Preventing Over-Indebtedness in Digital Credit Markets: Investors’ Checklist

1 Purpose

This discussion paper relates to Principle 9 of the Investor Guidelines for Responsible Investing for Digital Financial Services (DFS), which pertains to preventing over-indebtedness (OID) in digital credit markets. There is increasing investments from responsible DFS investors into this market given its potential power to further financial inclusion. However, in some markets, recent media show rising incidence of client defaults and persistently high prices. How can responsible investors differentiate DFS and fintech players that are innovating to strengthen customer protection versus those who do not? The aim of this paper is to be a springboard to help kickstart a dialogue amongst responsible investors on emerging best practices for identifying prospective fintech and DFS partners, building on lessons from past crises in global financial inclusion, and their implications for digital financial services.

2 Current State of Digital Credit in Selected Markets and Over-Indebtedness

The digital credit market is relatively nascent. In 2016, a study in Kenya and Tanzania was released by Microsave Consulting, which investigated the dynamics of the digital credit sector on both demand and supply side. The study has since been updated over the last three years, with key findings as follows:

1. **Financial inclusion improved.** The mobile money revolution has significantly contributed to financial inclusion in Kenya. Number of digital loans have doubled between 2016 and 2018; 86% of loans taken by Kenyans were digital. Half of the loans issued by traditional players such as banks are digital.

2. **Multiple borrowing is high.** Thirty-five percent of Kenyan digital borrowers have borrowed from more than one digital lender, and 14 percent had loans outstanding with more than one digital lender at the time of the survey.
3. **Defaults high.** About half of borrowers (2.2 million individuals) reported having repaid a digital loan late, and a significant proportion have defaulted. 49% of the digital credit borrowers with non-performing loans have outstanding balances of less than USD 10.

4. **Non-performing loans (NPL) higher than traditional microfinance.** NPL for digital credit is 3x higher than traditional loans; 16% versus 5%, although the trend has been decreasing. NPL is defined as arrears of more than 90 days.

5. **Struggling to repay.** Twenty percent of Kenyan digital borrowers reported reducing food purchases to repay a loan. 16 percent report having borrowed money to repay a loan.

### 3 Proposed Investors Checklist to Mitigate Over-indebtedness

Given the above context, this section proposes an Investor Checklist to mitigate the risk of over-indebtedness with the principal objective to help investors identify potential red flags in three risk areas: 1) **product offering**, 2) **underwriting practices** and 3) **reporting**. The Checklist includes suggestions on key questions that should be explored during the due diligence process and are primarily based on global customer protection standards\(^1\), particularly for digital credit. Some examples of nascent and advanced customer protection practices are also presented.

<table>
<thead>
<tr>
<th>Product Offering</th>
<th>Questions to Ask Digital Credit Provider</th>
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</thead>
</table>
| **Low, standardized loan amounts irrespective of income** | • Are products designed based on client feedbacks?  
• Is a suitability test conducted to ensure that the products offered are appropriate for borrowers?  
• Does the provider have a multiple loan policy?  
• Does the provider collect and analyse the risk of multiple loans? |
| **Concern:** Limited loan sizes generate multiple borrowing  
**Fact:** 62% of digital credit borrowers in Kenya have more than one digital loan\(^1\) | |

**Example of Advanced Practice:**
With the help of the Smart Campaign, Association of Microfinance Institutions in Uganda (AMFIU) launched a new system with various digital channels for clients to file complaints. When a complaint is filed, it is assigned to the appropriate Financial Service Provider (FSP) and AMFIU keep tracks of FSPs progress on responding to the complaints. This mechanism enables FSPs to design products that better serve their clients’ needs.

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### Product Offering – Digital Credit

#### High Pricing

**Concern:** “The lower costs of delivering digital credit at scale have not trickled down to customers. The interest rates offered by the variety of digital lenders vary considerably. However, these are generally not lower than the interest rates offered by traditional FSPs.”

