

THE REGULATION OF DIGITAL CREDIT IN KENYA: THE CASE FOR CONSUMER PROTECTION

Submitted in partial fulfillment of the requirements of the Bachelor of Laws Degree, Strathmore
University Law School

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March 2018

DECLARATION

I, MITHEU JOY MAKENA, do hereby declare that this research is my original work and that to the best of my knowledge and belief, it has not been previously, in its entirety or in part, been submitted to any other university for a degree or diploma. Other works cited or referred to are accordingly acknowledged.

Signed:

Date:

This Dissertation has been submitted for examination with my approval as University Supervisor.

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Contents

DECLARATION	i
DEDICATION	iv
ACKNOWLEDGMENTS	v
LIST OF ABBREVIATIONS	vii
LIST OF STATUTES	viii
1. INTRODUCTION	1
1.1 BACKGROUND OF THE STUDY	1
1.2 STATEMENT OF PROBLEM	5
1.3 RESEARCH HYPOTHESIS	5
1.4 STATEMENT OF OBJECTIVES AND RESEARCH QUESTIONS	5
1.5 JUSTIFICATION OF THE STUDY	6
1.6 LITERATURE REVIEW	6
1.7 CHAPTER BREAKDOWN	9
2. THEORIES OF REGULATION	11
2.1 INTRODUCTION	11
2.2 ECONOMIC THEORY OF MARKET FAILURE	12
2.3 THE CASE FOR CONSUMER PROTECTION	14
2.3.1 <i>RISK BASED APPROACH</i>	16
2.3.2 <i>PRINCIPLE BASED APPROACH</i>	18
3. RISK OF DIGITAL CREDIT AND CONSUMER PROTECTION CONCERNS	20
3.1 INTRODUCTION	20
3.2 THE RISK OF OVER INEBTEDNESS	20
3.3 CAUSES OF OVER INDEBTEDNESS	22
3.4 REGULATORY FRAMEWORK IN KENYA	28
3.5 CONCLUSION	31
4 REGULATION OF DIGITAL CREDIT IN INDIA	34
4.1 THE INDIAN DIGITAL MARKET	34
4.2 THE REGULATORY FRAMEWORK	34
4.3 CONCLUSION	38
5 A REGULATORY FRAMEWORK FOR DIGITAL CREDIT	40
5.1 INTRODUCTION	40
5.2 RECOMMENDATIONS	40

5.3	CONCLUSION.....	43
	BIBLIOGRAPHY	44

DEDICATION

To those unserved and underserved by the formal financial institutions.

ACKNOWLEDGMENTS

Praises and thanks to God for his able guidance and strength throughout this period.

A special note of thanks to my Supervisor Dr. Malala for the guidance and support and for being an inspiration.

My sincere gratitude to Mr. Victor Nzomo for his insight.

Special thanks to Mum and Dad for believing in me and supporting me.

To my sisters, Twiri and Kiki, thank you for stress eating with me.

ABSTRACT

This dissertation seeks to make a case for consumer protection for digital credit. Digital credit is a form of lending of short term loans while leveraging digital infrastructure. Digital credit is automatic and easily accessible even to those unserved and underserved by the formal financial institutions. Digital credit is therefore a technological tool of financial inclusion. However, if digital credit is not properly regulated, there are chances of the consumers being exploited. This is because of the vulnerable nature of the consumers who are unbanked, poor and financially illiterate. There are various consumer risks that arise as a result of digital credit. The risk of over-indebtedness is the focus risk of the dissertation. The dissertation also makes a comparison with India's regulatory framework given the rampant use of digital credit in the country and the economic similarity of Kenya and India. The dissertation finally gives a regulatory framework that can be adopted in Kenya to protect these consumers.

LIST OF ABBREVIATIONS

APR – Annual Percentage Rate

CBA- Commercial Bank of Africa

CBK- Central Bank of Kenya

COFEK- Consumer Federation of Kenya

FCA –Financial Conduct Authority

KCB – Kenya Commercial Bank

MNO- Mobile Network Operators

MVNO- Mobile Virtual Network Operators

P2p- Peer to Peer Lending

RBI- Reserve Bank of India

SMS – Short Message Service

USSD- Unstructured Supplementary Service Data

LIST OF STATUTES

Constitution of Kenya (2010).

Consumer protection Act No 46 of 2012.

Competition Act No. 12 of 2010.

Kenya Information and Communications (Consumer protection) Regulations, 2010.

Banking Act and Banking (Increase of Rate of Banking and Other Charges) Regulations of 2006.

1. INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Financial services are an important aspect of an economy. This is evidenced by the fact that the global economy as well as the national economies have set out initiatives to eradicate poverty and one of the ways of achieving this is by developing a financial sector and making the services available to all.¹ The role of the financial sector is to allocate resources within the market. However only a small percentage of Kenya's population are able to access the formal financial services.² Poverty is more than lack of income and one of its manifestation is exclusion from formal financial services.³ One way of ensuring that economic growth in a country is inclusive is through financial inclusion.⁴ The initiative by the Kenyan government through the blue print vision 2030 is to reduce the share of population without access to finance from 85% to below 70%.⁵ Those who have been formerly excluded, the poor, the unserved and underserved should be able to access financial products through financial inclusion.

Financial inclusion refers to all initiatives to make formal financial services available, accessible and affordable to all segments of the population.⁶ The initiatives are supposed to target the section of the population that has been historically excluded for various purposes. The people who belong to this segment are referred to as the underserved or the unserved. Efforts of financial inclusion require that institutions tap into the potential of this population by providing financial services to them.⁷

Efforts to deepen financial inclusion can and should be undertaken by private institutions. The private companies should be involved in creating market based solutions to the world's poorest

¹ UN 2030 agenda for sustainable development, sustainable development goal 1.

² World Bank Financial inclusion data/Findex <http://datatopics.worldbank.org/financialinclusion/country/kenya> on 22 January 2017.

³ UN sustainable Development goal 1.

⁴ Adalesossi K, 'The level of financial inclusion in the African countries and the world group regions' 14(3) China-USA Business review 2015, 1.

⁵ Kenya vision 2030 development blue print

⁶ Triki T and Faye I, 'Financial inclusion in Africa' African Development Bank 2013, 25 -- https://www.afdb.org/fileadmin/uploads/afdb/Documents/Project-and-Operations/Financial_Inclusion_in_Africa.pdf on 22 January 2017.

⁷ Prahalad CK, *Fortune at the bottom of the pyramid*, Wharton School Publishing 2nd ed, Upper Saddle River, 2009,

consumers, those at the bottom of the pyramid.⁸ The bottom of the pyramid refers to those who are unserved or underserved by the large organized private sector in this case, the financially excluded.⁹ Serving them demands innovation in technology, products and services as well as business models.¹⁰

Kenya has experienced technological innovation in the financial sector, especially the business of lending through digital credit. Most Kenyans, before the introduction of digital credit relied on informal lenders (shylocks) as well as relatives and friends for credit.¹¹ The banking business only provided services to the rich or those with collateral and could afford to pay the fees charged and access the bank branches. The banking institutions did not therefore have an incentive to serve the poor as the products were not only expensive but also not accessible to these persons. However the introduction of digital credit has revolutionized this. Digital credit is a product offered under digital finance that involves limited in person contact and leverages digital infrastructure.¹² The product relies on digital infrastructure to receive loan applications, determine creditworthiness of borrowers, approve the loan, disburse the funds and receive payment.¹³ Products that rely on digital infrastructure for the whole or even part of the process are referred to as digital credit products.¹⁴ The digital infrastructure used by these products coupled by the convenience has enabled its high demand in the market.¹⁵

There are four main characteristics of digital credit. First, the loan eligibility is enabled by existing digital access.¹⁶ One need not have a bank account or credit history to receive a loan. Most products require that the borrowers have existing subscriptions to mobile phones or mobile money services as well as social media accounts.

⁸ Prahalad, *Fortune at the bottom of the pyramid*, 5.

⁹ Prahalad, *Fortune at the bottom of the pyramid*, 6.

¹⁰ Prahalad, *Fortune at the bottom of the pyramid*, xv.

¹¹ Mutunga A, 'Mobile loan game the new shylocks' Nairobi Business Monthly 7 January 2016 - <<http://www.nairobibusinessmonthly.com/mobile-loan-game-the-new-shylocks/>> on 10 January 2017.

¹² The proliferation of digital credit deployments, Public disclosure authorized brief, World Bank 2016 - <<http://documents.worldbank.org/curated/en/830661467994632311/pdf/106035-BRI-PUBLIC-KNOWLEGDE-NOTE-Brief-Proliferation-of-Digital-Credit-Deployments-Mar-2016-1.pdf>> 23 January 2017.

¹³ The proliferation of digital credit deployments, Public disclosure authorized brief.

¹⁴ Introduction to digital credit, CGAP.

¹⁵ Malala J, 'Consumer Protection for Mobile Payments in Kenya: An Examination Of The Fragmented Legislation and The Complexities It Presents For Mobile Payments,' WPS/02/14 KBA Centre for research on financial markets and policy working paper series, 3.

¹⁶ Hwang B, Four common features of emerging digital credit offerings, CGAP 2016 - <<http://www.cgap.org/blog/four-common-features-emerging-digital-credit-offerings>> on 23 January 2017.

Secondly, loan decisions are based on non-traditional data and are automated.¹⁷ There is an approach taken by the digital providers that all data is credit data.¹⁸ They use alternative algorithms in determining creditworthiness of borrowers who lack a credit history. The data used is data such as mobile phone usage, mobile payment usage, airtime usage, as well as information from the social media accounts. This process substitutes manual decision making process. The third characteristic is that the loans are instant.¹⁹ This is due to the fact that the decision to offer the loan is automated. The money is often disbursed within five minutes of request if the borrower qualifies for a loan. This makes it fundamentally different from loans offered by traditional banks that take a long time to be approved.

The fourth factor is that the loans are short term and high risk due to the target market²⁰. The products are offered to the unbanked population who lack credit history and collateral and therefore offering the products to them makes the products pricy. The short term nature is also due to the fact that these loans are taken out during emergencies or as the consumers await for the next month salary.

Digital credit in Kenya is offered through four business models. The most common and the pioneer business model is the partnership of banks or microfinance institutions and mobile network operators (MNO).²¹ The MNOs offer credit algorithm from data they get through know your customer requirements. They use the data they have on their customers to develop a system that determines creditworthiness. Secondly the MNOs act as channels of disbursing the loans, collect the loans and interact with the clients. The banks or financial institutions run the customers' accounts, offer the capital used for lending and take the high risk of lending. Examples of such partnerships includes Safaricom M-Pesa and Commercial Bank of Africa (CBA) to provide M-Shwari, Safaricom M-Pesa and Kenya Commercial Bank (KCB) to provide KCB-M-Pesa loans and Airtel Money and Faulu Bank to offer Kopa chapaa loans.

