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A NEWSLETTER OF THE FINANCE LAB

December 2021, Volume 7, Issue 3

INDIAN INSTITUTE OF MANAGEMENT CALCUTTA

FRTL
Financial Research & Trading Laboratory

BNPL but ... Walk Don't Run

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I. Is Debt Dangerous?[1]

Half a century back, when TIME Magazine launched a campaign to rename the Air Force One in response to President Nixon's visit to China, one of the special mention entries was 'Go Mao Pay Later.' Unlike India, deferred payments were very much a part of the lifestyle in the U.S., where Singer Sewing Machines popularized the installment plan in the 1890s. With globalization and advanced technology, a staggered payments product called '*Buy Now, Pay Later'* (BNPL) came to focus from the early 2010s. It spread in developed and emerging economies, growing in the pandemic era, and India has not been able to buck this trend.

In many ways, BNPL is old wine in a new bottle and is popular with younger consumers. An unsecured retail credit product, lenders find it attractive – at the portfolio level, higher margins and spread-out risks make it more profitable.

"Alongside the step-change in the use of these products, there has been a rise in concerns about whether BNPL is giving rise to consumer detriment." (HM Treasury 2021, 2). These have become more pronounced after COVID, leading to interventions from consumer advocates and regulators.

Research specific to BNPL in India is scant. Scattered media reports indicate its growing use and mixed sentiments of consumers, as elsewhere. Since it is a retail unsecured credit product offered primarily online, I have used Digital Loans and Personal Loans, including Payday Loans, as proxies for analyses. This simplification of using BNPL as a generic (the title of the very interesting Harvard Business Review document "Buy Now Pay Later: A History of Personal Credit" reflects a similar thought process) does not detract from the message that I

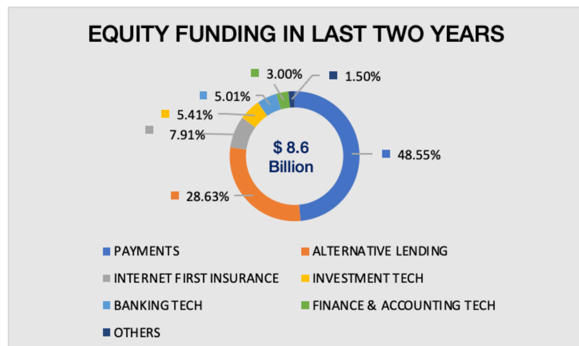
[1] Inspiration – Mian and Sufi (2014).

have tried to articulate – learning from experience elsewhere, and the Indian environment, the unsecured personal credit segment merit scrutiny for various policy purposes.

In this article, Retail Credit is essentially non-corporate loans and includes personal credit – loans extended to individuals. Other than a few exceptions like housing loans, they are unsecured or clean loans, uncollateralized by any asset. Consumer durable loans and personal loans for consumption expenditures are the two most important categories.

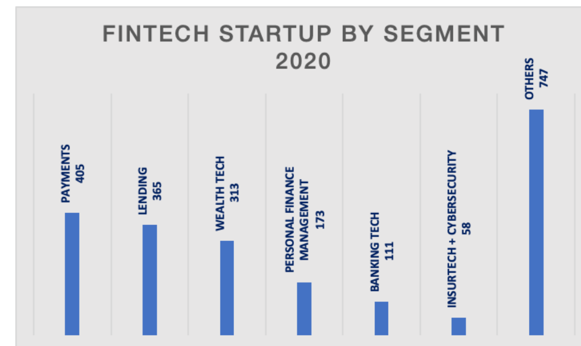
An overview of LendTech (Technology-enabled Lending) or Alternative Lending and the Personal Loans segment in India follows.

FIGURE 1: DISTRIBUTION OF FINTECH FUNDING



SOURCE: EY. SEPTEMBER 2021.

FIGURE 2: FINTECH STARTUPS BY SEGMENT



SOURCE: EXPERIAN 2021.

LendTech is now the second most important segment of FinTech as an equity funding destination and market presence in terms of numbers (**Figures 1 and 2**).

