial inclusion, providing credit access to those deprived of credit from the traditional sources, and is highly dependent on technology. This is an indication that the level of digitization and penetration of digital financial services to the marginalized community and the remote population has not been satisfactory in India.

The studies on the impact of digital lending on the welfare of the people shows a mixed response. A study on the effects of digital finance on rural household poverty in China, indicates the digital finance has significantly reduced absolute and relative poverty among the rural households in China. It is said to alleviate credit and information constraints of rural households, widening their social network and promoting entrepreneurship, thereby helping to curb the problem of poverty (Chen and Zhao, 2021). While on one hand it is argued that digital finance contributes to welfare by bringing about financial inclusion, it also said that, digital lending may lead to financial exclusion rather than inclusion when screening of borrowers is done through advanced technology that may exclude the poorer households who may not have access to the technical infrastructure. Further, digital credit can also increase the likelihood of people falling below poverty line since the interest rates on these loans are relatively higher and which reduces the income available for consumption especially for low-income households. Thus, digital credit could be harmful to borrowers' well-being. (Kandie and Islam, 2021).

A study about the Airtel's Kutchova digital-credit product in Malawi (Brailovskaya et al. 2022) found that people have very limited information about the terms of the digital loan such as the due date for repayment, late fee etc. The lenders often do not disclose the complete information to the borrowers. The researchers thus conclude that the digital credit does not improve lives, and it may contribute to predatory lending, when they lack transparency. Information asymmetry in digital lending can have a significant impact on digital finance and prevent its further development (Wang et. al., 2015).

A review of interest rates in some of the P2P lending websites show that the average interest rate is as high as 24 percent while promising a lending and borrowing rate of about 12 percent. (faircent.com). The platforms also charge the borrowers a processing fee, which sometimes depends on the interest rate or the income profile of the borrowers. The interest rates displayed in some of the P2P lending websites indicate that the probable interest rates charged by P2P platforms are higher than conventional loans. The Governor of Reserve Bank of India in an article published in 'The Hindu' dated September 20, 2022, had also raised concerns over the complaints regarding usurious interest rates, unethical recovery practices, and data privacy issues in digital lending.

The Reserve Bank of India issued guidelines on digital lending in September 2022 that lenders and other entities in the digital lending platform must adhere to. It aims at protecting the consumers by making it mandatory to disclose various terms of the loan to the borrowers through the key fact statements. It also provides guidelines for assessing borrower's credit worthiness, collection, usage and storage of data, recovery of loan and the regulatory framework for reporting to credit information companies and loan sharing arrangement in case of default. Further, it also provides for a mechanism for grievance redressal. However, these guidelines are applicable only to Commercial Banks, Primary (Urban) Co-operative Societies, State Co-operative Banks, District Central Co-operative Banks and Non-Banking Financial Companies, including the Housing Finance Companies. The guidelines are applicable to entities that are regulated by RBI. However, there are several unregulated lending applications tempting borrowers by promising instant approval of loans. A working group of RBI has identified 600 such illegal lending applications and several complaints against them. The RBI has also cautioned the people about the unscrupulous activities of unauthorized digital lending platforms (India Today, New Delhi, March 29, 2022). Yet the people who are in desperate need of finance and motivated by desires and temptations, fall prey to predatory lending practices as seen by the number of complaints received.

India is said to have the highest Fintech adoption rate of about 87 percent and the Fintech market is expected to reach Rs.8.35 lakh crore by 2026 (Fletcher, 2007) from about Rs.2.3 lakh crore in 2020 (RBI 2020). In the process of such rapid growth there is an increasing risk of customer exploitation, information asymmetry, unethical practices, personal data risk and issues of over indebtedness, which could affect the financial stability. Hence, it is essential to bring about a comprehensive framework to regulate and monitor digital lending activities. Lender should determine borrowers' affordability and cap the loans at appropriate levels. A ceiling on the interest rates can protect the borrowers from usurious interest rates. Measures should be taken to reduce information asymmetry that would promote the trust in the system. Customer should be educated about the terms and conditions of the loan and informed consent should be mandated before the approval of loans. They should be provided flexibility in terms of repayment and option to restructure loans in case of uncertainties that could affect repayment. There should be a grievance redressal mechanism with different levels of escalation and customers should be educated about the same. Stringent regulatory actions must be initiated on unauthorized lenders and unethical practices. The regulatory body should have information about the size of the digital lending industry including the amount of digital loans extended through different channels, purpose of the loans, tenure, prevailing rates of interest, basic profile of the customers and size of borrowing. This would help in bringing about suitable policy framework and enable better monitoring of digital lending activities.

In order to achieve the objective of financial inclusion, digital loans should be better accessible which requires creation of the essential infrastructure and it should also be made affordable. High interest rates and lack of adequate infrastructure may be detrimental in bringing about financial inclusion. India has more than 687 million broadband users and is one of the largest internet user in the world, yet significantly lack in terms of infrastructure. Fixed broad band penetration is only about 7.5 percent. The average broadband speed is relatively lower (12.5 mbps for mobile broadband and 38.2 mbps for fixed broadband) compared to many other developing countries. Future prospects of e-commerce and digital lending also depends on broadband coverage and quality (Deloitte 2020). Further, it is also essential to create awareness and educate the borrowers to make informed choices, and that would reduce the risk of default.

CONCLUSION:

Digital Lending Market is in its nascent stages of development in India especially in terms of reforms and regulations. It serves as an alternate source of credit and has greater scope in contributing towards financial inclusion. However, it is essential to ensure customer protection and well-being along with financial inclusion. The RBI had issued guidelines on Digital Lending on September 02, 2022 with the objective of protecting customers from the risks associated with Digital Lending. Analysis of the existing practices in the digital lending industry indicates that more comprehensive measures are required to ensure customer awareness and safe-guard of their interests. There should be co-ordination between mobile operators, commercial banks, non-banking financial institutions, application developers, other service providers and the regulator. Feedback from various stakeholders should be considered to strengthen the Digital lending market to ensure that customer's make informed decisions that would promote their well-being.

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