Annex: Chapter 4

Annex 4A

Ensuring financial stability and consumer protection as the financial system evolves to address emerging pandemic risks

Chapter 4 pointed out that restoration of lending during the pandemic recovery may require lenders to adopt innovative ways of managing risk. Some innovations involve adapting product features and risk modeling to the pandemic recovery, while others seek to improve visibility and recourse using digital channels and tools. The policies recommended are intended to approve new types of credit providers in the market, facilitate innovations in business models and products, enable the use of new types of data and analysis, and upgrade financial infrastructure. Even as they aim to guarantee continued access to credit, these recommendations for financial innovation may also pose new risks to the financial system and to consumers. A balanced approach will be needed to ensure the best possible outcome.

Safeguarding the stability of an evolving financial system

The pandemic accelerated the adoption of digital technologies in the financial sector (fintech) and the broader economy, but it also exposed the financial services ecosystem to new financial integrity and stability risks. For example, some jurisdictions eased know-your-customer (KYC) procedures for account opening to encourage the adoption of digital financial services during pandemic lockdowns. But these measures may undermine the integrity of their financial system by exposing it to money laundering and terrorist financing risks, especially if the regulatory and supervisory apparatus is weak or underdeveloped and new providers lack experience in compliance. Providers must “back-fill” any KYC gaps, and regulators should continue to monitor and attune risk-based approaches to KYC and other critical functions to balance inclusiveness and efficiency with maintaining systemwide integrity.

Product innovations can also pose financial stability risks if they result in overlending or inadequate risk management. Systemic risk is a threat even when lenders are not deposit takers and therefore are a limited direct contagion of the banking system. Large-scale losses to retail or institutional investors, or a sudden stop in payment services or credit to particular sectors, can have a systemic impact through wealth effects and through viable users’ loss of access to finance. In addition, concentration risks that may have systemic implications can emerge in lending contexts that leverage digital technologies to achieve economies of scale and scope, or network effects. At the customer level, lenders with advantages in data, customer connectivity, or capital can create positive feedback loops to grow larger. Most supervisory and resolution mechanisms are not yet designed to deal with the potential of a big tech or fintech lender becoming “too big to fail” and must therefore be adjusted to handle this new risk.
At the infrastructure level, adoption of cloud computing by incumbent financial institutions and new providers is resulting in a concentration of operational risks, including possible system failures or cybersecurity breaches. For example, almost 50 percent of the global cloud computing market share is controlled by one giant provider. If that one provider experiences an outage or a security breach, the impact could be broad. Regulatory authorities can put mechanisms in place to monitor the evolution of industry structure, keeping the trade-off between competition and stability in mind.

Specific aspects of some new lending models create new forms of risk that arise regardless of whether a lender is systemic or not, and they should be monitored by supervisors. Alternative lenders may have bigger risk appetites, some act as exchanges and so have little “skin in the game,” while others can offset loan losses with other revenue streams. Embedded finance could lead to forms of connected lending or “channel stuffing” in which the lender provides funding to prop up sales in its other business. Furthermore, linking credit origination to real sector profitability could amplify procyclicality in credit provision. Although more of the volatility of credit in recent credit cycles has originated in the financial sector than in the real sector, contextual finance lender-borrower links have yet to be tested during a cyclical downturn in which alternative lenders and embedded finance play a significant role.

Protecting consumers from risks associated with an evolving financial system

This section discusses some consumer protection risks arising from faster adoption of digital technologies during the pandemic; aggressive marketing and pricing by new types of providers; and potential misuse of personal and alternative data and highlights the need for informed customers and appropriate regulatory policy actions.

Faster digital adoption, slower consumer education and training

During the pandemic, digital adoption helped financial institutions to continue serving their customers and helped governments to deliver pandemic support programs. In Bangladesh, for example, the government opened 2.5 million digital financial accounts in less than a month so that garment sector workers could receive digital government-to-person (G2P) payments. Across the globe, authorities in several jurisdictions encouraged enrollment in digital financial services by relaxing onboarding requirements. As a result, in 2020 the more than 136 million new registered mobile money accounts worldwide accounted for approximately 12.7 percent growth over the previous year, significantly exceeding growth expectations. Yet supervisors of financial institutions consider consumer protection to be one of the top risks in fintech during the pandemic.