¹⁷ Hurley M and Adebayo J, 'Credit scoring in the era of big data' 18(2) Yale Journal of Law and Technology 2016, 148.

¹⁸ Hurley M and Adebayo J, 'Credit scoring in the era of big data' 148.

¹⁹ Review of digital credit products in India, Kenya, Nigeria, Tanzania and Uganda, Evans school policy and research EPAR technical report 351a.

²⁰ Kaffenberger M and Chege P, Digital credit in Kenya, time for celebration or concern? CGAP 2016 - <<http://www.cgap.org/blog/digital-credit-kenya-time-celebration-or-concern>> on 23 January 2017.

²¹ Francis E and others, Digital credit in emerging markets: a snapshot of the current landscape and open research questions, Bill and Melinda Gates foundation, 2017, 5.

The second business model is application based digital credit. This involves companies offering loans in their own name without partnership with a financial institution.²² The providers require the borrowers to install an app and to provide their social media accounts. The application monitors the mobile phone and mobile money usage as well as social media usage. From this data they are able to determine the creditworthiness of the borrowers. Examples of such lenders in Kenya include Tala, Branch and Saida loans.

Peer to peer lending (p2p) is the third business model used in Kenya. This business model is not as rampant as it is in other parts of the world. P2p lenders are an online platform that link lenders and borrowers. They do not lend money but they facilitate the lending process. Such companies in Kenya include Zidisha and Kiva Loans

The last business model, though not common is a bank offering digital services. This emerged as a result of the CBK licensing Mobile Virtual Network Operators (MVNO).²³ The banks do not need partnership with mobile network operators as they develop their own digital infrastructure. An example is Equity Bank, through Equittel. Their telecommunication infrastructure is a lease from Airtel Kenya.

The diversity in digital credit as well as product innovation is evidence of efforts to provide access to credit to the unbanked population with an aim to deepen financial inclusion. Financial inclusion goes beyond improved access to credit and encompasses a well-functioning infrastructure that allows individuals access to credit whilst protecting their rights. Digital credit is a disruptive form of innovation that operates outside the ambit of regulation. In fact some have argued that the lack of stringent regulations in Kenya has been one of the reasons for the success of mobile money. However, offering of credit to these vulnerable persons needs to be regulated to avoid the unintended consequences such as over-indebtedness which is a cause of poverty. In addition digital credit can be an enabler for the consumers to access formal financial services. However if the lending is not overseen, there are chances of predatory lending where the consumers are unable to pay giving them bad scores and thus diminishes all opportunities of accessing formal financial

²² Francis E and others, Digital credit in emerging markets: a snapshot of the current landscape and open research questions, 5.

²³ Mugo M and Kilonzo E, Community- level impact of financial inclusion in Kenya with particular focus on poverty eradication and employment creation, Central Bank of Kenya, 2017, 13.

services. Thus if such lending is not overseen, then companies will be making profit at the expense of consumer rights which is parallel to the efforts of financial inclusion.

1.2 STATEMENT OF PROBLEM

The World Bank describes mobile money as a success field and equally a regulatory minefield. Among the many legal issues regulators have to deal with is consumer protection. Digital credit is a type of consumer financial product and therefore its regulation should factor in consumer protection. Consumer protection should also be particularly of interest to regulators due to the type of consumers of this service. The consumers are vulnerable borrowers susceptible to exploitation. An issue arises as to how to protect these consumers from the various forms of exploitation they are likely to face. The question is not only how to ensure consumer protection but also who has the responsibility to do so seeing that the product is a result of interconnected industries.

1.3 RESEARCH HYPOTHESIS

- I) If digital credit is not properly regulated, it can easily exacerbate poverty levels through exploitation of vulnerable consumers.
- II) Regulation of digital credit will enhance financial inclusion and lead to decline of poverty levels among its consumers.

1.4 STATEMENT OF OBJECTIVES AND RESEARCH QUESTIONS

This research paper generally seeks to inquire whether there is need for government intervention through regulation in order to protect the borrowers of digital credit. The following is the statement of objectives of this research paper:

- a) To obtain a better understanding of the digital credit sector in Kenya.

Digital credit is a new form of offering credit to the unbanked through a digital platform. Understanding the digital finance sector in Kenya will help us understand why it is a preferred financial product and the challenges faced by the consumers. Digital credit success as well as the failure in other countries such as India will help us contextualize the problem of digital credit. The

research also seeks to determine the proper regulatory framework that enhances financial inclusion. The research questions are;

- I) What is the balance between access to credit and risk of default?
- II) What is the role of digital credit in financial inclusion?
- III) What challenges are the consumers of digital credit facing?
- IV) What has been the experience of other countries?
- V) Is there an existing gap on regulation?
- VI) What is the proper regulatory framework?

1.5 JUSTIFICATION OF THE STUDY

‘The volatile combination of profit seeking companies with minimal competition and vulnerable ill informed, ill-educated borrowers has opened up dangerous potential for exploiting the poor.’²⁴ The difference of capabilities and bargaining power of these parties’ calls for an intervention by a third party, the government in the form of regulation to protect the consumers. This paper seeks to identify the consumer risks that arise from digital credit and how the government can use regulation to minimize or prevent the risks. This ensures the benefits of financial inclusion are reaped.

1.6 LITERATURE REVIEW

Donovan defines poverty as more than a lack of money; it involves the lack of access to instruments and means through which the poor could improve their lives.²⁵ Financial exclusion is a barrier to a country’s economic development and there is therefore a need to build inclusive financial systems.²⁶ This can be achieved by companies targeting bottom of the pyramid customers to achieve inclusive banking and in turn achieve inclusive growth.²⁷ Mugo and Kilonzo point out that there is a positive linkage between financial inclusion, poverty reduction and sustainable

²⁴ Karnani A, ‘Regulate Microcredit to protect borrowers’ Ross School of Business Working Paper, Working Paper No. 1133 September 2009.

²⁵ Donovan K, ‘Mobile Money for financial inclusion’ World Bank overview <http://siteresources.worldbank.org> on 1 February 2017.

²⁶ Access to finance and development, World Bank Finance for all? Policies and pitfalls in expanding access, 21 -< http://siteresources.worldbank.org/INTFINFORALL/Resources/4099583-1194373512632/FFA_ch01.pdf> on 1 February 2017.

²⁷ Prahalad, *Fortune at the bottom of the pyramid*, 20.

growth.²⁸ It is only by delivering financial services to the poor that they can be brought within the ambit of mainstream economic activity.²⁹ Financial inclusion allows for capital accumulation and asset building that enables the poor to reduce their vulnerabilities to poverty.³⁰ In his first chapter, prahalad talks of the need for access to credit from an organized sector. This allows people to build equity and escape usurious money lenders and continuous struggle with poverty.³¹

Private institutions can and should be able to serve those at the bottom of the pyramid. Prahalad writes that the very poor represent resilient entrepreneurs and value conscious consumers.³² What is needed is a better approach to help the poor, an approach that involves partnering with them to innovate and achieve sustainable win-win scenarios where they are actively engaged and at the same time the companies providing the goods and services are making profits.³³ Financial institutions do not serve this segment of the population therefore an innovative means to offer credit to the poor has to be adopted.

Access to credit by the poor was an idea pioneered by Mohammed Yunus through the Grameen Bank.³⁴ In his book, *Banker to the poor*, he describes how little money brought so much joy to the poor and he thus decided he wanted a better arrangement of giving money, an institutional arrangement that poor people could find whenever they needed money.³⁵ He was of the idea that the poor need the money to carry out economic activity, to buy raw materials and supplies. The purpose of lending money to the poor is to free them from money lenders who lend capital at usurious rates.³⁶ The banks in Bangladesh often refused to grant loans to the poor because the loan amounts were too small and they were illiterate to even fill loan application forms in the first place.³⁷

²⁸ Mugo M and Kilonzo E, Community- level impact of financial inclusion in Kenya with particular focus on poverty eradication and employment creation, 2.

²⁹ http://shodhganga.inflibnet.ac.in/bitstream/10603/35262/11/11_chapter2.pdf on 1 February 2017.

³⁰ Mugo M and Kilonzo E, Community- level impact of financial inclusion in Kenya with particular focus on poverty eradication and employment creation, 2.

³¹ Prahalad CK, *Fortune at the bottom of the pyramid*, 22.

³² Prahalad CK, *Fortune at the bottom of the pyramid*, 25.

³³ Prahalad CK, *Fortune at the bottom of the pyramid*, 24.

³⁴ Yunus M with Jolis A, *Banker to the poor, the story of the Grameen bank*, Aurum press limited, 25 Bedford avenue, London, 1998.

³⁵ Yunus M with Jolis A, *Banker to the poor, the story of the Grameen bank*, 143.

³⁶ Yunus M with Jolis A, *Banker to the poor, the story of the Grameen bank*, 144.

³⁷ Yunus M with Jolis A, *Banker to the poor, the story of the Grameen bank*, 144.

Prahalad argues that active engagement of the bottom of the pyramid markets require a new and innovative approach to business.³⁸ He is of the opinion that the mere act of using the same business models that are used in developed markets does not work. Enabling access to credit to the poor requires departing from traditional banking methods as Grameen Bank does. The point according to Yunus is to be a banker to the poor through innovative ways.³⁹ Technological innovations are a very important way of enabling access to credit as technology reduces transactional costs making credit cheaper for the poor.⁴⁰ As per Donovan, mobile phones have the potential to develop more affordable and further reaching microcredit products.⁴¹ In addition they also provide an opportunity to deepen financial inclusion by reaching the unbanked. The paper by Yousif and others notes that use of mobile technology is likely to reduce operational and infrastructure costs required to offer credit.⁴²

Many microfinance institutions have tried to tap the unmet demand for credit however take up has not been so high due to the high transaction costs that translates to credit. However the G20 financial inclusion expert group reports that technology innovations have the capacity to reduce costs, increase efficiency as well as reach the unbanked population⁴³ Digital credit has therefore emerged as an alternative to offering short term loans. The proliferation of digital credit marks an important development in financial inclusion, building on and extending services beyond digital payments and promising to reach the poor at large scale.⁴⁴

In addition to achieve financial inclusion, the offering of digital credit needs to be properly regulated. From a Biblical perspective, if you lend money to the poor, you shall not extract interest from him.⁴⁵ This is a form of regulation that prevents exploitation of the poor by the lenders. Karnani, in the Michigan working paper, is of the view that the combination of volatile borrowers and lenders seeking profit has led to the potential dangerous exploitation of the poor thus the need to regulate microcredit.⁴⁶ According to Mohammed Yunus, microcredit was created to fight the

³⁸ Prahalad CK, *Fortune at the bottom of the pyramid*

³⁹ Yunus M with Jolis A, *Banker to the poor, the story of the Grameen bank*,

⁴⁰ The future of financial services, how disruptive innovations are reshaping the way financial services are structured provisioned and consumed, World Economic Forum industry project of the financial services community, 2015, 85.