The market remains attractive. PhonePe, a leading Payments player, and Visa and Mastercard building on their existing strengths plan to enter the market in 2022. Though only seven LendTech startups are currently profitable, lender brands disbursing 6,000 or more consumption loans annually registered a 42% growth during 2020.

Estimates of digital lending penetration in India vary. CGAP (Blog. 2021) estimates that there are almost 200 digital consumer credit apps in India, even after Google removed 30 apps from its Play store after complaints of consumer detriments. According to the more recent Report of the Reserve Bank of India (RBI) Working Group on Digital Lending (2021), during the period January 01, 2021, to February 28, 2021, approximately 1100 lending apps were available to Indian Android users across 80+ application stores. The herding seems based on a belief in Say's Law – that supply will create its own demand.

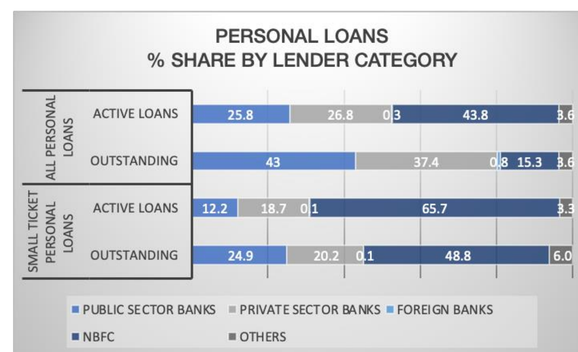
Market share, major products, and providers

1. LendTech's share (0.043% of outstanding and 2.87% of active loans) of total retail loans as of March 31, 2021, is miniscule.
2. Consumer Loans and Personal Loans contribute the most to digital lending (**Figure 3**), irrespective of geographical market segments.
3. Demand for Personal Loans is expected to increase due to the need to bridge the personal finance gap, have a flexible product structure, and provide greater access via digital channels.
4. Non-Banking Financial Companies (NBFCs) lead the market for Small Ticket Personal Loans (STPL, less than Rs. 1 lakh) by volume and value; and for all Personal Loans by number of active loans (**Figure 4**). 45% of all Personal Loan originations come from FinTech NBFCs. Small loans account for 97% of the portfolio of FinTech NBFCs.

FIGURE 3: STATUS OF LOAN CATEGORIES

SOURCE: FINTECH PULSE – VOL III.

FIGURE 4: LENDER CATEGORIES FOR PERSONAL LOANS



SOURCE: CRIF. 2021

Subsequent sections of the article are a bird's eye view of the various contextual issues, concluding with a suggested roadmap for addressing them. Increased consumer awareness of environmental sustainability and digital financial literacy, enhanced regulation and better consumer protection, and the participation of civil society and corporate bodies in the process are the three factors that can help moving in the right direction.

II. When The Bough Breaks

Consumer credit can arguably catalyze growth by increasing consumption and demand, thus boosting income and employment at the macroeconomic level. However, any widespread default due to subprime lending and economic uncertainties can lead to shocks like the 2008 recession. Credit quality is therefore highly relevant in the current pandemic situation.

Household credit and recession are well-researched topics and have several noteworthy studies such as Rajan (2010) and Mian and Sufi (2014). Their focus, however, is on the mortgage market in the USA and the 2008 financial crisis and their theories relate to the larger problem of an economic divide predicted by Galbraith (1958).

The first chapter of Rajan (2010) is titled 'Let them eat credit.' Khang (2019) succinctly lays out Princeton Professor Atif Mian's perspective that excess borrowing is the sign of increasing disparity in household income that has distorted an economic system.

This perspective is worth noting for us given India's high level of income inequality (World Inequality Report. 2018). According to Ghatak (July 2021), growth is necessary but not sufficient for poverty alleviation.

