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Digital Lending: Legal Aspect in India

Abstract:

Digital lending is the new age practice of applying for and giving out loan or credit to borrowers through the completely online or digital platform by financial services providers. Digital Lending is 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. Digital lending has emerged as an effective alternative to traditional lending (by financial institutions) for people who are new to credit or are underserved by the financial system. This business was mainly covered by fin Tech startups, neo banks and Non-Banking Finance Companies (NBFCs). Commercial banks are also fast joining as a financial intermediaries either lending digitally on their own or joining with NBFCs to share the synergies.

Key words: Digital lending, Fin Tech, NBFCs, synergy

Introduction:

The growing popularity of the Digital lending can be credited to factors such as growing smartphone usage, internet penetration, credit range flexibility, and the convenience and efficiency that digital brings. According to media reports, the digital lending market is projected to grow from USD 100 billion in 2019 to well over USD 350 billion in 2023. India had the highest FinTech adoption rate. With keeping digital lending progress in mind, India has developed numerous digital lending companies whose finances can manage smoothly. India is evolving to a great extent in the digital sector and financial inclusion. The country has cash for transactions. But with the evolving method of development and modernization, India is shifting toward a cashless economy. The top digital lending platforms in India are Lendingkart, Pine Lab, MobiKwik, Shiksha Finance, MoneyTap, Paytm, PolicyBazaar, Capital Float, Faircent etc.

Indian Legal Regimes:

In India, lending activity, online or otherwise, is governed by following laws, in addition to various regulatory instructions issued by RBI for its regulated entities:

Banking Regulation (BR) Act, 1949: Business of banking as defined in Section 5(b) of the Act, includes providing loans inter alia by a banking company, through online mode or otherwise. All banks (public and private sector) including small finance banks, regional rural banks and co-operative banks are required to get themselves registered with the Reserve Bank for undertaking digital lending.

Reserve Bank of India (RBI) Act, 1934: Besides banks, NBFCs, complying with principal business criteria are required to be registered with RBI as per provisions of RBI Act. For this purpose, an NBFC is defined as a company registered under the Companies Act 1956/2013 whose principal business is financial activity i.e., business of loans and advances, acquisition of shares / stocks/ bonds / debentures / securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business. To obviate dual regulation, certain categories of NBFCs, regulated by other regulators, have been exempted from the requirement of registration with RBI, viz. alternative investment fund companies/ merchant banking companies/ stock exchanges/ stock broking companies registered with SEBI, insurance companies registered with IRDAI, Nidhi companies/ mutual benefit companies under Companies Act, and chit companies under Chit Funds Act.

Companies Act, 2013: Companies, which are not meeting principal business criteria for registration as an NBFC with RBI, can also undertake lending activities subject to applicable provisions of the Companies Act, 2013 such as Section 186 of the Companies Act, 2013 which prescribes certain restrictions on the loan amount and minimum interest rate for such loans. Besides, there are Nidhi companies/ mutual benefit companies which are permitted to receive deposits from and lending to their members as per provisions of Section 406 of the Companies Act, 2013 and ‘Nidhi Rules, 2014’.

State Money Lenders Acts: The Constitution of India has conferred the power to legislate on matters relating to money lending and money lenders to the States. Most of the states have their respective money lenders legislations. Many of these are comprehensive legislations providing detailed and stringent provisions for regulation and supervision of the money lending business.

Chit Funds Act, 1982: Chit Fund companies are regulated under the Chit Funds Act, 1982, which is a Central Act, and is implemented by the State Governments. Those chit funds, which are registered under this Act, can legally carry on chit fund business which involves contributions by members in instalments by way of subscription to the chit and each member of the chit receives the chit amount by rotation.

Others: In addition to the above, there are other entities carrying out lending activities which are governed by their specific Acts (and other applicable laws) such as State Finance Corporations, Regional Rural Banks, Life Insurance Corporation of India and Credit Societies.

RBI Working Group Recommendations on Digital Lending

To study all aspects of digital lending activities to enable an appropriate policy approach, a Working Group was constituted by Reserve Bank of India on January 03, 2021 and such working group submitted its Report to RBI on November, 18, 2021. The recommendations of the Working Group seek to protect the integrity of the system against entities that are not regulated and not authorized to carry out lending business. The liability of subjecting third-party lending service providers to a standard protocol of business conduct would lie with the regulated entities to whom they are attached. Further, an institutional mechanism is envisaged to ensure the basic level of customer suitability, appropriateness and protection of data privacy. The working group report further seeks to ensure that there is orderly growth in the digital lending ecosystem without it being unduly disruptive towards the existing players in the ecosystem. The idea is that the existing players in the digital lending domain should follow recommended standards of appropriateness to address conduct / technological issues.

The approach adopted in Working Group Report is guided by the following three principles:

- **Technology Neutrality:** Neutrality towards technological differentials or business model while encouraging competition to maximize the benefits to the financial system.
- **Principle Backed Regulation:** Instead of a rule-based regime, a principle-backed approach to provide sufficient scope for innovation and adaptability in a dynamic environment.
- **Addressing Regulatory Arbitrage:** Addressing the arbitrage between different sets of entities in the digital lending ecosystem to ensure level playing field and market integrity.