⁴¹ Donovan K, 'Mobile Money for financial inclusion' World Bank overview.

⁴² Yousif F and others, 'Best Practices in Mobile Microfinance.' Grameen Foundation

⁴³ G20 High level principles for digital financial inclusion.

⁴⁴ Hwang B and Tellez C, The proliferation of digital credit deployments, CGAP World Bank authorized brief, 2016.

⁴⁵ Exodus 22:25

⁴⁶ Karnani A, 'Regulate Microcredit to protect borrowers'.

money lender not to become the money lender, which means it was aimed at a social good not exploitation of the vulnerable borrowers.⁴⁷

Regulation is needed to explicitly state the effective interest rate calculated and to describe the loan in a simple language. Karnani points out the need to regulate an interest rate cap for microcredit.⁴⁸ However, according to Fernando, interest rate caps often hurt rather than protect the most vulnerable by shrinking poor peoples' access to financial services.⁴⁹ The counter of Fernando criticism to the presumption given by Karnani is that setting an appropriate interest rate cap will actually expand the availability of microcredit given the monopolistic nature of the industry. Chiumya is of a similar view as Karnani when she notes that regulation and supervision is a way of ensuring provision of financial services to the poor yet economically active, through financially sustainable institutions.⁵⁰

Peter Cartwright additionally notes that a common justification for the regulation of financial services is the need to protect the consumer, particularly the vulnerable consumer.⁵¹ Jason Blechman is also of the view that consumer protection policies are a necessary enabler of financial inclusion, ensuring that the consumers are treated fairly and engendering confidence in financial services.⁵² The availability and accessibility of mobile credit products bring new risks to the most vulnerable financial consumers. The unique nature of digital credit makes sound consumer protection provisions essential.⁵³

1.7 CHAPTER BREAKDOWN

The research contains five chapters. This chapter introduces the research paper.

⁴⁷ Yunus M with Jolis A, *Banker to the poor, the story of the Grameen bank*, 140.

⁴⁸ Karnani A, 'Regulate Microcredit to protect borrowers'.

⁴⁹ Karnani A, 'Regulate Microcredit to protect borrowers'.

⁵⁰ Chiumya C, 'The regulation of microfinance institutions: A Zambian case study.', Unpublished LLM Dissertation, University of Manchester, 2006.

⁵¹ Peter Cartwright, 'The vulnerable consumers of financial services: Law, policy and Regulation.'

⁵² Jason G, Blechman 'Mobile credit in Kenya and Tanzania: Emerging regulatory challenges in consumer protection, credit reporting and use of customer transactional data.'

⁵³ Jason G, Blechman 'Mobile credit in Kenya and Tanzania: Emerging regulatory challenges in consumer protection, credit reporting and use of customer transactional data.'

The next chapter, chapter two provides the theoretical framework through which to examine the research topic. The theories used are the theory of market failure as well as the theory of consumer protection.

Chapter three analyzes the digital credit sector in Kenya. This chapter covers the problem of digital credit giving examples using particular cases that consumers have encountered with the different providers. This chapter also analyzes how Kenya is dealing with the issues arising either through the statutes or regulation.

Chapter four makes a comparative study with India. This is because of the economic similarity of India and Kenya. India has also been used because it has dealt with the problem differently from Kenya. India's fintech industry is highly regulated as opposed to Kenya which is highly deregulated. A comparative study of the two industries will inform the Kenyan policy makers on the best approach. The chapter deals with the digital credit industry in India as well as the regulatory framework.

Chapter five forms a discussion based on the findings of chapter three and four. The chapter interrogates issues such as whether indeed regulation is necessary as a tool to protect the consumers. This chapter gives the conclusion and will establish a regulatory framework.

2. THEORIES OF REGULATION

2.1 INTRODUCTION

Regulation is the use of the law or instruments of the law to implement social and economic policy.⁵⁴ The government uses its authority to compel persons, legal or natural to behave in a prescribed manner failure to which they attract sanctions such as imprisonment, fines and for businesses, revocation of licenses or closing of the business.⁵⁵

Economic regulations deal with the structure of the market such as market entry and the minimum requirements of the market players.⁵⁶ In the case of financial markets, these regulations prescribe who is allowed to offer financial services and a criteria they must fulfill before they are licensed to offer the services. This type of regulation however has been one of the reasons for low financial inclusion as it is a barrier to entry for suppliers of credit. Secondly, with regards to economic policy, regulation is used to prescribe the conduct of business of the market participants.⁵⁷ For instance the setting of price limits and standard quality of goods or services to be offered. For financial services, the regulations may put an interest rate cap as a price limit.

Social regulations deal with non-economic matters such as environmental protection, labor conditions and protection, anti-discriminatory laws as well as consumer protection.⁵⁸ For instance regulation to protect vulnerable consumers of financial services from exploitation. These regulations do not have economic objectives but they do have economic effects such as imposing costs and benefits to the market participants.⁵⁹

Poor regulation is one of the major obstacles of financial inclusion.⁶⁰ Therefore proper regulation is required to ensure the successful adoption of technology by the companies to serve the poor in

⁵⁴ Singh J, *Regulations institutions and the law*, Social science press, New Delhi, 2007, 1.

⁵⁵ Hertog J, 'General theories of regulation' Economic institute Utrecht University, 1999, 223.

⁵⁶ Viscusi W and others, *Economics of regulation and antitrust*, 4th ed, The MIT Press, Cambridge Massachusetts, 5.

⁵⁷ Hertog J, 'General theories of regulation' 224.

⁵⁸ Hertog J, 'General theories of regulation' 224.

⁵⁹ Hertog J, 'General theories of regulation' 224.

⁶⁰ Claessens R and Suarez L, Financial regulations for improving financial inclusion (brief), Task force on regulatory standards for financial inclusion, 2.

the sector of finance. In addition, the steps taken to improve financial inclusion should be compatible with traditional supervision such as ensuring stability of the system, maintaining its integrity and most importantly protecting its consumers.⁶¹ Traditional financial supervision is based on several theories that attempt to rationalize the need for government intervention in the financial markets.⁶² The need to achieve market efficiency which is the economic reason as well as achieving equity and fairness known as the social reasons have been used as the justification of government intervention through regulation. This dissertation discusses the theory of market failure as well as the theory of consumer protection.

2.2 ECONOMIC THEORY OF MARKET FAILURE

This is a normative economic approach to regulation that builds on the concept of economic efficiency. A perfectly competitive market is a market that achieves an efficient outcome.⁶³ However market failure is inherent in markets.⁶⁴ It is the inability of a market or system of markets to provide goods and services in an efficient way.⁶⁵ Markets can fail for four principal reasons.

The first reason is failure as a result of externalities where activities impose external losses or benefits to third parties that the market does not take into account.⁶⁶ The second reason is the offering of public goods which are goods for which consumption of the good by one individual does not retract from that of any other individual.⁶⁷ The third reason is the failure as a result of market power where a single firm or a cartel raises price above the competitive level.⁶⁸ If only one firm or a few firms offer a certain financial product in a situation where competition is limited or not encouraged, they are likely to charge high interest rate as they have the market power.

⁶¹ Claessens R and Suarez L, Financial regulations for improving financial inclusion (brief), 2.

⁶² Hertog J, 'General theories of regulation' 224.

⁶³ Veljanovski C, 'Economic approaches to regulation' in Baldwin R and others (ed), The Oxford handbook of regulation, Oxford University press 2010, 20

⁶⁴ Morey E 'Market failures' 2017, <https://www.colorado.edu/economics/morey/4545/introductory/marketfailures.pdf> on 2nd February 2018.

⁶⁵ Morey E, 'Market failures'

⁶⁶ Veljanovski, 'Economic approaches to regulation' 21.

⁶⁷ Veljanovski, 'Economic approaches to regulation', 21.

⁶⁸ Veljanovski, 'Economic approaches to regulation', 21

The fourth reason which is often a cause of market failure for a financial services market is asymmetric information.⁶⁹ Information is a valuable economic factor more so in financial services markets. It determines where a buyer will allocate his resources for the best quality goods at the lowest price. An efficient market assumes perfect information in the market however markets are characterized by imperfect information. Imperfect information may be as a result of information that is too costly or altogether impossible to find.⁷⁰ Information asymmetry is a situation where one party in a transaction has different or better information than the other.⁷¹

Information asymmetry in financial services markets occur as the lenders have more information than the borrowers regarding the product being offered and the cost implications. Policy makers often justify regulations on grounds that imperfect information exists in consumer markets.⁷² This affects consumer contracts in three ways. The consumers are uninformed about the risks that the contractual terms allocate and thus are unable to choose terms that reflect their preferences.⁷³ Lenders with better information can exploit the consumers' ignorance by offering lower quality goods. Secondly, consumers may lack information on the terms and prices offered in a market and thus accept poor bargains.⁷⁴ This deters companies from offering better deals to the consumers. Lastly the lack of understanding of language used, for example financial terms may give companies an incentive to exploit the ignorance by using 'hidden' terms that would disadvantage the consumer.⁷⁵

Likewise a buyer may have more information about his financial transaction and his financial future than the seller. This creates a situation of moral hazard where one person with opportunity takes advantage of another by taking risks that the other will pay for. Information asymmetry is a

⁶⁹ Veljanovski, 'Economic approaches to regulation', 21

⁷⁰ Shwartz A, 'Unconscionability and imperfect information: a research agenda,' Yale law school faculty scholarship series, 1991, 441.

⁷¹ Veljanovski, 'Economic approaches to regulation', 22.

⁷² Shwartz A and Wilde L, 'Imperfect information in markets for contract terms: the examples of warranties and securities interests,' Yale law school faculty scholarship series, 1983, 1389.

⁷³ Shwartz A and Wilde L, 'Imperfect information in markets for contract terms: the examples of warranties and securities interests', 1389.

⁷⁴ Shwartz A and Wilde L, 'Imperfect information in markets for contract terms: the examples of warranties and securities interests', 1389.

⁷⁵ Shwartz A and Wilde L, 'Imperfect information in markets for contract terms: the examples of warranties and securities interests', 1389.

market failure that needs to be corrected in order to protect both the lenders and the borrowers from unintended consequences.

Market failures provide a justification for government intervention through regulations. Some arguments although suggest that market failures regulations are a necessary but not a sufficient reason for the government to intervene.⁷⁶ The markets are able to generate self-corrective forces which many regulators fail to recognize.⁷⁷ Laws and regulations should only come in if they are a less costly way of organizing the economic activity.

Secondly, regulation to correct market failure is based on the assumption that government is a costless and effective instrument for altering market behaviour. However in practice, regulation is costly and it generates its own distortions and inefficiencies.⁷⁸ Just like the market, government is likely to have failures giving rise to additional inefficiencies in the market.