Other analyses across emerging economies provide insights into some of the effects of consumer credit on various economic metrics. A recent study by Garber et al. (2021) reveals the potential downside of using household credit as a stimulus in emerging markets, and how a Brazilian government program to facilitate credit resulted in a substantial rise in borrowing by government employees, particularly those with low financial literacy. Therefore, the recent growth in personal credit in India, whether government sponsored or externally induced, may not be beneficial.

III. There is no planet B (Berners-Lee 2019)

Gross Domestic Product (GDP), the conventional primary measure of economic activity, serves only a limited purpose for short-run macroeconomic analysis and management and does not consider the depreciation of assets – most importantly, the natural environment. This leads to the pursuit of unsustainable objectives that has severely impacted human habitat and should be a cause of concern for all. (The Dasgupta Review. 2021)

The IPCC 2021 report indicates that the clear and present danger from environmental degradation and global warming can no longer be wished away, and two of the 2021 Nobel Laureate physicists jointly won the prize "for the physical modelling of Earth's climate, quantifying variability and reliably predicting global warming." Indeed, the environmental effects and sustainability of mobile networks that form the very backbone of digital transactions are being studied closely by researchers.

Woetzel et al. (2020), National Intelligence Estimate Council (2021), and MoEs, Government of India (2020), to name a few, have highlighted India's grim future that is likely to result from climate change and the need for course corrections. Increased consumerism fueled by easy credit can make things worse.

The 2021 Annual Report of the International Finance Corporation (IFC) highlights the irony that the most vulnerable population of the world stand to suffer the most from climate change despite having contributed the least to it. The vulnerable population of India, currently growing from the impact of COVID, would become the frontline victims of this paradox.

IV. BNPL – Features and Issues

A consumer credit product enabling online and offline purchases at Points of Sale (POS); without paying the full price upfront, BNPL is a tripartite transaction involving the consumer, retailer, and the lender – the BNPL service provider who organizes the funding.

Consumers can purchase products with unaffordable upfront prices and benefit from short term liquidity. This short duration facility is offered purportedly without interest or charges and without rigorous checks on the creditworthiness of consumers, particularly for small value 'sachet' loans. With its ease of availability without the scrutiny associated with other channels, the facility is attractive for subprime and New to Credit (NTC) consumers and the Credit Invisibles (those without a credit history).

The merchant-lender nexus is symbiotic – benefitting the merchant from increased turnover with lower cart abandonment from free credit, consumers typically spending more than usual with BNPL, and repeat purchases. Smaller retailers can compete with price warriors who offer no installment facilities. BNPL providers help direct traffic to their merchant associates through their platforms. The lender benefits from multiple revenue streams – discounts for funding merchants, delay payment charges from consumers, advertising revenue from merchant partners, and white label services fees from merchants providing the facility in their own names.

BNPL can be seen through two different lenses, giving it a duality. Its virtues are sometimes extolled in hyperboles without considering the nuanced aspects. The skeptics call out the enticement to overspend in pursuit of wants rather than needs, hidden costs, and the impact of default on credit rating and debt collection-related stresses.

BNPL could also be a sign of impending harms. The Woolard Review (2021) lists several externalities from the growth of BNPL. Consumers may suffer due to promotion of BNPL, their poor understanding of the product, their lack of affordability assessments, and the BNPL provider's uneven treatment of distressed borrowers (HM Treasury 2021, 2).

Other risks identified in the Woolard Review include the BNPL provider and retailer nexus being detrimental for the consumer and the product being sales driven without taking any cognizance of its affordability for the consumer. The access to multiple BNPL providers limits the impact of checks on creditworthiness and carries the potential hazard of stacking up of debts. (p 47-49).

Supply-side actors use instruments such as advertisements to influence consumer behavior. Coupled with low financial literacy, which in the present context extends to digital financial literacy and debt literacy, it creates a toxic combination potentially detrimental for the consumer. (Lusardi and Mitchell 2014; Lusardi and Tufano 2009, Gurun et al. 2016, Dick and Jaroszek 2013). Many of the transaction processes are highly gamified – rewards from purchases often restrict redemption to future purchases. Negative feedback from consumers

indicates a trust deficit, using the product without a full understanding, feeling shortchanged, and regretting using the product.