To achieve these principles in a holistic manner, the Working Group has recommended a three pronged measure on a near to medium term. Some of the key recommendations of the Working Group are enumerated below:

(a) Legal & Regulatory Recommendations-

Near Term (up to one year)

A nodal agency should be set up which will primarily verify the technological credentials of DLAs (Digital Lending Application) of the balance sheet lenders and LSPs (Lending Service Provider) operating in the digital lending ecosystem. It will also maintain a public register of the verified apps on its website. Balance sheet lending through DLAs should be restricted to entities regulated and authorized by RBI or entities registered under any other law for specifically undertaking lending business. A suitable notification in this regard should be issued by the appropriate authority. An SRO(Self Regulatory Organisation) should be constituted covering the participants in the digital lending ecosystem. All loan servicing, repayments, etc. should be executed directly in a bank account of the balance sheet lender and disbursements should always be made into the bank account of the borrower. However, borrowers having only PPI(Prepaid Payment Instrument) account and no bank account can be disbursed loan if the PPI accounts are fully KYC compliant.

Medium Term (above one year)

Central Government may consider bringing in a legislation to prevent illegal lending activities by introducing the 'Banning of Unregulated Lending Activities Act'. RBI should develop a separate framework styled as Agency Financial Service Regulation (AFSR) for all customer-facing/ fully outsourced activities of REs including LSPs.

(b) Recommendations related to Technology-

Near Term

Compliance with the prescribed baseline technology standards should be a precondition to offer digital lending by the REs and by LSPs providing support to REs. Each DLA should have publicly available policies regarding data storage, its usage and privacy. Data should be stored in servers located in India. REs should document the rationale for the algorithmic features aiding lending decisions that should ensure necessary transparency. Data should be collected from the borrower/ prospective borrower with prior information on the purpose, usage and implication of such data and with explicit consent of the borrower in an auditable way.

Medium Term

An adaptive comprehensive regulatory framework for FinTechs and TechFins. Algorithm used for underwriting should be auditable and lenders shall ensure that outputs from such algorithms are knitted in ethical AI design.

(c) Recommendations related to Financial Consumer Protection-

Near Term

Each lender should provide a key fact statement in a standardized format. A look-up period of certain days should be provided for all digital loans with the option of exit by paying proportionate APR without any penalty. Use of unsolicited commercial communications for digital loans should be governed by a Code of Conduct.

Medium Term

An anti-predatory lending policy should be framed by each lender based on the characteristics to be defined by RBI/ proposed SRO.

Challenges:

Technological innovations have led to marked improvements in efficiency, productivity, quality, inclusion and competitiveness in extension of financial services, especially in the area of digital lending. However, there have been unintended consequences on account of greater reliance on third-party lending service providers mis-selling to the unsuspecting customers, concerns over breach of data privacy, unethical business conduct and illegitimate operations. While the current share of digital lending in overall credit pie of the financial sector is not significant for it to affect financial stability, the growth momentum has compelling stability implications. It is believed that ease of accessing digital financial services, technological innovations and cost-efficient business models will eventually lead to meteoric rise in the share of digital lending in the overall credit. The larger issue is protecting the customers from widespread unethical practices and ensuring orderly growth. As has been seen during the pandemic-led growth of digital lending, unbridled extension of financial services to retail individuals is susceptible to a host of conduct and governance issues. Mushrooming growth of technology companies extending and aiding financial services has made the regulatory role more challenging. In view of the ease of scalability, anonymity and velocity provided by technology, it has become imperative to address the existing and potential risks in the digital lending ecosystem without stifling innovation. Further, on a larger canvas and on a medium to long term horizon, digital innovations along with possible entry of Big Tech companies may alter the institutional role played by existing financial service providers and regulated entities. A fallout of this may get reflected in blurring of regulated and unregulated financial institutions/ activities. Such developments spurred by mere commercial considerations would pose regulatory challenges in ensuring monetary and financial stability and in protecting interests of the customers.

Conclusion:

With emerging scope for integration of improved technology tools – data analytics, Artificial Intelligence (AI), Machine Learning (ML), deep learning, Robotics in financial sector, deeper digitalization of financial sector including in dissemination of credit is possible. Many banks are likely to adopt the model of dispensing credit through use of digital mode – right from sourcing leads to disbursing loans. On the other hand, the possible entry of 5G can improve the internet speed and connectivity. With higher technology use, the Digital Lending Companies (DLCs) have to upgrade the management of operational risks built in credit risk. Skill up-gradation, systems audit of technology tools and systemic controls have to be constantly under watch to ensure that the merits of digital lending sustain in the long run. Governance, Risk and Compliance (GRC) should remain actively functional with its built-in checks and balances in place to ensure that DLCs contribute to economic growth. Digital lending will gradually make its bigger space in credit delivery system. It is the need of the time tech platforms, i.e., digital lender that lend to the end consumers should be regulated like NBFCs and must be brought under purview of RBI so as to prevent consumers from data theft, money theft and frauds. Ultimately the RBI’s role is to protect the end consumer.

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