2.3 THE CASE FOR CONSUMER PROTECTION

The concept of consumer protection is derived from the public interest theory. It is a regulatory response to market failures but it goes beyond that.⁷⁹ It aims at improving the economic as well as the social welfare of the consumers.⁸⁰ Consumer protection measures are to be taken to afford protection to the weaker party. The measures promote and advocate for the consumers' interests. The consumers should be able to derive a benefit and enjoy the benefits of the goods and services they purchase without being exploited by the stronger party.

Previously, consumers of goods and services were protected through law of contracts, doctrine of privity of contracts and through tort law. However this has since changed due to the need to have specific statutory regulations protecting consumers. In Kenya, article 46 of the Constitution provides for consumer rights.⁸¹ Consumers have a right to information necessary to them to gain full benefit from goods and services and the right to the protection of their economic interest.⁸² In

⁷⁶ Veljanovski , 'Economic approaches to regulation', 20.

⁷⁷ Veljanovski , 'Economic approaches to regulation', 22.

⁷⁸ Veljanovski , 'Economic approaches to regulation', 19.

⁷⁹Consumer protection, levelling the playing field in financial inclusion, Alliance for financial inclusion policy note, 2010, 3.

⁸⁰ Section 3(4), Consumer protection Act No 46 of 2012.

⁸¹ Article 46, *Constitution of Kenya* (2010).

⁸² Article 46(1)(2), *Constitution of Kenya* (2010).

addition, pursuant to the article, the Consumer protection Act was enacted that gives further consumer protection measures.⁸³

In a free uncontrolled economy, the consumer determines the goods to be produced, the price, the quality, and how the products are marketed. He is considered to be the sovereign king.⁸⁴ This is known as the concept of consumer sovereignty. The aim of the business should be to satisfy the consumer interests. However consumers are constantly cheated misguided and more importantly exploited.⁸⁵ Consumers are now often the most voiceless and vulnerable people in a market. With regard to digital market, the consumers are the poor, illiterate, unbanked people who are susceptible to exploitation. Therefore the concept of consumer sovereignty is negated and the consumer is constantly at the receiving end. Consumer protection is a measure adopted for the protection of the interests of the consumers from unethical malpractices by business and provides a speedy redressal mechanism for them.⁸⁶ It strives to protect the consumer from all forms and means of unconscionable, unfair, unreasonable, unjust or otherwise improper trade practices including deceptive, misleading, unfair or fraudulent conduct.⁸⁷ Companies offering products to the underserved should not only aim at making profits but should achieve the common good that ensures the consumers are able to access financial services.

Consumer protection is one of the important aspect of regulation of financial service markets. Due to the result of the global financial crisis, consumer protection has become a key and essential aspect of regulation.⁸⁸ It is essential that consumers are protected from abusive practices and enabled to make well informed decisions regarding the use of financial products and services.⁸⁹ A strong consumer protection regime is key to ensure increased access to credit and it ensures that the consumers trust the products being offered. Even in the effort to deepen financial inclusion, there is need to ensure complementary financial consumer protection.⁹⁰

⁸³ Article 46(2), Constitution of Kenya (2010).

⁸⁴ Consumer protection: a theoretical framework <http://shodhganga.inflibnet.ac.in/bitstream/10603/16566/9/09-chapter%201.pdf> on 3rd February 2018.

⁸⁵ ⁸⁵ Consumer protection: a theoretical framework.

⁸⁶ Consumer protection, Module 5 marketing notes, <http://download.nos.org/srsec319new/319EL24.pdf> on 3rd February 2018.

⁸⁷ Section 3(4), Consumer protection Act No 46 of 2012.

⁸⁸ Good practices for financial consumer protection, The World Bank financial inclusion practice, 2012, 2.

⁸⁹ Good practices for financial consumer protection, 1.

⁹⁰ Global financial inclusion and consumer protection survey, 1.

The challenge the regulators are likely to face is the balancing of the interest of consumers by providing consumer protection measures that imposing measures of fair and proper treatment against expanding of financial markets to ensure financial inclusion.⁹¹ Regulation may be costly as it is a barrier to emerging financial markets especially financial technology markets. It is necessary that consumers should be protected however regulators should ensure that the price of regulation is not too costly and that the regulations are not too stringent to prevent innovation and product development.

Countries have taken two approaches in regulating for purposes of consumer protection. They have used the risk based approach to regulation as well as the principle based approach to regulation which have been discussed below. These approaches set the regulatory framework for financial consumer protection.

2.3.1 RISK BASED APPROACH

The G20 Global Partnership for Financial Inclusion (GPFI) published a white paper which recommends a risk based supervision by financial regulators targeting excluded and underserved consumers.⁹² An effective regulation is key to the success of financial inclusion efforts.⁹³

Risk is becoming a significant organizing principle of government and the role of government is being assessed in terms of the identification, assessment and management of risks. Regulation is seen as a form of management of risk.⁹⁴ Risk means that there is a possibility that something undesirable will occur as a result of natural events of human activities.⁹⁵ Therefore it is government's mandate to intervene to prevent the occurrence of the undesirable consequence.

Risk determines the boundaries of the state's legitimate intervention in society. It is the government's role to manage risks and it is justified in intervening in the society in the pursuit of that objective. In the financial sector, there has been an individualization of risks which is an increasing emphasis on the individual's own responsibility for managing risks and an expectation

⁹¹ Global financial inclusion and consumer protection survey, 2.

⁹² Global standard setting bodies and financial inclusion- the evolving landscape, Global Partnership for financial inclusion, consultation document, November 2015.

⁹³ Juan Carlos, Ivo Jenkin, "Risk based supervision in the digital financial inclusion era" CGAP, 26 April 2016, <http://www.cgap.org/blog/risk-based-supervision-digital-financial-inclusion-era> 21 December 2017.

⁹⁴ Black J, 'Role of risks in regulatory processes' in Baldwin R and others (ed), The Oxford handbook of regulation, Oxford University press 2010, 307.

⁹⁵ Black J, 'Role of risks in regulatory processes' 309.

that people will provide for their own financial well-being.⁹⁶ The question therefore is who has the responsibility to bear the risk?⁹⁷ The UK Better Regulation Commission argues that government should wherever possible resist calls for more regulation whenever a risk emerges or comes to public attention. Instead the government should seek to push the responsibility for risk management down to the level of the individual or civil society. They are of the view that government should emphasize the importance of resilience, self-reliance, freedom, innovation and a spirit of adventure in today's society and only intervene if it really is in the best place to manage the risk.⁹⁸

As technology advances, regulation accompanies it in an attempt to manage the risks that are created in the course of innovation.⁹⁹ Regulation is directed towards the minimization of risk posed to health, environment and the financial well-being of people. The object of regulation therefore is defined in terms of the risk posed and the regulation is justified in terms of its role in minimizing the risk.¹⁰⁰ The risk of financial inclusion through digital credit is the exploitation of the vulnerable consumers by profit seeking companies. Digital credit a product offered in the financial services market causes a risk to the financial stability and well-being of these consumers. It is necessary for the government to intervene by coming up with sound regulation that minimize or prevent these consumer risks. Management of these risks should be through consumer protection regulations.

Regulation should be targeted at those who are most at risk and should take into account the opportunity costs of managing the risk.¹⁰¹ Digital credit financial inclusion aims at empowering the unbanked and financially excluded by providing them with financial services. These consumers are poor and illiterate and are at a very high risk of exploitation and other consumer risk. In order to protect these consumers, it is the best place of the government to intervene to level the playing field. In addition poverty eradication is a function of nations and therefore the government is best placed to deal with risks arising from financial inclusion. The opportunity costs of managing the risk however is the creation of a barrier to entry and withdrawal of players from the market due to

⁹⁶ O'malley P, 'Risk, society and crime prevention', 21(3) Economy and society, 1992.

⁹⁷ Risk, responsibility and regulation- whose risk is it anyway? Better regulation commission, 2006.

⁹⁸ Risk, responsibility and regulation- whose risk is it anyway? 2.

⁹⁹ Black J, 'Role of risks in regulatory processes' 308.

¹⁰⁰ Black J, 'Role of risks in regulatory processes' 308.

¹⁰¹ Risk, responsibility and regulation- whose risk is it anyway? 38.

the stringent rules. This reduces the number of lenders offering financial services to the underserved and thus limits the underserved access to credit.

A risk based approach helps regulators to allocate and use scarce resources strategically and to prioritize and adjust the intervention according to properly assessed risks.¹⁰² There are several risks posed by the digital credit product. The G20 in the white paper is of the view that the increasing challenges to effective consumer protection posed by digital financial inclusion and emerging consumer risk support the need for a risk based consumer protection regulation.¹⁰³

2.3.2 PRINCIPLE BASED APPROACH

This an approach that moves from reliance on detailed , prescriptive rules and relies more on high level broadly stated rules or principles to set the standards by which regulated firms must conduct business.¹⁰⁴

Principle based regulations express the fundamental obligations that all regulated persons should observe. They are written in a very general way so that they can be adaptable to different situations especially with technological innovation. In addition, they provide the reasoning behind the principles in order to achieve the outcome intended by the principle. They are therefore referred to as outcome based regulations. The principles allow the regulated a discretion to choose the means that best achieves the outcome sought by the principles. An example of this is the Financial Conduct Authority (FCA) 11 principles of business. One of the principles is the principle customers interest, a firm must pay due regard to the interests of its customers and treat them fairly.¹⁰⁵ Another country that has adopted this is India through the charter rights for consumers issued by the Reserve Bank of India (RBI) that provide for five principles of consumer protection. The standards set in a principle based approach are largely behavioral standards that are concerned with the integrity, skill, diligence and reasonable care with which authorized firms treat customers and manage conflict of interest.¹⁰⁶

¹⁰² Juan Carlos, Ivo Jenkin, 'Risk based supervision in the digital financial inclusion era'.

¹⁰³ G20 high-level principles for digital financial inclusion.

¹⁰⁴ Black J, 'Making a success of principles –based regulation' Law and financial markets review, 2007, 191.

¹⁰⁵ Principle 6, FCA 11 principles for business.

¹⁰⁶ Black J, 'Making a success of principles –based regulation', 193.

The advantage of this approach is that supervisors are able to enforce and to police the spirit of the rules as well as the letter of the rules avoiding issues of creative compliance. Secondly, the flexible nature of the rules anticipate possible situations and are therefore able to deal with future issues that arise as a result of technological advancement as well as product development. In addition it is easy to comply with the principles as opposed to detailed rules therefore reducing costs of enforcing compliance.¹⁰⁷

The approach as mentioned earlier is an outcome approach. It shifts from looking at the processes to be carried out by firms to the outcomes sought to be achieved. The approach if used in digital lending would require lenders to adopt a policy based on the principles given by the regulator without prescribing detailed rules of doing the same. This is based on the idea that firms and their management are better placed than regulators to determine what process and actions are required to achieve a given regulatory objective.¹⁰⁸ The financial services authority gives examples of outcomes expected in consumer protection measures.¹⁰⁹ These are;

- Consumers are provided with clear information and are kept appropriately informed before, during and after point of sale,
- Where the consumers receive advice, the advice is suitable and takes account of their circumstances
- Consumers are provided with products that perform as firms have led them to expect
- Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture

The principle based approach has several criticisms. It is unclear how the regulators measure or expect firms to measure the achievement of these outcomes. Secondly principles are ambiguous as opposed to detailed rules therefore they do not provide certainty which is essential in enforcing legal rights. The counter argument for this criticism however is that certainty of a rule does not depend on whether a rule is detailed or general but whether all who are applying the rule agree on what the rule means.¹¹⁰

¹⁰⁷ Black J, 'Making a success of principles –based regulation', 193.