Financial consumer protection (FCP) and financial education efforts have struggled to keep pace with accelerated digital adoption, giving bad actors opportunities to exploit consumers. The pandemic-driven surge in digital adoption, for example, created new opportunities for fraud and cybertheft stemming from a lack of user awareness and technology education. The reality is that the risk of fraud and cybertheft is not new to digital financial services, but it seems to have exposed consumers to more losses from fraud than traditional financial services. Lacking familiarity with novel and sometimes opaque or complex digital products, consumers may be defrauded by the staff of the alternative lenders, a third party, or other fraudsters especially if the control environment is weak. During the pandemic, many of the customers who adopted digital channels for the first time had a limited digital capability to carry out remote digital transactions, making them vulnerable to data privacy risks or to cybercriminals and other fraudsters. Inexperienced mobile money users have been known to share their phones or provide a merchant with their PIN numbers to complete a transaction.
There is no doubt that the role of robust FCP frameworks and provider self-regulation is important, but supervision and regulation alone cannot fully address the risks. Informed consumers are a critical line of defense against fraud and mis-selling. Promoting consumer awareness, knowledge, and skills about financial products and services can address “decision failures” and improve consumer protection. Even before the pandemic, adoption of digital finance outran financial literacy and consumers’ ability to wisely use credit. Mobile lending apps in Kenya and Tanzania are just one example.11 Rapid adoption rates during the pandemic, as well as urgent needs for credit, exacerbated financial literacy issues at a time when standard educational delivery channels were stymied. In an attempt to compensate, some governments shifted their delivery of financial education messages to digital channels.12 Technology-based channels can deliver simple, actionable, accessible, and personalized financial education, especially to youth. Innovations such as personalized financial counseling and behavioral nudges related to financial goals can also strengthen FCP.13 Although digital delivery of financial education promotes financial resilience in several ways, it requires basic digital skills and access to digital infrastructure (such as a smartphone and broadband internet). Lack of access may exclude the households most in need of financial literacy support.14

Aggressive marketing and pricing by new types of providers
On the provider side, many found it difficult during the pandemic to train users and gauge product suitability. As a result, providers may have been more likely to sell inappropriate products or engage in unfair lending practices that lack transparency—sometimes unwittingly. If they do not consider the precise needs and circumstances of consumers, providers may design products that may be too complex or too expensive. For example, digital credit providers may offer loans without adequately taking the repayment capacity of the borrower into account, resulting in overindebtedness. To mitigate this risk, providers can design products with the characteristics of consumers in target segments in mind, and regulators can require providers to enlist consumer segments to evaluate the suitability of product design features and sell products only to those segments.15 In 2019, the World Bank published guidance on how to design and distribute retail financial products to ensure their suitability.16 The guidance emphasized the role of appropriate legal requirements.

Digital lenders may use technology to exploit consumer behavioral biases and to target their marketing campaigns at consumers when they are most susceptible to taking on credit.17 These lenders also have a tendency to use manipulative sales techniques that lack transparency and adequate disclosures, thereby exposing consumers to hidden terms and conditions of credit. The use of digital delivery channels such as feature phones, for example, may be characterized by poor disclosures. Mobile loans in Kenya and Tanzania have been criticized for lack of transparency, high rates of default, and overindebtedness.18 Furthermore, some app-based lenders may exploit weaknesses in the regulatory framework, such as lack of vetting requirements, to defraud borrowers, perhaps by requesting up-front application fees and yet failing to extend credit. Along with undertaking financial literacy, regulators can address these problems by imposing authorization and vetting requirements on all credit providers, as well as risk management and governance requirements,19 and by enforcing requirements that providers warn consumers about risks related to their products.