Credit underwriting processes for digital lending are mostly algorithm-based and subject to Moravec's paradox – algorithms' ability to solve financial calculations without addressing complex ethical perspectives (Johnson et al., 2021). Algorithms can reduce competition and harm consumers (CMA 2021). In the absence of an evaluation of the overall quality of the BNPL book, which will eventually be securitized, there are apprehensions about the consequences of default in the portfolio.

Consumer advocates have highlighted the impact of BNPL on vulnerable populations and the potential for abuse. Cybercrimes pose a significant threat. In the U.K., it has been likened to quicksand (Shaw 2021); in India, it might become a veritable *Chakravyuha*.

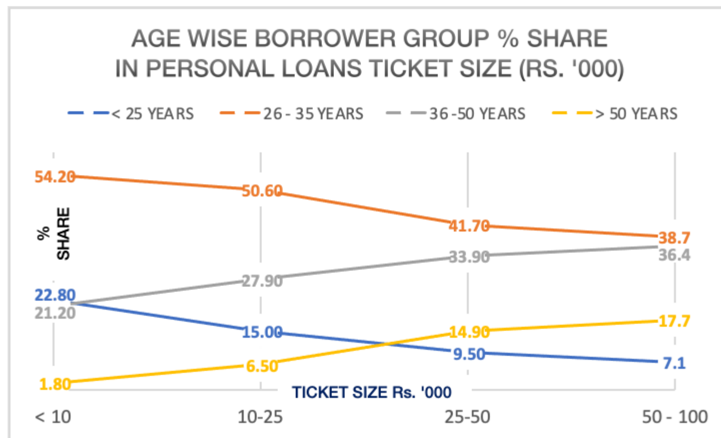
V. Retail Credit in India

The digital lending ecosystem in India is "still evolving and presents a patchy picture" (RBI 2021). Data on the retail credit sector in India available from different sources are disparate. Segmentations are based on different criteria. It is challenging to ensure homogeneity and have a reasonably uniform and comprehensive overview of Retail LendTech trends in India from such a mixed bag of apples and oranges. A few exciting features from which it is possible to draw inferences and test relevant hypotheses for further research nevertheless stand out.

I. *Demand Drivers:* Let us look at two demand drivers: demographics and buying behavior.

i. Demographics: Percentage shares in Loan Ticket sizes and Age Groups are directly correlated (**Figure 5**). Small cities play a big role. 71% of FinTech Personal Loans and 73% of STPL in 2020 originated from non-Tier 1 (population 40 lacs or less) cities. Average ticket size (Rs. 1.3 lacs) for Personal Loans is highest in Tier 4 (population less than 5 lacs) cities against Rs. 1.14 lacs in Tier 1 (population more than 40 lacs). 68% of enquiries for Personal Loans are from NTCs.