**Fact:** Pricing in Kenya

#### Questions to Ask Digital Credit Provider

- Is the lender covering its costs or rapidly approaching break-even?
- Are pricing strategies to reduce prices over loan cycles for creditworthy clients with a demonstrated track record of on-time repayment and avoids penalizing long-standing customers to cross-subsidize pricing for new customers?
- Does lender demonstrate commitment to its pricing policy through analysis of pricing trends and documentation of reasons for changes in pricing over time?
- Are price components calculated in a straightforward manner (e.g. interest on declining balance)?
- Does the lender have a reasonable limit when loan interest and/or fees (including arrears interest) stops accruing that is proportionate to loan tenure?
- Is Annual Percentage Rate (APR) or Monthly Percentage Rate (MPR) for all the lender’s major products (>20% of portfolio) within the accepted performance range of similar products in the market (e.g. by size, term, model, etc)? If outside the range, is there a valid justification? If market data is not available, does the APR of the lender show decreasing trend over time, and if not, why?
- Does the lender charge clients for confirmation of transactions upon payments or single balance inquiries? Borrowers should be allowed at no charge reasonable frequency updates: at least weekly for loans of 1-month term or less, and at least monthly for other loans.
- For prepayment, does the lender charge interest that would be accrued or ongoing fees between time of prepayment and the end of the loan term? They should not.
- Are arrears interest/fee and penalties compounded or calculated based on principal amount only?
- For new organizations (i.e. 1-4 years in operation), the Loan Loss Expense Ratio (LLER) over the past 3 years should show stability or a decreasing trend. If not trending downward, what is the justification? For mature organizations (5 or more years in operation), the LLER Ratio should be within market averages.
- For new organizations, Operating Expense Ratio (OER Ratio) over the past 3 years should stabilize or decrease. For mature organizations, OER ratio should be within market averages.
- For new organizations, Return on Assets (ROA) are reasonable and balance profitability with client well-being. For mature organizations, is it within market averages?

#### Example of Advanced Practice:

IFC conducts due diligence and portfolio reviews of its DFS investments to assess trends in pricing offered for financial inclusion products, relative to local markets and business operations. IFC disseminates case study experiences from DFS and fintechs to promote data analytics using positive behavioral decisioning, and customer analytics to support improved risk management and underwriting.

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2 Data Analytics and Digital Financial Services (2017); Risk Management (2016)
## Product Offering

<table>
<thead>
<tr>
<th>Concern: Aggressive sales, unsolicited push messaging, and deceptive marketing used to on-board customers and encourage automatic renewals create a sense of &quot;easy money&quot;, which could drive borrowers into a debt cycle trap.</th>
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</thead>
<tbody>
<tr>
<td>Questions to Ask Digital Credit Provider</td>
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<tr>
<td>- Does the lender define predatory and deceptive sales and marketing techniques that must be avoided by staff?</td>
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<tr>
<td>- Are staff trained on these policies?</td>
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<tr>
<td>- Is the incentive and/or bonus structure promoting predatory or deceptive sales by staff or management levels?</td>
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<tr>
<td>- Do the incentive schemes value portfolio quality as high as other factors such as client growth?</td>
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## Example of Nascent Practices:

**Breach of privacy:** Okash is known to randomly call numbers on a client’s contact list if they default on their loan. The app obtains permission from the customer during the installation of the app. The permission clause is hidden in a long and wordy T&C that many users do not read. Many customers are surprised when, upon default or delay in payment, Okash calls or texts their "most frequently used numbers" requesting them to put pressure on the defaulting client to pay.

**Push messaging:** Every time an M-PESA user attempts to send or pay money that is above their available balance in their e-wallet, a message from Fuliza pops up to prompt the user to overdraw using the facility. Unsolicited marketing messages are usually sent to the potential borrower with heavy above-the-line advertising during prime time on TV, on outdoor ad-sites, among other channels.

**Intrusive calls:** When a borrower defaults, the Afrika Loan call center makes multiple calls using different people who urge the client to repay. In a day, the calls can be as many as 3-5. The calls are usually made during the day but can also be made at odd hours with the possibility of inconveniencing the user.

## Underwriting

<table>
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<tr>
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<tr>
<td>- Does the lender have a working definition of client over-indebtedness that includes client stress?</td>
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<tr>
<td>- For loans below 10% of monthly GNI/capita, the lender demonstrate how capacity to repay is incorporated into underwriting?</td>
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<td>- For loans between 10% of monthly GNI/capita and 6x, does the lender include variables or proxies such as disposable income, transaction data, saving balance, credit history, revenues/expenses, household or business, as well as debt service to other lenders in the analysis?</td>
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<tr>
<td>- For loans above 6x of monthly GNI/capita, is underwriting based on disposable income, credit history, income, expenses and debt service to other lenders related to business and family?</td>
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<tr>
<td>- Does lender define a maximum percentage of borrower’s disposable income that can be applied to debt service?</td>
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<tr>
<td>- How does the lender verify the quality of income and other data?</td>
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<tr>
<td>- Does the lender mainly focus on collateral rather than cashflows?</td>
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## Example of Nascent Practice:
Findings based on mock loan applications in Kenya\textsuperscript{vi}: The app-based loans give standard amounts irrespective of income. For example, DFS and fintech providers in Kenya offer on average $10-$20 loans to all new customers, particularly first time applicants.

