For fintechs, RBI is the boy who cries wolf

Earlier this year, the banking regulator audited fintechs and flagged concerns with regard to daily operations, pricing, and credit risk. Fintechs see this as 'RBI overreach'

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Comment

We all know what happened to the boy who cried wolf. But what if the cries were not driven by boredom or sensationalism but rather by a sense of unfounded paranoia?

A similar question arises as the Reserve Bank of India (RBI)—wary of the "looming threat" that collateral-free retail loans pose—censures the fintech sector. Especially when unsecured loans have fueled their loan book growth by over 6X to over Rs 80,000 crore (US$9.6 billion) in the last five years.

In November 2023, the RBI first issued a blanket reclassification of risk weights on such loans—increasing them to 125% from 100%—so as to make the business more onerous and expensive.

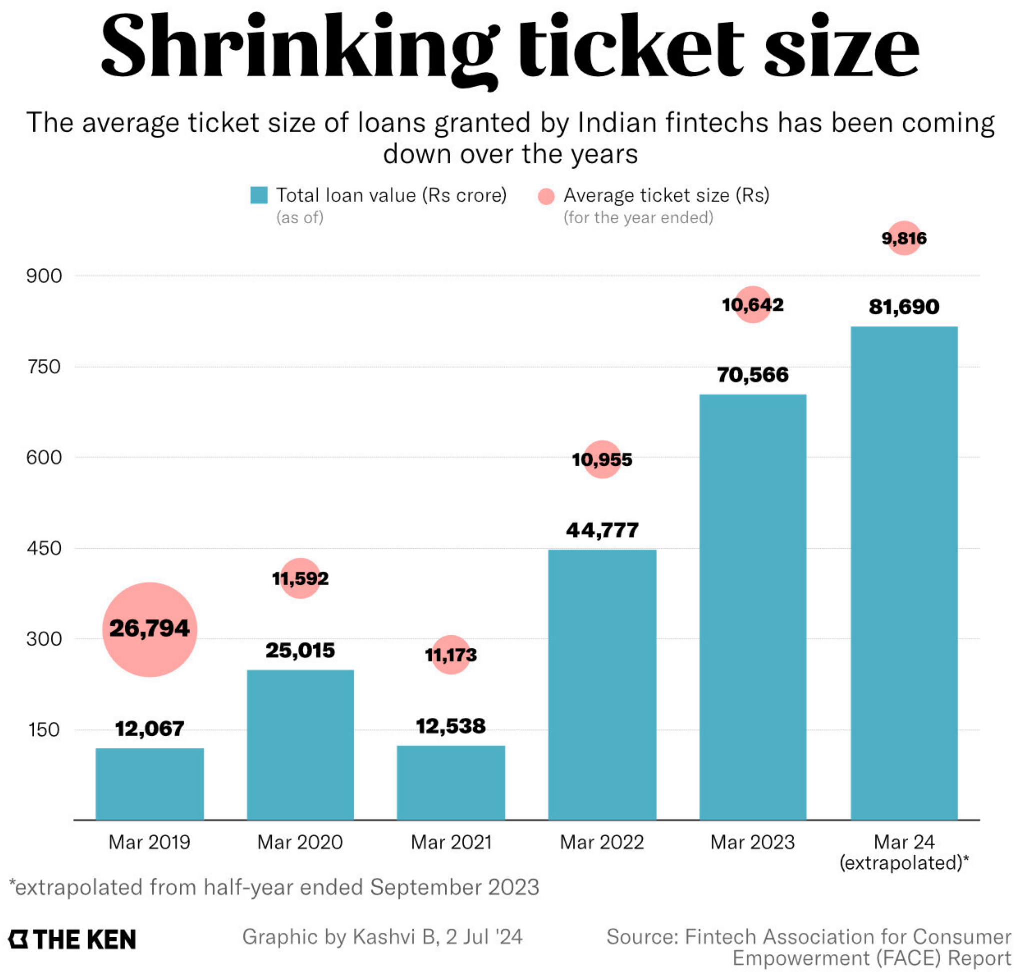
Shaktikanta Das, the RBI governor, justified the regulator's stance on unsecured loans in December. "We do not wait for the house to catch fire and then act. Prudence at all times should be the guiding philosophy, both for the regulators and the regulated entities," he had said .

Interestingly, just a few weeks later, the RBI stated that there were "no imminent signs of stress in the retail credit segment." While retail loans grew at a compound annual growth rate (CAGR) of 25.5%, "greater than the headline growth rate of 18.6%… underlying asset quality has improved," it said in its biannual Financial Stability Report from December 2023.

Despite the increase in risk weights, fintech loans continued to grow.

And so began RBI's forensic audits against several of these companies, having loan books of up to Rs 1,200 crore, in the first quarter of 2024.