These consumer protection risks are not entirely new; the pandemic has only made them more apparent. Providers and regulators have long recognized that not all financial products are suitable for all customers, and digital lenders can undermine consumer protection through aggressive marketing and pricing strategies exploiting weaknesses in regulation and consumer literacy. To develop FCP frameworks appropriate for their jurisdictions, policy makers can leverage the extensive policy guidance on FCP in the digital age provided by the G20-OECD Task Force on Financial Consumer Protection and the World Bank.20
Possible misuse of personal and alternative data

Another area of concern related to digital financial services is data ownership, access, and use. Effective data sharing can catalyze the restoration of lending during the recovery. Regulations commonly require that financial institutions share certain types of credit information to prevent overborrowing, thereby promoting systemic soundness. In the context of financial innovation, data frameworks for credit information systems should ensure that nontraditional lenders have access to that credit information and report their credit exposures. The Reserve Bank of India, for example, revised its legal framework to create a class of nonbank financial institution, account aggregators, to enable sharing of customers’ data across institutions.21

The use of alternative data requires data frameworks that protect consumer data privacy and ensure there is informed consent to collect data. Appropriate safeguards are needed as well on how those data are shared and used. Without adequate safeguards, data can be used for purposes other than originally intended, or they can be abused by unauthorized parties, resulting in loss of privacy, financial losses, or damage to consumer trust in financial services. Therefore, appropriate data ownership and sharing frameworks are needed to enable data-driven lending as part of the crisis recovery. In this connection, the 2021 World Development Report proposed a rights-based data governance framework that can promote data sharing while protecting against misuse.22 Data frameworks seek to protect privacy and recognize the economic value in it by clarifying who has rights to the data and how the data can be appropriately accessed and used. An issue is, for example, what right the bank and the customer each have for account and payments data. A robust data framework should ensure privacy of the individual through control of access and ability to limit the uses of their personal data.

Consumer empowerment in the data realm can be fostered by a well-designed open data framework, which enables the data subject to determine whether and how an entity that has collected data can—or must—share it with a third party. Open data ecosystems promote free and easy access to data for use, reuse, distribution, and republishing without restrictions, except for attribution and sharing.23 In banking, the notion of open data involves sharing customer-permissioned data with third parties to promote access to finance. Several emerging market jurisdictions are implementing open banking regulations24 with the aim of unlocking access to a broader set of data by new players and motivating incumbents to update their toolboxes to compete more effectively. For example, the Open Banking Directive, issued by the Bank of Brazil and in effect since June 2020, mandates the sharing of data related to service channels, bank accounts (such as deposit, savings, and credit accounts), and customer transactions.25 Building on the fintech law issued in 2018, the Comisión Nacional Bancaria y de Valores (CNBV) in Mexico released the first rules on open banking in March 2020, which require all financial institutions, including bureaus, to establish application programming interfaces (APIs) to enable sharing of open financial data, aggregate data, and transactional data.26 As of June 5, 2021, over 2,200 financial entities in the country were expected to have implemented APIs to exchange open data with third parties.

Conclusion

The policies for supporting lending during the pandemic recovery discussed in chapter 4 are aimed at achieving several outcomes such as enabling sound and well-regulated innovation, including entry of new providers, product innovation, and use of new types of data and analysis; protecting consumers through measures that ensure suitability of products, financial literacy, and data privacy; and investing in hard and soft financial infrastructure such as digital identity, connectivity, payments, and credit infrastructure. Achieving these outcomes requires better regulatory and supervisory capacity, as well as effective collaboration among sector regulators and competition/market conduct authorities both within and across jurisdictions.
Notes

2. GSMA (2020).
9. Klapper, Lusardi, and van Oudheusden (2015). This aspect is particularly important because digital illiteracy and lack of digital access were highly correlated with financial exclusion (Sahay et al. 2020).
12. OECD (2021b).
17. World Bank (2021a).
24. Asif et al. (2021); CGAP (2020).

References

Lake, Andrew James. 2013. "Risk Management in Mobile Money: Observed Risks and Proposed Mitigants for...