¹⁰⁸ Black J, 'Making a success of principles –based regulation', 192.

¹⁰⁹ Financial services Authority on treating customers fairly- towards fair outcomes for consumers, 2006.

¹¹⁰ Black J, 'Making a success of principles –based regulation', 194.

3. RISK OF DIGITAL CREDIT AND CONSUMER PROTECTION CONCERNS

3.1 INTRODUCTION

Consumer protection are measures taken to safeguard the customers when dealing with digital credit. Transparency and fair treatment are very crucial when dealing with the unbanked population due to their vulnerable nature. The consumer must be able to understand the commitments they make and the implications of the commitment. The lack of measures facilitating transparency and fair treatment means that the consumers are unable to understand the implications of the product that they purchase. In addition, consumer protection assures fair pricing of financial services e.g. fair interest rates as well as protect the consumer from fraud and misrepresentation.¹¹¹ Unchecked market forces and policies that relax regulation in an effort to open financial markets to serve the bottom of the pyramid can result in consumers that are harmed as a result of financial access.¹¹² The harm caused to the consumers as a result of offering of the digital credit product in an unregulated or deregulated market is what is referred to as the consumer risks. Consumer protection measures encourage the providers of the financial services to compete by offering better products and services rather than exploitation of the poorly informed consumer.¹¹³

3.2 THE RISK OF OVER INEBTDEDNESS

Access to credit is a crucial measure of financial inclusion. In fact, the number of retail loans is used as one of the key indicators of financial inclusion in a country.¹¹⁴ Availability of credit provides the populations with more options to realize economic plans and thus ensure the economic growth of a country is inclusive.¹¹⁵ Microcredit supply is an indicator of financial inclusion. However there are potential risks of rapid expansion of microcredit supply. With microcredit more so digital credit, borrowing has become easier and thus posing a greater risk of

¹¹¹ Malala J, Consumer Protection for Mobile Payments In Kenya: An Examination Of The Fragmented Legislation and The Complexities It Presents For Mobile Payments, 9.

¹¹² Consumer protection: levelling the playing field in financial inclusion, Alliance for financial inclusion policy note 2010, 3.

¹¹³ Malala J, Consumer Protection for Mobile Payments In Kenya: An Examination Of The Fragmented Legislation and The Complexities It Presents For Mobile Payments, 11.

¹¹⁴ Financial Access Survey, International Monetary Fund, <http://fas.imf.org/>

¹¹⁵ Responsible lending: Overview of regulatory practices, The World Bank, 2013, 3.

over indebtedness.¹¹⁶ The impact microcredit has on poverty alleviation may be an illusion and the industry faces increasing criticism for exploiting and in the worst case over indebting poor customers for profit motives.¹¹⁷

Over indebtedness occurs when borrowers owe so much that their loans have made them worse off than they could have been without the loan. Over indebtedness is not necessarily equated to default. It can be that the borrowers repay the loans but they cause so much harm to their financial well-being. The European centre for social welfare defines an over indebted household as one whose existing and foreseeable resources are insufficient to meet its financial commitments without lowering its living standards.¹¹⁸ Digital credit, a form of microcredit is considered a contributor to over indebtedness due to the percentage of people it makes worse off due to the credit it gives. The risks of over borrowing and consequently over indebtedness have been recognized as problems of microcredit. Over indebtedness is ranked as the top consumer concern in the microcredit industry. Over Indebtedness is a serious risk that affects both social impact and industry stability.¹¹⁹ It pushes consumers further into poverty accompanied by consequences of debt such as reduced standards of living.

One of the drivers of over indebtedness is poor financial decision making which is caused by the inadequate understanding of the real cost of repaying loan.¹²⁰ The lack of understanding by the borrowers can be as a result of their financial illiteracy. However it may also be as a result of the lenders lack of transparency on the real cost of the loan. The second reason for over indebtedness as a result of digital credit is poverty that pushes persons not capable of managing their expenses to take loans which they have a very small chance of repaying.¹²¹ The ease of access of digital credit, without the requirement of credit history makes credit available to the very poor consumers who are already in debt. The need of credit for these consumer in the first place arise already from their over indebtedness. They take out loans or multiple loans to repay their loans. This thus creates a viscous cycle for them as the new loan creates a new debt that they have to pay. They end up in

¹¹⁶ Persson A, 'Over indebtedness a growing problem' Stockholm Institute for Scandinavian Law, 2010, 464.

¹¹⁷ Shicks J, 'Microfinance over indebtedness: understanding its drivers and challenging the common myth,' Centre Emile Bernheim working paper 10/048, 2010, 1.

¹¹⁸ Over indebtedness: new evidence from the EU, European Centre for social welfare Research note 4/2010, 2010, 5.

¹¹⁹ Shicks J, 'Microfinance over indebtedness: understanding its drivers and challenging the common myth,' 1.

¹²⁰ Responsible lending: Overview of regulatory practices, 5.

¹²¹ Responsible lending: Overview of regulatory practices, 5.

a mouse maze. Thirdly many over indebted persons face a steady growth of indebtedness due the compound interest effect of the fees charged in the form of roll over fee as well as the harsh penalty charges imposed.¹²²

The characteristics of digital credit products offered in Kenya raise consumer protection concerns. Digital credit just like microcredit poses a risk of over indebtedness to the customers and thus there is a need to mitigate this risk through consumer protection measures. The consumer protection concerns with regard to the Kenyan context are discussed below.

3.3 CAUSES OF OVER INDEBTEDNESS

a) Charging of high interest rate

Where there are vulnerable consumers, it is difficult for profit seeking companies offering the goods and services to exercise self-restraint.¹²³ The lenders of digital credit offer a product to a group of people who would not otherwise be able to access such products. Consequently it is possible to exploit such people by charging high interest rates. The high interest rate is driven by the high risk of offering credit to the underserved.

M-Shwari the leading digital credit provider, charges a facilitation fee of 7.5% per loan per month. If the loan is not paid after the one month limit, the facilitation fee is charged on the outstanding balance. If this is calculated annually, then the loan is charged a facilitation fee of 138% per annum. The consumer Federation of Kenya (COFEK) insists that the facilitation fee is to be regarded as interest fee and consequently CBA Bank is going against s 33B(2) of the Banking Act.¹²⁴ This section denies any bank or financial institution to charge an interest rate in excess of that prescribed by law. The COFEK in October 2016 filed a petition, a class action, claiming infringement of article 46 of the Constitution on the rights of a consumer.¹²⁵ Other digital credit providers also charge a relatively high interest rate in comparison to traditional financial institutions. Tala Loan which is an App based service provider charge a service fee ranging between 11-15% per month.

¹²² Persson A, 'Over indebtedness a growing problem', 464.

¹²³ Karnani A, 'Regulate Microcredit to protect borrowers'.

¹²⁴ Section 33B (2). Banking (Amendment) Act 2016.

¹²⁵ Constitutional petition 404 of 2016.

Interest rate capping is necessary to prevent abuse by profit seeking lenders. The effective interest rates charged on digital credit are very high and thus the loans tend to look like payday loans. The interest rate if calculated in Annual Percentage Rate (APR) is very high compared to alternative sources of credit. In addition, the effective APR is even higher if you repay the loans earlier as the full amount must be paid despite borrowing for a short period of time.¹²⁶ This means that digital credit is very expensive and thus increases the chances of default or inability of the borrowers to repay the loans.

b) Easy access to multiple loans

Due to the nature of the credit being instantaneous the consumers tend to borrow from the various institutions offering digital credit. Multiple borrowing is a means of the borrowers to cobble together the lump sum that they feel they need.¹²⁷ The lenders have no way of knowing that the borrowers have multiple loans from various institutions. Some of the regulated lenders are required to report to the credit rate bureau however the non-financial institutions are not required to report making it difficult for other lenders to know of borrowers' outstanding loans. In addition, when determining creditworthiness, some of these institutions do not incorporate information from the credit rate bureau.

The problem of multiple lending is that the money is used for non-productive use such as meeting emergency needs or lending to family members. This means that the borrowers incur very high costs of the loan and yet they do not invest the credit. Another reason for taking out multiple loans is repayment of existing high interest loans with other lenders. The concept of borrow Peter to pay Paul. This is often in borrowers who are already in debt and are thus trapped in the debt maze.

When borrowers resort to multiple borrowings to smooth the burden, they bear a high cost such as transactional costs and the high interest rates of the loans.¹²⁸ Most take on credit that they are unable to afford. This increases the risk of inability to pay and ultimately the high risk of defaulting. These consumers use the minimal amounts they have that would otherwise be used to

¹²⁶ Kaffenberger M and Chege P, 'Digital credit in Kenya: time for celebration or concern?

¹²⁷ Wright G, 'Have we not been here before with microfinance?' MicroSave blog, <http://blog.microsave.net/digital-credit-have-we-not-been-here-before-with-microfinance/> on 5th February 2018.

¹²⁸ Venkata A and Yamiini V, 'Why do microfinance clients take multiple loans?' Microsave India focus note 33, 2010, 1.

improve standards of living to repay loans. They are thus unable to pay bills and other expenses that sustains their living conditions making them over indebted consumers.

c) Easy access to credit that leads to unintentional borrowing

Intentionality refers to the level of prior consideration of need, costs, and benefits consumers take when choosing to borrow as well as the extent to which they have thought of the purpose of the loan they take on.¹²⁹ Digital credit is automated and instant. This means one can borrow at whatever time and get the money instantly. For example the leading lender's loan volume surges between 3 and 5 in the morning because that is when small-scale traders purchase their stock for the day.¹³⁰ However some consumers may borrow with no intention to use it in a productive venture as the example above. Several consumers take out loans without an intentional purpose and sometimes spend the money on airtime top-up because they have no other use in mind for the loan at the time.¹³¹ Customers also borrow in attempts to “game” the algorithm and increase their loan limits:¹³² They borrow, repay, then immediately borrow again, as they believe that the more you borrow and repay in time, the higher your loan amount increases.¹³³

Unintentional borrowing may also be as a result of marketing approaches taken by lenders. Push marketing such as sending bulk short message service (SMS) is a strategy used by mobile lenders. The SMS's are an attractive form of an invitation to treat where the financially illiterate are likely to respond to. The SMS's are sent to all mobile network operators who did not have the intention of borrowing in the first place. This form of marketing encourages consumers to irrationally borrow money which they do not use for investment. Study shows that some people borrow for the fun of it as a result of the attractive marketing.¹³⁴ These marketing strategies give an incentive for irresponsible borrowing. Push marketing and unsolicited offers are not effective strategies in the long terms because they exacerbate the risk of encouraging borrowing with no purpose.¹³⁵ In

¹²⁹ CGAP Focus Note, 'Consumer protection in digital credit.'