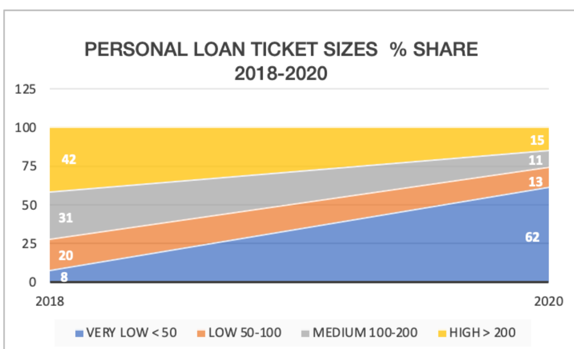
FIGURE 5: AGE GROUP & PERSONAL LOANS TICKET SIZES



SOURCE: CRIF. 2021

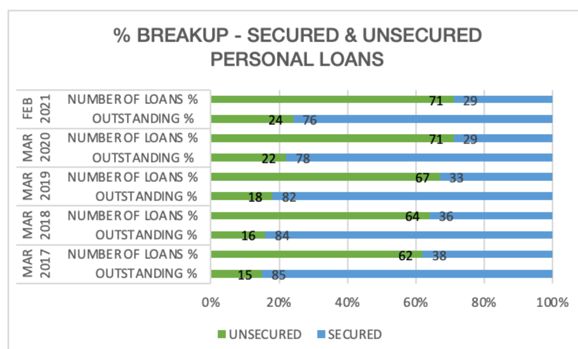
ii. Buying Behavior: The percentage share of unsecured loans has grown from 2017 to 2021 (**Figure 7**). Between 2018 and 2020, the share of STPL (Rs. 50,000 and less) increased by tradeoff with larger sized loans (**Figure 6**). STPL of ticket size Rs. 25,000 and below grew 23 times between 2017 and 2020. Average Ticket Size for Personal Loans from NBFCs (Rs. 15,571) is 75% higher than that for Consumer Loans and 75% of that for all products. 32% of consumers who took a consumption loan changed to a different lender type on their subsequent loan. 45% Growth in average consumption loan taken per borrower since 2017. Lenders are having increasingly larger shares of the loans wallet of consumers. Consumers are conscious about repayment obligations – personal loans generally have the highest payment priority among unsecured loans. Loan aversion is also common among some.

FIGURE 6: PERSONAL LOAN TICKET SIZES



SOURCE: EXPERIAN. 2021

FIGURE 7: SECURED & UNSECURED LOAN MIX



SOURCE: EXPERIAN. 2021

Inferences from Demand Drivers:

1. Despite their higher pricing, the demand for Unsecured Loans is the highest due to easy availability for short-term income expenditure mismatches. This can lead to unsustainable indebtedness in the long run.
2. Increase in small ticket borrowings and growth in average consumption loan per borrower can indicate indebtedness of consumers with lower income (and hence lower financial literacy) and higher probabilities of default.
3. Switching lenders can indicate overleveraging from stacking of loans and perpetual indebtedness.
4. Higher demand from smaller towns (with higher likelihood of lower financial literacy) and younger consumers (which would include a cohort with lower financial literacy) can be due to lower financial literacy and influencer impact of advertisements.

II. Supply Trends

i. Lender Risk Appetite: Digital First' FinTech' NBFCs account for the largest shares of below prime and NTC borrowers. Share of STPL prime and near-prime borrowers increased from 20 to 37% and 9 to 36% between 2017 to 2020. Share of the portfolio in the very high-risk segment (consumers who have moved from above subprime segment to subprime segment in the next 6 months) had increased for credit cards and personal loans even between 2018 and 2019.

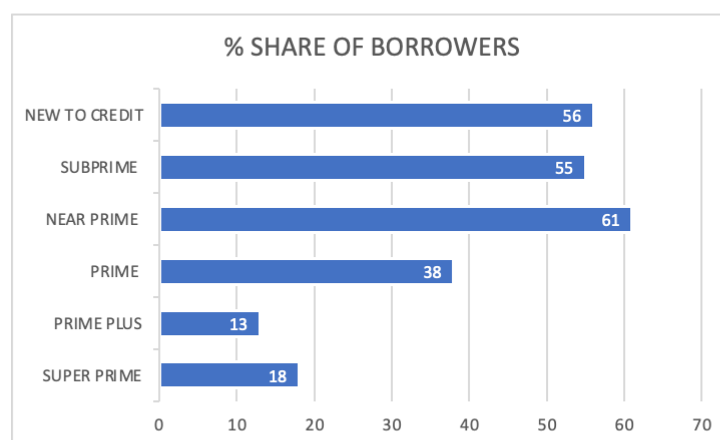


FIGURE 8: FINTECH BORROWERS ACROSS RISK PROFILE

SOURCE: TRANSUNION CIBIL – GOOGLE. 2020

ii. Asset Quality: STPL delinquencies are higher than that for Personal Loans; a trend that is more pronounced in 2021, presumably as a fallout of the pandemic (**Figure 8**). FinTech Personal Loan delinquencies (5.92%) were almost double the overall delinquencies for FinTech lending (3.08%) between March 2020 and March 2021. Asset quality for unsecured products is likely to be impacted more severely than asset backed products. Personal loans and credit cards are likely to be impacted most.