**Example of Advanced Practice:**
- Musoni, a digital MFI, is testing its digital agricultural financing product through USSD and app channels to differentiate by segment. \textsuperscript{vii}

### Underwriting

**Credit scoring algorithms opaque**

**Concerns:** Majority of digital lenders use their own scoring algorithms, which are still unproven.

**Questions to Ask Digital Credit Provider**
- Are the rationale for the algorithm documented, including factors/types of variables?
- Is the algorithm, its inputs and the effectiveness in predicting client repayment reviewed and tested by a unit of the organization independent of the algorithm development team (e.g. internal audit, senior management, or other)?
- Is there ability to override approval process by staff, if decisions are completely automated?
- If the algorithm has been deployed for at least 3 years, the lender can demonstrate improvement against the portfolio quality targets in the last 3 years?
- For mature deployment (i.e. >8 years), total credit risk should not average more than 20% during any quarter in the past 3 years, including the most recent quarter? If exceeded 20%, what kind of corrective measures have been put in place and how have it been tracked?
- Is the algorithm robust enough that clients cannot learn to game the system to qualify for amounts they are unable to repay?

**Example of Advanced Practice:**

### Limited validation of loan purpose

**Concerns:** Risk that borrowers are not using the loan for the intended purpose and therefore, cannot generate the cashflow to repay.

**Questions to Ask Digital Credit Provider**
- Does the lender validate loan purpose before disbursement? If so how?
- Post disbursement, does the lender monitor and analyse loan usage by client characteristic and product terms (e.g. terms, amounts, frequency, timing of borrowing)?
- On a sampling basis, does lender investigate reasons for borrowing, repeat borrowing and drop-out? Have products been adjusted based on those analyses?

**Example of Advanced Practice:**

Sempli is a digital lender that began operations in 2017 with a mission to support the growth of Colombia’s underserved small businesses. As part of its assessment process, Sempli performs a one to one online interview with each of its clients to validate key information of the business and the purpose of the loan requested before approving loans.

Similarly, Afrikaloan a new lending platform additionally relies on a live phone interview with the customer before lending\textsuperscript{viii}

### Reporting
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<tbody>
<tr>
<td><strong>Concerns:</strong> Increasing trend of non-performing loan</td>
<td>- How do management and the board monitor the market and heightened OID risk?</td>
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<td>- How is portfolio quality (including loans in arrears and restructured) tracked and reported?</td>
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<td>- How timely are the reporting, specifically in the case that loans are approved instantaneously and with short tenors?</td>
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<td></td>
<td>- Are reports analysing portfolio quality by geography, products and client segments that are adapted to DFS (i.e mobile usage, age, phone model, etc.)?</td>
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<td>- Does the provider have a policy on sustainable target growth rates considering the provider’s growth capacity and markets being targeted?</td>
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<td></td>
<td>- If the provider uses an automatic loan approval determined by an algorithm and have been deployed for at least three years, have the provider conducted a test to demonstrate the link between methodology and portfolio quality?</td>
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<tr>
<td></td>
<td>- If total credit risk has exceeded 20% at any point in the past 3 years for mature deployments, has the provider implemented corrective measures been put in place and its efficacy tracked?</td>
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</table>

**Example of Advanced Practice:**
In Senegal, MicroCred extends financial services across the country through a network of over 500 DFS agents. With a sophisticated MIS system that produces different interactive dashboards for daily operations and strategic goals, MicroCred is equipped to cope with the fast pace that comes with DFS.³

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<td><strong>Credit Bureau Reporting</strong></td>
<td>- If a credit bureau exists, does the lender report positive and negative reporting in a timely and systematic way?</td>
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<tr>
<td><strong>Concerns:</strong> Failing to report to credit bureau or providing incomplete reports. Lack of information could lead to over lending, creating a risk of debt cycle trap.</td>
<td>- Unless mandated by regulation, lenders should not negatively report loans to the credit bureau that: a) are disbursed as part of a blind deployment; b) have an outstanding principle amount under 5% of that country’s monthly GNI/capita.</td>
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</tbody>
</table>

**Example of Advanced Practice:**
Sempli, a fintech in Colombia focusing on SME loans reports regularly to the main credit bureau systems in Colombia despite not being required by regulators in order to contribute to the quality of the information available.

³ Data Analytics and Digital Financial Services
4 Potential Actions for Signatories

[in progress, comments highly welcome]

- Investors encouraging investees and prospective investees to implement same best practices
- Assisting industry networks and associations to set up self regulatory mechanisms
- Assisting regulators to regularly gather and analyze data and act to address key warning signs that are already emerging around transparency, suitability and responsible lending practices.
- Investing in financial and digital literacy for borrowers. For example: IFC has provided investment and advisory support to promote debt advice (Bosnia and ECA), including financial education solutions to strengthen customers’ financial health.

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1 Making Digital Credit Truly Responsible (September 2019)
2 Making Digital Credit Truly Responsible (September 2019)
3 Making Digital Credit Truly Responsible (September 2019)
4 Making Digital Credit Truly Responsible (September 2019)
5 Making Digital Credit Truly Responsible (September 2019)
6 Where Credit Is Due: Customer Experience of Digital Credit In Kenya
7 Making Digital Credit Truly Responsible (September 2019)
8 Making Digital Credit Truly Responsible (September 2019)