¹³⁰ CGAP Focus Note, 'Consumer protection in digital credit'.

¹³¹ Rafe Mazer, Alexander Fiorillo, 'Digital Credit: Consumer Protection for M-Shwari and M-Pawa Users' CGAP.

¹³² Rafe Mazer, Alexander Fiorillo, 'Digital Credit: Consumer Protection for M-Shwari and M-Pawa Users' CGAP.

¹³³ Rafe Mazer, Alexander Fiorillo, 'Digital Credit: Consumer Protection for M-Shwari and M-Pawa Users' CGAP.

¹³⁴ Digitally delivered credit: consumer protection issues and policy responses to new models of digital lending, CEMC Policy guidance note and results from regulators survey, 2017, 7.

¹³⁵ Digitally delivered credit: consumer protection issues and policy responses to new models of digital lending, 7.

addition to pushy sales marketing, there are advertisements that give false or incomplete information to the consumers that make the credit appear cheap. An example is an M-Shwari billboard advertisement that indicates the service fee is 7.5% per loan without indicating that it is a monthly charge.¹³⁶

The consumers' actions may also be influenced by how offers are framed in the marketing approach chosen. For example some lenders indicate the maximum limit one may borrow when marketing the product. A consumers is likely to respond to this by viewing it as an offer to borrow that amount.¹³⁷ Consequently they end up borrowing money that they did not need in the first place. In addition, marketing approaches such as SMS that emphasize higher loan limits may encourage unintentional and repeat borrowing.

Unintentional borrowing is very detrimental to the consumers. Financial inclusion is not only about access to credit but the ability of the poor to use the credit they access to participate in economic activities and to better their lives. The lack of intention when borrowing means that the credit is not used for useful purpose and thus does not generate income. Unintentional borrowing makes consumers bear unnecessary costs and consequently increase the risk of defaulting. The inability to pay is a factor that leads to over indebtedness of the consumers.

d) Lack of disclosure of Prices, Terms and Conditions

Users, particularly poor and low incomes individuals, lack awareness of both digital systems and financial products. They are not financially literate and are not always required to read terms of service agreements.¹³⁸ Providers often fail to disclose information before providing services. As a result, users do not fully understand the product and its accompanying terms and conditions, leading them to make poor financial decisions.¹³⁹

Some terms and conditions are inaccessible to the lender. Many digital lenders offer access to the product terms and conditions via only a web link, which cannot be viewed directly through the channel the consumer uses to borrow that is on the mobile platform unless the borrower has a

¹³⁶ Jason G, Blechman 'Mobile credit in Kenya and Tanzania: Emerging regulatory challenges in consumer protection, credit reporting and use of customer transactional data.

¹³⁷ GAP Focus Note, 'Consumer protection in digital credit'.

¹³⁸ CGAP Focus Note, 'Consumer protection in digital credit.'

¹³⁹ Responsible lending: Overview of regulatory practices, 5.

smartphone and mobile data. However many borrowers especially those from the rural area do not own smartphones. This makes it expensive if not impossible for the borrower to read the terms and conditions. For example, if the customer of M-Shwari wants to review the product terms and conditions prior to purchasing the loan, he must exit the Unstructured Supplementary Service Data (USSD) session and visit a page on the CBA website. This pre-purchase disclosure introduces a hassle factor that many customers in a survey by Consultative Group to Assist the Poor admit not trying to overcome, even if they are curious about the specific terms and conditions of the loan.¹⁴⁰ In their interviews only three M-Shwari borrowers could explain well the terms and conditions related to the loan fee and repayment period.

With regards pricing of the product, so many complex words which sound the same to the consumer are used. Such as a service fee, interest rate, and rollover fee. Even if the borrowers are able to access the terms and conditions, it is difficult for them to understand complex issues given that they are financially illiterate. In addition lenders provide inaccurate information such as failure to clearly state the actual sum of finance charges the consumer will pay and the use of monthly or weekly interest rate figures instead of a standardized calculation such as APR which makes the credit appear cheaper. The consumer should be able to differentiate the different fees charged and their implication to the amount that they will finally pay. Unclear pricing is a high risk to consumers as they do not understand the implications of the credit terms. Consumer understanding of costs can improve intentionality and repayment performance.

Some companies reveal the pricing, terms and conditions but only after the contract is complete. This means that borrowers may not know the cost or conditions of their product before they accept these conditions and become obligated to pay. The consequences of this can be seen in the limited ability of consumers to explain what will happen when they do not repay the loan on time. Many noted that there is increased interest assessed but were not able to state the penalty amount.¹⁴¹

Inadequate information imposes a disproportionate burden of credit on the weaker consumers.¹⁴² Because target consumers are inexperienced with financial services, they do not understand their own needs. The digital credit product lack user feedback where the borrowers can interact with the

¹⁴⁰ CGAP Focus Note, 'Consumer protection in digital credit.'

¹⁴¹ CGAP Focus Note, 'Consumer protection in digital credit.'

¹⁴² Gummi M et al, Consumer protection in financial technology risks unbanked and underbanked consumers face in digital credit and the technological and regulatory approaches to mitigate risk'

lenders. The borrowers cannot seek clarification on certain terms and conditions. Given the nature of the consumers of digital finance, it is important that the consumers are able to understand the pricing, terms and conditions. Misinformation will lead consumers to getting loans that are not useful for their needs. Providing information and disclosure of terms mitigates the risk of unintentional borrowing and thus reduces the risk of over indebtedness of the borrowers.

e) Hefty penalties of default

The digital credit is a service provided for those who are excluded from the formal services. At the beginning, the borrowers are eligible for the loans based on lender's algorithms.¹⁴³ However due to several factors, such as high interest rate, multiple borrowing, unintentional borrowing or lack of understanding of the terms leads the consumers to default.

The penalty of default and late repayment is sometimes hefty. For example, if a consumer repays the loan later than the required period, they are denied access to future loans from that institution.¹⁴⁴ In addition some institutions such as KCB through its product KCB-Mpesa automatically deduct the outstanding payment from the mobile savings account or any other KCB account. Taking the consumers savings as a method of repayment is very detrimental to the consumer as this deprives them of the little economic resource that they require to sustain a living.¹⁴⁵

The third is damaging of credit scores by reporting to the credit rate bureau.¹⁴⁶ The lenders are required to report to the credit report bureau in the case of default. The credit report bureau allows lenders to share information on credit scores of the borrowers in order for the lenders to determine creditworthiness of the client to reduce the lender's risk. The problem with this however is that borrowers are being blacklisted for amounts as little as KES 100.¹⁴⁷ A survey by Transunion Credit Reference Bureau indicate that 316,455 people have been negatively listed for outstanding balance of less than KES 100 associated with mobile money.¹⁴⁸ Such customers are unaware of the reporting to the bureau and only become aware when they seek alternative method of financing.

¹⁴³ Kaffenberger M and Chege P 'Digital Credit In Kenya: A time for celebration or concern.'

¹⁴⁴ KCB-Mpesa Terms and Conditions.

¹⁴⁵ Over indebtedness: new evidence from the EU, 5.

¹⁴⁶ Digitally delivered credit: consumer protection issues and policy responses to new models of digital lending, 6.

¹⁴⁷ George Ngingi, 'Pain of Kenyans blacklisted for amounts as small as Sh100 in mobile loans and bank fees', Business Daily, Thursday September 8 2016.

¹⁴⁸ George Ngingi, 'Pain of Kenyans blacklisted for amounts as small as Sh100 in mobile loans and bank fees'.

They are required to pay the outstanding balance and a clearance fee with the bureau which is KES 2000.

In essence the customers are punished severely for default of small amounts. This is because the banks and other financial institutions use the yes/no to determine customer's creditworthiness. The CBK Director of Bank supervision is of the view that the intention of the reference bureau was not to be used as a blacklisting mechanism but as a risk management tool. In addition to being blacklisted, some companies require job applicants to submit their credit clearance certificate in their job application.¹⁴⁹ Credit reporting for amounts so minimal especially for first time defaulters has adverse effects and it limits access to credit from other financial institutions. In addition, it imposes higher costs on the borrowers to clear their name from the blacklist.

3.4 REGULATORY FRAMEWORK IN KENYA

There are gaps in the regulation of digital credit with regards to consumer protection. Although this is not to say that the law is completely blind in matters to do with consumer protection of digital credit. The law is able to adapt and tackle the consumer protection issues that arise. There are several pieces of legislation governing consumer protection in general that may also be applicable to digital credit.

The Constitution

Article 46 gives provisions on consumer rights in Kenya. The consumer has the right to goods and services of reasonable quality, to the information necessary for them to gain full benefits from the goods and services, to the protection of their health, safety and economic interests and to the compensation for loss or injury arising from defects in goods or services.¹⁵⁰

This article gives the provider of the goods and services the burden to protect the consumer from the harmful effects of the products. The provider has the responsibility to offer goods and services of a reasonable quality. In addition they have the responsibility to disclose all the necessary information to enable consumers to make decisions that are fully informed and thus enable consumers to gain the full benefits of the goods. When offering digital credit, it is paramount that

¹⁴⁹ George Ngingi, 'Pain of Kenyans blacklisted for amounts as small as Sh100 in mobile loans and bank fees'.

¹⁵⁰ Article 46, Constitution of Kenya (2010).

the consumer is given information which enables him to make decisions based on a cost benefit analysis. The disclosure of the total costs charged determines whether the consumer can afford the goods and consequently whether there is need to purchase the goods. The consumer should be informed of the positive consequences of repayment on time as well as the negative consequences of default and late repayment and thus gives the consumer the incentive to repay the credit.

Article 46(2) requires parliament to enact legislation to provide for consumer protection and for fair, honest and decent advertising. Pursuant to this provision, the Consumer protection Act was enacted in 2012 giving detailed consumer protection goods of all consumer products.

Consumer Protection Act

A consumer means a person who has entered into a transaction with the supplier in the ordinary course of the supplier's business unless the transaction is exempt from the application of this Act.¹⁵¹ The Act deals with credit agreements. A credit agreement is a consumer agreement under which a lender extends credit or lends money to a borrower.¹⁵² It however exempts agreements under which a lender extends credit or lends money on the security of a mortgage or real property or consumer agreements of a prescribed type. The Act also deals with internet agreements that are described as consumer agreements formed by text based internet communications.¹⁵³

Part III provides for unfair practices. False misrepresentation is one of the unfair practices. A representation that a specific price advantage exists and it does not constitute unfair practices. The Act also categorizes unconscionable representation as unfair practices where the person making the representation knows or ought to know that the consumer is not able to reasonably protect his or her interests because of disability, ignorance, illiteracy, inability to understand the language of an agreement or similar factors. Unconscionable representations are terms that are so unjust or overwhelmingly one sided in favor of the party with superior bargaining power. The consumer of digital credit is a financially illiterate consumer and thus falls under this category. He should be protected from unconscionable representations.