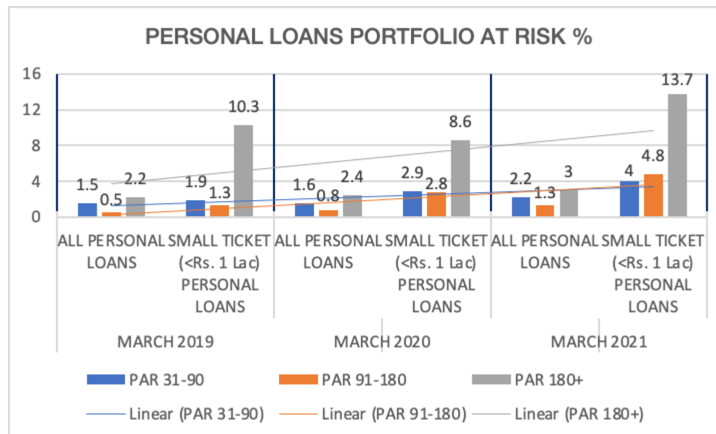


FIGURE 9: PERSONAL LOANS PORTFOLION AT RISK PROFILE

SOURCE: CRIF. 2021

iii. Pricing: Pricing in the personal loan segment is the most attractive for lenders, average spread being 5.85% over 3-year G-Sec rates (2019 Estimates).

Inferences from Supply Trends

1. There is an increased risk appetite of lenders (mostly NBFCs) due to technology-enabled underwriting and their objective of increasing market shares.
2. There is aggressive marketing of personal loans (a more profitable product) that increases delinquencies.
3. Increased delinquencies can lead to aggressive collection and recovery processes, resulting in consumer detriment.
4. Increased competition and losses from overcrowding of lenders can lead to predatory lending and lack of transparency and increase subprime lending and delinquencies.
5. There is no risk-based differential pricing to help preserve asset quality.

VI. Consumer detriment – the Indian experience

Several media reports that would make stones weep have described the unfortunate outcome of defaulting on personal loans availed through some digital channels. . These were priced usuriously with annualized interest

rates from 360% to 1,200%. Recovery processes include debt-shaming and other harassment (Duflos et al. August 2021). Approximately 55% loan apps available in India are illegal (RBI. 2021) and the process of initiating actions against them has been painfully slow.

Official channels for grievance redressal are onerous and advisories on illegal financial activities based on the principle of *caveat emptor*. Abusive collection practices have been reported on social media. A separate mechanism for redressal of complaints relating to digital payments does not include any provision for digital lending *per se*.

VII. Action Points

Based on the inferences drawn earlier, I have given below a suggested approach for implementing a set of interventions for consideration by policymakers and stakeholders to mitigate potential consumer detriment. There are obvious overlaps that reinforce the need for working in a synchronized manner.

1. According to Prasad (August 2021), while private sector players work on building critical business enablers, governments are responsible for the oversight of risk management and fair business practices.
   a. Regulators and Supervisors should:
      i. Strengthen relevant regulatory framework for LendTech, supervise cybersecurity, and leverage innovative technology for supervision (SupTech) for enhancing consumer protection. Consumer Lending should be included among the cohorts for the Regulatory Sandbox process of the Reserve Bank of India (RBI).
      ii. Initiate financial literacy and consumer protection campaigns.
      iii. Ensure that institutions do not become systematically important.
   b. Monetary policy authority should ensure optimal flow of credit.
   c. Government should:
      i. Provide regulatory framework and advocacies for responsible consumption, internet and telecom policies, and cybersecurity; and monitor I.T. enabled processes like online algorithms, and media campaigns.
      ii. Notify and implement the provisions for individual bankruptcy under the Insolvency and Bankruptcy Code (IBC), 2016.
      iii. Improve medical infrastructure to help mitigate distress borrowing for medical emergencies; and promote green transport initiatives like bicycle lanes and mass transport systems.