This, even as credit-card loans and gold loans by banks and larger non-banks grew 25–30% year-on-year, as of May 2024, against 19% growth in overall bank credit. Unsecured loans by fintechs, meanwhile, barely constituted 5% of the personal loan market with an average loan-ticket size of less than Rs 10,000.



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By increasing risk weights and initiating audits on fintechs, the regulator has made its intentions clear—it wants financial stability. To that extent, it even instructed fintechs in May 2024 to slow their pace of growth—from 30% to 15–20%.

When the regulator shared the results of its audit reports earlier this year with fintechs, many of its concerns focussed on operations, pricing, and credit risk.

But the issues seemed to be more the result of an exercise in finding fault with the fintechs than a serious attempt to contain inherent risk. At least, that's what executives from series-B and -C funded fintech lenders had to say. They declined to be named as they didn't want to be seen commenting on the regulator publicly.

"It's a waste to do business where the regulator is proud to contain credit growth and is even more proud that they will restrict someone if they smell a crisis," said one senior fintech executive. "They don't seem to need proof, mere feeling is good enough."

This means fintechs have to considerably change the way they conduct their daily operations. And, many of them feel it's a regulatory overreach.

Overhaul or overkill?

The regulator first took a shot at how fintechs conducted their know-your-customer (KYC) via video. It pointed out that these companies hadn't taken cognisance of the fact that the locations of some of their borrowers were shown to be in sensitive regions, such as along India's northern and eastern borders.

But it's well-known that locations picked up from the global positioning system (GPS) are more accurate in urban areas, outdoors, and when the satellite signal strength is unhindered.

It is, however, prone to errors, especially in remote locations, thanks to spotty and inconsistent coverage arising from an insufficient number of towers. It is not uncommon for logistics companies, for instance, to find that the GPS unit, say, on a truck to Chennai, reports its current location in countries as far away as Ghana in Africa or, sometimes, even in the middle of the Indian Ocean.

Despite subsequently proving that these fintech customers were indeed residents of India, the RBI has remained adamant on the KYC aspect while auditing fintechs.

But why would a fintech be interested in extending a loan to someone with mala fide intent or be negligent in corroborating its customers' details knowing that such an action would almost certainly make it incur a loss?

In any case, the customer's primary bank—more often, a public sector one—would have undertaken the original KYC and validated it. So, ideally, a tertiary loan-service provider shouldn't be responsible for such an individual's identity check.

Then, RBI insisted that fintechs also accept Form 60 , a self-attested declaration that records the borrower's name, address, income, etc., as a relevant document to process a loan application. The regulator, otherwise, considers it "discriminatory" to those without a PAN card.

While it's true that the PAN database isn't error-free, a Form 60 may be even less reliable because it's not possible to always verify the details in it. PAN lies at the core of India's financial fabric—it ensures both traceability and seamless integration with other parts of the financial system.

So, fintechs asking for the borrower's PAN card may not be so much of a case of discrimination as it is of exercising abundant caution.

Also, RBI expects that to complete the loan-application process, a borrower must either have their details in the Central Know-Your-Customer (CKYC) registry or should provide access to Digilocker, a state-backed digital wallet to store one's documents. But most customers who apply for small-ticket loans are not registered in the CKYC database. So, they are forced to create a Digilocker account using their Aadhaar ID, an additional step that only serves as a roadblock which delays their access to credit.

On one hand, the regulator's diktat affects how fintechs conduct their day-to-day operations, but the other directives could hit them where it really hurts—the bottom line.

High interest rate = price gouging?

Over 70% of the unsecured loans that fintechs provide are sub-Rs 50,000 and are granted for 90–180 days. And most of the borrowers need the money for personal emergencies, working capital management, and other unforeseen, and unexpected, but necessary, expenditures, say some fintech executives.

As the risk of recouping the loan from such customers is higher, fintechs classify them as "high risk" and often levy a higher annualised interest rate of 30–36%. (The average cost of funds—the rate at which the lender procures the money from other financiers—stands at about 22%.)

When other costs like the one-time setup, processing fees, and insurance premiums are added, a borrower's annualised percentage rate (APR) usually comes to around 40%.

But the regulator believes customers are charged an inordinately high rate compared to the rest of the market. While this is mathematically correct, the volume of customers served must also count for something. If fintechs will not lend to these people, the risk is that no other lender will, since neither banks nor large non-banks are interested in servicing this segment.