S 31 provides for disclosure of information on internet agreements. Information should be disclosed to the consumer by the supplier before the consumer enters into the agreement. In

¹⁵¹ Section 2, Consumer protection Act No 46 of 2012.

¹⁵² Section 2, Consumer protection Act No 46 of 2012.

¹⁵³ Section 2, Consumer protection Act No 46 of 2012.

addition, the supplier shall provide the consumer with express opportunity to accept and to decline the agreement and to correct errors immediately before entering into it. The disclosure should be in a manner that ensures the consumer has accessed the information and the consumer is able to retain and print the information.

Part VII makes provisions specific to credit agreements. S 56 provides that a borrower is not liable to pay the lender the cost of borrowing if the cost of credit is not disclosed through a statement or excess cost of what is disclosed in the statement. With regard to default charges, a lender is not entitled to impose on a borrower default charges other than charges reasonably incurred by the lender in recovering the loan.

Competition Act

S 55 makes false or misleading representation, unconscionable. With regard to unconscionable conduct, the authority may have regard to the relative strengths of the bargaining positions of the suppliers and the consumers. Whether the consumer was able to understand any documents relating to the supply of the goods or services.

S 56(3) gives provisions specific to banking, microfinance, insurance and other services. These institutions shall not impose unilateral charges and fees, by whatever name called or described, if the charges and the fees in question had not been brought to the attention of the consumer prior to their imposition or prior to the provision of the service.

S 56(4) provides that a consumer shall be entitled to be informed by a service provider of all charges and fees, by whatever name called or described, intended to be imposed for the provision of a service.

The Competition authority have developed consumer protection guidelines that seek to illustrate how consumer protection provisions of part VI may apply in practice. In addition, the authority listens to complaints from the consumers through the consumer protection department and gives directions to the supplier in the case of infringement of consumer rights. An example of cases handled is Beatrice Ndungu v Safaricom ltd. Beatrice complained of charges on Lipa na M-Pesa services provided by Safaricom not being disclosed to the consumers. The authority ordered Safaricom to create awareness and change point of sale materials in all petrol stations with Lipa na M-Pesa service and merchant shops.

Kenya Information and Communications (Consumer protection) Regulations 2010.

The minister of information and technology in consultation with the Communications commission of Kenya made the regulations in 2010 pursuant to the power conferred to them by KICA. KICA facilitates the development of information and communication sector i.e. broadcasting, multimedia and telecommunications as well as electronic commerce.

Regulation 3 gives the consumer of these services the right to receive clear and complete information about rates, terms and conditions for available and proposed products and services. The consumer also has the right to protection from unfair trade practices, including false and misleading advertising and anti-competitive behavior of the licensee. Regulation 5 requires licensees to make inquiries and complaints concerning its services.

Banking Act and Banking (Increase of Rate of Banking and Other Charges) Regulations of 2006

The Banking Act and the Banking regulations of 2006 have implications for consumer protection in Kenya as they regulate the limits of interest recovered on defaulted loans as well as limit of the rate of banking and other charges.¹⁵⁴ The increase of these rates is subject to the approval of the regulator, i.e. the Central Bank of Kenya. In addition, regulation 6 requires that every institution shall post in a conspicuous position at every place of business, the rates of banking and other charges levied on the products offered.

3.5 CONCLUSION

The most dominant form of digital credit in Kenya is the short term high interest loans that can be equated to payday loans. The high interest loans make it very easy for the borrowers to default the payment or repay the fees at a later date which attracts a penalty. In addition, the loans are offered to unsophisticated borrowers who are not able to access the terms and conditions of the loans or they do not understand the terms and conditions due to financial illiteracy. This means that most borrowers do not understand the cost of taking a digital loan and they end up taking several loans. This makes it easy for them to default in payment. Taking out several digital loans may also be as a result of the form of advertising used by the companies offering the credit that encourages more

¹⁵⁴ Malala J, Consumer Protection for Mobile Payments In Kenya: An Examination Of The Fragmented Legislation and The Complexities It Presents For Mobile Payments, 13.

borrowing. Thirdly, the lack of understanding means the borrowers are not aware of the consequences of default and late repayment.

Many companies discourage default and late repayment by affecting the access of future loans in that company. Some companies automatically deduct outstanding payment from linked mobile savings account or mobile money accounts and lastly blacklisting the defaulting borrowers in the credit rate bureaus for amounts as little as KES 100. Digital credit can be a double edge sword. It is an innovative way of bringing credit to the unbanked and thus furthering efforts of financial inclusion. On the other hand, the nature of the products offered cause over indebtedness of the consumers and limit their access to credit through the methods of discouraging default that is employed. Being black-listed in the credit bureau lowers the credit scores of the consumer and they are not able to access credit from any other financial institution. This means that a vicious cycle of poverty is created. Therefore if the risks customers are exposed to are not mitigated, then we will have a situation of financial exclusion rather than financial inclusion.

Digital credit is offered by several institutions, Banks, non-bank financial institutions and non-financial institutions. All these institutions partner with mobile network operators through different business models. This means that any person can offer digital credit as long as they are able to partner with mobile network operators. Some of these institutions are unregulated. Therefore certain rules and regulations which are crucial to persons in the lending business do not apply to them. These include regulations such as the interest rate cap rules on disclosure, treatment of customers, mechanism of lodging complaints and a system of resolving disputes. Consequently consumer risk of over indebtedness arises when dealing with the unregulated lenders as they have the freedom to exploit the vulnerable lenders.

Secondly consumer risks are brought about by the ambiguity of whose responsibility it is to care for the consumers in the case where the product is offered by a regulated partner e.g. banks. The M-Shwari loan is a partnership of CBA Bank and Safaricom. It is not clear on who is charged with the mandate of protecting the consumers. For example, who has the responsibility to disclose the terms and conditions of the loan and who should the consumers consult if an issue arises or if they need clarification on a matter.

Lastly it is difficult for the various regulator to use traditional mechanism of protecting borrowers as the market is made up of different players. The lack of regulations makes digital credit very

similar to payday lending. The lenders use the lack of regulation to their advantage. However, digital credit just like other forms of mobile money thrives in unregulated spaces, that regulatory freedom is required to ensure technological innovation. However this freedom should be balanced to ensure it is not at the expense of the consumer who needs to be protected in order to enjoy the benefits of access to credit.

4 REGULATION OF DIGITAL CREDIT IN INDIA

4.1 THE INDIAN DIGITAL MARKET

In India just like in Kenya most Fintech companies including m-wallets complement the existing traditional service providers rather than offering a new product that is completely distinct from the traditional banking system. Digital lending however has also been embraced through P2P lenders, alternative credit scoring platforms and crowd sourcing platforms as well as fintech companies offering a new product completely distinct from traditional banking system.

The digital credit market participants are regulated differently according to the business model. There is the payment banks guidelines, guidelines for business correspondents, the non-bank finance companies offering loans and peer to peer lending platforms. They are all regulated by the Reserved Bank of India (RBI) and therefore the India Charter of Customer rights apply to them.

4.2 THE REGULATORY FRAMEWORK

Guidelines for licensing of payments banks

Previously, the RBI allowed non-banks to participate in two restricted ways. They could build and manage a network of agents on behalf of a bank or they could issue a semi closed wallet that allowed customers to cash in but not cash out. This ensured that the Indian Banks controlled the savings, payments and particularly the market for credit. This restricted the innovative use of mobile money to reach the unbanked. The RBI issued payments bank guidelines that allowed companies to offer deposit accounts and payments as standalone businesses. Although these companies are not able to directly offer credit, they can serve as agents to distribute credit. This allows for partnerships between payments banks and the banks licensed by RBI to offer digital credit.

The objectives of the guidelines is to allow the setting up of payment banks that will further financial inclusion by providing payment or remittance services to migrant labour workforce, low income households and small businesses. The eligible promoters as provided in guideline II

include non-bank financial institutions, existing non-bank prepaid payment instrument issuers, mobile telephone companies and public sector entities among others.

One of the scope of activities pursuant to guideline III, which is paramount to this dissertation is that payment banks can act as business correspondent to other banks which is subject to the RBI guidelines on Business correspondent. The payment banks are not allowed to lend money on their own behalf. However according to the guidelines on business correspondent, guideline 4, the scope of business correspondents include identification of borrowers, collection and preliminary processing of loan applications, and disbursal of small value credit.

Guidelines for engaging of business correspondents

The guidelines provide consumer protection measures. Guideline 12 provides that the banks should take all measures to protect the interests of the customers accessing the bank through the business correspondents. The products and processes should be by the banks and the company cannot introduce products without the approval of the relevant bank. The charges of the various services should be made available to the consumers either through brochures for those using sub agents.

The responsibility of the bank is according to the India Charter of consumer rights that lays out five principles of consumer protection for consumer financial services. The charter requires that the lender should come up with a business code of conduct to ensure protection of the consumers.

Some of the fintech companies offering credit are partnership with traditional banks. The banks are the ones who lend the money while the fintech companies offer alternative means to determining creditworthiness of the borrowers. Some fintech companies are business correspondents to the banks and consequently the lenders are the banks. The other business model is the payment banks acting as business correspondents to the traditional banks as they are not allowed to lend on their own. As required by the guidelines, the banks therefore have the responsibility of protecting the customers according to the charter of customer rights that will be discussed below.

Non-Banking Financial companies

These are companies that lend in their own name and do not partner with banks. They are principally in the business of providing loans and advances, insurance, acquisition of shares,

debentures and stock leasing, hire purchase and even receiving deposits. If a company fulfils the 50-50 test, where the company's financial assets constitute more than 50% of the total assets and the income from financial assets constitute more than 50% of the gross income, then such banks are to obtain the commencement of business certificate from the RBI pursuant to s 45 1(a) of the RBI Act.

Not all non-banking financial companies are fintech companies. Some operate offline and do not leverage the digital infrastructure just like the traditional banks. In addition, not all fintech companies are non-banking financial institutions. There are companies that are registered by the RBI as NBFC that offer digital credit. This includes Aditya Birla Finance Limited. Such companies operate under the RBI and are subject to the regulations and guidelines of the RBI among this is the charter of customer rights that protects their customers. In addition some NBFC are P2P lending platforms that are under the RBI through the master directions.

Master Directions - Non -Banking Financial Company – Peer to Peer Lending Platform (Reserve Bank) Directions, 2017

The other business model that has been embraced by India Fintech companies is the peer to peer lending. The p2p companies are neither lenders nor borrowers but they offer a platform where the lenders and borrowers meet. The regulations seek to classify p2p companies as NBFC's These regulations define peer to peer lending platforms as the means an intermediary providing the services of a loan facilitation via online medium or otherwise to a participant (person who has entered into an agreement with a non-bank financial company to lend on it or to avail of facilitation services provided by it.