2. Corporate and civil society should carry out advocacies and provide necessary enablers for consumer protection, financial literacy programs, and environmental awareness, with technology support wherever possible.
3. Self-regulatory bodies like the Advertisement Standards Council of India (ASCI) should ensure that advertisers do not act perfunctorily to ensure compliance and just pay lip service – celebrities should endorse products responsibly. Financial institutions can join initiatives like 'The Principles for Responsible Banking'.
4. Development partners and corporate should promote initiatives for affordable finance. Development partners can play an influencer role in strengthening regulatory and supervisory processes for consumer protection; and ensure that funding for FinTech has an inclusive impact at the Bottom of the Pyramid.

VIII. "The discipline to draw on Nature sustainably must, ultimately, be provided by us as individuals." (The Dasgupta Review 2021).

Opinions about whether personal credit is desirable often have a moral perspective and border on the extremes. While the classic sermon has been to cut one's coat according to one's cloth, in an economy focused on optimum utilization of resources, credit cannot be labeled as evil, necessary or otherwise.

In ancient India, typically associated with asceticism, the Lokayata school preached the philosophy of borrowing in pursuit of hedonism. More recent times have seen movies like 'Dawn of the Dead' on the ghoulish face of consumerism. The need therefore is to strike the right balance.

Members of the credit ecosystem acting concertedly can enable consumers who are not adequately equipped, to use credit judiciously for effective management of personal finances. This would promote financial inclusion. The suggested interventions make a long wish-list, but they are not blue-skies – there are parallels, remote and recent, and best practices guidelines.

From the philanthropic lending of 1890s in the USA inspired by the monti di pietà of the Middle Ages (HBR. n.d.) to initiatives in current times by The Financial Times (https://ftflic.com/), and Experian (April 2021) to serve disenfranchised and vulnerable groups; corporate have contributed to consumer support. "Companies can easily add a debt literacy component to employee assistance program."; and have an internal credit support program (Lusardi and Tufano 2009).

And the romantically inclined social crusader may draw inspiration from the story of Budhu (Corbett 2018, 142-147).

Role of Technology

The need for being digitally literate raises the bar for financial literacy. Technology enabled personal financial management tools can help consumers but should be affordable. "Credit counselling provides a safety net for poor financial literacy" (Disney et al. 2015) and can complement it. There is no thumb rule for 'excessive borrowing' (the Debt-to-Income Ratio used as a benchmark must be contextualized for the borrower) and counselling can help provide customized answers. Credit counselling initiatives like those for farmers should be available for individuals as well. Civil society can catalyze this by leveraging technology (Duflos et al. 2021).

Globally, the clarion call is for appropriate regulations. While the Open Credit Enablement Network (OCEN) is expected to democratize credit in India, several important initiatives in the pipeline need to be implemented on priority basis to strengthen the regulatory framework.

RBI's initiative for proactive supervision (RBI 2021) is an encouraging development. Using SupTech in line with global practices (e.g., Broeders and Prenio 2018; Discussion Note. World Bank Group. June 2018; Fintech Note No. 7. World Bank Group. 2020; FinCoNet. 2020; OECD 2021) can enhance its robustness.

Digitalized financial advertising needs specialized regulation and supervision. This can be supported by leveraging technology and developing internal expertise. (FinCoNet. November 2020; Duflos et al. September 2021). Organizations like the Digital Lenders Association of India (DLAI) can play a critical role.

The Report of the Working Group (RBI. 2021), taking cognizance of many of these issues has recommended a phased approach for addressing the issue in a holistic manner. One of the key recommendations is enacting separate legislations and imposition of statutory provisions for strengthening the oversight of digital lending in India.

Last but not least, development funders may be able to create sustainable and inclusive fintech markets through strategic investment decisions and promote responsible lending (Baur-Yazbeck 2021; Murthy and Faz 2021).

The issues related to personal credit are multifaceted. Only a long-term balanced approach can help consumers benefit from credit while avoiding over-indebtedness.

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