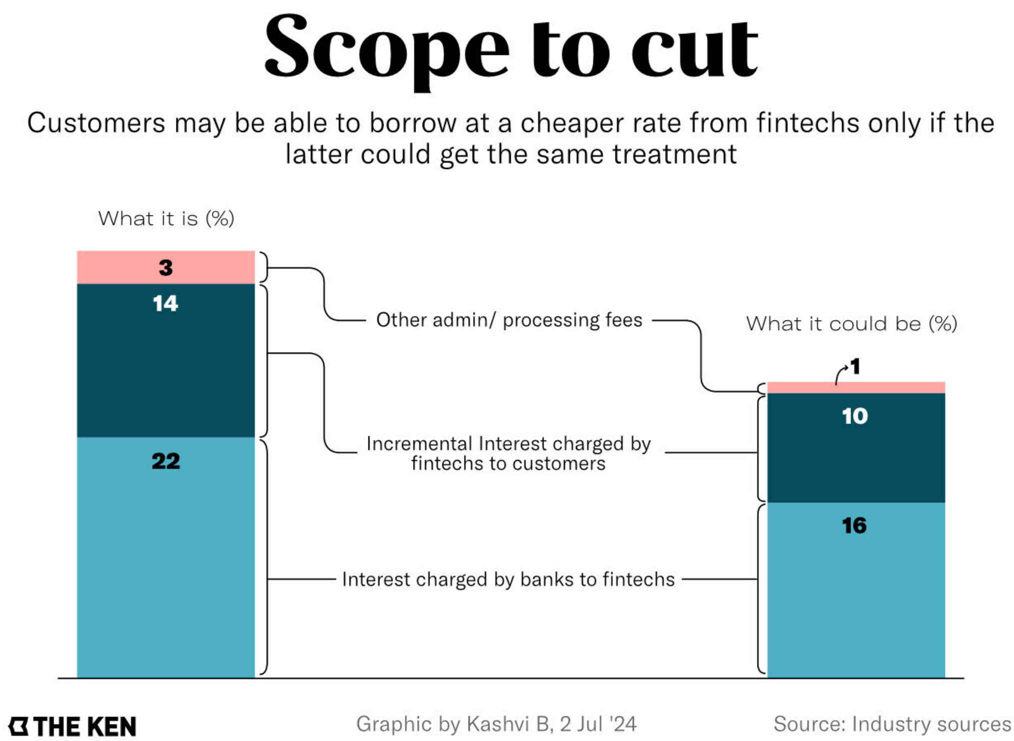
Banks and other financial institutions are not interested in giving out priority-sector loans to micro, small, and medium-sized enterprises (MSMEs) and in disbursing microfinance loans.

So, an Indian with a low income needs to approach a fintech. The other options would be to go to a moneylender who charges far higher rates or to go without a loan.

If the central bank intends to ensure credit to the financially marginalised sections at an interest rate that is not prohibitively expensive, it could limit it at, say, 25% for fintech lenders. But at the same time, the RBI also needs to ensure that banks and other institutions lend to these small-ticket lenders at a lower-than-prevalent interest rate.

RBI insists that fintechs charge an authorisation fee of Rs 1,000 each time a loan is sanctioned. An individual could end up taking three to four loans a year—so that would add up to Rs 4,000 or so as authorisation fees.

If the RBI allows a one-time fee that is valid for many transactions over, say, two years, that will reduce the APR, too.



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If that wasn't enough, the RBI has also raised concerns about the impact of unprecedented levels of unsecured credit growth on financial stability. But the data shows otherwise.

Higher write-offs equal significant credit risk?

Most bank customers in the database of Cibil, a credit-information company, are either under-served or have unserved credit needs. That's because the penetration of credit cards—the preferred bank vehicles for unsecured loans—in India is limited to single digits.

And so, low-ticket loans by fintechs are inevitable. But since their overall value would be lesser than credit-card loans, their overall losses would also be lower. Currently, the vintage delinquency —a measure of slippage—stands at 8.2% across personal loans, according to the RBI.

The value of loans disbursed by fintechs, however, accounts for a meagre 3% of the total value of loans disbursed by banks and non-banks, according to a report by the Fintech Association for Consumer Empowerment, a self-regulatory industry body of fintechs in India.

Even if these unsecured loans by fintechs were to show credit losses of 10–11%, it could just be a drop in the ocean compared to losses incurred at half that rate in portfolios held by larger financial institutions.

It's only fair to argue that small-ticket loan businesses would eventually come up with a model that ensures a comfortable profit margin—as was the case with the credit-card business and non-card-based personal loans about three decades ago.

In fact, a sample of some 29 fintech lenders shows that over 83% of them were profitable in the 2024 financial year.

And if the regulator intended to drive credit to priority sectors, these firms should be encouraged to fail and recover quickly, within the limits of promising growth.

So, were any of the RBI's actions justified? Not for some, at least.

"I really want to go to the court and question what gives them the right to act with such impunity," the above-mentioned senior fintech executive said.

Perhaps, it's a matter of concern when the town's ombudsman—not an ordinary shepherd boy—not only cries wolf but also presses its inhabitants into building sundry barricades.

It may be time now to consider having a mechanism in place to appeal against the central bank's decisions—as is the case with financial markets regulator, Sebi—in line with the recommendations of the Financial Sector Legislative Reforms Commissions committee.

After all, even regulators must be held accountable.

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