Regulation 5 requires that no company offering peer to peer lending shall operate without registration with the bank. These requires that new companies obtain a certificate of registration from the Reserve Bank of India.

Regulation 6 gives the scope of these companies, they act as intermediaries. They are not allowed to hold deposits or lend on their own. Their function is to undertake due diligence to the participants, undertake credit assessment and risk profiling of the borrowers and disclose the same to their prospective lenders, undertake documentation of loan agreements and other related

documents, provide assistance in disbursements and repayments of loan amount, render services of recovery of loans originated on the platform.

These companies are required to provide the borrowers with details about the lenders, these includes, proposed amount and interest rates offered. In addition, it should disclose on its website for public viewing, overview of credit assessment or score methodology and factors considered, disclosures on usage and protection of data, grievance redressal mechanism, and the business model. The company is required to ensure the provision of services are backed by appropriate agreements which categorically specify the terms and conditions. The terms and conditions should include the interest rate which should be displayed in annualized percentage rate format (APR)

Regulation 12(3) requires that for loan recovery, the company shall ensure the staff are adequately trained to deal with the participants in an appropriate manner and shall not resort to harassment, persistently bothering the borrowers or use of coercion in recovery of the loans.

Regulation 13 provides that the company should put in place a board approved policy to address participant's grievances. Complaints shall be handled or disposed of by the company within such time and in such manner as provided for in the board approved policy. If the complaint is not resolved within a month, the customer may appeal to the customer education and protection department of the RBI.

The charter of Customer rights

From the discussion above, it is evident that companies in the business of lending, whether online or offline are under the regulation of RBI. The RBI issued a charter of customer rights that apply to all lending money and registered under the RBI. The charter gives five principles as a measure of consumer protection. The principles offer a framework for these institutions to use when developing their model customer rights policy. These principles are

- a) Right to fair treatment. Both the customer and the financial services provider have the right to be treated with courtesy. The customer should not be unfairly discriminated against on the grounds of gender, age, religion, caste and physical ability when offering and delivering financial products.

- b) Right to transparency, fair and honest dealings- The financial service providers should make every effort to ensure that contracts or agreements it frames are transparent, easily understood by and well communicated to the common person. The products price, associated risks, the terms and conditions that govern and the responsibilities of both the customer and the financial services should be clearly disclosed. In addition, the customer should not be subject to unfair business or marketing practices, coercive contractual terms and misleading interpretations. Over the course of the engagement, the provider cannot threaten the customer with physical harm, exert undue influence engage in blatant harassment
- c) Right to suitability. The products offered should be appropriate to the needs of the customers and based on the assessment of the customer's financial circumstances and understanding.
- d) Right to privacy. Customers' personal information should be kept confidential unless offered specific consent to the financial service provider or such information is required to be provided under the law or it's provided for a mandated business purpose. Customers have the right to protection from all kinds of communications, electronic or otherwise, which infringe upon their privacy.
- e) Right to grievance, redress and compensation. The customer has a right to hold the financial services provider accountable for the products offered and to have a clear and easy way to have any valid grievances redressed. The provider should also facilitate the redress of grievances stemming from its sale of third party products.

4.3 CONCLUSION

The regulatory framework in India has not been centered particularly of digital credit. However regulation has been according to the business model that arises. The regulations make lenders offering credit through regulated business models such as business correspondents, non-banking financial institutions and p2p lending fall under the ambit of the banker's regulator, the RBI. The digital credit market is characterized by different types of business models as a result of

partnership. Having guidelines defines the scope of activities of the partners and consequently the responsibilities of the partners to the consumers.

In addition, the approach taken by India ensures that the lenders are regulated using the traditional methods of consumer protection as they all fall under the same regulator. The problem with this however is that digital credit is fundamentally different from traditional banking practices and therefore creates a need for new and separate regulation that caters for the technological development. The regulations do not cover internet application lenders therefore they are outside the ambit of RBI. This means the consumer risk arising from this product are not mitigated by the traditional consumer protection.

Regulation is important to protect the consumers. However the regulations may be too stringent and therefore prevent innovation in the market and consequently financial inclusion. This is evidenced by the high intake of digital financial services in Kenya as opposed to India. In addition, the products in Kenya are more innovative than those in India due to the regulatory freedom in Kenya.

5 A REGULATORY FRAMEWORK FOR DIGITAL CREDIT

5.1 INTRODUCTION

Regulation of digital credit is paramount to ensure financial inclusion as has been discussed in this paper. It is also true that technological innovations thrive in an environment that is not restricted by regulation. The government needs to strike a balance between the two in deciding whether to regulate the digital credit market. The best outcome is one that protects the consumers of digital credit as well as deepens financial inclusion.

5.2 RECOMMENDATIONS

There should be a clear legal framework that establishes an effective authority that protects the consumers. The legal framework should be a result of a consultative process that involves the government, the market players and the consumers.

The authority established may be a new institution that deals with digital credit. However it is not necessary to have a new institution. The Central Bank of Kenya may be given the authority to regulate the digital credit market as the lending business is part of the bank business regulated by the CBK.

Once a regulator has been established, the authority should make efforts to license the providers as is the case in India. The authority should set the minimum requirements to be met by any institution that want to be licensed. One of the requirement should be that the providers have appropriate governance, internal controls and policies in place that mitigate consumer risks. Secondly, their lending policies should be in accordance to responsible lending practices and fair treatment of consumers.

The legal framework should provide for the responsibilities, powers and accountability of the authority with regard to consumer protection. The regulator should be able to make regulations, or issue directives or guidelines that are in form of general principles that guide the market participants.

Regulatory guidelines

The CBK or any other regulatory body should issue guidelines on the conducts of business of digital credit providers. This includes guidelines on responsible lending practices and consumer protection. In addition, measures to protect consumers should be given by the CBK in the form of principles that should be adopted by the digital credit providers. Such principles should include transparency and fair treatment of customers as well as a right to redressal or complaints commission in case of a dispute from the consumers. The companies should adopt the principles in a manner that best suits them. The regulations should not provide strict regulations as this will encourage creative compliance by the providers. Principle based approach will ensure that the outcome which is to protect the consumers is achieved.

The regulations should give a scope of activities of the partners in the various business models. In so doing, they should assign responsibilities of mitigating consumer risks to either one of the partners or all the partners. Clearly defined obligations eliminate uncertainty and prevent regulatory arbitrage. This can also be done by requiring firms to adopt business policies indicating who is responsible for consumer protection and informing the public about this. This means that the consumers will be able to exercise their consumer protection rights against certain institutions.

The regulations or guidelines should cover matters on disclosure. The providers should be required to disclose the terms and conditions before the contract is completed. In addition, the consumer should be able to view the terms and conditions on the platform they are using. This ensures that those without access to the internet are able to read the terms and conditions without incurring further costs. The interest rate should be given in both APR and monthly percentage rate, In addition, the terms and conditions should be written in a plain and understandable condition in both English and Kiswahili to ensure that all persons accessing this form of credit understand the implications and costs of the product.

The interest rates on the digital products should also be regulated by the CBK and a cap on the interest rate should be set. The regulations by the CBK setting the interest at 14% p.a. should be extended to digital credit products or a new cap applicable to digital credit should be set to avoid issues of predatory lending.

There should be regulations put in place that ensure responsible advertisement by the digital credit providers. The advertisement should include the accurate information about the products. The interest rate should be expressed in the form of monthly interest as well as annual rate percentage

to give the consumer the full information of the pricing of the goods. Push SMS indicating the loan limits should also be restricted and the format should be regulated to ensure unintentional borrowing of credit.

Credit reporting bureau is an avenue to share information by lenders regarding borrower's creditworthiness. The guidelines should encourage the use of credit bureau for positive listing and not always negative listing to enable consumers' access formal financial credit based on their good credit history with the lenders. Credit reporting as a penalty for default in payment should be communicated to the consumers and they should be made aware of the negative implications of being blacklisted. They should also be made aware of positive listing on the credit bureau to give an incentive to responsible borrowing and proper use of the loans borrowed.

All the penalties of default should be adequately communicated to the consumers before the contract to be completed for them to be able to understand the full implications of default. This enables them to conduct a full assessment of the benefits they incur from the credit Vis a Vis the costs of the credit before making the decision to borrow.

Amendment to the Consumer Protection Act

The consumer protection Act affords a consumer sufficient protection in relation to a credit agreement however it does not provide for digital credit agreements. The consumer protection Act should be amended to include digital credit agreements in order to afford the consumers protection afforded to the consumers of other credit arrangements. The fact that the credit arrangement leverages digital infrastructure does not make the consumer protection measures fundamentally different.

Consumer engagement

The digital providers should adopt principles that are set by a regulatory body with regards to customer engagement. The providers should provide a forum, even though online where the consumers can ask questions and be advised on the suitability of the goods. For internet applications the forum can be on a website and for those using mobile phones the classic dial of 100 should be used to reach customer service. The customer should be made aware of such forums that enable them to interact with the consumers.

5.3 CONCLUSION

Digital credit is an innovative ways by companies to serve the unbanked population by enabling easier access to credit. Indeed digital credit is a tool for financial inclusion however in order to reap the benefits of financial inclusion, there is need to regulate the digital credit.

The benefit of non-regulation is to the provider of the service as they are able to set the terms and conditions in the way that best enables them to maximize profits. However the consequences of non- regulation or deregulation are faced by the vulnerable consumers susceptible to exploitation. Due the unequal bargaining power, it is prudent for the government to intervene to set minimum standards that ensure that the consumers are not exploited.

The digital credit products that are offered in Kenya already manifest terms and conditions that are unfavorable to the consumers which lead to over indebtedness. This is the same problem that is faced by microfinance banks e.g. Grameen Bank. The unbanked access products without understanding the terms due to the technical contractual terms or due to illiteracy. In addition, they are unable to understand the implications of borrowing in terms of cost This means that they do not make informed choices when deciding whether to get the credit or not. The availability and accessibility of the credit has made the consumers take out loans that are unnecessary to them adding further cost to them making repayment difficult if not impossible. This depletes their economic life as every income they get, they use to pay the loans and not to improve their economic positions. This means digital credit makes them worse.

A regulator is required to set minimum standards that should be met by every digital credit provider so as to protect the consumers. The traditional methods of regulation may be used however it is important that they are modified to cater for the different technology that is used as well as the difference in consumers. Secondly, other laws in Kenya, like the Consumer protection Act that do not expressly cover digital credit should be amended to cater for the same. For instance the definition of credit agreements in the Consumer protection Act should be extended to mean digital credit. The regulator should use flexible rules or principles when adopting standards to be able to adopt to new technological improvements in the digital credit industry.

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